ECONOMY

Romania should not attempt to join the Euro zone very soon; 'hardening' the Leu would do for the time being. Institutional reforms in agriculture are unconvincing.

JANUARY 1ST 2002: THE EURO AND THE ROMANIAN ECONOMY

By Daniel Daianu

Recent months have witnessed a last ditch, frantic effort by Governments in the EU area to finalize preparations for the advent of the Euro notes and coins. Governments and banks need to be ready for the technical operation of conversion, and citizens need to be well informed on how to cope with this operation. How would this event affect Romania, as a European and a EU accession country? There is a narrow answer to this question, which looks at implications of the introduction of the Euro coins and notes. And there is a broader answer, of much larger import, which would look at this issue along the lines of *nominal* and *real convergence* in the quest for EU accession.

Dispelling a cliché

However redundant may sound to some Euro watchers, it is worthwhile reminding a fact: the Euro has been functioning as an accounting and transaction currency for quite a while![21] What happens at the start of next year is merely the introduction of Euro notes and coins, which would replace national money in most of the EU area[22]. This is why the alleged talk about the advent of the Euro, without proper qualifications, is misguided in a fundamental sense. Nonetheless, EU Governments and monetary authorities are not unconcerned about the means for undertaking this operation in the smoothest possible way. There is a threat of counterfeit currency being used by criminal gangs – which could harm the Euro's credibility, and may cause some worry for the European Central Bank (ECB), as the guardian of monetary stability. But a lot of hard prevention work has taken place and, thereby, has drastically reduced this threat in the EU countries. There is also an expected lag in firms' and individuals' response in adapting to the material existence of the Euro, in spite of a massive information campaign.

The introduction of the Euro coins and notes is meant to send a powerful message about the irreversibility of the Monetary Union, to boost the Euro's fortune (at a time of continuing weakness vis-à-vis the US Dollar) and its credentials as an international reserve and transaction currency[23]. How will the Euro fare in the period to come depends basically on the evolution of the Euro-zone economy as compared to other dominant areas of the world economy, and the American economy in particular. It is certain that the next phase in the life of the Euro – against the backdrop of worrying signs of economic slowdown in the Euro-zone – hinges also on better economic policy coordination amongst the EU member countries.

The impact of the Euro on accession countries (Romania) – the longer run view

The birth of the Euro (the creation of the Euro-zone) indicates an almost irrepressible tendency for the emergence of currency and trading blocs. Against the background of increasing volatility in world financial markets, this development is welcome by those who value the benefits of an *optimal currency area*[24] – when the latter is seen as a shelter as well. How soon can (should) this monetary shelter be made available to other countries? Or otherwise said, can

[21] The official birth of the Euro was January 1st, 1999.

[22] Except Britain, Denmark and Sweden

[23] It is telling in this respect that, last November, China announced a rise in the Euro-denominated share of its foreign reserves; the move helped push the Euro slightly higher against the USD, at that moment

[24] The American economist Robert Mundell theorised on this issue in the early 60s of last century.

accession countries join the Monetary Union (MU) simultaneously with joining the EU? This is not a trivial question, whether countries join the EU in the first wave (in a couple of years), or later.

Nominal and real convergence

The above-mentioned question leads to the key issue of *nominal* and *real convergence*. According to the existing EU definition (The Maasstricht criteria) *nominal convergence* refers to: an inflation differential which is steadily not higher than 1,5% as against the average rate for the lowest inflation three countries in the Euro-zone[25]; a long term interest rate differential not higher than 2% as compared to the three countries mentioned; an annual budget deficit which does not exceed 3% of GDP on a steady basis and a public debt not higher than 60% of GDP; and an exchange rate that does not fluctuate outside the band of the Exchange Rate Mechanism (ERM) for two years before accession[26]. Real convergence refers to reducing the gap in income per capita, which is conditioned on big productivity gains and relative price convergence. For some data on nominal and real convergence see Fig.1.

Some can argue that a faster fixed link to the Euro (the functioning of a Euro-based Currency Board[27], or "Euro-ization" even before joining the EU) would help speed up structural reforms and convergence[28]. The downside, however, of a hastened stable link with the Euro is replete with risks/costs; these risks have roots in the likely persistence of a significant inflation differential and, consequently, the likely loss of external competitiveness over time. Related to this, one should not underestimate the effects of the disappearance of monetary and exchange rate tools for balance of payments adjustment purposes. In addition, over-borrowing from abroad and ensuing severe balance of payments crises could occur, which would annihilate the very thrust of the policy of a hastened close link to the Euro.

The inflation differential (vis-à-vis the Euro-zone) would clash with the inflation-related criterion for nominal convergence. A series of calculations show that an inflation differential of between 1.5-2.5% per annum would persist over a substantial period of time[29]. Thus, the policy options would be

[25] Where annual inflation has been between 1.5-2% for years now.

[26] These codified criteria are suplemmented by other exigencies according to Article 121 of the EU Accord: the integration of markets, the state of the current account balance, the state of labor markets, etc.

[27] The Currency Board fixes the value of the domestic currency in terms of a reserve currency, while the scope for monetary policy becomes nil; the dynamic of money supply depends solely on inflows and outflows of central bank's reserves.

[28] A few years ago, an intense debate on the usefulness of a CB took place in Romania as well. This debate was initiated in view of the apparent inability to defeat high inflation.

[29] T. Broeck and T.Slock (IMF Working Paper, no.56/2001; UN/ECE, Economic Survey of Europe, 2001 (chapter 6); F.Coricelli and M. Jazbec, CEPR Discussion Paper no.2689, 2001 (see also *Bundesbank Monthly Report*, October, 2001, pp. 25)

as follows: either the accession country finds a way to bring the inflation rate in line with the criterion, which may be very costly output wise; or something has to be done about the criterion itself, which may not be possible unless a political decision is made, to this end, by the EU.

In addition, an over hastened linkage to the Euro may harm the catching-up process owing to a growth-inflation trade-off. This is because an attempt to bring inflation in line with the benchmark in the Euro-zone may dent growth significantly. And without a considerably higher growth rate (than in the Euro-zone) *real convergence* would remain a distant objective and would diminish the prospects for an earlier EU admission.

The outlined policy dilemma seems to be less of an immediate concern for Romania, which has quite a long way to go in subduing inflation. On the other hand, this dilemma is not devoid of relevance to the extent one considers: (a) the pace of disinflation (gradual vs. abrupt); and (b) the suitability of a faster close link to the Euro, as a way to speeding up structural reforms and convergence.

Since 2000, Romania has embarked on a gradual disinflation policy rather than an abrupt one, which is motivated by existing powerful inflationary expectations and the anticipated costs associated with a brutal cut of domestic liquidity – including the strains which rapid disinflation would put on the banking system. The opposite policy, which implies a quick Euro-link as a means to foster structural reforms, is deemed to be counterproductive (overcostly). And it is deemed to cause, eventually, the failure of the disinflation (stabilization) policy and to perpetuate the boom and bust cycle of the last decade. This is a rather balanced, realistic line of reasoning.

Towards a "hard" ROL (Romanian Leu)?

The above considerations can help sort out the arguments in favor or against proceeding with the cutting off of several zeros (very likely – four zeros) of the ROL – namely the creation of a "hard" ROL. Romanian commercial bankers complain bitterly that transactions and calculations are impeded by the nominal weakness of the ROL, and they are asking for a swift move to the hard ROL[30]. There is another view, shared by Romanian central bank (NBR) officials, which would rather maintain the "soft" ROL for a while[31]. The rationale for the second view can be found in several arguments. One argument is that, since disinflation is gradual, it is better to wait for a couple of years (when inflation would be close to the one-digit level) in order to undertake the actual operation. Another argument, which is not explicit but is "floating in the air", assumes a successful disinflation by 2005 and suggests the possibility of hooking up rapidly with the Euro. An implicit assumption

[30] See *Ziarul Financiar* and *Adevarul*, 21 November, 2001

[31] It should be said that if the decision to turn to the "hard" ROL were to be made today, the technical preparations and the actual implementation would need at least one year.

seems to be that Romania would gear up for accession by that time. Several "trial balloons" were launched in this respect lately[32]. Should this second interpretation of the NBR's thinking be accurate, the emergence of the "hard" ROL would become a useless operation.

Summing up, **Romania needs to be more consistent with its structural reforms and their speedier advance would be more than welcome. But it would be quite risky to anchor the economy to the Euro, via a fixed linkage, ahead of time, i.e. before joining the EU.** The very logic of gradual disinflation points in this direction. And low correlation coefficients[33] (as indicators of real convergence) underline the costliness of giving up monetary sovereignty when adjustment instruments are still badly needed. Certainly, one can hypothesize on the possibility of benefiting from labor mobility across EU borders[34] (as an adjustment mechanism) and considerable fiscal transfers from Brussels as pain relievers of overtight monetary conditions, but these are quite unrealistic scenarios. The financial crises in countries, which resorted to fixed linkages (Argentina, for example), also provide a strong warning in this respect. Last but not least, the ECB may be reluctant to accept "Euro-ization" when this is perceived as creating *contingent liabilities* for the European Union. In conclusion, the NBR would be well advised to heed more the commercial bankers' view and consider the hard ROL option within the next couple of years.

More mundane concerns for the National Bank – the short run

The NBR (the Central Bank) has direct and indirect responsibility for the smooth technical introduction of Euro coins and notes.

The NBR's direct concern and responsibility are the liquidity control and exchange rate market conditions. As far as liquidity control is concerned, one significant aspect is the prevention of fake currency to get into circulation. This risk may be higher in an accession country (Romania) that is more cash-based[35], and to the extent public (monetary) authorities are less adept in dealing with law-offenders. Another aspect regards a possible change in the

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[32] At a recent seminar on the Euro coins and notes, NBR officials are reported to have asked, rhetorically, whether an eventual quick passage to introducing the Euro, presumably, at the time of a one digit inflation level (by 2005), would not make this operation redundant (*Adevarul*, 21 November, 2001)

[33] These coefficients refer to industrial ouput dynamics, unemployment rates, etc.

[34] Export of Romanian workforce and substantial remittances which cover a portion of the trade deficit. In recent years remittances were around 1 billion USD per year.

[35] The propensity of people to use cash instead of bank accounts is related to the size of the underground economy and the distrust in banking (finacial, in general) institutions. The share of cash-based in total transactions is about 12% in Romania, as compared to 5% in Western Europe and 3% in the USA (according to the Governor of the NBR, Ziarul Financiar, 5 November, 2001).

composition of currency in circulation, should individuals be wary of holding Euros. This fear may be mitigated in regions of the country where the DM is a preferred precautionary and transaction parallel currency, but, overall, a certain pressure on the exchange rate market may be experienced for a short while. This pressure would result from the proclivity of some individuals to increase their holdings of dollars as against the current composition of their cash portfolio. According to some estimates, EU member countries denominated currency worth approximately 500 million USD, is likely to come to banks' cashiers for conversion[36]. The higher this amount, the stronger would be the downward pressure on the Euro on the local foreign exchange market. It is true that much hinges on the distribution of conversion operations over the legally permitted period of conversion.

Fig. 1. Economic data for the EU negotiating candidate countries, 2000

	Income/capita, PPP, % EU average	GDP real growth %	Public budget, % GDP	PPI	Current account deficit
Bulgaria	24	5.8	-1.0	10.4	-5.8
Estonia	38	6.9	-0.7	4	-6.4
Latvia	29	6.6	-3.0	2.6	-6.8
Lithuania	29	3.3	-3.3	1.0	-6.0
Malta	53	5.0	-7.1	2.4	-14.5
Poland	39	4	-3	10.1	-6.3
Romania	27	1.6	-3.7	45.7	-3.9
Slovakia	48	2.2	-3.5	12	-3.7
Slovenia	71	4.6	-1.3	8.9	-3.2
Czech Republic	66	2.9	-4.9	4	-4.6
Hungary	52	5.2	-3.3	8.2	-3.6
Cyprus	82	4.8	-2.7	4.1	-5.0
The 12	44	4.1	-3.2	12.9	-5.3
EU-15	100	3.3	1.2	2.1	-.0

Source: Bundesbank, Monthly Report, October, pp.21
PPI- producer price index

Very topical is the NBR's reference currency for its exchange rate policy. For a long time the USD was "undisputed king". This situation has changed considerably, due to the increasing share of trade (exports and imports) which Romania carries out with the EU (Fig. 2). This trade, which has constantly risen and is, currently, more than 60% of the total for both Romanian exports and imports, argues in favor of relating the ROL to the Euro. The NBR seems to be bent on constructing a basket made up of the USD and the Euro, which can provide a bridge (temporary) solution for moving to the Euro as the reference currency for the exchange rate policy; though quite difficult in

[36] According to commercial bankers (see *Ziarul Financiar*, 5 November, 2001)

operational terms, such a move looks quite sensible and would respond to Romanian exporters' and importers' worries in this regard. On one hand, since Romania trades with the EU quite symmetrically, the impact of giving up, partially, the USD as a reference currency is mitigated. On the other hand, the composition of the external debt – which is largely denominated in USD – argues against an immediate swift to the Euro as the reference currency.

Fig. 2. Geographic distribution of Romania's exports and imports (1999, 2000)

	Structure (%)			
	1999		2000	
	Export	Import	Export	Import
EU-15	65.5	60.3	63.8	56.5
Italy	32.5	32.5	35.0	33.1
Germany	27.1	28.4	24.6	26.0
France	9.5	11.1	10.9	10.8
UK	7.4	7.0	8.2	7.2
Netherlands	5.9	3.7	5.0	3.8
Greece	3.9	3.2	4.9	5.0

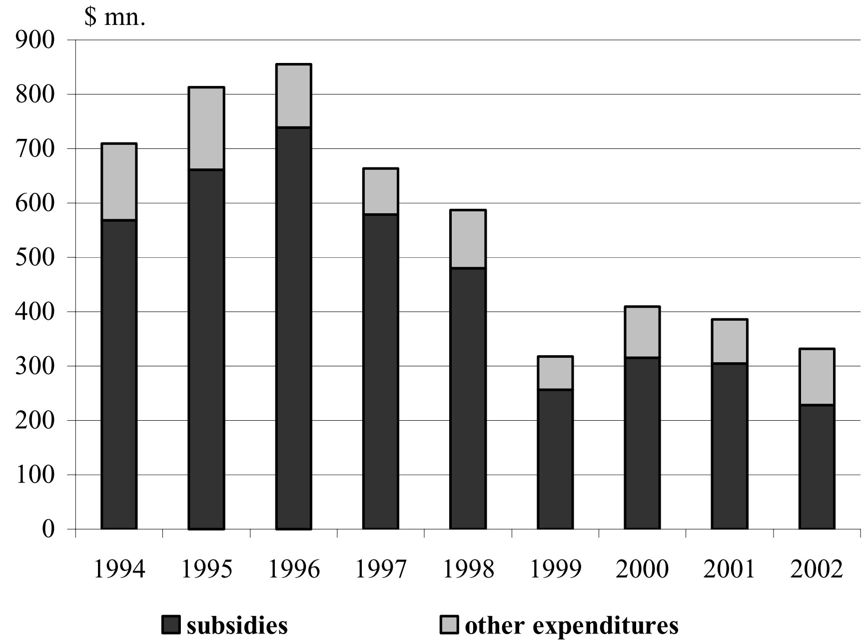
INPUT SUBSIDIES VERSUS COMMODITY SUBSIDIES IN AGRICULTURE

The 2002 budget of the Ministry of Agriculture, Food and Forestry illustrates the most confused situation in terms of Government support for agriculture in the past seven years. Every action intended as a step in the right direction is also likely to end up in fostering vested interests.

Fig.3 points to what amounts to a first good news, namely the further contraction of budget allocations which began in 1997 with the removal of price controls for the main farm commodities down the marketing chain (wheat, milk, pork and poultry meat). The reduction of expenditures, subsidies first of all, was a necessary step, given the non-transparent and inefficient measures taken in recent years. However, with scarce funds made available to the ministry for distribution, the contest to capture them become increasingly fierce. The details of the allocation mechanisms are not yet known, but it is likely that the interests of the larger producers will be taken into consideration at the expense of the smaller ones.

An encouraging sign is the largest-ever share (over 30 per cent) of other expenditures than subsidies, even though their materialization in a better supply of public goods (such as research, market information) is far from certain. But there is a real danger that the effort may end up simply in handouts for the bloated administration who currently manages the state intervention, plus repaying some foreign loans taken in the early nineties.

Fig. 3. MAFF Budget



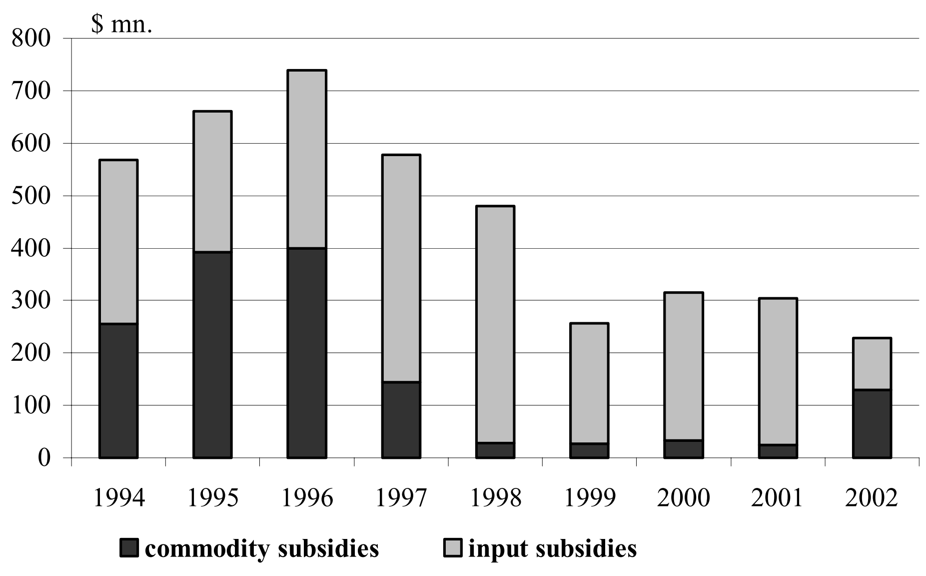
MAFF's attempt to put in place some EU-type agricultural subsidization mechanisms may be another good news. The bad news, however, is that such costly interventions supported by a large agriculture budget in EU countries cannot be implemented in Romania without running the risk of turning them into discriminatory and non-transparent actions. While the attempt to direct most subsidies to producers is correct in itself, the mechanism now under consideration can hardly ensure that the allocation process will be fair and that the budget will not be overrun.

The principles of efficient subsidization, most often ignored in the Romanian agricultural policy, are:

- reasonable size
- limited time
- precise definition of the target groups
- and fairness so as the agro-food market is not distorted.

In Romania, farm subsidies have been a mixture of input subsidies (vouchers, price subsidies for certified seeds and irrigation, etc) and output subsidies (guaranteed price for milk, export premiums). Each of them can be delivered either directly, with farmers as recipients (which was the case of input vouchers or milk premiums) or indirectly, when subsidies were paid to intermediaries (export bonuses or seed subsidies). Direct subsidization is preferable when target beneficiaries are readily identifiable and fair allocation can be ensured at low costs. The 1997 input voucher scheme is an example of direct subsidization that did not distort the farm commodity markets. However, with slight alterations made every year, the scheme was eventually 'adapted' to its needs by a careless and corrupt administration. Granting "one million lei (about 35 USD) for every hectare of land under crop" through the voucher scheme used this year was a far cry from the original goals – re-directing subsidies away from state farms, developing farm input markets, increasing small farm output. Should the mechanism be dismantled in 2002, it would hardly make any difference to farm households, other than the disappearance of a source of income that has been perceived rather as welfare support.

Fig. 4. Input vs commodity subsidies



In order to assess the level of intervention, we split the subsidies into two categories, according to their nature: input subsidies and products subsidies. Fig.4 shows a dangerous tendency to revert to the 1994-96 structure, although the total amount of money transferred is reduced. However, this is not an all-out return, nor could it have been one, given the publicly acknowledged failure of the farm policies pursued in the mid-nineties and the reforms carried out during 1997-2000, including the privatization of farm processors and removal of farm commodity price controls. Government control in agriculture, upstream or downstream on the market chain, may never be what it once was, though discretionary allocations may still occur. With funds in short supply, their allocation will be pressed hard in order to accommodate vested interests. Large farmers who also stand to gain by the provisions of the Emergency Ordinance on farm operations (No. 108/2001) will take advantage of their position to press for priority in Government subsidization.

Note: For reasons of comparability all the expenditures were converted into USD. In 1994-2000 the expenditures made were converted at the average leu/USD exchange rate. For the year 2001, the expenses are as specified after the latest budget adjustment (rectification), and the exchange rate used is an estimate of the yearly average (28,000 lei/USD). For 2002, the expenditures are those specified in the approved budget with the exchange rate forecast at 35,000 lei/USD.

FOCUS: AGRICULTURE IS NOT A PRIORITY IN ROMANIA, AND SO THE SAPARD PROGRAM CAN WAIT

The Sapard pre-accession program for agriculture and rural development has been since its inception in 1999 a rather marginal preoccupation for the Romanian Government, apart from the fierce institutional fights that took place among various ministries for taking over its management. The delays accumulated continue to affect its implementation, even though there have been periodical attempts to put things back on track. Sapard is a seven-year long program that was supposed to begin in 2000 in Romania, with a total amount of assistance of about 150 mil Euro per year, but the national Sapard agency has not been accredited yet, and as a result the transfer of the first installments keeps being postponed.

- The slow progress in the Sapard program reflects the lack of genuine interest in the agricultural sector of all the post-communist Romanian Governments. As a consequence, the last report from the European Commission mentions "the limited progress in meeting the Accession Partnership priorities in the agricultural sector".

- The Romanian authorities claim that the money that should have been used in 2000 and 2001 is not lost, since the Commission has just approved their spending in the following years. The problem, however, is that when the Sapard agency is finally operational, it will have to handle an increased volume of money and paperwork, with staff and procedures lacking the necessary experience. Now we can see what opportunity was missed in 1998-1999, when a pilot project called SPP was financed in Romania with the very purpose of running in the mechanisms for Sapard. SPP was a failure, no institutional framework was developed out of it and the whole process had to start from scratch two years later with the Sapard agency.

If the Agency is to become operational and run the funds, it has to be accredited domestically, and then obtain the final approval from Brussels. In 2001 the Romanian authorities managed to pull themselves together and pass some laws and regulations that are necessary in the accreditation process. A management unit was set up within the Ministry of EU Integration, and the organizational charts of the central and territorial offices of the Sapard agency were completed.

Finally, three strategic directions of action were agreed upon: improving the industrialization and marketing of the agricultural and fishery products, upgrading the rural infrastructure and technical assistance.

However, some important steps have yet to be taken before the EU money can arrive:

The Commission's approval on the preliminary audit is expected shortly, and after that the necessary adjustments should be made:

- Information and consultancy centers must be set up in municipalities where the regional Sapard offices will be located. The information campaign and the assistance provided to applicants is very important since the installment will be larger than initially planned in the first years of implementation, and the absorption capacity through sound projects has always been a problem in Romania.

- The procedural and application guidelines are not ready yet, which is hard to explain after so many years of discussions about Sapard.

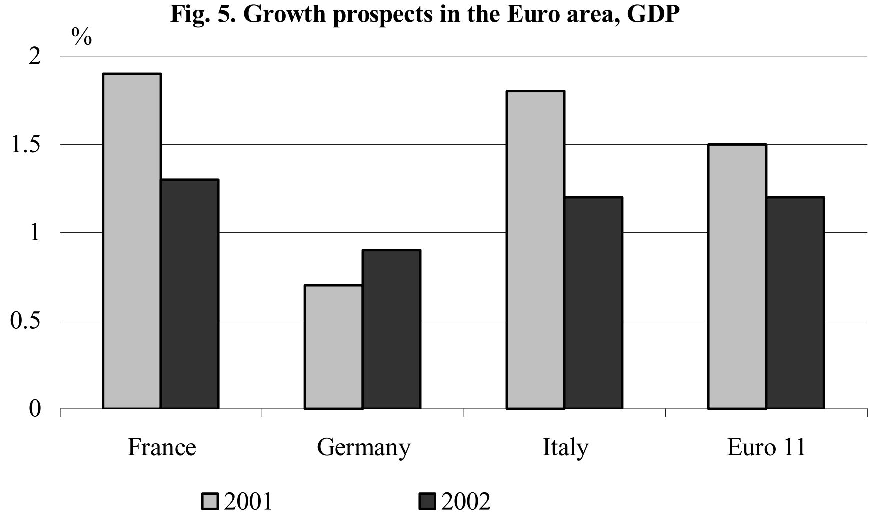
- The capacity to actually run the program is low, and the human resources seem to be one of the main problems in this area of assistance. Again, this is concerning given the fact that from the first year they will have to begin making up for the accumulated delays.

TREND: INTERNATIONAL ECONOMIC ENVIRONMENT

As the West European major powerhouses face a severe slowdown, the situation looks dire for the Romanian economy as well. Germany, our second most important trading partner, is close to a halt. Overall, the situation will probably get worse in 2002 (Fig. 5). In this context, the rosy forecasts put forward by the Romanian Government earlier this year are challenged by a new array of figures provided by international institutions (Fig. 6).

The fact is, these forecasts are notoriously unreliable, even when they come from organizations with solid credentials. At the beginning of this year, for example, most of the international agencies predicted that the Romanian economy would grow somewhere in the range of 1.5-2%; as it turns out, the real figure will be at least twice as high. This happened because of the extreme volatility of the domestic economic environment, which can still offer surprises, for good and for bad, and because of the fact that the East European countries have been surprisingly resilient to the global downturn this year. With the notable exception of Poland, they continued to grow impressively in the midst of the general gloom.

Fig. 5. Growth prospects in the Euro area, GDP



Source: The Economist, November

However, a slight reduction in the economic activity may still occur in this region too. The INSSE business confidence survey shows that the Romanian entrepreneurs' trust in industry has declined in the last quarter of 2001 (Fig.7). This might be just a seasonal effect – usually the activity contracts during the winter months, specially in constructions, which is a booming sector in Romania – but it may also signal a genuine slowdown. The good news is that the survey reveals stable expectations in manufacturing industry and retailing.

Fig. 6. Romania's growth prospects, GDP

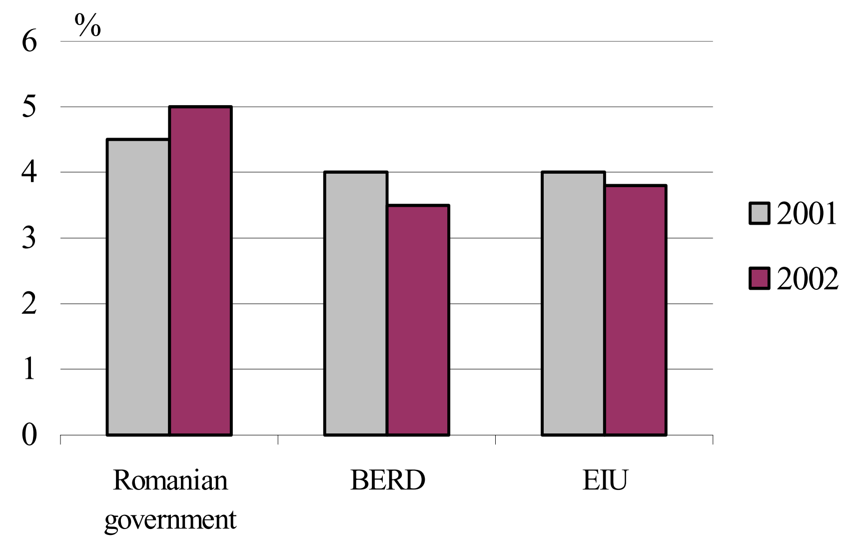
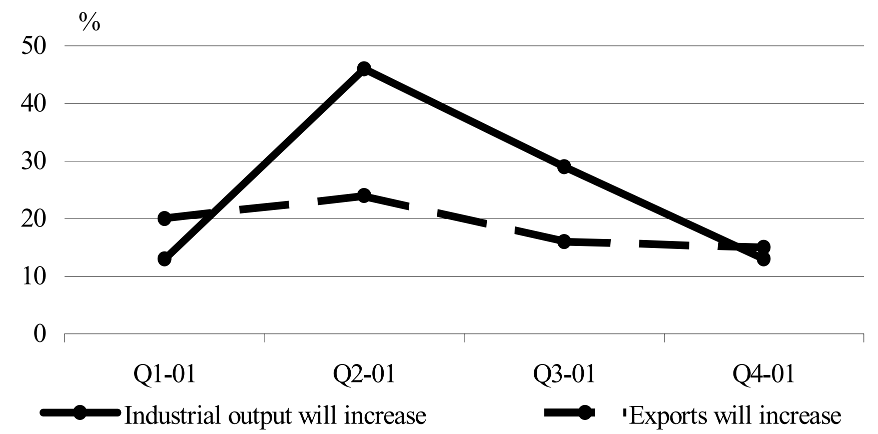


Fig. 7. Business confidence in Romania, 2001
INSSE opinion poll



TRADE DEFICIT: IT IS HAPPENING, AGAIN

In October, Romania's trade deficit unexpectedly shot up, threatening the macro parameters agreed with the IMF (Fig. 8). At 500 mn. USD, the deficit is more that three times as high as the one in September. Some analysts speculated that the massive increase in imports – 28% higher than last month – is due to the building up of the fuel inventories in the energy sector. However, the data in Fig.9 do not seem to support this view: it looks like the imports grew proportionately across all the main categories of goods. Therefore, the rise in imports must be caused by the same seasonal effect: as the year draws to a close, the domestic demand rises in consumer, durable and even some capital goods. This trend should be a matter of concern for the Government, since it is likely to continue in November and December. If this happens, the annual trade deficit in 2001 may reach 4 bn. USD.

Fig. 8. Trade deficit, 2001

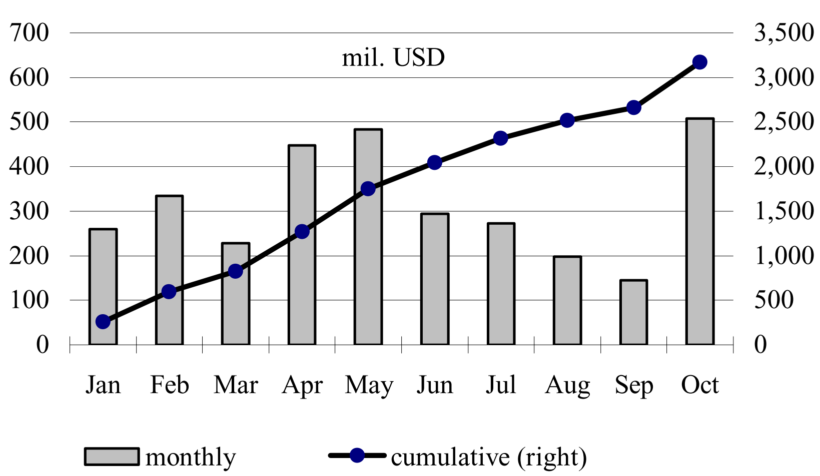


Fig. 9. Structure of imports - main categories ($ mn.)