The Euro: A Shelter?
A Perspective from Romania

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10eNB Conference on European Economic Integration
Vienna, November 16, 2009

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Summary

- Eurozone performance (esp. since 2007) as political economy reason for current spurring of interest in firmer plans for euro adoption among NMS
- Timing of euro adoption, challenges and constraints in sequencing choices
- Currency substitution (especially foreign-exchange lending) as important element of concern in policymaking (monetary policy, financial stability)

Timing of Euro Adoption: Initial Considerations

- Euro adoption as final stage of a complex convergence process, and not an initial condition of kick-starting such a process
  - ✓ OCA reasons: more catching-up necessary in *per capita* GDP; business cycle synchronization (low for Romania before 2008);
  - ✓ Need for diversified macroeconomic and structural policy toolbox in order to effectively manage disequilibria throughout pre-euro adoption period (w. monetary & exchange rate flexibility providing important degrees of freedom)
- Importance of sustainability in evaluation of how criteria are met
  - ✓ No change expected in definition of convergence criteria
  - ✓ Sustainability considerations will necessarily involve assessments with implications on real convergence and, perhaps, also financial stability
- Unilateral euro adoption not feasible and not a solution

‘Early’ Euro Adoption?

Pros

- More rapid expected reduction in transaction costs, exchange rate risk
- Improved time consistency of macroeconomic policy mix (esp. avoidance of fiscal, wage policy relaxation)
- Better incentives for timely implementation of structural reforms

Cons

- Low business cycle synchronization leaves economy prone to asymmetric shocks
- Loss of monetary/exchange rate flexibility leads to possibly significant macro adjustment being borne by output/employment
- Significant disparities in real convergence indicators make catching-up process difficult to manage sustainably (ex. magnitude of B-S effects raising equilibrium inflation rates)
- Difficulty of *ex ante* pinpointing (unmodified) central parity while equilibrium exchange rate may undergo substantial shifts

‘Late’ Euro Adoption?

Pros

- More progress in achieving nominal and real convergence
- Longer time span available for tackling necessary structural adjustments
- Further business cycle synchronization
- Preserving monetary policy autonomy for longer

Cons

- Persistence of higher transaction costs limits further financial, trade integration
- Higher incentives for fiscal relaxation, delayed implementation of structural reforms
- Delayed euro adoption sends unclear message to investors (domestic structural weaknesses or deliberate decision?)
- As corollary of above, limits on exchange rate variations against background of full capital mobility may lead to periods of pronounced volatility in financial flows

Romania's Timetable for Euro Adoption (I)

- Timing of ERM2 entry is planned for 2012 in order to:
  - provide some monetary and exchange rate flexibility (for a limited time period) in order to further necessary and substantial structural adjustment
  - maintain motivation to carry out reforms in a timely manner and consolidate macro discipline (need for significant fiscal consolidation in 2010 – 2012)
  - provide the possibility of setting the central parity based on a more accurate estimate of the equilibrium exchange rate after overcoming both the peak in capital inflows (which remained high even subsequent to EU accession), as well as the substantial and abrupt reduction in flows to EM after the onset of the global financial crisis
  - meet *ex ante* most of the convergence criteria and establish sustainability

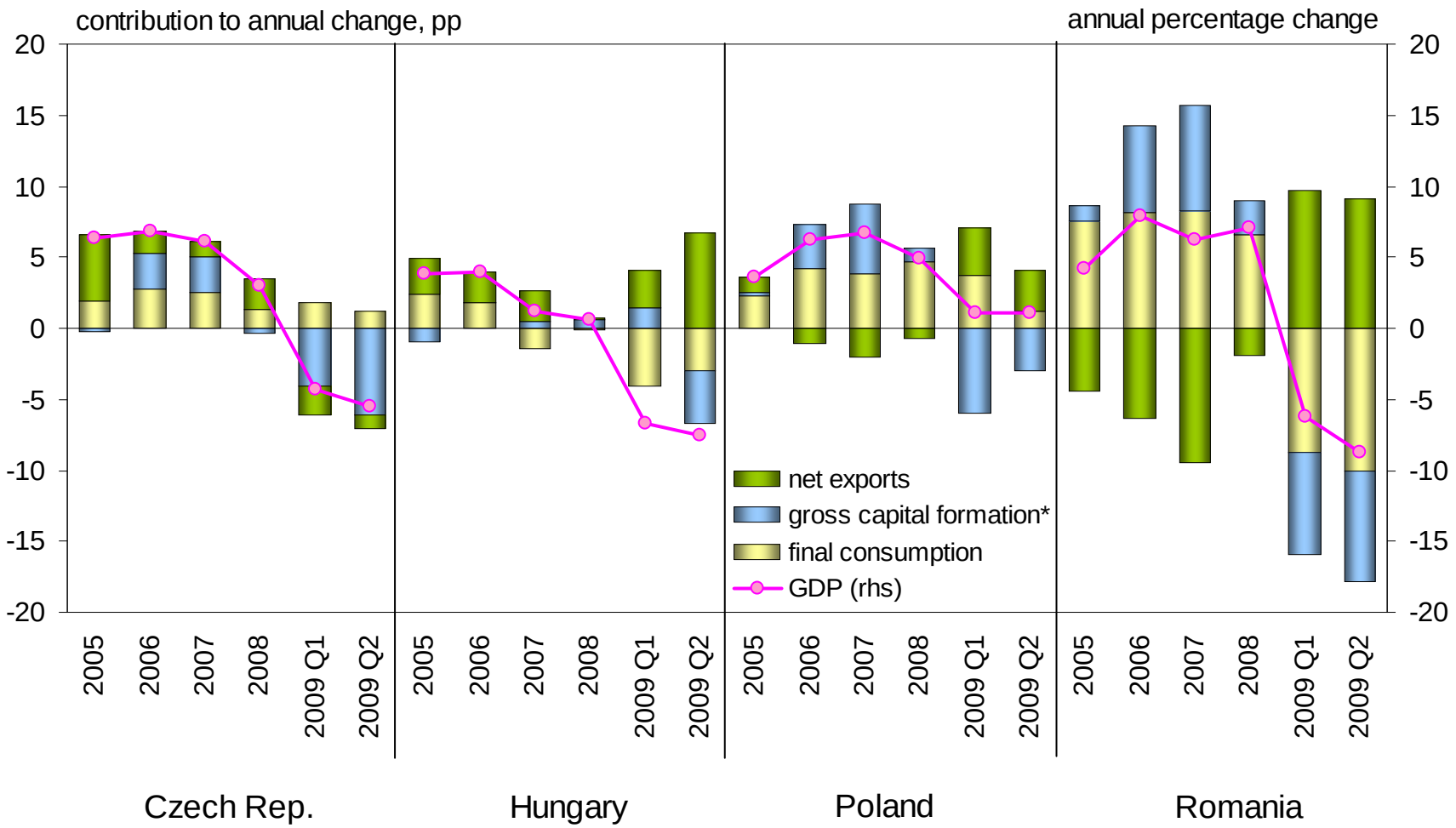
Romania's Timetable for Euro Adoption (II)

- Timing configured to ensure *ex ante* likelihood of shorter necessary stay in ERM2 (min. 2 years), considering:
  - credibility provided by final stage of the process (adoption of the euro) and attendant spurring of adjustment
  - possible volatile capital movements amid restricted exchange rate flexibility during interim period
  - the inflation targeting framework, to which exchange rate movements should be clearly subordinated
  - a choice of time frame providing a balance between ambition and feasibility should serve to both anchor inflation expectations and increase the underpinnings for time consistency in macroeconomic policy
- Eurozone entry is planned for January 1, 2015 (euro adoption decision expected in 2014)

Limiting the Speed of Growth of Foreign-Exchange Lending

- Successful euro adoption predicated on strong domestic currency in run-up
- Existence of currency substitution not problem *per se* in savings, but in challenges to macroeconomic management & financial stability posed by proliferation of lending in foreign exchange
  - Reasons: lower interest rates; incomplete domestic markets, shorter yield curves
  - NBR early on defined flexible implementation of IT as focused on ensuring compliance with sustainable progress of disinflation along medium-term path described by announced annual inflation targets, while remaining mindful of not exacerbating existing macroeconomic vulnerabilities or creating financial stability problems whose effects might compromise durability of secured disinflation gains: 'macroeconomic risk-management perspective', with primacy of price stability considerations
  - Also, continuous focus since 2004 on slowing down speed of growth of foreign-exchange credit (for macro as well as financial stability reasons, due to increasing asset-liability mismatches), using all available policy tools (reserve requirements, LTV, loan-to-income limits for households, exposure limits to unhedged borrowers, higher coefficients in stress tests for exposures to non-euro credit)

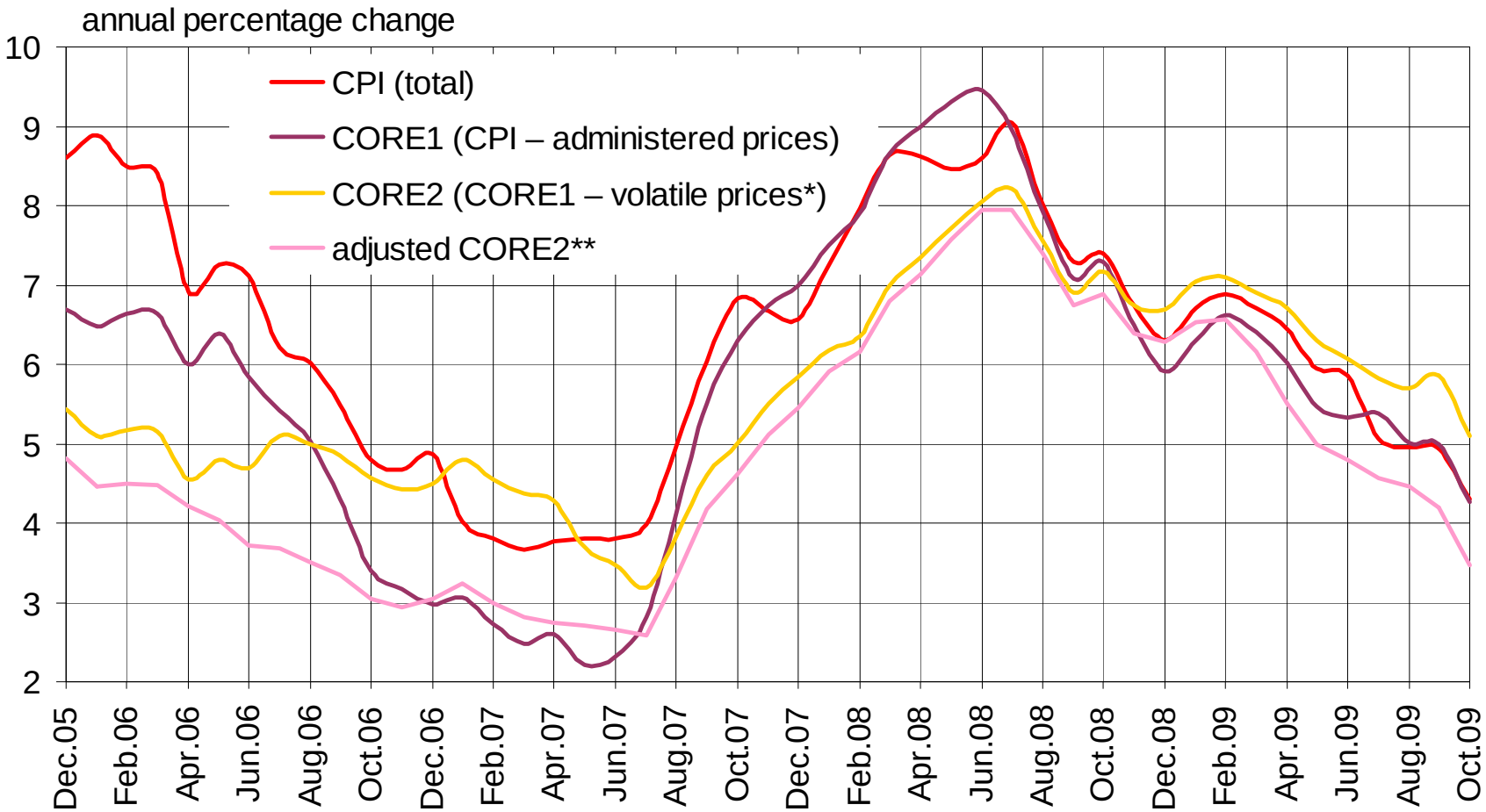
Economic Growth in Peer Countries



Source: Eurostat

* including statistical discrepancy

Headline Inflation and CORE Inflation

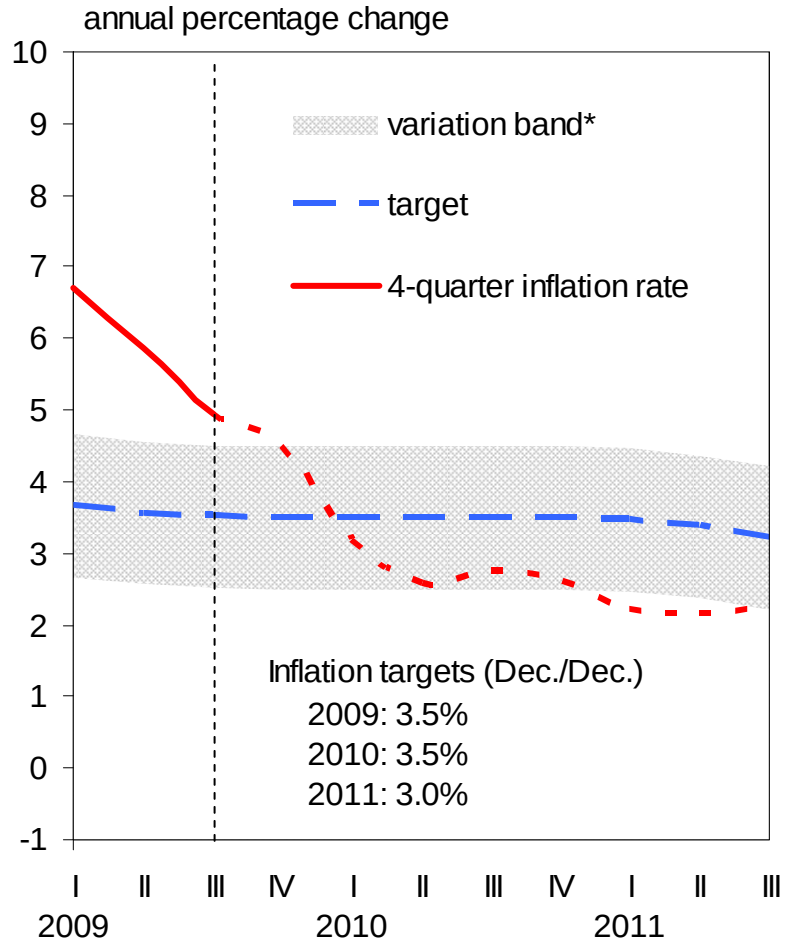


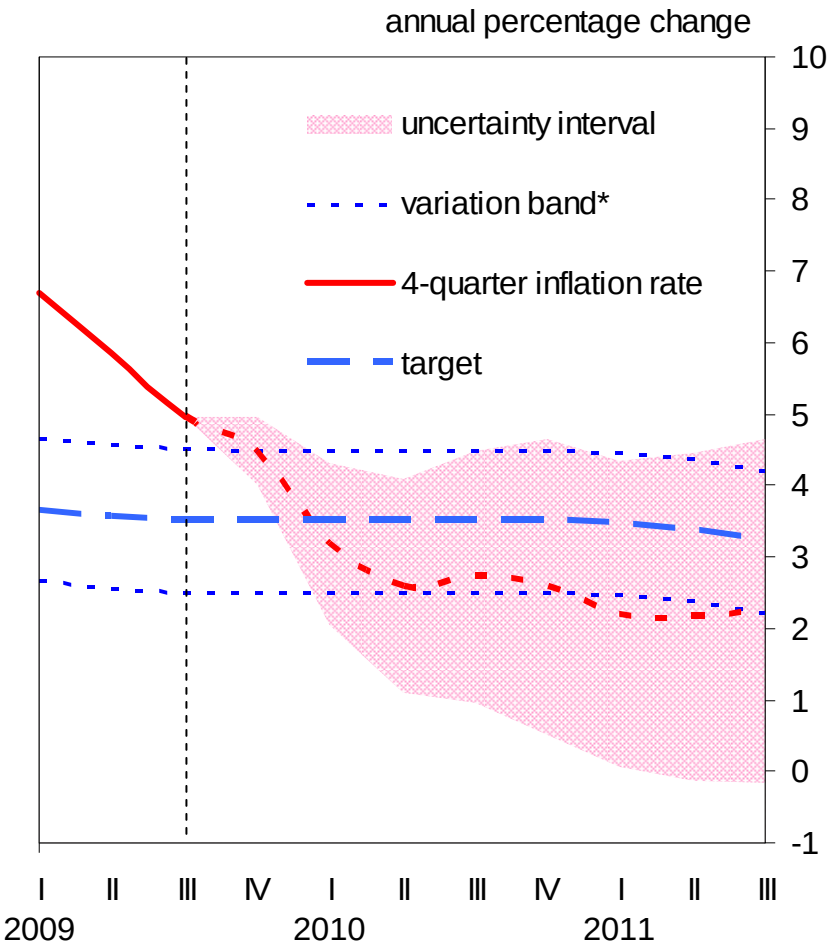
*) products with volatile prices: vegetables, fruit, eggs, fuels

**) excluding tobacco and alcoholic beverages

Source: National Institute of Statistics, National Bank of Romania calculations

Inflation Forecast

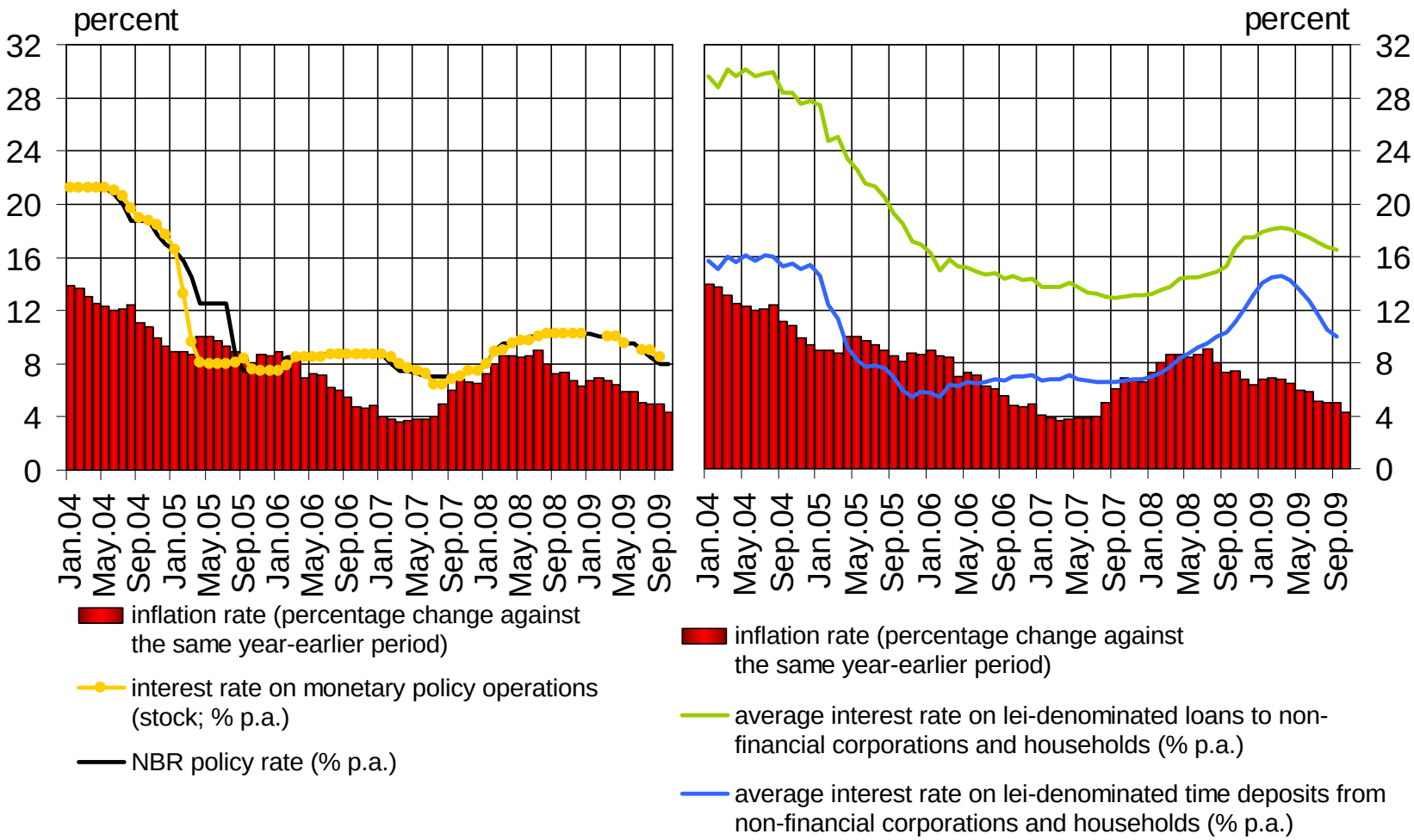




*) ±1 percentage point around the central target

Source: National Institute of Statistics, National Bank of Romania calculations

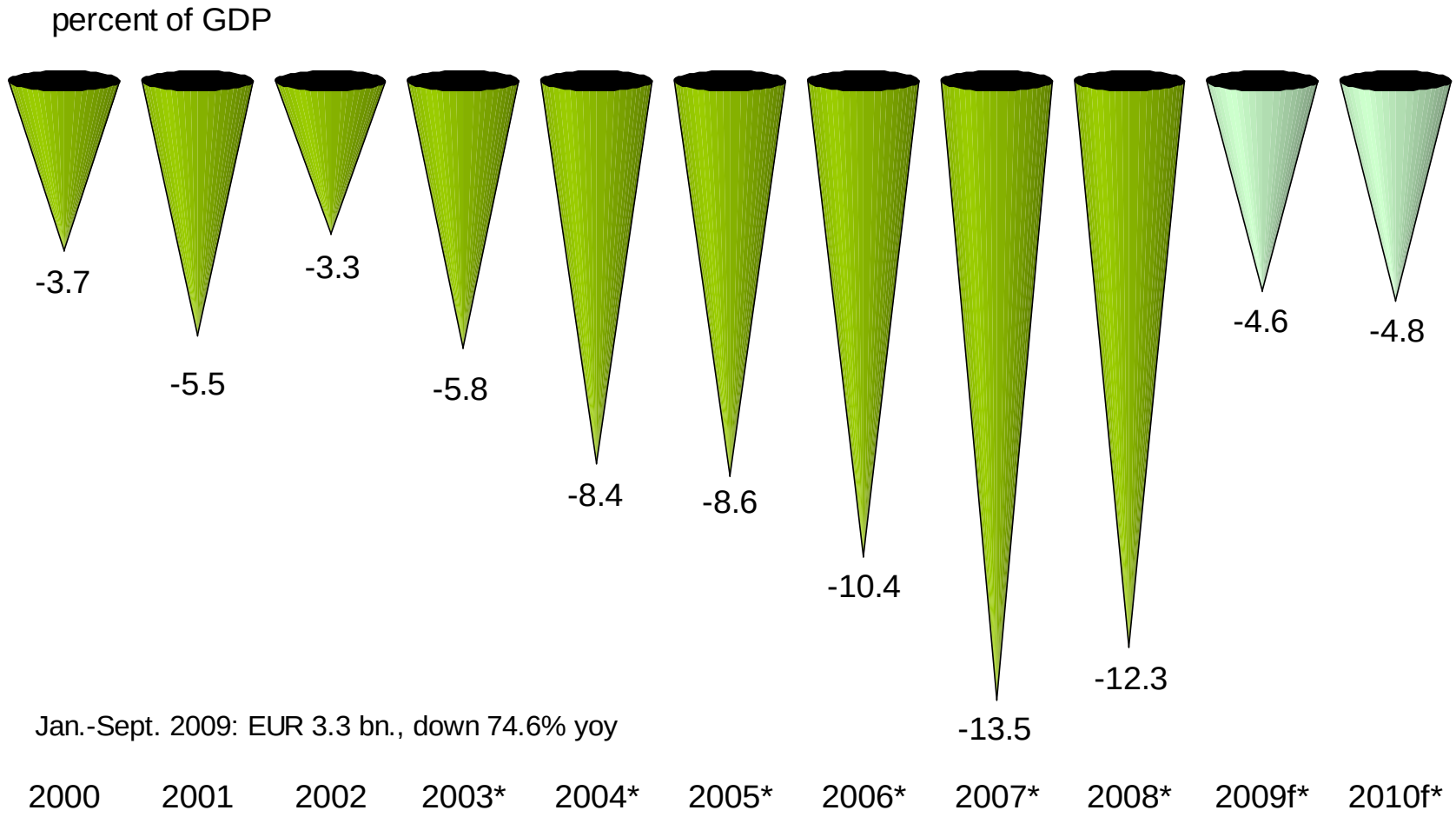
Inflation Rate and Interest Rates



NBR policy rate: 8.0% starting with September 30, 2009

Source: National Bank of Romania, National Institute of Statistics

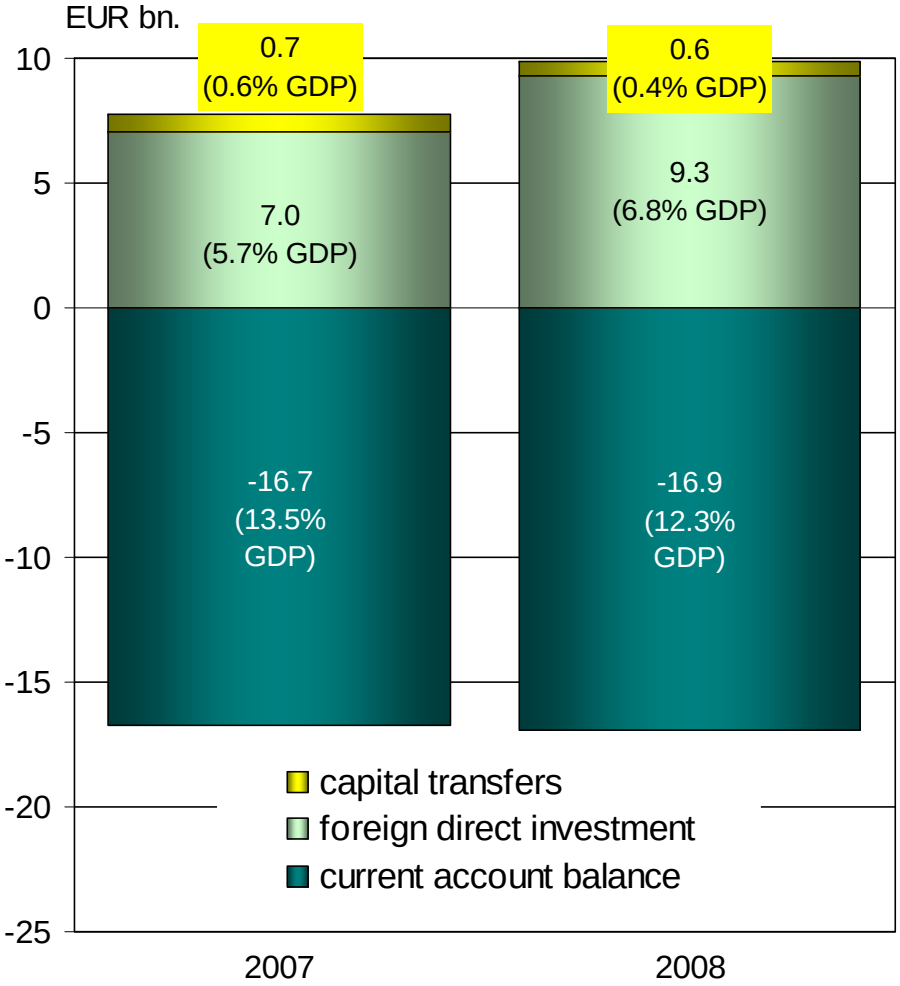
Current Account Balance

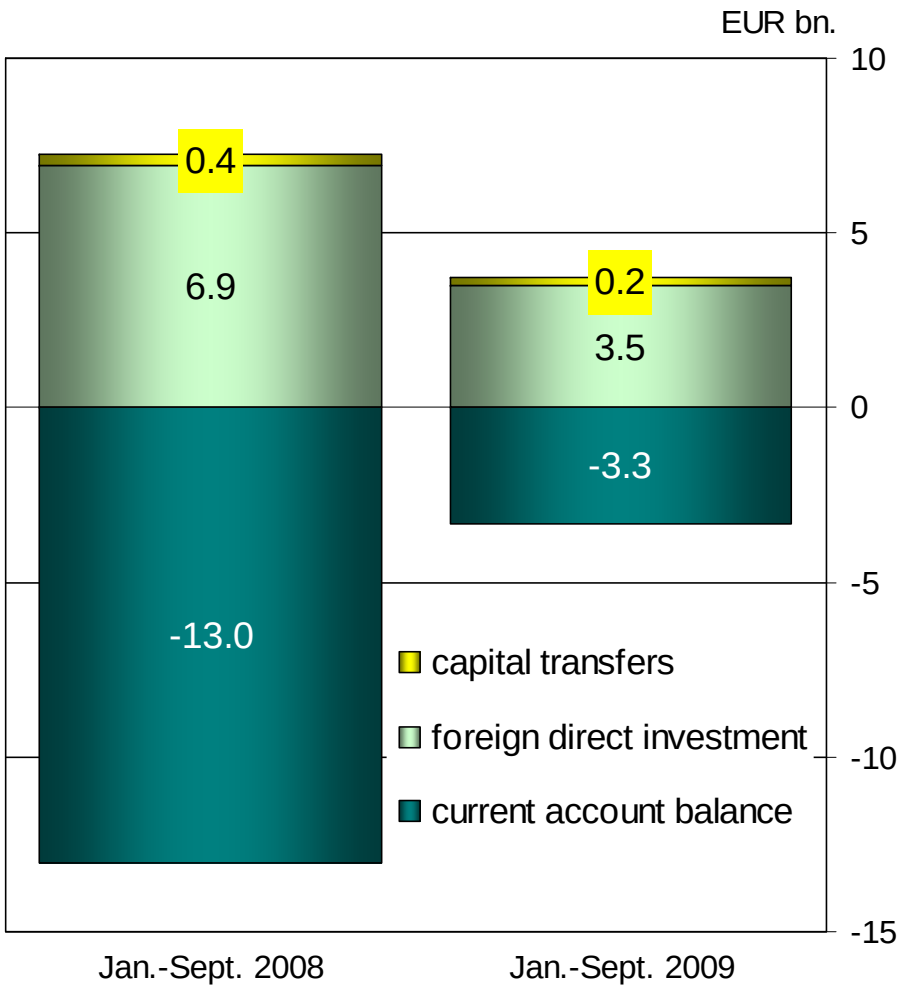


*) including reinvested earnings f) forecast

Source: National Bank of Romania, National Institute of Statistics, National Commission of Prognosis

Current Account Deficit Financing via FDI





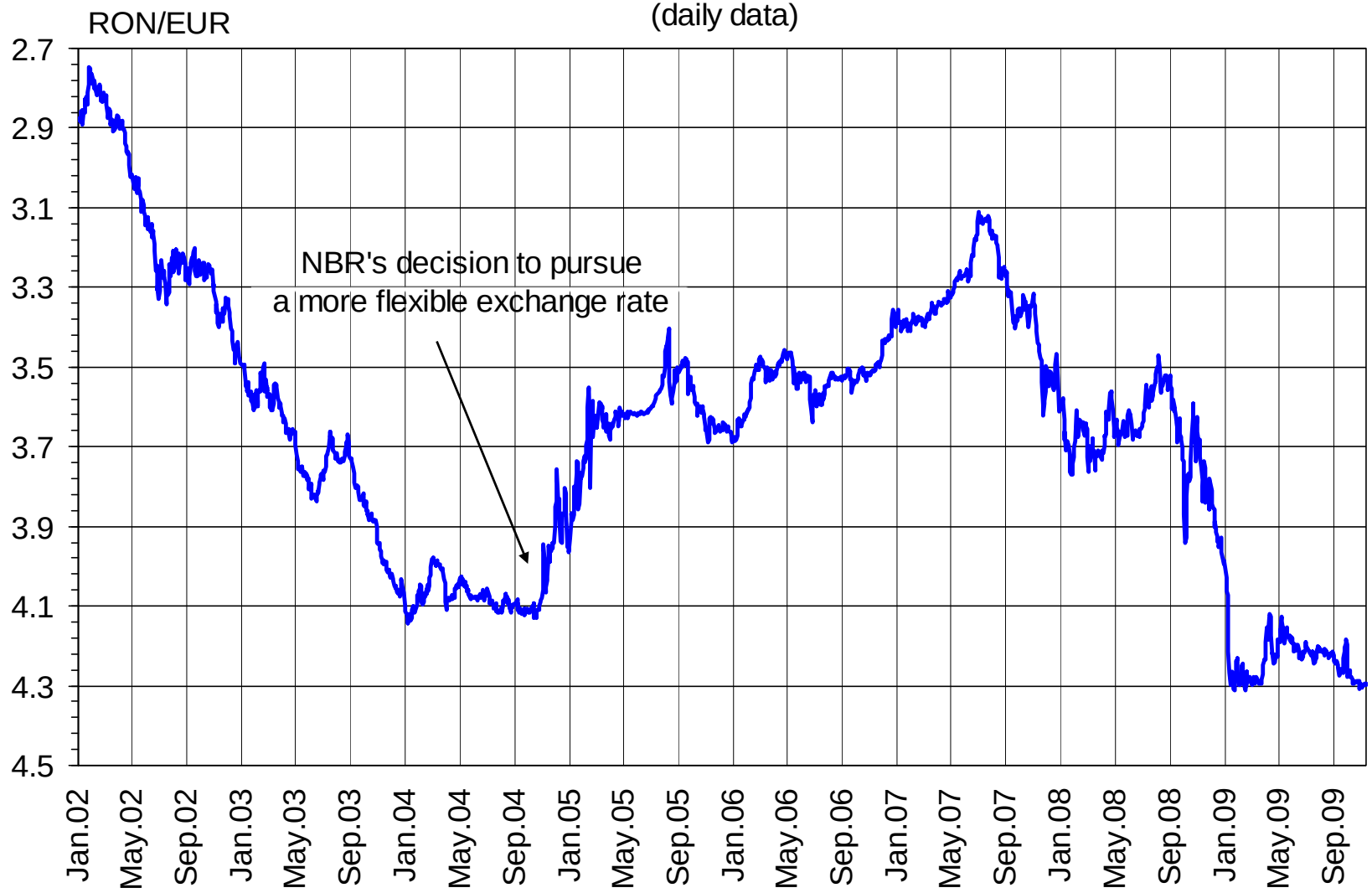
Current account financing via FDI (including capital transfers) amounted to 58.4% in 2008 vs 46.5% in 2007.
In 2008, net FDI increased 31.6% yoy.

Source: National Bank of Romania, National Institute of Statistics

Current account financing via FDI (including capital transfers) amounted to 112.6% in Jan.-Sept. 2009 vs 55.7% in Jan.-Sept. 2008.
In Jan.-Sept. 2009, net FDI decreased 49.4% yoy.

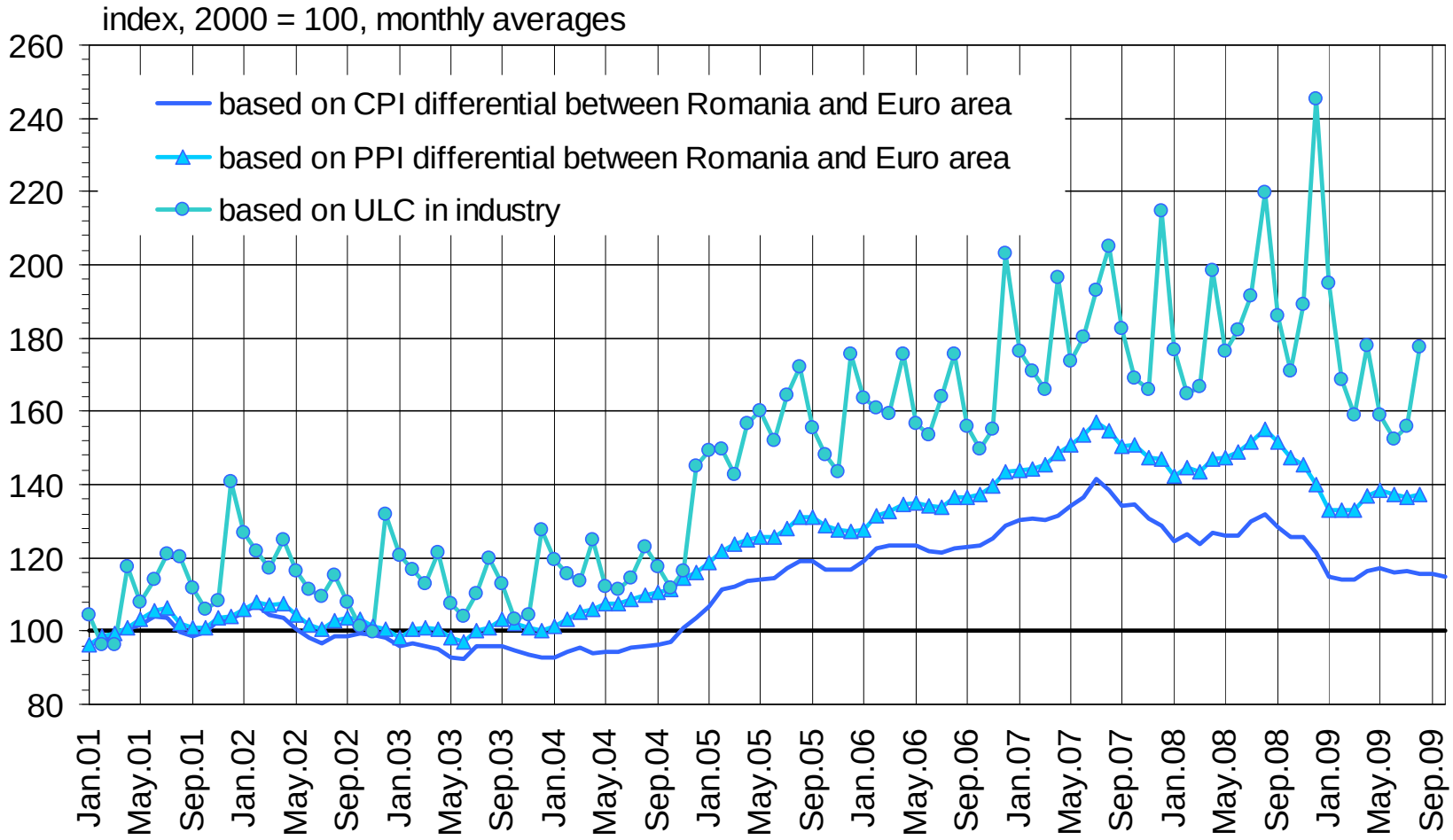
Nominal Exchange Rate

(daily data)



Source: National Bank of Romania

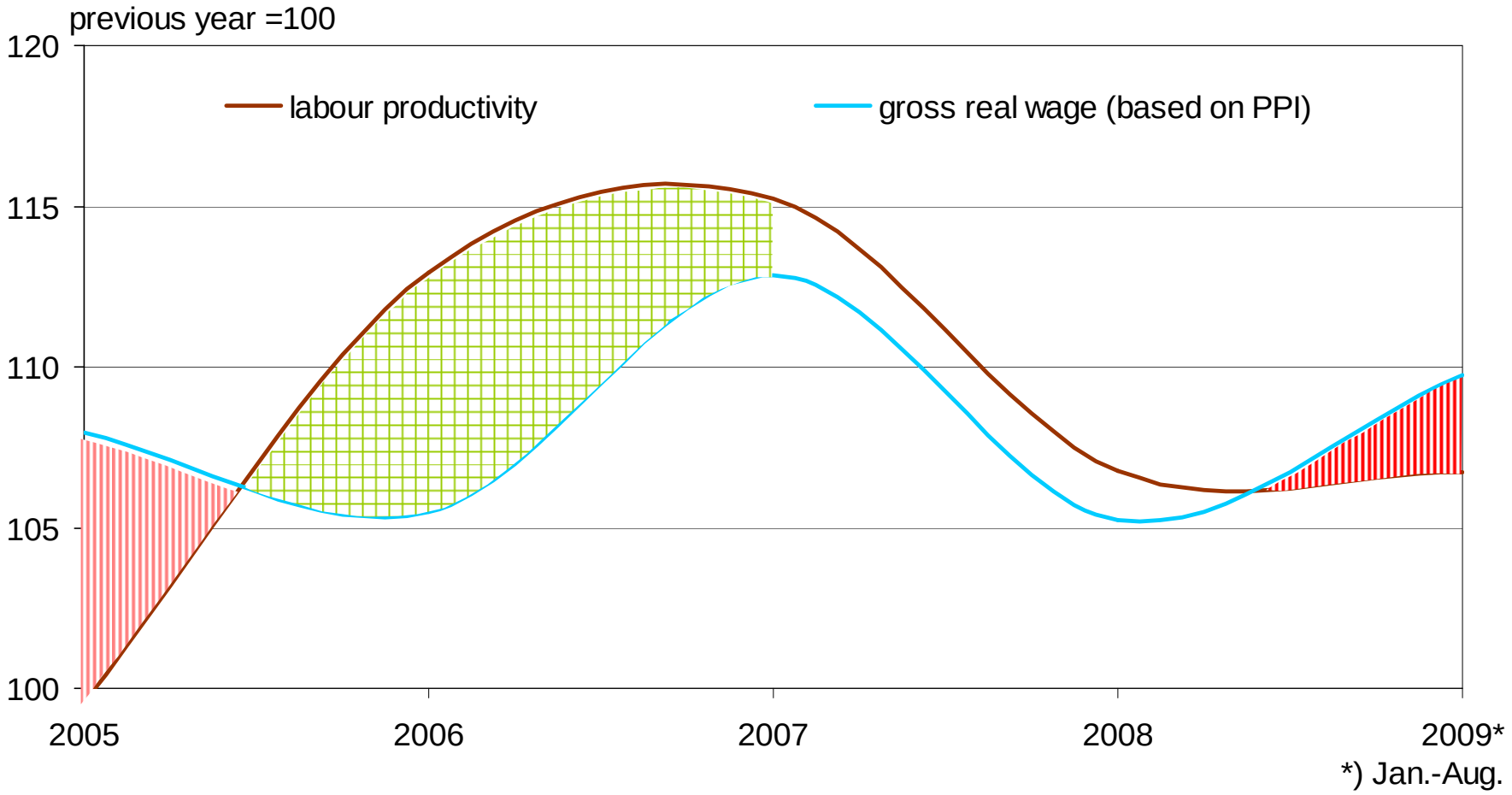
Real Exchange Rate of the RON against the EUR



Note: For PPI and ULC, data recalculated according to NACE Rev.2 and to the change in the base year (2005 instead of 2000) and weighting system.

Source: National Bank of Romania calculations, National Institute of Statistics, IMF - International Financial Statistics

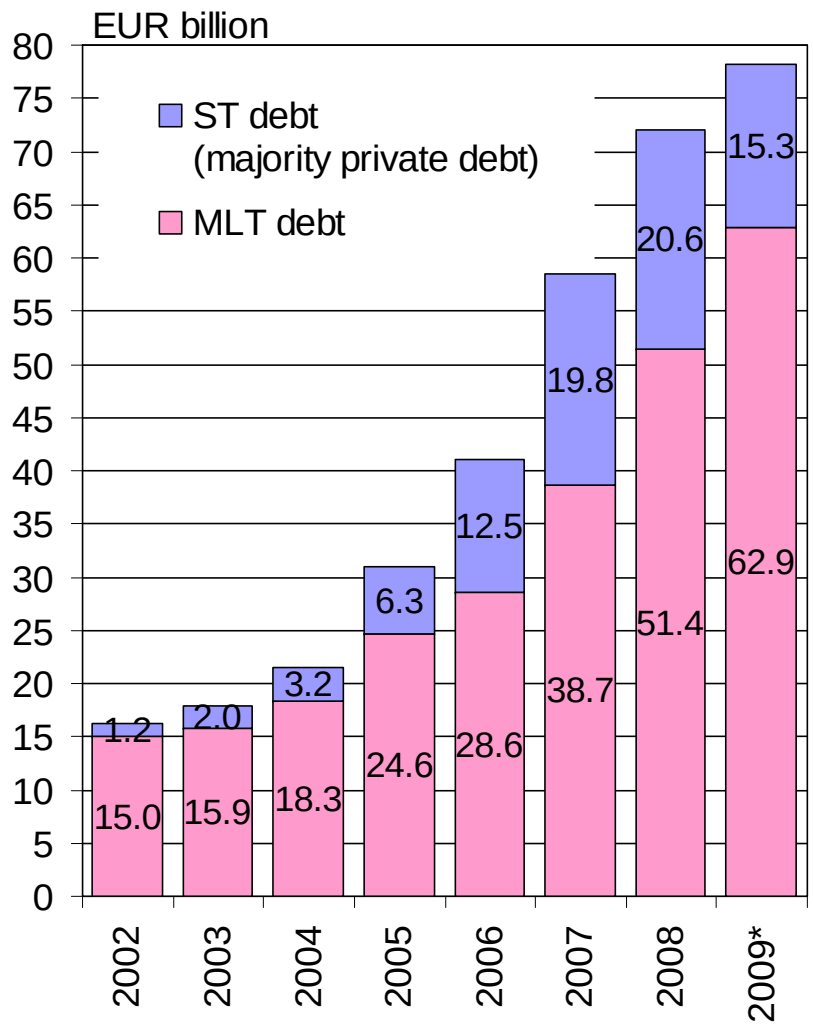
Real Wage and Labour Productivity in Industry



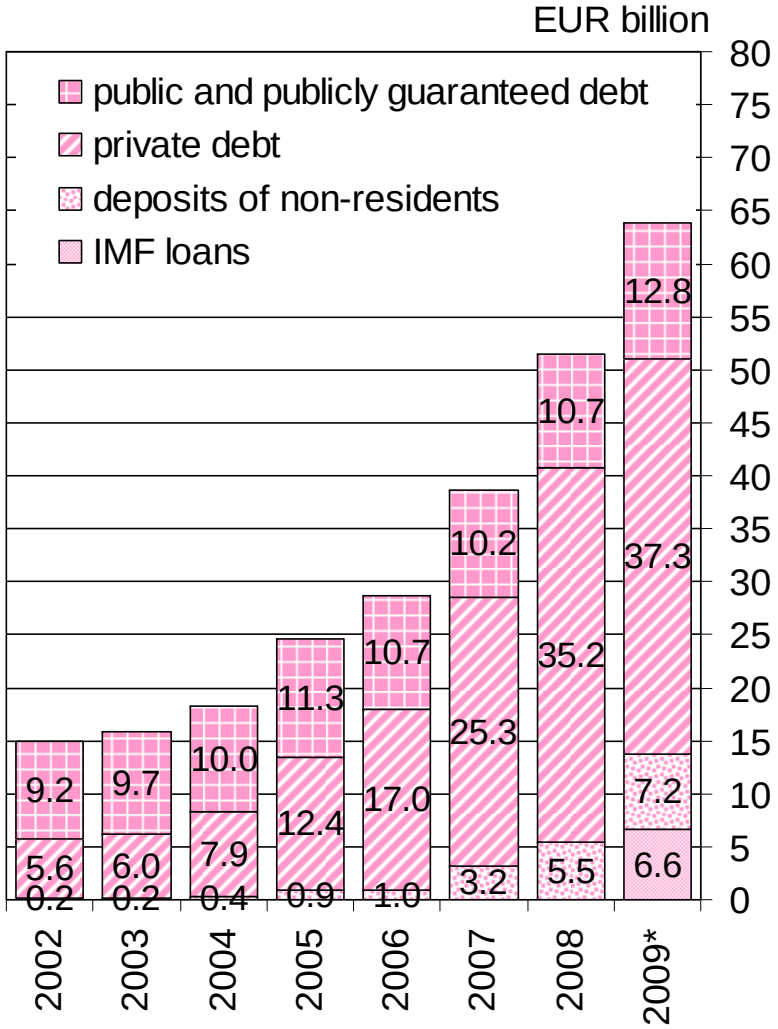
Note: Data recalculated according to NACE Rev.2 and to the change in the base year (2005 instead of 2000) and weighting system.

Source: National Institute of Statistics, National Bank of Romania calculations

Total External Debt



MLT External Debt

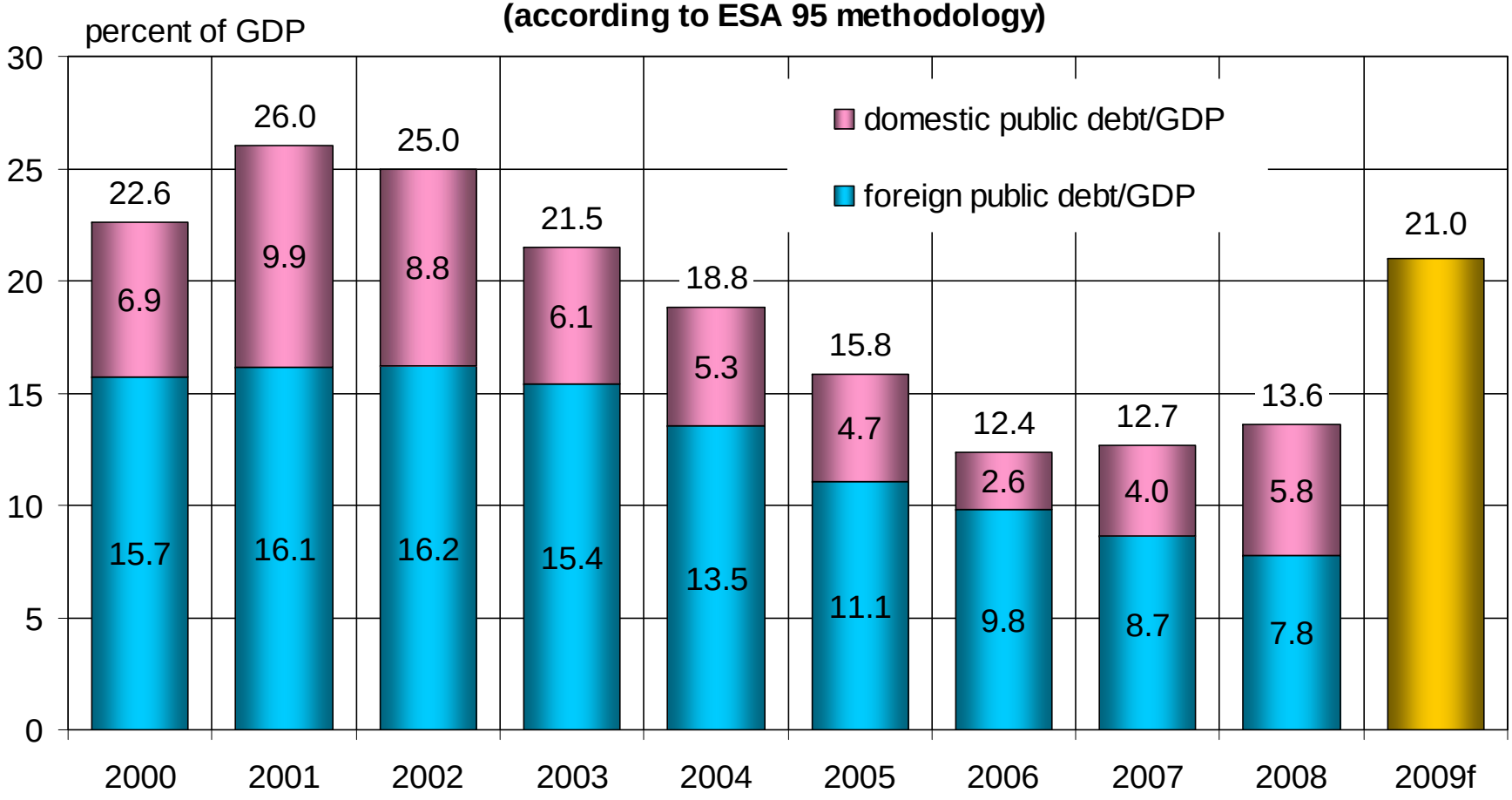


Source: National Bank of Romania

*) September

Public Debt

(according to ESA 95 methodology)



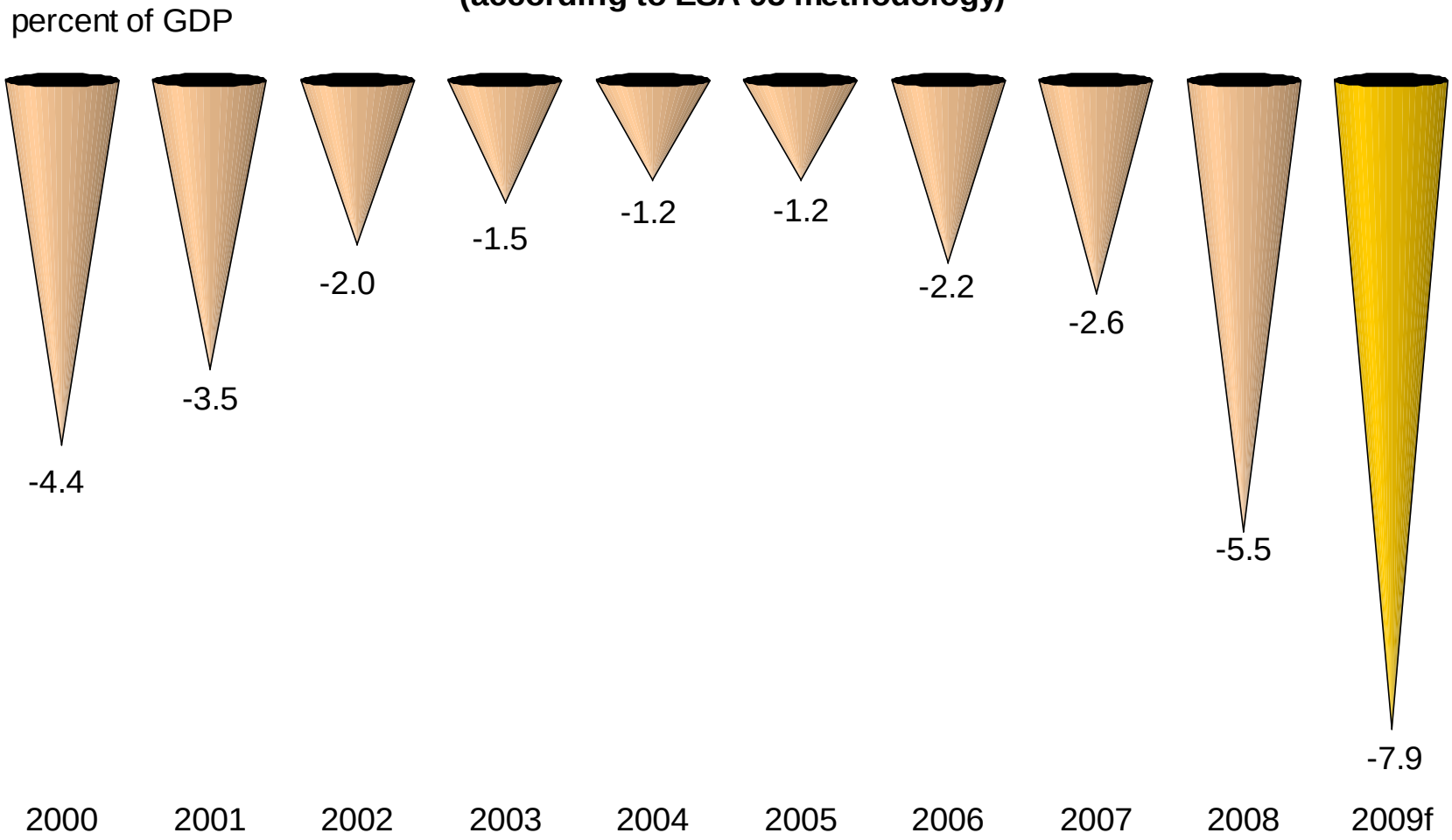
Note: Government securities in MFIs portfolio as share of GDP in Dec.07=1.7%, Dec.08=2.2% and Aug.09=7%

f) EDP Notification, October 2009

Source: Ministry of Public Finance, National Bank of Romania, National Institute of Statistics

General Government Deficit

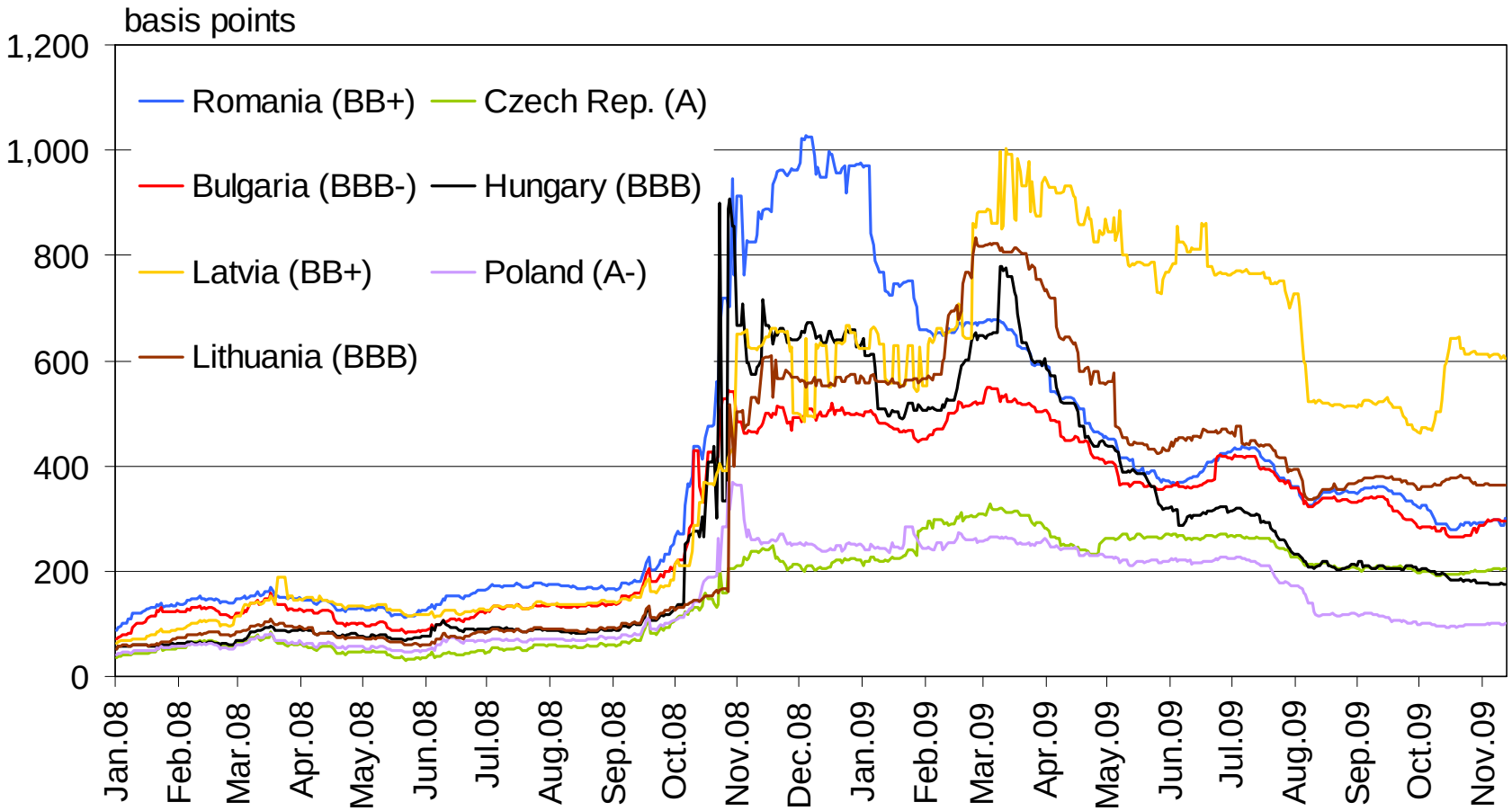
(according to ESA 95 methodology)



f) EDP Notification, October 2009

Source: Ministry of Public Finance, National Institute of Statistics, National Commission of Prognosis

Eurobond Spreads

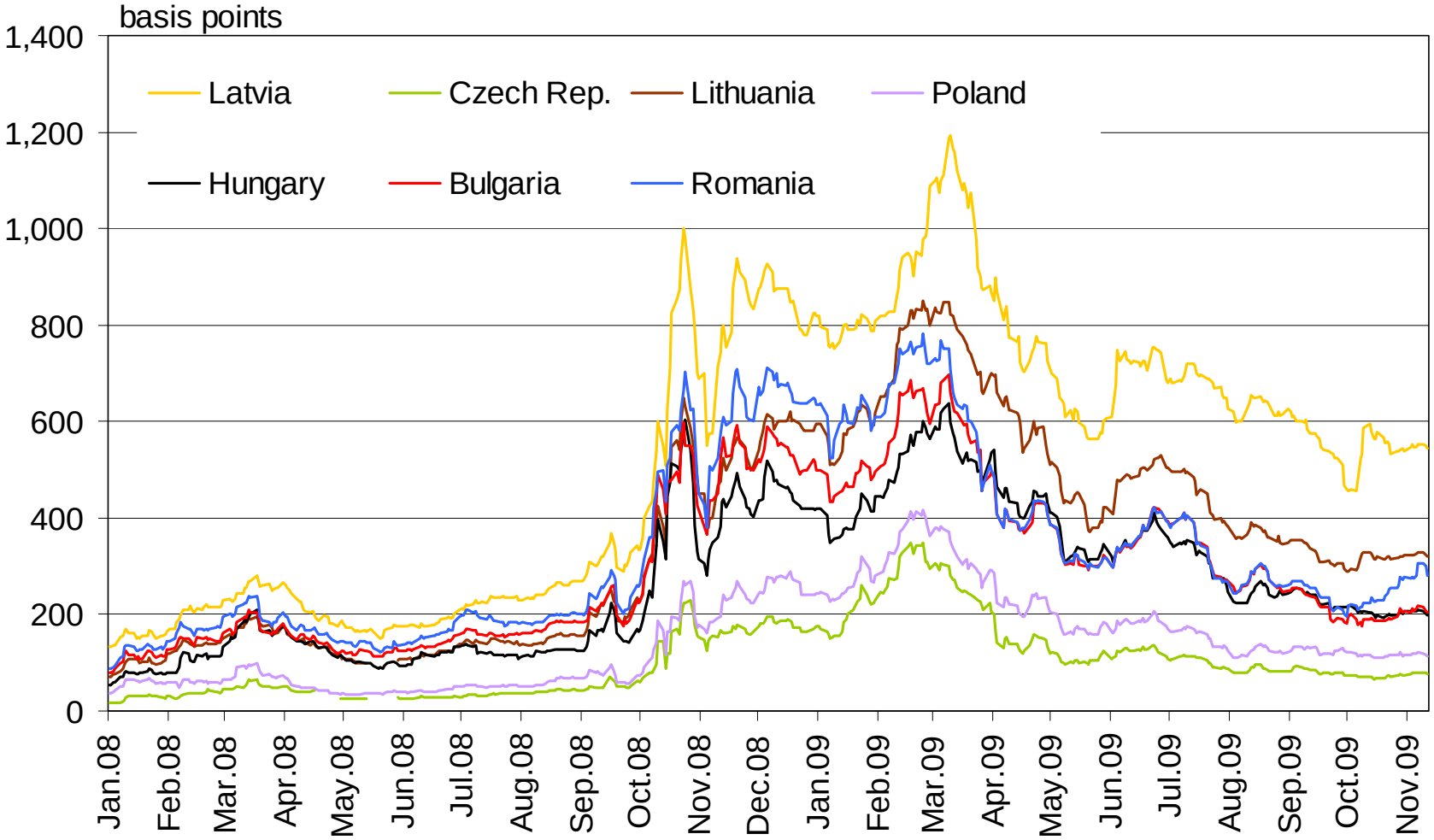


Note: The spread is calculated as against the yields on German Bunds maturing in 2012
Bond maturity: 2011 for Hungary; 2012 for Poland, Romania and Lithuania; 2013 for Bulgaria; 2014 for Czech Republic and Latvia

Source: Bloomberg

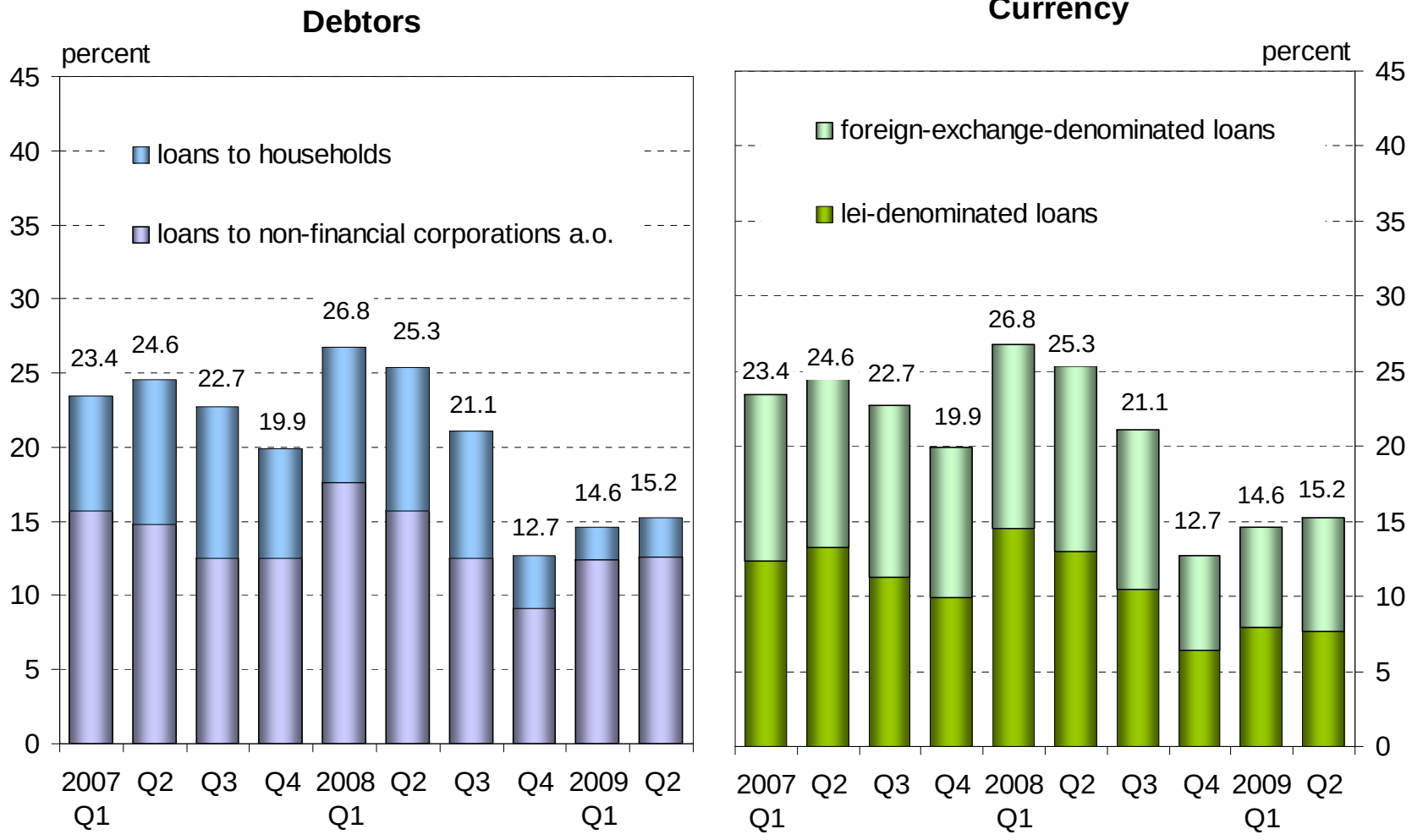
() Composite rating (Moody's, S&P, Fitch)

Spreads of Five-year CDS for Emerging Economies in Central and Eastern Europe



Source: Bloomberg

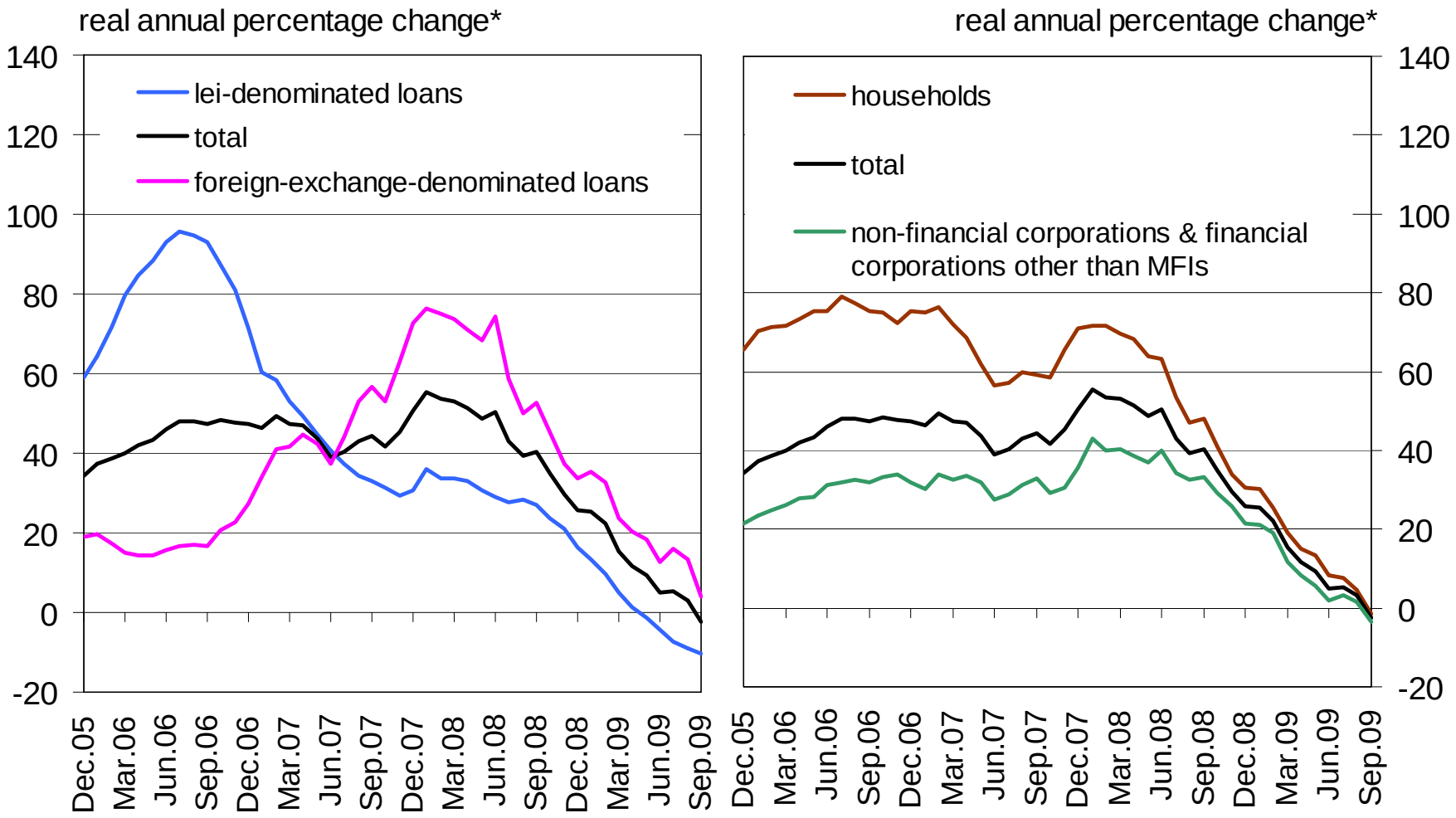
Financial Intermediation*
- Flows -



*) percent in quarterly GDP

Source: National Institute of Statistics, National Bank of Romania

Loans to the Private Sector

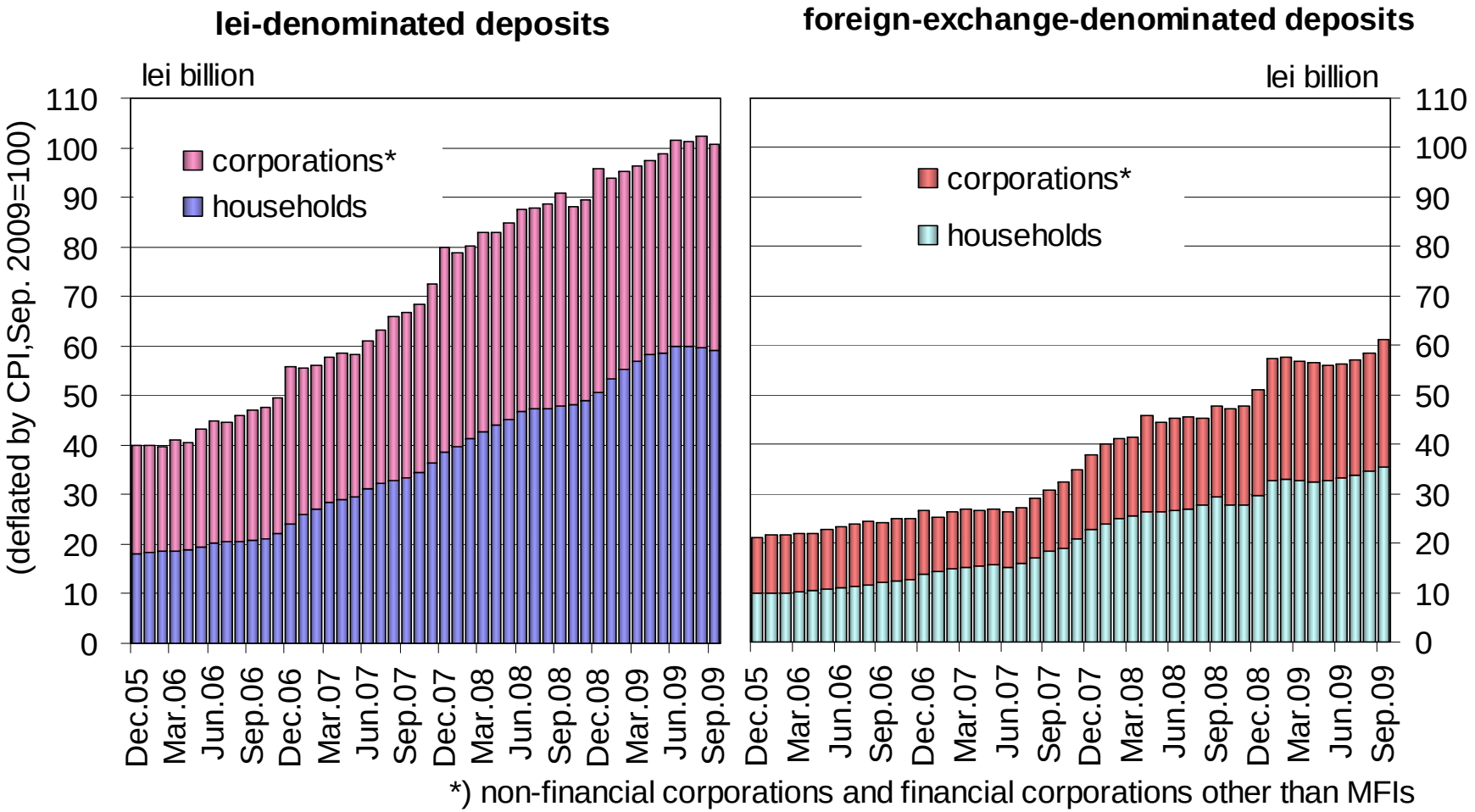


Source: National Bank of Romania, National Institute of Statistics

*) based on CPI

Private Sector Deposits

(in real terms)



*) non-financial corporations and financial corporations other than MFIs

Source: National Bank of Romania, National Institute of Statistics