*Guest article:*

# Romania's Euro Area Accession: The Question is *Under What Terms!*

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***Abstract***[2]: *Euro area (EA) accession should mainly depend on the achievement of a critical mass of real and structural convergence, which should diminish the risks to operate in an incomplete monetary union. Accession would also be enhanced by reforms in the functioning of euro area institutions and policies which should deal with asymmetric shocks. We argue that the true stake of euro adoption in Romania should be neither "if" nor "when", but "under what terms" and "how it will be done". The essential prerequisite for real convergence is raising competitiveness. Our analysis shows common problems regarding competitiveness in new member states in terms of infrastructure, institutional development, business sophistication, innovation; it points out the scale of risks attached to a premature euro area accession. This accession does not require the achievement of the euro area average level of GDP/capita (in PPP terms). As we argue, one can imagine Romania's accession after having achieved a minimum of 75% of euro area GDP/capita average and the fulfilment of a series of structural conditions against the backdrop of euro area reforms.*

***Keywords***: *Euro area accession, real convergence, structural convergence, Euro area sustainability, integration degree*

***JEL Classification***: *F02, FM5, G01, H12, P52*

## INTRODUCTION

There are benefits of euro area (EA) accession, among which enhanced economic links between Member States' economies, lower transaction costs, no currency risk, a safe haven currency when financial markets are moved by destabilising capital flows; joining the EA could speed up insertion into core European industrial networks, for which EU accession has paved the way. EA membership would also have a strong

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geopolitical dimension in light of recent years' uncertainty, including the outcome of the UK referendum (Brexit) and mighty centrifugal forces in the EU. On the other hand, the argument that EA accession should be as fast as possible is to be examined cool-headedly, not pathetically.

Most important lessons of the EA crisis are: the EA has achieved a deeper integration of EU Member States, but has failed to ensure sufficient convergence among them and has triggered major imbalances (competitiveness gap) between Northern Europe and Southern Europe; the thesis that the EA is not an optimum currency area (with structurally compatible economies) has proved right, and structural and real convergence gaps have salience; the EA does not yet have in place instruments to withstand asymmetric shocks, as is the case in a genuine monetary union (the United States, or Germany, as a federal state); policy space is tremendously relevant in the event of powerful adverse shocks and the EA now allows only domestic devaluation[3] as a correction mechanism, which comes at a hard social and political cost. There is another issue that we do not venture to call a lesson from the EA crisis, but which should not be overlooked: the difference between the Member States that rely on rules and those that prefer flexibility, discretionary intervention in the economy (Brunnermeier, James and Landau, 2016). The problem with this explanation, however, is that it appears to underestimate the question of policy arrangements within a monetary union.

There is a line of thinking in Romania which advocates joining the EA as soon as possible. One argument states that it is the only way to provide a new target for the country's development by making an analogy with EU accession. Yet, this analogy is questionable, considering the big differences between the Union and the EA in terms of the economic policy toolkit. And why would EA accession be more relevant for citizens than a development programme which envisages highways and motorways, good infrastructure, more resources for education and healthcare? This is what a development strategy, a nationwide project should put forward. One might reply that the transition decades have revealed weaknesses in completing projects without external guidance and a 'stick'. But a country is not accepted into the EA in order to be 'disciplined'.

Another argument in support of fast accession refers to euroisation, for currency risk (affecting quite a number of people) would vanish. But a legitimate question emerges: is euroisation, albeit significant, enough to make such a choice? When an economy is small and run by a currency board (the case of the Baltic States with one to three million inhabitants each), the decision seems relatively easy to make. Instead, in larger economies, where monetary policy is still a national prerogative, de-euroization is to be encouraged. There is also a 'political' and 'geopolitical' rationale for a fast accession into the EU's hard core, i.e. the EA, arguably, stands for. This argument is important, but it must be correlated with the conditions ruling in an economy that is structurally not yet compatible with what a monetary union implies. In addition, hard (military) security should be judged first via NATO membership, even though after Brexit the idea of having in place a single European defence force is gaining traction.

[3] This concept came up during the economic crisis in Sweden in the '90s and Finland's accession to the EU in 1995. It gained prominence during the latest economic recession of 2008-10 (Alho, 2000, p.11); see also Pisani-Ferry, 2010; de Grauwe 2012, de Larosiere, 2013.

When it comes to EA accession, two issues are of paramount importance in our opinion: a/ whether a candidate economy needs a critical mass of convergence (resilience) ex-ante; and b/ whether the EA is functioning properly, so that a candidate state be motivated to join it.

Nominal criteria are not enough to gain EA membership. Rich empirical evidence shows that, unless an appropriate structural compatibility translates into lasting real convergence (income/capita), a country's position in the EA is wobbly and highly risky. What we are dealing here with are not only simple conjectures, but facts, i.e. the experience of some economies that were not fit on EA accession date (Spain, Portugal, Greece, etc.). The GDP/capita ratio relative to the EA average increased in most of the EA periphery over time, but structural convergence was weak, ending up in major imbalances that called for broad-based corrective measures. Currently, Romania has a GDP/capita of approximately 25-26% relative to the exchange rate and approx. 57% of the EA average in purchasing power parity terms; we submit that it is too little. Furthermore, the Romanian economy has to surmount large structural gaps; the country also has considerable internal regional gaps.

Across the EA, as it works today, the range of choices for managing imbalances is confined to the control fiscal and quasi-fiscal deficits in the public sector and to cuts in wages and other incomes, as the case may be. As the EA crisis and other turmoil episodes (in Asia, for instance) have showed, large external imbalances are, frequently, due to private sector overindebtedness. Why the private sector is facing external debt overhang? Because capital flows from where it is saved to where it is "required" and where yields seem to be higher. Capital was prevailingly channelled towards non-tradeables sectors due to soft lending conditions, an incomplete common market and imperfect competition. This was also the case in Central and Eastern Europe, Romania included. The logic of capital movements is hard to beat from this standpoint. Here is where the argument that big development gaps make no difference falters, that once a country has gained EA accession things work out the way they are supposed to, in keeping with the free movement of factors of production.

If we think of means to mitigate asymmetric shocks (beyond the automatic stabilisers at national level), the first thing that comes to mind is the EA functioning, i.e. the second key issue worthy of a serious debate on accession. In spite of some institutional and policies reform, the EA still has major functioning flaws. Top officials in European institutions and national governments acknowledge this fact. It is true that currency risk is a thing of the past, which is a benefit nobody can deny. Equally true is that the EA may help an economy to protect itself from destabilising capital movements. As Helene Rey put it, the trilemma of macroeconomic policy in an open economy boils down to a dilemma: a monetary policy seeking some degree of autonomy needs administrative control over capital movements, which is difficult when major central banks (such as the FED or the ECB) disregard the externalities of their own monetary policy decisions. But even Rey's argument is not, arguably, a decisive one in accepting the EA's current functioning. The European Stability Mechanism (ESM), the Banking Union (BU) and other instruments introduced after the EA crisis outbreak have not dealt with core issues;

hence additional reform measures are needed. The reform proposals put forward by the European Commission (EC) in May 2017 are, arguably, steps in the right direction.

Policy space is critical for an economy still fraught with substantial rigidities and in need of major structural reform. An argument could calm the choppy waters of EA functioning, namely: if fiscal and political (institutional) integration went deep enough, allowing resource transfers to make the imbalances among EA Member States irrelevant - e.g. the resources transferred from West Germany to East Germany after the country's reunification. Yet, one can only fantasise with this idea these days. Not even the Five Presidents' Report (2015) nor the EC proposals on the future of Europe (2017), which mention a joint treasury and "fiscal capacity" in the future, go that far.

We have thus to identify the best way between reaching a critical mass of real and structural convergence ex ante, counting also on reform measures implemented in the EA to make it function better. What Romania needs are in-depth structural reforms, economic growth based on productivity gains, which implies more private and public investment, innovation in technology. There is a need for basic public goods (basic infrastructure, education, healthcare) financed by an adequate level of fiscal revenues (not the 26% of GDP in 2016, while the EA average is near 40%). A growth pattern drawing also more on domestic resources is called for, capable of creating competitive advantages and overcome the *middle income trap*. A country development strategy, as a complex effort of reform and economic construction could be an *alter ego* to EA accession.

EA accession can be hastened for geopolitical reasons. This choice, however, must be a rational one, based on reliable data and sound judgements.

This paper has four sections. Section one features empirical evidence on the EA functioning and a number of findings. Section two examines reform measures which deal with the institutional architecture of the Economic and Monetary Union (EMU). Section three makes a comparative analysis of the state of Romania's economy from the EA accession perspective. Finally, some guidelines of a EA accession roadmap are outlined.

## 1. THE ECONOMIC AND MONETARY UNION BETWEEN THEORY AND PRACTICE

The euro is a project with a prominent political dimension. Hence, the EA was born even though it did not follow basic prescriptions of the optimum currency area (OCA) theory, neither did it heed lessons that other currency unions have taught over the years to ensure a lasting nature. At the same time, the EA's first 16 years of existence have shown that most of the conditions that EMU founders had imposed on euro hopefuls have repeatedly been broken by the founding EU Member States (EA11). And the countries with the highest income gap against the group average at the time of accession faced the toughest hardships later on.

### 1.1. BENEFITS AND COSTS OF JOINING THE EURO AREA

The OCA theory has made headway since the '60s when it was set forth[4] via multiple empirical studies. **Benefits** of joining the EA can be summed up as follows:

- The credibility of the ECB and well-anchored inflation expectations, which allowed low interest rates for both short and longer term of up to 50 years. From this perspective, the countries saddled with high, volatile inflation had the most to gain from EA accession;
- closer trade ties following the cut in transaction costs and the removal of the exchange rate risk. However, some analyses show that, after the euro changeover, intra-EA trade rose, on average, by approximately 5-10% (Baldwin 2006, Baldwin et al, 2008), way lower than the initial forecast of above 80% (Rose, 2000);
- improved financial integration (EMU effect on FDI stood at 7%; Petroulas, 2007) thanks to lower risk premium and, implicitly, capital cost.
- The risk of speculative attacks on national currencies was thwarted. The euro has become attractive globally as a reserve currency (although the EA crisis tarnished its lustre).

But EA accession implies also costs deriving from relinquishing the national currency as a policy tool, specific costs from the EMU architecture and mode of functioning, which are summed up below:

- diminution of the capacity to withstand shocks; by relinquishing control over the currency, labour market flexibility, national fiscal and macro-prudential policies become the ways to stave off asymmetric shocks for lack of joint burden sharing instruments;
- free capital movements (following current account liberalization) helped hide economic policy and structural weaknesses, and favoured a build-up of imbalances;
- the absence of a lender of last resort (de Grauwe, 2011).

### 1.2. LESSONS ON THE FUNCTIONING OF EURO AREA

Observing the Maastricht criteria it was believed to prompt EMU countries to pursue prudent fiscal policies aimed at containing the incidence of asymmetric shocks and to implement structural reforms. A balanced fiscal budget was thought to allow an ample policy space, the rule of the time being that a 1% fall in GDP would make the fiscal deficit 0.5% of GDP higher through the automatic stabilisers. The Stability and Growth Pact (SGP) was deemed effective, and the step-up in financial integration was regarded as the prime mechanism to achieve convergence and stabilisation (World Bank, 2012). The first 16 years of EMU functioning, as revealed by the dynamics of EA11 macroeconomic aggregates, have shown that:

[4] The theory of the OCA was born from the debate on the choice of either a fixed or a floating exchange rate. Mundell (1961) coined the term OCA and clarified the circumstances in which a region/country could benefit from joining a currency union.

- the income gaps at the time of accession was overly large in EA11. The big growth potential of lower-income countries created a divide in economic behaviour against the other countries in the union.
- adoption of the single currency by the countries reporting a wide GDP/capita gap against the EA average does not secure real convergence per se. The EA allowed a catching-up in terms of income/capita gaps at the cost of large external imbalances, calling for exceedingly costly correction policies. From 2009 onwards, part of real convergence was reversed. A comparison in terms of average annual GDP growth rates from 1999 to 2013 and of average annual current-account deficit-to-GDP ratio over the same period for EA11 shows that the fastest growing countries, advancing at average yearly rates of 1.8%, were those in the group posting a current-account balance below 0.8% of GDP on average (France, Italy, Ireland) and those in the group posting a current-account surplus of 4.2% of GDP on average (Finland, Austria, Germany, Belgium, the Netherlands, Luxembourg); the countries in the group with a high current-account deficit (6.9% of GDP on average for Spain, Portugal and Greece) grew at the slowest annual pace: 0.9%.
- over the same period, non-EA Member States in Central and Eastern Europe (CEE), i.e. Bulgaria, the Czech Republic, Romania, Hungary, Poland, recorded an average annual GDP growth rate of 3.1% and an average current-account deficit of 5.2% of GDP. Thus, convergence outside the EA was three times quicker than that of low-income countries in the EA11. Moreover, intra-EA convergence prior to the crisis was largely unsustainable (Praet, 2014). This is because:
  - the Maastricht criteria, on the one hand, were not fulfilled at the time of accession – Portugal, Italy, Belgium could not qualify for euro introduction in 1999 because of their public debt levels; on the other hand, even when they were fulfilled at the time of accession, these criteria were not observed later on by the countries facing high income gaps. And the persistent departure from the inflation path entailed low real interest rates and a higher real exchange rate.
  - the single (one size fits all) monetary policy was hardly adequate. The need for catching up in the poor countries acted as a perpetual asymmetric shock. Prices in these countries were systematically higher than in the rest of the area due to either pay rises outpacing productivity gains (Balassa-Samuelson effect) or a pro-cyclical fiscal policy. Therefore, real interest rates were lower than in the rest of the union, inviting indebtedness, and the real exchange rate steadily appreciating, jeopardising tradeable competitiveness. Domestic devaluation remained the only means to bring the external balance back into equilibrium.
  - prior to the crisis, markets did not operate as a discipline enforcer of public and/or private indebtedness, nominal interest rates converged, thereby eliminating the credit risk margin, although economic fundamentals of EA countries differed in terms of both growth engines and indebtedness capacity. The single currency induced investors to perceive the risks associated with cross-border capital flows in the EMU as having vanished. As a result, massive capital flows went from the core to the periphery, as a perpetual source of asymmetric shocks, with devastating

effects when they stopped and the periphery was left with an overly high labour cost to be competitive.

- the excessive deficit procedure was too soft, allowing public debt to build up and cancelling the fiscal policy space and the possibility to act counter-cyclically during the crisis. The fiscal burden of periphery countries became so serious as it made payment default ominous.
- private sector debt overhang and the relationship with external deficits were underestimated.
- free capital movement and financial integration resulted in a lending boom. Much of the credit to the private sector underpinned the non-tradeables sector and the ensuing consumption binge contributed to a fast build-up of external deficits.
- the current bail-in resolution mechanism for credit institutions is not, arguably, a solid insurer against a systemic crisis encompassing large institutions with cross-border activity.
- the absence of a lender of last resort compounded the problem of liquidity squeeze and the sovereign default risk. Since the ECB is prohibited from acting as a lender of last resort the EUR-denominated loans to any EA member are equivalent to external debt that exposes countries to volatility in investor sentiment.
- banks are sovereign debt holders, so that sovereign default risk runs the risk of bank failure that reinforces sovereign default risk.

## 2. EURO AREA VULNERABILITIES AND REFORM LIMITS. FURTHER PROGRESS IS NEEDED.

The second prerequisite for accession to the EA refers to EMU robustness. The eagerness to join to EA depends on its capacity to withstand strong asymmetric shocks. Currently, there is a large amount of uncertainty and risks associated with economic and structural gaps inside the EA, in spite of a cyclical economic recovery underway.

### 2.1. WHAT NEEDS TO BE MENDED IN THE EURO AREA; KEY VULNERABILITIES

The EA is afflicted by a number of problems that weaken its functioning[5]:

**a/ Problems relating to political governance:** *EMU is still an incomplete project.* The EA problems did not crop up after the crisis broke out or in its aftermath; the current situation stems from economic and political dysfunctions[6] that built up and aggravated over time. For decades people fed on the Monnet thesis[7] of a gradualist approach for

[5] For details, see the EC reports on the state of EA that mark the beginning of the 2017 European Semester, available at: https://ec.europa.eu/info/strategy/european-semester/european-semester-timeline/setting-priorities_en

[6] See MacDougall Report (1977), Barre Report (1969), Werner Report (1970) and Delors Report (1989).

[7] Summarised in the renowned phrase: "Europe will be made in crisis, and will be the sum of the solutions adopted for these crisis", in *Memoire*, Monnet, J., 1976.

further integration. After the crisis broke out, economic integration proved rather a substitute than a complement of political integration (Fabrinni, 2016). Notably, the Five Presidents' Report (2015, p. 5) stated that the EMU is like a 'house that was built over decades but only partially finished'.

**b/ Problems related to economic governance:** *integration does not automatically generate convergence.* The EA has serious structural problems of sub-optimality (Eichengreen, 1991; Krugman, 1993; Friedman, 1997a; Feldstein, 1997; Issing, 1991; Alesina and Baro, 2004; Ricci, 2008; Dăianu, 2014). Bringing together countries with different economic structures, whatever strong the interconnections between these countries, did not make integration proceed automatically; the more so as there were no precise long-term targets in order to boost competitiveness, narrow structural gaps, nor any instruments to make diverging structures more compatible. Over time, structural gaps widened, affecting the Member States' capacity to control macroeconomic imbalances along the business cycle and undermining the aim of sustainable real convergence.

**c/ Problems related to fiscal governance:** *the EMU has limited fiscal integration.* Prior to the outbreak of the crisis, European leaders chose, driven by political reasons, fiscal integration limited to the Stability and Growth Pact (SGP) alone. The consequences of a weak SGP were manifest when the lack of transparency in the regular revision of the SGP rendered impossible the sanctioning of certain countries for infringement of the fiscal criteria set forth in the Treaty of Maastricht; the enforcement mechanism was also pretty weak. The EMU's greatest weakness remains the absence of fiscal union, i.e. the lack of specific instruments (European treasury, Eurobond issues, European Fiscal Council, etc.) to help withstand strong asymmetric shocks.

**d/ Problems related to financial governance:** *a complex and complicated financial and banking system, dogged by a vicious circle between leading banks and fiscal authorities.* Three types of major problems enhanced EA fragmentation: (i) a mismatch between the size of the national financial and banking sector (tasks of national authorities on licensing, regulation and supervision) and its global scale (cross-border transfers, spurred by the freedom of capital movements and the close interconnection of capital flows); (ii) the size and complexity of large financial conglomerates, which forced the incomplete and uneven integration of financial markets (Wallace, 2016), deepened the vicious circle between the financial and banking system and national authorities, putting greater pressure on national budgets (the 'too big to fail' syndrome); and (iii) the absence of adequate and effective instruments for crisis management and withstanding/absorbing asymmetric shocks, managing imbalances and minimising the cost of sovereign debt financing (Baldwin and Giavazzi, 2016).

The crisis has revealed a serious issue of an oversized banking system: indebtedness, i.e. both private and sovereign debts (which, in some cases, shot up to impressive levels (250-300% of GDP; 'debt overhang', Rogoff, 2015 a, b).

**e/ Problems related to institutional governance:** EMU heterogeneity stems from at least three sources: (i) differences between the national level and the supranational level. A certain amount of ambiguity and opacity persists as regards the transfer of powers from the national to the supranational level; (ii) differences in terms of fair enough redistribution policies. Public opinion reactions to the migrants crisis, terrorist threats, or the UK and Italy referenda are not only anti-establishment protests, but also an indication that collective memory tends to remember costs rather than benefits of integration; (iii) differences between the narrow policy space and the lack of intervention instruments to withstand strong asymmetric shocks accentuate EA heterogeneity and hamper the correction of macroeconomic imbalances.

**f/ Problems related to moral hazard:** while EA/EU accession is subject to certain conditions, the stay therein is presumed unconditional and perennial. Since there is no clause for exiting the EA, it has been assumed that accession is perpetual, regardless of the level of policy, leading to some sort of behaviour that fed the illusion of a united EMU (Issing, 2016).

### 2.2. REFORMS IMPLEMENTED IN THE EURO AREA AND THEIR LIMITS

Post-crisis reforms of the EMU included measures implemented on four tiers: fiscal, structural, financial and banking, and monetary; these reforms have limits however.

**a/ Fiscal limitations**: a set of common fiscal rules are not enough for a genuine monetary union; moreover, apart from structural reforms in member states, what it takes is a common fiscal policy stance to take over the burden from monetary policy.

The fiscal issue remains critical for advancing the European Project; without political will[8] no headway can be made to deepen fiscal reform. It is not at all simple to shift from a set of common fiscal rules to a system of supranational common institutions (common treasury, European Fiscal Council (The Five Presidents' Report, 2015, the EC Reports on the future of Europe, 2017)) or even a European finance minister[9] (Enderlein and Haas, 2015). But the benefit would be huge, above all because it would remove the discretionary nature of national fiscal policies; this implies a EA budget to include those components directly linked to the business cycle – the so-called automatic stabilisers that cushion the impact of strong asymmetric shocks – and their being backed by an adequate fiscal stance.

**b/ Limitations to lasting economic recovery in the long term**: every monetary stimulus reached its limits and competitiveness must be the central pillar for real convergence over the medium and long term. The ECB's unconventional monetary policy can no longer serve as a substitute for national governments in implementing structural reforms. Even though the EA economy is in a recovery period, monetary stimulus measures have reached their limits.

**c/ Financial limitations:** *The Banking Union (BU) project is right on track, but remains incomplete without the political force to deal with fiscal issues.*

[8] See the example of the EC initiative of 16 November 2016 rejected by Germany: 'Towards a positive EA fiscal stance – supporting public investments that increase economic growth' intended for the countries with enough policy space to encourage an expansion in fiscal policy and investment policies (Pisanny Ferry, article by Bruegel, 2016).
[9] Enderlein, H., Haas, J., 2015, *What would a European finance minister do? A proposal*, J. Delors Institute, Berlin, available at http://www.institutdelors.eu/media/ministrefinanceeuropeenjdi-ben.pdf?pdf=ok

The first line of action to counter the effects of the crisis focused on management and intervention tools: The European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). The ESM faces two sets of problems in its functioning: (i) access problems – the temporarily cash-strapped Member States can access funds only after exhausting the levers related to a bail-in, paying out their contributions to the Single Resolution Fund(SRF), and fulfilling a number of ex-ante conditionalities in a macroeconomic adjustment programme; and (ii) limited financing/capitalisation problems.

The second line of action was aimed at strengthening institutional governance (e.g., ESM institutionalisation, the establishment of the European Systemic Risk Board (ESRB), adding single supervisory tasks to the ECB's tasks).

The most notable effort was the launch of the BU project (2012) with a view to dealing with the impending need to break the vicious circle between big financial conglomerates and the state and to speed up the fiscal union and the financial union by circumventing fiscal integration; the implementation of the BU project and the launch of the European Investment Plan were thought to be enough to cushion the impact of strong asymmetric shocks. The BU project made considerable progress[10], but is still far from complete.

**d/ Monetary limitations:** When the crisis erupted, the ECB had only one tool to achieve price stability, i.e. the short-term interest rate. To tailor to the new environment, the ECB needed to adjust its policy stance and tools, together with the internal governance model. The monetary easing programmes (QEs) since 2010 have supplemented, the EFSF and, later on, the ESM. The ECB played a crucial role in crisis management ('the only one game in town', El-Erian, 2016). Its actually limitless involvement ('whatever it takes'[11]) bought time, calmed down the financial markets and, thereafter, mitigated deflationary risks. But QEs are not devoid of unintended and undesirable effects.

Managing the cohabitation relationship between two stability goals is not an easy task for the ECB. The association of financial stability as a dual primary goal with price stability can impair the efficiency of central banks' policies However, when the crisis broke out, the EA was badly in need of restoring financial stability, and there was no other tool in institutional and legal terms than the ECB's involvement.

## 3. CONDITIONS FOR JOINING THE EURO AREA: FROM NOMINAL CONVERGENCE TO REAL AND STRUCTURAL CONVERGENCE

The financial crisis and the EA crisis have convinced many that EA accession is not desirable to be done irrespective of circumstances. Shortly after entering the EU, the new Member States in Central and Eastern Europe (CEE) evinced various outlooks regarding

[10] At present, the BU project is implemented for pillar 1 (Single Supervisory Mechanism) and partly for pillar 2 (Single Resolution Mechanism); from a legislative perspective, the ECB was tasked with assuming and exerting supervisory tasks, along with national supervisory authorities in the EA in virtue of Article 127 (6) in TFEU.

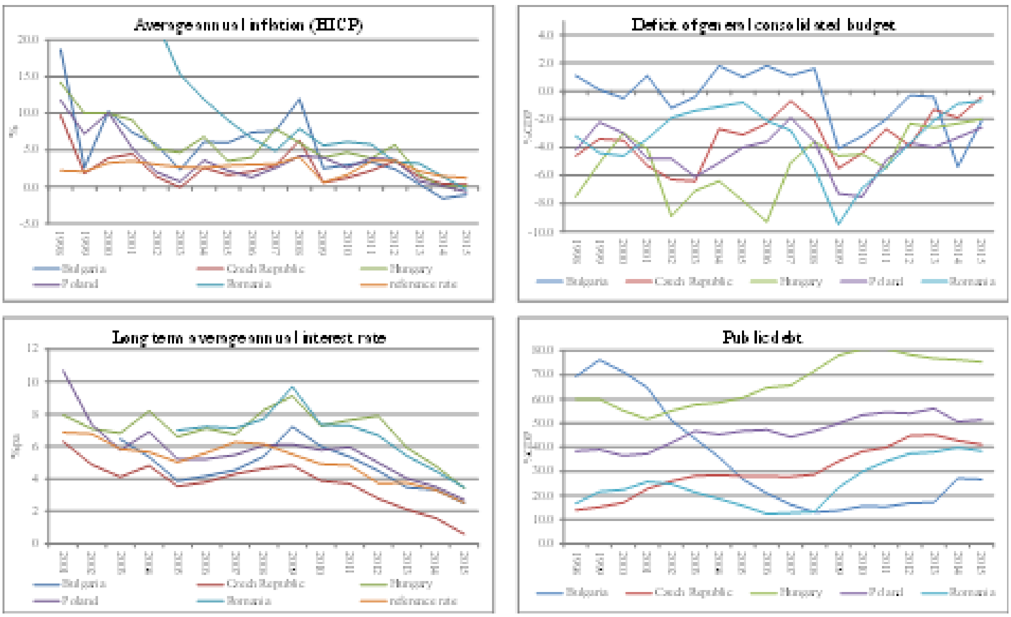
[11] Alluding to 'whatever it takes', as used by Mr M. Draghi, the president of the ECB, in his speech at the "Global Investment Conference", London, 26 July 2012. The complete quotation is: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough".

EA accession: either by stepping up institutional preparations (e.g., Hungary and Poland, the countries in the first EU accession wave, and Bulgaria, in the second wave), taking a steadily Eurosceptic stance (the case of the Czech Republic), or opting for moving targets for euro adoption (the case of Romania: 2014, 2015, 2019). Ironically enough, nearly all extra-EA Member States are now fulfilling (with few exceptions) the nominal criteria for entry into the EA when some EA members no longer fulfil them, at least not all of them. Currently, Member States that are outside the euro area have divided attitudes. As regards some real and structural convergence criteria, the issue is heavily debated, as in some cases considerable development gaps persist.

According to official reports, in 2016 the new EU Member States have fulfilled the criteria on price stability,  the convergence of long-term interest rates, government deficit, public debt (except Hungary) (ECB, 2016).

For Romania, to fulfil all the criteria consistent with the EC and ECB calculations (2016) is a breakthrough. According to previous Convergence Reports, Romania did not fulfil the criterion on price stability; the criterion on long-term interest rates has been fulfilled since 2014; as regards the public budget deficit, Romania faced the excessive deficit procedure between 2009 and 2013.

***Chart 3.1: Nominal convergence of CEE Member States***




*Source: Eurostat*

At this moment, the main concern relates to criteria that must be fulfilled in a lasting manner, not only at a particular point in time. Developments thus far indicate that most of the criteria were not fulfilled over most of the period since the EA was set up, and these criteria currently fulfilled does not warrant their future fulfilment (Chart 1). Although

Romania has attained the medium-term fiscal objective after 2013, the 2015-2016 fiscal easing measures put pressure again on the 3% public budget threshold and fuel external imbalances; they would also put public debt onto an upward path. Fiscal easing against the backdrop of economic recovery and closure of the output gap fuels inflationary pressures. In the absence of counteracting disinflationary pressures, they will surface once the effect of the tax cuts fade away. This will, in turn, put upward pressure on long-term interest rates.

### 3.1. ROMANIA'S REAL CONVERGENCE WITH THE EURO AREA

The current crisis has highlighted that the need for economic policies ensuring economic stability does not end after the euro adoption. According to the ECB's Annual Reports (ECB, 2015), countries that switched to the euro in 1999 or 2001 failed to achieve lasting real convergence, i.e. the progress made until 2008 was largely cancelled by the fall-out from the severe financial crisis and the EA crisis, whereas at the same time, across the EU28, a certain degree of real convergence had been recorded, mainly due to the catching-up in Central and Eastern Europe countries (CEE). Empirical evidence shows that there are no automatic mechanisms in the EA to warrant lasting real convergence for the countries already in the EA, owing mostly to institutional weaknesses, structural rigidities, poor productivity performance, and flaws in the design and policy arrangements across the EA.

*Sound, lasting real convergence* is a key prerequisite for the economies aiming to share the same currency and to withstand adverse shocks (ECB, 2015). A possible weakness of real convergence criteria could be that they are not explicitly mentioned in the EU Accession Treaty or another Treaty, which is why accession countries may or may not be stimulated enough to fulfil them or at least ensure a "critical mass" of real convergence.

One of the most widely used real convergence criterion is real GDP/capita at/adjusted for purchasing power parity (PPP). If prior to the crisis, CEE economies that had become EU Member States saw fast-paced growth, mainly amid the catching-up underpinned by massive capital flows from the EA, the current financial crisis depressed capital inflows and the growth path, highlighting major structural vulnerabilities and the need for massive macroeconomic adjustments in these countries.

***Table 3.1: GDP per capita*** ***EU28=100***

| | At purchasing power parity | | | | | | | In current prices (EUR) | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **EA 19 MS** | **BG** | **CZ** | **DE** | **HU** | **PL** | **RO** | **EA 19 MS** | **BG** | **CZ** | **DE** | **HU** | **PL** | **RO** |
| **2000** | 111 | 28 | 72 | 119 | 54 | 47 | 26 | 112 | 9 | 33 | 133 | 26 | 25 | 9 |
| **2001** | 111 | 29 | 74 | 118 | 57 | 46 | 27 | 112 | 10 | 36 | 131 | 29 | 27 | 10 |

| | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2002** | 110 | 32 | 74 | 117 | 60 | 47 | 29 | 112 | 10 | 40 | 128 | 34 | 26 | 11 |
| **2003** | 109 | 33 | 77 | 117 | 62 | 48 | 31 | 113 | 11 | 40 | 127 | 35 | 23 | 12 |
| **2004** | 108 | 35 | 79 | 117 | 62 | 50 | 33 | 112 | 12 | 42 | 125 | 37 | 24 | 13 |
| **2005** | 108 | 37 | 80 | 117 | 62 | 50 | 34 | 111 | 13 | 46 | 121 | 39 | 28 | 16 |
| **2006** | 109 | 38 | 81 | 117 | 62 | 51 | 38 | 110 | 15 | 49 | 120 | 37 | 29 | 19 |
| **2007** | 108 | 42 | 83 | 117 | 61 | 53 | 41 | 110 | 17 | 52 | 120 | 39 | 32 | 23 |
| **2008** | 108 | 45 | 81 | 117 | 63 | 55 | 48 | 111 | 19 | 59 | 122 | 41 | 37 | 27 |
| **2009** | 108 | 46 | 83 | 116 | 64 | 59 | 49 | 114 | 20 | 58 | 125 | 38 | 34 | 24 |
| **2010** | 108 | 45 | 81 | 121 | 65 | 62 | 50 | 112 | 20 | 59 | 126 | 39 | 37 | 25 |
| **2011** | 108 | 45 | 83 | 124 | 66 | 64 | 51 | 112 | 21 | 60 | 129 | 39 | 38 | 25 |
| **2012** | 108 | 46 | 82 | 125 | 65 | 66 | 54 | 110 | 22 | 58 | 129 | 38 | 38 | 25 |
| **2013** | 107 | 46 | 84 | 125 | 66 | 67 | 54 | 110 | 22 | 56 | 131 | 38 | 38 | 27 |
| **2014** | 107 | 47 | 85 | 126 | 68 | 68 | 55 | 109 | 21 | 54 | 131 | 39 | 39 | 27 |
| **2015** | 106 | 46 | 87 | 125 | 68 | 69 | 57 | 107 | 21 | 55 | 129 | 39 | 39 | 28 |

*Source: Eurostat, 2016*

In terms of real GDP/capita at purchasing power parity, Romania is still in a peripheral position relative to EU's advanced economies (Table 3.1). For instance, in 2000, GDP/capita in Romania was four times lower than EA average, half of that of Poland and Hungary, and 3 times lower than in the Czech Republic. By 2015, GDP/capita tripled, but remained well below both the EA average and the above-mentioned countries (Poland, Hungary, the Czech Republic). In relative terms (Table 3.1), Romania's GDP/capita at PPP went up from 26% (2000) to 57% of EU28 average (2015), but lagged far behind the Czech Republic (87%), Poland or Hungary (68/69%), and well below EA average (106%) or Germany (125%).

From the perspective of the average growth rate, Romania is faring quite well against both the EA average and its CEE peers. Thus, from 2000 to 2015, the pace of growth in Romania averaged out at 3.68% according to Eurostat, while the EA average was 1.18%. Seen from this point of view, Romania is closest to Poland, which, in the same period, grew at an average rate of 3.60%, while the Czech Republic and Hungary rose on average by 2.7% and 2.08% respectively.

Looking at these figures, it can be said that a major problem of CEE countries remains the large gap between their economic development and that of EA economies (GDP/capita, income/capita, average wage, etc.).

### 3.1.1. POTENTIAL GROWTH

The fall-out from the financial crisis on CEE countries was interpreted both as a spill-over effect and a shock that weighed on economic growth sources that proved unsustainable. Therefore, the need came up in these countries to speed up the pace of structural reforms in order to increase the economic growth potential and ensure lasting development. CEE economies grow currently at much slower rates than in the pre-crisis period. According to EC estimates, in Romania, the economic crisis caused the potential GDP growth rate to come down from 5-6% to arguably cca.3% (Table 3.2) (though it may be a little bit higher). Seen from the perspective of a massive drop in investment and weaker workforce participation in economic activity, Romania's growth potential has almost halved after the 2008 crisis. Economic policies underway have focused more on targeting macroeconomic indicators; for sustainable economic growth structural reforms and more investment are needed.

***Table 3.2: Potential GDP growth (reference year = 2010)***

| | Czech Rep. | Germany | France | Italy | Hungary | Poland | Romania |
|---|---|---|---|---|---|---|---|
| **2001** | 2.2 | 1.5 | 2.4 | 1.6 | 3.6 | 4.6 | 2.6 |
| **2002** | 2.6 | 1.4 | 1.7 | 1.3 | 3.7 | 4 | 2.7 |
| **2003** | 3.4 | 1.3 | 1.7 | 1.1 | 3.5 | 3.6 | 3.9 |
| **2004** | 4.2 | 1.3 | 1.9 | 1.3 | 3.6 | 3.5 | 4.9 |
| **2005** | 4.8 | 1.2 | 1.8 | 0.8 | 3.1 | 3.3 | 5.2 |
| **2006** | 4.5 | 1.4 | 1.7 | 0.8 | 2.6 | 3.4 | 5.9 |
| **2007** | 4.6 | 1.3 | 1.7 | 0.9 | 2 | 4 | 7.2 |
| **2008** | 3.9 | 1.2 | 1.5 | 0.2 | 1.2 | 4.2 | 6.7 |
| **2009** | 1.5 | 0.7 | 0.9 | -0.4 | 0.1 | 3.9 | 1.7 |
| **2010** | 1.4 | 1 | 1.1 | -0.4 | -0.3 | 3.9 | 1.2 |
| **2011** | 1 | 0.7 | 1.1 | 0.1 | -0.1 | 4.1 | 1 |
| **2012** | 0.4 | 0.8 | 0.9 | -1.1 | 0.1 | 3.5 | 1.7 |
| **2013** | 0.6 | 1.4 | 0.9 | -0.8 | 1 | 2.9 | 1.7 |
| **2014** | 1.4 | 1.5 | 0.9 | -0.7 | 1.9 | 3 | 1.9 |
| **2015** | 1.9 | 1.7 | 0.8 | -0.3 | 2.1 | 3.1 | 2.7 |
| **2016** | 1.9 | 1.9 | 1 | -0.2 | 2.1 | 3.2 | 3.1 |
| **2017** | 2 | 1.6 | 1.1 | 0.1 | 2.2 | 3.2 | 3.4 |
| **2000-2015** | 2.5 | 1.2 | 1.4 | 0.3 | 1.9 | 3.7 | 3.4 |
| **2000-2008** | 3.8 | 1.3 | 1.8 | 1.0 | 2.9 | 3.8 | 4.9 |
| **2008-2015** | 1.2 | 1.1 | 0.9 | -0.5 | 0.7 | 3.5 | 1.7 |
| **2015-2017** | 1.9 | 1.7 | 1.0 | -0.1 | 2.1 | 3.2 | 3.2 |

*Source: European Commission, CAAB, 2016*

One of the factors that proves crucial for ensuring real convergence of EA member states was the rise in total factor productivity (TFP). Once investment contracted, trend

TFP in Romania plunged, on average, from 4.3 in the period 2000-07 to 0.5 from 2008 to 2013, with low figures persisting into 2014 and 2015. The drop was considerably higher in Romania than in Poland, where TFP fell, on average, from 2.5 to 1.2 and 1.1 respectively, in Hungary, down from 1.9 to 0.2 and 0.3 respectively, or in the Czech Republic, down from 2.8 to 1.1 and 0.8 respectively (Table 3.3). The countries that relied heavily on capital inflows[12] prior to the outbreak of the crisis, such as the Baltic States and Romania, posted the sharpest declines in trend TFP after the crisis erupted. The drop in trend TFP in Romania can strongly be linked with the reduction in capacity utilisation; on the other hand, data on the sharp decrease in trend TFP also show that "creative destruction" (micro- and macroeconomic balance-sheet clean-up) was not sufficient during the crisis.

***Table 3.3: Trend TFP***

| | **2000-07** | **2008-13** | **2014-15** |
|---|---|---|---|
| **Austria** | 1.2 | 0.5 | 0.4 |
| **Belgium** | 0.6 | 0.2 | 0.2 |
| **Bulgaria** | 2.2 | 0.7 | 0.8 |
| **Czech Republic** | 2.8 | 1.1 | 0.8 |
| **Germany** | 1 | 0.6 | 0.7 |
| **Denmark** | 0.7 | 1.3 | 0.6 |
| **Estonia** | 2.3 | 0.7 | 1.1 |
| **Greece** | 2.4 | -0.8 | -1.3 |
| **Spain** | 0.2 | 0.8 | 0.7 |
| **Finland** | 1.8 | 0 | 0.2 |
| **France** | 0.8 | 0.4 | 0.4 |
| **Croatia** | 1.1 | -0.6 | 0.2 |
| **Hungary** | 1.9 | 0.2 | 0.3 |
| **Ireland** | 1.8 | 0.4 | 0.8 |
| **Italy** | 0.1 | -0.1 | 0 |
| **Latvia** | 3.6 | 1.2 | 1.5 |
| **Lithuania** | 3.7 | 1.5 | 1.6 |
| **The Netherlands** | 1.1 | 0.1 | 0 |
| **Poland** | 2.5 | 1.2 | 1.1 |
| **Portugal** | 0.4 | 0.9 | 0.9 |
| **Romania** | 4.3 | 0.5 | 0.5 |
| **Sweden** | 1.8 | 0.6 | 0.8 |
| **Slovakia** | 3.3 | 2.4 | 2.1 |

[12] In both public and private sectors.

| | | | |
|---|---|---|---|
| **Slovenia** | 1.7 | 0.4 | 0.3 |
| **UK** | 1.5 | -0.1 | 0.1 |
| **EU28** | 1.2 | 0.4 | 0.4 |

*Source: data processed from AMECO, EC databases*

### 3.1.2. PRODUCTIVITY, COMPETITIVENESS AND SOUND ECONOMIC GROWTH

What Romania needs is sound economic growth that does not entail major imbalances. In an environment where Romania's economic growth potential was severely hit by the current crisis, faster implementation of structural reforms and harnessing sustainable growth sources – investment in capital and technology, R&D and innovation, as well as healthcare and education – are the way ahead.

Romania's convergence with advanced economies lies with developments in productivity. In fact, one reason why wage earnings in Romania are so low is directly linked to labour productivity and efficiency of resource use. According to the latest statistics available, hourly labour productivity in Romania accounts for only 51.1% of EU28 average and labour productivity per person employed stands at 56.7%. The latter indicator saw its dynamics improving in the review period (surging steadily from 30.7% in 2000 to more than 50% in 2015). Nevertheless, it lags behind, for example, Hungary and Poland (both at 70%), well below the Czech Republic (about 80%) and much lower than the EA Core (above 100%).

## 3.2. ESTIMATION OF THE TIME NEEDED TO ENHANCE ROMANIA'S REAL CONVERGENCE WITH THE EURO AREA

Looking at the significant development gaps identified above for Romania both against the EA Core and CEE countries, a key question is whether Romania will be able to achieve convergence with the EA in terms of GDP/capita and especially how long it would take. To answer this question, the initial GDP/capita ratios and the average growth rates for the Romanian economy in the period 2000-15 were taken into account. In order to calculate the convergence period between Romania and the EA, the relationships between the initial GDP/capita ratios and the average annual growth rates of the two entities are considered, as follows:

$$Y_R = Y_{0R}(1+_{rmediuRO})^t \quad (1)$$

$$Y_{EA} = Y_{0EA}(1+r_{mediuEA})^t \quad (2)$$

where ($Y_R$) is Romania's initial GDP/capita ratio and ($Y_{EA}$) is that of the EA (Iancu, 2010). Convergence is achieved when the values of the two relationships above become equal, as

$$Y_{0R}(1+_{rmediuRO})^t = Y_{0EA}(1+r_{mediuEA})^t \quad (3)$$

By using logarithms and rearranging the terms, the time *(t)* needed for the convergence (equalisation) between Romania and the EA in terms of GDP /capita ratio based on PPP in euro is obtained:

$$t = \frac{(logY_{0EA} - logY_{0RO})}{\log(1+r_{mediuRO}) - \log(1+r_{mediuEA})} \quad (4)$$

Based on this formula, the time (years) that Romania needs to catch up with the EA, as well as with two of the frontrunners, i.e. France and Germany, is calculated. The hope that Romania will succeed in catching up with advanced economies is based on the assumption that the country will further post an average economic growth rate higher than that of the EA and the latter will expand at rates similar to the historical ones in the review period. The table below sets forth several scenarios on the number of years needed by Romania to catch up with the EA/or achieve a critical mass of 75% of the EA average, depending on various average annual economic growth rates.

***Table 3.4: Scenarios on the number of years needed to achieve real convergence with the EA***

| **Romania** ***versus*** | **3.68%** (100% EA average) | **5%** (100% EA average) | **3.68%** (75% of EA average) | **5%** (75% of EA average) |
|---|---|---|---|---|
| | | | | |
| **EA** | 27 | 18 | 13 | 9 |
| **Germany** | 33 | 21 | 21 | 13 |
| **France** | 26 | 17 | 14 | 9 |

*Source: the authors' calculations*

The results show that if the Romanian economy sticks to its average growth rate seen during 2000-15, it would equal the EA average in 27 years, and for reaching 75% of the EA average it would take 13 years. If the Romanian economy expands at an average rate of 5% per annum in real terms (on a sustainable basis), it would catch up the EA average within 18 years, and three-fourths of the EA average would be achieved by 2024.

EA accession does not require achieving the EA-wide average GDP/capita. As shown above, accession could be imagined after reaching 75% of the EA average and fulfilling key structural conditions.

The countries that switched to the euro after 2007 recorded a GDP/capita ratio in PPP terms relative to the EU28 average in the year prior to the changeover of 94% in Cyprus and 64% in Estonia. The Baltic States, where currency boards had been in place for many years prior to EA accession, have reached about 70% of the EA average and other countries (Cyprus, Slovenia, Malta, Slovakia) have accomplished approx. 80% of the reference value. Romania, in the authors' opinion, should target a GDP/capita ratio in PPP terms of at least 75% of the EA average by the time of accession. The Baltic States are not, arguably, a relevant case, given their size and the currency boards as monetary policy regimes prior to accession.

Although from 2000 to 2015 Romania witnessed the highest average annual growth rate among the countries under review, there are notable differences in terms of the GDP/capita ratio. In 2015, for instance, Romania's GDP/capita ratio stood at merely EUR 15,100 in PPP terms against the EA average of EUR 29,200, and EUR 33,900 in Germany and EUR 29,300 in France. Even against the Czech Republic (EUR 23,200), Poland (EUR 18,600) and Hungary (EUR 18,600), Romania's GDP/capita ratio is significantly lower. This is the reason why, according to calculations, for these countries to catch up with the EA, quite fewer years are needed than in Romania's case, even though their growth rates were lower than Romania's.

**Synchronisation of business cycles of Central and Eastern European countries with the Euro area**

If the economies participating in the monetary union are strongly interlinked and show similar responses to shocks, the need for monetary policy independence is low and the benefits of the common currency are likely to be reaped. In order to assess how synchronised business cycles of CEE countries and that in the EA are, several techniques are used; they capture aspects regarding the statistical correlation, the lag of the pass-through between business cycles in these countries, the persistence of business cycles, as well as the degree of synchronisation among them.

***Table 3.5: Correlation of business cycles with that in the EA***

| | **HP** | **BP** | **QT** | **PC1** | **HP** | **BP** | **QT** | **PC1** |
|---|---|---|---|---|---|---|---|---|
| | **Pearson Correlation** | | | | **Spearman Correlation** | | | |
| **Romania** | 0.63 | 0.51 | 0.76 | 0.63 | 0.53 | 0.41 | 0.67 | 0.53 |
| **Czech Republic** | 0.88 | 0.93 | 0.89 | 0.88 | 0.90 | 0.91 | 0.88 | 0.90 |
| **Poland** | 0.82 | 0.82 | 0.89 | 0.79 | 0.75 | 0.83 | 0.80 | 0.71 |
| **Hungary** | 0.81 | 0.93 | 0.68 | 0.74 | 0.73 | 0.90 | 0.64 | 0.62 |
| **France** | 0.94 | 0.97 | 0.93 | 0.95 | 0.89 | 0.94 | 0.89 | 0.90 |
| **Germany** | 0.95 | 0.98 | 0.87 | 0.94 | 0.92 | 0.98 | 0.81 | 0.92 |
| **Italy** | 0.96 | 0.96 | 0.96 | 0.96 | 0.94 | 0.94 | 0.96 | 0.96 |
| **Austria** | 0.90 | 0.95 | 0.88 | 0.92 | 0.81 | 0.92 | 0.84 | 0.85 |
| **Belgium** | 0.89 | 0.91 | 0.90 | 0.90 | 0.82 | 0.85 | 0.86 | 0.85 |
| **Greece** | 0.22 | 0.01 | 0.53 | 0.26 | 0.12 | 0.10 | 0.51 | 0.27 |
| **Spain** | 0.79 | 0.79 | 0.82 | 0.78 | 0.84 | 0.80 | 0.79 | 0.82 |
| **Portugal** | 0.66 | 0.65 | 0.70 | 0.66 | 0.70 | 0.66 | 0.70 | 0.71 |

*Source: authors' calculations*

***Table 3.6: Estimation of synchronisation via additional measures***

| | RO | CCH | PPO | HHU | FFR | DDE | AAT | BBE | SSP | PPG | GGR |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Highest correlation**<br>**Lead/Lag** | 0.70<br>1 | 0.88<br>0 | 0.67<br>0 | 0.74<br>0 | 0.95<br>0 | 0.94<br>0 | 0.92<br>0 | 0.88<br>0 | 0.78<br>0 | 0.66<br>0 | 0.26<br>1 |
| **Synchronisation indicator** | 0.6 | 0.76 | 0.71 | 0.62 | 0.95 | 0.92 | 0.94 | 0.89 | 0.80 | 0.75 | 0.56 |
| **Persistence**<br>No. of years when a one-unit shock remains above 0.5 | 0.90<br>1.5 | 0.91<br>1.5 | 0.88<br>1.25 | 0.94<br>2.25 | 0.89<br>1 | 0.87<br>1 | 0.85<br>0.75 | 0.87<br>1 | 0.95<br>2.75 | 0.92<br>1.5 | 0.96<br>3 |

*Source: authors' calculations*

The outcome confirms a very high correlation between business cycles of EA core countries and that of the EA as a whole[13]. Among the EA's peripheral economies, Spain displayed the highest degree of correlation with the EA in terms of business cycles[14]. By contrast, Portugal's business cycle was correlated at most 70% with the EA, while Greece was the EA's most divergent economy.

As for the CEE countries, the Czech economy was by far the most correlated business cycle-wise with the EA, with values of between 80 and 93%, higher than, for instance, those recorded by Portugal. Poland and Hungary posted relatively similar values, while Romania was the least correlated from among the CEE countries under review (41% and 76% respectively). Thus, according to the optimal currency theory, Romania would have the most to lose if it were to relinquish its own monetary policy.

**Structural convergence of Member States in Central and Eastern Europe with the Euro area**

As long as there are different economic structures, there will be different responses to common shocks. Therefore, an increase in the degree of structural convergence/having a critical mass of structural convergence in place *prior to* the entry of a country into the monetary union is a condition for reducing the likelihood of asymmetric shocks, while at the same time ensuring greater correlation of business cycles with the monetary integrated economies.

Structural convergence of CEE countries with that in the EA is assessed by employing three indicators, i.e. the Landesmann index, the Krugman index, and the structural asymmetry indicator In terms of the Krugman index, the boom in Romania fell short of reducing the structural divergence, while the slip into recession caused its expansion to near 53% in 2011, firming at around 40% from 2012 to 2015. The outcome shows that the Romanian economy has a quite different structure relative to the EA.

[13] Three of the leading core economies, i.e. Germany, France and Italy, reported correlation coefficients ranging from 93% to 99%.
[14] Correlation coefficients taking values from 79% to 84%.

Relatively high levels of structural divergence compared to the EA are also in the Czech Republic, but they are smaller than in Romania. The relative structural distance for the Czech Republic hovered around 35% from 2000 to 2013, but augmented to 40% in 2014 and 2015. Moreover, according to the Krugman index, there are structural differences compared to the EA in Poland and Hungary, but well below relative to Romania.

## CONCLUSIONS

At present, Romania fulfils all nominal criteria for EA entry. However, the financial and the EA crises have shown that a mere fulfilment of nominal criteria is far from being sufficient for a country to benefit from EA accession. Sustainable real convergence is a key condition for the economies aspiring to share the same currency and withstand adverse shocks.

The large development gap between Romania and the EA is the major hurdle on the way to euro adoption. The EA has already been grappling with a major heterogeneity problem. Wide economic performance gaps in the EA resulted in ever larger external imbalances which, in turn, entailed sovereign debt crises after governments took private debts over to public debt. In the absence of common instruments to cushion asymmetric shocks, development gaps within the EA lead to imbalances, as is the case with the current crisis, calling for extremely costly adjustments.

Besides the issue of economic gaps, the EA's functioning is also in need of new policy mechanisms and arrangements. These two overriding problems pinpoint the scale of risks associated with a premature EA accession.

An overriding factor to achieve real convergence is competitiveness. A faster increase of competitiveness would narrow the economic gaps.

What Romania needs is sound economic growth. In an environment where Romania's economic potential was severely hit by the financial crisis, faster implementation of structural reform and harnessing sustainable growth sources – investment in capital and technology, R&D and innovation, as well as healthcare and education of human capital – are avenues to move on.

Sustainable high economic growth rates are pretty hard to achieve under the circumstances taking shape in the European economy and the global economy. The spectre of a "secular stagnation" (Summers, 2014), the debt-overhang in the advanced economies, the cumbersome recovery of the EA economy, growing protectionism, etc. make up a complicated context. Therefore, domestic efficiency reserves have to be better made use of and there is need to shift to a new growth pattern.

EA accession does not require prior achievement of the average GDP/capita ratio in the EA. But EA accession can be imagined after reaching about 75% of the EA average and the fulfilment of a series of structural conditions, in conjunction with reforms of the policy arrangements in the EA.

The paramount stake for Romania's EA membership should not be if, but *under what terms* this will be achieved.

Apart from EA's inadequate functioning, this paper argues that the wide development gap between Romania and the EA is the main hurdle to adopting the single currency in the near future. A development strategy that should focus on steady productivity gains would be an alter ego of the process of joining the EA.

**The accession programme should include a number of objectives[15]:**

*Objective 1*: To narrow the real convergence gap: should the Romanian economy grow at an annual rate of 5%, according to our estimations, 75% of the EA average could be achieved in the period 2023-24. This does not imply that we suggest EA accession to be made based on a similar calendar, automatically. Because, not less important than the GDP/capita ratio are structural conditions. A relevant example comes in handy: if blatant income inequalities rise fast, GDP/capita becomes a largely irrelevant number. Moreover, EA accession does not imply full real convergence prior to it.

*Objective 2*: To fulfil a series of structural conditions: infrastructure development, increasing fiscal revenues to enlarge the "fiscal space", boosting competitiveness via improved production structure, such as higher-value added products (not via low wages), etc. The need to protect macroeconomic equilibria and limit external public debt is a paramount objective.

*Objective 3:* Entry into ERM2

*Objective 4*: Banking Union: joining the BU can precede EA accession, as well as the entry into ERM2.

*Objective 5*: Euro adoption. We think Romania should target a GDP/capita ratio in PPP of at least 75% of the EU average prior to accession.

EA accession should take place provided a sufficiently high degree of real convergence is achieved and major structural issues are dealt with. **Guidelines** for the Accession Strategy should be:

- improve the quality of institutions;
- operational ownership of programmes, policy ownership; it is worth underscoring here is the importance of protecting macroeconomic equilibria, i.e. sound public finances;
- an income policy that can reduce human capital exodus;
- strengthen the rule of law, which should prevent interest groups from embezzling public resources;
- the setting of priorities to be budgeted thoroughly (multi-annualy), until they are implemented;
- infrastructure development
- inclusive public policies to benefit the majority of citizens;
- the reform of the public sector, of state-owned companies;
- an institutional and regulatory environment supporting entrepreneurship, good business conduct; promotion of digitalisation in the economy, society;

[15] See also Isărescu (2016, 2017)

- to support general and vocational education; this sector must get at least 5% of GDP on a yearly basis;
- local capital must hold a larger share in strategic areas, including the financial sector; the Savings Bank (CEC) must be better capitalised, as well as Eximbank (that should turn into development bank, similarly to Germany's KfW);
- increase budget revenues to provide citizens with essential public goods (education, healthcare, basic infrastructure); current revenues are amongst the lowest in the EU (26% of GDP in 2016), showing large-scale institutional weakness, rent-seeking, bad practices in the corporate world (tax evasion and avoidance).

The economic policy mix must ensure a balance between efforts supportive of short-term economic growth and the implementation of broad-based reform measures that can reduce structural vulnerabilities of the economy (fairly poor efficiency of public investment, tax evasion, a low employment rate, social and economic disparities across regions, red-tape barriers to tapping European funds, etc.) and may foster productivity gains over the long term, sustainability of endogenous growth sources (infrastructure, education and healthcare, R&D, etc.).

The resilience of the Romanian economy to economic shocks needs to be strengthened. Romania must capitalize more on endogenous drivers of economic growth. A growth pattern that relies more on efficiency reserves and qualitative features is required.

Romania must get involved in rethinking how the Single Market works so as to benefit as many citizens as possible. Without inclusive economic processes that should feature, *inter alia*, more fairness and transparency, social cohesion will be increasingly damaged. EU Member States must put up a tough stance against tax evasion and tax avoidance, which also undermine citizens' confidence in democracy.

The European Union should not be idealized mythically; the reality is fairly nuanced and the "single market" exudes *rapports de force*, unfair competition frequently. The Union itself is at a crossroads and, unfortunately, the solidarity principle among the Member States often appears to be ignored. A big issue is a growing mistrust between governments and citizens, between governments and European institutions, between the latter, generally the elites, and citizens.

The bottom line is: European economies are faced with great challenges if we think about the drawbacks of over-financialisation, the fall-out from the financial and economic crisis, the threats posed by "secular stagnation", debt overhang, the perils of uncontrolled immigration, too skewed income distribution and erosion of the middle class, unethical conduct in business and politics, major threats and conflicts in EU's vicinities, terrorism, the need to reform EA design and policies, and, last but not least, the competition between liberal democracy and authoritarian capitalism.

The European Project is in need of in-depth reform; solidarity and accountability, common action so as to avoid getting mired into fragmentation and escape the dead-end street of a de facto dismemberment, which would send us back to an ugly past (Dăianu, 2017). EA accession must heed this extremely intricate and complex context.

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