

# EURO AREA ACCESSION: THE QUESTION IS UNDER WHAT TERMS!<sup>1</sup>

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## Abstract

Our paper contributes to the current debate with a discussion of a series of pre-conditions that we consider to be fundamental for making euro adoption commonsensical in economic terms: a/ the achievement of a critical mass of real convergence ex ante (before accession) and the fulfilment of a range of structural conditions, b) the reforms in the Eurozone which should make accession attractive to new member states. In addition, our analysis does not ignore the strategic (geo-political) imperatives which might hasten accession.

In our opinion, the Eurozone entry should mainly depend on the achievement of a critical mass of structural convergence, which should diminish risks to operate in a monetary union. 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 the region considered in terms of infrastructure, institutional development, business sophistication, and above all, innovation; it points out the scale of risks attached to a premature accession to Eurozone.

The euro adoption does not require the achievement of the euro area average level of GDP/capita. As we argue, one can imagine accession after having achieved 75% of the Eurozone average and the fulfilment of other structural conditions. Structural convergence analysis has to be nuanced.

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## 1. INTRODUCTION<sup>6</sup>

For Romania, it is vital that the European Project does not break up; it is also important that Romania joins the economic and political 'hard core' of the European Union (EU). This strategic target implies accession to the euro area (EA). Yet, accession to the EA that is set forth in New Member States' Treaties of Accession and the Treaty on the Functioning of the European Union (TFEU) should be a

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rational decision, considering the lessons of the past decades and formidable challenges facing the Union.

There are benefits of 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 leading European industrial networks, for which EU accession has paved the way. EA membership would also have a strong 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 be as fast as possible is to be examined cool-headedly, not pathetically.

Most important lessons of the EA crisis are: the euro area has achieved a more in-depth 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 have now 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<sup>7</sup> 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 should not be overlooked – this is usually referred to as a 'battle of ideas': 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 that advocates joining the EA as soon as possible. One argument is 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 similarity is debatable, considering the big differences between the Union and the EA in terms of the economic policy toolkit. And why would it be more relevant for citizens EA accession 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 an external 'stick'. But a country is not accepted into the EA in order to be 'disciplined'. Moreover, it is intimated, be it unintentionally, that Romania is congenitally incapable of advancing by its own efforts. This line of thought is neither acceptable from a moral point of view, nor in cognitive terms.

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?

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<sup>7</sup> The 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 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 is relatively easy to take. Another eligible country would be Croatia, where euroisation is upwards of 90% of total transactions. But in Romania the share of leu-denominated transactions in the total figure has steadily been increasing amid the dramatic fall in inflation and interest rates, which is not a bad thing after all and eats into the strength of euroisation argument.

There is also a 'political' and 'geopolitical' rationale for a fast accession into the EU's hard core, i.e. the EA, 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 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 again discussed.

When it comes to EA accession, two issues are of paramount importance: a/ whether the local economy requires a critical mass of resilience ex-ante; and b/ whether the EA is properly functioning, which encourages a Member State to join.

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 conjunctures, but facts, i.e. the experience of some economies that were not fit on EA accession date (Spain, Portugal, Greece, etc.). It is widely acknowledged that political reasons prevailed in taking these countries aboard. Some even formulated the thesis that convergence will take place inexorably sooner or later. The GDP/capita ratio relative to EA average increased in most of the EA periphery, but structural convergence was weak, ending up in major imbalances that called for broad-based corrective measures. This is a reason for an increasing attention paid to optimal currency area (OCA) convergence. Currently, Romania has a GDP/capita of approximately 25-26% relative to the exchange rate and 55-56% of the EA average in purchasing power parity terms; it is too little. Furthermore, the Romanian economy has to surmount large structural gaps; the country also has considerable internal regional gaps. But country joins the EA as a whole, not piecemeal.

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 cut in wages and other income, as the case may be. As the EA crisis and other turmoil episodes (in Asia, for instance) have showed large external imbalances are due to private sector over indebtedness. This was the case in Spain, Ireland, even Portugal. Greece is under scrutiny because of its huge public debt (even after the haircut), but the troubles of other EA members are largely associated with private sector's debt overhang.

Why the private sector is facing external debt overhang? Because, as economics textbooks point out, capital flows from where it is saved to where it is "required" and where related yields seem to be higher. This capital was prevalingly channelled towards non-tradeables sectors, which were incidentally profitable, due to soft lending conditions, an incomplete common market and imperfect competition. The possibility of rent seeking has a detrimental impact on productivity dynamics by turning the capital away from more productive uses. This is the big problem of the

real convergence gap. The above-emphasized countries have posted a capital/capita stock lower than the North, thus inviting capital inflows. 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 it falters the argument that big development gaps make no difference, 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. In a world of perfect competition and factor price equalisation, this can occur. But competition is imperfect and imbalances are part of reality. And factor price equalisation can occur over the long term, with large groups of winners and losers; this is where the strong negative reaction to borderless globalisation around the world (and Europe) comes from.

One would say that, in light of the lessons from the current crisis, the solution is to take macro-prudential steps on capping credit to the private sector. It is not at all clear whether these instruments will be sufficient. Moreover, it may also be assumed that new governance rules in the EA and the Union in general could limit those gaps decisively. These rules however are not properly tested. Furthermore, there is no euro-area-wide policy stance to alleviate a deflationary bias – the result is a current account surplus of the EA close to 3% of GDP, and currently 9% of GDP in Germany.

The convergence gap relates not only to the issues mentioned above. In countries with an income/capita ratio considerably lower than the EA average, the inflation differential is likely to be significantly positive. This means that, in time, unless there are substantial productivity gains, external imbalances would widen. Once a country becomes a EA member, the degrees of freedom in terms of correcting disequilibria go away. The larger the structural differences between the economies are, the more uncertain the capacity to react becomes.

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. EA is arguably more of a single currency area (an area sharing a common currency similar to the gold standard system in the inter-war years). 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. Even Rey's argument is not, in our opinion, a decisive one in accepting the EA's faulty functioning. The authors hold that the European Stability Mechanism (ESM), the Banking Union (BU) and other instruments introduced after the EA crisis outbreak have not dealt with the core problems; hence additional reform measures are needed. The reform proposals put forwards by the EC in May 2017 are steps in the right directions.

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 fantasize 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, goes 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. It has to be said that Romania would join the EA if it is accepted, not merely because the authorities in Bucharest feel like joining. The country may, however, join the Banking Union (BU) prior to gaining EA membership, considering financial markets integration in the EU, the massive presence of European banking groups in Romania and the close cooperation between local dedicated institutions (NBR, Financial Supervisory Agency) with European institutions within the European System of Central Banks (ESCB), and the new architecture of regulating and supervising financial markets (EBA, ESMA, EIOPA, ESRB).

What Romania needs is in-depth structural reform, 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 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 may be an *alter ego* to EA accession and may prove successful.

EA accession can be hastened for geopolitical reasons. This choice, however, must be a rational one, based on as many economic data and judgements as possible. EA accession entails a deep understanding of what is going on in the EA, in the global economy.

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, a blueprint of a EA accession strategy is set out mainly with focus on Romania.

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

The euro is the result of a project with a prominent political dimension. Hence, the EMU was born even though it did not follow basic recommendations of the optimum currency area (OCA) theory, neither did it heed lessons that other currency unions have taught along 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). 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<sup>8</sup> via multiple empirical studies. The **benefits**<sup>9</sup> of joining the EA can be summed up as follows:

- credibility of the ECB and of 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<sup>10</sup> following the cut in transaction costs and the removal of the exchange rate risk. However, it should be mentioned that some analyses show that, after the euro changeover, intra-euro area trade rose, on average, by approximately 5-10% (Baldwin 2006, Baldwin et al, 2008), way lower than the initial estimate of 85% (Rose, 2000);
- improved financial integration (EMU effect on FDI stood at 7%; Petroulas, 2007) thanks to lower risk premium and, implicitly, capital cost. Credit and market mechanisms of risk sharing have helped cushion shocks in certain countries or sectors;
- EA's greater resilience to external shocks than that of most of individual EU Member States. 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); and
- the political gain from closer economic cooperation between EA members.

But EA accession implies **costs** deriving from relinquishing the national currency, 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;

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<sup>8</sup> 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.

<sup>9</sup> Paragraphs taken from the homonymous work prepared by the four authors under the aegis of the European Institute in Romania, as part of the 2016 SPOS strategy and policy project.

<sup>10</sup>Havranek (2010) shows that the effect of euro introduction on trade between EA Member States is not statistically significant and is highly likely to be lower than 5%. Glick and Rose (2015) revised the study by Rose (2000), showing that the results of that work are sensible to the econometric specification of the model. Based on this outcome and the differences between the results of various individual studies, the finding was that the effect of the currency union on trade cannot currently be estimated in a robust manner.

- free capital movements (following current account liberalization) helped hide economic policy and structural weaknesses, as well as a build-up of imbalances; and
- the absence of a lender of last resort (de Grauwe, 2011). The central bank of a country with its own currency can buy the public debt when private lenders refuse to, which makes a local currency debt crisis less likely. In a currency area a debt crisis is more likely (Spain versus the United Kingdom, although the former's debt is lower than the latter's) since a liquidity crisis could turn into a solvency crisis.

In its decision on EA accession Romania must consider: **1/** developments in the countries that formed the EA in 1999, **2/** whether the Maastricht criteria have proved sufficient to ensure economic growth and employment, and **3/** how things stand in terms of the features supported by the OCA theory, which once they are fulfilled increase benefits/reduce costs associated with the euro adoption, without ignoring that the EMU has a major political dimension.

## 1.2. FINDINGS ON THE FUNCTIONING OF EURO AREA

Observing the Maastricht criteria<sup>11</sup> it was believed to prompt EMU countries to pursue prudent fiscal policies aimed at containing the incidence of asymmetric shocks and 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. Reaching the 3%-of-GDP deficit target would have allowed stabilising a 6% decline in GDP (Benassy-Quéré, 2015). Even though fiscal expenditure was back then treated as a risk to the union's stability, 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:

- the income gap 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. Frieden (2016) showed that even the history of establishing the American monetary union was marked by similar differences of economic interests between the fast-growing regions (in favour of expansionary monetary and credit conditions, namely low interest rates, soft regulatory standards and, eventually, more aggressive government spending ("easy money")) and the more stable and more advanced regions (advocating lower inflation, tighter monetary policy and lower government spending ("hard money")). The US experience suggests that the evolution of the monetary union hinges on harmonising such diverging interests.

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<sup>11</sup> In 1986, the Single European Act was enacted. It was aimed at putting in place a common market in the countries participating in the European Single Market. The Delors Report, which laid the foundation for the monetary union was approved in 1989. The Treaty of Maastricht was approved in February 1992 and the single currency, the euro, was announced by Austria, Belgium, Germany, Finland, France, Italy, Ireland, Luxembourg, the Netherlands, Spain, Portugal (EA11) in January 1999.

- 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. By the outbreak of the global financial crisis, EA functioning generated economic growth based on closer trade ties, flows of capital, from the rich countries to the less affluent countries, which allow the latter to save less, invest more and bridge the gap against the EA. But this was not the whole story. 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) grew at the slowest annual pace (Spain and Portugal, Greece): 0.9%.
- over the same period, non-euro area 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 why:
  - 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 further by the countries with high income gaps. And the persistent departure from the inflation path entailed low real interest rates and a higher real exchange rate. It appears that, when inflation is higher and the long-term interest rate on the sovereign debt is lower by more than half of a percentage point above the ECB's inflation target, as it persistently occurred in the countries facing major problems after the financial crisis broke out, the single monetary policy is not adequate and domestic and external imbalances build up.
  - the single monetary policy was not 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 appreciated, jeopardising tradeable competitiveness. Domestic devaluation remained the only means to bring the external balance back into equilibrium. And the fact that nominal interest rates stood at zero spelled wage cuts.
  - prior to the crisis the market 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 caused 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, actually a gradual, 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 threatened payment default. Adjustment problems turned into fiscal emergencies. In the aftermath of the crisis, the SGP criteria appear to stymie the symmetric adjustment mechanism, as they offset austerity in the countries that sought financial assistance with a fiscal stimulus in the rest of EA, which could facilitate the whole of EA being mired in recession.
- private sector debt overhang and the relationship with external deficits were underestimated. The absence of joint bank supervision and resolution exacerbated the financial cycle in the countries recording income large gaps and limited the risk-sharing potential during a downturn. Private sector indebtedness built up swiftly, most notably in the countries that subsequently faced problems. Between 2003 and 2008, financial intermediation rose by 80% in Ireland, 70% in Spain and 30% in Portugal, starting from already high levels.
- free capital movements 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 contributed to faster build-up of external deficits. The case of Spain (Otero-Iglesias, 2016) shows that banking system regulators need counter-cyclical intervention tools to offset the inadequate effects of the single monetary policy and resolution plans to enable fast intervention. To identify the problems and take early action is essential to curb rescue costs.
- the current bail-in resolution mechanism for credit institutions is not a solid insurer against a systemic crisis encompassing large institutions with cross-border activity. Bank supervision is as important as regulation, and shared supervision is not effective because either the standard requirements differ among regulators or after the shared supervision some areas could be left uncovered.
- 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. This was the case in Portugal, and threatened Italy, Spain and Belgium as well. The vicious circle between banks and sovereign countries is indicated by sovereign debt that is further a zero-risk asset and is accepted by the ECB as collateral. For this reason, after applying sterner rules on capitalisation, banks' interest in holding sovereign debt in their portfolios increased.

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

The second prerequisite for Romania's 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.

### 2.1. WHAT IS WRONG WITH THE EURO AREA; KEY VULNERABILITIES

The EA is afflicted by a number of problems that weaken its architecture and functioning<sup>12</sup>:

**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 (signalled in a steadfast manner)<sup>13</sup> that built up and aggravated over time. For decades people fed on the Monnet thesis<sup>14</sup> of a gradualist approach to integration: although the European Project was incomplete and dogged by internal crises, the effects of integration was hoped to be rather constructive than destructive<sup>15</sup>, meaning that it could trigger Monnet-type gradualist chain reactions (PadoaSchioppa, 2004, Spolaore, 2015) for further integration. After the crisis broke out, economic integration proved rather a substitute than a complement of political integration (Fabrinni, 2016). For the first time, the Five Presidents' Report (2015, p. 5) formally confirmed 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 interconnection between these countries, integration could not proceed automatically; the more so as there were no precise long-term targets such as to boost competitiveness, narrow structural gaps, nor any instruments to support fiscal transfers and, hence, the bringing together of diverging structures. 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 opted, driven by political reasons, for fiscal integration limited to the SGP alone. The consequences of

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<sup>12</sup>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](https://ec.europa.eu/info/strategy/european-semester/european-semester-timeline/setting-priorities_en)

<sup>13</sup> See MacDougall Report (1977), Barre Report (1969), Werner Report (1970) and Delors Report (1989).

<sup>14</sup>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.

<sup>15</sup> "incompleteness is not a bug but a feature", Spolaore, 2013, p. 10.

a weak SGP were manifest in terms of both correction, when 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, and prevention, since for want of political will an optimum level of disciplining national fiscal policies to prevent pro-cyclical policies could not be reached (Wallace, 2016). 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, stabilise the economy over several cycles and, ultimately, pave the way for fiscal sustainability.

**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 the over-banked European financial and 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). Breaking the vicious circle between the banking system and sovereign national authorities and debunking the myth of 'too big to fail' syndrome indestructibility can no longer remain only a task incumbent upon national competent authorities, or an objective "hanging" between the national level and the supranational one; and it can no longer be confined to macro-prudential measures.

**e/ Problems related to institutional governance:** EMU heterogeneity stems from at least three sources: (i) differences between the national level and the supranational level has unjustly marginalised Europe's utmost public good: peacekeeping, owing to a policy of consensus and compromise between national and supranational institutions. But a certain amount of ambiguity and opacity persists as regards the transfer of powers from the national to the supranational level (and vice versa), because what can be called as "subsidiarity principle in reverse" (Dăianu, 2015) shows how many obstacles heterogeneity can entail to implementing Union rules; (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; it is considered that, via more evenly distributed policies, more European public goods<sup>16</sup> could have been generated, and these could, in turn, have strengthened confidence in the European

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<sup>16</sup> Examples of European public goods: integration policies (e. g. the single market), EU-wide objectives (Europe 2020 Strategy), investment policies (Common Investment Fund), energy and environment policies, foreign and domestic security policies (border control, protection of ownership rights, etc.), labour market policies, etc.

Project (James, 1997, Sandbu, 2016, Korski, 2016) and (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, particularly in the case of large (sometimes huge) debts<sup>17</sup>.

**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 and the EU, 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). Here are a few examples: (i) lack of sanctions – repeatedly bending the rules, even by the founding members, was not punished, thereby prompting other Member States to exhibit even more fiscal pro-cyclicality and recklessness; (ii) the myth that ‘Europe will be built on money or it will not be built’ (Rueff, 1950) – the crisis confirmed how illusory the above-discussed thesis was, namely the one regarding the efficiency of the single monetary policy applied to a heterogeneous group of countries; and (iii) living in debt and the illusion of fast, easily-achieved wealth, at financing costs comparable to those in Germany.

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

Post-crisis reform of the EMU included measures implemented on four tiers: fiscal, structural, financial and banking, and monetary; they are likely to be sub-optimal in managing a future crisis.

**a/ Fiscal limitations:** a set of common fiscal rules and a new institutional architecture are not enough for a monetary union deepening; moreover, what it takes is a common fiscal policy stance to take over the burden from monetary policy.

The top priority in the fiscal realm was to strengthen coordination of national fiscal policies, considering that automatic stabilisers would be used for cushioning powerful shocks; other priorities were aimed at the management of structural issues (EA sub optimality), control and redress macroeconomic imbalances that affected EMU functioning. Indeed, EA members agreed and implemented a set of common fiscal rules which, however, need to be adjusted further, particularly in the implementation stage. A case in point is the European Semester: despite some clearly-cut benefits<sup>18</sup> in terms of coordination and disciplining national fiscal policies, more challenging appear to be the issues pertaining to the implementation of common national rules – a fuzzy, non-transparent system of penalties; indicators targeting more the structural component rather than the cyclical component of the fiscal deficit of some Member States, the inappropriateness of one-size-fits-all policies, etc. Since 2016, attempts have been made for a strategic change in the priorities of the European Semester and for a diversification by specific areas

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<sup>17</sup> Special mention deserves the fact that ultra-low interest rates and low inflation additionally weaken the efficiency of monetary policy as a growth-enhancing instrument.

<sup>18</sup> E.g., a firm calendar for planning fiscal policies, new preventive instruments such as the Macroeconomic Imbalance Procedure, Fiscal Treaty and the 6-pack, or the Guides to integrated economic and social policies, improved coordination between finance ministers and the EC in preparing draft budgets, a common decision-making process.

(economic, social, labour market), but it is too early to assess the impact of these changes.

The fiscal issue remains critical for furthering the European Project; without political will<sup>19</sup> 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<sup>20</sup> (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 the 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 major obstacles to economic growth and, thus, fostering real convergence are of a structural nature; investors' weak appetite for European assets has, in turn, structural roots. There are not only obstacles on the supply side (ageing population, cross-border legal, investment and fiscal frameworks, etc.) (De Galhau, 2016); challenging are mainly the discretionary national policies whose effect decreases insofar as they are not tailored to market conditions. If the structural reform-fiscal policy-monetary policy triangle (Draghi, 2016) shifts from the classic tone (output-labour-markets) to a broader approach, then we can reach a mutual reinforcement of policies and a greater appetite for reforms (a friendly tax and entrepreneurial environment and fairer income redistribution policies, institutional reform, etc. (La Silva, 2016)).

However, the ECB's unconventional monetary policy can no longer serve as a substitute for the national governments in implementing structural reform. Even though the EA economy would resume a steady growth path, monetary stimulus measures have reached their limits.

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

The first line of action to counter the effects of the crisis focused on management and intervention tools. The European Financial Stability Facility (EFSF) was difficult to access and featured an insufficient amount of resources. It was opted later (2012) for replacing it with a new tool for direct bank recapitalisation, the current ESM. This mechanism, however, has two faults in its implementation: (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

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<sup>19</sup> See the example of the EC initiative of 16 November 2016 rejected by Germany: 'Towards a positive euro area 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).

<sup>20</sup> 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/ministrefinanceeuropéenjdi-ben.pdf?pdf=ok>

the 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).

Nonetheless, 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 the big financial conglomerates and the state and to speed up the fiscal union and the financial union by circumventing the fiscal fundamentals; the implementation of the BU project and 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<sup>21</sup>, but is still far from complete. Work is now underway on a set of adequate mechanisms for the common management of risks that feed through fiscal and financial channels simultaneously. Yet, here political motivation intervenes, because financial risk management hinges directly on agreeing on a single deposit protection scheme (EDIS, the third pillar of the BU project) and the project of capital market union, and fiscal risk management depends on further fiscal instruments (Regling, 2016), such as the Rainy Day Fund, the European Scheme for Unemployment Insurance, or even a European finance minister (EC Report, 2017b).

**d/ Monetary limitations:** financial stability in the EA remains fragile if monetary policy lacks support in case of a new crisis.

When the crisis erupted, the ECB had only one tool to achieve price stability, i.e. the short-term interest rate. It was difficult, if not impossible, for the ECB to engage with a single tool in a complex and complicated situation and, simultaneously, get effective results in stabilising the EA foundations. To tailor to the new environment, the ECB needed to adjust its policy stance and tools, together with the internal governance model.

From the perspective of the ECB's monetary policy framework, monetary easing programmes since 2010 until the present day have supplemented, in a timely and efficient manner, 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'<sup>22</sup>) bought time, calmed down the financial markets and, thereafter, mitigated deflationary risks, but helped European leaders circumvent the fiscal solutions in managing the crisis.

Managing the relationship of cohabitation between two stability goals was not an easy task for the ECB. The association of financial stability as a dual primary goal with price stability can affect the efficiency of monetary policies' contribution to achieving financial stability, and the price stability goal. However, when the crisis

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<sup>21</sup> 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.

<sup>22</sup> 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 was: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough".

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.

As for tailoring the ECB's internal governance to the new reality, either the assumption of the macro-stability mandate, by resuming the means and instruments of administrative control over credit and the related potential systemic risks, or the single supervisory task, doubts still persist about the implementation of macro-prudential and single supervision decisions. It is true that there is now a Chinese wall (Schlosser and Laffan, 2015, p. 2) separating the supervisory function from the monetary policy function, but one question arises: how effective will it be in case of a future crisis?

### **3. CONDITIONS FOR JOINING THE EURO AREA: FROM NOMINAL CONVERGENCE TO REAL CONVERGENCE<sup>23</sup>**

EA convergence criteria should be the ultimate economic test to assess preparedness of an economy for joining this union. The Treaty of Maastricht does not set forth a firm calendar for the changeover to the euro, leaving this process to be implemented as each country chooses, in cooperation with the EC and the ECB. The Treaty provides, however, that each Member State has to reach lasting convergence to participate in the final stage of EMU. In other words, apart from fulfilling the nominal convergence criteria, EMU entry also requires the achievement of other criteria, referred to as real convergence criteria, which are not formally defined by the documents for EA accession, but have to be fulfilled by virtue of the catching-up process.

The financial crisis and the EA crisis have convinced many that EA accession is not desirable to be done whenever and anyhow. Shortly after entering the EU, the new Member States in Central and Eastern Europe (CEE) voiced various options regarding the preparation for the euro 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, most new CEE Member States that are outside the EA have taken a wait-and-see attitude, postponing the decision on joining. On the other hand, as regards some real and structural convergence criteria, the issue is heavily debated, as in some cases considerable gaps persist.

According to official reports, in 2016 the new CEE Member States have fulfilled the criterion on price stability, the criterion on the convergence of long-term interest rates, the criterion on government deficit, the criterion on public debt (except Hungary)<sup>24</sup> (ECB, 2016). Although none of the CEE countries participates in ERM II, the daily change in the exchange rate of their currencies against the euro compared to the level in the period from May 2014 to May 2016 remained within the

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<sup>23</sup> Paragraphs taken from the homonymous paper prepared by the four authors under the aegis of the European Institute in Romania, as part of the 2016 SPOS strategy and policy project were taken.

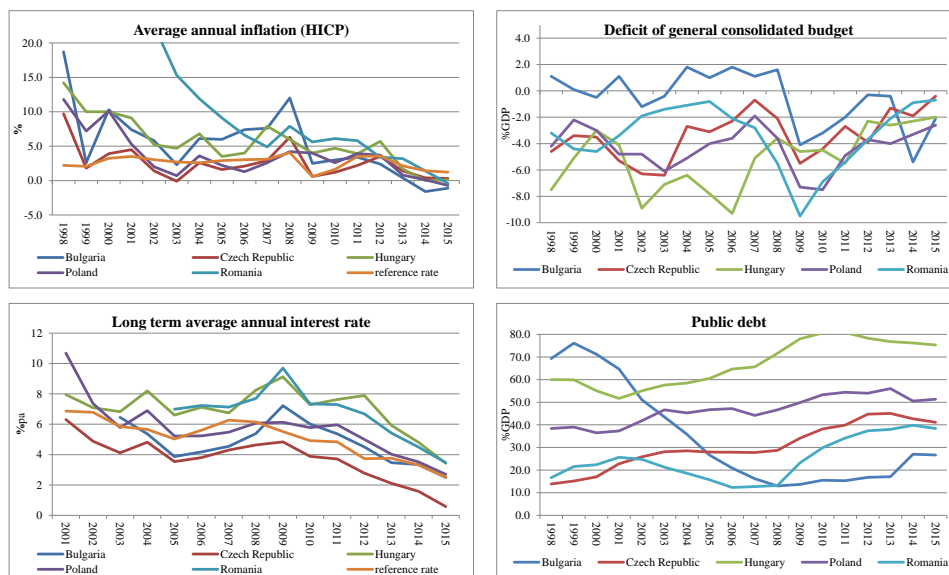
<sup>24</sup> The review period is May 2015-April 2016.

range (-2%, +3%)<sup>25</sup> in the case of Romania, whereas Poland recorded wider swings (-5%, +8%).

For Romania, to fulfil all the criteria consistent with the EC and ECB calculations (2016) is a breakthrough. According to the 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. On the other hand, the current macroeconomic stability has been achieved painstakingly. The expansionary drive, well above the economic growth potential in the period prior to the financial crisis, and went hand in hand with the build-up of imbalances which, once corrected, wiped out earlier income gains. Romania took six years to recover the 2008 income levels.

At this moment, the key 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 implementation of the 2015-2016 fiscal easing measures is estimated to push the deficit-to-GDP ratio beyond 3% and to 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 VAT rate cut fades out. This will, in turn, puts upward pressure on long-term interest rates.

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



Source: Eurostat

<sup>25</sup> Negative (positive) levels indicate depreciation (appreciation).



### 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 CEE countries. 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.

The EA crisis has thus underscored severe structural and institutional weaknesses of certain countries participating in the EMU. Those economies (Portugal, Ireland, Greece, Spain) posted high growth rates prior to the crisis, but all of them reported abrupt and significant declines in real GDP per capita after the crisis broke out. For these reasons, the key factors proving crucial in achieving real convergence of EA members are macroeconomic stability (sound public finance in particular), resilience of the economy, a rise in total factor productivity (TFP), economic integration of EA members, the capacity of national policy instruments to prevent speculative bubbles (ECB, 2015).

Real convergence has, however, several *dimensions*, which is another important lesson to be drawn from the current crisis. It must be analysed both from a quantitative perspective (actual level or speed of convergence) and a qualitative perspective (potential sources of economic growth, e.g. total factor productivity, the key source of a country's convergence process). The broader view to analyse a country's real convergence with the EA arises from the need for a sound, *lasting* real convergence based on strong economic, not one-off, fundamentals, representing perhaps one of the most important lesson drawn from the EA crisis for the EA candidate Member States.

*Sound, lasting real convergence* is, thus, 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. Another weakness is that it is not clear what are the indicators best quantifying the level of real convergence of these countries with the EA.

One of the most widely employed real convergence criterion in dedicated literature 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 at PPP 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. In 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 one of the major problems of CEE countries remains the large gap between their economic development and that of EA economies (GDP/capita, income/capita, average wage, etc.). The crisis showed that these differences matter most in currency unions because of negative externalities that the underperforming economies may generate across the area as a whole and due to the (EMU) lack of instruments to cushion asymmetric shocks. At present, the EA already has a large heterogeneity problem. During the crisis, the great differences in terms of economic performance between the countries fuelled ever increasing external imbalances, which in turn led to sovereign debt crises after governments chose to include private debt into public debt. For want of common tools, the intra-EMU development gaps appear set to create imbalances, as they did during the current crisis, or will persist, unleashing a detrimental impact on the monetary union functioning.

### 3.1.1. POTENTIAL GROWTH

The fall-out from the 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 arose in these countries to speed up the pace of structural reform in order to increase the economic potential and ensure lasting development. One of the highest costs of the 2008 financial crisis related to economic growth sources. The IMF's spring 2016 report emphasises that the CEE economies grow at much slower rates than in the pre-crisis period<sup>26</sup>. This is one of the possible reasons for the slow income convergence relative to the advanced economies in the EU. Other issues highlighted in the IMF's report refer to: quality of institutions, easier accesses to financial services and improvements in governance, so that productivity and competitiveness of the economies in the region to rise, helping to boost growth (IMF, 2016).

In Romania, the economic crisis caused the potential GDP growth rate to come down from 5-6% to 2.5-3% (see footnote 23) (Table 3.2). Seen from the perspective of a massive drop in investment and weaker workforce participation in economic activity, Romania's growth potential has, arguably, halved after the 2008 crisis. Moreover, as the major economic policies underway focused more on targeting macroeconomic indicators rather than implementing necessary structural reforms, the exit from the crisis was not accompanied by a return to 2000-08 potential growth rates. Even if GDP rises at rates higher than 4%, it should not be ignored the fact that Romania expanded at annual growth rates of 5 to 6% in the period 2005-08, pinpointing the need for a pick-up in the pace of structural reform to spur sustainable economic growth: investment in capital and technology, R&D and innovation, as well as healthcare and education.

*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

<sup>26</sup> It is worth noting that those rates were not sustainable and, thus, a downward correction could not be avoided. A bad thing is when an economy, after an unavoidable correction, grows below potential for a long time, which may have a detrimental bearing on production factor quality (the so-called hysteresis effect).

<b>2000-2015</b>	2.5	1.2	1.4	0.3	1.9	3.7	3.4
<b>2000-2008</b>	3.8	1.3	1.8	1.0	2.9	3.8	4.9
<b>2008-2015</b>	1.2	1.1	0.9	-0.5	0.7	3.5	1.7
<b>2015-2017</b>	1.9	1.7	1.0	-0.1	2.1	3.2	3.2

Source: European Commission, CAAB, 2016

One of the factors that proved crucial for ensuring real convergence of EA members 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<sup>27</sup> prior to the outbreak of the crisis, such as the Baltic States and Romania, posted the sharpest declines in trend TFP during and after the crisis. The drop in trend TFP in Romania during and after the crisis can strongly be linked to the reduction in capacity utilisation rate; on the other hand, data on the sharp decrease in trend TFP also shows 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
<b>Austria</b>	1.2	0.5	0.4
<b>Belgium</b>	0.6	0.2	0.2
<b>Bulgaria</b>	2.2	0.7	0.8
<b>Czech Republic</b>	2.8	1.1	0.8
<b>Germany</b>	1	0.6	0.7
<b>Denmark</b>	0.7	1.3	0.6
<b>Estonia</b>	2.3	0.7	1.1
<b>Greece</b>	2.4	-0.8	-1.3
<b>Spain</b>	0.2	0.8	0.7
<b>Finland</b>	1.8	0	0.2
<b>France</b>	0.8	0.4	0.4
<b>Croatia</b>	1.1	-0.6	0.2
<b>Hungary</b>	1.9	0.2	0.3
<b>Ireland</b>	1.8	0.4	0.8
<b>Italy</b>	0.1	-0.1	0
<b>Latvia</b>	3.6	1.2	1.5
<b>Lithuania</b>	3.7	1.5	1.6
<b>The Netherlands</b>	1.1	0.1	0
<b>Poland</b>	2.5	1.2	1.1
<b>Portugal</b>	0.4	0.9	0.9
<b>Romania</b>	4.3	0.5	0.5
<b>Sweden</b>	1.8	0.6	0.8
<b>Slovakia</b>	3.3	2.4	2.1
<b>Slovenia</b>	1.7	0.4	0.3
<b>UK</b>	1.5	-0.1	0.1
<b>EU28</b>	1.2	0.4	0.4

Source: data processed from AMECO, EC databases

<sup>27</sup>In both public and private sectors.

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

What Romania needs is sound economic growth that does not entail major imbalances, as shown above. In an environment where Romania's economic growth potential was severely hit by the current 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 – are the most feasible solutions. Theory connects real convergence to labour productivity. Many papers show that the index of structural convergence with the EU can increase largely via higher labour productivity, which relies on improved organisation, education, new technologies, and innovation. Thus, wage hikes are possible, economic growth gathers pace, the standard of living raises, etc.

The explanation for Romania's convergence pace towards Europe's advanced economies lies with the level of and developments in productivity. In fact, one reason why wage earnings in Romania are so low is directly linked to labour productivity and resource use efficiency. According to 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%).

*Table 3.4: Labour productivity per person employed (% , EU28=100)*

Year / MS	EA	Czech Rep.	Germany	Hungary	Poland	Romania
2003	110.9	72	107.8	65.4	59	30.7
2004	109.8	73.9	107.4	66.3	60.4	33.9
2005	109.7	74.1	108.2	67.1	60.1	35.3
2006	109.5	75.1	108.2	67.2	59.7	38.9
2007	109.4	77.6	107.9	66.6	61.1	42.5
2008	109.5	75.2	107.4	70.5	60.8	48.7
2009	108.8	77	103.7	72.7	64.5	48.9
2010	108.8	75.4	106.3	72.5	69.5	49.3
2011	108.5	77	107.2	72.8	71.7	50.6
2012	107.9	75.6	105.7	71.2	73.6	55.6
2013	107.9	76	104.8	71.8	73.6	55.8
2014	107.7	77.6	106.3	70.4	73.7	56.7

Source: Eurostat, 2016

An overriding factor for economic growth is *competitiveness*. In order to narrow economic, political, social and institutional gaps, competitiveness must increase at a brisk pace; significant progress in the pillars underlying the Global Competitiveness Index<sup>28</sup> can lead to a sustainable catching-up in the CEE countries.

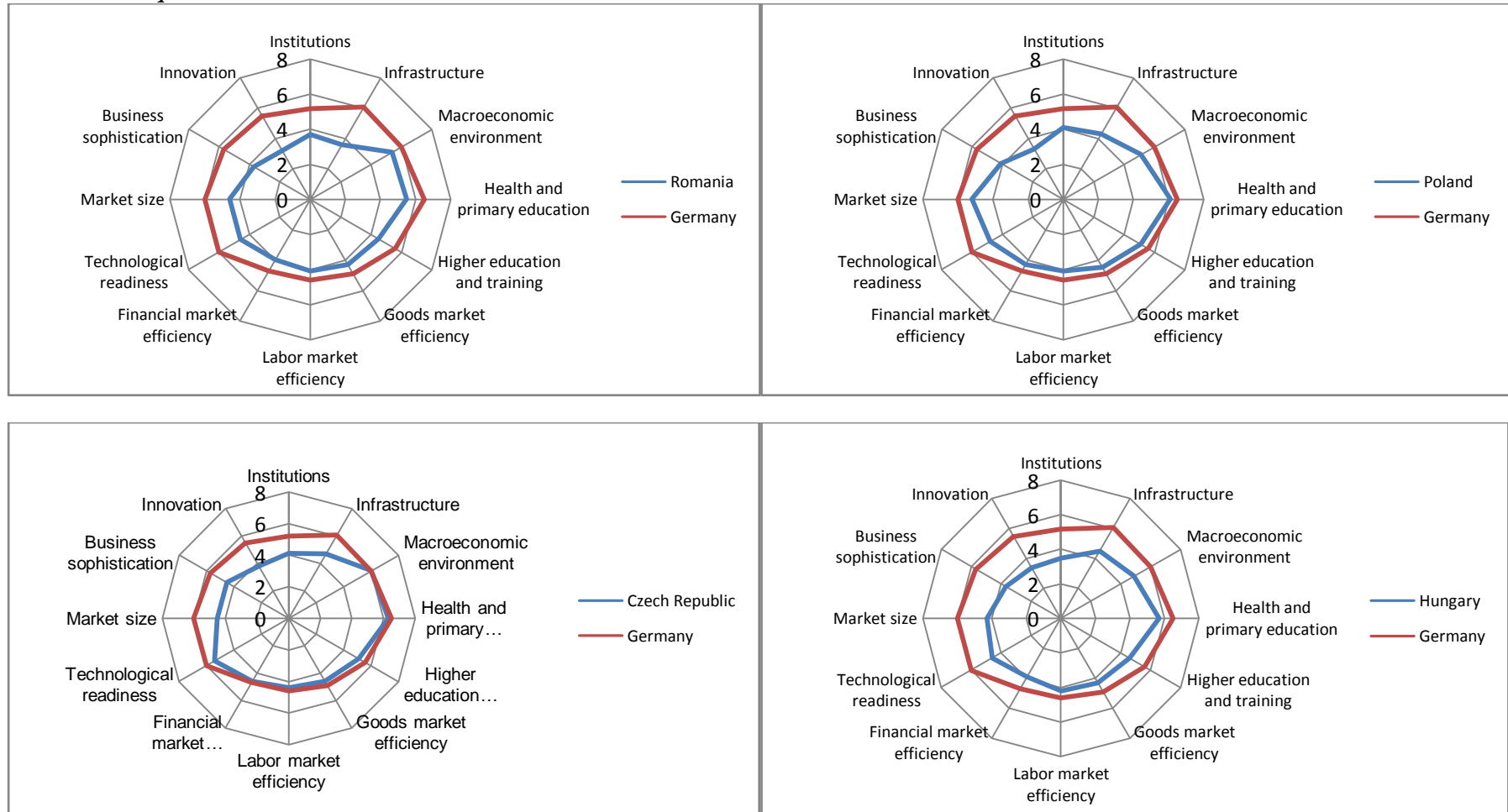
The GCI defines five development stages with three main stages: factor-driven, efficiency-driven, and innovation-driven economies, with two transition stages between them. Efficient goods markets, efficient labour markets and developed financial markets would pave the way for a growing degree of complexity in doing

<sup>28</sup>Annual calculations, World Economic Forum.

business and a shift towards endogenous drivers of economic growth, i.e. stepped-up investment in innovation, R&D and human capital. Along with macroeconomic stability and a functioning institutional architecture, infrastructure development would allow the provision of high-quality healthcare and education services, including economic growth. All this would allow these economies to shift from **efficiency-driven** to **innovation-driven**, a group comprising Germany and, trailing behind somewhat, the Czech Republic.

Chart 2 sets out the distance separating Germany from the CEE countries, depending on the pillars included in the said index – Institutions, Innovation). The charts set forth structural issues common to the region as a whole. The distance from Germany's benchmarks is great particularly in terms of infrastructure, institutional development, business sophistication and, above all, innovation. The farthest from the German economy is Romania's, while the Czech economy is within relatively close distance.

**Chart 3.2: Competitiveness indicators in CEE Member States**



Source: own calculations based on data taken from World Economic Forum, Global Competitiveness Report 2015-2016, available at <http://reports.weforum.org/global-competitiveness-report-2015-2016/>

### 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 the reviewed 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 would this take. To answer this question, the authors considered the initial GDP/capita ratios and the average growth rates for the Romanian economy in the reported period (2000-15). With a view to calculating the period of convergence between Romania and the EA, the relationships between the initial GDP/capita ratios and the average annual growth rates of the two entities were considered, as follows:

$$Y_R = Y_{0R}(1+r_{\text{mediuRO}})^t \quad (1)$$

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

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

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

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

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

Based on this formula, we calculated 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. The hope that Romania will succeed in catching up with the 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%, depending on the various average annual rates of increase.

**Table 3.5: Scenarios on the number of years needed to achieve real convergence with the EA**

<b>Romania versus</b>	<b>3.68%</b> (100% EA average)	<b>5%</b> (100% EA average)	<b>3.68%</b> (75% of EA average)	<b>5%</b> (75% of EA average)
<b>EA</b>	27	18	13	9
<b>Germany</b>	33	21	21	13
<b>France</b>	26	17	14	9

*Source: the authors' calculations*



The results of our study 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 could take 13 years. If the Romanian economy expands at an average rate of 5% per annum in real terms (in a sustainable fashion), it could catch up the EA average within 18 years, and three-fourths of the EA average could be equalled by 2024.

Growth rates above 5-6% per year in real terms on a sustainable basis are unrealistic considering the forecasts for the European economy and the global economy. Even a rate of increase equal to 5% per annum calls for a significant mobilisation of local efficiency reserves and shifting resources to a new growth pattern. It should be pointed out, however, that EA accession does not require achieving the EA-wide average GDP/capita. As shown above, accession could be imagined after reaching about 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 (given the country's currency board and its fairly small size!). 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 apx. 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 a case in point, given their size and the currency boards as monetary policy regime 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 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 Romania's case, even though their growth rates were lower than Romania's. The results show that the Czech Republic would succeed in catching up with the EA within approximately 15 years, whereas Poland and Hungary would take 19 and 21 years respectively, provided they grow, on average, at similar rates.

Furthermore, as pointed out in previous sections, another basic hindrance is the EA's flawed functioning, which is in need of new policy mechanisms and arrangements. Premature EA accession would pose major risks. We believe that paramount question for Romania's EA membership should not be if, but under what terms this will be achieved.

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

Following to the Optimum Currency Area theory, the cost-benefit balance of joining a single currency rests largely on narrowing development gaps between participants, as well as on the compatibility among countries' economies, their trade

integration, their business cycles synchronisation a. s. o. Thus, if the economies participating in the monetary union are strongly interlinked and provide similar responses to shocks, the need for monetary policy independence is low and the benefits of the common currency may be reaped.

In order to assess how synchronised business cycles of CEE countries and that in the EA are, the authors employed several techniques capturing aspects regarding the statistical correlation<sup>29</sup>, 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 3.6: 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 3.7: Estimation of synchronisation via additional measures*

	RO	CCH	PPO	HHU	FFR	DDE	AAT	BBE	SSP	PPG	GGR
Highest correlation	0.70	0.88	0.67	0.74	0.95	0.94	0.92	0.88	0.78	0.66	0.26
Lead/Lag	1	0	0	0	0	0	0	0	0	0	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	0.90	0.91	0.88	0.94	0.89	0.87	0.85	0.87	0.95	0.92	0.96
No. of years when a one-unit shock remains above 0.5	1,5	1,5	1,25	2,25	1	1	0.75	1	2,75	1,5	3

*Source: authors' calculations*

The outcome confirms a very high correlation between business cycles of EA core countries and that of the EMU as a whole<sup>30</sup>. Among the EA's peripheral economies, Spain displayed the highest degree of correlation with the EA in terms of business cycles<sup>31</sup>. By contrast, Portugal's business cycle was correlated at most 70% with the EA, while Greece was the EMU's most divergent economy.

As for the CEE countries, the Czech economy was by far the most correlated with that of the EMU, with values of between 80 and 93%, higher than, for instance, those recorded by Portugal. Poland and Hungary posted relatively similar values, while

<sup>29</sup> In order to assess the degree of business cycle synchronisation, authors employed the Pearson correlation coefficient, one of the measures most resorted to in quantifying linear dependence between the two series; in order to analyse the cycles' joint trend, the Spearman correlation coefficient was calculated.

<sup>30</sup> Three of the leading core economies, i.e. Germany, France and Italy, reported correlation coefficients ranging from 93% to 99%.

<sup>31</sup> Correlation coefficients taking values from 79% to 84%.

Romania was the least correlated from among the CEE countries under review (41% and 76% respectively). Thus, according to the OCA theory, Romania would have the most to lose if it were to relinquish its own monetary policy, especially since it does not have domestic mechanisms, other than the exchange rate, strong enough to withstand potential asymmetric shocks.

On the other hand, as set out in Table 2, the synchronisation of business cycles in CEE countries with that of the EA is compatible with that determined by the degree of cyclical correlation. Although Romania is one of the laggards (only Greece experienced a somewhat lower degree of concordance, the other countries posting higher values), according to literature, the value of the concordance indicator is high enough to state that there is a consistency in terms of business cycle phases with the EA. As for the time effect of a shock, it depends on its persistence on the national economy. Persistence was quantified by the number of years when the effect of a one-unit shock from the EA remains above 0.5<sup>32</sup>.

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

Looking at the composition of GDP by sector, it is important to determine how an economy will react to certain shocks, which will influence the correlation of business cycles. 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 was assessed by employing three indicators, i.e. Landesmann index<sup>33</sup>, Krugman index<sup>34</sup>, and structural asymmetry indicator<sup>35</sup>.

<sup>32</sup> The persistence of the shock was estimated by resorting to autoregressive models specific to each country. According to dedicated literature, when the degree of persistence of business cycles in a group of countries is similar, business cycle synchronisation increases.

<sup>33</sup> Landesmann index compares the weights of top ten economic sectors (NACE classification) in total added value of the candidate country and the benchmark country, namely EA. The index takes values from 0 to 1, the closer to 0, the higher the structural convergence between two economies. Landesmann

index =  $\sqrt{\sum_{k=1}^n (s_{k,i} - s_{k,ZE})^2} * s_{k,i} / 100$ , where  $s_{k,i}$  is the weight of  $k$  sector in the  $i$  country's added value and  $s_{k,EA}$  is the weight of  $k$  sector in the added value of the EA.

<sup>34</sup> Proposed by Krugman (1991) this index shows the structural distance between the sectoral structures of

two countries. Thus, Krugman index  $i/ZE = \sum_{k=1}^n abs(s_{k,i} - s_{k,ZE})$ , where  $s_{k,i}$  is the weight of  $k$  sector in

the  $i$  country's added value and  $s_{k,ZE}$  is the weight of  $k$  sector in the added value of the EA. The index takes values between 0 (perfect similarity) and 1 (largest divergence).

<sup>35</sup> Calculated as the standard deviation of a country's economic structure compared with EA average. The lower the value of the index, the more similar a country's sectoral structure with that of the EA. Structural

In terms of the Krugman index, the boom in Romania fell short of reducing the structural divergence<sup>36</sup>, while the slip into recession caused its expansion to near 53% in 2011<sup>37</sup>, firming at around 40% from 2012 to 2015. The outcome shows that the Romanian economy has the most different structure relative to the EA, not only because of the weights of the agricultural and industrial sectors, but also because of that of services. In Romania, the contribution of agriculture to gross value added formation declined in 2015 versus 2000 by about 60%<sup>38</sup>, yet it remains three times higher than in the EA, ten times higher than in Germany and much larger than in CEE countries<sup>39</sup>. The industrial sector had a relatively steady share in the composition of the Romanian economy throughout the said period, twice as high as the German economy and 35% higher than in the EA in 2015.

Relatively high levels of structural divergence compared to the EA are also in the Czech Republic, but they are smaller than in Romania. The relatively structural distance for the Czech Republic hovered around 35% from 2000 to 2013, but augmented to 40% in 2014 and 2015. Moreover, according to Krugman index, there are structural differences from the EA in Poland and Hungary, and well below relative to Romania. The results are not very different either if looking at the structural asymmetry index, as Romania's economic structure appears to be rather divergent against that of the EA, with the progress made over the past one-and-a-half decades being less significant from this perspective.

## CONCLUSIONS<sup>40</sup>

In Romania, macroeconomic stability was achieved after strenuous efforts have been made since 2010. The economy's overheating in the years prior to the crisis went hand in hand with the build-up of large imbalances which, once corrected, cancelled the previously-achieved income gains. Romania needed six years to recover the 2008 income (GDP) levels. Worth noting is that the economic recovery seen over the past few years did not bring yawning external deficits in its tail. Reasons behind it were the contribution of European funds to balance-of-payments financing and sectoral changes in the economy. There are signs of shifts in the export capacity, across the IT sector in particular. Transport services also surged. These positive facts do not invalidate the thesis that structural reform measures and investment of better quality are needed to avoid 'the middle income trap'.

At present, Romania fulfils all nominal criteria for EA entry. However, the current financial crisis has shown that a mere fulfilment of nominal criteria is far from being

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asymmetry indicator =  $\sqrt{\sum_{k=1}^n (s_{k,i} - s_{k,ZE})^2}$ , where  $s_{k,i}$  is the weight of  $k$  sector in the  $i$  country's added value and  $s_{k,ZE}$  is the weight of  $k$  sector in the added value of the EA.

<sup>36</sup> It was rather flat at around 45%.

<sup>37</sup> In other words, there is a relative distance of 46 percentage points between the added values of Romania and the EA.

<sup>38</sup> From 12% in 2000 to 4.8% in 2015.

<sup>39</sup> Almost twice as high as in Poland and the Czech Republic and one-third higher than in Hungary.

<sup>40</sup> Paragraphs are taken from the homonymous work prepared by the four authors under the aegis of the European Institute in Romania, as part of the 2016 SPOS strategy and policy project.

sufficient for a country to benefit from EA entry. Moreover, the need for economic policies enabling economic stability does not end with euro adoption. 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. During the crisis, wide economic performance gaps 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 EMU 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. In the light of the lessons from EA functioning, early accession is unlikely to be accepted by the bloc's frontrunners, although geopolitical reasons for speeding up accession can be imagined. However, joining the BU is possible prior to EA accession.

An overriding factor to achieve real convergence is competitiveness. A faster increase of competitiveness would narrow the economic gaps. The efficacy of goods markets, labour markets and financial markets should take account of social commitments (inclusive economic growth), thus fostering higher value-added business and boosting endogenous drivers of economic growth, i.e. stepped-up investment in innovation, R&D and human capital.

What Romania needs is sound economic growth that does not entail hard-to-manage imbalances. 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 feasible, albeit not easily to implement. The performance deficit in fields such as institutional development, infrastructure, business sophistication and innovation can sizeable be narrowed via efficient absorption of EU's structural and cohesion funds.

High economic growth rates are very difficult to attain under the circumstances taking shape in the European economy and the global economy. We refer to the spectrum of a "secular stagnation" (Summers, 2014) and the debt-overhang in the advanced economies, the cumbersome recovery of the EA economy, growing protectionism, etc. Local efficiency reserves have to be made use of and the maximisation of resources should be in place so as to shift to a new growth pattern.

EA accession does not require prior achievement of the average GDP/capita ratio in the EA. As shown in this paper, EA accession can only be imagined after reaching about 75% of the EA average and the fulfilment of other structural conditions.

### **Elements underlying the accession strategy**

As part of the European Project and in virtue of the EU Accession Treaty, Romania committed itself to adopting the euro sooner or later. A priority for Romania is to have a clear vision of its own way rather than simply assert the goal to adopt the

euro. Such a vision must come in the form of an official strategy, a euro adoption plan. In this vein, the effort of drawing up a development strategy is more than welcome.

The paramount stake for Romania's EA membership should not be if, but under what terms this will be achieved. Basically, for Romania's EA accession to be successful, a critical mass of real and structural convergence is required ex-ante.

Apart from EA's incomplete design functioning, this paper argues that the wide development gap between Romania and the EA is the main hurdle to adopting the single currency. Faster competitiveness growth at both micro- and macroeconomic levels would iron out economic, political, social and institutional gaps.

The performance deficit issue calls for implementing reforms and prioritised measures, depending on their importance. Implementing reforms and mobilising resources would bring together the build-up of production factors and the needed increase in their efficient use and, not in the least, innovation-based development.

Assuming that the GDP/capita ratio in PPP rises further at an average annual rate equal to that seen in 2007-15 in the EA and at a pace of 3 percentage points higher in Romania, then a 100% convergence would be reached in 2035 whereas a 75% convergence in 2025. But if in Romania the GDP/capita ratio in PPP grows 4 percentage points higher than in the EA from 2015 onwards, then 100% convergence will be reached in 2031 and de 75% convergence in 2023. From 2007 to 2015 the difference between the average annual growth rates of GDP/capita ratio in PPS in Romania and the EA stood at 4.4 percentage points.

A development strategy would be an alter ego of the process of preparation for joining the EA.

#### **The accession programme should include a number of objectives<sup>41</sup>:**

*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 more important than the GDP/capita ratio are the structural conditions. A relevant example comes in handy: if in one country blatant income inequalities rise fast, GDP/capita becomes largely an irrelevant number. Moreover, EA accession does not imply full real convergence prior to it.

*Objective 2:* To fulfil some 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. Among these overriding conditions is the health that should help protect macroeconomic equilibria in check and cap external public debt. External private indebtedness may be limited by macroprudential measures.

*Objective 3:* To enter ERM2. This is some sort of an EA waiting room with a minimum two-year stay where Romania must prove it can remain stable without resort to the RON/EUR rate that it loses once it has gained EA membership. In fact, ERM2 is an

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<sup>41</sup>See also Isărescu (2016, 2017)

ex-ante testing period for the Romanian economy before taking the final step, a period when the RON's swings versus the euro will be limited.

*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 on the accession day.

EA accession should take place when a high enough degree of real convergence is achieved, structural issues are dealt with and regional income disparities are lowered. Accession would comprise four or five stages depending on the decision to join the BU.

**Other benchmarks** for the Accession Strategy could 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 finance;
- an income policy that can reduce human capital exodus;
- strengthen of the rule of law, which should prevent interest groups from embezzling public resources;
- the capacity for mobilizing reserves, local resources in times of stress;
- the setting of priorities to be budgeted thoroughly until they are implemented;
- to develop infrastructure in an emergency regime; what is meant here is not “rocket science”, but efforts to benefit public interest;
- inclusive public policies to benefit the majority of citizens;
- the reform of the public sector, state-owned companies;
- an institutional and regulatory environment supporting entrepreneurship, good business conduct; promotion of digitalisation in the economy, society;
- to support general and vocational education; this sector must be at the receiving end of at least 5% of GDP on a yearly basis;
- local capital must hold a larger share in strategic areas, including the financial sector (stronger domestic roots are needed); the Savings Bank (CEC) must be better capitalised, as well as Eximbank (that should become a development bank, similarly to Germany's KfW);
- increase budget revenues to provide citizens with essential public goods (education, healthcare, basic infrastructure); current revenues are the lowest in the EU (26% of GDP in 2016), showing large-scale institutional weakness, rent-seeking, bad practices in the corporate world.

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, fragile labour productivity, 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 rely more on endogenous drivers of economic growth. A new growth pattern that draws more on mobilizing local 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 be characterised, *inter alia*, by fairness and transparency, social cohesion will be increasingly damaged and extremist political parties will gain more ground. 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 in myth; the reality is fairly nuanced and the "single market" exudes *rappports 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. Conversely, a big issue is made up of growing mistrust gaps between governments and citizens, between governments and European institutions, between the latter, generally the elites, and citizens.

Brexit, which stands for a more far-reaching syndrome across the Union against elites, has fuelled anxiety and great uncertainty. Against this background, the Eurosceptics that deny the European Project make their voices more clearly heard.

The troubles facing the EU paint a gloomy picture. 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 threat posed by "secular stagnation", the debt overhang, immigration, unethical conduct in the business world and politics, the need to reform EU 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 escapes the dead-end street of "dis-union", which would send us back to a period riddled with dangers and possible tragedies (Dăianu, 2017). EA accession must heed to this intricate context.



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