XXII CICLO DEL
DOTTORATO DI RICERCA IN

POLITICHE TRANSFRONTALIERE PER LA VITA QUOTIDIANA
TRANSBORDER POLICIES FOR DAILY LIFE

SCENARIOS AND PROSPECTIVES REGARDING THE EURO
INTRODUCTION ON THE ROMANIAN MARKET

(SETTORE SCIENTIFICO-DISCIPLINARE: MGGR/02 - GEOGRAFIA ECONOMICO-POLITICA)
Table of contents

Chapter I. INTRODUCTION ........................................................................................................... 1
Chapter II. CONCEPTS AND METHODOLOGY (a short theoretical approach) ... 14
   II.1. Concepts Regarding the European Economic and Monetary Union ..... 14
      II.1.1. What is a monetary union? ................................................................. 14
      II.1.2. A historical review ........................................................................... 15
      II.1.3. From the theory of Optimum Currency Areas to the European
             Economic and Monetary Union ......................................................... 17
      II.1.4. Costs and benefits of the Euro adoption ........................................... 20
      II.1.5. Stages and conditions for Romania to join the European
             Economic and Monetary Union ........................................................... 24
   II.2. Methodology ........................................................................................... 26
      II.2.1. Descriptive analysis ........................................................................ 26
      II.2.2. Preparing data for analysis – seasonal adjustments ....................... 27
      II.2.3. Convergence analysis for time series – the cointegration approach 27
      II.2.4. Granger causality ............................................................................ 32
      II.2.5. Exchange rate volatility ................................................................. 33
      II.2.6. The structural asymmetry indicator ................................................ 34
      II.2.7. Cyclic fluctuations – the Hodrick – Prescott filter and
             correlation issues ................................................................................ 35
      II.2.8. Spatial convergence among the EU members using spatial
             econometrics ....................................................................................... 37
Chapter III. THE ANALYSIS OF THE CONVERGENCE CRITERIA ....................................... 43
   III.1. Price Stability and Inflation Convergence............................................. 43
   III.2. Interest Rate Criterion ........................................................................... 48
   III.3. The Exchange Rate Mechanism II (the Exchange Rate Criterion)........ 49
   III.4. The Fiscal Criteria ................................................................................ 55
      III.4.1. The size of the budget .................................................................... 57
      III.4.2. The structure of the budget ............................................................. 59
Chapter IV. STRUCTURAL CONVERGENCE AND MARKET FLEXIBILITY. ... 62
   IV.1. Convergence of Gross Domestic Product (GDP).................................... 63
      IV.1.1. Time convergence of the GDP ........................................................ 63
      IV.1.2. Spatial convergence ...................................................................... 66
   IV.2. Price Convergence ................................................................................... 72
   IV.3. Structural Convergence ........................................................................... 78
      IV.3.1. Business cycles synchronization ..................................................... 79
      IV.3.2. Economic structure similarity with the Euro Area ......................... 87
      IV.3.3. Foreign trade integration ................................................................. 92
   IV.4. Labour Market Flexibility ....................................................................... 99
      IV.4.1. Demographic trends ...................................................................... 100
      IV.4.2. Labour market size, employment and unemployment .................... 103
      IV.4.3. The development of wages, incomes and productivity .................... 112
      IV.4.4. The labour market environment – fiscal burden and institutional
             characteristics ...................................................................................... 118
Chapter V. CONVERGENCE STRATEGIES, PROGRAMMES AND POLITICS ... 124
   V.1. Romania’s National Reform Programme 2007 – 2013 ......................... 124
   V.2. Convergence Programme 2008 – 2011 ................................................... 126
ABSTRACT

On the 1st of January 2007, Romania joined the European Union. From that point on, it has entered the second stage of monetary integration – the period of fulfilling the convergence criteria before entering the EMU. The goal of the present research was to see how is the Romanian market going to react to the introduction of the euro. Is it suitable for the present status of economic development or the efforts necessary to comply with it will be too big? Unfortunately, up until now, very few studies of this kind have been made for Romania, but none of them as complex as the present one. Consequently, the results and the problems presented here are of most importance and represent a headstone in the field.

The issue of Romania’s monetary integration is very complex. Its problems are no longer a matter of internal decisions and effects, but they have become transnational. Within the European Union, each member state is affected by decisions taken into another one. This phenomenon of transmission and its characteristics are very important for the stability of the Union in itself. Consequently, studying the intensity of the contagion effect is one of the main issues for every analysis regarding European integration. If member states have similar paths and quite similar characteristics, the effects would be the same for them. If not, the contagion effect will manifest through asymmetric shocks, causing divergent national evolutions and instability within the Union. To reduce the contagion effect, the European Union has established through its treaties a series of criteria and an economic standard for the candidate countries.

The first part of the paper is the Introduction. In it are presented the main reasons that led to the choice of this theme. Romania’s path towards full integration in the E.U. is the main subject in the everyday life of its citizens. It is necessary a deeper knowledge of the phenomenon, to help authorities, and not only, take the best decisions in this respect. Additionally, are presented the main theoretical aspects of European and monetary integration. Once a country joins the EMU and adopts the euro, the monetary policy is lost as an adjustment mechanism in the economy and others have to be found to replace it (the most encountered are the labour market and the fiscal policy). Romania is scheduled to enter the ERM II in 2012 and then adopt the euro no later than 2014 – 2015. Whether these targets are going to be respected or not depends on the actual level of complying with the Maastricht criteria in particular and with all the convergence criteria in general. Box 1 presents the major steps for Romania’s integration process.
**ABSTRACT**

<table>
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<tr>
<th>Box 1. Steps of Romania’s European integration process</th>
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<tr>
<td>1. <strong>1995 - June, 22</strong>: Romania sends the “Snagov Declaration” – its solicitation of becoming a member of the European Union, to which the European Commission responded in July 1997.</td>
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<tr>
<td>2. <strong>1999 - December</strong>: the European Council in Helsinki decides opening the negotiations with Romania.</td>
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<td>3. <strong>2000 – February, 15</strong>: Romania starts the negotiations with the European Union.</td>
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<td>4. <strong>2004 – December, 17</strong>: Romania closed the negotiation process.</td>
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<td>5. <strong>2005 – April, 25</strong>: Romania signed the Adherence Treaty in Luxembourg.</td>
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<tr>
<td>6. <strong>2007 – January, 1</strong>: Romania officially became a member of the EU.</td>
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<td>7. <strong>2012</strong>: the entrance in the Exchange Rate Mechanism II.</td>
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The goal of this study is to assess the effects of the euro adoption on the Romanian market. Would it benefit from it or the costs of the adoption would go far beyond what we can handle? Does Romania constitute an OCA with the euro area?

The complex analyses conducted throughout the paper regard all the components of the European economic integration, bearing in mind that Romania is among the largest countries of the European Union, both as area and as population. This is because one cannot compare the performances of a little country, which is very easy to manage, with the ones of a larger country. Moreover, another feature that has not to be forgotten is that Romania comes after a very long communist period, followed by 20 years of turbulent transition. The national economy entered on a stabilized path just few years ago, but was again shaken by the world economic crisis.

The rest of the introduction makes a short description of each of the chapters.

**Chapter II Concepts and Methodology** deals with theoretical issues related to the subject. First of all, what is a monetary union? The roots of it are to be found in Mundell’s theory of Optimum Currency Areas (1961). Consequently, the characteristics of the OCA became the main ones for the European Economic and Monetary Union. European attempts to form such unions are very old. Even before the fall of the Breton Woods system, in 1950 some of the Western European countries have laid the foundations of the European Payments Union. Afterwards were more and more attempts towards forming a monetary union in the European space, mainly due to counterbalance the international power of the American
ABSTRACT

Dollar. Finally, the Euro started to exist in January 1999 and replaced the national currency of the first member states on the 1st of January 2002. Now-a-days, 16 out of the 27 Union members have already adopted the common currency. This means that they have succeeded in complying with the Maastricht criteria.

The second part of the chapter makes a synthesis of the methodology employed throughout the research.

The status of Romania’s complying with the Maastricht criteria is described in The Analysis of the Convergence Criteria, chapter III. Each nominal convergence criterion is individually analyzed, to see how far or how close is Romania to the Euro adoption. Out of the five nominal criteria, only one is currently satisfied – the share of the general government deficit in the GDP is below the 60% limit. The other fiscal criterion was satisfied until 2008, when Romania’s deficit exceeded the 3% of the GDP admitted. Due to the registered value of 5.4%, the country is now under the Excessive Deficit Procedure and has to respect the European Commission’s provisions in order to stick to the monetary integration schedule. The international crisis that started in 2007 has also prevented the national inflation rate to get closer to the reference value. Moreover, the RON/EUR exchange rate has increased its fluctuations, arriving almost to the upper limit of the fluctuation band – 15%. The last of the five criteria, the interest rate, cannot be studied per se for Romania. This is a consequence of the shortage in data. For the criterion, there are necessary several issuances of long-term monetary bonds with a maturity of 10 years. Romania has only made 2. That is why, in the next analyses of the research were used as proxies the money markets interest rates for 1, 3, 6 and 12 month maturity.

The main conclusion of this chapter in that Romania still has to work a lot for fulfilling the Maastricht criteria. And, regardless of the value chosen as a benchmark for the exchange rate, at the entrance in the ERM II Romania has to go for the maximum admitted for the fluctuation band - +/-15%.

But the Romania’s performance for the nominal criteria is very much influenced by the other two groups – real and structural. Moreover, there have to be found other adjustment mechanisms for the monetary policy. The natural continuation appears, thus, to be the analysis of the Structural Convergence and the Market Flexibility (chapter IV). As every Union member, Romania has improved its performances. Still, in terms of GDP, regardless of the way it is measured, it is at the bottom of the hierarchy. This was demonstrated both through chronological and through spatial methods. Price convergence is more intense, although, in average, prices in Romania remain lower than in the Euro Area. This issue is
very delicate as the automatic price convergence process is against the price stability criterion, making harder the NBR’s job of reducing the inflation rate.

Structural convergence is given by three characteristics – the business cycles synchronization with the EA, the level of economic structure similarity between the two entities and the integration of the Romanian foreign trade. Romania proved to be contemporaneously pro-cyclical synchronized with the Euro Area. A shock that appears would have the same effect and manifest in the same quarter in Romania and the Monetary Union. Consequently, the common monetary policy should properly mitigate economic fluctuations. Moreover, the European Union and, consequently, the Euro Area are the main trade partners for Romania. The Romanian economic openness is even higher than for some old members. The problem resides, howsoever, in the fact that the economic structure of Romania is very different from the average European one. The Structural Asymmetry Indicator is the second largest, after Luxembourg. There is a lack of capital intensive sectors, products and services incorporate more low-paid workforce than innovation. Unfortunately, Romania is thus subjected to international asymmetric shocks on the labour market.

That is why the last part of chapter IV deals with labour market issues. After the Euro adoption, the labour market remains one of the major adjustment mechanisms. If the degree of flexibility is high enough, the benefits of the Monetary Union will overweight the costs. If not, either other adjustment mechanisms are found, or the entrance of Romania is postponed. From a demographic description of the Romanian population, the study goes on with issues of employment and unemployment as a whole and for specific categories. The lack of individual openness towards new and towards continuous education forced an important amount of the labour force to go either in unemployment or in the agricultural sector after the fall of communism. The issue was more sensitive for the older persons and for women. Moreover, the liberalisation of the educational market has led to an important increase in the number of students. The direct consequence is the drop in the employment rate for the group of young persons (15 – 24 years old). At the opposite side, there is the group of old persons with tertiary education. Lately, it has been noticed that they prefer to remain active even after the official retirement age (in a higher percentage than countries like Italy, France, Hungary, etc). The reduction of unemployment was very much helped by the intensive external migration phenomenon. Sustained by a common Latin origin, many Romanians have searched for better paid jobs in countries like France, Spain and Italy. From the same reason, the highly educated persons also chose to migrate in the more developed countries, which are more innovation and technology oriented. The flexibility given by the migration fluxes was
ABSTRACT

counterbalanced by the increase of wages without real bases. The study clearly shows that wage changes were more based on speculations and pressures, while not being based at all on productivity. They were more determined by the automatic convergence trend towards the EU and EA averages than on real foundations. All these, together with the increasing pressure of the trade unions, have diminished the labour market’s flexibility.

Political decisions in the respect of the European monetary integration are also of major importance. Chapter V makes a synthesis of the most important Convergence Strategies, Programmes and Politics. Among them are the National Reform Programme 2007 – 2013, the Convergence Programme, the Government’s Programme and the strategy of inflation targeting adopted by the National Bank of Romania. These, together with the ones of the political parties are all modelled on the actions Romania has to take for a good and soon adoption of the Euro.

Scenarios Regarding the Euro Introduction on the Romanian Market is the VI chapter. Based on econometric simulations and modelling, the chapter uses a progressive approach in studying what could be the effects of the European Monetary Integration for Romania. The inflation rate criterion is the most important. The first part of the chapter assesses the relationship between this and other macroeconomic variables on very short and short term, using the Phillips curve and derivations of it. The first relation to be studied is between inflation rate and the GDP. A reduction of the inflation rate in order to comply with the Maastricht criterion would cause the same effect in the GDP. In other words, reducing inflation leads to a diminishing of national welfare, by guiding the Romanian GDP towards its natural level. The best-known pass-through process from inflation to wages and vice-versa was proved as intense for Romania from wages towards inflation. In addition, other levers have to be found to sustain the inflation rate reduction without causing a boost in net wages and a heating of the national economy. The last short term relationship analyzed was between the inflation rate and the domestic demand to see how affected would be the citizens. Here appears a period of reluctance from the part of the citizens, during which inflationary expectations are readjusted according to the new value. Afterwards, changes in demand increase. When the two parameters are analyzed based on their gaps, a snowball effect appears, active for a long period of time.

The second part of chapter VI refers to scenarios regarding the Euro introduction on the Romanian market. The analysis enlarges, taking into account not only the inflation rate, but almost all the nominal criteria. The shocks applied in the models are constructed on the directions Romania has to take in order to join the EMU. Comparing the present values for
ABSTRACT

Romania with their targets, impulses were applied for inflation rate, interest rate, budgetary deficit and the exchange rate. The models focused on output, the labour market and the FDIs, using simultaneous equations and the VAR/VECM methodology. The main conclusion is that restrictiveness will proceed the Leu replacement with the Euro in Romania.

The last chapter, VII – Restructuring and Competitiveness in Post-Crisis Conditions, is intended to describe the level of Romania’s competitiveness on international markets, having as a benchmark the Lisbon Agenda and taking into account the international rankings made by different entities on this subject. When giving up the Leu, Romanian economic agents will have to face directly the international competition. If they fail to do it, the results will be fatal for the whole Romanian economic environment. The degree of competitiveness determines, thus, the balance between the costs and the benefits of entering the EMU. For every European country, the guide in this field is the Lisbon Agenda. The first part is dedicated to describing the provisions of the Lisbon Treaty. Romania is now in the transition phase from an efficiency – driven economy to an innovation – driven economy. The transition will be very hard as it has been seen in chapter IV that Romania is based on labour-intensive activities, with low value added, while the high-tech sectors almost inexistent. Yes, the gap between Romania and the European Union and the Euro Area has downsized. The growth rates of the most important macroeconomic indicators have been high, clearly showing the convergence process. But economic structures are different. In addition, only around 1.5% of the adult population was involved in education in 2008. The figures are not better for 2009, either. The tendency of the Romanians is either to go into unemployment if fired or to relocate into the subsistence agriculture. A lot of efforts are needed to increase the expenditure on research and development, as it is the only way to sustain innovation.

Almost all the indicators analyzed show a very bad competitiveness position of Romania – from prices to infrastructure (mainly roads). For example, in the 2009 – 2010 Global Competitiveness Report, Romania ranked 64th, while in the Doing Business ranking, it was on the 55th place for 2010. A deep restructuring process is necessary. And it has to start from education and from the political class.

The Conclusions part restates the main findings from each chapter. Romania is not yet prepared for monetary integration. The international subprime crisis has very much affected it. The main conclusion is that replacing the RON with the EUR implies on short term economic slowdown and restrictiveness followed by economic recovery and growth on medium term if the present premises are preserved. Consequently for Romania
ABSTRACT

will not be easy to enter the EMU. The reduction of the inflation rate has, as an immediate consequence, a drop in the level of the GDP on very short term. But, after a while, based on the income expectations and the price setting behaviour of the firms, the Romanian real output is expected to increase on medium term.

The stickiness of the labour market leads to important employment reductions as a consequence of monetary integration. Rigid wages and wage legislation, combined with the trade unions movements prevent the labour market to adapt through other channels than unemployment. Romanians are not willing to accept wage reductions against job creation. The most affected by the whole process will be the labour market, through the rise in unemployment, and the investments. Wages will, more or less, continue their convergence trend.

The scenario analysis clearly shows that the best channel for reducing inflation is the fiscal one. When applying fiscal impulses, the effects were seen more rapidly and more intensively than in the case of monetary innovations. When budgetary expenditures are high, the national banks usually augment the monetary policy interest rate and vice-versa. And, as the present trend of the NBR is to reduce the interest rate in order to stimulate investments and economic growth, the best alternative is to restrict governmental expenditures (and decrease the budgetary deficit) by reducing their unproductive components.

One of the major effects of adopting the Euro for Romania will be an increased international competition. If domestic companies are not able to deal with this, they will disappear and Romania will face a terrible fact – the incapacity to produce and to be competitive. Competitiveness is a very complex issue. In the world, different international forums and entities have different ways of measuring it, based on different parameters. For the European countries, the main indicator of comparison is the Lisbon Agenda index, which for Romania has a low value. But what is worrying is that the Southern members, with which Romania resembles most, had the worst performances after the Euro adoption. Instead of converging to the others, they diverged. The same evolution can be expected for Romania, too. In almost all the rankings, Romania is situated at the bottom, among the lasts. Labour productivity is very low and the international crisis has lowered it even more. Unemployment rate has augmented and the restructuring process is continuing. But the labour force is not able to cope with this. Instead of re-education and re-specialization, people prefer to remain unemployed, especially because the sum of money obtained now for unemployment has increased. Things have to be changed at educational level, to open individuals towards life-
ABSTRACT

long learning. Only in this way Romania will be able to get a little bit closer to the Lisbon target.

When considering prices and labour costs, the degree of competitiveness has also decreased in time. Unfortunately, as presented in chapter VII, Romania performs badly in many fields. The whole position is accentuated even more by the lack of proper infrastructure and, more important, the lack of political trust due to scandals. Not even the small and medium sized enterprises are now encouraged any more. In their efforts to gather as much money to the budget as possible, the political actors have forgotten one of the main laws of the fiscal policy – when increasing taxes, revenues at the budget will increase, but only up to a point. Afterwards, the result will consist only in a retraction of the economic activity, with more losses than gains. Instead of it, for a safer and sounder exit from the crisis, the government should increase its productive expenditures and not focus only on the social system. Romania’s high-tech sectors and the research and development sectors, that result in high value added, need all the support from the part of authorities. Because these sectors in Romania are young and do not posses all the necessary resources to develop accordingly.

Another interesting idea is related to agriculture. It is being said that the next international crisis will be a food crisis. Consequently, Romania, which has important resources in this respect, should focus on making its agriculture more intensive, preserving in the same time its ecological characteristics. As pointed out in this research, agriculture still has an important share in the total economy. The fact that it brings low value added could be counterbalanced by producing only natural, ecological products, which are very much asked for outside the country and are more expensive. In this way, Romania would not only profitably use its natural resources and its production capacities, but would also become an important actor worldwide.

The economic slowdown on short term which has resulted from the prospective analysis can be compensated by an increased absorption of structural funds. The proportion of Romania’s benefits depends on the authorities’ capacities to inform the citizens about the available structural funds. In addition, it is very important to find the proper ways (through projects, either public or private) to use them. Structural funds coming from the European Union may counterbalance the losses if they are used where needed. Through them, Romania may develop its production capacities, its poor infrastructure and so on. And, the most important thing, it may insure in the near future a higher life standard to its citizens.

Romania has set as a target to join the EMU in 2015. Whether this will happen or not, depends on the balance between the costs and the benefits related to it. The macroeconomic
policy has to guarantee the fulfillment of the convergence criteria in such a way as to minimize the costs. For example, as presented in chapter VI, a reduction in inflation towards the reference value implies a reduction in the GDP growth. Consequently, the welfare in Romania, instead of converging towards the European average would, for a moment, diverge. If authorities will be able to find the equilibrium and accomplish their targets, more benefits would result in an increased welfare on long term. Unfortunately, the present analysis has brought into light the fact that Romania is still far from the desired status of development. From the convergence criteria, nowadays only 1 is complied with. The situation is not better at all when dealing with real or structural convergence, too. The labour market is rigid enough as not to be the best substitute for the monetary policy. Its main adjustment tool is the level of employment which proved very sensitive to monetary integration in the scenario analysis. Concurrently, the problem of competitiveness is very sensitive.

But in order to give a more objective answer to whether the present situation of Romania would permit its entrance in the Euro Area with great benefits, an interesting example comes into mind – the UK test. When faced with the option of replacing the British Pound with the Euro, the British authorities chose five questions to which they had to answer (Howarth, 2004):

1. Is there any sustainable convergence between the UK and the Euro Area?
2. Is there enough flexibility in the British economy to face the changes?
3. What would be the effect upon FDIs in UK?
4. What would be the impact upon the financial services sector?
5. Is the Euro adoption suitable for employment?

Replacing the UK with Romania, the discussion is as follows.

1. For the moment, there is not enough sustainable convergence between Romania and the Euro Area. The Romanian GDP is far from the EA average, while most of the nominal criteria are not carried through. Although the EU is the main foreign trade partner for Romania and the business cycles are pro-cyclical correlated, the structure of the Romanian economy is one of the most divergent from the EA average. Romania has a labour intensive economy, with poorly developed high-tech sectors. This characteristic makes it sensitive to labour market shocks, which are best dealt with using the monetary policy. What should be done? The state should increase its investments in research and development according to the Lisbon Agenda targets, should invest and promote investments in the high-tech
sectors. And, why not, as previously mentioned, sustain ecological agriculture as the Romanian potential is very high in this field.

2. The degree of flexibility of the domestic economy is still low. It has been seen in the last 20 years how hard Romania has passed from a communist economy to a market economy. The lack of flexibility lies in the impossibility of the labour force to adapt to changes. The origin is in the individual’s education and perceptions. Once riffed, the major part of the employees is not able to professionally reconvert and find other jobs. A second reason is the lack of synchrony between the educational system and the labour market along with the fact that most of the young specialized work force prefers to go abroad due to the higher salaries in comparison with the national ones. Romania lacks both the flexibility and the means and management to efficiently assess economic changes related to monetary integration.

3. After important amounts of FDIs that entered Romania in the early 2000s, the decision of the NBR to apply a more strict monetary policy, has reduced these flows. Its recent change of strategy (that is in accordance with the Maastricht criterion) to reduce the interest rate should reinforce investments flows. But monetary policy is not the only one applied in relation to the Euro adoption. Simulations in the research have emphasized that all in all, together with the labour force market, investments would be the most affected in a negative way. When dealing in the same time with the problems in the budgetary deficit, in the inflation rate level and in the interest rate level, FDIs have proved to be the most negatively affected. This field had more or less the same reaction on short term when analyzing the vanishing of the exchange rate. Fortunately, on medium term, the FDIs flows recover with an interesting ascending path.

The problem is thus if Romania will be able to cope with the reduction of the investment flows for some periods of time until investors will react positively to the Euro introduction. A solution may be the use of all the structural funds Romania could access from the European Union.

4. The financial services have developed a lot once with the process of European integration. Actually, they started almost from zero. Due to increased confidence on the domestic market together with the important risk premia, many international banks have invested in Romania, opening working points here or
ABSTRACT

buying domestic banks – the consequence was an increased inflow of know-how in the field. European integration had a good impact on the Romanian financial services, by increasing competition in the field. Along with the banking sector, other types of financial services have developed. The consulting activities have flourished. The Romanian stock exchange becomes more and more integrated at international level. Moreover, the National Bank of Romania has started to be more lax in what regards financial regulations, making the market more flexible and the access on it easier.

With all this, the integration in the Euro Zone should positively influence the development of the Romanian financial services sector.

5. Normally, the Euro adoption should foster long term investments and lead to the creation of new and better jobs. This, because Romania would benefit from the entrance in a better ranked zone at international level; not to forget about the famous Lisbon Agenda. But here comes in front the problem of competitiveness. Investors are usually looking or for low paid work force or for very well qualified work force. Labour costs in Romania have increased lately, making a lot of multinationals to move towards East. From this point of view, Romania’s competitiveness has dropped.

Meanwhile, it has been demonstrated during the present research that the Romanian labour market is still rigid enough. Workers and union trades do not accept wage diminutions. Consequently, what reacts first is the level of employment. On short term, for each of the impulses applied in relation to the monetary integration, employment in Romania decreases\(^1\) (in some cases quite a lot). In some cases, on medium and long term it recovers to the initial level, but in others, it finds its equilibrium under that value. The question to be answered to is, thus, if Romania is able to cope with all the costs that would appear on the labour market due to the Euro adoption. Considering all the aspects (not to forget about the running Excessive Deficit Procedure), there is a high risk not to be able to do it. So, for the moment, one should be reluctant in what regards the benefic effects of the Euro introduction in Romania on the labour market.

\(^1\) The interest rate impulse was not even taken into consideration as its relationship to employment is too weak to matter.
The Romanian monetary integration proves to be a very complex process. As highlighted, most of the sectors of the national economy are not ready yet to enter the Euro Area. There are problems with the convergence process and with the capacity of other policies to come into force once the monetary one disappears. Economic reactions are divided between supply and demand. On one side, there are the expectations of both producers and consumers regarding their incomes and their lifestyle. On the other side, people are reluctant to changes and this is to be seen not only in the rigidity of the labour market, but also in other fields.

Based on the results obtained through this research it is clear enough that for Romania is still too costly to renounce to the Romanian Leu. The benefits of an OCA will be seen only on medium and long term. And it is not sure that Romania has in the present the necessary resources to sustain the integration process until its positive effects will appear.

To comply both with their EU engagements and with the ones taken in front of their electors, authorities will have to search for the proper policy mix to diminish at minimum the costs and to augment at maximum the benefits. To join the Monetary Union according to the schedule, Romania and Romanians will have to pass through a period of restrictiveness, especially from the fiscal point of view.

All in all, Romania is not yet ready to change the Leu for the Euro.

This study has analyzed Romania’s entrance in the EMU mostly from an economic perspective. It would be interesting for specialists in other fields (especially in sociology) to approach the issue.

Studying the monetary integration process of a country in general is of great interest. For me, as a Romanian it becomes even more important to see this process for Romania in particular. But the whole issue, with all its aspects, is so complex, that a sole research as the present one is not enough to comprise it entirely. The next steps of research refer to a deeper and more focused analysis of all the problems related to the Euro adoption in Romania. Moreover, the models proposed in chapter VI cover only parts of different national sectors. That is why future attention will be paid to obtaining a consistent system for Romania with no more than 10 - 15 equations that cover the whole economy, easy to apply in simulations and prospective analyses. The theoretical framework of this model is presented at the end of the research, in Appendix 5. Another future project is to assess more deeply the problems of the labour market in correlation with the characteristics of different productive sectors.

The extended analyses, with more complex explanations are presented in the Appendixes.
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