

Romania's Accession to the Economic and Monetary Union: The Role of Fiscal and Monetary Policy in Assuring Price Stability

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Abstract

In order that the monetary policy of the ECB to be efficient it is necessary that the monetary transmission mechanism from our country to be similar to the one from the euro area, which reveals the similarity of the financial system structure. In monetary transmission mechanism a major role is held by the structure of financial assets and liabilities of household and corporations. In this way, we have done a comparative analysis of the financial structure of households and corporations in Romania and the euro area for the period 2007-2010. The negative effects of loosing monetary policy autonomy can be taken away by promoting restrictive fiscal and income policies. But the inflation rate in Romania will be influenced not only by the national fiscal policy, but also by the fiscal policy of the countries from the euro area. Therefore, we have analysed the spillover effects of the fiscal policy.

Keywords: Euro, inflation rate, fiscal policy, spillover effect

1. Introduction

Romania's accession to the EMU implies the transfer of responsibility of monetary policy by the ECB. The single monetary policy takes place in a unitary manner for the entire euro area, without taking into consideration the peculiarities of each national economy.

In order that the single monetary policy to be efficient it is necessary not to exist differences between the monetary transmission mechanism of the euro area countries, otherwise, it can become a source of asymmetric shocks (Csajbók & Csermely, 2002, p. 89).

In the countries with an underdeveloped financial system, the impact of interest rate upon economy is low. Bitāns and Kaužēns (2004) comparing the monetary transmission mechanism from Latvia with the one from the euro area has noticed that the impact of the interest rate upon the GDP is 5-6 times lower than the one from euro area countries and the impact upon prices is insignificant. Because the effect of monetary transmission mechanism upon the real sector is quite limited, the authors conclude that Latvia's economy will not handle with notable loss when applying the common monetary policy. But the deepening of financial markets can increase the efficiency of monetary transmission mechanism.

The financial integration will reduce the differences between the financial structure of countries, leading therefore, to a monetary transmission harmonization and, therefore, to an increase of single monetary policy efficiency in assuring price stability.

2. The Comparative Analysis of Financial System Structure in Romania and Euro Area and Implications upon the Monetary Transmission Mechanism

Similar to the Czech Republic, Poland and Hungary, the financial system of our country is characterised by low financial depth, the ratio of total financial assets to GDP being of 4.96% in 2010, much below the average from the euro area. In 2010, this ratio has been of 12.03 in euro area.

Another feature of the Romanian financial system with implications upon the monetary transmission mechanism is the *moderate concentration*. If in the year 1999 the market share of the five first banks in the total assets was 66.7%, in the year 2008 this indicator was 54.4%, which means a decrease of concentration bank and, implicitly, an increase of importance of the loan channel on the Romanian economy.

Anzuini and Levy (2004) emphasize that an important role in the monetary transmission mechanism is held by the structure of assets and liabilities of households and corporations. From the point of view of adopting the euro currency it is beneficial that the effects of monetary policy won't significantly differ between the euro accession countries and the EMU member states. In this way, following the approach made by the Anzuini and Levy (2004), we have done a comparative analysis of the financial structures of households and corporations in Romania and euro area for the period 2007-2010, using data from the closing financial balance sheet of households and corporations given by Eurostat, in order to identify the monetary transmission channels in Romania and the euro area.

Analyzing the financial liabilities of corporations in Romania in the period 2007-2010, we have identified shares and the other accounts as the main sources of financing, each of them being of approximately 30% of the total. Loans have financed companies in a percent of 16.61 in 2007, registering an increase with almost 4 percentual points in the following years. If in the period 2007-2010 the weight of securities in the total of liabilities was between 14.77% (2009) and 16.95% (2008), in the year 2010 we notice a significant decrease of them (0.03%), in the same time with a significant increase of shares (from 34.85% in the year 2009 up to 51.78% in the year 2010). The dynamics of financial liabilities can be explained by the increase of share prices, being a stimulant for companies to issue new shares to procure resources, the average of new issued shares in this year being of 26% from the total of shares from the end of the year.

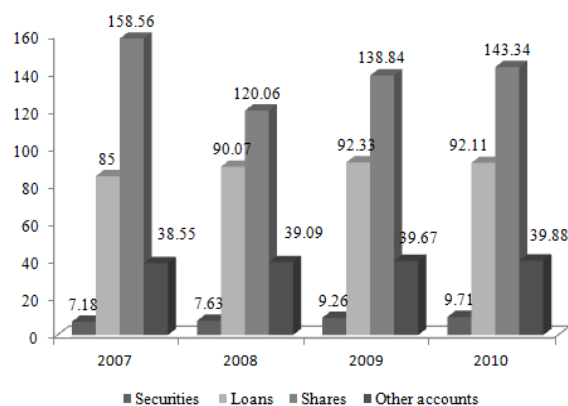


Figure 1. The financial liabilities of corporation in euro area (2007-2010, % in GDP)

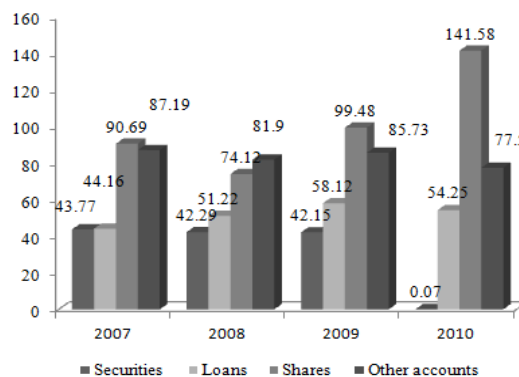


Figure 2. The financial liabilities of corporation in Romania (2007-2010, % in GDP)

Source: Eurostat, <http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/themes>, author's calculations.

In the euro area the structure of financial liabilities is different from the one of Romania. Therefore, we can notice that half of the financing is represented by shares, followed by loans, with 30%. The weight of securities is very low (approximately 3%), compared with Romania in the period 2007-2010.

Regarding the financial liabilities of households, in Romania we can notice that the main source of financing is the loan. In the period 2007-2010 we notice an increase of loan weight in the total of financial liabilities (from 69.22% up to 86.65%) and a significant diminishment of other accounts weight (from 24.39% to 6.79%). Consequently, the importance of loan channel has increased. In the euro area, 91% from the financial liabilities of households are represented by the loan. Therefore, the changes of interest rate in the euro area have a greater impact upon aggregate demand.

Relating each financial instrument to GDP (of corporations), we notice that securities and loans (total) in Romania have registered similar values with the ones in the euro area (90-100% of GDP) in the period 2007-2009, which means that the impact of monetary policy decisions was a similar one. In the year 2010 there has been registered a decrease by half of the external sources, the weight of securities and loans being of 54.32% of GDP, while in the euro area the value was approximately constant (101.82% of GDP). If in the years 2007-2010 the weight of shares in GDP was inferior to euro area, in the year 2010 there has been an acceleration of the weight of shares in the GDP in Romania, being of 141.58% (in the euro area - 143.34%).

The households have little financial assets, which consist of 120.85% of GDP in the year 2010, compared with 204.69% of GDP in the euro area. They have been represented, mainly, by shares (89.99%) and deposits (24.53%), which means that the wealth effect of assets price is relatively low in Romania.

The financial liabilities of households were of 27% of GDP in the year 2010, 23.4% of GDP being represented by loans, but they are much inferior to the euro area (72.14% of GDP).

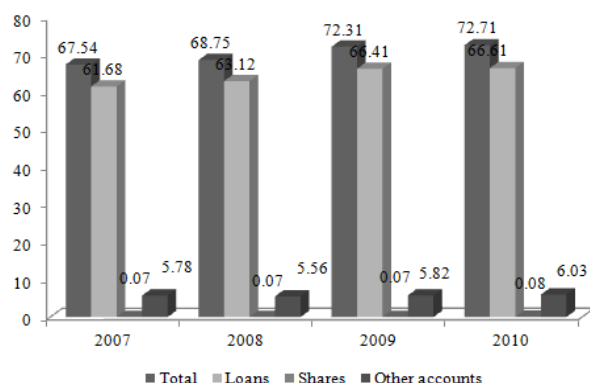


Figure 3. The financial liabilities of households in euro area (2007-2010, % in GDP)

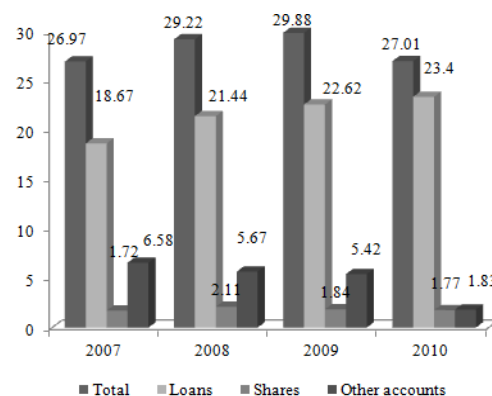


Figure 4. The financial liabilities of households in Romania (2007-2010, % in GDP)

Source: Eurostat, <http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/themes>, author's calculations.

The low relevance of the loan channel explains the difference between the transmission mechanism from Romania and the euro area, which means that the single monetary policy will have a low impact upon economy. The countries in which the loan channel is stronger are more vulnerable to changes of interest rate.

The importance of loan channel depends on the degree in which the loan diminishment influences demand and, implicitly, inflation rate. For example, the existence of other sources of financing (including commercial loan) limits efficiency of monetary policy.

Not only in the euro area, but also in Romania, the rhythm of growing for a non-government credit was superior to the one of consumption, which means that the borrowed amounts of money were not totally for consuming. But Figure 5 and Figure 6 suggest a stronger increase of credit, compared with consumer rise in Romania, which means that the highest part of the borrowed amounts were not for consuming, but for estate or shares acquisition.

The increase of demand for these assets can determine the increase of their prices, with an impact upon inflation. We consider that using loans to buy shares has a relatively high impact upon households, because most of the financial assets are represented by shares. Consequently, the increase of share prices will lead to an increase of financial wealth, leading therefore to consuming increase.

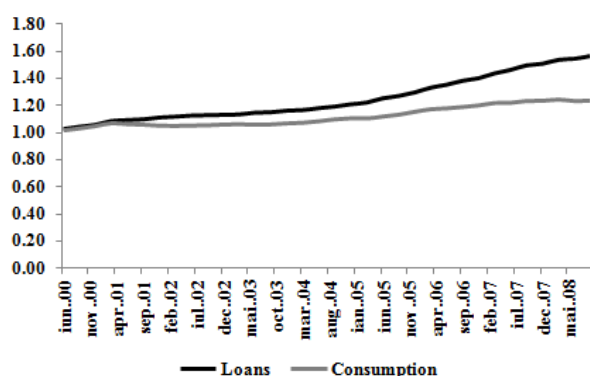


Figure 5. The evolution of non-governmental loan in euro area – fixed basis index (2000Q1 = 1)

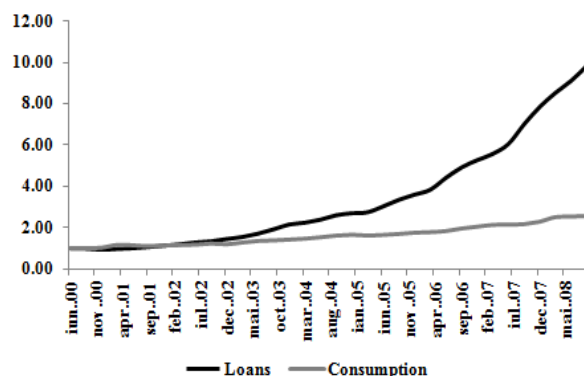


Figure 6. The evolution of non-governmental loan in Romania – fixed basis index (2000Q1 = 1)

Source: Eurostat, <http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/themes> European Central Bank, <http://sdw.ecb.europa.eu/>, Monthly Bulletins of National Bank of Romania, author's calculations.

To avoid the negative effects of adopting the common policy is necessary to promote a restrictive fiscal and income policy, in order not to determine an excessive increase of aggregate demand, this one being impossible to temperate through interest rate.

3. The Role of Fiscal Policy in Ensuring Price Stability in Romania after EMU Accession

The importance of fiscal policy in the EMU context derives from the necessity of assuming public finance sustainability, according to the Maastricht Treaty and Stability and Growth Pact. Sound fiscal policies and a

monetary policy geared to price stability are fundamental for the success of Economic and Monetary Union, these being the prerequisites for macroeconomic stability, growth and cohesion in the euro area (Statement of the Governing Council of ECB, 2005).

The fiscal policy of the euro area state members is independently established and reacts to national economic conditions. Although it is established on a national level, the fiscal policy is constrained by the measures of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. Firstly, this foresees the obligation for the member states to respect the limit of 0.5% of the GDP of the structural deficit and 60% of the GDP of public debt.

After the adoption of the euro currency, the fiscal policy is the only instrument to stabilise the national economy through automatic stabilisers. The automatic stabilisers capacity of absorbing the fluctuations of economic cycle depends on the nature of shock (demand or supply shock) and on their duration. For example, a shock of demand (the increase in private consumption, a decrease of exports) determines a modification of production and of inflation rate in the same way, and, therefore, the automatic stabilisers action in agreement with the central bank objective. If the economy deals with a temporary shock of supply (the increase in price of oil, unfavourable weather conditions), the production and inflation rate evolves in opposite direction. In this way, the automatic stabilisers influence the level of production, with the price of the high inflation. The inefficiency of automatic stabilisers upon inflation rate can be seen also in the case of a permanent shock of the supply. For example, in the case of productivity increase, the potential level of economy increase, and, consequently, the role of the automatic stabilisers is to create a balance: the convergence to the new potential level of production, the result being a high inflation.

Consequently, the role of the fiscal policy in tempering inflation rate is obvious in the case of demand shocks. But, in this case also, the efficiency depends on the size and openness of economy. For example, in the case of a small and open economy, for instance, the increase of the aggregate demand, as a result of increasing governmental expenses or decreasing taxes, is satisfied mostly by imports and less by the national production and, therefore, the impact upon national economy is low.

After the accession to the euro area, in Romania any of the previous mentioned shocks can occur, but the chances of occurrence for the permanent shock of the supply are increased, due to the catching-up process, which will follow. The result will be a superior level to the euro area of the inflation rate.

From the arguments listed above, we can conclude that *the fiscal policy is relatively inefficient in decreasing the inflationary pressures*.

The necessity of coordinating the fiscal policies in the monetary union is justified by the impact of the fiscal policy of a member state upon euro area a whole, not only on its own economy.

Fatás and Mihov (2009) consider that in the absence of a monetary policy, the fiscal policy must be more restrictive in order to smooth the business cycle, being the means of compensation for the shocks specific to one country. From our point of view, *fiscal policy in the euro area member states* has the role of macroeconomic stabiliser and, therefore, it must be counter-cyclical. If the economy deals with recession, a lax fiscal policy will be promoted.

In the context of the euro area the fiscal policy decisions from a member state have effects upon the other member states (the spillover effect), these ones being transmitted through the following channels (Weyerstrass et al., 2006; Giuliadori & Beetsma, 2004; Beetsma et al., 2001; Brunila, 2002):

- The trade channel: the fiscal expansion stimulates consumption and investments, influencing significantly the demand for imports and, consequently, influences the net exports in the other member states of the euro area. For example, the results of the study of Beetsma and Giuliadori (2004) have revealed the fact that the fiscal expansion from Germany, France and Italy has lead to a substantial increase of imports from the European market. Consequently, an expansionary fiscal policy in these countries, but also in Austria (as main trade partners from the euro area for Romania), leads to increase for the external demand, influencing, in this way, the level of inflation rate in Romania. Also, the effects of the fiscal policy upon domestic inflation are transmitted also upon inflation from the other states (imported inflation).
- The interest rate channel: the increasing national inflation rate, as result of expansionary fiscal policy, influences inflation rate in euro area, constraining the central bank to contract monetary policy, with effects upon all the member states. Also, fiscal policy effects upon budgetary deficit and, implicitly, upon governmental debt influences interest rate on the long term.

- The exchange rate channel (real and nominal): the increase of the interest rate leads to a nominal appreciation of the euro currency, with positive effects upon the inflationary process from all the member states. The increase of the consumer prices in a superior rhythm of the other member states determines a change of the real exchange rate (on the condition of the fix nominal exchange rate) with impact upon international competitiveness.

In our opinion, *an expansionary fiscal policy does not generate inflationary pressures if the economy increases under its potential level*. On the contrast, a procyclical expansionary fiscal policy exacerbates the inflationary process. Consequently, minimizing the spillover effects is connected to a counter-cyclical fiscal policy. In this case, the effects will occur only through the trade channel - the demand for imports.

We consider that the spillover effects of the fiscal policy are manifested in the whole world through the trade channel, because of the trade linkages that exist between states. Also, the interest rate channel generates effects in the entire European Union, not only on the euro area level, because the ECB interest rate influences the interest rate on the interbanking market (EURIBOR) and, consequently, it influences deposits and loans in euro. And the channel of the exchange rate generates effects in the entire Union, especially in the countries with a fix exchange rate (Lithuania, Latvia).

Therefore, the inflation rate in Romania will be influenced by the national fiscal policy and also by the one from the euro area member states. For instance, to decrease the inflationary pressures after the accession to the euro area, a restrictive fiscal policy is necessary not only in Romania, but also in the European states, because an expansionary fiscal policy in one of these states (especially with the states with trade linkages) will have negative influences upon inflation rate from our country on the imported channel on the one hand and, on the external demand channel, on the other hand. Consequently, the trade in the euro area influences the efficiency of the national fiscal policy. But we consider that a major role is being held by the way of restricting the fiscal policy. For instance, in Romania, the restrictive fiscal policy should be based on reducing the share of consumer expenses in the GDP and increasing the share of investment expenses in the GDP.

Gerald (2001) considers that if the fiscal policy on the euro area level is optimum, in the way of not creating pressures upon interest rate, the fiscal policy from each member state, does not have side effects upon the others. In the case when a fiscal stimulus leads to an inappropriate fiscal policy at the level of the euro area, it will lead to restrictions of the monetary policy through the increase of interest rate, with negative effects upon all the other member states. Because the aggregate values of the level of the euro area (the inflation rate, the structural deficit, the output gap) are influenced mostly by the individual values of the strongest economical powers (Germany, Italy, France), the effects generated through the channel of interest rate and the channel of the nominal exchange rate depend on the fiscal policy from these states.

We consider that the spillover effects of the fiscal policy from a member state will influence the inflation rate from Romania, on a large scale, *on the trade channel*, because most of our trade linkages of our country are with the EMU member states. As a consequence of the bilateral trade with the euro area, the generated effects on the nominal exchange rate channel will be relatively low. In what concerns the *interest rate channel*, the impact upon inflation rate depends on the interest rate elasticity of loan demand.

The main argument of coordinating the fiscal policies is represented by the possible negative consequences (Gerald, 2001, p.11, apud Buti & Martinot, 2000). In our opinion, the coordination of the fiscal policies is conditioned by business cycle synchronization. For example, if the economy of Germany is under its potential level, the fiscal policy will be an expansionary one, stimulating the external demand of Romania, having pressures upon consumer prices.

New fiscal treaty – the instrument for coordinating national fiscal policies – follows the prevention of excessive budgetary deficits, its aim being not to promote a fiscal policy of decreasing asymmetric cycles. The constraint imposed of maintaining the structural deficit under the limit of 0.5% of the GDP, limits the fiscal policy efficiency in the case of an economy under recession. The promotion of a counter-cyclical fiscal policy (the decrease of taxes, the increase of governmental expenses) would lead to an increase of the budgetary deficits.

4. Conclusions

The financial system of our country is underdeveloped, but the financial integration will reduce the differences between the monetary transmission mechanisms.

In the transmission mechanism of monetary policy, a major role is played by the structure of the financial assets and liabilities of households and corporations. If in the year 2007-2009 the weight of external sources of financing of corporations in the GDP was similar in Romania and the euro area, in the year 2010 in Romania

there has been a decrease by half of them, which means that the impact of the monetary policy decision was different.

Regarding the financial liabilities of households in Romania, these are mostly by bank loans, but their weight in the GDP is less inferior to the one from the euro area. Also, the effect of wealth of the assets price is relatively low in Romania, the financial assets of households (as a weight in the GDP) being half from the one in the euro area. Consequently, there are differences in the monetary transmission mechanism between Romania and the euro area, the loan channel being stronger in the euro area.

The negative effects of loosing the autonomy of monetary policy can be counteract by promoting some restrictive fiscal and incomes policies. After the adoption of the single currency, the fiscal policy is the only instrument to stabilise economy, but its capacity depends on the type of shocks, on the size and openness of economy. For instance, in the case of *Romania the fiscal policy will be relatively inefficient*, because the measures of the fiscal policy will affect on a low scale the national production. On the other hand, the probability of the supply shocks to manifest is high, shocks upon which the fiscal policy cannot action. But the inflation rate in Romania will be influenced both by the national and the euro area states member fiscal policy. Therefore, the inflation rate will be affected by the fiscal policy from the states with which Romania has trade linkages through the means of the external demand, in the case when this is counter-cyclical. If the fiscal policy from these states is procyclical, the spillover effects will be seen upon Romanian economy and on the channel of interest rate and exchange rate. In this case the effects will be positive, because a procyclical fiscal policy will increase inflation rate and, therefore, the ECB will react in order to temper it, through an increase of the interest rate and, implicitly, the euro currency will appreciate.

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