Romania's road to Euro zone.
From structural balance to structural balance corrected for absorption

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Abstract. *The sovereign-debt crisis in the European Union has determined the necessity to reform the signal indicators for the analysis of the public finances' sustainability. In this context, many of the developing/emerging countries consider that the informational value provided by the structural budget balance indicator is insufficient, especially during the periods characterized by absorption. The present study suggests the transition from classical structural budget balance (CAB) in the structural balance corrected for absorption (CAAB) and supports the use of an improved indicator of the structural budget balance with a superior informational relevance for the macro-economic policies decision makers. Based on the economic literature we will demonstrate that the structural budget balance indicator should be improved, in order to also take into consideration the deviation of the current account balance from its sustainable level, particularly in the stage of the economic cycle characterized by high absorption.*

1. Introduction

According to the Treaty of Amsterdam, all the countries which become member of the European Union must subsequently adopt Euro as currency, after a longer or a shorter period. Thus, the integration of a country within the European Union automatically engages its integration within the Economic and Monetary Union (EMU). The process of admitting the new Eastern candidates into the European Union and, subsequently, into the Euro zone, has been accompanied, from its very beginning, by a series of questions: Will the internal market get „eroded" at the moment of admittance of the less developed countries into the EU? How could the macro-economic stability be obtained within the candidate countries before the integration into EU? Which are the inter-dependencies between the nominal convergence and the real convergence? How could we reduce the development gap between the countries within the European model? Is it strictly necessary to abide to the criteria for admittance into the Economic and Monetary Union?

Even though the problem regarding the monetary union is more actual than ever, both for the countries which have already entered the Euro zone and for those which are less developed and which make preparations to fulfill the criteria so as to be admitted, the paradigm related to this theme appeared in the economic literature much earlier. Thus, the classical theory of the Optimum Currency Areas appeared starting with 1961 in an article presented by Robert Mundell, article which, subsequently, proved to have a special significance for the economic literature. At that time, Robert Mundell was succeeding in an extremely interesting thing: he was identifying certain *criteria* which should be fulfilled by a country which wishes to have net benefits from the integration into a monetary union. In fact, these criteria are based on a good operation of a new monetary union. Also, the role of this theory is to show *when* it is profitable for two or more countries to create a monetary union. In respect with this, almost 50 years ago, Robert Mundell was demonstrating that *the adoption of a unique currency in an improper moment may have more negative results than positive ones!* The classical theory of the Optimum Currency Areas was practically offering *the economic justification for the creation of the monetary unions*.

The selection of a system of the exchange rate has always been and it will remain for a log time a controversial problem for the specialists. The conclusions reached by the Mundell-Fleming model are especially important in order to understand *to what a country gives up in order to create a monetary union together with other countries*. In other words, the answer „the monetary policy is lost" (the main cost identified by Robert Mundell in the classical theory of the Optimum Currency Areas) may be trappy, on the conditions that the monetary policy is losing efficiency anyway, under the terms of a regime of

fix currency, in such a case *the fiscal policy* remaining efficient; moreover, according to the economic theory, the monetary policy is neutral for a long-term period (according to the principle of currency neutrality on a long-term).

A very interesting fact is that, after long analyses, Robert Mundell reached the conclusion (regarding the case of the European Monetary Union) that, once the countries within the European Union have *control over the budget deficits*, they will be able to make a choice for fixing the currencies according to the unique currency, with substantial benefits. That is why, after entire years of added/improved researches, Mundell himself was offering the solution for the European monetary union: when a country joins a monetary union, it gives up to one of the two macro-economic instruments – the monetary policy – but it keeps the complete control over the second – the fiscal policy. In other words, *the fiscal policy will have to fulfill a double task – it now becomes the only available macro-economic instrument.*

Considering that Romania should join the Euro zone as soon as possible, it is very important the analysis of the performance of the Romanian fiscal management, respectively to what extent the fiscal-budgetary policy in Romania is prepared to act as the only instrument capable of stabilizing the national economy subsequently to entering the Euro zone. Often, the efficiency of the Romanian fiscal policy has been analyzed on the basis of the estimation of the structural budgetary balance indicator, through which the dicretionarism degree of the fiscal-budgetary policy in Romania is evaluated. The estimation of the structural budget balance proportion is performed during three stages, as it follows: (1) the estimation of the gap between the gross domestic product effectively achieved and the potential gross domestic product (potential GDP) (output-gap or production gap); (2) the estimation of the cyclic component on the basis of the output-gap and of the gap sensitivity (in its turn, this one will be obtained through elasticity of incomes and through the budgetary expenses according to the GDP); (3) the estimation of the structural component by eliminating the cyclic component from the current budgetary component (Socol, 2009).

The sovereign-debt crisis in the European Union has determined the necessity to reform the signal indicators for the analysis of the public finances' sustainability. However, many of the developing/emerging countries consider that the informational value provided by the structural budget balance indicator is insufficient, especially during the periods characterized by absorption. Lately, it has been shown that, in order to make a correct assessment of a country's fiscal position in terms of public finances' sustainability, the structural budget balance indicator (CAB) is never so much enough, this indicator being obtained by adjustment depending on an economy's position on the economic cycle at a given moment (CAAB) (Socol et al, 2013).

2. Methodology (see details in Socol et al, 2013)

Lendvai et al. (2011) calculate the cyclically and absorption-adjusted budget balance (CAAB) by using the following sequence of equations:

$$CAB_t = \left(\frac{b}{y}\right)_t - \lambda_t (ygap)_t$$

here λ_t represents the standard budget elasticity (used in the EU studies)

$$CAAB_t = \left(\frac{b}{y}\right)_t - \beta_t (ygap)_t - \gamma_t (agap)_t$$

where γ_t is the elasticity of absorption (given by the share of the taxes and indirect taxes in the GDP). Considering the unit elasticity of the indirect taxes in relation to the CAB absorption and linearity to the output, we obtain as follows

$$\beta_t = \lambda_t - \gamma_t \text{ where } (agap)_t = \left[\frac{(a_t - a_t^*)}{y_t^*}\right] \text{ and } a_t^* = y_t^* - ca_t^* + it_t$$

Symbols: *b* the real budget balance; *y* and *y** the actual, respectively potential output; *ygap* and *agap* output gap and absorption gap; *a* and *a** absorption and potential absorption; *ca* current account norm*; *it* the amount of the revenues from abroad and the net transfers.

Lendvai et al. (2011) consider that, according to the above equations, we may reach the following relation

$$CAAB_t = CAB_t - \gamma_t (agap_t - ygap_t)$$

This relation is obtained starting from the hypotheses related to the unit elasticity of the indirect taxes in relation to absorption and the linear relation of the CAB to the output.

Results $CAAB = CAB_t - \gamma_t (agap_t - ygap_t)$

According to this formula, the authors' conclusions refer to the fact that "CAAB differs from CAB particularly when the share of the indirect taxes in the output is high and when the dynamics of the absorption significantly deviates from this output". The results obtained for the Romanian economy are presented in the Table 1:

Table 1

The CAAB estimation

Indicatori	CAAB
2005	-5.25
2006	-6.26
2007	-6.45
2008	-7.68
2009	-9.09
2010	-8.09
2011	-7.24
2012	-6.04

Source: author's estimates.

3. Conclusions

The differences between CAB and CAAB in Romania (see also Socol et al., 2013) denote the fact that the macro-economic policies should have been focused more on preventing the deepening of the current account unbalance, thus contributing to maintaining a sustainable macroeconomic environment.

The analysis of CAAB indicator proves the lack in efficiency of the public finances policies in stabilizing a fiscal position as profitable as possible. During certain periods, there can be observed a determination in carrying on the process of fiscal consolidation, but the evolution of the structural budget deficit in Romania compared with CAAB during the analyzed period reveals an inconsistency in respect with the applied fiscal and budgetary policies

From the point of view of the efficiency regarding the fiscal-budgetary policy, Romania still encounters problems. Moreover, the risks of the low efficiency in the management of the public finances will produce serious effects, especially on a long-term. The side-slippings of the budgetary policy will laying pressure on the twin deficits (the budget deficit and the current account deficit) and on inflation. The imperfect management of the budgetary policy in Romania will affect, in this way, Romania's admission to the Euro zone. Until the admission to the Euro zone, the Romanian decidents of fiscal-budgetary policy will have to increase the reaction rate regarding the adjusting to the shocks on the aggregate demand or offer, followed by rendering their action compatible with the practices of good governing in Europe.

By the increased occurrence of the effects regarding the phenomenon of "tye-hands of the authorities" who are decident in the monetary policies and those of rate exchange within the member countries, the decisions made by the specialists in public finances become more and more important. The authorities have to become aware of the fact that the efficiency of the budgetary policy will become more and more important. Watching towards the future, in respect with the loss of a few policy instruments which were at the disposal of the National Bank of Romania (simultaneously with the admission to the Euro zone, the instruments of monetary policy and of exchange rate become inoperable), the cautious fiscal policy for strengthening soundness public finances represent only a desideratum.

Aknowledgements

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