

EXCHANGE RATE APPRECIATION AND EXTERNAL TRADE SUSTAINABILITY: THE CASE OF ROMANIA

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Abstract. In most Central and Eastern European Countries, during the last 10 years, the real exchange rate appreciated. In the countries having adopted a flexible exchange regime, nominal exchange rate appreciation was a common phenomenon. Recently (starting with October 2004), this tendency could be observed even in Romania. Although considered a normal phenomenon, caused by the catching-up process, the exchange rate appreciation is feared in all countries, as it favours importations and slows down exportations, jeopardizing the sustainability of the external trade balance and having a negative impact on the national competitiveness. In this paper, the correlation between the exchange rate evolution and the dynamics of external trade is investigated, for Romania. The analysis tries to find some support for the fears expressed by the Romanian exporters regarding the appreciation of the leu toward the euro and for the accusations addressed to the national bank of Romania, concerning the exchange policy. All arguments considered, including the liberalization of capital movements, the decision of the National Bank of Romania, to let the leu float more freely on the exchange market, seems to be justified.

Keywords: exchange rate appreciation, external trade, national competitiveness

1. Introduction

The Central and Eastern European countries (CEECs) present many common features – especially those who entered the European Union (EU). Among the phenomena that can be observed in these countries, there is a strong real exchange appreciation. In the context of entering a unique market, with very strong competition, exchange rate appreciation can damage external trade competitiveness. The paper is trying to find a causal relationship between the evolution of the exchange rate and the performances of external trade for the case of Romania.

The exchange regime is first investigated, in all CEECs members of the EU, and then the evolution of the exchange rate against the euro is analyzed. The appreciation of the real exchange rate can be clearly seen in all the countries investigated. The analysis focuses especially on the exchange rate between the Romanian leu and the euro and its consequences on the Romanian external trade. Recently, the exchange rate appreciation became noticeable and the National Bank of Romania (NBR) stopped its interventions focused on limiting the real exchange rate appreciation. Romanian exporters expressed their fears and obvious discontentment accusing the NBR for all

their losses. The analysis could not find support for the accusations formulated by the Romanian exporters; on the contrary, all arguments considered the decision of the NBR, to let the leu float more freely on the exchange market and to give up any objective in terms of maintaining a certain level for the exchange rate, seem to be justified.

2. The exchange rate regime in the CEECs

At the beginning of transition, most of the CEECs were confronted to very high inflation rates (hyperinflation). Hoping that pegging the national currency to a strong currency used by a country (or group of countries) having a low inflation rate could help lowering the national inflation rate, many CEECs adopted a fixed exchange regime or a crawling-peg (crawling-band). Once the macroeconomic stability was achieved, the priorities of the monetary and exchange policy changed, and many countries passed from rigid exchange regimes to more flexible regimes

The exchange regimes currently used by the CEECs members of the EU are presented in table no. 1. Presently, four countries are participating to the European Exchange Rate Mechanism II (ERM II) – Slovakia, Estonia, Latvia and Lithuania (while Slovenia already adopted the euro).

Table 1. The exchange regime in CEECs

Country	Exchange regime	Pegged to
Bulgaria	Currency board	Euro
Estonia	Currency board	Euro
Latvia	Nominal peg	Euro
Lithuania	Currency board	Euro
Poland	Free float	-
Czech Rep.	Managed float	-
Romania	Managed float	-
Slovakia	Horizontal band ($\pm 15\%$)	Euro
Slovenia	Is part of the Euro area	
Hungary	Horizontal band ($\pm 15\%$)	Euro

Source: [1], p.139, (brought up to date with data from the Central European Bank)

The exchange policy of Romania is, since 1991, the exchange rate managed float. The full internal convertibility of the leu was achieved only at the end of 1997.

The absence of important pressures on the exchange market in the last few years (starting with 2002) allowed the NBR to reduce the frequency of its interventions on the exchange market, while keeping a comfortable level of the foreign reserves.

Starting with October 2004, the NBR reduced not only the frequency of its interventions on the exchange market, but also their predictability; by doing this, it allowed the “de facto” exchange regime to align to the official one: managed float (until then, the Romanian “de facto” exchange regime was considered by the IMF and several economists to be a crawling band).

For the years to come, Romania will maintain the same exchange regime (managed float) - until 2012, when the entry into the ERM II is scheduled.

3. The evolution of the exchange rate in the CEECs

The real exchange rate followed the same trajectory in all CEECs: a strong depreciation at the beginning of the '90s, followed by a continuous appreciation. The dimension of the appreciation was stronger or weaker, depending on the exchange regime adopted, the inflation differential (as shown by [2]) and the level of real convergence.

We can notice a clear distinction between the countries from the “first wave” and the countries from the “second wave”. The countries who started latter the accession negotiations

(Romania, Bulgaria, Slovakia, Latvia and Lithuania) recorded a higher appreciation of their real exchange rate against the euro (28%-39%) - compared to the other CEECs (6%-23%). The real exchange rate appreciation was particularly modest in Slovenia – the country that has the highest level of real convergence.

Usually, the real exchange rate appreciation did not lead to an overvaluation – it corrected (partially) the initial undervaluation of the currencies of those countries [3] and followed the tendency of appreciation of the equilibrium exchange rate [4]. Therefore, this appreciation process should be seen as a normal evolution, specific to the catching-up process. De Broeck and Sløk [5] showed that a catching-up speed of 1% in terms of GDP/habitant (expressed in PPP) is accompanied by a real appreciation of 0.4%.

The majority of the studies focusing on the CEECs show that there is no important difference between the effective exchange rate and the equilibrium exchange rate [6]. The equilibrium exchange rate is not constant for the CEECs – it evolved under the influence of economic fundamentals and catching-up.

A recent study [1] shows that the evolution of the real exchange rate of the CEECs is justified by economic fundamentals. It includes a detailed analysis of the exchange rate between the Romanian leu and the euro. The results obtained for Romania are very similar to the results obtained by other authors for the other CEECs [7], Coudert and Couharde [6] proving that the real exchange appreciation is an equilibrium phenomenon that needs to happen in order to allow the effective exchange rate to align to the equilibrium exchange rate.

4. The evolution of the exchange rate between the Romanian leu and the euro

The National Bank of Romania monitored closely the evolution of the exchange rate. First, the US dollar was used as a reference currency. After the euro was launched, the US dollar was replaced by a currency basket made by the US dollar and the euro. Gradually, the part of the euro increased in this basket. Finally, the reference currency remained the euro.

Although the legislation did not impose the NBR to focus on the evolution of the exchange rate, it chose to do so. Repeatedly, the NBR declared it has established an objective concerning the exchange rate: allowing a sustainable

appreciation of the real exchange rate against the currency (or the currency basket) used. The BNR allowed a real appreciation of maximum 2 – 2.5% per year, against the currency basket. When the euro strongly appreciated against the US dollar, the real appreciation of the Romanian leu against the euro was lower than 2% and sometimes even negative: starting with 2002 we can clearly notice a tendency of real depreciation of the Romanian leu against the euro.

The evolution of the real exchange rate (RER) of the Romanian leu against the euro and its trend (determined by means of a Hodrick-Prescott filter) is presented in the figure 1, for the period January 1995 – March 2004.

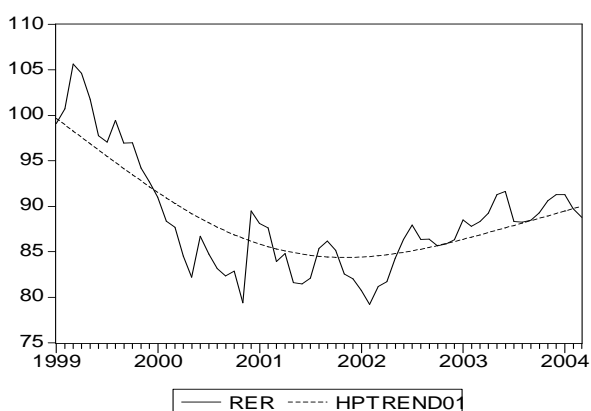


Figure 1 – The trend of the evolution of the real exchange rate RER

Source: [1], p.267

The graphic clearly shows that after an evident real appreciation experienced in the first part of the period (January 1999 – beginning of 2001), the trend changed. It should be noted that before 2001 the Romanian authorities used the US dollar as reference currency and the euro depreciated against the US dollar.

For the second part of the period (2002-2004) the Romanian leu shows an evident tendency of real depreciation against the euro (even if it appreciated against the currency basket used by the NBR during the whole period considered).

In June 2004, the Romanian Parliament adopted a new law on the Statute of the NBR, stating clearly that the main objective of the Romanian central bank is price stability. May be this legal modification determined the NBR to change its exchange policy. Not being bound any more to support the economic policy (understood usually as limiting the exchange rate appreciation in order to maintain the competitiveness of Romanian exportations), The NBR decided to

focus on its main objective, to put the price stability first and to care less of the exporters.

In October 2004, the NBR decided to reduce the frequency of its interventions on the exchange market. Its interventions became fewer, but more massive and less predictable. The decision was taking in the context of the liberalisation of capital movement, aiming at discouraging speculative attacks. It was also meant to prepare the following major change of the monetary policy: the adoption of a strategy of direct inflation targeting. Clearly, a predictable exchange rate is not well suited to free capital movements; and definitely, a monetary policy targeting the inflation rate needed more flexibility of the exchange rate than allowed up to this point.

After this decision of the NBR, in only a few months, the nominal exchange rate of the Romanian leu against the euro passed from 41.127 lei/euro in October to 38.494 lei/euro in December (an appreciation of 6.84%). In March 2005, the exchange rate was 36.422 lei/euro – meaning a nominal appreciation of 13% for a five months period. The nominal exchange rate against the US dollar had a similar evolution, dropping from 33.340 in October 2004 to 27.473 lei/dollar in March 2005. If we consider also the inflation differential between Romania and the Euro or the USA – around 7% at that time) we can have a clearer image of the size of the real appreciation of the Romanian leu.

This evolution came as a shock to most Romanians (population and companies). We should keep in mind that before 2004 the real appreciation was not really perceived by most Romanians: with an inflation rate well over 10% (2004 was the first year, after the 1989 Revolution, when the inflation rate in Romania was expressed by a single digit), the nominal exchange rate depreciated continuously, even when the real appreciation was strong. Therefore, after 15 years of depreciation, suddenly the Romanian leu strongly appreciated in nominal terms. It was definitely something difficult to accept, especially for the exporters.

The Romanian exporters began to accuse the NBR that it jeopardises the development of the national economy. The subject became rapidly one of the hottest topics in all Romanian mass-medias. The NBR was further accused of diminishing the competitiveness of Romanian companies, of generating a deficit of the trade balance impossible to sustain, and finally, of trying to destroy the

national economy.

Apparently, the strong appreciation of the national currency was not desired by the NBR and may be, not even anticipated by it. In its publications, the NBR stated that its monetary and exchange policy was able to maintain the effective exchange rate close to its equilibrium level, through a weak, but constant real appreciation. The real depreciation of the leu against the euro during the period 2002-2004 (obvious and easy to see, from the data published by the NBR) was never mentioned – most probably because it was not acknowledged. It is difficult to imagine that the NBR decided to let the national currency float more freely immediately after a long period of evolution contrary to the logical and normal one.

Yet, the NBR held to its decision, and after several months of strong appreciation, the exchange rate stabilised. Its level in January 2006 (3.6445 RON/EUR) was very close to the level from February 2005 (3.6765 RON/EUR). Apparently, the market found its equilibrium.

Starting with February 2006, the Romanian leu showed a clear tendency of appreciation, but in a completely different rhythm (passing to 3.2850 in May 2007 – an appreciation of roughly 10% over the last 16 months). This appreciation is more likely to follow the evolution of the equilibrium exchange rate and it is slow enough to avoid shocks. We could say that the exchange rate between the leu and the euro is now stable, according to the communitarian definition (it never passed the limit of $\pm 15\%$ in the last 2 years).

The fact that the exchange rate appreciated in all CEECs shows that the evolution of the Romanian leu against the euro was something normal, not a consequence of a mistake in terms of economic policy. As mentioned before, the real appreciation is not something new for the Romanian economy; it existed for a very long time (with some periods of contrary evolution) but it became visible only recently, in the context of lower inflation rates.

Still, although a normal phenomenon, the appreciation of a national currency is not favourable to exporters. It discourages the exporters and encourages the importations, and therefore it can lead to negative consequences, in terms of deficit of the trade balance. This is a risk to consider in Romania, since for years this country had an important and constantly growing deficit of the trade balance.

5. The influences of the exchange rate appreciation on the external trade

Analysing the Romanian exportations, we see that the exchange rate appreciation was accompanied by a certain reduction of the exportations during the period October 2004 - December 2004. But a more in depth analyses shows that this reduction was similar, if not less important, than the one recorded in July-August 2004. Apparently, the influence of the exchange rate appreciation is more visible on importations, which increased in a more accelerated rhythm. Yet, the Romanian importations always showed a similar tendency at the end of the year. Unfortunately, the period of time passed from the decision of the NBR to allow the national currency to float more freely is too short for econometric tests. But it is possible to analyse the facts.

In the first trimester of 2005, the level of the Romanian exportations was by 18.2% higher to their level in the first semester of the previous year. The level of importations was by 22.9% higher than the level recorded in the first trimester of 2004. For the whole year, the level of Romanian exportations was EUR 22.255 millions in 2005 – higher by 17.52% to the level reached in 2004. The level of importations increased, for the same period, by 23.9%. This evolution led to the widening of the deficit of the trade balance – but this evolution is perfectly in-line with previous evolutions. The deficit of the trade balance increased even during the period 2002-2003, when we had a nominal and real depreciation of the leu against the euro (as shown in Table 2).

During the last few years, the importations increased more rapidly than the exportations, leading to the worsening of the situation of the trade balance. In 2005, the deficit was 9.2% of the GDP (compared to only 6.0% in 2003). Yet the situation seems to be sustainable, if we consider the situation from other CEECs (14.7% in Bulgaria, 12.9% in Latvia, 12.1% in Estonia) and the situation of the foreign reserves held by the NBR, that cover over 5 months of importations.

Concerning the structure of Romanian exportations, we can notice the important part of textiles – around 20% of exportations, this type of product representing the category best sold. In this category, a large part is the result of job-processing contracts, meaning a low proportion of the autochthon costs and high level of correlation with the importations.

Table 3. Romanian external trade (mil. EUR)

Year	Exportations	Importations	Sold	Evolution of the sold
2000	11.273	13.140	-1.867	-
2001	12.722	16.045	-3.323	+77%
2002	14.675	17.427	-2.752	-11%
2003	15.614	19.569	-3.955	+44%
2004	18.935	24.258	-5.323	+35%
2005	22.255	30.061	-7.806	+46%
2006	25.850	37.609	-11.759	+51%

Source: NBR [8]

While analysing the effects of the exchange rate on the external trade, we should also consider the fact that the Romanian economy has a high degree of dollarisation/euroisation. In Romania many prices are established in euros or in US dollars (the prices for telecommunication services, the prizes for housing, rents, the prices for computers etc.) and other prices (e.g. for public utilities) are closely linked to the exchange rate evolution. Even wages are often negotiated in dollars or in euros. This aspect of the Romanian economy reduces the influence of the exchange rate on external trade.

Searching an explanation for the persisting inflation in Romania, Târhoacă [9] shows that the relationship between currency depreciation and external competitiveness is ephemeral. Theoretically, in case of high inflation, the exchange rate can be used as an intermediate objective for the monetary policy in order to reach price stability. Contrary to this theoretical possibility, the NBR systematically used the exchange rate as a target of the monetary policy, but seeking to protect the external competitiveness, not to achieve price stability: the leu was depreciated, leading to a relative increase of the prices of tradable goods; as a consequence, the resources were relocated from the sector of non-tradable goods to the sector of tradable goods, which led to an increase of the prices of non-tradable goods, offsetting the initial depreciation. This cycle continued repeatedly, the only durable effect being the increase of prices: inflation.

Târhoacă is not the only Romanian economist warning on the ephemeral relationship existing between exchange rate depreciation and external competitiveness. The recent evolution of the exchange rate in Romania proves clearly that the competitiveness of Romanian exportations is

influenced by the exchange rate in a very small proportion.

It is true that the modification of the exchange policy, which finally allowed the nominal appreciation of the leu gave a painful punch to exporters that had long-term contracts. But we need to be honest concerning the causes. For many years, the exporters need not worry about hedging methods, in order to cover the exchange risk. This risk was inexistent for Romanian exporters, since the exchange rate was very predictable: it could go in one direction only - a further depreciation of the leu [10]. Now we reached a normal situation for a market economy, where the operators (including exporters) have to learn to protect themselves against risks, including the exchange risk.

At the beginning of March 2006, an important financial publication from Romania (the Review "Capital") published an article [11] on the exchange rate and its effects on the businesses. This article starts with the following word: "Hedging. A new word entered into the Romanian business vocabulary that starts to be used more and more, not in conversations, but in the daily activity. The financial managers are thinking about the means to make their companies profit from the fluctuations of the exchange rate". Finally, the Romanian companies are learning to protect themselves and to profit from the fluctuations of the exchange rate. But why did it take so long?

In February 2006, the IMF recommended the Romanian authorities to pursue a strict monetary policy and to allow the appreciation of the national. The decisions of the NBR seem to be in line with these recommendations.

But the exporters have a hard time letting go the advantages they've been used to. In February 2006 they accused, again, the NBR of trying to "destroy" all Romanian exporters, of "continuing the funerals of the Romanian exportations", by allowing the appreciation of the leu.

Remarkably, face to these renewed accusation, the BNR stood strong and kept its way, putting the objective of price stability where it should have been: as its first priority. This being done, the NBR was successful with the new monetary strategy - although the inflation target for 2005 was missed, in 2006 the target was realised: 4.87% annual inflation rate (Dec/Dec).

6. Conclusions

We could say that starting with October 2004, the NBR stopped protecting the Romanian exporters; but we can also say that starting then, the NBR stopped sacrificing the interests and the well-being of the national economy, as a whole, for assuring an easy life to Romanian exporters.

The recent evolution shows that at that moment (October 2004) the exporters were already able to protect themselves. Of course, this change was not pleasant for them, as the new situation implies some supplementary efforts from their part. But we have to admit that the national economy is better off with the central bank pursuing its objectives in a normal way.

Actually, in long-run perspective, we could say that even the exporters had something to gain from this evolution, because they were forced to adapt themselves more rapidly to a competitive market and they had a few years to prepare themselves for the competition on the single European market, before becoming a part of it.

The exporters affirm that there is no measure that can be efficient enough in offsetting the effects of the exchange rate appreciation, since any possible solution has now a cost. Here we completely agree: all possible solutions now have a cost that the exporters must pay, while the exchange rate depreciation is the only solution free of cost for the exporters.

But if we take a closer look we observe that the exchange rate depreciation has its costs – paid by the whole economy. And those costs are far greater than the ones associated with hedging. Because there is no catching-up without appreciation of the currency – fact proved by the experience of all the other CEECs. More we fight this normal evolution, more we hinder and delay the catching-up process.

This is the main contribution of this paper: it brings light on a topic not very well understood or investigated so far. It shows that in Romania, just as in all other CEECs, the appreciation of the exchange rate is something normal. Although not something enjoyable for the Romanian exporters, this evolution did not lead to any major problem for them, nor for the external trade. Moreover, Romania is an open economy: the exportations are closely linked to the importations and the evolution of the exchange rate has only a marginal influence.

The exporters are extremely important to any economy and they should definitely be encouraged and supported by the state. But the

state needs to find the appropriate means to do that and one of the most important steps taken into this direction in our country was to acknowledge the fact that the monetary and exchange policy are not the appropriate means.

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