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THE COURSE POLICY AND THE FOREIGN CURRENCY REGIME IN ROMANIA

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Abstract

The increase of connections between national economies generated an enhance of foreign currency activities, thus being necessary a continuous arrangement /adaptation both for foreign currency policy and course policy to market mechanisms/devices. In Romania were registered frequently modifications of foreign currency policy, thank to the need to create a legal frame appropriate to the market economy and the financial tools evolution. In this work I have presented the main features of foreign currency regime and the course policy registered after 1990. Too, it is illustrate the co-ordinates for an optimum foreign currency policy strategy of Romania in the modern economical conditions.

The year 1990 marked a radical change in the economies of the countries of Central and Eastern Europe, which were subject to reforms and structural changes in order to form and develop functioning market economies. The currency policy was also an essential component of the macroeconomic strategy formulated in this regard, aiming to adapt the exchange system to the economic situation of each country. The options for implementing an exchange system were varied, even if there were similarities in their economic, political and social framework, all types of regimes being used (fixed rate, administered flotation or free flotation, but also intermediary regimes: crawling peg or crawling band). The exchange rate was used as a monetary anchor as well as a monetary multiplier, as was the case of Romania.

The selection of exchange regimes was made according to the practical situation of each country and to the major objectives concerned. Thus, countries with a poor economy, dependent in a significant proportion on imports, such as Bulgaria or Lithuania, have dropped the liberalized regime and switched to fixed regimes. However, other countries switched to liberalized regimes because of factors such as: increase of capital input, development of privatization process and, implicitly, entries of significant amounts representing direct investments of capital, development of financial markets and increase of the capital account liberalization degree.

Romania recorded, in early 1990, the most favourable external financial position of all the countries of former Eastern European Bloc. This was not the result of normal functioning of the economy but of export forcing until draining of the country resources and import limitations, endangering the productive potential of the economy. Abandoning of mechanisms regulating the external trade has been an objective and inevitable process that generated a rapid deterioration in the balance of external payments.

The official exchange rate was established by monetary authorities in January 1990 to the parity of 21 lei / dollar (while on the unofficial market a rate of over 80 lei / dollar was recorded), blocking the interest of any producer and boosting imports. Artificial maintaining of this rate led to rapid depletion of the currency reserve and to a serious deterioration of the trade balance. Opening of the interbanking currency market in 1991 resulted in the use of a

dual rate system, there being both the official rate and the interbanking market rate. The major discrepancies recorded between the two rates determined the need for unification.

At the beginning of 1992, in an attempt to limit the inflationary process, the freeze of exchange rates was imposed. The effects recorded were: significant increase of import demands, continuous reduction of exports on the background of continuation of the domestic inflationary process, national bank's inability to meet the demand for foreign currency, worsening of imbalances. Therefore the administrative freezing at an overvalued level of the domestic currency rate is not a measure that causes the population and economic agents' growth of confidence in the economic policy in general and in the foreign exchange policy in particular. It was also obvious that without a proper policy on interests and firm measures to improve financial discipline, the stabilisation of exchange rate evolution can not be achieved. In this context, the National Bank of Romania has passed a new package of monetary policy measures concretized by allowing economic operators' full retention of revenue from exports, in accounts opened at Romanian banks, and by letting the exchange rates find their balance at the level set by the market. The attempts for stability promoted by the NBR in the last part of the year did not have favourable effects: exports began to fall, the trade balance recorded increasing deficits, the rate established on the market of exchange rates moved away from the interbanking market rate, the transactions on the black market intensified, traders' confidence in the market was eroded, causing the maintenance of inflationary anticipations. To avoid recording an excessive inflation, de facto liberalization of interbanking tender and introduction of the mechanism of continuous and integrated foreign exchange market were chosen. These measures resulted in a slower depreciation of leu and certain stability by the end of the year. The foreign exchange market has performed well during the first months of establishment of the mechanism, proving that it was viable. Subsequently, there appeared a series of malfunctions mainly caused by: the low level of liquidity in foreign currency in the banking system (due to maintenance of the current account deficit, modest inputs of capital and promotion of domestic credit in foreign currency); the insufficient level of foreign exchange reserves of NBR, which did not allow it to exercise operative interventions in the market in order to eliminate tensions when they occur; the stiffness generated by the banking system; the political sensitivity towards depreciation of the leu. NBR has made a series of interventions on the foreign exchange market, but they led to a level which was no longer justified by the evolution of basic indicators in economy. The maintenance of an overvalued rate in most of the year 1996 generated the increase of trade balance deficit by over 50% compared to 1995. Its persistence, which caused a shortage of foreign currency on the market, together with a relaxed budgetary and monetary policy, led to amplification of the parallel market where importers have increasingly resorted to, the supply of foreign currency being assured from the export revenues which, under the given conditions have avoided the banking system and implicitly the official market. The considerable reduction of differences between the exchange rate practiced at the level of exchange offices and the rate formed on the interbanking market has been achieved through liberalization of the foreign exchange market at 18 February 1997. Nevertheless, the premises of an accentuated depreciation of the leu occurred again, and towards the end of the year there appeared serious problems of the banking system that could cause a systemic crisis, in the absence of central bank intervention. As a result, to maintain control over inflation, priority of the currency policy was to avoid an accentuated depreciation of the leu. In 1998, the coordinates of the currency policy were circumscribed to a slow and gradual depreciation of the national currency. NBR used the interventions on the foreign exchange market to counter the leu depreciation pressures and also as a less expensive means to absorb liquidities. Liberalisation of all current account transactions and of the access of population to foreign currency represented an important step in strengthening the foreign exchange market. Actually, accepting the obligations stipulated in

the Statute of IMF on the abolition of restrictions on current account transactions and Government's commitment not to introduce any such future restrictions has been a key point in the evolution of the exchange rate regime. **The exchange rate regime remained the controlled (managed) flotation** which, because of the interventions performed by NBR on the foreign exchange market, resulted in a limitation of the strong re-appreciation of the national currency, so that in 1999 the depreciation in real terms of the leu was 9.4% (December / December), which was the basis for improving the external position of the Romanian economy.

By its foreign exchange policy, NBR has sought to ensure functioning of the foreign exchange market at the balance parameters specific to the previous year, affecting the exchange rate only through direct instruments, namely through interventions on the foreign exchange market. However, the foreign exchange market continued to remain narrow and sensitive to a series of economic phenomena: the volatility of flows from portfolio investments; fluctuation of interests on the monetary market; increase of demand for imports; temporary pressures induced by seasonal factors.

During the year 2000, the foreign exchange market recorded a smooth growth trend characterized by over offer of currency, mainly as a result of export cashing and of current transfers, there being an increase of NBR interventions that aimed at eliminating the currency excess in order to avoid appreciation in real terms of the leu and to strength the foreign exchange reserve.

The foreign exchange market remained the most active segment of the financial market in 2001. In this regard, an accentuation of dynamism in the interbanking sector was manifested, more visible in the second part of the year when sales of currencies were higher with 31.5% and purchases with 31%. These increases are due in particular to the increase of foreign economic exchanges, but also to speculative transactions of operators on the foreign exchange market carried out in certain intervals.

The real appreciation trend of the exchange rate shown especially during 2001-2005 resulted in a considerable reduction in inflation. The specified purpose of NBR in this period was to place the annual pace of real appreciation to a level compatible with the observance of "the golden rule" (labour productivity growth is higher or at least equal to the sum of the national currency appreciation and average salary growth, expressed in real terms). As from 2004, NBR has reduced its interventions on the foreign exchange market, which resulted in strengthening of the national currency. This policy was not maintained for a long time because there has been an increased volume of capital input on short term, which made the national bank buy a huge amount of foreign currency (approximately 3.2 billion euros). But in the last two months of the year the NBR interventions were eliminated in order to have a greater flexibility of the exchange rate and to reduce the nature of predictability, to discourage currency speculations. In this context, the exchange rate had a high degree of volatility. In 2005 the trend of leu appreciation continued, without being registered significant changes in the exchange rate or other parameters of the interbanking foreign exchange market. In August 2005, NBR adopted the strategy of direct targeting of inflation. The change of monetary policy strategy was justified by the fact that targeting the monetary aggregates was no longer an effective strategy since the relation between monetary aggregates and inflation was weakened and became less predictable. The relative stability of the exchange rate has been made despite the influence of factors with adverse action (accentuation of current account deficit, external payments - in particular for the payment of external debt, increase of residents' investments abroad), encouraged however by the emergence of some positive factors (increase of private current transfers to Romania, increase of volume of foreign direct investment and of loans and credits, reduction of currency output corresponding to the portfolio investments of residents).

In 2006, the exchange rate had the most powerful oscillations during 2002 - 2006, the national currency continued to appreciate. The fluctuations recorded in 2007 had amplitudes of 16.42%, but without exceeding the threshold of 17.69% recorded in 2003. During the entire year, the exchange rate remained in the top variation range of volatilities recorded in regional markets.

A suggestive reflection of the exchange rate evolution is shown in Figure no. 1:

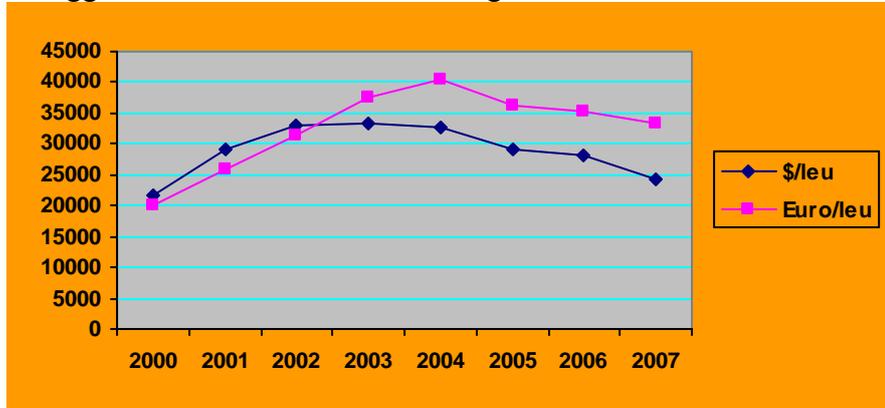


Figure no. 1 The evolution of real average exchange rate of leu against euro and dollar during 2000-2007

In our country several exchange regimes have been implemented. Thus, after 1990 the maintenance of a fixed rate was attempted, which however generated negative results (absence of daily fluctuations in the exchange rate does not provide decision-makers a feedback on the quality and impact of monetary policy decisions). The freezing of exchange rates in an attempt to limit the inflationary process since the beginning of 1992 did not result in raising the confidence of population and economic operators in the foreign exchange policy promoted by monetary authorities. Also, the use of exchange rate as an actual anti-inflationary anchor was a failure for Romania. The switch to controlled flotation was not effective either because of the lack of correlation with other measures imposed by the Romanian economy realities. Switching to free flotation caused large fluctuations of the exchange rate, keeping it however in certain ranges of fluctuation.

In conclusion, the adoption of a certain currency regime materializes the political option of decision-makers in the country, under some specific conditions of economic and financial nature and the application of economic policies appropriate for that exchange rate regime.

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