

## THE IMPLICATIONS OF VARYING EXCHANGE RATES FOR THE INTERNATIONAL TRADE

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*The benefit of international trade is a more efficient employment of the productive forces of the world.*

*(John Stuart Mill)*

*The exchange rate is a primary factor that influences economy. This instrument is used by some countries in order to improve the lack of balance caused as a result of the financial crisis felt in many countries considered by then infallible. The negative effects of the financial crisis can also be found in the decreased volume of commodities involved in international trade exchanges, as a consequence of modified prices and decreased offer. The globalizing trend leads to a constant expansion of exchanges between countries and to the consolidation of international cooperation. Except that economic interdependence generates an increased risk under the influence of economic, financial, monetary or political factors. The currency risk can generate either a gain or loss during foreign trade operations. The long period of RON depreciation made possible the entry of Romanian products on the international markets due to their prices. Sheltered by the gain generated by the evolution of the exchange rate, most of the exporters were not concerned by the increase of product competitiveness or by avoiding the currency risk. The fact that, for many years, the evolution of the exchange rate generated substantial losses for the exporters shows that risk coverage in Romania is, in most cases, a purely theoretical concept.*

*Key words: exchange rate, currency, depreciation, appreciation, J Curve.*

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### **1. The depreciation and its effect on the international trade exchanges**

Generally, by depreciation we understand any decrease of the exchange rate on the currency market. Taking this into consideration, a clear differentiation has to be made between two different circumstances:

- one in which the depreciation phenomenon manifests itself unintentionally, involuntarily or, in other words, without acting in an administrative manner towards deliberate depreciation;
- the second situation, where the depreciation phenomenon is a direct consequence of some actions undertaken by the monetary authority itself in this regard, and which is a voluntary, deliberate depreciation by the monetary authority. As regards the first situation, depreciation can be caused by – as a main element – the lack of equilibrium of the balance of payments, meaning that the level of imports frontloads the level of exports as opposed to a previous time, an element that is usually combined with: the weak competitiveness of domestic products on foreign markets and the diminished purchasing power of the domestic currency caused by inflationary phenomena.

However, studies have been made and practice has shown that choosing voluntary currency depreciation can constitute a monetary policy for using the exchange rate in order to balance the country's trade balance. This monetary policy option was based on a scheme of set foreign exchange rates, especially where depreciation could be established through administrative means, but was also applicable in the case of exchange rate schemes with managed floating.

The monetary authority can act deliberately upon the national currency exchange rate by buying foreign currency, so as to determine an increase in the exchange rate compared to other currencies, and thus, a depreciation of the currency. The direct consequence is the stimulation of exports which, according to the new terms, become more attractive and, on the other side, the inhibition of imports which, although there might be demand, are more expensive, and as the importer's profit margins are getting thinner, it is possible that his activity will be performed at the limits of return of profit, thus causing him to give up.

Under these conditions, the impact of deliberate depreciation on international exchange becomes a way of shifting the demand for goods and services from one country to another instead of changing the international demand level. (Rădulescu Magdalena 2005:64):

internally, depreciation will move the demand from imported goods towards the domestic ones; externally, deliberate depreciation of an exporting country's national currency will move the demand of another importing country from the area of domestic goods to the one of imported goods, made by the first country.

In general, it has been noticed that, if a country depreciates its exchange rate, it will then succeed, in fact, in attracting a more significant amount of the international demand to its own products and, accordingly, the domestic production will be stimulated, since under the new conditions, it will have to adapt to a developing level of demand (the export component).

*The national currency depreciation* (Ghe. M. Voinea 2007: 99) stimulates the exports of that country because the exporters cash a higher amount in national currency and impedes imports, since the importers spend a higher amount in order to pay for the goods obtained on the external market. Also, the currency depreciation gives advantages to the debtor because they are paying their debts in a depreciated currency, and disadvantages the creditors because they collect the debts in a weaker currency.

A country depreciates its currency in order to improve the price competitiveness of the products made by its companies, so as to increase exports, to reduce imports and, therefore, to rebalance the external balance of payments.

The success of depreciation is not guaranteed because its immediate effects are negative. The positive effects are visible only when exports and imports are flexible enough in comparison with the costs, i.e. the volume of exports increases as the prices of exported goods on external markets are falling, and the volume of imports is falling as the prices of imported goods are increasing.

### **3. The “J curve” and the impact of depreciation**

In economic theory, the effect of national currency depreciation is described based on the pattern of the “J curve”. So, the pattern was based on the regime of set rates, but can also be applied to the exchange rate scheme with managed floating. In both cases, a significant amount of foreign currency will be used as backup for the central bank interventions on the currency exchange market. This system is very expensive, but can affect net exports in the desired way by appreciation or depreciation of the national currency.

Paul Krugman and Richard Baldwin introduced the J curve in specialised theory (Krugman Paul, Baldwin Richard 1987:11-56). Their research uses data specific to the European and American economies and shows that a negative monetary shock reduces GDP for almost half a year, generating the currency appreciation for the same period. The trade balance achieves a surplus for one year and a half, followed by a trade deficit.

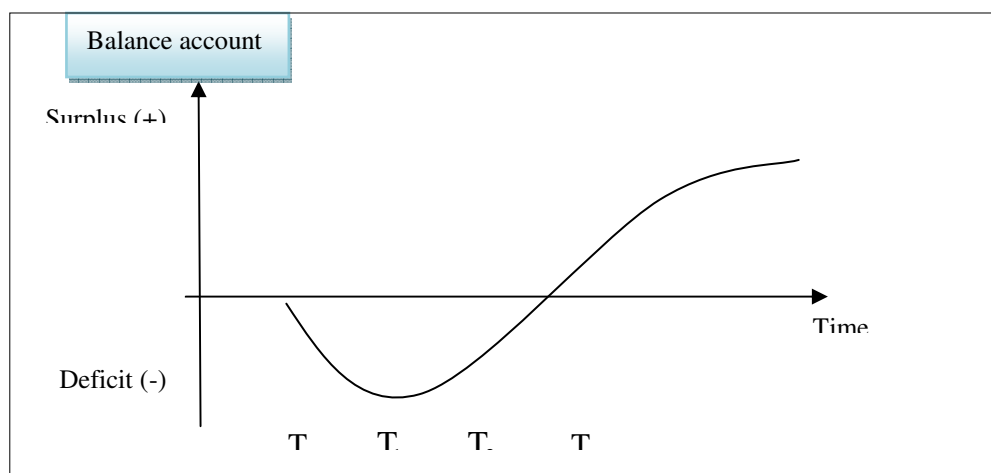
The J curve theory assumes that the positive effects of currency devaluation on the equilibrium of the foreign balance of payments is not visible immediately, but only after a certain period of time. According to the J curve, if national currency depreciates, then imports rise due to the influence of import prices, even if the quality remains unchanged. In time, imports fall and exports rise, contributing to the equilibrium of the trade balance.

These positive effects can only exist under certain conditions (Ghe. M. Voinea 2007: 99), such as: increasing the competitiveness of goods, expanding trade relations with other partners, developing the production capacity for transport, the transfer of product offer from one market to another.

The pattern of the J curve underlines the fact that a deliberate decision for the depreciation of the national currency can stimulate exports so as to equilibrate the trade balance within certain limits, but the positive effect will occur with some delay.

The impact of national currency depreciation on the external balance of payments, when the positive effect does not occur immediately, is represented graphically as follows:

**Chart no. 1: The effects of foreign currency depreciation in a “J curve”**



Source: Ghe. M. Voinea - "Relații valutare-financiare internaționale", Ed. Universității "Al. I. Cuza" Iași, p.99

Therefore, *the immediate or the short-time effect of depreciation* ( $T_0$  and  $T_1$  moments) show the worsening of the balance of trade deficit due to the increase of imports as a consequence of the influence of import prices (the prices of foreign commodities in the national currency are higher), although, as regards quantity, there is no change. In this situation, the so-called *price-effect of depreciation* can be noticed.

In the next period ( $T_2$  and  $T_3$  moments), depreciation has positive effect on the trade balance because the country considerably reduces its imports as they are more expensive, and increases the exports, these being cheaper on foreign markets. In this situation, there is the so-called *volume-effect of depreciation* which progressively compensates and surpasses the price effect.

However, the national currency depreciation also has some negative effects:

the growth of inflation even if only through the growth of prices for imported products, which reflects on the prices of domestic products (imported inflation);

foreign currency inflows into the country (through exports) lead to increasing money supply and bank liquidities, which favour the growth of credit, lower rates, thus increasing domestic demand; although depreciation can improve the price competitiveness of products, it does not solve the structural competitiveness problems such as insufficient quality of products.

In order to limit those unfavourable effects, depreciation must be accompanied by programs of internal recovery of the economy which aim at reducing domestic demand, stopping the increase of nominal costs and stimulating exports.

Essentially, it must be underlined that deliberate national currency depreciation policy, which openly stated the aim of stimulating exports, and thus, rebalancing the balance of payments, can have temporarily unfavourable effects, and the efficiency of such a policy on a longer term is tightly connected to the determinant factor – economic competitiveness – in which productivity plays a crucial role.

As the depreciation of the currency does not stimulate the export increase and restricts and discourages imports that maintain or increase, the country finds itself in a “*vicious circle*”. Structural imbalances in the economy and consumptions larger than resources contribute to forming the vicious circle between depreciation and the lack of equilibrium in the balance of payments which extends through inflation.

Professor Anghel Rugină (Anghel Rugină 1992:67) considered that the depreciation of a currency cuts both ways. “On the one side, it appears that it would actually help increase exports and bring in foreign currency which would improve the international balance of payments. But in fact, shortly after, the situation turns around, and a new inflation wave stops the export increase and encourages imports, thus eliminating every advantage and, moreover, it generates budget deficiencies and unemployment”.

#### **4. Currency appreciation and its impact on international economic exchange**

*The appreciation* of a currency is the process of increasing the national currency’s value in comparison with other currencies. The cause of currency appreciation resides in the persistence of surplus in the balance of payments. This leads to the diminishing (cheapening) of prices on imported foreign commodities in the national market and the simultaneous increase of prices for internal commodities intended for export. Thus, the effects of the appreciation are the opposite of those of depreciation, and are in fact the stimulation of imports and discouragement of exports, which lead to a decrease in payment surplus in current operations.

Under the provisions of the IMF statute, the supervision of exchange rate formation and movement as well as reference currencies or the reference according to which the states establish their national currencies still fall under the competences of the International Monetary Fund.

*In case of a repreciation of the national currency*, a state’s monetary authority principally accepts it for two reasons, and those are:

an underrated currency generates inflationist pressures, on the one side due to the imbalance between the offer and the internal demand which induce an increase in exports (stimulated by the underrating of the national currency), and, on the other side, due to the increase of the internal monetary mass generated by capital inputs.

the country with a price competitiveness which seems too big for the trade partners is subject to international pressures for the repreciation of its national currency.

Contrary to the depreciation of the national currency, *the repreciation of the national currency impedes imports* (foreign products seem cheaper in the national market). The decrease of prices for imported products helps fight inflation.

On the short term, a considerable repreciation of the national currency deteriorates price competitiveness of national products, because these are expensive in the external markets. Thus, national companies are being forced to comply with a structural competitiveness (outside the price), through (Jacques, Génèreux 1997:59):

improving the quality of products in order to attract customers less aware of the price;

a new specialisation concerning products for which the demand on the external market is less sensible to the selling price;

technical innovation or innovation in work management and production so that productivity would increase and the production costs would decrease; these will allow, in turn, to increase the profit without increasing prices or to maintain the profit when prices fall.

All three of the aspects mentioned above aim at consolidating the structural competitiveness of national products which would allow an increase of exports and, therefore, even up the external balance of payments or obtaining a surplus for the latter.

As far as the *appreciation of the national currency* is concerned, it limits exports because exporters cash a smaller amount in the national currency, and stimulates imports because importers spend a smaller amount in view of paying for the commodities purchased on the external market. The appreciation of the currency is a disadvantage for the debtors, because they pay their debts in a stronger currency, and an advantage for the lenders.

If the appreciation of the currency determines a moderate restriction of exports and a maintaining or an increase of imports within controllable limits, the balance of payments is kept in equilibrium and the country thus enters into a “*virtuous circle*”.

The increased interdependence of international markets, the rush for resources and the increasing complexity of financial markets determined the emergence of new models and practices in international trade. In this context, Romania’s place and role in the new global economical order has been determined by a series of events (primarily political) with a major impact on economic policies, especially on those related to international trade.

Romania’s accession to the European Union on the 1<sup>st</sup> of January 2007 involved a succession of economical and political changes, having a direct impact on the foreign trade. This way, Romania had to withdraw itself from any kind of agreement outside the EU from which it was part, and from the application of the common legal framework of the EU for external trade relations, including for the common import trade scheme, this causing changes in the structure of the trade balance for each country (i.e. before 2007, the Republic of Moldova used to export products in Romania without customs duties; starting from 2007, the same customs duties that apply for a third country also apply for the Moldavian goods). Romania must also withdraw its list of commitments agreed with the World Trade Organisation, following the renegotiation, together with all the members of the enlarged EU (27 countries – including Romania and Bulgaria), of new agreements regarding economic and trade cooperation.

Romania’s accession to the EU coincided with a period of economic growth without precedent (in 2008 the GDP grew by 7,1 % ), the statistic data for 2008 showing that the share of trade in GDP was higher by 23,3% than that of industrial production (22,9%).

The global financial crisis progressively affected Romania beginning with the fourth trimester of 2008 (when there was a decrease in GDP), causing gloomy predictions concerning economic growth, taking into account a decrease of the real GDP in the second trimester of 2009 by 8,7% over the same period in 2008, according to the data published by the National Institute of Statistic (Press Release no. 168 of 01.09.2009). Data from 2010 reveal a shy growth in the second trimester, but no optimistic outlook regarding the official exit out of the recession.

Finally, in a regional and international context, redefining the trade relations with former important trade partners (the Russian Federation) should be mentioned, as statistic data show a constant worsening of Romania’s trade deficit in relation to Russia, mainly because of energy imports. However, Russia remained a significant trade partner for Romania, being the second in place in 2007 in Romania’s external trade (with countries outside the EU), and the main non-EU exporter in the Romanian market (also due to energy imports).

According to the data published by the Directorate for external trade, the year 2009 marked a very sudden decrease of trade exchanges with countries from the former soviet area, with over 45% in the first seven months, as opposed to the same period in 2008. Among the products exported to the Russian market, a significant amount is represented by automobile components, electrical devices, chemical industry products, glass and glass items.

Romania’s external trade will increase by 15% in 2011 to 91 billion EUR, reaching 105 billion EUR in 2012, with an export rate maintained at 54%. Romania followed the pattern of

Central and Eastern Europe states as far as exports and imports are concerned, a phenomenon which also applies to its trade relationships, concentrated in the area of ten important partners, among which we find Germany, Italy, Poland and Russia.

The value of Romania's external trade has risen to 79 billion EUR in 2010, below the level registered in 2008 of 85 billion EUR, but with a 20% increase from 2009, when it had a total of 65 billion EUR.

The Romanian external trade will continue its positive development, reaching 91 billion EUR in 2011 and 105 billion EUR in 2012. Exports will cover 54% and imports 46%. The main countries in which Romania exported last year were Germany, Italy and France, and these partners are the same for imports.

The driving force of the Romanian external trade was the automobile industry, which covered 29% of the imports and 27% of the exports. The transportation and textile segments also had a positive development, while the chemical products sector registered the greatest deficit, covering 17% of the imports and 10% of the exports.

At a regional level, Romania is on the second place regarding the average annual growth of the external trade between 1999 and 2009, although the market share in Central and Eastern Europe was of 4%.

### **Conclusions:**

Therefore, establishing an optimal level for the foreign exchange which would support exports, but also discourage imports, and allow maintaining equilibrium for the balance of payments is a very difficult undertaking. The choice between the policy of the strong currency as opposed to the weak one depends on a country's economic and social structures and on the degree of technical ability. Unless the production structures are adequate and the capacity of entering new markets consolidated, a strong currency policy cannot be achieved. This will lead to a loss of traditional markets, because business competitiveness will decrease, making companies less adaptable and less profitable.

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