
LEU VERSUS EURO IN THE LIGHT OF ROMANIA JOINING E.M.U. AND THE GLOBAL FINANCIAL CRISIS

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Abstract:

The european single currency has marked and will continue to mark significant changes for all european countries, including those who are not yet included in the euro area, but which apply to European economic and monetary integration. The status of member state of the European Union from the 1st of January 2007 supposes that Romania will align the Economic and Monetary Union's requirments in the frame of assuming the adopting of the european single currency in time horizon 2014. The present paper aims to offer an overview of the euro/romanian leu exchange rate evolution having as departure point Romania's adhesion moment to European Union, the 1st of January 2007, outlining the main factors of influence that have led the trend of appreciation or depreciation of the national currency against european single currency under the economic and financial crisis. In the frame of the current international crisis Romania's adhesion to the Economic and Monetary Union (EMU) in 2014 might be affected, resulting in increased effort it involves the performance criteria for nominal convergence.

Keywords: european single currency, Economic and Monetary Union, euro/leu exchange rate, global financial crisis

JEL Classification: E4, E44, F31, F33

Introduction

The appearance of the european single currency in 1999 is clearly the most important financial event since the International Financial System, whose consequences continue to be commented, observed and expected. Monetary integration and the implications of the single currency have resulted in the exponential growth of discussions on this theme, the approaches on the concept of Economic and Monetary Union (EMU) and the single currency have developed explosive, both in the international and national literature. Adopting a single currency led to an economic system which has proved to be a successful one in which increasingly many countries wish to join, including Romania. Romania's EU accession on the 1st of January 2007, led to the primary place of the dollar to be made by the euro. National Bank of Romania (NBR) has passed from a policy focused on US dollars exchange rate to a policy in which a significant share returns to the european single currency.

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Issues on stability rate as applied criterion for accession to E.M.U.

Legal basis of the European single currency, the Maastricht Treaty (developed on the 9th-10th of December 1991, signed on 9th of February 1992 and entered into force on the 1st of November 1993) provides that, in order to access to Economic and Monetary Union (EMU), national economies must be prepared to face all its requirements, this training follow to be appreciated using the convergence criteria which were the main areas of national economic policy, namely: fiscal policy, monetary policy and exchange policy.

The convergence criteria for participation in Economic and Monetary Union means the economic test for assessing the country state of preparation to participate in the third stage of Economic and Monetary Union. One of the criteria established by the Maastricht Treaty refers to the *stability of the exchange rate*. The exchange rate must remain within the margins of fluctuation in the exchange rate mechanism (ERM II) for a period of at least 2 years without severe tensions, especially without a deal on its own initiative to devaluing the national currency against the euro. The new exchange rate mechanism (ERM II) replaced the ERM in January 1999 and aims to fix currencies of the Member States which are not part of the euro area by establishing, by common consent, a central rate, fixed but adjustable front euro and a standard fluctuation band of $\pm 15\%$. A band narrowest bandwidth can be established by agreement, as is making progress in terms of convergence. The “reception entry” in the euro area mechanism ERM II (Exchange Rate Mechanism II) is characterized by a central parity, around which there exist a “narrow” band ($\pm 2,25\%$) and a “range” band ($\pm 15\%$). [Lazea, (2003)]

			↑ + 15 %	↑ <i>range band</i>	
	↑	+ 2,25 %			↑
<i>central parity</i>	↓	- 2,25 %			↓
			↓ - 15 %	↓	
					↓ <i>narrow band</i>

Central parity of the national currency against the euro once fixed (at the beginning of the 2 years be spent in ERM II), it may not consider or be depreciated in nominal terms beyond the band edges.

Provisions of the Maastricht Treaty on the evolution of the exchange rate include: Article 121 (1) third indent as follows: “*respect the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years without devaluing the currency to that of another Member State*”, and Article 3 of the Protocol on the convergence criteria mentioned in Article 121 (1) of the Treaty states: “*the criterion for participation in the exchange rate mechanism of the European Monetary System referred to in Article 121 (1) third indent of the Treaty, means that a Member State has respected the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System without severe tensions for at least the last two years before the*

examination. In particular, the State has not devalued its own initiative, the bilateral central exchange of its currency against the currency of another Member State the same period”.

The Treaty refers to the criterion for participation in the mechanism of the European Rate Mechanism (ERM until December 1998, replaced by ERM II from January 1999).

First, the European Central Bank (ECB) consider whether the state has participated in ERM II “for at least two years before the time of examination” as specified in the Treaty.

Secondly, as regards the definition of the “normal fluctuation margins”, the European Central Bank (ECB) refers to the official opinion formulated by the Council of European Monetary Institute Council in October 1994 and the declaration published in November 1995 Report entitled “Progress towards convergence”. Opinion formulated by the Council of European Monetary Institute in October 1994 stipulated that “the fluctuation range band contributed to a greater degree of stability of exchange rates within the ERM”, that “in view of the Council of the European Monetary Institute, it is recommended the maintenance of currently agreements” and that “member states should avoid further exchange rate fluctuations by targeting their policies to ensure price stability and reducing budget deficits, thereby contributing to meeting the requirements contained in Article 121 (1) of the Treaty and relating Protocol”.

In November 1995 report entitled “Progress towards convergence”, the European Monetary Institute has recognized that “when drafting the treaty, the “normal fluctuation margins” were at $\pm 2,25\%$ around the bilateral central parities, while a fluctuation band of $\pm 6\%$ represent a derogation from the rules. In August 1993, it was decided to widen the fluctuation band to $\pm 15\%$, and interpretation criteria, particularly the concept of “normal fluctuation margins” has become less clear”. At that time was also proposed to be taken the “great evolution of the exchange rates of the European Monetary System (EMS) since 1993” in carrying out an ex post analysis. In this context, when it considers the evolution of the exchange rate is near the emphasis on exchange rates of central parities in the ERM II.

Thirdly, the issue of a “severe tensions” is generally approached by examining the exchange rates degree of deviation from central parities in the ERM II to the euro. This can be done using indicators such as short-term interest rates differential versus the euro area and their evolution, and taking into account the foreign exchange market interventions.

Exchange rate regime of Romania's national currency

Under Article 2 of Law no.312/2004 status NBR, one of the main tasks of the National Bank of Romania is the development and implementation of monetary policy and the policy rate.

Exchange rate means the price of a monetary unit expressed in another currency, price, reflecting the economic factors, political, social and institutional, internal and external assessments which may cause different rates of other currencies.

The exchange rate is the price of a currency against another currency, its balance on the open market is established, mainly based on supply and demand for currency, which in turn are influenced by the global market size of investment, trade, speculative, experts in arbitration and other rate [Ignat, (2006)].

The *exchange rate regime* is the way a country manages its currency in respect to foreign currencies and the foreign exchange market. It is closely related to monetary policy and the two are generally dependent on many of the same factors. Floating rates are the most common exchange rate regime today.

The current exchange rate of the flotation is controlled (managed), which is consistent with the use of inflation targets as a nominal anchor of monetary policy and allowing a flexible response of this policy to unexpected shocks that can affect the economy. Therefore, flotation (change) the course is not left entirely up to the market, the National Bank may intervene, but clearly very rare.

The influence factors and trends of the euro/leu exchange rate evolution after Romania's adhesion to the European Union

According to the NBR Report of inflation in February 2007, the exchange rate continues to fall and the downward trajectory before the moment of Romania's accession to the European Union, national currency amplifying substantially appreciation gained against the single currency (*Figure 1*).

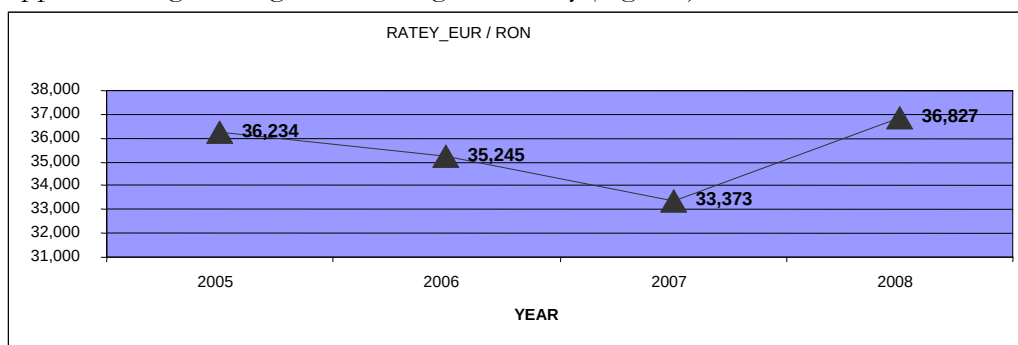


Figure 1. Evolution of annual average exchange rates EUR / RON

Starting the 1st of January 2007 – date of accession to the EU – until the 18th of April 2008, the Romanian leu did not participate in ERM II, but was traded in a flexible regime of exchange rate. In the reference period 19th of April 2006 – 18th of April 2008, the Romanian leu has been subject to pressures of depreciation by mid July 2006. Subsequently, it has appreciated significantly to the euro.

Strengthening of the national currency has been possible mainly due to different categories of speculative capital entries, caused by favorable conditions of the internal market and the anticipation of an accentuation of the downward trend of the exchange rate euro/leu. In this context, the appreciation of national currency gained against the euro over the year 2006 has doubled compared with that recorded during the first nine months of the year (7,2% in nominal terms and 12,4% in real terms).

However, the appreciation rate has been sustained and capital inputs in the form of financial loans, especially in the banking sector and portfolio investment (according to data published by the Bucharest Stock Exchange in October, the net purchases of non residents documents were nearly 20 times higher than in September), which have grown as a result of approaching accession of Romania to the European Union, of improving the country rating (on October the 6th Moody's Agency announced the improvement rating for investment category in Romania) and maintaining a relatively high interest rates.

Speculative capital massive entries led to the widening pressure on exchange rate appreciation on the Romanian leu, but at the same time, it boosted the risk of a sudden later correction, the depreciation of the national currency. This, the more the experience of countries which have acceded to our country prior to the European Union shows that, after integration, the expectations regarding the assessment of national currencies begin to fade.

Average rate continued in the first half of 2007 (*Figure 2*), the national currency gaining ground very fast in front of European single currency, where economic fundamentals are rapidly deteriorated: foreign trade deficit grew strong after the 1st of January 2007 and wages have increased well above productivity growth, case in which the Romanian leu was overvalued. Officials of the National Bank have agreed at the time of unsustainable appreciation rate to 3,11 lei/euro in the spring of 2007 and more praising national currency as “the king of exchange”.

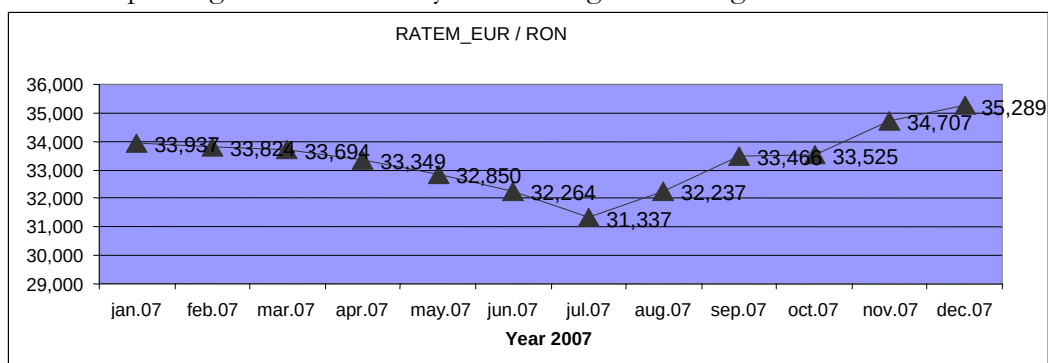


Figure 2. Evolution of average exchange rate EUR/RON in 2007

Since mid 2007, however, the national currency registered a significant depreciation and, thus cancelling all the added record in the first months of the year. Correction in this period was necessary, being stimulated by unfavorable context of world crisis caused by the mortgage market in the United States of America, which added to the weak economic fundamentals Romanian leu.

More specifically, since August 2007, national currency recorded a accentuated depreciation on the context of increased aversion to risk on international financial markets as a result of financial turmoil and concerns about the intense growing current account deficit and inflation inflammation. Generally, most of the reference

period, the Romanian leu was quoted at levels above the average net rate of exchange against the euro made in April 2006 with a relatively high degree of volatility. However, short-term interest rates differential over EURIBOR three months have been tempered, easily exceeding 2 percentage points at the end of 2007, before increasing to 5,1 percentage points during the three months ending in March 2008. In March 2008, the rate of real effective exchange rate against the euro stood at a level above the average historical net recorded in the last ten years, and the real bilateral compared to the same currency easily exceeded these values.

However, real economic convergence makes it difficult any assessment of the historical evolution of real exchange rate. Regarding other external developments, since 2002, Romania has recorded a gradual increase in the deficit on current account and capital balance of payments, which stood at 13,5% of GDP in 2007. Although significant external deficits may be partially generated by the alignment of an economy such as Romania, deficits of such magnitude raises questions of sustainability, especially if they persist for long periods. It appears that very large deficit recorded recently have been caused also the overheating economy.

From the financing perspective, net inflows of direct investment covered almost entirely by external deficit in 2006. However, recently, a significant part of the deficit was financed by net inflows of other investment in the form of foreign loans contracted by the banking sector and the non-banking one. In this context, the net international investment position of Romania has deteriorated from -19,3% of GDP in 1998 to -46,6% of GDP in 2007.

In November 2007, the national currency has experienced a trend of increased depreciation. Thus, if on the 1st of November, the euro was quoted at 3,3157 lei on 23th of November, the exchange rate gone to 3,6221 lei for one euro, which depreciated by almost 11% in nominal terms.

The evolution rate of the latter part of 2007 can be explained on the one hand the flow predominantly negative domestic economic news: the strong increase of current account deficit (approximately 13% of GDP in Q2 of 2007 compared to 10,3% of GDP in Q4 of 2006), and funding in an increasingly small proportion of foreign direct investment (only 38,7% during January-July 2007 compared to 91% in same period in 2006) and on the other hand of slowing economic growth in the first half of 2007 (largely explained by the prolonged drought) and the annual inflation rising rapidly (from a historical minimum of 3,7% in March 2007 to 5% in August 2007). Also, and more importantly can we say that the national trend has been influenced by a significant increase in inflationary expectations.

In this context, the macroeconomic indicators have taken a negative turn in Romania, non-resident investor sentiment towards Romania has changed from very positive one by one rather negative.

Early 2008 comes with a depreciation rate of over 9% in the first two weeks of the year. Evolution of the national currency falls in the trend that started in September 2007, when negative sentiment towards Romanian leu began to grow following the turmoil on the international level. The causes of currency depreciation

related to the deterioration of macroeconomic parameters, the poor functionality of the mix of fiscal-monetary policy and currency speculations. In 2008, however, the trend rate has been influenced by local investors.

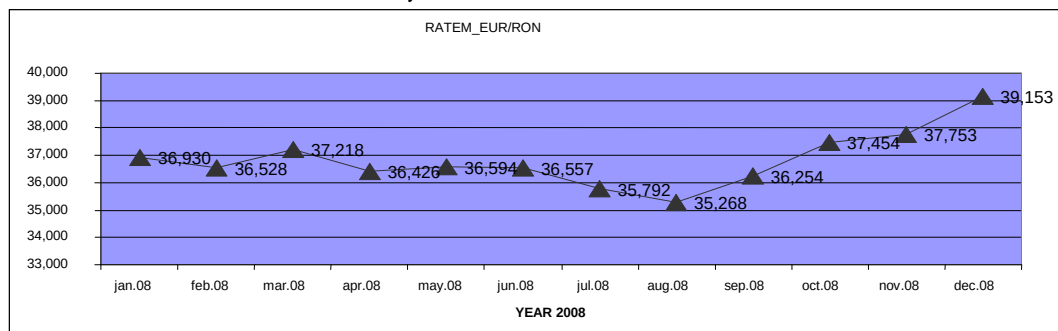


Figure 3. The evolution of average exchange rate EUR/RON in 2008

Growth rate euro/leu stimulates imports, leading to correcting the trade deficit and to a certain level the European currency depreciation neafectând the repayment of loans from the population.

April 2008 has been the best period of the early exchange rate euro/leu, the national currency stabilized around the threshold of 3,5640 in April 21 in descent from 3,6759 in early. Thus, in percentage terms, Romanian leu appreciated by over 4%, giving those who have borrowed in foreign currency the chance to rate you pay less in loans, after several consecutive months of negative classes. At this fragile national currency appreciation has contributed a number of factors. International situation has improved, which made all the currencies in the region to consider, including the lion. In addition, the national currency and was helped by high interest rates on the domestic money market, which temporarily reduced the pressure of depreciation. Robor rate at one month climbed up to 12,8%, compared to only 8% at the beginning of the year. High interest rates attracted more money from abroad for a change in national currency, which was the euro/leu down.

The trend appreciation of the national currency has continued. Increases after repeated interest rate by the NBR, the Romanian leu began to strengthen, reducing the unexpected, so that on the 7th of August, the National Bank of Romania announced the lowest level of the euro/leu exchange since 2008: 3,4719.

During August, the Romanian leu has gained 2,5 percentage points compared to the european single currency. Assessment was based on the reference growth rate by the NBR up to 10,25%.

Interest rates on leu is one of the factors that influence the exchange rate sensitive. The interest is higher, the currency tends to become stronger. Romanian leu high rates make the national currency investments more attractive for foreign investors and in order to make deposits in lei, they should sell the currency to buy lei, which considers the Romanian leu from the currencies.

However, there is no basis for a sustained appreciation of the national currency against the euro, the current account deficit is still being a very high level.

The threshold rate of euro/leu recorded in August 2008 has not been proven to be sustainable in the long term, but rather involved a speculative component of the moment. Boosted by the emerging trend of exchange and the European single currency depreciation, the lion was considered, although overall, the Romanian economy has not improved, even in a situation similar to last year. Thus, the assessment can not be considered a sustainable, because not based on an improvement in macroeconomic indicators. While flows of funds that determines the movement of a financial nature are most likely when sudden movements, and trade, as an expression of competitive imports, for example, the movement can not be a sustainable.

September 2008 comes with a depreciation rate of approximately 5%, the trend seen in the currencies of other countries in the region affected by the international financial crisis. With the beginning of September, the Romanian leu began to rapid depreciation against the euro. If at the end of August – early September, one euro bought approximately 3,55 lei, at the end of September is traded around the value of 3,73 lei.

Fall rate is based on the global financial crisis, increasingly acute as that caused investors to withdraw from the markets which are of greater risk.

In the context of the global economy affected by the crisis generated panic American depreciation rate was fulminant, the euro/leu has increased reach in a very short time in transactions on the interbank market at very close to 4 lei for one euro.

Most affected by this development were those who get income in lei, but record debt in foreign currency, often rate bank loans.

Depreciation rate was based on the difficulties which have arisen at several banks throughout Western Europe. In such an economic climate, investors withdraw from emerging markets because precept risk is higher. Investors are dubious about the ability of Romania to finance the large deficit the current account, which is why they avoid investments in lei, leading to currency depreciation.

Intervention in October 2008, the central bank that has sold directly to market about 40 million euros, helped Romanian leu to recover, the euro/leu in the range 3,75-3,80. One of the factors that have influenced this evolution could be populism of government, announced salary increases based on unsustainable economy having a negative impact on investor confidence in domestic currency.

Since November 2008, Romanian leu began to suffer seriously the strong depreciation against the euro. In only a month and a half, the national currency has lost more than 10 percentage points, the exchange rate jump from 3,5 to nearly 4 lei for one euro.

Once the crisis penetrate more into the real economy, meaning that the effects are felt at enterprises and then pockets of each of us, the macroeconomic situation of Romania is getting worse. The budget deficit and current account are the main reasons of the depreciation rate. Government deficit has reached alarming levels (in

October 3% of GDP) due to high government spending and the trend is all one has to increase. In addition, we continue to deal with negative feelings induced foreign investors in both the economy and the political instability in Romania.

Early 2009 to an exchange rate of the European single currency against the lion over 4 lei, tapping in a few days all records last years. On the 8th of January, the National Bank announce a rate of 4,1385 lei for one euro, level situated at a few tenths ban of the maximum of 4,1438 recorded in 5 years ago, namely on the 6th of January 2004. From this moment on, the euro/leu has continued to grow fulminant interbank market.

Passive attitude of the central bank in this period started in 2009 has dramatically affected the number of clients of credit institutions that have borrowed in foreign currency. That at that time, loans in foreign currency attained the level of 57% of total lending, may be the result, largely, a failure of monetary and fiscal policies of the Romanian authorities.

After a period of continuous depreciation of the national currency (*Figure 4*) towards the end of January 2009, the euro/leu exchange rate stabilized. Impairment of aggressive rate can be explained by investors' perception of the risk. Romanian currency is a risky one and when markets are volatile, investors withdraw from markets with high risk. Exchange fell from 3,7 lei/euro to 4,34 lei/euro level includes practically all the fundamental economy.

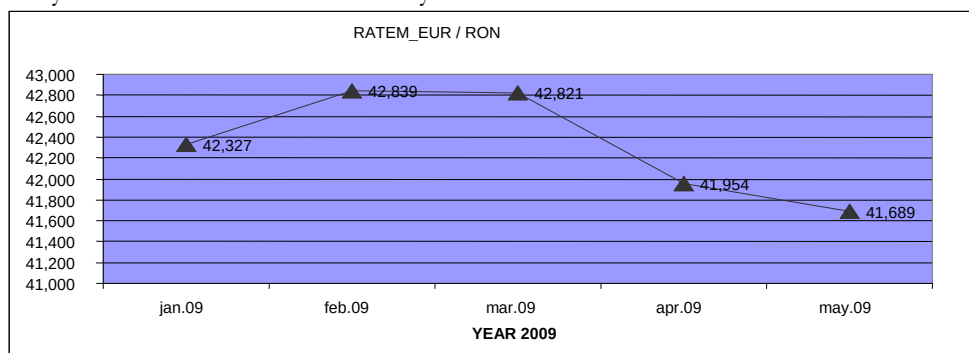


Figure 4. The evolution of exchange rate average EUR/RON in 2009

According to the NBR study in early 2009, much of external debt accumulated by the private sector can not be refounded this year,”the research shows that the government has the capacity to self founding on the foreign exchange but in the NGO sector is a goal out of funding: capital inputs are lower than outputs”. The solution found by central bank is the government to borrow more than is needed to alleviate any tension that may have on foreign reserves funding gap that is prefigurează private sector.

External debt of private sector medium and long term is almost 40 billion, and including interest rates falling due is estimated at around 10 billion euros in 2009. And greater problems arise when short-term debt in November 2008 the balance was 24 billion. These debts will be paid, and if the companies concerned do not have the

resources in foreign currency, they will be forced to buy foreign currency, which would create additional pressure on the exchange rate, leading to the depreciation rate.

Given that market liquidity is very low, to continue the course at 4,3 lei/euro is mainly due to the central bank interventions. Also, small volumes traded interbank foreign exchange market facilitated NBR position.

After almost two months (early 2009), the euro/leu remained around the 4,30, negotiating the agreement with the International Monetary Fund (IMF) has improved the perception of investors towards our country and support the national. Until the mid 2009, the euro/leu entered a downward trend, reducing it from 4,3 to 4,1-4,2 lei for one euro.

Conclusions

It is difficult to estimate the evolution of the national currency against the euro as long as things are uncertain at the level of international economies. In the following period, is expected to maintain the exchange rate euro/leu in the currently coordinates, but it is possible even a slight appreciation of the Romanian leu. The most difficult time for the national currency is the following assessment from the IMF, when will the conditions imposed here targeting single wage law, pensions law and changes in tax, the issue held the second money. Breaking these conditions would lead the euro/leu up, in other words a “debacle” of the national currency.

In the current financial crisis and international economic integration in the European Monetary Union in the 2014 time horizon might be affected because of the effort that it involves the performance criteria for nominal convergence. Romania could achieve economic convergence delay which means the postponement of accession schedule to the euro area. If we look at the monetary unification process in the frame of the global crisis through its benefits, then adopting the euro currency is the best thing for the Romanian economy because it will be a wall of protection crisis fund to protect companies volatility of exchange rates, a strong factor for monetary stability.

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