## NATIONAL CURRENCY INSTABILITY

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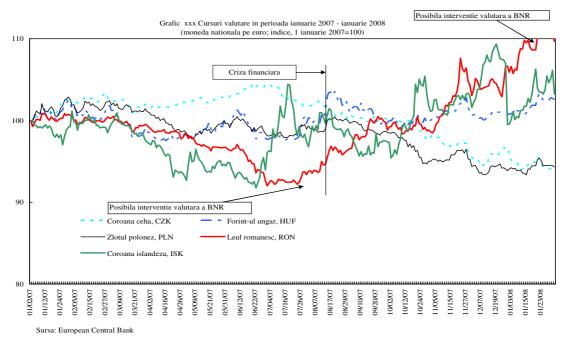
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The concept related to currency stability includes internal currency stability as intern price stability, the money demand and supply stability and the stability of the interest rate. Also it includes external currency stability through exchange rate mechanism. The equilibrium of national economy is determined by the evolution of inflation and by the evolution of nominal exchange rate mechanism as an expression of external stability.

Key concepts: monetary policies; financial crisis; currency stability

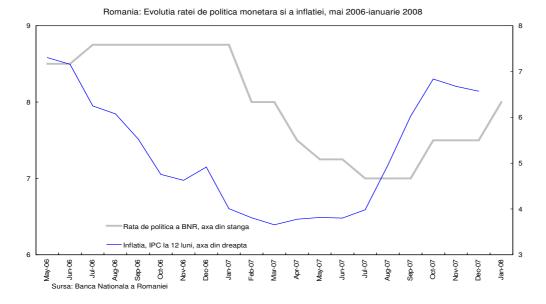
The financial crisis from august 2007 tests the credibility of emergent economies and also the foreign investors' attitude related to this crisis. As a consequence, the Romanian leu was the most affected currency in the European space.



In the first half of 2007, the Romanian currency became very powerful towards euro (Graphic I), as a consequence of diminishing the risk prime for RON. Taking into consideration a decreasing rate of anticipated and effective inflation, but ignoring the tensions for the other half of the year, the Central Bank decides to reduce the rate of monetary policy from 8,75% to 7% (Graphic II). After the financial crisis has started, the Romanian currency registers a continuous depreciation, being not correlated any more with the other currencies (Polish zlot, Czech corona and Hungarian forint).

Taking into consideration Graphic I there is a similitude between the evolution of Romanian and Islander currency, explained by some common elements from these two economies, even worse in Island, such as: flexible exchange rates, over 23% from GDP current account deficits in Island, 8% rate of inflation which is over the target and also the expansion of credit and of financial-banking sector.

Grafic II: Evoluția ratei de politică monetară și a inflației, mai 2006-ianuarie 2008



In spite the continuing economic growth process, some major intern disequilibria's occur as inflation, salary increases over productivity level but also external disequilibria's such as the increasing current account deficit.

The fast national currency depreciation has three main causes:

- The unsustainable current account deficit
- The monetary and fiscal policies mix which was improper
- The use of national currency against the currencies in a fixed regimes from the neighbor

Currency stability is the result of the economic evolution expressed both through price and exchange rate mechanism stability. The volatility of exchange rate mechanism is the result of intern economic evolution and of the economic policies measures but also of the economic evolution on the international markets. In Romania, the positive economic evolution having as a main characteristic sustainable economic growth, disinflation and continuous structural reform but also the adhere perspective to European Union has lead to an increase in confidence of the foreign investors having as a result an increase in foreign direct investments. This element led to a nominal and real currency appreciation, a phenomenon which deepened towards the end of 2006, following the complete liberalization of capital transactions.

Financial markets turbulences urge the investors to re-price risks. During this process Romania comes to be considering a riskier destination than neighboring countries in what concerns foreign capital flows. Rating agencies pick up on this trend and act to lower the country grading, thus fueling a strong currency depreciation tendency. The monetary policy is the only instrument used to reduce the apparently ever growing risks the Romanian economy is subject to.

The soar in inflationary pressures is brought about by a combination of external factors, internal policies and RON depreciation. Referring to the consequences of this unfortunate mix, it soon becomes clear that importers, being exposed to exchange rate changes, transfer the currency related risks to the consumer. Therefore, it is the consumer who bears the loss in case of depreciation, while any potential gains resulting from currency appreciation are retained by the importer.

Even though the strong appreciation of Romanian currency taking place in mid 2007 seemed to have had a positive contribution in the inflation targeting process, this economic phenomenon should be rather regarded as a threat to the current account stability. This is precisely why the Central Bank took the option of halting the appreciation, despite its self imposed objective of directly targeting inflation, which ought to leave out any intervention on other elements, such as the currency in this case.

However drastic the efforts made by the Central Bank to contain price fluctuation, if monetary policy fails to be appropriately complemented by the fiscal – budgetary policy, the results will come short of expectations. The pro-cyclical fiscal policy applied by the Finance Ministry encourages the expansion of internal demand, implicitly touching upon price stability and external economic unbalance.

A stable currency and a healthy economic evolution stand as prerequisites in the two stage transition process: firstly to a tighter currency regime – ERMII, and secondly to a fixed regime – the single European currency, the Euro.

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