

# THE INFLUENTIAL FACTORS ON THE EXCHANGE RATE IN ROMANIA

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*Abstract: The exchange rate between foreign currencies is a variable which depends on internal and external factors. By their nature, actors which influence the exchange rate can be economic, monetary, financial and psychological.*

*The stability of the exchange rate determines the predictability, homogeneity and continuity of the macroeconomic policies, whilst a greater volatility in the development of the national currencies exchange rate not only affects the accuracy of the forecasts but enhances its sensitivity as well, respectively the effect of its internal or external factors. In the following, I intend to highlight and to ascertain the fluency of these factors over the exchange rate in Romania, before and after its adhesion to the European Union.*

*Key words: exchange rate, influential factors (of influence), foreign currency, balance of payments, inflation rate, currency depreciation, currency appreciation.*

## 1. Introduction

The exchange rate is one of the most synthetic prices in the economy, the expression of a generalized balance on the real market, the monetary market and the capital market. The development of the exchange rate is influenced by the degree of economic growth, by the evolution of prices on the asset and services market (inflation), by the national economies' ramified structure, by external competitiveness and international openness as well as by the political stability and the governments ability to solve the internal crisis which an economy may have to face at a given time. The number of factors that directly or indirectly influence the exchange rate make it difficult to model such a complex and dynamic economic variable. But at the same time, the existent links between the foreign currency market, the monetary and the capital markets make that the short term, medium or long term evolution of the exchange rate itself has an influence over the global economic balance.

The exchange rate is not a static measurement but a dynamic one. The evolution of the exchange rate is determined by a number of factors which do not have a linear influence, but a particularly complex and inconsistent one, a single factor being able to neutralize the influence of others or several factors may act in the same direction.

1. One of the most important factors that influence the foreign exchange rate is the *position of the balance of payments*. The equilibrium external balance of payments depends on the import and export value, on the product efficiency and competitiveness, on the level of the prices, on international services and international market conjuncture. In return, the exchange rate influences the equilibrium of the external balance of payments, as a consequence of the connection between them. The depreciation of the foreign currency stimulates export growth, reduces imports and generates a tendency equilibration of the balance of payments.
2. *the ratio between the foreign currency demand and offer* has an influence over the foreign exchange rate, since the demand in foreign currency depends on the loan value, on the international services needed, on the credit reimbursements terms and on the interest rate;
3. *the increase in the circulating monetary mass* contributes to the depreciation of the national currency, and the actions to restrict monetary mass determine the appreciation of the national currency;
4. *credit encouragement or limitation* influence both the national economy and the exchange rate;
5. *increased interest* discourages credit demand, diminishes the circulating monetary mass and generates positive effects on the national currency's exchange rate. Decreasing the interest facilitates access to the credit, determines implicitly the growth in the circulating monetary mass and national currency depreciation;

6. the ratio between the export prices and the prices of imported assets influences the foreign exchange rate;
7. *the increase in internal inflation* determines the national currency depreciation, and the decreasing inflation index reflects positively on the national currency rate;
8. budget deficits and surpluses;
9. *tax policy and the structure of the budget expenditure* stimulate or restrain domestic production, public sector input;
10. *economic policy measures* which favor or enclose economic trades;
11. banks buying or selling foreign currency on the foreign currency market;
12. increased *output* reflects in competitiveness, export growth and insuring the internal balance;
13. investments directed towards high productivity and efficiency areas;
14. the degree of coverage of imports over exports.

The analysis of the determining factors of the foreign exchange rate evolution also implies knowing an issue particularly difficult to define, and that is if the analyzed determining factors of the foreign exchange rate themselves have not been influenced by the evolution of the foreign exchange rate. Thus, economic theory and practice show that the active or passive balance account of the current balance of payments or of the capital determines the foreign currency demand and offer, and through the mechanism of foreign currency demand and offer, the balance influences the exchange rate development. But is also true that economic theory and practice proves that the development of the exchange rate can stop or encourage import or export, stimulate or decelerate the input or issue of foreign capital in a country.

## **2. Influential factors on the foreign exchange rate in Romania in the period pre and post adherence to the European Union**

In Romania, there have been a series of changes regarding foreign currency and international transactions. It started from one of the lowest GDP/per capita level in Europe (1985- 1989). The Romanian New leu (RON) had an exchange rate set on three currencies (dollar, pound, german mark), but, in the context of accentuated inflation, this system overcharged the exchange rate with undesirable implications: decreasing competitiveness on the external market, deteriorating the net exchange index.

Starting from 1991, the Romanian New leu “internal convertibility in the current account” has been introduced, but the parallel foreign currency market maintains. A decision has also been taken (which later proved to be damaging) to convert in Romanian leu dollar deposits to the internal banks. The decision was revoked shortly afterwards. At the end of 1991, the exchange rate regime is managed floating (BNR intervenes to amortize fluctuations).

Ever since the beginning of the transition period, the interdependency relationships between the exchange rate, the inflation rate and the imbalance of the foreign balance of payments have constituted controversial issues of the Romanian economy. In establishing the role that the Romanian New leu exchange rate has in redressing the macroeconomic imbalance, there have been two options: that of anti-inflationist anchor and that of an influential tool of the external balance of payments. The extent to which one of the two options prevailed reflected in the evolution of the exchange rate.

Generally, there has been an attempt to maintain the balance between the necessity of Romanian New leu depreciation in order to stimulate export and avoiding prices to increase. In the Romanian economy, marked by serious structural imbalances and by an important corrective component of the inflation, the exchange rate has been one of the determining factors in the price movement, but not the most important one.

The import structure on groups of merchandise, defined by the great importance of the interchangeable component (raw materials, energy) contributed to the fact that the import demand has a reduced flexibility comparing to the price. The GDP, import, export, investment and input evolution in Romania in the 1989-2006 period is according to the table below:

***Tabelul nr. 1. The evolution of the main macroeconomic indicators in Romania during 1989-2006***  
(Values=millions RON)

Year	GDP	Export	Import	Investments	Input
1989	80.000	16.780	13.500	23.640	56.390
1990	74.652	11.585	18.467	14.669	59.190
1991	59.468	9.217	11.608	8.473	45.130
1992	54.376	12.607	1.671	8.014	41.870
1993	45.690	8.611	1.071	6.435	34.744
1994	70.186	14.488	15.516	11.289	53.405
1995	79.602	17.892	21.567	14.341	64.734
1996	76.605	17.556	23.163	14.731	63.256
1997	70.759	16.976	21.107	12.347	61.161
1998	74.377	16.825	22.795	12.041	67.148
1999	70.147	19.654	23.044	10.790	62.259
2000	73.429	24.135	28.269	11.418	62.842
2001	81.869	16.908	33.629	14.317	69.743
2002	90.155	31.947	37.086	16.173	75.748
2003	103.056	35.775	43.514	18.597	88.277
2004	117.626	42.262	52.919	21.414	100.296
2005	126.583	41.693	54.785	23.979	110.932
2006	143.488	46.474	63.857	25.287	126.607

Source: Processing of the Statistic Yearbooks data and data on [www.insse.ro](http://www.insse.ro)

From the analysis of the data taken from the Statistic Yearbooks one can observe that the evolution of Romania's GDP during 1989-2006 is an oscillating trend. Thus:

1. in the 1989-2003 period there is a decrease in the Romanian GDP, that concurs with the beginning of the social movements; the yearly maximum decrease is registered in 1991;
2. the years of 1991 and 1995 mark a national GDP growth;
3. the period between 1995-1999 represents a period of decrease of the national GDP, except for 1998 when there is registered a slight appreciation;
4. starting with the year 2000 one can notice that the Romanian GDP has entered an ascendant trend, registering for the first time a GDP greater than during the communist period in 2002.

The evolution of the prices on the external market for import, respectively export, difficult to anticipate and incontrollable by the national authority, strongly affect the exchange rate of an economy, such as the Romanian one. Moreover, they have deprived the Central Bank from quantifiable and predictable elements in defining the exchange rate policy. In the context of Romania's import and export commercial inflows, those products whose prices formed on the exchange market are exogenous variables (oil products, cereals, chemical compost) have an increased weight, and the Romanian economy remains a receptor of these external trends.

In the actual conditions of the Romanian market, liberalizing prices imposed itself as an objective requirement for the setting on economic fundamentals, on one hand of the ratios in the internal prices system, and on the other hand of the ratios between the internal and external prices. Concurrent to that, there has been the need to develop the restructuring process at a macroeconomic level, and the syncope and the inconsistencies have amplified the otherwise inevitable inflationist phenomenon.

The actual dynamics of the exchange rate reflected, with few exceptions, an overvalued level. The nominal depreciation index reveals an evolution systematically under the dynamics of the inflationist process (according to the price indexes calculated by the National Statistics Commission). Given the inflationist potential of every sudden movement in the exchange rate, the monetary authority pursued a “nominal target” using the methods specific to the Romanian New leu managed floating.

Overestimating the exchange rate generated distortions in the economy, equaling a subsidy given to the importers, respectively a tax bared by the exporters. Despite this, depreciation cannot be automatically accepted as a balance lever in reestablishing the equilibrium trade balance. Given the structural nature of the imbalance, solving it can only be made by using a macroeconomic policy mix (fiscal, budgetary, commercial, and monetary) corroborated with the reorganization of the real sector.

The exchange rate balance lever acts like an exogenous stimulus with limited effects over time. It cannot be efficiently used to correct some temporary imbalances. On a long term, the determining factor is economic competitiveness, in which productivity plays an essential part. Beyond the direct effect of the national currency overvaluation reflected in the balance of payments, there are also indirect effects that appear and which are less noticeable. Not being able to appropriately evaluate the production factors, the price system is the first one being affected. The typical case for the Romanian economy was that of the oil products.

In the foreign currency market area, overvaluation generated serious dysfunctions whose final consequence was the irrational distribution of resources and the input of inflationist forecasts. The monetary policy has been globally affected negatively, in that direction that dysfunctions induced by the exchange rate have been counteracted by increased interest levels.

During the first 10 months of 2005, the Romanian foreign trade continued to register an increased pace of growth of 16,9% on export and respectively 24,1% on import.

A positive aspect is noticed in the evolution of the net exchange rapport index (the ratio between import and export unitary value indexes) which has been of 103,5% during the first 10 months due to the more accentuated growth of export prices comparing to the import ones for most of the merchandise groups, representing an improvement by 3,5%. The ratio of gross exchange (the ratio between the physical volume of export and import indexes) was of only 98,6%, the increase in the physical volume of export and import) outmatching the export one by 6,1%.

By analyzing the exchange rate evolution corresponding to the two main currencies that prevail in the foreign exchange reserves, meaning ROL/EUR and ROL/USD, afferent to the period between 31.01.1995 – 31.05.2006, the following aspects were noticed:

1. since the putting into circulation as a scriptural currency (in 1999) and until its circulation (in 2002), the single European currency had an increasing trend;
2. a modulation point in the evolution of euro has been in 2003 when euro became a nominal anchor for monetary policy promoted by the BNR. Since that moment, the dollar lost ground against the single European currency. The national currency rate no longer follows a managed, linear trajectory comparing to the two other foreign currencies.
3. after the adoption of the direct inflation targeting regime and on the grounds of a free foreign currency quotation, a component of the current account's complete liberalization policy, the national currency knew historical appreciations comparing to the two currencies composing the foreign currency reserves: the euro and the American dollar. This appreciation has also been encouraged by the success of BNR in fighting against inflation.

### **3. Factors of influence over the foreign exchange rate during Romania's adhesion to the European Union**

Romania adhered to the European Union the 1<sup>st</sup> of January 2007. Even if we have been members of the European Union for over a year, the nominal and real convergence process towards the euro zone will have to continue, perhaps even faster than before. Romania's objective is to enter the Exchange Rate Mechanism (ERM2) and to subsequently adopt the euro. In order to accomplish this objective, the inflation rate will have to decrease substantially in the following years. This mission may be considered difficult considering the inflation persistence and the inflation rate forecasts in Romania.

January 2008 brought an increase of 1,6 % in the industrial production, comparing to December 2007, and by 6,1% comparing to last January, an increase maintained by the electric and thermal energy, natural gas and water, which increased by 5,1% and by the processing industry which increased by 2,4%.

After the 2007 progress, constructions have increased their weight in the GDP from 7,4% in 2006 to 9,1%, outranking for the first time agriculture, which went from 7,8% to 6,6% in 2007. For the year 2008, signals show a sustained progress of the sector in which Romania is the European leader, since the increase registered in January was of 29,5%.

Regarding the utilization of the gross domestic product in 2007, the population's input contributed the most, with 8%, to the economic growth, both as a consequence of the proportion as high as 77% that it holds, and also on the account of its increase in volume. If last year, the GDP forecast reduced the proportions held by the current account and budgetary deficiency to 13,9% of the GDP, and respectively 2,33% of the GDP, the forecast for this year is not as optimistic, even if January is the second consecutive month when the pace of export growth exceeded the import one. The import growth decelerated by 11,3% comparing to January 2007, while exports increased by 16,9%. As a consequence, the evolution of the trade balance deficit decelerated to 2,8%, until 1,4 milliards of euro, comparing to over 80% in January 2007.

Experts estimate that the pace of export growth will maintain more alert this year comparing to 2007, especially in the capital goods and high value-added products area. The weight of the commercial deficit in the GDP will position itself to approximately 16% of the GDP at the end of the current year, while the BCR prognosis indicates a current account deficit increase up to 15% of the GDP.

Surprisingly, a solution to save the economy at a loss would be the registration of an agricultural year favorable both to the progress of the GDP, the equilibrium trade balance, and to the inflation. The satisfactory agricultural production would impose a slower pace of imports in this segment and implicitly lower inflation "costs", thus reaching the maximum rate in the last two years. Reaching the maximum of the inflation rate in the last two years, 7,97 % in February, forced the National Bank to increase the monetary policy interest to 9,5% per year.

The inflation target of the National Bank is of 3,8 % with a margin of plus/minus a percentage point, but BNR revised the inflation prognosis to 5,9%, from 4,3 % in the previous version. Practically, 2008 is the second year when Romania misses the inflation targeting. Analysts stipulate the decrease in the prices of food products in the second part of the year, after the issue of the new agricultural harvest, so that inflation will decrease fewer than 6% towards the end of the year, and the pressure on the Romanian New leu would diminish. The national currency would have a closing rate of 3,5 RON/euro at the end of the year.

A practical solution and at all neglectful might be the depreciation of the Romanian New leu in order to dilute these deficits, and a lower rate than 3,7-3,8 RON/euro would be beneficial to the balance of payments. This might be possible if one considers the fact that in April, the Romanian New leu – euro registered a very low level. The Romanian New leu rate has not reached such a low level since the 27<sup>th</sup> of December 2007, when BNR had listed a reference exchange rate of 3,5282 RON/euro. But the Romanian New leu has appreciated significantly comparing to the dollar as well, by 0,54% up to 2,2350 RON/dollar, a level which it has not reached for almost eight years, since the 15<sup>th</sup> of August 2000, when BNR had listed a reference exchange rate of 2,2349 RON/dollar. In Romania, the RON gained value during the last days of the month of April, on the grounds of foreign exchange repatriations from abroad before holidays and of the fact that large international companies operating locally bought domestic currency in order to pay the taxes to the state.

National Prognosis Commission experts (CNP) made some estimation for the period between 2009 and 2013. Some of these examples might be:

1. the GDP growth will be of 5,9% in 2009, the GDP increase for 2010 being estimated to 5,8%, 5,8% for 2011 and of 5,7% for 2013;
2. the industrial production will increase by 5,3% in 2009, by 5,5% in 2010 and in 2011, and in 2012 and 2013 it will increase by 5,4%;
3. the yearly average inflation is estimated to 3,4% for 2009, for 2010 to 3,3%, for 2011 to 3,0% , and for 2012 to 2,7%, and for 2013, CNP maintained its forecast of 2,5%;
4. the current account deficiency will maintain at over 10% of the GDP during 2007 – 2013;

5. the average of the foreign exchange rate will be of 3,25 RON/euro in 2009, 3,20 RON/euro in 2010 and of 3,15RON/euro in 2011, and during 2012 – 2013, the exchange rate is estimated to 3,10 RON/euro.

#### 4. Conclusions

In conclusion, the exchange rate represents one of the criteria of nominal convergence, the criteria regarding the inflation rate depending on its accomplishment. With respect to the stability of the foreign currency exchange rate, the national currency must fit a fluctuation band of maximum +/- 15% for two years before Romania's entry into the Exchange Rate Mechanism 2(ERM 2).

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