STABILITY OF THE EXCHANGE MARKET IN ROMANIA, IN THE PERSPECTIVE OF JOINING THE ERM II

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Romania joined the European Union last year and now it is preparing to join the ERM II. The paper is investigating the recent evolution of the exchange rate leu/euro and its compatibility with a future participation to the ERM II. The findings show that while the exchange rate evolution was not very smoothly in the last few years, the stability of the exchange market was high enough and Romania does not seem to encounter any problems concerning a future participation to the ERM II. The forecasts for the next years confirm the maturity of our exchange market and its capacity of maintaining the exchange rate sufficiently stable so that Romania might achieve its objectives in terms of euro adoption.

Keywords: stability, exchange rate, ERM II

1. Introduction

From the 1st January 2007 Romania is a member of the European Union. Not yet a full member, since full membership is granted only to the countries having adopted the euro. Accomplishing the convergence criteria and joining the Euro Area is the next step in the European integration process of our country. Before adopting the euro, Romania must spend at least two years in the ERM II (European Exchange Rate Mechanism II), keeping its exchange rate towards the euro stable, inside a band of ±15%. As many other countries from Central Europe, Romania decided to wait and join the ERM II only when it counts on accomplishing all the convergence criteria in the next 2 years.

Table no. 1 – Objectives of the Central and European countries concerning the ERM II and the euro adoption (as expressed in 2004)

Country	Objectives concerning ERM II participation	Objective set for euro adoption
Estonia	Rapid entry, maintaining the fixed exchange regime (fluctuation band zero)	2007
Latvia	Maintaining a narrow fluctuation band, of ±1%	2008
Lithuania	Rapid entry, maintaining the fixed exchange regime (fluctuation band zero)	2007
Poland	The shortest possible duration (2 years), with a standard fluctuation band (±15%)	2008-2009
Czech Republic	The shortest possible duration (2 years), with a standard fluctuation band (±15%)	2009 – 2010
Slovakia	The shortest possible duration (2 years); possible start in 2005	2008
Slovenia	Rapid entry (end of 2004)	2007
Hungary	Rapid entry, followed by a participation of a duration depending on the pace of convergence criteria accomplishment	2008

Source: Călin (2004), p. 68

The ERM II is the successor of the ERM (Exchange Rate Mechanism) established in 1978 in order to limit the fluctuations of the exchange rate movements between the currencies of the Western European countries. The ERM II is a fixed and adjustable exchange rate system, involving the risk of speculative attacks. Naturally (and especially after the crises experienced by the Western countries participating to the

ERM in 1992), countries try to avoid such vulnerable exchange rate arrangements. But participation to the ERM II is required, because it is considered that a successful participation proves the durability of the nominal convergence reached by the members of the EU (and before being accepted as a new member in the Euro Area, a country should be put to the test, so that a nominal convergence forced and superficial is detected before jeopardizing the stability of all the countries from the Euro Area).

The rest of the paper is organised as follows: the second section is presenting the opposite views of the communitarian institutions and new member states, and the arguments used by each side; the third part is presenting the evolution of the exchange rate between the Romanian (new) leu and the euro; the forth section assesses the compatibility of the evolution of the exchange rate in Romania with the requirements of the ERM II, evaluating the stability of the exchange rate of the leu towards the euro; finally, the last section contains the conclusions.

2. ERM II – accelerator of real convergence or unnecessary purgatory?

There is no consensus between the communitarian institutions and the representatives from the new member states, concerning the ERM II. Yet the fact remains that participating to the ERM II for two years is a mandatory condition for the countries wanting to enter the Euro Area. But while the communitarian institutions are encouraging early entrance in the ERM II and a long stay inside the mechanism, the national authorities from those countries have opting for the shortest possible stay: 2 years (see table 1).

For their part, the communitarian institutions agree that the real and nominal convergence obtained by the EU member states adopting the euro must be durable. They argue that the ERM II is offering the participant countries a flexible, yet stable exchange rate arrangement, ideal for achieving nominal convergence (price stability) while allowing the exchange rate to adjust to the movements of the equilibrium exchange rate determined by the real convergence and the Balassa-Samuelson effect.

Although a soft peg, the ERM II is not considered a threat for the financial stability of the participating member states, since the extended fluctuation band (±15%) is large enough to discourage speculative attacks (it was tested on the EMR after 1993 and no currency was pushed outside the fluctuation limits by speculative attacks). Moreover, the ERM II is endowed with a short term financing facility allowing the countries attacked to find support and supplementary means for fighting the speculative attacks. There are even some economists from the new member states supporting this strategy (Orlowski, 2002; Jankovics, 2002; Backé and Wójcik, 2002). And the experiences of the current members of the Euro Area seems to prove that participation to the ERM II is safe and does not imply a high risk of speculative attacks.

So far, everything sounds very logical, but then, why are all the new member states afraid to stay too long in the ERM II?

Well, it remains a soft peg imposing the national authority to defend a certain exchange rate towards to euro, and such an exchange rate arrangement can engender severe crises, because exchange crises appear always in the countries trying hard to defend a fixed exchange regime (Aubin C., Norel Ph., 2000: p.268).

Many economists suggested that, for the Central and Eastern European countries, the best strategy would be to join as soon as possible the Euro Area (Csajbok and Csermely, 2002; Buiter and Grafe, 2001; Coricelli, Jazbec and Masten, 2003). Also, outstanding economists from outside Europe recommended the new EU members to spend as little time as possible inside the ERM II – P. Kenen (see IMF, 2004).

Some economists even proposed the unilateral adoption of the euro in the Central and Eastern European countries, even before the accession to the EU (Begg, 2001; Buiter and Grafe, 2001; Balcerowicz, 2002; von Hagen and Zhou, 2003) – this strategy was declared from the start as unacceptable by the communitarian institutions. Under no circumstances participation to ERM II can be avoided, since the communitarian institutions insist on the necessity of equal treatment of old and new member states and on the idea of using the exact same set of convergence criteria.

In June 2004, the first countries from Central and Eastern Europe joined the ERM II: Slovenia, Estonia and Lithuania. In May 2005 other three countries joined the ERM II: Malta, Cyprus and Latvia. Slovakia fallowed in November 2005. There were no problems – Slovenia, Cyprus and Malta successfully finished their stay in the ERM II and adopted the euro. The countries counting on a latter adoption of the euro have not entered yet into the ERM II (Czech Republic, Poland, Hungary, Romania, and Bulgaria).

3. The evolution of the exchange rate between the Romanian leu and the euro

The exchange policy of Romania is, since 1991, the exchange rate managed float. The National Bank of Romania monitored closely the evolution of the exchange rate. First, the US dollar was used as a reference currency. After the euro was launched, the US dollar was replaced by a currency basket made by the US dollar and the euro. Gradually, the part of the euro increased in this basket. Finally, the reference currency remained the euro.

Although the legislation did not impose the NBR to focus on the evolution of the exchange rate, it chose to do so. The BNR allowed a real appreciation of maximum 2 – 2,5% per year, against the currency basket used (made by the euro and the US dollar).

Before 2004, while the annual inflation rates were well above 10%, the analysis of the real exchange rate is definitely preferable to one of the nominal exchange rate. For the period 1999-2004 the real exchange rate (RER) of the Romanian leu against the euro and its trend (determined by means of a Hodrick-Prescott filter) is analysed and presented in figure 1.

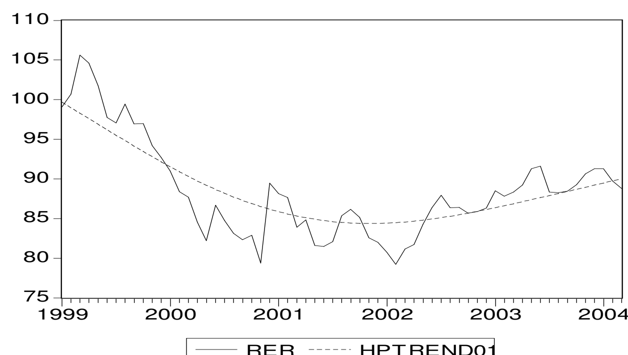


Figure 1 – The trend of the evolution of the real exchange rate

Source: Călin, 2004: p.267

The graphic clearly shows that after an evident real appreciation experienced in the first part of the period (January 1999 – beginning of 2001), the trend changed.

In October 2004, the NBR decided to reduce the frequency of its interventions on the exchange market. Its interventions became fewer, but more massive and less predictable. In only a few months, the nominal exchange rate of the Romanian leu against the euro passed from 41.127 lei/euro (October 2004) to 38.494 lei/euro (December 2004) – an appreciation of 6,84%. In March 2005, the exchange rate was 36.422 lei/euro – meaning a nominal appreciation of 13% for a five months period. If we consider also the inflation differential between Romania and the Euro or the USA – around 7% at that time) we can have a clearer image of the size of the real appreciation of the Romanian leu.

This evolution came as a shock to most Romanians (population and companies). After 15 years of depreciation, for the first time, the Romanian leu strongly appreciated in nominal terms against strong currencies as the euro and the US dollar. Apparently, the strong appreciation of the national currency was not desired by the NBR and may be, not even anticipated by it. Nevertheless, the NBR held to its decision, and after several months of strong appreciation, the exchange rate stabilised. Its level in January 2006 (3,6445 RON/EUR) was very close to the level from February 2005 (3,6765 RON/EUR). The market seemed to have found its equilibrium.

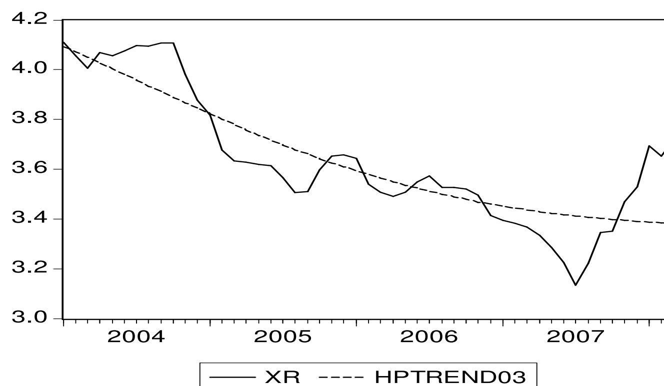


Figure 2 – The trend of the evolution of the nominal exchange rate (January 2004 – March 2008)

Starting with February 2006, the Romanian leu showed a clear tendency of appreciation, but in a completely different rhythm (passing to 3,1337 RON/EUR in July 2007 – an appreciation of 14,75% over a period of 18 months).

In the last few months, in the context of an increase in the level of the inflation rate (at over 8%), the nominal exchange rate started to depreciate (passing from 3,1337 RON/EUR in July 2007 to 3,7218 RON/EUR in March 2008). This seems to be a short-term deviation from the trend- as it can be seen in the figure 2, the trend did not change. Still, it represents a depreciation by 18,75% in only 9 months.

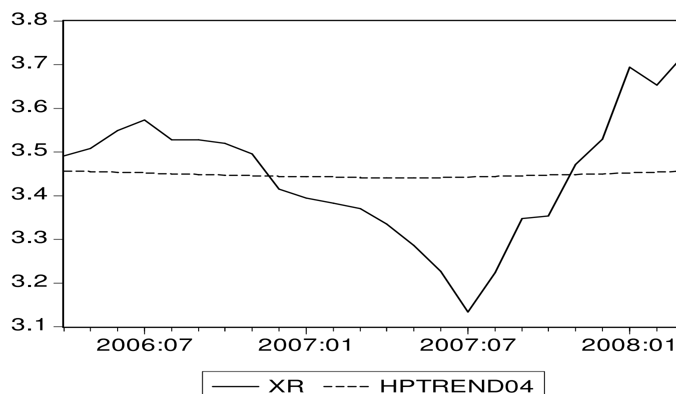
We could say that the exchange rate between the leu and the euro is now stable. In the end, the level of the exchange rate nowadays (April 2008) is around 3,6 RON/EUR, very close to the level from January 2006 or February 2005. But is a depreciation of over 18% in just a few months compatible with the ERM II?

4. Stability of the exchange rate

The ERM II allows fluctuations inside a band of ±15%, a band established around a central rate. If we should have chosen a central parity for the leu, it would have been, most probably, somewhere around 3,5 RON/EUR (most forecasts made in the last few years are estimating the exchange rate RON/EUR between 3,4 and 3,65 RON/EUR for the period 2007-2013).

Let us consider the last 2 years: April 2006-March 2008. The evolution of the exchange rate is presented in figure 3. If we look at the trend, the stability is obvious.

For our data sample, the mean is 3.446571, and the median is 3.4809. The maximum level reached by the exchange rate in the last 24 months is 3,7218 RON/EUR in March 2008, while the minimum value is 3,1337 RON/EUR in July 2007.



In table 2 we present the maximum deviation of the exchange rate between the Romanian leu and the euro, assuming various central parities.

Table 2 – Compatibility of the exchange rate evolution with the ERM II

Central parity	Maximum depreciation	Maximum appreciation	Compatible with ERM II
3,2	**16.3%**	2%	NU
3,3	12,78%	5%	DA
3,4	9,46%	7,83%	DA
3,5	6,33%	10,46%	DA
3,6	3,38%	12,95%	DA
3,7	0,59%	**15,3%**	NU

Considering the fluctuation band accepted in the ERM II as ±15%, the evolution of the exchange rate between the leu and the euro can be considered as stable (and compatible to the ERM II) for any central parity between 3,2363 and 3,6867 RON/EUR.

5. Conclusion

The Romanian exchange rate market reached a high level of maturity. By the time the NBR decided to dramatically cut the frequency of its intervention, the market was already able to function well without many interventions.

For years it has been said that in Romania the main problem concerning the convergence criteria is the inflation rate and that once the inflation is under control, the criteria concerning the interest rate and the exchange rate would be easily accomplished. This seems to be true for the exchange rate – with annual inflation rates expressed with a single digit, the exchange rate is already stable enough as to fluctuate within a band of ±10% around a central parity of 3,4 RON/EUR. Certainly, this does not mean that the participation to the ERM II is risk-free (on the contrary – so far, since the NBR was not forced to defend a certain level of the exchange rate, the incentives to speculative was lower; after joining the ERM II, that incentive will increase). But it proves that Romania will soon be able to participate to the ERM II and to accomplish the convergence criteria concerning the exchange rate, if that participation is handled with competence and caution.

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