THE POLICY OF THE EXCHANGE RATE PROMOTED BY NATIONAL BANK OF ROMANIA AND ITS IMPLICATIONS UPON THE FINANCIAL STABILITY

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The more profound world economic crisis has strongly marked the evolution of the Romanian financial system.
The size of current account deficit, the relatively high external financing needs and the dependence of the banks on it, the high ratio between loans in foreign currency and deposits in foreign currency made of the Romanian economy, a risky destination for investors. In these conditions, since the end of 2008 and throughout 2009, the government's economic program was focused on reducing the external deficit in both public and private sector, on minimizing the effects of recession, on avoiding a crisis of the exchange rate and on cooling the inflationary pressures.

Keywords: monetary policy, exchange rate, external financing, budget deficit

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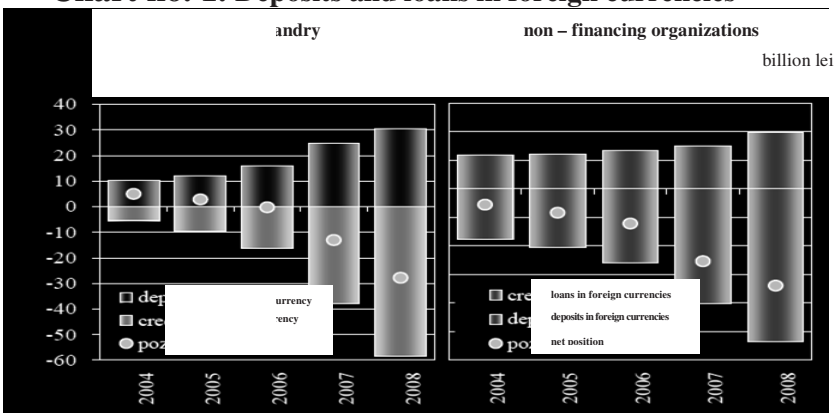
1. The interventions of NBR on the foreign exchange market

Supported by the global financial crisis, the evolution of the Leu rate has raised major problems. As in the period 2005-2007, the currency incomings have overestimated the Romanian national currency way above the level indicated by the fundamental factors of the exchange rate, the reduction of the foreign financing and the incertitude have afterwards determined an unjustified depreciation of the Romanian Leu. In spite of the high acquisition of currency in the anterior period, The National Bank of Romania has managed only to attenuate the unsustainable appreciation of the Leu, although the challenges in the bank system were very big. In the period 2004-2008, the continuous dynamics of the currency credits would have created negative effects at the level of the bank system under the circumstances of a rapid and excessive depreciation of the Leu (Chart 1).
Between October 2008 and April 2009, the Leu depreciated by 12% in comparison with the Euro (and by 21% in comparison with the Dollar), while the volatility exceeded 30% (Chart 2). These powerful contrasts between the two periods of 2008 could not have been anticipated, considerably affecting the reaction of the members of the economic environment and the business plans.

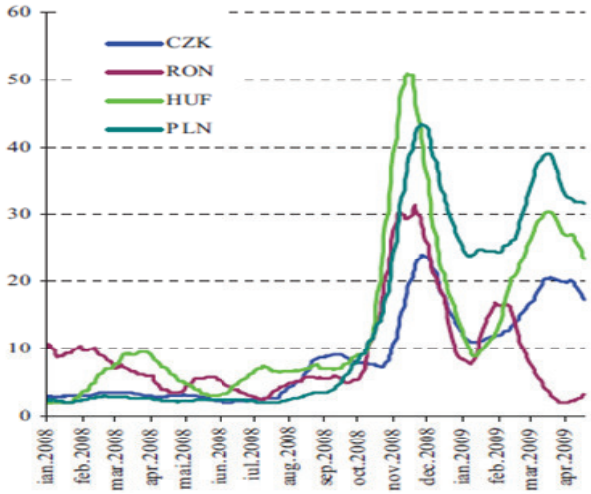
Chart no. 1. Deposits and loans in foreign currencies



Source: National Bank of Romania

The factors which contributed to this interruption in the dynamic evolution of the exchange rate were: **global** – a high incertitude regarding the situation of the global monetary system and the possible repercussions upon the emergent countries and **specific** – the worsening of Romania's qualification credit (of sub-investment) by two rating agencies (Fitch Ratings and Moody's).
As one can notice from Chart 2, the volatility of the national currency, although in a significant progress, has remained under the level of other currencies in the region, and at present it registers some of the lowest values.

Chart no. 2. The Conditioned Volatility of the Main Currencies EEC compared to the Euro (percentage, average on a period of 20 days)



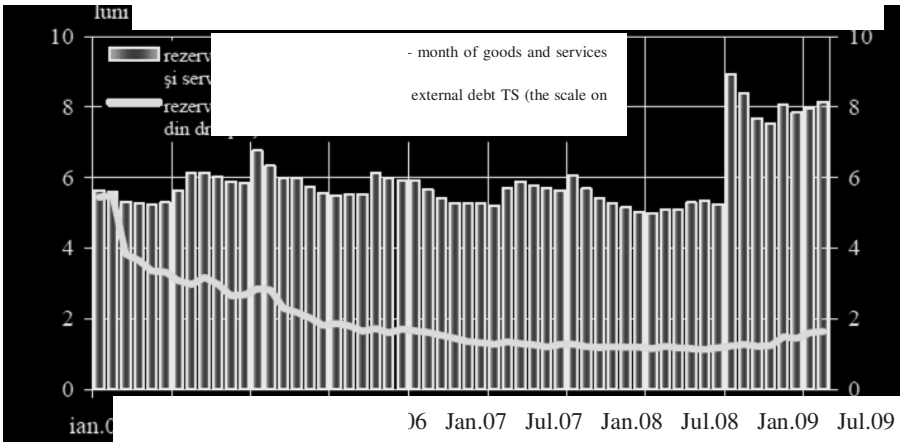
In this context, tl calculations. **interventions on the foreign exchange market** was oriented by the idea that a higher volatility of the exchange rate is detrimental to both the objective regarding inflation and the solidity of the real and financial sectors. Even more as the Romanian economy considered to be of small dimensions and with a high degree of openness is permanently exposed to the danger of some unfavourable capital movements at the level of the financial and especially the foreign exchange market.
The option of the National Bank of Romania to intervene on the foreign exchange market was not singular in Central and Eastern Europe, the system of managed floating of the national currency being practiced by other Central Banks too, their foreign exchange interventions being amplified after the beginning of the global financial crisis. Under the circumstances, the National Banks

from the Check Republic, Poland and Hungary, which have a flexible foreign exchange system have pronounced themselves against the excessive depreciation of the local currencies which could create destabilizing movements, promising, in their turn, to intervene in order to combat the phenomenon.

These interventions of the National Bank of Romania on the foreign exchange market have been aimed at the excessive depreciation of the national currency and the depreciation level was correlated to the progress registered by the adjustment of the current account.

These foreign exchange interventions were adjusted according to the **foreign exchange reserves** too. The foreign exchange reserves constituted due to the interventions from the period of overrating (2004-2008) and the sums received as a result of the financing agreement with the International Monetary Fund, the European Union and other international financial institutions have offered the central bank the possibility to support the national currency. Romania's National Bank aims at both the absolute value of the foreign exchange reserves and the derived indicators, respectively the foreign exchange reserve expressed in months of imports of goods and services and the report between the foreign exchange reserve and the short term foreign debt (Chart 3).

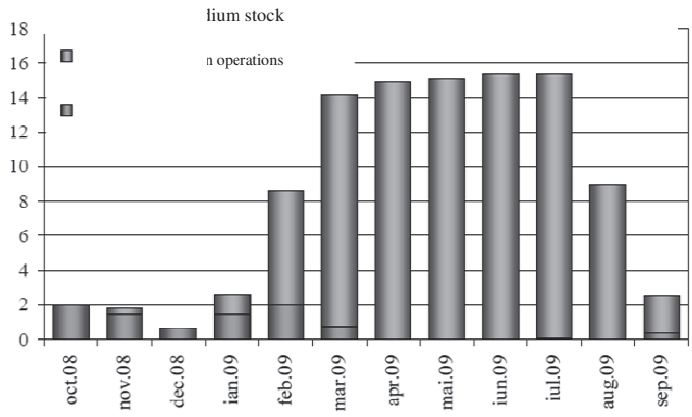
Chart no. 3. Foreign exchange reserves at NBR: derivative indicatives



Source: National Bank of Romania, National Institute of Statistics

The strategy of the National Bank of Romania to reduce the effects of the crisis has been aimed at both the correlated **amount and the moment of the foreign exchange interventions** and **the liquidities control on the monetary market**, under the circumstances in which the financing of the budgetary deficit was mainly done through the usage of the sums received from the International Monetary Fund and the European Union. In 2009, the National Bank of Romania supplied liquidities to the banks after it had been a net debtor towards the bank system due to the liquidity surplus generated by the massive capital inflow in the Romanian economy in the period 2004-2008. The foreign exchange intervention generated by the National Bank of Romania had as a purpose the attempt to avoid the reversal of its position as a creditor towards the bank system, a situation which could have caused problems for the implementation of the monetary policy (Chart 4).

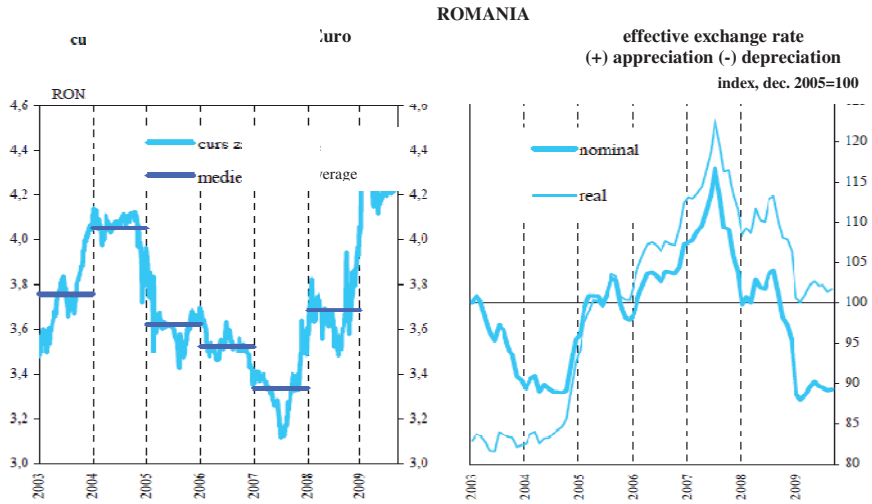
Chart no. 4. Liquidity provision operations



Source: National Bank of Romania

In this context, we can say that the foreign exchange interventions were necessary not only to maintain the exchange rate but also to properly manage the liquidities on the monetary market (Chart 5).

Chart no. 5



Source: BCE, BRI

Diminishing the depreciation of the Romanian Leu and implicitly the inflation pressures which appear by means of the exchange rate together with the fiscal consolidation efforts have allowed the National Bank to pass on to the **cautious relief of the monetary policy** ever since the beginning of 2010. The National Bank has taken the following **measures**: decreasing the monetary policy interest rate to 6.5%[533] per year, maintaining the present levels of the minimum reserves rates applied to both domestic and foreign currency liabilities of the crediting institutions

[533] During the meeting on 29 March 2010, the Administrative Board of Romania's National Bank decided to reduce the monetary policy interest rate to 6.5% per year.

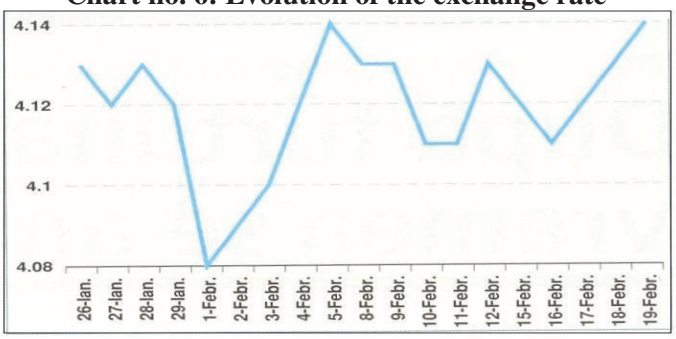
(15%, respectively 25%), firm administrating of liquidities in the bank system in order to consolidate the signals sent by the monetary policy.

2. The measures adopted by NBR to support the exchange rate

The beginning of 2010 marked for the national currency the highest appreciation in Europe as regards Euro and one of the highest level in the world, it only being overpassed by the Japanese yen.

Among the factors that sustained the appreciation of our currency – "leu" – in January can be mentioned: the unfavourable international opinions to European currency which has registered significant depreciation as regards many other currencies such as dollar, yen or the currency met in East European area, as well as the events on the internal level such as the declaration of IMF representatives as to the funds granted to Romania (Chart 6).

Chart no. 6: Evolution of the exchange rate



Source: NBR

In the years to follow, the exchange rate had contradictory evolutions, the depreciation being influenced by the publication of data regarding the evolution of the Romanian economy in the latter half of the year and by the information regarding inflation in January.

Therefore, the 4th term of the 2009 year did not mark the end of recession, but a deeper contradiction in comparison to the former term, and the inflation proved to be quite alert (+0,5pp. as to December 2009).

The analysts foresee for the end of this year a rate of 3.95 lei / Euro on the background of improving the economic basis. The positive signals will not cease the appear, the appreciation of "leu" being influenced by the positive perception of the investments for Romania drawn by high rentability as well as by low risks as a result of the positive answer connected with the receipt of financial instalments from national investments.

3. The Agreements with the International Monetary Fund and the European Union - a Support for the Consolidation of the Macroeconomic Balance and the Financial System

Under the circumstances of a slow recovery from the crisis, **the loan agreements** negotiated with **the International Monetary Fund** and **the European Union** and with the Global Bank and other international financial institutions purport to financially support the Government's economic program of macroeconomic and financial consolidation. The agreement with the International Monetary Fund and the European Union indirectly aims at an ordered adjustment of the foreign deficit with direct positive effects upon the exchange rate and implicitly upon the financial position of the companies, the population and the bank sector. These agreements have a clear preventive character ensuring **a higher degree of credibility to the Government's economic program** as well as the financial resources for **the correction of the macroeconomic lack of balance**.

Taking into consideration the general positive evaluation regarding the bank sector, the agreements with the International Monetary Fund and the European Union aim at ensuring the

solvency of the Romanian banks in order to have a safety margin in front of some possible new pressures generated by the global financial crisis. For this reason, the solvency of the banks will be of at least 10% during the agreement (2009-2010) compared to 8% as it is stipulated.
The agreements with the International Monetary Fund and the European Union stipulate other temporary (2009-2010) or permanent measures too. The banks which commit themselves to maintain the exposure on Romania during the program and raise their own funds to ensure a solvency above 10% will no longer be expected to have minimum reserves for the subordinate loans coming from the action holders or the international financial institutions.
The credibility acquired due to the influence of the European Commission and the International Monetary Fund ensured the financing of the Romanian economy, a financing which has reflected positively in a few directions: relatively hire investments comparatively to the situation in which the agreements would not have been closed; the attenuation of the Leu exchange rate depreciation in comparison with Euro and other currencies. Signing the Vienna Treaty by means of which the banks have committed themselves to renew the financing lines and preserve the capital rates at satisfactory levels.

Conclusion

Resuming the capital inflow in 2010 could mean increasing the amount of money in economy which has to be sterilized by the National Bank of Romania. Otherwise, if the capital inflow could not be sufficiently reduced, then the National Bank of Romania could be forced to increase the international reserves by means of purchases on the interbank market. At the same time, this process of resuming the capital inflow determines new requests of coordination between the monetary policy and the fiscal policy. In order to attenuate the inflation pressures, in 2010 the budgetary deficit should be diminished. Otherwise, the monetary policy would have to compensate the differences and adopt the necessary measures, among which the one referring to the dimension of the monetary interest rates.

Due to the process of foreign financing and capital inflow resuming, the adoption of political decisions in conformity with the European measures of pump priming represents a positive sign since the IIIrd trimester of 2010.

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