

## EXCHANGE RATE AND FOREIGN EXCHANGE MARKET DURING THE PRE-ACCESSION OF ROMANIA TO THE EUROPEAN MONETARY UNION

**Prof. Jenica POPESCU, PhD**  
**Dan SICHIGEA, PhD student**  
**University of Craiova**

### 1. Introduction

Currently in our country, the exchanges are in a position to have free market, where transactions are made directly purchase foreign currencies, without limitation, amounts negotiated free classes throughout the day.

A milestone in the functioning of the currency in Romania was the 1999, when National Bank of Romania did a "major correction" of exchange rate, correction due to the fact that the International Monetary Fund put us on the "black list" of potential default country. Then the Central Bank turned to "exchange valve" to balance the trade

deficit – the main component of current account - which defines the key indicator of our country payments balance (true mirror of how we consume in relation of we produce). In consequence, National Bank of Romania has accepted a devaluation of LEU (a major depreciation in real terms), almost scoring in 1999 year an upward movement of ROL/USD report.

In no. 1 table are presented the annual average rates values for the main currencies after 2000, as a normal development given that our country underwent a period of transition and economic performance isn't comparative with that the developed economies.

Table no. 1 - The annual average rates leu/dolar and leu/euro

Year	leu/USD Rate	leu/EUR Rate	Year	leu/USD Rate	leu/EUR Rate
2000	21692,7	19955,8	2006*	2,8090	3,5245
2001	29060,9	26026,9	2007*	2,4383	3,3373
2002	33055,5	31255,3	2008*	2,5160	3,6809
2003	33200,1	37555,9	2009*	3,1938	4,2304
2004	32636,6	40532,1	2010*	3,1801	4,2104
2005*	2,9137	3,6234			

\* after 2005 year the values are for RON;

The official site of National Bank of Romania: [www.bnro.ro](http://www.bnro.ro)

Regarding the dollar-leu (ROL/USD) exchange rate policy of the NBR saw the following developments:

a) in 2000 year there was an average impairment "year-on-year" of 41.7%, not much less than the average inflation of 46%;

b) in 2001 year the imbalance created in 2000 was extended until

December, the average depreciation being of 24 lei by day;

c) in 2002 year the devaluation of the leu has continued, but with less intensity, so that between May and December there was a period of constant;

d) in 2003 and 2004 years, the ROL/USD exchange rate has remained

approximately of 2002 year level, through a policy of maintaining the dollar exchange rate as a result of purchases of dollars by NBR;

e) in 2005-2008 period, the LEU experienced a slight appreciation against the dollar, its floating being much more realistic and more credible.

As for euro-leu exchange rate (ROL /EUR), in 2000-2008 period, it was showed the following trends:

a) the average depreciation of ROL/EUR rate in 2000 year was lower compared with the depreciation of ROL/USD rate (with only 22.7%), the depreciation being smooth, continuous and relatively;

b) the ROL/EUR exchange rate, in 2001 year, followed the trends of the international currency market where the average rate of euro fell to 0.89 USD;

c) the return in strength of the euro on international markets (April 2002) made the LEU against the euro to be held about four months; also in the coming months until the end of the year and in 2003-2004 years the LEU was depreciated, reaching in 2004 at 40532 lei for one euro;

d) between 2005-2007 years there was an appreciation of the leu against the euro, followed by a period of depreciation of the LEU.

The recent period, 2008-2010, requires a separate.

## **2. Evolution of exchange rate against major currencies during the period 2008-2010**

The early of 2008 year was marked by a slight increase of euro, which has evolved in the domain from 3.6 to 3.8 RON/EUR, while the dollar fell below 2.4 RON/USD (chart no. 1).

Worldwide, the U.S. dollar continued to depreciate (chart no. 2) the measures taken by FED for the liquidity crisis, i.e. reducing the discount fee, leading to an accentuation of this decline,

the report EUR/USD reaching at values of 1.55 to 1.60 during the period March 15 to August 7, 2008.

After this period, the deepening of financial crisis was also felt in Europe. Although the United States was declared bankrupt of major banks (Bear Stearns in July, Lehman Brothers, Washington Mutual and Merrill Lynch in September), the dollar - probably amid crisis spread in Europe but, especially, because of the psychological war launched by Americans against European currency - increases against the euro, reaching parity in November 2008 being 1.25 to 1.30 EUR/USD, however, the end of the year confirming a report of 1.4 - 1.45 EUR/USD.

*Most worrying phenomenon isn't the increase or decrease of this report, but very important to the economy is its high volatility, leading to significant margins of the currency risk. Basically, a trade exchange can bring big financial losses while the exchange rate differs greatly from the time when we complete the agreement and the payment time.*

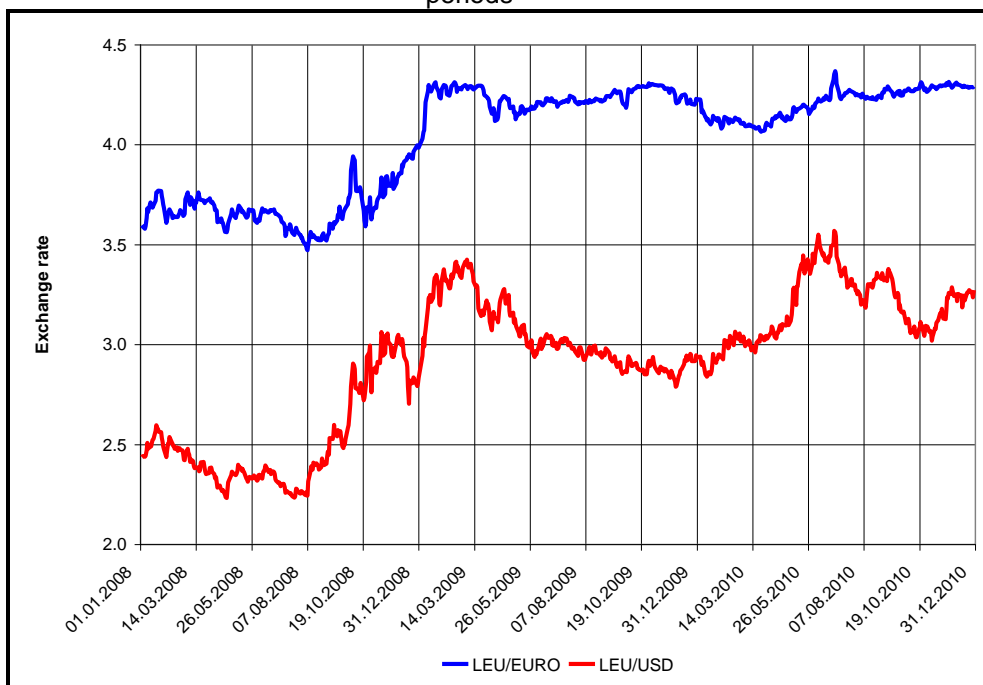
Propagation of the financial crisis in the real economy in the second half of 2008 year as a result of the crisis in real estate (land and buildings for housing construction), continued reaching adjacent sectors, i.e. industry of construction materials and equipment and automotive industry. We also mention the falling of oil prices and stock markets around the world, which has affected the ongoing strong investments, some of them very spectacular.

In Romania, the international financial crisis have been felt from the third quarter of 2008, affecting in the first phase, building and construction of houses sector, victims of lack funding as banks (for the most part with foreign capital and previously affected by the crisis in the West) have not given credit in this area. Fall of financial system also has seriously affected the construction of automobiles, the banks haven't given money to finance their purchase. In 2008,

Western banks have pooled resources they had, for the most part, to rescue their economies, and if more resources have to purchase other financial companies. It was, moreover, the first step to rescue the financial system, by purchasing "sick" banks by the "healthy"

banks. Because that recipe could not be applied in all cases, it was necessary the intervention of states by injection of money to balance accounts in the system and to provide financing activities in the real economy.

Chart no. 1: The ROL/EURO and ROL/USD exchange rates in 2008-2010 periods



In the first half of 2009, the LEU/EUR was maintained fairly stable at values of 4.1 to 4.3 RON/ EUR, first not to increase inflation. Unfortunately, many of Romanian people are betting on the most powerful, i.e. the euro, when it receives a decrease in confidence in national currency. The path to eurozation of the economy (like dollarization in the period 1990-2000) was being wide open. If we (Romanians) go immediately after we receive the many to the exchange office for changing our money into euros we only undermine any policy of exchange rate stability and inflation, obviously contributing to the national currency's depreciation against the euro.

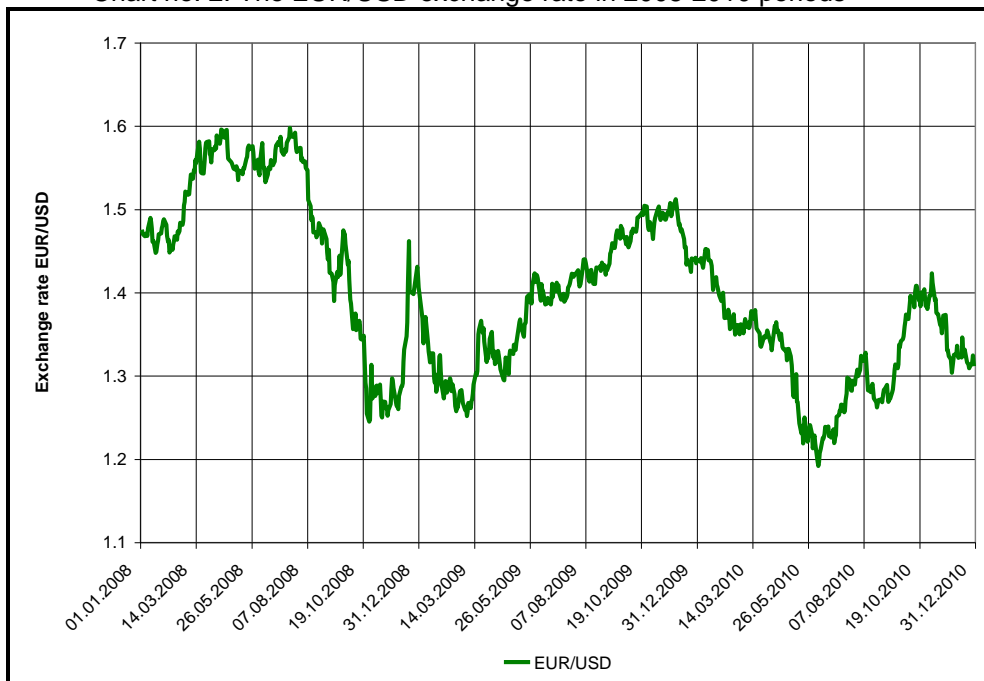
A forecast, even in the short term is difficult to do, especially under increased volatility of key economic indicators. While the members of government have announced some investment programs, required by the way, they are delayed due to lack of funding, budgetary income being insufficient to pay salaries and pensions provided in the budget. Under these conditions, the private firms must based only on sure revenues and eliminate expenses expenditures and that are not absolutely necessary.

Overall in the Second Quarter of 2009, showing a slight appreciation of the Leu against the Euro, while the reverse trajectory of the exchange rate recorded

during April was succeeded by a relative stabilization of it, reflecting, primarily, faded fluctuations in global risk appetite. However, the degree of correlation

between the exchange rate of the Leu and the exchange rates of major currencies in the region has increased, and its daily variations were reduced.

Chart no. 2: The EUR/USD exchange rate in 2008-2010 periods



Between April and June 2009, the Leu increased against the Euro by 1.5 percent in nominal terms (compared to a depreciation of 8.6 percent in first quarter); the Leu appreciation was slightly higher of Dollar - 8.2 percent in nominal terms - while the Dollar's value has fallen significantly against the Euro. In terms of average annual change in the exchange rate recorded in the second quarter of 2009, the Leu has slightly decreased the nominal depreciation, both against the Euro (12.9 percent) and against the U.S. Dollar (24.1 percent).

The relative stability shown in the first two months of 2009's third quarter for Leu/Euro exchange rate was followed, in September, by a slight upward of Leu/Euro report, the depreciation occurring in conditions of investor sentiment worsening on financial markets in our region and rising of uncertainties

regarding the short-term developments of Romanian economy.

Consequently, between July and September 2009, the Leu depreciated against the Euro by 0.5 percent and against the Dollar, however - given that the Dollar dropped against the Euro - Leu appreciated by 3.1 percent in nominal terms. The Leu/Euro rate was relatively stable in July and in August, reflecting the impact of divergent evolution of some of its main determinants.

The upward trend of Leu/Euro rate has soared in the first part of the fourth quarter of 2009, because of deteriorating investors' perceptions on economic and financial developments in the region and, also, of tension and internal political environment. The Leu /Euro exchange rate subsequently was returned to a generally slope downward movement, reflecting the relative improvement in global risk appetite and, to the end of the

range, because of climate stabilization of domestic political perspective. This development was accompanied, however, by daily and increased variations of the Leu/Euro exchange rate.

From October to December 2009, the Leu gained against the Euro by 0.3 percent in nominal terms (compared with 0.5 per cent nominal depreciation in the third quarter); compared to the U.S. Dollar - while its value fell slightly against the Euro – the Leu appreciated by 0.6 percent in nominal terms. In terms of average annual change in the exchange rate recorded in the fourth quarter of 2009, the Leu has diminished nominal depreciation against the Euro (10.6 percent), while recording the first appreciation of nominal value against the U.S. Dollar after six quarters (0,2 percent).

The first part of 2010, in terms of the exchange rate was somewhat calm, reflecting weaker euro against the dollar. Its cause is related primarily to the financial crisis of some European Union countries - countries PIGS: Portugal, Ireland, Greece (especially) and Spain – which are in a position to finance budget deficits with great difficulty, and to pay accumulated debts.

In addition, the perception that in the United States is signs of overcoming the financial crisis has led to a devaluation of the euro obvious, but is not as spectacular as hoped. Moreover, this impairment was hindered by tighter budgets, fund management in European Union countries, the measures to help the group called PIGS countries and the major difficulties still facing the U.S. economy.

Leu/Euro exchange rate has reversed the trajectory in April 2010, the movement was upward during the Second quarter mainly reflects fears of amplification of the Greek sovereign debt crisis and its possible extension to other euro area countries. Increasing of Leu exchange rate accelerated in the last part of the interval, while increasing its daily

wide variations due to the political tension and damages the internal financial market in the context of budget execution and prospects of further measures by the authorities for fiscal consolidation.

Consequently, during the April-June 2010, the Leu was depreciated against the Euro by 3.6 percent in nominal terms (compared with a 3.3 percent appreciation in the first quarter in nominal terms); against the dollar, however - provided that its value has risen sharply against the euro – our national currency depreciated by 12.7 percent in nominal terms (compared to a depreciation of 3.9 percent in first quarter).

The change in April for Leu/Euro exchange rate trajectory was mainly the result of inflammation linked to investors' worries about financial crisis of public finances in Greece<sup>1</sup>.

A upward movement of the Leu/Euro exchange rate also was boosted by investor sentiment about worsening of prospects for the Romanian economy in the short term, because of: a review of unfavorable forecasts for GDP and its budget deficit in 2010, especially emphasizing the uncertainties the government's ability to implement measures to reduce spending, the default parameter to execute for the agreement with the EU, IMF and international financial institutions.

These pressures have been mitigated by continuing strong growth in liquidity management by Central Bank on money market and implied a increasing of its yield. Local interbank foreign exchange market turnover has risen gradually - including gains due to speculative transactions - in May 2010 reaching the peak of last 16 months and the negative balance of foreign exchange transactions increased to a maximum

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<sup>1</sup> Reflected by the increase to a record, consider the history of EMU, the cost of financing the state foreign capital markets

value this year<sup>2</sup>; in these conditions, the Leu/Euro exchange rose on 20 May 2010 to the highest value in the last eleven months (4.1998). As a result, during April-May, the leu depreciated at 2.1 percent against the euro.

Depreciation's rate of Leu has intensified in June 2010 - similar of trends in the region - in terms of perception of risk associated with worsening regional developments. On the other hand, deterioration of market sentiment was induced by the difficulties in the process of adoption by the Romanian authorities to further measures for a fiscal consolidation - such as to postpone the deadline of periodic evaluation by the IMF board in conditions of the stand-by arrangement and release a new installment of the loan. Amid rising of uncertainties regarding the implementation of an austerity budget proposed by the government, the tensions in the interbank foreign exchange market have grown gradually rising in June 2010 to a maximum value of transaction turnover in the last 17 months. In turn, foreign exchange rate of Leu against Euro recorded a steep increase reaching the last days of the Second Quarter of successive highs; however, increased its daily variations, but they remain below the record the main parameters similar currencies in the region.

✓ The sharp increase, recorded by the Leu/Euro exchange rate at the end of the previous quarter, was corrected in the first days of July 2010, showing a stability until the last part of August, when he recorded a new amplification of episodic nature. These developments were reflected, mainly, the changes in market sentiment, to a lesser extent induced by fluctuations in global risk appetite and, especially, changes in the intensity of the uncertainties regarding the implementation and effectiveness of

fiscal consolidation measures adopted by the Romanian authorities. Under these conditions, the trajectory of the Leu/Euro decoupled from the descendant trend reported by the prevailing exchange rates of the koruna and zloty; in contrast, Leu/Euro exchange rate volatility continued to be lower than similar parameter of most values of currencies in our region.

Thus, in July-September 2010, the Leu was depreciated against the Euro by 0.6 percent in nominal terms (compared with 3.6 percent depreciation in nominal terms in the second quarter); against the Dollar but - in terms that its value has declined against the Euro - currency has appreciated by 5.3 percent in nominal terms (compared to a depreciation of 12.7 percent in the second quarter of 2010).

The upward trend that has positioned Leu/Euro exchange rate in the last decade of June 2010 was reversed in the first days of next month, amid uncertainties in the implementation of mitigating the austerity budget proposed by the government, mainly due to the encouragement given signal of IMF board's decision to approve the release of loan tranches for Romania. Under these conditions, the exchange rate returns on July 8 at the value of 4.2285 Lei/Euro, thus lowering 3.3 percent from the level reached in late June. Subsequently, the Leu/Euro rate rose slightly, reflecting the relative movement of the worsening market sentiment, prompted mainly by:

- multiplying the signs of a disappointing U.S. economic development;
- suspension, on July 17, of funding program between the IMF and EU and Hungary, and downgrading the rating outlook of this country;
- lowering of Portugal's credit rating.

In the last days of July, the Leu/Euro joined a descending trend, because of receipting, with other currencies exchange rates in the region,

<sup>2</sup> Including the effect of increasing net demand for foreign currency to customers resident legal persons

favorable effects exerted on investors' perception of:

- ✓ mitigation of risk assigned banks and sovereign issuers in the EU, including as effect of the smooth running of the first issuance of government securities made by Greece after the agreement with the IMF/EU, and because exercise stress testing results conducted in the banking sector of EU;

- ✓ above-expected development of most economies in the Euro area in the second quarter.

Descending movement of the Leu/Euro exchange rate was lower as amplitude (Leu was appreciated by 0.5 percent in August), while the improved of market sentiment was limited by the persistence of uncertainties regarding fiscal consolidation, as well as worsening of Romanian economy perspective (IMF revised its forecast to 1.9 percent decrease in GDP for 2010).

The Leu/Euro exchange rate has recorded a new episode of growth at the end of August and first week of September 2010, gains amid political tensions and government reshuffle process; growth, in these conditions, of the risk premium attached to Local investment market was enhanced by the negative signal given of deterioration since budget developments in Hungary.

Further dissipation of internal tensions, succeeded by the public affirmation of commitment to the Hungarian authorities about reducing the budget deficit below 3 percent in 2011 were likely to lead to a returning of Leu exchange rate, with that of the Forint, on a downward path; the movement also was supported by the relative increase in global risk appetite, driven, among other things, by the successful development of a Euro bond issues launched by Spain, Greece and Poland. However, the whole of September 2010 the Leu has depreciated in nominal terms by 0.6 percent.

### 3. Conclusions

During 2010 year, we appreciate that Romanian currency exchange rate has fluctuated quite small, this fact showing, we believe, that it has reached an equilibrium relationships between the major currencies and our national currency.

At a closer look at the representation of chart no. 1 we can say that changes in the exchange rates of major currencies against the Leu are qualitatively very different. If RON/EUR exchange rate includes two quasi-constant zones (the first 10 months of 2008 and after mid-January 2009 to present) between which there is an adjustment period (from November 2008 until mid-January 2009), in the Leu/USD things change very much in the sense that its variation has a greater degree of volatility. The latter fact is the result of chaotic evolution of the report Eur /USD, as stated above, is strongly affected by the struggle to preserve the dollar dominance.

Unfortunately, the appreciation of the Dollar, based more on positive comments on U.S. economic recovery and the difficulties in the Euro area countries, can no longer be supported by the U.S., its products and services being in decline across all markets. For speculators, the return to the old European currencies would represent new areas of "work." It raises a question: why can the Romanian currency, against the European currency, to keep a somewhat steady or predictable rate, despite of great problems of our economy, while worldwide, the EUR /USD, even if they was represented of strong and stable economies, fails to "appease" their exchange rate?

However, lately, and therefore large fluctuations of the Dollar, a shot with an important impact came against American from countries "spectators" (China, Russia and, predictably, Iran and

Venezuela) have decided that trading between them to run in their national currencies. It is anticipated that this group of countries will increase, India and Brazil being expected.

Based on these considerations, for the year 2011 may provide storage of leu / Euro exchange rate around current value (4.3 RON/EUR), the Romanian economy quickly adjusting to the European economy imbalance between November 2008 and mid-January 2009. The only signs that significantly influence RON/ EUR exchange rate would be a new economic recovery, which would require increased imports and investment, unlikely now, or an entry of Romania into default while the economy would shrink, increasing the budget deficit and exceeding the debt over its coverage.

The main problem of Romania is the budget deficit, largely due to the

government, unable to take measures to limit spending. To finance this deficit by borrowing, which will be more expensive, will increase the external debt reached such a high value (over 89 billion euros at end-October 2010).

In conclusion, because of fact that RON/EUR exchange rate is expected to remain stable in the short term, the prospect of Romania's accession to the European Monetary Union in 2015 is still possible, especially since this stability effect on inflation is positive, however, in the medium term, the situation may change completely the problem if there is no decrease in spending coupled with good economic growth. As Romania is very affected by the global context too, it would be desirable that the financial markets calm down, to provide a stable real economy.

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