EXCHANGE RATE AND ECONOMIC GROWTH. THE CASE OF ROMANIA

Nicolae Ghiba
"Alexandru Ioan Cuza" University of Iaşi
ghiba.nicolae@yahoo.com

Abstract: *Considering the difficulties created by the economic crisis, many exporters have criticized the National Bank of Romania (NBR)'s policy regarding the exchange rate evolution. They argue that depreciation is a necessary condition for recovery and not financial stability.*

On the contrary, Romania cannot afford a shock in the exchange rate level. The risk associated with such a measure is too high for an emerging country and it annihilates any export competitive advantages. Therefore, depreciation may delay the imperative of Romanian economic recovery. A solid economic recovery should have as starting point a financial system sound and stable. Excessive exchange rate depreciation jeopardizes the financial soundness of banks and the borrower's ability to repay their loans. Therefore, it creates inflationary flare-ups, particularly dangerous for the economy of any state.

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The exchange rate between EURO and Romanian leu (RON) didn't' fluctuate significantly in the last years. As a response, many exporters have criticized the National Bank of Romania (NBR)'s policy regarding the exchange rate evolution. They consider depreciation as a necessary condition for the domestic economy recovery. Also, they argue that the actual level of exchange rate of Romanian leu against EURO is overrated. The main argument is based on the exchange rate changes, correlated with inflation rate from our country in the last six years: the inflation increased by 42% and the national currency depreciated by only 3%. On the other hand, NBR's Governor Mugur Isărescu declares that excesive floating it is not suitable for an emerging economy such as that of Romania.

Therefore, some clarifications about the national exchange rate arrangement are needed. Romania practices a managed floating, which means interventions of Central Bank materialized in purchases and sales of convertible currencies. Monetary authority can interfere whenever necessary in order to prevent an imbalance of the financial system, with repercussions on the real economy. National Bank of Romania intervenes on currency market when the exchange rate does not reflect economic realities. The Central Bank has no obligation to sustain a certain level of Romanian leu to the pressures from public, institutions or companies interested in changing the exchange rate. Without NBR's interventions, the rate would have fluctuated even more, especially when there have been attacks on RON. Also, exchange rate is sensible to the prospects of macroeconomic environment stability. In these difficult circumstances, RON would have been weaker without Central Bank's interventions on currency market.

The present financial crisis, arisen mostly because of budgetary spending excesses and imprudent banking practices, favored the possibility of currency depreciation as solution for the Romanian economic recovery. The question is: does currency depreciation represent a sufficient incentive in order to stimulate economic growth?

Arguments that sustain the national currency depreciation rely, mostly, on its effects on international trade and current account situation: exports are stimulated and the national trade deficit is corrected. Currency depreciation is associated to an increased competitiveness of products and services exported abroad, and to decreasing imports. A growth in export volumes and smaller imports are desirable in the contemporary economy because they stimulate large amounts of currency into the country, with effects of additional demands for RON.

Exchange rate reflects the price of one currency expressed in another currency and is influenced by demand and supply of currencies. Rapidly increasing demand for RON leads to currency appreciation, which inhibits exports and stimulates imports, neutralizing initially desired effects. However, the lack of production capacities which can absorb additional demands for the national goods and services may annihilate the potential competitive advantages. In these circumstances, depreciation does not have the required effects on growth.

At the end of 2006, large capital inflows come from abroad, as effect of liberalizing the capital account. Therefore, RON appreciated to a record low of 3,11 units for one euro (reference course on 2 July 2010).

At a conference organized by the Faculty of Economics and Business Administration from Iasi, Mr. Napoleon Pop, board member of the National Bank of Romania said that RON appreciation in 2007 represented a threat for the Romania's balance of payments. The Central Bank interventions on currency market sustained the economic growth of that period. A speech like this, by a member of the Board of Central Bank was challenging for all students interested in the phenomenon of international finance and monetary policy, confirming the attention of authorities on the exchange rate, as a factor influencing economic growth.

Romania's national currency depreciation raises internationally attractiveness in terms of reducing labor costs. Accession to the European Union has brought an increasing confidence of foreign residents and companies to invest locally. Foreign investors may help Romanian economy by creating new jobs, increasing taxes base etc., with effect on growth direction. In the context of fiscal and political instability, the investors withdraw the capital, focusing to other directions.

In addition, significant exchange rate depreciation can only worry investors, because they associate exchange rate evolution with the economy going. Depreciation of RON attracts investors, who buy cheaper Romanian securities. Financial instruments price decrease may have beneficial effects on the ownership structure of the Romanian companies; having strong companies means additional experience and professionalism to help business growth.

Banking activity in Romania is characterized by a high degree of euroisation – two thirds of the loans granted to the population and companies are euro-denominated. Depreciation against the euro may cut the public's appetite for loans in foreign currency, restoring the confidence in the Romanian leu.

In order to support the exchange rate, the Romanian authorities have committed to apply structural reform measures on the public budget, by reducing spending and increasing taxation, in exchange for contracting a loan from International Monetary Fund and the European Union, amounting 20 billion euro. An important part of the amount borrowed ended up in the reserves of NBR, to ensure exchange rate stability.

Appellants of maintaining the exchange rate relative stable argue that all the national financial efforts delay the recovery of consumption and hence, of economic growth. Based on the calculation method, mathematical logic supports their ideas: gross domestic product includes investments, consumption and net exports of a country. However, the increase in consumption must have an economic basis and has to be strictly correlated with an increasing productivity.

I believe that sharp currency depreciation has several negative effects, with implications on financial system stability. Financial institutions with elaborate balance sheets expressed in foreign currencies bear the currency risk and may increase the incidence of systemic risk to financial stability. By weight and interlinkages with other components of the financial system, the banking system is considered to be the its core element. Currency depreciation has a significant influence on the banking institutions through the large volumes of foreign currency-denominated (especially euro-denominated) loans to households and firms. Most clients who took such loans receive revenues denominated in RON. When making currency conversion, customers need more units of their national currency to pay bills.

Decreased revenues and increased unemployment have significantly deteriorated loan portfolios of Romanian credit institutions. A shock caused by RON depreciation against the euro would increase debtors' outstandings. Therefore, banks' financial situation would worsen, increasing the costs of new loans granted. An instable banking environment leads to slow economic recovery, the opposite effect of the depreciation phenomena.

The high degree of euroisation of the national economy refers to the large number of products and services priced in foreign currencies. Many Romanian traders (car dealers, mobile operators, travel agents, hoteliers and real estate developers) express prices in euro. The situation attracted the attention of Central Bank's experts in finding solution to increase monetary instrument's efficiency, because the inflation management becomes more difficult to control. Losses in purchasing power of domestic currency imply higher prices for those products whose value is euro-denominated, with a direct impact of increasing inflation rate.

Currency risk is an important topic for those companies involved in international trade. Many Romanian companies/firms need raw materials from abroad and RON's depreciation increases the cost of final products because of the material expensiveness. Comparative to the constant household income, prices increase leads to a higher inflation rate.

I believe that Romania needs a series of measures to regulate the expression of prices in other currencies than RON. Romanian authorities must apply such measures in order to disconnect the economy from exchange rate fluctuations. Instruments of Central Bank's monetary policy would become more effective if the volume of loans foreign currency-denominated decreased. Restoring confidence in the national currency is essential to eliminate some of the negative effects of the exchange rate depreciation. The role of Romanian commercial banks is that of promoting lending and savings denominated in RON.

Massive absorption of European funds is a healthy alternative to depreciation, which can compensate the lack of public investments. An economic recovery based on European funding does not have significant negative effect on the Romanian economy. Every financing project has a destination that must be respected. Generally, these kind of projects are focused on developing existing infrastructure, the human resources etc., without jeopardizing the goals of sustainable development.

The present financial crisis highlighted the fact that the Economic and Monetary Union (EMU) member states which use a single currency don't have a guarantee in avoiding liquidity crisis and insolvency. Budgetary excesses have brought countries like Greece, Ireland, Portugal and Spain to the attention of European authorities. Being part of EMU makes it impossible to use depreciation as a stimulus for economic recovery. But unlike other countries that are not part of the single currency area, these countries received special financial assistance. The European Central Bank has guaranteed securities issued by these countries with financial problems. Given that Romania has decided to adopt euro in 2015, exchange rate deprecation is not a long term option. Achieving this objective implies limited exchange rate fluctuations in a fixed variation margin.

Economic recovery should be based on incentives for small and medium enterprises, not only on training programs for prospective entrepreneurs, but with clear measures and compliance in aggregates payment by the Governments to private firms.

Analyzing and comparing all above arguments of currency depreciation have convinced me of the need to support the exchange rate in assuring a stable macroeconomic environment. Depreciation can provide a competitive advantage of Romanian products, but is a measure with major negative effects. I believe that a solid economic recovery should have as starting point a financial system sound and stable. Excessive exchange rate depreciation jeopardizes the financial soundness of banks and the borrower's ability to repay their loans. Therefore, it creates inflationary flare-ups, particularly dangerous for the economy of any state.

The financial crisis has "shaken the roots" of financial market components with negative effects on the real economy. Nowadays, I believe that Romania cannot afford a shock in the exchange rate level. The risk associated with such a measure is too high for an emerging country and it annihilates any export competitive advantages. Therefore, depreciation may delay the imperative of Romanian economic recovery.