

# 14 ROMANIA'S EXCHANGE RATE POLICY TOWARDS ITS EUROPEAN MONETARY UNION MEMBERSHIP – PROSPECTS AND CHALLENGES

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## Abstract

*This paper has a focus in considering the implications of the European integration for the present and future exchange rate arrangements between the European Union and Romania as an emerging country.*

*The objective of this paper is to examine rather medium-term outlook for exchange rate arrangement involving Romania in its European membership process and the EU in the new single currency environment.*

*The national currency has a managed floating exchange rate regime against the single European currency, compatible with the inflation targeting policy currently promoted in Romania. Romania will also have to register a quite problematic coexistence of inflation targeting with an exchange rate stability after joining the Exchange Rate Mechanism II.*

*An exchange rate arrangement involving the national currency and the single European currency must be quite flexible to the economic conditions of Romanian economy and to the policy commitments of the authorities. The arrangement will also have to be compatible with the price stability objective of the European monetary policy and will need to strengthen the national authorities' capacity of achieving the structural adjustment. The flexibility within the ERM II will allow all of these ends to be fulfilled.*

*Joining the ERM II and thus registering a formal link to the single European currency, the Romanian economy will enjoy a greater credibility in the context of an anchor for macroeconomic policies.*

*The ERM II has also a few disadvantages. A hard pegging with the euro inside the ERM II wouldn't be appropriate given the incapacity of the emerging market system of*

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*determining an equilibrium level for the exchange rate of the national currency against the euro.*

*A real exchange rate appreciation could also generate tensions as a result of price tendency and differences in productivity growth between the national economy and the Euro Area countries.*

**Key words:** exchange rate policy, EMU

**JEL Classification:** E61, F15

## **1. Present stage of the exchange rate regime in Romania: definitive features and prospects**

Romanian's negotiations on its prospective EU membership focused on the need for structural improvements in economy without particular reference to exchange rate arrangements.

Romania is a member of the European Union starting on January 1<sup>st</sup>, 2007; it ultimately aspires to the adoption of the euro as a means to achieve its objective of full participation in the European Monetary Union. The longer-term challenge is, therefore, how to organize the transition from its current exchange rate regime to the irrevocable fixity of exchange rate against other Euro Area currencies, which would be implied by the adoption of the euro.

While the European Agreements recognize these facts and provide assistance to these ends, the economic elements of the Europe Agreements do not include an exchange rate arrangement. So, what are the prospects for exchange rate relations between the national currency and the euro?

In order to prepare for *the membership of the Exchange Rate Mechanism (ERM II) of the European Monetary Union*, Romania has moved through various types of regimes with ultimate shift being the adoption of the single currency.

Romania has started with a *fixed exchange rate regime* and moved gradually from an *intermediate (soft peg) regime* to a *managed floating regime*. Now the national currency has a managed floating exchange rate against euro.

Since November 2004, Romania has developed a new approach concerning the operational exchange rate strategy, characterized by:

- a greater flexibility of the exchange rate in the context of maintaining the managed-floating regime;
- a greater role of the market in the process of determining the exchange rate;
- less frequent interventions of the National Bank of Romania (NBR) in the foreign exchange market.

This new strategy provides also the following advantages:

- the discouragement of the speculative inflows;

- the reduction in the NBR intervention costs;
- an exchange rate mechanism compatible with the inflation targeting policy.

Romania has to prepare *to join to the ERM II (by 2009 or later)* and *to meet the convergence criteria for Euro Zone*, with a view to becoming an European Monetary Union member. This will shift the NBR's focus back from *price stability* to *exchange rate stability*.

Inflation targeting, as current national monetary policy, is to be maintained at least until the ERM II entry, the co-existence of inflation targeting with an explicit exchange rate objective being quite problematic; but the two goals are not inconsistent, since in the medium run the international value of the currency can be stable only if its internal value is stable. The strategy provides a progressive accomplishment of the Maastricht criteria, supporting at the same time the real convergence process.

Some of the features of inflation targeting in Romania are presented below:

- the consumer price indices–based inflation targeting;
- the target set as a midpoint within a band of  $\pm 1$  percentage points;
- the flexible assessing of inflation targeting (mainly its co-existence with managed floating regime);
- the joint announcement of inflation by the National Bank of Romania and the government;
- National Bank of Romania pro-active stance and transparency.

It could be concluded that an exchange rate arrangement involving the national currency and the euro must be adapted to the economic conditions of Romania and to the policy commitments of the relevant national authorities.

From the post-accession perspective, the timing of ERM II entry should be chosen:

- To ensure an exchange rate flexibility for a short period of time in order to further necessary and substantial structural adjustment;
- To continue the motivation to carry out reforms in time and consolidate the macro discipline;
- To ensure the possibility of identifying the central parity based on a more adequate estimate of the equilibrium exchange rate after overcoming the peak in capital inflows (expected to stay high even after the European Union accession).

Also, the timing should be configured to ensure the likelihood of shorter necessary stay in ERM II, given the fact that:

- the credibility provided by the final stage of the process (the adoption of the euro) is very important;
- it is possible to register volatile capital movements amid restricted exchange rate flexibility during interim period;
- there is an inflation targeting framework to which exchange rate movements should be clearly subordinated.

Romania's participation to the ERM II will be based on the firm commitment by the Romanian authorities to continue to take *the necessary measures to lower inflation in a sustainable way*; these include most notably measures aimed at further liberalizing administered prices and particularly advancing further with de-indexation of the wage and certain social transfer settings mechanism.

Continued vigilance will be also needed so that *the domestic cost developments, in particular wages, are in line with productivity growth*. Continued vigilance will be needed so that authorities, together with the European Union bodies, will closely supervise macroeconomic policies. Fiscal policy will have to play a central role in controlling demand-induced inflationary pressures and financial supervision will assist in containing domestic credit growth.

Structural reforms aimed at further enhancing the economy's flexibility will be implemented in a timely fashion so as to strengthen domestic adjustment mechanism and to maintain the overall competitiveness of the economy.

## **2. Joining the ERM II: advantages and perspectives for the exchange rate regime**

### *2.1. Advantages of ERM II*

The Exchange Rate Mechanism II links the currencies of a non-Euro Area Member States to the euro. By helping to ensure that the non-euro area Member States participating in the mechanism orient their policies towards stability, ERM II fosters convergence and thereby helps them make efforts to adopt the euro. As ERM II membership is one of the convergence criteria for the eventual adoption of the euro, new Member States are expected to join this mechanism at some stage.

The transition to the adoption of the euro is quite difficult and a series of steps toward an increasingly stable exchange rate with the euro can be envisaged. In this context, *the flexibility offered by the ERM II* would be an important advantage, in the form of:

- bilateral parities against the euro with a relatively wide standard fluctuation margin;
- timely realignments;
- the possibility of closer exchange rate links when appropriate.

This flexibility allows one to conceive of a broad spectrum of exchange rate arrangement within the new mechanism, ranging from very loose to progressively tighter arrangements, even including a currency board.

While the ERM II is not seen as the "natural habitat" of exchange rate arrangements involving Romanian currency and the euro, participation in such a mechanism as a member of the European Union could be attractive to the Romanian economy. The credibility to be gained from a formal link to the euro through ERM II participation could offer significant advantages:

- providing an anchor for macroeconomic policies;
- lowering interest rate premiums and attracting capital inflows;

- increasing attractiveness of a link to the euro as the new single currency evolves as an important international currency.

The rationale for pegging a country's currency to an anchor currency is based on two major policy concerns: the minimization of exchange rate risk and the stabilization of inflation.

Exchange rate pegs are typically used by small, open economies that peg to the currency of a major trading partner, if this currency is sufficiently stable. Fixed exchange rate pegs are also typically used in order to stabilize inflation when the credibility of the authorities is relatively low. The choice of a particular currency as an exchange rate anchor depends on three major factors:

- the importance of the trade relations with the anchor currency country;
- the importance of the financial flows with that country;
- the stability of the anchor currency.

On the basis of these three factors, the role of the euro as an exchange rate anchor for Romania gradually increased over time.

First, trade relations with the euro area intensified after the introduction of the euro. Not only the size of trade flows increased, but also the invoicing practices changed towards a larger use of the euro, so that Romania, as a trading country with the euro zone, is able to substantially reduce the exchange rate risk of its foreign trade by pegging to the euro.

Finally, the stability orientation of the Euro Area's policy mix, which results from the stability-oriented macroeconomic policy framework and from the independence of the European Central Bank, will contribute to the stability of the euro exchange rate.

Support for any exchange rate arrangement involving the euro could be expected on two conditions:

- the arrangement would need to be consistent with the price stability objective of the European Central Bank's monetary policy;
- the arrangement would need to buttress the Romania' commitment to stability-oriented policies and foster necessary structural adjustment.

As a whole, it is clear that the relevance and usefulness of exchange rate arrangements between the Romanian currency and the euro would be assessed on the basis of their *contribution to economic convergence as the means to achieve a successful catch-up and ultimately the adoption of the single currency.*

The flexibility within the ERM II would allow both of these conditions to be fulfilled by minimizing the necessity for large-scale foreign exchange intervention by the ECB and minimizing the risk that ERM II participation on some standardized set of terms might impede structural adjustment and the catching-up process.

The lack of flexibility represented by a narrow fluctuation margin would practically mean a fixed rate which could pose unnecessary risks for Romania as a future member state of the European Union. Given this context, investors could speculate in the foreign exchange market, forcing the central banks to intervene, pushing the currencies outside the fluctuation margin.

*2.2. Challenges in adopting a hard peg with the euro*

Despite the advantages of ERM II participation of Romania, a cautious approach to establish a hard peg with the euro would be seen appropriate.

The market-based system is in progress and time will be needed before it is fully effective. As the transition to the market system is not fully complete, relative prices have not yet fully adjusted and there is *no way of determining* (even with the customary degree of uncertainty) *the equilibrium level of the exchange rate*.

Moreover, the absence of relevant data and the dynamic nature of this economy would make the model-based calculations of an equilibrium rate particularly hazardous, as fundamental relationships within its economy remain difficult to determine and would be subject to significant change over relatively short period of time.

Without some understanding of equilibrium conditions, agreeing on a central parity for the national currency (RON) against the euro could be a rather "hit and miss" affair.

Attention must also be paid to the fact that Romania is an emerging economy where productivity, particularly in the manufacturing sector is likely to grow faster than that in the European Union countries.

This evolution is associated to the convergence process of Romanian's emerging economy to the developed Europeans economies; this tendency is also promoted by the international competition process and capital and modern technologies inflows in industries characterized by a high ratio of capital to labor force contribution (*the tradables sector*). An increasing level of productivity usually involves higher salary incomes in the tradables sector comparing to the nontradables sector; thus on the labor force market will appear salary equalization pressures between the two sectors, generating an increase in the nontradables prices faster than the one registered by the tradables prices.

According to the Balassa-Samuleson effect, economies registering high productivity differences between the two sectors have higher inflation rates. For these reasons, the general price level usually increases faster in the emerging economies if compared to the developed ones, generating a real exchange rate appreciation.

While a successful catching-up in the context of a hard exchange rate peg is not precluded, the implied productivity differential with other Euro Area countries would ordinarily be reflected in an exchange rate appreciation in Romania and could cause exchange rate tensions in the context of a hard peg.

Similarly, the positive expectations effects linked to EU membership could also create exchange rate tensions, as an expansion in aggregate demand ahead of supply potential in the economy creates a need for a temporary real exchange rate appreciation to contain inflationary pressures.

Given the specific characteristics of Romanian economy, exchange rate monitoring is of particular importance in the context of its participation in the ERM II.

EU membership means that Romania would be subject to the multilateral surveillance procedures provided by the Treaty. These procedures – to be enhanced in the context of new convergence programs required under the Stability and Growth Pact – will help to ensure a macroeconomic framework consistent with whatever exchange rate

arrangement the country might have in place. However, the addition of a regional dimension to the individual effort would bring important benefits.

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