  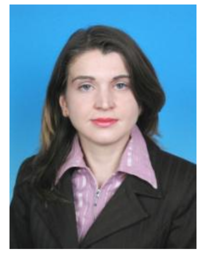

ASPECTS OF THE EXCHANGE RATE TRENDS IN THE NEW MEMBER STATES OF THE EUROPEAN UNION

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Rezumat

Dacă majoritatea indicatorilor macroeconomici, analizați pe o perioadă mai lungă, pot indica „starea de sănătate" a unei economii, evoluția cursului de schimb revelează, în general, creşterea sau scăderea, nu de puține ori brutală, a „temperaturii" unei economii. Astfel, analiza evoluțiilor cursurilor de schimb din noile state membre (NSM) ale Uniunii Europene (UE) poate constitui fundamentul pentru alte cercetări ce privesc aceste economii regionale, în contextul trecerii la moneda europeană. Desigur, euro nu reprezintă o soluție împotriva tuturor riscurilor (existând încă riscul supraîncălzirii şi al pierderii competitivității), însă, în condițiile declanşării şi manifestării crizei economice şi financiare globale, s-a dovedit a fi o protecție suficient de bună pentru țările zonei euro, crescând atractivitatea

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acestei zone monetare pentru NSM. Totuşi, NSM pot restrânge derapajele macroeconomice determinate de criză prin implementarea unor politici fiscale şi salariale echilibrate, iar cursul de schimb ori alte instrumente monetare pot constitui debuşee temporare pentru acumulările de tensiuni la nivelul acestor economii.

Abstract

While most macroeconomic indicators, analyzed on a longer period of time, may indicate the „health" of an economy, the exchange rate evolution reveals, generally, the increase or decrease, not seldom brutal, of the „temperature" of an economy. Thus, the analysis of the exchange rates evolution of the New Member States (NMS) of the European Union (EU) may constitute the basis for further research concerning these regional economies in the context of the changeover to Euro. Of course, the Euro currency is not a solution against all risks (it remains the risk of overheating and the risk of the loss of competitiveness), but amid the beginning and manifestation of global financial and economic crisis, the Euro currency proved to be a good enough protection for the euro area countries, increasing the attractiveness of this monetary area for the NMS. However, NMS can restrict macroeconomic slippages caused by the crisis by implementing balanced fiscal and wage policies, and the exchange rate or other monetary instruments may be temporary outlets for stress accumulation in these economies.

Keywords: economic and financial crisis, exchange rate, new EU member states of EU

JEL classification: F15, F31, G01

Evolution of the exchange rate in NMS before the start of the global crisis

The global financial crisis brought new challenges for the countries which accessed the European Union in 2004 and 2007, but which do not belong yet, to the Euro zone. Because they displayed stronger los of balance on the markets than the countries from the Euro zone, many of the new member states started to appreciate the protection which the quality of Euro zone membership offers during the periods of financial crisis.

The intensification of the world financial crisis starting with September 2008, brought new challenges for the monetary policy of many NMS which were not members of the Euro zone, several countries experiencing problems of liquidity on the interbanking markets, as well as tensions of the exchange market. The existing framework of monetary policy and the economic conditions were the factors which determined the typology of the reactions displayed by the national central banks to these challenges.

As the effects of the world crisis became increasingly evident in the NMS, the central banks started to use the instruments available to them in order to intervene on the market and to control the vulnerabilities displayed by the economy, using the key interest, the monetary volume and the exchange rate. The individual monetary policy adapted to the actual circumstances helps diminishing the effects of the crisis. The changeover of the NMS to Euro means giving up the national monetary policy, meaning that it will no longer be usable as instrument of economic policy adapted to the internal realities. At the same time, it means a protection against the speculative attacks on the national currency. Joining ERM II has the role of testing the central parity of the national currency and of orienting the expectations of the currency market so as to minimize the risks and vulnerabilities.

During 2004-2008, all the new member states fulfilled the convergence criterion for the exchange rate (Table 1).

Analysing the evolution of the exchange rates in the new member states in 2008, compared to the value in December 2007 (Table 2), one can make the following comments. The Czech crown and the Polish zloty appreciated in 2008. During 2005-2008, these two currencies appreciated considerably, 10-11% in relation with the Euro, showing a high confidence in the evolution of these two economies. The Czech crown, participant in ERM II until January 1st, 2009, and thereafter member of the Euro zone, already enjoyed since 2008 the protection of the European Central Bank, being among the few MNS currencies which didn’t depreciate in 2008.

After the appreciation of 2008, compared to December 2007, the Czech crown depreciated during the first four months of 2009, only to become stronger than by late 2009 and in 2010, than in December 2007. A possible explanation of this evolution pertains to the healthy macroeconomic situation of Czech Republic, with low fiscal deficits and low current account deficits, with a more rational economic growth, compared to the overheated economies of many new member states.

The Polish zloty started to depreciate in November 2008 (before which it was appreciating month by month, compared to the reference value from December 2007), evolution which persisted at high rates throughout 2009 and the first seven months of 2010.

The exchange rate of the NMS with currency board (Bulgaria, Estonia, Lithuania) remained unchanged in 2008 and 2009, and in the first seven months of 2010, while the national currencies of Latvia, Romania and Hungary depreciated in 2008, 2009, and in the first seven months of 2010, the Romanian leu displaying the strongest depreciation. The Romanian currency started to depreciate in October 2008, similarly with the Hungarian forint.

Of all the NMS, Hungary displayed the most dramatic situation in October 2008, when the Central Bank of Hungary had to intervene in order to restore the state securities market, which had stopped. As a consequence of these events, Hungary received financial support from IMF and the European Union (within a stand-by arrangement), which prevented the fall of the financial markets and thus the spread of a dangerous contagion to other capital markets in the region.

The Latvian lat started to depreciate strongly in June 2008, compared to December 2007, and this evolution accentuated in October. The depreciation of the Latvian lat maintained throughout 2009 and in the first seven months of 2010.

In 2009, only Poland and Romania didn't accomplish the convergence criterion for the exchange rate, while Hungary was unable to meet this criterion as of February 2009. While Hungary was able to accomplish this criterion until August 2009, in Romania, the fluctuation of the national currency from the reference value of December 2007, continued to be greater than 15%. Therefore, the prognosis for 2008 became true, according to which Romania and Poland will have exchange rate fluctuations in excess of +/- 15%. The prognoses show that in 2010 and 2011, all the new member states will accomplish the national currency convergence criterion.

Throughout 2009, the exchange rates from all new member states (except for those with currency board and the Czech crown, which appreciated towards the end of the period) depreciated, the Romanian leu showing the strongest depreciation, followed by the Polish zloty.

The trend of the situation remained unchanged during the first six months of 2010, the depreciation deceasing slowly in Romania and Poland, and becoming significantly stronger in Hungary.

As the appetite for risk decreased, the capitals were withdrawn from the emergent markets, and the quality of EU member was not enough protection against the outflow of capital from the new member states. By the end of 2006, the markets still were insensitive to risks, although some new member states had high levels of the current account deficit because the investors were seeking the best opportunities for profit under the conditions of a high level of liquidity. When the liquidities decreased globally and the aversion to risk increased, the economies with larger current account deficits were sanctioned stronger on the markets, irrespective of their currency regime.

Table no.1

Exchange rates of the New Member States – yearly changes (for analytical purposes the table also presents the evolutions from Sweden, Great Britain and Denmark)

	2004	2005	2006	2007	2008	2009	2010*	2011*
Bulgaria	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Czech Republic	-0.1	6.6	4.8	2.0	10.2	-6.0	2.6	-0.1
Estonia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	:
Latvia	-3.8	-4.7	0.0	-0.6	-0.4	-0.4	-0.4	0.0
Lithuania	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Hungary	0.8	1.4	-6.5	4.9	-0.1	-11.5	1.3	-1.8
Poland	-2.9	11.1	3.2	2.9	7.2	-23.2	6.3	-1.3
Romania	-7.9	10.6	2.6	5.4	-10.4	-15.1	1.0	-1.1
Sweden	0.0	-1.7	0.3	0.0	-3.9	-10.4	8.8	1.1
Great Britain	1.9	-0.8	0.3	-0.4	-16.4	-11.9	4.7	2.5
Denmark	-0.1	-0.2	-0.1	0.1	-0.1	0.1	0.1	0.0

*Source: Eurostat data (downloaded on 6 August 2010, the last Eurostat updating was on 4 August 2010) and calculations of the authors according to ECB methodology (negative value shows depreciation, positive value shows appreciation; note: *forecasts.*

The strong depreciation of the currencies with floating exchange rate and the implicit increase of the risk premiums and of the internal interest rates proved once more the validity of the results reported by the literature, according to which, for the small and open economies, an independent exchange rate is more like a source of shocks than an instrument which to absorb them.

The crisis increased strongly the internal interest rates and decreased abruptly the rates of economic growth in the countries with a fixed currency regime, on the background of the attempts to diminish the excessive current account deficits.

The events which unfolded during the recent years on the international financial markets showed that the quality of Euro zone member provides protection against the currency exchange risks and against the shocks associated to the financial crisis. The financial crisis increased, thus, the attractiveness of the Euro zone membership, but the new member states could not meet the convergence criteria, not even up to their previous accomplishments. Romania is a conclusive example in this direction: it didn't meet any of the nominal criteria for convergence and encountered legislative obstacles in matters pertaining to the central bank.

Exchange rate stability in the NMS during the interval between 2008 – first half of 2010

In 2008, the evolution of the exchange rates in the EU member states which are not members of the Euro zone, has been strongly influenced by the exchange policy of each individual country. We remind you that ***Bulgaria,*** the ***Baltic States and Denmark*** target the exchange rate, while ***Czech Republic, Hungary, Poland, Romania, Slovakia, Sweden*** and the ***United Kingdom***, target inflation.

In 2008, none of the NMS displayed changes in relation with their participation in ERM II. Thus, Bulgaria, Romania, Czech Republic, Hungary and Poland weren't and still are not ERM II members, while the Baltic States and Slovakia participated in ERM II during the analysed interval.

The national currencies of ***Denmark, Estonia, Latvia, Lithuania*** and ***Slovakia*** participated in ERM II and had a standard ±15% fluctuation band around the central parity against the Euro, except for the Danish crown, whose fluctuation band was narrower, ±2.25%. The participation in ERM II is, in some cases, accompanied by unilateral commitments for a narrower band of fluctuation. These unilateral commitments do not impose additional duties on the ECB. It was agreed that the ***Latvian lit*** and the ***Estonian crown*** may join

ERM II even if these countries have a currency board. The ***Latvian*** authorities decided to maintain the exchange rate of the lat at the central parity against the Euro, with a fluctuation band of ±1%. The agreements for the participation of the countries which have joined the ERM II in 2004 or subsequently (all the countries mentioned previously, except for Denmark) rely on several other political arrangements of the individual authorities. These arrangements refer, among other, to the enforcement of healthy fiscal policies, to the promotion of moderate wages and their evolution in agreement with the increase of productivity, to the enforcement of prudent crediting policies and to the implementation of new structural reforms.

Before the collapse of the Lehman Brothers in September 2008, the spreads of the currency market were quite stable in most of the mentioned countries, despite a relative volatility on the Latvian market. In the fourth quarter 2008, although the exchange rate evolution continued to reflect the official regimes of exchange rate targeting, the intensification of the world financial crisis, the deteriorating perspectives for economic growth, the concerns of the investors for the external vulnerabilities of some countries, the lower ratings for loans in the case of Latvia and Lithuania, and the decisions of the rating agencies to evaluate again Estonia with the view to decrease its rating, contributed to a fast and strong increase of the bond spreading and of the currency market spreading versus the Euro zone, in all ERM II countries, except for Slovakia. In ***Latvia***, where spread on the currency market increased sharply, and in ***Denmark***, the central banks supported the national currencies by interventions of the currency market and by increasing the spread of the official interest rate versus the Euro zone. On the background of a strong depression of the economic activity and of the tensions within the financial system, ***Latvia*** nationalised the largest bank with Latvian capital, and in December 2008 it implemented a joint international program of financial support amounting to 7.5 billion Euro.

On the other hand, the perspectives of ***Slovakia'***s[1] accession to the Euro zone, seem to have protected the Slovak crown from the negative impact of the world financial crisis. During the first half of 2008, the Slovak crown appreciated consistently versus the Euro. On

[1] *Slovakia demanded a country analysis on April 4, 2008, given its intention to adopt the Euro as of January 1st, 2009.*

29 May, its central parity was revaluated by 17.6472% to 30.1260 SKK versus the Euro. After the July 2008 decision of the Council of the European Union, to allow Slovakia to adopt the Euro, the Slovak crown maintained a level close to its new central parity, which also was the parity for its conversion to Euro, when the European currency was introduced in Slovakia (January 1st, 2009).

Slovakia is the first country which adopted the Euro after its national currency displayed for several years a trend of appreciation of the nominal exchange rate, which requires an analysis of the economic activity of this country with a fixed exchange rate regime.

The evolution of the national currencies of the EU member states outside the Euro zone, which didn't participate in ERM II, varied significantly with each individual country. Most national currencies were rather stable during the first six months of 2008, while the ***Czech crown*** and the ***Polish zloty*** appreciated and reached record levels versus the Euro. Yet, as of October, the amplification of the international economic crisis generated the fast and strong depreciation of several national currencies, particularly of the ***Polish zloty, Magyar forint, Romanian leu***, and less, of the ***Czech crown***.

The common international program for financial support for Hungary, which aimed to alleviate the tensions on the financial market, alleviated initially (at the end of October and in November 2008) the pressure on the forint and on other currencies from that area. However, the deterioration of the perspectives for economic growth, the concerns of the investors for the external vulnerabilities of some countries, the lower ratings for loans in the case of Bulgaria, Hungary and Romania, in October and November, caused a new and strong depreciation of the zloty, forint and leu, and less of the crown. In 2009 too, these currencies depreciated strongly; only the Czech crown decreased less. The pressure on the Polish zloty continued, although in May 2009, IMF approved a flexible line of credit for Poland. Given the currency board regime of ***Bulgaria***, based on the Euro, the leva maintained a stable exchange rate versus the Euro, despite the increasing spread of the interest rate versus the Euro. The ***British pound*** depreciated significantly versus the Euro in the fourth quarter of 2009, on the background of increasing fears for depression in the UK, while the interest rates differences from the Euro zone decreased. In the first eight months of 2009, the pound weakened further versus the Euro, reaching record low values throughout 2009 and in early 2010, exceeding much the level of -15%

imposed by the Maastricht criterion. The ***Swedish crown*** depreciated consistently versus the euro starting with October 2008, after a slight appreciation at the beginning of the year. The depreciation was stronger in the first eight months of 2009, and remained high until the beginning of 2010.

In 2008, the exchange rate regimes from most EU member states outside the Euro zone, maintained largely unmodified. However, in February, ***Hungary***, replaced the floating band versus the Euro with a free-floating exchange rate and flexibilized the current inflation-targeting regime.

The adoption of Euro remains a medium-term goal for most NMS. If initially, the main obstacle was to meet the inflation criterion, lately, the most important challenge refers to meeting the fiscal criteria.

In November 2008, the Polish government adopted a plan to changeover to Euro in 2010 and to join ERM II in 2009, event which didn't materialize. In Poland there is one more political aspect: the changeover to Euro requires the change of the Constitution, therefore it needs political agreement.

According to the governor of the central bank of Czech Republic, the adoption of the Euro in this country is possible between 2013-2015. The scenario seems possible because of the good results of the Czech economy and because of the sustainable appreciation of the exchange rate during this period of crisis; thus, the exchange rate appreciated versus the Euro, even in early 2010.

The accomplishment of all criteria of nominal convergence is affected by the economic and financial crisis: exchange rate stability (because of the highly volatile exchange rates); the fiscal control (because of the significant slowdown of the economic growth and because of the recession which increased the budget deficits and the public debt); inflation tempering (although the regional countries have fast deflation, the reference value is very low, because EU15 is in recession). Only if we consider the exchange rate stability criterion, we may observe that by late 2009 and early 2010, the NMS with free floating exchange rates displayed the highest variations of this indicator, the exchange rate being a real relief for the economic tensions (such as in Poland, Romania, United Kingdom).

The experience of the Czech Republic and Slovakia, two countries which maintained the macroeconomic stability, shows that such preoccupations should concern all the countries troubled by internal vulnerabilities.

The accession to the Euro zone, as long as the catching-up process is still running, may yield very low real interest rates, which may favour real estate investments and the non-productive consumption, as well as the national currency depreciation.

For the NMS which are not within the Euro zone, the crisis brought into discussion the issue of sustainability of the excessive dependency on the inflows of capital. The risk that these inflows diminish increased consistently. The countries whose internal investments rely massively on inflows of foreign capital will be put in front of a dilemma: stay outside the Euro zone and risk a lower rate if economic growth, or join the Euro zone and cope with the boom and bust cycles.

A special situation is that of the NMS with fixed exchange rate regimes, which are confronted with a difficult choice. Given the high indebting in foreign currency, giving up the fixed exchange rate regime, followed by a speedy depreciation would have devastating effects. However, under the conditions of the fixed exchange rate regime, the decrease of the current account deficit, required because the capital inflows ceased, will probably bring severe recession, which can only be avoided if the internal prices and wages are flexible enough, if no adjustment of the real exchange rate can be done. Irrespective of the economic policy implemented by each NMS, the problems entailed by the changeover to the Euro will not be solved by a premature entry in the Euro zone.

Some aspects concerning exchange rate stability in Romania

Within the context of the global financial and economic crisis, one of the advantages of Romania is just the flexibility of the exchange rate. It decreases as the amount of loans in the local currency increase.

Almost all NMS central banks were confronted with strong speculative attacks on the national currency, due to the current global crisis. This crisis touched the Romanian economy indirectly through several channels: financial, commercial and investors' trust in the Romanian economy, and through the exchange rate channel, when the lower inflows of capital caused the national currency to depreciate. Because of this, under crisis conditions, the defence of the national currency against its strong depreciation becomes one of the immediate goals of the National Bank of Romania. NBR had both direct and indirect, selective, interventions on the currency market, when there was a risk for strong speculative attacks which endangered the inflation or the financial stability.

The prolonged effects of the international financial crisis will make the investors to remain circumspect versus the investments in the Romanian economy. At the same time, however, the international lack of liquidities makes the foreign companies working in Romania to repatriate their profits. The massive outflows of foreign currency caused and will cause the leu to depreciate.

The structural characteristics of the Romanian currency market belong to a volatile development; hence the effects of the crisis are felt stronger in Romania than in other East-European countries.

The leu appreciated in 2008, compared to 2007, which yielded inflationist pressures which remained strong under the conditions in which the foreign deficit didn't decrease. The downwards trend of the leu which started in the second half of 2008, amplified in 2009. The increasing trend of thee exchange rate leu/Euro magnified as the evolution of the emergent economies worsened and as the perception of the financial investors concerning their perspectives, deteriorated dramatically. The depreciation of the leu creates problems, of course, to the companies which obtain European funds, which lose part of the EU money because of the exchange rate evolution, and to the importers and debtors. In the first part of 2010, the political tensions and the incertitude on the continuation of IMF agreement, reflected in the main macroeconomic indicators, particularly in the strong depreciation of the exchange rate, which exceeded much the ±15% band imposed by the Maastricht criterion.

Conclusions

Within the current national and international context, with adverse external influences and with a galloping evolution of the internal budgetary misbalances, the possible changes of monetary strategy, including a new position of the monetary strategy in relation to other monetary strategies, can make it possible to accomplish the economic conversion on the medium and long term, and the harmonious integration of these countries in the Euro zone.

The monetary policy of the inflation targeting countries must be thus modelled, as to help the economy get out of recession as easily as possible, and to support the process of adopting the Euro. Although the fundamental objective of the monetary policy is to ensure price stability, the national banks must aim, in parallel, to reach financial stability.

The new member states are in economic recession and their central banks should analyse comparative the effects of the slowing economic activity, the effects of supporting deflation, with the effects of a higher volatility of the national currencies (with potential for depreciation) during this period, volatility which might affect inflation.

A high volatility of the exchange rate shows that the macroeconomic policies are unstable, with effects on the trust of the population and economic agents in the evolution of the economy, trust which eroded substantially on the background of an emotional approach of the crisis.

The international financial crisis affects in the NMS some indicators which represent the criteria for nominal and real convergence, whose accomplishment is indispensable to the adoption of the Euro: exchange rate and price stability; interest rate level; proportion of the public debt within the GDP, level and sustainability of the current account deficit; economic stability.

NMS must adapt their macroeconomic policies to the new context created by the international financial crisis, which require recalibrating the mix of economic policies in agreement with the challenges of the crisis.

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Anexa

Table no. 2 – Monthly exchange rates – changes compared to December 2007

	2008M01	2008M04	2008M08	2008M10	2009M01	2009M04	2009M08	2009M10	2010M01	2010M04	2010M07
Bulgaria	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Czech Republic	1,0	4,8	7,7	5,9	-3,2	-1,7	2,5	1,7	0,7	3,8	3,8
Estonia	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Latvia	-0,1	0,0	-0,9	-1,7	-1,0	-1,7	-0,5	-1,6	-1,6	-1,4	-1,6
Lithuania	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Hungary	-1,1	-0,2	6,8	-2,8	-10,5	-16,6	-6,7	-6,0	-6,4	-4,9	-12,1
Poland	-0,2	4,4	8,6	0,7	-17,5	-23,1	-14,7	-17,0	-13,0	-7,7	-13,3
Romania	-4,5	-3,0	0,2	-6,0	-19,8	-18,9	-19,3	-21,3	-17,1	-16,8	-20,5
Sweden	0,0	0,7	0,4	-4,4	-13,7	-15,3	-8,4	-9,3	-8,1	-2,4	-0,7
United Kingdom	-3,7	-10,3	-10,0	-9,2	-27,4	-24,6	-19,7	-27,0	-22,5	-21,4	-16,0
Denmark	0,1	0,0	0,0	0,1	0,1	0,1	0,2	0,2	0,2	0,2	0,1

Source: Eurostat data (downloaded on 6 August 2010, the last Eurostat updating was on 4 August 2010) and calculations of the authors according to ECB methodology (negative value shows depreciation, positive value shows appreciation