 

EXCHANGE RATE IN THE NEW MEMBER STATES OF THE EUROPEAN UNION: DEVELOPMENTS WITHIN THE GLOBAL FINANCIAL AND ECONOMIC CRISIS

PhD. Camelia MILEA[*]
PhD. Floarea IORDACHE[*]

Rezumat

În condițiile crizei economice şi financiare globale, analiza stadiului îndeplinirii criteriilor nominale de convergență în noile state membre[72] (NSM) ale Uniunii Europene reprezintă un punct central în vederea aprecierii gradului de pregătire pentru adoptarea monedei unice europene.

Criza economico-financiară internațională a exercitat un impact relativ puternic asupra majorității NSM, întrucât dezechilibrele macroeconomice ale țărilor respective au condus la amplificarea gradului de vulnerabilitate. Efectele crizei asupra NSM s-au manifestat diferit în funcție de regimul valutar existent.

Pe parcursul ultimilor doi ani, piețele financiare din țările participante la MCS II (Mecanismul Cursului de Schimb II) au traversat perioade marcate de un grad ridicat de volatilitate, ceea ce a generat tensiuni puternice în cadrul acestui mecanism. Şi, cursurile de schimb ale

[*] *Scientific Researcher III, Centre for Financial and Monetary Research -"Victor Slăvescu", Romanian Academy.*

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[72] *The New member States who had accessed the European Union on 1 May 2004 (except Cyprus and Malta), plus the newest member states, Romania and Bulgaria.*

monedelor neparticipante la MCS II au înregistrat fluctuații accentuate în majoritatea țărilor analizate începând cu sfârşitul anului 2008.

Abstract

Due to the global financial and economic crisis, the analysis of the nominal convergence criteria fulfillment in the New Member States of the European Union represents an important point in evaluating the level of readiness of these countries for euro adoption.

The global financial and economic crisis had a relatively strong impact over most of the New Member States, as their macroeconomic disequilibria led to the amplification of their vulnerability level. The crisis' effects over the New Member States took place in a different manner depending on the existing exchange rate regime.

During the last two years, the financial markets of the countries participating to the Exchange Rate Mechanism II crossed highly volatile periods, which generated strong tensions inside this mechanism. The exchange rates of the non-participants to the Exchange Rate Mechanism II registered strong fluctuations in most of the analyzed countries beginning from the end of 2008.

Keywords: international economic-financial crisis, new member states, currency exchange, fluctuations, Exchange Rate Mechanism II

JEL classification: E 58, F15, F31, G01

The new member states of the European Union do not participate fully in the Economic and Monetary Union, being members with derogation, because they can not adopt the Euro immediately, rather after they meet several criteria of nominal convergence. The argument of maintaining the necessity to accomplish the criteria for nominal convergence comes from the possibility of weakening or even destabilizing the European monetary system by the integration of some economies which have serious disequilibria, protecting at the same time the economies of the countries shifting to Euro from the possible shocks from the direct confrontation with the Euro zone. This is why, within the current context of the global economic and financial crisis, the analysis of the stage of meeting the criteria of nominal convergence in the new member states is a central issue too evaluate how much prepared are these countries to adopt the single currency.

The international economic and financial crisis had a rather strong impact on most NMS, because the previous economic growth relied quite much on inflows of foreign capital. Once the risk aversion increased and the financing conditions harshened in this region, the macroeconomic disequilibria of these countries increased the level of vulnerability.

Some NMS have been affected dramatically by the accumulation of considerable macroeconomic disequilibria. As a consequence, the macroeconomic conditions deteriorated rapidly, particularly in late 2008 and early 2009. In most countries using a fixed exchange rate system, the necessity of refreshing the competitiveness lead to cut in the wages and prices due to the absence of the exchange rate flexibility. In the countries with more flexible exchange rate systems, the depreciation of the national currency observed in early 2009 slowed deflation. Over the past two years, the financial markets from the countries members of ERM II crossed periods marked by high volatility, which generated strong tensions within this mechanism. The exchange rate of the national currencies which do not participate in ERM II also had strong fluctuations in most countries, starting with late 2008.

The national currencies of the Baltic States are still part of ERM II since 2008. The national currencies of these states were within EWRM II for more than two years before their convergence was analysed according to article 140 of the Treaty. The agreements of participation in ERM II relied on several arrangements assumed by the authorities of those countries aiming, among other, the promotion of healthy fiscal policies and of prudent income policies, limiting the expansion of credit granting and pursued implementation of the structural reforms. In all three cases, there have been unilateral arrangements of those countries regarding the maintenance of a narrower band of fluctuation. These unilateral arrangements do not impose any additional obligation to the ECB (European Central Bank). More precisely, the participation of Estonia and Lithuania in ERM II was approved, while maintaining the existing currency boards. The Latvian authorities have committed to maintain a exchange rate of the national currency (lats) within a ±1% fluctuation band in relation with the Euro.

The commitment of the Estonian currency board was supported by prudent fiscal policies, open markets and a flexible economy, and it served as key anchor of the policy, benefiting of a wide popular support. The exchange rate afferent to the currency board will be preserved for the final conversion.

The national banks of Estonia and Lithuania do not set monetary policy interest rates. The internal interest rates are directly affected by the monetary policy of the Euro zone through the arrangement of currency board. The interest rate changes on the monetary market of the Euro zone are transmitted directly to the financial markets from Lithuania, where the liquidity is administered predominantly in Euro due to the high presence of the foreign banks within the Lithuanian banking system.

Within ERM II, none of the central parities of the Baltic States has been devalued during the analysed period (April 2008 – August 2010). The national currencies of Estonia and Lithuania have been quoted constantly at the set central parities. Starting from late 2009, the international decrease of the risk aversion, the fiscal evolutions and the perception of the market regarding the forecasted adoption of the Euro by Estonia, alleviated the market tensions. On January 1, 2011, Estonia became the 17th member of the Euro zone, getting closer to the accomplishment of the Maastricht criteria (it no longer meets the inflation criteria since April 2010).

On the other hand, the exchange rate of the Latvian lats fluctuated within the ±1% band of variation in relation to the Euro, peaking in April 2009 (compared to August 2008), and decreasing subsequently. There have been several situations marked by strong tensions on the markets, when the Latvian currency closed the lower limit of the fluctuation band. The first interval of strong tensions occurred in October-December 2008, being marked by the Lehman Brothers crash (September 2008), by the unfavourable economic perspectives associated to Latvia, by the rumours regarding a possible devaluation of the central parity of the lats within the ERM II, by the down rating operated by some rating agencies and by the increasing tensions due to the liquidity within the banking system. As these tensions affected the balance of payments, Latvia had to ask for international financial assistance (7.5 billion Euro from EBRD, IMF and the World Bank) and agreed to implement a firm plan of economic adjustment with the view to stabilise the financial sector, to restore the confidence and the competitiveness and to improve the balance of foreign payments. A second episode of strong tensions occurred during the interval March-May 2009, and it reflected the accelerated deterioration of the Latvia public finances and economic situation, new down-rating of the country and the worries of the investors about meeting the conditions set by the agreements of international financial assistance. The situation in Latvia improved in June 2009, when the plan of measures for budget austerity was announced. The incertitude regarding the adoption of fiscal measures by the Latvian Parliament in September 2009, marked a new interval of pressure n the exchange rate. In October-November 2009, the Latvian lats was bought close to the lower limit of the ±1% fluctuation band which Latvia assumed unilaterally. In February and July 2010, the Latvia lats once again passed close to the lower level of the fluctuation band.

Latvia doesn't meet the nominal criteria of the exchange rate. Only Estonia and Lithuania meet the nominal criteria of the exchange rate.

The national currencies of the other six NMS didn't participate in the ERM II until October 2010.

The ***Bulgarian leva*** didn't participate in ERM II, but was anchored tot the Euro within the currency board system. The National Bank of Bulgaria doesn't set the monetary policy interest rate, which is directly affected by the monetary policy of the Euro zone. Although the leva was stable versus the Euro during he analysed period, Bulgaria doesn't meet the nominal criterion of the exchange rate. The increased risk aversion within the context of the international financial crisis entered an ascending trend in the fall of 2009.

The ***Romanian leu, polish zloty*** and ***Hungarian forint***[73] do not participate in ERMII and they use a floating exchange rate system[74]. In

[73] *As of Februay 2008, the Central Bank of Hungary adopted a free floating exchange rate, abandoning the link to the Euro (within a +/- 15% fluctuation band), in order to*

the case of these national currencies, we may say that the national currency reflects the state of the economy. During the first half of 2008, the forint appreciated strongly following the three successive increases of the interest rate by the central bank. Over the next three months, the forint depreciated significantly due to the economic vulnerability to the international financial crisis. Up to the middle of 2008, the zloty and leu appreciated on the background of a favourable perception of the market maintained by the integration within the EU, by the improved prospects of economic growth and by the inflows of capital (direct foreign investments and EU funds).

The Romanian leu, Polish zloty and Hungarian forint were submitted to pressures, depreciating between the middle of 2008 and August 2010, devaluation which was stronger until April 2009 (compared to August 2008) (see Table 1), under the conditions of a stressed climate of incertitude on the international financial markets which reflected the Lehman Brothers crash, the unfavourable economic perspectives from the analysed countries and the worries of the investors for the external vulnerability due to the increased risk aversion. The depreciation of the Romanian leu was also determined by the large domestic macroeconomic misbalances.

Subsequently, the gradual normalization of the international financial markets allowed a partial reversal of this depreciation.

In 2009, Poland witnessed the strongest depreciation of the national currency, of all NMS, versus the Euro (23.2%). The strongest devaluation

keep better inflation under control, and in order to anchor more firmly the inflationist expectations.

[74] *In Romania, the exchange rate policy is subordinated to the inflation targets. The exchange rate flexibility allows NBR to maintain the domestic prices stable by increasing the efficacy of the monetary policy. In the period 2008-2010, Romania could not capitalise on the advantages provided by the free floating exchange rate system. There are opinions according to which the weakening of the national economy and a slightly higher inflation can stimulate the economic revival. But, on the long-term, inflation doesn't/t help to a healthy economic growth. According to other opinions, the exchange rate can stimulate an economic growth up to the limit when inflation starts to grow.*

compared to the average level of August 2008, was recorded in Poland in February 2009 (41%). Poland took advantage of the free floating exchange rate system and managed to have economic growth and decreased the current account deficit without increasing the inflation rate. In May 2009, IMF Board of Directors approved the preventing agreement for one year with Poland, within a flexible line of credit (amounting to 20.5 billion USD) to support this country to get passed the international economic and financial crisis. The fact that Poland didn't use these funds was a positive signal for the markets.

Table no.6
Monthly exchange rate – changes compared to August 2008

Țări/perioadă	aug.08	dec.08	apr.09	aug.09	dec.09	apr.10	aug.10
Cehia	0	-7,5473	-10,2400	-5,5956	-7,4196	-4,2039	-2,1370
Estonia	0	0	0	0	0	0	0
Letonia	0	-0,6393	-0,7672	0,3694	-0,5399	-0,5256	-0,6535
Lituania	0	0	0	0	0	0	0
Ungaria	0	-12,3537	-25,1738	-14,4862	-15,8301	-12,5700	-19,3191
Polonia	0	-21,6403	-34,6476	-25,4891	-25,8779	-17,8068	-21,1999
Bulgaria	0	0	0	0	0	0	0
România	0	-11,2160	-19,1942	-19,5968	-19,8832	-17,1104	-20,2007

Source: Eurostat data (retrieved on September 16 2010) and calculations of the authors

Poland didn't accomplish constantly the nominal convergence criteria regarding the exchange rate during December 2008 – August 2010 (compared to the value of the average exchange rate in August 2008).

For 2010 and 2011, the prognoses forecast the devaluation of the Polish zloty.

Due to the substantial pressures by the depreciation of the Hungarian forint, IMF Board of Managers approved in November 2008 a stand-by agreement for Hungary, to avoid the aggravation of the tensions from the financial markets[75]. This financial assistance together with the stronger monetary policy stabilized temporary the exchange rate in early 2009.

The depreciation of the Hungarian currency is not a solution to take Hungary out of the debt trap, because 63% of the loans of the population and of the companies are in foreign currency, particularly in Swiss francs. Hungary doesn't want a weak national currency which will affect dramatically the households. Two years after signing the agreement with the IMF and the EU, Hungary runs the risk of problems on the world markets.

The forint hit the bottom of depreciation in March 2009, not accomplishing the exchange rate convergence criterion during January-July 2009 and May-August 2010 and in September and December 2009. The forecasts show a slight appreciation of the forint in 2010, followed by depreciation in 2011.

In March 2009[76] a package of international financial assistance was agreed between Romania, the EU and IMF, with the purpose of supporting a sustainable and healthy restart of the economic growth.

During the past two years (from August 2008 to August 2010), the Romanian leu depreciated 20.2% versus the Euro. Romania did not accomplish the exchange rate convergence criterion between January 2009 and August 2010 (compared to August 2008). The top depreciation was in November 2009 (21.6%). On a year basis, Romania failed to meet the exchange rate convergence criterion only in 2009.

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[75] *The package of international financial assistance was granted to Hungary by the International Monetary Fund and the European Union, amounting to 20 billion Euro, of which 6.5 billion Euro within the facility for foreign payments balance. The bulk of the loan (14.2 billion Euro) was delivered at the end of 2008 and 2009, after the positive evaluations regarding the implementation of economic policy measures. The improved external conditions of financing prompted the Hungarian authorities not to ask the balance of the funds from this financial agreement, after September 2009.*

[76] *The International Monetary Fund the European Union and the World Bank granted Romania a package of international financial assistance amounting to 20 billion Euro, (of which 5 billion Euro within the facility for foreign payments balance). Until March 2010, more than half of these funds had been cashed in.*

The forecasts show a slight appreciation of the leu in 2010, followed by depreciation in 2011.

The ***Czech crony*** depreciated in 2009 and in the second half of 2008 (because of the increased risk aversion and deteriorating perception of the emerging markets), but the overall evolution in 2008 was currency appreciation (see Table 2).

The pressure of depreciation was low and the process of appreciation was resumed very slowly in early 2010. The forecasts for 2010 and 2011 show appreciation.

Czech Republic met the exchange rate nominal criterion throughout 2008-August 2010, except in February 2009.

Although on an annual basis,. Czech Republic, Romania, Poland and Hungary happen to meet the exchange rate nominal criterion of convergence, they don't meet this criterion because of the strong monthly/daily fluctuations.

The convergence report for 2010 elaborated by the European Commission shows that Romania fails to meet all the convergence criteria required for the adoption of the Euro.

Of the older member states national currencies which are not yet in the Euro zone, the Swedish crown depreciated strongly in 2009 and appreciated as strong in 2010.

The British pound also depreciated significantly in 2008 and 2009, but the forecasts for 2010 and 2011 show slight appreciation.

Efforts need to be pursued to accomplish the programs of reform on the markets for goods and services and on the labour force market, to increase the flexibility and in order to maintain favourable conditions for the economic expansion and increased employment. In ERM II countries, given the limited space of action of the monetary policy within the current systems of fixed exchange rates adopted by some countries, it is compulsory that the other policies support the economy to cope the specific shocks at the national level and to avoid the re-emergence of the macroeconomic disequilibria.

The experience of this crisis shows that the traditional factors promoting the revival of the economic activity function weaker than before.

During this period of national, regional and international great incertitude and turbulence which reached all the world states touched by the process of economic globalization, a balanced mix of macroeconomic policies is needed to ensure stability in the NMS.

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APPENDIX

Table No. 2
Exchange rates – differences between individual years

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*	2011*
Bulgaria	0.204897	-0.05133	0.010261	-0.22063	-0.12799	0	0	0	0	0	0
Czech Republic	4.300683	9.580838	-3.38268	-0.14131	6.613151	4.835135	2.03232	10.15631	-5.96889	4.437299	2.418653
Estonia	0	0	0	0	0	0	0	0	0	0	-
Latvia	-0.16094	-3.73148	-10.2754	-3.82394	-4.66025	0	-0.56018	-0.37138	-0.42692	-0.41094	-0.07056
Lithuania	3.055315	3.430757	0.193675	-0.00579	0.002896	0	0	0	0	0	0
Hungary	1.326719	5.311976	-4.38755	0.77281	1.434475	-6.53497	4.88534	-0.06366	-11.4588	1.205722	-1.85954
Poland	8.38531	-5.04616	-14.0561	-2.89117	11.12927	3.159334	2.879951	7.178159	-23.2197	7.750254	0.936827
Romania	-30.5291	-20.2507	-20.0863	-7.87995	10.61713	2.626419	5.403029	-10.4129	-15.1333	0.82785	-1.44359
Denmark	0.022807	0.289851	-0.00269	-0.12381	-0.15995	-0.09796	0.113955	-0.07248	0.131438	0.010744	-0.02955
Sweden	-9.59006	1.015656	0.40279	-0.0011	-1.73054	0.299498	0.046464	-3.94698	-10.4408	10.08089	3.398404
United Kingdom	-2.03288	-1.1192	-10.0441	1.926328	-0.75737	0.30272	-0.38285	-16.3574	-11.8878	4.231486	1.566968

*Source: Eurostat Data (retrieved on 7 October 2010) and calculations of the authors; * Eurostat forecast.*