COMPETITIVENESS AND MONETARY MANAGEMENT IN ROMANIA – A CRISIS OVERVIEW

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Abstract:
This paper aims to briefly present the effects of the financial and economic crisis in Romania in respect of the monetary developments and their impact on competitiveness, on firms involved in foreign trade on international market. All the analysis is undertaken in the general framework of the monetary integration process envisaging the Euro adoption, and in the context of actions of the Romanian National Bank as part of the foreign exchange and monetary policy strategy. Due to constant preoccupation from the most important monetary institution, the Romanian Leu has performed rather well compared to rest of the macroeconomic picture and seems to drag forward the whole set of other indicators, including economic aspects such as competitiveness. The connection between the foreign exchange rate and competitiveness can be best depicted in the effects on exporting firms.

Key words: exchange rate, competitiveness, monetary integration

Introduction

Everybody agrees on the fact that high liquidity has been an important issue in triggering the actual financial crisis. Many people have missjudged the phenomena as being a funadmental defect of capitalism. That is not true. The very inner nature of the economic cycle consists of ups and downs of recession and boom, with more or less acute picks. Realistically speaking, the crisis has been generated one one hand by cyclicity and on the other hand by missjudgement in the institutional level, in the system administration and capitalism itself is not to blame for the crisis. The economic overheat can most of the times generate such a recession if not well handled by responsible authorities well aware of the fact that individual consumers and firms must still be correctly directed, even in capitalism.

Crises and institutions can be connected to people. Administrators believed that the rules of functional economies could have been broken without any consequences. What will the lesson of this crisis be? Bad management can lead to such unfortunate financial events and not free markets.

Romania – Crisis and Competitiveness. A Monetary Approach

The starting hypothesis of the Romanian National Bank is that a more rapid increase in wages than in productivity would not lead to higher wellfare, but rather to a lower one due to the gap between the two fundamental indicators and to the fact that the imediate consequences are a rapid price increase and the foreign exchange rate depreciation. All these have a negative impact on invetsments, on competitivness and delay instead of hurring the real economic convergence. This – real convergence - is the key linking element between competitiveness and the „big picture" of monetary integration for the Romanian Leu.

During the ten years previous to the financial crises, the yearly productivity gain has exceeded 10%. This has been determined by several factors: low starting point, significant decrease of population occupied in agriculture, and very important – an increase in investments and competitiveness. Even though, this increase has been surpassed by the one in wages and it accounts for the dramatic raise of the external deficit and also the inflationary pressure. In time, once the financial and economic crisis installed, the situation changed dramatically. Productivity decreased, bankruptcy spread and this in connection to economic rigidities, the infrastructure issues and the ever slowing economic restructuring process.

Considering all that, the National Bank has and will always been, for the sake of the Romanian economy, a promoter of a healthy and durable growth maintaining a real feature. Even beyond that, the market, and especially the traditional and well rained external market where our exporters evolve, will always depict growth based on a competitiveness surplus. Everything else will transform into inflation and into the depreciation of the national currency, bringing down the wages level to where it can be covered in productivity.

Many analysts believe that monetary policy in Romania still owes in regard of the recession control. The production gap of over 7%, seems to bring substance to that idea, but not for long. Even more, in its definition not influenced by offer factors, inflation has dropped from 6,3% in December 2008 to 2,8% in December 2009. This decrease is due both to recession and to the prudence of the Romanian National Bank in reducing the effective interest rate. Thus, we might believe that inflation is no more a real problem and this year, the RNB should lower the interest rate abruptly in order to stimulate economic growth and an increase in competitiveness. That is what firms and households expect. Even though, new economic evolution might emerge and the monetary strategy might have further constraints. Economic growth and competitiveness increase would restart under the influence of a remake in trust and external economic growth. That is why the National Bank supported exporters in the 2 month struggle with the foreign exchange rate appreciation as Romania experienced massive foreign capital inflows. This would reduce the disinflationary gap and thus it will contribute to the inflation and interest decrease less and less. Still it is rather probable that new factors emerge and support interest rates reduction, while others could act oppositely. Contradicting influences will bring further constraints to the monetary strategy.

Under these circumstances, achieving the inflation targets - 3,5% for 2010 and 3% for 2011 remains difficult. Once the global trust has been rebuilt, the chances for capital inflows to ingeminate increase. Globally, the financial crisis has brutally corrected lacks in balance. The still remains uncertain whether correction of the countries' current accounts – Romania's as well – are complete in connection to the long term trends, but it is certain that these corrections have only been the result of cyclical factors – as previously mentioned. Reforms meant to prevent remaking of un-sustainable unbalances associated to abundance in capital inflows did not take place, and that might strongly affect future competitiveness especially on foreign markets. The structural factors of imbalances have remained.

Though, even in countries with current accounts deficits, the crisis has brought an increase in savings. This process may be reversed once future positive prospects come up. In the Euro-Area – our permanent convergence aim - structural rigidities prevent a relatively high competitiveness and finally economic growth. This combination in structural factors has existed previous to the crisis and lead to massive capital inflows, including in Romania. The new determining factor that could cause and inverse phenomena – meaning an outflow in the Romanian case is the financial crisis in Greece. This may occur as a consequence of the contagion effect. Only coherent policies can prevent that, for both the Euro-Area and the EU as a whole. As a consequence of recent actions of financial institutions from an international spectrum, that contagion probability remains rather low.

The perspective of large capital inflows from 2010 is more probable. Recent foreign investments and net foreign transfers have restarted their increase. Recent estimates (*The Economist*) appreciate a total volume of investments close to 8 bln. Euros for this year and it may even exceed this figure. Even more, the interest rate differential stimulates the carry-trade operations. For the time being, the aggregate effect of these movements of capital on the current account deficit is not clear, but deterioration would not worry if reflective of the economic recovery.

For 2010, the capital inflows would probably have, from a theoretical point of view at least three effects: - inflation decrease; - stimulation of debts in foreign assets – a possible threat for the first one; - decrease of domestic competitiveness on international markets that would slow down exports. Mainly, a decrease in the interest rate does not stimulate the first effect, but contributes to the attenuation of the other two.

Thus, only through means of exchange rate, a change in the interest rate could have conflicting effects in achieving monetary aims.

Even though, for the Romanian case, this is not completely true. Influences on the RON appreciation on inflation heavily depends on the price setting mechanism. Data show that there are nominal rigidities in Romania, preventing a strict reflection of foreign exchange appreciation into significant decrease in inflation. Thus, disinflationary potential of the RON's appreciation remains rather low. Meaning, if we exclusively consider the exchange rate channel, a decrease of the interest rate does not cause significant damage in terms of inflation.

The need of interest rate reduction comes up from the perspective of the other theoretic effect of the foreign exchange rate appreciation – an increase in the foreign private debt. For 2009, the inflation decrease and the RON depreciation made that the gap between the costs of loans in domestic currency and in foreign currency to stretch. This year, an appreciation in the RON's foreign exchange rate could remake the gap. This would severely affect the imbalance in foreign currencies between assets (mostly in RON) and passives (mostly in foreign currency) as part of the real sector, making it vulnerable to eventual foreign exchange rate depreciation. Obviously, from this very perspective, the National Bank, responsible for the financial stability, is interested in reducing the interest rate.

Pressure for reducing the interest rate could also be generated by reasons of economic competitiveness. The National Bank has never shown lack of reaction to the domestic currency foreign exchange variations, always pointing out the managed float feature of the foreign exchange rate regime. This has also at times such as recently protected exporters.

A decrease in the unit labor costs, even more evident since mid-2009, has created the desired conditions for a reasonable appreciation that we have recently witnessed, an appreciation that has not affected firms' competitiveness and that has been buffered by the RNB. This gap has been recently consumed by the RON appreciation, being accompanied only by reactions from the same monetary institutions and not by significant lowering in labor costs. Concluding, it is rather probable that the remaining gap for foreign exchange rate appreciation, if there is any, determining disinflation could have significantly diminished. The tighter the gap is, the higher pressure for reducing interest rates aiming to temper capital inflows.

Conclusions

The relatively low impact of the financial crisis from a monetary point of view is due to the Romanian National Bank, to the features of the financial environment in Romania, and also to the prudential measures in monetary policy and in strengthening the financial stability. They could be resumed as following: - credit institutions in Romania do not have exposures on financial products that represented the origins of such turbulences (the „subprime" instruments); - most banks in Romania, even foreign ones are subject to prudential control form the RNB; - some of the National Bank's measures have been more restrictive than Basel II; - the level of reserves stays high.

Even though, there have been several negative monetary aspects with further economic impact: high volatility of the foreign exchange rate, an increase in the external financing costs and a decrease in volume, a moderation in capital inflows and eventual repatriations, a possible deceleration of demand for Romanian exports as a consequence of competitiveness erosion and a decline in economic growth perspectives.

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