

## AN ASSESSMENT OF THE EFFECTS OF THE CURRENCY REGIME CHANGE SHOCK ON THE EXTERNAL EQUILIBRIUM OF SOME NEW EUROPEAN UNION MEMBER STATES

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**Abstract:** *In the context of globalization and regionalization, we consider to be important an analysis of the asymmetries from the balances of payments of the member states of the European Union (EU). The propagation of a shock determines different effects in the member states of the European Union, due to the existence of some heterogeneous elements in the structure of these economies. Such a situation implies the risk of occurrence of divergences between the member states regarding the joint decisions with impact on the economic development and the external equilibrium. The article aims at providing a theoretical analysis of the way a shock considered by the authors as being representative affects the current account balance of some countries with different economic characteristics, at least in terms of the foreign exchange regime. The theoretical analysis is followed by an empirical analysis of two European Union countries that have undergone the shock of the exchange rate regime shift generated by the entry into ERM II (Exchange Rate Mechanism II). Our research aims at showing the way in which this shock has been reflected upon the balance of the current account, and if the change of the exchange rate regime has been beneficial or not for the economies analysed. The article is based on wider research studies concerning the matters of external equilibrium, asymmetric shocks and European integration, and which have been developed by the authors during the last three years.*

**Keywords:** exchange rate regime, asymmetric shock; external equilibrium, economic vulnerability

**JEL Classification:** F15, F 31, F36, F41

### Introduction

We live in a globalized world in which the relations among countries are consolidated on the one side by globalization and on the other hand by regionalization processes, including the process of monetary integration. In this context, we consider to be important an analysis of the existence of asymmetries in the balances of payments of member countries of a currency area. These differences pose problems in terms of the effects on a balanced development of such a currency area. This is due to the existence of heterogeneity among the member states of a monetary union and it generates frictions when taking joint decisions with impact on the economic development and external equilibrium.

The euro area and the EU countries in general are an important source of research and of numerous empirical analysis, particularly for concerning the propagation of asymmetric macroeconomic shocks, being composed of countries with economies characterized by a variety of structural, financial and institutional elements. The propagation of asymmetric shocks takes place not only due to the existence of internal structural characteristics of the economies, but also as the effect of the existence of accumulated vulnerabilities (concerning the model of economic growth, the degree of indebtedness, the budget deficit and the current account deficit).

### Methodology

In order to highlight the manifestation of asymmetries in the balances of payments, we have used a comparative analysis, based on statistical data, of the economies of some European Union countries, considering that they have suffered the same shock.

The shock that we analyze is the currency regime change generated by the entry into ERM II<sup>1</sup>, as a common shock for two European Union countries (Slovakia and Estonia), which have different exchange rate regimes.

After an overview of the theoretical effects of the transition from a flexible exchange rate regime to fixed one, we compare the results obtained with the economic and external equilibrium evolution after the shock of the entry into ERM II, in the selected countries - Slovakia and Estonia. Slovakia had a flexible exchange rate regime before entering the ERM II (November 2005) and Estonia had a currency board regime until its entry into

ERM II in June 2004. The Estonian kroon has been pegged to the German mark from its reintroduction in 1992, and then to the euro. The Slovak koruna was in ERM II, between November 2005 and December 2008. During the period November 2005 - May 2008, its fluctuations ranged on average around 12%, and in the period June to December 2008 the Slovak koruna fluctuated on average by 1.9%. The Estonian kroon was in ERM II between June 2004 and December 2010, period during which it had not recorded any movement around its parity.

### **An overview of the potential effects arising from the shock of ERM II entry**

Theoretically, the transition from a flexible exchange rate regime to a fixed exchange rate regime means the loss of an instrument of economic policy used to mitigate the imbalances, especially the external disequilibria. Thus, exporters will not have the opportunity to take advantage of the exchange rate depreciation in order to obtain favourable conditions on the foreign markets, instead they will only rely upon the quality and the competitiveness of their products.

Also, the exchange rate trend will no longer be used to attract foreign investments. As we all know an appreciated currency or a currency expected to appreciate attracts investors due to further prospects of gainings. On the other hand, the depreciation can encourage the outflows or it can discourage the inflows of foreign capital as investments if interest rates remain unchanged.

Foreign direct investments contribute to cover a country's current account deficit, representing foreign capital inflows into the country in the capital and financial accounts. In addition, foreign direct investments can have a significant and immediate positive impact on the external financial position of the recipient economy (measured by the current account balance), and on its development prospects due to their potential impact in terms of management, technologic and restructuring process, resulting in the improvement of the structure and quality of exports. Also, foreign direct investments can generate the improvement of foreigners' perception of the host economy, contributing to the manifestation of other positive consequences, such as the reduction of external borrowing costs, access to a wider range of financial instruments and more stable capital flows.

The change of the exchange rate regime from the flexible exchange rate regime to the fixed one influences also the level of the budget deficit, through the effects on the level of the external public debt. Such a regime change eliminates the risk of currency fluctuations, as they reflect on the cost of external borrowing and on the level of foreign debt, either through an increase or by a reduction (as the national currency depreciates or appreciates). This change in the cost of borrowing is reflected in the current account in the balances of the subaccounts of "portfolio investment income" and "other capital investment income (interest)" and in the capital and financial accounts, in the accounts of "long-term loans and credits", "credits and loans from the International Monetary Fund" or "portfolio investment".

The level of the private external debt and of the related interests and commissions is also influenced by such a change of the exchange rate regime, through the developments registered in the subaccounts of "other capital investment income (interest)" and "portfolio investment income" of the current account and in the accounts of "short-term loans and credits" and "long-term loans and credits" of the capital and financial accounts. Exchange rate depreciation determines outflows of capital from the country, the increase of the value in national currency of the credits to pay back, and implicitly the increase of the foreign debt burden, causing the widening of the deficit or the decrease of the capital and financial accounts surplus. On the other hand, the domestic currency appreciation causes the increase of inflows or/and the reduction of outflows and the improvement of the capital and financial accounts balance. Therefore, national currency's depreciation has negative effects on the capital and financial accounts of the country whose currency loses value, and national currency's appreciation has positive effects. The adoption of a fixed exchange rate regime would eliminate these changes.

The adoption of a fixed exchange rate regime would also eliminate the changes in foreign prices relative to domestic prices, arising from currency fluctuations. In this case also, the effects are different, depending on the direction in which the domestic currency fluctuates. Thus, national currency's depreciation entails the increase of the domestic prices of imports and the reduction of the external prices of exports, the net effect on the trade balance depending on the elasticity of exports, respectively, imports by the exchange rate. Domestic currency's appreciation brings about the increase of external export prices and the decrease of domestic import prices.

The transition from a flexible exchange rate regime to a fixed exchange rate regime would also eliminate the changes affecting the trade, in terms of income levels, changes caused by currency fluctuations. Thus, if exchange rate depreciates importers' profits fall, they could even have losses, while exporters enjoy improved sale terms. National currency's depreciation increases the domestic prices of imported goods, resulting in inflation. Domestic currency's appreciation has opposite effects.

Exchange rate fluctuations influence also the inflows /outflows of compensation of employees (income) and of direct and portfolio investments. Thus, if in a country the national currency depreciates, the incomes transferred in the national economy by the national labor force working abroad can diminish in the context of the aversion of holding a currency with a lower value that would lead to the purchase of more expensive goods and to investments in a currency with reduced value. However, non-resident investors who obtain profits in that

country will not want to keep their profits in that country where they buy goods and services more expensive than abroad and invest in a currency with depreciated value. Exchange rate appreciation has, however, opposite effects, attracting capital into the country.

The waiver of exchange rate flexibility (even if we deal with a stable currency) may have other benefits in addition to those mentioned above. Among them, one of the most important may be the disappearance of capitals speculating exchange rate fluctuations, causing negative effects in the economy.

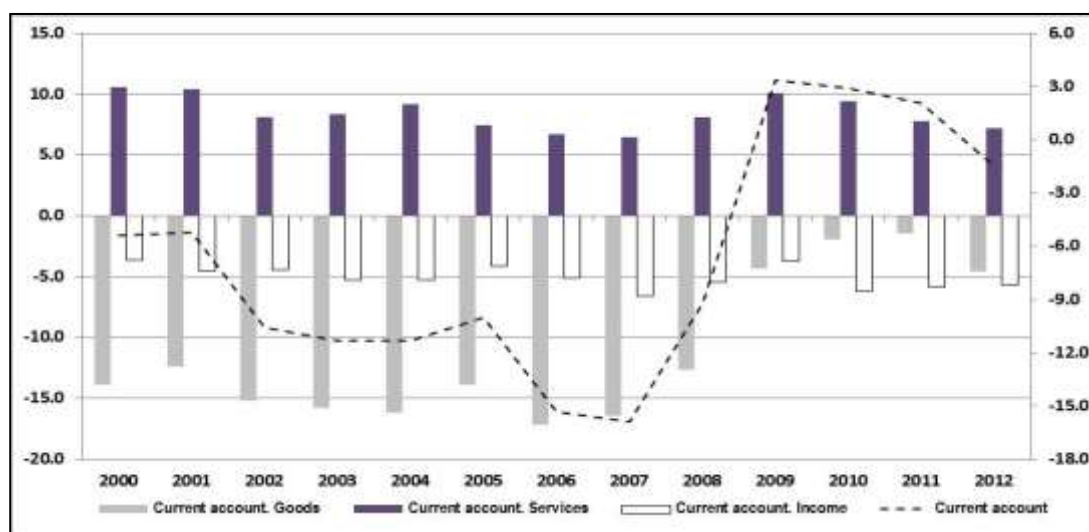
Only high and long-term volatility of the exchange rate has exclusively negative effects on trade, capital flows, external debt level and the terms of external borrowing because it brings about the increase of the uncertainty of the economic environment. Thus, foreign direct investments may be affected due to the influence of investors' risk appetite, in the direction of capital leaving the country which has major fluctuations of the exchange rate. The interest rate at which foreign loans are obtained is directly proportional to the stability of the national currency. In the case of major currency fluctuations, international credit conditions worsen, not only in the direction of interest rate increase. So we can conclude, at least theoretically, that the transition from a flexible exchange rate regime to fixed exchange rate regime could bring advantages such as better economic stability and improved foreign indebtedness conditions due to the absence of exchange rate fluctuations. On the other hand, this change in the currency regime could bring about long-term negative effects, because imbalances which were corrected through the exchange rate will be transferred to other macroeconomic variables (they will be transmitted through the channel of real exchange rate affecting that country's competitiveness).

Therefore, in the case of a currency with flexible exchange rate regime that records insignificant fluctuations and that does not generate interferences in the economic developments, the flexible exchange rate regime is a useful tool to correct imbalances that occur during economic developments due to the propagation of various shocks. Under these conditions, switching to a fixed currency regime may have negative effects if the country is not ready economically for this change and if the economic policies remained within reach for the authorities cannot manage efficiently the existing economic problems.

The transition from a flexible exchange rate regime to a fixed exchange rate regime can be considered an event with beneficial effects if during the period with flexible exchange rate regime that country's currency had large fluctuations.

### Empirical Evidence Concerning the Entry of Estonia and Slovakia into ERM II

Estonia, a small country with a fixed exchange rate regime before entering the ERM II, has required a longer period of time in order to adapt to the economic rigors of the euro area. She had spent seven years in ERM II until she met the criteria needed to be received into the euro area. In comparison, Slovakia participated three years in this mechanism. We conclude that the exchange rate flexibility, if properly capitalized, can easier and faster reduce the economic gaps, and it allows for a more effective preparation and implicitly a faster entry into the euro area.

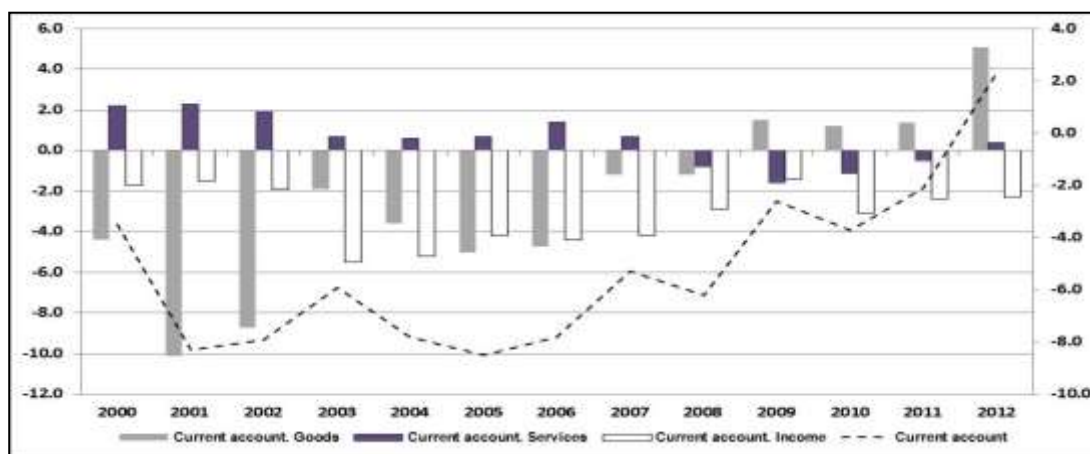


**Graph no.1. The evolution of the current account balance and its components in Estonia**

Source: Eurostat data

It is worth noticing that Estonia has started in 2004 from a high level of the current account deficit as a share of GDP (-11.3%), recording an increase in the deficit in 2006 and 2007, followed by a sharp decline in 2008 and 2009 (when the current account has reached a surplus of 3.4%), surpluses that have remained until 2011 inclusively, but of low values.

Slovakia has entered the ERM II with a share of the current account deficit to GDP of -8.5%, and it has showed a different trend compared to Estonia. Thus, its deficit has decreased gradually until 2011, in 2012 the current account being on surplus.



**Graph no. 2 The evolution of the current account balance and its components in Slovakia**

*Source:* Eurostat data

The period during which the Slovak koruna has participated in ERM II (November 2005 - December 2008) has been characterized by an excess of global liquidity and by a favourable perception of investors towards emerging economies, especially the new Member States of the European Union. The large capital inflows have provided the financing of the current account deficits - significant, but declining - and have strengthened the national currency. The exchange rate stability has maintained during this period, being also supported by the official interventions on the exchange rate market, which had not been sources of other imbalances in the economy.

During the period it has participated in the ERM II, the Slovak koruna has been subject to reassessment due to significant structural changes in the economy: the high differential concerning productivity increases of the Slovak economy compared with the euro area has caused substantial appreciation of the equilibrium real exchange rate after the entry into ERM II, the central parity being no longer in line with the state of the economy<sup>2</sup>. The appreciation of the nominal exchange rate, determined by the appreciation of the real exchange rate, together with the low differential with the euro area on inflation seems not to have affected either the profits or the volume of exports of Slovak companies, which have been growing. The explanation for this is given by the fact that the reforms implemented<sup>3</sup> in the Slovak economy have led to productivity increases, especially in the export sector, allowing Slovakia to maintain competitiveness.

From the above-mentioned, we can conclude that the entry into ERM II, which has changed the currency regime in Slovakia, has represented a shock, because it caused a turning point in the evolution of the current account balance. This moment has been followed by a gradual adjustment of the current account deficit that allowed Slovakia a faster entry into the Eurozone. This evolution has to be considered in the context of a sustainable national economic development, and of favourable international circumstances.

Instead, for Estonia, the entry into ERM II in 2004 has not been a shock, because this country has had a currency board regime since 1992, the Estonian kroon having had a stable trend in the period before the entry into ERM II. However, we notice significant adjustments in the trend of the external deficit of Estonia since 2007, possibly due to the manifestation of the effects of the global economic and financial crisis, which has diminished the current account deficits worldwide.

### Conclusions

We conclude that the effects of the shock of the exchange rate regime change depend significantly on the economic readiness of the country over which the shock occurs. Slovakia has proven to be better prepared economically than Estonia, who, maybe, lost too early the exchange rate tool by adopting the currency board regime. This statement may be supported by the stable development of the Slovak koruna in the period preceding the ERM II entry, followed by a slight appreciation due, to some extent, to the improvement of the economic outlook for Slovakia.

Also, from the analysis, it emerges the idea that the effects of the shock of the exchange rate regime change depend significantly not only on the national macroeconomic conditions, but also on the international conditions. In addition, the country's vulnerabilities play an important role in the transmission of the macroeconomic shock.

The exchange rate fluctuations may have either positive or negative effects on the current account and the external equilibrium, depending if the currency appreciates or it depreciates. Only sharp and long term volatility of the exchange rate has only negative effects on the trade, the capital flows, the level of the foreign debt and the external borrowing conditions, as it generates increased uncertainty of the economic environment. So, switching from a flexible exchange rate regime to a fixed exchange rate regime can be considered an event of immediate benefits, in the sense of better economic stability, if during the period with flexible exchange rate regime, that country's currency had major fluctuations. However, on a longer term, the shock of transition from a flexible exchange rate regime to a fixed exchange rate regime could produce negative effects, as the imbalances which were corrected through the exchange rate will be transferred to other macroeconomic variables (they will be transmitted through the real exchange rate channel affecting the competitiveness of the country concerned).

On the other hand, if the currency considered has insignificant fluctuations, which do not produce disturbances in the economic development, then the flexible exchange rate regime can be a useful tool to correct imbalances that occur during economic development due to the propagation of various shocks. In these circumstances, switching to a fixed exchange rate regime may have negative effects if the country is not ready economically for this change and if the economic policies remained available for the authorities can not manage efficiently the existing economic problems.

The exchange rate flexibility, if properly capitalized, can reduce economic gaps easier and faster, and it allows for a more efficient preparation and implicitly for a faster entry into the euro area.

### Endnotes

(1) *ERM II is an almost fixed exchange rate regime; the exchange rate of a currency is allowed to float within a range of  $\pm 15\%$  against a central parity established by each country, in agreement with European Central Bank, before the ERM II entry, so that to better reflect its economic performances. The ERM II is designed to improve stability of the participating currencies, and it represents an evaluation mechanism for testing the potential Eurozone members.*

(2) *At the end of 2007, the value of the national currency has been with 5% above the level of the central parity.*

(3) *Before entering the ERM II, Slovakia has implemented a wide range of important structural reforms, actively supported at the time by the IMF. The tax system has been restructured (including the well-known regime of the unique quota of 19%) and the labour market has been liberalized. These reforms have supported fiscal consolidation, which together with the EU accession have stimulated the inflow of foreign direct investments, especially in the automotive and electronics products industries, and the constraints on the supply side have been oriented toward investments.*

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