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EBS/84/255

CONFIDENTIAL

December 6, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Romania - Exchange Rate and Other Measures Introduced on
November 1, 1984

Attached for the information of the Executive Directors is a paper on a recent change in the exchange rate of the Romanian leu and other measures introduced on November 1, 1984.

If Executive Directors have technical or factual questions relating to this paper, they should contact Mr. Reitmaier (ext. (5)8817).

Att: (1)

INTERNATIONAL MONETARY FUND

ROMANIA

Exchange Rate and Other Measures Introduced on November 1, 1984

Prepared by the European Department and the
The Exchange and Trade Relations Department

Approved by Hans Schmitt and Eduard H. Brau

December 6, 1984

I. The Measures Taken

In a regular weekly cable dated November 2, 1984 from the National Bank of Romania the staff was informed that Romania's exchange rates were appreciated on November 1, 1984.

The currency (the leu) is pegged to a basket of the currencies of six major trading partners and rates are normally adjusted weekly. Romania maintains more than one exchange rate. Most transactions take place at the commercial rate but a small proportion, notably those involving private tourism, take place at a more appreciated noncommercial rate. In addition there is a so-called official rate at which no transactions take place but which is used for certain statistical purposes.

On November 1, 1984 the commercial rate was appreciated against the basket. The precise amount of the appreciation against the basket is not known but against the U.S. dollar the rate established on November 1 of lei 17.50 = US\$1 represented an appreciation of 32.46 percent as compared with the rate established on October 29, 1984 at the previous regular weekly fixing. At the same time and on the same basis, the noncommercial rate was appreciated by 20.80 percent against the U.S. dollar and was set at a level of lei 12.50 = US\$1. The official rate was appreciated from lei 5.00 = US\$1 to lei 4.47 = US\$1.

In a further cable dated November 12, 1984 sent in response to inquiries from the staff (Attachment), the National Bank of Romania gave the authorities' reasons for implementing the above changes. In essence, they state that the appreciation of the leu is justified by the stability of prices in Romania which in turn has been made possible by various measures to raise efficiency.

The staff has also learnt from Romanian press reports that certain other measures were taken on November 1, 1984. All interest rates were lowered. No information is available on the change in deposit rates or in those applying to investment financing but rates on all other categories of lending were lowered by at least 3 percentage points. In the major category of "current credits to industrial units, transportation, scientific

research, public services, supplies and sales, and foreign trade" the rate was lowered from 8 percent to 5 percent; the staff was previously under the impression that this rate had in fact been set at 10 percent since January 1, 1984.

Certain prices have been reduced by means of lowering permitted profitability ceilings in some sectors, apparently those producing intermediate manufactured goods. In addition, with a view to raising incentives, the share of profits resulting from above-plan performance that are distributed to the work force has been increased.

II. Background - Recent Economic Developments

Economic developments in Romania since 1980 have been dominated by the effects of a sharp drop in new capital inflows and the ensuing adjustment in the external current account. The current account of the balance of payments in convertible currencies moved from a deficit of US\$2.4 billion in 1980 to a surplus of almost US\$1 billion in 1983. Virtually all of this turnaround was accounted for by the merchandise trade account with a sharply reduced deficit on oil trade and the achievement of a large surplus on non-oil transactions. The latter was largely attributable to import contraction as non-oil exports fell both in value and volume terms in 1982 and 1983. This trend continued in the first quarter of 1984 but was apparently reversed in the second quarter. For the first half of 1984 as a whole the U.S. dollar value of non-oil exports was recorded to have increased by 9 percent from one year earlier.

Despite the severe contraction in imports, which was only offset by increased imports from the nonconvertible area to a limited extent, the authorities claim that real domestic output grew in every year, albeit more slowly than in earlier years. For 1983 the official statistics show growth in real GNP of 3.5 percent despite a poor result in agriculture. For 1984 the authorities latest estimates appear to be for growth in aggregate output of the order of 7 percent with a similar increase in industry alone which is the largest single sector.

The Fund approved a three-year stand-by arrangement with Romania in June 1981, the objectives of which were to strengthen the balance of payments at the same time as carrying forward a reform of exchange rates and domestic prices. To this end, the number of commercial exchange rates was progressively reduced and a unified commercial rate came into effect in mid-1983. At the same time there were substantial increases in domestic prices, notably for energy products, in both 1981 and 1982. Principal among the domestic policies implemented as part of the 1983 program under the stand-by arrangement were a cumulative depreciation of the leu against the U.S. dollar of some 30 percent between end-1982 and January 1, 1984, the adoption of a basket peg for the exchange rate as from July 1, 1983, and increases in interest rates which for most lending rates amounted to a total of 5 percentage points. However, the authorities, in line with a renewed emphasis on price stability, acted to prevent more

than a very partial passthrough of the effects of the latter measures to domestic prices. Both the retail and producer price indices rose by less than 1 percent in 1983 and appear to have shown no change, or perhaps even declined, so far in 1984.

III. Staff Appraisal

In discussions with the Romanian authorities on exchange rate policies over the last two years, the staff has been guided by the following two principal considerations:

1. The desire to reverse the declining trend of non-oil exports to the convertible area. Continuation of this trend, through its effects on import levels, appeared to carry the risk of increasingly severe disruption to domestic production because of shortages of imported inputs.
2. The desire to reverse the substantial but involuntary real effective appreciation of the leu which occurred in 1981-83 (see table). This appreciation resulted from the leu's being pegged to the U.S. dollar until mid-1983 and was broadly reversed by the devaluations made in 1983 and at the beginning of 1984.

The Romanian authorities cite the stability of domestic retail prices as the main justification for the recent appreciation of the leu. Stable Romanian prices did indeed contribute to a modest real effective depreciation in 1984 but this was much more than offset by the recent measures. Using retail price levels the staff estimates that against a basket of the currencies of 17 major trading partners in industrial countries the index of the export-weighted real effective commercial rate (January 1981 = 100) stood at 137 following the November 1, 1984 appreciation compared with 104 in January 1984 following the latest depreciation against the basket, and 132 at the end of 1982. In other words, the effects of the devaluations under the recent programs with the Fund were cancelled. If the reasoning which guided policy in the past still remains valid, there are grounds for believing that the chances for continuation of the recent revival in exports may be prejudiced. If this were to happen, and if Romania adheres to its objective of maintaining or even increasing the present current account surplus, the economy could be forced on to a path of lower domestic growth with tighter import controls than would otherwise be possible.

It remains to be seen whether this expectation will in fact be realized. The relationship between imports from the convertible area and the attainable rate of domestic growth is not a clear cut one. There may be compensating changes in import deliveries from the nonconvertible area, although up to 1983 this did not happen. Moreover, as noted in the preceding section; the official Romanian statistics claim that a positive rate of industrial output growth has been maintained throughout the period of import contraction, and that this rate has in fact risen significantly

in 1983 and 1984. As indicated in the staff report for the 1984 Article IV consultation (SM/84/180), the staff is sceptical of these claims but is not in a position to provide alternative estimates of its own. With such uncertainty about the record of past performance, it is impossible to forecast with any confidence what the growth implications of changing levels of external trade might be.

There is a further major uncertainty about the effects of the recent exchange rate change. The Romanian authorities have generally maintained that exchange rate policy is only one of a number of instruments available to them in influencing foreign trade. They have stated that its role is less important in their economy than in typical market economies and that the scope for achieving adjustment by nonprice measures through the central planning apparatus is correspondingly greater. Partially in reflection of this approach, the effects of the recent devaluations on domestic prices and profits have in many instances been offset, notably by compensating changes in the net flow of funds between the budget and the enterprise sector. Moreover, even where prices and profits have changed, there have apparently been further restraints on the responses in the form of changed patterns of investment and production.

For its part, the staff has argued for a fuller passthrough of the effects of exchange rate and other price reform measures both in order to improve the quality of information available to the central planners and to ensure that autonomous enterprise decisionmaking, to the extent that it is allowed, is guided by the appropriate price parameters. This view was reflected in the Chairman's summing-up of the recent Executive Board discussion of the 1984 Article IV consultation reports: "Directors focussed on the severe constraints on the effectiveness of the devaluations emanating from the failure to pass on their effects to final prices... While recognizing the distinctive features of centrally planned economies, including the less central role played by the exchange rate compared with market economies, most Directors urged the Romanian authorities to reduce these constraints substantially and to allow greater flexibility of domestic prices..."

The staff has become increasingly doubtful of the extent to which the authorities share these objectives, particularly since the cancellation of the stand-by arrangement in January 1984. There are growing indications that they have moved away from their earlier stated intentions of pursuing price reform at the same time as allowing greater autonomy at the enterprise level. If this is in fact the direction which policy has taken, the exchange rate, and pricing policy generally, may be expected to have only a subordinate role in the allocation of resources.

These issues will be fully discussed during the next Article IV consultation discussions with Romania which are scheduled for about May 1985.

Romania: Commercial Exchange Rate

End of Period	Nominal U.S. Dollar Rate	Export Weighted Effective Exchange Rate Indices 1/		
		Nominal	Real 2/	Real 3/
1981	(Lei/US\$)	(January 1981 = 100)		
March	15.0	101.4	99.3	101.3
June	15.0	113.2	108.8	113.8
September	15.0	112.6	106.3	115.0
December	15.0	111.6	104.4	116.0
1982				
March	15.0	120.1	116.2	127.9
June	15.0	124.8	123.3	136.7
September	15.0	128.4	131.5	145.1
December	15.0	124.1	132.3	144.9
1983				
March	16.5	117.5	124.5	136.6
June	16.5	121.7	127.2	139.8
September	17.9	116.3	120.3	131.7
December	18.2	117.9	121.2	132.4
1984				
January	21.6	101.7	104.0	113.3
March	21.3	99.2	100.6	109.4
June	22.0	102.5	102.9	112.2
September 4/	23.6	102.8	102.3	111.9
November 1 4/	17.5	138.5	137.3	150.3

Sources: Data supplied by the Romanian authorities; and Fund staff estimates.

1/ Weights reflect the pattern of 1980 exports to 17 industrial countries; an increase in the index indicates an appreciation of the leu. Quarterly figures for Romanian prices are interpolations of annual data. It is assumed that in 1984 Romanian prices remained constant at their end-1983 level.

2/ Nominal effective exchange rate deflated by relative consumer prices.

3/ Nominal effective exchange rate deflated by relative wholesale prices for partner countries and producer prices for Romania.

4/ Partly estimated.

ATTN. MR. HANS SCHMITT
ACTING DIRECTOR
EUROPEAN DEPARTMENT
INTERNATIONAL MONETARY FUND

RE: YOUR CABLE OF NOVEMBER 6, 1984

A. STARTING NOVEMBER 1, 1984 THE COMMERCIAL EXCHANGE RATE WAS CHANGED IN TERMS OF U.S. DOLLAR AT A RATE OF LEI 17.50 FOR U.S. DOLLAR 1, THE TRANSFERABLE RUBLE LEI 15.50 FOR 1 TRANSFERABLE RUBLE AND THE NONCOMMERCIAL EXCHANGE RATE LEI 12.50 FOR U.S. DOLLAR, REPRESENTING 32.46 PERCENT APPRECIATION FOR COMMERCIAL EXCHANGE RATE AND 20.80 PERCENT APPRECIATION FOR NONCOMMERCIAL EXCHANGE RATE, COMPARED WITH THE RATES ON OCTOBER 29, 1984, LEI 23.18 FOR U.S. DOLLAR 1 AND RESPECTIVELY LEI 15.10 FOR U.S. DOLLAR 1.

B. THE ALREADY EXISTING PROVISIONS REGARDING THE BASKET SYSTEM REMAINED UNCHANGED.

C. TAKING INTO ACCOUNT THE STABILITY OF RETAIL PRICES IN ROMANIA, THE IMPROVEMENT OF PRODUCTION PRICES ON THE BASIS OF IMPLEMENTING PROGRAMS REGARDING HIGHER TECHNOLOGICAL AND QUALITATIVE STANDARDS OF PRODUCTS, HIGHER PRODUCTIVITY, LOWER PRODUCTION COSTS AND BETTER CAPITALIZATION OF RAW AND SUBSIDIARY MATERIALS AND FUEL, IT WAS ESTABLISHED THAT THE EXCHANGE RATE OF THE LEU SHOULD BE IMPROVED IN RELATION TO OTHER COUNTRIES' CURRENCIES.

D. NO OTHER CHANGE OCCURRED WITH RESPECT TO THE LEU REVALUATION THAN ABOVE MENTIONED.

DIRECTOR, ION ILIE
FOREIGN EXCHANGE AND PRECIOUS METALS DEPARTMENT
NATIONAL BANK OF THE SOCIALIST REPUBLIC OF ROMANIA

Received in the Cable Room on November 12, 1984.