

SOME RISKS AND CHALLENGES IN ACHIEVING ROMANIA'S EXTERNAL BALANCE

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Abstract: *In this article¹, the author aims to identify the main challenges and risks in achieving Romania's external balance, given our country's intention to achieve sustainable economic development. The methodology used combines literature review, empirical analysis of statistical data and their interpretation, with identification of causalities. Romania's external position has deteriorated during the pandemic crisis and it remains a vulnerability for our country's economy. From the analysis, it can be concluded that among the challenges and risks to Romania's external balance there are the structure of exports and imports, the deterioration of the external deficit financing way, the large fiscal deficits, the large public net external loans, from 2017 till present, the legislative unpredictability. The evolution from recent years of cost competitiveness and of factors that determine non-cost competitiveness have affected and will continue to influence negatively Romania's external balance. In addition, the low number of people with higher education employed, the low capacity for innovation of the economy, the increase in unit labor costs, the low level of labor productivity and the low technological achievements do not support the qualitative and quantitative increase of our country's exports, the production of goods of high added value and incorporating high technology, and thus the achievement of external balance.*

Keywords: *foreign deficit, risks, vulnerabilities, challenges, structural factors.*

JEL Classification: *F10, F14, F41.*

1. Introduction

The external equilibrium can be defined as a balance of the current account of the balance of payments that can be supported by capital inflows, under conditions compatible with the growth prospects of the economy, without resorting to trade and foreign relationships restrictions, so that the level of international reserves should be adequate and relatively stable.

In 2020, the world economy has suffered a severe exogenous shock, caused by the covid-19 pandemic, which has resulted in an economic recession and has led to unprecedented challenges in recent years. Trade has been among the sectors the most affected by the pandemic, due to disruptions in global supply chains, and as a result of declining global production in the context of the pandemic, of the measures taken by the authorities to prevent the spread of the virus and to limit the negative effects on the economy.

In Romania, in 2020, the economic growth had a significant contraction, as a result of the effects of both the demand and the supply generated by the covid-19 pandemic, with consequences as the deterioration of internal macroeconomic balances, including from the perspective of the structure and financing cost of the budget deficit, and of the external equilibrium. But the recession was smaller compared to other EU member states, with a 3.9% drop in GDP in real terms, despite the contraction of private consumption (the main driver of economic growth in the years prior to covid-19) during the spring lockdown. Thus, there have been external demand shocks and supply chain disruptions with effects on exports. On the other side, investments had a significant contribution to GDP formation, due to the performance of the construction activity.

¹ The article is based on the research project "The issue of the external balance in the current international conditions. Requirements for Romania ", elaborated in CFMR "Victor Slăvescu" in 2021, under the coordination of Camelia Milea, Ph.D.

Therefore, the assessment of the challenges and risks to achieving the external equilibrium of our country, mainly driven by the existing vulnerabilities, is influenced by the emergence and occurrence of covid-19.

The implementation in Romania of expansionary fiscal and revenue policies in a period of economic growth has led to the deterioration of the budget balance and the current account deficit. These pro-cyclical policies have diminished the state's ability to interfere in the context of adverse economic developments, such as the covid-19 pandemic, given the high level of the budget deficit before the outbreak of the pandemic (NBR; 2021). Over the past year, the political actions have focused on mitigating the impact of the covid-19' shock and on facilitating the recovery. This has increased Romania's public indebtedness, but should support the medium-term adjustment. Looking into the future, the Recovery and Resilience Plan provides an opportunity to address imbalances, investment needs and reforms.

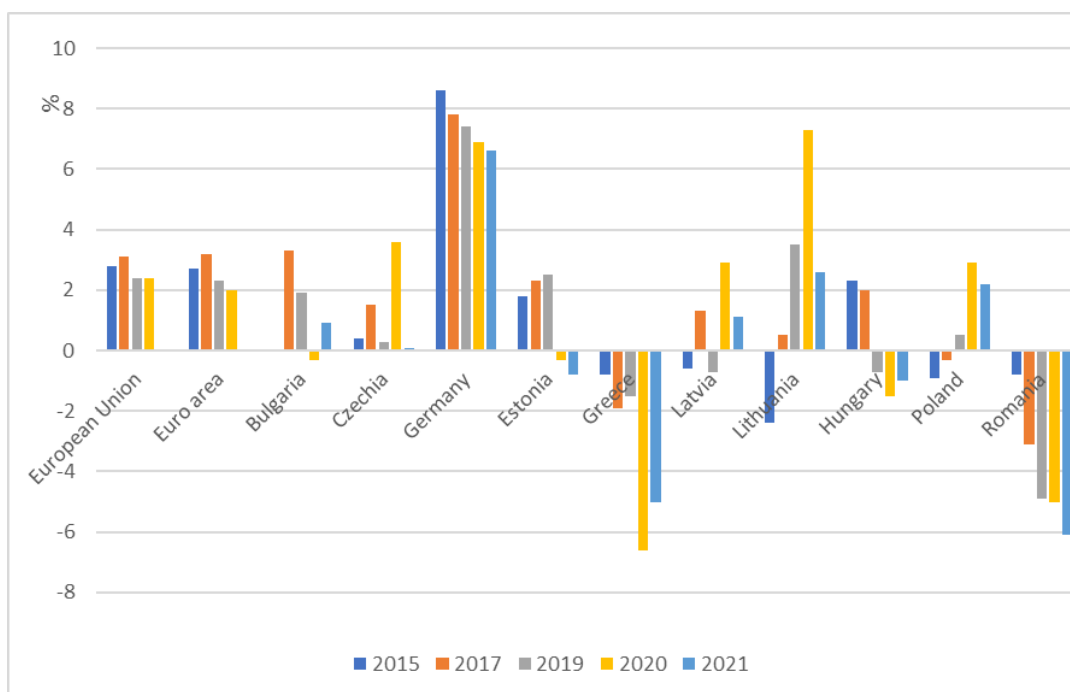
In the article, the period 2006-2021 will be analyzed, in order to compare the situation existing in 2021 (the second year of the covid-19 pandemic and its effects) with that of the year before the integration of our country in the European Union.

2. Risks in achieving Romania's external equilibrium

Macroeconomic imbalances in Romania are influenced by the risks of losing cost competitiveness, of deteriorating the external position, and of increasing the current account deficit, in the context of an expansionary fiscal policy and an unpredictable business environment. These vulnerabilities have risen to the surface both in 2019, 2020 and in 2021. Next, we will particularize those *risks that may affect the external equilibrium in Romania*:

➤ The marginal deterioration of the current account deficit to 5% of GDP in 2020 and 7.1% in 2021, as a result of a lower decline in imports compared to exports, which have decreased sharply (in 2020), respectively due to faster increase in imports versus exports (2021). Romania's current account deficit continues to be one of the highest in the European Union (see Figure 1). The net international investment position (NIIP) is negative and worsened to -47.3% of GDP in 2020. The decline in the NIIP during 2020 was determined almost exclusively by the negative current account flows. The NIIP is now slightly lower than the prudential threshold, but considerably higher than the "NIIP norm", which is currently at -11% of GDP (European Commission, 2021)¹. The composition of the NIIP is favorable, as it consists mainly of foreign direct investment. However, the net external debt has risen recently.

¹ European Commission (2021), Commission staff working document **In-Depth Review for Romania** in accordance with Article 5 of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, Brussels, 2.6.2021, SWD(2021) 411 final



Source: AMECO data, processed by the author

Figure no. 1 - The current account balance in the European Union, the euro area and in some Member States of the European Union in the period 2015-2021 (% of GDP)

➤ The structure of imports and exports influences negatively the evolution of the external deficit in Romania. Thus, exports consist mainly in intermediate goods, although the share of exports of capital and consumer goods has increased in recent years. The evolution of the structure of imports is worrisome, given that from 2016 until 2021, imports of consumer goods have grown, generally, faster than imports of other goods.

➤ Another negative aspect that can be considered a source of vulnerabilities and risks is *the change in the way of financing the growing external deficit*, namely the transition from financing mainly through foreign direct investment flows to financing through debt-generating flows (loans and portfolio investments)¹. Thus, the inflows of foreign direct investments have high values until the burst of the economic and financial crisis (8.7 billion in 2006, 7 billion in 2007 and 9.3 billion euros in 2008). If in the period 2013-2017, foreign direct investments covered more than 100% of the current account deficit, the degree of financing from these sources decreased in 2018-2020, reaching 27% in 2020, as a result of the 39% reduction in net inflows of foreign direct investments (partly due to the reduction of intra-firm debt) (only 1.85 billion euros). The significant decrease in the net balance of foreign direct investments in Romania in 2020 (when it was recorded the lowest level after 2003), is due to the risk aversion of investors in the context of the uncertainty generated by the effects of the measures adopted to stop the spread of coronavirus. In 2021, the situation has improved, foreign direct investments inflows increasing, with positive effects in the sense of increasing the coverage of the current account deficit to 43%.

The trend of reducing the financing of external imbalance through foreign direct investments has appeared in 2015, as a result of the sharp increase in the current account

¹ Long-term debt instruments in the form of securities.

deficit, although non-residents' direct investment inflows have increased during the period 2013-2019, and in 2021, reflecting improved foreign perception of our country. The increase of the net balance of foreign direct investments in the period 2015-2019, shows the raise of Romania's commitments towards non-residents, with negative consequences on the international investment position.

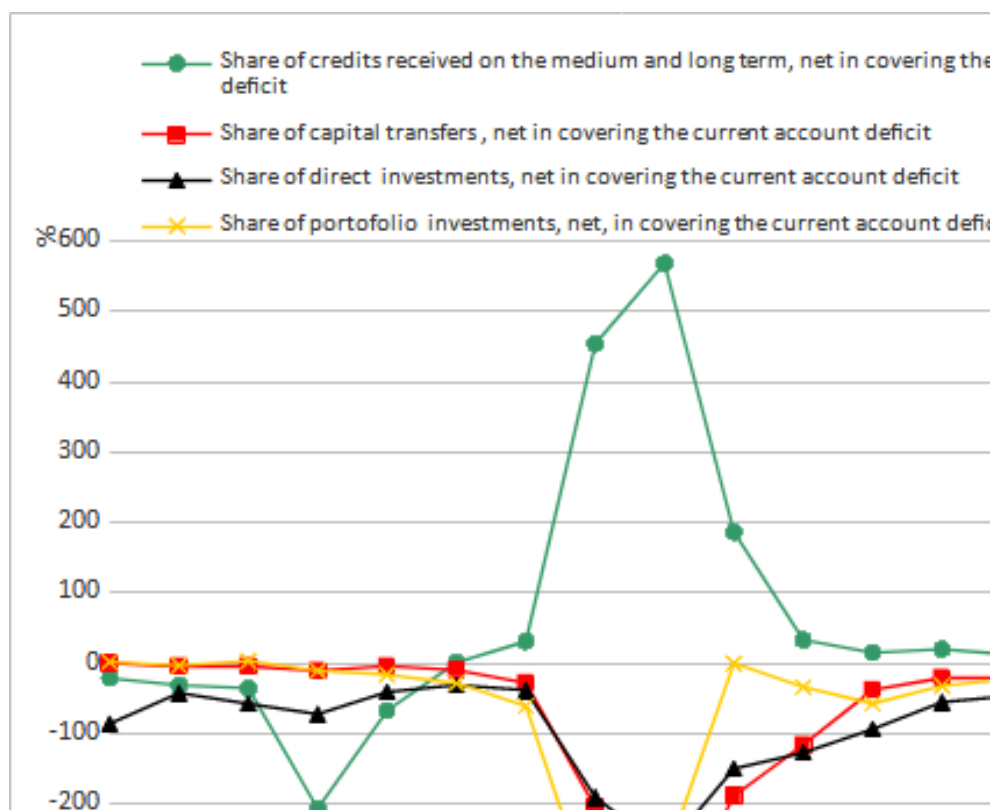
In 2020 and 2021, *capital transfers* (mainly European funds) have increased by 51.5% and 55.5%, respectively, compared to the value of the corresponding previous year. This development can be positive for the sustainable financing of the external disequilibrium of our country if it continues in the coming years.

After the peaks from 2013, 2014, *portfolio investments* have become again in 2020 the main source of financing the current account deficit (see figure no.2), increasing largely by 468%, representing the highest value since 1990 of this indicator, standing at about 6.5% of GDP, most of which have been issued by the government (NBR, 2021, European Commission, 2021). In 2021, portfolio investments inflows have declined, reaching approximately the level of the period 2017-2019.

Thus, the net inflows of portfolio investments have increased from EUR 2436 million in 2019 to EUR 13837 million in 2020, contributing to the sharp increase in the medium and long term external public debt.

Analyzing the composition of portfolio investments in 2020, we find that most of them are long-term debt instruments. So, in 2020, Romania has indebted itself heavily from private creditors, which implies an increase in costs, and implicitly in the risks related to the repayment and sustainability of external debt.

If between 2011 and 2019 there are capital outflows from our country for the return of medium and long-term *external loans* contracted in the previous years (1991-2010), in 2020 Romania has received loans from abroad, for the first time since 2010. In conclusion, in 2020, Romania's net external financing needs have been mostly met by increases in the government's external debt. In 2021, the trend from the period before 2020 has been resumed, namely external loans have been repaid.

Figure no. 2 - The current account financing sources in Romania in the period 2006-2021

Source: NBR data, processed by the author

➤ Further deterioration of the fiscal position, despite a less important recession than in other EU Member States, and a moderate package of emergency measures meant to support the economy to cope with the economic and social effects of covid-19 (including plans to back up the level of employment, of the medical system, and tax incentives). *The large fiscal deficits in Romania even before the outburst of covid-19 together with the fiscal effort necessary to face the sanitary crisis and to bolster up the economy generated the worsening of the external position of our country, being financed from abroad more and more, which has led to a sharp increase in external public debt since 2017.* Total public debt has been 47.3% of GDP in 2020, and 35.3% of GDP in 2019, and it is expected to grow at least until 2022. From the data above, we can see that a significant share of the public debt is financed. from abroad, in foreign currency. Despite the still low public debt-to-GDP ratio, *Romania faces substantial short and medium-term fiscal sustainability risks.* Moreover, *there are risks arising from the high share of public debt held in foreign currency (approximately 46%) and from the high share of debt held by non-residents (41%).* This situation was determined by the expansionary fiscal policy in the years of economic growth before the covid-19 pandemic. In addition, the expansionary fiscal policy also supported high demand and high consumer spending, and thus the worsening of the current account balance. The budget deficit has increased sharply in 2020 (to 9.6% of GDP), from 4.4% in 2019, driven by the high external financing needs of the Romanian economy, as a result of the fiscal effort to fight the covid-19 pandemic, but also due to the measures from previous legislations that have led to a sharp increase in spending. There has been an improvement in 2021 (6.72%, (Finance Minister (2021))), largely due to the

economic recovery and also reflecting a certain reduction in spending and an increase in budget revenues. The government intends to reduce the deficit below 3% of GDP by 2024. (European Commission, 2021). However, the poor getting in of budget revenues and the high share of rigid expenditures in the fiscal revenues are structural vulnerabilities that will slow down the process of fiscal consolidation.

➤ The significant increase in medium and long-term external public debt from 18% of GDP in 2019 to 26% of GDP in 2020 (24% in 2021), due to the sharp growth in 2020 of net portfolio investment inflows (most being long-term debt instruments), is another factor that influences negatively the external balance, by increasing the current account deficit due to the rise in outflows through the sub-accounts of Income from other investments and Income from portfolio investments.

The massive indebtedness from private creditors implies an increase of the costs, and implicitly of the risks related to the repayment and sustainability of the external debt, especially in the context of the high yields to the Romanian government bonds.

The analysis of the debt sustainability risk confirms that our country is listed with a high risk in the medium term¹. Thus, Romania's sovereign debt has been downgraded, until the spring of 2020, by all three major rating agencies from "stable" to "negative", on grounds of concerns about fiscal sustainability, reaching the lowest investment grade². At the beginning of 2021, S&P improved the prospects for our country's sovereign debt from "negative" to "stable", while maintaining the investment grade, amid a reduction in short-term fiscal risks, following the adoption of the first consolidation measures by the government. However, Fitch maintained the "negative" outlook due to Romania's poor track record in terms of fiscal consolidation and the high share of rigid spending in the budget.

Also, the increase of the external debt generates risks at the microeconomic level (effects on the Romanian banking sector and the rise of the exposure to a possible external shock). The effects of rising medium and long-term external debt can be diffused through the exchange rate channel (the sharp depreciation of the national currency would lead to a significant increase in the cost of external financing), through the trust channel (changing investors' sentiment and perception leading to increased risk premium and implicitly of the cost of external financing), through contagion (by a regional economic, political or social shock), or even through a shock intrinsic to the national economy, of conjectural or structural nature. In 2019 and 2020, there were some consequences (unfavorable perception of investors, high cost of external financing, fluctuations in the exchange rate of the national currency).

Given that Romania's external debt was 58% of GDP in 2020 (56% in 2021), and public debt accounted for 61.3% of the medium and long-term external debt in 2020 (60% in 2021), we can say that public debt is the main cause of the increase in Romania's external debt.

¹See SWD (2021) 530 accompanying the Commission Recommendation for a Council Recommendation under the Excessive Deficit Procedure and the "2020 Sustainability Debt Monitor" available at https://ec.europa.eu/info/publications/debt-sustainability-monitor-2020_en for detailed methodological issues.

²Fitch confirmed Romania's sovereign rating at "BBB minus" with a negative outlook, this being the last level in the "investment-grade" category (recommended for investments). The negative outlook reflects continued uncertainty over the implementation of policies aimed at solving structural budgetary imbalances in the medium term and the impact on Romania's public finances of persistent pandemic risks and rising energy costs, according to Fitch.

Consequently, it can be stated that the large net loans of the public sector, from 2017 till present, have significantly concurred to the high and persistent current account deficit, and implicitly to the deterioration of Romania's external balance.

➤ Another factor with a potential negative impact on the external balance of our country is the depreciation of the national currency which would increase the effort in national currency needed to return the public debt borrowed in foreign currency, especially given its increase in recent years.

➤ The ***pressures related to cost competitiveness, which came mainly from labor costs growth more than productivity increase in the years of strong economic growth and low and declining unemployment, before the covid-19 crisis.*** Although unit labor costs continued to rise considerably in 2020, reflecting the impact of low productivity amid declining output, they are expected to increase much less in 2021 and 2022 than in the years before the covid-19 crisis (European Commission, 2021). The prognosis show a productivity improvement amid a recovery in the economic activity and a moderation in wage growth which has began in 2020 and has become increasingly visible. In the long run, *non-cost factors* such as skills shortage and the high share of low-skilled workforce in the context of rapid demographic decline, together with shortcomings in education and training, limited availability of infrastructure, both quantitatively and qualitatively, low innovation capacity, cumbersome business environment or the seemingly unpredictability of the policy-making process *can hinder non-cost competitiveness gains.* Thus, *the evolution from the recent years of cost competitiveness and of the factors that determine non-cost competitiveness have affected and will continue to influence negatively Romania's external balance.*

➤ ***Legislative unpredictability remains a concern for the business environment.*** The lack of transparency concerning the direction of certain public policies, if prolonged, can increase the perception of an unstable business environment and *may have a negative impact on the country's financing costs, investors' confidence and capital inflows (foreign investments, loans), with negative effects on investments, economic growth, but also on the external balance by increasing capital outflows through the income sub-accounts of the current account (each corresponding to a type of financing).*

Prior to the outbreak of the pandemic, relatively strong GDP growth rates helped to improve investors' perception. But a number of legislative initiatives in recent years have led to a decline in international investors' confidence. Among others, the measures concerning the banking sector, although subsequently largely revised, but also some measures generating the increase in public spending. Moreover, the uncertainty regarding the 40% increase in pensions that was to be put into practice starting with September 2020 and the associated implications on Romania's fiscal outlook had also repercussions on credit ratings.

3. Essential structural factors generating risks and challenges for the achievement of the external balance in Romania

Other essential structural elements generating risks and challenges for the Romanian economy, in general, and, ***for the achievement of the external balance***, in particular, are briefly presented in table no.1.

Romania is a net importer of energy, given that the *share of energy-intensive industries in the economy* had increased slightly in the period 2012-2018, standing at around 12%. Also, the dependence on energy imports increased in 2016, 2017 (reaching 23%), after having decreased in 2013 and 2014 (16.4%). This development affects negatively the current account of our country both directly through the contribution of the negative balance of the energy balance of trade and indirectly, because high energy

consumption represents a brake for the production of high quality goods with high added value that can be exported at elevated prices.

The large differential between the level of the domestic interest rate and that of the international interest rate stimulates the entry of capital in Romania as portfolio investments and external loans, with negative effects on the external borrowing costs, and implicitly on the external balance.

The very high level of *foreign capital in the banking system*, although declining in recent years, shows a high dependence on foreigners of the capital needed by the Romanian economy, with unfavorable effects on achieving external balance.

The investment in research and development (R-D) remains extremely low. The intensity of R-D (i.e. R-D expenditure as a percentage of GDP) has remained unchanged since 2000, standing at 0.5% in 2018 compared to 2.7% in the European Union as a whole (the lowest in the EU, representing only one quarter of the national target). Public funding for R-D is insufficient and declining, and the government has no clear plans to address this issue.

The trade balance of high-tech products is negative throughout the analyzed period, with negative effects on the external balance, showing the low level of development of the Romanian exports.

The small number of people with higher education, as well as the relatively high and constant level of people leaving early the education and training system are impediments to supporting research and innovation, with effects in the sense of non-developing high-added value and high technology products. which negatively affects the achievement of long-term external balance.

The small and relatively constant number of *people employed with higher education and / or of people employed in the science and technology sector* (% of total employment) is an inhibitory factor for the production of goods with a high level of technology and a high degree of processing, which could be exported internationally at high prices, thus contributing to the improvement of our country's external deficit.

Table no. 1- The main structural factors which might represent challenges and risks for the achievement of Romania's external balance

	2012	2013	2014	2015	2016	2017	2018	2019
Energy import dependency¹ (%)	22,3	18,1	16,4	16,4	21,6	23,1	*	*
Energy balance of trade² (% GDP)	-3	-1,9	-1,4	-0,9	-0,94	-1,3	-1,6	*
Share of energy-intensive industries in the economy³ (% GDP)	11,6	11,4	12	12,3	12,4	12,4	12,33	*
Long-term interest rate spread versus Bund⁴ (basis points)	*	384,4	333,1	297,8	322,9	364,1	429	479,2
Private debt (% GDP)	*	*	62,1	58,0	53,7	50,9	47,4	46,7

1 Energy import dependency represents net energy imports divided by gross inland energy consumption plus fuels consumption of international sea transportation.

2 The energy balance of trade is the balance of energy exports and imports, expressed as % of GDP.

3 The share of energy-intensive industries in the economy represents the share of gross added value of the energy-intensive industries in GDP.

4 Bund is a debt instrument issued by the German government in order to finance spending. Bunds are issued with a maturity of 10 or 30 years. Bunds are generally considered to be the German equivalent of US treasury bills.

Gross external debt (% GDP)	public	19	21	21,8	19,6	19,0	18,0	17,3	17,2
	private	28,2	25,2	22,8	20,9	19,1	16,7	15,1	14,9
Foreign ownership of banking system (% of total assets)		*	*	90,0	90,5	91,4	77,3	74,9	74,5
Trade balance of high technology products (% GDP)		-1,79	-1,96	-1,66	-1,75	-1,6	-1,87	-1,78	*
General government expenditure on education (% GDP)		3	2,8	3	3,1	3,7	2,8		*
R&D Intensity		0,48	0,39	0,38	0,49	0,48	0,5	0,5	0,48
No. of persons having completed tertiary education (% of people aged 15-64)		14	14	14	15	15	15	16	*
Early leavers from education and training system (% of people aged 18-24 years)			17,3	18,1	19,1	18,5	18,1	16,4	*
Employed people with tertiary education and/or people employed in science and technology sector (% of total employment)		24	24	24	26	27	27	27	*
Unit Labor Cost index growth (t/t-1, %)									
- in industry									6,6
- in construction			-3,55	0,59	-0,06	7,24	6,6	10,74	
- in market services			-3,96	-12,1	4,96	-2,9	21,33	19,2	
			3	5,72	-0,17	10,65	7	13	
Growth of labor productivity per person (t/t-1, %)									
- in industry		-6,38	3,98	0,19	8,52	2,17	4,37	3,27	3,1
- in construction		9	4,72	2,7	6,84	5,37	-3,25	4,87	
- in market services		35,86	3,85	0,64	3,1	3,6	5	-0,04	

Source: Eurostat and NBR data

Since 2016, wage increases (in the public sector and the minimum wage) have far exceeded the relatively strong increase in productivity, which has led to an advance of *unit labor costs*, with negative implications for competitiveness. In turn, this led to an appreciation of the real effective exchange rate based on unit labor costs. Both developments have influenced the external deficit in the sense of growth, by reducing the attractiveness of exports and stimulating imports.

Despite the increase in labor productivity per person until 2018 inclusive, *labor productivity* in Romania is at a low level compared to other European Union countries (the main trading partner of our country). This shows an unfavorable situation in terms of quality and prices of exported goods and services, not supporting the achievement of the external balance.

4. Conclusions

In the short term, the economic evolution is affected by the dynamics of the pandemic, by the profile of an excess demand shaped since the beginning of 2021, by the effects of the turbulence on global value-added chains, and by the implications of a war in the country's neighborhood, which cumulatively slow the activity of domestic economic recovery. In addition, the evolution of the covid-19 pandemic, the recovery capacity and the possible structural implications of the crisis are still uncertain.

Macroeconomic imbalances in Romania are directly influenced by the risks of loss of cost competitiveness, of deterioration of the external position and of a growing current account deficit, in the context of an expansionary fiscal policy and an unpredictable business environment. These vulnerabilities have come to surface in 2019, 2020 and in 2021.

Romania's external position has deteriorated during the pandemic crisis and it remains a vulnerability for our country's economy. The covid-19 crisis does not seem to have fundamentally changed the dynamics of the external sector. In general, policy action over the past year has focused on mitigating the impact of the covid-19 shock and on facilitating recovery. This has increased Romania's public indebtedness, but should support the adjustment in the medium term.

The evolution in recent years of the cost competitiveness and of the factors that determine non-cost competitiveness have affected and will continue to negatively influence Romania's external balance and investments.

Analyzing the essential structural elements generating risks and challenges for the Romanian economy, in general, and for achieving the external balance, in particular, we can say that the low number of people employed with higher education, the low capacity of innovation in the economy, increased unit labor costs, the low level of labor productivity and low technological achievements do not support the qualitative and quantitative increase of our country's exports, the production of high value-added goods that include high technology, and thus the reduction of our country's external deficit.

In general, while policy risks have been largely mitigated by subsequent corrective policy measures, legislative unpredictability continues to affect business environment, fiscal outlook and investors' perceptions.

We can say that the trend of our country's current account deficit since 2015 is a source of vulnerabilities for the sustainable development of the economy (a growing external deficit requires additional sources of financing), but also for the prospect of joining the euro area (being exceeded the limits allowed in the procedure regarding the macroeconomic imbalances within the alert mechanism of the European Commission), whereas Romania's current account deficit continues to be one of the highest in the European Union.

The structure of Romanian imports and exports (predominantly exports of intermediate goods, and imports of consumer goods growing faster than imports of other goods from 2016 to present), the depreciation of the national currency, the change of the way of financing the growing external deficit, in favor of debt generating flows (loans and portfolio investments), the sharp increase in external public debt since 2017 (meant to finance large fiscal deficits recorded in Romania also before the emergence of covid-19, but also to cope with the health crisis) can be considered sources of vulnerabilities and risks, with negative effects on the evolution of the external deficit in Romania. The massive indebtedness from private creditors implies an increase of costs, and implicitly of the risks related to the repayment and sustainability of the external debt. Public debt is the main cause of Romania's external debt increase.

The lack of continuous reform efforts, the increase of the budget deficit and of the current account deficit endanger the sustainability of Romania's economic growth. The strong domestic demand, driven by tax cuts and high wage increases, was the engine of economic growth in the period prior to the emergence of covid-19. This consumption-based growth model has led to an unceasing increase of our country's current account and budget deficits. In addition, unfavorable demographic developments have led to a significant shortage of labor force and skilled personnel, thus limiting the country's growth potential. If the upward trend in the external deficit is not adjusted and if there is no firm commitment to structural reforms, there is a risk that Romania will face significant obstacles in her efforts to place the economy on a sustainable development trend.

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