Fiscal Council of Romania

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Rising public debts: why are markets so complacent?[1]

Public debt sustainability is a concern in many countries. In the US, as the economic linchpin of the developed world, public debt has exceeded 130% of GDP and is causing heated debate, in Congress as well. In the EU, the financial crisis, the pandemic, and the energy transition (with effects augmented by the war in Ukraine) have caused public debts to soar; there are countries in the euro area (Greece, Cyprus, Italy, France, Belgium, Spain, Portugal) with public debts that range between 100% and 175% of GDP. By the way, the ECB was forced to intervene through special operations to save the Eurozone during the sovereign debt crisis.

Public debts are considerably lower in Central and Eastern Europe, but some of the countries in this region are not part of the Eurozone (thence a currency risk exists) and have large budget deficits; this is also the case of Romania, with a structural budget deficit of over 5% of GDP, perhaps the highest in the Union (the structural deficit is defined in a narrow sense as the difference between permanent revenues and

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permanent expenses - though no part of the budget can be viewed as permanent forever).

The fiscal governance reform in the EU focuses on public debt sustainability and, to this end, a more rigorous control of net public expenditure (which excludes debt service and temporary expenditure) aims at ensuring that its dynamic does not exceed GDP growth. For public debt sustainability, the real interest rate applied to servicing public debt must not be higher than the real economic growth rate.

The current overall landscape is mirrored by rising public debt in many countries, and strong, even aggressive, monetary policy tightening by major central banks (FED, ECB, BoE, BoJ), which influences monetary conditions on international markets and the cost of financing. In not a few countries there is a complicated situation of public pension systems, which represent *hidden liabilities* for public budgets.

As defense spending increases in the conditions of the war in Ukraine and the aggravation of geopolitical confrontations, the pressure on public budgets rises in the EU.

The adverse effects of climate change must also be taken into account, for they force governments to allocate additional resources to deal with repeated emergencies. What is happening this summer in Europe (with the highest temperatures on record in hundreds of years) speaks eloquently.

A legitimate question to ask is why markets do not react strongly to rising public debt in so many economies: A few suppositions can be advanced in this regard:

- The USA, despite having a current public debt higher than the level registered after the Second World War, has the strongest economy in the world and seems to be pulling a global "train" of indebtedness;
- public debts in highly developed countries are a benchmark for debt dynamics in the world; there is here an effect of obscuring cases of emerging economies that have major vulnerabilities;
- there is a global rush for *safe assets*, and sovereign bonds of large developed economies provide such assets. Gold comes into the discussion here as well, but it does not reduce the status of securities issued mainly by the US treasury, of EU common bonds (though the latter are limited in range);
- in very tense geopolitical confrontations, the attractiveness of investments in "safe havens" increases, and the American economy, some European economies, are preferred destinations;
- developed/rich economies have national wealth that gives them a great advantage; they also have external assets (investments in other countries) that represent valuable assets.
- international financial institutions operate in a way that seeks to safeguard the global financial system; in this system, the US and the G-7 (the group of 7 highly industrialized countries) play a major role, that was evident during the financial crisis that broke out in 2008. Then, the big central banks and the governments of the G-7 worked together to prevent a collapse of the global financial system. Even if China and other (BRICS) countries try to build an alternative to the established international financial regime (set up after the Second World War – the so-called

Bretton Woods Arrangements), the pre-eminence of the G-7 can hardly be challenged;

- bank failures in the US in 2023, as well as the forced takeover of Credit Suisse by UBS (at the behest of the federal government in Bern) show that central authorities are ready to intervene whenever the situation becomes very precarious, with visible contagion effects in sight; these interventions give a sort of guarantee to markets against a possible chain collapse.
- the financing of industrial and ecological projects could have a significant impact on "clean" economic growth. But this reasoning is not unquestionable given that such investments mean an increase in public debt unless compensated by a decrease of other budget items. In addition, a boost in economic growth, which would curb the dynamics of public debt as a share of GDP, is uncertain. EU countries that benefit on National Recovery and Resilience Plans (NRRPs) must capitalize on them to the utmost from this perspective.
- An often-inherent myopia of markets does operate.

Whether the suppositions advanced above have relevance is to be examined. The bottom line, however, is that, public debt sustainability cannot be removed from the agenda of governments. *Financial repression* (when interest rates are below inflation) can help assuage debt sustainability concerns, but is it a reassuring argument? And public debt cancellation cannot be done in the case of developed countries, though debt restructuring can be envisaged; there is no one to do cancellation as the very same countries are supposed to intervene when financial systems are in distress - there is an obvious vicious circle here: who saves whom? Against this background, the control (reduction) of

public expenditure and more robust budgetary revenues are a must for public debt sustainability. For poorest and most indebted countries, debt cancellation makes sense.

In the context outlined above, a well-known corollary operates: economies that issue reserve currencies are much better shielded than emerging economies, the latter striving to have robust foreign reserves. Emerging economies are bound, therefore, to run relatively small deficits.

Romania’s public debt tripled after the global financial crisis, reaching just under 50% of GDP in 2022 (from approximately 14% in 2008), which is a level comparable to that of Poland and the Czech Republic (in Hungary and Croatia, public debts are over 75% of GDP), and which is below the 60% of GDP benchmark set up by the EU fiscal governance framework. However, please note that:

- Romania’s public debt can increase substantially if the structural budget deficit, which has stayed above 5% of GDP, is not reduced; the burden of public debt service becomes heavier if the deficit is not reduced and monetary policies remain tight.
- the budget deficit contributes largely to the current account deficit, which will be around 8% of GDP this year (down from 9.2% of GDP in 2022 due to a terms of trade improvement); if the budget deficit would be brought down to 3% in a few years time, the current account deficit could decrease to around 4-5% of GDP.
- a significant portion of the public debt is held by non-residents, which poses a vulnerability; and local banks have a considerable exposure to Romanian sovereign bonds.

- the year 2022 was exceptional, with "surprise inflation" (much higher than forecasted) and additional revenues for the public budget, including from the overtaxing of energy providers; this conjuncture was underestimated in the construction of the 2023 budget.
- Romania's sovereign rating (BBB-) is just above "junk" status (risky for investments), making it one of the lowest in the EU.
- Romania has one of the lowest fiscal revenues in the EU (26-27% of GDP, including social and health contributions – compared to an average of about 41% in the Union); this explains the structural strain in its public budget and a very limited fiscal space.

Apart from the global context highlighted above, it is likely that markets are not yet reacting nervously to Romania's public budget situation, because:

- its public debt is not (yet) overwhelming;
- the National Bank of Romania (NBR) holds considerable foreign exchange reserves;
- the National Recovery and Resilience Plan (NRRP) has brought substantial amounts of "hard cash" into the country. These resources add to the tens of billions of euros provided by EU structural and cohesion funds;
- Romania is a member state of the EU and is obliged to respect fiscal rules;
- EU membership provides financial support; this has been seen via financial assistance provided to various member states after 2008, however controversial the programs in the Eurozone were.

- after the outbreak of the Pandemic and the ensuing economic downturn, that were followed by the energy crisis, budget deficits rose much throughout the European Union; Romania has no longer been singled out for its budget deficit (nota bene: in 2020 it was the only country under the *excessive deficit procedure*). In 2022, according to data from the European Commission, countries with budget deficits exceeding 4% of GDP were Belgium, France, Hungary, Spain, Romania, Italy, and Latvia; starting from 2024, the excessive deficit procedure will be reactivated, and, probably, other countries will be targeted as well. However, it remains to be seen how much of the size of those deficits has a structural nature.

Romania's budget deficit is a major vulnerability that cannot be sustained indefinitely. In the coming years, Romania will catch the eye again in the EU due to its high budget deficit if no solid adjustment takes place. Financial markets will react, probably nervously, and its financial creditworthiness will be impaired. Therefore, the government must adopt measures to reverse the trend of the budget deficit, which is heading well above 6% of GDP this year unless correction measures are enacted. If a significantly lower deficit is achieved in 2023 compared to 2022 (when it was 6.2% of GDP according to the European methodology, ESA), even if above 4.4% of GDP (a target considered unrealistic by the Romanian Fiscal Council), it is fair to assume that markets will not overreact. This is especially true if the deficit trend is modified through corrective measures, and the deficit is seen to continue to go down in 2024.

To reduce the budget deficit, it is necessary to eliminate as much as possible from what makes Romania's tax regime regressive and unfair

(where those who earn more pay proportionally less), to do away with tax optimization loopholes and privileges (ex: the case of self-employed individuals – PFA, the micro-enterprise regime, etc.), and the National Agency for Fiscal Administration (NAFA) undertakes better tax collection. Expenditure must also be cut down (wherever it is possible) and be made more efficient (*spending reviews* are underway currently), social assistance be more targeted (not granted regardless of households' incomes). Recommendations made by the European Commission (some are included in the NRRP), the World Bank, the IMF, the Romanian Fiscal Council, and by domestic economists provide paths to follow.

It is not a simple demarche at all, as changes in the tax regime inherently affect the incomes of not a few people, and there is loud opposition to changes. However, it is important to see the bigger picture and consider the interests of society as a whole. Besides, there is no magic solution! To reduce burdensome external financing, unwarranted internal subsidies and preferential tax treatments must be done away with.

It is crucial not to reach a situation where obtaining external financing is conditional on taking extremely painful measures. The issue of the structural budget deficit, the lack of fiscal space, have been overlooked for many years, and necessary measures have constantly been postponed. Tit is high time to act!

P.S.: Public communication needs improvement, especially when it concerns a package of painful budget adjustments. It is essential to explain the necessity of a correction program by not alluding, primarily, to the loss of funds from the NRRP (National Recovery and Resilience Plan). The fundamental reason for correction is that budget deficits of 6-

7% of GDP cannot be perpetuated. In addition, a deficit correction involves a fairer tax regime. This needs to be stated clearly.