Daniel Daianu, February 27, 2023

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The external imbalance: some remarks and conjectures

Comments are multiplying in the domestic debate regarding the current account deficit in 2022, which reached 26.571 billion euros (9.2% of GDP) – an increase of 52% compared to 2021, while the trade imbalance reached 34 billion euros. NBR documents also refer to this development. Increased attention is required because, let us remember, the external balance was affected by big problems after 2008, although the public debt was then around only 15% of GDP. In the 2007-2008 period, the current account deficit was, on average, over 12% of GDP. Romania was not the only country in the EU with great financing difficulties once the financial crisis broke out, under the conditions of massive capital movements, with an important speculative component. Against the background of the "boom and bust" cycle, the current account deficit in the pre-crisis years was generated by both the public and non-governmental sectors.

What numbers say and what they don't say: it is not like in 2007-2008

There were two stages in the reduction of the current account deficit after the outbreak of the financial crisis: in the first years after 2008 capital inflows stopped almost suddenly and there was an adjustment that brought the current account deficit to around 5% of GDP between 2009 and 2012. The second stage was a severe compression of public spending after 2012; the current account deficit was reduced to 0.3% of GDP in 2014 and the budget deficit to 1.2% of GDP in the same year; the current account deficit fluctuated between 0.3% and 1% of GDP between 2013 and 2015. The reduction of the budget deficit was also facilitated by the increase in VAT from 19% to 24%.

It is hard to admit that such a drastic cut in public spending was sustainable. On the other hand, there should have been prudence in the budgetary policy after 2015. **Changes in the fiscal regime after 2015 and other measures with budgetary impact led the structural budget deficit to over 4% of GDP in 2019**, and this evolution was seen in the upward path of the external imbalance, the phenomenon of twin deficits being exhibited – see Figure 1 and Figure 2.

It should be noted that Romania had difficulties financing the external balance when the public debt was much lower (as a percentage of GDP) than it is now – approx. 15% of GDP in 2008 compared to approx. 48% of GDP in 2022. The explanation concerns the substantial budget deficits (the cash deficit in 2009 hid the ESA deficit of 5.4% by using resources from the privatization of the Romanian Commercial Bank) while the financial crisis increased risk aversion considerably. As a consequence, Romania had to resort to a package of external financial assistance.

Under the conditions of the energy crisis and the invasion of Ukraine, **in 2022 there was a deterioration of the terms of trade for most EU countries**, which led to increases in current account deficits; the surplus of the euro area decreased and in neighboring countries from Central and Eastern Europe (Czechia, Hungary, Poland) the deficits increased (see Figure 1). In the case of Romania, a deterioration of the terms of trade equivalent to 1-1.5% of GDP can be presumed, which should be seen in relation to the current account deficit estimated by NIS at 9.2% in 2022. Beyond the deterioration of the terms of trade, there were companies that shut down due to their energy-intensive production and were substituted by imports. Moreover, disruptions in production and supply chains have affected the export capacity of the economy. In the absence of these effects, the current account deficit in 2022 would probably have been not far from that of 2021 (when it was approx. 7% of GDP).

Twin deficits

What makes external deficits special in our country is the contribution of the budget deficit to their size; structural budget deficits (which do not take into account the cyclical position of the economy and procyclical policies) were reflected in external deficits (Figure 1 and Figure 2).

It is rightly stated by experts and specialized institutions that the budget adjustment is mandatory to bring the budget deficit below 3% of GDP and, at the same time, to reduce the current account deficit. This consolidation will no longer be able to count on the "surprise inflation" from 2022 (Figure 5), which was considerably above the assumption on which the budget was built. A massive absorption of European resources can support economic growth (which is decelerating) and the financing of the external balance. European resources can bring public investments (which include capital expenditures) to 6% of GDP as an average in the coming years, which would alleviate the contractionary impact of the budget consolidation.

If the budget deficit (ESA) were to be reduced to 3% of GDP, we could imagine a decrease in the current account deficit as follows: to 6% of GDP if the current terms of trade are maintained; to approximately 5% of GDP if the terms of trade were to return to the level of 2022. There is also an effect here of the appreciation of the USD against the EUR, given that many energy products and other raw materials are priced in USD (however, we see that the USD has depreciated against the EUR in recent months, which, *mutatis* *mutandis*, can help improve the terms of trade). But the reasoning presented above, in both versions, implies a 1 to 1 transmission of the budget deficit adjustment in the reduction of the current account deficit, which is an implausible hypothesis. The transmission coefficient is smaller than 1; some studies place it below 0.4, others see it at 0.6 (see also the IMF analysis on Romania from August 2022). The experience of the impact of the budget correction on the current account deficit during the past decade suggests a transmission coefficient towards the upper threshold that was mentioned, perhaps even above.

Why there is no depreciation pressure on the Romanian leu?

The yield differential is attractive for investors who assess Romanian bonds and other liquid assets in their portfolios. In January 2023, Romanian government securities held by non-residents reached the historical peak of 67 billion lei (24% as a share of total bonds in circulation). The relative stability of the Romanian leu compared to other currencies in the region should also be included in the picture (some might even speak of a "put"). In 2022, the NBR raised the monetary policy rate to 7%, comparable to the monetary policy rates in Poland (where it is 6.75%) and Czechia (where it is 7%); there is a feeling that the budget deficit will be reduced in a few years despite the electoral cycle (Romania is in the excessive deficit procedure!), there are European resources through the Multiannual Financial Framework and the NRRP of over 80 billion euros, the public debt is not (yet) overwhelming, the degree of euroization of the economy is much lower than 15 years ago (2/3 of the transactions are denominated in lei now compared to about 1/3 then), the domestic banking system is well capitalized and is mainly based on residents' deposits (the loans-to-deposits ratio is below 80%), the foreign exchange and gold reserves of the NBR are substantial, we are a member state of the EU (which can avoid a solvency crisis), inflation has started to decrease with the capping scheme being effective (as it has also been in Spain and France).

A persistent question: why do other neighboring countries have more balanced external balances?

<u>Large structural budget deficit</u>

The regressive tax system (where low or modest-income citizens pay a proportionally higher amount than those with high incomes), errors in fiscal policy, numerous exceptions and "loopholes," have contributed to the worsening of the budget deficit by reducing tax revenues. With tax revenues of 26-27% of GDP (including contributions), Romania is the worst performer in the EU. An analysis under the aegis of the Fiscal Council (in 2022) shows that revising the tax regime could bring in additional tax revenues of over 3% of GDP within a few years. But many people are complacent in their hypocrisy; they realize the situation (regarding tax revenues), but as in Caragiale's play, they have an attitude like "let things change, but only here and there... in non-essential parts."

Revising the tax regime would allow for a reduction of labor taxation that would not, however, prejudice budget consolidation. Higher tax revenues would also allow for an incomes policy that takes into account that citizens with low incomes have a considerably higher propensity to consume than those with high incomes, which affects import dynamics.

Tax evasion and tax avoidance must be combated with institutional force and political determination. We should not give in to internal and external pressures. Let us hope that European institutions will also be more determined in this regard, in general.

<u>The overvaluation of the leu in real terms</u>

The overvaluation plays a significant role in the evolution of the external balance over time. Some analyses place this overvaluation (the effective exchange rate) at 5%-10%. However, we see how, despite the external imbalance and this overvaluation, there is currently pressure for a nominal appreciation of the leu. Even if fundamental economic data would suggest a different "equilibrium" level of the leu, financial conditions keep the national currency in a territory of overvaluation; here the logic of determining the equilibrium level based on trade flows collides with the logic that concerns financial flows, which may be more or less durable (note that speculative capital inflows are different from long-term investments). **The NBR has to navigate with great care between Scylla and Charybdis; the exchange rate cannot be left adrift, nor can it be allowed to appreciate excessively or enter into a frenzy of depreciation.**

Even if the NBR were to attempt a depreciation of the leu, beyond the possible rekindling of inflation, there is a problem of effectiveness in such an undertaking. Much of domestic production is part of cross-border value chains, and it is not clear to what extent and how quickly exports would be stimulated and imports discouraged by a depreciation; there are elasticities at play that can be more or less favorable. These elasticities must adhere to the Marshall-Lerner condition (the sum of the elasticity of export demand and the elasticity of import demand must be greater than 1) to have a positive effect, and the J-curve (a negative effect on the deficit before a positive effect shows up) must operate as weakly as possible.

Moreover, intentional depreciation cannot be done simply. Injecting a large amount of monetary base into the economy to cause depreciation of the leu would be a very dangerous experiment, doomed to fail; it would throw everything up in the air! The current excess liquidity in the banking system (as seen in market interest rates) is not due to a deliberate policy by the NBR to depreciate the currency, but rather due to European funds and investments by non-residents in Romanian bonds and other assets. It should also be noted that the leu is not a reserve currency and market sentiment can change dramatically if monumental mistakes are made. The NBR has to solve difficult trade-offs.

It should be said that a flexible exchange rate regime would be easier to implement if we had a robust public budget, a significant fiscal consolidation.

<u>The production of tradables is insufficient</u>

It is plausible to assume that **the production of tradables (exportable goods and goods that can replace imports) has not kept pace with aggregate consumption, with internal absorption; we have a resource allocation process** that has favored the expansion of non-tradables.

Many investments go into residential and commercial real estate. Infrastructure is still poor. IT and transportation services have not been able to stop the growth of the deficit. The position in production and supply chains could be more favorable; components and sub-components are assembled or produced, many of which do not have high added value. And a change in the exchange rate of the leu cannot have rapid effects when there are significant rigidities (as mentioned regarding the Marshall-Lerner condition). On the other hand, the variety of domestic industrial production is an important premise for a better situation in the future, for optimism.

There are also other structural problems; for example, the underdevelopment of the agri-food industry – agricultural land accounts for 57% of the country's surface area while the external deficit of this sector is 0.5-0.6% of GDP. In general, we have an insufficient good use of resources, of internal raw materials, which is also reflected in the fact that we import goods whose manufacturing includes essential inputs from Romania. We do not have high quality tourism that should stimulate "internal exports" while Romanian citizens spend billions of euros abroad.

Industrial policies targeting the production of tradables and the increase of added value (including in the agri-food sector) are weak. Our economy also has a dual structure, characteristic of the less developed ones: important sectors are dominated by large foreign companies and there are many weak domestic companies. In the energy sector, we have companies with majority domestic ownership that can support a national strategy in this field. However, industrial policies require higher budget revenues, even though the NRRP contains elements that can support the domestic production of tradables and increase the robustness of the economy. It is good that a development bank is finally being set in motion.

Labor emigration

Massive emigration also took place from other European economies, especially after their entry into the EU, but from Romania, proportionally, it seems to be higher. The stock of human capital has decreased and this affects the present and future potential GDP, the production of tradables. There are telling studies by the World Bank and other organizations in this regard. Unfortunately, these flows of human capital are difficult to mitigate under the current conditions. It is true that Romanian citizens working abroad send billions of euros home, which can reach 1.5-2% of GDP annually; without this money, the current account deficit would be higher. But the loss of human capital cannot be replaced by these money inflows. Let's think that many of those who emigrate are young, given that Romania's population is aging; demography puts us at a greater disadvantage than other European countries (even if the population is aging there as well) considering immigration.

Toward war economies?

In the new geopolitical and geo-economic context, Romania will allocate more for defense (about 2.3% of GDP in 2023, compared to 1.76% in 2022), which does not represent basically production of tradables; in fact, weapons purchases mostly mean larger budget and current account deficits, other conditions assumed unchanged. Only if we had a significant increase in internal defense production (including the offset component) the impact on the external balance could be reduced. The Baltic countries have defense expenditures of over 2.5% of GDP, Poland more. The statements of many NATO leaders go in the same direction, indicating the end of the "peace dividend" after the fall of the Berlin Wall, the increase in defense production.

Even if the war in Ukraine ends, this does not mean a return to the situation before the invasion. We will live in another world, of a new cold war. The allocation of resources for military resilience, for security, means pressure on public budgets, reallocation of resources in economies; and everything must be judged from the perspective of de-globalization, the regionalization of some trade and financial flows, when security becomes more important than efficiency understood in a narrow sense.

There are also effects of climate change, other extreme events, which must be taken into account in the construction of the public budget; therefore, the creation of "fiscal space", the increase of fiscal/budgetary revenues is absolutely necessary.

The production of indispensable goods for non-military security - food, for example - will have to be developed. It is worth noting that the situation of the agri-food industry was also examined in meetings of the National Committee for Macroprudential Oversight. That is why industrial/agricultural policies are needed. The NRRP, with adaptations (as it also happens with the NGEU, which is the overall program of the EU), can help for this purpose. And we thus return to the issue of the robustness of the public budget.

The EU has a handicap compared to the USA and other regions of the world regarding energy resources and "critical" raw materials. If the EU succeeds in speeding up the transition to renewable energy resources, at reasonable prices, the benefits would be enormous. The Union will have to undertake industrial policy measures as is done in the USA (see The Inflation Reduction Act). All in all, Romania must capitalize its natural resources better and extract as many benefits as possible from the available European funds.

Some conclusions

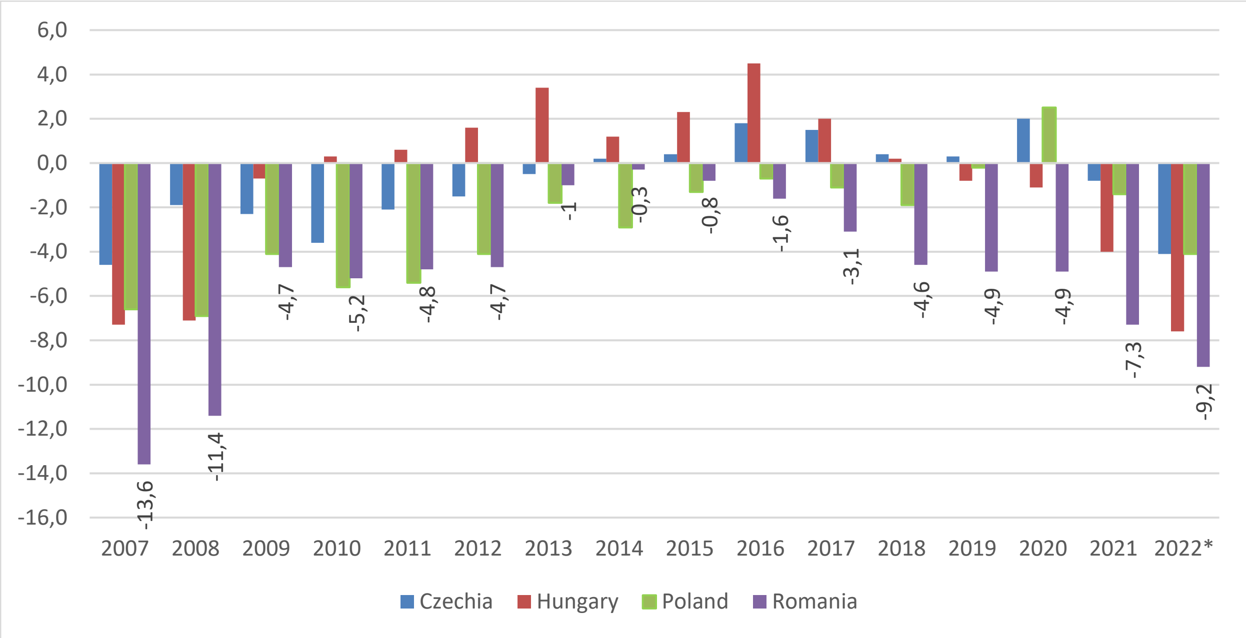
The external imbalance presents a vulnerability, which can be reduced through consistent efforts on several fronts: budgetary consolidation (reducing the budget deficit), a better allocation of resources in the economy to support the production of tradables, massive absorption of European funds. In 2023 and 2024, the anticipated reduction in the economic growth rate can mitigate the current account deficit. A falling inflation and attractive interest rates on deposits would stimulate domestic saving, with a favorable effect on the external imbalance.

Serious reforms must be undertaken in the economy to favor robust economic growth, strengthening the premises for the production of tradables; such reforms include, among others, digitalization, the reform of the fiscal regime, more efficient public spending (spending reviews are currently being carried out for education and health, actions that are also required by the NRRP), prioritization of investments oriented towards tradables and rigorous control of their achievement, fair salary and pension systems (see also the recommendations of the World Bank in this regard), allocation of additional resources for education and health (which ask for higher budget revenues), etc.

We can return to current account deficits below 5% of GDP, with unproblematic financing, in a few years, but we need adequate macroeconomic and structural policies.

P.S. A current account deficit of 6% of GDP can be more advantageous than one of 4% of GDP if it is financed entirely by direct investments, while the 4% deficit is financed exclusively by borrowing. The nature of the investments also matters considerably, for it is one thing to invest in tradables, in high-tech, and another thing to invest in malls and residential areas. In other words, the devil is in the details.

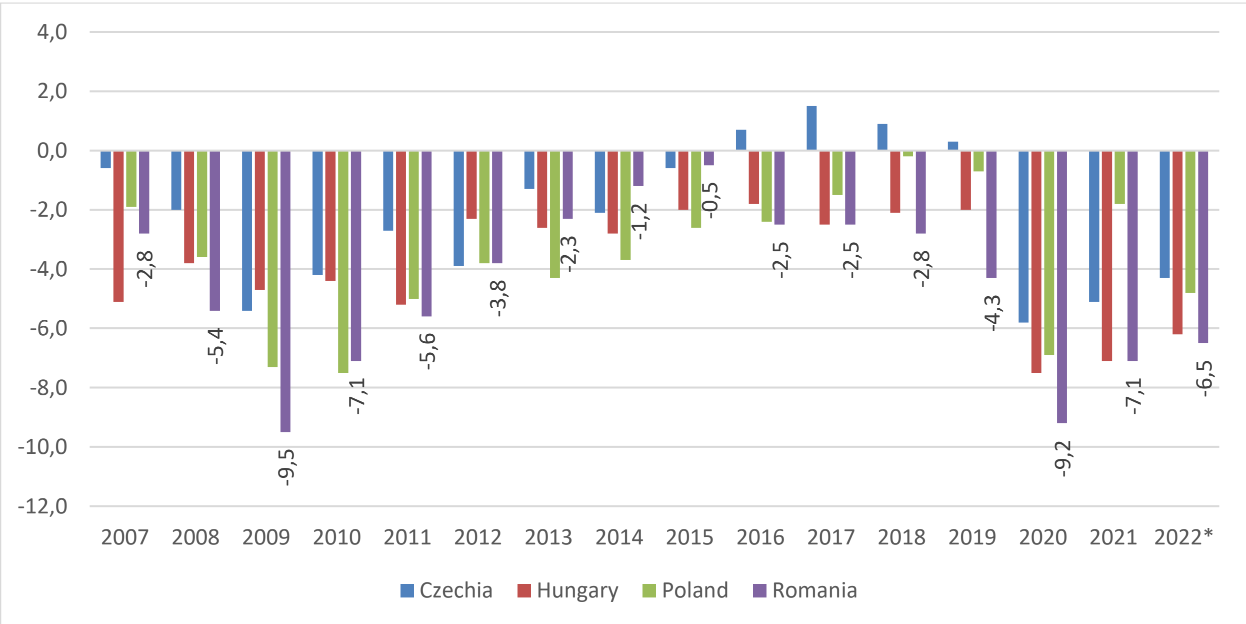
Figure 1. Current account balance in the period 2007-2022 (% of GDP)



Source: AMECO

Note: For 2022, the value of the current account balance is taken from the NBR website, relative to the GDP forecast from the NCSP 2023 winter forecast.

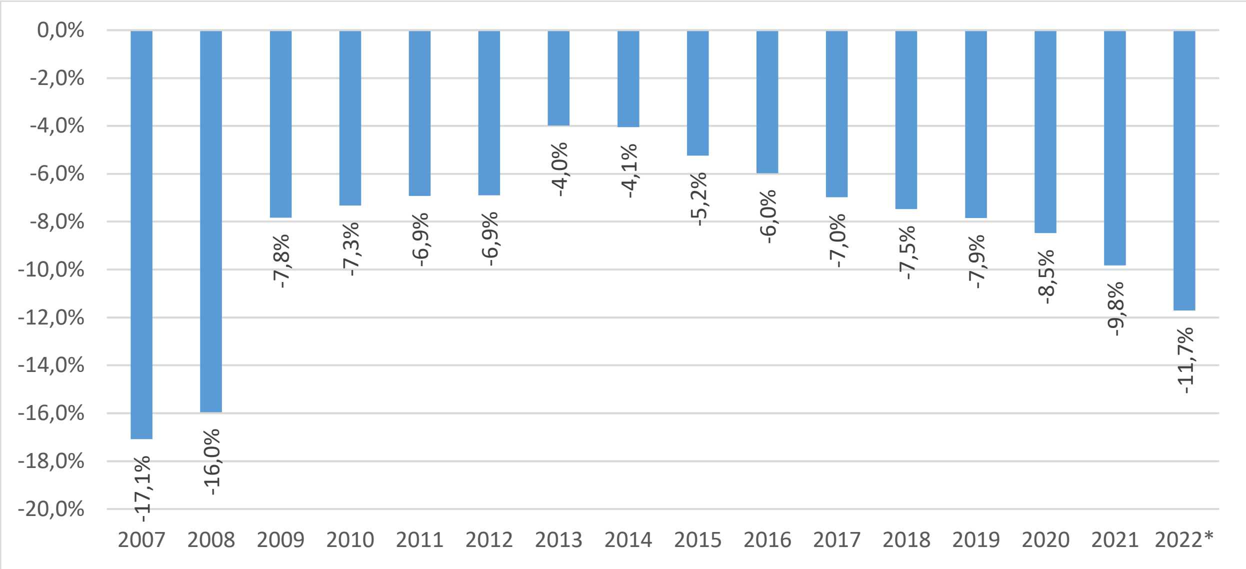
Figure 2. Budget balance in the period 2007-2022 (% of GDP)



Source: AMECO

Note: For 2022 the presented values are estimates.

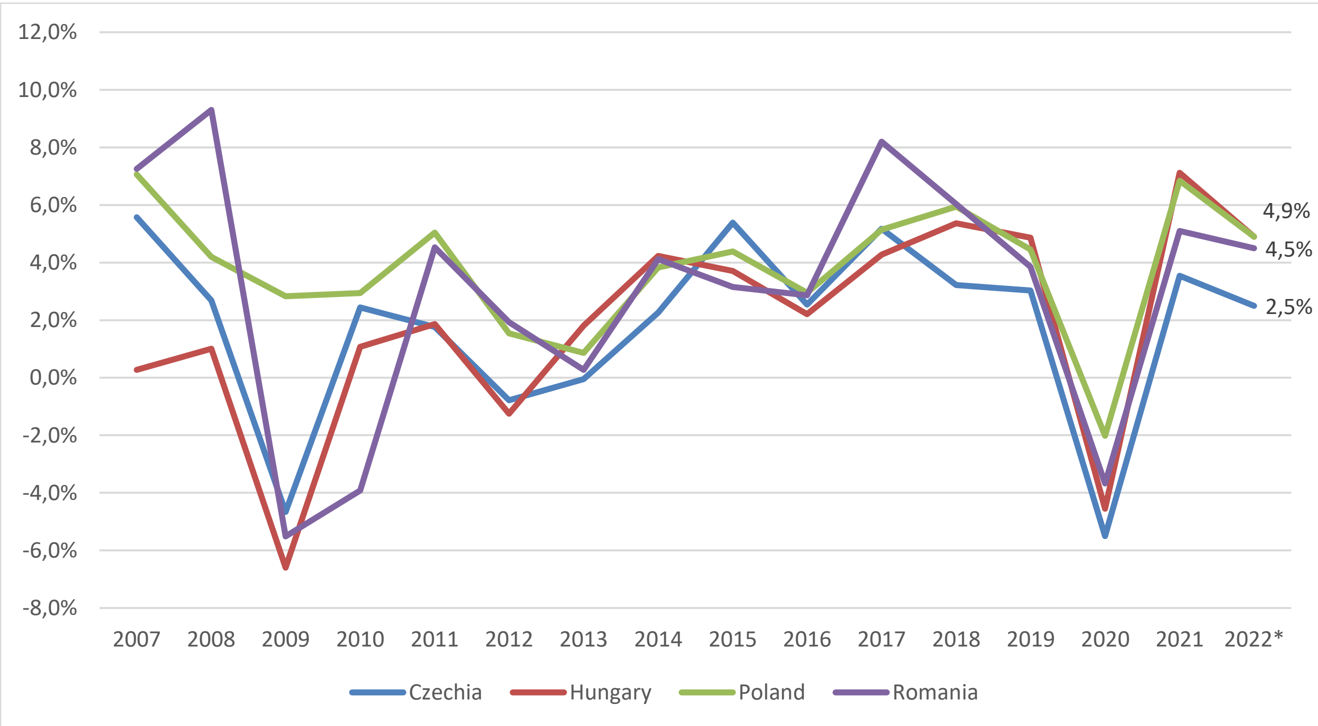
Figure 3. Balance of trade evolution in Romania during the period 2007-2022 (% of GDP)



Source: AMECO, NCSP

Note: The data is obtained as exports FOB-imports CIF, the reporting until 2020 was made to the GDP provided by AMECO, for the years 2021 and 2022, the value of GDP and that of the trade balance are taken from the NCSP 2023 winter forecast.

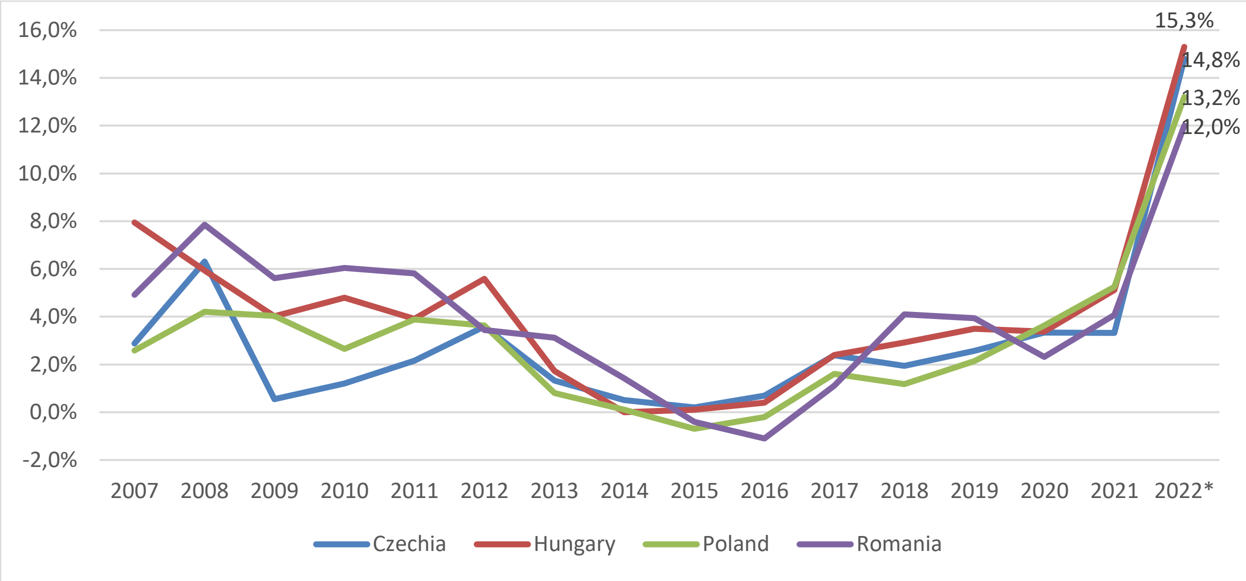
Figure 4: Real GDP dynamics during the period 2007-2022 (%)



Source: AMECO

Note: For 2022, the values are taken from the EC 2023 winter forecast.

Figure 5: HICP inflation during the period 2007-2022 (%)



Source: AMECO

Note: For 2022, the values are from the 2023 EC winter forecast.