

FINANCING THE CURRENT ACCOUNT DEFICIT IN ROMANIA

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Abstract

In Romania, the current account has a negative balance every year since 1990. In the article [1], the author aims to analyse the ways of financing Romania's current account deficit, considering the importance of the financing structure for the sustainability of the external imbalance, and implicitly, of the economic development. It is found that after 1990, the current account deficit has been covered mostly by external flows non-generating of debt, but in recent years, its financing has worsened in terms of sources and costs. From the analysis, we can also notice an increased dependence of Romania on foreign direct investments (FDI) from the European Union countries, on the economic and political evolution of this entity.

The methodology used joins the descriptive, theoretical and empirical analysis of statistical data and their interpretation, with the identification of causalities.

Keywords: foreign deficit, sources of financing, effects, costs

Jel classification: F14, F21, F32

Introduction

The equilibrium is rather a theoretical concept, an ideal towards which any economy strives both domestically and externally. The conditions upon which depends the equilibrium in an economy are of economic, monetary, financial, currency and social nature.

The external equilibrium is assessed through the balance of payments, which is a statistical document that reflects the position of a national economy in its relations with foreigners, reflecting the country's external competitiveness.

Both from a practical and theoretical point of view, the deficits of the balance of payments (and not its surpluses) are more important, because the adjustment process subjects the country to the pressure of corrective measures and it brings about the diminishment of the country's international reserves.

A current account deficit is sustainable when the determinants support a smooth correction in the future. While a current account deficit in itself is neither good nor bad, it is likely to be unsustainable and to lead to harmful economic consequences when it is large over the long term, when it fuels consumption rather than investment, when it occurs in parallel with excessive domestic credit growth, when it is driven by an overvalued exchange rate, when it accompanies budget deficits with uncontrolled growth, or when it is financed predominantly by external debt generating flows at high costs.

In the article, the author analyses the period 2006-2023, in order to capture both the effects of Romania's entry into the European Union and of the crises from 2008 and 2020 on the external deficit.

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The statistics have been taken from the National Bank of Romania, the National Institute of Statistics, as well as other statistics from studies in the field.

The methodology used combines descriptive, theoretical and empirical analysis of statistical data and their interpretation, with the identification of causalities.

The topic analysed is important because it falls within the broader theme existing at the national level, of mitigating the imbalances existing in the economy, and of preparing the process of joining the euro area.

A few characteristics of the current account deficit in Romania

Romania has had a current account deficit every year since 1990 (see chart no. 1). Its evolution is explained by domestic factors (internal structural changes in the economy, the continuation of the convergence process, the real appreciation of the national currency between 2005 and 2007, in 2010 and 2013, fiscal policy measures), but also by exogenous shocks (the crises in 2008 and 2020, geopolitical factors, etc.). The discontinuous downward trend of the current account deficit between 2008 and 2014 is due to the decrease in domestic absorption as a result of the drop in revenues in 2008, in parallel with the implementation of the fiscal consolidation process.

Between 2015 and 2022 inclusive, the current account deficit has increased, in parallel with the rise in the budget deficit, evolution brought about also by the effects of expansionary fiscal and revenue policies, marked by several measures adopted that led to an increase in the disposable income of households, but also as a result of the injection of liquidity into the economy (in 2020) in order to support some categories of population affected by the measures meant to prevent the spread of covid-19. (NBR, 2020, NBR, 2023).

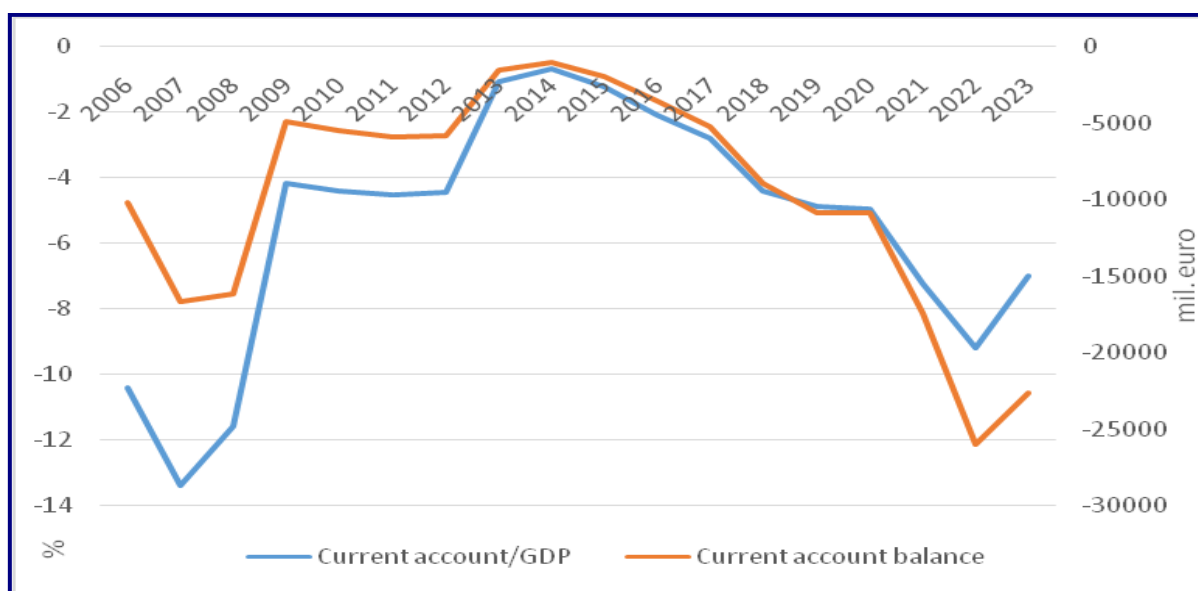


Chart no. 1. The trend of the current account deficit in Romania (%)

Source: author's calculations based on NBR data

In Romania, the conventional threshold for sustainability of the current account deficit (5% of GDP) was constantly exceeded during the period 2004-2008, and after 2020, making it necessary to adopt policies in order to ensure the sustainability of the current account deficit in the medium and long term.

During the period 2009-2014, as a result of the reduction in population income and liquidity in the context of increased risk aversion of investors, the share of Romania's current account deficit in GDP decreased considerably (compared to the previous period) (see chart no. 1) (to values below the conventional sustainability threshold accepted internationally). This evolution has been also caused by an exogenous factor, namely the international economic and financial crisis. Starting with 2015, the share of the current account balance in GDP has risen again, as a result of the recovery of the national and international economy, the Romanian economy still having structural deficiencies. In 2020, the share of Romania's current account deficit in GDP reached the conventional sustainability threshold (of 5% of GDP), and in the following years it exceeded it.

The domestic demand unsatisfied at the national level is the main cause of the trend of the current account balance, and it requires the adoption of economic restructuring measures in order to manufacture inside the country some of the necessary goods, which are currently imported.

The financing of the current account deficit

Although it was large according to international standards, Romania's current account deficit was not a cause for concern as long as its financing was ensured through autonomous sources of financing. Thus, after 1990, the current account deficit has been covered mostly by flows non-generating of external debt, the most important of which were the inflows of foreign direct investment. These represented a constant source of financing of Romania's external deficit, but with very different shares. Thus, there were years when they covered almost the entire current account deficit, but there were also years when they financed less than half of our country's foreign deficit.

But, starting with 2009, along with the deterioration of the current account balance, its financing has also worsened in terms of sources and costs. Thus, foreign direct investments and flows recorded in the capital account have diminished their share in financing the external imbalance, and the contribution of debt-generating financing sources (external loans and portfolio investments that represent risk elements for the sustainability of the Romanian economy) have increased, especially in 2020 (when the net balance of foreign direct investments in Romania decreased dramatically, reaching the lowest level after 2013). This evolution has been due both to the effects of the crises (from 2008 and from 2020-2021 - the almost generalized dispaity of investors' aversion to risk, and the decrease in international liquidity, against the background of uncertainty), to regional tensions (armed conflict), and to domestic causes (the exhaustion of privatizable objectives, the existence of insufficient tax facilities or not adapted to investors' requirements, the existence of strategies for drawing strategic investors that do not always lead to the desired effects, poor transport infrastructure, etc.), with effects in the direction of rising borrowing costs.

Although the net balance of direct investments increased between 2015 and 2018 and in 2021, amid the sharp growth of the current account deficit, their share in financing Romania's current account negative balance decreased almost continuously from 2015 to 2023, except for the rise in 2021. Thus, in 2021, the situation improved (as a result of the decrease in investors' risk aversion and of the improvement in foreigners' perception of our country), significantly increasing the share of direct investments compared to the previous year, and decreasing the importance of foreign loans in covering the current account deficit (see chart no. 2).

In 2022, the inflows, respectively the net balance of foreign direct investments, slacken in the context of increasing risk aversion brought about by geopolitical factors that created uncertainty, and led to increased inflation (against a background of increased volatility in the

prices of raw materials and energy resources) and to the worsening of financing terms. Thus, FDI contribution to financing the current account deficit decreased compared to the previous year.

The top five investing countries, in 2022, provided over 60% of the net inflows of direct investments of non-residents in Romania. They were Austria, the Netherlands, Germany, Luxembourg and France. We can see there is a high dependence of Romania on the countries of the European Union, on the economic and political situation of this entity.

In 2023, the net balance of foreign direct investments decreased, as it did their contribution to financing Romania's external deficit.

For many years, Romania has attracted foreign investors due to its fiscal policy, to cheap labor and to low energy prices. As a result, the rise in energy prices in the aftermath of the war in Ukraine, together with the deepening labor shortage, have caused the loss of our country's main advantages over other economies in the region in attracting foreign direct investments.

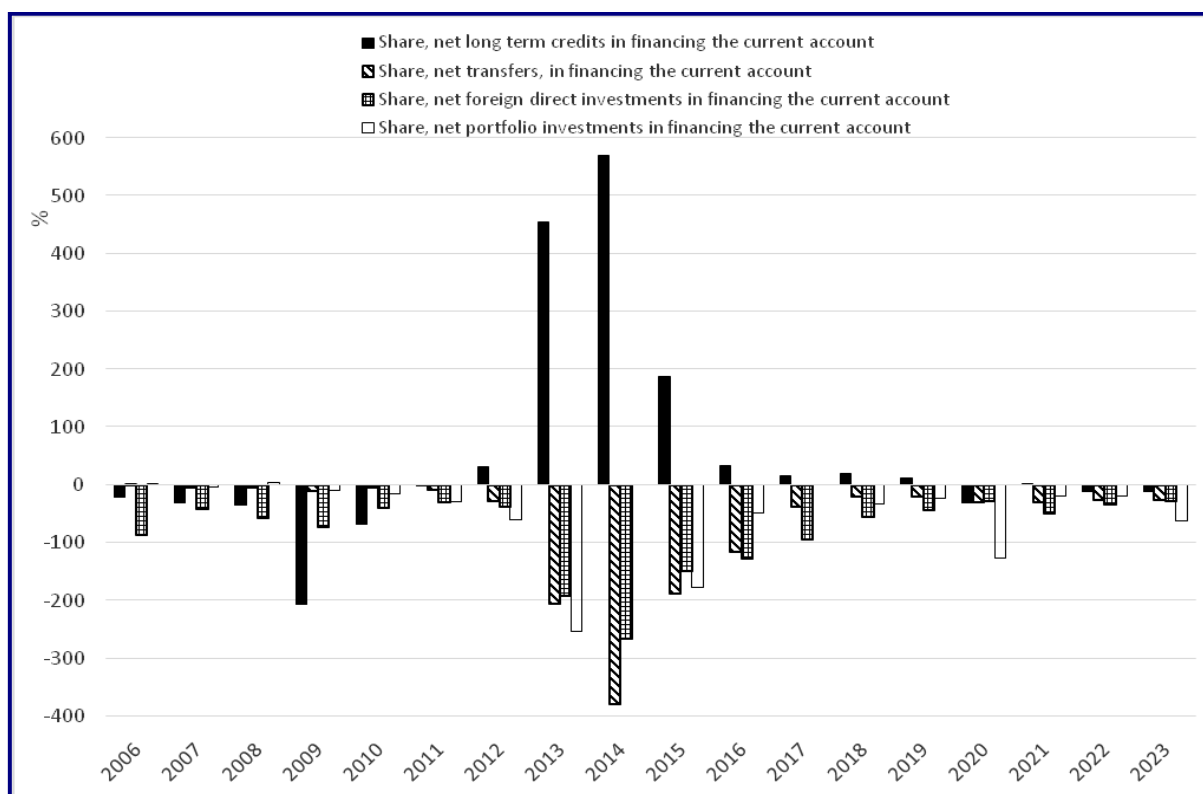


Chart no. 2. Sources of financing the current account deficit in Romania (%)

Source: author's calculations based on NBR data

Nota bene: the negative sign shows the counteraction of the current account deficit, and the positive sign signifies the contribution to the current account negative balance

The main element generating the increase in net inflows of FDI was the rise in equity and investment fund shares/units until 2016, but their trend is discontinuous decrease starting with 2017. In the context of the improvement of investors' confidence in the economy, after the negative values from 2008-2014, the reinvestment of earnings has been positive and rising in 2016-2022, with a large growth in 2022. In 2023, the reinvestment of earnings has decreased after eight years of continuous increase. Starting with 2019, the reinvestment of

earnings has been higher than equity and investment fund shares/units. Debt instruments had a fluctuating balance from year to year, of lower value compared to equity and investment fund shares/units and to reinvestment of earnings in 2013-2020. But in 2021 and 2022, they became positive and they represent an important element of foreign direct investments. Although the trend of reinvestment of earnings reflects the improvement of the quality of capital inflows since 2015, the evolution of debt instruments shows that there is still a dependency on them in the structure of FDI (see chart no. 3).

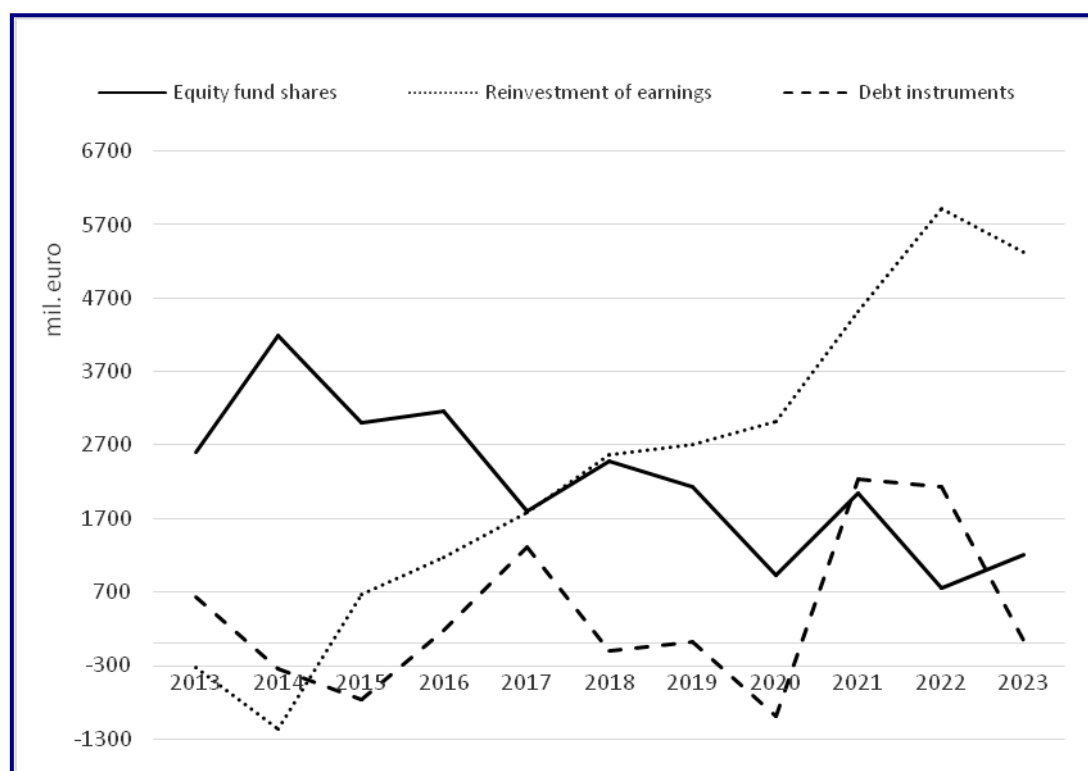


Chart no. 3. The structure of foreign direct investments in Romania

Source: NBR data

The surplus of the **Capital Transfers** account represents another autonomous source of financing the current account deficit in Romania during the analyzed period, mainly due to public administration operations, namely the non-reimbursable funds received from the European Union for fixed capital formation: the European Regional Development Fund, the Cohesion Fund, partly the European Agricultural Fund for Rural Development.

The importance of capital transfers in financing the current account deficit fluctuates during the analyzed period. Starting from 2020, Romania benefits of more non-refundable European funds for fixed capital formation, which causes the value of capital transfers to increase slightly (compared to the trend in previous years) in financing the current account deficit (see chart no. 2).

Medium and long-term external loans received increased significantly in 2007, the year of joining the European Union, and in 2009, as a result of the loans received by Romania that year from the International Monetary Fund, the World Bank and the European Union, in the context of the economic and financial crisis. In 2011, the evolution of medium and long-term external loans had a turning point. Thus, from 2011 to 2019 and in 2021, capital outflows

from our country have occurred in order to repay the medium and long-term external loans received.

In 2020, amid the uncertainty generated by the evolution of covid-19, but also by the measures adopted by the authorities with the declared aim of limiting the spread of this disease, and, due to the increase in risk aversion of private investors, another turning point has occurred in the evolution of the medium and long-term external loans, net, after 2011. Thus, in 2020 Romania has received loans from abroad, for the first time after 2010, a situation that has continued in 2022 and 2023.

It should be borne in mind that ***the increase in the external debt generates risks at the microeconomic level*** (over the Romanian banking sector and the rise in exposure to a possible external shock), but ***also at the macroeconomic level***, from the point of view of the sustainability of the external debt. The increase in external debt can cause problems through the exchange rate channel (the sudden depreciation of the national currency could lead to a significant increase in the cost of external financing), through contagion (due to an economic, political or social shock in the region), through the confidence channel (change in investor sentiment and perception leading to an increase in the risk premium and implicitly in the cost of external financing), or even through an intrinsic shock to the national economy, of a conjunctural or structural nature.

Portfolio investments represent another autonomous source of financing the current account deficit in Romania, with particular importance since 2016 (see chart no. 2).

In 2020, the portfolio investments balance had a significant annual increase (468%), representing the highest rise of this indicator since 1990. Thus, portfolio investments represented the main source of financing the current account deficit in 2020. In the period 2021-2023, the portfolio investments balance has had an increasing trend.

On the one hand, the existence of a diversified portfolio of bondholders (both by type of investor and geographically), reflects long-term confidence in the economic policies and in the development of the Romanian economy.

On the other hand, analysing the composition of portfolio investments in recent years, we find that most of them are long-term debt instruments. So, after 2020, Romania has become heavily indebted to private creditors, which implies an increase in costs, and implicitly in the risks related to the repayment and sustainability of external debt.

Throughout all the period analysed, the current account deficit has been covered in a proportion of over 50% from autonomous sources, namely through direct investments (equity fund shares and reinvested profits), capital transfers and other net inflows of the capital account, the difference being covered through government bonds and external loans.

From chart no. 2, it can be noticed that foreign direct investments, portfolio investments and capital transfers support the financing of the current account deficit. In contrast, between 2011 and 2019 and in 2021, medium and long-term loans received, net, exacerbate the external deficit; in the other years, including 2022 and 2023, external loans also concur to covering the current account deficit.

Considerations on the different types of financing the external deficit

Covering the current account deficit through external loans is a short-term solution. In the long term, this method only means postponing the settlement of the real causes that generated the deficit. In addition, by recording the payment of these credits (interest, fees) in

the debit of the income account (in the current account), the current account deficit is perpetuated in the medium and long term.

Drawing foreign direct investments can support rebalancing the balance of payments through the foreign capital injected into the economy, but also through the inflows of technology. In addition, FDI diminish the pressure on the exchange rate generated by a trade balance in deficit. This method seems to be more suitable for counteracting the external deficit, provided that the interests of foreign investors are not opposite to the interests of our country (foreign investors do not pursue profit without taking into account the legislation in force, good practice; repatriation of profits does not generate shocks on the foreign exchange market, etc.).

Accessing European funds can support the economic growth and the financing of Romania's external deficit, and European resources can support public investments, which would partially mitigate the contractionary impact of budgetary consolidation.

European funds can also be used for infrastructure development. Agriculture and tourism also benefit from special structural funds with which investments can be made to achieve European standards and progressively reduce the pressure of these sectors' deficits on the current account. In addition, there are structural funds with which the workforce can be retrained/specialized, which would make the labor market more attractive domestically for companies and stop the workforce from leaving abroad in search of a job.

Conclusions

The financing of the current account deficit has been achieved, in the analyzed period, mostly from autonomous sources, namely direct investments, capital transfers and other net inflows of the capital account, which is an element that supports the sustainability of the external deficit. The difference has been covered by portfolio investments and external loans. But the almost continuous deterioration of the current account deficit has also been accompanied by a worsening of its financing in terms of the sources structure and costs. Thus, foreign direct investments and capital transfers have diminished their importance in financing the external imbalance, and the share of external loans (starting from 2020) and portfolio investments has increased, which led to the emergence of vulnerabilities and risks in the evolution of Romania's external balance, in terms of the repayment effort and of the sustainability of the accumulated external debt. The Covid-19 crisis has concurred to accentuating this trend, in the context of rising investors' risk aversion.

Also, the weakening of global economic growth in 2022, especially in the context of the war in Ukraine and other geopolitical factors that created uncertainty and led to increased inflation (against a background of high volatility in the prices of raw materials and energy resources) led to the deterioration of financing conditions, as a result of the increase in interest rates and in risk aversion, and to the decrease of foreign direct investment inflows in 2023. In this context, there are premises that the possibilities of attracting foreign direct investments will continue to diminish both internationally as well as domestically and regionally.

Under these conditions, the rise in borrowing costs together with the increasing trend of the external debt and of the total external debt service represent risk elements for the sustainability of the Romanian economy.

The evolution of the structure of foreign direct investments since 2019 (increase in reinvestment of earnings, equity fund shares and decrease in inflows of debt instruments), shows the improvement of the quality of capital inflows since 2015 and of investors'

confidence in the economy, the diminishment of the dependence on debt instruments, and implicitly the improvement of the sustainability of the external balance financing.

Analyzing the origin of foreign direct investment inflows, we can note an increased dependence of Romania on the countries of the European Union, on the economic and political evolution of this entity.

The correlation of the current account deficit with its financing sources should be pursued, in order to stabilize and even increase non-interest financing sources (foreign direct investments and capital transfers).

Text notes

[1] The article is based on the research project "**Romania's external deficit in current domestic and international conditions**", elaborated in CFMR "Victor Slăvescu" in 2023, under the coordination of Camelia Milea, Ph.D in economics.

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