

# VULNERABILITIES AND RISKS ASSOCIATED WITH THE EVOLUTION OF THE CURRENT ACCOUNT DEFICIT IN ROMANIA. RECOMMENDATIONS FOR JOINING THE EURO AREA

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## **Abstract:**

*The article<sup>25</sup> highlights some of the causes of Romania's external deficit, as well as some economic consequences of the trend of our country's current account deficit. The persistence of risk factors and vulnerabilities for Romania's external deficit can diminish the economy's ability to adapt to internal and external shocks. The trend in the evolution of the current account deficit of our country since 2015 is a source of vulnerabilities for the sustainable development of the economy, but also for the prospect of joining the euro area. The article also presents some recommendations for overcoming the challenges caused by the evolution of Romania's foreign deficit in the perspective of joining the euro area, including improving the research and innovation capacity of the economy, and developing activities with higher added value.*

**Keywords** (3 – 5 words): foreign deficit, risks, vulnerabilities, consequences

**JEL Classification** (maximum 3 codes): F10, F15

## **INTRODUCTION**

The external deficit represents a macroeconomic imbalance caused by the relations of an economy with the rest of the world and it refers to the deficit of the balance of payments. It is determined, from a behavioral point of view, by the situation and structure of the national economy, by the external conditions and by the evolution of the currencies in which foreign trade takes place.

In our country, the external deficit is mainly caused by the negative balance of the current account.

For Romania, a country dependent on imports, but also concerned with development, consolidating the convergence is imperative in order to avoid the deterioration of the macroeconomic balances in the perspective of joining the single currency area.

Strengthening the tendency to improve the structure of goods' exports is dependent on supporting efficient activities, by attracting investments in high value-added sectors, respectively by increasing the capacity of Romanian companies to adapt to foreign market standards and cope with possible adverse developments. The large share of the involvement of multinational companies in Romania's foreign trade imposes policies that should concur to the improvement of value chains and the equilibration of imports in the fields dominated by them (e.g. trade in consumer goods).

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In the paper, it will be analyzed the period 2006-2020, in order to compare the situation from 2020 with that of the year before the integration of our country in the European Union.

## **Vulnerabilities and risks associated with the evolution of the current account deficit in Romania**

The increase in the budget deficit in recent years, in the context of an expansionary fiscal-budgetary policy, the deterioration of the current account balance, the slow pace of structural reforms, the unpredictability of public policy decisions and legislation, the migration of population, the low rate of population with high professional training, the low level of labor productivity in Romania compared to European Union countries, the high energy intensity, the increasing unit labor costs, the poor innovation capacity of the economy and the low technological achievements, the underdeveloped infrastructure and the cumbersome business environment are vulnerabilities of the Romanian economy which in the medium and long term will affect negatively the sustainable development of the Romanian economy, by maintaining and accentuating the imbalances, including the external disequilibria.

The current account deficit has widened since 2015, mainly due to a growing deficit in trade of consumer goods. The imports of consumer goods have been a major factor in the deterioration of the current account. Thus, since 2016, the imports of consumer goods have grown faster compared to the imports of other goods. In addition, despite significant external demand and an increase in the market share of exports since 2012 (excluding 2020), the growth of imports has consistently outpaced that of exports.

*The evolution of our country's current account deficit since 2015 represents a source of vulnerabilities for the sustainable development of the economy, but also for the prospect of joining the euro area.* Thus, on the one hand, a growing external deficit requires sources of financing, and in the absence of domestic capital, external financing will be used, including loans, which will increase our country's external debt. On the other hand, our country's current account deficit is at risk of exceeding the limits allowed under the procedure for macroeconomic imbalances in the European Commission's alert mechanism, in other words, Romania may become noneligible for the adoption of the euro.

Public policy measures have concurred to the accumulation of vulnerabilities in the Romanian economy in several respects. Thus, the expansionary fiscal-budgetary policy stimulated private consumption, leading to an increase in the current account deficit, by encouraging imports.

The increase in the minimum wage and in public sector wages has put growing pressure on unit labor costs. Until 2018, the impact of wage policies on cost competitiveness has been partially mitigated by a number of factors such as: increasing productivity, a slow transfer to the commercial sector of rising unit labor costs across the economy and the depreciation of the national currency. However, after a period in which the price of goods exported in national currency (measured by the deflator of goods exports) decreased (2013-2016), in 2017 the growth has resumed (by 3.5%), a trend that has continued in 2018 (4.5%).

On the other hand, the appreciation of the real exchange rate in 2017 and 2018 may have had consequences as loss of competitiveness in terms of costs and prices. But in 2019 and 2020, the real leu / euro exchange rate has depreciated, the effects being reversed.

In this context, there are concerns about the possibility of declining Romania's price competitiveness, making our country vulnerable to external shocks.

Also, the way public policy and legislative decisions have been taken in recent years have brought to the prevailing perception according to which the environment of policies' making and adoption is unpredictable and the legislation is unstable, creating new risks to the functioning of the financial sector, to international capital flows and private investment, by eroding investors' confidence.

The unfavorable demographic developments, namely the high level of labor emigration, especially of those with tertiary education and highly qualified, until 2019, as well as the lack of

relevant skills have led to a tightening of the labor market, with effects of increasing the labor cost and slowing down the production of high quality goods and services, with high added value, which can be exported at high prices, helping to improve the current account imbalance of our country.

In addition, the developments in 2020 and 2021, as a result of measures taken by the authorities at national and international level, with the stated aim of preventing the spread of covid-19, have had the effect of reducing production, and have diminished trade flows. as a result of the decrease in economic activity, leading to the worsening of the current account situation of our country.

The measures taken in the context of covid-19 could lead to the build-up of quasi-independent regional production chains, leading to shortening of supply chains, favoring the strategic use of stocks and a new approach to risks (due to insecurity in the global economy), with effects on costs, and implicitly on prices, but also on the logistics process (Milea, 2020).

In this context, the Romanian current account balance is expected to continue to deteriorate over the medium term.

According to the theory, the current account deficit influences the level of external debt. Thus, Dornbusch (1987) quantifies a relationship between the change in net external debt, the current account deficit and net capital inflows, which can be written as:

$$\Delta FD_N = CA - (K_{TL} + K_{TS}), \text{ unde}$$

$\Delta FD_N$  represents the change in net foreign debt;

CA is the current account deficit;

$K_{TL}$  are the net inflows of long-term capital (direct and portfolio investments);

$K_{TS}$  are the net inflows of short-term capital

The above relationship shows that net inflows of private capital cover partly the current account deficit. Long-term net capital inflows (direct and portfolio investments) are preponderant, followed by foreign capital inflows in the form of external loans.

In Romania, the sharp increase in the trade deficit, respectively in the current account deficit since 2014 and 2015, respectively, requires additional sources of financing. Given that the balance of foreign direct investments, net remains relatively constant in recent years (2016-2019), at a level of 4500-4900 million euros, the coverage of the external deficit will be done either through external loans or through portfolio investments<sup>26</sup>. The situation worsens significantly in 2020, when the net inflows of foreign direct investment fall to 1850 million euros, amid risk aversion of investors, in the context of the panic created by the spread of covid-19, but also due to the measures taken by the authorities to prevent people getting sick with the new coronavirus. Both forms of financing (external borrowing and portfolio investment) carry costs (interest, and dividends, respectively) and risks to economic sustainability. Although medium and long-term external debt has been declining in Romania since 2013, there has been an increase in short-term external debt since 2015. Short-term external debt is more risky than long-term external debt in terms of volatility, and affects negatively budgetary decisions of the government and its development projects. In 2019 and 2020, the total external debt has increased more compared to the previous period (2011-2018) (by 10% and 14% respectively), as a result of the larger growth in long-term external debt (25% in 2020). Short-term external debt has declined in 2020 (6.7%), after rising slightly more than the medium and long-term external debt in 2019.

On the other hand, portfolio investments involve risks: the uncertain term of supplementing financial capital resources (without guaranteeing their mobilization for productive purposes), with possible sudden and destabilizing movements - repatriations of capital -, given that they represent a financial investment and therefore they are more sensitive to changes in financial factors.

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<sup>26</sup> Portfolio investments include equity securities (participatory securities) and debt securities (bonds and money market instruments).

Foreign direct investments also involve risks. Although capital inflows as foreign direct investments may determine the appreciation of the real exchange rate of the national currency of the host country, it is considered that foreign direct investment inflows may be partially offset by imports of equipment and components required for production by foreign direct investment firms, which reduces the impact on exchange rates. On the other hand, exits in the form of repatriated profits and transfer pricing can put considerable pressure on the balance of payments, in the sense of exacerbating the external deficit, and loans by foreign direct investment firms obtained locally give rise to the risk of removing local firms from the capital market of the host country. At the same time, foreign direct investments may have a significant impact at the microeconomic level, being in the position to change the productive structure of the host country.

Among the main **external risks** to Romania's economic outlook, there are a sharp shift in global risk appetite in the context of a continued normalization of monetary policy in the European Union, as well as the occurrence of trade tensions that could lead to lower external demand. If these developments materialize, it would affect negatively foreign investments and exports, in the sense of reducing foreign investment inflows and export demand.

Another important risk for the sustainable evolution of the Romanian economy is the occurrence and implications of the new coronavirus, the way the national authorities and those in Romania's partner countries have considered necessary to act in order to prevent the spread of this disease. Thus, the measures taken by the authorities have significantly slowed down the national and global economies by shrinking production levels, household spending, investments and international trade. Trade flows have diminished as a result of declining economic activity, affecting adversely the access to essential food and medical supplies, as well as jobs, living standards, and economic activity. (Milea, 2020)

An additional stress factor on international trade in 2020 has been the (temporary) export bans and restrictions that some countries and customs territories have introduced in order to alleviate critical deficiencies in medical supplies, pharmaceuticals, medical equipment. food and toilet paper at the national level. (Milea, 2020)

The main determinant of trade contraction was the severity of business collapse, and was not necessarily correlated with the hardness of the disease, but rather with the way in which the authorities implemented quarantine measures and closure of activities. Variations in imports and exports in an economy depend not only on the severity of covid-19 in that country, but also on the evolution of the disease in most partner countries, in the context of complex interdependencies between countries. (Milea, 2020)

The authorities need to keep in mind that economic imbalances are transmitted to trading partners through trade and global value chains.

The duration and the extent of the downward trend in international trade as a result of covid-19 are still unknown.

### **Recommendations for overcoming the challenges posed by the evolution of Romania's external deficit in the perspective of joining the euro area**

Romania has an economy dependent on imports. In order to reduce the current account deficit, we consider necessary to promote the consumption of domestic products both by supporting the domestic supply of quality products with a high degree of processing and by a campaign to motivate the population and focus on Romanian goods.

To this end, we consider as useful to improve the research and innovation capacity of the economy, inclusively by increasing the expenditure for research-development-innovation, in order to support the growth of the production of high value-added goods, and which should incorporate high technology, thus favoring the qualitative and quantitative improvement of the Romanian goods in order to satisfy both the internal and the external demand. In recent years, Romania's trade balance of high-technology products has been negative.

**Table no. 1. Research and innovation performance indicators (%)**

Indicator	2013	2014	2015	2016	2017	2018
The trade balance of high-tech products as % of GDP	-1.96	-1.66	-1.75	-1.6	-1.88	-1.78

*Source: European Commission, 2020*

The transition to higher value-added activities can be stimulated by developing a coherent plan of action. Existing policies (National Competitiveness Strategy, National Research, Development and Innovation Strategy and Government Strategy for Small and Medium Enterprises Development of 2014) are poorly coordinated and do not consist of adequate measures for the progress of companies in the value chain. Non-financial measures for start-ups remain underdeveloped and existing systems (mainly financing measures) are not customer-oriented (European Commission, 2018). The combination of grants from European Union funds and financial instruments is largely unexplored.

We also consider as necessary to intensify cooperation between science and business, including through investments, in order to improve the skills acquisition process, to guide vocational education and training and higher education towards the training of skills required in the labor market. The decrease in the number of higher education graduates in science, technology, engineering and mathematics (European Commission, 2018) further limits the transfer of knowledge.

In 2018, the percentage of people with a university degree was 16%, slightly increasing compared to the previous years, and the rate of people aged 30-34 who had a university degree was 26.3%, much lower than the EU average, of 40%.

**Table no. 2. Performance indicators in education and training**

Indicator	2013	2014	2015	2016	2017	2018
Early leavers from education and training (% of population aged 18-24)	17.3	18.1	19.1	18.5	18.1	16.4

*Source: European Commission, 2020*

Romania is also facing a significant migration of specialists. Our country has one of the largest scientific diasporas of European Union countries (European Commission, 2018).

In addition, in order to support the improvement of our country's current account, it is necessary to reduce the Romanian economy's energy dependency on imports, and to mitigate energy consumption throughout the economy, in order to diminish the energy trade balance deficit, but also to obtain high quality goods with high added value that can be capitalized on export at high prices.



**Table no. 3. Green growth performance indicators**

<b>Green growth performance</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
Energy intensity (at macroeconomic level) <sup>27</sup> (Kgoe/euro)	0.27	0.24	0.23	0.22	0.21	0.21	0.2
Industry energy intensity <sup>28</sup> (Kgoe/euro)	0.16	0.15	0.14	0,14	0.13	0.12	0.12
Energy trade balance <sup>29</sup> (% of GDP)	-3	-1.9	-1.4	-0,9	-0.94	-1.3	-1.6
Share of energy-intensive industries in the economy <sup>30</sup> (% of GDP)	11.6	11.4	12	12,3	12.4	12.4	12.33
Transport energy intensity <sup>31</sup> (Kgoe/euro)	0.6	0.54	0.53	0,48	0.43	0.42	0.41
Energy import dependency <sup>32</sup> (%)	22.3	18.1	16.4	16,4	21.6	23.1	-
Aggregated supplier concentration index <sup>33</sup> (HHI)	12.4	18	16.2	21,8	29.2	26.1	-

*Source: European Commission, Eurostat, 2020*

Measures should also be taken in order to reduce and eliminate persistent legislative instability, to talk to relevant stakeholders for policy making and to evaluate ex-ante impact, with the purpose to attract investments.

Also, in order to stimulate investments, but also competitiveness, measures must be taken to improve the infrastructure both in terms of quality and quantity.

## CONCLUSIONS

A country's external deficit must be assessed not only in terms of its immediate economic effects, but also in terms of the amount borrowed in order to balance it. Thus, in the long run, it is advisable to have a tendency for equilibrium of the balance of payments. The chronicity of the external imbalance may influence negatively the domestic equilibrium of the national economy.

It is preferable that certain ways of achieving external balance should be avoided or used thriftily and cautiously. Thus, there is a limit to the volume of short-term capital that a country should import, due to the volatility of these funds, generated by their speculative nature.

In order to achieve the external balance, a mix of domestic economic policies must be adopted. Although, in theory, the equilibrium of the balance of payments can be achieved, in practice, this may be difficult due to not using the right mix of economic policies.

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<sup>27</sup> Energy intensity (at macro level) represents the ratio of a physical quantity to GDP (in 2010 prices), thus gross inland energy consumption (Europe 2020-2030) (in kgoe) divided by GDP (in EUR)

<sup>28</sup> Industry energy intensity represents the final energy consumption in industry (in kgoe) divided by gross value added of industry, including constructions (in 2010 EUR).

<sup>29</sup> Energy trade balance is the balance of exports and imports of energy, expressed as % of GDP.

<sup>30</sup> The share of energy-intensive industries in the economy is the share of gross added value of the energy-intensive industries in GDP.

<sup>31</sup> Transport energy intensity is final energy consumption of transport activity including international aviation (kgoe) divided by gross added value in transportation and storage sector (in 2010 EUR).

<sup>32</sup> The dependency on energy imports is net energy imports divided by gross domestic energy consumption inclusive the consumption of international bunker fuels.

<sup>33</sup> The aggregated supplier concentration index is Herfindahl-Hirschmann index for net imports of oil, gas and coal. Smaller values show larger diversification and hence lower risk.

In Romania, the external deficit is generated by the negative balance of the current account.

The widening of the budget deficit in recent years, in the context of an expansionary fiscal-budgetary policy, the slow pace of structural reforms, the legislative instability, the unpredictability of decision-making process, the population migration, the low rate of high-skilled population, the low level of labor productivity in Romania compared to other European Union countries, the high energy intensity, the increase in unit labor costs, the poor economic innovation capacity and the low technological achievements, the underdeveloped infrastructure and the cumbersome business environment are factors that influence negatively Romania's foreign trade, with consequences in exacerbating the current account deficit. These elements also generate risks to the functioning of the financial sector, to international capital flows, as they undermine investors' confidence. Also, the legislation of the financial sector, the privately managed pensions and the energy and telecommunications sectors could also hinder future investment opportunities and increase uncertainty, making the economy less attractive to domestic and international investors.

In addition, the persistence of these trends may reduce the economy's ability to adapt to shocks that may occur domestically or come from abroad and may affect the growing external financing needs of the economy, caused by the high and widening external deficit, by worsening borrowing conditions, and even reducing loans obtained and long-term investments.

*The trend of our country's current account deficit since 2015 is a source of vulnerabilities for the sustainable development of the economy, but also for the prospect of joining the euro area.* On the one hand, a growing external deficit requires sources of financing, and in the absence of domestic capital, external financing will be used, especially loans, which will increase Romania's external debt. The growth of the external debt makes it more difficult to obtain new loans, generates risks at the microeconomic level (especially in the banking system), as well as macroeconomic implications for the sustainability of external debt.

On the other hand, our country's current account deficit risks exceeding the limits allowed under the procedure for macroeconomic imbalances in the European Commission's alert mechanism, in other words, we are not eligible for the adoption of the euro.

The improvement of the current account balance as well as Romania's long-term economic outlook depend on the economy's ability to move from the production of relatively low-tech goods to higher value-added products and services, which requires a significant increase in financing research and innovation activities.

In addition, in order to put the economic growth on a sustainable path, we believe that it is necessary to invest in infrastructure as well. The poor quality of transportation infrastructure also undermines companies' investment decisions. Investments in energy infrastructure are also needed in order to ensure better integration into regional energy markets, as well as to support the country's energy supply.

Romania's economic growth model, based on consumer spending, affects the country's ability to achieve in a sustainable manner the standard of living in the European Union. The need to put the economy on a sustainable path towards convergence with the standard of living in the European Union requires ensuring the continuity of reforms and moving to a growth model based on investments.

The duration and the extent of the downward trend in international trade, and therefore the worsening of our country's external deficit, as well as the diminishment of financing sources of the external deficit, especially foreign direct investments, as a result of covid-19, are still unknown, but they depend on how the authorities implement quarantine measures designed to prevent the transmission of the disease.

For a speedy and vigorous recovery, fiscal, monetary and trade policies measures must converge. The adoption of protectionist measures would introduce new shocks. Keeping markets open for international trade and investments would help.

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