Romania’s external debt threats

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Abstract. The paper focuses on the sharp increase in the external debt level, both sovereign and private, threatening Romania’s financial stability, associated with weaknesses and risks arising from an unpredictable business environment and an unfavourable global and regional context. The study highlights inter-conditional ties between short-term and long-term debt, public and private debt, internal and external public debt. The increase in long-term external debt stock (more than two times during 2007-2013) has led to a significant rise in the related annual service (17.8% of GDP in 2013), deteriorating the financial framework of Romania and the growth perspectives. Excessive levels of the external indebtedness and critical debt-to-GDP ratio are recorded in the case of Romania as compared to international standards and national specific, exposing the debt position to higher default risk. Despite large external borrowings, due to the lack of their efficiency, the results, in terms of economic development and competitiveness gains, are much below expectations. The easiness of appeal to external borrowings by successive governments and the debt rollover year by year contradicts the principle of intergenerational ethics.

Key words: global crisis; external debt sustainability; macroeconomic efficiency; vulnerabilities of external debt; sovereign risk.
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1. Introduction

The study of the external debt level and sustainability has become crucial under the circumstances of the ongoing global crisis, which has affected the sovereign risk at international and European level.

If in the past, approaching this issue was specific to developing countries, the international financial crisis triggered a shock on public indebtedness level in advanced countries, deteriorating their financial strength, sometimes beyond their repayment capacity.

The internal and external financial framework of Romania became increasingly imbalanced in recent years by budget and current account deficits accumulation, covered by sovereign and private borrowing, including post-crisis financial assistance from the IMF and EU, which has led to an accelerated growth of domestic and external indebtedness.

In the case of Romania the external debtor position is more risky, showing a major dependence on external financing, including for the debt service payments, and putting under continuous pressures the budget deficit, the fiscal regime, the foreign currency market and the exchange rate of the national currency.

It is obvious that loans, both sovereign and of the private sector should be oriented to meet financing needs, particularly in activities of vital importance for the national economy (mostly in primary and secondary sectors) and less in tertiary sector, frequently dominated by pseudo-tertiarization or speculative tendencies.

We think that foreign borrowings should necessarily be founded in a comprehensive and sustainable manner, especially in terms of economic and social efficiency, technological advance and sustainable development on different time horizons, so that, on this basis, the future funding sources for debt repayments to be achieved and strengthened.

The current level of Romania's external indebtedness is affecting the investment capacity, implicitly the sustainable economic growth, and the chronic trade balance deficit deprives the national economy of foreign currency, partially diverted for due debt repayments.

The high degree of external debt, public and private, increasing vulnerabilities associated with an unpredictable domestic business environment, dominated by foreign capital and a high level of taxation, presumably to become even more constrictive, are likely to lead to the deterioration of debt sustainability, hindering the Romanian economy attractiveness for foreign investments, both on short and long term.

2. The issue of external debt sustainability in international and European debates

Under the circumstances of persistent uncertainty regarding the global economic trends and the volatility on financial markets, the approach of external debt issues is constantly changing, including due to increasing global markets interconnectedness and contagion effects risks, its analyse proving to be crucial for restoring the international financial balances.

Globally, having in view that high debt levels threatens the growth prospects, under the debt sustainability analysis (DSA) approach, the international financial institutions, mainly the IMF (2012, 2014a), are considering an unified framework for limits (ceilings) setting up regarding the sovereign debt (domestic and external, public and publicly guaranteed) for all countries, including for advanced market economy countries (IMF, 2013a, b).

According to the new approach of sovereign risk, the assessment of public debt sustainability have to pay more attention to the national particular issues i.e. the ability to generate primary surpluses of the budgetary balance, the capacity of compliance with the debt service, the prospects for the economic growth and for the taxation level, the costs of deficit financing on international capital markets, the health of the banking system, the vulnerability to external shocks.

At European level, due to the banking system bailouts financed by public funds in 2009-2010 and to the global crisis persistence which has widened the budgetary imbalances, the EU countries have adopted austerity programs imposing severe fiscal constraints, generating tensions, both economic and social, hindering the post-crisis economic recovery and thus affecting their debt repayment capacity, despite this, some of them entering default, as happened in the case of Greece.

Stressing the importance of real GDP growth, borrowing costs, non-standard revenues and expenditures (bank bailouts and privatization) and primary balance, Darvas et al. (2014), by simulating the public debt-to-GDP ratios up to 2030 for several highly indebted European countries and taking into account the major risks of the resulted debt trajectory, have advised a new financial assistance program for Greece, which remained vulnerable to external shocks. Indeed, at the end of October 2014, the European Commission and the IMF have discussed about concluding a precautionary agreement for another financial assistance package for Greece, taking into account the predictable effects of fiscal and pension reforms (IMF, 2014b).

The world experience has shown that there is not a unique level at which the public debt prove to be unsustainable and also, in the economic literature, there is no consensus regarding a sustainability benchmark for a certain debt-to-GDP ratio (Reinhart and Rogoff, 2009, Austin and Levit, 2008, Albu, 2008).

Some authors (Cecchetti et al., 2011) using a database for 18 OECD member countries tried to assess the benchmarks at which debt positive effects turns into negative ones, concluding that when the public debt is in the range of 85%, a further increase is leading to significant reduction of trend growth.

Measuring the debt sustainability as difference between the debt stabilizing primary balance and the primary balance, Belhocine and Dell'Erba (2013), using a standard regression model applied to a panel of 26 emerging market economies found that a level above 45% of public debt-to-DGP ratio could doubling the bond spreads on international capital markets, which mean a sharp increase in borrowing costs.

The approach of debt sustainability should not be limited to the public debt. As concerns the private external debt, it is recognized that balance of payments crisis can also arise from the increase of corporate, households and banking debt, with increased contagion risks on public debt (Austin, 2008).

A study of European Central Bank on corporate indebtedness (ECB, 2012) showed also that a substantial level of non-financial corporation debt remain a source of vulnerability, particularly to the risks associated with increased costs of debt financing.

Along with the public debt limiting issue at national level, the international debate around debt sustainability should include, as a priority, finding a large consensus regarding the status of sovereign debt, in order to avoid payments default cases at the state level or to take internationally accepted legal actions for addressing situations like sovereign insolvency.

The debate should start with clearly (re)defining basic concepts regarding the matter of sovereign debt as jurisdiction, accountability, enforceability, warning levels and ceilings, government bonds issues under national/foreign laws, budget deficit and primary balance, sovereign credit rating, sovereign default, contagion effects etc. and the related procedures/methodologies for enforcement/assessment.

Following the recent case of Argentina, downgraded to default by the rating agencies despite having the capacity to meet its payment obligations and contrary to repayments agreements with creditors from other countries, including members of Paris Club, highlighted a paradox: due to different clauses and treatment of sovereign debt and government bonds issues at international level, it may happen that foreign judicial systems decide upon the debt repayment (or restructuring) terms against a certain state.

The recent resolution of UN General Assembly on sovereign debt restructuring towards the establishment of a multilateral legal framework, introduced by the Group of 77 developing countries and China, at the initiative of Argentina, has been approved with more than two-thirds majority, emphasizing the importance of the question, including for maintenance of the international economic security and revealing its global dimension.

In our opinion, the major lesson to be learned after the crisis of 2008-2009 and the recent experience of Argentina is that each nation must ensure, in its own way, the strength of the internal and external financial framework, a strong competitive economy, a performing management of the public sector, with a functional market economy and a transparent and efficient business environment.

3. The deterioration of Romania's external debt position over the period 2007-2013

The situation of Romania's external indebtedness witnessed a significant deterioration during the post accession period, endangering the financial stability of the country. The total external debt of Romania recorded a sharp increase, from 58.6 billion EUR in 2007 to 96.1 billion EUR in 2013, in the last year slightly down compared to the previous year (Table 1).

By maturity, while the short-term external debt ranged around EUR 22 billion during the considered period, the long-term external debt recorded a continuous growth, doubling from EUR 38.5 billion in 2007 to 76.8 billion EUR in 2013.

The breakdown by sectors shows differences between the much more accelerated growth of the public debt (including publicly-guaranteed debt and IMF loans), i.e. around 3.5 times during 2007-2013, compared to around 1.5 times increase in the private debt.

It is worth mentioning that the sharp increase in the external public debt has been driven, under the circumstances of dramatic effects on the Romanian economy incurred from the global crisis, by the emergency financial assistance from the IMF and EU, granted, given the context of major risks concerning the balance of external payments occurred in the spring of 2009, amounting to EUR 20 billion.

Table 1

Total external debt breakdown by maturity and sectors

- EUR million -

Total external debt	2007	2008	2009	2010	2011	2012	2013
I. Long-term external debt	38,526	51,762	65,616	72,909	75,929	78,760	76,894
I.1. Public external debt*	10,197	10,749	19,057	26,948	31,312	33,833	34,284
I.2. Private external debt**	28,329	41,013	46,559	45,961	44,617	44,927	42,610
II. Short-term external debt	20,103	20,592	15,589	19,549	22,795	20,921	19,166
Total external debt (I+II)	58,629	72,354	81,205	92,458	98,724	99,681	96,060

* including publicly-guaranteed debt and loans from IMF
** including deposits of non-residents
Source: National Bank of Romania, Interactive database. For I.1. and I.2., own calculations based on NBR data.

Other pressures on the public debt situation, mainly in foreign currency, through the issuance of government bonds on international financial markets in order to meet the country financial obligations (debt servicing and fiscal deficit financing) were added later.

Examining the gross external debt breakdown by debtor type (Table 2), it can be seen a total reversal in positions. The Romanian authorities (Government and Monetary Authority), starting from a minor position in 2007 (16.7% of total external debt), became the main debtor in 2013, holding more than 35% of total external debt. While the share of non-financial sector, including inter-company direct investments did not recorded significant changes, the banking sector, dominated by foreign capital, even if more involved in government bonds purchasing, suffered the severe contraction of lending and of the withdrawal of credit lines from the part of parent banks, going down from the position of main debtor in 2007 (33.2% of total external debt) into the smallest one in 2013, holding only 18.2% of total external debt.

Table 2

Total external debt breakdown by debtor type

Year	Total external debt (EUR million)	out of which (%): (total external debt =100.00)				
		Government	Monetary Authority	Banks	Other Sectors	Inter-company direct investments
2013	96,060	30.54	4.91	18.21	24.10	22.24
2012	99,681	25.63	8.74	20.81	24.20	20.62
2011	98,724	22.58	10.42	23.09	24.60	19.31
2010	92,458	20.04	9.85	24.55	26.27	19.29
2009	81,205	16.73	7.10	26.46	31.06	18.65
2008	72,354	14.17	0.42	34.31	30.92	20.18
2007	58,629	16.43	0.25	33.19	29.78	20.36

Source: NBR, Interactive database

4. Vulnerabilities of Romania's external debt position

The growing gap between the external indebtedness and the economic growth has significantly deteriorated the efficiency of foreign borrowings utilization, weakening Romania's financial resilience to external shocks, increasing vulnerabilities and risks associated to sovereign debt sustainability (Zaman and Georgescu, 2012).

In real terms, comparing to an annual average of around 2% the GDP growth rate during 2007-2013, the gross external debt increased 4 times faster and, as concerns the long-term external debt, even 6 times faster. If, in 2007, for 1 EUR long-term external debt were returned 3.15 EUR of GDP, in 2013 the figure declined to 1.85 EUR i.e. 41 percent less (Table 3). The annuity related to long-term external debt accounted for more than 17% of GDP in 2013 as against 7% in 2007 and, compared to exports of goods and services, increased from 23% to 42% during this period. The deterioration of international financial position of Romania is also revealed by the ratio of long-term external debt service to FX reserves (excluding gold), which has increased from 33.6% in 2007 to 77.8% in 2013.

Table 3

External debt vulnerability indicators*

Indicators	2007	2008	2009	2010	2011	2012	2013
GDP/Gross ED	2.07	1.93	1.43	1.35	1.33	1.32	1.48
GDP/LTED	3.15	2.70	1.76	1.71	1.73	1.67	1.85
GDP/ LTED public	11.90	13.00	6.08	4.62	4.20	3.90	4.15
GDP/ LTED private	4.28	3.41	2.49	2.71	2.95	2.93	3.34
LTED service (% in G&S exports)	23.35	30.82	34.07	33.41	28.76	34.95	42.24
LTED service (% in GDP)	7.01	9.38	10.61	11.82	11.49	14.19	17.79
LTED service (% in FX)	33.59	50.13	45.02	46.46	46.12	60.14	77.85

***Note**: ED - External Debt; LTED - Long Term External Debt; G&S -Goods and Services; FX - Foreign Exchange Reserves (without gold)

Source: Own calculations based on National Bank of Romania and National Commission for Prognosis data

Despite the recent entry of external debt on a downward trend, the last report regarding the financial stability published by the National Bank of Romania (NBR, 2014) draws attention on the persistence of several vulnerabilities regarding both main components, public and private.

The increased presence of non-resident investors purchasing financial instruments issued by the Romanian government (in national currency and EUR) could make vulnerable the debt repayments to the changes in market sentiment and risk perception. Another vulnerability of the public external debt is generated by the reduced capability of the government to cover possible additional financing needs, given the persistence of the low level of budgetary revenues (compared to GDP).

The increased exposure of banks to the public sector carries a potential risk of eviction in the case of the credit demand recovery, including from the part of non-financial companies. The persistence of high dependence on external financing and the increased levels of debt service could expose the sovereign debt to currency exchange rate risk.

The private external debt remained concentrated in vulnerable sectors, companies in the real estate sector continuing to hold a significant proportion (almost one third) of external debt contracted by the non-financial sector. The deterioration of the ability of external indebted companies to cope with adverse economic developments could affect, mainly by the trade channel, the real sector and implicitly, the sources of foreign exchange earnings.

In fact, the major threat to the financial stability of Romania arises from the chronic vicious circle fuelled by the rollover of due debt repayments to the expense of investment expenditures, diminishing the potential development and slowing the GDP growth rate, which hinder the recovery of external debt sustainability.

5. The external debt during the first nine months of 2014 and perspectives in the medium term

The balance of payments current account of Romania (see Table 4), compiled in accordance with the new IMF methodological standards (BPM6) recorded a deficit of EUR 558 million in January-September 2014 compared to EUR 412 million in the same period of 2013, mainly due to the deficit increase in the primary income balance (by EUR 744 million) and to the surplus decrease in the secondary income balance (by EUR 305 million).

According to NBR estimates, direct investments of non-residents in Romania reached a value of EUR 1,522 million in the first nine months of 2014, of which equity stakes (including reinvested earnings) amounted to EUR 1.34 billion and intra-group loans to EUR 171 million.

Data from Table 4 show that, both in 2013 and 2014, the tourism - travel services and the primary income balance have adversely affected the current account situation. The trade balance deficit, which has become chronic, still burdens Romania's external balance of payments.

Table 4

Balance of payments current account over the period 1.01–30.09.2014

- EUR million. -

	Jan. – Sept. 2013			Jan. – Sept. 2014		
	CREDIT	**DEBIT**	**BALANCE**	**CREDIT**	**DEBIT**	**BALANCE**
CURRENT ACCOUNT (A+B+C)	**47,884**	**48,296**	**-412**	**51,349**	**51,907**	**-558**
A. Goods and services	**42,008**	**42,496**	**-448**	**45,679**	**45,264**	**415**
a. Goods	**32,280**	**36,235**	**-3,955**	**34,683**	**38,585**	**-3,902**
b. Services	**9,728**	**6,261**	**3,467**	**10,996**	**6,679**	**4,317**
- manufacturing services on phisical inputs owned by others	**1,654**	**110**	**1,544**	**1,918**	**117**	**1,801**
- transport	**2,823**	**1,011**	**1,812**	**3,205**	**1,154**	**2,051**
- tourism - travel	**852**	**1,082**	**-230**	**998**	**1,251**	**-253**
- other services	**4,399**	**4,058**	**341**	**4,875**	**4,157**	**718**
B. Primary income	**2,071**	**3,619**	**-1,548**	**2,241**	**4,533**	**-2,292**
C. Secondary income	**3,805**	**2,181**	**1,624**	**3,429**	**2,110**	**1,319**

Source: NBR data

The long-term external debt amounted to EUR 77.4 billion on September 30, 2014 (80.7% of total external debt), down 1.9% compared to the end of 2013. The short-term external debt stood at EUR 18.5 billion i.e. 19.3% of total external debt, lower by 3.7% compared to the end of 2013 (see Table 5). The long-term external debt service ratio to exports of goods and services was 35.9% in the period January-September 2014 compared to 42.9% in 2013. The coverage of international reserves stood at 6.8 months of imports of goods and services on 30 September 2014 against 7.3 months at end of 2013.

As regards developments of the long-term external debt over the considered period, a modest reduction has been observed, as in the case of short-term external debt. The external debt service through January to September 30, 2014 totalized EUR 37.7 billion, of which EUR 21.3 billion on short-term, an amount whose level in undoubtedly burdensome.

Table 5

Romania's external debt over the period 1.01 – 30.09.2014

- EUR million -

	External debt		**External debt service**
	End of 2013	**End Sept.2014**	**Jan. – Sept. 2014**
I. Long-term external debt	**78,860**	**77,397**	**16,399**
I.1. Public debt	**30,294**	**31,617**	**5,275**
I.1.1. Direct public debt, of which:	**29,069**	**30,493**	**5,146**
I.1.1.1. Loans from the IMF	**1,121**	**320**	**844**
I.1.2. Publicly guaranteed debt	**1,225**	**1,124**	**129**
I.2. Non-publicly guaranteed debt, of which:	**42,756**	**42,717**	**8,142**
I.2.1. Deposits of non-residents	**6,453**	**6,067**	**1,660**
I.3. Debt of the monetary authority, of which:	**5,810**	**3,063**	**2,982**
I.3.1. Loans from the IMF	**4,708**	**1,904**	**2,982**
I.3.2. Allocations of SDRs	**1,102**	**1,159**	**0**
II. Short-term external debt	**19,209**	**18,499**	**21,363**
Total external debt (I+II)	**98,069**	**95,896**	**37,762**

Source: NBR data

But the most worrying is that both, reimbursements of external debt and its service have not preoccupied the policy makers as concerns ensuring sustainable funding sources. We believe that the appeal to new borrowings cannot be a convenient option because it would mean a further increase in external debt burden passed on to future generations. In addition, it would constitute a mitigating factor Romania's investment capacity in the future.

Therefore, a serious analysis of sustainable sources for external debt repayments in the short, medium and long term have become of vital importance. Basically, talking about sustainability, in the end, it will depend on the economic and social efficiency of borrowed money.

Regarding the external debt service, the short-term debt service accounting for 56.5% of the total debt service represents a particularly sensitive challenge that the Romanian economy will have to face. No less reassuring is the fact that the long-term external debt service accounts for 43.5% in the total debt service.

For the next period, during 2015-2017, according to the Convergence Programme of the Romanian Government, one of the priorities is to strengthen the public finances quality and, in this context, to increase the share of budget deficit financing from domestic sources (government bonds), reducing the public debt exposure to currency risk. In accordance with the provisions of the EU fiscal compact agreement (Directive 85/2011 and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) new numerical fiscal rules on public debt and prudential intermediate thresholds, including automatic action if exceeded, have been introduced, as follows:

a) if the debt-to-GDP ratio stands in the range of 45% to 50%, the Ministry of Public Finances will submit to the Government a report on the debt increases reasons, formulating proposals for maintaining this indicator to a sustainable level;

b) if the debt-to-GDP ratio stands in the range of 50% to 55% a program to reduce this ratio enters into force, freezing the public sector wages being the first measure undertaken;

c) if the debt-to-GDP ratio stands in the range of 55%-60%, in addition to the measures in paragraph b), measures to determine the freezing of total expenditures on social assistance in the public system are initiated.

In our opinion, this vision regarding the treatment and management of public debt sustainability is mistaken in at least two ways:

- on the one hand, it is unilateral, only referring to measures affecting budgetary expenditures side, socially high sensitive (freezing wages and social assistance), not considering measures to increase budget revenues;
- on the other hand, it assumes the impossibility of predicting and preventing the increase of debt-to-GDP ratio, given that, the current level of public debt (42.5% of GDP at the end of 2013, including state guarantees, according to national methodology) stands already at an unsustainable level, which requires the refinancing of its annual service.

Therefore, in order to ensure the public debt sustainability it would be of highest urgency and importance to concede a maximum threshold of 40% for debt-to-GDP ratio and, starting with 2015, to enforce a compulsory report with a statement of reasons for any increase in debt, under total transparency circumstances, including proposals to maintain this indicator below this threshold.

Moreover, from the data presented in the Convergence Program, follows that the Romanian Government foresees a gradual decline in the debt-to-GDP ratio in the period 2014-2017 from 39.9% to 38.5% with a GDP growth rate between 2.5% and 3.3% over the period (Table 6). This optimistic trend is contradicted by the recent forecast of the European Commission, which, in addition to more moderate growth rates of GDP, predicts an increase in the debt-to-GDP ratio from 39.4% in 2014 to 41.1% in 2016 (according to the EU methodology, not including state guarantees).

Table 6

Medium-term perspectives for economic growth and public debt

	EU Forecast			**Convergence program**			
	2014	**2015**	**2016**	**2014**	**2015**	**2016**	**2017**
GDP growth (%)	**2.0**	**2.4**	**2.8**	**2.5**	**2.6**	**3.0**	**3.3**
Public debt* (% in GDP)	**39.4**	**40.4**	**41.1**	**39.9**	**39.6**	**39.1**	**38.5**

* According to EU methodology (excluding state guarantees)
Source: *European Economic Forecast Autumn 2014*, European Economy 7, E.C., p. 103; *Convergence Program 2014-2017*, Romanian Government, April 2014, p. 62.

6. Concluding remarks

The study has found increasing levels of Romania's external indebtedness, more pronounced regarding the long-term debt, almost doubled over the period 2007-2013. The calculation of debt vulnerability indicators for Romania, in line with the existing international metric, has revealed that many of them are already at critical levels as concerns the external indebtedness and the debt service.

It became obvious that recovering the external debt sustainability requires a coherent strategy in this area, based on an approach decoupled from political and electoral circumstances, often marked by short-term interests of governments that show insufficient or totally lack of interest related to the effects of foreign borrowings in the long-term, contrary to the principle of intergenerational equity.

Challenged by high levels of the external debt service, persistence of economic vulnerabilities, lack of export diversification, low absorption of European structural funds that could cover partially the external financing needs, high exposure to interest rates variations on international capital markets, Romania could face serious difficulties in complying with due external debt obligations, both for public and private sectors.

In order to increase Romania’s debt sustainability on short, medium and long-term, a set of factors can be activated for ensuring the debt repayment sources, aimed at reducing the trade balance deficit, mainly by supporting exports’ increase and diversification, increasing the impact of foreign direct investments and of the related reinvested profits, improving the structure of the banking sector by a larger market share of banks with Romanian majority capital, reducing interest rates for financing investments, increasing employment in sectors which generate high value added in the context of promoting new industrial policies.

The analysis of vulnerabilities and risks that threaten the sustainability of Romania’s external debt on short, medium and long-term highlighted the importance of debt thresholds setting up specific to our country and of limiting the public borrowings through annual ceilings approved by the Parliament.

Looking at the future, despite the decline in the external indebtedness expected for the next years in Romania under the agreements with IMF and EU, unpredictable events and the persistence of the global crisis impact may hinder the macroeconomic sustainable recovery, threatening the financial stability of the country. The predictability of the fiscal regime and the business environment are still under the threat of hangover effects, being expected higher taxes in the attempt to increase the budgetary revenues, including for complying with debt repayments obligations.

The return into recession of some advanced EU countries in 2014 is supposed to have an adverse impact also on the Romanian economy and implicitly on its external debt sustainability.

Future research should focus on other external debt determinants (remittances, taxation, quality of policies and of public administration, public investments etc.) and on deepening the analysis in terms of more accurate assessment of foreign borrowings effectiveness according to positive and negative externalities they generate, the possibilities and opportunities of optimal ratio between internal and external debt, public and private, as well as Romania's repayment capacity on different time horizons.

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