# 6 CURRENT ACCOUNT DEFICITS AND IMPLICATIONS ON COUNTRY RISK OF ROMANIA

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## Abstract

This study focuses on the implications of current account deficit upon the external debt increase in Romania, revealing higher risks for the sustainability of its international financial position. Considering the trade deficit as a main cause of current account balance deterioration, several exports weaknesses are pointed out, mostly resulted from neglecting both slowing IPT flows and growing FDI stock adverse effects. Under the circumstances of diminishing contribution of compensatory flows to the current account deficit coverage, an increasing share of autonomous flows is expected. But an excessive rise in the long-term external debt, including its service level, could have negative effects on Romania's country rating, i.e. on the external financing costs and borrowing ceiling of the international capital markets. For preventing a possible financial turmoil turning into a "hard landing" of the economy the Romanian, firstly by admitting the risks occurring from current account deficits and accelerated debt accumulation, by sound monetary and fiscal policies, promoting structural reform and exports.


**Key Words:** Foreign Trade, Foreign Direct Investments, Current Account, Balance of Payments, External debt, Economic Growth, Country Risk

**JEL Classification:** E-20, E-22, F14, F21, F36, F43, G38

## 1. Introduction

The current account deficit is becoming a growing concern for the Romanian economy's prospects, holding the attention also of the international financial institutions and rating agencies. The increasing macroeconomic risks following the current account sharp deterioration in recent years could heavily affect the external position of Romania and its development outlook in the long run.

Having the knowledge of Romanian economy structural design and according to the lesson of the Central European countries admitted into the EU in 2004, the actual

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magnitude of the current account deficit has been foreseeable. Nevertheless, the policy-makers have proved a lack of adequate capability of receiving and processing the signals generated by constant surpassing of the warning level for this indicator (5-6 percent of GDP, according to the international financial institutions standards) in the last years (see Table 1).

**Table 1**

| | 2003 | 2004 | 2005 | 2006 | 2007* |
|---|---|---|---|---|---|
| Current account deficit (EUR million) | 3060 | 5099 | 6888 | 9973 | 13350 |
| Percent of GDP (%) | 6.0 | 8.4 | 8.7 | 10.3 | 11.5 |

**The Projection of Main Macroeconomic Indicators for 2007-2013 (Autumn Forecast), Romanian National Commission for Prognosis (EU Commission forecast for 2007 stand at 12.1%).*

## 2. Under-savings versus excessive consumption

Considered as a balance of aggregate savings and investments, the current account deficit reflects the partial coverage of the economy's functioning and development needs by external financing. Theoretically, this could occur, even for a long time during a transition period, but the paradox of Romania is that, instead of a relative decrease in the external financing following the investment positive returns, after 17 years an opposite trend is revealed. That means either not enough restructuring, or its misleading, or, more probable, a residual combination of the two. Besides, an almost unfavourable international context and inherent transition adverse costs, the Romania's external financial position has continuously been under the pressure of its economy radical defaults, originated in the 1960's-1970's, alongside with "socialist industrialisation" on an extensive scale. Among these, the most essential has been the dependence of industrial structures on energy and raw materials from abroad, which created a high elasticity of GDP growth to such imports increase, in the meantime, recording much higher external prices. At the beginning of the 1990's, mainly due to the dismantlement of intra-trade system of ex-communist countries (CAEM), the obsolete technologies of Romania's economy, the dominant share of energy-intensive sectors and the lack of external competitiveness became obvious. Given the structural rigidities and the absence of fundamental changes during the transition to the market economy, transforming Romania into a country which yields its comparative advantages in the era of globalisation has proved to be impossible. The low level of the gross saving rate (around 15 percent in the last years, below the average for other Central-European countries) and the excessive growth of consumption, fuelled by non- government credit expansion (households in particular), also explain, from this point of view, the recent sharp deterioration of the current account balance (See National Bank of Romania, *Financial Stability Report*, 2007).

## 3. Higher trade deficits leading to external imbalance

An analytic view of the current account components (see Table, 2) reveals the main source of its imbalance, i.e. the trade deficit, which went up by EUR 4 billion in 2006, more than 50 percent compared with 2005. The increase of current transfers surplus (mainly remittances from Romanians working abroad) by EUR 1.2 billion could not compensate the current account deterioration, because also of income balance worsening (mainly reinvested profits and dividends repatriated by the foreign investors).

**Table 2**

*- EUR million -*

| | 2005 | | | 2006 | | |
|---|---|---|---|---|---|---|
| | Credit | Debit | Net | Credit | Debit | Net |
| CURRENT ACCOUNT (A + B + C) | 31,680 | 38,580 | -6,888 | 38,621 | 48,594 | -9,973 |
| A. Goods and services (a + b) | 26,357 | 34,512 | -8,155 | 31,363 | 43,116 | -11,753 |
| a. Goods (exports FOB - imports FOB) | 22,255 | 30,061 | -7,806 | 25,850 | 37,609 | -11,759 |
| b. Services | 4,102 | 4,451 | -349 | 5,513 | 5,507 | 6 |
| - transport | 1,188 | 1,583 | -395 | 1,489 | 1,913 | -424 |
| - tourism – travel | 852 | 750 | 102 | 1,034 | 1,035 | -1 |
| - other | 2,062 | 2,118 | -56 | 2,990 | 2,559 | 431 |
| B. Incomes | 1,241 | 3,567 | -2,326 | 1,776 | 4,790 | -3,014 |
| C. Current Transfers | 4,082 | 489 | 3,593 | 5,482 | 688 | 4,794 |

*Source: National Bank of Romania.*

It is worth mentioning that the trade deficit increase has taken place under the circumstances of a higher growth rate of imports (25 percent) than exports (16 percent) and of the national currency real appreciation against the euro (more than 10 percent). Considering the weakness of exports as the main factor of growing trade and current account deficits, the impact of IPT (Inward Processing Trade) has to be underlined (for more topic see, by the same author, *Inward Processing Trade and Implications for the Balance of Payments Current Account*, Romanian Journal of Economic Forecasting, Vol.1/2006).

The international trade data, on custom regime, during 2002-2006 (see Table 3) and the separation of IPT flows (goods which are not subject to Romanian companies' property or influence upon the final market destination) point out the critical state of trade balance: the real trade deficit almost tripled in the last five years, soaring to EUR 18.5 billion in 2006. The real external receipts from domestic products exports (EUR 14.2 billion) to which revenues from IPT (EUR 3.6 billion) is to be added, stood at half of the final imports payments (EUR 32.7 billion). We emphasize that the so-called total exports value of EUR 25.8 billion includes a nominal value of around EUR 8 billion – statistically registered for custom procedures only – representing the value of temporary imported goods, then domestically processed and re-exported by the Romanian companies under IPT regime. Lately, IPT flows entered a slowing trend, which is supposed to become more accentuated, having in view the diminishing comparative advantages of Romania.

**Table 3**

*- EUR billion -*

| | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|
| TOTAL EXPORTS (FOB) | 14.7 | 15.6 | 18.9 | 22.3 | 25.8 |
| Final exports | 6.5 | 6.9 | 9.0 | 11.6 | 14.2 |
| Exports after IPT | 8.2 | 8.7 | 9.9 | 10.7 | 11.6 |
| TOTAL IMPORTS (CIF) | 18.9 | 21.2 | 26.3 | 32.6 | 40.7 |
| Final imports* | 12.9 | 14.8 | 19.5 | 25.1 | 32.7 |
| Imports for IPT | 6.0 | 6.4 | 6.8 | 7.5 | 8.0 |
| TRADE DEFICIT (FOB-CIF) | | | | | |
| Total (apparent) | -4.2 | -5.6 | -7.4 | -10.3 | -14.9 |
| Real (adjusted | -6.4 | -7.9 | -10.5 | -13.5 | -18.5 |
| Revenues from IPT | 2.2 | 2.3 | 3.1 | 3.2 | 3.6 |

***** *Goods in financial leasing included.*

*Source: Romanian National Institute of Statistics.*

More dramatic for the Romanian exports is that among 17 product Sections (NC-HS classification) only 3 still recorded trade surpluses (Textiles and articles thereof, EUR 0.8 billion; Footwear, EUR 1 billion;  Wood and wood items, EUR 0.5 billion), those continuously decreasing also in the last years, while the other product sections pointed deficits (out of which: Mechanical and electrical equipment, EUR 4.6 billion; Mineral products, EUR 3.3 billion; Transport means, EUR 2.2 billion; Chemical products, EUR 2.1 billion; Plastics an rubber articles thereof, EUR 1.5 billion; Agri-food products, EUR 1 billion). The trade balance of the section “Metals” and articles thereof, traditionally in surplus, for the first time in 2006, registered a deficit, mainly due to the decreasing of pig-iron, iron and steel exports.

The structural nature of trade deficit is also revealed by the majority quota held by items having low technological level (minerals, chemicals, basic metals, wood, clothes, footwear) which accounted for around two thirds of the total final exports in 2006. In our opinion, the assertion concerning a significant structural improvement of exports - as acknowledged in the National Institute of Statistics’ Press Release regarding Romania’s international trade in 2006 – by the passage of Mechanical and electrical equipment on the first position in the product sections top (20.3 percent of total exports) is profoundly mistaken. Instead of EUR 5.2 billion, an apparent value of mechanical and electrical products, the real exports of such commodities came in only to EUR 2.2 billion, the remainder of EUR 3 billion representing in fact exports after IPT (out of which imports for IPT of EUR 2 billion nominal value, the revenues from this domestic processing amounting only to EUR 1 billion).

Even if in a market economy the policy makers have limited control and decision means, it should be emphasised that the trade balance worsening occurred under the circumstances of Romania’s confused development strategy, lacking in a possible focus on exports, incoherent economic policies - fiscal, monetary, foreign trade –, of inadequate EU accession preparing, which created adverse costs ex-ante and ex-post, of insufficient exports support by external promotion and financial incentives. Not even Foreign Affaires policies were of too much help, their almost exclusive Euro-Atlantic position depriving them of a global vision on world market development and neglecting essential destinations as Russia and Asia, which are, not accidentally, concentrating the most part of trade deficits.

## 4. Adverse lagging effect of the FDI stock accumulation

While the strong effect of trade balance deterioration on the current account worsening is enough visible, the implications of direct investments are less perceived and examined, at least in Romania. Obviously, the inflows of FDI are supposed to provide, mainly through technology transfer, prerequisites for economy's performances increase and for productivity improvement. In some cases, this evidence has to be seen cautiously, considering for instance that privatization of some state entities represents a disinvestment, substituting in fact the shareholder (in the case of Romania, mostly by attracting FDI), without immediate effect on technological changes, supposed to come further, following other possible investments.

Initially, when the FDI stock is relatively small, an unimportant monetary impact on a country external financial position occurs. While FDI stock increases, by profit re-investing included, it has growing effects on the current account balance. Moreover, due to the comparative advantages erosion, the annual FDI inflows could enter a downward trend, while the FDI stock continues to accumulate. The Balance of Payments is therefore suffering a double pressure from the monetary flows related to FDI, on different tiers but in the same direction. On the one hand, the increasing debit of incomes balance is affecting the current account and, on the other hand, the diminishing credit of direct investments is affecting the capital and financial account. This could create more difficulties for the BoP balancing i.e. through growing external indebtedness, which is worsening the parameters of international investment position of Romania, potentially affecting its sovereign rating and subsequently the external financing costs and borrowing ceilings. It has to be recognized that, paradoxically, besides their positive effects, the foreign direct investments are inducing a latent financial instability which, under certain conditions (a massive and rapid migration of FDI for instance, accompanied by portfolio investments and speculative capital outflow), could lead to a dramatic financial turmoil.

**Table 4**

*- EUR Million -*

| | | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|
| Current account balance (net) | Czech Rep. | -4,426 | -5,043 | -5,245 | -2,070 | -4,719 |
| | Poland | -5,399 | -4,108 | -8,670 | -4,130 | -6,273 |
| | Hungary | -4,929 | -5,933 | -6,916 | -6,091 | -5,197 |
| | ROMANIA | -1,623 | -3,060 | -5,099 | -6,888 | -9,973 |
| Incomes balance (net) | Czech Rep. | -3,752 | -3,764 | -4,945 | -4,778 | -6,472 |
| | Poland | -1,992 | -3,204 | -9,264 | -9,001 | -10,649 |
| | Hungary | -3,838 | -3,678 | -4,935 | -5,530 | -6,083 |
| | ROMANIA | -488 | -1,195 | -2,535 | -2,326 | -3,014 |

*Source: National statistics of central banks.*

Comparing the current account and incomes balance in Romania with some other countries recently admitted into the EU (see Table 4) similar symptoms become obvious: large current account deficits, with growing negative contribution of incomes deficits, due mainly to lagging effects of FDI stock accumulation. Breaking down the income balance, its deficit coming from the repatriated capital incomes (dividends and re-invested profits) related to FDI has to be noticed. But while in the Czech Republic, Poland and Hungary, thanks to the recovery of trade balances, a stabilization trend of the current account deficits amount is registered, in Romania the widening of external imbalance seems unceasing: the first half of 2007 ended with a trade deficit widened to EUR 9.6 billion (66 percent up compared with the first half of 2006) and the current account deficit to EUR 7.8 billion (double as compared with the same period of the previous year). As mentioned before, more adverse effects of FDI stock are expected in the next future, being added to those of trade imbalances. By dividing the net income outflows to the FDI stock (around EUR 30 billion at the end of 2006) a capital repatriation rate of 10 percent comes out, which, even remaining constant, will refer to an increasing FDI stock, speeding up the deterioration of the current account balance.

## 5. The vicious circle of economic growth in Romania

The trade deficit also reflects a macroeconomic disequilibrium. On the demand side of GDP growth, due to the higher rate of import volume increase than the export volume one, the negative contribution of net exports in 2006, for instance, cut almost half of the domestic demand, resulting a real GDP growth rate of 7.7 percent (see Table 5). From this point of view, the international trade is slowing the economic growth of Romania and if the domestic demand hadn't been driven by the final consumption (fuelled by the credit expansion) a much lower GDP growth rate could have been registered.

**Table 5**

*- % -*

| | 2003 | 2004 | 2005 | 2006 | 2007* |
|---|---|---|---|---|---|
| Real GDP growth | 5.2 | 8.5 | 4.1 | 7.7 | 6.5 |
| Contribution of: | | | | | |
| domestic demand | 8.8 | 12.9 | 8.7 | 14.1 | 12.3 |
| net exports | -3.6 | -4.5 | -4.5 | -6.4 | -5.7 |

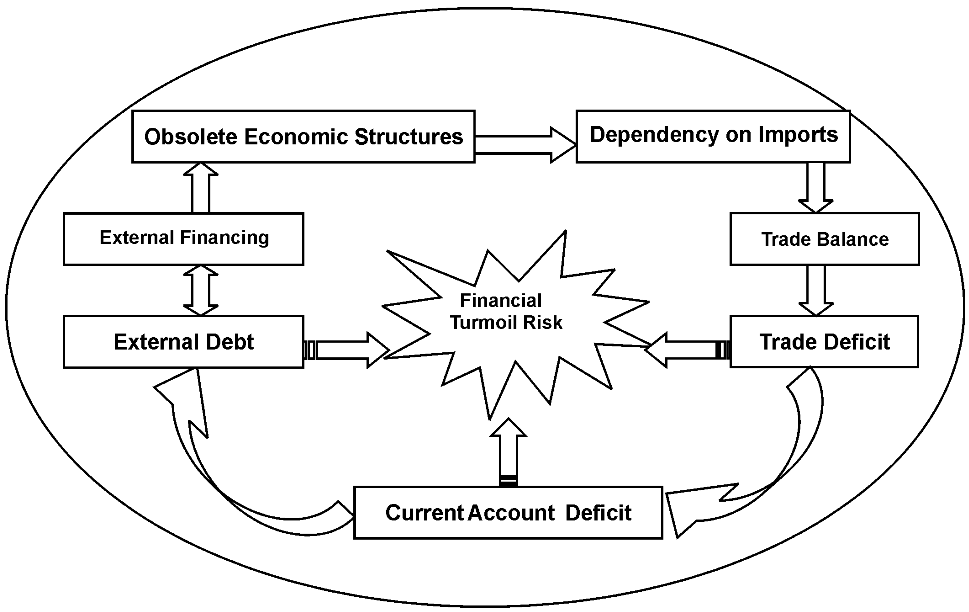
***** *Romanian National Commission for Prognosis.*

The macroeconomic costs of the persistent trade deficits are severely penalising Romania. The reversal of a high GDP growth rate of Romania, which is trying to match the development gap with EU during the process of economic and monetary convergence, is the worsening of its external balance. In our view, the trade and current account deficits are also revealing the Romania's lack of competitiveness, the limited resilience capability to the market forces pressure and the integration difficulties, not only in Europe but also at the global level. The energy intensity stands for the competitiveness factor with the most significant gap compared to other European countries. Moreover, the energy inputs, more and more expensive, spread through inefficient channels in the entire economy are seriously damaging the product competitiveness both on internal and external markets. The huge energy bill (including from imports, which amounted to EUR 5 billion in 2006, under the circumstances of higher world prices) is also a major contributor to trade deficit widening.

The vicious circle of Romania's economic growth (see Figure 1), whose primary causes have been shown, is made up by a chain of vulnerabilities, starting from the obsolete economic structures (energy-intensive and material-intensive) which are creating an intrinsic dependency on imports, contributing to the rise of trade deficits and implicitly of current account deficits, whose coverage through progressive compensatory flows is going to increase the external debt. As a consequence, higher risks for the external balance sustainability occur, including for a financial turmoil, which could damage Romania's international position and its economic development.

**Figure 1**

**The vicious circle of economic growth in Romania**




## 6. Implications for country risk

The long-term external debt of Romania witnessed a sharp increase in the last years, soaring to more than EUR 31 billion at the end-June of 2007 as compared with EUR 15 billion in December 2002 (see Table 6). Adding to this, the exponential growth of short term debt (below EUR 2 billion in 2002, amounting more than EUR 13 billion in 2006) a clear trend of accelerated external indebtedness is pointed out, driven by the private sector borrowing. The debt burden seems already to be excessive for the

Romanian economy, the LT debt service amounting to EUR 6 billion in 2006 and probably to more than EUR 7.5 billion in 2007.

**Table 6**

*- EUR billion -*

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 (H1) |
|---|---|---|---|---|---|---|
| Long term external debt | 15.0 | 15.9 | 18.3 | 24.6 | 27.7 | 31.6 |
| External debt service | na | 3.2 | 3.8 | 5.3 | 6.1 | 3.8 |

*Source: National Bank of Romania (data for 2007 covering the first half i.e. end-June).*

The rating agencies are monitoring very closely the political and economic developments in Romania. Despite recent favourable borrowing conditions for Romania on the international capital markets (benefiting, prior to the EU accession in 2007, of rating progressive improvements up to investment grade), a possible worsening of the international investment position could lead to a downgrade of the country rating. Taking into account that the LT FC country ratings for Romania are only one or two notches above the speculative grade *("BBB-"* assigned by Standard and Poor's, *"Baa3"* by Moody's and *"BBB"* by Fitch) a credit rating downgrade following the deterioration of external key parameters is likely to have negative effects, as the decline of potential investors and the increase of external borrowing prices.

A recent classification of external financing vulnerability published by Fitch (taking into account some indicators as short term debt, forex reserves, current account deficits, FDI net flows for 20 European emergent countries) ranked Romania among the first 10 assessed countries. Fitch is stressing that their dependency on high and rising external financing leave them exposed to a liquidity risk, in terms of the privatization revenues decline - implicitly of FDI inflows, decreasing also their coverage rate of current account deficit - and of the foreseeable reduction in the availability of international capital flows.

Romania's financial stability and its country rating are also facing growing risks arising from the international environment: an abrupt correction of the current account global imbalance and the uncertainties related to the unpredictable monetary flows movements coming from the huge international reserves concentrated in Asia, mainly in China and Japan. In our opinion, Romania is constrained to take steps for preventing a fatal slipping from the sustainable development path and to reformulate its economic and monetary policies, aimed to maintain the external balance, giving priority to exports recovery and to attract FDI in area with clear comparative advantages.

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