

Milea, Camelia

## Article

Vulnerabilities of the Romanian economy generated by the foreign trade, the external debt and the exchange rate after Romania's accession to the European Union

Financial Studies

## Provided in Cooperation with:

"Victor Slăvescu" Centre for Financial and Monetary Research, National Institute of Economic Research (INCE), Romanian Academy

*Suggested Citation:* Milea, Camelia (2018) : Vulnerabilities of the Romanian economy generated by the foreign trade, the external debt and the exchange rate after Romania's accession to the European Union, Financial Studies, ISSN 2066-6071, Romanian Academy, National Institute of Economic Research (INCE), "Victor Slăvescu" Centre for Financial and Monetary Research, Bucharest, Vol. 22, Iss. 4 (82), pp. 41-56

This Version is available at:

<https://hdl.handle.net/10419/231670>

## Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

## Terms of use:

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*



<https://creativecommons.org/licenses/by-nc-nd/4.0/>

# **VULNERABILITIES OF THE ROMANIAN ECONOMY GENERATED BY THE FOREIGN TRADE, THE EXTERNAL DEBT AND THE EXCHANGE RATE AFTER ROMANIA'S ACCESSION TO THE EUROPEAN UNION**

---

**Camelia MILEA, PhD\***

## **Abstract**

The paper analyses the vulnerabilities which can be brought about by the structure and trend of the foreign trade and the external debt, and by the exchange rate to the Romanian economy, in the period after our country's accession to the European Union. The structure and the trend of the current account can represent a cause of vulnerabilities for the sustainability of each country's economy. Therefore, the present article analyses the Romanian current account and its characteristics. Based on these findings, the author draws some conclusions regarding the possible effects of the vulnerabilities induced by the current account. Also, the author analyses the structure of the Romanian external debt on maturities and on creditors and points out the possible vulnerabilities generated affecting the evolution of the economy. Finally, in the article it is analysed the stability of the Romanian leu/euro exchange rate in the context of Romania's goal to join the eurozone.

**Keywords:** current account deficit, national currency, stability, indebtedness

**JEL Classification:** F31, F32, F34

## **1. Introduction**

Since 2014, the international methodology framework for the Balance of Payments and the International Investment Position has been updated in order to enhance the completeness, consistency and harmonization among the balance of payments and other macroeconomic data sets, such as: the national accounts, the statistics

---

*\* Scientific Researcher III, "Victor Slăvescu" Centre for Financial and Monetary Research, Romanian Academy, Bucharest.*

of government finance, the monetary and financial statistics, etc. The new methodology is presented in the IMF Manual of Balance of Payments and International Investment Position, 6th Edition (BPM6), which replaces the BPM5 version of 1993.

After 2008, the slowdown of capital markets and the steep decline in international financial flows forced multinational companies to limit their global expansion to their financial resources, with effects in terms of diminishing international trade flows.

The analysis period in the article is from 2006 (the year before our country's accession to the European Union) until present. In this context, ***the significant periods in the evolution of Romania's foreign trade*** stand out to be 2003-2007 (before the international economic and financial crisis, whose effects started to be felt in Romania in 2008), 2009-2013 (characterized by a decrease in the deficits of the current account and goods account, mainly due to the effects of the international economic and financial crisis), and 2014-2017 (restarting of the upward trend of the trade deficit).

## **2. Vulnerabilities caused by foreign trade that can bring about imbalances in Romania**

The trend of imports and consumption shows that Romania's economy depends on imports to meet the excess demand in the domestic market (for final consumption of households, for intermediary consumption, and less for gross capital formation). In this situation, if a shock emerges (e.g. the economic and financial crisis) with effects such as the significant decrease of the imports of goods, there will also be a decrease of the goods necessary for the productive process, leading to a limitation of the activity of the economic agents and implicitly to a contraction of the Romanian economy's growth.

As a consequence, in order to support the sustainable development of the national economy, measures must be taken in order to diminish the dependency of the national production on imports, without causing the decrease of the activity of the economic agents on the background of the reduction of the goods needed for the productive process, reaching a balance between the demand for domestic products and the demand for imports. In this regard, we suggest the adoption of measures to guide domestic consumption toward national products, both through a campaign meant to raise the interest of Romanian consumers for national products, but also by stimulating

Romanian producers to offer requested, high quality goods and by intensifying quality controls of the authorities.

It should also be considered that too high domestic consumption compared to the possibilities resulting from the external competitiveness has negative consequences on the macroeconomic stability. Previous experiences show that adjustment through austerity is less beneficial, and the plain financial equilibration through cuts in public grants is not a medium and long-term solution. Measures should be taken to create jobs in areas that will improve the external competitiveness and the overall Romanian economy.

It is noticed that Romania's commercial specialization is in goods with low and medium technology, and also that Romania is engaged in intra industry foreign trade. In recent years, as a whole, there is an improvement in the structure of foreign trade, both in terms of exports and imports.

In order to support the sustainable development of the Romanian economy, consolidating the trend of improvement of the structure of goods exports through faster growth of exports of products incorporating greater innovation and higher added value should be a priority for macroeconomic policy management for the next period, by creating the premises for intensifying the activity of foreign trade in branches that involve a high level of innovation and technology, by attracting investments in high added value sectors and by increasing the Romanian companies' ability to adapt to the high competitive standards of external markets and by strengthening the capacity of these firms to cope with possible unfavourable developments.

The low share of exports of goods in GDP (about one third) shows the lack of a macroeconomic policy to consolidate Romanian exports, as well as the inability of exports to capitalize the opportunities offered by the increasing opening of Romania's economy toward international markets, the insufficient degree of adaptation of industrial production to the requirements of foreign markets.

Analysing the indicators in table 1, one can see a **degree of openness**<sup>1</sup> of our country not very high on the background of relatively low competitiveness of Romanian exports. In 2007, the year of our country's joining the EU, Romania had a degree of openness of 61.7%.

---

<sup>1</sup> The degree of openness is calculated as the sum of a country's exports and imports in GDP.

As a result, mainly, to the intensification of trade relations with the EU countries, Romania reached a degree of openness of 67.2% in 2017.

**Table 1**  
**Romania's degree of openness (%)**

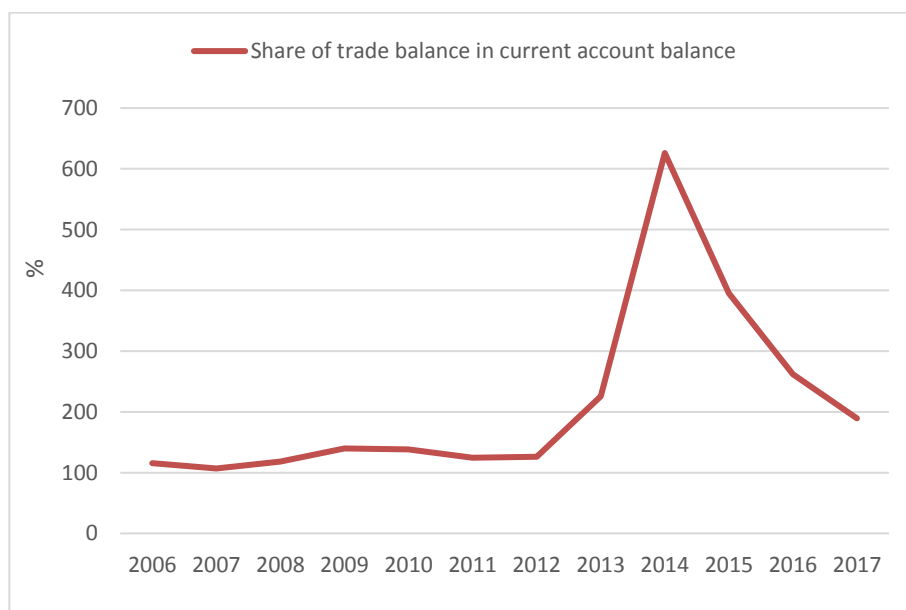
Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Degree of openness	64,9	61,7	61,9	55,0	66,2	74,6	74,1	64,9	66,5	66,1	67,0	67,2
Exports in PIB	26,4	23,7	24,1	24,6	30,0	34,5	34,2	30,4	31,1	30,6	30,7	30,4
Imports in PIB	38,5	38,0	37,8	30,4	36,2	40,1	39,8	34,4	35,4	35,5	36,2	36,8
Commercial deficit in PIB	-12,0	-14,3	-13,7	-5,8	-6,1	-5,6	-5,6	-4,0	-4,2	-4,9	-5,5	-6,3

Source: author's own calculations based on NBR's data.

We consider that improving the degree of openness of our country, by increasing the share of exports in GDP, and the reduction of the trade deficit, should become objectives of national interest, before starting the steps for joining the euro area.

Considering that the evolution of the trade balance is the main cause of the current account deficit (Chart 1), we can say that the economy needs rather a mitigation of the openness and a more efficient restructuring. Thus, the trade deficit can decrease and support the reduction of the current account deficit insofar as the implemented macroeconomic policies can find effective ways to reduce imports (their value) (both productive imports, and especially consumption imports) and to increase the value of exports, in particular by improving the quality and added value of exported goods.

**Chart 1**  
**The trend of the share of trade balance in the current account balance in Romania during the period 2006-2017**



Source: author's own calculations based on NBR's data.

Data are calculated according to BPM5 methodology for the period 2006-2012.

Data are calculated according to BPM6 methodology for the period 2013-2017.

Prior to the international economic and financial crisis, whose effects began to be felt in Romania in 2008, the situation was alarming due to the permanent deepening of the trade balance deficit on a year to year basis. The increase in the negative balance of the trade balance was caused in the context of higher increase of imports than the dynamics of exports, stimulated by the increase in demand for consumer goods and primary energy resources, by the increase in wages and the fast increase of non-governmental credit for durable goods. However, the situation has moderated in 2008 due to the effects of the crisis, when, in the context of the narrowing of the imports volume, the balance of goods improved, namely the high growth rate of the deficit diminished. Taking into account the decrease in the trade deficit and the current account deficit from 2009 to 2013, respectively 2014, followed by the resumption of the increase from 2014, respectively 2015 up to 2017 included, it can be concluded that the

deficits reduction was mostly due to the effects of the economic and financial crisis, so it does not have a profound, lasting character. In these circumstances, it is necessary to restructure our country's economy on sustainable basis.

Long-term existence (Romania's situation) of a trade deficit means insufficient competitiveness compared to domestic consumption.

The increase in the last years of the surplus of the services subaccount can be considered an evolution of the Romanian economy towards a structure similar to that of the developed economies, whose services sector is very developed. Analysing in depth the structure of services, it is noted that the positive evolution of the balance of this subaccount is mainly due to transport services. Given that road and railroad infrastructure in Romania is still underdeveloped, and given the high demand for transportation through our country, in order to capitalize this opportunity, we consider as absolutely necessary to develop the road infrastructure at an accelerated pace as a priority of our country.

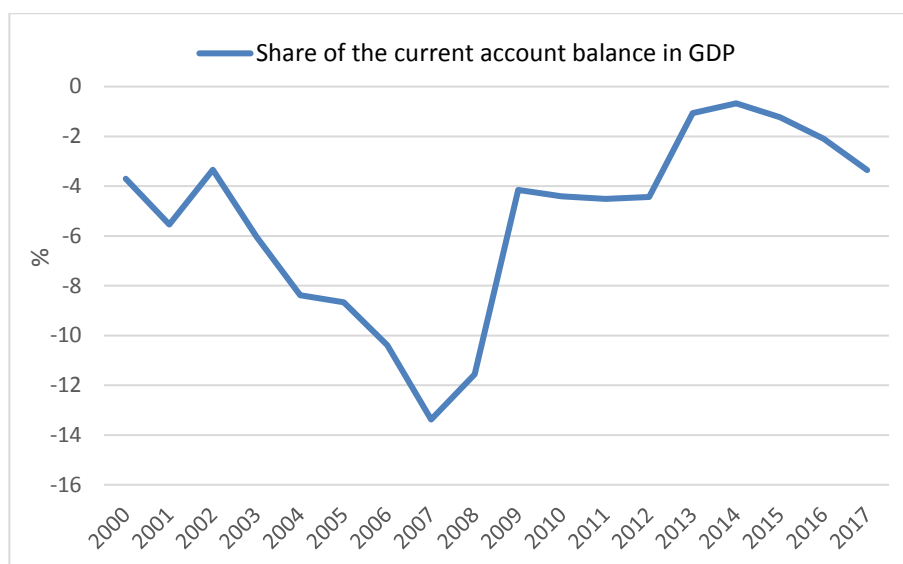
The high share of the current account deficit in GDP shows a negative effect of the current account balance on the domestic economic process. Between 2004 and 2008, the conventional sustainability threshold of the current account deficit (5% of GDP) has been constantly exceeded. Therefore, it is necessary monitoring, and, most importantly, adopting policies to ensure the sustainability of the current account deficit in the medium and long term. Although high according to international standards, Romania's current account deficit as a share of GDP was not a cause of alarm as long as its funding was secured, in particular by inflows of foreign direct investments (FDI). It seems that Romania's economy has opened up faster than it has restructured.

The considerable decline of Romania's current account deficit as a share of GDP over the 2009-2017 period compared to the period before 2009 (see Chart 2) (below the international conventional sustainability threshold of the current account deficit) represents an element favourable to the Romanian economy as a whole and to the balance of payments situation, although it is due, mostly, to the effects of the economic and financial crisis and not to the restructuring of our country's economy on sustainable basis, so it has not a deep, lasting character. The decrease of the value of the current account deficit in GDP may also be due to the improvement of the quality of Romanian

exports and to the conformation of their structure to the external requirements, manifested after the effects of the crisis have moderated. However, it is noticed that starting from 2015, the share of the current account balance in GDP begins to increase slightly. This trend can also be explained by the consistent deterioration of the balance of goods as a share of GDP over the period 2015-2017. According to RFS (Report for Financial Stability) 2016, the increase in the current account deficit in the recent years has been driven by increased consumption and domestic demand.

**Chart 2**

**The trend of the share of the current account balance in GDP in Romania during the period 2000-2017**



Source: author's own calculations based on NBR's data.

Data are calculated according to BPM5 methodology for the period 2000-2012.

Data are calculated according to BPM6 methodology for the period 2013-2017.

The evolution of FDI inflows after 2010 in Romania and the diminishing of their importance for covering the current account deficit shows a low degree of attraction and capitalization of foreign direct investments in the context of the display of factors such as: poor transport infrastructure, lack of fiscal facilities, lack of viable strategies for attracting strategic investors.

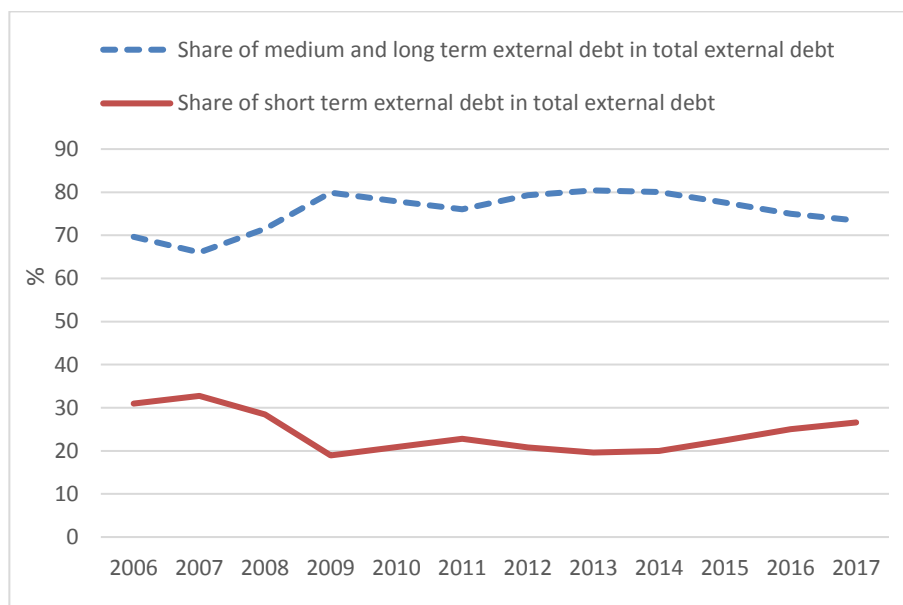


The evolution of medium- and long-term external loans had a turning point in 2011. Thus, over the period 2005-2010, the current account deficit was covered partly by the medium to long term loans. But, starting with 2011, Romania pays for the large external loans received the previous years. As a result, as of 2011, the long-term loans have concurred to the building-up of the balance of payments deficit with absolute decreasing values in 2013-2017.

### 3. Vulnerabilities caused by the foreign debt that can bring about imbalances in Romania

Over the period 2006-2017, the medium- and long-term external debt holds the largest share of Romania's total external debt (74%) (see Chart 3). It can be said that the structure of our country's external debt is quite adequate. Longer maturity favours the national economy sustainability, as the debt burden is staggered over a longer time horizon that does not "press" tightly on government budget decisions and jeopardize its development projects.

**Chart 3**  
**The trend of the medium- and long-term foreign debt and of the short-term foreign debt in Romania during the period 2006-2017**



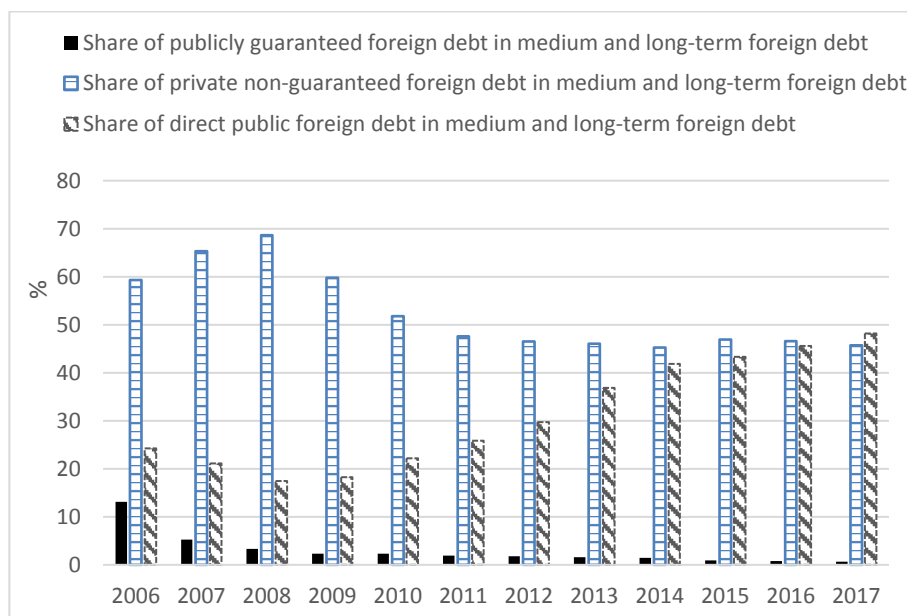
Source: author's own calculations based on NBR's data.

The fact that short term external debt is resuming growth since 2015 compared to the medium- and long-term external debt that has declined since 2013 represents an evolution that needs to be monitored as this type of debt can raise sustainability problems.

As a result of the almost continuous increase in the share of the private non-guaranteed foreign debt between 1994 and 2008, and from 2005 to 2010 inclusively, the private non-guaranteed foreign debt held the majority share in the total medium and long term external debt of our country, which shows, at the same time, the significant increase of the addition on external financial markets in terms of risk and uncertainty for both borrowers and creditors. Since 2009, the share of private non-guaranteed foreign debt decreases, in 2016 it becomes equal to the share of the total public external debt in the medium- and long-term external debt. In 2017 the public debt holds a higher share than the private non-guaranteed debt in the medium- and long-term external debt (see Chart 4).

**Chart 4**

**The trend of the components of the medium- and long-term foreign debt in Romania during the period 2006-2017**



Source: author's own calculations based on NBR's data.

A negative fact refers to the disadvantageous lending conditions on the Romanian market. As a result, the private sector has often preferred to borrow from foreign markets at a comparatively advantageous foreign cost compared to capital prices on the domestic market due to the high active interest rates in Romania, to the not quite adequate behaviour of the domestic banks in the lending process, to an appreciated real exchange rate of the national currency.

The evolution of Romania's public debt shows the needs of the Romanian economy for external financing both in the period of the economic boom, and especially in the context of the global economic and financial crisis, with an important increase in 2009-2010.

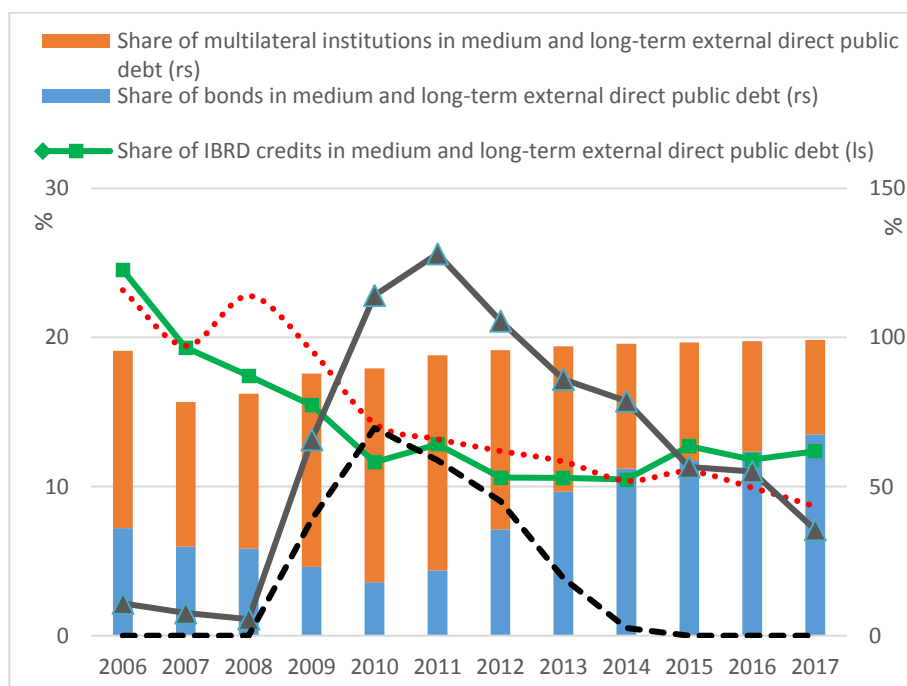
In the structure by creditors of the medium and long term external public debt, multilateral loans, which have the largest weight in the period 2006-2012, are gradually declining in favour of bond issues, reaching 31.7% in 2017.

Regarding the importance of the credit institutions in the total medium and long term external public debt, it is noted that as a result of obtaining the loan granted to our country in 2009, the share of loans from the European Union has increased significantly between 2009 and 2011, being important between 2009 and 2016 compared to the previous period.

Chart no. 5 shows that, despite the excessive media coverage of the loans from the International Monetary Fund, they do not have such a high share compared to the loans received from IBRD, EIB and EU.

**Chart 5**

**The trend of the structure by creditors of the medium and long term public foreign debt of Romania during the period 2006-2017**



Source: author's own calculations based on NBR's data.

Bond issuance has grown significantly starting with 2011, bringing an increase in the medium and long term external public debt. As a result, their share in the total medium and long term external public debt equals the weight of multilateral institutions in 2013 and bonds become majority since 2014, situation that continues up to the present (see Chart 5).

Thus, there has been a replacement of institutional creditors with private creditors. Given that debt from multilateral institutions has lower costs, taking into account the interest rates charged to countries perceived as having a high risk on the international private financial market; longer grace period; longer total duration, the replacement of the creditors represents a profoundly negative evolution of the Romanian economy's situation, from the point of view of the reimbursement effort. Instead of returning the contracted foreign debt, we become more indebted, under harsher credit conditions.

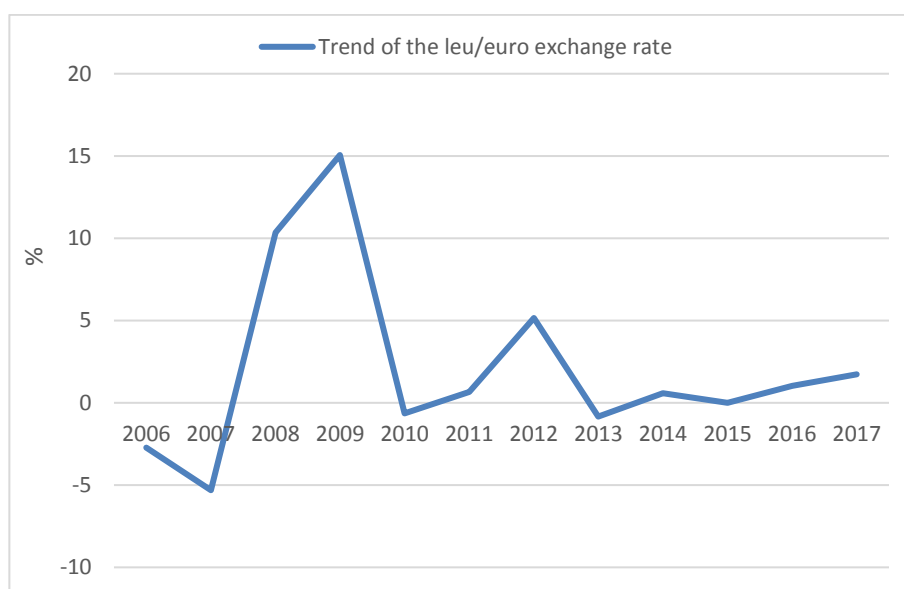
It is worth mentioning that the increase in external debt generates microeconomic risks (higher exposure to possible external shocks and more important effects on the Romanian banking sector), but it also has macroeconomic implications from the point of view of external debt sustainability. The growth of the external debt in the medium and long term may cause problems through the exchange rate channel (the sudden depreciation of the national currency would lead to a significant increase in the cost of external financing), through the confidence channel (the change in investor sentiment and perceptions leading to higher risk premium, and implicitly to higher cost of external financing), through contagion (through an regional economic, political or social shock), or even by an intrinsic shock of the national economy of a conjunctural or structural nature. With some of these consequences we are currently confronted (unfavourable investor perceptions, high cost of external financing).

This highlights the importance of a comprehensive and coherent strategy for external debt reimbursement in close co-ordination with the restructuring of the national economy and with the progress of economic reform and of an indebtedness strategy which should establish an optimal ratio between medium and long term debt and short term debt, respectively between their maturities, so that the burden of external debt to be spread evenly over the years in order to avoid payment peaks.

#### **4. Vulnerabilities caused by the exchange rate that can bring about imbalances in Romania**

From chart no. 6, it can be noticed that in most of the years from the period 2005-2017, the annual variation of the leu / euro exchange rate is small. We note the appreciation of the leu / euro exchange rate from the period before Romania's accession to the European Union (2006, 2007), but also the significant depreciation in 2008, 2009 (when it is reached the 15% limit of the fluctuation band, characteristic of ERM II), in the context of the economic and financial crisis and its effects.

**Chart 6**  
**The trend of the leu/euro exchange rate during 2006-2017**



*Source: author's own calculations based on NBR's data.*

Thus, the leu / euro exchange rate has been subject to strong fluctuations, mainly generated lately by investors' aversion to risk. In order to benefit from investors' confidence, a certain level of economic development, economic and political stability are needed.

It can be concluded that the national currency of our country is unstable at shocks. Thus, although Romania fulfils the exchange rate convergence criterion and the level of international reserves is quite high in the last years, which allows the action of the National Bank of Romania to limit the major fluctuations of the national currency, however, if we consider the entry into the euro area to be like a shock, this weakness of the leu / euro currency has to be taken into account.

As it is known, establishing the exchange rate parity between the leu and the euro will have a significant impact on the future evolution of the Romanian economy. Thus, joining the euro area at a too much appreciated exchange rate would negatively affect the economic growth, in particular through the slowdown of exports, and a too depreciated national currency against the euro could generate

inflation. Euro is a strong currency, and Romania needs a weak currency to support exports.

Also, it should be taken into account the behaviour of the population after the announcement of the date of entry into the euro area. There may be an increase in the demand for euro from the population in order to change the holdings of national currency, hoping to gain through the exchange rate difference and to avoid the danger of imposing a restriction for the amount of currency that will be exchanged at the time of the changeover to euro. In the first phase, pressures on the demand for the euro may lead to an increase in the exchange rate of the national currency and then to inflation increase.

### **5. Conclusions**

Strengthening the trend of improving the structure of goods exports through more rapid growth of exports of products incorporating greater innovation and higher added value should be a priority for the management of macroeconomic policies for the next period by creating the premises for intensifying the foreign trade activity in branches that involve a high level of innovation and technology, by attracting investments in high added value sectors, respectively by increasing the capacity of Romanian companies to adapt to the highly competitive standards of the foreign markets and to strengthen the capacity of these companies to deal with possible adverse developments.

We consider that the improvement of the degree of openness of our country as a result of the increase in the share of exports in GDP and, implicitly, the decrease of the trade deficit should become objectives of national interest, before starting the steps for joining the euro area.

It is necessary, in order to support the sustainable development of the national economy, the guidance of the domestic consumption towards national products, both through a campaign to raise Romanian consumers' interest toward national products, and also by stimulating the Romanian producers to provide the required goods at high quality, also by enhancing quality controls by the authorities.

The entry into the euro area, but first in ERM II, must be correlated with the situation of the national economy, with its level of development so that the entry into the euro area would bring our country more advantages than disadvantages.

There may be problems for the new Member States adopting the euro due to lack of control over the interest rate (influencing the

monetary base, stimulating economic growth, managing shocks, including currency shock affecting directly inflation) and due to the too appreciated exchange rate, the new Member States need a weak currency to support exports. Generally speaking, the adoption of the euro means giving up power over economic decisions, which will be taken outside the country.

The decisions of the European Central Bank (ECB) represent an answer to the problems of the entire eurozone and not just to one country. Thus, the policy adopted by the ECB can only respond to the evolution of some euro area economies, if there are regional disparities concerning economic growth. If Romania remains outside the euro area, it is free to set and implement the monetary policy it needs in order to support economic growth, and to overcome existing imbalances.

The premature adoption of the euro means abandoning the instrument of changing the exchange rate and interest rate used to adjust the differences between Romania and the euro area countries. This means putting too much emphasis on labour market and commodity prices adjustments, as the only remaining markets for adjustments would be the labour market and the commodity market. Fiscal policy might absorb part of the shocks, but for the moment it must remain pro-cyclical. We do not think that these together can, at present, replace the possible lack of control over changes in the interest rate and in the exchange rate. Thus, it would not be possible to ensure full employment and price stability.

A single currency means a pan-European interest rate that limits the government's ability to manage the problems of the national economy. The various stages of economic development and different economic cycles make it difficult to find a fair interest rate for all euro area countries.

Managing a modern economy requires effective monetary bumpers, integrated in the economy. By joining the European Monetary Union, Romania is deprived of these shock absorbers, exposing itself to a new type of shocks, namely the shocks on the euro. The volatility of the euro-dollar exchange rate would cause fluctuations in the prices of commodities that are the subject to trade and hence in inflation.

Strengthening the convergence also implies sound management of public debt as the loss of the central bank's ability to control the domestic money supply through the interest rate has a



direct effect on the cost of borrowing and on the overall balance of the economy.

All the benefits brought about by joining the euro area can become real only under certain conditions. The theory and the recent practice show that the states participating in a monetary union can have net benefits, but only when their economic structures are similar. Otherwise, there is a risk that some of them, poorly prepared, would be adversely affected.

Considering the vulnerabilities highlighted above, we can say that Romania's economy is not ready yet to adopt the euro. It is unstable, vulnerable to shocks. As a result, we consider it is wise to expect signs of the stability of the Romanian economy and of the disappearance of the economic vulnerabilities before setting a fixed or estimative date for Romania's joining the euro area.

#### References

1. National Bank of Romania (2011-2018), Monthly Bulletins, December 2000 - May 2018, Bucharest.
2. National Bank of Romania (2007-2016), Annual Report – Balance of payments and the International Investment Position of Romania, Bucharest.
3. National Bank of Romania (2016), Report on Financial Stability *December 2016*, Bucharest.
4. National Institute for Statistics (2017), Romanian Statistical Yearbook, data 1990-2016, Bucharest.
5. Ministry for Public Finance (2017), Report - The Trend of Public Debt according to UE methodology for the period 2010 - April 2017. (Available at [http://discutii.mfinante.ro/static/10/Mfp/buletin/executii/Evdat\\_orieguvconformUEromanaaprilie2017.pdf](http://discutii.mfinante.ro/static/10/Mfp/buletin/executii/Evdat_orieguvconformUEromanaaprilie2017.pdf))
6. Ministry for Public Finance, Report –The Trend of Public Debt 2000-2009. (Available at [http://discutii.mfinante.ro/static/10/Mfp/buletin/executii/Evolutia\\_DP\\_2000\\_2009.pdf](http://discutii.mfinante.ro/static/10/Mfp/buletin/executii/Evolutia_DP_2000_2009.pdf))

#### Online resources:

<http://www.bnro.ro/page.aspx?prid=10117>