Economic analysis from the European Commission's Directorate-General for Economic and Financial Affairs

Volume 6, Issue 1

09.01.2009

ECFIN COUNTRY FOCUS

Highlights in this issue:

- **Romania's domestic demand boom came along widening fiscal and external deficits**
- **The financial crisis calls for an ambitious adjustment to correct imbalances**
- **A credible fiscal consolidation package is needed to shore up investor confidence**

Romania: unwinding imbalances – need for fiscal consolidation

*By Stefaan Pauwels**

Summary

Romania's domestic demand-driven economic boom has come at the expense of rising imbalances. High external borrowing has led to a rapid build-up of external debt; widespread foreign currency lending has increased households' and companies' balance sheet exposure; and high private sector dissaving was exacerbated by rising fiscal deficits.
The financial crisis and its spillovers to the real economy through currency, trade, financial and confidence channels has made the task of rectifying imbalances ever more urgent. To rebuild investor confidence, the new government will need to urgently reverse Romania's expansionary fiscal policy and pass a credible fiscal consolidation budget for 2009. The credibility of any fiscal consolidation strategy will be helped by the implementation of a medium-term fiscal framework and by restructuring fiscal expenditure towards productive investment (including through accelerated EU funds absorption).

Building-up imbalances

Romania's impressive annual GDP growth averaging 6.2% between 2002 and 2007 has gone hand in hand with rising external imbalances. The current account deficit widened from 3% to 14% of GDP in the same period, the fifth highest among EU10 Member States[1] (Graph 1). The rapid expansion of financial intermediation, combined with steadily increasing income expectations has fuelled a domestic demand boom, for both consumption and investment, leading to a rapid increase in imports. A negative income balance, linked to profit repatriation by direct investors and interest payments was offset by current transfers (including mainly remittances and EU funds).

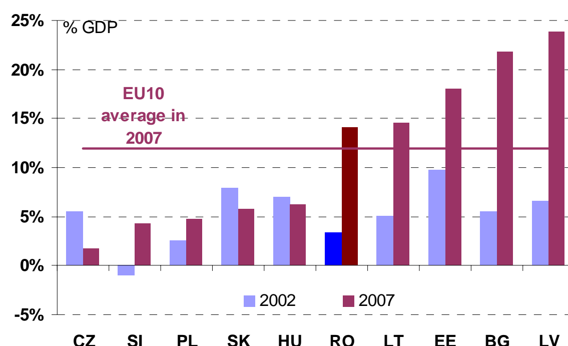
Financial intermediation has played a key role in channelling international capital flows to Romanian residents. Between end-2002 and November 2008, domestic credit to the private non-financial sector tripled from 11% to 39% of GDP, against a background of fierce competition amongst largely foreign-owned banks, which have benefited from ample liquidity injections by their parent companies until the beginning of 2008. Yet, the credit stock in Romania is still moderate compared to the EU-10 average of about 66% of GDP in 2007.

*** Directorate for the Economies of the Member States.**

The views expressed in the *ECFIN Country Focus* are those of the authors only and do not necessarily correspond to those of the Directorate-General for Economic and Financial Affairs or the European Commission.

Widening current account deficits have been fuelled by a boom in financial intermediation

Graph 1: Current account deficit in EU10 Member States



Source: *Commission services*

Whereas the rising external deficits have been mainly driven by the private sector, public sector net lending has also contributed to and increasing degree, with deficits rising from 1.2% of GDP in 2005 to probably more than 3% in 2008.

Sources of vulnerabilities

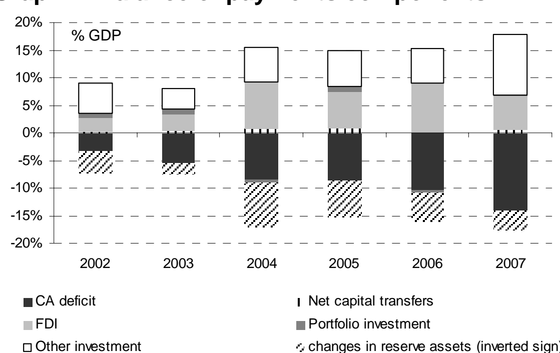
In the light of the current international financial crisis and its spillovers to the real economy, vulnerabilities mainly appear on the financing side of the external deficit and in household and corporate balance sheets.

A. Rising external debt

External debt increased from 30% of GDP in 2000 to 51% of GDP in 2008

Between 2000 and 2006, FDI was the principal financing source, covering around 75% of the current account deficit (Graph 2). However, from 2007 onwards, FDI inflows dropped to roughly ½ of the deficit, as the privatization programme of state-owned enterprises was coming to an end. Also the composition of FDI inflows has changed. The share of equity inflows (including privatization receipts) shrank from 59% in 2004 to 13% in 2007, while intercompany loans have become more prominent, rising from 13% to 52% in the same period. The difference, i.e. reinvested earnings, stayed roughly constant.

Graph 2: Balance of payments components



Source: Commission services

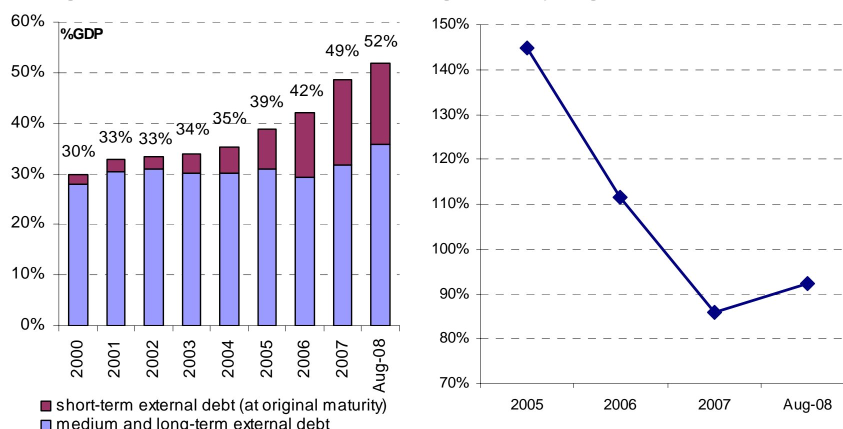
The rest of the current account deficit was more than covered by "other investment", being mainly loans and currency deposits. The capital account has remained slightly positive and stood at 0.7% of GDP in 2007, partly reflecting the inflow of EU funds. Significant privatization receipts and the NBR foreign-exchange reserve requirements for credit institutions have also lead to a fast accumulation of reserve assets.

The increasing importance of FDI intra-company loans and other investment has resulted in a steady increase in external debt from 30% of GDP in 2000 to 52% of GDP in August 2008 (Graph 3). However, this is still moderate compared to external debt in Bulgaria, Estonia, Latvia and Lithuania, where it exceeded 100% of GDP in 2008.

Short-term debt roll-over risks have increased

While medium- to long-run debt as a percentage of GDP has only risen slightly over the past years, short term debt increased eightfold from 2% of GDP in 2000 to 16% of GDP in 2008, entailing increased short-term debt roll-over risks. Moreover, the coverage of short term debt by foreign exchange reserves has rapidly declined in the last few years, but appeared to stabilize in 2008 around roughly 90%. Yet, it has to be noted that slightly less than half of these reserves represent commercial banks' foreign exchange reserve requirements and are as such to be considered as contingent short-term net drains on official reserves.

Graph 3: Gross external debt composition (left) and foreign exchange coverage of short-term debt at remaining maturity (right)



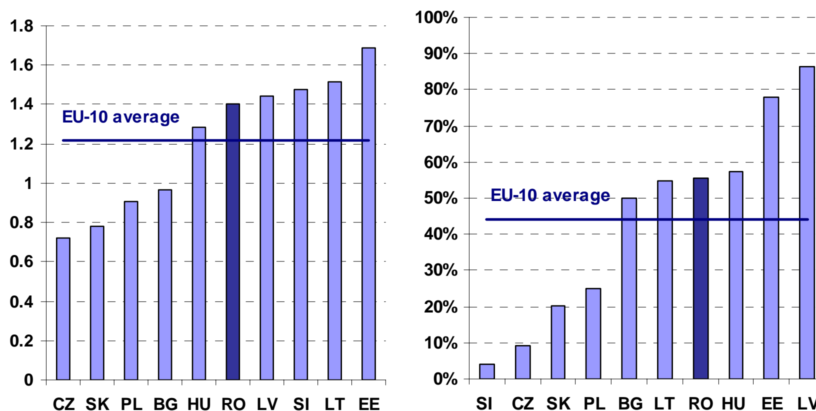
Source: Commission services, National Bank of Romania

B. Weakening household and corporate balance sheets

Notwithstanding the moderate domestic credit stock, the high reliance on foreign currency lending and low domestic deposit coverage imply increased balance sheet risks

The domestic counterpart of rapidly increasing external debt has been the acceleration of bank lending to households and enterprises. The stock of private non-financial sector credit tripled from 11% of GDP end-2002 to 39% of GDP in November 2008, leading to annual credit growth oscillating around 55% over the last 3 years. As the growth rate of domestic deposits remained subdued at roughly 30% over the last 3 years, the loan-to-deposit ratio increased rapidly from 0.7 end-2004 to 1.4 in November 2008, which is slightly above the EU average of 1.2. (Graph 4). In the same period, the foreign currency loan to deposit ratio even reached 2.2.

Graph 4: Loan to deposit ratio (left) and share of foreign currency loans in private non-financial sector credit (right) at end-2007



Source: ECB (2008), Commission services
Note: Data for Romania are as of end-November 2008

The fast-paced increase in domestic lending has been mainly driven by foreign-exchange denominated loans, thanks to their lower interest rates (which are on average 3,5 pps below interest rates on RON-denominated loans) and low perceived currency risk in a context of sustained RON appreciation (until mid-2007).

This brought the total share of foreign currency denominated loans to 56% in November 2008, i.e. above the EU-10 average of 44% (see Graph 4).

The high share of forex loans and the particularly high loan to deposit ratio in foreign currency underscore balance sheets' vulnerability to increased exchange rate volatility.

Likely adjustment channels

While in the medium run export performance is likely to improve, thanks to positive developments in international competitiveness indicators, Romania's immediate challenges relate to dealing with increased pressures on the exchange rate and avoiding a sharp drop in domestic demand.

A. Increased pressure on the exchange rate

RON volatility has increased over the last few months

Pressures on the RON have significantly increased in recent months and have resulted in a 25% depreciation since August 2007, which partly reflects a correction from previously overvalued levels. The central bank has been able to fend off speculative attacks, by draining liquidity from the money markets. However, faced at the same time with weakened interbank markets, the central bank has to walk a fine line between ensuring sufficient liquidity to the financial system and avoiding the risk of further speculative attacks, given the balance sheet exposures of households and companies.

In this context, the recent downgrade of Romania's foreign currency rating by Standard and Poor's and Fitch to below investment grade, may be adding pressure on the currency market and might also affect Romania's access to international capital markets, with knock-on effects on domestic demand.

B. Domestic demand adjustments

After recording double-digit growth rates during the past four years, domestic demand is expected to cool down significantly into 2009 on the back of tightening credit conditions and weakening consumer and investor confidence.

Increasing strains on banks' liabilities have led to a sharp deceleration of domestic credit growth

Credit conditions have tightened in terms of both volumes and cost over recent months. While the central bank has imposed stricter prudential norms for foreign currency lending by banks, a more binding constraint to credit growth in the short run is likely to be banks' reduced access to financing. The strong growth of loans and deposits from parent companies (representing about 30% of banks' liabilities at end-2007) on which banks have increasingly relied in the last years, appear to be levelling off since mid-2008. Meanwhile, growth of domestic deposits (representing roughly half of banks' liabilities) has remained subdued and even turned slightly negative in October on a m-o-m basis. Increasing strains on the banks' liabilities side have led to a sharp deceleration of domestic credit growth from 67% y-o-y in January to 38% in November 2008, implying a virtual standstill in lending on a m-o-m basis.

The cost of domestic credit is also on the rise as banks' borrowing costs on external capital markets have significantly increased. This is reflected in the spreads on sovereign credit default swaps (CDS), which have shot up from 100bps in January 2008 to roughly 650bps by mid-December (as compared to German CDS spreads standing at about 50bps). Another proxy for increased borrowing costs is the interbank market rates. Following increasing liquidity constraints, market rates have come under increased pressure, with bid-ask spreads peaking to 4000 bps end-October and weekly average interest rates on transactions reaching 35%. After the central bank eased the RON reserve requirements from 20% to 18%, rates returned to about 11% mid-December, which is still higher than the levels registered beginning of the year; traded volumes are also low. Furthermore, monetary policy remains tight, with the reference rate currently standing at 10.25%, compared to 7% in October 2007.

Tightening credit conditions for the private sector are exacerbated by high government financing needs, following an expansionary fiscal policy. The public sector is also facing increasing difficulties in tapping the market for government paper, as evidenced by the rapidly increasing yields on recent government issues (reaching up to roughly 500bps more since the beginning of 2008), and the overall low auction success rate. Moreover, financing has become increasingly short-term.

High public sector financing needs exacerbate already tight private sector credit conditions

Apart from the credit squeeze, domestic demand is likely to be affected by weakening consumer confidence, as indicated by the Economic Sentiment Indicator entering into in negative territory in October. Wealth effects from falling house prices could also have an impact, although comprehensive data on house price developments are unavailable at present. Other factors such as wealth effects from stock market losses are likely to be limited, due to the low market capitalisation levels (about 13% of GDP end-October).

As a result, the Commission Autumn 2008 forecast projects a sharp drop in domestic demand growth in 2009. Yet, risks to growth are squeezed to the downside, especially in case access to funding by banks remains restricted for a longer period of time, or suffers reductions, or in case consumer and investor confidence deteriorate more. In this context, a soft landing scenario would entail a gradual deceleration of both household and government consumption growth, allowing for a restoration of balance sheets. Under this scenario, a continuation of bank lending would also be ensured, although at more a moderate pace, in order to allow the financing of productive investments, which will be crucial to rectify the external imbalances and to maintain employment.

C. Improved export competitiveness

In the longer run, further adjustment of external imbalances could come from recent FDI driven improvements in export competitiveness[2]. In the first three quarters of 2008 export growth accelerated and exceeded import dynamics for the first time since 2004. While the economic downturn in the Euro Area (representing 70% of Romania's exports) may significantly dampen export performance in the short run, it is expected that once demand by the Euro Area will pick-up, the trade channel will play a more prominent role in boosting growth.

The improved export competitiveness has in particular been reflected in the composition of exports, showing an increasing share of higher value added products[3]. Furthermore, in spite of relatively low volumes, export market shares (as a percentage of world exports) have doubled from 0.15% to 0.3% between 2000 and 2007, in line with most other recently acceded Member States. And finally, notwithstanding increasing labour shortages and higher wage claims, the exporting sector has managed to maintain profit margins[4] thanks to favourable export price developments. Furthermore, the improved exports performance until Q3-2008 has also been fuelled by a real effective exchange rate adjustment, from previously overvalued levels.

Main policy implications

Romania's growth model has implied large external imbalances and has relied on increasing volumes of foreign capital inflows. With the intensification of the international financial crisis, access to domestic and external capital sources by banks has been constrained, leading to a sharp drop in domestic credit growth; consumer and investor confidence are weakening; higher exchange rate volatility poses significant balance sheet risks to households and (unhedged) companies; and weaker demand from the Euro Area will weigh on export performance.

In this context, there is a key role for fiscal policy, notably to shore up investor confidence by presenting a credible medium term fiscal consolidation plan[5], based on prudent macroeconomic projections. The initial fiscal starting position and external imbalances leave no room for expansionary fiscal policy. However, convergence and stabilisation needs could be satisfied by restructuring fiscal expenditure towards productive investment and speeding up the absorption of EU structural funds, while ensuring they target the right priorities. This would trigger a

positive demand effect in the short run, while at the same time increasing Romania's future growth potential.

Restoring investor confidence is particularly relevant in the area of supporting banks' balance sheets. Although banks will have to rely increasingly on deposit collection as a means to finance credit growth, a strong signal from fiscal policy, within an ambitious adjustment programme, would also contribute to containing the risks of a protracted freeze or contraction of banks' financing sources from parent companies. This should help maintain credit availability and allow for a smoother domestic demand adjustment.

Finally, pursuing structural reforms is essential for a long-run positive supply response, in particular with respect to cutting red tape, improving the regulatory environment, strengthening administrative capacity and continuing the reform of labour markets and education systems, in line with the Lisbon framework[6].

References

Abiad, A, D. Leigh and A. Mody (2007), International finance and income convergence: Europe is different, IMF Working Paper 07/64.

ECB (2008), EU banking structures.

Herrmann, S. and A. Jochem (2005), Determinants of current account developments in central and eastern European EU Member States – consequences for the enlargement of the euro area, Discussion paper, Series 1: Economic studies, N° 32/2005, Deutsche Bundesbank.

Herzberg, V. and M. Watson (2007), Growth, risks and governance: the role of the financial sector in south-eastern Europe, European economy occasional papers N° 29.

IMF (2008), Romania 2008 Article IV consultation – Staff report and selected issues.

Lane, R. and G. M. Milesi-Ferretti (2005), Financial globalization and exchange rates, IMF Working paper 05/3.

Lane, R. and G. M. Milesi-Ferretti (2006), Capital flows to Central and Eastern Europe, IMF Working paper 06/188.

National Bank of Romania (2008), Financial stability report 2008.

Pauwels, S. and L. Ionita (2008), FDI in Romania, from low-wage competition to higher value-added sectors, European Commission, Country Focus 3/2008.

Rahman, J. (2008), Current account developments in new Member States of the European Union: equilibrium, Excess and EU-phoria, IMF Worling paper 08/92.

Székely, I. P. and M. Watson (2007), Growth and economic policy: are there speed limits to real convergence?, European economy economic papers N° 294.

Vamvakidis, A. (2008), Convergence in emerging Europe: sustainability and vulnerabilities, IMF Working paper 08/181.

---

[1] EU-10 refers to the recently acceded Central and Eastern European Member States, notably Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia and Romania.

[2] Between 2000 and 2007, roughly 30% of all FDI inflows went to the tradable sector, leaving Romania in a middle position between on the one hand Bulgaria, Latvia and Estonia (with an average of 15%) and Czech Republic, Hungary and Slovakia with an average of 45%.

[3] See among others Pauwels and Ionita (2008).

[4] Profit margins as proxied by the difference between manufacturing unit labour cost developments and the export deflator.

[5] In line with the Commission Policy Advice C(2008) 2563.

[6] In line with Country-specific recommendations provided by the Council in the framework of the Lisbon strategy of May 2008 (OJ L 139, 14.5.2008, p. 57).

The *ECFIN Country Focus* provides concise analysis of a policy-relevant economic question for one or more of the EU Member States.
Chief Editor: Elena Flores, Jürgen Kröger, Directors - Economic and Financial Affairs
Coordinating Committee: Heinz Jansen, Mary McCarthy, Stefaan Pauwels, Ann Westman
Layout: Yves Bouquiaux, Fabrizio Melcarne
E-mail: ECFIN-CountryFocus@ec.europa.eu
Website: http://ec.europa.eu/economy_finance/publications/countryfocus_en.htm