ECONOMY

THE MOOD IS POSITIVE AND GROWTH CONTINUES –BUT DEFICITS AND FINANCIAL INDISCIPLINE ARE STILL A PROBLEM

How Threatening is the Trade Deficit?

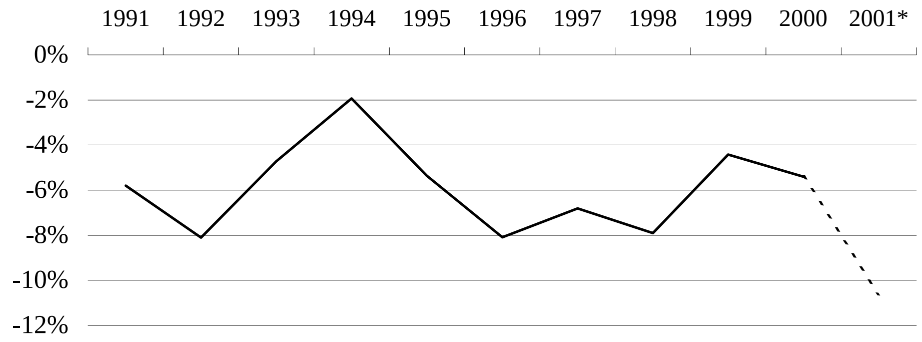
by Daniel Daianu

As it was expected, economic recovery accelerated. After a rise of 1.6% in 2000, the GDP is likely to grow by over 4.5% this year. Exports continued their buoyancy under the spell of a special tax incentive introduced at the end of 1999. This is part of the good story. But there is a less rosy part of it as well. In the first half of this year imports literally “exploded”; they grew much more rapidly than imports and brought the trade deficit to over US$ 2 billion. While exports rose by around 18% against the corresponding period of last year, imports moved up by about 35%. If this tendency continues unchecked, the trade deficit could surpass US$ 4 billion in 2001, which represents around 11% of GDP.

Is this looming trade deficit a real cause of worry? On one hand, Romania is, arguably, a transition country, which needs to catch up economically. Consequently, importing foreign savings for raising domestic investment should not come as a surprise. And this may last for quite a number of years. As a matter of fact, Romania has been running a relatively large trade deficit for the whole past decade (Fig. 1); only in 1994 was the trade deficit lower, at

2% of GDP. On the other hand, a persistent large structural trade deficit would, in the absence of resilient offsetting flows, have to be dealt with, sooner or later. This structural deficit is mirrored by the external debt of Romania which, although rather low (around 30% of GDP) by world standards, has been growing rapidly in the last decade. In addition, a rapid increase of the trade deficit could easily cause liquidity problems.

Fig. 1. Trade balance, %GDP
(* projection based on July data)



Nonetheless, as aforementioned, a country may have sources for financing a large trade deficit outside the capital account -- such as tourism revenues and remittances. Whereas tourism, unfortunately, plays an insignificant role in this respect in Romania, remittances have contributed increasingly to financing its balance of payments (Fig. 2). Romania is increasingly a supplier of both highly skilled (IT/software) and less skilled (construction) labor. It is noteworthy that remittances were close to US$ 1 billion, in each of the last two years – almost as large as FDI inflows. Consequently, attention needs to be focused on the current account deficit. (Fig. 3)

Fig. 2. Inflows of foreign remittances

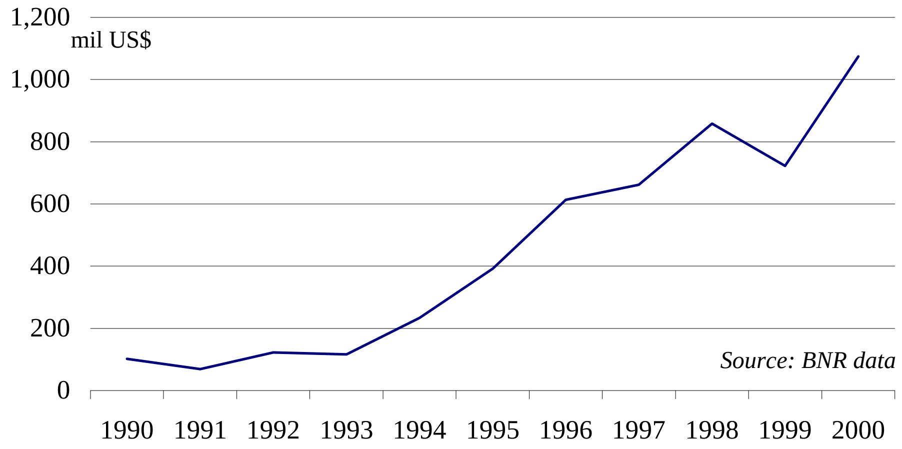
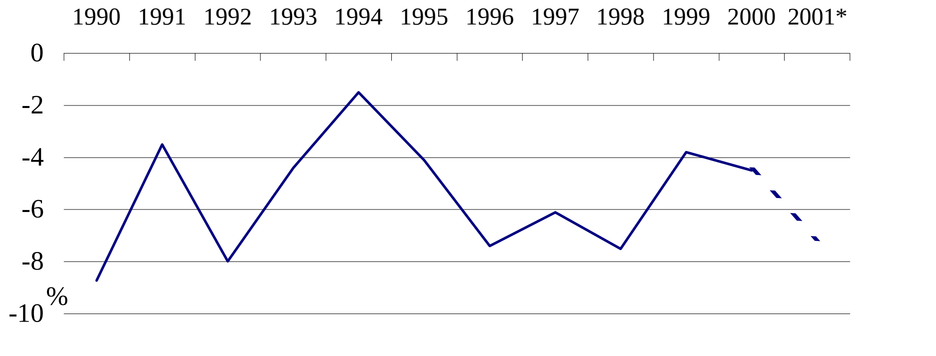


Fig. 3. Current account balance, % GDP
(* projection based on June data)



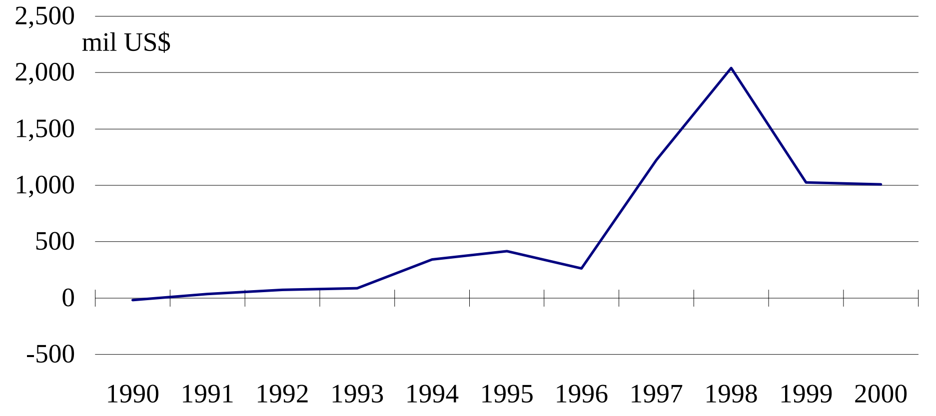
The current account deficit, itself, shows a stunning rise this year; up to US$ 1.197 billion for the period January-May, as compared to US$ 538 million during the same period of last year. Apparently, the financing of the current account deficit poses no major problem. The National Bank of Romania (BNR) has continued to be a net buyer of foreign exchange, which contributed to increase its foreign reserves (at the end of June, they reached a record high of US$ 4.4 billion, including gold), and autonomous (non-debt creating) inflows have been quite substantial. But complacency would be a grave mistake in judging the magnitude of the increase of the external deficit.

There are several reasons why the government and the central bank should pay careful attention to the evolution of the current account deficit:

- Romania has experienced critical moments in the management of its external deficits, which suggest a nuance in assessing the composition of external financing. One such moment was the balance of payments adjustment in 1999, when the current account deficit was halved from over 7% to 3.8% of GDP. At that time autonomous flows proved their volatility (their share in GDP declined to 3.19%, as compared to 8.77% in 1997), and the financing of public debt had to be covered internally, with heavy repercussions on domestic interest rates.
- Most Foreign Direct Investment (FDI) in the Romanian economy is not greenfield; it is due primarily to privatization deals, which are a sort of “compensatory flows in disguise”; in 1998 FDI receipts, which were of over US$ 2 billion (Fig. 4), helped to finance a current account deficit that exceeded 7% of GDP. As opposed to greenfield investment, FDI in the form of equity capital is reversible. In each of the last couple of years FDI inflows were just above US$ 1 billion and the situation does not look better in 2001.
- The dramatic rise in autonomous outflows, which did occur in particular years (mainly due to large outflows of speculative money), together with the net negative compensatory flows, in 1998 and 1999, show the fragility of current account financing.

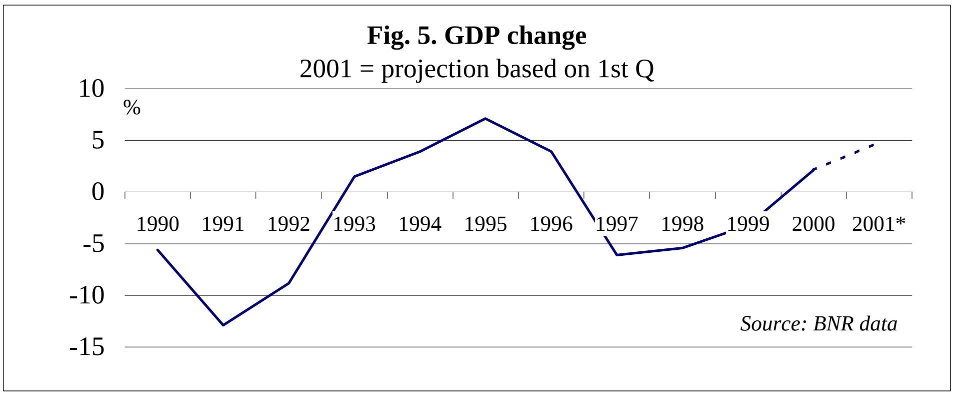
- The highly unstable flows (portfolio; errors and omissions[1]) represent a non-negligible share of autonomous flows. During the first five months of 2001, "errors and omissions" made up 729 million USD, almost 60% of the current account deficit!
- Romania still needs substantial compensatory flows, including from multilateral organizations. Private capital markets play an equally important role. This year, the government borrowed around 600 million Euro through a bond issue in order to finance the budget deficit (which is estimated at 3.5% of GDP after an intended rectification in September). It goes without saying that financial markets would look more than cautiously to a ballooning current account deficit. This cautious attitude may be reinforced by recurrent crises in emerging markets (Argentina, Turkey, etc).

Fig. 4. Net FDIs *Source: BNR data*



The remarks made above show that a stance of benign neglect regarding the trade and the current account deficits is unwarranted, and that corrective measures would have to be taken in due course in order to keep things under control. Otherwise, the specter of the boom and bust cycle, which has been plaguing the Romanian transition economy in the last decade, would show no sign of fading away (Fig. 5).

[1] The last item (residual) in the official balance of payments published by BNR. It basically represents inflows for which BNR has not identified the source.



What should be done to limit the external deficits?

Firstly, one has to look at the causes of the rapidly increasing trade deficit. There is no doubt that economic recovery is taking its toll; the rise in domestic absorption is illustrated by the sharp increase of consumption and production related imports. The rise in food industry imports (foodstuffs) is glaring; the deficit at this category of imports almost doubled, to around US$ 350 million during the period January-May 2001. Imports were also favored by the trade facilities introduced at the start of this year, which were the equivalent of a real appreciation of the national currency. In a way, it is ironic that a country which does have difficulties in financing its external deficits encourages imports via trade facilities. The reasoning behind this policy move may have been that this is a means to bring in more capital goods and enable, thereby, technological renewal. But such a policy can easily backfire. A proof is that the rise in capital goods imports (as compared to last year) was of less than US$ 100 million for the first five months of the year, out of a rise in total imports of US$ 835 million! Another factor that contributed to increase domestic expenditure was the attempt to resuscitate big loss-making state owned companies; this measure enhanced both financial indiscipline (the growth of arrears which, purportedly, reached 40% of GDP in the first half of this year) and imports. It is telling that the trade deficit of energy carriers and mineral products grew to US$ 684 million for the first five months of this year (as compared to US$ 378 million for the same interval of last year). And finally, the real appreciation of the ROL (the Romanian leu) did not help the trade balance either.

In order to contain the trade deficit, the government and the central bank need to adopt a classical combination of expenditure reduction and switching policies –but within a policy framework which relies on furthering structural reforms and disinflation. The budget deficit should be reduced together with the imposition of much harder budget constraints on loss-making companies (state utilities and other *regies autonomes*), import facilities should be rescinded, wage policy in the state sector should be closely linked to productivity as indicated by sales (and not output/inventory levels), and exchange rate policy should not allow a real appreciation of the ROL. Such a set of measures will likely reduce the GDP growth rate for next year below the targeted level of

5.2%, but it would represent a necessary corrective stage in order to secure sustainable growth in the future.

As for the exchange rate policy, a crawling band, which should preserve the attractiveness of ROL and help discourage "hot money", would be better suited for sustainable growth and steady disinflation. For, under the current circumstances and the rapidly rising trade deficit, a real appreciation of ROL may help reduce inflation a while, but at the cost of future new bouts of rising prices –when, presumably, an adjustment would be necessary via a real depreciation as well. It is advisable for the government and BNR to target a current account deficit not larger than 5.5-6% next year and the set of policy guidelines sketched above would work for such a purpose.

Fig. 6. Macroeconomic indicators, 1990-2000

Indicators	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
GDP (annual trend), %	-5.6	-12.9	-8.8	1.5	3.9	7.1	3.9	-6.6	- 5.4	- 3.2	1.6
Inflation, % Dec / Dec	37.7	222.8	199.2	295.5	61.7	27.8	56.9	151.4	40.6	51.4	40.7
Nominal devaluation, % Average Dec / Dec.	50.3 140.4	240.5 444.5	303.1 143.3	146.8 177.4	117.8 38.4	22.8 45.9	51.6 56.5	132.5 98.8	23.8 36.5	72.7 66.6	41.4 42.0
Consolidated budget deficit, % GDP (including privatization income)	1.0	3.3	-4.6	-0.4	-1.9	-2.6	- 3.9	-3.7	- 3.5	- 2.2	-3.5
Current account deficit, % GDP	-8.5	-3.5	-8	-4.5	-1.4	-5	-7.2	-6.7	- 7.5	- 3.8	-4

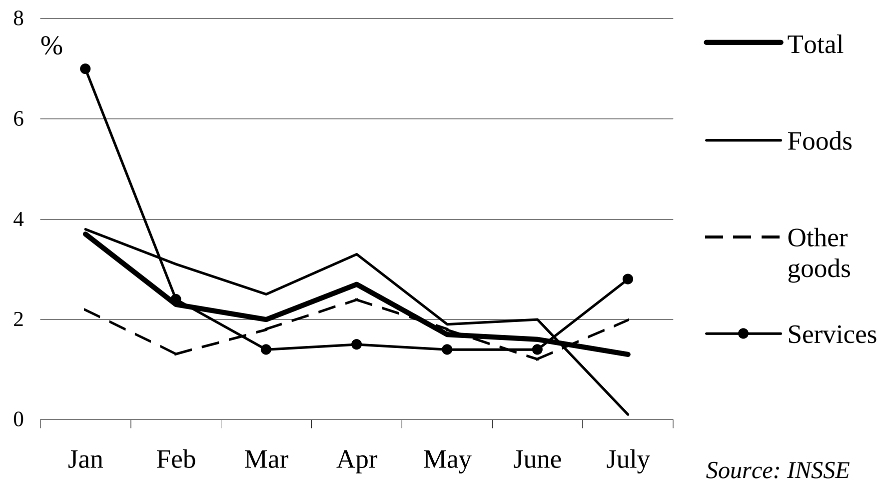
Source: BNR data

Warning: Food Prices are the Wrong Target for Government's Intervention

These days the prevalent opinion in government circles and part of the public opinion is that food prices are going up and something should be done about it quickly, not only for social protection, but also in order to achieve the broader goal of keeping the inflation under control. Cooking oil and sugar are specially mentioned in government officials' statements, as a rise in prices is expected when the plants start to process the new harvest and the demand traditionally increases at the beginning of the autumn.

However, a simple analysis of data provided by INSSE reveals that there is nothing new concerning food: their prices have moved slightly above the general inflation rate for most of 2001 and dropped significantly in July (Fig. 7). Moreover, the cooking oil has lagged behind everything else in the first seven months of this year (Fig. 8), with sugar around the average. By contrast, the prices of services were much more erratic, most of them being government-controlled.

Fig. 7. Consumer prices in 2001



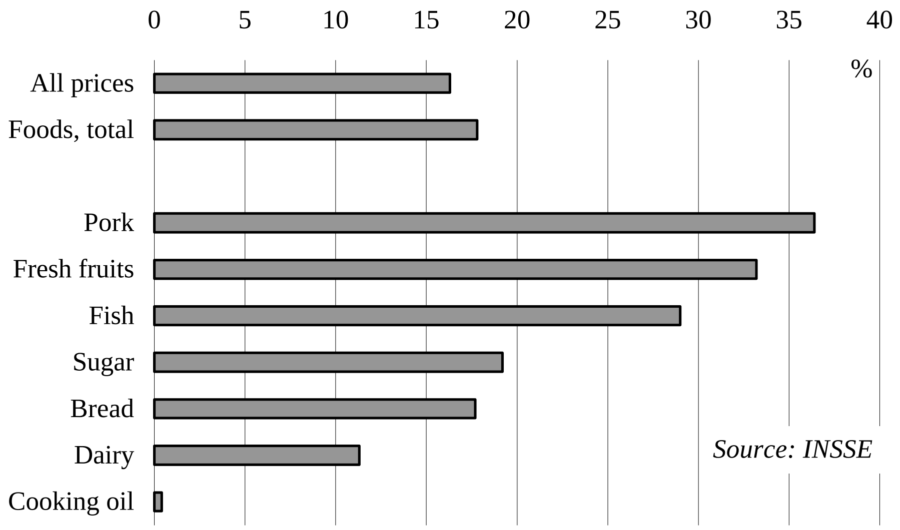
Source: INSSE

When prices rise on such a fragmented and competitive market like that of foods, this is a clear sign that the move is demand-driven. A conspiracy of all the producers, invoked recently by the minister of agriculture, is very unlikely. Furthermore, the tariffs aimed at 'protecting the domestic sugar industry' mentioned in the very same statement are completely at odds with the first goal –if anything, they will determine a rise in the price of sugar. As a consequence, the government should:

- Refrain from imposing price caps (directly or indirectly, through controls aiming at 'curbing speculative activities') on goods produced by a competitive industry and whose price behavior does not show any concerning trend – anyway, not for the two products targeted by the government. As the increase in prices is clearly demand-driven, the caps could only create shortages – if they are enforced, which in practice is almost impossible.

- Co-ordinate sectorial interventions with its general economic policy. For example, if the goal is to keep domestic prices low, this cannot be achieved through higher import tariffs.
- Focus its intervention on areas where it can be effective – for example, in dealing with monopoly service providers.
- Tighten the salary policy in the public sector and state-owned utilities. The rises of salaries in these sectors explain at least in part the surge in domestic demand that the government deems 'artificial', and they are also to blame for the alleged 'overheating' of the Romanian economy mentioned recently by the prime minister. Getting things out of control in the state sector represents the real threat for the anti-inflationary program initiated by the government and the central bank, as well as for the prospective agreement with the IMF.

Fig. 8. Food prices increase, Jan-Jul 2001

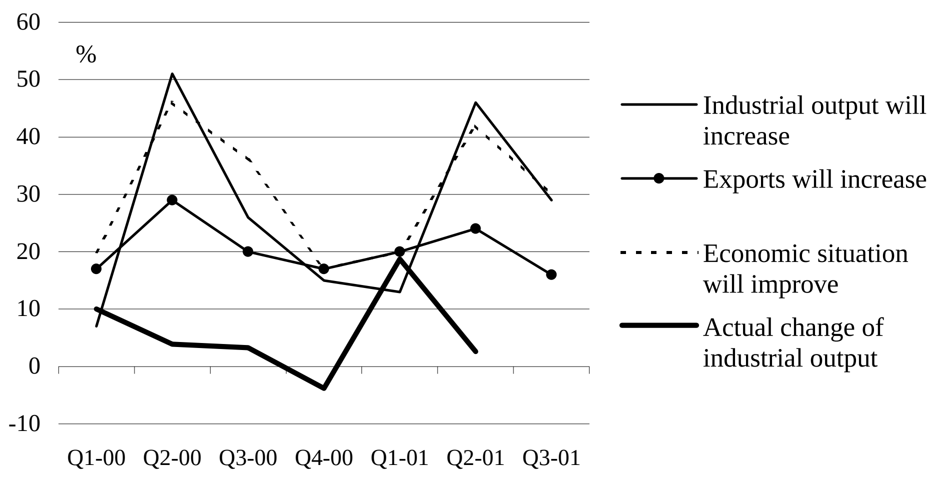


Business Confidence Rises in Spite of the World Slowdown

The National Institute for Statistics and Economic Studies (INSSE) runs a quarterly survey of domestic firms in order to assess the business confidence and make projections for the following quarter. Fig. 9 shows that most domestic business leaders believe that the positive trends we have seen lately will continue.

- For three important indicators (industrial growth, exports and the general economic situation) those who think that things are going on well are a majority, but the margin of optimism is decreasing.
- This optimism should, therefore, be interpreted with a pinch of salt: if we compare the fluctuations in opinion with the actual change of industrial output, we find that the domestic business confidence is not a predictor for growth. Instead, it is the other way around: business-people adjust their opinions to the actual evolution of the economy – with a lag.
- Nevertheless, KPMG's survey of foreign companies operating in Romania confirms the upward trend of the domestic economy – see the table of indicators on the first page – as the percentage of those who forecast an increase in their business on the third quarter went up to 65%.

Fig. 9. Business confidence and growth,
quarterly data

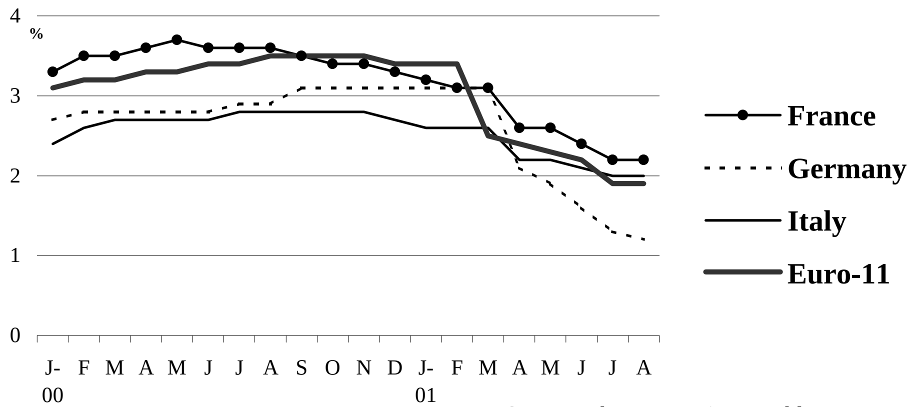


Source: INSSE survey

International Environment and Trade: Romania is Slowly Improving Its Position

The growth projections in the European Union have been constantly revised downwards over the last months. Romania's main trading partners, Italy, Germany and France, absorbing roughly half of Romania's exports, will have GDP growth around or below 2% (Fig. 10); Germany's GDP will grow this year only half as much as in 2000.

Fig. 10. GDP growth projections for the current year, Euro area

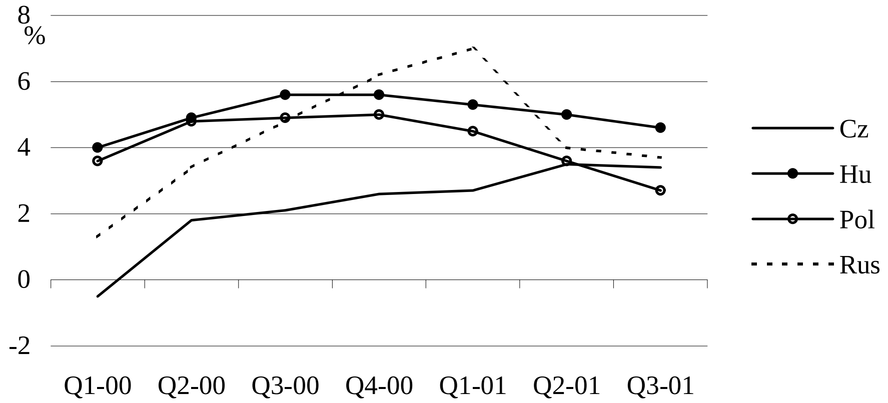


Source: The Economist monthly survey

The EU slowdown will also inevitably affect Central and Eastern Europe (Fig. 11). The first wave of accession countries will most likely have a GDP growth below 4% in 2001 (except Hungary). Even the Russian economy will lose steam, in spite of the still high level of prices of oil and natural gas, which are its main exports.

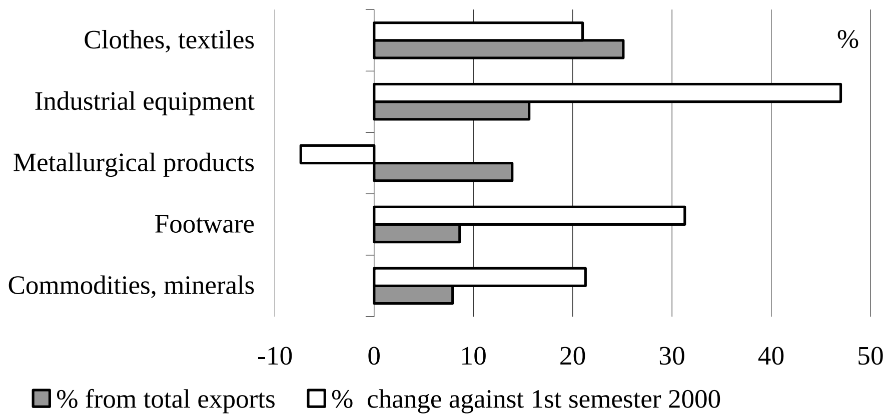
In this context, a GDP growth of more than 4% would make Romania one of the best performers in the region, after many years. The government has just revised upwards its projection from 4.1 to 4.5%. This would be a very good achievement indeed. However, even if the Romanian economy starts feeling the influence of the world economic slowdown in the second semester of 2001, and growth falls back towards 4%, the government should proceed with caution and abstain from injecting resources in the economy just in order to meet the target. Any artificial stimulus could widen the trade deficit and derail the anti-inflation program.

Fig. 11. GDP growth projections for the current year, CEE



Source: The Economist quarterly survey

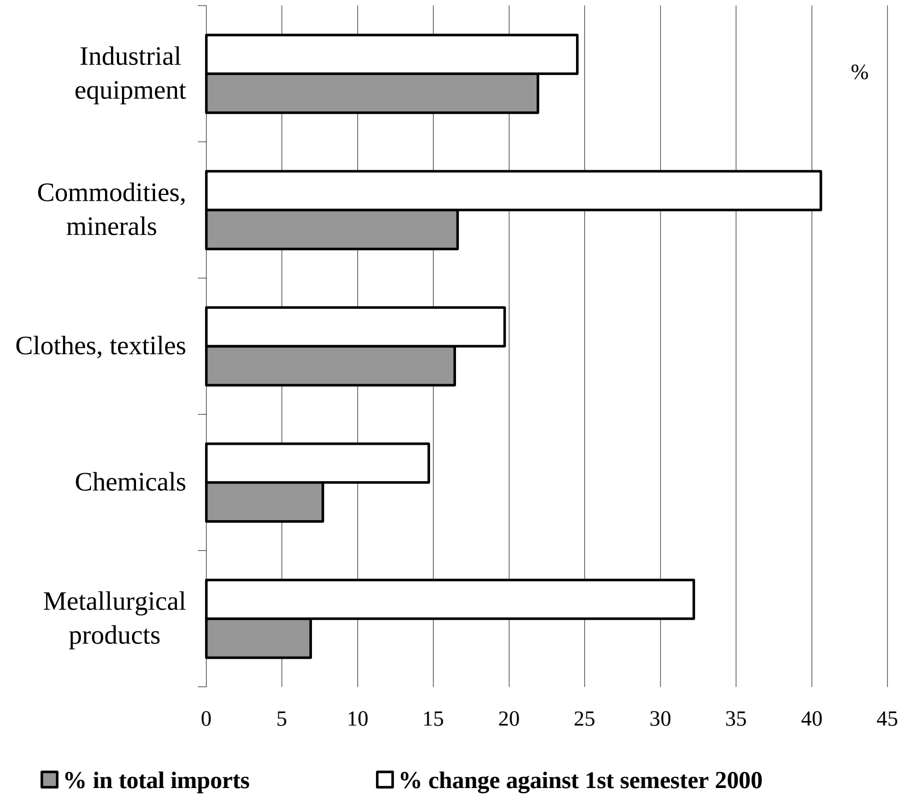
Fig. 12. Exports, 1st semester 2001



Source: INSSE

The slight change in the structure of Romania's foreign trade is also encouraging. The increase in exports of industrial equipment, electric and electronic devices over the last year have surpassed by far those of other, more traditional Romanian products such as apparel, textiles or metallurgical goods (Fig. 12). This development suggests that the Romanian economy is slowly moving up on the value-adding scale. On the other hand, the industrial revitalization has caused a disproportionate increase in demand for imported minerals and fuels (Fig. 13), which shows that the industry remains energy-intensive and inefficient, and that structural adjustments are still needed.

Fig. 13. Imports, 1st semester 2001



Source: INSSE