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BALANCE OF PAYMENTS REPORT

26 February 2018

The strong domestic demand weighs on the C/A balance, but the gap is still covered by FDI flows and EU funds; debt falls

- In the last quarter of 2017, the deterioration seen in the case of external financing capacity (EFC) indicators has stopped (see Chart 1), as transfers from the EU picked-up sharply (Chart 3). This rebound came after EU fund absorption hit multi-year low earlier in 2017. On the other hand, the downward trajectory of the current account balance (C/A) continued at the end of last year, as domestic-demand-fuelled imports' growth outpaced that of exports. The good news is that, despite a modest fall in Q4, foreign direct investment (FDI) flows remained healthy, covering the gap of the EFC indicators. This, coupled with the rapid economic growth, helped the external debt ratio to fall further at the end of 2017 (Chart 10&11). Q4's outturn is in line with our more general view: despite the gradual underlying deterioration, the country is still on a sustainable path. Nonetheless, it is also worth mentioning that the pro-cyclical fiscal policy as well as the threat coming from overheating economy translates into negative risks to our base scenario.
- We note that as the financial crisis hit the economy, Romania entered into a consolidation period with the external balance indicators pointing to remarkable correction. Nevertheless, after domestic demand showed a strong revival, underpinned also by aggressive fiscal easing measures, the key external balance indicators marked a turning point in 2014-2015 (Chart 1). A series of tax cuts accompanied with increasing personnel expenses and social transfers resulted in higher financing need for the government (Chart 2). However, it seems that the private sector remained more cautious than before the outburst of the financial crises, helping to mitigate the risks resulting from loose fiscal policies.
- At the end of last year, the current account deficit rose to around 3.5% of GDP (4Q rolling data), up from 3.1% a quarter earlier, according to our calculations based on the NBR's provisional statistics. Primarily, this was the result of a higher gap in the balance of goods (6.4% vs. 6.0%), but the slowly shrinking surplus of the services account (4.3% from 4.4%) also weighed on the C/A balance (Chart 4). The detailed external trade figures revealed that mainly consumption products and, to a lesser extent, intermediate goods were responsible for the rising deficit (Chart 5). In the case of capital goods, which are imported in order to carry out investment projects, the shortfall was practically unchanged in the latest period. We recall that in the past few quarters, chiefly, the revival of consumption expenditures supported the cheering GDP growth figures, while gross capital formation showed a less impressive performance.
- Similarly to the balance of goods, the robust domestic demand started to put pressure on the services' account too. The surplus of the services' balance marked a turnaround, as imports grew faster than exports (Chart 6). A deeper look on the data shows that the travel segment was the key driver behind the deterioration. Nonetheless, it is also worth mentioning, that some of the most competitive sectors of the country also pointed to moderation (Chart 7&8). The surplus generated by the IT&C and transportation industry softened in 2017. It cannot be excluded that, beside the challenges caused by the tightening labour market, government actions (like the re-introduction of the special excise duty on fuels and the uncertainties around the tax intensives for IT companies) had negative spill-over effects too.
- The capital account (Cap.A) ended last year with 1.2% surplus owing to a significant uptick in EU fund absorption in December (Chart 3). Earlier in 2017, EU funds disappointed, as the accreditation process of the 2014-2020 operational programmes registered large delays. We think that further improvement may come in the quarters ahead, helping the surplus of the capital account to getting gradually closer to its historical average (1.7% of GDP in the period of 2010-2016) and, accordingly, mitigating the pressure on the EFC indicators.
- Net inward FDI flows finished last year at a healthy level (2.4% of GDP), but slightly lower than at the end of Q3 (2.7%; Chart 9). It is important to underscore that FDIs covered entirely the deficit of the EFC indicators. Accordingly, Romania's gross external debt (excluding intercompany lending) eased further, to 35.9% of GDP (Chart 10). This threshold corresponds to pre-crises levels and is also among the lowest in the CEE region. However, we reiterate as well that Romania's current account and EFC balances point to a less favourable picture than those of other countries in the CEE region.

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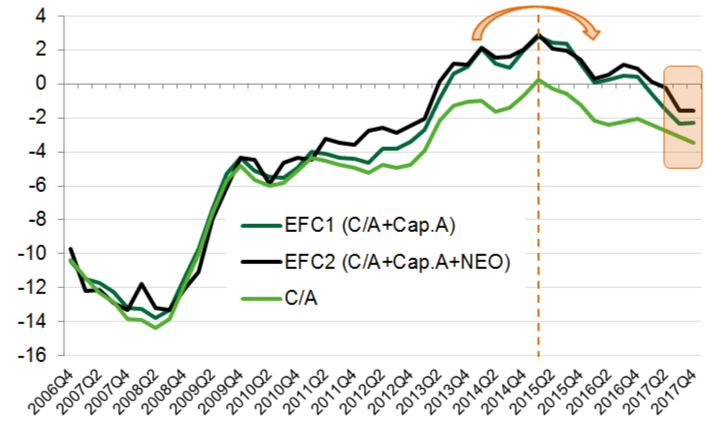
- Summing it up, Q4's data shows that debt sustainability risks are low at this moment. However, the deterioration seen in underlying external balance indicators translates into some warning signs. The NBR had started the [monetary policy] normalisation process, which could help to gradually cool down the economy. Nevertheless, the [fiscal policy], most likely, will continue to struggle with the 3% deficit limit and several structural vulnerabilities too.
- In this context and also due to the cyclical position of Romania's economy, we think that the C/A balance will remain on a downward trajectory in the years ahead, reaching 3.9% in 2018 and 4% in 2019. The following few months will be worth watching, as the impact of tighter monetary conditions should spill over into the real economy, while the effect of tax changes (transferring the burden of social contributions from employers to employees) is also set to show up.

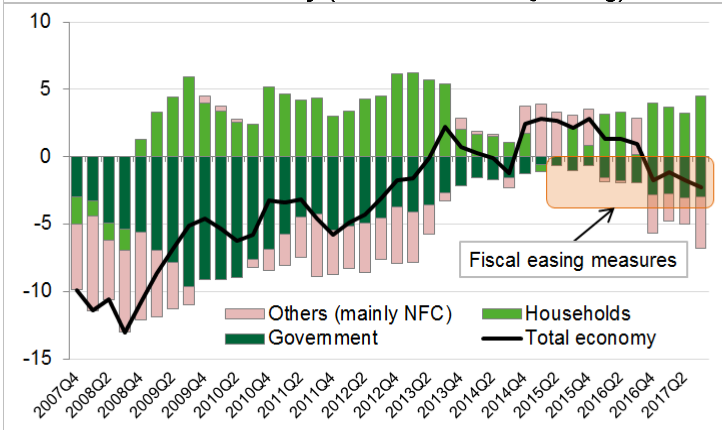
Chart set:

Chart 1: Main indicators of external balance
(as % of GDP, 4Q rolling)



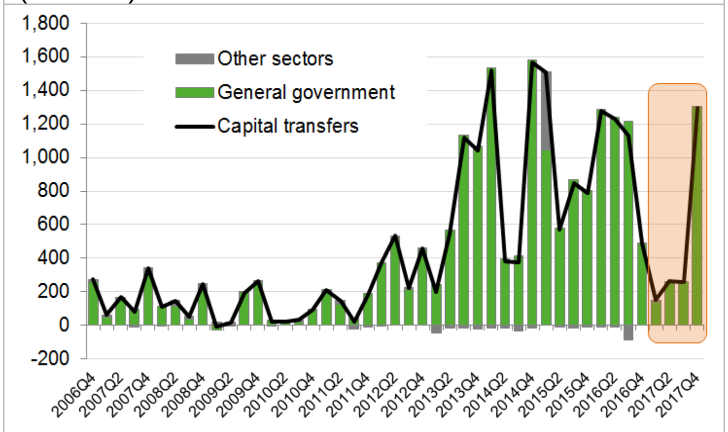
Sources: NBR, NIS, OTP Research
*Note: **EFC1** (External financing capacity 1) = Current account + Capital account; **EFC2** (External financing capacity 2) = EFC1 + Net errors and omissions*

Chart 2: Net financing capacity of the main sectors and the whole economy (as % of GDP, 4Q rolling)



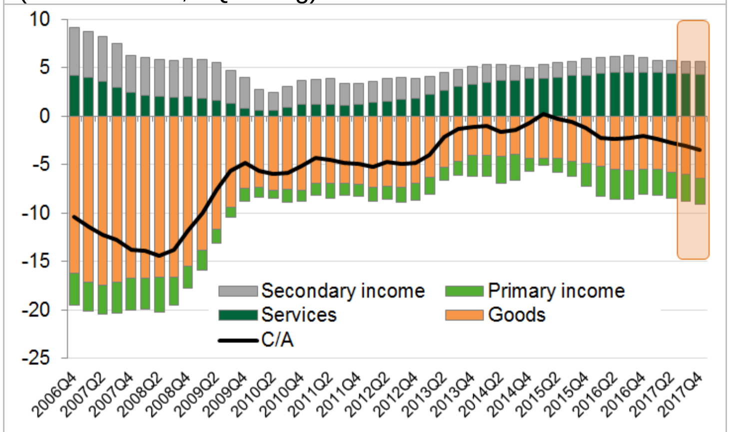
Sources: NBR, NIS, OTP Research
Note: Q4 2017 data is not available yet

Chart 3: Capital transfers
(EUR mn)



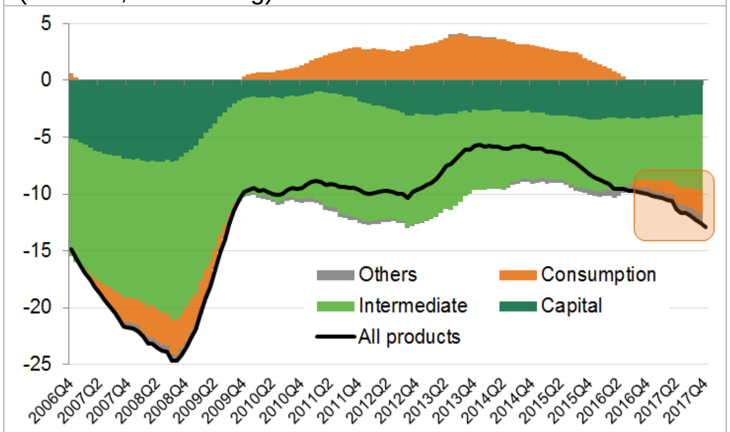
Sources: NBR, OTP Research

Chart 4: Current account by its main components
(as % of GDP, 4Q rolling)



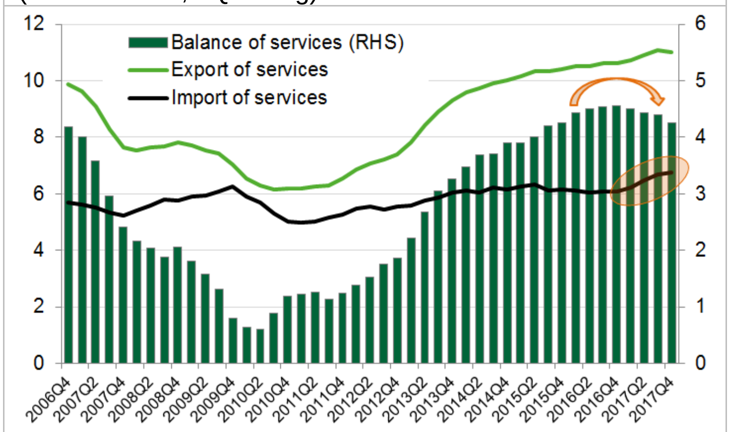
Sources: NBR, NIS, OTP Research

Chart 5: Balance of goods by main product types
(EUR bn, 12M rolling)



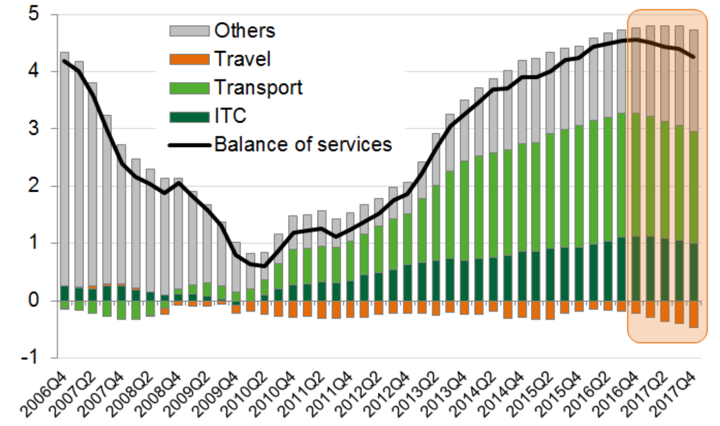
Sources: Eurostat, OTP Research
Note: detailed December 2017 data is not available yet

Chart 6: Services' account
(as % of GDP, 4Q rolling)



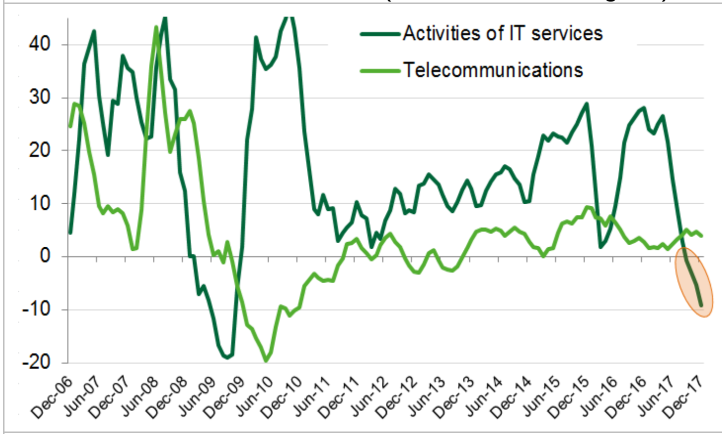
Sources: NBR, NIS, OTP Research

Chart 7: Services' account by its main components
(as % of GDP, 4Q rolling)



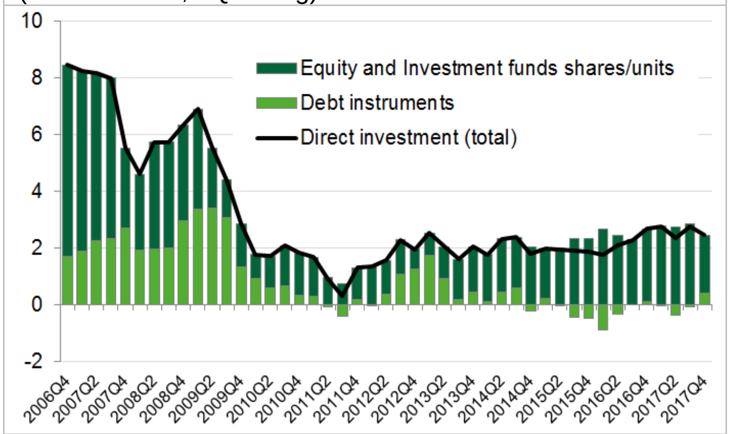
Sources: NBR, NIS, OTP Research

Chart 8: Turnover indices of IT and telecommunication services (YoY %, 6M moving av.)



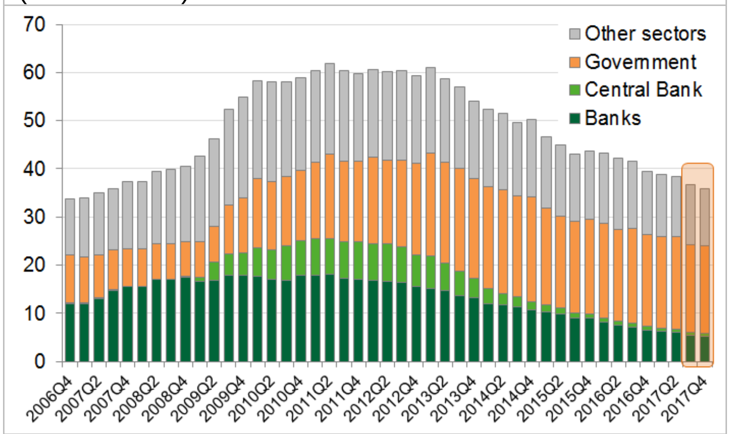
Sources: NIS, OTP Research

Chart 9: Net direct investment
(as % of GDP, 4Q rolling)



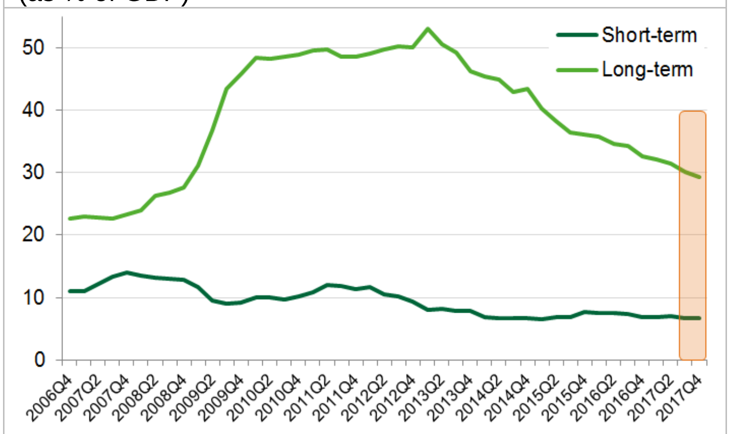
Sources: Sources: NBR, NIS, OTP Research

Chart 10: Gross external debt by sectors
(as % of GDP)



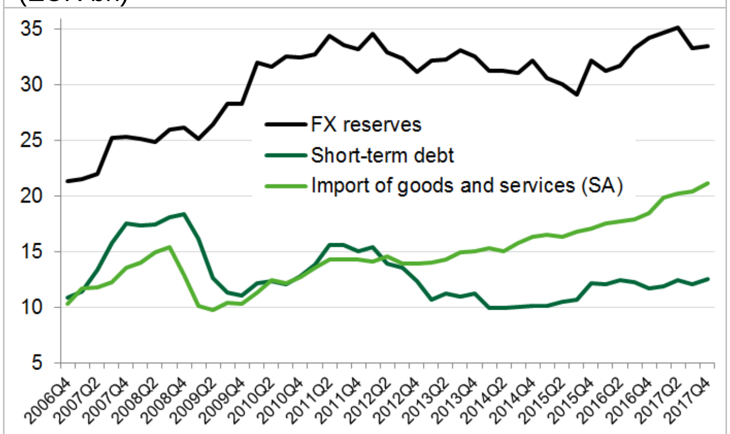
Sources: NBR, NIS, OTP Research
Note: without intercompany lending; based on BPM5 methodology until 2012 Q4

Chart 11: Gross external debt by tenor
(as % of GDP)



Sources: NBR, NIS, OTP Research
Note: without intercompany lending; based on BPM5 methodology until 2012 Q4

Chart 12: Reserves and reserve adequacy rules
(EUR bn)



Sources: NBR, NIS, OTP Research
Note: without intercompany lending; based on BPM5 methodology until 2012 Q4

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