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ROMANIA'S IMPLICATION IN THE GLOBAL FINANCIAL CYCLE

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Abstract

In this article we intend to approach the global financial cycle and the international production networks, as well as Romania's international investment position through its main components. The targets relate to: the global financial cycle and the recent experience of emerging economies, describing global production networks, the implications of extending international production networks, the influence of trade integration on economic development. Also, we approach the evolution of investments in our country in 2015, with reference to international reserves, gross external debt and net external debt. Drawn conclusions refer to mitigating the contagion effects generated by the increase of the degree of global financial integration.

Keywords: *global financial cycle; international production networks; emerging economies; gross external debt; net external debt; financial integration; international investment position.*

JEL Classification: E2, E6, F4

Introduction

In an internal and external environment marked by a high degree of uncertainty, in which the vulnerabilities the Romanian economy has faced not long ago are likely to recur, only a coherent set of policies in the

macroeconomic, structural and macro-prudential field enable the ascendant evolution of the Romanian economy on a long-term and the insurance of price and financial system's stability. In these circumstances, the process of economic convergence – nominal and real – would take place in a sustainable manner, its advance being achieved while maintaining the macroeconomic balances. In the absence of a serious effort in this regard, there is the danger that the notable performance on these fronts – visible especially in 2015, but achieved over time – to not last.

The recent experience of emerging economies

The evolution of the emerging economies in the past two years, marked by turbulences on the financial markets and massive capital outputs, has brought back to the attention of the economic policy makers the importance of understanding *the effects of the global financial cycle on national economies.* Thus, beyond the influence of the business cycle, whose movements are captured by the indicators of the real economy, the economic activity is affected as well by the movements of the global financial cycle. Unlike the first, this one manifests on a much longer period of time (circa 15 years, compared to 1-8 years in case of the business cycle) and is harder to identify and assess, being generally correlated with the evolution of property and lending prices. Even if there is no consensus on the definition of the phenomenon in literature, the global financial cycle can be understood as a result of continuous interaction between:

(i) investors' perceptions on the value of (under/overvalued) assets;
(ii) their appetite for risk;
(iii)the financial constraints encountered Borio, 2012.

Taking into consideration the important role held by the US dollar not only in the international trade but also on the international financial markets, Fed's monetary policy is an important source of the global financial cycle fluctuations. Moreover, in a recent speech, New York Fed's President said that US central bank has "*a special responsibility to manage the monetary policy in a way that contributes to promoting the global financial stability*".

In this context, monetary easing in the US after the crisis triggering in 2008, mostly through the practice of some interest rates close to zero and

some unconventional policies, such as direct purchases of assets, has generated globally a surplus of liquidity, putting growth pressures on the assets' prices and thus fuelling investors' appetite for risk.

As a result, the foreign capital has migrated towards emerging markets, in search of higher returns and to achieve a better portfolio diversification. The States in question have received such funding (perhaps even the technological advances associated), which has sustained the economic development and, as a result, the increase of the living standard. Even if Fed's loose monetary policy has boosted the expansion of the capital flows, it should be noted that their final destination has depended crucially on factors specific to the countries, which related primarily to the macroeconomic stability (quality of the institutions, fiscal and monetary policies, the level of deficits and debt, of the reserves, etc.).

These internal coordinates have proved to be more relevant in times of sudden change in investors' sentiment. The deterioration of the growth prospects of the emerging economies and the emergence of the first signals (in May 2013) concerning the interruption of Fed's longest cycle of quantitative easing, which also materialized by the end of 2015, made it possible for us to assist today to the significant redirection of the capital from emerging markets towards the advanced ones, together with the general decrease of the main raw materials prices on the international markets. Thus the situation has become delicate for the emerging economies as the massive withdrawals of capital, which have generated strong pressure for the devaluation of the national currencies, leading to the diminishing of the international reserves, have coincided with the end of the boom period in raw material prices, the previous episodes of overlay (e.g., the 80s) leading systematically to sovereign debt crises Reinhart et al., 2016.

According to the IMF assessment, the recent episode of capital withdrawal from the emerging economies is similar to that of the 90s (the Asian crisis) and the 80s (Latin America), both as amplitude of restricting net as share in the GDP (about 4%) and as percentage of the affected states (about 70%). However, there is an important distinction from the previous episodes, namely the one that the risks to the sustainability of the external debts seemed relatively manageable, largely due to strengthening the

macroeconomic policy framework. In this respect, a key role belonged to the exchange rate flexibility, which has facilitated an orderly depreciation of those counties' currencies. However, the better adequacy of the international reserves, and especially the predominance of some relatively moderated levels of the foreign debt have acted in the same direction IMF, 2016. Instead, the globalization of the financial markets and the more closely integration of the emerging economies into the international trade chains have determined the adverse effects to propagate not only regionally, but also at the level of the advanced economies, the latter facing fluctuations on the capital markets and especially a deceleration of the commercial transactions worldwide.

Global production networks

The influence of the external environment on the domestic economic context has acquired an additional dimension as the incorporation of some local sectors within the international production networks has grown. The relevance of this development for the Romanian economy is significant, practically lying at the base of reconfiguring the production on a more competitive structure that has favoured the correction of the external imbalances and has stimulated the economic recovery after the financial and economic crisis outbreak.

The main coordinates of extending the international production networks

In a broader perspective, at the level of the post-war global economy, the production process has acquired an increasingly transnational character along with blurring the restrictions which aimed at the trade and investment flows between countries, the two phenomena empowering one another. The expansion of the global production networks recorded an acceleration staring with the mid-1980s (**Figure no. 1**), mainly along developed economies – emerging economies axis, especially as a consequence of the information technology's progress, transmitted in the decrease of the communication costs Baldwin and Lopez-Gonzales, 2015 and which has facilitated the remote coordination of the network's nodes.

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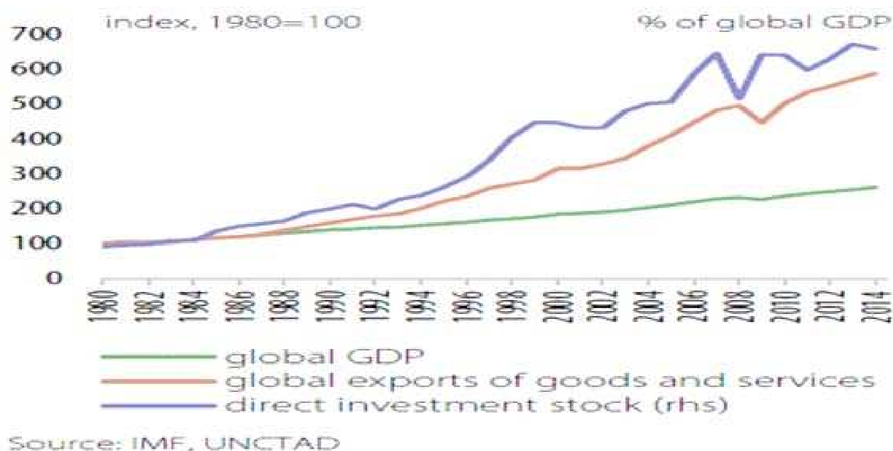

Figure no. 1. GDP, international trade and direct investment stock at global level

Source: Data published by IMF, UNCTAD

Over the decades that have brought about the emergence and expansion of the international production networks, the mechanism underlying this phenomenon has remained broadly unchanged. It essentially involves a company that seeks to improve its own activity – either by improving the cost structure or by expansion on new markets – and which, in this respect, finds favourable conditions for the realization of a production capacity in another country, usually an emerging economy. Beyond the complexity of cost-benefit analysis underpinning these investment decisions, the company primarily looks for a friendly economic environment, with predictable legislation. Another frequently cited element refers to the wage level, generally lower in emerging economies compared with that of developed countries, which translates into lower costs. However, at the same time, in terms of the human resources, manpower availability, possessing the skills necessary to carry out the appropriate parameters of productivity, is particularly important. Other relevant factors in the decision to locate a production capacity may concern the quality of transport infrastructure, the existence of cluster-type concentrations, for the types of networks where these structures play an important role (such as, for example, those from the automotive sector) or the consumption potential of the local market.

Starting with 2004, after the unequivocal outlining of Romania's European road, direct foreign investment rose steadily. Important flows

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were directed towards industry (**Figure no. 2**), the role of these companies in the economy currently being prominent. However, in the light of current developments, the maintenance of the problems related to the insufficiency of the skilled labour force, the wage advance situated above that of the productivity and the lack of a noticeable improvement of infrastructure's quality have eroded the competitive advantage.

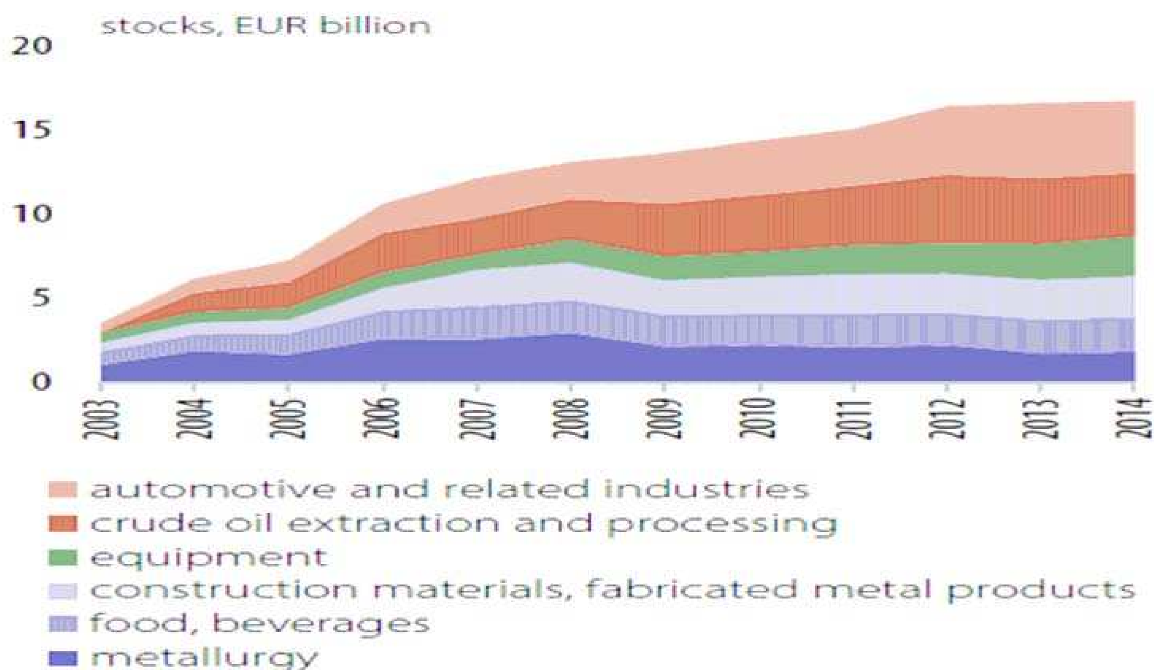

Figure no. 2. Direct investment in main industrial activities
Source: Data published by Annual Report of Romanian National Bank, 2015

Extending the international production networks

Widely fragmentation of global production in stages developed in different countries has claimed the adjustment of the way in which the economic evolutions are analysed and interpreted, and, implicitly, of the elements pursued in the substantiation of the trade, structural or development policies.

First, it is necessary that the evaluation of the competitiveness of an economy to look beyond the expansion of exports, as their relevance in

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terms of creating jobs, incomes and welfare depends on the proportions in which they contain added value achieved at national level. In fact, high levels of exports show most often a significant content of added value of foreign origin (**Figure no. 3**).

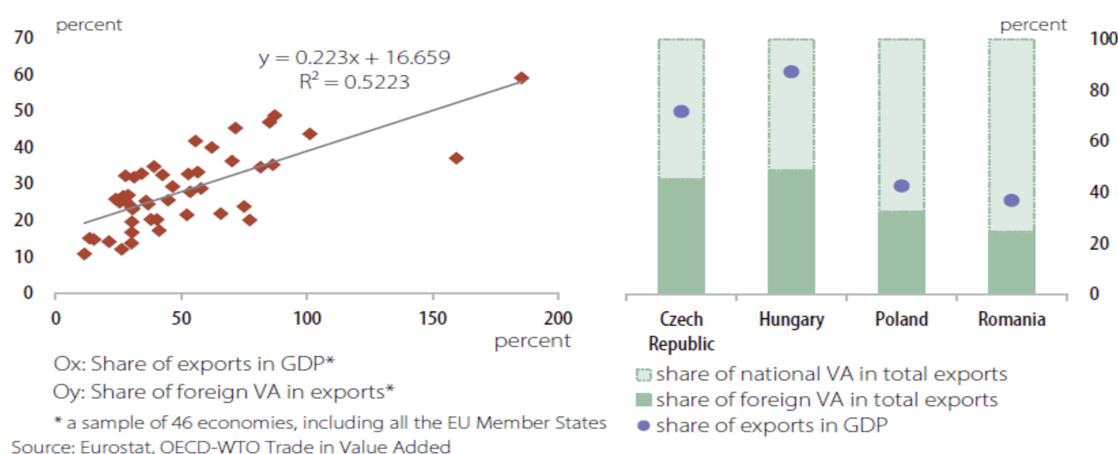

Figure no. 3. Export performance and share of foreign value added in exports (2011)
Source: Data published by Annual Report of Romanian National Bank, 2015

Regarding the export performance of the Romanian economy, although it is lower than other European emerging economies, has been accompanied by maintaining a substantial share of national added value.

Moreover, the interpretation of all the indicators that aim the exports (market share, technological content, etc.) should consider the size of the national production factors' contribution. For example, it is possible that the sluggishness or even the cessation of the activity of an exporter of products with high technological content to have relatively small effects on the national economy, to the extent that the local operations aim stages with a low added value (such as product assembly). However, beyond the implications of such a scenario, any foreign investment can bring, beside the immediate benefits, advantages in the medium and long term, to the extent that, conditioned by the existence of some favourable circumstances, the company decides to expand its operation, possibly towards activities with a higher added value content.

Trade integration has led, obviously, to an amplification of the exposure to external shocks, which means that potential adverse events are

transmitted stronger and faster locally. In addition, the complexity of the trade relations worldwide makes it difficult to quantify the relevance of the external shocks for a certain economy. For instance, the structural changes recorded in China's economy have the potential to influence the exports of the ECESE states despite of a possible limited direct exposure, by integration into the German production networks (IMF, 2016). Therefore, the assessment of the foreign demand should take into account the fact that the aggregated income of a trading partner is less relevant for the domestic production and exports, to the extent that this partner includes intermediate nodes of the networks, the demand for final goods which "activates" the transactions with it actually coming from third countries. For Romania, the foreign demand thus determined has revealed a lower exposure compared to the group of other EU countries (about 60% in 2011, according to OCDETiVA data), than that indicated by the share of commercial transactions (over 70%), which suggests that the exports directed to these countries are in consistent manner further processed and forwarded to other regions.

Also, the integration into the international production chains has implications on the traditional relationship between the exchange rate and the exports. Thus, the assumption that a depreciation in real terms (which can be determined, *caeteris paribus*, by a nominal depreciation) supports the sales to external partners loses its relevance if the domestic production depends on the imported *inputs* (which become more expensive). This theoretical mechanism has been validated from empirical perspective as well, the indicator effective real exchange rate that takes into account production's imported *inputs* having a superior performance than that calculated in the "classic" manner in explaining the evolution of exports.

Trade integration and economic development

The widely co-optation of the emerging economies in the production process represents an evolution with multiple implications in terms of welfare and economic development for all parties involved, although there is no consensus on the magnitude of the positive contributions relative to the negative ones.

From the perspective of the developed countries, the interpretation according to which the phenomenon is reduced to the loss of the productive capacity and of the jobs directly and indirectly attached was called into question by some studies, which ascribe it an increase in the utilization of the highly skilled labour force for a review of the literature, one can consult Amador and Cabral, 2015. Therefore, these economies essentially would

have recorded a re-qualification of the labour market, in the sense of increasing the importance of the employees with high level skills, to the detriment of those carry out activities that require a medium and low level of education. At the same time, an improvement of the production process parameters, transmitted in a more favourable price-performance ratio for the ultimate good, is beneficial for all the consumers in these countries.

For emerging economies, the advantages are clearer, the mitigation of the development gap between them and the group of rich countries being due, in a consistent manner, to the integration into the international production networks. From the perspective of the European project, this development has provided support for the enhancement of the real convergence between the new Member States and the "centre" consisting of the developed countries, thus acting as *de facto driver* of the European integration process. However, to the extent that the benefits are distributed unevenly in the society, they can lead to the appearance or increase of some imbalances. In this regard, an issue that requires attention in the national economy aims the dissonances between the development profiles of each region.

Romania's investments evolution in 2015

Direct investments have totalled in 2015 net inflows amounting to 2,765 million Euros, up by 2.3% compared to 2014, against the background of reinvested profits. Non-residents' investments in Romania reached 3,044 million Euros, with a level of shareholdings[1] amounting to 3,335 million Euros, diminished by the net negative value of the intra-group[2] loans. The top five investor countries[3] have been: France (44.1%), the Netherlands (18.7%), UK (10.6%), Germany (9.2%) and Austria (3.4%).

*Portfolio investment*s have recorded in 2015 net outflows of 776 million Euros, compared with the net inflows of 2,859 million Euros in 2014, under the terms of a lower volume of long-term government securities issued by the public administration and of the sale by non-residents of some holdings to residential investment funds.

"Other investments" component in 2015 has recorded net outflows amounting to 5,481 million Euros, down with 44.6% compared with 2014, trajectory imprinted by loans and deposits. Thus, long-term received loans

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[1] Including the reinvested net estimated profit.

[2] Loans between the foreign investor and the resident company.

[3] In terms of the share of direct investment inflows of the non-residents in Romania in 2015 (preliminary data). The five countries account for 86% of the total.

have totalled net outflows of 3,956 million Euros, compared to 5,419 million Euros in 2014, in the context of a lower volume of repayments in the account of central bank's loans. Short-term received loans have recorded net inflows of 365 million Euros, compared to net outflows of 77 million Euros in the previous year, against the background of easing of loan repayments of the non-financial corporations. Deposits have recorded net outflows of 1,537 million Euros, compared to 3,859 million Euros in the previous year, being noticed an increase in deposits opened by non-residents to resident banks and a decrease of the volume of residents' deposits (banks and non-financial corporations) abroad.

International reserves

At the end of 2015, Romania's international reserves totalled 35,485 million Euros, 20,7 million Euros less than at 31st of December 2014. The contribution of the net transactions and the price influences has been negative, amounting to 821 million Euros, this being counterbalanced by the exchange rate influences (+801 million Euros). Monetary gold has diminished its value with 42.7 million Euros, in line with the evolution of the quotations on the international market. Romania's international reserves have covered at the end of period 6.4 months of imports of goods and services, compared to 6.8 months at the end of 2014[4].

Gross foreign debt

At 31st of December 2015, the gross external debt totalled 90 billion Euros. Long-term external debt[5] has decreased compared to the end of 2014 by 6.8%, reaching to 70.7 billion Euros, due to some net outflows of 5.8 billion Euros, of the price influences related to debt securities (-0.4 billion Euros) and of the conversion of debt into shares and reclassifications (-0.1 billion Euros), opposing the change in exchange rates (+1.2 billion Euros).

Long-term external debt service amounted to 23.1 billion Euros in 2015, the capital ratios representing 21.3 billion Euros, while the cost with the interests and fees totalling 1.8 billion Euros.

[4] The coverage degree of imports of goods and services is calculated as ratio between Romania's international reserves (foreign exchange + gold) at the end of the period and the average monthly imports of goods and services during that period.

[5] Coming from trade credits and foreign loans, bonds, deposits and DST allocations.

The structure of the external debt by institutional sector in the long-term shows that at the end of 2015 the public administration sector continued to hold the largest share (44.4%), being followed by non-banks sector (39.5%). The banking sector (14.2%) and the monetary authority (1.9%) have continued to show diminished values, determined by the decrease in the balance of the deposits and payment of due instalments on the debt to the IMF.

The analysis of the long-term external debt on types of creditors reveals the steady decline of the share held by the international bodies (from 25.6% at the end of 2014 to 23.1% at 31st of December 2015) as a consequence of the repayments made under the loan granted by the IMF in 2009 (1.5 billion Euros), but also in account of the external debt to other multilateral creditors – EU, IBRD, EBRD, EIB (3.2 billion Euros). The trend of increasing the share of private sources (from 74.4% at the end of 2014 to 76.9% at the end of 2015) has maintained through the access to financing on the private capital markets in the form of securities.

Regarding the classification of maturity, on 31st of December 2015, the external debt with maturity over 5 years continued to hold the most important position (81.5%) in the long-term external debt.

The structure on currencies of the long-term external debt at end of the analysed period reveals a majority share of the Euro currency (74.2%, up by 0.9 percentage points versus December 31st, 2014), followed by RON (10.9%, up by 0.6 percentage points), US dollar (10.1%, up by 0.7 percentage points), DST (2.0%, down by 1.7 percentage points), Swiss franc (2.0%, down by 0.6 percentage points) and other currencies (0.8%).

Long-term external debt has represented 44.1% of the GDP at end of 2015 (down by 6.4 percentage points from the previous year end; **Figure no. 4**). The rate of the long-term external debt service has reduced by 3.5 percentage points, from 38.5% at end of 2014 to 35.0% at 31st of December 2015.

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percent

	2014	2015
Gross external debt/GDP	63.1	56.1
Net external debt[97]/GDP	29.6	23.6
Long-term gross external debt/GDP	50.5	44.1
Long-term gross external debt/exports of goods and services	122.5	107.3
Long-term gross external debt service ratio	38.5	35.0

Figure no. 4. Key external indebtedness indicators
Source: Data published by Annual Report of Romanian National Bank, 2015

Short-term external debt totalled 19.3 billion Euros at the end of 2015, its balance being 2.2% higher than 2014, as a result of some net capital inflows amounting to 1.8 billion Euros. Short-term external debt service totalled 28.1 billion Euros and its corresponding rate has been 42.7% at 31st of December 2015, with 12.1 percentage points less than at the end of 2014.

Net external debt[6]

Compared to 2014, at the end of 2015 the net external debt has recorded a low level, from 44.5 billion Euros to 37.9 billion Euros, due to the decrease of the net external debt of all institutional sectors[7] (**Figure no. 5**).

[6] The net external debt is equal to the difference between the gross external debt and the foreign assets which are based on the debt instruments (External Debt Statistics – Guide for Compilers and Users – IMF, 2013 edition).

[7] Nonbanking sector; companies that accept deposits, excluding the central bank; public administration; the central bank.

EUR million

	Gross external debt	External assets in debt instruments	Net external debt
	(1)	(2)	(3) =(1)-(2)
General government	31,459	2,071	29,388
Cash and deposits	83	6	77
Debt securities	18,155	0	18,155
Loans	13,197	0	13,197
Trade credits and advances	2	1,985	-1,982
Other liabilities/assets	23	80	-58
Central bank	1,560	32,238	-30,678
Special drawing rights (SDR)	1,252	11	1,241
Cash and deposits	186	4,378	-4,192
Debt securities	0	27,849	-27,849
Loans	122	0	122
Other liabilities/assets	0	0	0
Deposit-taking corporations except the central bank	14,869	3,781	11,088
Cash and deposits	14,536	2,789	11,747
Debt securities	173	293	-120
Loans	0	475	-475
Other liabilities/assets	160	224	-64
Other sectors	21,693	10,961	10,732
Cash and deposits	0	3,129	-3,129
Debt securities	14	1,430	-1,416
Loans	19,918	3,703	16,214
Trade credits and advances	1,677	2,474	-798
Other liabilities/assets	85	225	-140
Debt instruments under direct investment	20,454	3,083	17,371
Total	90,034	52,134	37,900

Figure no. 5. Romania's external debt at the end of 2015

Source: Data published by Annual Report of Romanian National Bank, 2015

At the end of 2015 the public administration sector has marked a debtor external position in decline, the net debt reaching to 29.4 billion Euros (compared to 30.8 billion Euros in 2014), mainly as a result of repaying the outstanding external loans.

Net debtor position of the credit institutions, amounting to 11.1 billion Euros (compared to 12.8 billion Euros in 2014) has been determined by the diminution of the deposits attracted from mother banks.

Non-banking sector has recorded a net debtor position of 10.7 billion Euros (compared to 13.8 billion Euros in 2014), following the increase of foreign assets in the form of securities, of the deposits and loans, while reducing the external liabilities in the nature of loans.

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The net creditor position of the central bank, of 30.7 billion Euros (compared to 29.6 billion Euros in 2014) has been generated by the increase in the foreign assets which are based on debt instruments (securities) and of reducing the debt to IMF by repaying the due instalments in the account of the stand-by agreement.

Debt instruments in the nature of direct investment have registered an increasing net debtor position, amounting to 17.4 billion Euros (compared to 16.8 billion Euros in 2014), determined by increased of the intra-group loans.

Conclusion

With regard to mitigating the contagion effects generated by the globally increase of the financial integration degree, Constâncio 2015, with whom we agree, exposes two currents of ideas. The first directly addresses the source of the global financial cycle, being also called *the global solution*, and presupposes an international coordination of Fed's monetary policy with that of the national central banks. Such a solution is however difficult to implement, given the fact that each central bank operates in a specific institutional and economic context, in accordance with its own status which provides the establishment of one or more basic objectives from national perspective. The second stream of ideas, more pragmatic, believes that the best line of action is to strengthen the national economies resilience to potential external shocks by *strengthening the macroeconomic fundamentals*, as well as *the calibration of the macro-prudential policy* according to the circumstances specific to each country. Within the latter, Rey 2015 distinguishes cyclical measures, which limit the growth rhythm of credit and of indebtedness during the economic expansion and, respectively, structural measures, which impose stricter limits of indebtedness to the financial intermediaries.

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