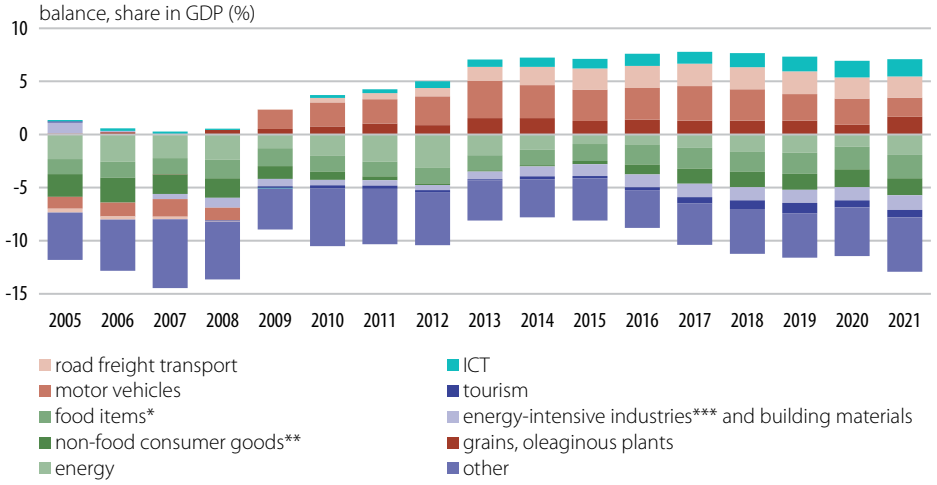
Box 2. Structural dimension of the current account deficit: a sectoral perspective

The external disequilibrium is one of the main vulnerabilities of the domestic economy and a decisive influence in this respect comes from structural deficiencies (Chart A)[1]. They explain to a large extent the magnitude of the deficit, but also its quasi-steady nature – basically, from 1990 onwards, Romania reported only external deficits, regardless of the phase of the domestic or external business cycle. This analysis aims to highlight a number of structural factors affecting the external position, based on a sectoral approach that facilitates the distinction between idiosyncratic issues and aspects transcending the particular framework of some areas of activity. The sectoral analysis also allows identifying coordinates of how a sudden adjustment of the external disequilibrium (the so-called "hard landing") could unfold in terms of related costs.



*) Combined Nomenclature, Chapters 2-4, 7-9, 11, 13, 15-23
**) excl. the goods produced under processing arrangements
***) base metals, fertilisers, pesticides
Source: Eurostat, NIS, NBR calculations

Chart A
Balance on goods and services

Structural factors of the external position

Energy

Romania is a net energy importer, a position maintained over the past few decades. In this period, energy consumption declined, in step with the global rate of improvement in energy efficiency. According to the International Energy Agency, energy intensity (measured as total energy supply per unit of gross domestic product) decreased internationally by more than a third between 1990 and 2019. Romania's energy intensity followed a downward path, more pronounced than that at EU level – while in 1995 Romania's energy intensity was almost twice the EU-27

[1] The analysis draws on (fob-fob) trade balance data by group of goods, mainly based on the 2008 Classification of Products by Activity. The exceptions are the group of agri-food items (where the classification in the Combined Nomenclature was preferred, as it allows for a finer detail) and the group of non-food consumer goods (where the Classification by Broad Economic Categories was used, as it facilitates the exclusion of trade flows related to goods produced under processing arrangements).

average[2], in 2008 the indicators were at par, and in 2020 it made up about three fourths of the EU average. The increase in domestic energy efficiency entailed lower resource requirements, which attained a peak of the last decades in 1996, at the height of the business cycle. At the apex of the next boom phase in 2008, GDP stood almost 60 percent higher, on the back of gross domestic energy consumption lower by approximately 21 percent. The trend continued, so that at the next peak in 2019 GDP advanced 28 percent from 2008, whilst energy consumption decreased by another 17 percent.

The contraction in energy consumption was accompanied by a decline in domestic energy production. Reliance on energy imports[3] ranged generally between 20 percent and 30 percent from 1990 onwards, in 2021 recording a value close to the upper bound of the historical variation range.

The information emerged in recent years about natural gas deposits in the Black Sea area, but also on-shore, suggests that energy independence – either on the whole or only in the natural gas segment – could have already been achieved assuming a swifter pick-up in prospecting activities and the integration of new resources in the exploitation circuit. The latent manifestation of the vulnerability posed by the reliance on energy imports (it posted fluctuations, as mentioned above, but did not worsen over time) appears to have limited the authorities' drive to promote more effectively the discovery and harnessing of new resources. In fact, legislative uncertainty and the interventions to cap energy firms' benefits eroded the attractiveness of investment in this sector. In addition, the recent push towards reducing carbon emissions led energy producers to focus on renewable resources, possibly to the detriment of traditional ones.

Sources such as wind or solar energy have become more relevant locally in recent years, generating together about 14 percent of national electricity production in 2021 (with wind energy prevailing), whereas they were marginally important 15 years ago. The segment's buoyancy is based on extensive investment in the first half of the previous decade – gross fixed capital formation in the NACE division that includes production and distribution of electricity exceeded 10 percent of the economy-wide value for the period 2013-2014 and more than a third of industrial sector investment. The shift in the authorities' focus on the support for renewable energy producers, which is seen as overly generous and burdensome for the energy-intensive industry, put a cap on the development of production capacities after 2014. More recently, however, amid the commitments to achieve carbon neutrality, the upward path is expected to resume, with EU funds acting as an incentive.

The energy sector is currently very dynamic and challenges are great. Specifically, the across-the-board increase in commodity prices affects not only the value of energy imports, but also the feasibility of projects oriented towards renewable

2 Indicators were adjusted for the purchasing power.

3 The indicator is defined as the ratio of net energy imports and total energy delivered to and used in the economy.

resources – the costs of such investment followed a downward track starting 2010, which has however reversed as of late[4]. Uncertainty further surrounds issues such as the role of nuclear energy (euro area's economic powerhouses, i.e. Germany and France, address this issue quite differently), but also the extent and pace at which fossil fuels are to be phased out. All these aspects are significantly influenced by technological innovations, with an intrinsically unpredictable nature. Moreover, if Romania were to capitalise on the opportunity provided by EU funds and make the necessary investment, it could significantly narrow its energy-related trade deficit over a few years.

Automotive sector

This economic segment expanded markedly over the past two decades[5], its advance being discontinued by the COVID-19 pandemic alone. This area gradually came to generate a substantial trade surplus (somewhat lower in 2021: 1.8 percent of GDP). The expansion of the automotive sector is based on extensive investment aimed at creating, enlarging and streamlining production capacities, made with the participation of key global actors, whose know-how and financial resources played a major role. The business orientation is mainly aimed at meeting foreign demand, either directly or indirectly[6], while the market share of automotive exports expanded gradually, from fractional values to nearly 1 percent in recent years[7]. More recently, the sector has been taking steps towards integrating into the trend of electromobility – two major electric battery manufacturers announced their intention to open production capacities in Romania, while the next years could see the launch of hybrid and fully electric car models (currently, a mild hybrid model is being produced in the country).

However, further development of the sector is stymied by a number of structural problems. Specifically, the sorry state of transport infrastructure has a significant adverse impact, given the outward orientation of the activity, which implies the need for an easy connection with European transport routes. This weighs heavily on the firms' decisions to establish or enlarge capacities and contributes to maintaining a very uneven geographical distribution of production. The automotive industry ranks halfway in the top of the unit value of manufacturing exports (about EUR 10,400/tonne in 2021), illustrating that the share of transport costs is significant; ranking high are segments such as electronics or pharmaceuticals, where transport costs are less significant in relative terms. The unit value of car exports increased over time, also benefiting from qualitative improvements in domestically-manufactured car models; however, transport infrastructure remains a relevant issue.

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4 According to *World Energy Investment 2019* and *Renewables 2021. Analysis and forecast to 2026*, International Energy Agency reports.

5 For further details on the developments in the automotive industry, see the box entitled "The automotive sector – incidental disruptions and structural metamorphosis" in the November 2019 *Inflation Report*.

6 The activity of suppliers serving local producers also hinges largely on external demand for the models made by those manufacturers.

7 Given that the market share of exports of goods is below 0.4 percent.

The difficulties in hiring skilled staff began to prevail among the factors limiting production as of 2016 until the outbreak of the pandemic, according to an EC-DG ECFIN Survey. The relevance of the problem faded subsequently, as other factors came to the fore (the pandemic shock, input availability, etc.), but also amid automation efforts, further requiring, however, investment capacity.

Another structural factor with an adverse effect on the external position of the automotive industry concerns the insufficient increase in the national car fleet. Given this need, motorcar imports (for final consumer or investment demand) made a large negative contribution to the trade balance, as they grew sharply especially prior to the outbreak of the financial crisis, before posting more modest developments, yet still on a rising trend from 2013 to 2019. Nonetheless, Romania further ranked last in Europe by number of cars per inhabitant; the said increase in imports materialised essentially only in a narrowing of the gap between the before last and the last place (of Romania) in that ranking. This structural influence is expected to continue in the period ahead, given the economy's need for development and mobility. Of course, the perceptible pressure on the existing road infrastructure[8], which puts the idea of a shortage of transport means in a counterintuitive light at first, highlights yet again the need to improve the road network.

Agri-food sector

The agri-food sector is characterised by a quasi-steady trade deficit (0.5 percent of GDP in 2021), despite the significant potential of agri-food production – agricultural area covers about 57 percent of the country's territory, allowing a variety of crops and livestock farming.

In agriculture, grain and oilseed production expanded in recent years, resulting in significant trade surpluses (1.7 percent of GDP in 2021). By contrast, the other key segments (fruit and vegetables, animal products) recorded higher deficits, with positive developments being detected only for a few items (nuts, honey, mutton), with marginal effects on the overall picture. Going beyond the explainable situation of exotic products, the local supply of vegetables, fruit or meat is systematically short and unable to keep the pace with the scale and qualitative requirements of domestic demand, which can easily be met by products from other countries in Europe or in the region.

Behind the good performance in agriculture stood the extensive investment made over the last two decades. A new impetus could benefit the underprivileged areas, but also those reporting favourable developments, amid the aim of improving yields and fostering integration into organic farming trends – only 3.5 percent of the country's farmland achieved or is about to see a conversion in this direction, the EU average being 9.1 percent.

8 As also indicated by the number of road accident fatalities, which is the highest in Europe and showed no signs of decline by the start of the pandemic.

In the food industry, investment was on the rise until 2008, but the financial crisis-related decline lingered on, spurred by weak demand. The situation changed markedly in the middle of the past decade, amid the reduction in the VAT rate on food and the higher income, while food trade has expanded by more than 5 percent every year starting in 2014; the major leap was in 2015-2016, when demand grew by more than a third overall. However, given the weak investment profile in the past, the boom entailed a pick-up mainly in imports and to a lower extent in local production. Similarly to the production of vegetables, fruit or animal products, the competitiveness of many countries in Europe or in the region eased the transmission of demand growth into imports. In the same direction acted the expansion of modern trade, with other quantitative or qualitative requirements than traditional trade.

The buoyant domestic demand, however, left its mark on local supply – gross fixed capital formation halted its decline, while the rate of business start-ups moved higher after 2016. Nonetheless, this reaction had little effect on the sector's overall picture, especially as start-ups are mainly small-sized (with up to 10 employees) and their economic performance and ability to gain a foothold on the market are generally lower than those of larger companies.

Processed food exports gained momentum in the last 10 to 15 years, yet the favourable path was overshadowed by the visible gap in relation to the potential level and the level of other European countries, as the values recorded in 2021 by Romania and Poland differ strongly in terms of size (EUR 2.1 billion and EUR 27 billion respectively).

Production of other consumer goods

A mismatch of industrial production with demand can also be observed in the case of other consumer goods, whereas exports were weak on the whole, the ensuing deficit standing at 1.6 percent of GDP in 2021. Given that such activities are mainly characterised by high labour intensity, producers of consumer goods responded unfavourably to the hikes in unit labour costs seen since 2014-2015; this is the case of the furniture industry, but especially those of wearing apparel, footwear and leather goods. It is true that longer-term developments do not favour the expansion of activities using cheap labour amid the convergence trend of wages to those at EU level. Hence, the decline in these areas includes an exogenous structural component, to which added, however, the effects of a generous income policy initiated at the middle of the last decade.

At the same time, pharmaceuticals accounted for a significant part of the consumer goods shortage, as they have followed a steady uptrend from 1999 onwards, reaching 1.3 percent of GDP in 2021, with exports lagging behind imports in terms of quantity and unit value. This is also based on structural factors, revealed by the concentration of activities with a key innovative component particularly in the advanced economies.

IT sector

The ICT sector has witnessed a sizeable expansion in recent years[9], the related trade surplus coming in at 1.6 percent of GDP in 2021. Notable advantages in this regard are the availability of skilled workforce, as reflected by the number of ICT graduates and the favourable evolution of the communication infrastructure. Aside from this upward path, however, the sector is in a fledgling state, the activity being generally aimed at carrying out less complex works than other technological hubs.

The development avenues of the ICT sector include preserving the relation with external demand that is expected to remain robust amid the fourth industrial revolution, but also a possible boost in domestic demand from firms and the general government, given its starting from a low level, whereas the pandemic proved the benefits of using ICT tools. Specifically, the workforce needs to be trained in order to improve their digital skills, which would make it easier for local firms to access such solutions. Digitalisation can also benefit from EU funds, which is a major opportunity in terms of strengthening the position of the ICT sector and, at the same time, the productivity of the local economy.

Transport sector

The road freight transport sector also recorded a positive path, with net receipts equivalent to 2 percent of GDP in 2021. Although the sector's performance, also reflected in its larger share in the European market, is bolstered by relatively high ULC competitiveness (compared to countries with more visible presence on Europe's roads, such as Poland, Czechia or Lithuania), a more in-depth analysis highlights some deficiencies. Thus, the advantage in ULC terms is attributed solely to low wages, whereas labour productivity is relatively modest, even if the capital stock per person employed is similar or even higher than in the above-mentioned countries. A possible explanation is the reduction in the quality of domestic fleets – for example, from 2015 to 2020, the journey of the load carried by vehicles more than 10 years old increased by about 7 percentage points (up to 28 percent), bucking the trend recorded in the comparison group. Another productivity erosion factor concerns the state of the country's road network, which is the culprit for the longer time needed to exit the country, larger fuel consumption and higher maintenance costs.

Maintaining a competitive position of the domestic road freight transport sector calls for solid investment. Specifically, the car fleet renewal is likely to curb intermediate consumption (as local firms are at a disadvantage), which could offset the adverse effects of implementing the EU Mobility Package starting in 2022. Such effects are expected to weigh on both wage costs (in light of the provision stipulating that drivers should be paid at least a specific national minimum wage when posted) and the expenses related to the obligation to return to the transport

[9] The box entitled "The post-pandemic economy and the new technological paradigm" in the NBR's 2020 *Annual Report* makes an in-depth analysis of the local ICT sector.

company's home country every eight weeks. As for infrastructure investment, the endeavour to expand and modernise the local network currently has a historical opportunity to materialise, due to the NRRP strategic framework for sustainable transport, decarbonisation, road safety and smart transport systems.

Tourism

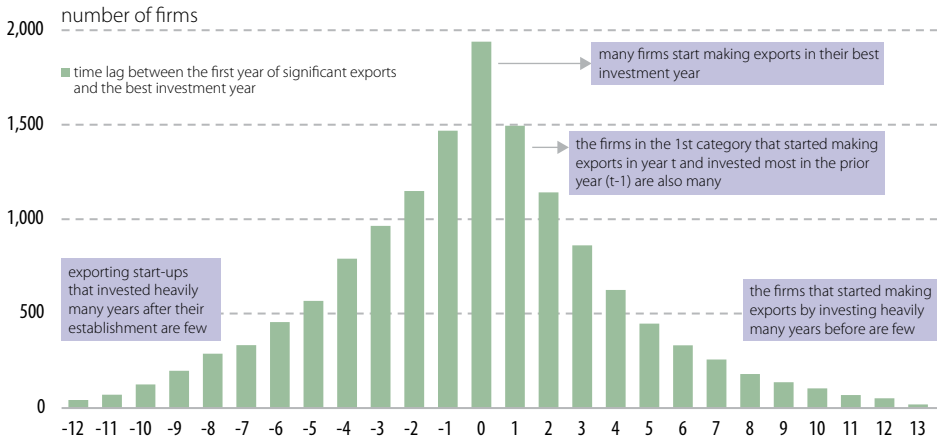
Romania counts among the countries where international tourism stepped up in recent decades amid looser cross-border travel conditions in a context of gradually rising standards of living. However, what differentiates the path of Romania's travel balance is its historical deficit, which is at odds even with the course of this balance in countries where international tourism is not a major income source.

Even though the Romanians' appetite for travelling abroad made a certain contribution to this imbalance, its pressure was generally moderate (imports of tourism services did not exceed 1.5 percent of GDP until 2017, yet it increased subsequently amid mounting consumer demand). In fact, the deficit on travel services in Romania owes mainly to poor receipts: on average, 1 percent of GDP in the 2007-2019 period, i.e. an EU-wide low. The tepid performance of this economic segment is due to a number of supply-side issues of a quantitative nature – the number of accommodation places stagnated over the last decades – but also qualitative nature – the occupancy rate rose mildly until 2019, the almost 40 percent level lagging well behind that of the countries in the region. The current context marked by subsidising demand via government-provided holiday vouchers, profitability supported by low wages and partial tax compliance, as well as the problem of (road and rail) transport infrastructure, prevents this activity from reaching its potential level.

Overview

Romania's current account deficit is under multiple influences, confirming the assertion that the external balance is a mirror of the local economy, yet some issues keep coming to the fore, such as investment, transport infrastructure or the availability of skilled workforce.

The analysis of various business sectors shows that a robust competitive position hinges on investment. At microeconomic level, virtually every momentous event in a company's lifetime revolves around the step-up in investment activity; this obviously refers to the setting up of the firm, but also the starting of an important trade relationship domestically or abroad (Chart B). An aspect that should not be ignored concerns investment efficiency, and from this perspective there is certainly room for improvement in the local economy, since the investment-to-GDP ratio has been comparable over time to that of Czechia, Hungary or Poland, while the competitive position has been more unfavourable, as shown by Romania's current account performance.



Note: The chart depicts the difference between the year of exporting firms being recorded in the database (proxy for the first year of significant exports) and their best investment year. The pooling of values around 0 shows the importance of export and investment coordination. The database covers the 2007-2020 period. The analysis leaves out of account the companies making exports in 2007 (the first year in the sample), with the first exports preceding most likely this moment. The sample does not include the firms with less than 5 years in business.

Source: NIS, MF, NBR calculations

Chart B
Relationship between the pick-up in investment dynamics and presence on external markets

Poor transport infrastructure hampers the development and expansion of economic sectors, with major negative effects, including in social terms, given that in recent years Romania has been faced with the paradox of recording the highest traffic-related death rate in Europe, the lowest car ownership rate notwithstanding. Recent signals show that authorities are keen to see this issue solved, yet an integrated approach is needed to optimise competitiveness gains. For example, the expansion of the motorway network will support local car producers, but also foreign firms delivering agri-food products to the domestic market, *inter alia* facilitating transport to tourist destinations outside the country. Given that local suppliers of food items and tourism services benefit from local road improvements, steps in this direction, together with the expansion of the motorway network, would exert a more pronounced positive effect on the overall competitive position.

The shortage of skilled workforce is an issue lingering in many areas of activity. One instance is the scarcity of staff with secondary technical education, an issue whose solving prospects are however somewhat more favourable, given the higher enrolment rates in vocational education over the previous decade (albeit from a very low level)[10]. Furthermore, automation can be implemented more easily for repetitive tasks, and there are signs that this process has already started in a number of businesses. At the same time, the aim should be to enhance digital skills both at a basic level, with a view to increasing the use of ICT solutions in local companies, and at an advanced level, for the continuous development of the sector. Moreover, the sector also needs the integration of high-level business and management knowledge so as to offer better solutions.

The expansion of the ICT footprint in the economy, with its both sides – integration of related solutions into various economic activities and development of the

[10] *Raport privind starea învățământului preuniversitar din România 2019-2020*, Ministry of Education.

sector generating those solutions – is all the more important as certain structural influences signal the risk of a middle income trap. Specifically, at one end, the convergence of wages towards the European average systematically erodes the price/cost competitive advantage of Romania's light industry, and at the other end, the level of economic development hinders the R&D investment that would allow, for instance, the production of innovative medicines. Attaining the status of an advanced economy is also feasible in the absence of major transitions, as the focus should be on adapting the sectors that have previously hinged more on the low-cost advantage to a new business strategy based on quality and productivity. In fact, these coordinates refer precisely to the creation of favourable conditions for inclusive development that fosters the preservation of social cohesion.

Fiscal policy plays an important role in improving the external imbalance. In this vein, one of the relevant aspects refers to an adequate calibration of the implemented stimuli in light of the evidence that producers are often not prepared to accommodate the full increase in demand, causing the current account deficit to widen. At the same time, heed should be paid to the implementation of a tax regime ensuring adequate incentives economy-wide; specifically, a preferential tax regime for small- and medium-sized enterprises supports the setting-up of firms, yet its differentiated nature may stifle the incentive to expand the business. Last but not least, fiscal discipline, legislative predictability and compliance with the commitments made will ultimately lead to improved credit ratings, a sustainable cut in interest rates and a boost in investment.