ROMANIA'S PUBLIC DEBT COMPARED TO THE EUROPEAN UNION MEMBER STATES

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Abstract

Through this paper, I aim to highlight the level of public debt as well as the evolution of macroeconomic indicators, in line with the financing policy of the Ministry of Finance regarding the mobilization of resources necessary for the implementation of the financing plan. The main objectives regarding government public debt aim to ensure the financing needs of the central public administration's budget deficit, while minimizing medium and long-term costs; limiting the risks associated with the government's public debt portfolio, and developing the domestic government securities market by maintaining the foreign exchange reserve at a level covering up to four months of gross financing needs. The purpose of this scientific endeavor is to emphasize the importance of keeping the public debt ratio under control, promptly reacting to changes in the market context and investor behavior, increasing individuals' accessibility to purchasing government securities within the two dedicated programs TEZAUR and FIDELIS within an annual ceiling. Considering the aforementioned issues that target Romania's public and strategic interest in ensuring the sustainability of gross financing needs in the domestic market, which is 100 billion lei, and the estimated amount to be attracted from the external market is approximately 12 billion (equivalent) euros, through Eurobond issuances within the MTN program, drawdowns under loans contracted from international financial institutions (IFIs) and the European Union, including the PNRR loan component. If the debt is excessively high, especially as a percentage of gross domestic product (GDP), this may signal difficulties in meeting financial obligations, which could lead to economic instability and significant exposure to exchange rate risk.

Keywords: government public debt; domestic government securities market; inflation rate; interest rate on loans; refinancing risk; foreign direct investments

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1. Introduction

This paper aims to highlight the importance of keeping the government debt ratio under control, analyzing the realities and challenges currently faced by Romania, in order to find the optimal solution for adjusting the long-term budget deficit, which will lead to the reduction of macroeconomic imbalances. Equally important is the evolution of the level of participation in the government securities market by other categories of local investors, such as investment funds, private pension funds, which have significant potential in supporting the development of the domestic government securities market.

Given Romania's current situation regarding the increase in interest rates associated with emerging markets, where holdings of government securities have a negative effect on bank profitability and capitalization due to recognizing losses from marking-to-market fixed income instruments held, which affects demand at government securities auctions, although government securities holdings represent an important source of liquidity for the banking system, being accepted as eligible assets for monetary policy operations.

In the medium term, the Ministry of Finance intends to continue its partnership with international financial institutions, including the European Union, to benefit from the financial advantages of their products in limiting costs and extending the maturity of the debt portfolio through the cost and maturity conditions offered, for the purpose of financing the budget deficit and refinancing government public debt, releasing funds based on the achievement of measures and/or other necessary actions in the field of sectoral reforms. According to the International Monetary Fund, global public debt decreased from 100% of GDP in 2020 to 92% of GDP in 2022, supported by strong real GDP growth, inflation surprises, and the withdrawal of fiscal support measures related to the effects of the COVID-19 pandemic. On the other hand, the total global debt of households, companies, and governments is nearly $250 trillion, equivalent to 250% of global GDP. The long-term trend has been an inexorable increase in debt, driven by large and chronic government deficits in developed markets and massive real estate investments in China. Public debt as a proportion of global GDP tripled in the past few decades, while China accounts for 30% of the total global corporate debt. However, in recent years, the level of debt has stabilized and significantly decreased as a proportion of GDP, as inflation growth has boosted nominal GDP and diluted this fixed debt burden.

According to the IMF database, out of 20 advanced economies, 11 have a debt-to-GDP ratio of over 100%. At the top is Japan, whose national debt has remained above

100% of GDP for the past two decades, reaching 255% in 2023. It is followed by Greece and Singapore with 168%, Italy with 144%, and the United States with 123%. Among the countries with a debt-to-GDP ratio of over 100%, we also find France, Portugal, Spain, Belgium, and the United Kingdom. At the other end of the spectrum, among the countries with a low debt-to-GDP ratio, there are many small nations, such as Macao, Brunei, and Kuwait. In this category, we also find countries like Turkmenistan with 5%, Azerbaijan with 18%, Bulgaria, the Russian Federation, and Kosovo with 21% each, and Estonia with 22%.

The largest economy in Europe, Germany, has a ratio of nearly 66%, the lowest in the EU, although it has risen following the COVID-19 pandemic. All EU member states are striving to keep their ratios below 60% for stability. Otherwise, when debt rises beyond what countries can afford, emergency rescue measures and the inability to pay lead to the collapse of economies, as seen in the European debt crisis from 2009-2014.

According to IMF data, Romania has a debt-to-GDP ratio of 51%, Poland 50%, the Czech Republic 45%, and Hungary is at almost 69%. Although debt has recorded steady increases over the past 10 years, Romania's debt-to-GDP ratio is still below the average of the emerging market group and developing economies, at 67%. In contrast, the average for advanced economies is at 112%, and that of the G7 is at 128%. Even compared to the European average of 79%, Romania's public debt is still low. But the forecast is that Romania's public debt will continue to rise steadily between 2023 and 2028 by $122.1 billion (+70.44%). After the tenth consecutive year of growth, it is estimated that national debt will reach $295.44 billion in 2028, according to a statistical study. Rising interest rates have increased borrowing costs, including for the US government, fueling national debt and budget deficits. According to research, the total estimated budget deficit of the US government between 2022 and 2031 will be $12.7 trillion. A half percentage point increase in the key interest rate leads to a $1 trillion increase in the deficit. But, at the time of this analysis, the interest rate has already risen by over 4%. That is why interest rates are extremely important for everyone, governments, investors, and the population.

2. Evolution and Level of Government Public Debt in the Medium Term 2022-2024

Romania ended 2021 with an annual inflation rate of 8.19% (an increase of 6.13 percentage points compared to the level of 2.06% in December 2020), with inflation reaching a high level of 14.5% in May 2022. For the end of 2022, an inflation rate of 9.7% is estimated, gradually decreasing to a projected level of 2.7% by the end of 2024[1].

The unemployment rate stood at 5.6% at the end of 2021, 0.5 percentage points lower than the previous year (6.1% in December 2020). A decreasing trajectory of the unemployment rate is estimated in the medium term, with a forecasted level of 5.4% by the end of 2022 and 4.8% in 2024.

In 2021, the current account deficit increased to 7.0% of GDP, compared to 5.0% in 2020, with a projected level of 6.9% of GDP in 2022 and 6.3% of GDP for 2024. The macroeconomic framework configured for the period 2022-2024 was based on considerations such as the economic developments of 2021, sustained economic growth mainly driven by investments and consumption, in an internal environment favored by stability and predictability of macroeconomic policies, as well as effective government policies mitigating the shock of the COVID crisis. Furthermore, the IMF has revised down global economic growth to 3.6% in 2022 and 2023.

Budget planning for the years 2022 - 2024 was based on measures undertaken by the Government of Romania in 2020 and 2021 to revive the economy and mitigate the negative effects of the pandemic, along with new measures to be taken in 2022, which will influence the macroeconomic framework and budget indicators for the period 2022-2024, as well as funding priorities from the national budget, and expectations of a real GDP growth of 2.9% for 2022.

In the medium term (2022–2024), under conditions of fiscal consolidation, reducing the budget deficit will lead to a reduction in government financing needs and, implicitly, public debt.

[1] CNSP- Projection of the main macroeconomic indicators, Spring Forecast, May 5, 2023

Table 1: Forecast of financing needs

Indicator	2021 operation execution	2022 prog	2023 prog	2024 prog
Central public administration revenues (billions of lei)	306,7	363,1	406,4	449,8
Central public administration expenses (billions of lei)	389,8	443,1	470,7	496,3
The budget deficit related to the central public administration (I) (billions of lei)	83,1	80,0	64,3	46,5
Refinancing of government public debt (II) (billions of lei)	51,8	68,4	71,8	65,5
Gross financing requirement (I+II) (billions of lei)	134,9	148,4	136,1	112,0

Source: Ministry of Finance

According to the Fiscal Budget Strategy, in the medium term (2022 – 2024), under conditions of fiscal consolidation, the estimates regarding the evolution of gross government debt, according to the EU methodology, indicate that this indicator will be kept at a sustainable level.

The government debt indicator calculated in accordance with the European Union methodology, based on preliminary data, expressed as a percentage of GDP, stands at 49.2% of GDP at the end of April 2022. This includes pre-financing of the loan component for the implementation of the PNRR, as well as the debt contracted to finance the approved budget deficit for 2022 and the refinancing of maturing public debt. For the end of 2022, the forecast for government debt as a percentage of GDP is 49.4% of GDP, calculated based on the projected economic growth of 2.9% for 2022[1] and the level of the budget deficit of the general consolidated budget of 5.84% of GDP.

The macroeconomic assumptions of the Strategy for the period 2022-2024 are presented in the table below.

[1] Calculated based on cash data by applying the EU methodology.

Table 2: Baseline scenario of macroeconomic projections

Indicator	2021	2022 prog	2023 prog	2024 prog
Nominal GDP (billion lei)	1.181,9	1.327,9	1.460,7	1.581,8
GDP growth (%)	5,9	2,9	4,4	4,8
Budget deficit related to central government (% of GDP)	-7,0	-6,0	-4,4	-2,9
Current account deficit (% of GDP)	-7,0	-6,9	-6,7	-6,3
End-year inflation (%)	8,19	9,7	3,5	2,7
Annual average inflation (%)	5,05	10,1	5,4	3,0
Average exchange rate lei/EUR	4,9481	4,97	5,03	5,08
Average exchange rate lei/USD	4,3707	4,47	4,49	4,54

Source: CNSP Spring Forecast, April 28, 2022, Ministry of Finance

Budget estimates and economic forecasts may deviate from the levels in the baseline scenario, due to the possible materialization of risks that may arise both domestically and externally, with different implications for the evolution of public finances.

The ongoing war between Russia and Ukraine and the international sanctions imposed, which have the potential to affect domestic macroeconomic and financial developments by exacerbating the energy crisis and supply chain blockages, as well as developments in the international financial market, along with the conduct of central bank monetary policies, are important factors that can lead to volatility affecting investment appetite for financial assets issued by emerging economies.

As a result of the increase in energy and raw material costs, including the prices of Ukrainian grains, the foreseeable effects will manifest in fueling inflation globally, whose transient nature fades away, requiring firm measures from national and supranational monetary authorities. Since the beginning of 2024, the nominal value of holdings of government bonds in the portfolio of privately managed pension funds and optional pension funds has shown an increasing trend, while their share in total assets has recorded a marginal decrease during the same period.

The Ministry of Finance will continue dialogue with institutional investors from Romania or abroad, aiming to strengthen their holdings of Romanian government bonds in their portfolios.

The Ministry of Finance intends to diversify funding instruments by issuing "green" bonds, depending on the finalization of the overall framework for green bonds aimed at protecting the environment and combating climate change, as well as those in the social and sustainable development domain at the sovereign level, through coordinated efforts at the ministry level to identify expenditures/projects that will be financed through these bonds.

Considering the forecasted level of ESA budget deficits for the period 2023-2026, and the projected evolution of macroeconomic indicators, we estimate that the share of gross government debt will be below 50.0% of GDP at the end of the forecast horizon. If liquid financial assets[1] are taken into account, the level of net government debt (representing gross government debt minus liquid financial assets) will not exceed 41% of GDP during the analyzed period.

Additionally, to reduce exposure to currency and interest rate risks associated with the government's public debt portfolio, the Ministry of Finance intends to use financial derivative instruments (currency swaps), with ISDA Master Agreement framework agreements being concluded with several counterparties in 2022.

Factors influencing changes in the government debt-to-GDP ratio during the period 2023-2026, including stock-flow adjustments, are depicted below:

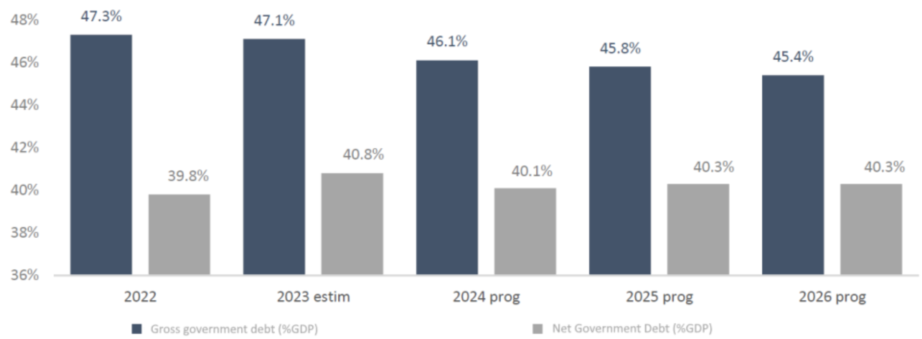

Figure 1: Government debt according to the EU methodology

Source: Ministry of Finance

[1] Liquid financial assets refer to the following instruments: AF1 - gold and SDR, AF2 - deposits and cash, AF3 - securities other than stocks, AF5 - stocks and other equity interests, if listed on the stock exchange, including mutual fund shares, according to the methodology for the Convergence Program.

3. The Role of the Main Risk Indicators in Reflecting Public Debt

Maintaining exchange rate risk should consider ensuring a higher proportion of net financing from domestic sources starting in 2024 and maintaining the share of debt denominated in the national currency within the total government public debt between 45% (minimum) - 60%. This financing strategy will take into account the absorption capacity of the domestic market for government securities and the associated cost. Another characteristic of exchange rate risk is maintaining the share of debt denominated in EUR within the total debt denominated in foreign currency in the range of 80% (minimum) - 95%. With the use of derivative financial instruments, this indicator will be calculated after assessing the debt as a result of using currency swaps.

Refinancing risk plays a crucial role in maintaining the proportion of debt maturing within 1 year for debt denominated in the national currency and between 10% and 20% (maximum) for total debt, as well as maintaining the range of 4-6 years for debt denominated in the national currency and between 7-8.5 years for total debt. Keeping control over exposure to interest rate risk by limiting the proportion of debt subject to interest rate changes within one year and the average period until the next interest rate change for the entire debt portfolio.

Using financing instruments offered by international financial institutions (IBRD, EIB, EBRD, etc.), including those established at the European Union level to support the recovery and resilience process at the member state level, taking into account the favorable terms and conditions offered by them[1].

Predominantly funding in the national currency, aiming to further develop the domestic government securities market and simultaneously support reducing exposure to exchange rate risk, while considering the limited absorption capacity of the domestic market, and, in general, the demand for domestic currency-denominated debt instruments[2], as well as the need to diversify the investor base in government securities. In the context of high funding needs due to excessive budget

[1] The Convergence Program 2023-2026 conducted by the Romanian Government in May 2023

[2] In addition to domestic demand for government securities in lei, non-residents can play an important role both in terms of volumes placed on the domestic market and in the maturity structure in the financing process, considering their high appetite for government securities with medium and long-term maturities

deficits, net financing (the budget deficit) will be sourced from both domestic and external sources, predominantly from domestic sources starting in 2024[1].

4. Public Debt at Present Compared to the Previous One

At the same time, the National Bank of Romania (BNR) maintained tight control over liquidity in the money market and kept the existing levels of reserve requirements for liabilities in both lei and foreign currency of credit institutions. BNR kept the monetary policy interest rate at 7.0% in February 2023, as annual inflation dynamics plateaued in the fourth quarter of 2022, as anticipated, and according to new assessments, is forecasted to decrease significantly more sharply by the middle of next year than previously anticipated, especially from the third quarter of 2023, in the context of the extension of energy price capping and compensation schemes until March 31, 2025, and the redefinition of their characteristics starting January 1st, 2023[2].

In perspective, monetary policy will continue to aim at bringing and maintaining the annual inflation rate in line with the target, including by anchoring medium-term inflation expectations, in the conditions of minimizing costs in terms of economic growth.

The magnitude of public debt results in decreased economic growth, depreciation of the national currency, as well as fiscal slippage affecting the government debt balance, influencing the depreciation of the national currency and changes in interest rates on interest payments. A one percentage point decrease in real GDP dynamics would lead to a 5.4 percentage point increase in the debt level as a share of GDP in 2026. Similarly, a 10% depreciation of the national currency against the Euro would result in a 2.3 percentage point increase in the government debt-to-GDP ratio in 2026. A fiscal slippage resulting in a cash deficit to be financed of 5% in 2023 and 4.8% of GDP in the period 2024-2026 would lead to an increase in the debt level by up to 5.1 percentage points of GDP in 2026, while the combined influence of these factors on the government debt-to-GDP ratio results in an increase of this indicator by 13.8 percentage points in 2026[3].

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[1] Filip, Gh., *Finanțe Publice*, Course support, second year, Finance-Banking, academic year 2009-2010

[2] The Convergence Program 2023-2026 conducted by the Romanian Government in May 2023

[3] According to EUROSTAT communique no. 47 of April 21, 2023

Depreciation of the national currency against the Euro or a 1 percentage point increase in interest rates would have a modest unfavorable impact on interest payments, resulting in an increase in their share of GDP by up to 0.07 percentage points in 2026. The combined influence of these factors on interest payments would lead to an increase in these payments by 0.14 percentage points of GDP in 2026.

The government's main concern is related to the interest on public debt that must be paid every year, say Liebermann and Hall. These must be paid from state revenues derived from taxes. When annual interest payments increase by a certain percentage, let's say 7%, then the government will need to collect 7% more funds in the budget. Borrowing to pay the interest would only postpone the problem. Future interest payments would become even higher, and ultimately, their payment will have to be covered by increasing taxes[1].

5. Conclusion

As a final conclusion, I consider that the prospects for reducing interest rates are weak for the beginning of 2024, as I foresee a potential increase in inflation following the recent tax hikes and introductions by the government. As the Governor of Romania has mentioned, discussions regarding interest rate cuts could start once inflation falls below the key interest rate level. However, the latest forecast from the National Bank of Romania (BNR) sees inflation dropping below the key interest rate level of 7.00% only in the second quarter of 2024 (6.8% year-on-year until the end of Q2 2024). Therefore, it is possible that the key interest rate will remain unchanged until the May 2024 meeting.

It is estimated that 2024 will be a year with mixed results for public debt. While governments worldwide struggle to keep debt under control, some countries will see a decrease in the debt-to-GDP ratio, while others will continue to see growth.

In 2024, central banks, including the European Central Bank, are likely nearing the end of interest rate tightening cycles. Typically, this should also mark a shift in dynamics in fixed-income markets, as the focus will then turn to the timing of rate cuts.

[1] Lieberman, M. & Hall, R.E. (2010) *Principles & Applications of Economics*, 5th edition, p. 739, South-Western: Cengage Learning

According to a Reuters survey, approximately 57% of economists predict at least one cut in the key interest rate by mid-2024, with it falling from 4.5% to 3% by the end of the year.

At the beginning of the current year, the inflation rate increased due to the impact of increases and introductions of indirect taxes and duties aimed at continuing budget consolidation, and subsequently resumed its decline, so that capital markets and the labor market were only slightly affected. This is the definition of a soft landing for the economy, and the long-awaited interest rate cuts could take place before we realize it.

Global tensions do not seem to be easing, which may bring many uncertainties, unexpected costs for governments, and instability in the financial markets. While governments seek ways to limit debt growth, and investors look hopefully beyond the peak of interest rates and await the first cuts, 2024 is shaping up to be a complicated year.

While for investors, 2024 is a year of hope that stock markets will continue to rise, they should focus on their goals without neglecting risk management. Based on the above, it can be concluded that the refinancing risk and the interest rate risk associated with debt denominated in the national currency, although they remained at a relatively constant level throughout 2023, are still risks associated with the government's public debt portfolio that should not be overlooked and must be correlated with the third objective of the Medium-Term Government Public Debt Management Strategy, namely the development of the domestic government securities market.

The long-term sustainability of public finances will be influenced by the implementation of reforms regarding the revision of the fiscal framework and undoubtedly represents a topical research theme, especially in the context of the accelerating globalization and digitization processes.

All in all, investigating inappropriate fiscal behaviors will certainly bring increased efficiency in terms of revenue collection for the consolidated general budget.

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