

April 2023

Debt and stability – some thoughts¹

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Thank you for the invitation to participate in this event with an exciting theme. On this occasion, I pay tribute to those who 110 years ago laid the foundations of the prestigious economic education institution that is ASE nowadays.

In what follows I will share some thoughts on the relationship between debt, public and private, and economic stability. What I say starts from established economic thinking, the dynamics of economies in recent decades, and my own experience, including as rapporteur for the European Parliament of the Lamfalussy-Follow-up² legislative project, which called for the re-regulation of the financial system by examining the origin and consequences of the crisis global financial; I also have in mind the extreme events of recent years. Finally, I refer to the problem of *twin deficits* in Romania.

1. What does data show?

There are findings from the examination of historical data that are easy to make. Extreme events, such as military conflicts and large-scale financial crises, the pandemic, the energy crisis, have led to massive increases in public debts. Data

¹ Presentation made at the conference "Public finance in the current context" organized under the aegis of ASE 110 years by the Financial-Monetary Research Center within the Faculty of Finance, Insurance, Banking and Stock Exchanges (CEFIMO), April 5, 2023. The text is on the website- the Fiscal Council. I bear sole responsaibility for the views expressed.

² leke van de Burg, Daniel Daianu: "Lamfalussy Follow-up", 2008, EP, Brussels.

provided by international institutions, by national governments, are eloquent in this sense. In the US, for example, public debt exceeded 130% of GDP in 2022, well above what Rogoff and Reinhart envisioned as a critical threshold of -90%³.

In Europe, public debts have increased a lot after the financial crisis and the Pandemic. Globally, public and private debts have reached very high levels. And this happened in the context of increasingly speculative financial markets, with increasing systemic risks, with the expansion of what is called the "shadow banking sector" (which is under-regulated). Persistent problems in the financial system are evidenced by the collapse of SVB (Sillicon Valley Bank) and Signature Bank in the US (plus major difficulties of regional banks also in the US), the forced takeover of Credit Suisse by UBS in Switzerland, deep turmoil in the crypto-asset market. It should be noted that this increase in public and private debt preceded the global financial crisis by many years (Chart 1).

Chart 1. Evolution of public and private debt worldwide in the period 1970-2020 (percentage of GDP)



Historic highs

In 2020, global debt experienced the largest surge in 50 years. (debt as a percent of GDP)

Sources: IMF Global Debt Database and IMF staff calculations. Note: The estimated ratios of global debt to GDP are weighted by each country's GDP in US dollars.

Source: Graphic taken from the article Global Debt Reaches a Record \$226 trillion, Vitor Gaspar, Paulo Medas, Roberto Perrelli, December 15 2021, IMF Blog (Global Debt Reaches a Record \$226 Trillion (imf.org)).

³ Reinhart and Rogoff (2008) saw exceeding this threshold as having a negative impact on economic growth

A legitimate question is: Why didn't financial markets react more strongly to the large increase in debts?

I have in mind developed economies bearing in mind, I repeat, thresholds such as the one stated by Reinhart and Rogoff (2011).

In a special section I will comment on the dramatic decline in R* (the real natural rate of interest) in recent decades and the relationship between (r), the real rate of interest, and (g), the real rate of GDP growth which, according to the reasoning of Blanchard (2019) and others, offers a possible explanation regarding the attitude of financial markets, but which is not undisputed.

But before that I will refer to what I consider to be myths, clichés of conventional thinking, which have been disavowed by economic reality.

2. Clichés disavowed

First of all is the belief of many that price stability ipso facto ensures financial, economic stability. The financial crisis proved the falsity of this thesis, which forced central banks to reconfigure their mandates, more or less explicitly; to support financial stability by re-regulating the financial system, by resorting to macroprudential rules and instruments, which limit external imbalances, including private indebtedness, leverage in the banking sector, the use of "toxic" products; new regulatory institutions were also created for this purpose – EBA, ESMA, EIOPA in the European Union.

Another cliché is that public debt essentially conditions economic stability. Yes, these debts play a key role, but private indebtedness can also cause big trouble if left unchecked (as already mentioned). The boom and bust cycle in the European economy, which preceded the financial crisis that broke out in 2008, is revealing in this regard and was mirrored in the balance sheet crises in the Euro Zone, in the Baltic countries, Romania, Hungary, etc.; the Asian crisis of 1997-1998 is another eloquent example. So balance of payments crises can be triggered by both excessive public debt and excessive private indebtedness. Here we must distinguish between liquidity crises and solvency crises; the former can easily turn into solvency crises when access to financing closes for various reasons. It should be remembered that public debt in Romania in 2008 was below 15% of GDP, but the external imbalance was large with the contribution mainly of private indebtedness.

It must be said that "self-fulfilling prophecies" operate in financial markets, and when they get going they are difficult to stop.

Another cliché is that full exchange rate flexibility would ensure external balance. Not only is the trilemma more of a dilemma for emerging economies (Helene Rey, 2013), but avoiding very wide swings in the exchange rate is useful for economic stability - texts signed by Agustin Carstens, the current general director of BIS, should be read in this regard (2017). If developed economies do not leave their exchange rates completely free, the reluctance of emerging economies to practice full floating is all the more understandable. The Asian crisis, especially, showed that there is a need to limit private indebtedness, to have as large foreign exchange reserves as possible, in order to avoid speculative attacks on the national currency. The IMF's recommendation then was to run very large budget surpluses to reduce large external imbalances, although these were mainly caused by private indebtedness. And economies suffered enormously. But the IMF also learned from that episode, just as it learned that the free movement of capital is not always the optimal solution.

Finally, the myth that markets can regulate themselves, that "they know best", was shattered by the global financial crisis; that "light touch regulation", initiated by the *big-bang* of 1986 in the City of London, proved that it brings great trouble and is harmful to economic stability. This line of reasoning includes the invalidation of the thesis that the state has nothing to do in the economy. It is true that a ubiquitous and abusive state must be avoided, for it harms checks and balances, but it has been seen that in moments of crisis it is the one which has to intervene to avoid social and economic disasters, and operates even as "market maker" under conditions of bug turmoil. The US state and governments in the EU bailed out the financial industry and intervened forcefully when the Pandemic hit. To intervene effectively, however, you must have a robust public budget, with sufficient revenues. Just as high taxes can damage the economy, so too low taxes can cripple the economy.

The state also has a stabilization function. It can be seen, moreover, that in the Eurozone there is more and more talk of a "common fiscal capacity" (represented, in a way, by the NGEU). So far, the Eurozone does not have a common fiscal capacity and a common deposit guarantee scheme. Here there is a battle between

those who support only risk reduction measures and those who advocate a combination of risk-reduction and risk-sharing. I believe that a monetary union needs risk-sharing mechanisms, safe assets; basically, even ECB operations are forms of risk-sharing.

3. A change of regime? From very low inflation to high inflation and tightening monetary policies

I return to the question of R* (natural, equilibrium, real rate). There are analyzes that show a decrease of R* to lower and lower levels in the last decades (Laubach and Williams, Summers, etc) which, in conjunction with the fall of inflation (against the backdrop of globalization) led to ZLB (zero lower bound), to an effective lower bound on the monetary policy rate (see Charts 2 and 3). Another cause for very low R* is the need for safe assets (Caballero, 2016), etc. This situation forced the resort to QE programs, massive monetary base injection into economies, in the US, in the Eurozone (Chart 4).

Chart 2. Real rates show the 10-year average yield of inflation-linked bonds in the G7 over the period 1980-2013



Source: King and Low, 2014; Rachel and Smith (2015), Haldane (2015), Laubach and Williams, IMF, etc.





Chart 4. Central bank balance sheets (2007-2021)



Source: Federal Reserve Economic Data (FRED), ECB Statistical Data Warehouse (SDW) and BoJ.

Here one can find an explanation for the appetite of governments in developed countries to practice budget expansion, especially since the paradigmatic context also suggested that this is possible without entailing great risks. As mentioned, Blanchard (2019) argued that high public debt levels can be sustainable when the cost of financing in real terms, (r), is lower than the real rate of economic growth (g), i.e. r < g -- since higher debt costs would be easy to bear.

We must distinguish between the state of developed and emerging economies, as the relationship between (r) and (g) is more complicated for the latter; I will devote a section to this issue. But back to the (r) and (g) discussion.

The dynamic of public debt is given by the primary balance and the service of the public debt. If we want a stabilization of public debt (D) as a percentage of GDP, $D_t - D_{(t-1)} = 0$ with the relationship below,

$$\frac{D_t}{PIB_t} - \frac{D_{t-1}}{PIB_{t-1}} = (r - g)\frac{D_{t-1}}{PIB_{t-1}} - \frac{S_t}{PIB_t}$$

where S_t is the primary balance of the budget (a debt monetization is not taken into account, which would imply increased inflation, with undesirable effects), the primary balance to keep constant D in GDP is

s = (r - g)d, where s is S/PIB and d is D/PIB.

The above relationship is defined, clear, and if (r)>(g) a primary surplus is needed to stabilize public debt.

But if (r<g), primary deficits can exist seemingly indefinitely and public debt can remain constant as a share of GDP, so it would be sustainable. If the primary deficit were to increase suddenly, the public debt would also increase, but it would still converge to a new level. There are known technical aspects. However, there are observations to be made when the logic "a la Blanchard" becomes problematic.

A first issue is the discount rate of the primary balances with which the sustainability of the public debt is judged. If a "risk premium" and the cyclical movement of savings are taken into account, the discount rate should be higher than the interest rate at which governments borrow (Wijnbergen, Olisslagers, de Vette, 2020). As these authors mention, "there is no free lunch" in terms of indebtedness. Jiang (2021), Willems and Zettelmeyer (2022) and others think likewise. Bohn (1995,1998) must also be mentioned here. If this risk premium is considerable, the relationship highlights the need for budget surpluses at some point in time. And the sustainability relationship is:

$$\frac{\mathrm{D}}{PIB} = EPV\left(\sum \frac{\mathrm{S}}{PIB}\right)$$

where the "expected present value" (EPV, expected present value) is given by r-g, where r > g.

There are other factors that can modify the relationship between r and g. If, for example, in the longer term, the thesis of secular stagnation (Summers, 2014), or a secular slowdown were to be true, (g) should be lower. Strong adverse shocks would reinforce the stagnation trend. If, simultaneously, there would be a change of monetary conditions (which is not equivalent to giving up inflation targeting) that would drive the real rate (r) up, the combination of trends would undermine the thesis that (r-g)<0 in the long term; upon a change in monetary policy which would be aimed at combating inflationary expectations, the risk premiums would go up and the discount rate should be higher.

Goodhart and Pradhan cite, along with deglobalization, demographics, which would lead to higher inflation, albeit down from double-digit levels in 2022 (2017, 2022). Blanchard (2023) believes that the real rate, r, will remain lower than the GDP expansion rate, g, in the future, which would allow higher sustainable public debt; it is a position also expressed by Jean Marc Natal and Philip Barrett, which can also be found in the IMF World Economic Outlook of April 2023. On the other hand, Blanchard also accepts that a certain level of public debt involves a risk

premium that can affect the relationship between (r) and (g). Climate change and the need for investments can affect the natural rate, R*.

Ricardo Reis (2021,2022) introduces the concept of "debt revenue" into the discussion and reformulates the dynamics of debt accumulation. He believes that it is more appropriate for the discount rate to be done not with the rate at which governments borrow, but at the level of the marginal return on capital in the economy, m, which is greater than the dynamics of GDP, g. And he adds a new component to the relationship of accumulation of debt which concerns what is called "**debt income**"; this incone would be given by debt multiplied by (m-r), which signifies the difference between the marginal return on capital and the rate at which the government borrows. The relationship becomes:

$$\frac{\mathrm{D}}{PIB} = EPV_{m-g}\left(\sum \frac{\mathrm{S}}{PIB}\right) + EPV_{m-g}\left((m-r)\frac{\mathrm{D}}{PIB}\right)$$

This new component in the formulation of debt accumulation would explain why debts have reached so high levels; at the same time, the debt progression would not be endless, since m>r. If m=r, the relationship returns to its original form.

But there remains some confusion about the concept of debt income. Reis mentions a series of factors that would explain an r<m, among which liquidity, the effect of regulations and, not least, the availability of "safe assets". I believe that only the last aspect (*safe asset*) can justify the notion of "debt income", semantically and economically. American bonds have this feature and so do German bunts, which are a benchmark for the Eurozone. But even the US do not create debt to provide safe assets to the rest of the world, or to earn debt⁴ income! The course of the public debt of the USA is given by internal needs!

⁴ The Fed grants financing lines, or has swap operations with other central banks, but which does not mean debt income.

Could the Japanese scenario with very high public debt and continued QE repeat itself?⁵ It's hard to believe given the conditions: inflation is high in the US and Europe currently (in Japan it's still very low), Japanese bond purchases are in the hands of residents, monetary policies are tightening in the US and Europe.

4. QE in EMs and implications for debt sustainability analysis

In a ptrevious text I argued that while central banks in developed countries use QE to mitigate the shock of the Pandemic, QE in emerging economies should be viewed with great caution because it poses important risks⁶. The logic in the argumentation is also valid for the analysis of public debt sustainability in EM, including Romania. So:

- these economies do not issue reserve currency, which limits the effectiveness and autonomy of monetary policy;

- exchange rate dynamics matter a lot, especially where dollarization/euroization is significant.

- local financial markets are "thin" and cannot absorb large bond issues; there are also exposure limits on local sovereign bonds;

- although it is advisable to finance a lot in the local currency, the size of the local financial markets may force the financing on foreign markets; resulting in vulnerability and fear of major impairments.

- if an autonomous monetary policy is an advantage, it can be diminished by the currency risk, by the degree of confidence enjoyed by the local currency.

⁵ The issue of inflationary expectations should be taken into account if we consider the Japanese experience after the great crisis of the 90s. For many years, Japan has been trying to get out of economic quasi-stagnation; liquidity injections were used preceding QE programs in the US and Europe, but to no avail. The question arises why, even where unemployment is not very high (the gap disappears), inflation has been persistently low, and expectations are not increasing. An explanation would be needed starting from a neo-Fisherian formulation -- i = ir + π exp, where (i) is the nominal interest rate, (ir) is the real interest rate, and (π exp) is expected inflation; the reasoning would be that when inflation is persistently low and the output gap and the unemployment gap disappear (as it was in the US before the Pandemic) Taylor's rule turns into a Fisher equation; at a zero monetary policy rate (the so-called ZIRP), i = ir + π (exp) + μ π (gap) + β Q (gap) becomes i= ir + π (exp), when the unemployment gaps and production are no longer relevant (James Bullard, "A tale of two narratives", Saint Louis Fed, July 2016).

⁶ "Quantitative Easing (QE) in Emerging Economies: Risks and Pitfalls?" (Opinii BNR, 1 July 2020), English version published by SUERF (2020); extended English version (Dăianu, Alupoaiei, Kubinschi, 2022)

- for weaker EU economies, the free movement of capital can be a disadvantage in times of market stress; it was seen in the Euro Zone when money left from the South to the North, it was seen in countries outside the Euro Zone where money sought to flee in 2009-2010;

- emerging economies that have back-up arrangements (swaps and repos) with central banks that issue reserve currency have a notable advantage.

An IMF document noted that out of 81 economies classified as emerging economies (EMs), 55 adopted measures to support financial markets...central banks trying to reduce short-term funding pressures on the money market. EMs rarely intervene in the capital market due to the dominance of the banking sector in their markets⁷. But in all these countries programs are much smaller than what is seen in developed economies.

It is worth remembering a phrase from a speech by Agustin Carstens, the head of the Bank for International Settlements: emerging economies practice regimes of quasi-controlled floating in conditions where their central banks do not welcome brutal movements of exchange rates either up or down ...the movement of exchange rates can fundamentally influence the dynamics of inflation and the capacity of monetary policy⁸.

Some analysts appreciate that QE can be practiced in emerging economies that have a credible institutional framework, where floating exchange rate regimes are practiced and sovereign debt is issued in its own currency⁹. But what do you do when structural deficits are high and dollarization/euroization is significant? And there is another relevant aspect here: even bond issues in local currency and sales to non-residents can create an implicit rollover risk. During periods of high risk aversion, when local currencies are under pressure and domestic assets are being sold, foreign investors seek to reduce their exposures and may not roll mature positions. Andrea Presbitero and Ursula Wiriadinata rightly point out that although the differential between economic growth and the interest rate, (r-g), has become negative in many countries, which can facilitate fiscal expansions, a reversal of the

⁷ Central bank support to financial markets in the coronavirus pandemic", IMF, MCMO, 2020," p.6

⁸ "Exchange rates and monetary policy frameworks in emerging market economies", Lecture at LSE, 2 May 2019

⁹ G. Benigno, J. Hartley, A. Garcia-Ferrero, E. Ribakova, "Credible emerging market central banks could embrace QE"", VoxEu, 29 June, 2020

(r-g) relationship can occur when public debts increase excessively and these debts are denominated in foreign currency¹⁰. It is difficult therefore to speak of a "quiet revolution in monetary policy in emerging economies through QE as some do¹¹.

5. Public debt sustainability analysis

Public debt sustainability must take into account the costs of population aging and climate change. Moreover, it is necessary to consider in this analysis the cost of the war in Ukraine and the very likely increase in defense-related spending in many EU states in the years to come; the *peace dividend* is likely over. Against the background of the energy crisis and the war in Ukraine, some economies are becoming a kind of "war economies", the allocation of resources being strongly impacted.

De-globalization and "decoupling"/de-risking in the world economy can also influence economic growth and debt sustainability. The energy crisis, followed by the rapid increase in the relative price of energy (and other critical materials), strongly affects income and resource allocation, with major distributional effects. All these developments affect public budgets, and the debt sustainability analysis should take them into account.

National tax regimes must be viewed in light of low tax revenues in some EU Member States; the case of Romania is pathetic from this point of view. Also, the international tax system must be reformed in such a way that tax evasion and avoidance are reduced, regardless of how difficult this goal would be to achieve, as it is opposed by extremely powerful vested interests. Tax haven jurisdictions must be eliminated.

The assessment of the sustainability of public debt must take into account some hidden liabilities (vulnerabilities) of economies, which appear more and more due to the tightening of monetary policy (and quantitative easing, QT).

Fiscal rules and macroprudential rules

¹⁰ "The risks of high public debt despite a low interest rate environment", VoxEu, 5 august 2020

¹¹ As Piroska Nagy-Mohacsi argues, "The quiet revolution in emerging markets monetary policy", Project Syndicate, 18 august, 2020?)

An assessment by the EFB (European Fiscal Board) of the conduct of fiscal policy in the Eurozone is useful. But this cannot be done separately from the analysis of macroprudential policy in the Eurozone (private sector deficits can affect the Eurozone as much as public sector deficits). One must also take into account the functioning of the global financial system, where the Fed's monetary policy plays a dominant role. It is justified for the CFE to consider systemic risks as a whole, which go beyond the task of judging only those coming from fiscal policy. It would be useful for the EFB Chair to regularly attend ESRB meetings.

Independent national IFIs should also analyze the conduct of macroprudential policy as it may impact external imbalances. And the heads of IFIs should participate in meetings of national supervisory authorities that consider systemic risks.

It should be noted that the ESRB and the ECB are analyzing the application of macroprudential regulations also at the level of the non-banking financial sector, which presents increasing systemic risks due to weak regulation.

6. Romania: *twin deficits*

There was a strong increase in the current account deficit in 2022, to 26.571 billion euros, about 9.2% of GDP. Let's remember, the external balance was at the origin of big problems in the economy after 2008. In the period 2007-2008 the current account deficit was on average over 12% of GDP and Romania had great financing difficulties, although the public debt did not it exceeded 15% of GDP in 2008. It was not the only country in the EU with such difficulties, in the conditions of very large capital movements, with an important speculative component. To a large extent and in the context of the *boom and bust* cycle of that period, the current account deficit was mainly generated by the overindebtedness of the private sector -- a major imbalance between saving and investment. Graph 5 shows the evolution of the current account deficit between 2004-2022, in comparison with the situation in other neighboring states.

It's not like 2007-2008

There were 2 stages in the correction of the current account deficit after the outbreak of the global financial crisis: in the first years after 2008 capital inflows

stopped almost suddenly and there was a forced adjustment that brought the current account deficit below 5% of GDP in the 2009-2012 interval. The second stage was a strong compression of public spending, of the budget deficit, which brought both deficits (budgetary and current account) to around 1% of GDP in 2014, and the current account average to below 1% of GDP between 2013-2015, through a program of severe reduction in public spending, including investment. The reduction of the budget deficit was also done by increasing the VAT from 19% to 24%. It is hard to admit that that drastic cut in public spending was sustainable. On the other hand, there should have been prudence in fiscal policy after 2014. Uninspired changes in the fiscal regime after 2015 and other measures with budgetary impact pushed the structural budget deficit towards 5% of GDP in 2019, and this development was seen in the increase of the external imbalance, with the phenomenon of *twin deficits* being obvious - see also graph 5.1.

It should be noted that Romania had difficulties financing the external balance when the public debt was much lower as a percentage of GDP than it is now (approx. 15% in 2008, approx. 48% of GDP in 2022). The explanation is that the budget deficits were large (the real deficit in 2009 was hidden by the use of resources from the privatization of BCR) while the impact of the financial crisis enormously increased risk aversion. As a consequence, Romania was forced to resort to a package of external financial assistance.

In the conditions of the energy crisis and the war in Ukraine, in 2022 there was a strong deterioration of the terms of trade for most EU countries, which resulted in unfavorable developments for current account deficits. In the case of Romania, a deterioration of 1.5-2% of GDP in the terms of trade can be estimated, which must be judged in relation to the current account deficit estimated by the INS at 9.2% in 2022. In the absence of this effect, the deficit of current account from 2022, it is presumed, would have been similar to that of 2021 (around 7% of GDP). Beyond the deterioration of terms of trade, there were energy guzzlers enterprises that closed their doors; imports were therefore used to replace domestic production.

Twin deficits

What characterizes the external deficits in Romania is the massive contribution of the budget deficit to their size; large structural budget deficits (which do not take into account the cyclical position of the economy) – about 4-5% of GDP, were

systematically reflected in external deficits (see Chart 5.1 and Chart 5.2). In the year of the Pandemic (2020), the current account deficit (below 5% of GDP) was almost half of the budget deficit (9.2% of GDP) as the non-governmental sector had much reduced investments.

The budget adjustment is absolutely necessary to bring the budget deficit below 3% of GDP in a few years and to stabilize the public debt, given that it will no longer be possible to count on the "surprise inflation" of 2022 in the years to come. European resources, which can lead investments to 6% of GDP on average in the coming years, would mitigate the contractionary impact of budget consolidation.

If the budget deficit (cash and ESA) were to reduce to 3% of GDP in the following years, we could assume a decrease in the current account deficit to about 6% of GDP if the current teerms of trade is maintained; and to 4% of GDP if the terms of trade were to return to that of 2021. There is also here an effect of the appreciation of the USD against the Euro as many energy products and other raw materials are priced in USD. However, we see that the USD has depreciated against the Euro lately, which, mutatis mutandis, may help an improvement in the terms of trade. But this reasoning implies a 1-to-1 transmission of budget deficit reduction into current account deficit reduction, which is an implausible assumption. The transmission coefficient is subunit; some studies place it below 0.4, others go to 0.6 (see the IMF analysis on Romania from August 2022, on the organization's website). The experience of the impact of the budget correction on the external deficit in the last decade suggests a transmission coefficient towards the upper threshold for our economy.



Graph 5.1 The evolution of twin deficits in Romania in the period 2004-2022 (% of GDP)

Source: AMECO

Graph 5.2. The evolution of the twin deficits in Romania in the period 2004-2022 (% of GDP)



Source: AMECO

A key question: why do other neighboring states have much more balanced external balances?

I will no longer insist on the budget deficit since references have been made.

a. The overvaluation of the leu in real terms

Overvaluation plays a not negligible role. There are analyzes that place this overvaluation (effective exchange rate) at between 5%-10%. But we see how, despite the size of the imbalance and this overvaluation, there is a nominal appreciation pressure on the leu at present. Even if fundamentals would suggest another level of "balance" of the leu, the financial conditions keep the national currency in an overvalued territory; here the logic of determining the equilibrium level according to trade flows collides with the logic regarding financial flows. The NBR must navigate very carefully between Scyla and Charybda; the course cannot be allowed to fall, neither to appreciate copiously, nor to enter into a rush of depreciation.

Even if the BNR were to try to depreciate the leu, beyond the possible rekindling of inflation, there is a problem of the effectiveness of such an approach. A lot of domestic production is part of cross-border value chains and it is not clear to what extent and how quickly a depreciation would stimulate exports and discourage imports; elasticities operate here that can be more or less favorable. These elasticities should meet the Marshall-Lerner condition (the sum of the elasticities of export and import demand be above 1) to have a positive effect, and the J-curve (negative effect on the deficit before a positive effect appears) to be as weak as possible as an initial influence.

But a deliberate devaluation cannot be done at order, and introducing monetary base into the economy to cause the leu to depreciate is conceptually and operationally sheer folly; it would blow everything up. Let's not forget that the leu is not a reserve currency and market sentiment can change radically if monumental errors are committed in economic policy.

b. The production of tradables is insufficient

It is plausible to assume that the production of tradables (exportable goods and goods that can replace imports) has not kept pace with aggregate consumption; it can be thought that we have a faulty resource allocation process, which favored the development of non-tradables. The exchange rate played a role, but it doesn't explain everything. Location in production and supply chains is not among the most favorable because components and subcomponents are assembled or produced in Romania, many of which do not mean high added value; and a change in the exchange rate of the leu cannot have quick effects when there are important rigidities in the markets (the Marshall-Lerner condition).

There are other acute structural problems: for example, the underdevelopment of the agro-food industry -- we have agricultural land that means 57% of the country's surface and the deficit of this sector is 0.5-0.6% of GDP in recent years. In general, we have an undervaluation of internal resources/raw materials, which is also seen in the fact that we import products whose production includes essential inputs from Romania (famous example: we export cereals and import flour).

The regressive fiscal regime (citizens with low or modest incomes pay proportionally more than those with high incomes), errors in fiscal policy, the abundance of exemptions and "loopholes" contributed to increasing the budget deficit by reducing potential tax revenues. With tax revenues of 26-27% of GDP (including social security contributions) we are the red light in the EU. As an analysis coordinated by the Council Fiscal showed in 2022, the revision of the tax regime could bring additional tax revenues of over 3% of GDP.

The revision of the tax regime (which would bring at least 3% of GDP additional tax revenues) would also allow a decrease in labor taxation, which would not harm the budgetary consolidation. A much better collection of tax revenues would also allow for an income policy that takes into account that the propensity to consume of citizens with low resources is considerably higher than that of citizens with high incomes, which affects the dynamics of imports. Tax evasion and "tax avoidance" must be combated with all institutional force and political

determination. We must not give in to internal and external pressures of all kinds. Let's hope that the European institutions will also be more determined for this purpose.

There are insufficient industrial policy measures aimed at the production of tradables, the increase of added value (including in agrobusiness). It should be noted that our economy has a dual character: important sectors are dominated by large foreign companies, which have their own strategies, and there are domestic companies, which are much weaker. In energy, we have companies with majority local ownership, which can support a national strategy. Anyway, industrial policy demands higher budget revenues, even if the PNRR (National recovery and resilience plan) contains elements that can develop the internal production of tradables, can increase the robustness of the economy. European resources also help finance external deficits.

c. Skilled labor emigration

Massive emigration also took place from other European economies, but proportionally more from Romania. The stock of human capital is lower and this affects the present and future potential GDP, the production of tradables. There are studies by the World Bank that highlight these effects.

7. Some conclusions regarding our economy

In the new geopolitical and geoeconomic context of the war in Ukraine, Romania will allocate more for defense, which does not mean necessarily production of tradables; in fact, arms purchases mean higher budget and current account deficits, other conditions unchanged. The Baltic countries take this spending to over 2.5% of GDP, Poland to even more. The statements of many NATO leaders go in the same direction, indicating the end of the "peace dividend" after the fall of the Berlin Wall.

Even if the war in Ukraine were to end this year, this does not mean a return to the pre-invasion situation. The allocation of resources for robustness, military resilience, means pressure on public budgets, reallocation of resources in

economies; everything is to be judged through the prism of de-globalization, the regionalization of some commercial flows, when security/security becomes more important than efficiency understood in the narrow sense. There are also adverse effects of climate change, which must also be taken into account in the construction of the public budget.

The production of essential goods for security, not only military, will also have to be developed; I mean food. It should be noted that the situation of the food industry was also examined in CNSM (National Committee for Macroprudential Supervision) meetings. That is why appropriate industrial/agricultural policies are needed. PNRR, with some adaptations (as will happen with NGEU) can help a lot.

Romania must capitalize on the natural conditions (resources), which give it an advantage over other EU member states; we did not know how to use these resources properly. When it comes to cutting-edge technologies, global competition is fierce and it's hard to predict what will happen. It is to be believed, however, that an increasing emphasis will be placed on safety, security in multiple senses.

Serious reforms must be undertaken in the economy; it is about salaries and a pension system that are fair, digitization, the reform of the fiscal regime, of public spending that should be more efficient (spending reviews are currently being carried out for education and health, as is done in the OECD), prioritization of investments with orientation towards the production of tradables, allocation of additional resources for education and health (which, however, implies higher budget revenues), etc.



Chart 6. Current account balance in RO, HU, PL, CZ in the period 2007-2022 (% of GDP)

Source: AMECO

Note: For the year 2022, the value of the current account balance is taken from the BNR website, the report being made to the GDP forecast by the CNSP on the occasion of the 2023 winter forecast.



Chart 7. Budget balance in RO, HU, PL, CZ in the period 2007-2022 (% of GDP)

Source: AMECO, for the year 2022 the values are estimates.

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