Economic Development, Technological Change, and Growth

Financing the Current Account Deficit through Foreign Direct Investments versus External Loans

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Abstract: The purpose of the article is to compare the financing of the current account deficit by foreign direct investments and by external loans, presenting the advantages and disadvantages of each type of financing. The analysis shows that both foreign direct investments and external loans may have positive and negative effects on the economy of the host country. In addition, some advantages of foreign direct investments have disappeared in recent years (eg stability has been partly replaced by volatility). In the article, the author also presents the characteristics of current account deficit financing in Romania during the period 2006-2018. Concerning the foreign debt, it is noticed that in Romania there has been a replacement of institutional creditors with private creditors, which we consider to be a negative evolution of the situation of the Romanian economy from the point of view of the reimbursement effort and the sustainability. The research methods used consist in comparative analysis in time, qualitative and quantitative evaluations, interpretations and correlations.

Keywords: positive and negative effects; disequilibrium; microeconomic and macroeconomic level; current account deficit funding

JEL Classification: F14; F21; F32; F34

1. Introduction

In the article, the author presents the characteristics of the current account deficit financing in Romania during the period 2006-2018, through foreign direct investments (FDI) and external loans. It also analysed, theoretically, the financing of the current account deficit by foreign direct investments compared to the financing through external loans, presenting the advantages and disadvantages of each type of financing.

Although apparently, it is more advantageous for an economy to use foreign capital in the form of foreign direct investments to cover the current account deficit, in the

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article the author shows that foreign direct investments may also have negative effects in the recipient economy.

We chose as the base year for the analysis, 2006, as it is the year before Romania has joined the European Union, in order to have the possibility to compare the present situation with the one before our country has became a member state of this community.

2. The Financing the Current Account Deficit in Romania

The high and rising (up to 2008) current account deficit as share of GDP in our country shows a negative effect of the current account balance over the domestic economic process. Between 2004 and 2008, the conventional sustainability threshold of the current account deficit (5% of GDP) has been constantly exceeded, being necessary the supervision and, most importantly, the enactment of policies to ensure the sustainability of the current account deficit over the medium and long term. These include deep, coherent and consistent measures to restructure the national economy. Although it was high by the international standards, Romania's current account deficit as a share of GDP was not a cause of alarm as long as its funding was secured, in particular by inflows of foreign direct investments. It seems that the Romanian economy has opened faster than it has restructured.

Thus, in our country, the current account deficit after 1998 has been mainly funded by foreign direct investments (autonomous sources of financing), which showed a high level of sustainability of the current account deficit of our country.

2009 represents a year of breach in terms of financing the current account deficit. Thus, in 2009, foreign direct investment inflows have declined significantly, and the foreign capitals borrowed by the government have increased. We notice that until the onset of the global economic and financial crisis, the inflows of foreign direct investments were high in Romania, certifying the high level of confidence of foreign investors. But with the outburst of the crisis, the possibilities of attracting FDI decreased both internationally, by showing quite widespread risk aversion and liquidity diminishment, as well as locally and regionally (amid regional tensions, including the war in Ukraine, and the characteristics of our country). These include exhaustion of objectives to be privatized, the lack of tax incentives, the deficiency of designing viable strategies for attracting strategic investors, the poor transport infrastructure, the very weak economic growth which failed to attract greenfield investments, etc. All these have led to a modest degree of attraction and capitalization of foreign direct investments in Romania after 2009.

In the years 2006, 2009, and 2013-2017 there is a high level of funding the current account deficit by foreign direct investments, amid a sharp decline in both the external deficit and the inflows of foreign direct investments (until 2015).

The inflows of foreign direct investments rose from 2930 million EUR in 2013 to 4880 million EUR in 2017. Although in 2018 the FDI balance increased by 70% compared to the level recorded in 2013, the degree of financing the current account deficit by foreign direct investments declines gradually over the period 2015-2018, in the context of a sharp rise in the current account deficit.

Romania enjoys inflows of foreign direct investments, as it is shown by the direct investment sub-account balance during the period 2006-2018. The inflows of non-resident direct investments increase over the period 2013-2018, reflecting the improving perception of foreigners over our country. Between 2013 and 2016, Romanians' direct investments abroad are also increasing. The net balance of direct investments increases between 2015 and 2018, which means the growth of our country's commitments towards non-residents, thus a negative influence over the international investment position.

The rise in foreign direct investment inflows was due to the raise of equity, except in the year 2018, when reinvested earnings are higher than equity. This shows the improvement of the quality of capital flows since 2015 and the reduction of debt instruments, except in 2018 when they grow. Against the background of improving investors' confidence in the Romanian economy, after having negative values in 2008-2014, the reinvested earnings remain positive and is increasing in the period 2016-2018.

In Romania, *the financing of the current account deficit by external debt has some characteristics.*

Thus, medium and long-term external loans received have increased significantly in 2007, the year when Romania has joined the European Union. In 2009 also, the medium and long-term external loans have a peak explained by the loans received by Romania this year from the International Monetary Fund, the World Bank and the European Union. In 2011, the trend of medium and long-term external loans shows a turning point. Thus, over the period 2005-2010, the medium and long-term loans have concurred to counteracting the current account deficit. However, starting from 2011, in the context of paying back a part of the previously contracted loans, the medium and long-term external loans have contributed to the formation of the external deficit with absolute values declining over the period 2013-2017, with a sharp decrease in 2016 and 2017.

Under these circumstances, it can be said that Romania is paying, starting with 2011, for the massive external credits obtained the previous years.

The private non-guaranteed external debt held the majority weight in the total medium and long-term external debt of our country between 2005 and 2010, which shows the dependency on the foreign financial markets in conditions of risk and uncertainty for both borrowers and creditors.

Analysing the structure of the external direct public debt by creditors, we note that between 2013 and 2018, the loans from multilateral institutions drop significantly in favour of bond issues (25. 7% in 2018 compared to 73. 9% in 2013), which become the majority since 2014. Bond issues have increased significantly between 2011 and 2014, an upward trend continuing until 2018 inclusively, concurring to an increase in the medium and long-term external direct public debt.

Therefore, there has been a replacement of institutional creditors with private creditors. Given that debt from multilateral institutions enjoys lower costs (taking into account the interest rates charged to countries perceived as having a high risk on the private market of international capital), longer grace period; longer total term; we consider that the replacement of creditors represents a negative evolution of the Romanian economy in terms of reimbursement effort and sustainability. Instead of paying back our foreign debt, Romania becomes more indebted, under harsher credit conditions.

On the other hand, the loans received from official creditors have also disadvantages: their availability is limited and the large-scale call for this type of funding sends a negative message to foreign investors, given that exceptional funding is intended to cover the current account deficit and to support the efforts of structural adjustment of the economy, in the context that that signal shows efforts to reform the economy, never finalized.

Analysing, in figures 1 and 2, the structure of the sources of financing of the current account deficit, we find that foreign direct investments counteract the current account deficit. Instead, starting with 2011, the medium and long-term net loans have concurred to the increase of external deficit.

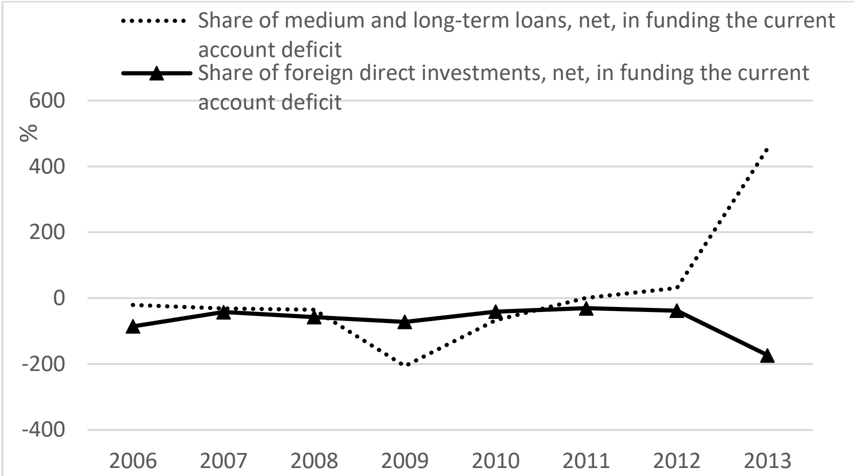

Figure 1. Sources of Financing the Current Account Deficit in Romania During the Period 2006-2013

Source: National Bank of Romania data, Monthly bulletins December 2007, December 2010, January 2012, January 2013. Data are calculated according to BPM5 methodology

Note: the negative sign shows that the current account deficit is being funded, and the positive sign means the contribution to the formation of the current account deficit

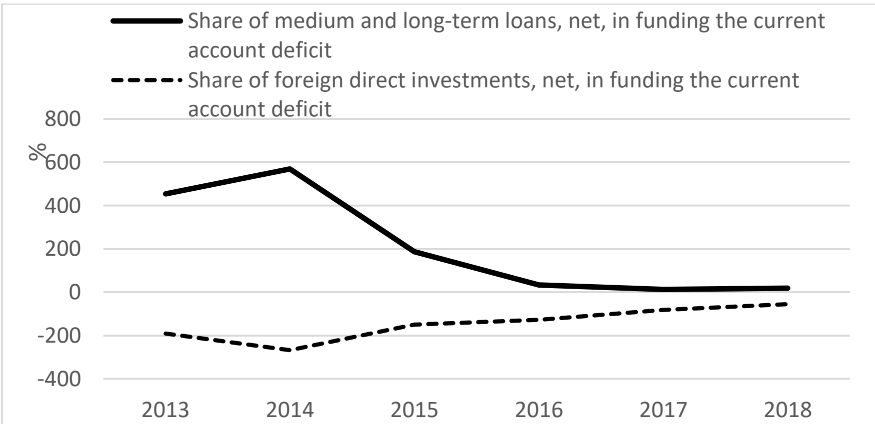

Figure 2. Sources of Financing the Current Account Deficit in Romania During the Period 2013-2018

Source: National Bank of Romania data, Monthly bulletins January 2013, January 2014, June 2014, December 2016, December 2017, January 2018, February 2018, December 2018, February 2019. Data are calculated according to BPM6 methodology

Note: the negative sign shows that the current account deficit is being funded, and the positive sign means the contribution to the formation of the current account deficit

3. Theoretical Considerations Regarding the Financing of the Current Account Deficit through Foreign Direct Investments and External Loans

In an economy, foreign direct investments have effects both at the macroeconomic and at the microeconomic level. These effects may represent advantages or disadvantages for the economy receiving the foreign direct investments.

At the macroeconomic level, the inflows of foreign direct investments represent a way of offsetting the balance of payments, concurring to the increase of the surplus or to the decrease of the deficit of the capital and financial account, directly, but also to the improvement of the current account balance by increasing export earnings (when foreign direct investments support the rise in exports of the host country). On the other hand, however, in the current account, the inflows of foreign direct investments generate, with a certain time lag, effects in the direction of increasing the deficit or decreasing the surplus due to the repatriation of profits and to the payment of interest and principal when the investments are financed by external loans.

There may be even situations when the outflows resulted from inflows of foreign direct investments (in the form of repatriated profits - when projects are profitable - and payments of principal and interest) exceed the initial inflow of foreign direct investments. Thus, the more profitable the project is, the lower is the inflow of foreign funds. This situation may be in the national interest of the host country when the foreign direct investments induce the capitalization of business, and the economic growth, thus supporting the creation of adequate conditions or sufficient funds to balance the balance of payments and to support the sustainable development of the country host.

The inflows of foreign direct investments can generate a rise in tax revenues to the state budget from foreign direct investment firms, but also from their suppliers (if foreign direct investment firms use domestic suppliers).

Foreign FDI inflows can lead to the growth of domestic production and, implicitly, to exports increase, generating the rise of international trade flows and the improvement of the balance of goods situation in the host country.

Excessive leverage may limit the benefits of foreign direct investments. If the investments made in the host country by international investors come largely from funds borrowed on the domestic credit market, then the share of domestic investment funded from foreign economies through foreign direct investment inflows may be small and the earnings from foreign direct investments may be diminished by the domestic borrowing made by firms with foreign control (Loungani & Razin, 2001).

In addition, foreign direct investments are considered to be more stable capital flows compared to portfolio investments because they do not leave the country immediately when a turbulence occurs, which provides the premises for a sinuous evolution of the host economy. However, in recent years, there is a greater volatility in foreign direct investment flows, as foreign investors seek to maximize profits, to increase market share, and to exploit the domestic resources at low-cost. Thus, as the attracting elements of foreign direct investments disappear or diminish over time, foreign investors will move to other more attractive areas, leaving behind unemployment and the breakdown of the production and sales chain in the field and geographic area where the companies with foreign capital had the activity.

In addition, the volatility of foreign direct investment flows makes the recipient country more vulnerable to external shocks. The unstable nature of foreign direct investment flows is generated by financial transactions (intra-company loans), by the high risk aversion of foreign investors.

The speculative nature of foreign direct investments is another determinant of their volatility. Thus, there are foreign direct investors who engage in speculative business, who do not intend to develop a lasting business in the host country, but seeks profits from the price differences of some goods (e. g. the price of land and real estate in Romania).

Globalization has concurred, on the one hand, to changing the mentality of investors, for which the relocation of production has become a routine and, on the other hand, to reducing the cost of production shifts, and to diversifying the opportunities that foreign investors can use.

Inflows of foreign direct investment also influence the trend and the level of the exchange rate of the host country’s currency. Thus, the inflows of foreign currency on the foreign exchange market generates the appreciation of the national currency, which on the one hand prevents the increase of the inflation rate and, on the other hand, stimulates the domestic demand for imports and hampers the external demand for exports, if the elasticity of imports and exports are supraunitary, causing the deterioration of the country’s balance of payments.

Consequently, foreign direct investments may, in positive situations, lead to restoring some equilibria in the economy of the host country either directly as in the case of the balance of payments or, indirectly, as it is the case of the state budget.

At the microeconomic level, foreign direct investments influence the number of firms existing on the domestic market, but also their turnover, and thus competition between firms. When foreign direct investment firms call upon local suppliers for different services, but also for construction, equipment, accessories, business opportunities for national firms are emerging, and demand for local producers is increasing.

But direct foreign direct investment firms may also bring in the reduction of the turnover or even the bankruptcy of local companies due to “predatory practices” ("stealing" partners and/or customers) (Mazilu, 2004), to the use of foreign suppliers after eliminating local competition. Other times, foreign direct investment firms buy local competitors for annihilating them in order to obtain a market share with a minimal investment effort, lacking the ability to sustain a local investment or to develop in a highly competitive environment (Meyer, 1996).

The creation of foreign direct investment firms can help to increase competition in the internal market for goods and services, with the effect of improving the quality of goods and services produced in the economy, which is an advantage for local consumers.

Foreign direct investment firms concur to increased competition on the credit market by obtaining loans from the local market to fund their projects.

Foreign investors facilitate the access of domestic products on foreign markets.

The inflows of foreign direct investments may lead to the transfer of technology superior to the one existing in the host country through the infusion of machinery, equipment, production and marketing processes; the transfer of managerial techniques, of good corporate governance practices, accounting regulations (Kozenkow, ?) with effects on improving product processing, the quality of products, work productivity, on emerging new products, on increasing the added value of the goods and services obtained in the host economy, and not least in the direction of increasing the revenues to the state budget due to the widening of the tax base in the context of the business development.

The effects of foreign direct investments depend considerably on the host economy's capacities and skills necessary to use new technologies, to adapt them to the local conditions, to make possible improvements, but also on the existence of macroeconomic stability, foreign direct investment regulations, favourable business environment, a certain level of education, the existence of developed institutions and a high degree of openness of the economy.

With regard to environmental issues, foreign direct investment firms may have negative effects on the host country if there is no environmental protection policy or if the foreign direct investment has aimed at relocating the pollutant production from the mother country, or if the technology brought by the investment firms is old, and therefore "unfriendly" to the environment.

There are situations when foreign direct investment firms bring negative effects in the host country, such as: when they fail to comply with business ethics principles; when they try through different practices (e. g. transfer pricing) to pay lower income taxes to the recipient country's budget; when they use crucial information about the firms they control to the detriment of the domestic investors owning a number of stocks that do not give them control or access to that information.

When foreign direct investment firms reinvest a large part of their profits in the host country, this economy's development is supported in the medium and long term.

Inflows of foreign direct investment have also important effects on the labour force market. Thus, foreign direct investment firms can concur to the development of human resources by organizing training courses. Also, these companies usually create jobs by hiring local employees, but jobs can also be created at the suppliers of foreign direct investment firms if they use domestic suppliers. Thus, inflows of foreign direct investments can help to improve the standard of living of population.

But there may be also negative effects of foreign direct investment inflows on the labor force. The most important is the reduction in the number of jobs that can occur in several situations. Thus, multinational companies can lead to the bankruptcy of national firms or they may shut down their production or they do not use local suppliers. The reduction of jobs is also due to the fact that foreign direct investment enterprises are usually capital intensive and labour-efficient, so they invest in intellectual property and equipment, and less in wages (Vaknin, 2007).

If only the benefits listed above are taken into account, foreign direct investments concur to economic growth in the host country, to its development.

But when analysing the effects of foreign direct investment inflows on the recipient country, their negative effects must also be taken into consideration, which, as the above analysis shows, are not few neither insignificant.

For a country to take advantage of the inflows of foreign direct investments, a minimum of conditions is required. Thus, the economic, political, business environments must be stable. Institutions must be strong and independent of politics, especially in justice. Legislative and tax frameworks should be attractive and beneficial to the business environment, clear, stable and predictable. It is also necessary to have a developed infrastructure in the field of transportation, communications, etc.

The financing of the current account deficit through external loans has certain disadvantages, which include the costs (interest, commissions, possible penalties), the terms imposed by the lending institutions (which are not negotiable and sometimes have effects opposed to the sustainable development of the recipient economy),

Moreover, the external debt implies the existence of microeconomic risks (increased exposure to a possible external shock and the effects on the banking sector), but also macroeconomic implications from the point of view of the external debt sustainability. Thus, external debt may cause problems through the exchange rate channel (the sudden depreciation of the national currency would lead to a significant increase in the cost of external financing), through the trust channel (the change of the sentiment and perception of investors leads to an increase in the risk premium and implicitly in the cost of external financing), by contagion (through an economic, political or social shock of a regional nature), or even through a shock of the national economy, of a conjunctural or structural nature. In addition, in the case of short-term external debt, there is a risk of capital volatility. Also, longer maturity supports the national economy sustainably, as the debt burden is staggered over a time horizon that does not "press" tightly on government budget decisions and jeopardize its development projects.

Also, the financing of the external deficit through external loans sends a negative message about that country at the international level, showing insufficient efforts to reform the economy.

4. Conclusions

In the positive scenario, if only the benefits outlined above are taken into account, foreign direct investments may lead to the retrieval of some disequilibria in the economy of the host country either directly (in the balance of payments) or indirectly (in the case of the state budget). Foreign direct investments may concur to the economic growth of the host country, to its development. But the inflows of foreign direct investments have also negative effects on the country of destination, which are neither little nor insignificant.

From the analysis, we find that foreign direct investments are no longer a source of foreign capital absolutely better than foreign loans in terms of positive effects. Although they have some advantages in addition to external loans (know-how infusion, human resource development, etc.), however, in the last years, some of the beneficial effects of foreign direct investments have disappeared, leaving place to negative consequences (for example, stability has been replaced by volatility).

A very important aspect, of national interest, for any economy, is the preservation of national sovereignty. Thus, it is imperative to avoid creating a dependency of the host country on foreigners as a result of foreign direct investments or external borrowing.

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