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The Romanian Economy and the EU

The wiiw Balkan Observatory

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About

Shortly after the end of the Kosovo war, the last of the Yugoslav dissolution wars, the Balkan Reconstruction Observatory was set up jointly by the Hellenic Observatory, the Centre for the Study of Global Governance, both institutes at the London School of Economics (LSE), and the Vienna Institute for International Economic Studies (wiiw). A brainstorming meeting on Reconstruction and Regional Co-operation in the Balkans was held in Vouliagmeni on 8-10 July 1999, covering the issues of security, democratisation, economic reconstruction and the role of civil society. It was attended by academics and policy makers from all the countries in the region, from a number of EU countries, from the European Commission, the USA and Russia. Based on ideas and discussions generated at this meeting, a policy paper on Balkan Reconstruction and European Integration was the product of a collaborative effort by the two LSE institutes and the wiiw. The paper was presented at a follow-up meeting on Reconstruction and Integration in Southeast Europe in Vienna on 12-13 November 1999, which focused on the economic aspects of the process of reconstruction in the Balkans. It is this policy paper that became the very first Working Paper of the wiiw Balkan Observatory Working Papers series. The Working Papers are published online at www.balkan-observatory.net, the internet portal of the wiiw Balkan Observatory. It is a portal for research and communication in relation to economic developments in Southeast Europe maintained by the wiiw since 1999. Since 2000 it also serves as a forum for the Global Development Network Southeast Europe (GDN-SEE) project, which is based on an initiative by The World Bank with financial support from the Austrian Ministry of Finance and the Oesterreichische Nationalbank. The purpose of the GDN-SEE project is the creation of research networks throughout Southeast Europe in order to enhance the economic research capacity in Southeast Europe, to build new research capacities by mobilising young researchers, to promote knowledge transfer into the region, to facilitate networking between researchers within the region, and to assist in securing knowledge transfer from researchers to policy makers. The wiiw Balkan Observatory Working Papers series is one way to achieve these objectives.

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Global Development Network Southeast Europe

This study has been developed in the framework of research networks initiated and monitored by wiiw under the premises of the GDN–SEE partnership.

The Global Development Network, initiated by The World Bank, is a global network of research and policy institutes working together to address the problems of national and regional development. It promotes the generation of local knowledge in developing and transition countries and aims at building research capacities in the different regions.

The Vienna Institute for International Economic Studies is a GDN Partner Institute and acts as a hub for Southeast Europe. The GDN–wiiw partnership aims to support the enhancement of economic research capacity in Southeast Europe, to promote knowledge transfer to SEE, to facilitate networking among researchers within SEE and to assist in securing knowledge transfer from researchers to policy makers.

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PART 1: THE ROMANIAN ECONOMY AND THE EU

The big “game” in Europe is joining the *Union*. For accession countries, and especially for the poorer ones, the EU can provide the decisive impetus for economic catching up and modernization –which is a goal which goes deeply down into history. But the quest to join the EU has been a highly complicated endeavor in view of the very intricate nature of reforms in post-communist countries and the developmental handicaps they are facing. At the same time, the Union itself is going through delicate moments, which do not necessarily favor a smooth relationship with the accession countries. For Central European and the Baltic countries the year 2004 is a turning point in history as accession is to happen at that time; for Bulgaria and Romania the accession timetable is optimistically set for 2007.

1. The EU factor

More than, probably, most of the European candidate countries, Romania sees in the relationship with the European Union an extraordinary chance to accomplish a secular quest for modernization. Why is it so? For sustained rapid economic growth (economic development), or what in the Anglo-Saxon literature is called *catching-up*, is a very rarely encountered phenomenon in modern history. In the last century, there were few cases of sustained fast development, of economic convergence, that reduced important economic gaps. In Western Europe, Ireland is the most interesting case, whereas Spain and Portugal wittnessed remarkable evolutions as well, albeit less spectacular, after the end of Franco’s and Salazar’s dictatorships. The miracles in Southeastern Asia should be considered exceptions that confirm the rule.

The experience of economic development, worldwide, demonstrates that the formulae of "the catechism" of transformation (privatization, liberalization and stabilization) are not sufficient in order to explain and ensure rapid economic growth over a longer period of time. Hence, what could become the driving force for Romania, in the sense of what Paul *Rosenstein-Rodan*, theorized many decades ago under the name of *The Big Push*? It is not without interest to recall that *Rosenstein-Rodan* introduced this concept by examining the state of economic backwardness of South-Eastern Europe (*Problems of industrialization of Eastern and South Eastern Europe*, Economic Journal, 53, June-September, pp. 202-211, 1943).

The challenges of transformation and development could be easily tackled if public policy and private entrepreneurs could "plant" adequate, progressive institutions in unfavorable environments, changing almost instantaneously social (organizational) physiologies and anatomies. But institutions cannot be “purchased”, nor can they be assimilated in a blink of an eye. They are by themselves a native socio-historical outcome, which demonstrates that time cannot be compressed, as we would like. The lesson for Romania is that in the absence of adequate institutions and a responsible public policy it will be practically impossible for her to experience the rapid economic development she needs. And without such a dynamic it will be more and more difficult for her to catch up with prosperous European countries.

It should be noted that Romania has an income per capita that represents roughly 25-27% out of the average of the European Union (fig.1), being at the same time a country with a relatively large population (22.4 million), as compared to the average in Central and Eastern Europe. Various estimations point out that under the hypothesis of an average rate of economic growth of 5%, over the longer run, while the EU average rate of economic growth would be 2%, Romania would need 20 years to reach half the average income per capita in the EU. Similarly, the catching-up of the income per capita (at purchasing power parity) would not be possible in less than 45 years. Entering the EU does not require the attainment of the average level of the income per capita in "the Club" (as suggested by the experience of some countries such as Portugal and Greece), but such numbers reveal the size of the gaps and the huge challenge for Romania.

Fig. 1

Per capita income levels in Europe (1998, in PPP terms as % of EU average)

Country	Per Capita income level	Country	Per Capita income level
Greece	66	Latvia	27
Ireland	101	Lithuania	31
Bulgaria	23	Poland	
Czech Republic	59	Romania	36
Estonia		Slovakia	27
Hungary	37	Slovenia	
	49		46
			68

Source: "Progress Towards the Unification of Europe", World Bank Report, 2000, p.40

EU accession as a strategy of economic development

A sustained economic progress would require higher saving and investment ratios in Romania (of over 30% of the GDP), hence the importance of foreign capital inflows, a public policy geared to favor the development of human capital and infrastructure, and Romanians using increasingly what the new ITs offer (interestingly, Romania is a leader among transition countries when it comes to ITs). But such developments depend, in their turn, on the functioning of institutions: a competent, honest and innovative (central and local) public administration, a solid financial and banking system, good structures of corporate governance (orientated towards higher economic performances), an education system offering equal chances to children and adults, laws that enjoy social acceptability and are respected, and a favorable social ethos. The quality of public policy itself depends on the functioning of our institutions.

It is not easy to find the key to collective and individual wisdom that would open the doors to sustained overall progress, especially in a world which is increasingly complex and uncertain and, which is, often, prone to a type of games with a few winners only (*winners take all*). It is pure naiveté to believe that openness towards a global economic space where asymmetries, agglomeration effects and cumulative causality, volatile (unstable) financial markets are pretty much present, would ensure, *ipso facto*, economic development. In nowadays' world extraordinary opportunities can coexist with failures of large proportions, which can become national (collective) tragedies. Arguably, integration in the world economy cannot be a substitute for an economic development strategy.

If one takes for granted the hypothesis that not any kind of integration brings about benefits, it makes sense to judge the joining the European Union as a possible solution to the secular desire of economic development and modernization of the country. This could provide the "Big Push" Romania needs in order to reduce the economic gaps between her and the developed European countries. Moreover, this integration would shelter Romania from the instability and troubles of the rest of the world.

Romania's road toward the EU is tougher

Romanians' huge expectations vis-à-vis the EU lies behind the very high percentage (over 80%) of those who support joining the Union. It might be that, this percentage is due to a lesser knowledge about the exigencies of the Club[1], to the fact that Romanians still "have time" to "develop" their own doubts and grasp the complexity of operating inside the EU.

When referring to Romania's EU accession dossier one needs to highlight features of her economy such as: the unusually high percentage of rural population and the share of farming in overall economic activity, the costs of upgrading the energy sector and of environmental protection, the costs of overhauling the social security system, etc. Likewise, Romania needs to bring inflation to a one digit level and achieve an adequate degree of nominal convergence (according to the Maastricht criteria), which should be supported by continous real convergence. All these tasks ask for an effective public policy, which,

[1] The EU, as a phenomenon, is exceptional, in a historical perspective; it is unique both economically and politically in modern history. This is why one can hardly establish an analogy between NAFTA and the Europe agreements, which the accession countries have with the EU.

depends on good public administration. But, as Romania's transition indicates quite clearly, public administration, itself, is in need of deep reform.

Are the current negotiations and the efforts to adopt the 'Acquis Communautaire' the equivalent of an effective strategy for economic catching-up? In many domains, they may well be so, to the extent that good institutions are smoothly "imported" and function effectively, and to the extent that technology transfer and upgrading of production (via FDIs) occur intensely, for the benefit of a majority of the citizens (and social cohesion is not impaired). Central and Eastern European societies do not look poor in important respects (e.g. the literacy rate of the population and general educational standards, behavioral patterns), but most of them face a set of challenges, which are specific to poor countries: still fragile institutions, perturbing growing inequality[2] (precarious social cohesion), inferior political elites, endemic corruption, which distorts and taxes business, etc. Therefore, these countries need to formulate policies, which should tackle poor countries-type problems as well; they need development (catching-up) strategies

Empirical analyses show that the opening of the economy and integration with the outside world have better chances to foster economic growth when an adequate inflow of foreign direct investment upgrades the capital stock and human capital of the recipient countries – while it does not crowd out domestic investment. It is no surprise, therefore, that the frontrunner accession countries have received a disproportionate share of FDI.

Equally, a strategy of economic development (catching-up) requires policy ownership, which refers to both domestic intellectual capabilities (expertise), as well as to the capacity to formulate policies. This is the lesson of the most impressive cases of catching-up of the last century (whether one thinks of Japan, South Korea, Singapore, and more recently, Ireland).

It may be that the EU arrangements could supplant partially the need for domestic policy capabilities. But, as the reports of the European Commission consistently document, particularly in the case of the less performing accession countries, public administration reform is critical for development, which indicates essential tasks of domestic policy. It is true, however, that, within the constraints of the institutional functioning of the EU, domestic policy formulation acquires a new connotation. But the problem remains as such, since Brussels cannot be a substitute for key decisions at the national level.

A caveat on the linkage between EU integration and convergence is necessary. Some of the premises for catching-up may clash with the strict conditionality of the Maastricht Treaty criteria, in case the accession countries intend to join the Exchange Rate Mechanism

[2] It should be acknowledged, nonetheless, that much of this growing inequality is unavoidable, as a result of the change from a command (highly equalitarian) to a market-based economic system.

(ERM2) and, later on, the Monetary Union. A related situation is entailed by the implications of the Balassa-Samuelson Effect, which may make it impossible for accession countries to comply with the requirement of a low inflation rate in order to fit the EU (ERM) area. And, should they try to attain a very low inflation rate, this may undermine growth and, therefore, catching-up. If this is the case, should some of the accession criteria be made more flexible?[3] How would the EU member countries view such a weakening of criteria? To what extent can the logic of a "variable geometry" play a role in this context? Would such a variable geometry process of enlargement be manageable?

For the EU candidate countries, the low inflation criteria (and, further, the Maastricht Treaty provisions) and the negotiations with Brussels raise two main sets of questions: one regards trade links and, more specifically, the capacity of accession countries to withstand competitive pressures when trade protection asymmetries disappear; the other issue regards the possibility for the candidate countries to accommodate the stern exigencies of a very low inflation environment, even if they do not adopt the single currency.

2. Economic criteria for joining the EU

Aspirant countries to EU accession are asked by the EU Commission in Brussels to comply with two fundamental requirements: to have a so-called "functioning market economy"; and to withstand competitive pressures inside the economic/monetary union.
The first requirement –"the existence of a functioning market economy"[4]-- connotes an institutional set up (the functioning of basic market institutions) which would enable, *inter alia*, effective financial discipline (exit and entry market take place easily), proper law enforcement and protection of property rights, effective financial intermediation, an adequate policy mix framework, which ensures efficacy in dealing with adverse powerful shocks.

The second demand takes cognizance of the dramatic reduction of the scope of national economic policy in a region which practices a common monetary policy, where intra-trade barriers no longer exist, which has a single currency in 12 member countries, and, in a softer form, the Exchange Rate Mechanism 2(ERM2) constrains exchange rate policy in the other states significantly, etc. Both exigencies are seen as essential for enhancing nominal and real convergence –without which the Union would be undermined from within.

[3] One can make an analogy with the current debate on the adequacy of some of the provisions of the Stability Act of the European Union –the 3% budget deficit upper limit at a time of very slow growth in the Eurozone.

[4] A "functioning market economy" is quite curious terminologically; this notion cannot be found in an economic textbook, since all market economies are functioning, whether well or bad. What the experts in Brussels have, most likely, in mind is a "well functioning market economy", which relies on a sound institutional setup and low information and transaction costs.

The transition countries which are to be admitted in 2004 were granted the status of "functioning market economy" a while ago; Bulgaria, too, was assigned it last year. Bulgaria's economy upgrade, Croatia's ambition to be put on a fast track, and the debate on Turkey and other would be accession countries have raised the stakes for Romania - in a race which becomes ever more challenging in view of the economic and geopolitical circumstances which accompany *Enlargement*.

"To be or not to be" is a question which has tormented policy-makers in the candidate countries since long, for both international politics and economics intertwine in the quest to join the Club. Consequently, being left behind in a race which has its own symbols (specific criteria and diplomatic language –-"functioning market economy" is one of them) can harm one country's credentials. On the other hand, rushing into joining the Union[5], at any costs, can be self-defeating; the laws of economics cannot be bent beyond certain limits and the very ultimate goal (accession) could become more distant.

It can be submitted that, if the next wave of *Enlargement* does not proceed smoothly, Romania would have to show increasingly better results in order to justify the quest to join the EU in a few years time –for inner political and economic dynamics in the Union may turn against another round of *Enlargement* any time soon

3. Where does Romania stand?

Do basic market institutions exist and do free prices, mostly, allocate resources in Romania? Clearly they do. Romania has a "market economy"[6] in a deep sense. And Romania's economic performance has improved substantially in recent years. But this improvement does not mean that the Romanian economy is devoid of significant weaknesses regarding financial discipline, enforcement of market regulations, transparency and stability of the regulatory framework, the public administration and the judiciary..

3.1 How does Romania fare comparatively?

Recently, the EU Commisssion appreciated that "Romania can be considered as a functioning market economy once the good progress made has continued decisively"(Regular Report on Romania's ProgressTorwards Accession, 2003, pp.44) This pretty strange wording may reflect the Commission's desire to acknowledge, on one hand,

5 The verb "rushing" may sound inappropriate because a candidate country does not enter the Union at a moment of its own choosing; the implication here is that a candidate country's policy-makers and political elites need to be well informed about the preconditions for a successful joining of the Union and, also, that the terms of accession are highly relevant (which means that a country has some room for negotiation).

the economic progress achieved in Romania in recent years, and on the other hand to see it consolidated in an election year. Herein, probably, has the equivocal wording its roots. It may be instructive to compare the current state of the Romanian economy with the situation of other EU candidate countries when they received the status of "functioning market economy".

Figure 2.

Key macroeconomic indicators, selected EU candidate countries, at the time the European Commission considered them "functioning market economies" – as compared to Romania before the Commission's 2003 Country Report

	Czech Rep. 1997	Hungary 1997	Poland 1997	Slovak Rep. 2000	Bulgaria 2002	Romania 2003
GDP,% annual real growth	1.0	4.4	6.9	2.2	4.8	4.8 (projection)
Inflation rate, % Dec/Dec	10.0	18.3	13.2	8.4	3.8	14.5 (projection)
Unemployment rate, %	5.2	8.1	10.3	17.9	17.4	6.8
Current account deficit, % GDP	-6.1	-2.2	- 3.2	-3.7	-4.4	-4.8 (projection)
Budget deficit, % GDP	-2.2	-4.6	- 3.1	-6.7	-0.6	-2.6 (projection)
Gross foreign debt, % GDP	41	63.1	28	37.3	71.9	33.0 (end 2002)
Official gross foreign reserves, in months of imports	4.9	5	5.9	3.7	5.3	4.7 (Sept. 2003)
M2, % GDP	67.3	39.4	38.2	66.0	43.3	24.7 (end 2002)

Note: all projections for Romania are those of the Government, and are endorsed by the latest IMF country analyses

Source: European Commission, IMF, national statistics

The figures in the table above are comparable in most respects. If the same standards operate in the judgement of economic performance Romania shall be looked upon favorably by the Commission in Brussels. One could argue that judgements evolve over time and that they are more severe nowadays in view of recent years' developments both inside and outside the Union. This is not an argument to dismiss out of hand; on the other hand, how can one reconcile such a line of reasoning with, for instance, recent years' balooning budget deficits in some countries which are to join the EU in 2004?

Figure 3

Latest economic data from selected EU candidate countries

	Czech Rep.	Hungary	Poland	Slovak Rep.	Bulgaria	Romania
GDP,% annual real growth	2.2 (Q1 2003)	3.6 (2003 IMF projection)	1.3 (end-2002)	4.4 (end-2002)	5.0 (2003 IMF projection)	4.3 (H1 2003)
Inflation rate, % Dec/Dec	1.8 (end 2002)	5.3 (2003 IMF projection)	0.8 (end-2002)	3.4 (end-2002)	-0.2 (Q1 2003)	14.5 2003) (forecast)
Unemployment rate, %	8.9 (end 2002)	6.0 (2003 IMF projection)	18.1 (end-2002)	17.8 (end-2002)	15 (Q2 2003)	6.8 2003)
Current account deficit, % GDP	-6.5 (end-2002)	-4.8 (2003 IMF projection)	- 3.6 (end-2002)	-8.2 (end-2002)	-10.2 (Q1 2003)	-4.8 (2003 IMF projection)
Budget deficit, % GDP	-7.25 (2003 IMF projection)	-6 2003 IMFprojection	- 5 (2003projection	-4.5 (2002)	0.3 (Q1 2003)	-2.6 (2003 IMF projection)
Official gross foreign reserves, in months of imports	6.1 (Q1 2003)	3.8 (2003 IMF projection)	8.3 (end-2002)	5.9 (end-2002)	5.2 (2003 IMF projection)	4.7 (Sept 2003)

Source: IMF, national statistics

This state of affairs has not been unnoticed by the main rating agencies, which have improved Romania's standing during the spring of 2003. Most recently, Standard and Poor's raised it to BB.

Figure 4

Credit ratings, Standard & Poor, countries' sovereign fixed income long term debt, as of October 1st, 2003

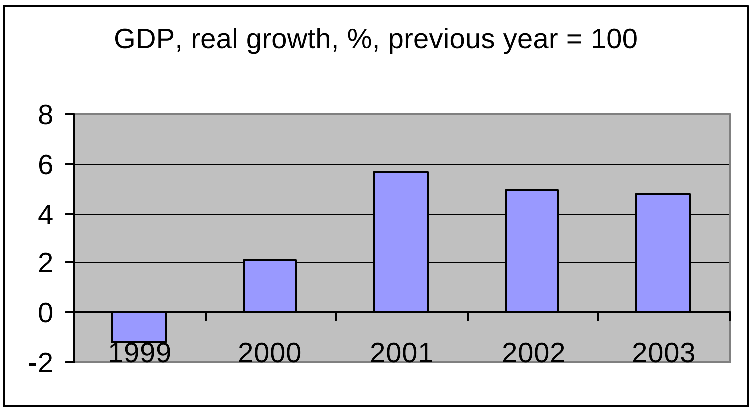
	Local currency		Foreign currency	
	Rating	Evolution	Rating	Evolution
Romania	BB+	Positive	BB	Positive
Bulgaria	BBB-	Stable	BB+	Stable
Czech Rep.	A+	Stable	A-	Stable
Cyprus	A+	Stable	A	Stable
Hungary	A	Stable	A-	Stable
Lithuania	A-	Stable	BBB+	Stable
Poland	A	Negative	BBB+	Negative
Slovak Rep.	A-	Stable	BBB	Positive

Romania's rating is still under investment grade, but prospects for further positive revisions are deemed fairly high[7].

3.2 Positive developments

Let us see a series of positive economic developments in the Romanian economy.

- Economic recovery has been under way for several years now; the GDP grew by 5.7% and 4.9% in 2001 and 2002, respectively. It would, probably, rise by around 4.5% this year; the current deceleration would be, due, primarily, to fallout from economic stagnation in the West and a bad domestic harvest. For 2004 a forecast of 5% is reasonable in view of an expected revival in EU economies, the growth of domestic non-governmental credit (and a further rise in domestic investment), and, hopefully, a better harvest.



- Inflation, the big scourge of the past decade, has been coming down consistently: from 30.3% (Dec. on Dec.), in 2001, it went down to 17.8% in 2002, and would, likely, drop to around 14.5% this year; it is forecast to go further down to about 9% in 2004.

[7] Analysts from leading investment banks consider that, in spite of these upgrades, rating agencies continue to underrate Romania's performance ("Sovereign Eastern Europe Update, Bear and Stearns, 26 June, 2003)

Figure 5

macroeconomic indicators

	2000	2001	2002	2003*	2004**
-Real GDP, % change	2.1	5.7	4.9	4.5	4.8
-Inflation (CPI)					
End of Dec.	40.7	30.3	17.8	14.5	10
-Budget deficit	-3.5	-3.3	-2.7	-2.7	-3.3
-Current account					
deficit	-5.7	-5.6	-3.6	-4.8	-5
-Official reserves					
(billion USD)		4.8	7.1	8	
-Total ext. debt,					
% GDP		31	35	32	34
% of exports		81	85	85	
-Interest payments					
% of exports		4.1	3.8		

Source: National statistics and own estimates

* estimates, **: forecasts

- The overall public indebtedness has stayed below 30% of GDP, out of which the external public and publicly guaranteed debt is cca ¾, while short term indebtedness is pretty low (below 5% of total foreign debt).
- Budget deficits have been kept under 3% in recent years. Nonetheless, significant quasi-fiscal deficits blur this assessment
- Current account deficits have been kept, on average, around 5% in recent years while the international reserves of the Central Bank have surged to almost 8 billion euro in October 2003 (which covers more then 4.7 months of imports).
- The private sector's contribution to GDP formation is nearing 70% currently, while this sector accounts for over 55% of social capital in the economy and more than 70% of employed population.. The figure below shows how Romania compares to other accession countries in this respect.

Figure 6

Private sector's share in selected accession economies

Czech Republic/1999: 80% of GDP

Poland / 1997: 60% of GDP, 65% of employed population
/ 2001: 65% of GDP, 70% of employed population

Hungary / 1997: 65% of GDP
/ 2001: 80% of GDP

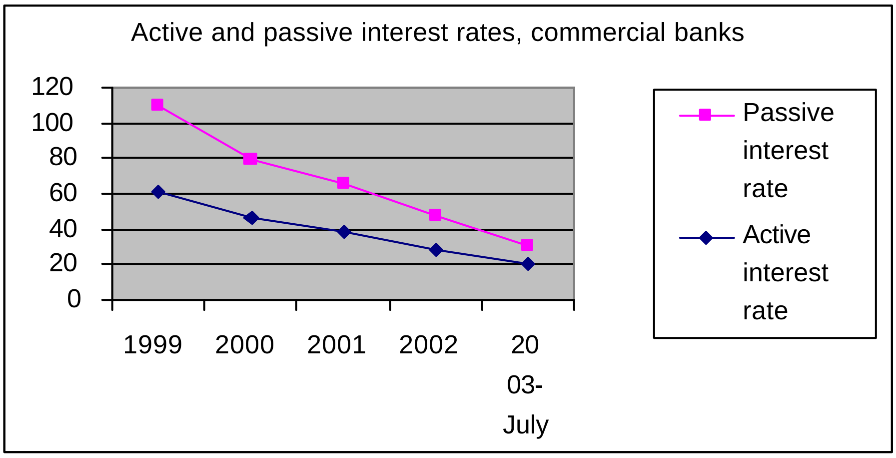
Slovak Rep. / 2001: >50% of GDP, >55% of employed population

Bulgaria / 2001: 71% of GDP, 73% of employed population
Romania/ 2001: 67% of GDP, 70% of employed population

Sources: OECD and World Bank data

- <u>The banking system is much sounder</u> nowadays, after a massive clean up operation in the late 90s and the introduction of a new regulatory framework –which fits the BIS new recommendations. This evolution has taken place on the background of increasing foreign ownership in the banking sector (to above 60% of total assets and loans), which has meliorated corporate governance in this sector. Recently, Banca Comerciala Romana, which is the largest commercial bank, has got IFC and EBRD as new share-holders.

The banking system has increased its capacity to provide effective intermediation between savers and investors. Both the active and the passive interest rates have decreased substantially, and the spread between them also diminished (figure below). Likewise, the range of financial products has increased remarkably (these products have fuelled non-governmental credit).



The annual yield for t-bills, which was a major attraction for banks' investment policy, decreased from 76.0% in 1999 and 35.7% in 2001 to 17.3% in 2002 and 15.5% as of August 2003. This evolution has provided another stimulus to domestic non-governmental credit, which has boomed by a 25% , in real terms, in the first half of 2003. It is noticeable that despite this big rise prudential indicators are still in safe territory[8]. Lately, the Central Bank has adopted a series of measures aiming at restraining the upsurge of this credit –as a sort of preemptive policy..

[8] Even if some numbers are likely to be overstated the overall picture evinces a remarkable turnaround as against the late 90s.

Figure 7

Key prudential indicators in the banking system

	1999	2000	2001	2002	2003 July
Solvency rate (>12%)	17.9	23.7	28.8	25.0	22.8
Bad loans, as % of total assets	2.36	0.29	0.32	0.23	0.42
Credit risk rate	35.4	3.8	2.5	1.1	3.9

Source: NBR Monthly Bulletin 7/2003

Capital adequacy – net assets / total assets; Credit risk – unadjusted exposure relative to loans and interest under "doubtful" or "loss"/ total loans and interest excluding off-balance sheet items

The non-financial sector has also developed rapidly, the market capitalization of the Bucharest Stock Exchange: grew from 1.04% of GDP in 1999 and 3.3% of GDP in 2001, to 6.05% of GDP in 2002 and cca.7% of GDP in the first half of 2003.

3.3 What clouds the sky?

Major weaknesses persist in the Romanian economy; these weaknesses can harm macroeconomic conditions and GDP growth over the longer term unless reforms go farther. [9]. Such weaknesses are listed underneath.

- Financial (including fiscal) discipline.
  - Hard budget constraints do not operate yet ubiquitously and loss making companies produce sizeable arrears/ quasi- fiscal deficits[10]. The high inflation has been used by many companies as a means to stabilise arrears in real terms and, thereby, survive. The current disinflation puts pressure on the loss-making sector and, unless restructuring makes more headway, persistent large quasi-fiscal-deficits would clobber the budget and, further, the economy in the years to come; the persistence of large quasi-fiscal deficits would question the suitability of moving fast with the liberalisation of the capital account and the adoption of inflation-

[9] The strain which some leading EU economies are undergoing in meeting their budget targets raises an important question: is it sensible to be over-strict with accession countries when weighty members of the Union have a very hard time in meeting Maastricht criteria? Certainly, one can reverse the logic of this observation and ponder: if well functioning market economies can have such a hard time inside the Union, how would, presumably, a worse functioning market economies fare after joining the *Club*? Thence one can infer with regard to the importance of nominal and real convergence before a country joins the Union. But in order to answer such a question one would have to examine other basic issues such as: the ability to give up considerable autonomy of policy making (as a shock absorber device) as it is implied by accession; and relatedly, are the Maastricht criteria in need of amendment, so that policy responses be enhanced in time of duress. These issues concern the EU member and aspirant countries equally. As far as Romania is concerned, her targeted time of accession allows some room of maneuver for coping with the second economic requirement.

[10] Especially in the energy sector, where the losses were cca. 1.5-2.% of GDP in 2002. Arrears (losses) are also significant in the petrochemical industry.

targeting in the near future[11]. A series of measured adopted indicate that the Government has high on its agenda a quicker pace of structural reforms (including privatisation) and a more effective budget (tax) policy administration. These measures are:

- structural reforms through privatization. The privatization commitments undertaken in the PSAL I and PSAL II programs with the World Bank are on track; other privatisation processes are also advancing12. Recent privatizations of some companies with a history of loss making, like Tepro Iasi, Tractorul, Roman Brasov, ARO and Siderutgica are worth mentioning. In the energy field, the privatization of Petrom, the national oil company, is making headway, and 11 potential investors have qualified for the tender. Also, the privatization of two branches of the national electricity provider, and the privatization of two gas distribution companies is under way.
- tax administration. A unit for large taxpayers has been established in Bucharest; the setting up of a semiautonomous tax administration unit, which should enhance the institutional capacity to collect taxes, is almost completed; a legal framework has been created in order to unify the collection, audit and enforcement of the social security funds under the supervision of the Ministry of Public Finance. Hopefully, these measures will be validated by results.
- a new fiscal code. A new fiscal code is to be adopted by the Government until the end of this year. This code brings together all relevant pieces of tax legislation and aims at simplifying fiscal procedures and increasing transparency.
- state aid and competition. Romania is currently applying the EC criteria in the authorization of new state aids, and is monitoring the existing aid with the goal of bringing it in line with the Acquis. It is fair to acknowledge that arrears in the public sector soften considerably this assertion, but progress is, nonetheless being made in this regard.

- The investment climate. The investment climate has been plagued by various administrative and red tape barriers, and has been allegedly damaged by corruption practices. Consequently, particular attention has been devoted to the improvement of the business environment in areas such as:
  - market access. To this end procedures have been simplified. Thus market entry registration and authorization procedures have been streamlined by improving the work of the Sole Office and introducing a silent approval procedure. In order to facilitate market exit, a legislative project on bankruptcy and reorganisation procedures has been initiated, aiming at increasing the ability for creditors to file for bankruptcy.

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[11] Adding quasi-fiscal deficits to the official public budget deficits has its own flaws methodologically (as a means to illustrate an actual "consolidated" public deficit), but ignoring/underestimating them would be a serious mistake.

[12] One way to enhance financial discipline, via combating rent seeking and improving corporate governance, is by better defining property rights and privatisation. Many state-owned companies are grossly inefficient and concentrate a large chunk of arrears; for these companies the only available remedy is, arguably, privatisation.

- the simplification of customs procedures; the adoption of the “sunshine law” regarding the transparency of public administration procedures and legislative process; and extending the e-procurement system are steps forward.
- an anti-corruption legislative package has been passed; it aims at increasing political accountability by regulating the conflict of interests and the lobby activities, and at enhancing the anti-corruption institutional framework.

The above mentioned measures look impressive on paper, but the changes for the better in the actual investment climate hinge fundamentally on how all these normative modifications will be enforced –for enforcement is, like in other transition economies, the critical element in fostering real change[13] And enforcement itself depends on political will and institutional changes (including the functioning of checks and balances in society)

- The pension system. The pension system is increasingly under strain. The system is unbalanced, with much of its financing coming from the health insurance’s budget. The problem is of a chronic nature, because the number of the retired population exceeds the number of employees (the ratio is nowadays 3:2, as compared to 1:2 in the early nineties). Public authorities seem to move closer to a deep reform of this system and private schemes are to be introduced
- Agriculture. The agricultural dossier is burdensome and an issue of concern in Romania’s negotiations with the EU. About 40% of the population lives in the rural area, while agriculture contributes a mere 12% to the GDP formation. The future of Romanian farmers is not a topic much present in the public debate, and the level of awareness of what the negotiations with EU are about is quite low among rural population. Among the solutions one can envisage for rural development would be a rapid expansion of rural credit mechanisms involving the efficient use of EU rural development funds. One should recall, at the same time, that the fate of Romanian agriculture depends on how the CAP will be shaped in the years to come and on how Romania will use the EU financial assistance oriented toward this sector.

4. Policy and performance prospects

4.1 Prospects in 2004

For 2004 the GDP is forecast to rise by 5.5, which I see as overly optimistic in view of the need to control the current account dericit and continue disinflation. The inflation is forecast

[13] The dynamics of investment provide signs of improvement. Although not large enough to support long term economic growth by itself, domestic investment is growing: gross fixed capital formation progressed slowly, but steadily, from 17.7% of GDP in 1999, to 18.9% in 2000, 20.5% in 2001 and 21.1% in 2002. Foreign direct investment is also accumulating: by the end of 2003, the FDI stock will be in the vicinity of 10 billion USD, and this figure does not account for the reinvested profit. FDI-controlled companies have became dominant in a number of industrial sectors such as: food and beverages, machines and equipment, metallurgy, cement.

to go down to 9%, which is pretty amtbitious and the current account deficit to stay around 5.5% of GDP. The central bank has announced a tightening of monetary polcy for 2003 as a means to to reach its inflation target (interest rates have edged up slightly lately) and there is goint to be a continuation of the ROL slight appreciation vis-à-vis the currency basket (60% euro and 40% USD).

The budget policy foresees a slight relaxation (a budget deficit of 3% of GDP), while fiscal revenues are to reach 28.6% of GDP in 2004 (as against 28.8% in 2003) and the overall revenues are to be 30.1% (as compared to 30.4% in 2003 (see annexe). It is noteworthy that budget revenues have declined in the last three years, which raises the profile of EU funds. Romania's fiscal and non-fiscal revenues fluctuate around 30% of GDP while these revenues are 35-40% of GDP in Central European and Baltic transition countries (see annex 1**),** but this feature hardly suggests an Anglo-Saxon pattern. The main challenge, over the medium term, is how to raise the volume of revenues, for the current medium term program forecasts a, somewhat, surprising tendency of stagnating or even declining budget revenues in the period 2003-2006 (tabel 3).

Main policy threats in 2004 are:

- a danger of excessive populist macroeconomics in an election year.(imprudent wage policy; dangerously declining interest rates, which may fuel again inflation; leniency towards tax offenders, etc;
- persistency of high inflation
- quasi-fiscal defcits's impact on budget policy and the current account;
- the expansion of the non-governamental bank credit (plus a possible rising mismatch between the time structure of bank deposts and lending)

While significant policy dilemmas are:

- low budget deficits which should help disinflation while there is need for public financing of badly needed large infrastructure projects;
- manageable current account deficits and further disinflation (plus exchange rate appreciation), against the backdrop of minimal trade protection, which could overwhelmingly put the burden of adjustment, primarily, on budget policy;
- productivity growth and subdued short-term welfare gains (wages grow slower than productivity in order to retain the labour costs-driven competitive advantage) while prices grow anyway (because they were initially below world levels).
- free movement of capital flows and interest rates cuts, which may strain the balance of payments while capital account liberalisation proceeds further;
- he current type of competitiveness (based on wage differential) vs. the innovation-driven type of economies, to which Romania is trying to converge (Romania's spending on research and development is seven times lower than the Lisbon target of 3% of GDP).

It should be stressed, nonetheless, that most of these policy dilemmas and resulted trade-offs do not concern Romania only; other candidate countries, which are to join the Union in 2004, are not relieved of painful trade-offs[14].

4.2. A look further ahead

The problems highlighted herein cannot be dealt with rapidly, since most of them have a structural nature. It is worthy to notice that, some of these problems do not pertain to Romania only; they have a high profile in other accession (and not only) countries as well. For instance, agriculture has strained Poland's accession negotiations; likewise, the crisis of the pension (welfare) systems shows up increasingly in all accession countries and in the Euroland, too. The energy sector needs huge investments, while the interests of potential investors have to be reconciled with the protection of numerous low income individuals. Moreover, as the experience worldwide indicates, energy (like financial) markets need effective regulations, for market failures can be pretty damaging in this field. These qualifications are not meant to downsize the responsibility of Romanian authorities in addressing these issues, but merely to stress why it is sensible to moderate expectations for a quick progress all across the board.

Several major inferences come out in this context:

- a) <u>disinflation can advance and macroeconomic conditions can improve on a more sustaimable basis if financial discipline</u> (hardening of budget constraints) <u>improves substantially;</u> this precondition depends on an adequate pace of restructuring and a strengthening of „organised" market institutions (which should permit adequate market access and exit). It goes without saying that a wise policy mix is a must in order to achieve this goal.
- b) <u>over the longer term –which is relevent for judging the chances for durable growth and economic catching-up-- improved financial discipline and a friendlier investment climate would likely foster savings[15] and investment,</u> which, further, would bolster growth[16].
- c) <u>rural development and further expansiont of SMEs[17] are needed in order to deal with *social exclusion*.</u>
- <u>Romania needs better infrastructure, which presumes adequate public investment (thence the importance of higher budget revenues)</u>

[14] The hot debate surrounding the Balassa-Samuelson effects is quite relevant in this respect.

[15] In order to encourage domestic saving and, thus, support domestic investment, it would be good for the Government and the banking authority to consider the introduction of specific saving-enhancement instruments; the experience of several Asian economies can be quite relevant in this respect.

[16] The domestic saving ratio has been moving up steadily, though slowly, during this decade (it is approaching 15% of GDP), while the investment ratio hovers around 20% of GDP. In Central European accession countries the investment ratio is, on average, close to 30%.

[17] SMEs provide over 50% of GDP; if the parallel economy is accounted for the number would go above 60%.

- EU financial assistance (structural and cohesion funds) could make a big difference in supplementing budget revenues[18] and increasing the provision of essential public goods (education and health care) –which are a prerequisite for economic and social development. EU assistance would have to crowd in other funding, from private and public sources.

Trends indicate that Romania is moving, albeit slowly, in the right direction.

5. Summing Up

The bottom line is::

- Romania-s economic performance has improved considerably in recent years;
- Romania's economy has major weaknesses, which is not surprising in view of domestic and international circumstances; these weaknesses (some of which are not specific to Romania) make up the domestic reform agenda for the years to come;
- Since accession is timed (in the optimistic case) for 2007 Romanian authorities have some leeway for autonomous economic policy making, which should be used in order to reduce the economy's vulnerabilities;
- Romania needs to overahaul public administration and the judiciary radically; these reforms condition public policy in action and the progress of the economy;
- the opening of the capital account (KAL) as well as *inflation targeting*[19], as a change of the monetary policy regime, should be undertaken in pace with adequate structural reforms (effective hardening of budget constraints, in particular);
- Romania can benefit on EU financial assistance amounting to cca 1 billion euro per year were economic and institutional progress well under way and good projects were worked out properly;.
- populism should not lead economic policy astray in the upcoming election year.

No solid proof guarantee exists that Romania will join the EU in 2007 unless structural weaknesses are dealt with by strong political commitment and signs of improvement (which involve the assimilation of the *Acquis*) multiply in a convincing manner. Romania needs a considerably better functioning market economy in order to join the EU successfully.

[18] Budget revenues could be increased by EU funds to the tune of 2.5% of GDP.

[19] Complete capital account opening and inflation targeting are risky moves in case large fiscal-deficits persist. It may be that the current timetable for capital account liberalization, despite some delayed measures until the moment of intended accession, is too bold; likewise, the introduction of inflation targeting in 2005 should not be undertaken unless quasi-fiscal deficits are well under control and the prudential regulations in the financial system have passed a relevant time test.

Annex 1a: Structure of budget (2002, 2003, 2004)

General Consolidated Budget	2001	2002	2003	2004 (draft)
Total revenue (%of GDP)	32.7	30.5	30.4	30.1
- fiscal revenues	30.5	28.8	28.8	28.6
-Social security contributions(SSC)	11.9	11.6	10.4	
Overall expenditure		33.4	32.6	33.1
Budget deficit	3.5	3	2.6	3

Source: national statistics

Annex 1b: Medium term budget framework

	2001	2002	2003	2004	2005	2006
total revenues	30.5	30.5	30.0	29.4	29.1	29.5
total expenditure	33.7	33.4	32.6	32.0	31.8	32.2

Source: official statistics

Annex 2: tax revenues as a ratio of GDP

	1999-2000 (average)
Albania	18
Bulgaria	30.5
Croatia	39.3
Romania	**30,5**
Czech Republic	37.2
Poland	32,6
Slovakia	34
Slovenia	40,3
Hungary	36,1
Russia	33.8
CIS	24.8
Austria	48,2
Belgium	45
Danmark	49,2
France	42,2
Germany	38
Italy	42,8
Portugal	33,3
Spain	33,5
Australia	29
Canada	37,3
Ireland	32,7
New Zeeland	32,5
USA	27,6

Source: Pradeeb Mitra and Nick Stern, ‘Tax Reform in Transition”, World Bank, manuscript, 2002

PART 2: PROPOSED ISSUES TO BE ADDRESSED CONCERNING MATURITY FOR EU MEMBERSHIP OF SEECs (COPENHAGEN ECONOMIC CRITERIA)

Sub criterion 1: existence of a functioning market economy

To what extent has liberalisation been completed in the area of prices and foreign trade? What is left to do in these two fields?

Price liberalisation. The majority of the prices and tariffs are liberalized. A small number of prices and tariffs are still regulated by the Competition Office and other regulatory bodies, such as the prices and tariffs of the regies autonomous and those of the activities entailing natural monopoly or of some activities under special regime (electric and thermal energy, natural gas, persons' transport on railway and internal water, human drugs, telephonic and postal services, water and sewerage). However, the share of the regulated prices and tariffs is decreasing, as the market opening process continues in fields such as food products, telecommunications, energy and gas etc. New state aid rules have recently been adopted, supporting price liberalisation, however the implementation record of these rules is still unsatisfactory.

Trade liberalisation. Licensing of export and import operations will be removed by end-2003, except for those items where the EU itself applies them, like drug precursors, fire guns and ammunition, nuclear use materials etc.. Moreover, Romania has started to introduce the mutual recognition principle since the second semester of 2003. Further liberalization of trade in basic and processed agricultural products is under way.

One of the main objectives of Romanian trade policy will remain the further negotiation of new free trade agreements, especially with the countries with which EU has signed similar agreements.

Are there still barriers to market entry (establishment of new firms) and exit (bankruptcies, liquidations)? Are the respective regulations in force, if yes, to what extent can they be enforced?

Market entry. After the successful implementation of the Sole Office as a "one-stop-shop" institution for firm registration and authorisation, the duration of incorporating a business in Romania fell dramatically, to less than 20 days. Moreover, the Government decided in November 2002 to focus on further improving market entry by integrating the Trade Registry and the Sole Office within the Ministry of Justice. Although this institutional change caused a temporary state of confusion among entrepreneurs, currently the registration and authorisation procedures are working properly.

The next step in improving market entry is envisaged by the *2003 Action Plan for removing administrative barriers from the business environment*, and focuses on reforming the authorisation process in order to simplify it even further.

Market exit. Since 2000 the market exit procedures have undergone a substantial reform. The first important reform package entered into force in August 2002 and was subsequently approved with small revisions by the Parliament in March 2003. The reform created a more consistent legal framework for bankruptcy and liquidation, filling up numerous gaps that previously created major obstacles for businesses. The new legislation (Law 82/2003) introduced several amendments on the liability, including criminal liability, of the administrators, as well as on the control exercised by the syndic judge on their activity within the reorganization and liquidation procedures.

The Ministry of Justice has already initiated the next part of the market exit reform in April 2003, through a Draft Law envisaging the simplification and acceleration of the bankruptcy and liquidation procedures. The new project aims at redressing the current unbalance between bankruptcy and judicial reorganization, by offering more leeway to creditors to ask for bankruptcy. Moreover, the new initiative will allow a more rigorous control over the activity of the administrators and/or liquidators. The draft Law has been approved by the Government in 24.04.2003 and is now under parliamentary debate in the Chamber of Deputies in order to be adopted.

To what extent does the legal system, first of all the regulation of property rights, correspond to the requirements of a market economy? Can laws and contracts be enforced?

In order to improve the judiciary system and bring it in line with the EU ones, the Government approved the Strategy for judiciary reform on 4 September 2003. The Strategy provides for the principles underlying the reform of the judiciary, the objectives established and the means to accomplish them. One of the main components of judicial reform in Romania is institutional reorganisation, in view of further integrating Justice as a public service for society. Therefore, the new draft Law on judicial reorganisation, drawn up in 2003, envisaged mainly the specialisation of instances, the collegiality of completes, the necessity for magistrates to participate in the organisation and functioning of instances and courts. The most important measures concern the setting-up of specialized courts for fields such as: juveniles and family, commercial, administrative-fiscal, labour and intellectual property, starting with 2004.

By 31 July 2003, 94.1% of the total of property titles have been issued (95.1% for agriculture lands and 86.7% for forest lands, respectively).

Concerning macro-economic stability, to what extent is inflation under control? Are public finances and external accounts sustainable?

The current account deficit in the first eight months of 2003 was up 40% year on year.. This development was mainly attributable to the widening of trade deficit, as a result of the sharper rise in imports fuelled by the pressure that higher wages and enhanced availability of credit (for both businesses and individuals) put on domestic demand. It is worth mentioning that this development does not pose financing problems given that FDIs cover 56.5% of the current account deficit, (21% above the year-ago level due mainly to capital increases in the non-bank sector) and due to Romania's improved access to international capital markets over the past three years.

It is worth mentioning that Romania's international reserves amounted at end September to over MEURO 7500, of which MEURO 1063 worth gold, which helped maintain the coverage of the official foreign exchange reserve in months of imports of goods and services at above 4.7 months, an adequate level by international standards.

Is the financial sector sufficiently developed to channel savings towards productive investment?

In order to create a stable and competitive banking system made up of banks capable to provide efficient financial intermediation, the BNR focused on completing the clean-up of the banking system, on enhancing the quality of supervision according to international standards, as well as on improving the indirect support provided to bank supervision through instruments such as the Credit Risk Bureau, the Payment Incident Bureau and the Bank Deposit Guarantee Fund. In 2003, the *banking system* consolidated its financial intermediation function. The consolidation process increased the safety and efficiency of the banking system, as pointed out by the real values of the key economic, financial and prudential indicators, which displayed favourable trends. The increase in real terms of the net aggregate assets (by 2%) was due mainly to the growth in real terms of the loans to non-banking customers (+2.5%), which benefited from half of the attracted and borrowed sources. The balance of loans granted to non-banking customers increased, in real terms, for 70% of the Romanian banks. The expansion of credit is reflected by the growth of the general risk ratio from 42.9% end-December 2002, to 46.8% end-June 2003. The increase of the loan portfolio did not affect its quality or the liquidity of banks.

Based on analysis of corporate finance and leverage, and the potential vulnerabilities of the banking system, it was found that banks are able to deal with considerable stress from the corporate sector. In addition, credit risk, interest rate risk, and exchange rate risk stress testing was applied to the banking system, indicating highly resilience to shocks. The financial soundness indicators show high capital adequacy ratios, strong liquidity, and manageable levels of non-performing loans.

Concerning the insurance sector, the legislative framework has been completed and improved. The Insurance Supervisory Commission has started to play an active role in authorising and controlling the market. However, it still lacks administrative capacity in order to fully achieve its mandate.

Romanian *capital markets* are still underdeveloped. Concrete actions have been undertaken for transposing the Acquis. Moreover, the two regulated markets, BVB and RASDAQ, have shown an ascending trend as regards both traded value and market capitalisation (which approach 7% of GDP currently).

Sub criterion 2: the ability to withstand competitive pressures and market forces within the EU

Can economic agents in your country make decisions in a climate of stability and predictability?

Legislative instability still remains a major obstacle for economic agents. However, positive evolutions have been noticed in the last year. Firstly, the Government has decided to limit the issuing of Emergency Ordinances only to a strict number of cases. Secondly, the framework for public hearings and consultations before enacting legislation has been provided through the recently adopted Transparency Law. Although enforcement of these provisions is not always consistent, public authorities seem more accountable in terms of realizing the importance of a stable and predictable business environment.

Is human and physical capital, including infrastructure (energy supply, telecommunications, transport etc.), education and research available in sufficient amount and at an appropriate cost?

As regards **human capital**, the Romanian economy has a good capacity to face competition on the external and internal market. The labour force training level is high. At the same time, efforts regarding retraining and professional improvement of labour force have intensified, under the supervision of the National Agency for Employment (ANOFM). However, the government spending on education and research still remains low, albeit rising.

Concerning the **capital stock**, Romania needs important investments in infrastructure areas such as railways, motorways, agriculture, energy etc. Gross fixed capital formation increased in real terms with 7.8% at the end of H1 2003. Although several steps in this direction have been taken, with positive results, and the perspective for a further increase in FDI is good, a rise in investment spending still remains a major priority of the economy.

What is the state's contribution to the competitiveness of economic agents in your country through trade policy, competition policy, state aid and support for SMEs?

Regarding trade policy, state intervention is rather limited. In certain cases safeguard taxes have been used temporarily, and some tariff barriers are still present in trading agricultural products, but otherwise trade liberalisation prevents the use of protectionist instruments.

Concerning competition policy, the legislation is currently under revision, as certain amendments are still required in order to ensure full compatibility with the acquis.

There are some problems in implementing state aid regulations, especially when it comes to the important volume of fiscal arrears. Therefore, several state and private companies are still tolerated on the market, instead of entering into forced execution.

The Romanian state has defined and implemented an important set of instruments under the framework of its regional policy, as authorised state aid schemes. As a result, a large part of the pre-accession funds has been channelled directly at the regional level. Moreover, the development of industrial parks was meant to contribute to the competitive development of economic agents.

Last but not least, SME support has been provided through a wide set of instruments, starting with providing fiscal provisions for micro-enterprises, facilitating access to finance, promoting entrepreneurship, supporting R&D, promoting export activities etc.

How far has trade integration with the EU progressed concerning both trade volume and composition of trade?

In the first seven months of 2003 the share of EU in the total Romanian exports was of 68.2%. The share of exports and imports of goods and services in GDP has increased, reaching 43% in the 1st semester 2003 and, respectively 51%, which shows the higher degree of opening of the Romanian economy. Export towards EU Member States was 3% higher as compared to the same period in 2002. This trend was also obvious in the case of imports from EU, which have increased with 8.0% as compared with the same period of previous year.

Half of the imports value from EU represents raw materials, components or spare parts which are manufactured/assembled on Romanian territory under "processing" regime, the resulted products holding around two thirds of our country's exports towards the EU. This proves a high degree, not only of trade integration with EU, but also, from the point of view of manufacturing production structures in some sectors (garment, footwear, electronics, car spare parts and other), the increase of Romanian products competitiveness on the EU internal market.

The structural analysis of trade exchanges performed with EU in the first seven months of 2003, as compared to the same period of 2002, reveals more significant value growth of exports and imports in certain sectors, such as:

- The export increase of machinery (+20.9%), transport means (+30.1%), plastics and related products (+36.7%), textile products (+6.4%);
- The import increase of transport means (+30.2%), plastics and related products (+21.9%), common metals and articles thereof (+15.6%), machinery and equipment (+9.9%).

Regarding the structure of trade changes with the EU, it should be substantially improved by stimulating the export of products with higher degree of processing. A considerable spread of lohn - inward processing trade - is recorded, especially in light industry (clothes, footwear) and currently, even in branches such as chemical industry, metallurgy and machinery building industry.

Do small firms account for an appropriate share of the economy, proving that the departure from the organisational structure of the pre-transition era has been completed?

SME statistics shows an economic rebound, confirming the positive evolutions in the dynamics of the private sector development. Most of the aggregate indicators for SMEs, such as turnover, gross and net profit, value added, number of employees etc. have increased in the last period.

From the point of view of structure of SMEs according to their field of activity, three sectors concentrate more than 90% of all SMEs - trade, services and industry. It is important to underline that the weight of the trade sector participation is decreasing while more and more SMEs choose to develop in the service or industrial sectors.

SME development is one of the governmental priorities, as several recent initiatives have focused on supporting an institutional, legal and financial framework favourable for developing private entrepreneurship and for stimulating investment. An important starting point in elaborating a domestic strategy in this field was the European Charter for Small Enterprises, which was endorsed by Romania in April 2002, and served as a guideline for several actions implemented by the Government.

Proposed issues to be addressed concerning the potentially difficult chapters at prospective accession negotiations with the EU

Free movement of goods

How far has free trade in industrial goods with the EU been implemented?
To what extent has agricultural trade been liberalised?

The accession negotiations for Chapter 1 - Free movement of goods has been opened on March 21, 2002 and provisionally closed on June 2, 2003. Much of the acquis in this field has been either transposed or endorsed. Some minor problems remain in terms of enforcement, but overall free trade in industrial goods with EU has been implemented. Significant progress has been achieved in the process of public procurement, where a system of electronic auctioning has been designed and implemented with excellent results in terms of savings. As regards agricultural trade, further liberalisation for basic agricultural products has already been negotiated with the EU, whereas for processed agricultural products, negotiations are underway.

Free movement of persons

What is the assessed outward migration potential of your country?
How high/low are the wages in Euro and PPS (power purchasing standard / power purchasing parity (PPP)) in your country compared to the current accession countries?
How serious is unemployment compared to the accession countries?

Negotiations on Chapter 2 - Free movement of persons were opened on 21.03.2002. Presently there are no overdue commitments registered. Income per capita in Romania is about 27% of the EU average, which exlains why so many Romanians have looked for jobs abroad; yearly, these Romanians send back home cca 2 billion USD. Unemployment in Romania was 6.9% at the end of July 2003, which is low if compared with Poland (18.1%), Slovakia (17,8%), Bulgaria (15%), or even Czech Republic (8.9%) – this number is clearly underestimated.

Free movement of capital

To what extent has capital movement been liberalised? To what extent is money laundering under control? What is the population's attitude towards selling agricultural land and second homes in holiday resorts to foreigners without restrictions once the country is member in the EU?

The negotiations have been provisionally closed on 7 April 2003. Romania was accepted two transitional arrangements, namely 7 years with regard to the acquisition by the non-residents of forestry and agricultural land and 5 years regarding the acquisition of ownership over land for secondary residence.

Romania has continued the **liberalization of capital** transactions, according to the timetable established by NBR. The medium and long-term financial loans and credits granted by residents to non-residents were liberalized starting October 2002. Beginning January 2003, the following capital transactions are no longer subject to NBR authorization: - transactions of residents with foreign securities and units of foreign undertakings for collective investment; - short term financial loans and credits granted by non-residents to residents; - financial loans and credits and personal loans granted by residents to non-residents; - guarantees granted by residents to non-residents.

Moreover, a major accomplishment in this field is the adoption of the new Constitution, which stipulates that private property is guaranteed and protected equally, irrespective of titular; and foreign citizens, stateless persons and foreign legal persons may acquire the right of property on land.

The public received this new constitutional provision with mixed feelings. On one hand, all landowners are happy because the price will go up due to the higher purchase power of the citizens from the current member states. Moreover, many Romanians agree that foreign direct investments are an important source of economic growth and wealth. On the other hand, some people regard this legal provision as reducing the sovereignty of Romania and underestimating the consequences of Romanians' low incomes (in terms of distributional aspects).

The adoption of the Law no. 656/2002 on the prevention and sanctioning of **money laundering** represented a highly important legislative progress. As regarding institutional development, the implementation authority, NOPCML, has granted a special attention to its own personnel training, as well as of the personnel from the reporting entities and from the institutions involved in money laundering combating.

An especial productive activity has been carried out by NOPCML in the area of international cooperation, by implementing with a lot of success a twinning PHARE project, and by developing contacts with similar institutions in several other countries.

Competition & state aid

Is the economy of your country sufficiently mature to transform prevailing non - EU compatible subsidies granted to domestic state and private companies and foreign investors to EU compatible ones? Is there a road map to achieve EU compliance in this matter? How far is the current level of deregulation in the economy from the level required from EU members?

The negotiations on this chapter were opened in November 2000. The major impediment is this field is represented by the large volume of arrears, which is a form of state aid. The big test for the Romanian economy would be a strict enforcement of hard budget constraints. Deregulation is less advanced in the energy sector, but accelerated privatisation would change the rules in this sector as well. Telecommunication is quite advanced with deregulation.

Agriculture

How far apart are the quality standards in meat and milk production, horticulture etc. in your country from those required in the EU? Is the farm structure compatible with the subsidisation philosophy of CAP (very small farms are excluded)? Is there absorption capacity available for SAPARD type transfers and transfers for rural development?

The negotiations have been opened in October 2002, for the sanitary-veterinary and phytosanitary legislation and respectively, in December 2002, for the legislation on the Horizontal Issues, Common Market Organization, Rural Development and Forestry.

Almost all of the acquis related to quality standards in meat and milk production or horticulture has been transposed into the Romanian legislation. However, arable land is highly fragmented in terms of ownership, so that very small firms predominate, along with subsistence agriculture. In terms of rural development, several assistance programs have been initiated, out of which the SAPARD programme is the most important.

The implementation of SAPARD Program has started with positive outcomes. For the measures, which are accredited, the funding has already been contracted. As a result, for improving the processing and marketing of the agriculture and fisheries products, 70% of the allocated funding was contracted, whilst for developing and improving the rural infrastructure, 100% of the available funding was contracted.

At the same time, the Romanian SAPARD Agency has proceeded with the preparation for accreditation of new measures, such as Investments in agricultural exploitations, Vocational training, and Development and diversification of the economic activities that generate multiple activities and alternative incomes. Moreover, the Government (MAPAM) has implemented several administrative actions in order to increase the efficiency of the SAPARD Agency, including the provision of staff training for the technical implementation and international technical assistance.

Taxation

Is the taxation system EU compatible? If not, what steps are necessary? Is the economy sufficiently mature to function smoothly under an EU compatible taxation system?

The negotiations have been provisionally closed on June 2nd, 2003. Romania had obtained derogations related to international passenger transport, related to VAT taxation threshold and to a special regime for alcohol distilled from fruits, as well as a 3 year transitional arrangement, in order to reach the minimum level imposed for the excise duties.

The taxation system is generally compatible with the EU provisions. However, the enforcement of certain legislation can be further improved, as it is the case with VAT refunds. Regarding excise, the gradual increase process led to a current level of duties that is significantly closer to the minimum level imposed by the relevant European Directives, and the process is ongoing. Concerning direct taxation, the profits from export will soon be taxed at the same level with any other profits. In the context of the progresses recorded in this area, it must be mentioned the drafts of Fiscal Code and Fiscal Procedure Code that have been drawn up during this period.

Important institutional progress has been made through the creation of the National Agency for Tax Administration, which will become operational starting with January 1, 2004. Moreover, fiscal administration was consolidated by the set up of large taxpayers units. Nevertheless, tax collection remains low and tax administration is still weak. Reducing the large volume of arrears to the state budget represents an important priority of the Government.

Energy

Is there a nuclear power station in your country? If yes, is it compatible with EU safety standards? If not, is there a viable solution to that problem?

The negotiations related to this chapter were opened on 21 March 2002. Romania has a nuclear plant at Cernavoda, which is compatible with EU safety standards, as it is based on Canadian CANDU technology. In the last period, nuclear safety has been a priority of the Government, and most of the related acquis has already been transposed.

Regional policy

Is the regional administrative structure of your country compatible with the EU requirements in this field? Can potentially necessary changes in this area be made acceptable to the population? Is public finance in your country able to provide co-financing to EU projects?

The negotiations for Chapter 21- Regional policy and coordination of the Structural Instruments have been opened in March 2003. Romania currently has eight development regions, compatible with the requirements of the EU related to NUTSII statistical units. The regions are not administrative units, and they focus mainly on implementing the pre-accession funding, after the model of the EU structural funds. The debate over the future of the regional framework is still ongoing, and there is a certain degree of sensitivity from the population related to a possible increase in regional autonomy. So far, the Government did not initiate any initiative in this sense.

As regards the capacity to provide co-financing, Romania has succeeded so far to match the EU money. However, given the increased financial assistance from the EU in the next years, co-financing may become a challenge for the Government. From an institutional perspective, the financial management of the funds granted under the Structural Instruments will be handled by the National Paying Agency, within the Ministry of Public Finance. The National Paying Agency will fulfil the attributions of Paying Authority for each Structural Fund as well as for the Cohesion Fund. The National Paying Agency is to be established as close as possible to the accession date, mentioning that the agency will take over the specific structure of the pre-accession instruments existing at that time, in order to ensure a specialized staff and its coherent and uniform training continuity.

Environment

What role do low environmental standards play in competitiveness of domestic firms and in attracting foreign investors? Can costs of compliance with EU standards be assessed for the business sector, on the one hand, and for the central and local governments, on the other hand? What transitory regulations would your country need in case of accession to the EU?

The negotiations for Chapter 22 - Environment were opened in March 2002. There are Romanian firms which have undertaken major investment (in recent years) in order to comply with EU regulations. Some estimates put the burden of overall compliance in this field at more then 3% of GDP, which would more than compensate the upper limit of the promised EU assistance.

Justice & home affairs

To what extent is criminality under control? What would be the cost of taking over the Schengen standards on your country's future non-EU borders?

The negotiations for this chapter were opened in April 2002. The level of corruption is frequently alluded by analysts and IFIs, but it is not singular among transition economies. The same can be said of criminality.

Customs union

What would be the impact of taking over the relatively low (about 5% for industrial products) external customs tariffs on competitive positions of economic agents in your country?

The negotiations on Chapter 25 - Customs Union were opened in 2001, and were provisionally closed on 8 November 2002. This would be a major blow for some industries; for instance textile and garments industry representatives have voiced major concern in this respect.