ROMANIAN ECONOMIC PROGRESS TOWARDS EU ACCESSION

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ABSTRACT
Taking into consideration the achievements in the economic development of Romania in the last years, it complies with the criterion of being a functioning market economy. Despite the favorable trends registered, our country is still reforming and restructuring its economy. Therefore, vigorous implementation of its structural reform program should enable Romania to cope with competitive pressure and market forces within the European Union. Some improvements can be made in sustaining macroeconomic stability and in deepening structural reforms which requires strong political commitment, stable institutions, coherent public policies and financial resources.
Keywords: **European Integration, Economic Development, Restructuring, Privatization**

Introduction

Romania's transition, starting in 1990, was in many respects more difficult than in the other countries of Central and Eastern Europe. This was partly because by the late 1980s, the country's economy was on the verge of collapse after 40 years of rigid central planning that emphasized self reliance, an excessive focus on heavy industry and large, uneconomic infrastructure projects. Over the past fifteen years, the Romanian economy has been characterized by a series of stop-and-go reform attempts that have resulted in a highly cyclical growth pattern.
Like most transition countries, the second half of the 1990s was turbulent

times for Romania, characterized by failure to stabilize the economy. For the period as a whole, this contributed to low average growth, high inflation and a volatile situation in external accounts from 1993 to 1996. Against all expectations, the Romanian authorities averted a liquidity crisis in mid-1999 and adopted a new set of economic policy measures to stabilize the economy.

Starting with 2000, Romaniaôs macroeconomic performance has been mixed, but increasingly successful stabilization has contributed to sustained economic recovery and a significant decline in inflation. Thus, the macroeconomic trends have improved distinctly, building upon the cumulative impact of successive rounds of structural reform attempts, increased openness and competition in the economy and the adoption of a more balanced and responsive policy mix.

R**ECENT ECONOMIC DEVELOPMENTS**

Romania was a late starter in the reform process, with key measures in the area of liberalization and enterprise reform only since 1997. Considerable progress has been achieved since then. Price and trade liberalization has progressively taken place and the adjustment in administered prices has resumed. Reform of the enterprise sector has gradually advanced. The banking sector was overhauled in the late 1990s and the regulatory framework considerably strengthened, resulting today in a well capitalized and liquid banking system. More recently, the industrial sector has been undergoing reform, with the privatization of larger state-owned enterprises advancing at an increasing pace. The weight of the private sector has increased gradually due to privatization and entrepreneurship. In the energy sector, progress has been slow and uneven, but step by step the integrated companies were split up, markets opened and prices adjusted towards cost recovery levels.

This has paved the way for initial privatizations, which represent important milestones for restructuring and reduced government control. Restructuring of the mining and transport sectors made important steps although considerable progress is needed to reduce losses and subsidies. For a long time, the economy has been hampered by weak financial discipline, characterized by continued provision of energy at a price below costs, ineffective bankruptcy procedures and poor payment records among enterprises, households and public institutions. Serious problems remain, but the authoritiesô efforts since 2002 in raising energy prices, stepping up efforts to enforce payment of obligations, carrying out measures to improve the performance of state-owned enterprises and attempting to deal with the large stock of entangled debts in the economy have started to yield results.

After a severe real contraction in the economy, GDP growth resumed in 2000 and the economy is going through its fifth consecutive year of economic recovery on the back of rising domestic and external demand. Economic activity, however, remained buoyant, and GDP grew by 6.6% in 2004 on the back of strong household consumption, high investment growth and improved export performance.

Table 1:

Main Economic Trends ï Romania

Elements		**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Real GDP growth rate	%	-6.1	-1.6	-1.2	2.1	5.7	5.0	4.9
Inflation rate	%	154.9	59.1	45.8	45.7	34.5	22.5	15.3
Uneymployment rate	%	5.3	5.4	6.2	6.8	6.6	7.5	6.6
Budget balance	% of GDP	-4.5	-3.2	-4.5	-4.4	-3.5	-2	-2
Current account balance	% of GDP	-6.7	-7.8	-4.3	-3.7	-5.5	-3.4	-5.8
	million Euro	-2104	-2917	-1437	-1494	-2488	-1623	-2877
Gross foreign debt of the whole economy	% of exports of goods and services	82.6	91.6	81.7	67.3	71.9	64.8	67.9
Foreign direct investments (balance of payments data)	% of GDP	4.3	5.4	3.1	2.6	2.6	2.3	3.2
	million Euro	1224	2040	1025	1048	1174	1130	1591

Source: National Bank of Romania, Yearly Report 2000-2005.

Household consumption expanded considerably due to high real wage growth and rose sharply by 7.1% in 2003 on the back of surging consumer credit. Investment rose by 9.2% in 2003, reflecting the ongoing replacement of Romaniaôs capital stock. Exports have performed well and weathered the economic slowdown in the EU with continued expansion at double-digit annual rates, although strong domestic demand has in general led to a negative contribution from net exports to growth.

The current account deficit has been high and its sustainability at times a source of concern, but external vulnerability diminished over the period. Following two years of successful external consolidation, the current account deficit widened in 2001, but dropped sharply in 2002 to 3.4% of GDP. Due to a further widening of the trade deficit, a continuously high current account deficit was reported for 2004 and 2005.

Financing the external deficit has, however, gradually become easier due to improving borrowing conditions and a steady inflow of foreign direct investment (FDI).

Despite economic growth in the past years, important challenges remain. Further structural reforms are crucial to build a competitive market economy capable of withstanding the pressures of EU integration.

ASSESSMENT IN TERMS OF THE COPENHAGEN CRITERIA

The existence of a functioning market economy requires prices, and trade to be liberalized and an enforceable legal system, including property rights, to be in place.

The consensus about the fundamental aims of economic policy has progressively broadened, driven forward by a stronger pledge to implement reform policies. Fear of political and social costs often deterred resolute implementation of macroeconomic stabilization and structural reform. However, the authoritiesô commitment to achieve macroeconomic stabilization and bringing forward structural reforms has become more enduring and consensus about the objectives of economic policy has gradually emerged.

Unemployment remained fairly low, owing partly to the limited progress in economic restructuring. The unemployment rate averaged 6.3% during the analyzed period, and after rising moderately during the recession, it has, since 1999, been fairly stable. It declined moderately in 2003 and continued to fall in 2004 and 2005.

The fairly low unemployment rate may reflect the fact that economic restructuring is not yet accomplished and that labour market participation has declined. Moreover, hidden unemployment may be high, in particular in the agricultural sector and in rural areas.

Unemployment was considerably higher among the young people, while being lower for those with the lowest and highest educational attainments. This reflects the stage of restructuring of the economy.

Inflation has been gradually reduced from high levels, but continues to be threatened by high wage growth. Inflation has been one of the most visible symptoms of the economyôs structural weaknesses and macroeconomic imbalances, as the failure to implement an effective incomes policy and soft budget constraints in the enterprise sector caused excess demand, which at times was exacerbated by disorderly corrections of the overvalued currency. Even excluding the 1997 spike caused by price and exchange rate liberalization, the annual inflation rate has been high at 37.2% on average. After declining more than targeted in 2002, inflation remained on a downward path in 2003 although it was hampered by a sizeable minimum wage adjustment early in the year and strong domestic demand. The year-end inflation rate declined to 14.1% in 2003 and got to 8.7% in 2005[1]. This improved record indicates that inflationary expectations have moderated in the economy, and that a more coherent policy stance has strengthened the credibility of the disinflation process. However, the wage developments remain periodically a threat to inflation.

The conduct of monetary policy has contributed to lower inflation and increased macroeconomic stability. Before 1999, an environment characterized by a fragile external position, a weak financial sector, a pervasive lack of financial discipline, and unsupportive fiscal and income policies, implied that other policy objectives than price stability routinely determined monetary and exchange rate policies. Progress on these fronts has allowed the monetary authorities to increasingly focus on disinflation. In 1999, a managed float regime was adopted in which the exchange rate was used as the main anti-inflationary instrument. Within this framework, the central bank intervenes to keep the exchange rate on a path consistent with the authoritiesô inflation target.

This monetary policy stance has been appropriate and contributed to both gradual disinflation and a real exchange rate development compatible with a sustainable current account position.

Given the already rapid credit growth, the widening of the current account deficit and continued inflationary pressure, the authorities decided to delay the liberalization of non-residents' access to domestic deposit accounts denominated in leu (the national currency), which was originally foreseen for 2004, in order not to spur further credit growth and add to the potential volatility of the balance of payments. The situation illustrates that the attainment of a higher degree of

[1] National Bank of Romania, *Yearly Report, 2005*

macroeconomic stability remains an important objective for Romania as it would allow liberalization to move forward as planned without raising concerns that such a step could have adverse economic effects and could limit the effectiveness of monetary policy. Credit growth to the non-government sector has since moderated considerably, and since June 2004 the central bank cut its reference rate many times. In order to limit the risks stemming from a rapid growth of credit denominated in foreign currency, minimum reserve ratios for foreign currency deposits were also raised.

Despite recent progress, fiscal consolidation is imperative in order to support macroeconomic stability and counteract risks to medium-term sustainability. As the substantial reduction in interest payments in recent years, due mainly to a decline in market refinancing rates and improved debt management, was not fully used to consolidate public finances, the primary balance has returned to deficit. Care should be taken to ensure that recent policy initiatives, such as the planned reductions in income and profit tax, do not engender a significant primary deficit over a prolonged period, which could threaten the sustainability of public finances.

A continuing reduction in the broad public sector deficit by stricter enforcement of tax claims, reduction of losses in state-owned enterprises and higher energy prices also remains important instruments for improving medium-term fiscal prospects. Revenue collection improved considerably as further measures were taken to strengthen the budgetary framework and tax administration. A new Public Finance Law was adopted and the new Fiscal Code contributes to ensuring greater transparency and stability of tax legislation.

The VAT system was further reformed, among other things by abolishing exemptions and developing a new risk-based reimbursement system, which however needs to be improved and extended in order to reduce delays and combat fraud. A few reduced VAT rates were introduced. The reduced rate of taxation on profits made from exports was abandoned, which was conducive to simplifying the tax system and reducing distortions.

Most prices are liberalized and further adjustments of energy tariffs have taken place. Weak payment discipline among enterprises, households and public institutions continues to affect the workings of the price mechanism, but there are signs of progress where action is taken.

Administered prices have often lagged behind inflation, most notably for energy prices, which have been kept below cost recovery level in order to indirectly subsidize consumers and the enterprise sector. A stop-go policy has delayed the establishment of energy prices that appropriately reflect short and long-term costs. This has hindered the proper functioning of the price mechanism. However, Romania has over the last year increased prices over and above inflation for both electricity and natural gas. Following these adjustments, coverage of operational costs as well as most financial costs, long term investment and environmental costs is attained.

The private sector has continued to grow, even if the weight of large public enterprises remains high. Averaging 65.2% over the period, the share of the private sector in GDP has steadily increased. The state-owned sectorôs contribution to GDP has declined partly because of privatization and partly because many of the companies are loss-making and therefore subtracted rather than added value

Private sector employment grew from 57% of total employment in 1997 to 76.3% in 2004[2], reflecting the fact that in that period employment in the state-owned corporate sector and public administration was reduced. The continuing influence of public ownership largely rested upon its predominant role within the energy sector, which accounts for 33% of industrial turnover. In the agricultural sector, private entities stood for nearly 99% of value added, and 96.3% of all land was privately owned. The process of land restitution continued.

The privatization of companies accelerated considerably, but the authoritiesô agenda remains unfinished. Initially, privatization efforts therefore focused on smaller and medium-sized enterprises. Since 2001, the privatization of larger enterprises has advanced at increasing pace, in terms of both the number of enterprises and share capital sold. The total number of companies in state ownership decreased from 1673 at the end of 2001 to 1187 in 2004, of which close to 90% belonged to the privatization agency and the remaining to various ministries. The agency ceased its activity in April 2004 and transferred its residual company portfolio to the authority responsible for recovery of state assets (AVAS), which kept up the good progress. The privatization process has, however,

[2] Ministry of European Integration, *The Priority Legislative Programme for the Accession to the European Union* (Bucharest, 2005)

not come to an end.

The legal framework for a market economy has strengthened, but a better business environment remains dependent on improvements in the judiciary and the public administration. Efforts to enhance the investment climate were made, for instance, by cutting red tape, consolidating contradictory legislation, increasing the openness of the public administration to the views of interested parties, enhancing dialogue on the investment climate with local authorities and social partners and establishing the Romanian Agency for Foreign Investment in 2002. In the field of taxation, a new Fiscal Code (2004) was an important step forward in improving the business environment and the National Agency for Fiscal Administration a welcome simplification. A system potentially capable of speeding up VAT reimbursements has also been developed.

Other remaining impediments to the investment climate, such as excessively restrictive provisions in the new labour code, have not yet been addressed.

The banking sector has developed considerably from low levels. Early in the period, development of the banking system was seriously hampered by the slow pace of reform and the misuse of public banks for subsidizing the enterprise sector. In the aftermath of a creeping banking crisis, which forced the authorities to close, clean up and privatized banks, the authorities embarked in 1999 on a restructuring of the financial sector and strengthened the regulatory framework. This resulted in the gradual development of the sector in the direction of privatization, concentration and foreign participation. The last success registered is the privatization of the Romanian Commercial Bank at the end of 2005.

Financial intermediation still remains underdeveloped, partly due to the use of arrears as financing, but continued nevertheless to grow, with total banking assets rising from 29% of GDP at the end of 2000 to 32% of GDP in 2004[3]. Bank profitability has increased since 2001, but still depends on a large spread between deposits and lending rates. The high credit growth to the non-government sector reaching a rate of 42% in July 2004 compared to one year earlier, runs the risk of outpacing improvements both in intermediation expertise and in the legal and supervisory framework, and the National Bank of Romania passed regulations tightening the eligibility for consumer and mortgage credit in

[3] National Institute of Statistics, Bucharest - *Statistical Yearbook of Romania 2005.*

order to stem the risks from rapid credit expansion. The banking system was generally sufficiently capitalized, liquid and prudently supervised. Vulnerability indicators have improved significantly.

The non-banking financial sector is still in its infancy. The equity markets remain small, with capitalization of the Bucharest Stock Exchange (BSE) and the over-the-counter exchange (RASDAQ) amounting to 12.2% of GDP in 2004. Annual turnover is also quite low at 7.8% of total capitalization. Since mid-2003, a positive market trend has resulted in a sizeable increase in both turnover and capitalization. Emission and trade in municipal and corporate bonds emerged as a new activity, but the slow reform of the pension system held back the deepening of markets.

Supervision of the financial sector has been tightened. In banking, the regulatory framework is broadly compliant with the Basle principles. The supervisory framework has improved substantially and been adjusted in tandem with credit market developments, but supervision on a consolidated basis has to be fully accomplished and the coverage of credit registers should widen. In order to support the development of the non-banking financial sector, the authorities have tightened the regulatory and supervisory framework. In the insurance sector, minimum capital requirements were increased and the regulatory framework improved. In the capital market, IAS-compatible financial statements for listed companies have increased transparency, but compliance with IAS-standards needs to be fully implemented for all companies. Supervision needs to be further developed in line with international best practices and EU recommendations.

The quality of infrastructure is on the rise, but there is a large need for further investment. Following years of underinvestment, the transport, energy and irrigation networks have depreciated. Transport infrastructure remains inadequate, although public roads were upgraded and significant investment was made in motorway construction. To ensure financing and quality for money, there is a need to carefully consider the priorities in the field of motorway construction and to respect open and transparent procurement procedures, which are instrumental for cost-efficient public investment. Forced for a long time to provide quasi-subsidies to the rest of the economy, energy companies were unable to make sufficient investments, but recent price adjustments and privatizations have prepared the ground for much needed investments. A recently adopted strategy for the district heating network includes energy saving investments. Irrigation networks are gradually being reconstituted, but further investments would improve the protection of the agricultural sector against adverse climatic conditions and support the transformation of the agricultural production structures towards higher productivity and competitiveness. Expanding the role played by SMEs depends on an improved business environment and easier access to financing. The number of newly registered companies increased rapidly during the period. SMEs have traditionally been micro-enterprises operating in retail, wholesale and tourism, but they are progressively expanding into construction and industry also, where they contribute to a dynamic export performance and stimulate the local economy[4]. Business conditions for SMEs remain, difficult, notably due to uneven implementation of legislation, red tape and limited access to finance. In line with the SMEsô growing economic weight, the authorities have launched several targeted initiatives to support the development of the SMEs. The new fiscal code, simplified procedures for tax controls and facilitated company registration and authorization are helpful for SMEs.

CONCLUSIONS

Taking into consideration these achievements can be concluded that Romania complies with the criterion of being a functioning market economy but the country is still comprehensively reforming and restructuring its economy with a view to joining the EU in 2007. Vigorous implementation of its structural reform program should enable Romania to cope with competitive pressure and market forces within the Union.

Improvements can be made in sustaining macroeconomic stability and in deepening structural reforms. Priority should be given to preserve the momentum in disinflation and safeguard the sustainability of the external position by maintaining a prudent policy mix and by further reducing the deficit of the broader public sector. To achieve this, significant improvements in enforcing financial discipline, continuous adjustments

[4] Popa, A., GiurcŁ-Vasilescu, L., Cristea, M., *Romanian Small and Medium Enterprises Sector and European Integration*, Yasar University, 1st International Conference on Business, Management and Economics, ñBusiness, Management and Economics in a Changing Worldò, 16-19 June 2005, Cesme, Izmir, Turkey.

of energy prices towards cost recovery levels and improved financial performance of public enterprises are vital. Fiscal sustainability needs to be strengthened by advancing expenditure reform and further improving tax compliance. The privatization process should be accomplished, post-privatization disputes be settled and non-viable enterprises more actively dismantled. In key sectors, such as energy, mining and transport, perseverance in restructuring and a more manifest strive for privatization should go hand in hand. Substantial progress in the functioning of the judiciary and the public administration, including an even and predictable application of law, is required to create an enabling business environment with a level playing field. As part of this, the Government seeks to build institutions and design and implement public policies to fundamentally transform Romaniaôs economy and society. This requires strong political commitment, considerable expertise and resources, as well as popular and external support.