ECONOMY

ROMANIA'S FINANCIAL OPENING

By Daniel Daianu

Recently, The National Bank of Romania has initiated a series of limited measures in regards to its capital account and the consequent capital inflows and outflows (see Fig.1). These measures can be examined in the context of the role that foreign capital has played in the Romanian economy during the last decade. Likewise, they can be judged through the lenses of Romania's commitment (vis-à-vis the European Union) to open its capital account, by and large, by 2004.

The need for capital inflows

There are several features of the Romanian economy, which point to the need for external resources. One feature is linked with the "shock therapy" of the eighties, during which Romania paid back, entirely, an external debt of over US$10 billion. That policy entailed a drastic reduction of domestic absorption (and of domestic consumption in particular), which aggravated shortages of all kinds; one effect of this situation was a massive decompression of consumption and imports after 1989, which depleted rapidly the reserves of the Central Bank.

A second feature is the magnitude of the required resource reallocation following price liberalization, against the backdrop of structural rigidities, institutional disarray, and scarce domestic resources; these circumstances pointed to the need for substantial capital inflows.

Thirdly, the implosion of the economy in the early nineties, and again in the late 90's, led to lower saving ratios than anticipated. This large drop in savings further increased the need for capital inflows to finance domestic investment and consumption.

And last but not least, the uncertainty and fuzziness of the domestic environment enhanced capital outflows, particularly in the early years of transition, which aggravated an already precarious situation.

The circumstances highlighted above would, *prima facie*, consolidate the thesis that financial opening is a must in order to create channels for capital to flow into Romania. Financial inflows are also to be related to the functional opening of the economy, which was one of the main features of the reforms after 1989. However, this judgement fails to address a crucial issue, namely the speed and the nature of financial integration with the outer world. Should domestic financial markets be developed at full speed, and be integrated with external ones as quickly as possible for the sake of attracting foreign capital? How feasible is this, in view of both institutional and structural constraints that currently exist?

The speed of financial opening

Financial opening helps attracting external funds. It can be argued that the more advanced in reforms and restructuring an economy is, the more likely it is that financial opening will entail considerable benefits. But, on the other hand, it can also be argued that, where rigidities are considerable and institutional fragility is high, less sophisticated and less (externally) integrated financial markets are probably better suited in fending off external shocks[2]. Clearly, the effects of liberalizing capital flows hinge on the soundness of the financial system.[3] When lending by official creditors is available, the pressure to resort to external private capital markets is lessened.

Romania's experience seems to vindicate the view underlined above. On the one hand, a certain financial opening of the economy brought benefits and helped develop internal financial markets. This opening occurred against the background of a gradual liberalization of domestic financial markets; caps on interest rates were lifted at the end of 1993, rationing on the official foreign exchange market was terminated in the early 1997, and full convertibility of the ROL (Romanian leu) was achieved in 1998. Likewise, the Stock Exchange started to operate in late 1996 and bank privatization got under way afterwards. Given this situation, Romania was only able to avoid external default, in 1999, owing to an exceptional balance of payments adjustment program, which halved the current account deficit, at that time. Arguably, this was also warded off, due to a lesser integration with external financial markets and to less developed domestic financial markets – which prevented speculative capital to cause havoc. Although Romania returned to private

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[2] See also Christian Weller and Bernard Morzuch, "International Financial Contagion: Why are Eastern Europe's banks not failing when everybody's else's are?", *Economics of Transition*, vol.8(3) 2000, pp.639-663

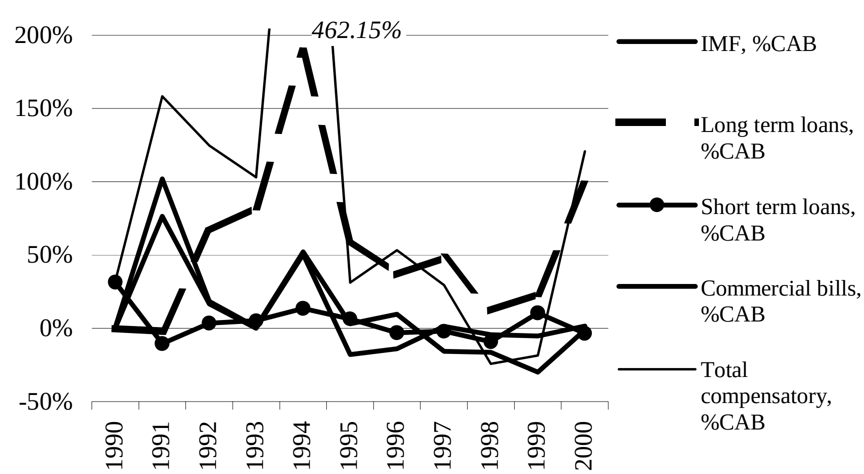
[3] James A. Hanson, "Opening the capital account: costs, benefits, and sequencing", in S.Edwards (ed.), "Capital Controls, Exchange Rates and Monetary Policy in the World Economy", Cambridge, Cambridge University Press, 1995, pp.383-429

capital markets in late 1995 (after a lapse of more than twenty years) and borrowed heavily in 1996, it kept its domestic capital markets officially closed to foreign investors. This actually proved not to be an unwise measure, in view of what happened in Russia in 1998 and in other emerging economies, which succumbed to the temptation to open widely their domestic capital markets capital accounts. This is an episode which deserves particular attention, taking into account the quasi-unanimous opinion of rating agencies (and not only theirs') on Romania's chances to avert external default in 1999.

The Romanian experience, therefore, supports the conclusion that, in transition economies, which are less integrated with the world economy, banking crises have, essentially, an internal origin. This is linked with a low ability of local banks to lend properly, or to extricate themselves from a hostage relationship (specially in the early years of transition), and with mistaken policies.

The pains of reforms made Romania rely extensively on funding from the international financial organizations and other official lenders, and compensatory flows played a major role in bridging the financial gap in the balance of payments, especially in the first half of the past decade (see Fig.1). This pattern of financing underwent substantial changes following the Asian and the Russian crises and the increasing role of remittances in the current account balance (CAB)[4].

Fig. 1. Compensatory flows, financing CAB



Source: Daniel Daianu, Liviu Voinea, Foreign Capital Flows in Romania, ICEG, forthcoming Occasional Paper.

[4] Remittances accounted for more than US$1 billion in recent years.

Looking forward: the opening of the capital account

Policy does make a difference. But it can be also argued that there is a certain "natural" speed of development of domestic financial markets; this speed hinges on the local institutional culture and on the mental readiness of local agents to use new financial instruments. The infrequent use by Romanian individuals and firms of new, market-based, financial instruments, as well as the almost "frozen" Stock Exchange in recent years (in spite of tremors around the world) indicate limits to speeding up the development of domestic financial markets. Only during 1997, shortly after the Stock Exchange started to operate, and when there was a lot of euphoria linked to "the new policies", had the Romanian Central Bank a hard time in managing capital inflows. Otherwise, much of the pains of controlling liquidity is to be assigned to the persistence of the National Bank's substantial quasi-fiscal operations in the late 90's, which are linked essentially with the attempted rescue packages for several banks.

The development of domestic financial markets has to be seen in conjunction with the financial opening of capital flows. Whereas the latter process can bring great benefits, it poses high risks as well; these risks are magnified when domestic policies are not sound and institutions are frail. In addition, the risks are heightened in a world economy, which is increasingly uncertain and volatile.

Actually, the recurrent financial crises around the world force countries to seek *shelters*. In this context, the support of the EU to transition countries in Europe would really be most welcome – under the understanding, of course, that they should comply with the requirements of the *acquis communautaire*. Romania, however, is less connected financially with the EU and seems to have relied less on it as an anchor – as has been the case with some front-runner candidate countries. But this situation will very likely change, should the country move closer to the Union. A clear indicator of such a development would be when the economic cycle in Romania will move, more or less, in tandem with the cycle in the EU; at that time external shocks will be felt similarly and policy responses will, presumably, become alike.

Romania's quest to join the EU involves the pledge to open the capital account, basically, by 2004. This is a time which will, very likely, precede the accession into the EU. As it is widely accepted by economists and amply proven by worldwide experience, the opening of the capital account needs to rely on solid institutions (including the financial and the banking system) and good economic performance – which, for Romania, implies convergence towards the EU benchmarks. Inflation should be in the range of the one digit level, interest rate differentials should be low, and external debt should grow at a lesser pace than the rate of GDP growth. Likewise, the economy would have to be able to cope with sudden reversals of capital flows without unbearable trouble. In general, hard budget constraints (financial discipline) would have to become the rule of the game and fiscal prudence would be a must for public policy conduct.

There are some premises for thinking about opening the capital account in Romania, according to the pledged timetable: disinflation is underway, albeit, it should be said, the battles ahead will be very painful; the banking system is more solid, as compared to its situation in the late nineties; domestic nominal and real interest rates have been declining considerably lately; the public debt seems to have flattened out; external debt is relatively low, and only a small part of it is short term debt. Accordingly, the credit rating of the country improved at the end of 2001[5]. However, inflation is still too high; arrears have grown by 6% of the GDP in 2001; the trade deficit rose sharply last year; economic growth is likely to slow down in 2002 because of the worsening international conditions and of the need to reduce the budget deficit, and foreign direct investment is below expectations. Equally, there are other characteristics of the domestic financial and monetary environment which should provide food for thought: financial markets are relatively thin (see Fig.2), which increases the likeliness for capital flows (in and out) to produce disturbances; the ability of the National Bank to sterilize money supply can easily be overstretched, and wide fluctuations of the exchange rate could have negative effects on trade flows and price stability.

The bottom line is: the Romanian economy is still fragile, in spite of positive developments that have occurred in the last couple of years. This is why there is a clear need to have a discussion about the ways and means regarding the opening of the capital account. Such a discussion should not be put aside just because there is a policy commitment towards the EU to carry out such an opening.

Fig. 2. Broad money (M2) % of GDP (international comparison, as of 1999)

Country	M2 / GDP
Czech Republic	76%
Slovak Republic	51%
Hungary	46%
Albania	45%
Poland	42%
Croatia	39%
Bulgaria	32%
Romania	25%

Source: IMF statistics, WIIW database

The opening of the capital account is actually an issue of utmost importance for policymakers, for two reasons at least. One is linked with policy formulation in the next few years. Can economic policy be geared in such a

[5] In December 2001, Moody's upgraded the country's rating for Government bonds in both foreign currency and domestic currency, to B2 (from B3 and Caa1 respectively).

way so that the requirements of opening of the capital account be met according to the timetable? In this respect, one has to provide answers to a series of problems, which have proved quite intractable during Romania's transition. One such problem is the degree of financial indiscipline, another problem is the import dependency of the Romanian economy. At the same time, can financial markets become sufficiently strong and can the Central Bank improve its effectiveness sufficiently in dealing with possible massive flows of capital in and out of the country? Or, how can a steady policy course be maintained, which should achieve a substantial amount of nominal and real convergence, in a relatively short span of time; and is this convergence possible? Certainly, the more the EU opens its labor markets to Romanian workers and the more EU direct investments flow into Romania, the easier it is to advance with financial opening – however, the questions raised above remain valid. The second reason for caution concerns the pitfalls of opening totally the capital account without a proper preparation of the institutional setup and some substantial improvement in economic performance. Therefore, aside from an optimistic scenario, one has to consider the case that, by 2004, the concrete circumstances would not warrant the complete opening of the capital account, and imagine alternative measures.

Romania needs to honor its commitments and policy planning is a must in the quest to join the EU. But on the other hand, the opening of the capital account should take place in accordance with the actual performance of the economy and not as if it is a god dictated event.

Fig.3. Romania's capital account opening: stages and timeframe

	1st stage (under way)	**2nd stage (January 1st,2003)**	**3rd stage (January 1st,2004)**	**4th stage (no later than EU accession)**
Shares or other securities of a participating nature	Sale or issue abroad by residents	Purchase abroad by residents	Sale or issue locally by nonresidents	Purchase locally by nonresidents
Bonds or other debt securities	Sale or issue abroad by residents	Purchase abroad by residents	Sale or issue locally by nonresidents	Purchase locally by nonresidents
Money market instruments			- Purchase locally by nonresidents - Sale or issue locally by nonresidents - Sale or issue abroad by residents - Purchase abroad by residents	
Collective investment securities	- Purchase locally by nonresidents - Sale or issue abroad by residents		- Sale or issue locally by nonresidents - Purchase abroad by residents	
Derivatives and other instruments			- Purchase locally by nonresidents - Sale or issue locally by nonresidents - Sale or issue abroad by residents - Purchase abroad by residents	
Credits		To residents from nonresidents	By residents to nonresidents	
Guaranties, sureties, and financial back up facilities	By residents to nonresidents (EU only)	- By residents to nonresidents - To residents from nonresidents (EU only)	To residents from nonresidents	
Direct investment	- Inward direct investment - Controls on liquidation of direct investment - Outward direct investment			
Real estate transactions	- Sale locally by nonresidents - Purchase locally by nonresidents (except land by private nonresidents) - Purchase abroad by residents			
Provisions specific to commercial banks	- Borrowing abroad - Foreign loans (EU only)	Nonresidents deposits	Foreign loans	Deposits overseas
Personal capital movements	- To residents from nonresidents - Debt transfer by immigrants	By residents to nonresidents		

TREND: ARREARS ARE STILL AN UNSOLVED PROBLEM

After 1989, as the role of the Romanian state in the economy diminished, the direct budget subsidies toward enterprises were drastically reduced. The number of centers performing the corporate governance of firms increased from one (the government) to four (the government, the banks, the utilities and "the other enterprises"). Cutting off investment funds received from the state budget, abolishing the automatic access to bank financing, and the price liberalization forced enterprises to look elsewhere to find ways to overcome the tighter budgetary constraints. The main channels available to the firms in order to reduce the pressure exerted on them, have been the state budget, commercial banks, utilities and the other commercial partners.

During the transition period, "the other enterprises" have been the only ones performing adequate corporate governance. Irrespective of their property form, they have learned very rapidly the importance of commercial credit controls, exerted through standard market economy procedures.

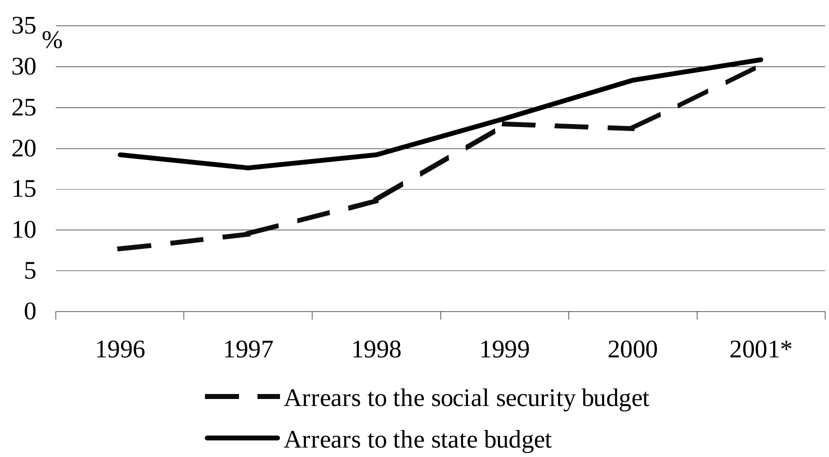
The delay in the privatization of the banks led, in the mid nineties, to the accumulation of a huge stock of bad loans in the banking sector. Thus, the large loss-making state owned enterprises were allowed to survive financially by borrowing great amounts of money from banks and not paying back. However, the liquidation of Bancorex, the collapse of a few well-known private banks and the privatization of some of the state-owned banks (Agricola, Bancpost, BRD), led to a gradual hardening of the borrowing conditionality. The stock of bad loans decreased substantially and the banking system moved towards adequate corporate governance.

By contrast, utilities and the state budget have remained major sources of financial indiscipline. The utilities – the energy sector first of all – are a permanent source of soft loans on the one hand, and a reckless commercial creditor on the other. First, the cash collection rate of the energy bills has always been low. Second, because of social protection reasons, the energy price was maintained at a level below the cost-recovery level. In order to survive financially, the utilities accumulated a substantial stock of fiscal arrears toward the state budget. The government's tolerance of such behavior actually represented a disincentive for restructuring the utility sector and perpetuated lax budgetary constraints on firms with political connections from the sector of the "other enterprises". Thus, a dual financial regime emerged.

The budget, as the fourth center of corporate governance, stands out as a consistent source of soft budgetary constraints in the economy. The large state-owned enterprises have been allowed to preserve their structural inefficiency by not paying their tax liabilities. This behavior was encouraged through frequent roll-overs and unconditional tax cancellations granted by the fiscal authorities. Such measures created an image of soft creditor for the government, diminished the fiscal authorities' credibility and led to the extension of such a behavior to the profitable private companies.

After 1990, the overall level of arrears has increased steadily, reflecting both the incapacity of successive governments to act on this issue and the inherited distortions in the Romanian economy. From 33.6% of GDP in 1997, the level of arrears climbed to 40.67% in 2000. However, such data do not reflect the reality entirely, as the amounts of tax debts cancelled or rolled-over by administrative decisions were not included. If these are included, the total stock of arrears would be substantially higher. What is worrying is that lately the growth of arrears accelerated. In the first semester of 2001, arrears increased by 39% compared to the same period of 2000. The debt to the social security budget increased by 57%, while the debt to the state budget went up by 36%.

Fig. 4. The evolution of the share of private sector arrears in the total stock



** first semester*

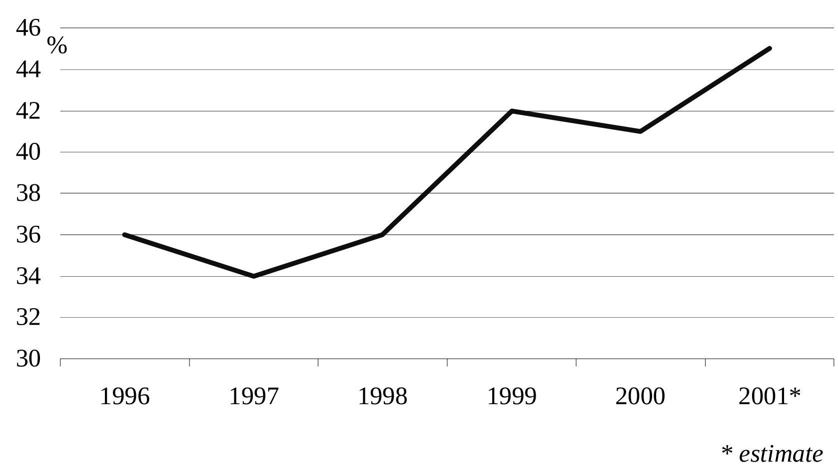
The bulk of the problem seems to be concentrated in a limited number of firms. The arrears of the largest 200 tax debtors toward the consolidated state budget increased by 32% in the first semester of 2001 compared to the first semester of 2000. In fact, it is the state budget that bears most of the burden: the share of the state budget arrears in the total structure of the fiscal arrears increased from 47.4% in the first semester of 2000 to 61.4% in the first semester of 2001. But the situation worsened in the social security budget as well.

The bad demonstration effects of the government's incapacity to collect taxes have become apparent over time. The private sector has learned that there is no punishment for not paying the taxes and contributions due, and as a consequence the share of the private sector in the total stock of fiscal arrears to the social security budget increased from 7.6% in 1996 to 22.4% in 2000. The trend continued in the first semester of 2001, when this figure reached 30% (Fig. 4).

The situation is not different with the special funds, where the share of the private sector arrears increased from only 10% in 1996 to 33% in 2000.

The total fiscal arrears of the companies that have a gross profit greater than 1 billion ROL and a fiscal debt greater than 10 billion ROL, was of about 20,000 billion ROL at the end of the first semester of 2001, which amounts to 4.5% of the GDP for the period considered. As a proportion of the GDP, the total stock of arrears was 40.7% in 2000. Extrapolating the average rate of growth of the arrears in the last three years, one can estimate a total stock of arrears at the end of 2001 of around 45% of GDP.

Fig. 5. Arrears evolution, % GDP



Conclusions

Many fiscal exemptions and tax holidays were granted during the past year. The price of the energy was maintained under the cost-recovery level and represented an important hidden subsidy. However, even in this environment, the enterprises did not begin to pay their taxes and the stock of fiscal arrears increased substantially.

The *recommended strategy* to deal with the tax arrears is twofold – and is meant to address the problems on the short term, and on the medium term.

The essence of the **short-term strategy** is to limit the tax arrears problem by putting a high priority on restoring and maintaining the position of the government as a tough creditor. The fact that loss-making firms accumulate large tax arrears even in leading transition economies suggests that in Romania, as elsewhere, some tax arrears are difficult to avoid. The serious danger appears when tax arrears spread beyond loss-making firms, since the stability of the fiscal system itself can be put at risk under such circumstances.

– The Government should attempt to contain the problem only to the loss-making and financially distressed firms. This means that the Ministry of Public Finance should maintain the pressure on companies and try to collect tax revenues, considering the use of the forced execution procedures by asset seizures and bank accounts seal-offs. On the short term, the liquidation and closure of the large loss-making state-owned enterprises would face political and social obstacles that may be difficult to overcome. However, while they are still operating, government can put pressure on these firms in order to contain the magnitude of the problem.

– Tax discipline should be restored in the profitable firms. If the current situation of moral hazard (when it pays to be a debtor to the state budget) is terminated, these firms will have to hold down their wage bill or borrow from banks rather than accumulate tax arrears.

– In the case of energy suppliers, it is essential to align energy prices to cost-recovery level and allow these energy suppliers much greater freedom in cutting off supply to non-paying customers. In order to reach a long-lasting solution, the production and the distribution of energy should be privatized and opened to competition. Some steps were taken already, but the process must be speeded up. In terms of priorities, it is important that a sound regulatory framework be in place prior to privatization. Equally, since the main problem is the energy bill collection, the privatization of distribution companies should be initiated before the privatization of the production companies.

– The Government should avoid measures to write off or reschedule tax arrears for different categories of firms – like the ones granted at the beginning of 2002. Such programs are extremely dangerous: they only aggravate the moral hazard behavior and create perverse expectations for future unconditional tax forgiveness, thus increasing the marginal propensity of companies to accumulate tax liabilities. Furthermore, the social utility of such measures is often questionable (for example, when the Government reschedules or cancels debts of private tobacco and beer producers), and they represent incentives for corruption.

The medium-term strategy used by the leading transition economies has been to deal with the problem companies by privatization or selling of assets, whenever this was possible.

When the above is not possible, because the political or social concerns prevent the sale or closure, the problem of the tax arrears should be gradually reduced trough the sustained application of hard budget constraints. Faced with tougher rules of the game, the loss-making firms will eventually shed large amounts of labor out of necessity. Thus, the scale of the problem would decrease in time, and it would become easier to deal with individual firms in a variety of ways depending on the situation: restructuring, privatization or closure of the firm. Such a strategy also proved effective in other transition economies.

AGRICULTURE: RIGHT ENDS, WRONG MEANS

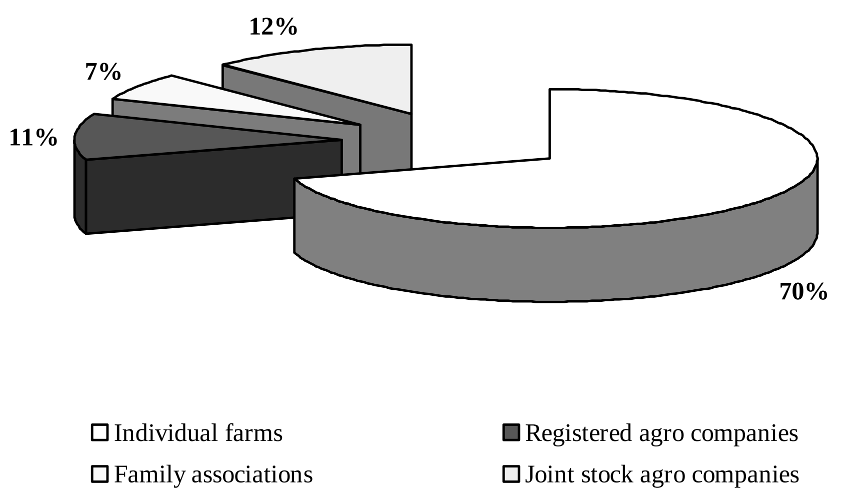
The current attempts to encourage consolidation of farms are unlikely to make an impact

Due to its current structure, the Romanian agriculture is not able to fully realize its competitive advantage in the agro-food sector. A large number of tiny, traditional family farms producing largely for their own consumption (there are over 4 million such small exploitations at present) coexist with a small number of large industrial farms that inherited the assets and management of the former communist state farms (IAS). The vast majority of the agricultural land is, however, still owned by small holders (Fig.3): the average area of an individual household exploitation has been of about 2.3 ha over the past five years. Agro companies (most of them former communist cooperatives – CAP) exploit little over 400 ha on average, and a family association around 100 ha. The former IAS dominate the sector by their size, with an average of 3,300 ha in 1999. Once the second wave of restitution and concession of state owned land began in 2000, the participation of the state sector in agriculture has further diminished; but more than half of the IAS have yet to be privatized.

The polarization of exploitations, increasingly visible in the Romanian agriculture, is taking place everywhere in Central and Eastern Europe. However, the situation is so dramatic in Romania, that it has to implement radical measures in order to change this situation. What are the chances for the current policies of the Nãstase government to achieve their intended results? Not very high, as it will be argued below.

The Ministry of Agriculture tried to tackle the problem of agriculture land fragmentation by issuing Emergency Ordinance 108/2001. This legislation defines the agro exploitation by type, in a very peculiar way: in the areas where cereals are grown, only farms with more than 110 ha qualify as such; dairy farms should have more than 15 animals; etc. The ordinance specifies the minimal dimension for every culture or type of livestock – and only the exploitations that meet the criteria will have access to "state support similar to that practiced in the EU". The units that fail the test are considered "family farms" and do not qualify for support.

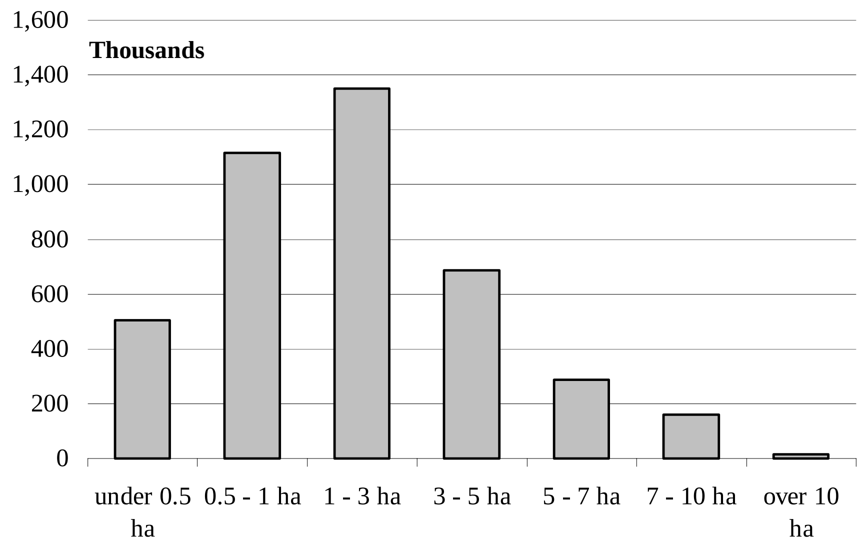
Fig. 6. Agriculture land by type of exploitation, 1999



The data in Fig. 7 show that the 4 million individual farms are practically excluded. As a consequence, the households who rely on these agro activities for subsistence will see their living standards declining even further. At present, the state provides little support for smallholders and they do not sell much of their products on the market. However, the new policy will isolate them even more from the official economy. The Government's argument is that the farmers will, in this way, be stimulated to consolidate their lands into agricultural associations of viable size; and that such forms of co-operation are widespread in the European Union. However, what the authorities do not mention, is that in the EU the co-operatives have other purposes than production (with the exception of the Eastern German lands), which is almost always realized on an individual basis.

It is unlikely that the policy promoted through the Ordinance 108/2001 will have a significant impact on the number of the legally registered associations, the only ones eligible for support. Moreover, their overall economic performance over the last years has been modest, with slightly better performance in the plain areas with cereal crops. Their number and size have not changed much for the better – indeed, there was a slight decline in the last three years.

Fig. 7. Number of individual farms by size, 1999



The significance of the new policy is twofold. First, it reveals the Government's nostalgia for the old forms of associative production, based on massive social engineering and selective assimilation of Western models (real or imagined). Only the old instruments of political coercion are replaced by new economic incentives. But nobody can guarantee that associations will be set up voluntarily by private agents when they do not appear to be very enthusiastic in this respect in the first place. On the contrary, the analyses available so far demonstrate that the profitability of existing associations can hardly be a reason for promoting them.

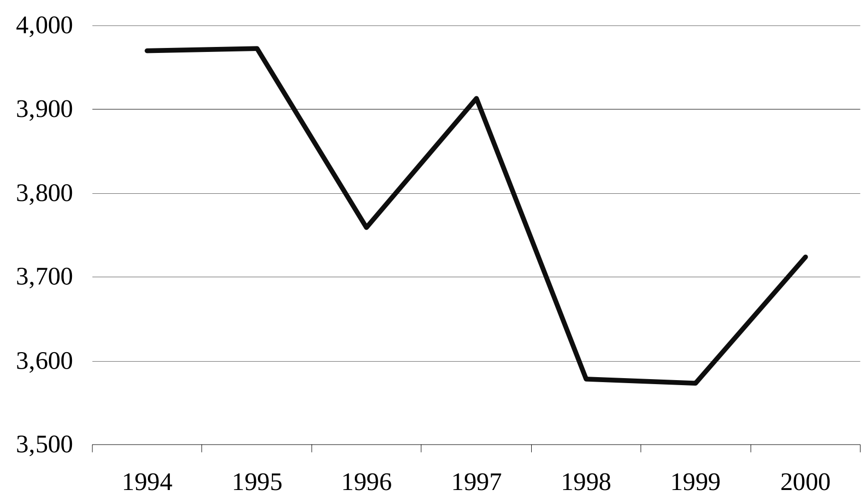
Second, the way the ordinance was drafted and debated in the Parliament – with little concern for the rural votes that might be lost – shows that the interests of the large farm owners prevailed. Who are, in fact, these people, the winners of the battle for agricultural aid? The scarce public resources will go mostly to:

- the agro associations, whose managers are able in most of the cases to extract personal benefits at the expense of the members,
- the former IAS, still state-owned, which are hugely indebted and managed by directors appointed by the Ministry of Agriculture,

– the new private administrators of lands on lease from the Agency of State Domains (subordinated to the Ministry of Agriculture), typically over-diversified commercial holdings, and

– the few real farmers who qualify for support according to the ordinance.

Fig. 8. The number of registered agro companies

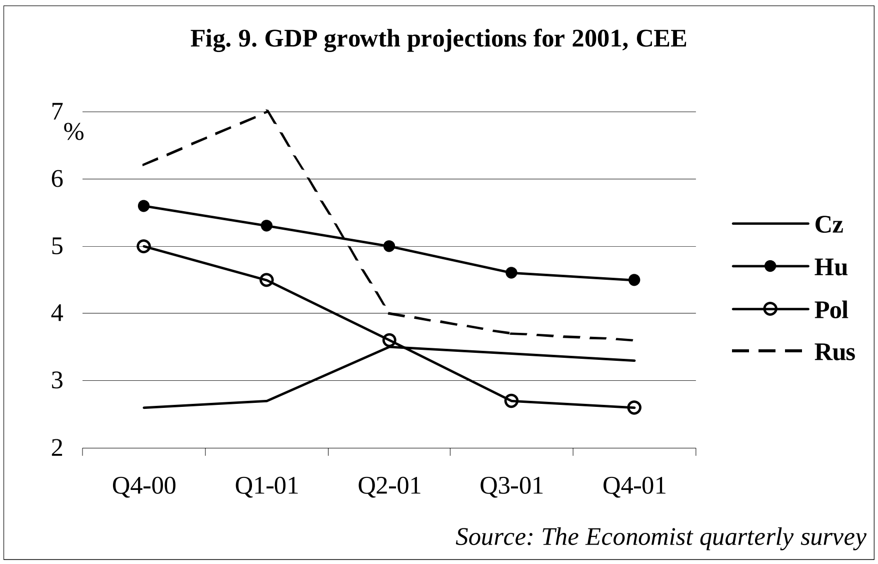


The number of all these beneficiaries revolves around 10,000, and they hold about 30% of the agricultural land of Romania. Although the Senate has amended the Ordinance, including amongst its beneficiaries the mixed farms, the principle of discrimination according to size was preserved in spite of its foreseeable social and economic consequences. The lower Chamber has still the chance to amend a piece of legislation that was rushed through the Senate in 2001.

The official position of the Government is that the policy will speed up Romania's European integration. The problem is, such policies that discriminate among farmers do not exist in the EU, and the average farm size is no bigger than 18.4 ha (1997 data). Most European farmers would have a hard time meeting the strict criteria imposed by the Romanian Government. A real harmonization policy would require that Romania stimulate the consolidation of farms within the size bracket of 20-50 ha, all the more so, since the economies of scale, mentioned by the initiators of the ordinance, have limited effect in agriculture. The increase in productivity and profitability of the Romanian agro-food sector, together with the actual realization of the competitive advantage of our country (if indeed there is one) in this respect, are legitimate goals – but they must be pursued through different means than those envisaged in Ordinance 108/2001.

GROWTH PROSPECTS AND THE DOMESTIC BUSINESS ENVIRONMENT

Romania goes against the trend, for good and for bad. In 2001 it was mainly for the good, but it may not happen again this year.



The world seems always willing to forgive you for other things if you are able to deliver growth – especially when you are a Romanian government at a time when the whole Central and Eastern Europe has become gloomier, following the general trend of the world economy (Fig. 9). With an expected growth rate close to 5% in 2001 (see the table of indicators in page 2), Romania will most likely outperform its more advanced neighbors. The downturn of our main EU trading partners did not seem to have a substantial influence either. This surprising results allowed the Romanian government to gain credibility, domestically and abroad. The question is, will the same thing happen again in 2002?

Most probably, the growth rate in 2002 will be lower than in 2001, because:

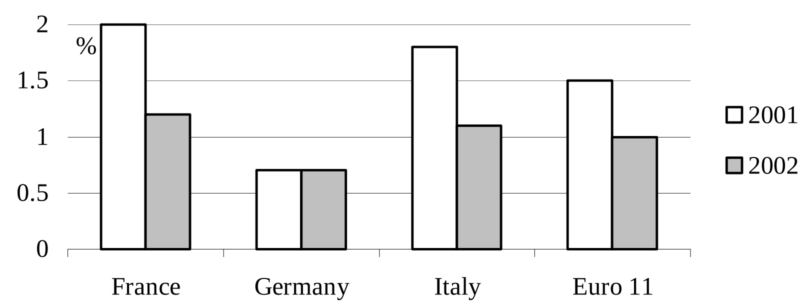
– The agriculture will not be able to grow as impressively as in 2001 in relative terms (2000 was a bad year for crops, which explains the push ahead in this sector last year).

– Romania's main trading partners – and the whole Euro area – will slow down even more in 2002 before their economies will recover (Fig.10). Even though it proved to be quite disconnected from the world trends so far, it is unlikely that the Romanian economy will not be affected eventually.

– Domestic demand, the most important source of growth in 2001, will have to adjust to the austerity measures that the government must take, namely: reduce subsidies, decrease public spending and exert a much tighter control over the salaries in the public companies.

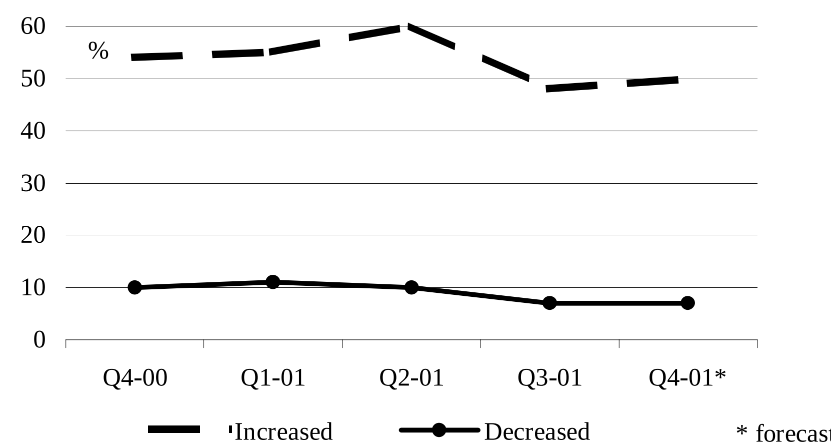
– Arrears represent a serious problem that no government has been able to tackle so far, which only got worse in 2001 (see the analysis in this report). Most probably, the arrears also contributed to the GDP growth last year, but this should not happen again in 2002 if the government is to preserve its credibility.

Fig. 10. Growth prospects in the Euro area, GDP



Source: The Economist, December

Fig. 11. Business mood - foreign companies' operations, 2001



The Government would be well advised to pay attention to the activity of the foreign companies, since they are the ones who bet with their money on the Romanian economy:. The KPMG quarterly survey of the foreign investors shows them in stationary mood (Fig.8,9,10). The deterioration of their financial position and business activity towards the end of 2001 may be attributable to the ups and (mostly) downs of the world economy. However, the very fact that they felt that they were worse off in the fourth quarter than in the first should be a matter of concern. The government should remember such market signals as it plans ahead for the new year.