ECONOMY

Economic Policy Challenges

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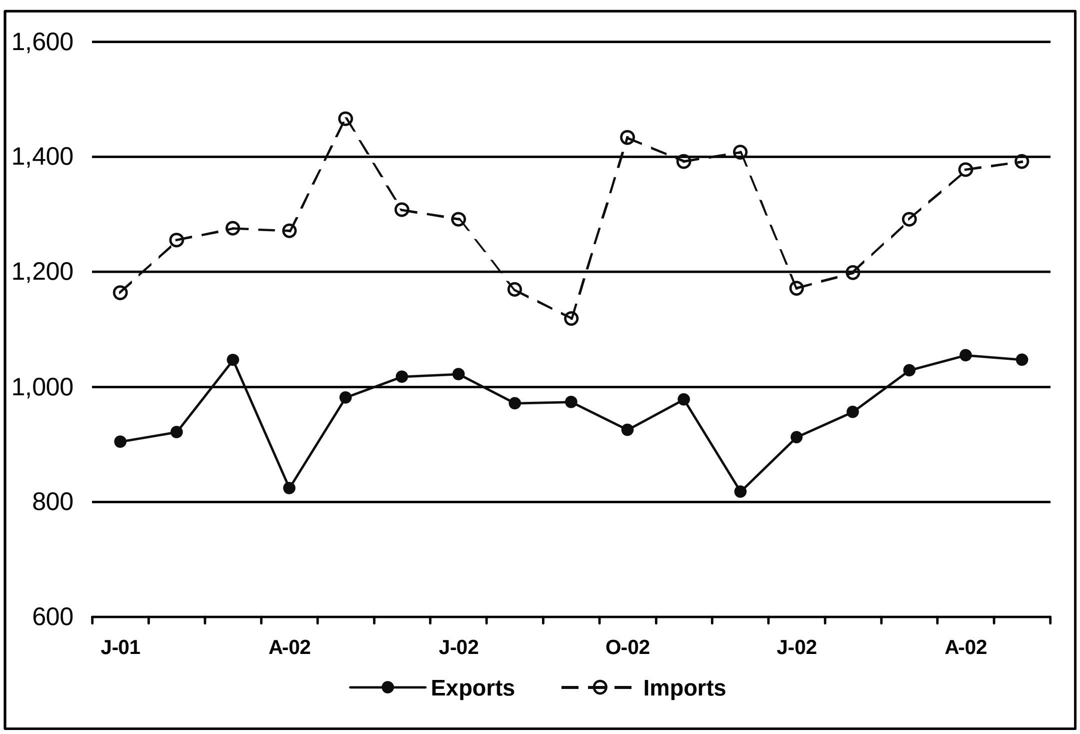
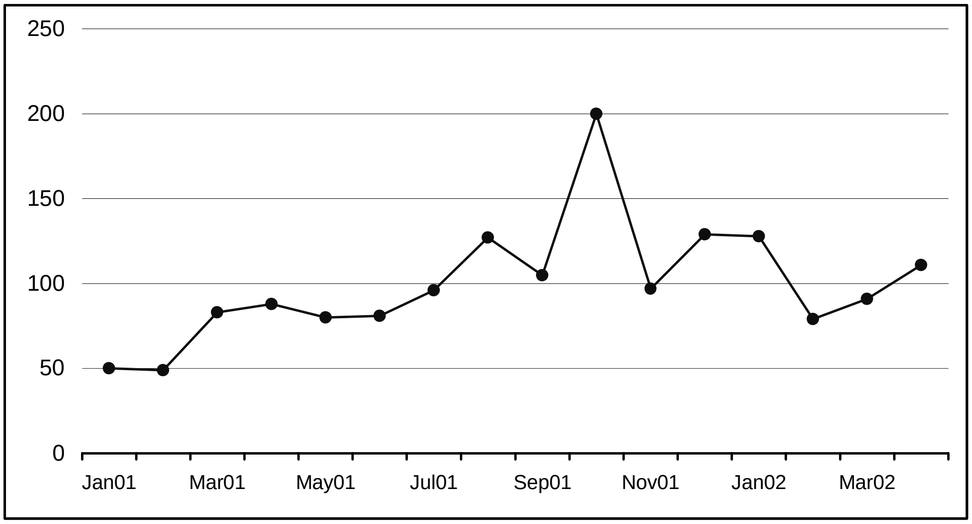
This is the second part of a review of challenges which economic policy is bound to face in Romania in the period to come. New data confirm some positive macroeconomic dynamics; disinflation continues at a brisk pace and the rise in private transfers from abroad has helped reduce the current account imbalance in the first months of this year as against the same interval of last year. One should introduce a note of caution, however, since imports surged quite rapidly during last April and May.

Fig. 1. Foreign trade evolution, monthly data ($ million)



Source: NBR

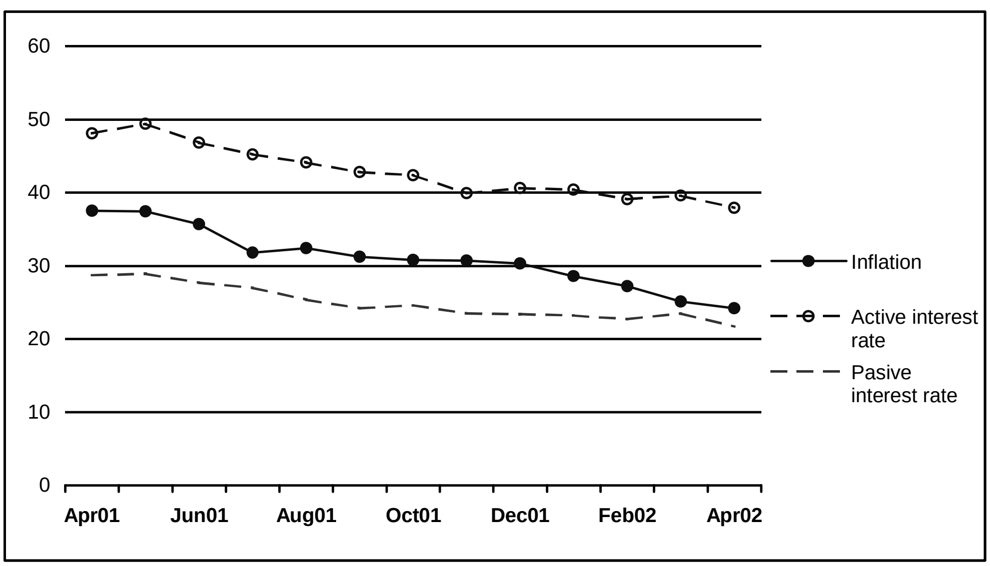
Fig. 2. Foreign remittances, net monthly flows ($ million)



Source: NBR

But substantial worries remain vis-à-vis the extent of financial indiscipline in the economy against the background of disinflation and insufficient restructuring (owing, also, to the feeble level of foreign direct investment in the Romanian economy at a time when domestic capital formation is still low). Likewise, the decreasing interest rates, which follow the decline of inflation, may strain banks which use high spreads as a means to cover various high costs – including the consequences of their non-performing loans. It is fair to add, nonetheless, that decreasing interest rates help those firms, which are burdened with debt.

Fig 3. Interest rate, nominal and real, for non-banking customers, %



Source: NBR

In the present article, the focus is on the relationship between the price of energy and arrears, a key aspect of policy coordination, and last, but not least, on the pledge made by the Government to raise the minimum wage.

1. Arrears and the price of energy; the social dimension

As a phenomenon, arrears (financial indiscipline) can be much compounded by the ability (or inability) of many households and firms to respond adequately to the drastic change in the relative price of energy. It is hard to dispute the rationality of the rise in the price of energy for the corporate sector to a market equilibrium level; this rise is part and parcel of the process of imposing hard budget constraints in the economy by eliminating an across the board subsidy and of stimulating energy saving and productivity gains in the enterprise sector.

A more refined analysis should be made in the case of households. A similar big rise in the energy price happened in early 1997[7], whereas, at that time, the proportion of individuals living below the poverty line was about 22% of the population. During 1997-1999, as a result of very painful adjustment measures, the economy plunged, which had a quite severe impact on many people's incomes. At present, the proportion of the population living below the poverty line is of more than 40%. Even before the rise in the price of energy price, many households (especially made up of retired people) were not capable of paying their electricity and heating bills during the cold season. It is no secret that these people will continue not to be able to pay their energy bills; and the collection rate of these receivables (for the energy suppliers) will fall accordingly[8]. Therefore, the financial situation of energy providers is not likely to improve in this respect; indeed, overall things could get even worse, specially considering the social implications of this measure as well.

Arguably, the rise in the price of energy for households was not well calibrated (it was too high). In addition, it was not accompanied by a program of a distribution in time of the additional payments to be made by households. Arguably, the Government should have tried to implement a two-tier price structure, with the household sector paying less. However, to reduce the price of energy for households now would be a non-starter, since it would damage the policy credibility in general. To keep the price of energy stable for a longer period of time (which should cause its erosion due to inflation) does not solve the problem in the immediate future. Consequently, the Government has no choice but to come to the rescue of the most afflicted individuals. Reportedly, it intends to work out an assistance program for those who cannot pay, but its technicalities are still to be drawn up. Whatever the means envisaged for alleviating the financial burden put on low-income

[7] According to EWR 5/2001, the electric energy price for households grew from 10 USD/MWh in February 1997 to 45 USD/MWh in April 2001, and the price for heating increased from 5 USD/Gcal in February 1997 to 17 USD/Gcal in April 2001.

[8] It is quite surprising how those who worked out this plan bet on a better collection rate (as far as households are concerned), which should be judged as a performance criteria in the discussion with the IMF and be included in the additional letter of intent.

households, one should be aware of the threat that some of those who used to pay may cease to do it – which would make the situation for the energy providers even worse – unless the assistance is very well targeted. Equally, if subsidies are considered, these should be paid directly into the escrow accounts of the energy suppliers, instead of being given to low-income individuals, in order to prevent that subsidies be diverted to other purposes.

It is fairly difficult to evaluate the impact on the finances of energy suppliers of the rise in the price of energy for households; it is also difficult to estimate the impact on the public budget of the pledge made by government to help needy families, since this assistance has not been yet outlined in concrete details.

As far as the corporate sector is concerned, a very strict monitoring has to take place in order to verify whether payment amelioration, where it does exist, is sustained. In addition, it may well be that some of the firms, which eventually started to pay (or pay more) for electricity and heating, in order to avert being disconnected from energy suppliers, increased their arrears toward other suppliers. Thus, aggregate arrears may not necessarily decrease, as it is expected. Such a state of affairs would be bad omen for the sustainability of economic recovery and would not wait too long before showing up in the books. This is why the Government urgently needs to identify the worst offenders, those who can pay but do not pay, and put pressure on them.

2. Policy coordination

There is considerable room for improving economic policy coordination. The last EWR (no.4/2002) dealt with several aspects in this respect and argued in favor of a cut in the number of economic ministries and for the creation of a Ministry of the Economy[9], which could include the Department of Foreign Trade as well[10]. Herein we discuss the cooperation between the Government and the National Bank (NBR) in order to pursue effectively the main goals of economic policy, namely disinflation and economic recovery.

The linkage between budget policy and monetary and exchange rate policies should increase.

Lately, there has been a flurry of statements regarding the level of interest rates in the economy. Government officials decried the level of real interest rates. At the same time, National Bank spokesmen explained the limited ability of the Central Bank to intervene and the dangers of letting liquidity loose, as a means to reduce interest rates. This issue was discussed in the last EWR. The overall impression that one receives from such statements is that there is not much of a dialogue between the Government and the NBR regarding policy coordination. As a matter of fact, a

[9] The Ministry of Economy, as in Germany (actually, this model is to be found in Austria, Greece and other EU member countries), would cumulate the prerogatives of the current Ministry of Development and Prognosis and have the task of coordinating overall economic policy. But such a task would not be easy to implement in view of the number of existing economic ministries, the key role played by the Ministry of Finance in the whole algorithm of economic policy-making, and the political heavyweights which are at the helm of some ministries (The Ministry of Industry, the Ministry of Transportation).

[10] The Department of Trade could join the Ministry of Industry, as in the UK and Greece. A Ministry of Industry and Trade would deal with all issues regarding the functioning of industry and trade.

substantial and substantive policy coordination between the Government and the Central Bank is indispensable for implementing the agreements with the International Financial Institutions, and the Stand-by agreement with the IMF in particular. This is because the monetary program and the exchange rate policy of the Central Bank are closely inter-linked with the budget policy of the Government. The rise in the reserves of the Central Bank, the pace of disinflation, the expansion of base money (of net credit in the economy and of the money supply, in general) are seen in connection with the size of the budget deficit, the recourse of the budget to domestic sources of finance, the expected trend in interest rates, the wage policy of the Government, and so forth. To the extent that the Stand-by agreement is viewed as a *process,* the operational linkages between the Government, via the Ministry of Finance, and the NBR are obvious. But clashes of views do occur during program implementation, as economics is not a hard science and policy options present trade-offs. However, there are ways to enhance the communication between the Government (Ministry of Finance in particular) and the NBR, and to establish an operational consensus which should help policy implementation.

Recently, the Prime Minister asked his office (his economic advisor) to maintain a closer relationship with the NBR. This can definitely help. But in order to have a clear venue for consolidating a systematic dialogue between the Government – via the Ministry of Finance – and the NBR, one possible option would be to resuscitate the Joint Credit Markets Committee; this body, which is made up of leading officials and experts of the Ministry of Finance (MOF) and NBR, was set up in 1998 and used to hold weekly meetings aimed at coordinating the interventions of the two institutions in the credit markets. The Treasury of the MOF actually operates as a mini-central bank by drawing liquidity from the credit markets through its borrowings and injecting liquidity when it makes expenditure. MOF's interventions in the credit markets have counterparts in the sterilization operations of the NBR, when the latter tries to keep control of the expansion of money supply. Actually, the dynamic of domestic interest rates is driven by both MOF's borrowings and expenditure, as well as by NBR's attracted deposits and money injections through foreign exchange transactions. Consequently, the coordination of both institutions' policy moves is critical for their impact on credit markets and on interest rates, specially given that the monetization of the economy (the share of money supply in the GDP) is low.

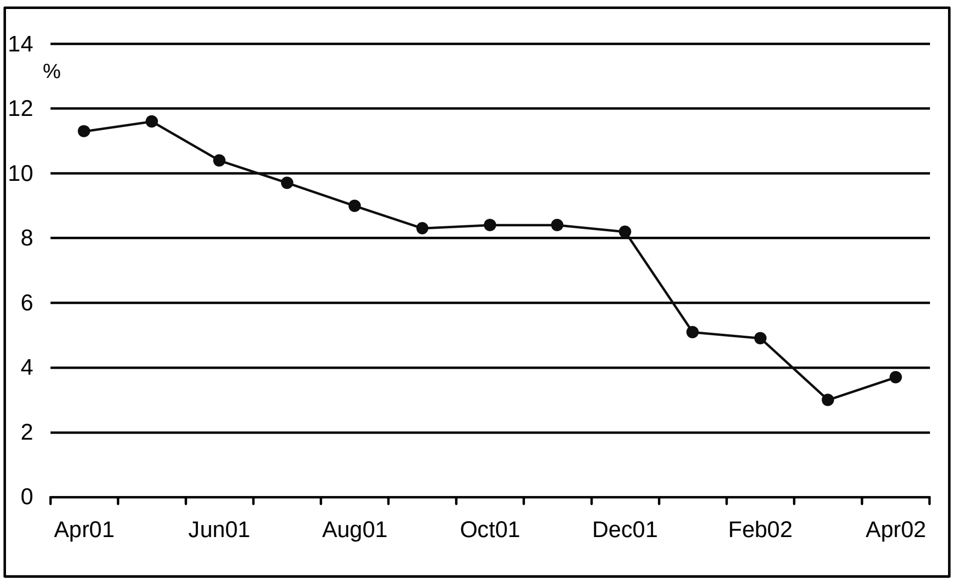
The revival of this committee would be more than useful and it should be complemented with a more effective dialogue between the members of a troika: the Governor of NBR, the Minister of Finance, and the Prime Minister's advisor for economic affairs. It goes without saying that a better communication between the Prime Minister himself and the Governor of the NBR would smooth things out considerably. The creation of a Ministry of Economy, if well thought out and prepared, would significantly simplify policy coordination.

3. The rise in the minimum wage

The Government announced a rise of about 25% in the minimum wage: from approx. 60 Euro to 75 Euro (2,5 million ROL at the current exchange rate). This planned rise is the outcome of protracted talks with some trade unions and was hailed by some as a means to preserve social peace this year. One can go further and see this rise in the context of the search by the Government of ways to compensate for the drastic rise in the price of energy.

But one has to consider the downside of this measure as well. To the extent that this increase pushes the rest of the pay scale upwards, inflationary pressures will appear next year and the profitability of some firms (where productivity gains do not occur quickly enough) may be impaired. As a matter of fact, there are few signs that productivity is rising according to expectations. Whilst the growth of industrial production is less impressive, the number of employees has actually increased since the beginning of this year (from 4.31 millions in January 2002, to 4.38 millions in April 2002).

Fig. 4. Industrial production, aggregated growth as to similar period last year



Source: NBR

The propensity to operate in the shadow economy is likely to increase for such firms. All this sequence of possible effects would have a budget impact, which needs to be estimated by the Government. Such estimates were not made when the decision was taken to increase the minimum wage, maybe because the government surmised that most of the effects would be felt in the next year's budget. But this is not a convincing reason when all possible effects are considered. Again, lapses in policy coordination and formulation come to the surface and require to be carefully and decisively addressed. The Government needs to bolster its analytical capacity in the economic field and be more forward looking with its decision-making.

How Volatile Is the Romanian Economy?

Over the last 3 years, the Romanian economy has embarked on a path of growth that promises to be more than short-lived. Capital flows enter the country to such an extent (adding to more than 15% of GDP last year) that they pose serious sterilization problems – in 2000 and 2001, the accumulation of net official reserves hardly covered one third of the net private capital inflows. The exchange rate is appreciating in real terms, inflation is calming down (although the pace of disinflation is disputable) and foreign trade volume is expanding (although at a slower rhythm than last year).

How stable are these evolutions, however, and what are the risks for them to be suddenly reversed in case of adverse shocks? To answer such a question, we calculated the volatility of various macroeconomic variables, by their coefficient of variation, equal to standard deviation over mean for a sample of data.

In Romania, private capital inflows volatility is among the highest in the region (see table 1). As theory predicts, FDI proved, indeed, less volatile than portfolio investments, and these, in turn, were less volatile than other short-term private flows. Nevertheless, the FDI volatility, highest amongst EU candidate countries, validates the hypothesis that FDI has been more attracted by conjectural reasons (mainly opportunities to conclude special privatization deals with the authorities) than by solid macroeconomic grounds. A recent work[11] finds that FDI in Romania is strongly correlated with the accumulation of trade deficit and private debt[12], indicating that capital inflows from direct investments are associated with significant capital outflows.

Volatility of portfolio investments is likely to continue amid various reorganization measures on the BSE and Rasdaq; over the first four months of 2002, portfolio invetsments were actually net negative (-$37 million). As regards the volatility of other capital inflows, the capital account opening will only add to the trend, a fact already revealed by recent significant changes in the volumes (and sign) of the balance of certain payments items, such as direct investment outflows[13] or residents' deposits abroad[14].

However, the overall volatility of net foreign assets is remarkably decreasing lately. This is normal in view of the fact that the policy of capital account opening was to liberalize capital inflows before capital outflows. When capital outflows will be fully liberalized – in the near future – as well as specific money market instruments, major reversals may appear and volatility may dramatically increase. As Fig. 7 points out, historically, net foreign assets have a higher volatility than net domestic assets, and this feature was particularly visible in times of financial liberalization, as it was the case in 1997.

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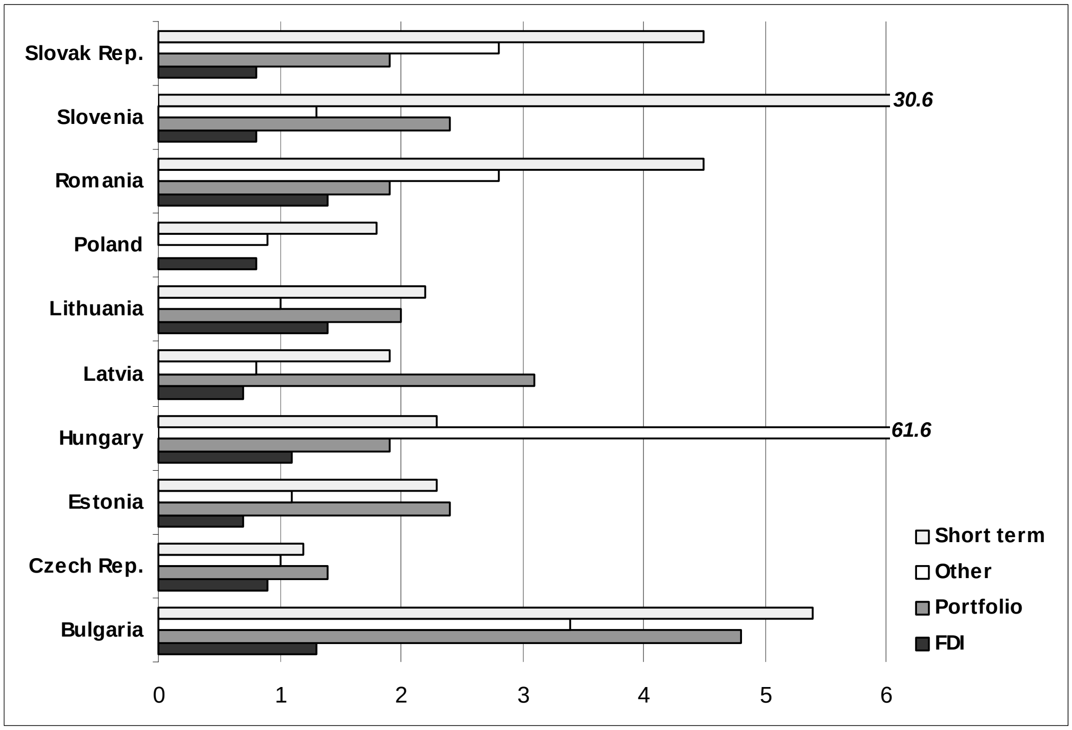
[11] Liviu Voinea (2002) *Revisiting FDI Patterns in Transition. The case of Romania*, paper presented at the 7th EACES Congress, Bologna, June 2002.

[12] Correl = 0.65, respectively 0.68, for a number of 12 observations.

[13] From $18 million in the first four months of 2001, to –$34 million in the first four months 2002.

[14] From $1 million in the first four months of 2001, to $340 million in the first four months 2002.

Fig. 5. Volatility of capital inflows



Note: quarterly data for the '90s were used; abnormal data for Hungary and Slovenia come from the underestimation of the mean, due to some significant capital reversals. Source: Claudia Buch, Lusine Lusinyan (2002), Short-Term Capital, Economic Transformation, and EU Accession, Economic Research Center of the Deutche Bundesbank, Discussion paper 02/02

Fig. 6. Volatility of net foreign assets (st. dev./mean), monthly data, 1991-2002

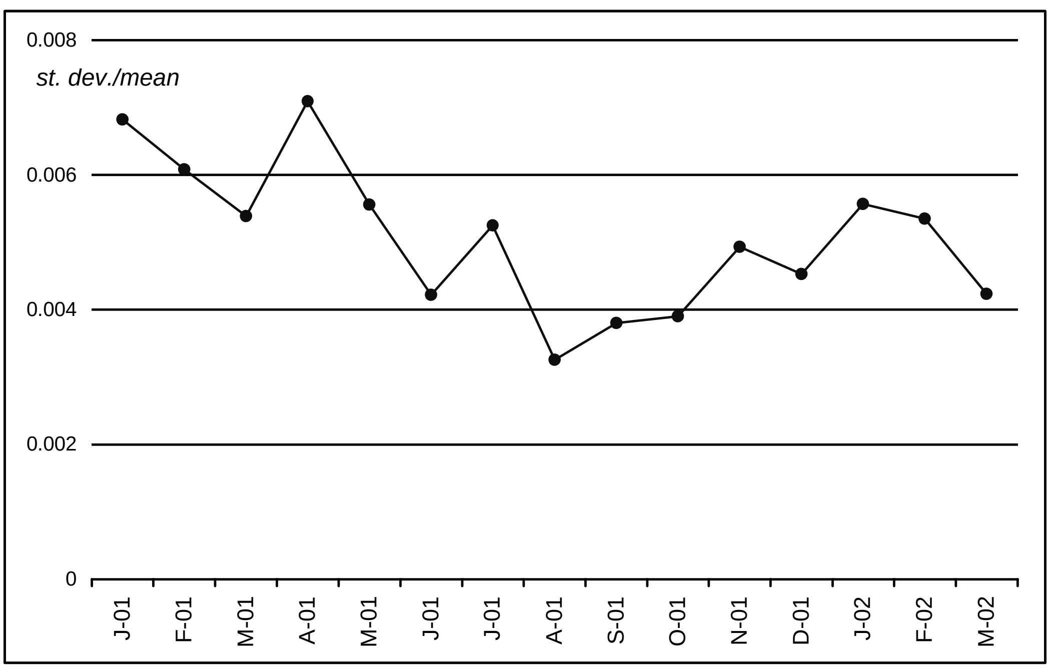


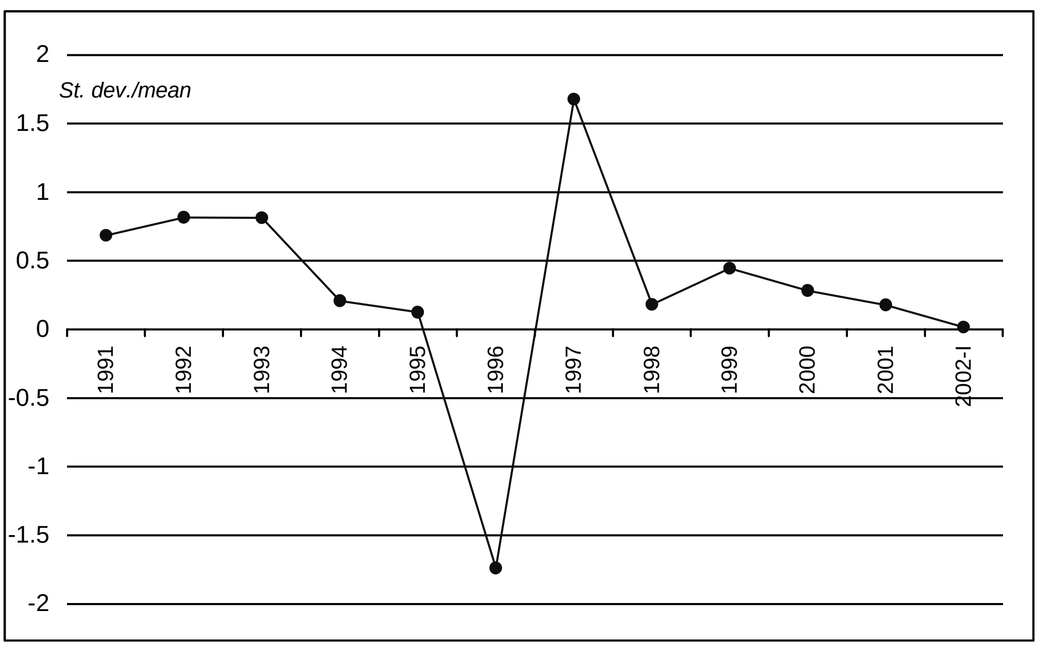
Fig. 7. Volatility of various macroeconomic indicators

	Number of observations and period	Standard deviation / mean
Net foreign assets	135 / January 1991 – March 2002	1.83
Net domestic assets	135 / January 1991 – March 2002	0.95
Exports	15 / March 2001 – May 2002	0.07
Imports	15 / March 2001 – May 2002	0.08
Exchange rate ROL-USD	317 / January 2001 – March 2002	0.06
Transactions' volume, Bucharest Stock Exchange	18 / January 2001 – May 2002	0.61
Transactions' volume, Rasdaq	18 / January 2001 – May 2002	0.56

As expected, transactions on the primary and secondary markets proved volatile. Exports and imports were very stable, a finding which is consistent with the lack of significant changes in trade structure and performance, as described in our previous materials (see Annual EWR 2001, and EWR 3/2002).

The stability of the exchange rate is particularly worth noting. Variations were in a very narrow band.

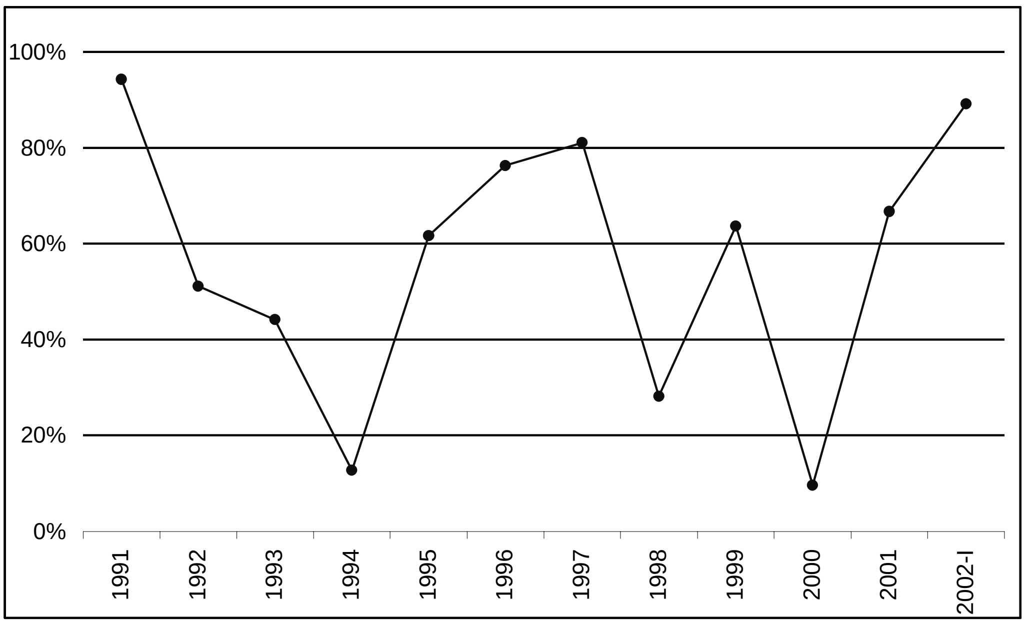
Fig. 8. Exchange rate volatility



The above can provide a hint on the policy options in the near future. The recent international financial crises (Mexico 1994, Asia 1997, Argentina 2001) validate the theoretical remark of the "impossible trilemma", which states that the concurrent existence of a fixed exchange rate, autonomous monetary policy and free capital flows is unsustainable in the medium and long run. If the National Bank is tempted to make the apparent stability of the exchange rate more official, in the form of a fluctuation band or a peg, then pressures will appear either towards giving up the monetary autonomy (through Euroisation), or towards slowing down the process of capital account liberalization.

Returning to the issue of foreign financing, an indicator of volatility and reversibility is the ratio of short term to medium and long term foreign capital flows; it indicates large oscillations, and a recent upward evolution.

Fig. 9. Ratio of short-term to medium and long term gross foreign capital flows



Note: short-term flows = portfolio + short-term foreign debt + errors and omissions; medium and long term flows = FDI + medium and long term foreign debt; source: author

This should be considered together with the predominance of short-term (less than one year) financing in Romania's international bank credit – 40% of total, ranked third in the region after Czech Republic and Latvia – and in international debt securities – 28.3% of total, ranked first in the region[15].

Based on all the indicators above, our warning is that the economy is more volatile than one might think at a first sight; moreover, with respect to capital flows and short term financing, Romania seems to feature volatility amongst the highest in EU candidate countries. Capital outflows are not at all unlikely during and following the process of capital account liberalization, and the financing of the current account is not without risks, in view of such high level of volatility.

[15] IMF and BIS data for year 2000 (quoted in Buch, op.cit).