ECONOMY

What Threatens the Economic Recovery?

WARNING

In the past one and a half years we have witnessed a – somehow unexpected – strengthening of the Romanian economy, which confounded the typically gloomy foreign and domestic forecasters. The growth has remained high, in spite of the world economic downturn. The current account deficit remained within manageable limits and exports have kept pace with imports, even though the national currency, Leu, has appreciated against the US dollar in real terms. Arguably, the recent increase of the Euro against the dollar has helped to reduce the trade deficit in recent months, since the EU is the main destination of Romanian exports. Equally beneficial was the steady increase in the flow of remittances – most of them savings sent home by Romanian citizens working abroad. However, these factors alone cannot explain entirely Romania's macro-economic performance. Finally, the inflation rate has constantly declined over the last couple of years while, for the first time after 1989, the Central Bank has been able to create disinflationary expectations among the public at large.

The current economic recovery may prove unsustainable without restructuring at the micro level. It has happened before.

How did this come to happen? Is this recovery solid? We argue here that, while some positive developments are undeniable, they are mostly due to the resilience of the fledgling Romanian private sector, which managed to provide economic growth in difficult circumstances. By contrast, while the macroeconomic policies have been more prudent and consistent than they used to be in the past decade, the pledges to speed up privatization, improve the business environment and restructure the hard core of the heavy industry created during the communist times were inconsequential. The two big privatizations concluded in 2001 – Banca Agricola and Sidex – had been initiated by the previous cabinet, and this government carried them through. The government should of course be given credit for this, but it is far from enough.

For instance, Petrom, the national oil company, represented a stumbling block in the negotiations with the IMF, since the government tried to placate the unions and put off the required downsizing of staff. Other important privatizations that seemed to be agreed upon years ago went back to the phase of conceptual debates, and the government looks undecided about them. This is not necessarily bad when it comes to highly complex issues, such as those regarding the energy sector, which cannot be dealt with in a rush or in a simplistic way – by overlooking competition policy concerns and the need to protect consumers. However, there is a need to eventually formulate a coherent strategy, and to implement it irrespective of pressures that might come from various lobby groups with interests in the energy sector.

In fact, since the banking sector has been by and large restructured in the last years, there is a real danger that the energy sector will become the main provider of unintended soft credits in the Romanian economy, with all the risks rising from such a situation. Until some years ago, governments and lobby groups were using the state owned banks for pumping money into loss-making enterprises and keep them afloat. A classic combination of twin deficits (trade and budget deficits) showed up in a worsening current account and growing external debt. This was often accompanied by monetization of the quasi-fiscal deficit, which led to a burst of inflation in 1996, reversing the previous downward trend. The strategy of forcing economic growth (7% in 1995) against the backdrop of insufficient restructuring led to ballooning inventories and hidden deficits, accumulation of bad credits and, eventually, the collapse of the second largest bank (Bancorex) and near-collapse of others, at a cost for the public budget of about 2.5% of GDP. It was a typical case of a bubble generated by public policies aimed at accelerating growth by injecting resources into an unrestructured system.

Utilities have become providers of soft credit, like the state banks 6-7 years ago. This creates a major threat

After 1997, no massive monetization of deficits has taken place. In addition, foreign lenders became more prudent in the aftermath of the financial crises in Asia and Russia. As a result, the strains in the Romanian economy show up in rising domestic arrears – i.e., quasi-fiscal deficits; the latter will severely affect the budget unless financial discipline improves dramatically in the coming period. Unlike in 1995-96, the current economic recovery is threatened by growing arrears and by the budget deficit getting out of control should large quasi-fiscal deficits turn into budget deficits. In the short run, this threat can be mitigated through external borrowing by utilities with state guarantees (Termoelectrica has just done that) and declining interests rates, which save on budget programmed expenditure. But on the medium term the capital account liberalization, scheduled for 2003-04, may lead to rising debt of unrestructured utilities and eventually to an additional burden on the state budget.

The dynamics of arrears presented in Fig. 1 supports the view that utilities, which are still in public hands, have taken over the role of soft creditors for the Romanian ailing companies. It is no coincidence that the share of arrears in GDP, most of it due to energy bills, has increased dramatically after 1997 as formerly state owned banks were being privatized. We have warned about this vicious development in previous EWRs.[1]

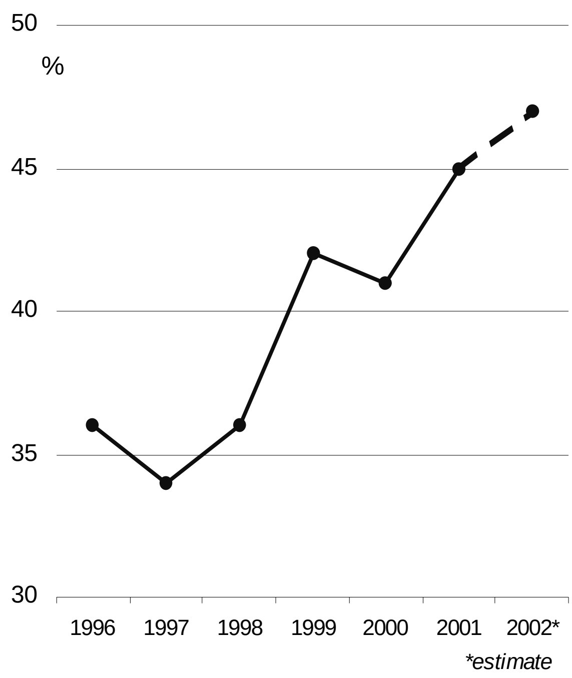
[1] The sustainability of growth initiated in 2001 is discussed at length in EWRs no. 4/2001, 5/2001, 2/2002, 4/2002, 5/2002. The issue of arrears is analyzed in the 2001 Annual EWR. All the reports are available from www.undp.ro or www.sar.org.ro

Being deprived of access to funds from financial sources, many companies have begun to regard non-payment of energy as a handy exit. They fall largely into two categories:

- Big and unrestructured state owned firms; they are unresponsive to market signals anyway, and the authorities fear that bankruptcy accompanied by massive lay-offs would trigger social problems.
- Private (or privatized) companies with strong political connections, able to extract preferential treatment from their state-owned energy suppliers.

Unfortunately, the government has sent conflicting signals by admitting in public statements that arrears are a serious problem, but rushing in many cases to block decisive action whenever energy companies tried to disconnect bad debtors. As a result, industrial companies that have piled up enormous bill arrears have only to be patient and never lose confidence that the government will, eventually, come to their rescue. In 2002 the government has issued numerous decrees and norms to reschedule their debts over various periods and/or prevent utilities from cutting supply. For instance, an April ordinance can now be implemented after its application norms were published at the end of July. This ordinance 59 allows utilities to write off debtors' penalties and reschedule their debts if they pay their current bills on time. On request from the debtors, including state and private companies, their unpaid bills of 2000 and 2001 will be rescheduled in the form of monthly installments. Their debt-related fines and penalties will either be remitted or postponed until after the last installment of the rescheduled debt. While there may be some truth to that, the problem here is the incentive that the ordinance creates for other consumers. Many companies that have paid their bills on time think that these favors to debtors are unfair, since they can be seen as hidden subsidies for underperformance.

Fig. 1. Aggregate arrears evolution, % GDP



Moreover, these measures only reinforce the view that all the trouble generated by the April gas and power cutoffs and the ensuing reschedule agreements that utility companies reached with their debtors were just an attempt to please the IMF, since new agreements have now to be concluded between utilities and debtors. And even those might be again negotiated when the application norms are published for another ordinance issued in June, which provides for an up to ten-year reschedule of the penalties. On top of everything, the law 137 for stepping up privatization prohibits utilities from halting supply to companies preparing for privatization. These companies are under special administration, but this doesn't really mean that they will be privatized any time soon. Since most state companies are supposed to be privatized sooner or later, they may feel entitled to a similar treatment – and thus have one more reason to halt payments. Under these circumstances, there is hardly any chance for utilities to improve their bill collection.

Utilities are even less prepared than the banks were in 1994-96 to deal with credit issues and market risks

Being slated for privatization may thus become another means for buying time indefinitely by loss-making firms. In order to be effective, the process should not be open-ended, but follow strict milestones and deadlines. The discipline in wage policy has also been poor all across the public sector, but especially in unprivatized monopolies and the heavy industry, which threatened periodically the agreements with the IMF. Tellingly, in Romania average wages are substantially higher in the public sector than in the private one. And the energy sector loses money not only through high operating costs or questionable deals with its clients, but in similar deals with its suppliers as well. The Iaşi police and the media have just uncovered an extended network of firms, built around the import of liquid fuels for Termoelectrica, the national power generator, which seem to use inside connections in order monopolize the supply at above-market prices. The experience with Sidex, the large steel plant sold last year to a multinational, shows that only a strong private owner can terminate such suspicious arrangements, which are hard to avoid as long as firms are administered by state-appointed managers.

All these are serious problems. The latest series of ordinances transform Romanian utilities into de-facto lenders to commercial firms – but they are even less prepared than banks were (during the '90s) to deal with credit issues and to manage market risks. State managers are hardly able to withstand the pressure to raise salaries without consistent government support, since labor in the heavy industry is highly unionized. If the top officials do not step in and promote good corporate behavior in this monopolistic sector, nobody else will. Payment discipline will deteriorate further, encouraged by the lack of consequences of non-payment and overstaffing, and utilities will continue to incur losses in various forms – until the whole arrangement will collapse.

In fact, the decision-makers should assume responsibility for reforms in large, monopolistic sectors even before strategic investors arrive. Using soft commercial credit from utilities, irrespective of circumstances, as a life-support system for industrial companies will not make them more competitive, nor will it determine the managers to improve efficiency. Every month that passes pushes the arrears upwards, aggravating the situation of these utilities and, ultimately, of the state budget, unless economic "bonanzas" happen. The price of dragging the feet now will be paid by the public later, in many ways: lower privatization receipts when the energy sector is eventually privatized, heavier investments burden on the new owners, higher shocks to the public from necessary price adjustments. The government is now in the best position to manage efficiently the relationship between consumers and utilities, while the latter are still in its hands. It would be quite unrealistic to expect that future private owners will be able to deal better with the fundamentally political problem of reforming – or disconnecting – large and inefficient industrial plants.

Determined action should be taken sooner rather than later. The challenge posed by the current situation should not be underestimated, and it makes no sense to postpone tough decisions. Almost halfway into its mandate, the current cabinet should not let reality disprove Romania's improving image abroad. Financial institutions, foreign partners and donors, and independent analysts have understood and praised the successes achieved so far: a better and more stable financial sector, lower inflation, economic recovery. But, at the same time, they have outlined lingering weaknesses of the Romanian economy, having to do primarily with unclear and inconsistent economic policies.

The bottom line is that while the macro aggregates look good for the moment, some of their micro fundamentals are questionable. With heroic efforts Romania avoided a major crisis and external default in 1999, but at a high cost for the taxpayer. At same time, the former ruling coalition had to pay a political price for taking painful measures to deal with the tensions that had accumulated for years in the Romanian economy.

Pinch the bubble before it bursts

At present, pressure is again building up. The current government should learn from past mistakes and be aware of the threat posed to the current economic recovery by rising arrears and the worsening balance sheet of public utilities. Unlike in 1997, the aggregate figures now look reasonably good and the unemployment rate is in single digits (actually, half of that in Poland, Bulgaria or Slovakia). This is a good time to impose financial discipline at the firm's level. The growth bubble must be pinched before it bursts.

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PRIVATISATION WATCHOUTS

by Daniel Dăianu

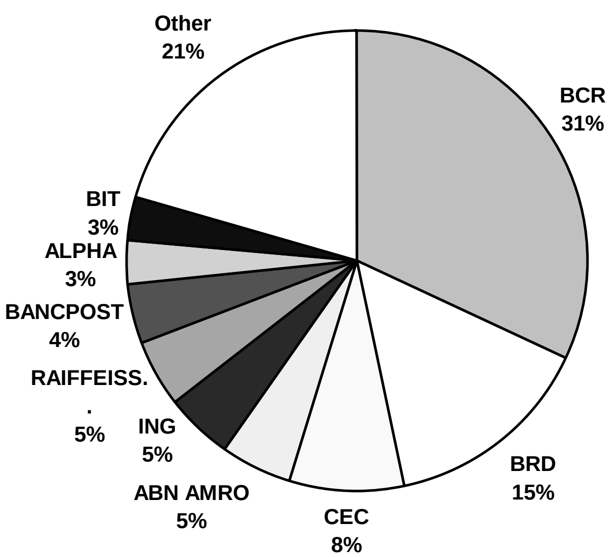
FOCUS

The Government intends to privatize Banca Comercială Română (BCR) and Petrom, which are among the most attractive state-owned companies in Romania and, probably, in South East Europe. There is a time schedule to this end and an advisor was chosen (Daiwa Sec.) in the case of BCR. But these two planned operations are remarkably complex endeavors, which will have wide repercussions and involve highly complicated policy issues.

1. THE COMMERCIAL BANK OF ROMANIA (BCR)

The privatization of BCR needs to be judged from several perspectives: the role played by BCR in the Romanian banking system; the expected outcome in terms of the sector-wide quality of corporate governance; the timing of this operation in relation with the program of capital account liberalization; and last, but not least, the central bank's ability to contain adverse shocks by cooperating with domestic commercial banks. The price factor has not been mentioned above, although this is by no means a trivial aspect.

Fig. 2. BCR's share of Romanian banking assets



a. BCR is a "market maker".

The sheer size of its assets and attracted deposits – almost 1/3 of the whole banking system (Fig. 2) – speaks for itself. BCR has a significant market power, which is backed by the private information it has about its corporate clients. Market power can easily translate into monopoly behavior and harm competition in the banking industry. But this size-related status can also be a source for weakness when lending is done inappropriately and the bank is captive to some of its big clients, or becomes subject to government pressure to lend to inefficient companies.

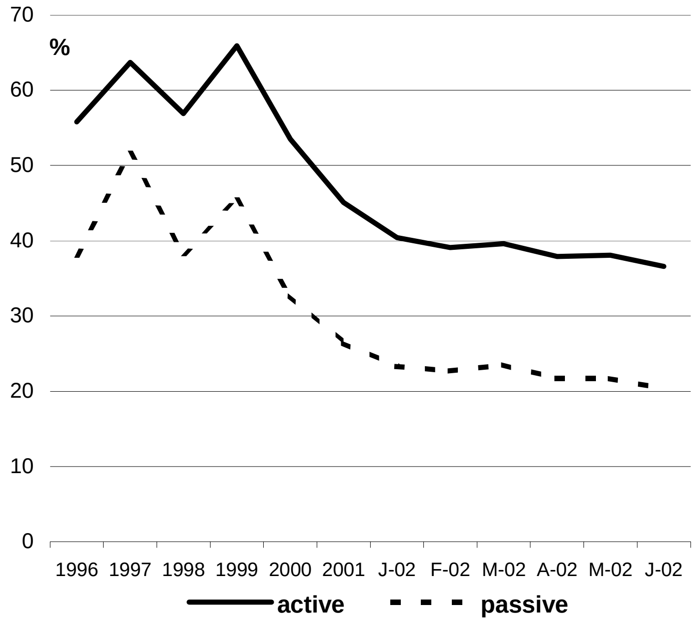
BCR's market power can be used more or less positively. Consequently, were it to happen, privatization needs to consider carefully the proper context for preventing BCR's market power from being turned into a threatening monopoly. In Hungary, the privatization of the largest commercial bank was preceded by its split; in Poland, there was no rush in privatizing the largest commercial bank. In both countries the issue of market power and competition policy was taken carefully into account.

b. Corporate governance

BCR privatization should foster competition and efficiency in the domestic financial sector

Privatization is, allegedly, seen as a means to improve corporate governance and raise the efficiency of BCR's operations as well as its profits. At the same time, it should bring about badly needed modernization and improvement of its banking services. The expected positive effects of privatization would help defend BCR's market share. Currently, BCR is feeling the heat of a growing competition in retail banking following the takeover of Banca Agricola by Raiffeisen and the decision made by Citibank to develop its retail services simultaneously with the strides forward made by Banca Romana pentru Dezvoltare (BRD-SG), ING and ABN-AMRO. Other banks are also stepping up their efforts to improve the services that they offer to corporate and individual clients. Undoubtedly, for BCR, modernization involves a lot of investment and a corresponding shift in the use of its profits (which have gone prevailingly to the state budget until now).

Fig. 3. Active and passive interest rates, non-banking clients



The improvement of corporate governance should be judged against the background of BCR's attempt to become a "financial supermarket", with an increasing array of financial services. But these transactions are risky at a time of rapid financial innovation in the world and opening of Romanian financial markets. Like other Romanian banks BCR is under immense pressure to improve its risk management expertise, in general, and privatization could help achieve it to the extent that the new investor(s) undertake the necessary steps to this end.

A question can be posed: can corporate governance be improved only via a strategic investor, namely a big outside player? Not necessarily, if the new shareholders do not have the required financial muscle and management skills. As data indicate efficiency remains low in the Romanian banking sector, and there are large spreads between active and passive rates (Fig. 3). The issue of BCR's privatization should not preclude the current management team from improving the Bank's corporate governance and further its modernization. To this end the management team needs to be totally dedicated to modernization and push aside deleterious political strings.

c. Industrial policy

Privatization would clearly cut the link between the BCR and the Government's attempts to come to the rescue of inefficient firms. And, in all likelihood, this is a basic reason why the IMF is adamant about BCR's privatization, as a means to improve financial discipline in an economy which continues to be plagued by large arrears (financial indiscipline). Wherever state-owned banks do exist in highly performing economies (Germany and Austria in Europe; Singapore, or Taiwan in Asia) financial discipline is a fundamental rule of the game; and preferential credits are well targeted in order to enhance the development of certain sectors. The privatization of BCR would force the Romanian government to redeem its tools of industrial policy, were it to have such a policy.

d. The liberalization of the capital account (LCA)

The Romanian government committed itself to basically open the capital account by 2004, well ahead of the likely moment of accession to the European Union. Such an early move would supposedly inject more rigor into macroeconomic policy and foster better resource allocation in an economy which is starving for additional investment resources. But as worldwide experience shows, LCA is extremely risky unless the country has previously closed the institutional gap with the advanced economies and is able to sustain an effective monetary and fiscal policy. For Romania this challenge is highly relevant, since EU accession is not going to happen soon and early euro-isation is not contemplated by the Government as a realistic option – a view to which the author of this report subscribes.

The timing of privatization and capital account liberalization should be reassessed

BCR's privatization would seemingly fit into the pattern of market-oriented reforms and would hopefully put the banking system on an even sounder basis following the cleaning up of the sector in recent years. This would be the rosy scenario. There is, nonetheless, a less bright scenario, which should not be dismissed lightly. This scenario would also consider the untested new regulatory and prudential framework of the financial (banking) system, the still high inflation (at double digit rates), the insufficient financial discipline in the Romanian economy, etc. If powerful adverse shocks occur, it is not clear how the banking industry would cope with the pressure. Foreign ownership of banks can bring about major benefits in terms of competition and better corporate governance. But this is not a miraculous device, in itself, for the overall functioning of the economy. And it may even increase the difficulties of dealing with major capital flow reversals. As Alexander Lamfalussy, an *eminence grise* of the financial world put it: "All in all, the greater integration of an emerging market country into global markets, through current transactions, long term capital flows, and foreign direct investment, the less efficient becomes the control mechanism on short term capital inflows or outflows"[2].

As a matter of fact, the key issue for the Romanian financial and banking system is testing the new regulatory and prudential supervision framework (after the sequence of bank collapses and financial scams of the 90s). Arguably, this challenge is more important than undertaking the privatization of BCR irrespective of circumstances – unless one sees this privatization as a *sine qua non* measure for reaching the stated prime objective of creating a sound, well functioning financial system.

[2] Alexander Lamfalussy, "Financial Crises in Emerging Markets", New Have, Yale University Press, 2000, p.132

e. The Central bank's policy dialogue with commercial banks

Balance must be kept in the banking sector between domestic and foreign capital

The remarks made above introduce a big caveat in believing that foreign ownership of banks improves, *ipso facto*, the policy dialogue between the central bank and commercial banks. When privatization and the operation of highly reputed external players improve the local environment dramatically, there is a strong assumption that policy communication and coordination improves as well. But one has to think about a possible downside as well. As the crises in Latin America show, foreign banks, when scared by local circumstances, would rather adopt a damage control stance and try to get out of the "mess". This would complicate an already precarious situation and accentuate self-fulfilling prophecies. Therefore, it does make sense to maintain a balance between local and foreign capital in the banking industry.

The bottom line is: good governance needs to be buttressed by sound macroeconomic policy, financial discipline, and a solid stake by all local players (whether owned by local, or foreign capital) in the well being of the local economy.

Recommendation

BCR's privatization should be examined thoroughly in the context of the need to foster competition and avoid creating a powerful private monopoly. Likewise, local capital needs to stay involved in the Romanian banking sector, which has implications for the venue chosen for BCR's privatization. More specifically, it would be wise to have a significant portion of the Romanian banking sector financed with Romanian residents' capital, with the role of "sand in the wheels of capital mobility". This also implies not rushing with the full opening of the capital account until proper macroeconomic and institutional conditions exist.

2. PETROM

The new major shareholder of Petrom should be a strategic investor with a stake in the Constanța-Trieste oil pipeline project

Petrom, Romania's largest industrial company is also slated for privatization. It recently contracted an EBRD loan of US$150 million, whose purpose is to help the company improve its operations and prepare the ground for privatization. Petrom is a profitable company, though it could be more profit-oriented by rationalizing some of its loss-making operations.

This analysis does not aim at getting into the technicalities of such a complex process. There are nonetheless a series of aspects which merit to be underlined when considering the privatization of Petrom. First and foremost is the nature of oil – a very strategic commodity, which is at the epicenter of world geopolitics. The Caspian Sea is increasing its profile in the landscape of major world oil basins, at a time of increasing uncertainties in international relations and a rising tide of non-conventional threats. Moreover, Romania's location can be an advantage in the context of a reconfiguration of oil and gas routes in the region.

Since Petrom holds such a strategic importance for the Romanian economy its privatization should not be divorced from the way in which Romania defines its strategic economic (and not only) interests. For quite a while Romania has been advocating the construction of an oil pipeline, which should transport Caspian oil on the route Constantza-Trieste. Following the political developments in Belgrade, this project has become much more appealing, and a very recent tri-partite deal between Romania, FRY and Croatia (signed on September 10) opens the way for its implementation. But much hinges on the interests of the big players in the oil market and the plans of the major oil companies. The Constantza-Trieste oil pipeline is a very costly project and its relevance depends on routes to be defined for the whole Caspian and the Black Sea regions. Under these circumstances it does make sense to consider a linkage between Petrom's privatization and the interest of one of the major oil companies in helping build the Constantza-Trieste pipeline. It may be that the likely invitation for Romania and Bulgaria to join NATO would increase the chances for this project to take off.

3. THE PRIVATISATION OF PUBLIC UTILITIES

Low payment discipline decreases the interests of the prospective investors

The previous article in this Report stresses that the delay in imposing financial discipline in the economy worsens the conditions for an advantageous privatization of public utilities – when this is seen as a means to increase their efficiency. Thus, there is a real danger that would-be investors would be primarily interested in concluding agreements which guarantee remunerative prices (to cover costs and secure a certain profit rate), instead of undertaking the necessary investments. There is some relevant experience worldwide which substantiates such a fear. An earlier EW Report highlighted this possible unfortunate outcome in the field of energy production and distribution, unless privatization contracts are properly negotiated[3] – so that both consumers and investors be protected.

The precarious state of Romanian energy producers should be a stark reminder of the need to pay utmost attention to how privatization is done. At the same time, the Government should spare no efforts in dealing forcefully with the worst debtors. Unless financial discipline improves dramatically, the economic stability of the country is jeopardized over the medium term (with quasi-fiscal deficits turning into fiscal deficits), while the propensity of foreign investors to engage themselves on the Romanian market will decline. At the end of the day Romanian consumers would see their lot much deteriorated. There is a vicious circle here, since investments may be needed in order to reduce costs and help, thereby, raise the capacity to pay back debts. This is why the time factor is of major significance, and there is a need for timely action.

[3] With examples from Argentina and Hungary

EXAMINING SOME MACROECONOMIC DATA FOR THE FIRST HALF OF 2002

FOCUS

INDUSTRIAL PRODUCTION

GDP grew in the first half of the 2002 with 4.4% as against the same period of 2001. Agriculture contributed significantly to this growth (+11.4%), but the focus of our material is on the evolution of industrial production, productivity, and external sector. In the first semester 2002, the Romanian economy has continued the upward trend it embarked on two years ago. Industrial production (adjusted for the number of working days) increased by 4.3% compared to the first semester 2001, due to the 5.7% increase of manufacturing. However, not all sectors recorded such growth – in 12 out of 21 manufacturing sectors production has actually decreased; textiles, wood industry and furniture, chemical industry, construction materials, electric machinery and equipment were among the underperformers. Best performers in terms of output growth were metallurgy (+28%), food and beverages (+15.9%) and road transportation means (+8.6%). The level of stocks in these three sectors is below the manufacturing industry average, and it is decreasing either in nominal terms (metallurgy), or in real terms (the latter two sectors).

Fig. 4. Evolution of productivity and wages, June 2002 compared to June 2001

	Labor productivity W*	Real wages Sr**	Index W / Sr
Total industry	12.1%	4.5%	1.073
Manufacturing	12.7%	3.2%	1.092
- food industry	7.7%	6.2%	1.008
- ready-made clothes	11.1%	-7.6%	1.202
- footwear	- 4.4%	0.2%	0.953
- metallurgy	34.5%	6.6%	1.261
- mechanical machines and equipment	-1.4%	4.5%	0.943
- electrical machines and equipment	3.8%	-8.7%	1.136
- road transportation means	23.6%	0.2%	1.233
- furniture industry	21.3%	6.3%	1.140
Energy	-2.7%	3.2%	0.943

* W = P/N, where P is the value of production (in US$) and N is the number of employees
** Deducted from nominal wages, using the June/June inflation rate of 24%.

Productivity increased in almost all manufacturing sectors (in Fig. 4, comparison is made against June 2001; if we make this comparison against December 2001, then significant productivity gains appear also in mechanical machines and equipment and in footwear). Productivity grew on average by 12.7%, most impressive gains being recorded in metallurgy (34.5% vs. June 2001 and 81.7% against December 2001) and road transportation means (23.6% vs. June 2001 and 46.3% vs. December 2001). Part of these gains are nevertheless due to lay-offs (the number of employees decreased with 10% in metallurgy, 9% in machines and equipment and 1% in road transportation means), but on the manufacturing average, the decrease in the number of employees was irrelevant (0.3%).

It should be noted that these best performing sectors – metallurgy, road transportation means, and food and beverages – are dominated by foreign capital. Metallurgy is the last comer in this category, following the privatization of SIDEX. One can submit the hypothesis that FDI spillovers in these sectors represent a major determinant of the above average productivity growth – although such an assertion needs to be supported at a deeper level of sector data disaggregation.

THE INCREASE IN REAL WAGES WAS KEPT BELOW THE INCREASE IN PRODUCTIVITY, WHICH HAS CONTRIBUTED TO DISINFLATION.

The main outlier from the trends mentioned is the energy sector (including electric and thermal energy, gas and water). Indeed, by the end of the first semester 2002, compared to the same period of 2001, labor productivity decreased by 2.7%, nominal wages increased by 27.2%, and producer prices surged by 56.8%. This shows that simply increasing energy consumer prices does not represent an effective restructuring/reform strategy.

Productivity gains, outmatching real wages' increase in a number of foreign capital dominated sectors, have been one of the growth engines this year.

a. Foreign trade

Another engine of growth seems to be the expansion of foreign trade, although it was less impressive than in the last couple of years. In the first semester of 2002, as against the first semester 2001, total exports increased by 9.1% (6.7% with EU) whereas total imports rose by 3.1% (3.6% with EU). Arguably, this outcome was influenced by the Euro's appreciation (against the US$) at a time when exports to the EU area make up more than 65% of the total. The coverage ratio has slightly improved on average (77.9%, as against 73.2% in 2001 and 79.4% in 2000) and with EU (90.7%, as against 86.5% in 2001 and 89.5% in 2000), but has decreased with CEFTA-5 (42.9%, as against 44.2% in 2001 and 52.0% in 2000) and with SEE-7 (136.1%, as against 149.6% in 2001 and 252.9% in 2000).

However, no major trend changes have occurred in either the structure or the performance of foreign trade, except maybe for the rise in exports of mineral products towards EU (this group accounts now for 5.6% of exports, compared to 2.4% last year). The machines and equipment group has made further progress in reducing the comparative disadvantage, which may indicate that increasingly more production stages are undertaken by local firms. As predicted in the 2001 Annual EWR and in EWR 3/2002, trade with agricultural products worsened (on all groups from I to IV), as a consequence of further liberalization with EU on these products.

b. External sector

The trade deficit has decreased, in accordance with the overall improved exports' performance over imports, contributing to reducing the current account deficit. Foreign remittances remain decisive in financing the trade deficit; moreover, they increased by 45% in the first six months, and continue to represent, for the third year in a row, the main private foreign capital inflow in the Romanian economy.

Arguably, the most striking change in the balance of payments is the big rise in capital outflows: outflows from the incomes balance have increased by 51%, portfolio outflows have more than doubled (US$411 million in the first semester 2002), and the same is valid for residents' deposits abroad. Only from these three balance of payments' items, capital outflows in the first semester 2002 exceeded those in the first semester 2001 by more than half a billion dollars. The explanation may lie with the process of capital account liberalization, which encouraged capital outflows. In the same line of reasoning, net errors and omissions hit a record low level (five months data showed even negative errors and omissions), unregistered capital outflows almost matching unregistered capital inflows for the first time. For the time being, the access to international capital markets compensates for these outflows, as foreign debt increased by US$1.3 billion in the first six months of 2002.

Fig. 5. Selected items of the balance of payments, net positions, US$ million

	1st sem. 2001	**1st sem. 2002**
Current account, of which:	-1306	-909
- goods and services of which tourism	- 1588 - 63	- 1288 - 28
- incomes (from direct, portfolio, and capital investments)	- 227	- 343
- foreign remittances	419	609
Capital account, of which:	834	847
- foreign direct investments	436	480
- portfolio investments	735	289
- residents' deposits abroad	135	326
Errors and omissions	472	62

CONCLUSION

In the first semester of 2002 growth has been driven by productivity gains in manufacturing, mainly in some foreign dominated sectors, and by the expansion of foreign trade. The positive developments in the Romanian economy (e.g. the successful taming of inflation, the further build up of foreign reserves, the cheaper access to international capital markets, and the good relationship with the international financial institutions) should not obscure the less bright side of the story. For instance, unless utilities undergo deep restructuring, the energy sector will continue to plague the economy (low productivity, high real wages) and is likely to stifle its growth.

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