ECONOMY

POLICY CHALLENGES IN 2004

Focus

What can one expect in 2004, in view of the specific conditions entailed by an election year, while the Government aims to conclude as many of the remaining chapters of negotiations with the EU as possible and get the status of a "functioning market economy" as an unambiguous statement? This section explores a series of economic policy issues for 2004, with particular focus on the macroeconomic agenda[9]. The challenges posed by the chapter negotiations with the EU – particularly the energy and agriculture dossiers – are not addressed here as they will be subjects of future reports by SAR.

1. THE OVERALL PICTURE

Romania has finished 2003 with a positive, but not unblemished macroeconomic record. Growth has been probably around 4.7%, inflation has come down to 14.1% (Dec on Dec), the budget execution has ended, apparently, with a deficit of 2.3% of GDP (less than the programmed one of 2.6%), and the reserves of the Central Bank have grown marginally to just below 8 billion euro (Fig. 1). Inward foreign direct investment also has risen to over 1 billion euro, though not in a spectacular fashion. These results were accompanied by upgrades made by the main rating agencies, albeit Romania is still several notches below an investment grade. What has spoiled the picture somewhat has been the big surge of the current account deficit, which is estimated to have reached about 6.5% of GDP (which is cca. 3% more than in the previous year). In addition, tensions related to an insufficient restructuring of the hard core of industry have continued to be felt and may have contributed to the rise of the trade deficit. An illustration of these tensions is the persistence of large arrears in the economy.

[9] Important economic policy challenges, including issues linked with the privatization of BCR (the Romanian Commercial Bank) and Petrom (the oil state-owned company), were examined in previous reports. See also our prognosis for this year in the first section of this report.

Fig. 1. Macroeconomic indicators

	2000	2001	2002	2003*	2004**
Real GDP, % change	2.1	5.7	4.9	4.7	4.8
Inflation (CPI), end Dec	40.7	30.3	17.8	14.1	10
Budget deficit	-3.5	-3.3	-2.7	-2.3	-2.3
Current account deficit	-5.7	-5.6	-3.6	-6.5	-6
Total ext. debt,					
% GDP		31	32	32	34
% of exports		81	85	85	

*Source: National statistics and own estimates *estimates, **forecasts*

Arguably, the economic year 2004 is important per se, but also for the direction the Romanian economy takes afterwards. This is so since disinflation is getting into a critical stage, whose further advance hinges essentially on fiscal and financial discipline; while the latter depend considerably on the restructuring of several key industrial sectors (such as energy generation and distribution).

2. WHY HAS THE CURRENT ACCOUNT DEFICIT GONE UP SO MUCH?

There seems to be a safety ceiling for CA deficit around 7% in Romania, due to low level of FDI; when this is reached, painful adjustments become unavoidable

For those who have watched closely the dynamic of the trade deficit during the first half of 2003 its substantial increase should have been ominous. The summer time hopes that the deficit would moderate its rise were not vindicated, with big increases seen during the last quarter of the year. It is fair to say that, while the rise in the deficit is quite considerable (from 3.6% in 2002 to, probably, 6.5% of GDP in 2003), this evolution needs to be judged over a longer period of time. As a matter of fact, an average size of the current account deficit would be around 5% of GDP during the period 2000-2003. An inference would be that both 2002 and 2003 appear as opposite outliers. At the same time it is important to notice that, because of the insufficient level of inward foreign direct investment, a threshold limit for the safe financing of the current account deficit –- in the case of the Romanian economy – appears to be around 7% of GDP. Whenever the deficit moved in the vicinity of that level its financing became pretty difficult and painful adjustment of the balance of payments were asked for. This situation is amply illustrated by the last decade.

What were the driving factors behind the rise of the current account deficit in 2003? A macroeconomic explanation would be the engine of economic growth last year, which was internal demand (and not exports, as in previous years). Other causes are to be found in the financial indiscipline and inefficiency of many actors (for arrears allow firms to import while not paying domestic creditors), heavy dependency of exports on imports of intermediate goods, the worsening terms of trade for the Romanian economy (oil has been more expensive), the severe drought which entailed additional imports of grains and other foodstuffs[10], the low ability to produce competitive products, the real exchange rate appreciation of the domestic currency (and the euro's appreciation vs. the USD, which made imports from the US dollar zone extremely attractive), and last, but not least, the lowering of the general subsidy given to exporters since 2000[11]. Consumer credit, too, has made a contribution to this rise.

How should the stunning rise of consumer credit be judged in this context in view of the late public controversies in this regard? Commercial banks are justified in their wish to extend consumer credit as this product can generate handsome profits. Consumers, too, are happy to be able to buy on the basis of expected future earnings. Likewise, it is noticeable that consumer credit represents only about 20% of all non-governmental credit (about 2.4% of GDP), which would suggest that it is not the principal factor behind the ballooning trade deficit. That said, however, the speed of the rise of consumer credit has been stunning (by about 300% in one year), even if one considers the very low level from which it started and a simple fact, that only recently consumer credit has become available, as a mass financial product, to consumers. Therefore, some banks, which may have weaker internal prudential regulations, might face difficulties in the period to come, which can affect the banking system as a whole. Another worry is the one mentioned above, that the current account deficit is approaching a threshold level, which can question a sensible economic policy. Unless FDI finances the deficit to a larger extent[12] and the inflows of portfolio capital are less speculative, a deficit which goes beyond 6.5% of GDP would undermine policy credibility and pave the way for unpleasant surprises. This would be quite ironic in view of the series of upgrades Romania got from the main rating agencies lately.

3. POLICY TARGETS AND TRADE-OFFS IN 2004

The assumed (some of them revised) main policy targets of the Government for 2004 are:

- bringing inflation down to a one digit level, to 9%;
- a 5.5% growth rate of GDP;
- a reduction of the current account deficit to 5.8% of GDP – albeit this figure is still being discussed with IMF experts.

[10] The trade deficit for foodstuffs is likely to have exceeded 1 billion euro in 2003, which is about 60% higher than in 2002.

[11] This subsidy (a 5% profit tax for export oriented production, instead of the general one of 25%) was granted in 2000; subsequent commitments with the EU and the IMF have involved a gradual phasing out of this subsidy, which is to be terminated this year.

[12] The sales of large state-owned assets (such as BCR and PETROM) should not be seen as a means to finance the current account deficit. In general, it would be a mistake to use privatization revenues for consumption purposes unless terrible adverse shocks hit the country. These revenues should instead fund the production of public goods (including the reform of the pensions system)

The possibility to meet these targets has to be related to the pressures of an election year, the rise in the current account deficit, and structural constraints. Among the latter prominent are quasi-fiscal deficits, which can burden the budget exceedingly unless they are dealt with in due course. On the other hand, the aim of concluding negotiations with the EU would provide a good policy anchor.

There are two outstanding features regarding the policy targets. One is the highly ambitious disinflation rate (from 14.1% to 9%); the second is a looming conflict between the economic growth target and the need to control the current account deficit.

3.1. Achieving a single digit inflation level

The challenge of bringing down inflation at a one digit level should be examined in the context of an insufficient restructuring of the economy and the persistence of arrears. Previous PWR analyses have outlined this relationship, but the topic is so important that a reminder here is necessary. Hard budget constraints do not operate ubiquitously and loss making companies produce sizeable arrears/ quasi-fiscal deficits[13]. High inflation has been used by many companies as a means to stabilize arrears in real terms and, thereby, survive. Total arrears in the economy were about 38% of GDP at the end of 2002 (larger than in 2001 – Fig. 2). Reliable data are not yet available for 2003, but progress appears to be scanty. Interestingly, the share of the private sector has increased in total arrears, which is highly indicative of the intensity of moral hazard in the economy. Current disinflation strains increasingly loss-making firms and, unless restructuring makes considerable headway, persistent large quasi-fiscal-deficits would clobber the budget and, further, the economy in the period to come.[14] Disinflation would stalemate at one point in time unless hard budget constraints operate unabatedly.

Fig. 2. Arrears of payment

	1998	1999	2000	2001	2002
National economy	35.61	40.36	40.48	35.76	38.29
To suppliers	14.99	17.23	17.78	16.55	17.20
To other creditors	6.68	9.05	10.31	9.88	11.94
To banks	5.97	6.16	3.89	3.57	2.34
To budget	7.96	7.93	8.57	5.75	6.81
Private sector	15.37	18.66	17.71	19.28	20.9

Source: World Bank data

[13] Especially in the energy sector, where losses seem to be cca. 2.% of GDP yearly. Arrears (losses) are also significant in the petrochemical industry.

[14] Moreover, the persistence of large quasi-fiscal deficits would question the suitability of moving fast with the liberalisation of the capital account and the adoption of inflation-targeting in the near future. Adding quasi-fiscal deficits to the official public budget deficits has its own flaws methodologically (as a means to illustrate an actual "consolidated" public deficit), but ignoring/underestimating them would be a serious mistake.

3.2. Growth and macroeconomic balance

We believe that the pace of disinflation this year (to an annual rate of 9 percent) and the economic growth objective of 5.5 percent are clashing against the backdrop of the big surge in the current account deficit. One can imagine a scenario according to which the growth target would be least impaired by trying to stick to this year's current account deficit – in the hope that larger inward FDI and portfolio inflows would make financing relatively easy. The desire to maintain the economic growth objective of 5.5% looks quite attractive in relation with expected pressures during an election year. But this policy mix would jeopardize the macroeconomic balance by betting on highly variable factors. Consequently, a more sensible policy would try to diminish the current account deficit to below 6% of GDP. As a matter of fact, diminishing the current account deficit seems to have become a priority and policy is being reshaped to this end: liquidity has been squeezed by the Central Bank (which has made interest rates higher for Rol-denominated borrowing recently) and measures to restrain the expansion of consumer credit were announced by the central bank, the budget deficit target is going to be cut, probably, to 2.3% (from the envisaged 3%), and there is the intention of clamping down on quasi-fiscal deficits. All these measures are aimed at restricting domestic aggregate demand.

The targets for growth and disinflation in 2004 clash with the goal to reduce the CA deficit

The bottom line is that bringing inflation down to a one digit level and reducing the current account deficit by a substantial margin (0.7-0.8% of GDP) would ask for containing domestic demand firmly, which, other conditions unchanged, would unavoidably bear on the GDP dynamic. Certainly, one needs to factor into all this picture the effects of the electoral year, which may cause policy slippages. There are premises for limiting collateral damage (coming out of populist measures) owing to the EU anchor (Romania wishes to conclude as many negotiating chapters as possible and get the status of a functioning market economy by the end of 2004). If policy slippages stay small a one digit inflation rate could be achieved together with a current account below 6% of GDP. Instead, a focus, primarily, on growth would harm the other goals. A policy mix which aims at optimizing under constraints would have to include a prudent liberalization of the capital account.

3.3. Prudence in the liberalization of the capital account. Why?

Romania's economy needs capacity (instruments) to adjust to various adverse shocks because: quasi-fiscal deficits are large; the current account deficit has widened sharply in 2003; economic competitiveness is low and exports have been flagging lately (there are insufficient export products of high added value; there is a weak policy to stimulate exportable output, or to replace imports); dependence on private transfers from abroad is quite high (they stand at over 1.5 billion Euro and finance 30% of Romania's trade deficit); direct foreign investment is insufficient.

Unless adjustment capacity is adequate the budgetary policy would be overburdened. Overburdening of the budget policy can be easily detected in EU member countries as well, but in Romania's case it would be more severe. Total liberalization of the capital account would complicate the conduct of monetary policy and the exchange rate policy of the National Bank, and it could subject the economy to major shocks.. This is why it is welcome to see that the NBR has backed down on some of the programmed measures for 2004. Prudent liberalization would also help preserve a necessary degree of autonomy of monetary policy.

3.4. The impact of *acquis* implementation

The elimination of state aid and remaining trade barriers in the process of EU accession will drive many companies out of business

The relationship between inflation, financial indiscipline and, ultimately, economic growth would fall increasingly under the impact of the effects of the *acquis* implementation. Competition policy and state aid, in accordance with the provisions of the *acquis*, would put tremendous pressure on inefficient companies. It is true that arrears do not relate to state budget only and that this could soften the pressures resulting from implementing EU provisions, but the change of regime would be quite radical. Additional pressures would be felt via the gradual elimination of trade barriers and the need to comply with the *acquis* regarding environmental protection. Without massive restructuring and productivity gains many companies would have to bow out. On one hand, this would reduce pressures on the balance of payments; on the other hand, it could strain the economy socially. To reduce this strain job creation needs to be intense and, therefore, economic growth has to be durable. But durability of economic growth relies on deeper restructuring and financial discipline, on more inward investment. This is why restructuring is so important, in 2004 and in the years to come (for the implementation of the *acquis* would have to be speeded up after 2004). Thence, too, comes the high profile of FDI, as a means to help restructure the economy and supplement domestic investment.

4. THE POLICY MIX FOR 2004

Monetary policy

Monetary policy has been tightened lately, for good reasons. The official euroization (dollarization) of the economy creates perverse effects to the extent people and companies raise their propensity to borrow in hard currency (when ROL-interest rates go up). If disinflation goes on successfully and there is sufficient fiscal support for it real interest rates would start coming down in a few months time. But much hinges on the Government not succumbing to populist pressures.

Exchange rate policy

A closer linkage between the Romanian leu and the euro is appropriate for the sake of disinflation. But ROL's real appreciation can be deceptive unless quasi-fiscal deficits are reduced, wage policy is prudent (despite the election year), and the budget deficit is under control.

Budget policy

Budget policy needs adjustments in several respects. The budget deficit target for 2004 (3%) would have be scaled down in order to control the current account deficit. This adjustment should not be terribly painful due to better revenue collection –signs of which have been visible in 2003. Moreover, a diminution of quasi-fiscal deficits would enhance the work of lower budget deficit.

Budget execution has to be better implemented and correlated with the NBR's policy of controlling liquidity. The situation of last year, when only 0.7% of the programmed budget deficit (for the whole year), was executed by the end of last November should be avoided. This state of affairs has, quite likely, put additional pressure on the current account deficit in the last quarter, and it may complicate budget policy planning and execution in 2004.

Cofinancing EU-funded projects will create additional budgetary strains

Budget planning should account for the need to co-finance projects for which EU funding is available. This endeavor would be particularly challenging at a time when the implementation of the *acquis* starts to "bite" (think, for instance, about the costs implied by environmental protection) while NATO accession is pretty demanding for the military budget. A warning for what lies ahead is the fact that budget revenues have declined in the last three years[15]. Better tax collection, together with an adequate absorption of EU funds are a must for budget policy in the years to come.

Restructuring policy

Restructuring at company and sector level is a must for reducing quasi-fiscal deficits. FDI would help in this regard, as well as the policy determination of authorities to impose harder budget constraints. Is it possible in an election year? This is a big question mark. There is some good news that segments of power distribution (gas, in particular) would get strategic investors this year; this is a field which demands massive investment for technological renewal and restructuring. On the other hand, failure to do it would undermine the quest to diminish quasi-fiscal deficits and, thereby, reduce the current account deficit in 2004.

Supply side measures are needed

The agreements with the World Trade Organization and the European Union have left the country more vulnerable in the absence of adequate productivity gains. Moreover, available tariff barriers are used unsatisfactorily (there are many under-invoiced goods which enter Romania and not a few foreign exporters are practicing unfair

[15] Romania's fiscal and non-fiscal revenues fluctuate around 30% of GDP (these are 35-40% in Central European and Baltic transition countries. The current medium term program of the Government forecasts a – somewhat surprising – tendency of stagnating or even declining budget revenues in the period 2004-2006

competition). Likewise, the protection of our markets via non-tariff means is quite inexistent. The enforcement of the *acquis* in the field of environmental protection and quality standards would entail additional costs on many Romanian enterprises.

Economic policy has to try to boost the competitiveness of domestic production, so that Romania exports goods of higher added value and domestic production substitute more imports. A policy designed to enhance domestic production does not entail fostering market competition only. Fiscal and financial instruments can be used. There is a need for financial instruments that would boost domestic saving and investment and, thereby, production. Giving up incentives for inward direct investments should, arguably, be delayed as much as possible (particularly, in the case of large investments). For Romania does not get into the EU in 2004 and one should use all available means to get the economy stronger before accession. The Commission in Brussels may disagree with such a policy stance, but realism and pragmatism have to imbue policy. The experience of some European and Asian countries is illuminating in this respect, while falling prey to economic fundamentalism would be harmful (fiscal neutrality in this case is a trap). Yet, it is essential that, by trying to boost domestic production, inefficiency and "rent-seeking" be not favored. Public-private partnerships should also be pursued in order to develop infrastructure and modernize the economy. PPPs could raise the investment ratio quite significantly and support economic catching up. Privatization in the energy sector should be accompanied by the implementation of an effective regulatory framework, which should protect both consumers and investors.

Supply side stimulants such as favourable regimes for FDI and agro-investments should be applied – and boldly negotiated with the EU Commission

Because commercial banks are highly reluctant to invest in the rural areas, while Romania has become, ironically, a large net importer of farm products and foodstuffs, special financial arrangements (financial entities) should be devised in order to finance farm production and the foodstuff industry, as well as modernize rural areas. More SAPARD funds could be used to this end. Again, the European experience, of younger or older vintage, should be used in this respected.

5. SUMMING UP

- 2004 will probably witness a trade-off between the growth target (5.5%) and the disinflation/current account deficit tandem goals.
- Sustained disinflation depends on reducing arrears/quasi-fiscal deficits. Inflation-targeting, itself, which the Central Bank intends to introduce in 2005, depends on the success in imposing hard budget constraints and achieving easy financing of external imbalances.
- The public budget deficit would better be scaled down (to 2.3% of GDP) for the sake of controlling the current account deficit. Diminishing quasi-fiscal deficits is essential for fiscal balance in the years to come (when Romania would have to bear additional costs entailed by the implementation of the Acquis). For this to

happen it is essential to restructure the energy sector and reduce the strain in the social security system.

- The costs of implementing the *acquis* could be overwhelming for not a few companies unless restructuring proceeds at a swifter pace.
- Rural development demands a much more coherent and financially consistent public policy; to this end there is need for specially created financial vehicles (which could use EU funds as well)
- Tighter pegging to the Euro and the real appreciation of the ROL would help disinflation, but it would ask for other effective means to reduce the current account deficit, unless inward foreign investment grows.
- Autonomy of monetary policy is needed for the sake of securing adjustment capacity to adverse external shocks. Therefore, liberalization of the capital account should be prudent.
- EU financial assistance (structural and cohesion funds) could make a big difference in supplementing budget revenues[16] and increasing the provision of essential public goods
- External negative circumstances for the conduct of our macroeconomic policy are, *inter alia*, increased foreign market volatility (competitive devaluations) and trade protectionism, which is on the rise in the world; a positive circumstance is the economic recovery under way in the main external markets for Romanian exports.

Fig. 3. Medium term budget framework

	2001	2002	2003*	2004**	2005**	2006**
total revenues	30.5	30.5	30.0	29.4	29.1	29.5
total expenditure	33.7	33.4	32.3	32.0	31.8	32.2

Source: National statistics **estimates, **forecasts*

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