II. ECONOMY

THE ELUSIVE 'FUNCTIONAL MARKET ECONOMY'

1. Economic criteria for joining the EU

Aspirant countries to EU accession are asked by the EU Commission in Brussels to comply with two fundamental requirements: to have a so-called "functioning market economy"; and to withstand competitive pressures inside the economic/monetary union. The first requirement – "the existence of a functioning market economy"[4] – connotes an institutional setup (the functioning of basic market institutions) which ensures effective financial discipline, easy market entry and exit, proper contract enforcement and protection of property rights, and an adequate policy mix framework, with mechanisms to deal with adverse shocks which are reasonably effective.

The second requirement refers to the reduction in scope for the national economic policy in a region with a common monetary policy. EU accession means joining a club where, among other things, intra-trade barriers will no longer exist, there is a single currency in 12 member countries, and, in a softer form, the Exchange Rate Mechanism (ERM2) constrains exchange rate policy in the other states significantly. Both requirements are seen as essential for enhancing nominal and real convergence, without which the Union would be undermined from within.

2. Why is it important for Romania to get the status of functioning market economy?

The transition countries to be admitted in 2004 were granted the status of "functioning market economy" a few years ago; Bulgaria received it in 2002. This upgrade of our southern neighbor's, and the debate on Turkey and other would-be accession countries, have raised the stakes for Romania in a race which becomes ever more challenging in view of the economic and geopolitical circumstances which accompany enlargement. Being left behind in a race which has its own symbols (specific criteria, diplomatic language and cryptic qualifiers, not always transparent to outsiders – such as that of functionality in the "functioning

[4] A "functioning market economy" is quite curious terminologically; this notion cannot be found in economic textbooks, since all market economies are functioning, whether well or poorly. What the experts in Brussels have, most likely, in mind is a "well functioning market economy", which relies on a sound institutional setup and low information and transaction costs.

market economy") can harm one country's credentials. As a result, it is easy to understand that in Romania this issue has a lot of political capital attached to it. On the other hand, rushing to join the Union at any cost can be self-defeating. The laws of economics cannot be bent beyond certain limits without threatening the very ultimate goal (accession).

Nevertheless, if the next wave of enlargement does not proceed smoothly, Romania would have to show increasingly better results in order to justify her quest to join the EU, as the inner political and economic dynamics in the Union make another round of enlargement unlikely any time soon.

3. Where does Romania stand?

Do basic market institutions exist and do free prices play their role in allocating resources in Romania? By and large, they do. In a broad sense, Romania already has a "functioning market economy" and her performance has improved substantially in recent years. Significant problems remain to be tackled such as the poor financial discipline, weak enforcement of market regulations, low transparency and stability of the regulatory framework, the inefficient public administration and judiciary. Nonetheless, some progress has been made on all these dimensions in recent years. Moreover, since some leading EU economies have a hard time in meeting the Maastricht criteria, the question could be raised if is it sensible to be over-strict with accession countries.

Romania has inherited huge structural problems, and as a result faces a number of dilemmas and constraints in reforming its economy. They appear as a series of trade-offs:

- low budget deficits which should help disinflation while there is need for public financing of badly needed large infrastructure projects;
- manageable current account deficits and further disinflation (plus exchange rate appreciation), against the backdrop of minimal trade protection, which could overwhelmingly put the burden of adjustment, primarily, on budget policy;
- productivity growth and subdued short-term welfare gains (wages grow slower than productivity in order to retain the labour costs-driven competitive advantage) while prices grow anyway (because they were initially below world levels).
- free movement of capital flows and interest rates cuts, which may strain the balance of payments while capital account liberalisation proceeds further;
- the current type of competitiveness (based on wage differential) vs. the innovation-driven type of economies, to which Romania is trying to converge (Romania's spending on research and development is seven times lower than the Lisbon target of 3% of GDP).

Romania alredy has a market economy, though burdened with many inherited distortions

It should be stressed, nonetheless, that some of these policy dilemmas and resulted trade-offs do not concern Romania only; other candidate countries, which are to join the Union in 2004, need also make painful decisions.

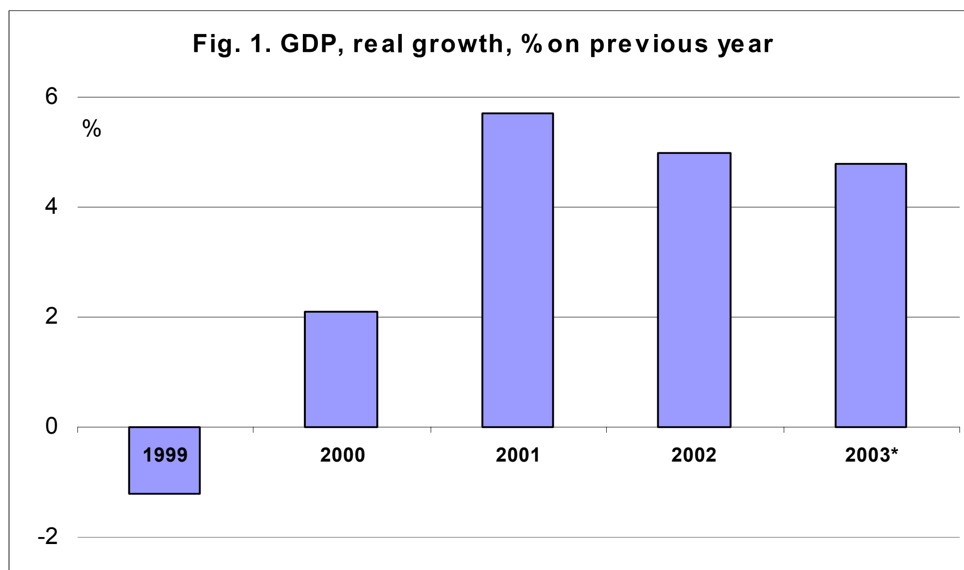
3.1. What speaks in favor of an upgrade?

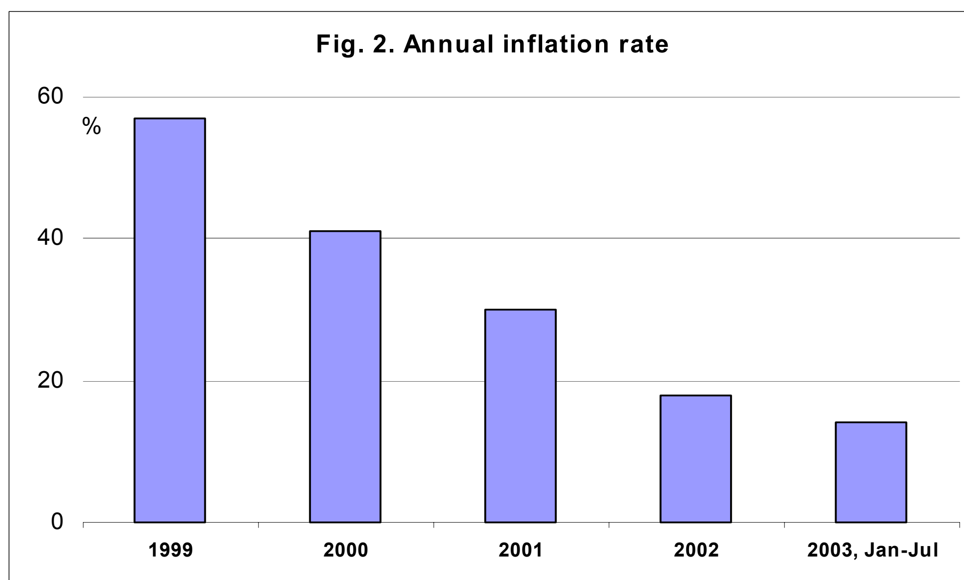
There are economic arguments which support an upgrade if Brussels' implicit criteria are to be consistently applied.

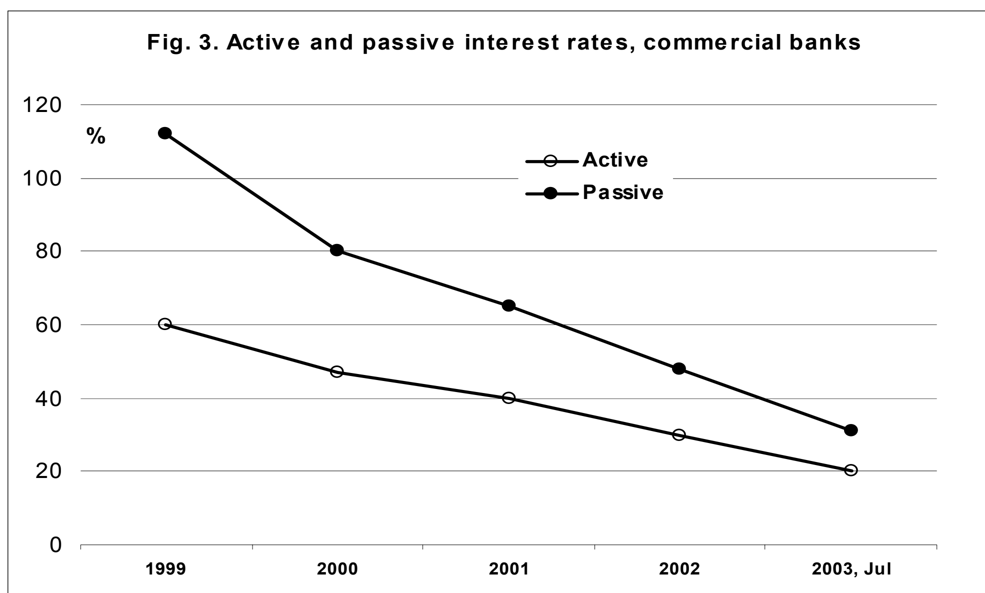
- ***Economic recovery has been under way for several years now***; the GDP grew by 5.7% and 4.9% in 2001 and 2002, respectively. It would, probably, rise by around 4.5% this year; the current deceleration would be, due, primarily, to fallout from economic stagnation in the West and a bad domestic harvest. For 2004 a forecast of 5% is reasonable in view of an expected revival in EU economies, the growth of domestic non-governmental credit, a further rise in domestic investment, and, hopefully, a better harvest.
- ***Inflation, the big scourge of the past decade, has been coming down consistently***: from 30.3% (Dec. on Dec.), in 2001, it went down to 17.8% in 2002, and would, likely, drop to around 14% this year; it is forecast to go further down to about 9% in 2004.
- ***The overall public indebtedness has stayed below 30% of GDP***, out of which the external public and publicly guaranteed debt is cca ¾, while short term indebtedness is pretty low (below 5% of total foreign debt).
- ***Budget deficits have been kept under 3%*** in recent years. Albeit significant quasi-fiscal deficits blur this assessment, it is encouraging that they have shown a tendency of decline lately. ***Current account deficits have been kept, on average, around 5%*** in recent years while the international reserves of the Central Bank have surged to almost 7 billion euro in September 2003 (which covers more then 4.7 months of imports).
- ***The private sector's contribution to GDP formation is nearing 70%*** currently, while this sector accounts for over 55% of social capital in the economy and more than 70% of employed population.
- ***The banking system is much sounder*** nowadays, after a massive clean up operation in the late '90s and the introduction of a new regulatory framework that fits the BIS new recommendations. This evolution has taken place on the background of increasing foreign ownership in the banking sector (to above 60% of total assets and loans), which has ameliorated corporate governance in this sector. Recently, Banca Comerciala Romana, which is the largest commercial bank, has got IFC and EBRD as new share-holders. Banks are on the average better at providing effective intermediation between savers and investors. Both the active and the passive interest rates have decreased substantially, and the spread between them also diminished (Fig. 4). Likewise, the range of financial products has increased remarkably and led to a boost of non-governmental credit.
- Some ***structural reforms*** (including privatisation) and a more effective budget (tax) policy administration have been implemented recently. A good part of the privatization commitments undertaken in the PSAL I and PSAL II programs with the World Bank are reasonably on track: companies with a history of loss making, such as Tepro Iasi, Tractorul and Roman Brasov, and ARO have just been sold.
- ***A new fiscal code*** is to be adopted by the Government until the end of this year, and a special unit for large taxpayers has been established in

Bucharest in a move to strengthen tax administration. New legal framework has been created to unify the collection, audit and enforcement of the social security funds under the supervision of the Ministry of Public Finance.

- ***Market access procedures*** have been simplified. Registration and authorization have been simplified by setting up a one-stop-office, and a silent approval procedure was introduced. In order to facilitate market exit, a legislative project on bankruptcy and reorganisation procedures has been initiated, aiming at increasing the ability for creditors to file for bankruptcy.
- ***State aid and competition***. Romania is currently applying the EC criteria in the authorization of new state aids, and is monitoring the existing aid with the goal of bringing it in line with the *acquis*. However, the issue of arrears, discussed in the following sections, questions the progress in this direction.







- ***The annual yield for T-bills***, which was a major attraction for banks' investment policy, decreased from 76% in 1999 and 35.7% in 2001 to 17.3% in 2002 and 15.5% as of August 2003. This evolution has provided another stimulus to domestic non-governmental credit, which has boomed by a 25%, in real terms, in the first half of 2003. It is noticeable that despite this big rise prudential indicators are still in safe territory. Lately, the Central Bank has adopted a series of measures aiming at restraining the upsurge of this credit –as a sort of preemptive policy.
- ***The non-financial sector*** has also developed rapidly, and the best indicator in this regard is the market capitalization of the Bucharest Stock Exchange: from 1.04% of GDP in 1999 and 3.3% of GDP in 2001, it has climbed to 6.05% of GDP in 2002 and 7% of GDP in the first half of 2003.

Fig. 4. Key prudential indicators in the banking system

	1999	2000	2001	2002	2003 Jul
Solvency rate (>12%)	17.9	23.7	28.8	25.0	22.8
Bad loans, as % of total assets	2.36	0.29	0.32	0.23	0.42
Credit risk rate	35.4	3.8	2.5	1.1	3.9

Source: NBR Monthly Bulletin 7/2003

2.2. How does Romania fare comparatively?

It is instructive to compare the current state of the Romanian economy with the situation in other EU candidate countries when they received the status of "functioning market economy". The data in the tables below are comparable in most respects. If the same standards operate in the judgement of economic performance, Romania can be given serious consideration for an upgrade. One could argue that judgements evolve over time and that they are more severe nowadays in view of recent years' developments both inside and outside the Union. This is not an argument to dismiss out of hand; on the other hand, how can one reconcile such a line

of reasoning with, for instance, recent years' balooning budget deficits of some countries which are to join the EU in 2004?

Fig. 5. Private sector's share in selected accession economies

	Private sector, % GDP		Private sector, % employment	
	1997	**2001**	**1997**	**2001**
Hungary	***65****	80		
Poland	***60****	65	***65****	70
Bulgaria		***71****		***73****
Romania		67		70

** At the time when it was declared a functioning market economy*
Source: OECD and World Bank data

Fig. 6. Key macroeconomic indicators, selected EU candidate countries, at the time the European Commission considered them "functioning market economies" – as compared to Romania before the Commission's 2003 Country Report

	CZ 97	**HU 97**	**POL 97**	**SK 00**	**BUL 02**	**RO 03**
GDP,% annual real growth	1.0	4.4	6.9	2.2	4.8	4.8 (proj)
Inflation rate, % Dec/Dec	10.0	18.3	13.2	8.4	3.8	14 (proj)
Unemployment rate, %	5.2	8.1	10.3	17.9	17.4	6.6 (Aug 03)
Current account deficit, % GDP	-6.1	-2.2	- 3.2	-3.7	-4.4	-4.8 (proj)
Budget deficit, % GDP	-2.2	-4.6	- 3.1	-6.7	-0.6	-2.7 (proj)
Gross foreign debt, % GDP	41	63.1	28	37.3	71.9	33.0 (end 02)
Official gross foreign reserves, in months of imports	4.9	5	5.9	3.7	5.3	4.7 (Sep 03)
M2, % GDP	67.3	39.4	38.2	66.0	43.3	24.7 (end 02)

Note: all projections for Romania are those of the Government, and are endorsed by the latest IMF country analyses. *Source: European Commission, IMF, national statistics*

There are countries which have registered sharply deteriorating economic indicators (budget and current account deficits) in the last couple of years, quite ahead of their forthcoming year of accession, in 2004 – for instance: Hungary, Poland, Czech Republic. During this period Romania' economic performance has visibly improved. This state of affairs has not been unnoticed by the main rating agencies, which have improved Romania's standing during the spring of 2003. Most recently, Standard and Poor's

raised it to BB. Romania's rating is still under investment grade, but prospects for further positive revisions are deemed fairly high[5].

Fig. 7. Latest economic data from selected EU candidate countries

	CZ	HU	POL	SK	BUL	RO
GDP,% annual real growth	2.2 (Q1 03)	3.6 (03 IMF proj)	1.3 (end-2002)	4.4 (end-2002)	5.0 (03 IMF proj)	4.3 (H1 03)
Inflation rate, % Dec/Dec	1.8 (end 02)	5.3 (03 IMF proj)	0.8 (end 02)	3.4 (end 02)	-0.2 (Q1 03)	7.3 (8m 03)
Unemployment rate, %	8.9 (end 02)	6.0 (03 IMF proj)	18.1 (end 02)	17.8 (end 02)	15 (Q2 03)	6.6 (Aug 03)
Current account deficit, % GDP	-6.5 (end 02)	-4.8 (03 IMF proj)	- 3.6 (end 02)	-8.2 (end 02)	-10.2 (Q1 03)	-**4.8** (03 IMF proj)
Budget deficit, % GDP	-7.25 03 IMF proj	-6 03 IMFproj	- 5 03 proj	-4.5 (2002)	0.3 (Q1 03)	-2.7 (03 IMF proj)
Official gross foreign reserves, in months of imports	6.1 (Q1 03)	3.8 (03 IMF proj)	8.3 (end 02)	5.9 (end 02)	5.2 (03 IMF proj)	4.7 (Sep 03)

Source: IMF, national statistics

Fig. 8. Credit ratings, Standard & Poor, countries' sovereign fixed income long term debt, as of October 1st, 2003

	Local currency		Foreign currency	
	Rating	Evolution	Rating	Evolution
Romania	*BB+*	*Positive*	*BB*	*Positive*
Bulgaria	BBB-	Stable	BB+	Stable
Czech Rep.	A+	Stable	A-	Stable
Cyprus	A+	Stable	A	Stable
Hungary	A	Stable	A-	Stable
Lithuania	A-	Stable	BBB+	Stable
Poland	A	Negative	BBB+	Negative
Slovak Rep.	A-	Stable	BBB	Positive

Other indicators, capturing the deep structural characteristics of CEE economies, also offer an interesting view, as on many dimensions Romania is not necessarily the outlayer. Labor costs as a share of per capita GDP revolves around the regional average, unlike in a few other countries where they appear to be unsustainably high (Fig. 9). The large agriculture sector is indeed inefficient, but not more than Poland's – in this respect Bulgaria fares

[5] Analysts from leading investment banks consider that, in spite of these upgrades, rating agencies continue to underrate Romania's performance ("Sovereign Eastern Europe Update, Bear and Stearns, 26 June, 2003)

indeed better than the other two countries, while in Hungary the agriculture is virtually as efficient as the rest of the economy (Fig. 10). The energy consumption per one dollar of GDP, a fair measure of the advance in restructuring a post-communist economy, is lower in Romania than in Bulgaria, though higher than in other CEE countries which have moved faster towards energy efficiency (Fig. 11). And the deviation from the world prices expressed by the purchasing power parity (how much more similar goods one can buy in one particular country with 1$ than in USA) also show that Bulgarians face the longest way until they catch up with the rest of the world (Fig. 12).

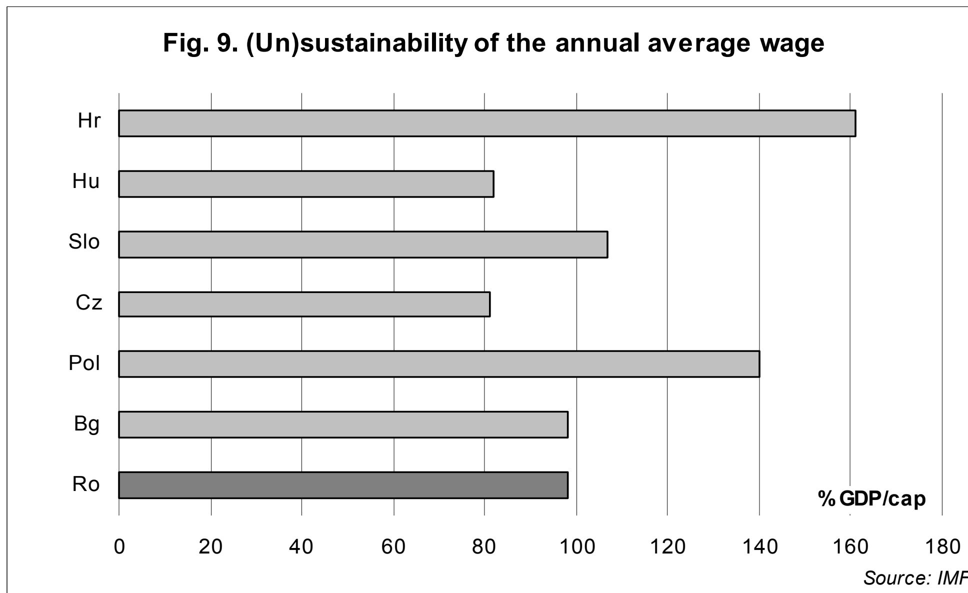
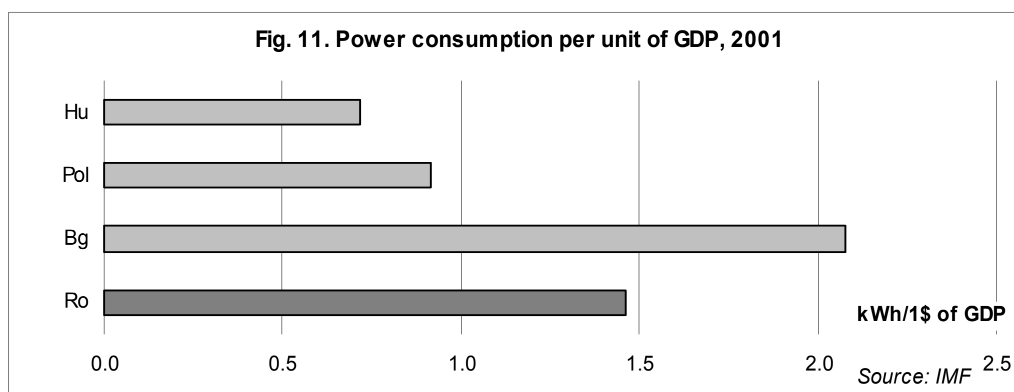


Fig. 10. The efficiency of the agricultural sector

	Ro	Bg	Pol	Hu
Agriculture, % employed	42	27	18	6.2
Agriculture, % GDP	15	13	5.1	6
Agriculture efficiency: GDP share/employment share	*0.36*	*0.48*	*0.28*	*0.97*

Source: IMF



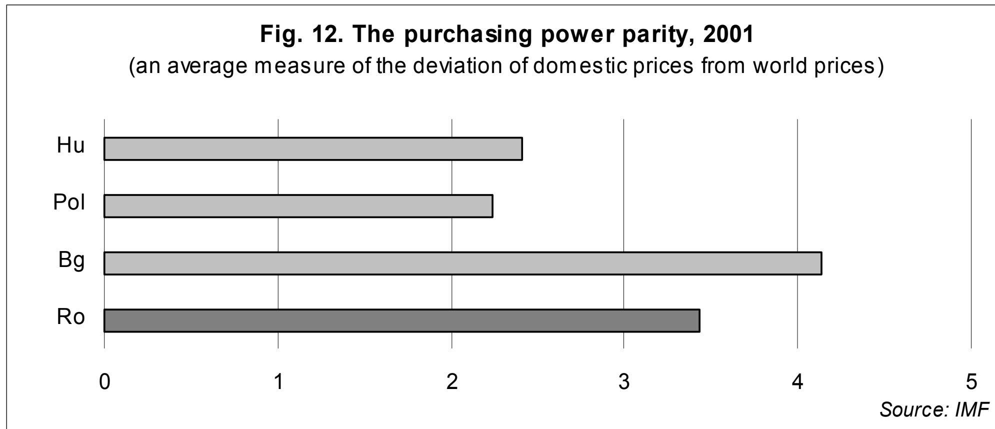


Fig. 12. The purchasing power parity, 2001
(an average measure of the deviation of domestic prices from world prices)
Hu
Pol
Bg
Ro
0
1
2
3
4
5
Source: IMF

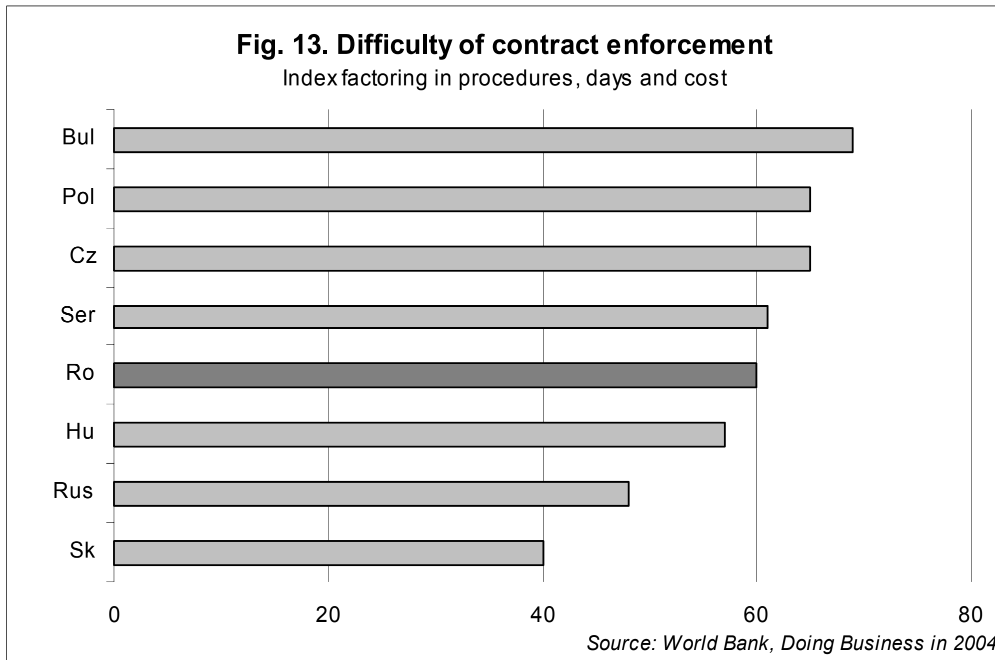


Fig. 13. Difficulty of contract enforcement
Index factoring in procedures, days and cost
Bul
Pol
Cz
Ser
Ro
Hu
Rus
Sk
0
20
40
60
80
Source: World Bank, Doing Business in 2004

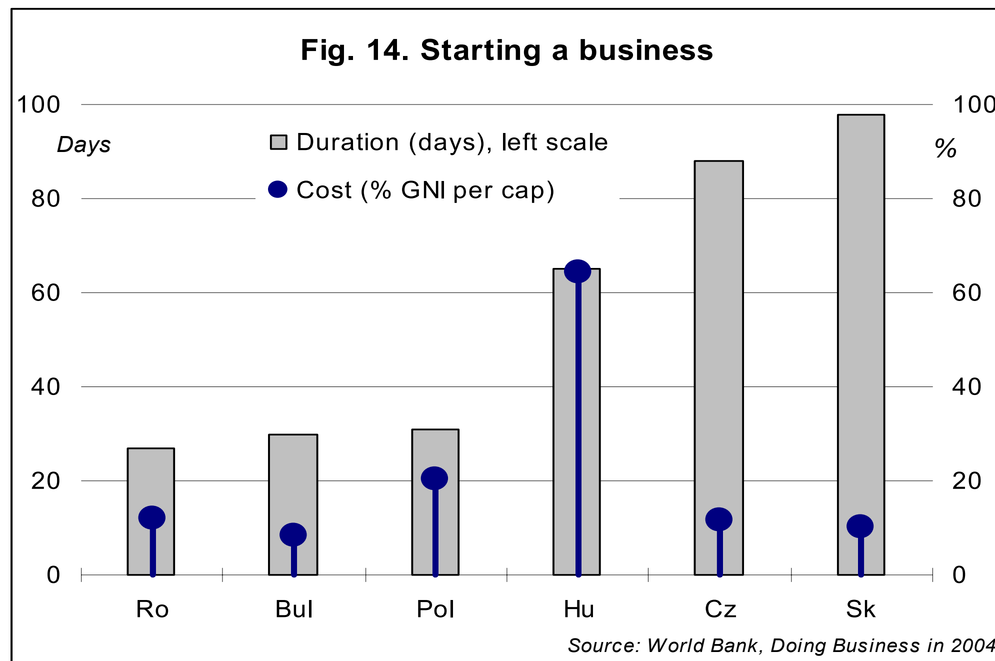


Fig. 14. Starting a business
Days
%
Duration (days), left scale
Cost (% GNI per cap)
100
80
60
40
20
0
Ro
Bul
Pol
Hu
Cz
Sk
Source: World Bank, Doing Business in 2004

The overall picture emerging from these comparisons is therefore more nuanced than that offered by the annual reports of the Commission.

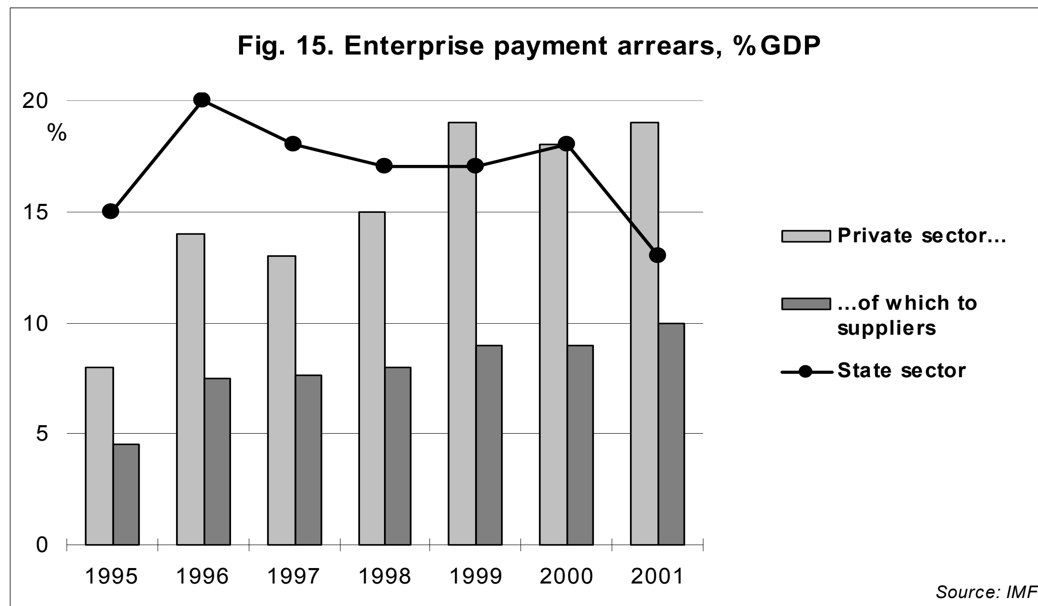
- There is a heavy burden of rural underdevelopment in Romania and Poland, with Bulgaria performing surprisingly better in this respect. However, in Poland agriculture and the pension system appear to be used less than in Romania as safety valves against unemployment.
- Privatization has advanced faster in Bulgaria than in Romania, especially since the current government took over in Sofia. In combination with the tight monetary policy of the currency board, it has led to the current perception of better macro stability and reformist drive. The latest move by Bucharest to privatize some loss-making companies, after years of feet-dragging, is probably too recent to have trickled into the regular reports of international observers.
- By contrast, the alignment to world prices seems to be more advanced in Romania than in Bulgaria. Most probably, this is the case with energy prices that were liberalized faster in Romania. As a result, the Romanian economy appears to be more energy-intensive today, though still behind those of the first-wave countries.
- The business environment has improved in Romania lately, at least on the indicators measured by World Bank and reported in a recent study: contract enforcement seems to be no more difficult than in other "market economy" countries; while starting a business has become relatively easy and cheap (Fig. 13-14).

2.3. What clouds the sky?

Romania's economic track record after 1999, when the country fended off the threat of a Bulgarian-style crisis, is very patchy, however. As already mentioned, major weaknesses persist which could harm GDP growth and macroeconomic conditions unless reforms go on. This caveat does not refer to unavoidable business cycle related fluctuations, but to an imaginable relapse into a combination of revived inflation and balance of payments difficulties. The current poor financial discipline and the unfriendly investment climate in Romania have been repeatedly stressed by observers as risk factors, and a number of government initiatives were aimed at improving things lately.

- **Inflation** is still high and has in the past been used by many companies as a means to survive. The current disinflation puts pressure on the loss-making sector and, in absence of bolder restructuring, large quasi-fiscal-deficits would clobber the budget in the years to come. The persistence of these 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. Although adding quasi-fiscal deficits to the official public budget deficits has its own methodological flaws – this is how the actual "consolidated" public deficit is measured most of the time – ignoring or underestimating them would be a serious mistake.
- Related to the point above, **financial (including fiscal) discipline** is not enforced consistently and loss making companies produce sizeable arrears / quasi-fiscal deficits. This is especially the case in their relationship with the energy sector, where the losses amount to about

1.5-2% of GDP. Arrears (losses) are also significant in the petrochemical industry. Also concerning is the fact that the arrears generated in transactions between private agents are on the rise and soon will overcome those generated by the sate sector, which was predominant in the early '90s (Fig. 15). It is true that the total arrears declined in real terms lately, including in the energy sector, and the budget deficit has been capped at 3%. However, these goals should not be achieved by hiding twice the amount of the deficit in various dark corners of the economy, as the director of World Bank mission in Romania recently pointed out. He estimated the current quasi-fiscal deficit to around 2-3% of the GDP, an unsustainably high level, and argued that the problem is kept under the lid since no official data are published on these issues and the public is not properly informed.



- In spite of the recent improvements in **the business climate** mentioned above, red tape and corruption remain major concerns. What is more, while all the recent measures look impressive on paper, the changes for the better in the actual investment climate hinge fundamentally on how all these normative acts and regulations will be enforced – for enforcement is, like in other transition economies, the critical element in fostering real change.
- **The pension system** is increasingly under strain. The system is unbalanced, with much of its financing coming from the health insurance's budget, a fact usually denied by the government. The problem is chronic, because the retired population exceeds in number the employees (the ratio is nowadays 3:2, as compared to 1:2 in the early nineties). Public authorities seem only now to move closer to a real reform, after the abolition in early 2001 of the private pension laws adopted by the previous government. The accumulating of hidden deficits in the pension system, in parallel with a low and steadily declining employment rate, is not good omens for a would-be market economy.

- In the **energy sector** Petrom, the national oil company, is slowly advancing towards privatization, and so are two branches of the national electricity provider and two gas distribution companies. However, the general perception is that too little is done, and too late, as the government will soon enter the last year of its mandate. True, the energy sector poses specific problems because it needs large investments, while the interests of potential investors have to be reconciled with the protection of numerous low-income individuals. Moreover, as the experience worldwide indicates, energy markets need effective regulation, for market failures can be especially damaging in this area. But none of these arguments can be an excuse for foot-dragging and letting state energy companies become suppliers of soft credits, like the banks which eventually went bust six or seven years ago.
- The same bold reforms are also needed in **the mining and railways sector**. When the fourth and final instalment from the current agreement with IMF was approved in October, thus completing the first of six such agreements since the fall of communism, the result was achieved only with four important waivers included. The general impression was that Romania has gasped over the finish line rather than run a brilliant race.
- There are also important **"legacies" of delayed reforms** from PSAL program with the World Bank, such as the unfulfilled promise to sell BCR, the largest Romanian bank, and CEC, the savings bank. It is true that the lack of interest from strategic investors made the privatization slow and difficult. But whatever the reason, this is another point on which Romania compares defavourably with Bulgaria, which has fully privatized its banking sector and insulated it from political intervention. As things stand PSAL II can only be concluded by rolling over the "legacies" into the new PAL program currently negotiated with the Romanian government.

The problems highlighted in this brief analysis cannot be dealt with rapidly, since most of them are structural. Some of them do not even pertain to Romania only; they loom large in other accession (and not only) countries as well. For instance, agriculture has already strained Poland's accession negotiations; likewise, the crisis of the pension (welfare) systems shows up increasingly in all accession countries and in the Euroland, too.

The real danger: the para-legal network economy developed by predatory elites

What is specific to Romania, however, is the rapid growth in the last years of a para-legal network economy which came to represent a substantial share of the private sector. Its core consists of a group of powerful businesspeople who have built their companies either as startups or, more often, in the privatization process, using political connections. In this sense, they are more political than economic entrepreneurs. The lists of companies high on public debt published by the Departament of Finance after public pressure contains almost all the big names of Romanian business with huge sums. The difference between independent entrepreneurs and state captors is easy to be traced in their treatment, also published by Department of Finance: the former are forcibly pursued, the latter have their debts 'rescheduled'. The latter includes Corneliu Iacobov, the brothers Micula, Tofan Group, and practically all the private electronic media. What would remain of these fortunes and businesses had they finally need to settle their debts? Some of these people have been directly involved in the privatization process before becoming fully private: one can notice

immediately that after they take over a state owned enterprise its performance does not get any better – and sometimes gets worse. Such entrepreneurship explains in part the increase in arrears generated by the private sector (Fig. 15). Second, their influence goes much beyond the actual share of assets they own in the total economy, since these people have become trend-setters. Their success and impunity encourage every entrepreneur to try to emulate such successful role models. Various industries such as oil refining and retailing, constructions, tourism or agro-businesses have been partly captured by the para-legal network economy, but other sectors suffer too. Their influence is so strong that even in those rare occasions when infringements of laws are blatant and widely known to the public – as it happened recently when football clubs, mostly owned by the same group of people, were found that they did not pay any tax or social contributions towards the lavish salaries of their players, and frankly admitted it – the authorities cannot muster enough courage to act, apply penalties and recuperate the debt.