ECONOMY

Mixed signals

In June of this year, both the IMF and the World Bank, while recognizing the positive performance of the Romanian economy, issued serious reservations and warnings regarding the direction and pace of the government's economic policies. The **IMF** postponed its decision about extending the current agreement until August-September, in order to give the government more time to speed up privatization and draft the 2002 budget. The **World Bank** based its 2002-2004 country assistance strategy on a pair of opposite scenarios, pointing out that it was entirely up to the Romanian government to avoid the pessimistic one. Taking all these signals into account, there are serious risks to the Romanian economy over *the next six month*s; and strong action is needed in order to avoid them:

- Public spending must be strictly controlled, including salaries in the public sector
- Tax exemptions that may appear pro-business are in fact just costly, distortive and ineffective, and the same applies to soft lending through state owned banks; both should be avoided
- The government should eventually come up with a speedy and clear plan to privatize state owned banks
- Energy price subsidies should be eliminated
- The government should avoid confusion and mixed signals in the privatization process

This second issue of the Early Warning Report analyzes the developments on these directions and gives a number of **warning signals**.

While the output and business confidence have slightly increased over the first five months,

- *Privatization* is still muddled (see Focus),
- The government intends to implement controversial *tax exemptions* for IT employees (see the Social section),
- And the *international short-term perspectives* remain rather unfavorable, and finally,

- There are strong *social pressures* to block the restructuring of newly privatized companies. Although the government is right to take them into account (Social section), yielding too much to anarchic street pressures and fuelling the public's anti-business sentiment with inflammatory language (Social section) is a poor strategy in the long run, since it might reduce international trust in the Romanian government, at a time when the financial position of the country is still fragile and there is still great need for external financing.

Warning: Wrong Signals to Investors

7

Case study 1: labor conflict at CS Reşiţa

The decision by the Authority for Privatization (APAPS) to seek legal cancellation of the CS Reşiţa privatization contract with the American company Nobel Ventures may be well grounded. The mismanagement of the Reşiţa crisis, however, sent the wrong signals to both the Romanian public and foreign investors.

Background

Last September 94.4 % of CS Reşiţa was sold for 85.25 million dollars, a sum which also included future investments by the buyer in environment-friendly new technology. The arrears of the company were of 120 billion lei (around 56 million dollars at the time), i.e. four times the equity value.

The first conflict broke up in January, when workers started a spontaneous strike to protest against a few days of wage payment delays. Ever since that moment the new owner has entered a cash flow crisis that prompted cuts from gas and electricity supplies, leading to the suspension of production on March 15. By April 1st wage payments saw another two-week delay, and the workers protested by blocking the national road Reşiţa-Caransebes. Interventions by the Privatization Minister Ovidiu Muşetescu led to a temporary relief. Government Ordinance 490/2001 granted the owner a restructuring of its debt in exchange for the promise that dues to APAPS, wages and investments specified in the contract would be paid on time. The owner complained that Reşiţa could not on its turn collect debts by other Romanian enterprises, such as Petrotub Roman.

On May 31st wage payments were once again delayed, leading to new conflicts and an attempt by the owner to fire the union leaders who had initiated the protests. From then on the situation has escalated, with the management asking that work be resumed in order to pay wages, while the union's condition for resuming work was the resolution of back payments. The owner needed the workers to resume production in order to get a bank loan to pay wages: no bank would have credited an enterprise paralyzed by a general strike. By June the unions had endorsed the cancellation of the privatization contract as their main goal. Following their demands APAPS announced it would seek a Court order to cancel the privatization contract.

APAPS asked Reşiţa's management to abide by the provisions of the privatization contract, such as:

- Comply to the Romanian work legislation
- Not to reduce personnel for a minimum of five years
- Export by the end of 2001 goods with a value of US$ 100 million
- Invest US$ 67 million over the next five years
- Increase production to 1,2 million tons per year by 2002
- Pay arrears of US$ 35 million by September 15, 2001

As many of these conditions cannot realistically be fulfilled, the cancellation of the privatization contract may appear justified. However, the strikes in Reşiţa have all along been illegal. The government's decision to seek cancellation came only after this point became the union's main claim and it was badly received by the international business community and the foreign media. Reşiţa has created a signal that the government would endorse illegal trade union action against lawful management. This, of course, was not the intention of the government, but its actions were misleading enough to give such an impression. Furthermore, Reşiţa provides an interesting case study, being comparable, on a smaller scale, with SIDEX, the next big steel plant to be sold by APAPS. Why would future foreign investors buy such difficult companies under constraining conditions when it has become clear that the government would not be supportive in difficult times? Reviewing the pattern that led to the crisis in Reşiţa, there are a few actions that the government should have better avoided:

- Delaying some debt relief specified in the contract with Reşiţa's buyer Nobel Ventures. This allowed the company to consider itself exempted from its own contractual obligations. In the future the government must respect its contractual obligations, if it wants investors to do the same.
- The intervention of APAPS in the negotiations between the management and the union, which clearly falls outside the agency's profile and ability. Other government agencies should be entrusted with such actions, such as the Social and Economic Council, which had been designated as a social mediator at its establishment (but was subsequently reduced to an advisory role by the previous governments).

- The negotiations by the government with a union leading an illegal strike and blocking a national road. Tolerance towards illegal behavior further weakens the rule of law and enforces current widespread perceptions that such acts are not prosecuted, hence they are a legitimate strategy. Furthermore, from a legal point of view, APAPS should have only one partner, that is the buyers of prvatized companies. If APAPS steps out of its role as the promoter of privatization to side with the unions, its credibility will suffer.
- Bringing up late in the crisis the issue of the unfulfilled clauses in the contract with Nobel, right after the union declared the cancellation of the contract to be its main revendication. This created the impression in the public opinion that APAPS gave in to union pressure, The workers may be pointing to real problems; however it is not APAPS' role to engage into dialogue with them. Rather, APAPS should have its own post-privatization monitoring system to ensure that the new owners comply with their contractual obligations.

Case study 2: modifications to the forest restitution law

On June 27, 2001 the Romanian government adopted by emergency ordinance a bill modifying law 1/2000 regarding the restitution of forests. Although announced long ago, this bill has the potential of creating some serious problems:

1. Despite the government repeatedly stating that it would give up emergency rulings, this modification of an organic property restitution law was again passed through emergency procedure, on the first day of Parliamentary summer leave. This led to protests from the opposition and the media and gave the impression that the government wanted to avoid having a Parliamentary debate on this topic.
2. The law strengthens the signal that the government is not willing to let forests into private hands: many exceptions are created, compensation is favored over restitution, and some categories, such as Romanian citizens living abroad, are excluded, unlike in the previous version of the law. The new legislation discriminates between associations, whose members will receive up to 20 ha, and individual owners, who will receive up to 10 ha. It also discriminates between Transylvania, which had a better recording system, and the Old Kingdom, by not allowing witnesses in the process of establishing property rights. This means that many Romanian associations from sub-Carpathian regions, who do not have full property documentation, will resort to using the justice system, where witnesses are admissible. It is, therefore, very likely that the new law will antagonize forest owners, an estimated 250,000-300,000 people, by entrusting almost discretionary powers to the National Forests Agency, a 33,000 employee state company which manages nationalized forests.

3. Like the Law 18/1991, which has entangled land property rights throughout the first transition decade, this new law creates so many exceptions and limitations that the restitution of nationalized forests becomes the exception rather than the rule. Furthermore, the form of damages paid in the event that the restitution is not made in nature is again patterned after a disputed law, the 10/2001 bill, which provides compensations to former owners not in cash, but in shares of privatizing companies, which are of doubtful market value.

Conclusion

Unlike real estate property laws, which presented social problems opposing former owners to current tenants, forested land restitution presents no social danger in itself, as nationalized forests are managed and owned by the State. Defending state property and a particular company against private property again sends the signal that the current government is no friend of private property. Future protests by former private owners are likely to occur, and clashes between employees of the Forest State Agency and associations of former private owners are likely to escalate. No reliable, independent evaluation on how the Agency manages tree cuts is available to support the government's claim that private owners are more of a danger to the environment than the state.

The government should, therefore, negotiate with all stakeholders during the summer and give up some of the most controversial points of the new bill, before it comes up for approval in the two Chambers of the Parliament this autumn.

Trends: Economic Indicators

The GDP estimated for the first quarter of 2001 registered a real term increase of 4.8%, compared with the same period in 2000. Industrial output growth leads the way with a gross added value increase of 11.8% followed by the construction sector with 7% and services with 2.4%. These three sectors, representing 87.6% of GDP, are the engine of GDP growth.

Industrial Sector

In April 2001, industrial output continued its upward trend, with 11.2% in absolute terms and 13.4% in comparable terms. Indices of industrial output (adjusted by amount of days worked) recorded values above those of the previous months (Fig. 1). Higher output was registered in the manufacturing industry, while the extractive industry and power, water and gas sectors recorded a small decrease in output.

The increase in industrial output is, therefore, exclusively based on the manufacturing industry, which continued its positive trend that started in January 2001.

Capital goods, intermediate goods and consumer goods continued to expand while energy and durable goods show signs of stagnation.

Fig. 1. Industrial output (adjusted by days worked; previous month = 100)

	2000				2001			
	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
INDUSTRY	109	94.9	103.9	97.6	94.3	111.1	101.2	103.9
Extractive Industry	105.6	100.1	101.8	95.8	105.1	103	98.5	98.5
Manufacturing Industry	109.9	93.5	103.7	97	92	113.7	103	105.6
Power, thermal, water and gas	104.1	104	108.7	105.1	103.4	100.3	88.1	93.7
Capital goods	113.8	104.3	106.3	91.7	89.3	112.8	105.2	111
Durable goods	118	96.6	105.7	92.4	101.1	114.2	95.5	90.6
Consumer goods	107.6	88.5	105.8	105.2	90	108.7	102.9	107.3
Energy	103.8	100.5	104.7	100.1	105.6	102.3	92.7	97.1

Source: INSSE, May 2001

Taking a closer look at the evolution of the Manufacturing industry will depict a more complex picture, since not all branches expanded in the same way.

Comparing April to March within the manufacturing industry, 11 out of 21 branches recorded increases while 10 industrial branches recorded decreasing output (Fig. 2). The most surprising was Communications equipment, Radio and TV sets that jumped to 167% after three months of decline and Electric machines by 126%. The rise of these two branches is important because they are branches with high value added.

Other branches such as Medical instruments, optical and precision devices and Chemical and artificial fibers showed positive results.

Sectors such as Other transportation means, Metallurgy, Equipment and Machines and Textile products recorded more constant output evolutions while in others the level of outputs oscillated.

On the whole, the output within the Manufacturing industry rose due to mixed evolutions of the branches (increases and decreases) but without a sharp decline in any of its components.

Fig. 2. Evolution of output in the manufacturing branches (previous month = 100)

Manufacturing branches	Jan	Feb	Mar	Apr
1. Communications equipment, Radios and TV sets	79	95.3	99.7	167
2. Electric machines	96.4	113	98.6	126.7
3. Food and drinks	76.1	110.6	108.8	122.2
4. Printing and sound	95	94.9	92.5	115
5. Rubber and plastic processing	110.6	108.3	107.3	114.3
6. Construction materials	89.8	117.6	121.5	114.3
7. Medical instruments, optical and precision devices	84.5	145.5	81.4	112.9
8. Chemical and artificial fibers	82.1	137.8	103.2	112.2
9. Metal construction	90.5	115.1	104.8	111
10. Oil processing	102.3	112.5	91.7	109.1
11. Other means of transportation (other than auto)	86.9	109.1	96.6	100.6
12. Metallurgy	112.4	116.3	103	99.1
13. Equipment and Machines	87.4	123.1	110.9	98.9
14. Textile products	98.1	116.3	96.3	96.4
15. Automobile as a means of transportation	103.2	100.4	105.2	96.4
16. Paper and cardboard	99.8	118	97.3	93.5
17. Shoes and leather	121.4	113.9	94.5	89.1
18. Timber processing	100.1	111.7	95.7	87.1
19. Furniture and others	108	111.3	97.1	85.3
20. Clothes and textiles	113.2	104.7	91.9	81.1
21. Tobacco processing	69.8	137.9	151.7	72.7

Source: INSSE, May 2001

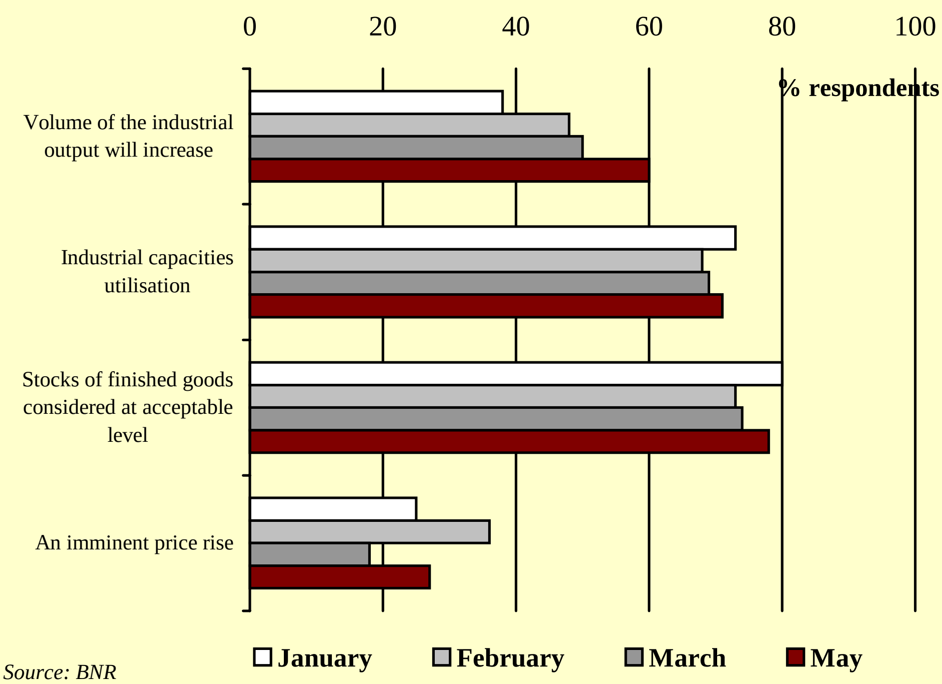
This evolution is not attributable to measures related to the Government's industrial policy. Until now, the Ministry of Industry and Resources (MIR) has not drafted such a policy. Two important measures were, however, issued in early February: VAT and custom taxes exemptions for equipment imported for development. These two exemptions had a mixed effect, since they contributed to worsening the trade balance and represented a disincentive for Romanian manufacturers of such equipment.

Trends: Expectations of the Business Community (first five months of 2001)

A National Bank of Romania (BNR) survey reveals cautious optimism amongst the business community, with expectations that this year will show a steady increase in industrial output. Inventories remain at acceptable levels and no imminent rise in prices is expected.

This cautious optimism is reflected in the increase of investments over the first quarter of 2001, especially in construction and industrial equipment (including transportation means).

Fig. 3. Business expectations



Source: BNR

Fig. 4. Investments, first quarter 2001

	Compared with first quarter 2000, %
Investment - total, of which:	**104,7**
• Construction	105,1
• Equipment (including transport means)	108,1

Focus: Privatization

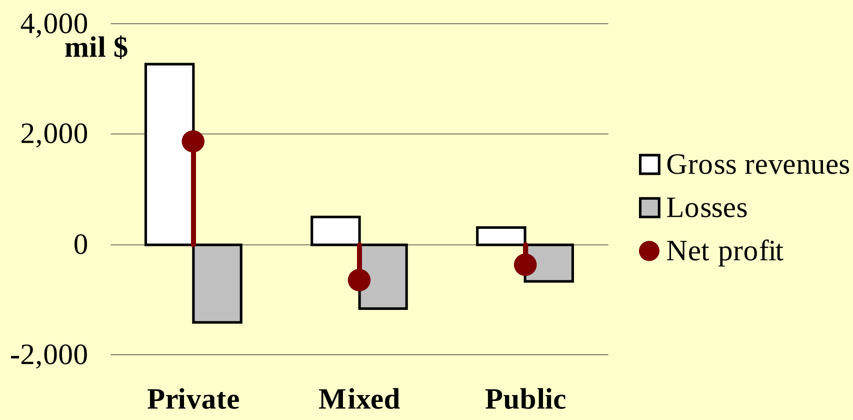
Why privatize and how

Today, after more than a decade of transition in the ex-communist countries, there is a broad consensus based on experience among policy experts on a number of points. If there was room for speculation ten years ago, now it has become more or less clear that:

- *Privatization brings an overall increase in efficiency*. Even though there are isolated cases of companies where privatization did not have a positive impact, in general productivity factors (both capital and workforce) and investments increase after privatization. These general conclusions are confirmed in Romania as well (Fig. 5, 6 and 7). The actual increase in efficiency may be even higher, since many small private enterprises hide a substantial part of their profit, which therefore goes unreported, and exaggerate their reported losses, for tax purposes.
- *The concentration of property produces better corporate governance*. Mass privatization through vouchers or MEBO schemes is less effective in CEE than in Western countries where it was designed in the first place, because the former do not have strong markets with powerful institutions to secure the transparency of transactions and protect their minority shareholders. The mass distribution of shares tends to be either irrelevant or end up in murky financial deals.
- *Foreign investors are better than the domestic investors***.** The concentration of ownership in the hands of foreign direct investors has the advantage of providing additional capital, management skills and access to markets which otherwise take decades to develop domestically. For example in Hungary, one of the most successful post-communist countries, 75% of the Top 100 companies ranked by sales volume have a multinational

company as the dominant owner. The current economic strength of Hungary has therefore less to do with the pre-transition conditions, as many people believe, and more with the determination to sell state companies to private owners who can turn them around – especially through the 'big push' of 1995-96, when most gas and electricity suppliers, power plants, utilities and banks were sold to strategic investors, in spite of the temporary hardships and political costs for the government. This is how the foundations of the current economic prosperity have been laid.

Fig. 5. Public and private companies, 1997



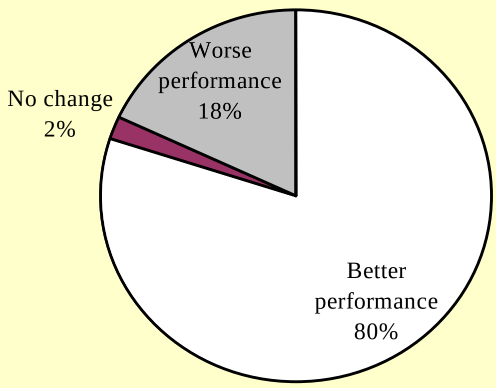
Source: INSSE, 1999

Fig. 6. Comparative performance in industrial firms, 1997

Source: INSSE, 1999

In conclusion, the regional experience shows that the ideal situation is when state assets are sold to foreign strategic investors. If privatization sometimes fails, or its results are sub-optimal, this should not be a deterrent: in such situations, state ownership is also likely to fail, and the hidden social costs are generally higher in this latter case.

Fig. 7. Performance after privatization



Source: FPS, 2000

Where we are

Despite many years of discussions and a significant acceleration of privatization in late 1998, the bulk of companies that were state owned in 1990 are still under state control. While progress was made in the early years of transition on small scale and farms privatization, Romania ranks last among EU candidate countries on the large-scale privatization index calculated last year by the IMF (Fig. 9), as well as on the share of the private sector from the total GDP (Fig. 10).

Fig. 8. Small scale privatization index

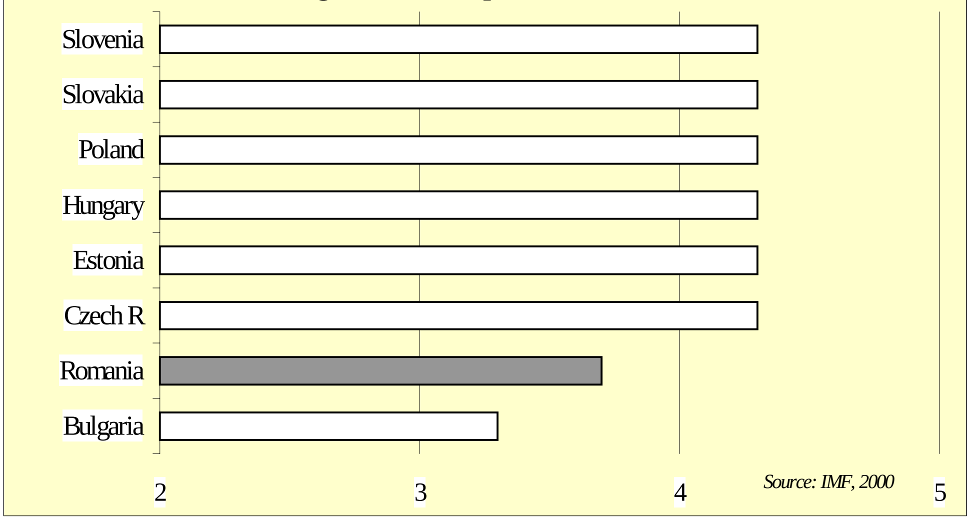
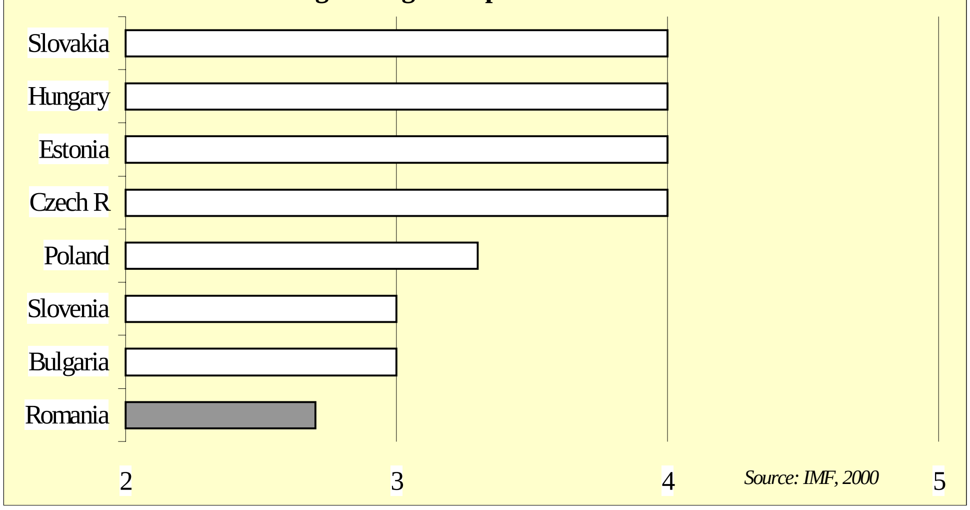
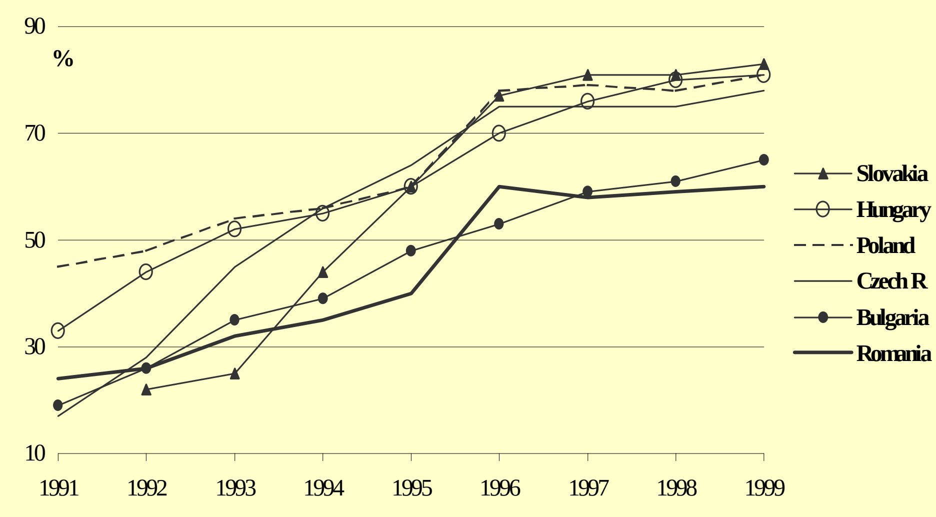


Fig. 9. Large scale privatization index



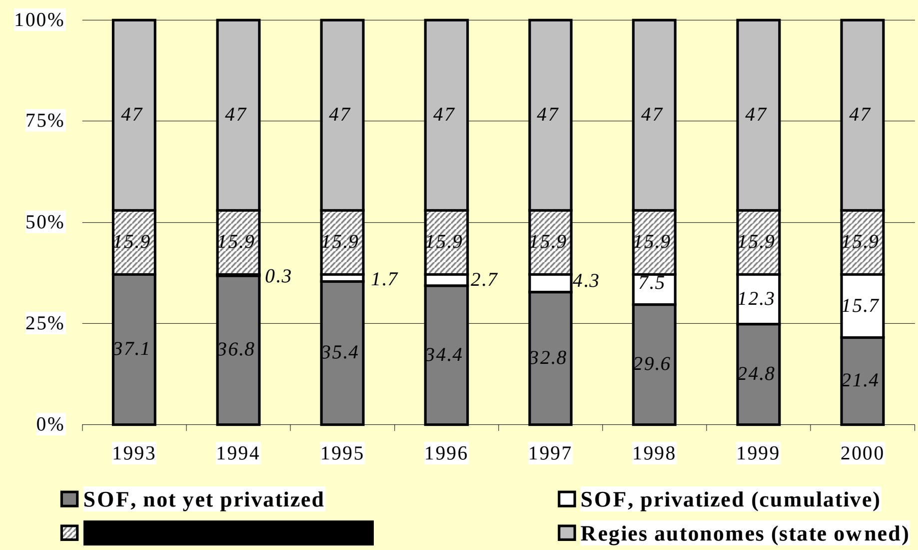
The *regies autonomes* established in 1990 (almost half of the total industrial assets) have yet to be privatized, although some steps have been taken in the last three years to reorganize them. The hard industrial core of the socialist economy has therefore been barely scratched (Fig. 11). This also shows how performant the small private sector is, since it manages to produce about 60% of the GDP with less than 32% of the industrial assets.

Fig. 10. Private sector, % GDP



Source: IMF, 2000

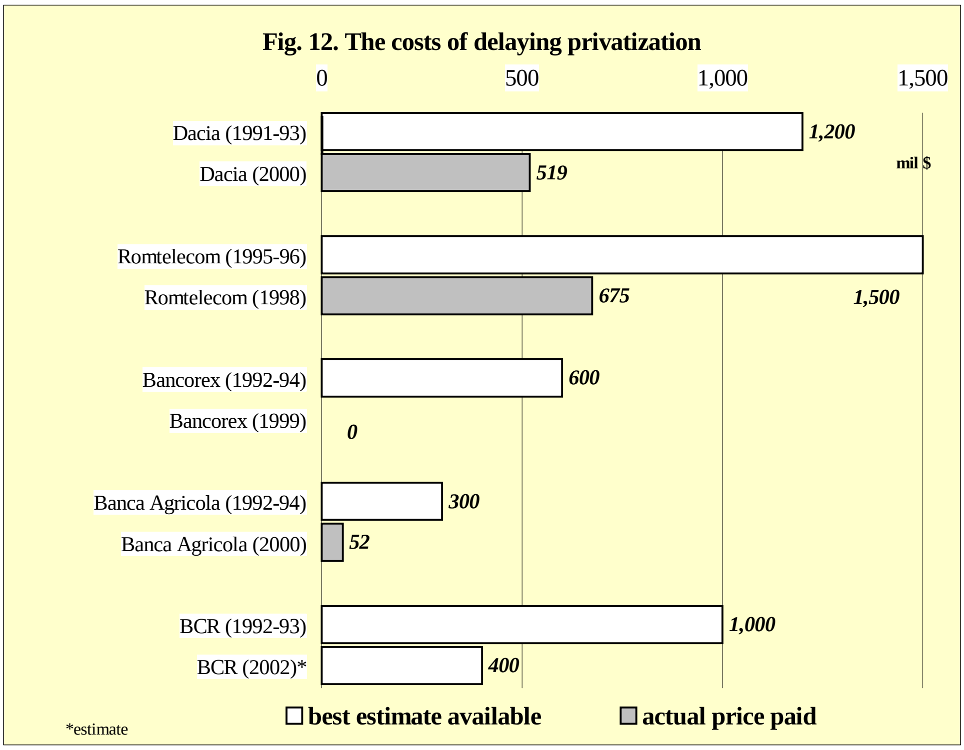
Fig. 11. The dynamics of privatization: % of state industrial assets



Sources: IMF, 2000

Directions to be followed and warning signals

- The privatization of *large companies* should be accelerated. Any delays would entail additional costs to the Romanian society, both in the form of foregone efficiency gains and the decreased value of the assets sold. For example, Fig. 12 presents such an estimate of the money lost by the Romanian state because of the late privatization of some major companies.



- The government should avoid confusions and mixed signals in the privatization process. When firms incur losses, officials tend to argue that it is difficult to find a buyer; but as long as companies create profits they do not seem very eager to privatize them. A recent case is **Alro**, a profitable aluminum plant, over which the government appeared to be ambivalent. The agency **FitchIBCA**, which recently upgraded an emission of Romanian Eurobonds, referred explicitly to the Alro case as an example of muddled policy, which prevents further improvements of the country ratings.

- A greater concern is the impression that the government **ambivalent** about the privatization of the large steel plants and other large industrial loss-making firms where the unions are likely to oppose restructuring by the new owners. The backtracking in the case of the Reşiţa steel plant is a bad signal for the fate of **Sidex Galati**, one of Romania's largest companies now in the final stage of privatization (see the Social section for details).

- It is time to begin serious privatization in the *tourism sector*, as many country reports underline this Romanian anomaly: a business sector that was one of the first targets of the restructuring and privatization process in the other CEE countries is still in a mess in Romania, after ten years of transition. The **JP Morgan**'s country evaluation released in May 2001 points out that there has been almost no foreign direct investment into this sector, 'which in our view is a clear sign that privatization in that sector has not been effective.'
- Many observers, beginning with the IMF and the World Bank, have also noted that **state agricultural farms** (IASs), should be privatized without delay. The performance of their appointed management is a dismal. Recently the Government dismissed many managers for their passive opposition to the privatization process, but their attitude has been largely encouraged by the lack of determination and the mixed signals coming from the Government in the past years.

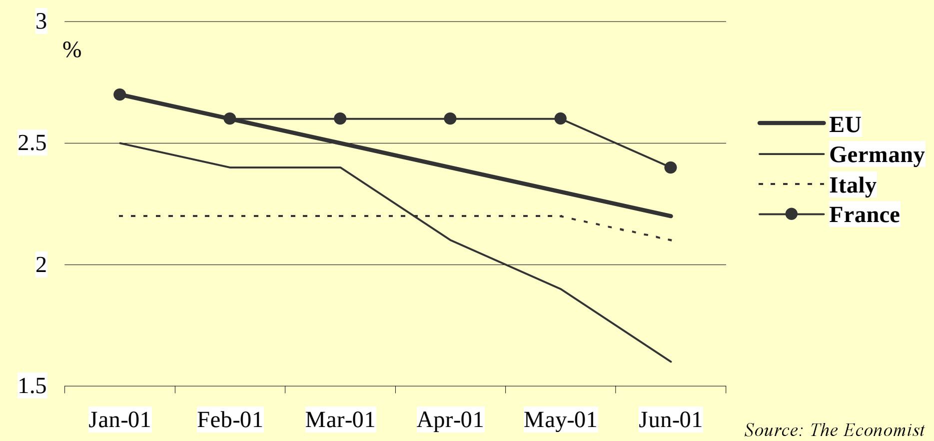
Test cases over the next three months:

- The completion of the privatization of **Sidex Galati**, the largest steel plant in Romania, against the opposition of local stakeholders and their political lobby interested in continuing the siphoning of funds. The negotiations with Ispat International, the only investor who submitted a bid, should clearly determine the investment commitments, social guarantees for the workforce and the responsibilities for the environmental clean up. The Government must agree to pay the political costs related to the agreed layoffs.
- Sorting out the confusion over **Alro** (and its sister company Alprom) in a speedy and transparent manner.
- Starting the preparations for the selling of **BCR**, the largest Romanian commercial bank, by overcoming the tacit opposition of the bank's debtors (mostly state-owned borrowers accustomed to soft financial constraints) and employees.
- Starting the serious privatization process in the **tourism** sector and in state agricultural companies.

Trends: International Situation, Growth and Trade Deficit

Standard & Poor's has recently upgraded Romania's country risk rating from B- to B. But other considerations compel us to closely analyze the current international conjuncture and its impact on Romania. Although Romania is relatively isolated from international economic swings, a few external developments could affect the recovery currently under way.

Fig. 13. Decreasing optimism in the Euro area: growth projections for 2001

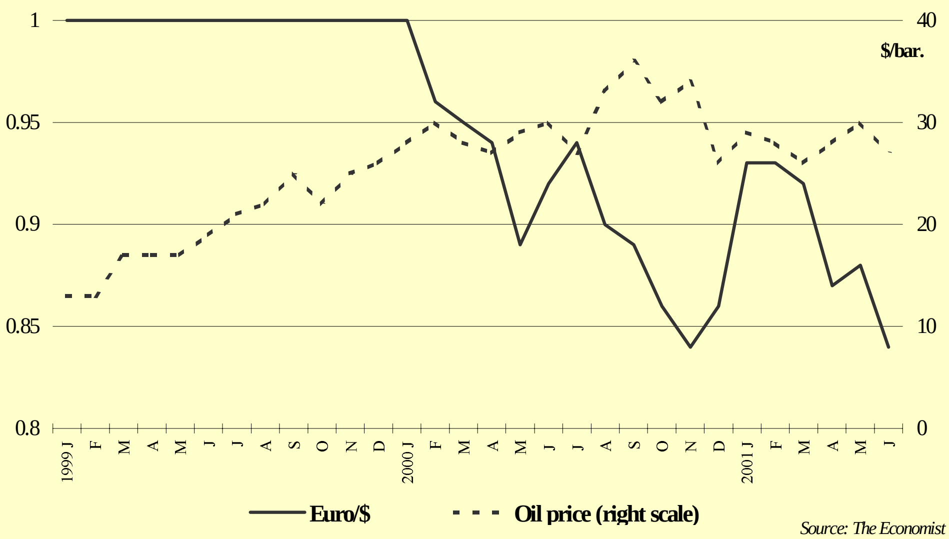


First, there is the continued drama of **the European currency**, which is not likely to end for at least another six months. The high price of energy (Fig. 14) together with the sliding Euro unfavorably influences the international position of the Romanian economy. The European currency, which has lost almost a quarter of its value since January 1, 1999, is currently being traded at around $0.85 dollars, only slightly above the historical floor of $0.8225 attained last October. Though cheerful hails and optimistic predictions accompanied its launch, two and a half years of depreciation prove that the initial enthusiasm was unwarranted. In the beginning, European monetary authorities did not seem to take the Euro's decline seriously, claiming that observing the inflation limit within the Euro area was a more important objective, but subsequently noticed that the Euro's weakness at the international level was not only an embarrassing reality, but also an important psychological factor in shaping the attitude of Europeans towards the newly born monetary union. It is worth noting that last year, even before the Euro spin to

$0.82, a group of German economists publicly stated that the Euro's depreciation meant the failure of the European monetary architecture, and warned that if these developments continued, a financial disaster would ensue. Since then, the European Central Bank (ECB) sensibly changed its attitude, but the internationally coordinated round of interventions in September 2000 did not significantly alter the Euro's fluctuating path.

As a consequence, Romanian exporters will continue to support the burden of the current international monetary situation, or at least those companies selling on EU's market (70% of all exports), while Romanian importers will bring cheap merchandises to domestic consumers. *The present growing discrepancy between exports and imports has, from this point of view, no chance of declining over the next months.* Equally concerning is the increasing pessimism of business analysts regarding the economic growth of the Euro area in 2001, the most important market for Romanian products.

Fig. 14. Between a rock and a hard place



Source: *The Economist*

Another factor that could negatively affect the Romanian economy is the **price of oil**. World economic growth and the relative rigidity of the oil supply have pushed it at historically high levels. Iraq's decision to stop selling oil within the agreement "food for oil" (amounting to 2.1 million barrels per day) will apparently sustain high prices, especially in the present state of affairs, when weak infrastructure severely constrains the supply and do not allow for a significant response from oil producers. The meeting of the main exporting countries (OPEC) this month ended without a decision to increase production, as many analysts expected. In fact, except for a few important producers (such as Saudi Arabia), OPEC members are producing at maximum capacity. The decision to convene a new meeting on July 3, and the postponement of any substantive response for the third quarter of this year, reflected the hope for a diplomatic resolution of the current situation, and the uncertainty related to a possible world economic slowdown. This will not relieve the upward pressure on oil prices; on the contrary, after a short period of calm the summer will arrive with crisis-level prices. This perspective is not at all encouraging for Romania, a country that imports 2/3 of its energy resources and is about to build up reserves for next winter.

As a result of the agreements regarding Romania's accession to the EU and CEFTA, a gradual decline on tariffs for Western and Central European imports determined an expansion of trade, with imports growing faster than exports in the last months. As long as Romanian companies do not manage to provide Western customers with desired high-quality commodities, this situation will become worrisome. The complete elimination of tarrifs for EU's industrial goods beginning January 1, 2002 and the resumption of import facilities for CEFTA (especially Hungarian) agricultural products will add pressure on the **balance of payments**.

Some Romanian commentators have expressed their concern that an increase in the current account deficit might pose problems in the long run. However, the last country report by JP Morgan is rather optimistic on this point: even if they project large deficits in 2001 and 2002, JP Morgan's researchers believe these can be financed from net foreign investments. Previous commitments contained in privatization agreements and greenfield investments are likely to be fulfilled – especially the investment plans of Renault, Continental Tire, Michelin or the Italian Gruppo Frati.

Directions for Action

- It is widely known that the more robust the economy's fundamentals, the more likely it is to resist to external shocks. Hence, Romania has to continue to restructure its economy and adjust the production structure to match the demands of domestic and foreign consumers. The energy-intensive industries, which were designed before the energy crisis and built in order to enhance the country's capacity to survive in autarchy, have to be thoroughly restructured.
- The theory shows that the exchange rate is a shock-absorbing buffer, if it is set in a free market. In Romania, the central bank (NBR) has, however, traditionally interfered with the market to regulate the leu's exchange rate. It hindered depreciation when it wished to use the exchange rate as an anchor for inflation, or it sped up leu's depreciation in order to help exporters. NBR has bought significant quantities of foreign currency over the previous year (its reserves average 3.5 billion dollars) with a view to promote exports. Yet the stimulation of exports through only

monetary activism in order to set in motion "sound" overall growth (precisely because it is export-driven) is not the safest road to prosperity.

- Against the notion that Euro's depreciation hindered the decrease of Romanian inflation rate, it is essential to mention that NBR tried to keep the existing terms of exchange with EU by depreciating the national currency. This policy and the recent statement of NBR's Governor that inflation would not fall under 10% for the next 3 years demonstrate that the stability of prices is not at the top of NBR's agenda, as it is in all developed and neighboring countries.