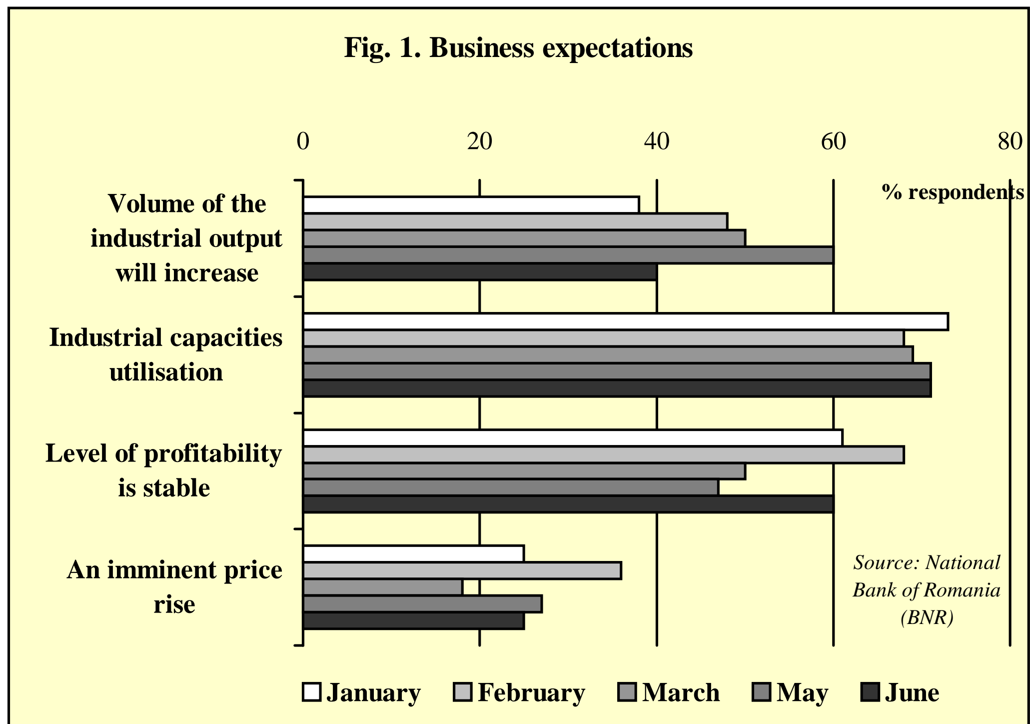
ECONOMY

BUSINESS IS GOOD, BUT THE TRADE DEFICIT WIDENS

Expectations of the Business Community (first six months - 2001)

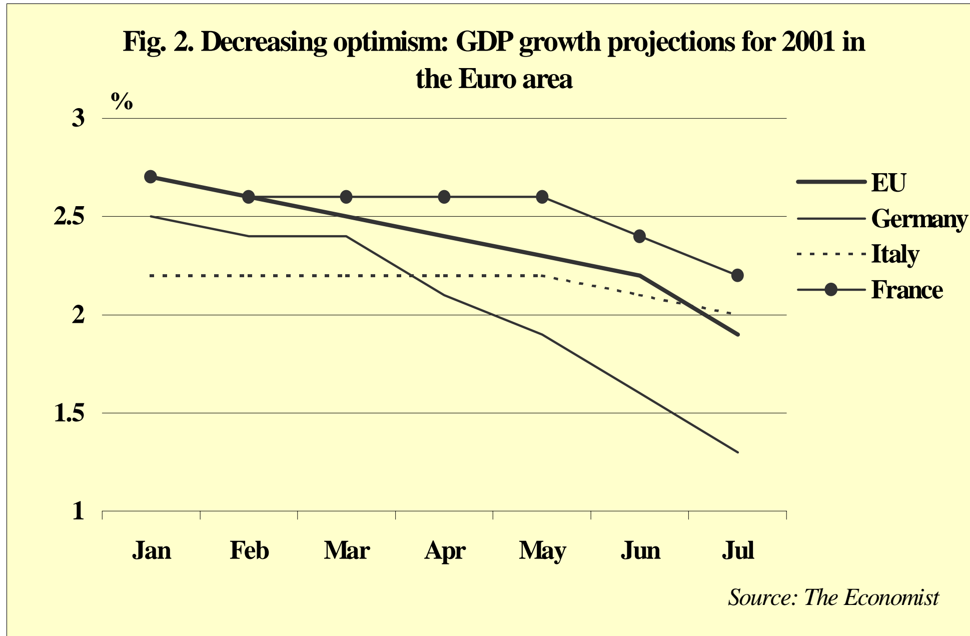
The National Bank of Romania (BNR) opinion poll shows continuity in most of the trends monitored since January. Entrepreneurs are still optimistic, but there is also some concern regarding the continuation of industrial growth – in June, the expectations in this respect fell back to January levels.



Trade and the international environment

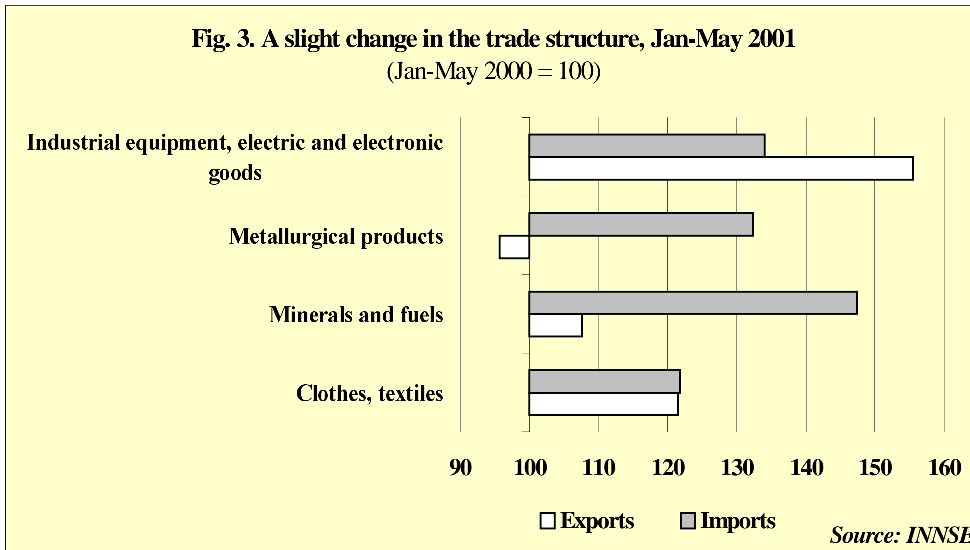
In spite of the declining growth and confidence in the Euro area (Fig.2) Romania currently trades more with EU countries than last year. The surge in exports to EU by 26% in Jan-May 2001 compared with the same period of last year, coupled with a slight change in the composition of exports (less metallurgical products, more industrial and consumer equipment and machinery) suggests that the Romanian industry is moving towards quality and higher value-added products (Fig. 3.).

Fig. 2. Decreasing optimism: GDP growth projections for 2001 in the Euro area



Source: The Economist

Fig. 3. A slight change in the trade structure, Jan-May 2001
(Jan-May 2000 = 100)



Source: INNSE

FOCUS: IS ROMANIA'S RATING REALLY ON THE RISE?

This issue's guest editorial is by Professor Daniel Daianu

A few months ago, Standard & Poor's, one of the main western rating agencies, raised Romania's rating from B- to B. This was a big relief for a country, which not long ago (in 1999), was threatened by external default. **What are the prospects now and could Romania come close to an investment grade in the foreseeable future which would propel her nearer to the main EU candidate countries?** In order to answer these questions, a bit of background history could be useful.

For those who closely observe transition economies, Romania provides a typical example of boom and bust. There was substantial growth during the period between 1993-1996, which explains the B/B- rating the country received from the main western rating agencies. But those years of growth were achieved at the expense of mounting tensions in the banking system and a rapidly increasing external debt. In spite of heavy borrowing on international capital markets, the official foreign exchange reserves of the country stood at less than US$ 700 million at the end of 1996, whereas monthly inflation reached double digit levels. When the growth period came to an end, a severe adjustment was in the making in order to avoid grave difficulties. The adjustment undertaken in 1997 relied on further price liberalizations, unification of the exchange rate, massive cuts in subsidies, accelerating privatization, etc. The policy turnaround invigorated the stock exchange for a period and replenished Central Bank reserves. With the benefit of hindsight, that policy of adjustment, arguably, fended off the worst possible consequences of contagion, which engulfed world financial markets after the fall of the Thai baht in late 1997.

Yet the economic plunge was unavoidable, owing to the toughness of the austerity measures. The GDP declined by 6.6% in 1997, 5.4% in 1998, and 3.2% in 1999; by almost 16% cumulatively. There was also a bout of high inflation in 1997, due to corrective measures taken that year; as a consequence, inflation, which reached at 151% in 1997, dropped to 40.6% in 1998. Another shock came in 1999, when very high debt service payments were due, which brought in the specter of external default. The threat was further reinforced by the IMF's new philosophy of burden sharing with private investors, promoted in a period when private investors were withdrawing from emerging markets, following the Russian crisis. Being denied access to international private capital markets (due to exorbitant interest rates), Romania could avert default only by an exceptional balance of

payments adjustment. The latter involved substantial expenditure switching and cutting, which almost halved the current account deficit to 4% of GDP; the national currency depreciated considerably in real terms and the budget deficit was brought down to 2.2% (without including privatization revenues). What is less talked about is the social cost of this policy. At the end of 2000 not fewer than 45% of the population (as compared to 22% in 1996) lived below the poverty line, which suggests a high social cost and deep frustrations, as well as tremendous challenges for policy-makers in the years to come. These challenges consist in working out policies which foster economic growth simultaneously with protecting social cohesion.

Last year brought a slight economic recovery (+1.6%), fueled primarily by a significant increase of exports, of more than 20%. The recovery has also sped up this year, with a rise of the GDP projected at more than 4%. Inflation is on a descending trend; after 40.7% last year, inflation could come down to 30-31% this year. The cleaning up of the banking system made an important stride forward with the restructuring of Bancorex and its merger (actually its take over by) Banca Comerciala, and the sale of Banca Agricola to a foreign consortium. There is also a slight recovery in investment. And not least, the bulging reserves (including gold) of the Central Bank, which reached US$ 4.5 billion (i.e. 4 months of imports) at the end of June this year, would justify S&P's decision to upgrade Romania's rating.

But there are pieces of bad news as well. Not quite unexpectedly – in view of the expansionary policies pursued by the current government and the Central Bank—the trade deficit (FOB/CIF) soared to US$ 1.75 billion in the first five months of 2001. Unless corrective measures are urgently adopted, the trade deficit could easily surpass US$ 4 billion this year, which would bring the current account deficit to more than 8% of GDP. Such a current account deficit would question the sustainability of the current policy thrust.

What lies behind the surge in imports? A set of explanations would have to highlight, inter alia: the unwarranted linkage of wages to expected inflation instead of productivity; a worsening of financial discipline among big state owned companies –mirrored by the rise of arrears by over 30%; fiscal and trade incentives, which raised the propensity to import, a recent real appreciation of the leu and, not least, an increasing budget deficit (programmed at 3.7% for this year).

Some may argue that the concern regarding the size of the balance of payments current account deficit is overblown since there is, seemingly, no pressure on the Leu on the foreign exchange market and, in addition, the real appreciation of the Leu does help disinflation. However attractive this line of reasoning may sound to some, there is ample ground to judge it as being shortsighted in view of several facts:

- The Romanian economy is still heavily dependent on compensatory flows, which are highly variable;
- Autonomous capital inflows are not insignificant, but they are mostly short-term and easily reversible;

- FDI inflows are much below the level recorded in the frontrunner transition countries and quite low in absolute terms and as a percentage of the current account deficit;
- The trend of productivity gains in the Romanian economy cannot be judged as permanent;
- World financial markets would become quite nervous about a current account deficit that is not financed from stable capital flows – the crises in Argentina and Turkey are quite ominous.

The issues linked with arrears and wage policies are likely to dominate the talks with the IMF mission next August. As a matter of fact, the delay in signing a new stand by agreement is a result of these very problems. Moreover, the soaring trade and current account deficit will be added as another hot topic to the talks. These issues will form the discussion core for the construction of the 2002 budget and of the policy mix, which, not surprisingly, will have to restrain the external deficits and improve financial discipline in the economy. One can surmise that the budget deficit target for next year would not exceed 3%, that the inflation target would be set at around 21-22%, and that the current account deficit would need to be targeted at substantially less than its current level. Cutting inflation to less than 25% in 2002 is very ambitious since inflation has become chronic; many enterprises "need" inflation in order to deal with arrears (reduce them in real terms) and inflationary expectations are powerful.

The need to reduce the current account deficit, and the corresponding policies to be pursued to this end, would very likely dent the growth, which was envisaged for next year; instead of 5%, the growth rate may have to be scaled down to 4%. The Government would have to work hard in imposing financial discipline in the state sector, in fostering privatization, in restraining wage demands from the unions, in simplifying the fiscal regime and making it more transparent, and in moving forward with the pension system reform.

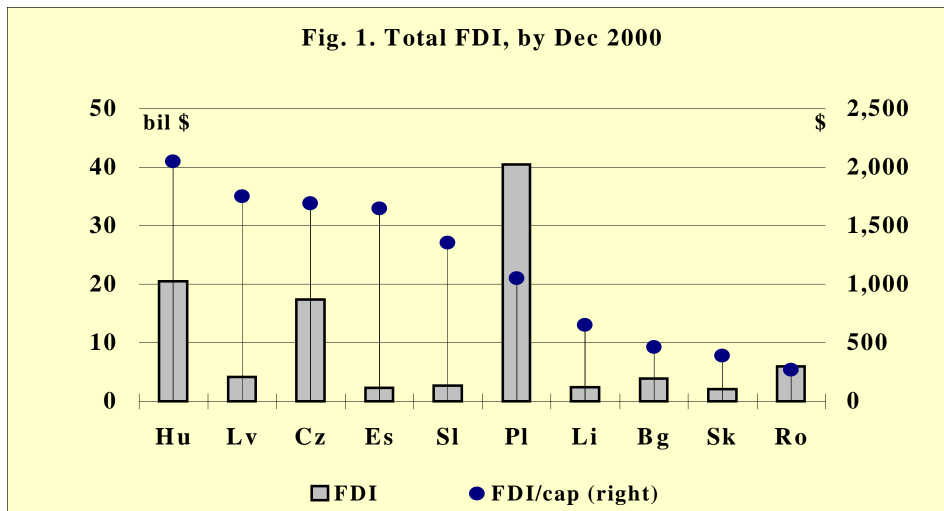
The final act in the sale of Banca Agricola and the privatization of Sidex would enhance the Government's reform commitments and send positive signals to the business community, at home and abroad. At the same time, Sidex's privatization would save the jobs of thousands of workers on a solid basis and would ease the burden on the public budget (the giant steel conglomerate costs the budget US$ 250 million yearly).

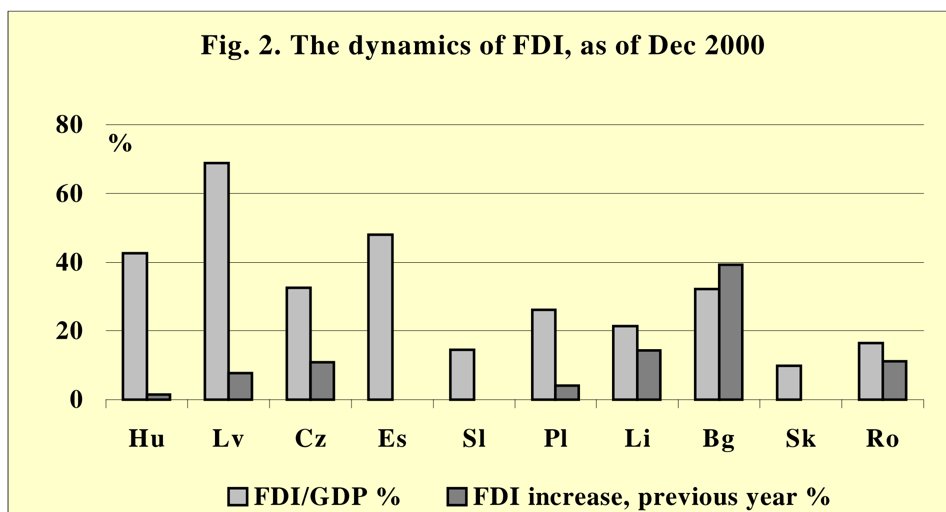
There has been some progress in the last 18 months, which is illustrated by certain economic indicators; but the road ahead is still littered with menaces and the way to deal with them is to have a Government determined to go forward by not succumbing to the pressures of vested interests. Otherwise, Romania would continue to muddle through, in spite of having been invited to start accession talks with the EU.

FOCUS: FOREIGN DIRECT INVESTMENT

The lowest FDI *per capita* in the region, and the blame rests mostly with the Romanian governments

As in many other respects, Romania ranks last among CEE countries negotiating admission into the EU in respect to the amount of investments by international companies. The total FDI in Romania is very low for the second largest country, in terms of size, in the region, and the lowest FDI/capita (Fig. 1). Despite addressing the issue and the sense of urgency that has prevailed lately in Bucharest, things have not improved much and the gap separating us from Bulgaria, the main regional point of comparison, continues to widen. While Sofia can support, with real data, its claims that privatization has accelerated (Fig. 2), Romania has been stuck in a phase of good intentions and in drafting its institutional framework.





Every new Romanian government after 1990 pronounced, at some stage, a fresh beginning with foreign investors. In fact, there has never been a coherent strategy and a stable legislative framework concerning investments, whether foreign or domestic, because either the Romanian authorities did not want to give up control of the economy, or they repeatedly changed their minds about the right system of incentives. Overall, two main stages can be discerned.

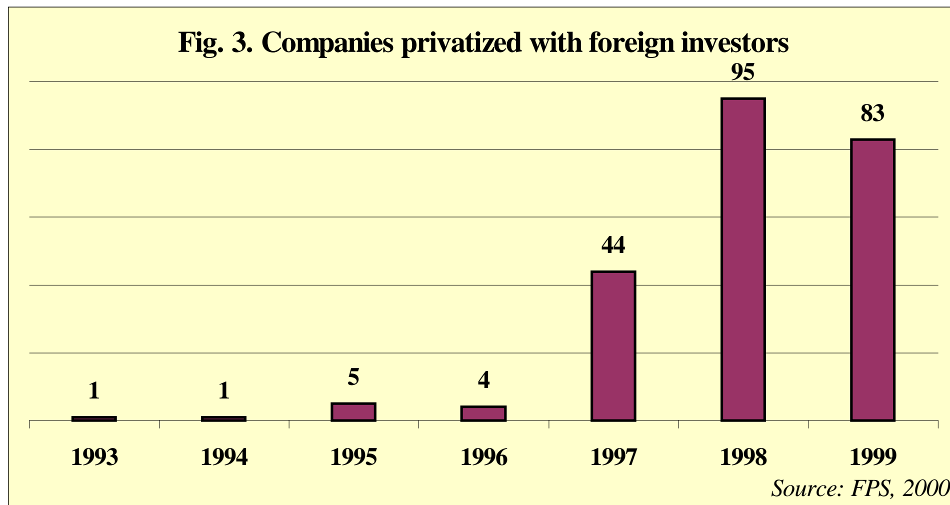
- **Before 1997**, the fear of foreign investors was high – and sometimes pathological. The ruling post-communist coalition was not convinced that privatization with multinationals was necessary, and focused its efforts on the inconsequential mass privatization scheme. This stagnation proved beneficial for domestic business groups with political connections. Very few companies were sold (Fig. 3), and no banks, since they were regarded as a tool for promoting the government's expansionary policies.

  Unfortunately, the period between 1991-1996 was the most favorable for privatization in Central and Eastern Europe. The world economy was on the rise and the major investors' mood towards emerging markets was running high, and this was when most of our CEE neighbors privatized. The positive attitude was never recovered after the Asian slump and the Russian crisis, which explains in part why it has been so difficult to find good investors subsequently.

  The opportunities lost during this period by the previous PDSR governments, especially by the one run by Nicolae Vacaroiu, are incalculable. According to most analysts, major Romanian companies are worth two or three times less today than ten years ago (Fig. 4) – and these are the good ones that eventually managed to find a buyer. Firms that were worse off are still state-owned and no investors have shown interest (ex. Promex Braila, a large industrial equipment plant, which has often been included in various privatization programs, but to no avail). Most probably, the politics of delaying privatization in early '90s stripped many of the state industrial and banking assets of whatever value they might have had after the fall of Communism, and left Romania with a FDI handicap that could not be overcome ever since.

- **After 1997**, the new center-right governments were less ideologically constrained to sell to foreign strategic investors. However, besides the swing of the international business climate, they were also incoherent. A flurry of contradictory Emergency Ordinances and Methodological Norms were issued in 1997 and early 1998, with the aim of putting foreign and domestic investors on a par – which meant in practice to extend to the latter the same facilities granted to the former. Finally, two years of effort and negotiations were summarized in the new Investment Law (241/1998) passed by the parliament in December. But only two weeks later the government changed its mind and eliminated most of the facilities, in return for lowering the corporate

profit tax. The new provisions were incorporated into the 1999 Budget Law, approved by the parliament in March. More than two years were thus lost, just to reach the simple ideas of a non-discriminatory and neutral investment regime, and an overall reduction of corporate tax.



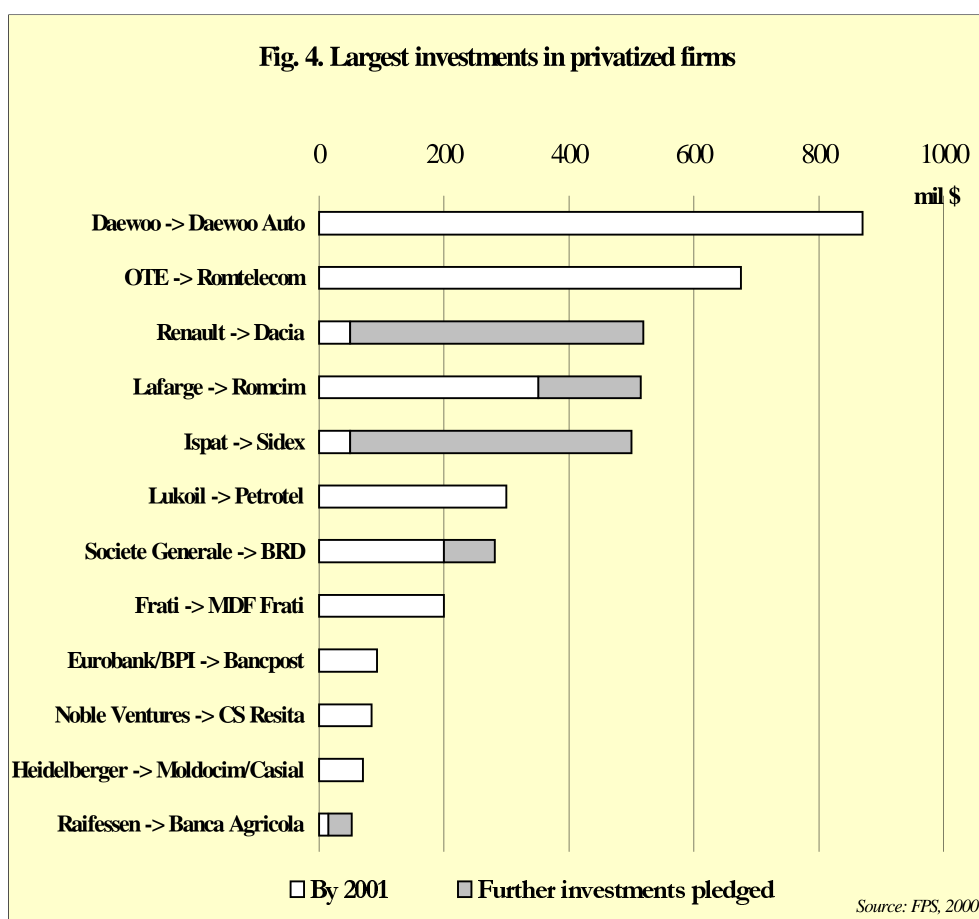
The new PSD (the former PDSR) government that took power in December 2000 has given signs of a break with their old practices, by luring in foreign investors. Banca Agricola was sold earlier this year, and Sidex Galati is in the final stage of privatization. However, there are still many things the government should / or should not do in order to boost its credibility with the international business sector.

- Privatization should be sped up in *tourism* and *agriculture,* since it has lagged for no good reason, and because productivity in these sectors is abysmal and there are no serious social problems associated with their restructuring.
- A clear schedule should be set for privatizing *BCR*, the largest Romanian bank. The selling of BCR has been regarded for some years by the international financial institutions and independent observers as a test case for the willingness of the Romanian authorities to give up political control over commercial lending. The fact that the bank has been kept in a state of uncertainty for more than three years, with no convincing explanation as to why all the deadlines were missed, suggests that either the government is reluctant to sell its last financial outlet, or underlying pressure from stakeholders (creditors and employees) has been too high. In either case, the government's credibility suffers. The strange silence surrounding BCR casts doubt over the statement of a top Central Bank official, that the bank will be ready for privatization by the end of 2001.
- The government should not be overgenerous with facilities and tax breaks, only to withdraw them later, when it becomes clear that they

are unaffordable. All business surveys show that legal and institutional instability, and not taxation, is the main problem for multinational corporations in Romania. The new Law on Foreign Investment introduced in June offers substantial advantages to large investors, both foreign and domestic. After what happened between 1997-1999 (and given the law's poor drafting, see below) its reliability will remain low – at least until the 2002 draft budget is endorsed, in early autumn.

- The government should not convey the impression that privatization contracts signed by APAPS (former FPS, the State Ownership Fund) with foreign investors can be 'reassessed' or even suspended by political decision. In the case of CS Resita, a steel plant sold to a smallish American firm with cash flow problems, the members of the cabinet were just too happy to issue threatening statements before they knew the exact legal limits of their intervention. Similarly, an embarrassing soap opera is currently going on in the form of an investigation into the 1998 privatization of Romtelecom, the national telephone monopoly. It still remains to be seen if there were any wrongdoings in this case. Many investment bankers suggest that a conclusion could have been reached without much fuss, by starting with the careful reading of the contract (including the confidential clauses) and comparing the success fee paid (about 1.3%) and the procedures (the commission was paid to consultants by the part who had hired them – in this case the seller, not the buyer). Meanwhile, the high-profile investigation of former ministers and foreign CEOs, who are brought for hearings to a shabby police station under a media spotlight, looks more like settling political scores than trying to settle a commercial litigation, if there is any.

More generally, the new government has a problem of language and appearance, which, if not fixed soon, threatens to become its trademark. The prime minister and other top officials, probably because they lack good and timely technical advice, rush to judgment and issue inflammatory utterances, only to backtrack later. Last month when the new law on foreign investments was being discussed, the PM scorned at the IMF and the World Bank's reservations regarding the facilities and tax breaks reintroduced: 'if they don't get it, we'll explain it to them again – twice, three times, until they understand'. These days the media is full of articles that point out to the vague provisions, amateurish phrasing and contradictions in the law. A less obnoxious approach to international officials and investors, especially given the long history of mediocre performance, would allow the current government to appear more professional before its business partners.



ROMANIA'S ENVIRONMENTAL FUND: THE GREEN ROAD TO EUROPE

Since the beginning of the transition towards a market economy, environmental funds have been a mainstay of CEE countries' efforts to address the communist legacy of environmental damage and the misallocation of natural resources. Nearly all countries in the region have at least one environmental fund and a few countries (Poland, Lithuania, Latvia, Bulgaria) have two or more, organized at the national, regional, or local levels. The funds share a common goal – assisting in the co-financing of environmental activities – but differ in their size, organizational structure, procedures for selecting projects, sources of revenue, and methods of distribution.

Some funds support broad-based environmental and natural resource projects while others are narrowly focused funds that finance the operations of a single park or protected area. Some funds are organized through government structures while others are independent legal entities such as trusts or foundations.

The Role of Environmental Funds

Environmental funds play two important roles in environmental and natural resource policy. First, environmental funds are a tool of environmental policy, providing financial resources for environmental and natural resource purposes. Second, environmental funds are institutions that can make a strategic contribution to environmental and natural resources policy.

Environmental funds, through their financial support, may address funding shortfalls in governmental conservation programs and provide a source of funding for organizations such as conservation and environmental NGOs with limited fundraising capabilities to cover operations and project costs. These two funding needs reflect the focus of "parks" and "grants" funds that have been established with the support of USAID and the UNEP/UNDP/World Bank Global Environmental Facility (GEF) to promote conservation and biodiversity objectives.

In countries with weak or developing capital markets, environmental funds may also provide financing for environmental investments and business developments at attractive (subsidized) financing terms for organizations with poor access to capital. This type of support reduces polluters' costs and creates incentives for facilities to address environmental problems ahead of compliance deadlines or compensate for the weak environmental enforcement capacity that is pervasive in developing countries.

Also, the environmental funds often provide considerable scope for public participation in governance and their procedures are structured to promote transparency and accountability. Thus, funds may demonstrate these important principles and serve as a catalyst for government agencies to accommodate public participation and access to information.

The experience of CEE countries

In CEE countries there are 21 operational Environmental Funds (some countries operate 2 or 3 such schemes).

Only Albania, Romania and Croatia do not have Environmental Funds. This instrument is not a part of the environmental acquis, but is strongly recommended by the EU as an important instrument for solving the complex environmental problems that exist in transition countries.

The amount of revenues administered by the funds gives an illustration of some of the differences. In 1997, aggregate revenues of the eight CEE "national" environmental funds surveyed (which excludes the Polish and Bulgarian EcoFunds, which nevertheless operate nation-wide, and the

Krakow Provincial Fund), totaled approximately US$ 720 mil., or US$ 9.44/capita. In contrast, the corresponding figures for the eight NIS "national" environmental funds surveyed (which excludes Russia's National Pollution Abatement Facility), are approximately US$ 36 mil., or US$ 0.16/capita. Even within the CEE and NIS regions the funds differ dramatically, at least in size. The 1997 revenues of Russia's Federal Environmental Fund (US$ 18 mil.), for instance, exceed the combined revenues of all other national funds in the NIS for that same year (US$ 17 mil.). The same can be said of Poland's National Fund for Environmental Protection and Water Management, whose 1997 revenues of about US$ 403 mil. surpassed the aggregate revenues of the other CEE national environmental funds that year (US$ 317 mil.).

The evolution, effectiveness and potential of the funds is closely linked with the broader progress being made by CEEC/NIS with economic and political reforms, as well as with developments in national environmental policy frameworks. **While funds may help to overcome some of the environmental financing challenges encountered during the transition period, they are not substitutes for fundamental reforms and should not be expected to fully mitigate the shortcomings of such reforms**. Significant differences in the development and potential of the funds can be seen between the CEEC, where reforms have been fairly steady and are advanced, and the NIS, where reforms have been less consistent.

Even as many CEE/NIS countries begin to benefit from successful reforms and to make progress through the "transition" period, environmental funds, endorsed as potentially effective transitional instruments, continue to play significant roles in financing environmental protection in the regions.

The Situation in Romania

In Romania, the Environmental Fund Law was promulgated in May 2000 as a Parliamentary initiative (Law no. 73/2000). This law was intended on one hand to solve one of the most important environmental issues in Romania and, on the other hand, to respond to EU concerns about the lack of economic instruments in dealing with pollution. ("The cost of compliance with the environmental acquis has only been roughly estimated but, according to a study financed by the European Commission, its order of magnitude is of approximately US$ 20 billion. A rational use of all the financial resources available is essential as well as the promotion of financial instruments related to the efficient use of natural resources and the respect of the "polluter pays" principle. **In this context, the establishment of an operational Environmental Fund should be considered a top priority**." - 2000 Regular Report from the Commission on Romania's progress towards accession)

Generally, the very fact that the legal basis for the Romanian Fund was established by Parliamentary Law was an important achievement, compared with many other CEE countries. However, the law was drafted in a "quick and careless" way that made its application impossible.

This was very disappointing given the fact that discussions regarding the establishment of an environmental fund in Romania had been taken place for several years. There is a wide body of experience concerning the advantages and flaws of other funds in the region. International experience provided a perspective on certain fundamental problems in relation with: revenues, functioning mechanisms, and disbursement mechanisms. The most important shortcomings of the law were:

- Lack of clear, specific mandate and objectives for the Fund and lack of a termination clause;
- Lack of clear legal status;
- Unclear definition of responsibilities of different bodies within the Fund;
- Unclear accountability and transparency provisions;
- Lack of provisions for cost-effectiveness;
- Legally weak, distorted and unpredictable revenue sources;
- Risky disbursement instruments and high fiscal risk due to contingent liabilities.

For instance in regards to accountability and transparency provisions the law does not provide for external financial audits to be conducted by independently chartered accountants and by the fiscal (treasury) authorities. Neither does it provide for legal audits (checking for the compliance with the laws) to be undertaken by the State Auditing Authority, or for performance audits (evaluation against stated objectives and performance standards) to be conducted by a relevant entity.

The law does not include performance criteria to be later evaluated by the Steering Committee and the Board of Directors. This problem may be corrected in the regulations for the Fund that are to be developed by the Government.

The law does not clearly define to whom the Fund should report to and who should elaborate and approve the reporting standards. There exists a very ambiguous statement in Art 6(e) that a report on the funds destinations and usage should be made public. Placing the reporting responsibility with the lowest structure (Executive Secretariat) runs against good international standards.

In what revenue sources are concerned, there are several important issues to be highlighted.

In order to achieve its objectives, meet its commitments, and prepare realistic programs and budgets, the Fund needs a predictable and stable revenue stream. Hence, the revenue composition is of utmost importance. Unfortunately the revenue sources listed in Art 9 are very controversial. The law does not identify institutions responsible for the collecting of revenues and the proportions to be allocated to the Fund. Art 9(2) provides for it to be

determined by Government decree. Normally no government agency will have the incentive to collect revenues, which will have to be later transfered to another institution (i.e. the Environmental Fund), unless there is a legal requirement to do so. It will be difficult for government agencies to agree on who will take on this additional burden and even more difficult to enforce collection later on. Revenue sharing arrangements usually strengthen the incentives for effective revenue collection. The law does not mention sanctions for delayed payments, other than a very weak provision in Art 12(2).

The revenue sources represent a bizarre mixture of administrative charges, sales taxes (second and sixth tier), pollution charges and others. In most cases the revenue sources for the Fund involve tax competition and only Art 9(1)(b) includes a disclaimer. Equally, Art 9(1)(a) involves competition with the revenue for environmental administration, which will cause either resistance to collect these charges by environmental authorities, or claims on the funds expenditure (for the financing of the administration from the regular budget).

If the Fund will provide loans, as hinted in Art. 10(2)(c), and loan guarantees, the law should explicitly state that repayments of loan principal and interest as well as credit guarantee fees can provide revenue sources for the Fund. Otherwise they are illegal. By the same token, interest on bank deposits should be legally allowed as a form of revenue if Art 8 is to be effective.

The law does not provide for an income tax exemption on Fund revenues, it neither refers to the required changes in the Tax Law, nor does it give the Ministry of Finance the delegation to apply tax exemptions.

Fig. 1. Environmental Funds in CEE Countries

		Major Sources of Revenue (% of revenue)		Major Disbursement Mechanisms (% of funds)	
Country and Fund	**1996 Reven. (mil $)**	**Leading Source**	**Second Source**	**Primary**	**Secondary**
Bulgaria: National Environmental Protection Fund	8.9	Carryover 31%	Import Duty on Used Cars 21%	Grants 46%	No interest loans 45%
Bulgaria National Trust Fund	5.5	Debt Swap 74%	Profits/ financial operations 23%		
Czech Republic: State Environmental Fund	197	Env Fees 49%	Privatization proceeds 37%	Grants 55%	Soft loans 43%
Estonia: National Environmental Protection Fund	6.7	Env Fees 50%	Water use charge 21%	Grants 95%	Soft loans 1%
Hungary: Central Environmental Protection Fund	93	Fuel charges 47%	Product charges 29%	Grants 51%	No interest loans 17%
Poland: National Fund for Environmental Protection and Water Management	433	Env Fees 49%	Loan repayments 30%	Soft loans 64% in 1995	Grants 18% in 1995
Poland: EcoFund	31.3	Debt Swap 89%	Profits/ financial operations 10%	Grants 100%	
Poland: Krakow Regional Environmental Protection Fund	17.2	Env Fees 61%	Profits/ financial operations 28%	Soft loans 73%	Grants 24%
Slovak Republic: State Environmental Fund	42.7	Env Fees 67%	State budget 22%	Grants 100%	
Slovenia: Environmental Development Fund	24.5	Carryover 38%	Privatization proceeds 23%	Soft loans 100%	

Source: *"Sourcebook on Environmental Funds in Economies in Transition: a Regional Overview and Surveys of Selected Environmental Funds in Central and Eastern Europe and the New Independent States." October 1999, OECD*

Most fiscal (or quasi fiscal) instruments to raise revenue for the Fund seem very distortionary and leave a great room for discretion with the authorities in charge of collection. For instance what legal definition is used to determine the products with a short life cycle? It is not known if all these instruments are already in use and definitions, rates, billing and collection systems are already in place. If not (as implied by Art 9.2), than establishing of a good systems within 3 months seems very ambitious.

Another series of problems lie with chancy disbursement instruments and high fiscal risk due to contingent liabilities.

Article 10(1) provides a list of eligible projects, which is all-inclusive and will provide little guidance to the Fund as to what its priorities are and how to

implement them. We have already discussed hazards of such abroad and the ambiguous definition of Funds objectives and eligibility criteria.

Article 10(2) of the law provides for the following disbursement mechanisms:

- Interest subsidies on credits provided by banks;
- Guarantees for Government borrowing for public (infrastructure) projects;
- Guarantees on bank credits provided to firms and direct loans to enterprises for introducing cleaner technologies;
- Awards for special achievements by enterprises/organisations.

Out of all these instruments, only interest subsidies and "awards" are not controversial. Interest subsides are relatively simple to manage, have a high leverage effect and can help the Fund accumulate experience with financial management, contracting, project appraisal, etc.

All other financial products listed in Art 10 require advanced and sophisticated risk management skills. It is essential for the disbursement instruments to be adjusted to the institutional and managerial capacity of the funds. In other CEE and NIS funds it was usually best to first allow the fund to use simpler instruments, such as direct grants and interest subsidies in order to accumulate experience with financial management, contracting, project appraisal and implementation monitoring. Major financial failures occurred when newly created, understaffed funds issued resource intensive financial products such as direct loans, equity or loan guarantees. Unless a loan department was created (with at least 2-3 experienced credit analysts) to analyse creditworthiness and the borrowers collateral, or the task was contracted out to commercial banks (for a fee), the loan portfolios would usually quickly turn into a stock of worthless assets.

Allowing the Fund to issue contingent liabilities such as a credit guarantee is particularly dangerous. Most environmental funds in CEE are not allowed to do so. The limited experience with loan guarantees has so far been unfortunate. For example, over-commitment of loan guarantees and forward commitments of grants (in lieu of expected revenue) has caused serious liquidity risk to the Czech Republic’s Environmental Fund and triggered management replacement (the Fund collapsed later on).

As a result of the above-mentioned problems, the law could not be applied since its promulgation. In the meantime, due to domestic and external pressures, the Government issued an Emergency Ordinance to address some of the law’s shortcomings.

Emergency Ordinance No. 93/21.06.2001 brings some changes to the Law but does not solve all the problems. Accountability and transparency provisions are not included in the new Ordinance, and the decision mechanism within the Fund has not been clarified.

However, a spectacular change, not seen across CEE countries, was made in respect to revenues. Now the biggest contribution to the Fund will consist in

a 20% share of scrap iron exports and a 30% share of timber (and logs) and nonferrous waste exports.

Collecting revenues will, however, be a challenging enterprise, taking into account that no country in Europe has done this for Environmental Funds. All the more so, since there is no mechanism for collection, despite the fact that on paper the potential for those revenues is of around US$ 125 mil./year. Another problem lies with the narrowness and instability of the tax base. It seems that, in choosing these revenues, the intention is to reduce exports of the above-mentioned raw materials instead of collecting revenues for the Environmental Fund.

Equally, there is no new provision that deals with VAT exceptions for fund activities.

There is an improvement regarding disbursement mechanisms; more options were added such as: grants, the co-financing of projects financed by foreign sources, interest subsidising, and carry-over. Unfortunately, the provision regarding guarantees has only been modified by limiting the guarantee to 60% of the loan.

Law 73 should be amended with the provisions in the Emergency Ordinance by Parliament. This will be a good chance to further improve the law, in order to make it functional.