

## **Romania: growing, but not yet a functioning market economy**

Romania has been encouraged by the EU Commission to finalize accession negotiations by the end of 2004 and to join the EU in the year 2007. In the first half of 2003, Romania opened all 30 chapters of the accession negotiations and closed 19 of them. The latest chapters, closed in June, were on taxation and free movement of goods.<sup>26</sup> The most immediate pressing issue is whether the country will, as the last among the accession countries, get the 'functioning market economy' status from the Commission in the autumn 2003 Regular Report. The government believes that it will be able to improve its position in the remaining months. While it can demonstrate progress in the development of most macroeconomic indicators, it has so far failed to meet the established targets regarding privatization and financial discipline.

The country is still in the course of catching up to its pre-transformation GDP level which requires high rates of economic growth despite a slump in its main foreign markets. After two years of economic growth in the range of 5%, a slowdown to about 4% can be expected for 2003. In the first quarter of the year, GDP was 4.4% higher than in the same period a year earlier. Gross value added increased only 3.5%; the rapid expansion of tax revenues made up for the rest of the growth. Despite an extraordinary increase in minimum wages, private consumption expanded by just 3.8% while government consumption stagnated. The most important growth item was gross fixed capital formation, up 6.8%. Its share in GDP surpassed 16%. The recovery of investments comprised first of all machinery and equipment investments, which indicates increasing restructuring efforts.

A slow shift in the output and export structure towards higher value-added goods is under way. While industrial output rose just 1.3% in the first four months and the main export industries (clothing and footwear) did not increase output, the production of electrical and transport equipment expanded. The latter also gained export shares, for the first time exceeding 20%, while the share of clothing in exports dropped below 25%. Merchandise exports increased dynamically up to March, but fell back in April. For the first four months, exports were 10% higher and imports 9% higher in euro terms than in the same 2002 period. The leu appreciated marginally against the currency basket consisting of 60% euro and 40% dollar. The widening gap between the strong euro and the weak dollar helped primarily the exporters of chemicals and oil derivatives. Exporters of finished goods work mostly under processing contracts where only the Romanian value added matters. At constant euro prices, exporters of clothing and footwear earned in May 9% more lei than at the end of 2002, while consumer price inflation was only 5.6%. The floating exchange rate

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<sup>26</sup> Some derogations could be achieved in both chapters. As to the free movement of goods, Bucharest will abolish all unchecked imports as of 2004. It also pledged to eliminate trade barriers and set up the Authority for Food Security. In the taxation chapter, companies with an annual turnover of less than EUR 35,000 will not need to pay value added tax for some more years.

regime seems to support competitiveness in an economy where the impact of capital inflows on the exchange rate is relatively small.

The current account deficit for the first quarter of 2003 was significantly lower than in the same period a year earlier (less than 2% of the GDP). Deficits on goods and services were to a large extent compensated by an increasing inflow of current transfers. Labour remittances from abroad have become one of the main currency earning activities. Revenues from FDI are small, but on the increase, with USD 389 million invested in the first quarter. A position that causes rising concern in the balance of payments is the unexplained increase of negative errors and omissions amounting to USD 654 million for the first three months. Had these been recorded in the current account, the deficit would be five times higher. Unrecorded net capital outflows started at the beginning of 2002, reversing earlier trend, but reached a high extent only in 2003. Local analysts assume either over-reporting of exports or capital flight. We may also consider unrecorded repatriation of Serbian deposits.

The major obstacle to becoming a functioning market economy is the failure of the state-owned sector, which comprises 40% of the industry, to function on the basis of hard budget constraints. Most of the 83 major companies put under special surveillance two years ago keep producing losses and their arrears to the budget, to utility companies and the rest of the economy do not decline. Insufficient competition, distorted prices and inefficient production prove that markets do not function in this part of the Romanian economy. The government's industrial policy, saving bankrupt companies and rescheduling the debts of troubled debtors, often delays restructuring instead of encouraging it. The Bank Assets Realization Agency (AVAB) plays a positive role as it aims to collect unserviced debt. AVAB recouped debts of some USD 372 million in the first five months of 2003. This was mostly achieved through the direct sale of the loss-making assets. AVAB's portfolio includes 1055 bankrupt companies, out of which 1002 are under liquidation procedure, and 53 are under reorganization process. AVAB also started to confiscate the personal wealth of managers of bankrupted state-owned firms.

The pace of enterprise reform is kept up by IMF and World Bank pressure. The Ministry of Industry and Resources is expected to send to the IMF a record of the payments received by the electricity and gas distribution companies every month. Energy sector privatization is seen crucial for fully enforcing discipline in payments to utilities, given the continued prevalence of weak corporate governance in the state-owned sector. Keeping down public sector wages and reducing over-employment in 22 companies are further closely monitored targets. These are difficult to meet as the authorities have to fight militant trade unions. Romania is not yet a 'functioning market economy'. It may nevertheless get that status in this year's Regular Report as a result of political negotiations. Reducing outside pressure will not help the Romanian transition process. With IMF surveillance phasing out and elections drawing near in 2004, slipping in macroeconomic stability may become a real danger. Disinflation may not continue at a rapid pace and the current account deficit may expand.

Table RO

## Romania: Selected Economic Indicators

	1998	1999	2000	2001	2002 <sup>1)</sup>	2002 1st quarter	2003	2003 forecast	2004 forecast
Population, th pers., mid-year	22502.8	22458.0	22435.2	22408.4	22391.0	.	.	.	.
Gross domestic product, ROL bn, nom.	371194	545730	800773	1167243	1512257	259019	327703	1850000	2210000
annual change in % (real)	-4.8	-1.2	2.1	5.7	4.9	3.1	4.4	4	4
GDP/capita (USD at exchange rate)	1859	1585	1645	1792	2043	.	.	.	.
GDP/capita (USD at PPP - wiiw)	5450	5510	5740	6230	6610	.	.	.	.
Gross industrial production									
annual change in % (real)	-13.8	-2.4	7.1	8.4	6.0	3.1	1.1	3	4
Gross agricultural production									
annual change in % (real)	-7.5	4.0	-14.8	22.7	.	.	.	.	.
Goods transport, mn t-kms <sup>2)</sup>	62364	45988	42131	40647	45961	9957	.	.	.
annual change in % <sup>2)</sup>	.	-26.3	-8.4	-3.5	13.1	11.0	.	.	.
Gross fixed capital formation, ROL bn, nom.	68111.6	96630.4	151947.2	238977.5	319645.1	39132.6	53615.7	.	.
annual change in % (real)	-5.7	-4.8	5.5	9.2	8.3	4.8	6.8	6	5
Construction output total									
annual change in % (real)	-0.5	-0.2	2.8	9.0	5.4	3.2	5.3	.	.
Dwellings completed, units	29692	29517	26376	27041	27302	3188	3704	.	.
annual change in %	-0.8	-0.6	-10.6	2.5	1.0	-7.7	16.2	.	.
Employment total, th pers., end of period	8812.6	8420.0	8629.0	8563.0	.	.	.	.	.
annual change in %	-2.3	-4.5	2.5	-0.8	.	.	.	.	.
Employees in industry, th pers., average	2272.0	1991.0	1873.0	1901.0	1882.0	.	.	.	.
annual change in %	-7.0	-12.4	-5.9	1.5	-1.0	0.6	-1.9	.	.
Reg. unemployed, th pers, end of period	1025.1	1130.3	1007.1	826.9	760.6	1257.4	779.2	.	.
Reg. unemployment rate in %, end of period	10.4	11.8	10.5	8.8	8.1	13.4	8.3	8	8
LFS - unemployment rate in %, average <sup>3)</sup>	6.3	6.8	7.1	6.6	8.4	10.0	.	8	9
Average gross monthly wages, ROL	1357132	1957731	2876645	4282622	5452097	5004791	6304419	.	.
annual change in % (real, net) <sup>4)</sup>	3.4	-3.8	4.6	4.9	3.7	4.4	9.6	.	.
Retail trade turnover, ROL bn	125513	160137	213569	287278	.	.	.	.	.
annual change in % (real)	20.6	-6.4	-7.0	1.9	0.8	-2.3	2.9	.	.
Consumer prices, % p.a.	59.1	45.8	45.7	34.5	22.5	26.9	16.7	18	15
Producer prices in industry, % p.a.	33.2	44.5	53.4	41.0	24.6	26.4	23.3	.	.
Central government budget, ROL bn									
Revenues	67216	93240	120342	148203	179206	34385	50977	.	.
Expenditures	77617	106887	149168	184012	226824	45613	58700	.	.
Deficit (-) / surplus (+)	-10401	-13647	-28826	-35809	-47618	-11228	-7723	.	.
Deficit (-) / surplus (+), % GDP	-2.8	-2.5	-3.6	-3.1	-3.1	-4.3	-2.4	.	.
Money supply, ROL bn, end of period									
M1, Money	22110	29669	46331	64309	88304	55881	79940	.	.
M2, money + quasi money	92530	134123	185060	270512	373712	275326	369451	.	.
Discount rate, % p.a., end of period <sup>5)</sup>	35.0	35.0	35.0	35.0	20.4	34.2	18.4	.	.
Current account, USD mn	-2968	-1469	-1363	-2223	-1573	-247	-170	-1500	-2500
Current account in % of GDP	-7.1	-4.1	-3.7	-5.5	-3.4	-3.1	-1.7	-2.7	-4.1
Gross reserves of NB excl. gold, USD mn	1374.8	1526.3	2469.7	3922.5	6125.7	4074.1	6323.0	.	.
Gross external debt, USD mn <sup>6)</sup>	9322.6	8770.7	10273.4	11924.5	15251.0	11616.8	15683.2	.	.
Exports total, fob, EUR mn <sup>7)</sup>	7412.4	7955.6	11219.2	12710.7	14677.5	3305.5	3767.9	15600	16500
annual growth rate in %	-0.3	7.3	41.0	13.3	15.5	6.2	14.0	6	6
Imports total, cif, EUR mn <sup>7)</sup>	10569.3	9896.0	14128.2	17362.5	18898.0	4168.6	4531.9	20200	21600
annual growth rate in %	6.3	-6.4	42.8	22.9	8.8	4.2	8.7	7	7
Average exchange rate ROL/USD	8875.6	15332.9	21692.7	29060.9	33055.5	32350.4	33155.4	32700	36400
Average exchange rate ROL/EUR (ECU)	9989.3	16295.6	19955.8	26026.9	31255.3	28344.3	33619.9	36000	40000
Purchasing power parity ROL/USD, wiiw	3028.9	4414.0	6213.2	8367.0	10221.0	.	.	.	.
Purchasing power parity ROL/EUR, wiiw	3298.2	4808.2	6806.5	9169.1	11051.2	.	.	.	.

Notes: 1) Preliminary. - 2) From 1998 new methodology in road transport. - 3) From 2002 new methodology in accordance to EU definitions. - 4) From 2000 excluding various social security contributions of employees. - 5) Reference rate of NB from February 2002. - 6) Medium- and long-term. - 7) Converted from USD to EUR using the ECB EUR/USD foreign exchange reference rate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.