

Romania: 2002 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Romania

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2002 Article IV consultation with Romania, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **October 11, 2002**, with the officials of Romania on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on December 19, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **January 8, 2003** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its January 8, 2003 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for Romania.

The document(s) listed below have been or will be separately released.

Selected Issues Paper and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

ROMANIA

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for
the 2002 Consultation with Romania

Approved by Susan Schadler and Liam P. Ebrill

December 19, 2002

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I. INTRODUCTION

1. The Article IV staff discussions were held in Bucharest during October 8–11, followed by discussions on the third review under the Stand-By Arrangement during October 12–18.¹

2. **In concluding the last Article IV consultation in November 2000, Executive Directors commended the authorities for progress in stabilization and reform, but noted that Romania still lagged behind most transition economies in Central and Eastern Europe.** Directors pointed out the importance of further fiscal consolidation, along with restrained monetary policy, financial discipline in state-owned enterprises, and rapid privatization, which were seen as crucial for strong growth, successful disinflation, and strengthening Romania's external position. These issues were subsequently addressed under a Fund-supported program approved on October 31, 2001. In completing the first and second reviews, Directors welcomed the progress in reducing inflation and containing the current account deficit, while reiterating the need to eliminate the quasi-fiscal deficits, contain wages in state-owned enterprises (SOEs) and accelerate structural reforms, which would be key to improving economic efficiency and the outlook for sustained growth.

3. **The completion of the third review under the SBA has been delayed owing to repeated slippages in wage policy in state-owned enterprises (SOEs).** The PC on wage bills in SOEs was again missed at end-September, rendering the end-December 2002 target beyond reach. The observance of a revised target is one of the prior actions for Board consideration of the review in February or March 2003.

4. **The World Bank's Board approved the second Private Sector Adjustment Loan (PSAL II) on September 12.** The loan supports privatization and reforms in the financial and energy sectors, and improvements in the business environment (Appendix II).

5. **The European Commission recently assessed Romania's progress as positive, but concluded that Romania had not yet completed the transition to a fully-functioning market economy.** In its 2002 progress report, the Commission emphasized that macroeconomic stabilization needed to be underpinned by the stronger enforcement of enterprises' financial discipline, improved tax administration, accelerated privatization, and readiness to liquidate loss-making enterprises. The newly created institutions for fighting

¹ The mission, led by Mr. Mates, included Messrs. Westphal, Gueorguiev, and Carnot (all EU1), Lall (PDR), Harjes (AFR), Ms. Rivera (administrative assistant EU1), and the resident representative, Mr. Cosse. Ms. Schadler, EU1 Deputy Director, participated in Article IV discussions. The mission met with Prime Minister Năstase, Governor of the National Bank of Romania (NBR) Isarescu, Minister of Public Finance Tanasescu, Minister of Labor Sârbu, Minister of Industry Popescu, Minister for Privatization Musetescu, Minister for Forecasting and Development Cazan, Minister for EU Accession Puwak, representatives of two opposition parties and the Council of Foreign Investors. Ms. Marinescu, Advisor to the Executive Director for Romania, participated in most of the meetings.

corruption, which remained a cause for serious concern, had yet to prove effective. Moreover, the executive's involvement in judicial affairs had not yet been reduced.

6. **The government commands firm support in Parliament.** Following Romania's invitation to join NATO, the ruling party is discussing the option of calling elections in early 2003. Regular elections would be due in 2004.

7. Romania accepted the obligations of Article VIII, Sections 2, 3 and 4 of the Articles of Agreement in March 1998, and maintains an exchange system free of restrictions on the payments and transfers for current international transactions. The statistical base is broadly adequate for surveillance and program monitoring (Appendix III).

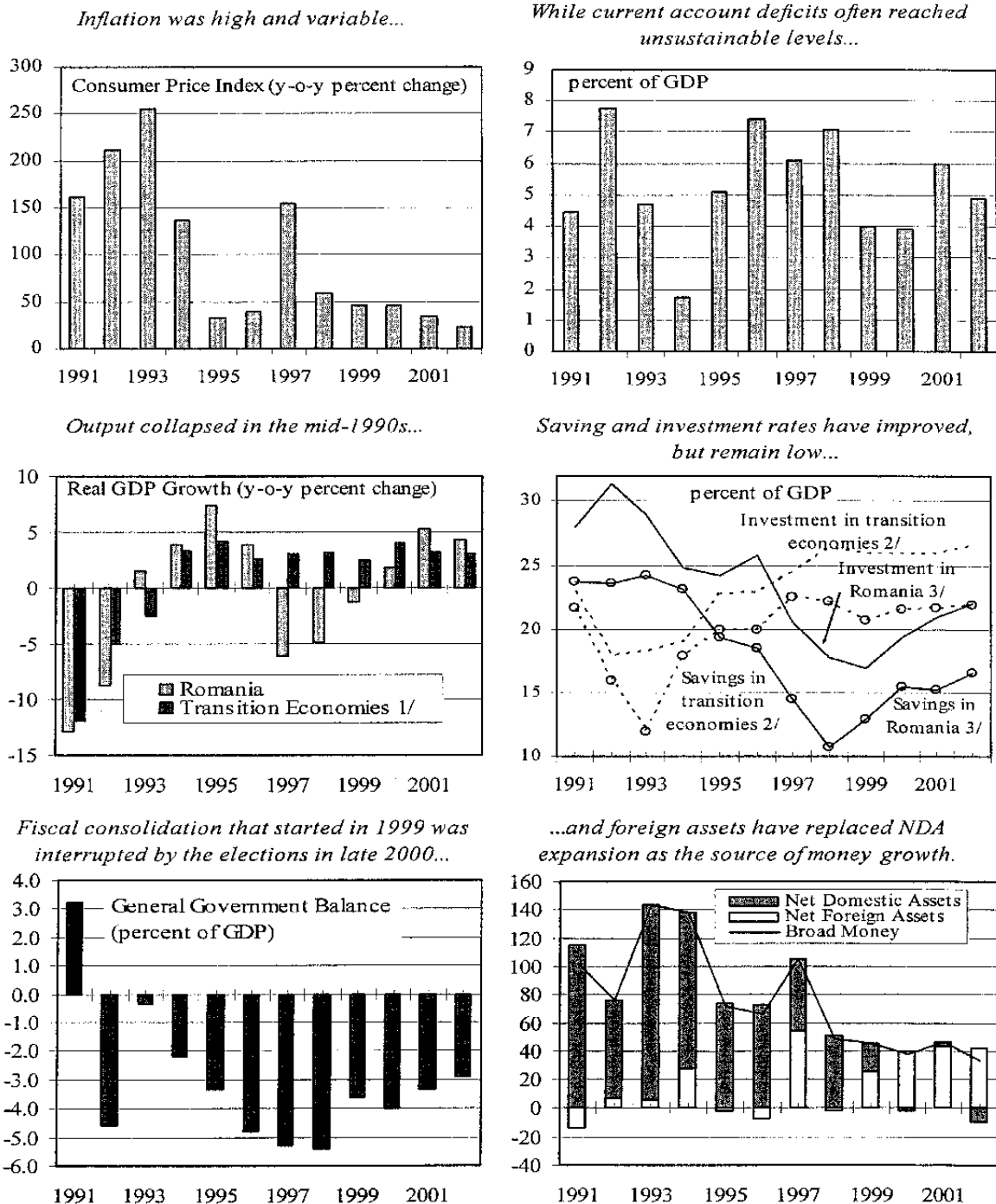
II. BACKGROUND TO THE DISCUSSIONS

8. **Until recently, Romania's macroeconomic performance in the course of transition was weak and characterized by boom-and-bust cycles.** Policies often fell prey to electioneering and the instability of coalition governments. The high and variable fiscal and quasi-fiscal deficits, financed largely through money creation, repeatedly led to unsustainable current account deficits and high inflation (Figure 1). Output collapsed in 1997-98, while domestic saving and investment rates dropped and have not yet recovered to levels recorded in other CEE transition economies. Romania compares unfavorably with these countries with respect to FDI, privatization, the perception of corruption and the business climate. However, having begun the transition with virtually no debt, it remains one of the least indebted transition countries (Figure 2). The performance under five Stand-By Arrangements approved in the 1990s was weak, and all programs went off track.

9. **Over the last year and a half, the economy has experienced an exceptional combination of disinflation, a declining current account deficit and strong growth (Text Table 1).** Following an election-triggered boom in domestic demand in late 2000 and early 2001, the authorities implemented a program of budget restraint, energy price adjustments and attempted to firm up wage controls. This dampened domestic demand and reduced the current account deficit. On the other hand, export and GDP growth were among the highest in the region, reflecting the fruits of private investments in export-oriented consumer goods industries over the last few years and the gains in competitiveness from the 1999 depreciation (Figure 3). Moreover, investment picked up, supported by expansion in credit to the private sector. The decline in employment, characterizing the 1990s, has recently bottomed out, and the unemployment rate has stabilized for the time being at about 8½ percent, a moderate level for a transition economy.² Inflation was brought down from 36 percent in mid-2001 to 19 percent in October 2002, owing to a gradual reduction in the depreciation rate supported by a slowdown in nominal wage growth (Figure 4).

² According to the ILO methodology, the unemployment rate was even lower, only 6½ percent, reflecting substantial employment in the informal sector. Labor market issues are discussed in the Selected Issues paper, Chapter III.

Figure 1. Romania: Inflation, Current Account and Government Deficit, Money Growth, Economic Growth, Savings and Investment Rate, 1991-2002 1/



Sources: Romanian authorities and Fund staff estimates.

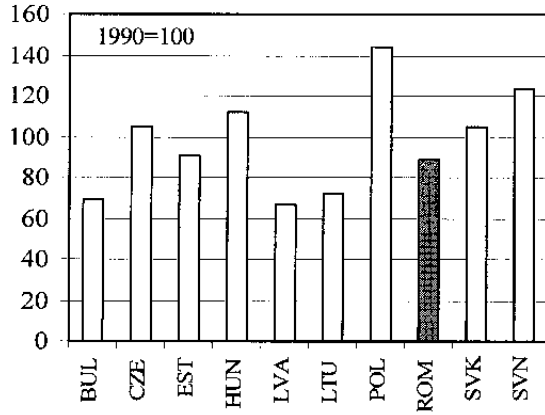
1/ 2002 is a staff estimate.

2/ Poland, Hungary, Czech Republic, Slovenia, Slovak Republic, Bulgaria and Croatia.

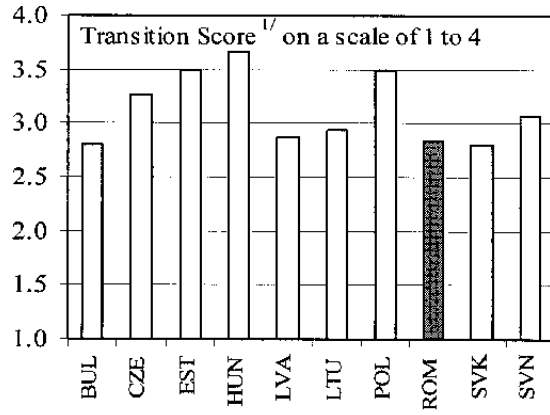
3/ Investment and savings rate includes extremely large increases in stocks in early 1990's.

Figure 2. Selected EU Accession Countries: Comparison of Economic Indicators, 2001

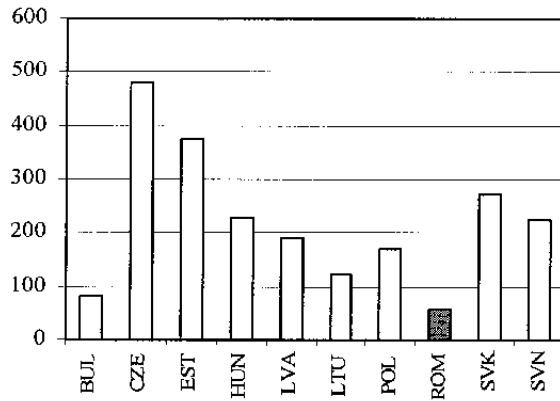
Growth performance was disappointing...



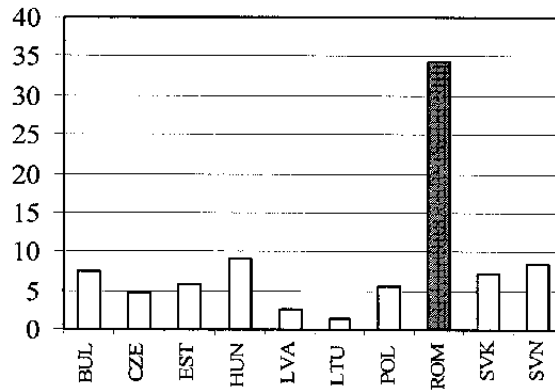
...while structural reforms, proceeded slowly



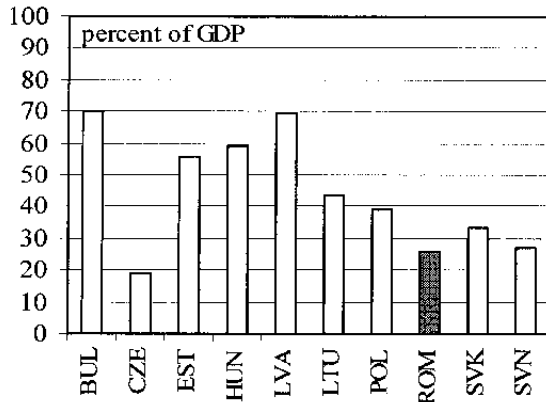
...and FDI per capita has been lower...



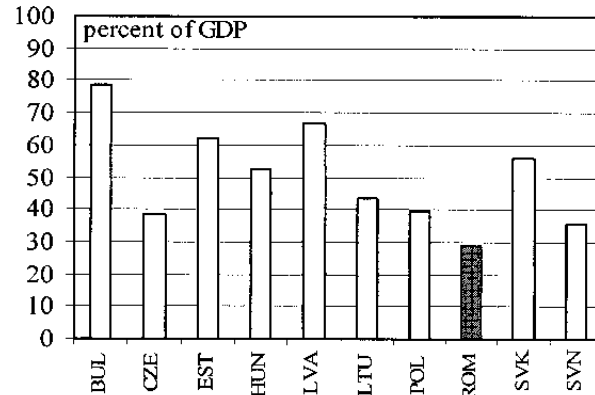
...while inflation is still the highest among transition countries.



However, total public debt...



...and foreign debt are comparatively low.



Sources: World Economic Outlook, Global Development Finance 2002, World Bank and Transition Report 2001, European Bank for Reconstruction and Development.

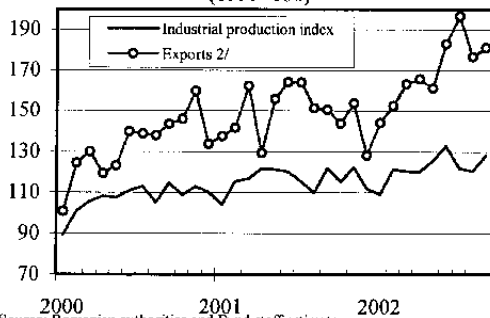
1/ EBRD transition score, averaged across enterprise, markets, infrastructure and financial institutions.

**Table 1. Romania: Main Economic Indicators, 2001-03
(annualized percentage changes, except where indicated)**

	2001		2002			2002	2003
	H1	H2	Q1	Q2	Q3 Est.	Proj.	Proj.
GDP	4.7	5.5	3.1	5.7	4.7	4.5	4.9
Final domestic demand	6.4	5.5	3.3	3.6	4.8	4.0	5.1
Total consumption	6.5	5.3	3.1	3.0	3.5	3.3	3.8
Gross fixed capital formation	6.4	6.2	4.8	6.3	9.8	7.6	10.9
Net exports (contribution to GDP growth)	-4.6	-2.8	1.1	2.6	-0.8	-0.2	-0.4
Exports of goods and services	20.8	6.3	3.8	10.6	18.4	15.4	8.1
Imports of goods and services	29.7	12.8	1.1	2.6	19.3	12.1	7.2
Current account (in percent of annual GDP)	-3.4	-2.5	-0.5	-1.5	-0.6	-4.8	-4.7
Inflation (eop)	35.7	30.3	25.1	24.0	19.8	19.0	15.0
Official reserves (eop, US\$ billion)	4.6	4.9	5.1	5.7	6.1	6.8	7.6

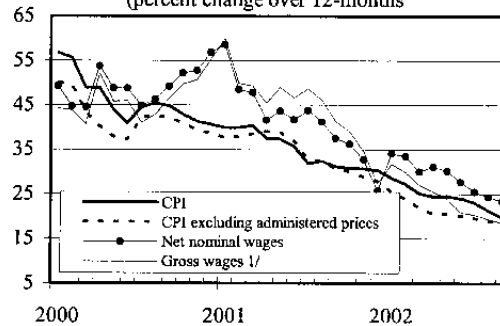
Sources: National Institute for Statistics; Ministry for Economic Development and Forecasting; and Fund staff projections.

Figure 3. Romania: Industrial Production and Exports, 2000-02 1/ (1999=100)



Source: Romanian authorities and Fund staff estimates.
1/ Seasonally adjusted data.
2/ Measured against a basket of 60% euros and 40% U.S. dollars.

Figure 4. Romania: Consumer Price Index (CPI) and Wages, 2000-02 (percent change over 12-months)

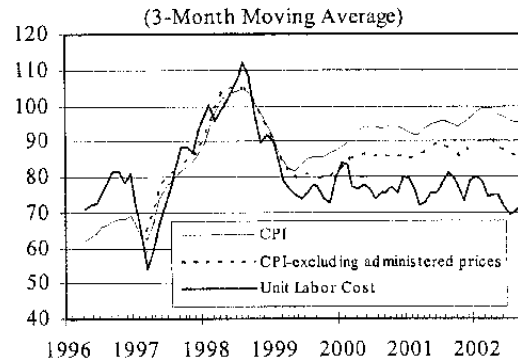


Source: Romanian authorities and Fund staff estimates.
1/ Gross wages adjusted for employers' social security taxes.

10. **The balance of payments considerably strengthened.** In 2001–02, the increase in net official reserves reached about US\$3.6 billion; gross reserves rose to 4 months of imports and 188 percent of short term debt by remaining maturity. In this period, Fitch and S&P upgraded Romania’s sovereign risk by two notches, and Moody’s by one. The spreads on Romania’s sovereign issues dropped to 270 basis points above comparable bunds.

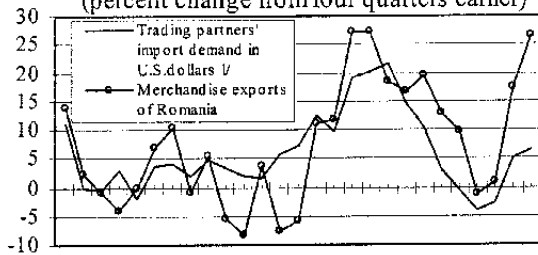
11. **Rising productivity, complemented by moderate economy-wide wage growth, has preserved competitiveness despite the slowing rate of depreciation.** The CPI-based real effective exchange rate (REER), adjusted for increases in administered prices (which affected primarily households), has recently appreciated only modestly, driven by terms-of-trade gains and possibly the Balassa-Samuelson effect.³ ULC-measured competitiveness seems to have improved, as productivity gains offset real wage increases (Figure 5). Not surprisingly, since early 2000 Romania has gained market shares in its main export markets (Figure 6). And wage share indicators suggest that profitability of Romanian producers has strengthened (Figure 7).

Figure 5. Romania: Real Effective Exchange Rate, 1996-2002



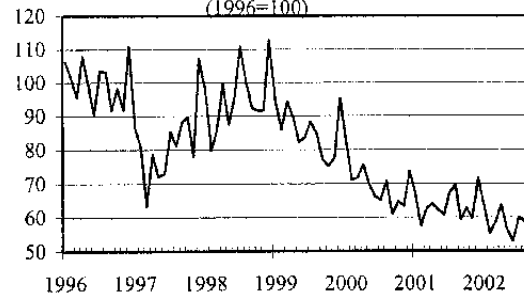
Source: Romanian authorities and Fund staff calculations.

Figure 6. Romania: Trading Partners' Import Demand and Romania's Exports 2000-02
(percent change from four quarters earlier)



1996Q1 1997Q2 1998Q3 1999Q4 2001Q1 2002Q2
Source: Romanian Authorities, Direction of Trade Statistics (DOTS) and Staff estimates.
/ Trade-weighted average for Romania's trading partners. 2002 Q3 is an estimate.

Figure 7. Romania: Unit Labor Cost Deflated by Producer Price Index, 1996-02
(1996=100)



Source: Romanian Authorities and Fund staff estimates.

12. **The successful stabilization has reflected progress in imposing hard-budget constraints on SOEs, but further efforts in this area are needed.** Throughout the 1990s, owing to persistently weak governance, SOEs incurred large losses, which were monetized by the central bank or financed by state-owned banks, arrears to the budget and to energy suppliers. SOEs access to bank credit was curtailed following the 1999 banking crisis and the subsequent reform, which closed the largest state-owned bank, Bancorex, and restricted the activity of Banca Agricola, until it was privatized in early 2001. Since then, the level of bank credit to SOEs has remained modest, equivalent to about 1½ percent of GDP. However, the

³ A discussion of Romania's equilibrium real effective exchange rate is included in the Selected Issues paper, Chapter I.

energy sector continued to subsidize other loss-making SOEs and households, as its prices were kept below the cost recovery level and the practice of nonpayment remained widespread. After the energy sector losses sharply increased in 2000 and early 2001, the government implemented substantial price adjustments. Between mid-2001 and mid-2002, the gas price for households was raised by over 85 percent in U.S. dollar terms, the heating price was doubled, and the electricity price for all users was increased by 42 percent. However, losses in the energy sector are still estimated at about 2¾ percent of GDP in 2002, owing to only modestly improved collections and the remaining disparity in gas prices relative to costs of imports (Text table 2).

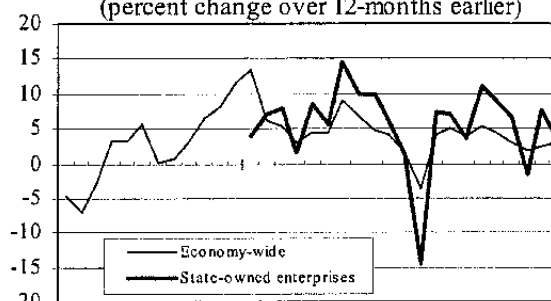
Table 2. Budget Deficit and Quasi-Fiscal Deficit in the Energy Sector
(In percent of GDP)

	1998	1999	2000	2001		2001	2002	2003
				H1	H2			
Deficit of the General Consolidated Government	5.4	3.6	4.0	1.5	1.8	3.3	2.9	2.65
Total Implicit Subsidies and Losses in the Energy Sector	...	...	4.9	6.3	3.9	4.8	2.7	1.8

Sources: Ministry of Public Finance, ANRE (electricity regulatory agency), Termoelectrica and Distrigaz Nord and Sud; World Bank; and Fund staff estimates.

13. **The results of wage policy in the state-owned sector have been mixed (Figure 8).** Weak financial discipline in SOEs and their excessive wage growth, which often carried over to economy-wide wages, derailed disinflation efforts in the past, including under the 1999–2000 SBA. In January–September 2002, economy-wide real wages grew by 4 percent year-on-year, in line with productivity growth. However, SOEs wages continued to outpace those in the private sector.⁴ Moreover, labor unions, which are strong primarily in the state-owned sector, successfully pressed the government to approve a 43 percent hike in the minimum wage—scheduled for January 2003—which might trigger an increase in overall wages and be a setback for disinflation. Unions representing budget sector employees are already pushing for a wage increase of 35 percent in the same month. And while the present legal framework for employment and wage

Figure 8. Romania: Real Wage Growth, 2000-02 1/ 2/
(percent change over 12-months earlier)



Source: Romanian authorities; and Fund staff estimates.
1/ Net of withholding taxes.
2/ The particularly low increase in December 2001 and the spike at the beginning of 2002 are primarily due to a postponement of bonus payments.

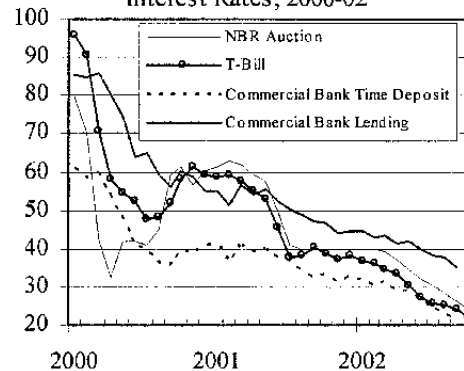
⁴ This was due primarily to the weak ownership of the wage program in the Ministry of Industry.

settlements in the private sector appears to be sufficiently flexible, the authorities are now proposing a new draft labor code, which according to preliminary information received after the mission, would strengthen the role of the trade unions in the wage bargaining process and might render layoffs more difficult.

14. **Fiscal policy supported the reduction in imbalances.** The consolidation, which started under the 1999–2000 SBA, was interrupted by the 2000 elections, but continued in 2001 and 2002 (Text Table 2). To address the substantial revenue loss caused by various tax incentives extended in 2000 and early 2001, the authorities implemented a far-reaching reform of the VAT and profit tax legislation in 2002, which eliminated many distortionary incentives and improved the business climate. In the same year, the extremely high payroll taxes were reduced by 3 percentage points. They will be cut by another 5 percentage points in January 2003. The authorities have also approved the new Law on Public Finance, which is an important step forward in improving fiscal transparency, although further work will be needed to include in the budget reporting on quasi-fiscal activities as recommended by the recent fiscal ROSC report. While the authorities maintained pension expenditure in this period roughly constant relative to GDP, they decided to correct pensions unfairly treated in the past in several steps in 2002–04. This will increase annual pension expenditure by about ½ percentage point of GDP by the end of this period.

15. **Monetary policy supported disinflation by reducing the crawling rate while keeping the policy interest rate high.** The targeted average monthly depreciation rate was reduced from 2.1 percent in early 2001 to about 1.1 percent in the first half of 2002 (Figure 10). The frequency of intervention has, however, been reduced to allow for a greater variability of the exchange rate and thereby reduce incentives for short term inflows. In June, the NBR switched its benchmark from the U.S. dollar to a basket (60:40 euro/U.S. dollar) to better reflect the weight of the euro in Romania’s trade and financial transactions. In January–October, against strong upward pressures on the leu, the NBR had to engage in massive purchases of foreign currency, which reached US\$1.7 billion. The main policy interest rate was cut by 16 percentage points during the same period (Figure 9), but in real terms based on forecasted inflation, it has fallen from 14 percent to the still high 7½ percent.

Figure 9. Romania: Evolution of Nominal Interest Rates, 2000-02

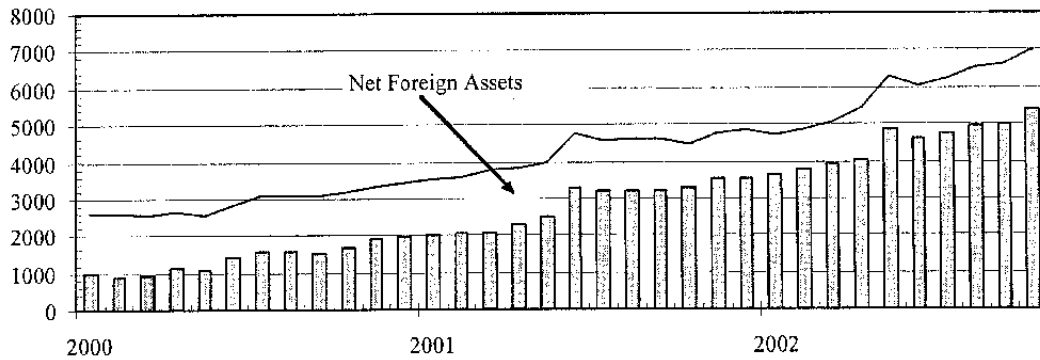


Source: Romanian authorities and Fund staff estimates.

Figure 10. Romania: Reserves, Exchange Rates, and Bond Spreads, 2000-02

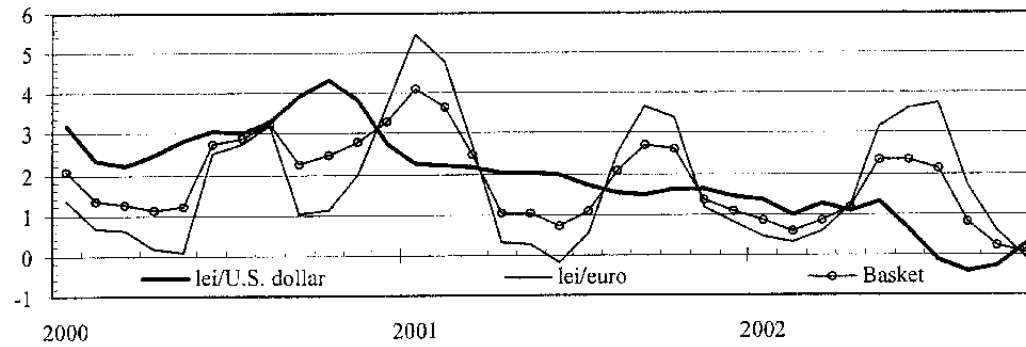
Reserves

Millions of U.S. dollars



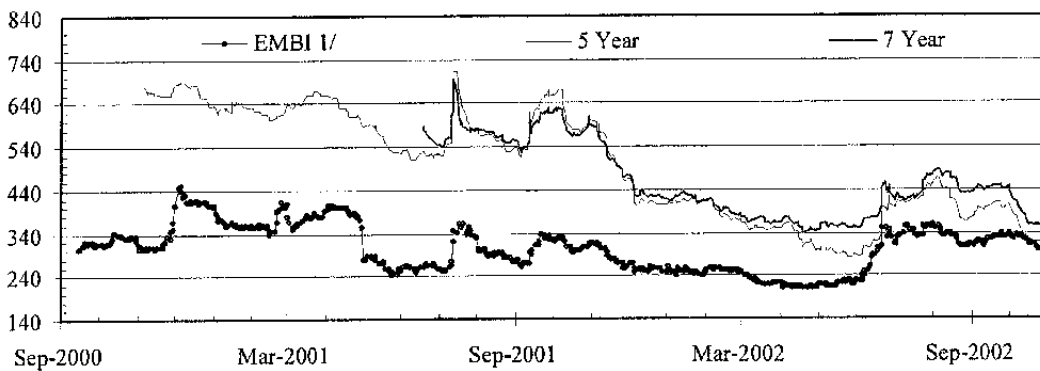
Monthly Depreciation Rate of Lei,

Three-month Moving Average



Bond Spreads

Basis points



Sources: Romanian authorities; Fund staff calculations and Bloomberg.

1/ Euro EMBI Global index excluding Latin America.

16. **The soundness of the banking system has improved, but recently a rapid expansion of bank credit has caused concern.** Following the 1999 banking reforms, commercial banks were recapitalized, and the system-wide capital adequacy ratio is now 27 percent; while all banks meet the mandatory 12 percent ratio, 27 out of 30 have ratios above 18 percent. The banking sector is profitable, with return on equity generally in the range of 21–24 percent since mid-2001. Except for the largest bank, Banca Comerciala Romana (BCR), only two other banks remain state-owned; the Savings Bank, which is in the process of restructuring, and Eximbank. Foreign banks account for the majority of bank assets. However, recent rapid growth, albeit from a low base, in banking credit to the nongovernment sector of about 35 percent in real terms, primarily in foreign-currency-denominated credit, has raised concerns. The credit surge is spread across almost all banks. The reported below-standard loan ratio remains low, 5–6 percent, but this may reflect an inadequate classification rule, which provides opportunities for evergreening. A clearer picture will be revealed in 2003, when a new regulation on loan classification and provisioning will require that borrowers' financial performance is taken into account, in addition to their repayment history. The authorities have requested participation in the FSAP, with a view to having an independent assessment of the potential vulnerabilities in the financial sector.

17. **The slow progress in privatization continues to hold back Romania's economy.** In 2001, the private sector accounted for 67 percent of GDP, one of the lowest shares among EU accession candidates. Collusion between the management of state-owned enterprises, trade unions and some factions within the government has often derailed privatization efforts. Despite a few notable successes in 2001 (including the largest steel mill Sidex and Banca Agricola), privatization has in general been slowed by restrictions on labor retrenchment and investment requirements. The privatization of BCR, the only remaining state-owned bank of systemic significance, has now been delayed. The government was disappointed by the weak response of potential investors to the first invitation to express interest, when only two consortia applied, both of which encountered legal difficulties. When the authorities reannounced the tender in November, albeit with limited enthusiasm, no investor participated. The authorities are now exploring the option of selling about a quarter of shares to the EBRD and IFC, as a transitory step to the final privatization.

III. POLICY DISCUSSIONS

18. **The authorities affirmed that joining the EU in 2007 is their overarching medium-term goal.** To achieve the status of a fully functioning market economy by the time of the next EU accession report, the authorities were in the process of adopting an action plan to accelerate structural and institutional reforms to address the core deficiencies identified by the EU and in line with the objectives incorporated in the SBA and PSAL II. At the same time, however, they considered it crucial that the reforms and renewed growth produce tangible benefits for the general populace, as otherwise political support for the reform endeavor would be at risk. They also noted that social considerations required a gradual approach to reforms.

19. **While acknowledging progress in macroeconomic stabilization and invigorating growth, staff emphasized that it was critical to proceed expeditiously with reforms and avoid another cycle of instability.** The weak governance in SOEs, the still large quasi-fiscal deficits and the long privatization agenda continued to weigh on the medium-term macroeconomic outlook, in particular on the prospects for achieving a low inflation rate and containing the current account deficit. Another bout of slippages in enforcing financial discipline could reverse the current favorable macroeconomic performance and compromise the objective to join the EU in 2007. Staff noted that the authorities' preference for a more gradual approach to reducing the quasi-fiscal deficit would come at the price of requiring stronger budgetary consolidation than would otherwise be necessary.

A. Medium-Term Macroeconomic Framework

20. **The authorities were optimistic about short- and medium-term macroeconomic prospects.** With consumption growth having been reduced to a sustainable rate and exports doing well, the authorities felt

Table 3. Macroeconomic Adjustment, 2001-05.

confident that the 2003 objectives of reducing inflation to 14-15 percent, containing the current account deficit to 4.7 percent of GDP, and sustaining output growth at 5 percent, were within reach. They reiterated their commitment to fiscal consolidation of ¼ percentage point of GDP, measures to further reduce energy

	2001	2005	
		PEP	Staff
GDP growth (average 2002-05 in percent)	5.3	5.1	4.9
	In percent of GDP		
Current account balance	-6.0	-3.5	-4.7
Government overall balance	-3.3	-2.7	-2.3
Non government investment	18.7	20.7	20.2
o/w energy sector	2.8	...	3.1
Non government saving	16.0	19.8	17.8
o/w energy sector	1.0	...	2.8
Inflation (eop)	30.3	7.0	6.0
Foreign debt	29.6	28.5	28.7
Public Debt	26.0	26.0	24.0

Source: Romanian authorities and Fund staff estimates.

sector losses relative to GDP by about 1 percentage point, and more effective wage discipline in SOEs. Pointing to the successful stabilization and the recent improvement in the business climate, the authorities were confident that strong growth of about 5 percent would continue over the medium-term, as envisaged in their 2002 Pre-Accession Economic Program (PEP) (Text Table 3 and Table 7). The depth of the 1997-98 crisis rendered it likely that the medium-term growth rate of the Romanian economy would exceed those in neighboring transition countries.

21. **Staff emphasized that sustaining such growth rates over the medium-term, while possible, would require a significantly faster pace of structural reform (Box 1).** To release resources for the development of the private sector, the authorities would need to proceed more rapidly with privatization and impose strict financial discipline on state-owned

enterprises. Moreover, more vigorous efforts to improve the business climate would be necessary. Staff commended the authorities' drive to make up for the disappointing growth performance of the 1990s, but recommended that medium-term fiscal plans be based on more conservative assumptions to avoid painful choices should the outcome be weaker.

Box 1: Romania's Medium-Term Growth Potential

Romania's GDP growth averaged only 1.2 percent annually in 1992–2001. Over this period, employment dropped by about 17 percent. The capital stock is estimated to have increased by about 10 percent over the period, contributing ½ percentage point to the annual growth rate. Growth accounting suggests that total factor productivity (TFP) contributed about 2.0 percent to the annual growth rate. The privatization and restructuring process have gradually improved utilization and allocation of factor inputs by reducing hidden unemployment and raising labor productivity.

Looking ahead, a 5 percent annual output growth over the medium term could be feasible, provided productivity accelerates and capital accumulation becomes a major driving force. Due to the renewal of the capital stock over the 1990s and the induced lower depreciation rate, an increase in the investment rate by 1.3 percentage points would suffice to push up capital's contribution to output growth to about 2–3 percentage points. The recent expansion in production and exports of new consumer good industries bodes well for such prospects. The decline in employment should come

to a halt as job creation in new industries and services is expected to broadly match the unemployment effects of further restructuring. Institutional improvements, more efficient management and human capital accumulation will be required to sustain and accelerate productivity gains. To arrive at 5 percent real growth, annual TFP growth would need to reach 2–3 percent, about 0.5–0.7 percentage point higher than in recent years (Selected Issues paper, Chapter II).

Romania's Growth Potential

	GDP Growth	Contributions		
		Capital	Labor	TFP
1992-2001	1.2	0.4	-1.3	2.0
2002-2005	5.0	2.5	0.0	2.5

Note: Capital share assumed to be 0.4.

22. **The authorities indicated, and the staff concurred, that the gradual disinflation strategy remained appropriate as long as wage inertia prevailed in the state-owned sector.** Targeting a faster pace of disinflation in such circumstances could prove to be either unrealistic or damaging for competitiveness and growth. Staff pointed out that wage policy remains the most serious obstacle to faster disinflation: both the recent excessive wage growth in SOEs and the decision to increase the minimum wage in January 2003 were major concerns. The authorities reiterated their commitment to contain the effects of the minimum wage increase, and were confident that they would overperform in reducing inflation in 2003, as they did in 2002.

23. **On the medium term fiscal stance, which was the main issue in discussions on the macroeconomic framework, the authorities argued that there was no need for further fiscal adjustment after 2003.** In their view, the need to catch up with neighboring transition economies in improving health, education and infrastructure, and the costs of EU accession spoke in favor of maintaining the general government deficit over the medium term at its level targeted for 2003 (2.7 percent of GDP). They emphasized that the levels of foreign and public debt were very low and that other accession countries had been running higher deficits, notwithstanding significantly higher debt ratios. Attempts to shift infrastructure investment projects to the private sector had not been successful in other transition economies, and the authorities therefore indicated their intention to expand the use of government guarantees for investment in infrastructure. Such a fiscal position was in their view consistent with reducing the external current account deficit to about 3½ percent of GDP and strong growth in investment, as they expected that the non-government saving rate would increase by almost 4 percentage points.

24. **Staff argued that macroeconomic stability over the medium term could only be preserved with a more vigorous approach to eliminating the losses in SOEs and a tighter budget stance.** Staff expressed concern that the PEP did not clearly address the need to further reduce losses in the SOEs, particularly in the energy sector. In staff's view, the private saving rate is unlikely to increase substantially over the medium term, as profit margins decline as competition intensifies, and the households' savings rate falls once their access to bank credit and the expectations about the permanent incomes improved. Thus, even an improvement in the non government saving rate of about half that in the authorities' projections, could only be achieved by proceeding forcefully with the elimination of losses in the energy sector. In staff's view, containing the current account deficit at about 4¾ percent of GDP, which would keep the foreign debt to GDP ratio stable, required the elimination of the energy sector losses and improvement in the saving-investment balances of other SOEs, combined with the reduction in the general government deficit to no more than 2¼ percent of GDP by 2005. Staff also argued that additional fiscal tightening would be required in case of a surge in foreign exchange inflows, to prevent upward pressure on the leu and a deterioration of the current account, developments that could leave Romania vulnerable to a consumption boom, misallocations of resources, and ultimately a crowding out of needed investment.

B. Fiscal Policy

25. **In staff's view, the approved 2003 budget is consistent with the authorities' macroeconomic objectives.** The targeted fiscal contraction of about ¼ percentage point of GDP and the reduction in the energy sector losses of 1 percentage point were considered sufficient for compensating the impact of the surge in private investment on domestic demand. Moreover, the 5 percentage points cut in social tax rates will facilitate further improvement in competitiveness and the business climate. While the revenue projection appears prudent at this stage, staff shared the authorities' view that should a revenue shortfall occur, a supplementary budget would be needed to cut expenditure, preferably in the area of

subsidies. Staff reiterated that the fiscal stance would need to be tightened if the authorities do not succeed in containing the spill-over effects of the minimum wage increase.

26. **The discussions on a medium-term fiscal strategy are in an early stage and a debate is ongoing about further tax cuts, possible gains from improving tax collections, and expenditure priorities.** The PEP assumes gains in tax collections of almost 2 percentage points of GDP as a result of improved tax administration between 2003 and 2005, and an increase in primary spending of a similar size, reflecting the government's priorities to increase social spending and investment

Table 4: Fiscal Adjustment 2003-05

	2003	Change 2003-2005 (in percentage points of GDP)	
	Budget.	PEP 2/	Staff 2/
Tax revenue	28.1	2.1	0.6
Primary expenditure 1/	29.9	1.9	0.2
o/w capital expenditure 1/	3.7	0.6	0.2
Primary current expenditure 1/	26.1	1.3	0.0
Overall balance	-2.65	0.0	0.4

Source: Romanian Authorities and Fund staff estimates.

1/ Excluding EU grants

2/ While the PEP does not assume tax cuts in 2004-05, the staff estimate assumes a further cut in social security contributions in January 2004 with a revenue impact of 0.6 percent of GDP.

(Text Table 4). An alternative scenario developed in the context of the 2003 budget, envisaged a further reduction of the social security tax rates by 7 percentage points in 2004-06 to build on the positive reaction of the private sector and labor unions to the cuts in 2002

and those scheduled for 2003. Moreover, in line with their election program, the authorities considered introducing a second, lower VAT rate, which they argued, was a common feature in EU countries.

27. **Staff supported further cuts in social security taxes, but not the lower VAT rate.** As the high social security taxes have created significant distortions in the labor market and fostered the growth of the informal economy, staff welcomed further reductions, emphasizing that their scope would depend on success in broadening the base of social security contributions and improving collections, as well as further pension system reforms (see below). The authorities and staff agreed on the need to gradually reduce the national development tax on electricity consumption of industrial users—the last remnant of the pre-transition tax system. In staff's view, there was no scope for cuts in other tax rates, which were generally in line with neighboring countries. A split VAT rate would adversely affect an already weak tax administration and should be avoided.

28. **Staff concurred that there was substantial scope for increasing collections by strengthening tax administration and broadening the tax base of social security contributions.** Comparisons with other countries suggest that tax collections are low for the given tax rates (Text Table 5). The authorities have therefore decided to implement a comprehensive tax administration reform, in line with FAD technical assistance recommendations, and to broaden the social security tax base by curtailing exemptions for the so-called civil contracts. Staff strongly welcomed the resolve to improve collections, but estimated the revenue effects more conservatively, at about 1 percentage point of GDP.

Table 5. Cross Country Comparison of Revenue Collection and Tax Rates in 2001

	VAT			Social Security		Personal Income Tax		Profit Tax	
	Revenue in Percent of GDP	Standard Rate	Reduced Rate	Revenue in Percent of GDP	Contribution Rate	Revenue in Percent of GDP	Maximum Rate	Revenue in Percent of GDP	Standard Rate
Bulgaria	8.3	20	...	7.8	42.7	3.6	38	3.9	28.0
Czech Republic	7.0	22	5	14.7	47.5	4.9	32	4.3	31.0
Slovak Republic	7.6	23	10	12.2	50.8	4.6	42	2.3	29.0
Slovenia	9.6	19	8.5	13.6	38.0	6.3	50	1.5	20.0
Hungary	8.0	25	12	13.0	42.0	6.8	40	2.1	18.0
Poland	7.3	22	7/3	9.9	45.0	3.2	40	1.8	30.0
Romania	6.4	19	...	10.9	57.0	3.2	40	1.9	25.0

Sources: Authorities data and Fund staff estimates.

29. **Staff pointed out, and the authorities concurred, that more detailed medium-term expenditure plans were not formulated with sufficient concreteness to provide a clear view on the affordability of the planned tax cuts.** Staff welcomed intentions to continue downsizing employment in the budgetary sector but pointed to the importance of providing resources for improving public administration, the judicial reform, and for strengthening the institutional capacity for absorbing EU grants, which require the recruitment of well-qualified civil servants. Staff also advised the authorities to undertake a comprehensive review of social transfers and subsidies, combined with measures to downsize public enterprises, to free sufficient resources for financing EU accession-related expenditure.

30. **The authorities acknowledged that further reforms were needed to contain the deficit of the public pension system.** Staff pointed out that a combination of social security tax cuts and the compensatory adjustments of the pensions unfairly treated in the past will increase the deficit of the pension fund relative to GDP by almost 1 percentage point by 2006. While the overall pension expenditure at 7 percent of GDP would not be high relative to the other transition economies, this would still put pressure on other spending. Staff therefore recommended exploring the scope for accelerating the scheduled increase in the retirement age and equalizing it for men and women. The system should also be made more transparent and predictable to participants, in particular by reducing the authorities' discretion in setting the parameters of the pension system, including the indexation mechanism. However, these changes should not result in a substantial increase in the replacement ratio. The authorities were somewhat more optimistic in respect to prospects for improving collections, but they agreed with the need for greater transparency in determining the parameters of the system.

C. Monetary, Exchange Rate, and Financial Sector Policies

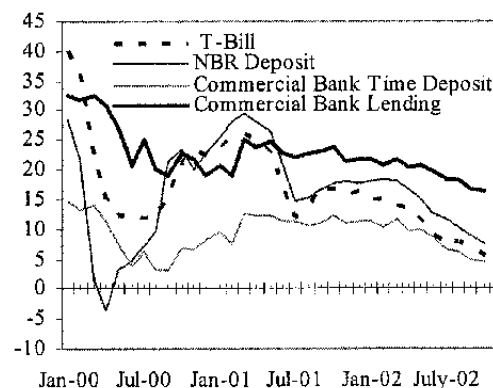
31. **The authorities and the staff agreed that the current exchange rate regime with targeted depreciation used as a nominal anchor remains appropriate until inflation has been brought down and wage discipline in state-owned companies strengthened.** Such a framework combines guidance to inflation expectations with sufficient flexibility for the exchange rate to react to adverse shocks. An outright switch to inflation targeting under the

current rigidities and inertia in SOEs' wage setting, combined with the steady excess supply of foreign exchange would likely result in an excessive real appreciation relative to what can be justified by the trends in the country's terms of trade, FDI and productivity differentials relative to trading partners (Selected Issues paper, Chapter I). At the same time, the authorities emphasized and staff concurred that the current regime is transitional. When control over SOE wages improves and inflation declines to single digits, it should be replaced by inflation targeting, a framework suitable for period leading to the EU accession. Until then, staff added, the liberalization of capital flows should be cautious, especially with respect to investments by non-residents in short-term instruments.

32. **The overriding concern of the NBR was the large surplus in the foreign exchange market, which prompted discussions on the appropriate policy response—lowering the rate of depreciation and/or lowering interest rates.** Having already reached the 2002 annual target for increasing official reserves in September, the NBR was concerned that further purchases would expose it to criticism for depriving the economy of credit while incurring sterilization costs. In its view, the foreign currency inflows were not attracted by high lei interest rates, but by improved investment opportunities and a surge in workers' remittances. Furthermore, real positive deposit interest rates were seen as necessary for the stability of demand for domestic currency assets. The authorities were therefore partial to slowing the purchases and lowering the depreciation rate. The NBR acknowledged the potential negative impact on competitiveness, but considered it manageable particularly in light of booming exports.

33. **Staff argued in favor of reducing interest rates (Figure 11).** The improvement in the country risk perception has rendered the policy of high interest rates inconsistent with the targeted depreciation rate, despite the existing restrictions on short-term capital inflows. The policy interest rate—at 24 percent in October—was providing an unduly strong incentive for inflows, which would further strengthen if the depreciation rate were reduced. While prudent cuts in lei interest rates would switch, on the margin, demand from lei time deposits to foreign currency deposits (and thereby relax the upward pressure on the exchange rate), this would not affect overall household financial savings, which were mostly motivated by the precautionary motive. Staff accepted that the depreciation target could be lowered somewhat in line with the reduction in the inflation target, but argued that the NBR should not try to undershoot the inflation target by lowering the depreciation rate by more than a small amount. Owing to nominal inertia in wages and the budget, any faster reduction in depreciation would put competitiveness at risk and could result in an inappropriate increase in aggregate demand. Since the mission, the authorities have cut the

Figure 11. Romania: Evolution of Real Interest Rates, 2000-02



Source: Romanian Authorities; and Fund staff estimates based on 12-month forward-projected inflation.

policy interest rate by 2½ percentage points and have guided the exchange rate roughly consistently with the revised inflation target.

34. **Staff expressed concerns about the recent rapid growth of bank credit, in particular in foreign currencies.** At such speed, the quality of banks' assessment of borrowers' creditworthiness was likely to deteriorate, and unhedged borrowers were assuming excessive exchange rate risk translating into higher credit risk for banks. The authorities noted that the stock of bank credit to the nongovernment sector was low—12 percent of GDP—that on average bank capital had recently increased even faster than credit exposure, and that growth in credit reflected the improved business climate. They expected, however, that the new regulation on loan classification, effective in January 2003, would press the banks to lend more selectively. On other possible measures to curtail credit growth, they were reluctant to increase the weights of foreign currency-denominated loans in calculating capital-adequacy ratios, as this was not a customary practice and it might be interpreted as a new restriction on capital flows. In any event, most banks had capital adequacy ratios well above the statutory floors. The authorities agreed, however, to increase the reserve requirements on foreign currency deposits from 22 percent to 25 percent, and reduce those for lei deposits from 22 percent to 18 percent, creating incentives for a more balanced currency composition of credit. (The existing requirements were contributing 5.5 percentage points to the lei deposit-lending spread, compared to 1.4 percentage point for foreign currencies; the difference will now be reduced by 1½ percentage point.) Staff encouraged the authorities to monitor the situation vigilantly, and implement the new regulation on loan classification and provisioning forcefully, including by targeting on-site inspections to banks with the highest increase in foreign currency lending.

35. **The authorities are proceeding with preparations to adopt a fully-fledged inflation targeting framework (IT) by 2004, when inflation is expected to fall to single digits.** These include the legislative changes to ensure full independence of the NBR in line with the commitments agreed in the context of EU accession, as well as developing technical capabilities for IT with the help of external technical assistance, including from the Fund. The switch to IT will also require strengthening of instruments for open market operations, and a gradual disengagement from frequent interventions in the foreign exchange market. While generally supporting the adoption of IT, staff warned that the capacity for developing reliable inflation forecasts was still limited, and that the transmission of interest rate changes to prices was weak. Staff also suggested that, in preparing economic agents for the new regime, a joint announcement by the NBR and the government of annual inflation targets and supportive fiscal and incomes policies would increase the credibility of the target and commit the government to consistent macroeconomic policies.

D. Policies for the State-Owned Sector

36. **The authorities recognized that establishing wage discipline in the state-owned sector was critical for improving financial discipline and reducing losses.** Staff reiterated concerns about the recent non-observance of wage discipline in several large companies and the need for vigilance regarding the effects of the sharp minimum wage increase in January

2003. If this increase feeds through into the overall wage scale in SOEs, macroeconomic stabilization would be seriously endangered. The authorities pointed out that in 2003, avoiding the problems caused by the reorganization of several industrial enterprises, wage policy would be better coordinated based on the experience acquired in 2002. They reconfirmed their commitment to limit the wage adjustment to employees with wages below the new minimum wage.

37. **The authorities intend to eliminate the deficits in the energy sector in a gradual fashion.** They pointed to the drastic 2001–02 price increases as evidence of their commitment, but noted that too fast an increase in the natural gas producer prices toward import prices (which are about twice as high) would be socially disruptive and could endanger competitiveness in some industries. Social concerns also motivated the authorities to postpone the gas user price adjustment from US\$82.5/tcm to US\$90 from January to March 2003; in July 2003, the price will be raised to US\$93/tcm. Staff noted that a sustained improvement in the financial performance of energy companies required further adjustments in gas prices and improvements in the collection performance in the entire energy sector. The increase in gas prices was also crucial for creating conditions for new exploration and avoiding rising dependency on imports. Regarding collections, the staff suggested to build upon the progress achieved by implementing disconnections of perennial nonpayers in the first half of 2002. While generally concurring with the importance of improved collections, the authorities insisted that in some cases disconnections or the liquidation of nonpayers could result in social hardship and acute unrest, particularly in regions that already suffered from de-industrialization.

E. Privatization and Business Climate

38. **While the authorities presented an ambitious privatization agenda, staff pointed out that an acceleration of privatization would crucially hinge on avoiding investment and employment conditions.** Privatization has so far proceeded slowly, but a relatively large number of projects are now in the pipeline. Moreover, by end-2003 the Ministry of Privatization plans to offer all companies in its portfolio for sale, with about 154,000 employees or 12 percent of public employment outside of the budget sector. The authorities argued that imposing employment and investment conditions on investors was necessary for ensuring socially responsible behavior. Staff emphasized disincentives to potential purchasers and delays caused by such conditions, which also often give rise to subsequent costly legal disputes.

39. **The authorities had decided to proceed with the privatization of BCR, but pointed to the weak market conditions.** They noted that the terms of sale would need to be fully commensurate with the value of this large and profitable bank. Staff concurred, but pointed out that prospects for recovery in the market were highly uncertain, so that delaying the sale may not be optimal.

40. **Discussions with representatives of the private sector suggested that the business climate had improved, but further efforts were crucial for increasing private**

investment. Foreign investors, who noted improvements in the predictability of economic policies and tax legislation, considered that administrative hurdles continued to be significant obstacles. They also noted that while minority shareholders' rights needed to be protected, the recent legislative changes on their mandatory compensation were imposing an unreasonable burden on majority shareholders. In discussions with the authorities, staff welcomed the authorities' recently announced program for improving the business environment by eliminating red tape, but noted that reinforcing the fight against corruption, in line with EU recommendations, was imperative. Greater transparency in the area of tax rescheduling and timely payment of VAT refunds would also be helpful.

41. **The authorities are contemplating a revision of labor legislation, but its overall direction remains unclear at the moment, and the private sector has complained about the absence of appropriate consultations.** In the medium term the working age population is expected to grow modestly, at about ¼ percent a year, and the participation rate to remain constant. With inevitable further restructuring in the state-owned sector, which still comprises over 30 percent of employees, preventing an increase in unemployment will require strong growth, a reduction in the tax wedge between gross and net wages, and flexible labor markets. In that regard, the new labor code should avoid introducing restrictive regulations, particularly on hiring and firing, that could hamper the growth in private sector jobs.

42. **Romania has a relatively liberal trade regime.** Trade in industrial products with the EU is free from tariffs, but agricultural tariffs are expected to be eliminated only upon accession. Romania also maintains a large number of Free Trade Agreements with the CEE countries, and it is in negotiations with some South East European countries. The authorities noted that through annual government decisions, approved in consultation with employers, labor unions, and end-users of imports, the tariffs on imports from other countries are reduced below the official MFN tariff rate, especially for imports from developing countries. Staff welcomed the ongoing efforts at liberalizing trade with non-EU partners.⁵

⁵ The trade regime is free from tariffs for industrial products trade in the EU area. Agricultural tariffs are expected to be eliminated upon accession to the EU. Negotiations on the liberalization of trade in some "sensitive" agricultural products, however, may be completed by early 2003. Romania maintains a large number of Free Trade Agreements with the countries of Central and Eastern Europe, and is in negotiations with some South East European countries under the Stability Pact. Negotiations with Macedonia, Yugoslavia, Albania and Bosnia-Herzegovina are nearing completion. The average overall effective barriers to trade are small and the average effective tariff rate, measured by import duty revenue relative to imports, is low, about 2 percent in 2001.

IV. VULNERABILITIES AND BALANCE OF PAYMENTS PROSPECTS

43. **Vulnerability indicators point to reasonably low short-term risks, but medium-term prospects crucially hinge on persevering with stability-oriented policies and structural reforms.** Foreign, public and publicly-guaranteed debt to GDP ratios are on the low side, and the level of official reserves relative to imports, money aggregates and short-term debt is high (Appendices IV and V provide an assessment of external and public debt sustainability). However, Romania has yet to show that the current reform efforts can survive a full electoral cycle. Reform stalling or an outright populist switch in political priorities would lead to a deterioration in fiscal and/or quasi-fiscal positions and ultimately to a reversal of disinflation and current account trends. FDI would weaken, and GDP growth would slow. Losing access to external financing seems unlikely, but the credibility loss would be severe, and the chance of significantly improving living standards and acceding to the EU later in the decade would evaporate under such a scenario. The first upcoming test of the authorities resolve to resist populist pressures will be their effort to limit the spill-over effect from the minimum wage increase. While the direct impact of this measure appears limited (about ¼ percent of GDP in additional wage payments), the authorities' determination will be key to prevent it from translating into overall wage increases.
44. **In general, the outlook for growth and inflation is expected to be robust to moderately adverse changes in the external environment.** Recent export resilience in a slow partner demand environment speaks to the likelihood that Romania could weather without disruption a slow recovery in western Europe. An outright recession in Europe, however, would require that fiscal policy be revisited to avoid a deterioration in the external current account. Higher oil prices may result in a temporary rekindling of inflation pressures, but the current account is unlikely to be seriously affected, as Romania exports a significant amount of petrochemicals based partly on local oil and gas production.
45. **The balance of payments outlook in 2003 and over the medium term appears favorable.** The authorities believe that improved confidence in the economy's prospects in the aftermath of the invitation to join NATO and the road map to accession provided by the EU will spur an increase in foreign direct investment and improve private sector access to foreign credit. Public sector borrowing will be reduced in line with the lower budget deficit. They also emphasized the importance of maintaining a sustainable external debt term structure. Staff generally concurred, pointing out that the favorable prospects would crucially depend on maintaining the debt ratios at their relatively low existing levels.
46. **Banking system vulnerability remains low for the immediate future; however, the current speed of credit expansion appears excessive.** In terms of stocks, the overall indebtedness of the private sector and its exposure to foreign currency denominated credit (both to domestic banks and foreign creditors) are low compared to other accession countries, which reduces risk for domestic banks (Text Table 6). Owing to the openness of its economy

and the substantial inflows of remittances, it is likely that foreign currency denominated borrowing will continue to grow, although disinflation should reduce the bias against borrowing in lei. Should, however, the current obviously excessive pace of overall credit expansion continue, the authorities would need to implement additional measures to protect the solvency of banks.

Table 6. Debt of Non-Government, 2001
(in percent of GDP)

		o/w in foreign currency
Bulgaria	30	20
Croatia	68	32
Czech Republic	72	42
Hungary	47	23
Poland	61	35
Romania	19	15
Slovak Republic	71	43
Slovenia	61	28

Source: National authorities and Fund staff estimates

V. STAFF APPRAISAL

47. **Romania has made impressive progress in addressing several long-standing weaknesses and is now reaping the performance to match.** A laggard in transition during the 1990s, Romania has made substantial progress in addressing its budget and broader public sector deficits, particularly in the energy sector, and made some, albeit insufficient progress in improving wage policies in the state-owned sector. The resulting reduction in macroeconomic imbalances has boosted confidence and investment, leading to a strong pick-up in growth over the past two years. Inflation has fallen and both the saving and investment rates have risen. The considerable strength of exports despite the protracted economic weakness in the EU suggests improved supply conditions.

48. **Continued strong performance over the medium term requires sustaining macroeconomic stabilization efforts and accelerating structural reform.** The macroeconomic framework and policy mix for 2003 remain adequate, although adjustments could be needed if a weak recovery in the EU cuts into projected export growth. Beyond 2003 monetary and fiscal policies will need to remain oriented toward disinflation and containing the current account deficit. The key challenge will be to continue with decisive structural reforms to improve the financial position and efficiency of state-owned enterprises while accelerating privatization. Such efforts will improve the business environment and attract foreign investment. Combined with the underutilized but skilled labor force and competitive wages, they should provide an excellent basis for strong growth. Actual performance will, however, hinge crucially on whether stop-and-go policies, which repeatedly derailed stabilization and reform efforts in the past, are avoided.

49. **Efforts to contain the general government deficit will need to proceed in tandem with measures to improve the structure of revenues and expenditures.** While the PEP puts fiscal policy on a path consistent with the Maastricht criteria, a larger adjustment is likely to prove necessary to support further disinflation and protect the current account in the face of a much needed acceleration of private investment. Within this envelope, social

security contribution rates need to be lowered and expenditures must be carefully prioritized to make room for accession-related spending on infrastructure and other investments.

50. **Completing the task of stabilization crucially hinges on progress in imposing hard budget constraints in the state-owned enterprise sector.** Large and volatile losses of these enterprises, particularly in the energy sector, have undermined stabilization efforts in the past, either directly when financed by borrowing, or indirectly by affecting tax collections and reducing resources for investment. Policies to improve financial performance and enforce a hard budget constraint in the state-owned sector will therefore remain crucial in the medium term. In the energy sector, the emphasis must be on stepping up the fight against the nonpayment of utility bills and tax arrears; quick closure of nonviable debtors; and further increases of gas prices to the import parity level, a position supported by the World Bank, as well as timely adjustments of electricity and heating prices in line with costs.

51. **Rapid wage growth in SOEs has plagued both enterprise finances and disinflation efforts.** Growth in SOE's already-high wages has substantially exceeded that in the private sector and should be contained. The signal effect of recent SOEs excesses for private sector wage settlements has been limited, but this could change, particularly if the role of the unions in private sector wage negotiations is strengthened. The authorities would be well advised to make every effort in limiting the spillovers from the large minimum wage increase in January 2003. Further real increases in the minimum wage, now that it has been raised to a high level compared to the average economy-wide wage, should be avoided. A more systematic approach towards wage policies in the SOEs, accounting for changes in productivity and labor market conditions would be welcomed.

52. **Better discipline in state-owned enterprises, however, is only a bridge to the imperative of privatization.** It is heartening that the authorities plan to put up for sale by end-2003 most of the companies remaining in their portfolio outside of the energy sector. But successful completion of these sales may prove impossible if conditions for preserving employment and committing to large investments are attached. Social hardship arising from a temporary decline in employment would be better addressed with the social safety net and by eliminating barriers for setting up small- and medium-size enterprises.

53. **The new labor code, the main features of which remain under discussion, should avoid imposing restrictive regulations on employers and should not complicate the downsizing of state-owned companies.** Further reduction in employment in state-owned enterprises is a necessary condition for reducing losses and accelerating privatization. Moreover, the new law needs to strengthen incentives to create new employment in the private sector, which would be significantly weakened by restricting layoffs. For Romania to escape the sharp increase in unemployment that has plagued the later years of transition in many other Central European economies, the authorities must spare no effort in maintaining flexible labor market conditions and creating an environment conducive to private sector growth.

54. **The authorities are aware that comprehensive institutional reforms are necessary for further improving the business climate.** Catching up with other EU accession countries requires institutional reforms in several areas; perhaps most importantly, the fight against corruption, perceived as a key impediment for expanding business activities in Romania, needs to be stepped up. Among other measures, in this regard, reform of the judiciary system to improve its effectiveness and independence stands out. Also important will be implementing an efficient bankruptcy mechanism for insolvent enterprises, an area where Romania lags behind all other EU accession countries.

55. **The current policy of guiding the exchange rate consistently with the inflation target has been successful and it remains appropriate in the near future.** Falling risk premia create scope for further interest rate cuts, which will reduce upward pressures in the foreign exchange market. To assure that credit growth remains sound, the authorities will strengthen bank supervision and strictly enforce the new regulation on classification and provisioning. While the overall exposure of the private sector to foreign currency risk is currently limited, should the rapid growth in foreign currency loans continue, additional measures will need to be kept under review.

56. **As sound policies succeed in reducing inflation to single digits and EU accession draws nearer, it will be appropriate to move to an IT framework for monetary policy.** The introduction of IT needs to be well prepared by establishing the institutional, operational and analytical prerequisites for its success. This includes the strengthening of the NBR's independence in line with Maastricht requirements. A joint announcement by the NBR and the government of annual inflation targets, and supportive fiscal and incomes policies, would increase the credibility of the target and commit the government to consistent macroeconomic policies.

57. It is suggested that the Article IV Consultation with Romania be held on the standard twenty-four-month cycle, subject to the provisions of the decision on consultation cycles approved by the Board on July 15, 2002.

Table 1. Romania: Main Economic Indicators, 1998-2003

	1998	1999	2000	2001	2002		2003
					Program	Projections	Projections
Real economy (change in percent) 1/							
Real GDP	-5.4	-1.2	1.8	5.3	5.0	4.5	4.9
Final domestic demand	-0.7	-2.9	1.6	5.9	4.0	4.4	4.9
CPI (end of period)	40.6	54.8	40.7	30.3	22.0	19.0	15.0
CPI (period average)	59.1	45.8	45.7	34.5	26.0	22.7	17.6
Unemployment rate (end of period; percent)	10.4	11.8	10.5	8.6	8.0	10.0	9.0
Gross national saving (percent of GDP)	10.8	12.0	15.8	16.0	14.1	16.7	18.0
Gross domestic investment (percent of GDP)	17.9	16.1	19.7	21.9	19.7	21.5	22.8
Public finance (general government, percent of GDP)							
Overall balance	-5.5	-3.6	-4.0	-3.3	-2.9 2/	-2.9	-2.7
Primary balance	-0.7	2.4	0.9	0.6	0.8	0.3	0.3
Total public debt (in percent of GDP) 3/	23.8	26.9	26.3	26.0	...	...	...
Money and credit (end of year, percent change)							
Real domestic credit 4/	20.5	-7.6	9.9	25.6	26.9	29.4	20.1
Broad money	48.7	46.4	39.2	47.8	29.5	32.6	24.2
Interest rates (percent)							
NBR interest rates (end of period) 5/	105.0	88.7	60.1	39.9	...	...	...
Treasury bill rate (period average)	103.8	99.9	59.4	46.7	...	...	...
Balance of payments (percent of GDP)							
Trade balance	-6.3	-3.5	-4.6	-7.5	-7.4	-6.5	-6.2
Current account balance	-7.1	-4.0	-3.9	-6.0	-5.6	-4.8	-4.7
External debt	23.5	24.6	27.7	29.6	30.4	28.6	28.1
Official reserves (end-year, US\$ million)	2,299	2,472	3,396	4,880	5,038	6,767	7,592
Reserve cover (months of prospective imports)	2.4	2.1	2.5	3.2	3.2	3.9	4.2
Exchange rate							
Lei per US\$ (end of period)	7,985	18,250	25,926	31,597	...	33,524 6/	...
NEER appreciation (+) (annual average in percent)	-51.9	-39.8	-22.8	-22.6	...	-15.1 7/	...
REER appreciation (+) (CPI-based, annual average in percent)	16.5	-14.8	9.5	1.6	...	3.4 7/	...
REER appreciation (+) (CPI excl. admin. prices, annual average in percent)	...	...	6.0	1.9	...	0.9 7/	...
REER appreciation (+) (ULC-based, annual average in percent)	37.9	-21.8	-0.3	-0.9	...	-4.1 7/	...

Sources: Romanian authorities; and Fund staff estimates.

1/ In 2002, national accounts data starting 1998 have been revised due to methodological change (adoption of ESA95 guidelines).

2/ The original target for the nominal budget deficit was equivalent to 3.0 percent of GDP. The upward revision of the nominal GDP was reflected in a lower deficit target in terms of GDP.

3/ Including domestic public debt and external public debt (public and publicly guaranteed).

4/ Credit to nongovernment sector. From 1999 onwards, weighted average of real lei credit growth and U.S. dollar-measured foreign currency credit growth.

5/ NBR deposit auction interest rate.

6/ End-October 2002.

7/ Jan-Aug 2002 over Jan-Aug 2001.

Table 2. Romania: Balance of Payments, 2000-02
(In millions of U.S. dollars)

	2001		2002						2003				
	Act.	Prog.	Q1	Q2	Q3	Q4	Proj.	Prog.	Q1	Q2	Q3	Q4	Proj.
			Act.	Act.	Proj.	Proj.			Proj.	Proj.	Proj.		
Current account	-2,385	-2,295	-277	-621	-285	-974	-2,157	-2,294	-380	-630	-365	-1,057	-2,432
Ratio to annual GDP	-6.0	-6.0	-0.6	-1.4	-0.6	-2.2	-4.8	-5.6	-0.7	-1.2	-0.7	-2.1	-4.7
Trade balance	-2,969	-2,781	-473	-668	-586	-1,160	-2,887	-3,039	-571	-662	-718	-1,253	-3,204
Exports	11,385	11,819	2,900	3,316	3,758	3,264	13,238	12,699	3,105	3,658	4,188	3,585	14,536
Imports	-14,354	-14,600	-3,373	-3,984	-4,344	-4,424	-16,125	-15,738	-3,676	-4,320	-4,906	-4,838	-17,740
Services account, net	-591	-465	-103	-248	37	-210	-525	-433	-96	-268	53	-221	-532
Receipts	2,281	2,288	497	648	702	713	2,560	2,587	564	698	791	780	2,833
Payments	-2,872	-2,753	-600	-896	-665	-923	-3,085	-3,020	-660	-966	-738	-1,001	-3,355
Of which: Interest, net	-394	-470	-54	-161	-20	-173	-409	-460	-39	-149	21	-158	-325
(Unrequited transfers (net))	1,175	951	299	295	264	396	1,254	1,178	287	300	300	417	1,304
Capital account	3,115	3,226	473	868	499	638	2,477	2,580	595	1,261	673	497	3,027
Direct investment and capital transfers	1,257	1,219	253	243	351	388	1,215	1,457	346	333	444	531	1,554
Portfolio investment	70	110	4	0	10	20	34	50	15	10	10	15	50
Borrowing by public sector 1/	1,103	1,401	60	387	85	301	833	673	63	489	25	-85	493
Loans (net)	314	611	81	35	85	301	502	530	63	89	25	59	236
Disbursements	1,337	1,605	339	341	401	693	1,773	1,670	373	379	316	352	1,420
Of which: Direct debt	465	800	114	109	166	540	929	840	172	237	262	301	912
Of which: Government guaranteed	873	804	225	231	235	153	844	830	201	142	114	51	508
Amortization	-1,023	-994	-257	-305	-316	-392	-1,271	-1,140	-311	-289	-290	-293	-1,383
Bonds (net)	789	790	-22	352	0	0	331	143	0	400	0	-144	256
Disbursements	790	790	-22	641	0	0	641	440	0	400	0	0	400
Amortization	-1	0	0	-289	0	0	-311	-297	0	0	0	-144	-144
Borrowing by private sector (net)	493	295	58	170	73	-71	230	399	121	379	144	-14	630
Disbursements	956	841	168	293	366	373	1,200	1,075	299	578	557	630	2,664
Amortization	-463	-546	-110	-123	-293	-444	-970	-676	-178	-199	-413	-644	-1,434
Trade credit (net)	193	201	98	68	0	0	166	0	50	50	50	50	200
o/w short-term (net)	188	200	89	55	0	0	144	0	50	50	50	50	200
Net errors and omissions	1,074	492	-227	135	67	872	847	300	0	0	0	0	0
Overall balance	1,805	1,422	-31	382	281	535	1,167	587	215	631	308	-560	595
Financing	-1,805	-1,422	31	-382	-281	-535	-1,167	-587	-214	-632	-308	559	-595
Net foreign assets NBR (increase, -)	-1,809	-1,484	-195	-665	-357	-612	-1,829	-507	-244	-662	-338	529	-715
Assets (increase, -)	-1,484	-1,021	-174	-626	-453	-484	-1,737	-621	-342	-739	-316	572	-825
Liabilities	-325	-463	-21	-39	95	-128	-92	114	98	77	-22	-43	110
IMF, net	-50	-51	-21	-39	96	-28	8	114	98	77	-22	-43	110
Purchases	67	67	0	0	105	0	105	211	106	106	0	0	212
Repurchases	-117	-118	-21	-39	-10	-28	-98	-97	-8	-29	-22	-43	-102
Others, net	-275	-412	0	0	0	-100	-100	0	0	0	0	0	0
Short-term	0	-100	0	0	0	-100	-100	0	0	0	0	0	0
Medium and long-term, net	-275	-312	0	0	0	0	0	0	0	0	0	0	0
Net foreign assets DMBs (increase, -)	4	62	226	283	76	77	662	-80	30	30	30	30	129
Assets (increase, -)	-99	130	167	114	6	37	324	-80	0	0	0	0	0
Liabilities	103	-68	59	169	70	40	338	0	30	30	30	30	129
Financing gap	0	0	0	0	0	0	0	0	0	0	0	0	0
Memorandum items:													
Current account balance plus FDI	-1,128	-1,075	...	...	...	...	-942	-836	...	...	...	...	-778
Ratio to GDP	-2.8	-2.8	...	...	...	...	-2.1	-2.0	...	...	...	...	-1.5
Export growth (percent)	9.8	14.0	0.9	17.5	26.6	19.9	16.3	7.4	7.1	10.3	11.4	9.8	9.8
Import growth (percent)	19.1	21.2	-1.1	6.6	31.3	13.5	12.3	7.8	9.0	8.4	12.9	9.4	10.0
Terms of trade (percentage change)	2.3	-2.3	...	...	...	...	0.9	-0.6	...	...	...	...	-1.1
External debt (US\$)	11,742	11,220	...	...	...	...	12,911	12,467	...	...	...	...	14,464
Of which: Public and publicly guaranteed	7,716	7,874	...	...	...	...	8,456	8,661	...	...	...	...	9,059
External debt/GDP (percent)	29.6	29.5	...	...	...	...	28.6	30.4	...	...	...	...	28.1
Debt service (US\$)	2,462	2,814	...	...	...	...	3,434	3,070	...	...	...	...	3,617
Debt service ratio	18.5	19.9	...	...	...	...	22.3	20.1	...	...	...	...	21.5
Gross official reserves of the NBR 2/	4,880	4,417	...	...	...	...	6,767	5,038	...	...	...	...	7,592
(in months of imports of goods and services)	3.2	3.0	...	...	...	...	3.9	3.2	...	...	...	...	4.2
(as percent of short-term debt)	159.6	165.7	...	...	...	...	190.4	183.4	...	...	...	...	174.1
Net external financing of the budget (US\$ mln)	882	1,038	...	...	...	...	646	711	...	...	...	...	663
Nominal GDP (US\$ bln)	39.7	38.0	...	...	...	...	45.1	40.8	...	...	...	...	51.4

Sources: Romanian authorities, and Fund staff estimates.

1/ Including public enterprises.

2/ Includes gold.

Table 3. Romania: Summary of Consolidated General Government, 1999-2006

	1999	2000	2001	2002	2003	2004	2005	2006	1999	2000	2001	2002	2003	2004	2005	2006
	Actual	Actual	Actual	Supplem. budget 5/ 31-Oct-02	Budget approved 13-Nov-02	Staff estimate	Staff estimate	Staff estimate	Actual	Actual	Actual	Supplem. budget 31-Oct-02	Budget approved 13-Nov-02	Staff estimate	Staff estimate	Staff estimate
	(in billions lei)								(in percent of GDP)							
Total revenue and grants	173,838	251,095	351,741	451,202	562,457	658,068	749,878	833,347	31.9	31.4	30.5	30.2	30.4	30.2	30.4	30.5
Current	173,337	249,945	351,108	450,499	561,202	657,068	748,747	832,095	31.8	31.2	30.4	30.1	30.3	30.1	30.4	30.5
Tax	164,026	235,048	326,699	423,654	523,968	615,422	706,825	790,326	30.1	29.4	28.3	28.4	28.3	28.2	28.7	29.0
Profits	17,037	20,334	22,206	28,093	39,596	47,085	55,787	60,142	3.1	2.5	1.9	1.9	2.1	2.2	2.2	2.2
Wages and salaries 1/	17,834	26,998	37,203	42,600	59,434	69,975	79,145	87,618	3.3	3.4	3.2	2.9	3.2	3.2	3.2	3.2
Social security 1/	57,667	86,557	125,106	169,628	195,760	226,000	260,729	291,531	10.6	10.8	10.8	11.4	10.6	10.4	10.6	10.7
Other direct taxes	8,276	8,081	13,025	13,020	19,151	22,547	25,502	28,233	1.5	1.0	1.1	0.9	1.0	1.0	1.0	1.0
VAT	32,471	50,439	73,604	103,366	124,572	149,598	172,587	194,886	6.0	6.3	6.4	6.9	6.7	6.9	7.0	7.1
Customs	7,847	8,702	9,038	9,000	8,163	7,596	8,429	9,135	1.4	1.1	0.8	0.6	0.4	0.3	0.3	0.3
Excise	16,958	20,636	27,293	33,792	45,880	55,637	64,816	72,473	3.1	2.6	2.4	2.3	2.5	2.6	2.6	2.7
Other indirect taxes	5,937	13,301	19,224	24,155	31,412	36,983	41,829	46,308	1.1	1.7	1.7	1.6	1.7	1.7	1.7	1.7
Nontax	9,311	14,897	24,409	26,845	37,234	41,646	41,922	41,769	1.7	1.9	2.1	1.8	2.0	1.9	1.7	1.5
Capital	297	826	387	498	849	1,000	1,131	1,252	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Grants	204	325	246	205	405	0	0	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	193,567	283,351	389,321	494,402	611,977	712,549	806,570	893,389	35.5	35.4	33.7	33.1	33.1	32.7	32.7	32.7
Current	177,835	255,275	351,794	445,310	541,467	627,548	707,965	781,497	32.6	31.9	30.5	29.8	29.2	28.8	28.7	28.6
Wages and salaries	26,259	43,894	58,174	74,299	90,996	104,616	118,326	130,995	4.8	5.5	5.0	5.0	4.9	4.8	4.8	4.8
Materials and operating expenditures	57,504	56,503	81,119	104,672	125,811	148,207	167,629	185,576	10.5	7.1	7.0	7.0	6.8	6.8	6.8	6.8
o/w: health insurance fund	22,597	24,997	36,779	47,924	55,184	68,916	81,065	92,437	4.1	3.1	3.2	3.2	3.0	3.2	3.3	3.4
Interest	28,796	38,973	44,610	48,076	54,317	61,225	64,986	68,832	5.3	4.9	3.9	3.2	2.9	2.8	2.6	2.5
Subsidies and transfers	80,239	115,905	167,891	218,136	269,166	309,142	352,094	390,637	14.7	14.5	14.5	14.6	14.5	14.2	14.3	14.3
Subsidies	9,303	17,581	24,294	30,795	33,616	28,334	27,116	27,291	1.7	2.2	2.1	2.1	1.8	1.3	1.1	1.0
Transfers	70,936	98,324	143,597	187,341	235,550	280,808	324,978	363,346	13.0	12.3	12.4	12.5	12.7	12.9	13.2	13.3
o/w: Pensions	37,854	53,579	79,578	103,926	124,964	156,925	179,954	199,221	6.9	6.7	6.9	7.0	6.8	7.2	7.3	7.3
Capital	15,015	24,482	36,549	47,884	68,923	82,821	96,140	109,162	2.8	3.1	3.2	3.2	3.7	3.8	3.9	4.0
Lending minus repayments	717	3,594	978	1,208	1,586	2,180	2,465	2,729	0.1	0.4	0.1	0.1	0.1	0.1	0.1	0.1
Overall balance (cash, including grants)	-19,729	-32,256	-37,580	-43,200	-49,520	-54,481	-56,692	-60,042	-3.6	-4.0	-3.3	-2.9	-2.7	-2.5	-2.3	-2.2
Financing	18,080	28,322	36,948	43,200	49,520	...	...	...	3.3	3.5	3.2	2.9	2.7	...	...	...
Domestic	8,614	-1,913	10,730	13,603	18,590	...	...	...	1.6	-0.2	0.9	0.9	1.0	...	...	...
External	2,360	22,575	20,104	23,497	25,030	...	...	...	0.4	2.8	1.7	1.6	1.4	...	...	...
Privatization proceeds	6,859	5,062	3,460	4,000	4,000	...	...	...	1.3	0.6	0.3	0.3	0.2	...	...	...
Bank asset recoveries	247	2,597	2,654	2,100	1,900	...	...	...	0.0	0.3	0.2	0.1	0.1	...	...	...
Discrepancy 2/	-1,649	-3,934	-632	0	0	...	...	...	-0.3	-0.5	-0.1	0.0	0.0	...	...	...
Memorandum items:																
EU grants 3/	...	...	3,276	11,636	25,516	20,103	25,576	31,128	...	...	0.3	0.8	1.4	0.9	1.0	1.1
Primary expenditure 4/	160,956	244,167	344,711	446,326	557,660	651,325	741,584	824,557	29.5	30.5	29.9	29.9	30.1	29.9	30.1	30.2
Primary current expenditure 4/	149,039	216,302	307,184	397,234	487,150	566,324	642,979	712,666	27.3	27.0	26.6	26.6	26.3	26.0	26.1	26.1
Primary balance (cash, including grants) 3/	12,883	6,928	7,030	4,876	4,797	6,743	8,294	8,790	2.4	0.9	0.6	0.3	0.3	0.3	0.3	0.3
Nominal GDP (billions lei)	545,730	800,308	1,154,126	1,494,223	1,851,197	2,179,510	2,465,126	2,729,056	545,730	800,308	1,154,126	1,494,223	1,851,197	2,179,510	2,465,126	2,729,056

Sources: Ministry of Public Finance; and Fund staff estimates.

1/ 1999 actual values adjusted for the collections of health contributions (3,484.5 and 10,483.2 billion lei, respectively) which were previously classified as wage taxes under the program.

2/ Overall balance (cash, including grants) plus financing.

3/ Authorities and staff estimates. EU grants (except for RICOP) are neither included under grants nor under expenditures.

4/ Excluding EU grants and cash expenditure for bank restructuring.

5/ As the 2003 budget incorporated various extrabudgetary revenues and expenditures, the budgets for 2002 and 2003 are not fully comparable. On a comparable basis, revenues and expenditure in the 2002 budget are higher by about 0.3 percent of GDP, leaving the overall balance unchanged.

Table 4. Romania: Monetary Survey, 2000-02

(In billions of lei, actual/program exchange rates)

	2001				2002				2003							
	September program	September actual	December program	December actual	March program	March actual	June rev. program	June actual	September rev. program	September actual	December rev. program	December projection	March program	June program	September program	December program
Monetary Survey																
Net foreign assets (including valuation changes)	146,192	155,922	159,279	171,866	169,198	178,368	201,736	197,564	202,910	209,139	210,913	239,897	254,115	282,990	300,823	286,713
In millions of U.S. dollars	4,789	5,118	4,980	5,439	5,074	5,424	5,885	5,901	5,910	6,327	5,955	7,012	7,227	7,858	8,166	7,606
Of which: Commercial banks	788	1,039	788	866	808	639	325	356	236	203	145	203	173	143	113	83
NRR	4,001	4,079	4,192	4,573	4,266	4,785	5,560	5,545	5,674	6,047	5,810	6,809	7,054	7,715	8,053	7,523
Net domestic assets	79,162	79,223	92,958	98,646	89,723	96,958	95,328	103,347	108,218	108,193	139,350	119,085	113,475	109,464	107,585	158,969
Domestic credit	129,803	129,349	139,312	143,245	149,943	155,234	185,881	164,421	177,450	170,243	204,530	196,179	213,115	227,578	243,508	269,706
Government	26,856	26,119	28,061	24,990	30,453	24,997	33,659	17,154	17,220	13,241	26,667	20,505	24,319	26,063	26,521	33,740
Of which: T-bills for bank restructuring 1/	22,734	23,506	14,681	16,310	14,294	16,632	17,449	16,392	13,523	9,543	8,621	8,647	8,044	3,820	2,664	1,718
Non-government	102,948	103,230	111,251	118,254	119,490	130,237	152,223	147,267	160,230	157,002	177,863	175,674	188,796	201,515	216,986	235,966
In foreign currency	60,565	61,332	65,215	70,721	69,593	78,627	96,846	94,486	101,843	98,923	111,478	110,868	117,620	125,671	133,064	143,982
(in millions of U.S. dollars)	1,984	2,013	2,039	2,238	2,087	2,391	2,825	2,822	2,966	2,993	3,147	3,148	3,345	3,490	3,612	3,820
In lei	42,383	41,898	46,036	47,533	49,897	51,610	55,377	52,781	58,388	58,079	66,285	64,806	71,177	75,844	83,922	91,984
Other items net	-50,642	-50,126	-46,354	-44,598	-60,220	-58,276	-90,553	-61,074	-69,212	-62,050	-65,180	-77,094	-99,640	-118,114	-135,923	-110,736
Broad money	225,353	235,145	252,237	270,512	258,921	275,326	297,063	300,912	311,148	317,337	350,263	358,982	367,590	392,454	408,408	445,683
Of which: Lei denominated (M2)	124,614	128,348	143,490	154,728	142,875	157,746	171,241	176,348	183,755	189,458	217,429	221,059	224,785	245,112	256,583	288,440
Currency in circulation	31,270	32,645	34,703	35,635	31,602	33,416	36,956	39,615	41,741	42,334	46,077	46,032	44,061	50,079	53,304	56,906
Lei deposits	93,344	95,703	108,787	119,092	111,273	124,330	134,285	136,733	142,014	147,124	171,352	175,027	180,724	195,033	203,279	231,535
Foreign currency deposits	100,740	106,797	108,747	115,784	116,046	117,580	125,823	124,564	127,393	127,874	132,834	137,922	142,805	147,342	151,825	157,243
In millions of U.S. dollars	3,300	3,506	3,400	3,664	3,480	3,575	3,670	3,721	3,710	3,869	3,750	4,031	4,061	4,091	4,121	4,171
Memorandum items: 3/																
Broad money (M2X) growth	38.0	44.0	36.3	46.2	35.2	43.7	42.5	44.3	32.3	35.0	29.5	32.7	33.5	30.4	28.7	24.2
NPA contribution	56.6	62.6	49.1	55.9	31.9	36.7	31.5	29.5	20.0	22.6	14.4	25.1	27.5	28.4	28.9	13.0
NDA contribution	-18.6	-18.5	-12.8	-9.8	3.2	7.0	11.0	14.8	12.3	12.3	15.0	7.6	6.0	2.0	-0.2	11.1
Lei-denominated money growth (M2)	31.1	35.0	30.2	40.4	31.9	45.7	44.4	48.7	43.2	47.6	40.5	42.9	42.5	39.0	35.4	30.5
Growth of currency in circulation	37.4	43.4	34.8	38.4	32.9	40.6	24.7	33.6	27.9	29.7	29.3	29.2	31.9	26.4	25.9	23.6
Real broad money growth	5.4	9.7	5.7	12.2	5.6	14.9	14.8	16.4	7.6	12.7	6.1	11.5	12.3	11.4	9.7	8.0
Real lei-denominated money growth (M2)	0.1	2.9	0.9	7.8	3.1	16.4	16.4	19.9	16.4	23.3	15.2	20.1	19.8	18.7	15.4	13.5
Real growth of currency in circulation	4.9	9.3	4.5	6.3	3.8	12.3	0.5	7.7	4.0	8.3	6.0	8.6	10.9	8.0	7.3	7.5
Growth of lei credit to nongovernment, adjusted 2/	47.5	45.9	48.4	56.3	49.4	54.5	48.7	41.7	39.4	38.6	39.7	36.3	37.9	43.7	44.5	41.9
Growth of lei credit to nongovernment, adjusted, real 2/	12.6	11.2	15.0	20.0	16.7	23.5	19.8	14.3	13.3	15.7	14.5	14.6	16.0	22.8	23.1	23.4
Growth of foreign currency credit, adjusted, in US\$ 2/	27.7	31.1	17.5	29.2	12.7	31.0	40.1	40.4	42.7	45.2	34.3	38.3	32.7	23.2	19.7	17.9
Growth of credit to nongovernment, composite 2/ 4/	21.9	23.5	16.6	25.6	14.5	28.1	32.6	31.1	33.1	34.4	26.9	29.6	26.4	23.0	21.0	19.6
CPI inflation	31.0	31.2	29.0	30.3	28.0	25.1	24.1	24.0	23.0	19.8	22.0	19.0	18.9	17.0	17.3	15.0
M2X (Broad Money) velocity	5.0	5.1	4.9	4.8	5.3	5.1	5.0	5.0	5.0	4.8	4.7	4.5	4.8	4.7	4.6	4.4
M2 (Domestic Broad Money) velocity	9.4	9.4	8.6	8.4	9.6	9.0	8.6	8.5	8.4	8.0	7.6	7.3	7.9	7.5	7.4	6.8
M2X+Tbill velocity	4.5	4.5	4.3	4.3	4.7	4.5	4.4	4.3	4.3	4.2	4.1	4.0	4.3	4.2	4.2	4.0
M2X+Tbill growth	50.7	48.8	41.1	49.3	34.0	43.9	41.4	43.5	33.9	35.3	31.7	31.2	29.1	27.8	26.0	22.5

Sources: Romanian authorities; and Fund staff estimates.

1/ Bonds issued to restructure Bancorex and Banca Agricola.

2/ Adjusted for write-offs in the last 12 months and changes in the US\$/EUR exchange rate. Owing to large-scale write-offs and reclassifications, credit growth rates are estimated.

3/ All changes are 12-month rates of change, unless otherwise indicated.

4/ Real lei credit growth and foreign currency credit growth, weighted by their respective shares.

Table 4. (continued) Romania: Balance Sheet of the National Bank, 2000-02 1/
(In billions of lei, actual/program exchange rates, monthly averages)

	2001				2002				2003							
	September program	September actual	December program	December actual	March program	March actual	June rev. program	June actual	September rev. program	September actual	December rev. program	December projection	March program	June program	September program	December program
National Bank of Romania																
Net foreign assets (including valuation) 2/ In millions of U.S. dollars	100,243	99,834	111,199	114,890	118,385	127,410	160,612	157,476	160,128	166,157	169,768	188,529	202,570	231,389	249,090	234,910
Net domestic assets	-40,597	-39,392	-48,102	-48,929	-56,184	-59,972	-85,673	-82,286	-79,768	-84,518	-80,571	-95,038	-110,139	-129,871	-141,073	-118,120
Total credit	-12,152	-15,776	-17,749	-21,036	-22,097	-28,853	-55,216	-56,753	-56,077	-60,843	-56,711	-57,063	-56,994	-79,541	-82,875	-62,075
Credit to banks	-14,937	-17,517	-20,234	-20,993	-25,523	-31,246	-35,853	-39,010	-42,568	-51,250	-47,895	-53,072	-53,777	-62,582	-68,787	-56,603
NBR refinancing (including to DGP and Law 101)	5,280	5,239	4,980	4,900	4,693	4,684	4,655	4,626	3,794	3,751	3,161	3,118	3,118	2,785	2,785	2,152
NBR refinancing to litigious debtor	284	284	284	284	284	284	284	284	284	284	284	284	284	284	284	284
NBR credit line to Deposit Guarantee Fund	3,847	3,832	3,547	3,510	3,547	3,503	3,510	3,481	3,510	3,467	2,877	2,834	2,834	2,501	2,501	1,868
Law 101 (Bancorex) & Special credit to BA	1,148	1,123	1,148	1,105	861	898	861	861	0	0	0	0	0	0	0	0
Deposit taking operations	-15,904	-20,844	-20,901	-24,835	-25,903	-33,956	-39,689	-42,847	-45,543	-54,072	-50,237	-55,261	-55,966	-65,366	-71,572	-58,754
Reverse repo	-4,313	-1,912	-4,313	-1,058	-4,313	-1,974	-819	-790	-819	-928	-819	-928	-928	0	0	0
Credit to government	2,785	1,741	2,486	43	3,427	2,393	-19,363	-17,743	-13,509	-9,593	-8,816	-3,992	-3,217	-16,960	-14,088	-5,473
Treasury balance (+/deficit, -surplus)	-7,702	-8,524	-5,717	-7,762	-4,776	-4,746	-25,577	-24,776	-18,071	-14,973	-11,436	-6,473	-5,473	-16,960	-14,088	-5,473
Treasury overdraft	-1,000	-2,295	0	-3,158	-1,299	-3,511	-3,168	-3,168	-3,168	-9,054	-3,168	-2,554	-2,554	-2,554	-2,554	-2,554
Treasury deposits	6,702	6,230	5,717	4,605	3,477	1,235	22,410	21,608	14,903	5,919	8,268	2,919	14,406	11,534	2,919	2,919
Treasury bills	10,487	10,266	8,203	7,719	8,203	7,139	6,214	7,033	4,562	5,380	2,620	2,482	2,256	0	0	0
Other items net	-28,445	-23,617	-30,354	-27,893	-34,087	-31,119	-30,457	-25,533	-23,692	-23,675	-23,861	-37,975	-53,146	-50,330	-58,199	-56,045
Lei reserve money 3/ 6/ Currency	59,647	60,442	63,096	65,961	62,202	67,438	74,938	75,190	80,360	81,639	89,197	93,491	92,430	101,518	108,017	116,789
Bank deposits 6/ Memorandum items: 4/	32,704	32,894	35,465	37,747	32,714	35,407	39,499	39,495	43,721	44,727	48,072	49,753	46,955	52,618	57,016	58,931
Lei reserve money growth	30.0	31.7	23.0	28.6	20.5	30.6	30.3	30.7	33.0	35.1	41.4	41.7	37.1	35.0	34.4	24.9
NFA contribution	137.9	137.0	124.7	131.9	118.9	136.4	141.6	136.2	99.8	109.7	92.8	111.6	111.5	98.3	110.7	49.6
NDA contribution	-108.0	-105.4	-101.6	-103.2	-98.5	-105.8	-111.4	-105.5	-66.8	-74.7	-51.5	-69.9	-74.4	-63.3	-76.3	-24.7
Real reserve money growth (adjusted) 5/ Adjusted lei reserve money growth 5/ NDA contribution	4.5	5.6	3.5	6.9	2.9	14.2	14.8	15.2	12.1	16.9	16.2	19.8	15.3	15.4	14.6	8.6
NFA contribution	36.9	38.6	33.5	39.3	31.7	42.9	42.4	42.9	37.9	40.0	41.7	42.6	37.1	35.0	34.4	24.9
Real reserve money growth (adjusted) 5/ NFA contribution	-101.5	-98.0	-87.8	-89.7	-87.1	-93.3	-99.1	-93.1	-56.9	-64.3	-43.5	-60.1	-76.6	-66.5	-78.3	-31.1
CPI inflation	31.0	31.2	29.0	30.3	28.0	25.1	24.1	24.0	23.0	19.8	22.0	19.0	18.9	17.0	17.3	15.0

Sources: Romanian authorities; and Fund staff estimates.

1/ For program purposes, all values are defined on a monthly average basis.

2/ Program definition excludes deposits of commercial banks to meet required reserves against foreign currency deposits. This, and the fact that the figures here are monthly averages, explain the differences from the monetary survey.

3/ Indicative targets based on which the NDA PC is set.

4/ All changes are 12-month rates of change, unless otherwise indicated.

5/ Adjusted for both (i) shortfalls in reported reserve money and (ii) changes in minimum reserve requirements.

(i) Shortfalls in reported reserve money occurred in 1999 and early 2000 owing to failure of some banks to observe the reserve requirements and the time lag given to BCR to absorb certain transferred deposits from former BX in the first part of 2000. Small deficiencies persisted throughout 2000 and 2001 and disappeared since mid-2002.

(ii) Minimum reserve requirement for lei deposits was decreased in 2001 from 30 percent to 27 percent on July 1 and further to 25 percent on October 1.

In 2002, further cuts were made (to 22 percent in April and to 18 percent in December).

6/ Adjusted to correspond to a 25 percent reserve requirement.

Table 5. Implicit Subsidies and Losses in the Energy Sector 2000-03

	2000	2001 (w/o adjustments) 2/	2001 Program	2001 Actual	2002 Program	2002 Projections	2003 Projections
Termoelectrica's losses							
Heating							
Cost recovery price (\$/Gcal) 4/	22	20	20	20	20	22	21
Current prices (\$/Gcal, year-average)	11	10	12	12	17	17	20
Termoelectrica's heating output sold (million Gcal)	23	26	26	23	26	23	23
Termoelectrica's losses from heating (\$m)	257	249	198	179	77	134	23
Electricity							
Cost recovery price (\$/Mwh) 4/	35	40	40	37	40	39	39
Actual prices (\$/Mwh, year-average)	35	29	52	32	38	38	39
Termoelectrica's electricity output sold (million Mwh)	26	29	29	28	29	28	28
Termoelectrica's losses from electricity (\$m)	12	329	234	141	47	25	0
Total losses from operations (\$m)	269	578	432	320	124	159	23
In percent of GDP	0.7	1.5	1.1	0.8	0.3	0.4	0.0
Collection rate (in percent)	82	75	95	86	98	90	95
Losses from non-collection (\$m)	210	270	61	172	38	145	78
Total losses including non-collection (\$m)	479	848	493	492	162	304	101
In percent of GDP	1.3	2.1	1.2	1.2	0.4	0.7	0.2
Implicit Subsidies from Natural Gas							
Natural Gas Production							
Import price (average, \$/bcm)	124	130	130	130	120	110	110
Domestic wellhead price (average, \$/bcm)	35	26	35	35	46	40	45
Domestic output (million bcm)	14.0	14.0	14.0	13.0	14.0	12.3	12.0
Loss from low prices (\$m)	1246	1456	1327	1250	1025	861	780
Total supply to end-users, incl. transp. & dist. (\$m)	566	1103	1103	974	1155	1015	1080
Collection rate (in percent)	87	76	95	81	98	95	97
Losses from non-collection (\$m)	74	270	55	185	29	51	32
Total losses and implicit subsidy (\$m)	1320	1726	1382	1415	1054	912	812
In percent of GDP	3.6	4.3	3.5	3.6	2.3	2.0	1.6
Total Implicit Subsidies and Losses	1799	2574	1875	1907	1216	1216	913
In percent of GDP	4.9	6.5	4.7	4.8	2.7	2.7	1.8
Change in losses relative to the previous year	...	1.6	-0.2	-0.1	-2.1	-2.1	-0.9
Estimated change in saving - investment balance of public enterprises 4/	...	-0.5	0.1	0.0	0.7	0.7	0.5
Memorandum item:							
GDP (in US\$ Mill.)	36,730	39,721	39,721	39,721	45,135	45,135	51,424

Sources: ANRE (electricity regulatory agency), Termoelectrica and Distrigaz Nord and Sud; World Bank; and Fund staff estimates.

1/ Cost recovery price estimates are based on WEO fuel price projections as of September 16, 2002.

2/ Estimates, as of September 2001, based on the assumption that the adjustments as envisaged under the program were not implemented.

3/ For 2002 and 2003, Termoelectrica's data as shown includes all externalized units.

4/ The reduction in losses only partially translates into an improvement in the saving-investment balance, owing to three offsetting factors: (i) increase in losses in other public enterprises; (ii) higher tax payments of the energy sector; (iii) higher investment in the energy sector. For 2003, this effect is estimated at 1/2.

Table 6. Romania: Medium-Term Balance of Payments Outlook, 2000-06

(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005	2006
	Act.	Act.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account	-1,435	-2,385	-2,157	-2,432	-2,662	-2,868	-3,089
Ratio to GDP	-3.9	-6.0	-4.8	-4.7	-4.7	-4.7	-4.6
Trade balance	-1,684	-2,969	-2,887	-3,204	-3,447	-3,678	-3,902
Exports	10,366	11,385	13,238	14,536	15,846	17,180	18,626
Imports	-12,050	-14,354	-16,125	-17,740	-19,293	-20,858	-22,527
Services account, net	-254	-591	-525	-532	-616	-724	-841
Of which: interest, net	-382	-394	-409	-325	-328	-360	-396
Unrequited transfers	860	1,175	1,254	1,304	1,401	1,534	1,653
Capital account	2,738	3,115	2,477	3,027	3,554	4,010	4,360
Direct investment and capital transfers	1,087	1,257	1,215	1,654	1,992	2,074	2,190
Portfolio Investment	50	70	34	50	50	50	50
Borrowing by public sector ^{1/}	882	1,103	833	493	471	508	773
Loans (net)	805	314	502	236	-209	-95	-227
Disbursements	1,544	1,337	1,773	1,420	1,368	1,398	1,380
Amortization	-739	-1,023	-1,271	-1,183	-1,577	-1,493	-1,607
Bonds (net)	77	789	331	256	680	603	1,000
Disbursements	259	790	641	400	829	900	1,000
Amortization	-182	-1	-311	-144	-149	-297	0
Borrowing by private sector	748	493	230	630	841	1,178	1,147
Disbursements	1,059	956	1,200	2,064	2,363	2,541	2,731
Amortization	-311	-463	-970	-1,434	-1,522	-1,363	-1,584
Short-term (net)	5	188	144	200	200	200	200
Credit extended	-34	5	22	0	0	0	0
Net errors and omissions	264	1,074	847	0	0	0	0
Overall balance	1,567	1,805	1,167	595	892	1,142	1,271
Financing	-1,567	-1,805	-1,167	-595	-892	-1,142	-1,271
Net foreign assets NBR (increase, -)	-1,094	-1,809	-1,829	-715	-792	-983	-999
Assets (increase, -)	-928	-1,484	-1,737	-825	-691	-909	-847
Liabilities	-166	-325	-92	110	-101	-74	-153
IMF, net	20	-50	8	110	-101	-74	-153
Purchases	115	67	105	212	0	0	0
Repurchases	-95	-117	-98	-102	-101	-74	-153
Other, net	-186	-275	-100	0	0	0	0
Net foreign assets DMBs (increase, -)	-473	4	662	120	-100	-159	-272
Assets (increase, -)	-336	-99	324	0	-100	-159	-272
Liabilities	-137	103	338	120	0	0	0
Financing gap	0	0	0	0	0	0	0
Export growth (percent)	21.9	9.8	16.3	9.8	9.0	8.4	8.4
Import growth (percent)	23.7	19.1	12.3	10.0	8.8	8.1	8.0
External debt/GDP (percent)	27.8	29.6	28.6	28.1	28.2	28.8	29.3
Public and publicly guaranteed debt/GDP (percent)	18.8	19.6	19.0	18.0	16.8	16.1	15.6
Net External Indebtedness/GDP (%)	14.6	13.3	10.8	10.9	11.1	11.3	11.6
Debt service ratio	16.9	18.5	22.3	21.5	22.9	21.0	20.4
Gross reserves of NBR (in US\$ mns.) ^{2/}	3,396	4,880	6,767	7,592	8,283	9,192	10,038
(over short-term debt by remaining maturity)	179.0	159.6	190.4	174.1	186.6	193.3	216.6
(in months of imports of following year)	2.5	3.2	3.9	4.2	4.2	4.3	4.4

Sources: Romanian authorities; and Fund staff estimates.

^{1/} Including public enterprises.

^{2/} Includes gold.

Table 7. Romania: Medium-Term Projections, 2000-06

	2000	2001	2002	2003	2004	2005	2006
			Projected				
Income and prices							
Nominal GDP (in trillions of lei)	800.3	1,154.1	1,494.2	1,851.2	2,179.5	2,465.1	2,729.1
Nominal GDP (in billions of US\$)	36.9	39.7	45.1	51.4	56.2	61.4	67.1
Real GDP	1.8	5.3	4.5	4.9	5.0	5.0	5.0
Domestic Demand	4.1	8.1	4.3	4.8	5.2	5.1	5.1
Household consumption	-0.9	6.7	3.8	3.6	3.4	3.2	3.0
Government consumption	10.4	1.4	3.3	2.6	3.1	2.6	2.5
Gross fixed investment	4.6	6.6	7.9	11.8	11.0	12.2	11.9
of which: private	4.3	6.1	7.5	9.5	11.0	12.0	12.0
of which: public	8.8	11.3	11.7	34.9	11.0	13.7	11.0
Increase in stocks (contribution) 1/	2.5	2.4	0.0	0.1	0.6	0.4	0.5
External Demand (contribution)	-2.5	-3.3	-0.2	-0.4	-0.7	-0.6	-0.7
Exports of goods and services	24.1	10.6	15.4	8.1	7.0	6.2	6.2
Imports of goods and services	28.2	17.5	12.1	7.2	7.0	6.2	6.2
GDP deflator	44.1	37.0	23.9	18.1	12.1	7.7	5.4
CPI, c.o.p.	40.7	30.3	19.0	15.0	10.0	6.0	5.0
CPI, p.a.	45.7	34.5	22.7	17.6	12.1	7.7	5.4
Saving and investment balances							
Total domestic saving	14.5	13.9	15.0	16.3	17.4	18.5	19.8
Net factor receipts and transfers from abroad	1.4	2.0	1.8	1.8	1.8	1.8	1.7
Total national saving	15.8	15.9	16.7	18.0	19.1	20.3	21.6
Non-government	16.8	16.0	16.3	16.5	17.2	17.8	18.8
of which: energy sector	1.2	1.0	2.0	2.5	2.7	2.8	2.9
Government	-1.0	-0.1	0.5	1.6	1.9	2.5	2.8
Total investment	19.7	21.9	21.5	22.8	23.9	25.0	26.2
Non-government	16.6	18.7	18.1	18.5	19.4	20.2	21.1
of which: energy sector	2.7	2.8	3.0	3.3	3.2	3.1	2.8
Government	3.1	3.2	3.4	4.3	4.5	4.8	5.1
Savings - investment balance	-3.9	-6.0	-4.8	-4.7	-4.7	-4.7	-4.6
Non-government	0.1	-2.7	-1.9	-2.1	-2.2	-2.3	-2.4
of which: energy sector	-1.5	-1.8	-1.0	-0.8	-0.5	-0.3	0.1
Government	-4.0	-3.3	-2.9	-2.7	-2.5	-2.3	-2.2

Sources: Romanian authorities; and Fund staff estimates and projections.

1/ Includes statistical discrepancy.

Table 8. Romania: Indicators of External Vulnerability, 1997-2002 1/

(In percent of GDP unless otherwise specified)

	1997	1998	1999	2000	2001	2002 proj.	2003
Financial indicators							
Public sector debt	28.1	27.7	30.3	30.0	27.7	25.0	
Broad money (percent change, 12-month basis)	104.8	48.9	44.9	38.0	46.2	32.7	
Credit to non-government (percent change, 12-month basis) 2/	33.7	64.7	43.2	50.3	57.7	54.2	
Real credit to non-government (percent change, 12-month basis) 2/	-46.9	17.0	-9.2	7.4	26.0	29.6	
Monthly weighted average t-bill rate	133.5	82.4	105.2	62.4	47.4	24.3	4/
Monthly weighted average real t-bill rate 3/	-8.3	14.6	40.7	11.5	13.0	3.8	4/
External Indicators							
Exports (percent change, 12-month basis in US\$)	4.6	-1.6	2.4	21.9	9.8	16.3	
Imports (percent change, 12-month basis in US\$)	-1.4	4.8	-12.1	23.7	19.1	12.3	
Terms of Trade (percent change, 12-month basis)	9.0	-4.0	0.2	2.7	2.3	0.9	
Current account balance	-5.4	-6.9	-4.0	-3.9	-6.0	-4.8	
Current account balance after FDI	-1.9	-2.0	-1.2	-0.9	-2.8	-2.1	
Errors and omissions	3.2	1.4	2.2	0.7	2.7	1.9	
Gross official reserves (in US\$ millions)	3,075	2,299	2,472	3,396	4,880	6,767	
(in months of imports GNFS of the following year)	2.9	2.4	2.1	2.5	3.2	4.0	
Central Bank short-term foreign liabilities (in US\$ millions)	100	0	170	100	100	0	
Gross reserves of the banking system (in US\$ millions)	4,763	3,789	3,633	4,893	6,476	8,039	
(in months of imports GNFS of the following year)	4.5	3.9	3.1	3.6	4.2	4.8	
Short term foreign liabilities of the commercial banks (in US\$)	267	188	221	225	371	577	5/
Open foreign currency position of the commercial banks (in US\$)	1,400	1,933	724	372	355	361	5/ 10/
Official reserves/Broad money (M2)	40.3	27.2	33.6	47.6	57.0	64.5	
Official reserves/Narrow money (M0) 6/	242.6	107.1	144.2	183.7	231.8	272.7	
Total short term external debt by remaining maturity 7/	8.0	6.5	4.7	5.1	7.7	7.9	
In percent of reserves	91.8	118.7	67.8	55.9	62.7	52.5	
In percent of total debt	27.4	29.6	23.8	18.5	26.0	27.5	
Total external debt (in US\$ millions)	9,467	9,903	8,771	10,273	11,742	12,911	
Of which: Public and Publicly guaranteed debt	6,855	7,001	6,169	6,955	7,716	8,456	
Total external debt (in percent of exports of G&S)	95.1	104.0	88.9	84.7	88.1	83.9	
Total external debt/ GDP	26.9	23.5	24.5	27.8	29.6	28.6	
External interest payments (in percent of exports of G&S)	5.0	5.7	5.1	4.4	4.4	4.5	
External amortization payments (in percent of exports of G&S)	15.9	18.0	23.9	12.5	14.1	17.9	
Exchange rate (per US\$, period average)	7,195	8,881	15,274	21,688	29,056	...	
REER appreciation (+) (12-month basis)	16.5	30.0	-14.8	9.5	1.5	...	
Financial Market Indicators							
Foreign currency debt ratings							
Moody's	Ba3	B3	B3	B3	B2	B1	8/
Standard and Poor's	BB-	B-	B-	B-	B	B+	8/
Spread of benchmark bonds (basis points, end of period)	350	1,300	780	406	421	282	9/

Sources: Romanian authorities; and Fund staff estimates.

1/ All stocks are measured end-of-period.

2/ Adjusted for bad loans written off. Real credit growth is weighted average of real lei credit growth and U.S. dollar-measured foreign currency growth.

3/ Real rate is based on ex-post 12-month CPI inflation.

4/ Actual as of September 2002.

5/ Actual as of October 2002.

6/ Narrow money is defined as currency plus lei-denominated sight deposits.

7/ Defined as short-term debt by original maturity basis plus amortization falling due on medium-term loans and bonds.

8/ Actual on December 19, 2002.

9/ In 2001 the benchmark bond is the '05, while for earlier years it is the '02. Actual on December 19, 2002.

10/ On-balance-sheet only. The overall open currency position, including off-balance-sheet items and capital paid in foreign exchange, was US\$10 million as of end-October.

ROMANIA—RELATIONS WITH THE FUND
(As of October 31, 2002)

I.	Membership Status: Joined 12/15/72; Article VIII						
II.	General Resources Account:		<u>SDR million</u>	<u>% Quota</u>			
	Quota		1,030.20	100.00			
	Fund holdings of currency		1,367.46	132.74			
III.	SDR Department:		<u>SDR million</u>	<u>% Allocation</u>			
	Net cumulative allocation		75.95	100.00			
	Holdings		4.38	5.77			
IV.	Outstanding Purchases and Loans:		<u>SDR million</u>	<u>% Quota</u>			
	Stand-By Arrangements		274.42	26.64			
	Systemic Transformation		62.84	6.10			
V.	Financial Arrangements:						
	Type	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR million)</u>	<u>Amount Drawn (SDR million)</u>		
	Stand-By	10/31/01	04/29/03	300.00	134.67		
	Stand-By	08/05/99	02/28/01	400.00	139.75		
	Stand-By	04/22/97	05/21/98	301.50	120.60		
	Stand-By	05/11/94	04/22/97	320.50	94.27		
	Stand-By	05/29/92	03/28/93	314.04	261.70		
	Stand-By	04/11/91	04/10/92	380.50	318.10		
VI.	Projected obligations to Fund (SDR million; based on existing use of resources and present holdings of SDRs):						
		<u>Overdue</u>	<u>Forthcoming</u>				
		<u>07/31/01</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
	Principal		22.34	79.61	78.96	58.02	67.33
	Charges/interest		<u>2.69</u>	<u>10.24</u>	<u>7.64</u>	<u>5.56</u>	<u>3.82</u>
	Total		25.03	89.85	86.60	63.58	71.15

VII. Exchange Rate Arrangements

From August 1994, a decentralized direct dealing interbank market has been in operation. The official reference rate published by the NBR is an average of rates reported for interbank and client transactions. Romania has accepted the obligations of Article VIII, Sections 2, 3, and 4, with effect from March 25, 1998. Romania's exchange system is free of restrictions on

the making of payments and transfers for current international transactions. Romania maintains de jure a managed floating exchange rate regime with no preannounced exchange rate path, while the de facto regime is an unannounced crawling band.

VIII. Article IV Consultation

Romania is on a 12-month consultation cycle. The last consultation was concluded on November 29, 2000.

IX. Technical Assistance

The transition in Romania has been supported by substantial technical assistance from multilateral agencies and bilateral donors. The Fund has provided support in a number of areas with more than 40 technical assistance missions since 1990, although the authorities have had a mixed record with regard to implementation. Expert Fund assistance has focused on a number of key areas, including: fiscal reforms; modernization of the central bank and the banking system; creating a market-oriented legal structure; training; and improving the collection and reporting of statistics. A comprehensive tax administration reform, scheduled to be implemented in several steps in 2003 and 2004, is being designed in line with the recommendations of several technical assistance missions of the Fund's Fiscal Affairs Department. In May 2002, a fiscal ROSC mission of the Fund's Fiscal Affairs Department visited Bucharest.

X. Safeguards Assessment

Under the Fund's safeguards assessment policy, National Bank of Romania (NBR) is subject to an assessment with respect to the Stand-By- Arrangement, which was approved on October 31, 2001 and is scheduled to expire on April 29, 2003. A full safeguards assessment of the National Bank of Romania (NBR) was completed on May 13, 2002. The assessment identified certain weaknesses and made appropriate recommendations, as reported in EBS/02/150, which the authorities have begun to implement.

XI. Resident Representative

The Fund has had a resident representative in Bucharest since 1991. Mr. Stephane Cosse assumed the post in December 1999.

ROMANIA: RELATIONS WITH THE WORLD BANK

Partnership in Romania's Development Strategy

1. The Romanian authorities are pursuing a strategy designed to maintain macroeconomic stability and establish sustainable economic growth and poverty reduction, moving towards the eventual goal of accession to the European Union. Key elements of this policy include tightening payments discipline throughout the economy, especially in the energy sector, hardening budget constraints for state-owned enterprises, actively pursuing enterprise and banking privatization and restructuring, and strengthening the social safety net. Over the medium term, continuation of the current economic recovery will depend critically on the maintenance of reform momentum and moving steadily ahead with governance and private sector development reforms. Such reforms would stress transparency and accountability in government, improvements in the business environment, and actions to strengthen the regulation and oversight of financial and capital markets.
2. In broad terms, the IMF has taken the lead in assisting Romania in maintaining macroeconomic stability. As such its program focus is on the fiscal framework, monetary policy and those elements of the structural reform program that have a direct bearing on the macroeconomic situation. The main vehicle for its dialogue with the authorities is an 18-month Stand-By Arrangement (SBA) covering the period October 2001 to March 2003. The First and Second Reviews under the SBA were completed successfully in August 2002, while the conclusion of the Third Review is expected to be considered by the IMF Board in February or March 2003.
3. The World Bank has taken the lead in policy dialogue on structural issues, including poverty reduction measures, private sector development, institution building and governance. It has a range of instruments through which it conducts dialogue, including adjustment lending operations such as PSAL 1 and PSAL 2, a planned series of Programmatic Adjustment Loans, several sector investment operations and economic work such as the recently completed Public Expenditure and Institutions Review (PEIR), and a planned Country Economic Memorandum (CEM).
4. In some areas where the Bank takes the lead in the dialogue, its analysis is shared with the IMF and is used as input for the fiscal framework, but there are no directly corresponding structural benchmarks or policy conditions in the IMF SBA. In other areas where the Bank takes the lead, the SBA does reflect certain elements in its conditionality. These are generally structural reform measures which have important fiscal implications, such as energy sector reform and restructuring. There are further areas of formal joint responsibility such as the Financial Sector Assessment Program (FSAP).
5. Overall the IMF and World Bank staff maintain a close collaborative relationship in supporting the Government's reform program and are coordinating their policy advice to the Romanian authorities.

IMF-World Bank Collaboration in Specific Areas

Areas in which the World Bank leads and there is no direct IMF involvement

6. The policy areas in which the Bank leads and which are not directly incorporated into the IMF program or country dialogue include strengthening the social safety net, revitalizing the economy in rural areas, institution building and governance, and improving the business environment. Bank policy dialogue for strengthening the social safety net includes poverty monitoring, social assistance, pension reform, child welfare reform, health sector reforms, and labor retraining and redeployment. These have been supported by the Bank's Employment and Social Protection Loan, the Social Sector Development Loan, the Social Development Fund and the Mine Closure Loan. They are further supported by economic work such as the recently completed Poverty Profile and the Local Services Delivery Study, and by planned economic studies on poverty and vulnerability, pension reform and gender assessment.

7. The Bank has a range of programs to revitalize the economy in rural areas. These include the Rural Finance Loan which supports income generation activities and will be complemented by a Rural/Urban Linkage Growth Study to set the stage for a Rural Development Loan supporting infrastructure development and improved governance at the community level. The Irrigation Rehabilitation loan supports infrastructure rehabilitation and institutional reform. Other supporting economic work includes the Community Networks Study and the Jiu Valley Development Study.

8. The Bank has a strong institution building and governance program. This builds on recent reforms in local public finance and taxation and decentralization. Policy dialogue has been facilitated the recently completed Public Expenditure and Institutions Review (PEIR) which included analysis and recommendations relating to 1) improved resource allocation in the health sector; 2) delivery of social assistance at the local level; 3) pension reform; 4) institutions for budget management 5) fiscal decentralization; and 6) reforms to the budget process in the judiciary. The policy dialogue will continue through a Country Financial Accountability Assessment (CFAA) to be launched shortly. The Bank completed a Diagnostic Survey of Corruption in Romania prior to the Government's preparing of its National Program for Prevention of Corruption. Work is now beginning on a series of Programmatic Adjustment Loans (PAL) the first of which will focus on institutional and governance reforms in the public service and the judiciary as well as public expenditure management. This will be supported by a \$18.6 million Private and Public Sector Institution Building Loan (PPIBL) which will provide technical assistance for these activities and others relating to privatization. Other institution-building support includes financing of a cadastral and land titling project, a project on the environmental aspects of mine closures, a hazards mitigation project cofinanced by a GEF grant which focuses on damage from earthquakes, floods toxic wastes and other hazards in high risk areas, and by a regional project on Trade and Transportation Facilitation in South East Europe.

9. Policy advice and support for reforms in the business environment have been offered by the Bank in several areas. Through PSAL 1 and PSAL 2 the Bank has focused on reducing barriers to entry for firms and joint ventures, implementing internationally

recognized accounting standards and introducing improved bankruptcy and liquidation procedures. The PALs will also address business environment issues, and all these initiatives will be supported by technical assistance provided under the PPIBL.

Areas in which the World Bank leads and its analysis serves as input into the IMF program

10. The Bank supports the GOR's privatization program through PSAL 2 which includes targets and timelines for privatization of commercial SOEs and financial institutions. The program builds on the progress established under PSAL 1 and identifies pools of SOEs from which set minimum numbers of enterprises are selected for case-by-case privatization and workout. Specific enterprises including Alro, Alprom, and Petrom, were also identified. Key to the success of this program is agreement with the Bank on strategies for the privatization of these entities and the subsequent adoption of a clear, open and transparent tender process using the services of qualified investment advisors in a manner consistent with Bank policies.

11. The Bank has led the dialogue on restructuring, reform and eventual privatization of enterprises in the electricity, district heating and gas industries and on the adoption of regulatory legislation in preparation for privatization to strategic investors. As part of this process the Bank is supporting, inter alia, energy tariff reforms and the elimination of arrears in the electricity, district heat and gas sectors, and these objectives are woven into the policy conditions of PSAL 2, along with conditions related to the privatization of electricity distribution enterprises. These conditions have been closely coordinated with the IMF since the SBA also includes provisions for structural reforms in the energy sector including tariff setting, arrears clearance and collection rates, as well as one industry structure condition requiring the shift of seven heat-producing units to local municipalities. The Bank is leading the IFI dialogue with the Government on such critical long-term issues as power generation sector restructuring and the integration of the Romanian power sector with the South East European Regional Electricity Market and with the EU's electricity market, and provides assistance on the associated regulatory and market operation issues. The Bank is also providing technical assistance to the Ministry of Industry to establish a system of pricing and taxation of gas consistent with attracting further investment into the industry. Policy dialogue in these and other areas, notably including the district heating sector, will be further facilitated by ongoing dialogue with the Government on the recently completed Energy and Infrastructure Strategy paper and its operational recommendations. Again, the series of PALs will be used as vehicles for incorporating policy advice in these areas into Bank lending operations.

12. The Bank has taken the lead in dialogue and policy advice regarding regulation, restructuring, privatization and liquidation of banks. Under PSAL 1 the Law on Bank Privatization was modified and transparent privatization procedures established. Liquidity and solvency requirements of the NBR were tightened and provisions introduced for improved compliance with prudential regulations and external audits conducted according to International Accounting Standards. Legal and institutional reforms were introduced for orderly disposition of non-performing assets. These policy changes underpinned liquidation of the most troubled bank (Bancorex) while Bank Agricola was restructured and eventually privatized as were two smaller state owned banks. This policy agenda is continued under

PSAL 2 with steps to complete the sale of Banca Comerciala Romana (BCR) and to restructure the Savings Bank (CEC). These initiatives have been supported by the IMF which has included Stand-By performance criteria relating to privatization of BCR and prior actions related to NBR provisioning requirements. The Bank is continuing dialogue with the government on the need to move forward with further improvements of the legal and regulatory framework for the securities and insurance sectors as well as the banking sector. The PPIBL will provide funding for these activities.

Areas of shared responsibility

13. While the Bank has taken the lead in privatization and in structural reforms in the energy sector as described above, the IMF has a strong interest from a macroeconomic perspective since privatization revenues are used to retire public debt, and quasi-fiscal deficits of the SOEs present a threat to macroeconomic stability. Accordingly, there is high degree of consultation and coordination between the two institutions on these matters. The IMF has introduced into its SBA conditions relating to electricity tariff rates, arrears in gas and electricity collections as well as the privatization of a subset of the enterprises covered under the Bank's program. While the terms of the respective programs are mutually consistent and supportive, the focus and motivation for the Bank's program are on the efficiency of the resulting market structures, improved enterprise operation, service delivery and financial performance, and the transparency of the process and improvement in overall sector governance, and that of the IMF are on immediate revenue generation and expenditure control, and containment of ongoing fiscal burdens.

14. The Bank and the IMF have a formal agreement to conduct jointly a Financial Sector Assessment Program on which work will be completed this fiscal year.

Areas in which the IMF leads and its analysis serves as input into the World Bank program

15. While the Bank has focused on simplifications to the taxation system as a means of improving the business environment the Fund leads the dialogue on fiscal matters. In addition to the achievement of overall fiscal targets the Fund's Stand-By program includes structural benchmarks and performance criteria relating to introduction of new VAT and profits tax laws, increases in specific excises, and elimination of tax preferences under the customs duty and profit tax systems. The IMF is also providing technical assistance in support of unification of the payroll tax systems.

16. The IMF leads the dialogue on certain policies to contain certain expenditures in the public sector. These include policies regarding wage-setting in both the public service and SOEs. The IMF requires monitoring reports of the budgets of a set list of SOEs and has conditions in its Stand-By program relating to the containment of the wage bill in these enterprises and to the achievement of agreed layoff targets. In addition the IMF leads the discussions relating to requirements for disconnections of nonpayers in the gas and electricity sectors.

17. In these areas the Bank takes into account the policy recommendations of the IMF and ensures that its own policy advice is consistent.

Areas in which the IMF leads and there is no direct World Bank involvement

18. The IMF is fully responsible for the dialogue on monetary policy, interest rates, the exchange rate regime, the balance of payments and all the related statistical and measurement issues.

World Bank Group Strategy and Lending Operations

19. A Country Assistance Strategy (CAS) for Romania was presented to the World Bank's Board on June 19, 2001. The CAS defines the Bank's lending and advisory services based on the Government's priorities of poverty reduction and EU accession, and builds on the work initiated under the Comprehensive Development Framework, for which Romania was one of the pilot countries. About one half of the FY02–04 lending program is adjustment lending. Two distinct lending scenarios were outlined. A low case in which Romania pursued a hesitant pace of reforms would result in significant reductions in Bank Group support to a level of \$60 million during FY02–04 with actions centered on a few poverty focused interventions. However, Romania has successfully remained in the high-case lending scenario under which Bank commitments of up to \$995 million during FY02–04 were envisaged, compared with \$600 million in FY98–00. This reflects the fulfillment of the high-case triggers, which included progress in establishing a macroeconomic environment conducive to lower inflation and sustainable growth as well as progress on structural issues including privatization as initiated under PSAL 1, initiation of the privatization and work-out process for a number of remaining large state-owned enterprises, agreement on a plan and schedule for reducing energy arrears, agreement on a method and timetable for privatization of Romanian Commercial Bank and the Savings Bank, improvements in the financial sector legal and supervisory framework, an agreement on an anti-corruption strategy, and approval of social assistance legislation.

20. The high-case scenario embodies a program of accelerated structural and sectoral reforms that will pave the way for Romania's eventual accession to the EU. The first stage of this program has now been launched with the approval of PSAL 2 by the Bank Board in September 2002, and the delivery of the Public Expenditure and Institutions Review (PEIR) in July 2002. In the second stage to follow PSAL 2, the Bank would offer support through a series of Programmatic Adjustment Loans (PALs) focusing on institutional and governance reforms, completion of the privatization agenda, implementation of the recommendations of the Energy and Infrastructure Strategy Paper and improvements to the business environment, as well as a Country Financial and Accountability Assessment.

21. The World Bank has been active in Romania since 1991 and has built up a portfolio of 35 Bank-financed operations with total commitments of US\$3.6 billion. Romania's portfolio is the second largest in ECA in terms of number of projects and the fourth largest in terms of commitments. The active portfolio as of September 30, 2002 consists of 19 projects with aggregate net commitments totaling \$1,032.5 million and a total undisbursed balance of

\$508.3 million. Sector composition in terms of net commitments is dominated by energy and infrastructure (58 percent, seven projects) and the social sectors (28 percent, also seven projects).

22. The quality of the Bank's Romania portfolio has been improving over the past several years. While the overall performance indicators are positive, several cross-cutting implementation issues persist. These include: (i) the need for special attention to monitoring and evaluation capacity building; (ii) the need to align financial reporting requirements with international best practice; and (iii) the need to strengthen the Government's budget priority-setting process, to ensure adequate IBRD loan disbursements and counterpart funding, in order to yield maximum development impact from the Bank's portfolio.

23. IFC has dedicated substantial resources to implementing a strategy intended to advance structural reform, assist the development of capital markets and infrastructure (utilities and telecommunication), and provide support for small and medium enterprises (SMEs). To date, IFC has approved over US\$200 million, in 25 projects amounting to over US\$950 million (including regional projects investing in Romania). In addition to investments, IFC has undertaken a number of advisory assignments aimed at supporting the privatization and restructuring of large state-owned enterprises, public utilities and the health sector. The degree of IFC's future success will be dependent to an extent on the Government's willingness to demonstrate a sustained commitment to accelerated reform, particularly with regard to transparency in enterprise privatization, reform of the banking and financial sector, restructuring and deregulation of the energy sector, fiscal decentralization, land privatization and continued reform of the agricultural sector, access to quality education in rural areas, and reform of the pension system to ensure sustainability in the context of an aging population. The ultimate success will also be dependent upon the ability of Romania to attract foreign direct investment.

Questions may be referred to Ron Hood (473-0115) or Myla Williams (473-6997)

ROMANIA: STATISTICAL ISSUES

1. Romania's data collection and reporting is adequate for surveillance and program monitoring. The authorities have made limited progress in improving their statistical base over the past three years with the help of Fund TA missions, although more needs to be done, in particular in the areas of balance of payments and fiscal statistics, and the consistency between monetary and fiscal data. Romania has participated in the GDDS since February 2001. A STA mission visited Romania in November 2000 to assist the authorities in preparing metadata. The mission also prepared a data module for the ROSC, which is posted on the IMF website.

Real Sector

2. The national accounts statistics produced by the National Institute for Statistics (INS) for quarterly and annual series on Gross Domestic Product (GDP) are methodologically sound, but arrive with lag of about 3 months. Furthermore, harmonization of quarterly and annual national accounts is not done on a regular basis and late revisions can sometimes be significant; the 1999 GDP growth rate, previously reported as -3.2 percent, was revised to -2.3 percent in April 2001. The INS has moved to update the framework from the European System of Accounts 1979 (ESA79) to ESA95, and data based on ESA95 were released at the end of 2000. The INS staff has been downsized significantly over the past two years, which might affect the quality and timeliness of the data.

3. The Consumer Price Index (CPI) is subject to the standard annual re-weighting, and it is considered to be a reliable source. However, the INS reduced the coverage of the Producer Price Index (PPI) from the value of all shipments of the covered industries to shipments for domestic uses only, beginning with 1998 data. The INS planned to reinstate export coverage with the next index revision sometime in 2001.

Public Finance

4. Consolidated data on central government operations are yearly reported for the *GFS Yearbook* and quarterly reported for *IFS*, while the EU1 department receives monthly budget data. Transaction data, but not debt data, through 2001 are soon to be in the *GFS Yearbook 2002*. A multi-sector statistics mission visited Romania in December 1999 and recommended that all major fiscal categories be reported on a quarterly and monthly basis. The mission also called for the documentation and reporting of all government transactions related to the Agency for Bank Asset Recovery (AVAB), which has received large amounts of nonperforming bank claims in exchange for the bank receipts of government securities. The multi-sector mission also recommended the introduction of detailed financing and debt classifications in the Treasury's chart of accounts and budget classifications. These recommendations have not yet been implemented as of end 2002. Work continues on the establishment of a new aid coordination unit to monitor data on grants.

Monetary and Financial

5. The National Bank of Romania (NBR) reports money and banking statistics for *IFS* on a regular and timely basis. The NBR adopted accrual accounting as part of the introduction of a new chart of accounts. However, loans extended by the NBR and the commercial banks continue to be recorded on a cash basis. Also, in contrast to the *Monetary and Financial Statistics Manual* and the fifth edition of *Balance of Payments Manual* residency recommendations, NBR's foreign assets and liabilities exclude the central bank's claims on, and liabilities to, international organizations (except liabilities to the IMF), which are treated as domestic assets and liabilities. STA will consider in its RAP for FY2003 a monetary statistics TA mission request expressed by the NBR in November 2002.

Balance of Payments

6. The NBR routinely reports balance of payments statistics in a timely fashion. Data collection and compilation have improved following technical assistance. The ROSC data module of November 2001 noted that the authorities were in the process of implementing a program of improvements to the data collection and compilation systems for the balance of payments and international investment position data. It noted particular concerns with (1) the coverage of the direct investment data (stocks and flows) and related income flows and (2) the quality of data on *current transfers*, in particular with the *general government* sector. Improvements planned included the introduction of a survey of direct investment in Romania to address (1) above; improvements to the monitoring of aid flows into Romania to address (2); and an improved international transactions reporting system that would provide more detailed information to facilitate improved classification of transactions between residents and nonresidents of Romania. A technical assistance mission is scheduled to visit Romania in spring 2003 to address BOP data issues, including large errors and omissions and recording of repatriated earnings.

Table 1: Romania: Core Statistical Indicators
as of December 9, 2002

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	Dec 9, 2002	Dec 6, 2002	Oct. 2002	Dec. 6, 2002	Oct. 2002	Oct. 2002	Nov 2002	Oct. 2002	Sep 2002	Oct. 2002	Q3 2002	Sep. 2002
Date Received	Dec. 9, 2002	Dec. 6, 2002	Nov. 2002	Dec. 6, 2002	Nov. 2002	Nov. 2002	Dec. 9, 2002	Dec. 2000	Dec. 2002	Nov. 25, 2002	Dec. 5, 2002	Nov. 2002
Frequency of Data	Daily	Daily	Monthly	Daily	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Frequency of Reporting	Daily	Daily	Monthly	Bi-Weekly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly
Source of Update	National Bank of Romania/ Bloomberg	National Bank of Romania	National Bank of Romania	National Bank of Romania	National Bank of Romania	National Bank of Romania	National Institute of Statistics	National Institute of Statistics	National Bank of Romania	MoF	National Institute of Statistics	National Bank of Romania/ MoF
Mode of Reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published	Published
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly

EXTERNAL SUSTAINABILITY SIMULATIONS

Romania is a relatively open economy, with foreign trade equivalent to some 65 percent of 2002 GDP. The current account deficit of US\$2.2 billion is financed mainly through FDI and capital transfers (US\$1.2 billion), public and publicly guaranteed external borrowing (US\$0.8 billion), and private sector borrowing (US\$0.2 billion). There is little portfolio investment into domestic financial markets, and the exposure to short-term debt is low. The presence of significant controls on capital flows do not allow short term investment in the domestic fixed income market. The domestic equity market is relatively small and illiquid. Significant restrictions on the contracting of short-term external debt have also limited short-term exposures of both the public and private sectors to external refinancing risks.

The main sources of vulnerability therefore lie in the potential inability to roll over maturing medium- and long-term debt from private sources, a pull back in FDI, or an outflow of foreign currency deposits from the banking system and its flight from Romania. These could be motivated by either adverse developments in international capital markets for emerging market borrowers, or rise in the perception of country specific risks for Romania. Also, a sharp depreciation of the currency prompted by, for example, a terms of trade shock and a widening of the current account deficit, could increase the external debt burden.

Romania's total stock of external debt amounted to US\$13.2 billion at end July 2002 (29.3 percent of GDP), almost all of which was medium and long term (MLT). By debtor composition, public debt as a ratio of GDP is 12 percent, publicly guaranteed debt is 7 percent and private debt is 10 percent of GDP. In addition, external interbank credit lines totaled US\$113.1 million (0.25 percent of GDP), mostly of 5-12 years maturity. More than 50 percent of the total external public debt has a maturity of greater than ten years. In terms of currency composition, 51 percent of total MLT debt is denominated in dollar and 46 percent is denominated in euro.

From the point of view of creditors, some 56 percent of total public debt is from official creditors. Furthermore, two-thirds of the direct debt outstanding is to multilateral creditors while bond financing is 30 percent. Refinancing risk from market sources for external public debt arises therefore

Total External Debt (US\$ mn)	13193.7
Medium and Long Term	12767.7
Public	5365.6
Maturity 1-5 years	135.4
Maturity > 5 years	5230.2
Publicly Guaranteed	2979.3
Maturity 1-5 years	1088.7
Maturity > 5 years	1890.6
Private	4422.8
Maturity 1-5 years	2385.9
Maturity > 5 years	2036.9
Short Term	426
Documents in transit	173
Letters of Credit	158
Other	95

July 2002.

	US\$ mn	% of total
External Public Debt	5726.6	100.0
Official	3972.3	69.4
Multilateral	3755.9	65.6
Bilateral	216.4	3.8
Private	1754.3	30.6
Banks	1.6	0.0
Bonds and Notes	1724.1	30.1
Other	28.6	0.5
External Publicly Guaranteed Debt	2980.8	100.0
Official	855.4	28.7
Multilateral	330.3	11.1
Bilateral	525.1	17.6
Private	2125.4	71.3
Banks	1658.6	55.6
Bonds and Notes	269.5	9.0
Other	197.3	6.6

August 2002.

mainly from rolling over bonds. Bond amortizations are approximately US\$150 million in 2003 and 2004 each, US\$450 million in 2005 and US\$300 million in 2006.

Of the publicly guaranteed debt, 29 percent is to official creditors while bank finance comprises the majority of private creditor financing. Some 63 percent of the private creditor financing is of maturity greater than five years, however, mitigating any risks from refinancing at higher market spreads.

Of the stock of outstanding private sector debt of US\$4.44 billion, US\$716 million is from multilateral creditors and US\$66 million is from bilateral creditors. The remainder (US\$3.6 billion) is identified as (nonguaranteed) supplier's credit which would normally be linked to conditions in trade and is somewhat immune to adverse financial market developments.

On the external front therefore, the main categories of debt that could be subject to some refinancing risk and adverse market conditions are sovereign bond issuances (US\$1.7 billion), and publicly guaranteed bank and bond financing of maturity between 1-5 years (US\$1 billion). Nonetheless, the amortization profile of debt (see chart) and the composition of this debt suggests rollover risk of external debt for Romania under plausible financing conditions appears low.

The results of the external sustainability exercise show that stress tests do not alter the debt dynamics towards dangerous trends under the general assumptions of the exercise. In any event, the composition of creditors in the case of Romania also mitigates the risks. The most notable increase in debt ratios results from the application of a shock to the GDP deflator, which reflects the high standard deviation (17.2 percent) of this component as

a consequence of the transition from high inflation. This leads to an expected rise in the debt ratios which then stabilize once the shock is removed. The other notable case of a deterioration in debt dynamics when historical averages are used results from the low average real GDP growth over the past ten years (0.3 percent). However, with the recent strengthening of GDP growth and success with disinflation, the results of the sustainability exercise are likely to exaggerate the likely risks. Other shocks such as a sharp increase in nominal interest rates, or a one-time 30 percent nominal depreciation, do not endanger Romania's debt dynamics.

Short Term Debt (Residual Maturity)

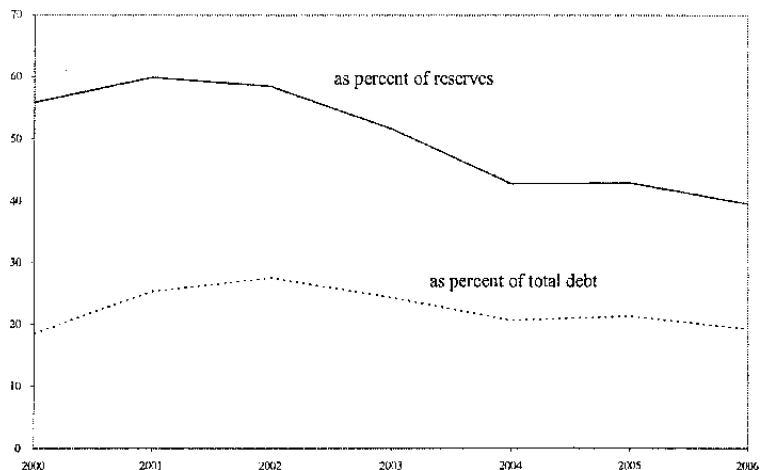


Table --. Romania: External Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	1997		Actual			Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1 External debt	27.0	23.5	25.6	28.9	30.6	29.5	28.8	28.8	29.3	29.8	30.8
2 Change in external debt	1.4	-3.5	2.1	3.2	1.7	-1.1	-0.7	0.1	0.5	0.5	1.0
3 Identified external debt-creating flows (4+8+11)	1.9	-2.4	5.3	0.1	1.0	-1.5	-1.8	-0.7	-0.6	-0.6	-0.2
4 Current account deficit, excluding interest payments	4.7	5.8	2.7	2.4	4.4	3.3	3.3	3.3	3.2	3.1	3.1
5 Deficit in balance of goods and services	6.3	7.2	3.9	5.3	8.0	6.5	6.5	6.5	6.4	6.3	6.3
6 Exports	28.8	23.2	28.0	32.9	33.6	34.1	32.7	32.4	32.1	31.8	31.9
7 Imports	35.1	30.4	31.8	38.1	41.6	40.6	39.2	39.0	38.6	38.1	38.2
8 Net non-debt creating capital inflows (negative)	-4.3	-5.1	-3.1	-3.0	-2.9	-2.6	-3.0	-3.0	-2.9	-2.7	-2.7
9 Net foreign direct investment, equity	3.5	4.8	2.9	2.8	2.9	2.6	2.9	3.0	2.8	2.7	2.7
10 Net portfolio investment, equity	0.8	0.3	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
11 Automatic debt dynamics 1/	1.5	-3.1	5.6	0.7	-0.5	-2.2	-2.1	-1.0	-1.0	-1.0	-0.6
12 Contribution from nominal interest rate	1.4	1.3	1.4	1.5	1.6	1.5	1.5	1.5	1.5	1.5	1.5
13 Contribution from real GDP growth	1.4	1.1	0.3	-0.4	-1.4	-1.2	-1.3	-1.3	-1.3	-1.3	-1.4
14 Contribution from price and exchange rate changes 2/	-1.3	-5.5	3.9	-0.4	-0.6	-2.5	-2.3	-1.1	-1.1	-1.1	-0.8
14 Residual, incl. change in gross foreign assets (2-3)	1.5	-1.1	-3.1	3.2	0.7	0.4	1.1	0.8	1.1	1.0	1.3
External debt-to-exports ratio (in percent)	93.7	101.3	91.6	87.8	91.1	86.6	88.1	88.3	91.4	93.7	96.6
Gross external financing need (in billions of US dollars) 3/	6.0	7.5	5.3	3.3	4.7	5.3	5.7	6.4	6.5	6.8	7.3
in percent of GDP	17.2	17.8	15.0	9.1	11.7	11.8	11.1	11.4	10.6	10.2	10.1
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	-6.1	-4.8	-1.2	1.8	5.3	4.5	4.9	5.0	5.0	5.0	5.0
Exchange rate appreciation (US dollar value of local currency, change in perc	-57.1	-19.0	-41.9	-29.6	-25.4	-12.2	-8.0	-7.2	-3.4	-1.3	-1.3
GDP deflator in US dollars (change in percent)	5.9	25.8	-14.1	1.5	2.3	8.8	8.6	4.1	4.0	4.0	2.7
Nominal external interest rate (in percent)	6.0	5.8	5.1	6.1	5.9	5.6	5.7	5.6	5.6	5.6	5.5
Growth of exports (US dollar terms, in percent)	4.6	-3.6	2.3	21.3	9.9	15.4	9.2	8.6	8.1	8.1	8.2
Growth of imports (US dollar terms, in percent)	-1.3	3.6	-11.1	23.7	17.4	10.9	9.9	8.8	8.1	8.0	8.1
II. Stress Tests for External Debt Ratio											
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2007	29.5	32.9	36.1	39.7	43.2	46.9					
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004	29.5	29.0	29.4	29.9	30.3	31.3					
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004	29.5	33.4	38.8	39.0	39.1	39.9					
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004	29.5	43.8	63.9	63.3	62.6	62.9					
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004	29.5	33.5	38.1	38.3	38.5	39.3					
6. Combination of 2-5 using one standard deviation shocks	29.5	42.1	57.9	57.4	57.0	57.4					
7. One time 30 percent nominal depreciation in 2003	29.5	37.4	37.1	37.4	37.5	38.4					
Historical Statistics for Key Variables (past 10 years)											
	<u>Historical</u>		<u>Standard</u>								
	<u>Average</u>		<u>Deviation</u>								
Current account deficit, excluding interest payments	4.2		1.9								
Net non-debt creating capital inflows	2.2		1.7								
Nominal interest rate (in percent)	5.8		0.5								
Real GDP growth (in percent)	0.3		5.3								
GDP deflator in US dollars (change in percent)	4.4		17.2								

1/ Derived as $[r - g - p(1+g) + \alpha e(1+r)] / (1+g+p+gp)$ times previous period debt stock, with r = nominal effective interest rate on external debt; p = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-p(1+g) + \alpha e(1+r)] / (1+g+p+gp)$ times previous period debt stock. p increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

3/ Defined as non-interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.

FISCAL SUSTAINABILITY SIMULATIONS

Total public debt is about 26 percent of GDP in 2002 and is projected to decline slightly in the next five years. This is based on the assumption of continuing fiscal consolidation and a gradually declining real interest rate, as EU accession draws nearer.

Stress tests indicate that, while the debt-to-GDP ratio is susceptible to several shocks, the most dangerous shock combinations are unlikely to occur. In contrast, the most likely shocks increase the debt-to-GDP ratio only moderately.

Two stress factors could potentially double the debt-to-GDP ratio:

(i) a combination of a recession in 2003–2004 with a real interest rate of 25 percent and a primary deficit of 1.7 percent of GDP. This compares with a baseline of 5 percent growth, a real interest rate of 4–5 percent, and a primary surplus of 0.2–0.3 percent of GDP. Although a recession combined with high interest rates did occur in 1999, the situation at that time was clearly exceptional, with Romania being cut off from international financial markets owing to the risk of default;

(ii) an average real interest rate on the total public debt in excess of 40 percent. This is a statistical artefact generated by the high variability of the real interest rate in transition and the particular method of calculating the real interest rate.

Further fiscal adjustment over the medium term than envisaged in the PEP is critical for sustaining rapid medium-term growth without jeopardizing hard-won progress in stabilizing the economy. The process of macroeconomic stabilization has not been completed and the credibility of fiscal policy is yet to be established. The private sector saving rate remains low by regional standards and fiscal policy will need to make room for private investment. Medium-term fiscal plans should therefore aim at further reducing the general government deficit and fully eliminating the quasi-fiscal deficits.

The most likely (in a relative sense) shock is a fall in the revenue-to-GDP ratio two standard deviations below the historic average, to 28.2 percent in 2003–04 from 30.3 percent in 2002. This is a policy risk, generated by possible delays in improving tax and social security collections in line with the rapidly growing GDP and leading to a fall in the overall income elasticity of revenues. Under this scenario, debt will increase for two years, reaching 31 percent of GDP in 2004 and stabilizing thereafter at this not particularly high level.

Table 1. Romania: Public Sector Debt Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1 Public sector debt 1/ o/w foreign-currency denominated	25.4	23.8	26.9	26.3	26.0	25.8	25.1	24.9	24.8	24.7	25.0
2 Change in public sector debt	3.0	-1.6	3.1	-0.6	-0.4	-0.2	-0.6	-0.2	-0.1	-0.1	0.3
3 Identified debt-creating flows (4+7+12)	15.0	-2.7	8.2	2.6	0.8	1.1	0.2	1.0	0.4	0.1	0.2
4 Primary deficit	1.4	0.7	-1.7	-0.9	-0.6	-0.4	-0.2	-0.3	-0.3	-0.3	-0.3
5 Revenue and grants	28.6	29.7	31.9	31.4	30.7	30.3	30.8	31.2	31.6	31.9	31.9
6 Primary (noninterest) expenditure	30.0	30.4	30.2	30.5	30.2	29.9	30.6	30.9	31.3	31.6	31.6
7 Automatic debt dynamics 2/	14.8	-2.1	10.6	3.9	1.3	1.3	0.1	1.0	0.3	0.0	0.1
8 Contribution from interest rate/growth differential 3/	-8.9	-6.0	-3.3	-4.5	-5.2	-1.2	-1.4	-0.4	-0.3	-0.2	-0.1
9 Of which contribution from real interest rate	-9.5	-6.8	-3.5	-4.2	-4.2	-0.3	-0.4	0.6	0.8	0.9	1.0
10 Of which contribution from real GDP growth	0.6	0.8	0.2	-0.3	-1.0	-0.9	-1.0	-1.1	-1.1	-1.1	-1.1
11 Contribution from exchange rate depreciation 4/	23.7	4.0	13.8	8.4	6.5	2.6	1.5	1.4	0.6	0.2	0.2
12 Other identified debt-creating flows	-1.3	-1.4	-0.7	-0.4	0.1	0.2	0.3	0.3	0.4	0.4	0.4
13 Privatization receipts (negative)	-1.7	-1.8	-1.3	-1.0	-0.5	-0.4	-0.3	-0.3	-0.2	-0.2	-0.2
14 Recognition of implicit or contingent liabilities	0.5	0.4	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	-12.0	1.1	-5.1	-3.2	-1.2	-1.3	-0.8	-1.2	-0.5	-0.2	0.1
Public sector debt in percent of revenues 1/	88.7	80.2	84.5	83.9	84.4	84.9	81.5	79.8	78.3	77.5	78.5
Gross financing 5/ in billions of U.S. dollars	8.3	10.4	11.1	11.7	9.8	9.8	9.1	9.5	9.3	7.4	10.9
	2.9	4.4	4.0	4.3	3.9	4.4	4.7	5.3	5.7	5.0	7.9
Key Macroeconomic and Fiscal Assumptions											
Real GDP growth (in percent)	-6.1	-4.8	-1.2	1.8	5.3	4.5	4.9	5.0	5.0	5.0	5.0
Average nominal interest rate on public debt (in percent) 6/	141.4	41.1	83.6	52.6	40.6	23.3	17.2	15.8	11.7	9.8	8.7
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-5.8	-14.2	35.9	8.5	3.6	-0.6	-0.9	3.6	4.0	4.3	4.7
Nominal appreciation (increase in US dollar value of local currency, in percent)	-57.1	-19.0	-41.9	-29.6	-25.4	-12.2	-8.0	-7.2	-3.4	-1.3	-1.3
Inflation rate (GDP deflator, in percent)	147.2	55.3	47.7	44.1	37.0	23.9	18.1	12.1	7.7	5.4	4.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-12.4	-3.6	-1.9	2.8	4.1	3.7	7.2	6.1	6.3	5.9	5.0
II. Stress Tests											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007						25.8	28.1	30.3	32.6	34.8	37.6
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						25.8	35.0	47.7	47.9	47.8	48.2
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						25.8	28.9	33.3	33.4	33.5	34.0
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						25.8	28.3	31.5	31.4	31.4	31.7
5. Combination of 2-4 using one standard deviation shocks						25.8	35.4	48.2	48.4	48.5	49.0
6. One time 30 percent real depreciation in 2003 7/						25.8	39.9	40.3	40.4	40.3	40.7
7. 10 percent of GDP increase in other debt-creating flows in 2003						25.8	35.1	35.3	35.3	35.2	35.6
8. Impact on debt-to-GDP ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						25.8	27.7	30.6	30.5	30.5	30.8
8a. Impact on debt-to-revenue ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						84.9	98.2	108.4	96.5	95.5	96.7
Historical Statistics for Key Variables (past 10 years)											
		Historical Average	Standard Deviation								
Primary deficit	94-01	0.4	1.3								
Real GDP growth (in percent)	94-01	1.3	4.8								
Nominal interest rate (in percent) 6/	97-01	71.8	42.6								
Real interest rate (in percent)	97-01	5.6	19.1								
Inflation rate (GDP deflator, in percent)	97-01	66.2	45.7								
Revenue to GDP ratio	94-01	30.8	1.3								

1/ Gross debt of the general government.

2/ Derived as $[(r - \pi(1+g) - g + \alpha(1+r))/(1+g+\pi+g\pi)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency debt

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the denominator in footnote 2/ as $\alpha(1+r)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

**Statement by the IMF Staff Representative
January 8, 2003**

1. This statement summarizes macroeconomic information that has become available since the release of the staff report. The staff appraisal remains appropriate.
2. Recent data confirm that macroeconomic developments remain favorable:
 - In January–October 2002, the current account deficit was only 2.5 percent of annual GDP, compared to 4.1 percent in the same period of 2001. This suggests that the annual 2002 deficit is unlikely to exceed 4½ percent of GDP.
 - Inflation in December is preliminarily estimated at 1.6 percent, which would bring the 12-month rate to 18 percent, compared to the authorities' original target of 22 percent.
- 3 In December, Parliament adopted a new Labor Code. The Code, which aims inter alia at harmonizing Romanian with EU legislation, appears to have introduced substantial restrictions on layoffs, imposed costly administrative procedures on employers and extended industry-wide collective agreements to non-participating employers, to the detriment of small and medium-size enterprises. The World Bank is currently involved in discussions with the authorities on possible revisions in the law, and staff welcome such efforts.



INTERNATIONAL MONETARY FUND

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with Romania

On January 8, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Romania.¹

Background

Until recently, Romania's macroeconomic performance was weak and characterized by boom and bust cycles, driven by loose fiscal policy and weak financial discipline in state-owned enterprises (SOEs). Since mid-2001, a combination of budget restraint, ambitious energy price adjustments and prudent monetary policy moderated domestic demand and reduced the current account deficit. At the same time, export and GDP growth were among the highest in the region, reflecting the fruits of private investments in export-oriented consumer goods industries over the last few years, and the gains in competitiveness from the 1999 adjustment in the real effective exchange rate. Rising productivity, complemented by moderate economy-wide wage growth, has preserved competitiveness despite the slowing rate of depreciation and allowed Romania to expand its share in its main export markets.

The far-reaching reform of the VAT and profit tax legislation in 2002, which eliminated many distortionary incentives, has contributed to improving the business climate. Moreover, the extremely high payroll taxes, which have contributed to the growth of the informal sector of the economy and narrowed the tax base, were reduced by 3 percentage points in 2002 and will be cut by another 5 percentage points in January 2003. Monetary policy contributed to disinflation

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

by reducing the rate of crawl while keeping interest rates high. The soundness of the banking system has improved, but the recent very rapid expansion of credit to the private sector, which supported the pick-up in investment, is of concern owing to its potential implications for the quality of the credit portfolio of commercial banks.

The successful stabilization has reflected some progress in imposing hard-budget constraints on SOEs. However, wages in state-owned enterprises have continued to outpace those in private sector. An additional risk for disinflation has been created by the sharp minimum wage increase in January 2003. Collections of the largest utilities have improved only modestly, and natural gas prices remain much below import prices. The slow progress in privatization continues to hold back Romania's economy and, as a result, the private sector has one of the lowest shares in GDP among EU accession candidates. Privatization has in general been slowed by restrictions on labor retrenchment and investment requirements.

Executive Board Assessment

Directors commended the authorities for Romania's progress in addressing several long-standing economic weaknesses. Macroeconomic performance had been encouraging; the budget and the broader public sector deficits, especially in the energy sector, reduced; inflation brought down; and the external position strengthened substantially. The authorities' commitment to stabilization and reform had served to boost investor confidence and investment, and had contributed to the strong pick-up in growth over the past two years.

Directors noted that continued strong performance over the medium term would require a steadfast commitment to macroeconomic stabilization and accelerated structural reforms that would include a strengthening of the efficiency of SOEs, completion of privatization, and increased efforts to improve the business environment. It would be important not to revert to the stop-and-go policies of the 1990s. Directors encouraged the authorities to continue orienting monetary and fiscal policies toward macroeconomic stabilization, with focus on a further reduction of the still high inflation rate, and containing the current account deficit; and to address vigorously the problem of losses and quasi-fiscal activities of SOEs. These efforts would also be crucial for completing Romania's transition to a fully operational market economy and for paving the way for EU accession.

Directors strongly welcomed the recent reduction in Romania's extraordinarily high social security contribution rates and the recent reforms in the area of VAT and profit taxation, which contributed to improving the business climate. They supported further cuts in the social security tax rates, but pointed to the need to broaden the tax base and improve tax administration in general. To make tax cuts affordable and avoid putting at risk the fiscal balance, Directors saw a need for the authorities to develop detailed medium-term expenditure plans. They noted that expenditures should be carefully prioritized to make room for accession-related spending on infrastructure and other investments. Most Directors recommended that the authorities aim at a somewhat tighter budget stance than envisaged in Romania's Pre-Accession Economic Program submitted to the EU in August 2002.

Directors noted that completing the task of stabilization would require rapid progress in eliminating the still substantial losses in the state-owned companies, particularly in the energy sector. While commending the ambitious increase in energy prices as a key step toward reducing losses in this sector, Directors considered that further progress in enforcing hard budget constraints would depend on stepping up the fight against the nonpayment of utility bills and tax arrears. They urged the authorities to accelerate the closure of nonviable enterprises, to implement further gradual increases in gas prices to import parity levels, and to ensure timely adjustments of electricity and heating prices in line with costs. Directors also stressed the importance of proceeding with privatization in the energy sector.

Directors welcomed the authorities' plan to offer for sale by end-2003 most of the state-owned companies outside of the energy sector. They noted with concern the government's intention to continue imposing conditions for preserving employment and committing buyers to large investments, a practice that has deterred investors and significantly contributed to the disappointingly low speed of privatization. Directors strongly encouraged the authorities to continue reducing employment in SOEs as a necessary condition for reducing losses and accelerating privatization. They noted that social hardship arising from restructuring should be addressed by further improvements in the social safety net and by stimulating private sector growth, notably by eliminating barriers for setting up small- and medium-size enterprises.

Directors emphasized that establishing wage discipline in the state-owned sector is critical to improving financial discipline and reducing losses. They were concerned about the continuously poor performance in this area, which had often undermined disinflation efforts in the past, and called for vigilance in efforts to prevent the sharp minimum wage increase scheduled for January 2003 from feeding through to the overall wage level. Moreover, they cautioned against further real increases in the minimum wage, which would adversely affect employment. Directors stressed that a convincing performance in this area and a full adherence to the related performance criteria on SOE wages, agreed under the Stand-By Arrangement, would be preconditions for completion of the delayed third review under the program.

Directors pointed out the importance of preserving flexible labor markets, which are seen as crucial to keeping the economy on a fast growth path and completing the far-reaching restructuring process in the Romanian economy. They urged the authorities to review, in close cooperation with the World Bank, provisions in the new labor code that could adversely affect this flexibility and impose a particularly heavy burden on small- and medium-size enterprises, and welcomed the fact that discussions had already begun.

Directors commended the authorities for progress in improving the business climate, but emphasized that further institutional reforms and a stepped-up fight against corruption, which they considered a key impediment, are needed for private investment to gain further strength. They strongly encouraged the authorities to complete the reform of the judiciary system with a view to improving its effectiveness and ensuring its independence, and to implement an efficient bankruptcy mechanism. Directors urged the authorities to continue with their efforts to liberalize foreign trade, with the medium-term goal of full harmonization with the EU, as well as to continue to reduce tariffs with non-EU partners.

Directors agreed that the current exchange rate regime, which, in the context of capital controls and lingering credibility issues, features a gradually declining targeted depreciation rate as a nominal anchor, had been one of the key factors for the recent success in reducing inflation while protecting external competitiveness. In the context of the persistent surplus in the foreign exchange market, several Directors saw some scope for a further gradual reduction in interest rates; several others, in light of the still high inflation rate, suggested erring on the side of caution and instead accepting some slowing in the rate of depreciation of the exchange rate. Directors noted that the current regime would remain appropriate until inflation had been brought down to single-digit levels and wage discipline in SOEs strengthened. They considered, however, that once these conditions had been met, inflation targeting would be a sustainable medium-term framework. Concomitantly, Directors encouraged the authorities to step up preparations for establishing the institutional, operational, and analytical prerequisites for its introduction, inter alia, by strengthening the National Bank of Romania's independence in line with Maastricht requirements.

Directors expressed concern about the recent rapid growth of bank credit, in particular in foreign currencies, which indicated that commercial banks might be overstressing their credit portfolio at the expense of a prudent assessment of borrowers' creditworthiness. They welcomed the authorities' measures to strengthen banking supervision and their intention to strictly enforce the new regulation on classification and provisioning with a view to ensuring that credit growth remained sound. While the overall exposure of the private sector to foreign currency risk was low, Directors recommended that additional measures be considered should the brisk pace of the growth in foreign currency loans continue. Directors supported the authorities' request to participate in the Financial Sector Assessment Program exercise.

Directors encouraged the authorities to make rapid progress in preparation for subscribing to the Special Data Dissemination Standard.

Directors commended the authorities for the passage of anti-money laundering legislation and for their actions to prevent the funding of terrorist activities.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Romania is also available.

Romania: Selected Economic Indicators

	1998	1999	2000	2001	2002 (Proj.)
Real GDP growth	-5.4	-1.2	1.8	5.3	4.5
Final domestic demand	-0.7	-2.9	1.6	5.9	4.4
CPI (eop)	40.6	54.8	40.7	30.3	19.0
Unemployment rate (eop)	10.4	11.8	10.5	8.6	9.0
Overall balance	-5.5	-3.6	-4.0	-3.3	-2.9
Primary balance	-0.7	2.4	0.9	0.6	0.3
Public debt	23.8	26.9	26.3	26.0	...
Real domestic credit	20.5	-7.6	9.9	25.6	30.0
Broad money	48.7	46.4	39.2	47.8	30.1
Trade balance	-6.3	-3.5	-4.6	-7.5	-6.5
Current account balance	-7.1	-4.0	-3.9	-6.0	-4.8
External debt	23.5	24.6	27.7	29.6	28.6
Official reserves (months of prospective imports)	2.4	2.1	2.5	3.2	4.1

Sources: Romanian authorities and IMF staff estimates.

Statement by J. de Beaufort Wijnholds, Executive Director for Romania
January 8, 2003

On behalf of the Romanian authorities, I would like to thank staff for the constructive discussions and continuous efforts to assist Romania in its transformation to a functional market economy. In the authorities' opinion the staff report is a comprehensive and convincing assessment and the additional analysis in the Selected Issues paper is equally welcome.

Since the last Article IV discussion, the Romanian economy has experienced rapid growth, among the highest in the region, accompanied by improved macroeconomic stability. At the same time, the Romanian authorities have proven their reform commitment by adopting a realistic economic strategy and implementing a number of much-needed measures to consolidate the macroeconomic performance. Their efforts have been supported by a new Stand By Arrangement approved in October 2001. Furthermore, a World Bank PSAL II program, aimed at supporting the restructuring and privatization strategy, was approved in September 2002.

EU accession has become a key driving force behind the country's adjustment and reform efforts. Trade with the EU is growing steadily. In the first nine months of 2002 more than 68 percent of Romania's total exports went to the EU countries (compared with 64 percent in 2000). By end-2002, negotiations on all chapters of the *acquis communautaire* had been opened and 17 of them had been provisionally closed. The country's goal is to complete the accession negotiations in 2004 and assume the obligations of the EU membership by 2007, as envisaged at the Copenhagen summit in December 2002.

With the Romanian authorities being committed to accelerate the reform process, they are aware how challenging it will be to sustain the achievements made so far and translate them into a long-term strategy to move forward in a number of key areas and to address still existing weaknesses of the economy.

Recent economic developments and outlook

Macroeconomic developments and policies have improved during 2001-2002 and fiscal tightening combined with an ambitious energy price adjustment have consolidated the favorable performance. As a result, after a strong GDP growth of 5.3 percent in 2001, 2002 economic growth is estimated at about 4.5 percent, driven mainly by exports and investment, consolidating the favorable trend started in 2000. Inflationary pressures receded, and the 12-month inflation rate declined significantly from 41 percent in 2000 to 30 percent in 2001 and 18 percent by end December 2002 (well below the program target). The current account deficit was contained below 6 percent in 2001 and is projected at close to 4.5 percent in 2002 (also below the program target). The increase in international reserves was significantly stronger than initially estimated and the end December 2002 reserves level in terms of import coverage was already reached in August, amounting to 4 months of prospective imports. The prudent fiscal policy has borne fruit and the fiscal deficit has been steadily reduced from 4.0

percent of GDP in 2000 to an expected less than 3 percent in 2002. Romania improved its credibility on the international financial markets. The good performance on the macroeconomic front and in implementing further market-oriented reforms has led all major credit rating agencies to upgrade Romania's sovereign risk three times in the last year. Under these circumstances, the country accessed the markets at attractive conditions, while spreads on its foreign bonds have continued to narrow significantly.

The whole economic strategy should be seen in the context of the aim to accelerate the process of integration with the EU economy and attain full membership by 2007. The Romanian authorities see the near-term economic outlook as broadly favorable and further policy implementation is aimed at ensuring the long-term sustainability and strategic objectives of the country, presented in the Pre-Accession Economic Program (PEP). Economic growth is projected to average 5 percent annually in 2003-2005, while inflation is expected to fall to 15 percent in 2003 and to reach single digits by 2004. A fiscal deficit of 2.65 percent in 2003 will support the disinflation trend. Exports, current account deficit and international reserves level will continue to develop favorably. From this perspective, I would like to point out a few challenging tasks still facing the Romanian authorities in the period ahead.

Fiscal policy

The authorities are determined to continue the fiscal consolidation, which will remain at the center of their economic strategy in the next years. They are aware that the budget has to accommodate substantial fiscal costs related to NATO and EU accession, and at the same time maintain a sustainable fiscal position over the medium term. Under these circumstances, the 2003 budget was already approved by the Parliament with a deficit objective consistent with the fiscal consolidation commitment and a continuation of the disinflation efforts and containment of the current account deficit. The budget is oriented toward fiscal consolidation and could create scope to increase capital expenditure and improve the social safety net. At the same time, it states the commitment to maintain the current income tax rates and a prudent wage policy, while continuing to downsize overall budgetary sector employment. The authorities agree with staff that revenue collection, despite some improvements, is below potential. New steps have been considered and approved in 2002 in order to address more forcefully this issue. Therefore, new regulations on excises and new VAT and profit tax laws were approved, with the main objective to reduce tax exemptions and distortionary tax incentives. In the same vein, the government intends to broaden the tax base of pension and unemployment funds. More importantly, on the expenditure side, the government is consolidating further the management of public funds, strengthening the expenditure management, and imposing better transparency. To meet these goals the authorities will pursue the way to prioritize and manage public spending. During discussions they expressed concern about the growth in budget expenditure in the next years. This should be driven by increased commitments to allocate resources for investment, as the government is determined to increase investment in projects that will bring infrastructure in compliance with EU requirements and promote economic growth in the medium term.

The authorities will remain vigilant and stand ready to take any corrective measures if the fiscal target is put in danger. They are also committed to implement the tax administration reform which has been initiated in line with the FAD technical assistance missions. A separate tax administration department has been set up in the Ministry of Public Finance and legislation for establishing a common agency for collection, audit and enforcement of social security contributions under the Ministry of Public Finance on January 1, 2004 has recently been approved.

Monetary policy and banking sector

The current monetary policy in Romania is focused on promoting gradual disinflation without putting external competitiveness at risk. There is full agreement between the authorities and staff that this policy has been successful so far and remains appropriate in the near future. Nevertheless, in order to encourage economic convergence and integration with the EU area, as well as to harmonize trade and competitive conditions with those existing in the EU, the National Bank of Romania has taken preparatory steps to replace the currently used euro/US-dollar basket with the lei/euro exchange rate as the reference exchange rate in Romania, which will mark another significant step towards European integration. At the same time, as agreed with staff, the central bank is giving more weight to the real exchange rate appreciation issue as the tight fiscal and monetary policies have recently resulted in an excess supply of foreign exchange. Moreover, steps have been taken to slow down the rapid expansion in foreign currency denominated credits. In October the NBR differentiated the reserve requirements in lei and foreign currency, to 18 and 25 percent, respectively (from their common level of 22 percent) and continued to exercise close supervision of the most active lenders. The new regulation on loan classification and provisioning in force from January 2003 will encourage commercial banks to closely monitor their portfolios with a view to reassess the credit risk stemming from the rapid credit expansion. The introduction of a fully-fledged inflation targeting framework is considered for 2004 when inflation is expected to fall to single digits and the legislative and technical capabilities will be in place.

The banking sector has been strengthened considerably and banking legislation is now at a high degree of alignment with international standards. There are only three state-owned banks and their share in the total net assets will decline significantly after the BCR privatization. The share of foreign banking institutions has also increased steadily, as the 32 foreign owned banks and branches account for more than half of total banking sector net assets and three fifths of all loans. The clean up and restructuring process in the banking sector has been completed, and, as a result, the share of non performing loans in total loans fell from more than 71 percent in 1998 to 2.8 percent by mid-2002.

Restructuring and Privatization

Progress is being made as regards structural reforms. The process is aimed at strengthening financial discipline, financial sector stability and improving the business climate. The cornerstones of the ambitious structural reform agenda are restructuring and privatization of the large state-owned companies. Despite important progress in some sectors,

the authorities agree that restructuring and privatization is still incomplete and that performance in this area requires continuous attention. The World Bank PSAL II program is now supporting these efforts.

In order to ensure stronger public sector wage discipline which was one of the weaknesses of the past programs, corrective measures have already been taken to contain the wage bills in the SOEs as agreed with staff and the 2003 budgets of monitored SOEs have already been approved by the Cabinet. At the same time, employment reductions in these companies have been made. The authorities are carefully monitoring the developments in this area and stand ready to take the necessary measures to limit any spillover from the minimum wage increase in January 2003.

To address weak financial discipline, mainly in the energy sector, special mechanisms have been set up to improve revenue collection: significant price adjustments to cost-efficiency levels, disconnections to the larger non-payers and transfer of some activities to local municipalities have been implemented. At the same time, in order to accelerate competition within the sector, the privatization of two electricity distribution companies, as well as the oil company Petrom, has been initiated.

The private sector has continued to grow and the authorities are giving due consideration to accelerating the process. Since the last Board discussion in August 2002 six large companies have been privatized and 8 others are in final stages of negotiations. The large scale privatization program is to be completed within a year. In considering the slow pace of privatization so far, the unfavorable market conditions and the limited attractiveness of some large loss making enterprises should be taken into consideration.

After two failed attempts to sell the majority stake of BCR, the largest commercial bank, the Romanian government is considering a change in the privatization strategy to allow the transitory participation of the EBRD and the IFC with a view to facilitating the sale of a majority package to a strategic investor as international market conditions improve. The authorities do reiterate their commitment to complete this process.

Other Issues

In the area of combating money laundering, the National Office of Prevention and Control of Money Laundering is now operational and the increase in its investigative activity is noticeable. The authorities are intensifying their fight against fraud and corruption. A National Anti-Corruption Prosecutor's Office was established in July and has begun functioning in September.

The Romanian authorities would like to restate their determination to continue the prudent policy course aimed at getting ready for EU accession.