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Romania: Ex Post Assessment of Longer-Term Program Engagement—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Romania

In the context of the ex post assessment of Romania' performance under Fund-supported programs, the following documents have been released and are included in this package:

- the staff report for the ex post assessment of Romania's performance under Fund-supported programs, prepared by a staff team of the IMF. **The staff report was completed on March 25, 2004**. 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 Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its April 12, 2004 discussion** of the staff report.

- a statement by the Executive Director for Romania.

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ROMANIA

Ex-Post Assessment of Longer-Term Program Engagement

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International Bank for Reconstruction and Development[1]

Authorized for distribution by the European and
Policy Development and Review Departments

March 25, 2004

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EXECUTIVE SUMMARY

Main Findings and Lessons

Main Findings

- **Romania had some of the worst starting conditions of any transition economy.** Because of the policies of the Ceauşescu regime, it had not only one of the largest state enterprise sectors, but also the most energy intensive and the most self sufficient. Similarly, agriculture was dominated by very large collective farms. Potential starting assets, the absence of any foreign indebtedness and the availability of domestic energy supplies, reinforced the view among many that Romania not only should, but could, undertake a gradual approach to transition.

- **As a result, the approach of successive governments to macroeconomic stabilization and structural reform has been hesitant and piecemeal since the beginning of the transition.** The structural hurdles together with a lack of ownership of sustained reform efforts has produced a weak record of policy implementation, with macroeconomic policies alternating dramatically between periods of tightening and relaxation, and made Romania a laggard among EU accession candidates. Consequently, out of the six Stand-By Arrangements (SBAs) since the start of Romania's transition all but the last eventually went off-track.

- **Accommodating losses from quasi-fiscal activities persistently undermined stabilization policies.** Significant overvaluation of the leu (to protect energy intensive enterprises), tolerance of large arrears to the budget and utilities, and large directed lending to ailing SOEs in industry and agriculture periodically undermined macroeconomic stabilization and impacted negatively upon financial sector stability.

- **Implementation of reforms was stop-and-go over most of this period and the first five SBAs went off track.** This primarily reflected fluctuations in reform ownership and in the authorities' determination to confront vested interests. The first three SBAs focused more on the macroeconomic symptoms and achieved little in terms of restructuring SOEs, accelerating privatization, and reducing losses from quasi-fiscal activities. Some key structural reforms were achieved under the following two SBAs (1997-98 and 1999-2000), even though both of them eventually went off-track as well. In particular, besides policies to address imminent macroeconomic imbalances, they significantly reduced quasi-fiscal activities and comprised key structural reforms, including in the crisis-ridden banking sector.

- **Reflecting the reforms under the previous two SBAs and more consistent macro policy implementation under the last SBA, Romania has enjoyed a period of strong real GDP growth and steady, if gradual, disinflation since mid-2001.** Inflation declined from 40 percent in early 2001 to 14 percent at end-2003. Failure to implement an effective incomes policy to complement monetary and fiscal policy in an environment with soft budget constraints, was the key obstacle preventing more rapid disinflation, and explains why inflation in Romania has been considerably higher compared with other transition economies.

The current account deficit has recently widened as a result of a boom in private sector credit and an excessive minimum wage hike.

- Despite progress, soft budget constraints remain a problem, as evidenced by arrears and wage settlement in SOEs and the still high inflation rate.

Lessons

- **The Fund's long-term engagement in Romania reflected unfavorable starting conditions at the beginning of 1990s and repeated reversals of macroeconomic stabilization efforts on account of the lack of program ownership**. Strong vested interests, particularly the collusion between the management of large SOEs, labor unions, and factions within the ruling parties, were the main factor behind the slow progress in privatization and long delays in restructuring state-owned enterprises.

- **The performance under the three SBAs between 1991-96 raises questions about the appropriateness of the composition of conditionality under these three arrangements.** While the build up of major macroeconomic imbalances and the slow pace of structural reforms during this period primarily reflected the authorities' insufficient ownership of the stabilization and reform programs, it also raises the question why it took the Fund until 1997 to recognize that re-engaging with Romania in a program relationship would need to address the issue of vested interests through front-loaded structural conditionality. It can be argued that the emphasis on macro-based conditionality in Fund-supported programs postponed the emergence of sustained growth.

- **Progress towards a market-based and financially stable economy gradually increased under the last three SBAs.** This reflected the comprehensive use of structural conditionality under the last three SBAs. More recently, the government's strong commitment to join the EU in 2007 has moved the need to sustain macroeconomic stabilization and accelerate structural reforms to the top of the policy agenda.

- **While conditionality appears to have been generally appropriate under the last three SBAs, a few shortcomings could have been addressed earlier.** The comprehensive reliance on structural conditionality proved effective in addressing the resistance of vested interests against structural reform. However, given the risks emanating from quasi-fiscal activities, efforts to measure losses resulting from these activities should have started earlier. Moreover, while the last SBA brought about major progress in improving the utilities' collection rates in the electricity and gas sectors, collections in the ailing district heating sector hardly improved, reflecting the absence of a strategy for reforming this sector.

- **The potential drawbacks of longer-term engagement were mitigated by the Fund's requirement of a positive track record prior to the approval of a new program.** While the Fund showed flexibility by re-engaging with Romania despite uneven performance, the bar for such re-engagement was progressively raised over time to preserve the credibility of its program signals and limit the development of expectations that Fund program support was automatic. In terms of program design, the increasing reliance on prior actions proved effective in bringing about reforms. By contrast, the granting of multiple waivers, may have lessened the authorities' resolve to implement their commitments once the program was approved.

- **The Fund's determination not to accommodate major policy slippages limited the Fund's exposure and contributed to preserving its credibility.** With the exception of the last SBA, programs went off-track by margins too great to be reasonably accommodated. Accordingly, many reviews were never completed and, despite the Fund's extensive engagement with Romania, there has not been a prolonged period of high Fund exposure. Indeed, at end-2003, outstanding Fund credit was less than 40 percent of quota. Frankness in Article IV consultations was maintained, many of which were completed when program negotiations had stalled.

- **Despite repeated slippages in policy implementation Fund involvement was beneficial for promoting good policies**. While the stop-and-go pattern of reform prevented Romania from making faster progress in the transition to a fully-functioning market economy, these programs have facilitated significant structural change, with for example the share of the private sector in GDP increasing from 55 percent in 1996 to 65 percent in 2001.

- **The Fund's Private-Sector-Involvement Initiative (PSI) in 1999 strained relations with the authorities.** The Fund, concerned about being viewed as bailing out foreign private creditors in the aftermath of a $750 million bond repayment, conditioned its support on the authorities securing new money from private creditors. In this context, the Fund's decision to include Romania as a case on which to pursue PSI alongside countries that could have been illiquid or insolvent, worsened the difficulty Romania faced in securing new money. As the Fund recognized the problems with the PSI, and the balance of payments strengthened, the Fund gradually eased and eventually dropped the condition.

- **The overlap between Bank and Fund conditionality has been substantial, reflecting the unfinished structural reform agenda and mixed reform ownership.** Bank technical expertise was used as key input for the design of Fund programs. In areas that are crucial for macroeconomic stabilization the Fund incorporated Bank conditionality into its own programs when this facilitated faster implementation. While not conducive to reducing the number of conditions in Fund programs, this approach successfully increased pressure on the authorities to maintain the reform momentum.

- **The authorities' request for a new arrangement could be supported if it provides assurances that macroeconomic stabilization will be sustained and vigorous structural reforms will continue.** While the progress achieved under past programs would now make a surveillance-only relationship feasible, a new arrangement could (a) address the recent deterioration in the current account; (b) help ensure sufficient credibility of macroeconomic policies that is a prerequisite for achieving single-digit inflation; (c) strengthen the momentum of structural reforms during the run up to the elections; and (d) create the conditions for a successful transition to a surveillance-only relationship.

- **Features of a new arrangement should comprise:**

- Given the absence of an imminent financing need, a successor arrangement should be a low access precautionary SBA.

- To ensure the implementation of key structural reforms, a longer program period of at least 18 months would be preferable.

- To guard against the risk that there is an automatic move from one program to the next, an explicit strategy for exiting from Fund program-engagement should be formulated and made public.

- Given the importance of structural reform for medium-term external viability and the low probability that reform ownership will strengthen in the run up to the elections, there is limited scope for streamlining conditionality in a future program.

- As in past programs, the Fund should continue to condition new arrangements and reviews on the prior completion of significant structural reforms.

- As weaknesses in governance remain a major barrier to generating sustained private sector growth and attracting FDI, stepping up the fight against corruption and the reform of the judiciary would need to be addressed more forcefully.

- Critical structural reforms should be coordinated and agreed with the World Bank early on, to ensure a unified front vis-à-vis the authorities, and to allow the Bank to prepare for supporting implementation.

I. Introduction

1. **This paper reviews the experience of the Fund's longer-term engagement in Romania and discusses options for future Fund involvement.** With six Stand-by Arrangements (SBAs) since the beginning of the 1990s, Romania has been a prolonged user of Fund resources, thus requiring an assessment of the Fund's longer-term involvement (SM/03/233). In part, this ex-post assessment builds on the findings of a C*ountry Strategy Paper* (CSP) prepared by staff in June 2003, which assessed progress since the previous CSP in 1997. The focus of this paper is on Romania's more recent engagement with the Fund.[2]

2. **Since the beginning of the transition, the approach of successive governments to macroeconomic stabilization and reform has been hesitant and piecemeal.** This, together with the burdensome political and economic legacy of the Ceausescu era, has produced a weak record of policy implementation under the five SBAs in 1991–2000 and made Romania a laggard among EU accession candidates. While none of these programs was completed, important progress was made under the two SBAs from 1997–98 and 1999–2000, laying the foundation for stronger performance under the 2001-2003 SBA.

3. **Recently, the government's strong commitment to EU accession has served as an anchor for economic policy.** While policy implementation improved, as the authorities became increasingly aware of the scope and the urgency of reforms required to keep EU accession on track, ownership has remained mixed with respect to a number of key structural reforms.

II. Achievements and Shortcomings Under Fund-Supported Programs

A. The 1990s: Slow Progress in Macroeconomic Stabilization and Structural Reforms

4. **Romania started the transition to a market economy under difficult initial conditions.** Even though Romania's external public debt had virtually been repaid by the end of the 1980s, the legacy of Romania's communist regime was particularly poor, with very rigid central planning, a massive misallocation of resources—particularly in energy-intensive industries and agriculture—and a heavily obsolete capital stock. State-owned enterprises (SOEs) were highly inefficient and engaged in massive quasi-fiscal activities. Given these circumstances, a lengthy transition was unavoidable.

5. **These disadvantages were exacerbated by weak macroeconomic stabilization efforts and slow structural reforms prior to the 1997 SBA.** Following a combination of an output contraction and inflation burst in the early years of transition, in 1994 Romania's

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[2] For a detailed discussion of the earlier programs see Staff Report for the 1997 Article IV Consultation and Request for Stand-By Arrangement (4/9/1997).

growth performance improved and inflation started to decline. These developments were, however, based on large subsidies to inefficient, and in many cases unviable state-owned enterprises (SOEs), rising fiscal deficits, and surging quasi-fiscal losses that aggravated the underlying macroeconomic imbalances by late 1996 and led to the banking crisis of 1997–99. External debt rose rapidly from the negligible levels at the start of the transition process.

6. **Difficulties in reforming SOEs were central to Romania's slow progress and uneven macroeconomic performance.** Large vested interests, in particular the collusion between the trade unions, management, and factions within the ruling parties, have been a crucial factor for excessive wage growth and the lackluster privatization performance, with the privatization of large SOEs only starting in 1997 and proceeding very slowly thereafter.

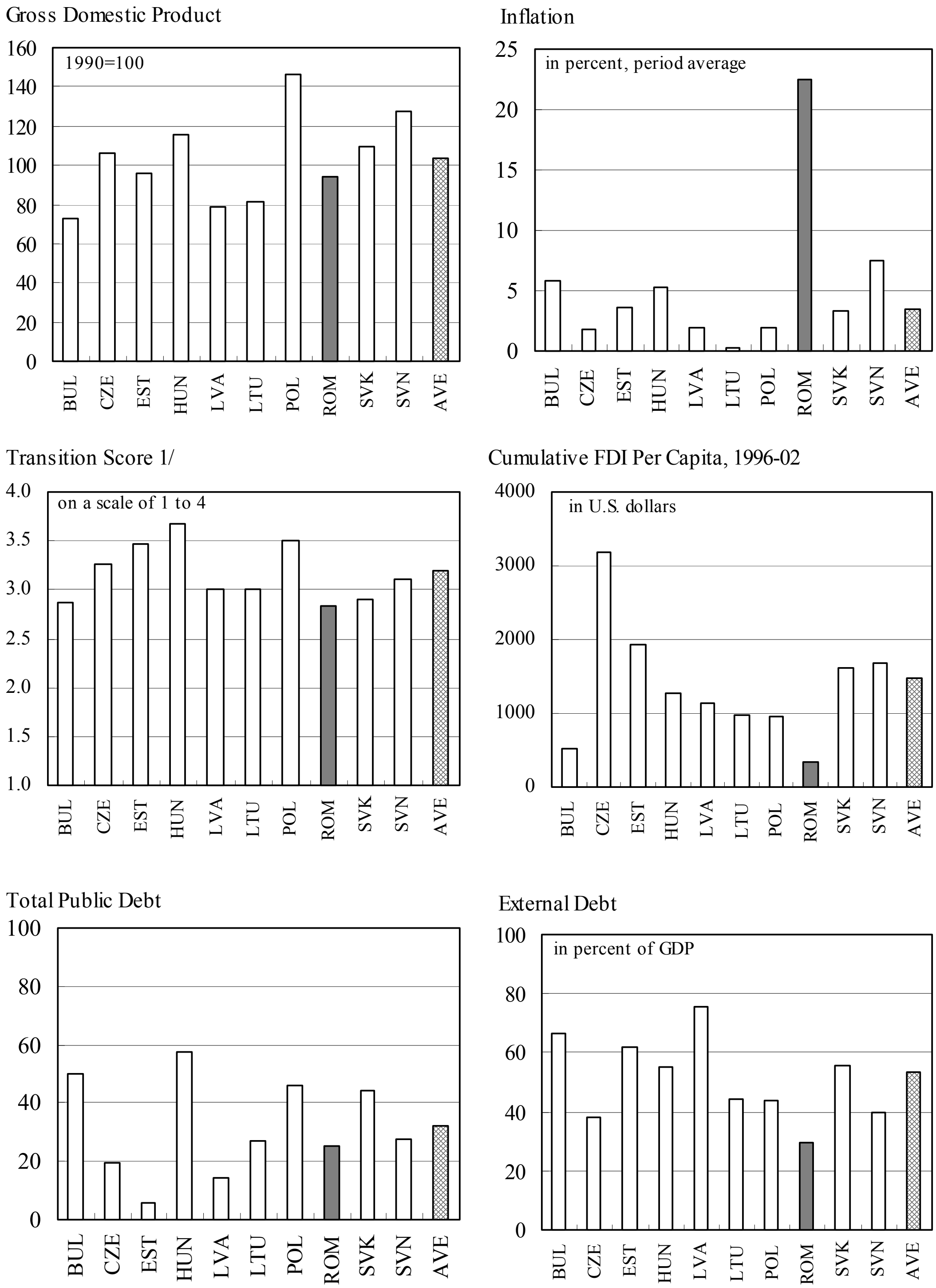
7. **Accommodating losses from quasi-fiscal activities persistently undermined stabilization policies.** Significant overvaluation of the leu, which subsequently required large corrections, tolerance of large arrears initially between enterprises and/or to the banks, and later to the budget and utilities, and the large directed lending to ailing SOEs in industry and agriculture periodically whipsawed domestic demand and undermined macroeconomic stability and financial sector stability.

8. **The unfavorable growth performance also reflected adverse conditions for private sector development.** The much slower private sector development compared to other EU accession countries reflected the lack of macroeconomic stability, mayhem in the area of tax policy, weak enforcement of property rights, and the prevalence of weak governance. These factors were also responsible for low FDI inflows compared to other countries in the region (Figure 1).

9. **Notwithstanding some key reforms by a newly elected government in 1997, the Romanian economy soon veered back toward financial instability.** In early 1997, prices and the exchange and trade regimes were liberalized and quasi-fiscal subsidies through the National Bank of Romania (NBR) were terminated. The government also attempted to rein in fiscal spending. However, the authorities soon relaxed fiscal and wage restraint and relied instead on slowing the lei depreciation to contain inflation. A weakening current account and deteriorating investor confidence, exacerbated by the Russian crisis, led to heavy reserve losses and mounting concerns of a default on privately held bonds. As a result of the ensuing currency crisis, real GDP fell by 12 percent from 1997 to 1999, inflation averaged 72 percent, and gross reserves fell by over US$1.0 billion (Figure 2). Largely on account of difficulties in raising public sector savings on a sustained basis, the current account deficit was very volatile.

10. **High and variable inflation in 1997-2000 reflected inconsistent macroeconomic policies and reluctance to tackle quasi-fiscal losses.** In early 1997, the NBR attempted to reduce inflation by using foreign exchange market intervention to slow down the depreciation rate. However, without sufficient support from fiscal policy and, in 1998, wage restraint, this attempt failed after heavy reserve losses in late 1998. The ensuing disorderly exchange rate depreciation thwarted disinflation efforts in 1999–2000, via both the direct pass-through effect on the domestic price level and a surge in inflationary expectations.

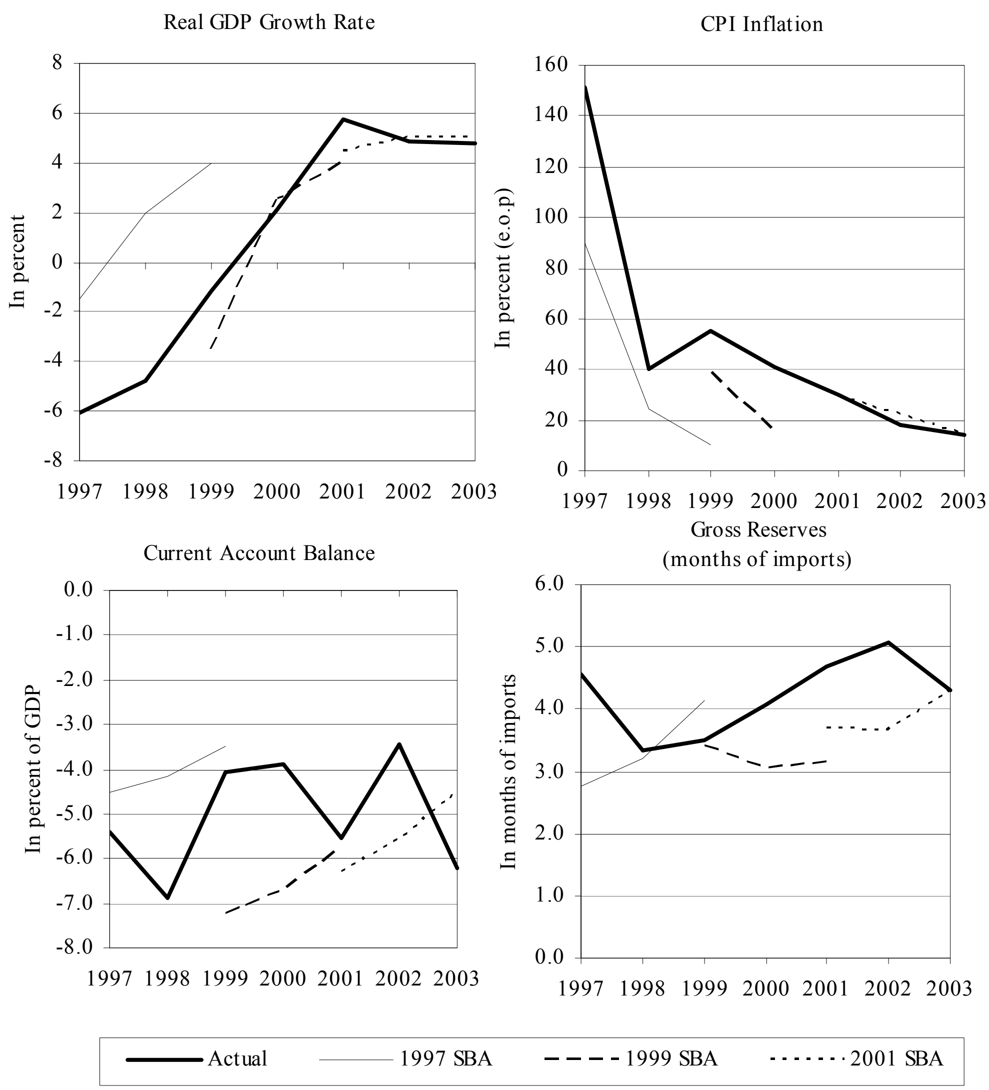
Figure 1. Selected EU Accession Countries: Comparison of Economic Indicators, 2002



Sources: World Economic Outlook, Global Development Finance 2002, World Bank and Transition Report 2003, European Bank for Reconstruction and Development.

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

Figure 2. Romania: Key Macroeconomic Variables



Throughout the period, the large loss-making SOE sector was kept afloat by a combination of implicit acceptance of non-payment of taxes, directed lending from state-owned banks, and maintenance of below-cost energy prices, all of which contributed to raising domestic demand to excessive levels and thus to high inflation. In turn, high inflation disguised the true cost of failing to reform the SOEs by ultimately distributing their losses over the whole society.

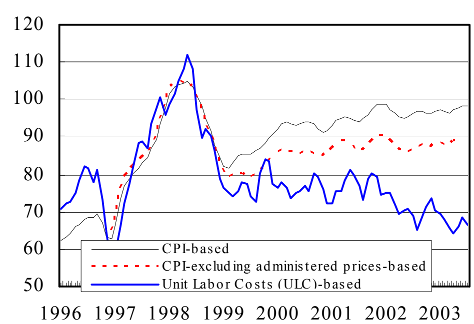
B. Recent Macroeconomic Developments

11. **Confronted by the currency crisis, the authorities took decisive policy measures in 1999 to stabilize the economy.** Fiscal and real exchange rate adjustment laid the groundwork for improved macroeconomic performance. Following feeble attempts in 1997 to address the issue of directed lending and lax bank lending standards that resulted in a rapid accumulation of non-performing loans, the authorities finally resolved the banking crisis by terminating directed lending, closing the biggest state-owned bank Bancorex, transferring most of the non-performing loans to an asset recovery agency, recapitalizing other state-owned banks, and tightening banking supervision. This helped lower the current account deficit to sustainable levels, and laid the basis for recoveries in export, investment and real GDP growth. International reserves were rebuilt, and the soft unannounced crawling band regime anchored a steady decline in inflation since 2000.

12. **Since mid-2001, Romania has enjoyed a period of strong real GDP growth and steady, if gradual, disinflation.** Budget and wage restraint and energy price adjustments moderated domestic demand and earned greater credibility for stabilization policies in general. This allowed the NBR to successfully guide exchange rate depreciation on a downward path, both alleviating the cost-push effect and moderating inflationary expectations. As a result, inflation declined from 40 percent in early 2001 to 14 percent at end-2003, but still remains high compared to other EU accession countries. The gains in external competitiveness achieved by the 1998–99 correction in the exchange rate (Figure 3) have been largely preserved through sizable productivity increases, moderate growth in economy-wide wages through 2002, and cuts in social security contribution rates from 60 to 49.5 percent during 2001–04. The annual average unemployment rate declined from 9 percent in 2001 to 7.6 percent in 2003 against the background of a steady decline in the labor force and a slight increase in salaried employment.

Figure 3: Real Effective Exchange Rates

(3-Month Moving Average; 1998=100)



Sources: Romanian authorities, and Fund staff estimates. CPI based measures use INS weights, while ULC-based REER includes advanced economy partners only.

13. **However, the current account deficit has recently widened as a result of a boom in private sector credit and an excessive minimum wage increase.** In 2003, the current account deficit surged to 6.1 percent of GDP (in U.S. dollar terms) from 3.4 percent in 2002. The most important driving force was the increased flow of credit to the private sector, equivalent to 6¾ percent of GDP in 2003, compared to 4 percent of GDP in 2002, while the

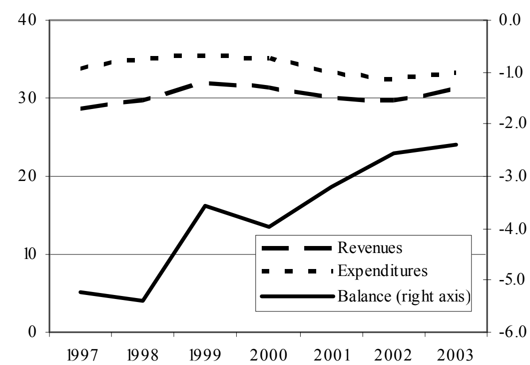
43 percent minimum wage increase on January 1, 2003 (over 25 percent in real terms) and delayed energy price adjustments together raised the current account deficit relative to GDP by about 1 percentage point.

C. Fiscal Policy

14. **A turnaround in fiscal policy performance began in 1999 in response to severe balance of payment problems** (Figure 4). A large upfront-adjustment in 1999, primarily based on revenue measures, reduced the deficit of the general government to 3.6 percent of GDP from 5.4 percent of GDP in 1998, but fiscal consolidation was interrupted by an election-related spending spree in late 2000 and early 2001. In the negotiations on the latest SBA in 2001, the authorities agreed that further fiscal consolidation was required to reduce inflation and contain the current account deficit, but insisted on a gradual approach to facilitate improvements in the social safety net and an increase in capital spending. Consequently, while the deficit of the general government relative to GDP declined from 4 percent in 2000 to 2.3 percent in 2003, this largely reflected a decline in interest expenditure by 2.7 percentage points owing to progress in disinflation and renewed access to international capital markets. At the same time, primary expenditure relative to GDP rose by 0.8 percentage points, with the largest share (0.6 percentage points) being used for an increase in capital spending. Public sector debt (including publicly guaranteed debt) remains relatively low at 26 percent of GDP at end-2003.

Figure 4: Consolidated General Government

(in percent of GDP)



15. **Major progress was made under the recent SBA in reforming the tax system and improving revenue administration.** In 2002, the authorities implemented a comprehensive VAT and profit tax reform that eliminated several distortionary tax incentives that had adversely affected revenue performance and clouded the investment climate. Moreover, following a period of excessive increases in social security taxes, which created strong incentives for shifting labor to the informal economy, contribution rates were cut by a cumulative 10.5 percentage points between 2001–04. Furthermore, the authorities have started implementing comprehensive tax administration reform.

16. **The authorities have recently strengthened the social safety net.** The authorities introduced a minimum income guarantee scheme in January 2002. In 2003, to mitigate the social impact of energy price increases and privatization, they improved the scheme for heating-related transfers to low-income households and introduced and a generous "supplementary income scheme" for employees laid off by large SOEs.

D. Monetary Policy and Banking

17. **The authorities chose a gradual disinflation strategy**. In the face of rigid collective labor contracts and powerful trade unions, the authorities were not confident that they could

enforce a restrictive wage policy stance in SOEs. Indeed, failure to implement an effective incomes policy and a more aggressive stance to reduce the consolidated public sector deficit were the key obstacles to controlling inflation and explain why inflation in Romania has been considerably higher compared with other transition economies. Over the last three years, relying on the exchange rate as a soft nominal anchor, the NBR has guided the exchange rate broadly in line with the disinflation target and the scope for real effective appreciation resulting from the productivity growth differential. The existing restrictions on non-resident purchases of T-bills and deposits with local banks have afforded the NBR a degree of autonomy in setting its policy interest rate, used mainly for supporting the desired exchange rate dynamics and reserve accumulation. This monetary framework successfully anchored inflation expectations by avoiding large and disruptive fluctuations in the exchange rate. At the same time, the steady, if gradual, disinflation path preserved competitiveness by avoiding unsustainably large and rapid real exchange rate appreciation. Dollarization of bank assets and liabilities[3], while still substantial, is less of a problem than in many neighboring countries and does not, at present, constrain the NBR's exchange rate policy.

18. **Recent experience has shown, however, that this framework can create tensions with the choice between inflation and external objectives.** In both early and late 2003, emerging net outflows created a dilemma between adhering to disinflation targets by supporting the targeted exchange rate path or observing the NFA targets. As disinflation is the NBR's primary objective, the Bank both times resolved this dilemma in favor of the former. This choice was facilitated by the comfortable reserve level and the expected temporary nature of the outflows (a judgment vindicated *ex post*).

19. **The soundness of the banking system has improved significantly.** The 1997–1999 banking crisis led to discontinuation of the use of state-owned banks for directing lending and financing quasi-fiscal losses. In its aftermath, banks have been restructured and many of them privatized. Currently, out of 30 banks, only three remain in state hands, and foreign banks control more than half the assets in the banking system. The crisis left its scars on financial intermediation: despite recent rapid growth, credit to the non-government sector—about 16½ percent of GDP—still remains low by international standards. The 2003 FSAP found that banks are well-capitalized and liquid, even though the reported high capital adequacy ratios may be somewhat overestimated because of problems with the valuation of fixed assets.

E. Structural Reforms

20. **Throughout the transition, losses from quasi-fiscal activities were a major source of macroeconomic instability, but efforts to reduce these losses started in earnest only in the second half of the 1990s.** During 1996–2000, about four percent of GDP in quasi-fiscal operations—in the form of implicit exchange rate subsidies and subsidized lending to the agriculture sector in the form of directed lending—were curtailed and, to a relatively small extent, replaced by budgetary subsidies. However, depressed energy prices continued to be used to subsidize unviable energy-intensive industrial users.

[3] As of late 2003, about 56 percent of bank loans and 46 percent of deposits were denominated in foreign currencies.

21. **Sharp increases in energy prices under the recent SBA have reduced energy sector losses substantially**. Breaking with the tradition of depressed energy prices, the authorities have since 2001 brought electricity prices close to cost-recovery levels, sharply increased heating prices and raised domestic gas prices, though the latter remain substantially below import parity. Estimated energy sector losses (including implicit subsidies) fell from 4.7 percent of GDP in 2000 to 2.5 percent of GDP in 2002, but rose to 2.8 percent of GDP in 2003 owing to delayed price adjustments (Text Table 1).

Text Table 1. Estimated Losses From Quasi-Fiscal Activities in the Energy Sector 1/
(In percent of GDP)

	2000	2001	2002	2003	2004 2/
Gas 3/	3.6	3.5	1.9	2.3	1.5
Electricity and Heating 4/	1.1	1.3	0.6	0.5	0.2

1/ Including losses resulting from payment arrears from non-collection.
2/ Staff projection
3/ Predominantly implicit subsidies resulting from pricing below import parity.
4/ Cash losses resulting from pricing below cost-recovery levels.

22. **The fight against the non-payment culture in the energy sector has been partially successful.** In the electricity and gas distribution sectors, utility bill collection rates have risen significantly and reached levels similar to those in industrial countries, reflecting an aggressive use of conditionality to enforce the disconnection of nonpayers under the recent SBA. However, the wholesale electricity collection rate, while improved, remains problematic. In the heating sector, collection rates have risen only marginally, largely reflecting the absence of a credible restructuring strategy for this sector. Such a strategy would need to comprise the conclusion of delivery contracts with individual households and their metering, the closure of unviable plants, and the modernization of economically viable plants.

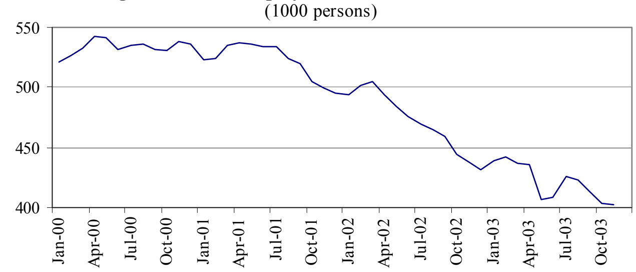
23. **Arrears to the budget have been persistent, thus undermining an efficient allocation of resources and creating an un-level playing field among enterprises.** Four factors account for the continued prevalence of arrears. First, the authorities have tolerated arrears from well connected private sector companies and socially sensitive SOEs such as the railways and mines. Second, tax administration has been weak since until very recently. Third, the budgets of public enterprises are often approved with little attempt to ensure that the enterprise concerned will be able to pay its budgetary obligations. Fourth, as noted above, the culture of offsets of obligations means that companies often have little incentive to pay. Recent data show that the stock of tax arrears of the monitored SOEs (excluding accrued interest and penalties) increased by ½ percentage point of GDP between mid-2002 and mid-2003. The increase in arrears was particularly pronounced in the mining and railway sectors, for which long-overdue restructuring measures have been repeatedly postponed. Moreover, the arrears of a number of large private companies have surged, particularly in the refinery sector. On the positive side, the electricity and gas distribution companies were able to repay their tax arrears by September 2003.

24. **Indiscipline in wage policy has repeatedly threatened stabilization efforts.** Two areas were critical. First, wages in SOEs persistently exceeded agreed norms, primarily

reflecting the lack of determination on the part of the line-ministries to enforce the approved wage budgets. As a result, performance criteria were repeatedly breached, resulting in delays in completing reviews. Second, yielding to pressures from trade unions in June 2002, the government unexpectedly agreed to a 43 percent minimum wage hike from January 2003, thereby contributing to the surge in the current account deficit and preventing more rapid disinflation in 2003.

25. **Privatization fell continuously short of program targets, but picked up in 2003**. Faster privatization of enterprises in the portfolio of the Privatization Agency, primarily comprising industrial SOEs outside the energy sector, was initially impeded by the requirements that investors provide guarantees to preserve employment and make sizeable investments. In 2003, the authorities implemented a large-scale voluntary employment reduction program, which facilitated the privatization of some large loss-makers. Outside of the banking and energy sectors, the government has privatized 35 large companies with over 112,000 employees since 2001, in many cases involving substantial employment reductions (Figure 5). Generous severance payments for laid-off workers and write-offs of liabilities have facilitated the privatization process considerably. However, in the energy sector, the Ministry of Economy and Commerce has moved slowly in starting several important privatization projects, reflecting its reluctance to give up influence in this sector. Recently, some major privatization projects have experienced significant delays, including the integrated oil company Petrom, the largest company in the country, owing to investors' request to have more time for due diligence, unresolved legal issues of land ownership, and the authorities' subdued enthusiasm. Delays also occurred for the privatization of two electricity generation facilities and the two gas distribution companies.

Figure 5: Total Employment in 86 Monitored SOEs
(1000 persons)



26. **Despite recent improvements, the business environment has remained mixed.** Foreign investors have welcomed the more stable macroeconomic environment and the tax legislation overhaul under the recent SBA. However, progress in improving governance, eliminating corruption, and increasing transparency has been insufficient, and enforcement of laws by the judiciary has remained weak. Employers associations have raised concerns about the new labor code, which has imposed undue impediments to layoffs.

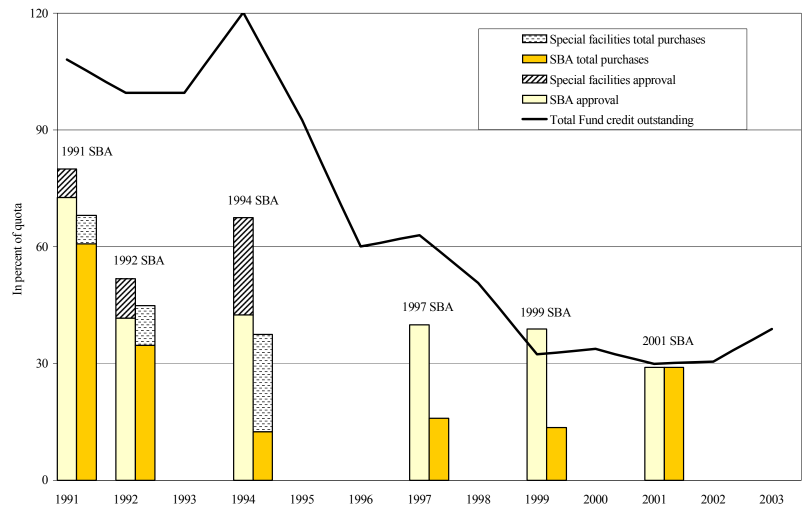
III. Nature and Reasons for the Fund's Long-term Engagement

27. **The Fund's engagement with Romania has indeed been extensive.** Since the start of the transition, Romania had six (non-precautionary) SBAs, three of which were extended.[4] As all but the last program eventually went off-track, access under these arrangements was not fully disbursed. As a result, there has not been a prolonged period of high Fund exposure.

[4] New arrangements were approved in 1991, 1992, 1994, 1997, 1999, 2001, and extensions in 1995, 2000, and 2003.

After peaking at 120 percent of quota in 1994, outstanding use of Fund credit now stands at around 40 percent of quota (Figure 6).

Figure 6. Romania: Engagement with the Fund, 1991-2003



28. **The Fund's long-term engagement in Romania reflects two main factors:**

- **Romania's large structural reform agenda:** Owing to the particularly unfavorable starting conditions at the beginning of the 1990s, a lengthy transition was unavoidable.[5]

- **The slow pace of reforms and repeated reversals of macroeconomic stabilization efforts:** Largely reflecting a lack of ownership of sustained reform efforts, macroeconomic policies throughout the decade alternated dramatically between periods of tightening and relaxation.

29. **There are a number of reasons why the Fund repeatedly re-engaged with Romania in a program context:**

- *Balance of payments pressures:* In most cases, Fund approval of new arrangements was a response to severe immediate pressures on Romania's balance of payments.

- *Strong program design:* Successive programs targeted strong adjustment and structural problems that remained unresolved from preceding programs.

- *Progress in policy and reform implementation:* Progress was notable around the approval of each program, with heavy reliance on prior actions. However, with mixed

[5] This was recognized early on. At the 1992 Article IV consultation "Directors noted that the transformation of the Romanian economy into a functioning market economy would necessarily be a lengthy process. Success would require perseverance in domestic policies as well as substantial financial assistance from abroad for an extended period." (6/5/1992)

ownership of reforms, program implementation often weakened during the program period, particularly after immediate macroeconomic pressures had subsided.

- *Support for reforms and stabilization policies:* In addition to external financing, successive governments were interested in Fund programs to boost their policy credibility. Moreover, reform-oriented factions within the government saw program engagement as the best means of furthering their economic policy objectives.

30. **The performance under the three SBAs between 1991-96 raises questions about the appropriateness of the composition of conditionality under these three arrangements.** While the build up of major macroeconomic imbalances and the slow pace of structural reforms during this period primarily reflected the authorities' insufficient ownership of the stabilization and reform programs, it also raises the question why it took the Fund until 1997 to recognize that re-engaging with Romania in a program relationship would need to address the issue of vested interests through front-loaded structural conditionality. It can be argued that the emphasis on macro-based conditionality in Fund-supported programs postponed the emergence of sustained growth.

31. **While conditionality appears to have been generally appropriate under the last three SBAs, a few shortcomings could have been addressed earlier**. The comprehensive reliance on structural conditionality proved effective in addressing the resistance of vested interests against structural reform. However, given the risks emanating from quasi-fiscal activities, efforts to measure losses resulting from these activities should have started earlier. Moreover, while the last SBA brought about major progress in improving the utilities' collection rates in the electricity and gas sectors, collections in the ailing district heating sector hardly improved, reflecting the absence of a strategy for reforming this sector.

32. **The potential drawbacks of longer-term engagement were mitigated by the Fund's requirement of a positive track record prior to the approval of a new program.** While the Fund showed flexibility by re-engaging with Romania despite uneven performance, the bar for such re-engagement was set sufficiently high to preserve the credibility of its program signals and limit the development of expectations that Fund program support was automatic (Table 1). The Fund's strategy to advance reform was to place conditions for re-engagement on deep-seated structural measures that would be difficult to reverse, in particular in the areas of bank restructuring and enterprise privatization. For this purpose, given the authorities' mixed ownership, the use of comprehensive structural conditionality, particularly prior actions, was effective in moving reforms forward.

33. **The Fund's determination not to accommodate major policy slippages that could have derailed macroeconomic stabilization also contributed to preserving its credibility.** With the exception of the last SBA, programs went off-track by margins too great to be reasonably accommodated. Accordingly, many reviews were never completed. This likely helped maintain frankness in Article IV consultations, many of which were completed when program negotiations had stalled. Under the most recent SBA, Fund staff did recommend approval of multiple waivers largely on account of the overall good macroeconomic performance, especially when compared to earlier programs. The granting of multiple waivers also reflected the fact that some of the structural conditionality was difficult,

involving action among many different agencies and institutions. At the same time, it is worth noting that granting multiple waivers may have lessened the authorities' resolve to implement their commitments under the program.

34. **Progress towards a market-based and financially stable economy gradually increased under the last three SBAs.** The comprehensive use of structural conditionality, in particular prior actions, under the last three SBAs, and more recently, the authorities' commitment to join the EU in 2007 have tangibly increased the "delivery rate" of policy measures that were agreed under the last three SBAs.

35. **The Fund's Private-Sector-Involvement Initiative (PSI) in 1999 strained relations with the authorities.** In the aftermath of a $750 million bond repayment in mid-1999, the Fund did not wish to provide financial support and thereby appear to bail out (*ex post*) the private creditors, which would have undermined the credibility of the PSI initiative. In the context of the 1999 SBA, the Fund required Romania to secure new money from private creditors as a condition for approval of the arrangement and subsequent completion of reviews. Taking into account Romania's circumstances, the Fund accepted the authorities' assurances that they would be able to secure *new* money from various private creditors as a basis for approving the SBA in August 1999, even though the staff had concerns about the feasibility of this new borrowing. In the event, the authorities found it difficult to secure but a small proportion of the required new private money and complained that they were effectively forced to borrow on unfavorable terms. They also noted that their efforts to borrow were undermined by the Fund's inclusion of Romania as a case on which to pursue PSI alongside countries that could have been illiquid or insolvent. In the context of a strengthening balance of payments and recognizing the problems with the PSI, the Fund gradually eased and eventually dropped the borrowing requirement.

IV. Lessons and Challenges Going Forward

A. Program Ownership

36. **Several political and institutional factors set the stage for improved performance under the recent SBA**. These factors include: (i) the government's strong commitment to joining the EU; (ii) political stability and the comfortable majority in Parliament, which ensured smooth passage of the budgets and the comprehensive tax reform; and (iii) previous stabilization and reform efforts, which, despite their shortcomings, created more propitious conditions for further reforms.

37. **Nevertheless, policy ownership remained mixed, reflecting the contradiction between the government's strong commitment to EU accession and its temptation to give in to populist pressures.** This tension was characteristic of the authorities' commitment to various components of the program:

- **On the one hand, fiscal and monetary policies were on track.** Reflecting the unambiguous commitment of the Minister of Public Finance and the NBR to sustain the recent gains in macroeconomic stabilization, policy implementation in these two core areas of the Fund's expertise was generally strong.

- **On the other hand, the authorities' commitment in the areas of wage policy and structural reforms remained weak, largely reflecting resistance from vested interests.** The collusion between the management of large SOEs, labor unions, and factions within the ruling parties has frequently hampered efforts to impose financial discipline on SOEs and accelerate privatization. In this context, concerns about the social impact of restructuring and privatization have been used by vested interest to defend keeping unviable SOEs afloat, while efforts to render the social safety net compatible with accelerated structural reforms have started only recently.

38. **Policy coordination within the government has not been sufficiently strong to overcome ownership problems.** The absence of a clear intra-governmental consensus on key economic policy parameters has weakened the line-ministries' resolve to ensure timely and full implementation of agreed measures. While the Prime Minister often intervened in such inter-ministerial differences to keep the program on track, valuable time was lost, and program reviews had to be postponed repeatedly.

39. **In the course of 2003 the authorities gradually recognized that stepping up reform efforts is imperative for keeping EU accession on track.** Even though the authorities have always acknowledged that EU accession requires accelerating privatization and SOE restructuring, the inclination to translate this agenda into ambitious front-loaded action plans has remained weak. However, the EU Commission's decision in November 2003 *not* to grant Romania the status of a fully-functioning market economy and the still substantial number of EU-negotiation chapters that need to be closed by end-2004 (8 out of 30) gave rise to fears that Romania might run out of time. As a result, EU accession has become an important anchor of the political process. Nevertheless, it remains to be seen whether the authorities' resolve to sustain the recent macro-stabilization and continue with structural reforms will prevail in the run up to the parliamentary and presidential elections scheduled for November 28, 2004.

B. Bank-Fund Cooperation

40. **The overlap between Bank and Fund conditionality has been substantial, reflecting Romania's extensive quasi-fiscal activities, unfinished structural reform agenda, and the authorities' mixed ownership.** The Bank has taken the lead in the policy dialogue with the authorities on several structural reforms, including privatization, private sector development, poverty reduction, institution building, and governance (Text Table 2). The Fund has, however, played a major role in structural reforms with important fiscal and quasi-fiscal implications. When structural reforms have lagged in areas with a significant macroeconomic impact, Fund program targets have been difficult to reach and have led to a tendency for the Fund to introduce structural conditions of its own.

Text Table 2. The Bank's Recent Adjustment Programs in Romania

Loan	Conditionality
PSAL 1 -US$300 m. May 1999	**Enterprise sector**: SOE privatization, hard budget constraint, improvements in the business environment. **Financial Sector:** Bank restructuring and regulation, government securities market development **Social sector:** unemployed and displaced worker programs
PSAL 2 - US$300 m. April 15, 2002	**Banking sector**: BCR privatization, CEC Bank reorganization **Enterprise sector:** privatization of large SOEs, Alro Alprom, Petrom, gas distribution power sector, collection and arrears in power and oil and gas sectors. **Business environment:** removal of administrative barriers. **Social sector:** Minimum income guarantee, unemployment insurance, displaced worker programs institutional reforms, pension reform. **Other:** Selected tax reforms and review of bankruptcy procedures.
PAL - US$400 m. (series of three the first of which is expected to go to the Board in May 2004)	**Public sector** Reforms in public administration public expenditure and the judiciary **Private sector** privatization of residual APAPs portfolio, remaining energy sector privatization, CEC and BCR privatization, district heating, mining, Tarom, Labor code amendment, selected capital market reforms **Service delivery** Education, health, pensions, decentralization and local government financing mechanisms

41. **While the overlap between Bank and Fund conditionality in the area of structural reforms was not conducive to reducing the number of conditions in the Fund program, it helped increase the pressure on the authorities to maintain the reform momentum**. Given the government's reluctance to proceed with long-overdue structural reforms, the involvement of both the Bank and the Fund in some key structural measures (e.g., the closure of Bancorex, the privatization of large SOEs, and energy sector reforms) was essential for their success.

42. **Bank-Fund cooperation was generally close, and the Bank's technical expertise was a key input for the design of Fund programs.** The Fund relied to a significant extent on the comprehensive technical work of Bank experts, in particular in the areas of energy sector reforms and privatization. Fund staff consulted with the Bank on measures to be included in the Fund's structural conditionality and invited Bank staff to participate in relevant Fund missions. This approach has proven successful in improving the collection rates in the electricity and gas sectors and setting energy prices at a level that would attract further investment.

43. **Collaboration has been most effective when it has started early in the program preparation cycle and when areas of separate and joint intervention have been clearly defined from the outset.** If areas outside the Fund's core competencies are key for achieving the targets under Fund programs, an early involvement of the Bank during the program preparation is imperative. While this principle was generally adhered to in designing the recent SBA, there were areas in which an earlier and more systematic involvement of the Bank would have improved the prospects for meeting the program targets. For example, it is questionable whether, in the absence of a comprehensive medium-term strategy for reforming the ailing district heating system, there was ever a reasonable chance of meeting the collection rate targets.

44. **Bank-Fund consultation should also extend to structural reforms where implementation exceeds the duration of Fund programs.** There has been a tendency for the Fund to focus on reform measures that stood a chance of being implemented in the relatively short duration of the respective SBA. This approach has at times diverted attention from structural reforms that can only be addressed over a longer-term horizon. For example, had efforts to use the Bank's expertise for designing medium-term strategies for reforming the large loss-making sectors of mining and railway transportation been initiated earlier, the substantial pick up in these sectors' quasi-fiscal losses in 2003 might have been avoided. The benefits of developing such medium-term sectoral strategies can be expected to outweigh potential delays during the program preparation stage.

45. **While the Bank and the Fund always agreed on the direction of reforms, reaching consensus on their timing and details required at times significant efforts.** For example, with respect to privatization schedules for competitive international tenders, the Fund often favored tighter deadlines for intermediate steps in the interest of expediting the process, while the Bank emphasized that a close scheduling of large privatization deals with a limited number of potential buyers might reduce the likelihood of successful outcomes. This might in part reflect the different design of the two institutions' conditionality, with time-bound quarterly reviews under the Fund's SBAs contrasting with floating decision points for the disbursement of PSAL 1 and 2 tranches.

46. **Joint Bank-Fund communications with the authorities have contributed to successful policy dialogue.** In addition to enhancing policy leverage, it gives the authorities comfort that the requirements of the IFI programs are consistent with each other and reduces the scope for strategic delay. Joint communications have been used effectively, i*nter alia,* on gas pricing, labor code amendments, and the reform strategy for the mining sector.

C. Key Challenges

47. **In the period ahead, the two key challenges facing the authorities are how to sustain macroeconomic stabilization and maintain the momentum of structural reforms over the election cycle and in the run-up to EU accession:**

- While the macroeconomic environment has improved markedly, inflation still has some way to go before settling in single digits and efforts to contain the current account deficit have to be stepped up.

- Completing structural reforms will be key for keeping EU accession on track and maintaining high growth.

Sustaining Macroeconomic Stabilization

48. **Major efforts are needed to ensure further disinflation to EU levels.** Experience in other EU accession countries shows that the transition to single-digit inflation is difficult. Achieving the authorities' inflation targets of 9 percent by end-2004 and 4 percent by end-2007 will require further fiscal consolidation, prudent monetary and exchange rate policy, including measures to constrain rapid credit growth, and tighter incomes policy entailing low minimum wage increases and significantly improved wage discipline in SOEs.

49. **To contribute to reducing inflation and the current account deficit, further fiscal consolidation is required.** With public and foreign debt-to-GDP ratios at moderate levels, the main consideration for the medium-term fiscal stance is the need to contribute to disinflation and contain the external current account deficit below a level that would raise market concerns. As the private savings-investment balance is expected to continue to deteriorate with strong consumption and investment, public sector savings will have to provide an offset, in the form of both lower budget deficits and stronger SOE finances. This offset will have to be sufficiently strong to compensate for the impact of the credit boom on the private savings-investment balance.

Continuing Structural Fiscal Reforms

50. **The authorities should address the remaining weaknesses in the tax system and implement the second phase of the tax administration reform**. While the recent VAT and profit tax reform eliminated several major distortionary tax incentives, some exemptions remain embedded in, *inter alia*, special legislation for industrial parks, free zones, and disadvantaged areas. These should be carefully reviewed with a view to establish a schedule for their elimination. Moreover, building on recent major institutional changes, substantial further efforts are required to modernize systems and operations of the newly established revenue administration. At the same time, the authorities will need to create a forceful precedent for their seriousness in addressing the culture of nonpayment of taxes by, *inter alia*, initiating bankruptcy procedures against large public and private debtors.

51. **While the pension fund to date has not incurred large deficits, further reforms are crucial for ensuring its long-term sustainability.** Despite a high and rising dependency ratio, the deficit of the pension fund has been contained below 1 percent of GDP over the last few years, largely reflecting a relatively low and declining replacement ratio. Looking forward, however, several factors are putting at risk the sustainability of the public pension system: (a) the authorities envisage further cuts in social security contribution rates which, even after the latest cuts, still amount to 49.5 percent of gross wages; (b) given the already modest level of the replacement ratio, the scope for using a further decline in this ratio to compensate for declining revenue appears to be very limited; (c) the dependency ratio will increase further, as employment growth is projected to fall short of the increase in the number of retirees, with the old-age dependency ratio forecasted to double over the next 40 years. Against this background, further measures are required to ensure the financial viability of the public pension system, in particular by broadening the social security tax base, accelerating the increase in the retirement age, and equalizing the retirement age for men and women, as recommended by the World Bank.

52. **The role of Romania's *Pre-accession Economic Programmes* (PEPs) for the medium-term fiscal framework should be strengthened.** While both the PEPs and the budgets submitted to Parliament provide a three-year forecast horizon, both documents have often been inconsistent and have undergone frequent revisions, thereby undermining their utility for medium-term policy analysis and design. Increasing the consistency and credibility of the medium-term fiscal framework would help internalize long-term implications of expenditure programs and prioritize spending priorities. To enhance the credibility of the medium-term framework and build ownership, the authorities could consider establishing an autonomous agency for assessing medium- and long-term fiscal risks emanating from the

envisaged large-scale use of off-budget guarantees and Public-Private Partnerships (PPPs), the sustainability of the pension fund, and contingent liabilities in the banking sector.

Monetary Policy and Banking Supervision

53. **The NBR will need to manage the transition to a new monetary policy framework.** The current exchange-rate-based framework with multiple, but prioritized objectives is expected to stay in place until inflation settles in single digits. The success of the current framework depends on maintaining restrictions on short-term capital inflows. While such restrictions have their merits until low inflation is firmly entrenched, they will have to be relaxed in the medium term to reap the full benefits from integrating into the international financial system and to comply with EU requirements. Changes in the NBR Law are needed to guarantee the primacy of the inflation target, as well as the operational independence of the central bank in line with Maastricht criteria. In addition, given the close correlation between wage inertia and inflation inertia in Romania, a strict incomes policy needs to complement monetary policy to achieve single-digit inflation. The authorities are planning to adopt a flexible form of inflation targeting to succeed the current monetary framework. As the exchange rate pass-through to prices still dominates the effect of interest rate changes on inflation, the exchange rate would continue to be used as an implicit nominal anchor in the beginning of the gradual transition to the new regime. Further progress in understanding the monetary transmission mechanism and developing effective monetary instruments and forecasting techniques is required before inflation targeting can be considered a viable option.

54. **On the prudential side, the NBR needs to find the most effective instruments in managing the financial system.** While the low degree of financial intermediation calls for sustained high credit growth in the medium term, the current rapid expansion, targeted primarily at households, is overstimulating domestic demand and raising concerns over the resilience of the credit portfolio to macroeconomic shocks. In particular, sharp exchange rate depreciation and/or a slowdown in growth may impair borrowers' ability to pay and thus lead to bank losses. Close monitoring and enhancing supervision through strengthened risk assessment, as well as adopting more conservative supervisory and regulatory practices in some areas, particularly consumer loans and weak banks are imperative.

Completing the Structural Reform Agenda and Improving the Business Climate

55. **Completing the task of stabilization crucially hinges on progress in privatization and imposing hard budget constraints in the state-owned enterprise sector.** The main challenges in this respect are:

- *Privatization needs to proceed expeditiously.* Despite improved performance in 2003 in privatizing large SOEs under the privatization authority, further reducing the size of the still large state sector is imperative. While the authorities' intention to finalize the privatization of the SOEs that remain in the portfolio of the privatization authority by end-2004 is laudable, privatization in the energy sector, which is characterized by particularly poor governance, will need to accelerate, with the sale of Petrom being the litmus test for the authorities' reform ownership in this area. In the banking sector, privatization should be completed by selling BCR, the largest bank in the country, and CEC, the savings bank, to strategic investors as soon as possible. Given the continued macroeconomic relevance of quasi-fiscal activities, including strong structural conditionality on privatization in a possible successor arrangement with the Fund would be imperative.

- *Efforts to eliminate losses from quasi-fiscal activities, particularly in the energy sector, need to continue.* The momentum in fighting the nonpayment of utility bills needs to be maintained, while further increases of gas prices to the import parity level, as well as timely adjustments of electricity and heating prices in line with costs are required. Eliminating quasi-fiscal losses also requires the closure of unviable industrial consumers with large arrears to the budget and utilities. Moreover, developing a medium-term strategy for the district heating system is long overdue. Given the macroeconomic risks emanating from quasi-fiscal activities and the key role of conditionality in this area under the recent SBA, it is surprising that efforts to implement a reliable accounting framework for measuring the broad public sector deficit have started only recently. To mitigate the social impact of structural reforms, the existing social safety will need to be further strengthened, in particular by improving the administrative capacity and broadening the coverage of the minimum income guarantee scheme.

56. **Stepping up efforts to improve governance and the business environment is crucial for sustaining robust economic growth.** A revision of the labor code is crucial for maintaining unemployment at the relatively low current level during the ongoing restructuring of the SOE sector. Major progress in improving governance is needed, building on the work of the recently created anti-corruption authority. As weaknesses in governance remain a major barrier to generating sustained private sector growth and attracting FDI, stepping up the fight against corruption and the reform of the judiciary remain top priorities on the agenda of institutional reforms to improve the business climate. The last SBA addressed governance issues implicitly by promoting legislative changes in core areas of the Fund's competencies, *inter alia* by eliminating distortionary tax incentives and aligning banking supervision with Basel standards. However, given that weak governance continues to be a major impediment for faster progress in structural reforms and sustained robust growth, the Fund would be well advised to broaden its approach by seeking agreement on initiatives in areas related to its own core competencies as well as by supporting core components of the World Bank's conditionality:

- The recently established anti-corruption office should step up the fight against corruption, including (a) in the tax and customs administrations; and (b) with respect to recent cases of non-transparent privatization and public procurement.

- The independence of the energy sector regulators needs to be strengthened to ensure their *de facto* autonomy. This could be achieved by establishing the requirement (a) for the presidents of these agencies to be appointed for seven years (rather than four years); and (b) for the agency budgets to be approved by parliament (rather than by the government) for a multi-year period.

- Transparency in the SOEs' accounting system needs to be improved, *inter alia*, (a) by ensuring full compliance with IAS and requiring for all energy sector companies auditing through internationally recognized auditing companies; and (b) by establishing an obligation for the government to submit to parliament, together with the draft budget, a report on quasi-fiscal activities, tax subsidies to SOEs, and envisaged measures to reduce losses from quasi-fiscal activities.

- The Fund should insist on amendments (a) to the Law on the Declaration of Assets which, in its current form, is insufficient for containing corruption; and (b) to legislation allowing for the "extraordinary appeal" by the Prosecutor General, which has been identified by the World Bank as a major impediment to the independence of the judiciary. The Bank has conditions in its PAL program on both issues and has indicated that supportive actions under the Fund's SBA would be helpful provided the terms and timing of respective conditionality are closely coordinated.

V. Strategy for Future Fund Engagement

57. **The progress achieved under past programs would make a surveillance-based relationship feasible now.** Romania achieved major progress in macroeconomic stabilization, regained international market access, and does not have an imminent balance of payments need. It would be possible for further reforms to be completed outside of an arrangement with the Fund as in other transition economies.

58. **However, the authorities see further Fund engagement as crucial for keeping EU accession on track and reducing balance of payments vulnerabilities and thus have requested a new SBA, which they intend to treat as precautionary.** Reform-oriented factions within the ruling party continue to consider program conditionality as a commitment mechanism to enhance credibility, particularly during a year that is key for ensuring the next steps toward EU accession.

59. **The request for a new arrangement could be supported if it provides assurances that (a) macroeconomic stabilization will be sustained; and (b) vigorous structural reforms will continue.**

- The recent surge in the current account deficit indicates that balance of payments vulnerabilities still exist. A new arrangement would mitigate these vulnerabilities by addressing the causes of the deterioration in the current account. The key instruments for achieving this objective would be a reduction in the public sector deficit combined with measures to contain the excessive credit growth and wages in the SOE sector. A new program could also be instrumental in ensuring sufficient credibility of macroeconomic policies that is a prerequisite for achieving single-digit inflation.

- A new SBA may strengthen the momentum of structural reforms during the run up to the elections. By contributing to giving shape and content to macroeconomic policies and structural reform, it may also help keep EU accession on track.

- Good performance under one more program would provide a favorable opportunity to exit program engagement on a positive note and to establish a strong track record outside the context of a Fund program, thereby enhancing policy and institutional credibility.

- A successor arrangement should be a low access precautionary SBA given the absence of an imminent financing need. The precautionary nature also better corresponds with the transition to a surveillance-only relationship. Moreover, to ensure the implementation of those structural reforms that are key components of an exit strategy, a somewhat longer program period, say 24 months, would be preferable.

- However, a surveillance-only relationship would be preferable if agreement on a strong program cannot be reached.

60. **Elements of a new arrangement should comprise:**

- *Explicit exit strategy*: To guard against the risk that there is an automatic move from one program to the next, an explicit strategy for exiting from Fund program-engagement should be formulated and made public. Developing the institutional capacity for effectively addressing the remaining structural reform agenda and building a broad political consensus in favor of such a strategy is a prerequisite for EU accession. In this process, the role of Fund programs as a commitment mechanism that partially substitutes for full reform ownership is evaporating.

- *A strong and front-loaded structural reform component:* The next Article IV report or program document should specify the key structural reforms, the completion of which is critical to medium-term external viability.

- *Early coordination with the World Bank*: These critical reforms should be coordinated and agreed with the World Bank early on, to ensure a unified front vis-à-vis the authorities, and to allow the Bank to prepare for supporting implementation.

- *Maintain focus on structural conditionality:* Given the importance of structural reform for medium-term external viability and the low probability that reform ownership will strengthen in the run up to the elections, there is limited scope for streamlining conditionality in a future program.

- *Continued readiness to use strong prior actions:* As in past programs, the Fund should continue to exploit the effectiveness of conditioning new arrangements and reviews on the prior completion of significant structural reforms.

- *Prepare public perceptions:* An external relations policy under a successor program that helps to prepare public perceptions for the graduation to a surveillance-based relationship may help to reduce the risk that the end of program engagement is interpreted as a negative signal.

VI. Reaction of the Authorities

61. **The authorities thought the report was generally balanced and realistic, and saw it as important to the transparent cooperation between Romania and the Fund**. They thought, however, that some issues warranted more emphasis or greater discussion of their context. On general issues, they noted:

- Three factors explained why the transition process in Romania took so long (para. 2-10). First, as emphasized in the EPA, the starting point differed significantly from that in other transition economies. Structural problems were deep-rooted, and social concerns played a prominent role. Attempts to speed up economic reform would have triggered large social disturbances. Second, shock therapy was not a viable option since Romania had just emerged from the shock of harsh austerity linked to the early repayment of Romania's external debt during the Ceauşescu era. The deliberate decision to adopt a gradual approach to reform in the 1990s inadvertently resulted in a lack of decision and a piecemeal approach. Third, some approaches to reform were wrong but were corrected. Two specific examples were noted:
    - Under the first three SBAs, the coordination between the Fund, the World Bank, and the authorities on structural reforms was weak, and Fund conditionality did not sufficiently address the structural reform agenda. This coordination failure also contributed to the stop-and-go policies characteristic for the 1990s.
    - The Fund's PSI initiative confused a liquidity crisis for a solvency crisis in Romania and cut off Romania's market access at a critical juncture (para. 35). The authorities had to struggle to regain unduly lost credibility.

- The authorities reiterated the current government's commitment to reform, reflected in the strong measures taken in the last three years and the successful completion of the most recent Stand-By Arrangement (para. 36-39). In this regard, improved coordination of economic policies between the authorities, the Fund, and the World Bank was instrumental in the positive achievements (para. 40-46).

62. On the forward-looking aspects of the report, the authorities agreed that a relatively long program period would be appropriate in a new arrangement with the Fund in order to ensure the implementation of the large structural reform agenda (para. 59). Successful completion of such a program should pave the way to graduation from future use of Fund resources (para. 60).

63. **In response to specific assessments in the report, they made a number of observations**:

- The authorities defended their decision to adopt a gradual disinflation strategy (para. 17), arguing that a more ambitious approach was not feasible owing to social and structural reasons. They also underlined that disinflation should not be achieved at the expense of growth.

- The authorities thought the assessment understated progress in energy sector reform (para. 21-22). They referred to numerous technical restructuring measures implemented during 2001-2003. With respect to the heating sector, they noted that a strategy will be drafted with World Bank support, and two PHARE projects are being implemented (para. 22 and 55).

- Regarding the assessment that public enterprise arrears to the budget have been persistent, giving these companies an unfair advantage over competitors (para. 23), the authorities noted that APAPS improved financial and wage discipline in the companies under its authority, and the related performance benchmarks under the IMF program were largely met. On the criticism that repeated postponements of the mining sector reform contributed to the increase in arrears, they noted that reform in this sector has been particularly challenging because it was oversized at the beginning of transition, and many mining activities are in isolated areas with few attractions to new investment.

- The authorities held the view that the report understates what has been achieved in privatization over the last three years (para. 25). Since the beginning of 2001 APAPS has sold 1½ times as much share capital as in the previous 8 years. Moreover, this privatization targeted the "tough core of the Romanian economy," which had resisted privatization/restructuring attempts for more than 10 years. The authorities stated that conditions on preserving employment or making investment were not imposed in the sale offers of public enterprises, nor were they considered to be compulsory in selecting the winning bids. They emphasized that privatization is also underway in the energy sector though there are delays and difficulties, mainly due to the unfavorable international environment in the sector.

- Reacting to the claim that an efficient exit mechanism for unviable state-owned and private companies remains to be established (para. 50 and 55), the authorities stated that Romania has a number of mechanisms to address unviable companies including through voluntary liquidation, judicial reorganization, and bankruptcy procedures. Some state-owned enterprises were restructured to prepare them for privatization.

- Commenting on the Fund's use of conditions on deadlines for intermediate steps in the privatization process (para. 45), the authorities noted that such conditions put adverse pressure on the government and work in favor of potential investors, especially when the number of potential investors is limited.

- They disagreed with the assessment that the independence of the energy sector regulators needs to be strengthened (para. 56), stating that the gas and electricity regulators are autonomous agencies, not financed from the budget, with the power to establish prices according to their own methodologies. In this context, they noted that the gas price regulator has already announced the implementation of the new price-cap pricing mechanism starting in 2005.

- Regarding the assessment that the elimination of the "extraordinary appeal" of the Prosecutor General is a key component of the judiciary reform (para. 56), the authorities noted that the "extraordinary appeal" procedure has already been eliminated for civil and commercial verdicts, and its elimination for penal verdicts is currently being drafted.

Table 1. Romania: Conditionality under the last three SBAs

	Prior Actions			Quantitative PCs			Structural PCs			Structural Benchmarks		
	Met	Not Met	Total	Met	Not Met	Total	Met	Not Met	Total	Met	Not Met	Total
1997-1998 SBA												
Approval	8	-	8	-	-	8	-	-	-	-	-	10
First Review	6	-	6	6	2	8	-	-	-	7	3	10
1999-2000 SBA												
Approval	10	1	11	-	-	9	-	-	-	-	-	4
First Review	2	-	2	3	6	9	-	-	-	3	1	4
2001-2003 SBA												
Approval	10	1	11	-	-	8	-	-	4	-	-	4
First and Second Review	11	-	11	5	3	8	4	1	5	5	-	5
Third Review	13	1	14	7	1	8	7	2	9	2	4	6
Fourth Review	11	1	12	5	3	8	6	1	7	7	-	7

Source: IMF Staff Reports.

Statement by Jeroen Kremers, Executive Director for Romania and Lucian Croitoru, Senior Advisor to Executive Director
April 12, 2004

The broad picture

The Romanian authorities appreciate the staff paper, which accurately assesses the country's performance under the Fund-supported programs and gives a well-balanced evaluation of successes and failures. The staff report also provides a correct view of the policy challenges ahead, both for the macroeconomic environment and for structural reforms, and has a balanced approach to the future Fund engagement in Romania. The authorities consent to the publication of the Ex Post Assessment report and the PIN.

The authorities regret that unfavorable starting conditions,[1] weaknesses in design[2] and especially in the implementation[3] have prevented the completion of all but the last program. However, they agree that these programs facilitated significant structural changes and were accompanied by improving policy implementation, although ownership remained mixed with respect to a number of key structural reforms.

Since mid-2001, economic growth in Romania has remained strong and disinflation continued, reflecting key structural reforms under the previous two SBAs and more consistent macro-economic policies implementation under the last SBA. From 41 percent at end-2000, inflation went down to 14 percent at end-2003. However, although significant, disinflation could have been even more rapid if the authorities had succeeded in implementing a more effective incomes policy to compensate for the soft budget constraints that reduced the efficacy of macro-policies. A more effective income policy would also have moderated the current account deficit increase from 3½ percent in GDP in 2002 to 6 percent of GDP in 2003, which was driven also by the increased flow of credit to the private sector.

With an eye also to the strong commitment to EU accession, the authorities decided to improve the ownership of the reform program. Notwithstanding the significant progress achieved in the last three years, key challenges remain, both in the areas of macroeconomic environment and structural reform. To achieve their inflation targets of 9 percent by end-2004 and 4 percent in the medium term, and to contain the current account

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[1] Acknowledged for the first time by the Board at the 1992 Article IV consultation (6/5/1992), and now by staff in "Romania—Ex Post Assessment of Longer-Term Program Engagement" (3/25/2004).

[2] As underscored in the staff report, it took the Fund almost seven years to recognize the need to address the issue of vested interests through front-loaded structural conditionality. Thus, staff is right when it suggests that the emphasis on macro-based conditionality in the first three Fund-supported programs postponed the emergence of sustained growth. It is also worth mentioning the weaknesses staff identified in the programs' design when it analyzed Bank-Fund cooperation (see paragraphs 43, 44 and 45). In addition to the weak coordination between the Fund, the World Bank and the authorities under the first three SBAs, the authorities assess that the inclusion of Romania in the experimental PSI exercise was a serious weakness in the design of the fifth SBA program, which cut off Romania's market access at a critical juncture and made Romania unduly lose its credibility.

[3] Reflected in the slow pace of reforms that subsequently led to repeated reversals of macroeconomic stabilization efforts.

deficit to safe levels, the authorities will employ further fiscal consolidation and prudent monetary and exchange rate policy, including measures to constrain credit growth. To complete the task of stabilization and assure robust economic growth, the authorities are decided to move further with imposing hard budget constraints, accelerate the privatization process, and improve the governance and business environment.

In addition to improving ownership, the authorities see further Fund engagement as crucial for keeping EU accession on track and reducing balance of payments vulnerabilities. They agree with staff that the reasons why the Fund repeatedly re-engaged with Romania in a program context were (paragraph 29): (i) balance of payment (BoP) pressures, (ii) the authorities' willingness to agree on a strong program design, (iii) progress in policy and reform implementation, and (iv) the opportunity to support reform and stabilization policies in the form of external financing and credibility. With the exception of the imminent BoP financing need, all the remaining reasons remain in place. The authorities agree with the staff that a new SBA, which they seek, should be of a precautionary nature and extend over at least 18 months. The implementation of structural reforms under this program should facilitate exiting from Fund program engagement.

Structural reforms and the business climate

Looking forward, structural reforms remain key to completing stabilization and sustaining robust economic growth in Romania. Therefore, the authorities will adopt a more decisive approach to privatization, strengthening financial discipline, and improving the business climate. Progress in these areas will allow the Romanian economy to become a full functioning market economy, able also to withstand competition within the EU.

Privatization of the SOEs in the privatization authority's portfolio is to be completed by end-2004 and privatization in the energy sector will be accelerated. Progress has already been achieved in preparing the privatization of Petrom, the largest company in the country, by reducing restrictions that could affect the success of the privatization. Therefore 51 percent of Petrom's equity is expected to be in private hands towards end-2004. Substantial progress is to be achieved over the next two years in the privatization of utilities and some power generators, in close consultation with the World Bank. Efforts to complete the privatization in the banking sector will also continue. The timetable for the privatization of CEC, the State Savings Bank, will be decided in April this year, with a view to completion in 2005.

The authorities will continue to reduce losses from quasi-fiscal activities in the energy sector. Progress in this area has been substantial and was achieved by increases both in energy prices and collection rates. Price adjustment allowed losses from quasi-fiscal activities in the energy sector to be reduce from 4.7 percent of GDP in 2000 to 2.8 in 2003. Efforts to fight nonpayment in the electricity and gas distribution sectors have already been reflected in significant increases in bill collection rates. However, much still has to be done. To this end, the authorities intend to intensify the fight against nonpayment of utilities and make timely increases of gas prices so as to reach import parity level in 2007, as well as timely adjustments of electricity and heating prices in line with costs. Further efforts to increase collection rates will focus on the closure of unviable industrial consumers with large arrears. In addition, a credible restructuring strategy for the district heating system will be prepared in the first half of this year. To mitigate the structural impact of structural reforms, the administrative capacity of the social safety net will be improved and the coverage of the minimum income guarantee scheme will be broadened.

In line with their strong commitment to accede to the European Union in 2007, the authorities' efforts to strengthen public administration, eliminate corruption and improve the business climate will continue in close cooperation with the EU and the World Bank. Stepping up the fight against corruption and the reform of judiciary remains top priority of the reform agenda, as prerequisites for further improvements in the business climate. This year, the authorities will approve laws on judicial organization, on the status of magistrates, and on the Superior Council of the Magistracy. The new laws, conceived as a package, will strengthen the role of the Superior Council of the Magistracy as guarantor of the independence of the judiciary. The "extraordinary appeal" of the Prosecutor General has already been eliminated for civil and commercial verdicts and its elimination is ongoing for penal verdicts. Furthermore, the legislation on the declaration of assets by government and parliamentary officials and near relatives will be strengthened to be more efficient in containing corruption. To the same end, additional resources for the National Prosecutor's Anti-Corruption Office will be provided this year. The authorities decided to evaluate, in cooperation with the World Bank, the impact of the new Labor Code on the labor market and employment and amend it accordingly, to preserve labor market flexibility. The transparency in the SOEs' accounting will be improved.

Wage policy

To protect the competitiveness of the Romanian economy, the authorities decided to only modestly increase the public wage bill in 2004. Under the last SBA, wage policy was the main route by which ownership of the program was eroded. Therefore, the government approved a prudent increase of 12 percent in the minimum wage on January 1, 2004, and decided that no other increase will take place this year. To ensure a prudent wage policy in the SOE sector, the government also limited the average gross wage growth to about 9 percent in nominal terms, while reducing employment by over 19,000 positions (4¼ percent) in 2004. To strengthen the credibility of the wage bill target, the ministries will block payments equivalent to 4 percent of the quarterly wage bill in 72 monitored SOEs until the last month of the quarter, and will release it only after it has become clear that the respective target will be reached.

Fiscal policy

Further fiscal consolidation will contribute to reduce inflation and the current account deficit, while creating scope for further private sector investment. In particular, the authorities decided to tighten the general government deficit, (although the size of the containment has not yet been decided), with a view to assuring markets that they are taking appropriate measures to contain the current account deficit. In addition, measures envisaged to improve the saving-investment balances of the SOEs will allow for an overall adjustment in the broad public sector deficit of more than 1 percent of GDP. To ensure that the fiscal objective for the broad public sector is met, this year the authorities will establish monthly monitoring of the public sector borrowing requirement (PSBR). Moreover, the authorities are also ready to tighten fiscal policy further if the current account or disinflation targets are at risk.

On tax policy, the authorities decided to continue the policy reducing payroll tax rates and to further improve the tax system. This year, the employers' pension fund contribution rate was cut by 2.5 percentage points and the employers' unemployment fund contribution rate by 0.5 percentage point. The eligibility for the reduced VAT rate will be limited to pharmaceutical products, hotel accommodation, newspaper distribution, and a small group of previously VAT-exempted products. No other modification in tax legislation will take place in 2004 and any amendments that may be envisaged for 2005 will be done in consultation with Fund staff.

The comprehensive tax administration reform will continue. The modernization of the newly established revenue administration will now focus on operations, systems and processes, and human resources. Moreover, to complete the integration of revenue collection, the customs administration and the Financial Guard will be subordinated to the Minister of Public Finance as of January 1, 2005.

Further reforms will be promoted to ensure the long-term sustainability of the public pension fund. The deficit of the pension fund has been contained below 1 percent of GDP. However, its sustainability may be put at risk by the foreseeable increases in the already high dependency ratio and in the low replacement ratio. In addition, the authorities envisage further cuts in the currently high social security rates. Against this background, the authorities are committed to agree with the World Bank's proposal to accelerate the increase in the retirement age and to equalize it for men and women.

Monetary policy

The NBR has already started preparation of the transition to a new monetary policy framework. The current exchange-rate-based monetary policy framework, with multiple, but prioritized objectives helped the disinflation process in the last four years, but it tends to become obsolete. Its efficacy depends on maintaining restrictions on short-term capital inflow, which is in contradiction with the EU requirements for accession countries to liberalize their short-term capital account operations. Therefore, to comply with EU requirements and to fully benefit from integrating into the international financial system, the NBR decided to relax this framework after the inflation settles to single digit this year. The central bank has already drafted a new NBR Law that attempts to guarantee the primacy of inflation target, as well as that the operational independence of the central bank is in line with Maastricht criteria. Given the effect of the exchange rate pass-through to prices dominates the effect of interest rate changes on inflation, the authorities plan to adopt a flexible form of inflation targeting. Moving to inflation targeting will be in line with progress in developing effective monetary instruments and forecasting techniques.

On prudential supervision, the NBR will permanently improve its instruments in managing the financial system. Supervision will be enhanced to make sure that credit increases associated with the process of financial deepening, cyclical movement of the economy or credit boom episodes will render the credit portfolio resilient to macroeconomic shocks. To that end, risk assessment will be enhanced and more conservative supervisory and regulatory practices will be adopted in relevant areas.

Technical assistance

The Romanian authorities are grateful to the Fund for the valuable technical assistance rendered over the years. Staff did not dedicate a special paragraph to assess the TA the Fund provided to Romania in the last fourteen years. They only mentioned the good cooperation with the authorities. However, Romania has benefited significantly from past TA, especially in the fiscal and anti-money laundering areas, but also in banking supervision, and statistics.

In closing, we would like to convey to the management and staff of the Fund the appreciation of the Romanian authorities for their continuing support, frankness in discussion and constructive policy advice.

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April 23, 2004

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

IMF Reviews Romania's Performance Under Past Fund-Supported Programs

On April 12, 2004, the Executive Board of the International Monetary Fund (IMF) reviewed Romania's experience with Fund-supported programs since the early 1990s, under the new guidelines on assessments of countries with a longer-term program engagement.[1]

Background

Romania's approach to its transition to a market economy had initially been hesitant and piecemeal. Macroeconomic policies oscillated dramatically in the 1990s between periods of tightening and relaxation, while the inherited unfavorable structure of the economy and lack of sustained reform efforts resulted in weak progress in restructuring and enforcing financial discipline. Nevertheless, some key structural reforms were achieved in 1997–2000, in particular in reducing the scope of quasi-fiscal activities and resolving the banking crisis. The gradual accumulation of a critical mass of reforms and more consistent macroeconomic policy implementation under the most recent program supported by a Stand-By Arrangement have resulted in a period of strong real GDP growth and steady disinflation since mid–2001. Moreover, the quasi-fiscal losses declined further, and privatization accelerated.
Despite progress, soft budget constraints remain a problem, as evidenced by large arrears and wage settlements in state-owned enterprises and an inflation rate that is in double digits.

Executive Board Assessment

Executive Directors welcomed the opportunity to review Romania's experience with Fund-supported programs under the guidelines on assessments of countries with longer-term program engagement. Since the beginning of Romania's transition in 1991, Fund program engagement has comprised six Stand-By Arrangements, the first five of which went off track,

[1] This PIN summarizes the views of the Executive Board as expressed during the April, 12, 2004 Executive Board discussion based on the staff report.

reflecting slow overall progress in structural reform and macroeconomic stabilization. Directors commended the authorities for improvement in policy implementation under the last Stand-By Arrangement, completed at end-2003, which helped to usher in strong economic growth and steady disinflation, though they noted that progress on structural reform remained uneven.

Directors acknowledged that the Fund's longer-term program engagement with Romania reflected several factors, including unfavorable starting conditions and recurrent balance of payments needs, but it was also a response to the authorities' willingness to accept progressively tougher up-front conditionality in each successive program as a means to facilitate the implementation of reforms and to boost their credibility.

At the same time, Directors recognized that mixed ownership of reform elements and some aspects of program engagement may have also contributed to the slow pace of reform. They observed that the Fund initially conditioned its engagement on macroeconomic reforms and was slow to require deep-seated structural reforms, despite an awareness that such reforms were critical to macroeconomic stabilization. Directors concurred that the Fund should have emphasized containing losses from quasi-fiscal activities sooner, given their importance to program success. Finally, they stressed that earlier consultation between the Fund and the World Bank on medium-term strategies for reforming large loss-making sectors such as mining, district heating, and railway transportation, would have increased the pace of reform. A few Directors referred to the Fund's Private-Sector-Involvement initiative of 1999 in Romania, and agreed that the Fund's conditioning of its support on the securing of money by the authorities from private creditors exacerbated the difficulty Romania had in obtaining new loans on appropriate terms.

Most Directors considered that despite Romania's repeated slippages in policy implementation, Fund engagement had been beneficial for promoting good policies. Directors broadly agreed that the Fund's strategy of linking its program engagement to critical structural reforms that would be difficult to reverse, such as in the areas of bank restructuring and enterprise privatization, had been appropriate. Overall, they concluded that, given the authorities' mixed ownership of the programs, the use of comprehensive program conditionality, particularly prior actions, had been effective in moving reforms forward and that the Fund had limited its exposure appropriately in the face of program slippages. A few Directors noted that granting multiple waivers, as was done during the most recent Stand-By Arrangement, contributed to program flexibility, while a number of others viewed it as having lessened the authorities' resolve to implement program commitments.

Directors observed that the overlap in the coverage of World Bank and Fund programs had been substantial under the most recent arrangements. Against this background, Directors underscored that close coordination in the Bank and Fund's respective conditionalities had helped to move reforms forward, and that the involvement of both on some key reforms, such as in the banking and energy sectors and privatization, had been essential for their success.

Directors welcomed Romania's recent economic progress, but agreed that Romania still faced considerable challenges to complete structural reforms and to sustain macroeconomic stabilization in the run-up to EU accession. They saw the need to ensure further disinflation to EU levels and to reverse the recent widening of the current account deficit, via further fiscal consolidation, prudent monetary policy including measures to contain rapid credit growth in a consistent monetary framework, and a tighter incomes policy, including moderation in public and state enterprise sector wages.

Directors emphasized that completing the task of macroeconomic stabilization hinges critically on completing structural reform of state-owned enterprises. They stressed that transparent privatization of state-owned enterprises and efforts to eliminate quasi-fiscal losses and implicit subsidies, particularly in the energy sector, need to proceed quickly. To mitigate the social impact of these reforms, Directors urged further strengthening of the social safety net. They also emphasized the importance of strengthening public administration and banking supervision, continuing restructuring of the tax and pension systems, and in particular, improving governance and the business environment to sustain robust economic growth and attract foreign direct investment.

While Directors agreed that the progress achieved under past programs could in principle make a surveillance-based relationship feasible now, they nevertheless supported the view that a strong precautionary Stand-By Arrangement with low access would help to strengthen the momentum for structural reforms in the run-up to elections later in the year, support the authorities in paving the way for EU accession, and facilitate a credible exit from the Fund's program support. They emphasized that a follow-up program should reflect the lessons from the ex-post assessment and stressed the importance of strong ownership and a front-loaded conditionality, supported by prior actions in critical reform areas. Directors agreed that a surveillance-based relationship would be preferable if agreement on a strong program cannot be reached.

Directors welcomed the authorities' reactions to the staff's assessment and shared their view that the assessment was an important basis for transparent cooperation between the Fund and Romania.

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.

Selected Economic Indicators

	1999	2000	2001	2002	2003	2004 Proj.
Real economy (change in percent)[1]						
Real GDP	-1.2	2.1	5.7	5.0	4.9	5.0
Final domestic demand	-2.9	2.1	6.9	3.4	7.3	5.5
CPI (end of period)	54.8	40.7	30.3	17.8	14.1	9.0
CPI (period average)	45.8	45.7	34.5	22.5	15.3	12.0
Unemployment rate (end of period; percent)	11.8	10.5	8.6	8.1	7.2	6.5
Gross national saving (percent of GDP)	11.9	15.6	17.0	20.1	20.6	21.3
Gross domestic investment (percent of GDP)	16.1	19.5	22.6	23.5	26.5	26.5
Public finance (general government, percent of GDP)						
Overall balance	3.6	-4.0	-3.2	-2.6	-2.3	-1.9
Primary balance	2.4	0.9	0.6	0.4	-0.2	0.2
Total public debt (in percent of GDP) [2]	30.5	29.9	27.4	26.8	26.2	27.4
Money and credit (end of year, percent change)						
Real domestic credit[3]	-7.9	7.9	28.0	33.1	54.9	21.6
Broad money	44.9	38.0	46.2	38.1	25.0	26.0
Interest rates (percent)						
NBR interest rates (end of period)[4]	88.7	60.1	39.9	21.5	23.4	...
Treasury bill rate (end of period)	104.8	59.4	38.4	17.4	18.4	...
Balance of payments (percent of GDP)						
Trade balance	-3.5	-4.5	-7.4	-5.7	-8.0	-7.0
Current account balance	-4.0	-3.9	-5.5	-3.4	-5.9	-5.2
External debt	25.6	28.7	30.7	34.3	34.6	33.1
Official reserves (end-year, US$ million)	2,472	3,466	5,090	6,975	7,994	9,610
Reserve cover (months of prospective imports)	2.1	2.5	3.2	3.5	3.3	3.7
Exchange rate						
Lei per U.S. dollar (end of period)	18,250	25,926	31,597	33,500	33,019	...
NEER appreciation (+) (annual average in percent)	-39.8	-22.8	-22.3	-14.4	-11.1	...
REER appreciation (+) (CPI-based, annual average in percent	-15.1	9.3	1.5	2.6	0.4	...
REER appreciation (+) (CPI excl. admin prices, annual average in percent	...	6.0	1.8	1.0	0.0	...
REER appreciation (+) (ULC-based, annual average in percent)	-21.8	-0.3	-0.9	-6.7	-5.6	...

Sources: Romanian authorities and IMF Staff estimates.

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

[2]Including domestic public debt and external public debt (public and publicly guaranteed).

[3]Credit to the nongovernment sector. Weighted average of real lei credit growth and U.S. dollar-measured foreign currency credit growth.

[4]NBR's deposit auction interest rate, compounded.