Economic Reform in Romania: Sustaining the Momentum

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Romania is showing promising signs of breaking away from its legacy of erratic economic management during the 1990s. If this trend continues, it has every chance of emerging as an important economy in the Central and Eastern European region. After almost a decade of inconsistent reform efforts, the government that took office in December 2000 has begun implementing the reforms needed for a successful economic transition and eventual accession to the European Union. The year 2001 was an encouraging year with GDP growth at five percent. The key challenge ahead is to sustain that growth through continued and accelerated structural reforms.

Romania now has a unique opportunity to demonstrate its commitment to reform through actual achievements, breaking the stop-and-go cycle that hindered its progress in the past.

This paper examines the factors driving Romania's transition. It analyzes recent economic trends and weighs the immediate future, focusing mainly on structural elements.

EXPECTATIONS FROM THE PRESENT GOVERNMENT

For a number of reasons, Romania now has a unique opportunity to demonstrate its commitment to reform through actual achievements, breaking the stop-and-go cycle that hindered its progress in the past. Previously, fragmented coalition governments found it difficult to successfully champion reform, despite their best intentions. Now, there is a convergence of views among the key stakeholders of development, including the one-party government, to move ahead with reforms. Although

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technically a minority government, it has sufficient support within the parliament to enable faster decisions at the national level. By and large, it is a cohesive and internally communicative government that has clearly articulated its commitment to reform, driven by aspirations of European integration. It fully acknowledges the high incidence of poverty and the consequent need for a strong social agenda as an integral part of the reform framework. Despite some reversals in the reform process, it has demonstrated during its first year in power that it is a pragmatic government fully conscious of the realities of the modern environment and not driven by outdated ideologies. The current government took office in the wake of a modest 1.6 percent growth rate in GDP during the year 2000, driven by strong export performance. This growth has accelerated to a respectable five percent in 2001. Given the above factors, it is not surprising that both the domestic and international communities have high expectations of performance from the present government.

ECONOMIC PERFORMANCE: THE LEGACY AND THE OUTLOOK

Throughout Romania's volatile transition, following the collapse of the hyper-centralized socialist system in 1989, successive governments were unable to address some of the economy's core challenges. Recurrent policy slippages in the past resulted in repeated macroeconomic reversals, with significant falls in output and returns to high inflation. Even now, with some encouraging developments and prospects, it is fair to say that, as in other transition economies, Romania's macroeconomic stability remains fragile, indicating the need to strengthen the reform process and reduce inherent risks.

In the last two years, and particularly in the last year, stabilization efforts have started to bear fruit. At the end of 1999, boosted by the start of EU accession discussions in Helsinki, the economic performance of the country began to show signs of improvement. The process continued to gather momentum in 2000, when the country recorded its first year of real GDP growth at 1.6 percent, after three successive years of contraction. In 2001, supported by strong export performance (over 20 percent growth in 2000 and a further 12 percent in 2001) and a gradual increase in aggregate consumption and investment, Romania began to show tangible progress on the path of reform and restructuring.

Recent indicators illustrate more strengths than weaknesses: Romania's GDP growth of five percent in 2001 was one of the highest in Europe; inflation, while still prohibitively high, has been brought down steadily, from 54 percent in 1999 to 40 percent in 2000 and 30 percent in 2001; unemployment currently fluctuates at approximately 10 percent of the labor force, much lower than in many countries in the region, though one can argue this is partly because reform is still at an early stage; foreign reserves of the central bank have increased to approximately $4.5 billion dollars (including gold), equivalent to some three and a half months of imports; the external balance is stable with no prohibitive debt peaks in sight; foreign direct investment is on an upward trend, although much lower than its potential; and export volumes in 2001 were the highest in the history of the country. The fiscal deficit during 2001 was contained to 3.5 percent of GDP. On the other hand, the balance of trade is becoming increasingly negative with an unprecedented rise in imports, thus fuelling a growth in the current account deficit, which at the end of 2001 stood at nearly six percent of GDP.

This turnaround in economic performance resulted from a newfound political will to pursue measures for the stabilization of the economy backed by structural reforms. Examples of key steps are the implementation of a macrostabilization program based on a standby agreement with the International Monetary Fund which led to the resumption of IMF financing in the fall of 2001; the privatization of large unprofitable enterprises such as the giant steel complex, SIDEX, and the public sector bank, Banca Agricola; the renewed focus on the process of EU accession (nine chapters of the Acquis have been provisionally closed and a further 17 opened); and the recent successful negotiations for a wide-ranging structural adjustment program with the World Bank which, subject to the completion of a few remaining prior actions, would trigger the resumption of structural adjustment lending from the bank in the first half of 2002.

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For the near future, the prospects are cautiously optimistic. The economy is expected to continue its robust growth in 2002 although, as the government itself has pointed out, the predicted five percent growth rate will need to be downgraded somewhat in light of changes in external circumstances, primarily the recession in the U.S. and Western Europe. Between 65 to 70 percent of Romania's trade is with EU countries. A further 10 percent is with EU candidates Hungary, the Czech Republic, Poland, the Slovak Republic, and the Baltic Republics, all of which are exposed to fluctuations in EU activity levels. Exports, industrial output, and productivity are nevertheless likely to continue growing. If prudent monetary and fiscal policies are maintained and financial discipline in enterprises is further enhanced, the disinflation process will continue, and the budget deficit can remain within three percent of GDP in 2002.

Notwithstanding recent achievements, the economy still remains vulnerable to externally or internally triggered shocks. Therefore, the mission of the government remains complex. Many of the challenges are similar to the ones encountered during the early transition. These include the downsizing of the corpulent industrial sector, the privatization of large, unprofitable enterprises, and the application of rigorous financial discipline on enterprises and banks. Improved macroeconomic fundamentals, sustained by wage moderation in the public sector, steady employment creation, enhanced financial discipline, supportive policies fostering investment, and an improvement in the business climate should lay a solid foundation for a virtuous cycle of growth.

STRUCTURAL REFORM: PERFORMANCE AND PROSPECTS

The pace of structural reforms is a key determinant for sustained economic growth. Under an agreement with the World Bank, during 1999 and 2000 the government focused on four key areas of reform: financial sector reform focused on banking, privatization of state-owned enterprises, social security reform, and improvement of the business climate. In short, the structural and institutional reforms needed to move Romania closer to a market-based economy. In the financial sector, in addition to strengthening the central bank's supervisory and regulatory functions, the government undertook measures to restructure and privatize state-owned banks and, where necessary, provide for exit arrangements. A large number of enterprises in the portfolio of the State Ownership Fund were privatized and, more significantly, the government established a transparent, internationally acceptable bidding process to engage privatization advisors for a large batch of enterprises. Detailed plans were prepared for introducing fiscal business incentives, some of which have been transformed into laws and regulations. Plans were also prepared for the removal of administrative barriers to businesses.

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Inevitably, the reform process slowed and even reversed at some points during the election period last year. During the early months of the new government, the pace of reforms could have been more rapid, but it was evident that Romania was on a steep learning curve. Slippages were inevitable and time was lost in revisiting and correcting mistakes. However, there was a growing realization that reversing reversals brought the situation back to its starting point. It was necessary to demonstrate progress. Accordingly, the government has achieved some tangible and credible advances. Examples include introducing further investment incentives, revamping privatization regulations, revitalizing the privatization process, and continuing with privatization of key state-owned banks and enterprises, such as Banca Agricola and SIDEX.

On the institutional side, the government created a number of new ministries. The Ministry of European Integration is responsible for EU accession efforts. The Ministry of Development and Prognosis manages a national planning process by consulting with development stakeholders, including key donors such as the EU, IMF,. and World Bank. The Ministry of Communications and Information Technology is giving due emphasis to e-business, e-government, and the development of a knowledge-based economy. Recently promulgated laws introducing e-procurement in government and electronic payment of income taxes can be seen as concrete steps towards good governance. The Ministry of Small and Medium Enterprises was set up to encourage the development of small and medium enterprises as an engine of growth and employment. Some adjustments and harmonization of the incentive systems initially applied are being undertaken with the objective of creating a stable and equitable environment for all businesses. The Public Administration Ministry is involved in decentralization and strengthening the role of local government. While much has yet to be achieved by some of these fledgling ministries, their creation is an indication of the priority accorded to the reform process.

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For the future, Romania has committed to continuing reform in each of the four areas discussed above. In the financial sector, with the gradual phasing out of public sector banking, it hopes to facilitate the growth of private banking through regulation and supervision arrangements compatible with international standards. To provide the banking system with a durable long-term source for capital and equity, the government proposes to support legal and regulatory reform in the non-banking financial sector including investment funds. In privatization, the stated objective is to reduce the burden on the economy, enhance enterprise efficiency, and increase receipts through sales and enhanced revenue streams. As such, privatization is expected to accelerate and to include large profit-marketing enterprises.

As for the business environment, there are plans to introduce fiscal incentives and remove administrative barriers, including a revamping of institutional and procedural arrangements to promote investment and provide services to new investors. Current practices are excessively bureaucratic and an impediment to the start-up and operation of businesses. This is expected to give a much-needed boost to foreign direct investment, which is still well below the country's potential. In social security, the objective is to promote a wider and more-sustainable social safety net. Specific measures will include promotion of active labor redeployment measures, when affordable, the introduction of a multi-pillar private pension scheme. Also on the reform agenda is the all-important energy sector. In this realm critical and long-standing issues such as enterprise arrears need to be addressed in addition to accelerating restructuring and privatization.

The success and sustainability of the above agenda is contingent on another key reform area that has garnered considerable attention from the government, the population, and the international community: public administration reform. Strong public institutions capable of formulating, implementing, and monitoring public policies effectively and transparently are a prerequisite for EU integration. In the context of Romania, essential elements include judicial reform, civil service reform, implementation of an anti-corruption strategy, and an effective de-centralization of authority to local government levels. Cognizant of the disruption caused by incidences of corruption, the government declared 2001 a year for promoting good governance in general. Anti-corruption measures are particularly high on the government's agenda, starting with the recent adoption the National Strategy for the Prevention of Corruption and the National Action Plan against Corruption. The major financial institutions and aid agencies such as the World Bank, EU, United Nations Development Program, and U.S. Agency of International Development are strongly supportive of these trends and are assisting with advice as well as finances.

Realistically, it will take time before structural reforms result in a significant decrease in poverty levels. This does not mean that nothing can be done for the poor in the short term. This year, the government declared its intention to strengthen its social agenda, while keeping budget constraints in mind. One possible approach could be the judicious use of subsidies. This implies adherence to three key principles: clear targeting to the intended beneficiaries (which implies accurate means-testing); transparency both in sources of financing and the process of distribution; and, above all, affordability. No government can give what it cannot afford. If it does, the benefit will be, at best, short-lived and will have serious repercussions when assistance is inevitably withdrawn. Measures such as across-the-board tariff or VAT reductions, as the government is realizing, do not achieve the intended purpose. In addition to distorting the market, they lack targeting and are generally unaffordable. Ironically, one advantage of starting the reform process late is that it is possible for Romania to draw lessons from the very substantial and well-documented body of international experience, both in the region and more widely. In this way, Romania would be able to effectively design and implement its subsidy policies so that the deserving poor will actually benefit. Other measures include aligning investment priorities to include the poor. In this endeavor, Romania is strongly supported by major donors such as the World Bank, which has targeted the bulk of its future investment operations at poverty alleviation through the delivery of social services and revitalizing the rural economy.

The agenda presented above is vast and its implementation will require substantially increased efforts from all Romanian institutions involved. Some will need to be strengthened to meet the challenges. Because the principal areas of reform are inextricably linked, the government has little choice but to implement them simultaneously. The government's flexibility is further limited by its desire, in response to popular demand, to hasten the European integration process. The task at hand is complex but this is the best moment for Romania to achieve its reform goals. ■