

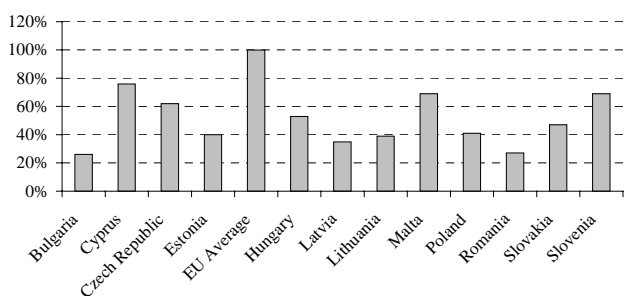
ROMANIA'S CHALLENGES FOR JOINING THE EU: A DREAM TOO FAR AWAY?

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The pace at which economic and social transformation takes place nowadays in most East European countries is probably faster than ever. Lured by the potential long-term benefits of joining the European Union (EU), ten countries¹ are set to become fully fledged members from 1 May 2004. Missing out on this first wave of EU enlargement, Bulgaria and Romania are taking big strides to catch up with the first entrants. In June 2003 the Thessaloniki European Council reassured the two countries that they are 'part of the same inclusive and irreversible enlargement process' and that 'depending on further progress in complying with the membership criteria, the objective is to welcome Bulgaria and Romania as members in 2007'.

Almost fifteen years after the fall of communism Romania's determination to join the EU is stronger than ever. As with the other candidate countries the benefits of being inside the EU outweigh the costs of staying outside. The EU is by far Romania's largest trading partner, accounting for almost two thirds of its trade. Access to a large EU market could ensure the realisation of economic growth rates that would help close the existing GDP per capita gap between Romania and other EU members. Although Romanian GDP per capita is only 27% of the EU average (Figure 1), it has been following an upward trend over the last years.

Figure 1: GDP per Capita as Percentage of EU Average for the Accession Countries in 2002



Source: Eurostat

An export-led economic recovery favoured by comparatively low labour costs and rising productivity has been pushing GDP growth rates at an average of almost 5% over the last three years, and this despite the slowdown in

the EU. The economy is forecast to grow by 4.9% this year and 5.1% in 2005, driven by rapid investment.

It is therefore not surprising that Romania is very keen to make up for the lost ground and satisfy the membership criteria as soon as possible — which effectively means compliance with the requirements set out in the 31 chapters of the *acquis communautaire*, the entire body of European laws. When the Social Democratic (SD) government of Prime Minister Adrian Nastase took office in December 2000, its priorities were to obtain NATO membership and speed up the EU integration process. Four years later, the results are somehow mixed. While the government has accomplished the former task and Romania has joined NATO, advancement on implementing the much needed structural reforms has been rather slow. The latest European Commission (EC) report on the country's progress towards accession, which was released in November 2003, stated that 'Romania can be considered as a functioning market economy once the good progress made has continued decisively. In addition, a vigorous and sustained implementation of its structural reform programme is required in order for Romania to be able to cope with competitive pressure and market forces within the Union in the near term'. The conclusion of the report was a setback to the government's plans which hoped that the country would be granted the essential 'functioning market economy' status.

However, there is no doubt that the country's macroeconomic stability has improved markedly over the last years (Table 1). Inflation has been falling continuously to reach 15% at end-2003 from 60% at end-1998. Political stability, which has taken root in the last election, led to a coherent co-ordination of fiscal and monetary policies. Much to the success of bringing down inflation expectations owes to the implementation of a tight fiscal policy and restraint of public sector wage increases. The National Bank of Romania (NBR) was granted independence in 1998 and has been given the task of maintaining price stability. In practice the NBR has been pursuing a managed float regime and has often been involved in sterilisation procedures of capital inflows aimed at maintaining a competitive exchange rate for Romanian exporters.

Also, the financial system is much healthier than several years ago when a series of bank and investment fund collapses damaged its credibility.

¹ They are Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia.

Table 1 Selected Macroeconomic Indicators

	1998	1999	2000	2001	2002	2003*
Real GDP growth	-7.3	-2.3	1.8	5.3	4.5	4.9
Public sector and guaranteed debt (% of GDP)	27.6	30.5	29.9	27.4	28.3	28.4
Current Account (% of GDP)	-6.9	-4.0	-3.9	-5.5	-3.4	-6.2
Inflation — annual change (%)	59.1	45.8	45.7	34.5	22.5	14.9
Exchange Rate (Lei/USD)	10,951	18,250	25,926	31,597	33,500	33,391
NBR Reserves (million Euro)	2,278	2,493	3,490	5,114	6,999	7,889

* Estimated, Source: IMF

Against a favourable macroeconomic background stands the much less impressive progress in privatisation and structural reforms. A major problem is the poor financial discipline that has been persisting within the economic system. Since 1990 loss-making companies, especially state-owned enterprises and public utilities, have accumulated large arrears. The establishment of such a culture in which the non-payment of utility bills and other budgetary debts has been tolerated meant, in effect, that large implicit subsidies have been continuously draining the budget. In addition to this, high inflation has helped these companies to survive, thus masking their inefficiency. As a result resources have not been allocated to the most productive uses, impairing competitiveness. The upshot has been a dramatic increase in quasi-fiscal deficits that constantly put under strain the future state of public finances. To remedy this, in 2001 the government issued an emergency ordinance that set the legal framework for monitoring the financial discipline of 86 large debtors. The purpose was to try reducing the volume of arrears by setting up a monthly surveillance programme of wage expenses, debts and losses for these companies.

Attracting foreign direct investment (FDI) has been a key priority of the government. But a relatively poor investment climate, and a high level of bureaucracy and other administrative barriers, have been major obstacles to luring foreign investors to come to Romania. Between 1989 and 2002 the country managed to attract less than US\$500 per capita FDI, by far the lowest level among the candidate countries (Figure 2). Also the privatisation process of targeted enterprises under the IMF and World Bank programmes has faced repeated delays. However, with the government moving closer to the long-awaited sell-off of

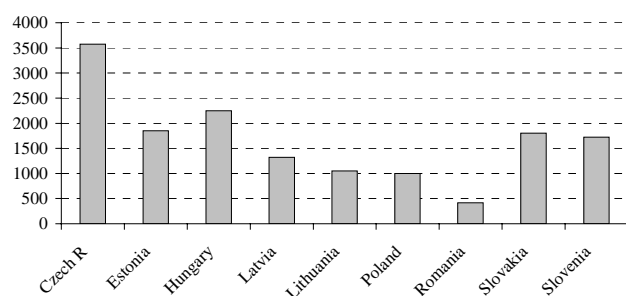
stakes in several profitable banks and companies, foreign investors are again turning their attentions to Romania.

After the successful privatisation of Sidex — Romania's largest fully-integrated steel producer — three years ago, plans to sell Petrom — the state oil company — are in their closing stages. The company has two refineries, processes over 6 million tonnes crude oil a year and has more than 650 filling stations. Its privatisation is perceived as a strong indication of the government's commitment to reform. Eleven companies or consortia have already submitted letters of intent for Petrom.

The energy restructuring process has been progressing painstakingly slowly over the last years. In early 2000 Romania opened up 10% of its energy market by allowing 10 large industrial companies to choose their own electricity supplier. Now, under continuous pressure from the monitoring international financial organisations, a wholesale privatisation of the energy sector is on the cards. This has been running large losses due to the fact that energy tariffs, which are indexed to the US dollar, have been set below cost recovery levels. These losses have been further accentuated during the first half of 2003 due to the increase in the world fuel prices and a weak dollar. Effectively the whole energy sector desperately needs investment to upgrade its obsolete facilities. The government and the IMF agreed a timetable for energy price liberalisation and, in spite of several delays in its implementation, energy prices are set to increase gradually every quarter so that convergence with EU levels will be achieved by 2007.

With general elections looming large in November 2004, the government has been reluctant to take unpopular measures that would involve raising energy prices and job losses. But stalling has ceased to be an option anymore; adopting such a strategy could be fatal and even jeopardise the country's potential EU entry in 2007. Recently, there have been calls in the European Parliament for the suspension of the country's EU accession negotiations unless significant progress is made in the implementation of judiciary reform and fight against corruption. In response to this Mr Nastase has hastily reshuffled his cabinet. The move was part of a wider strategy aimed at supporting his expected candidature to the presidency later in the year. The acting President, Ion Iliescu, who will complete serving his second — and last — term in office is

Figure 2: Cumulative FDI per Capita 1989-2002, US dollars



Source: EBRD

widely tipped to take over the SD Party leadership once again.

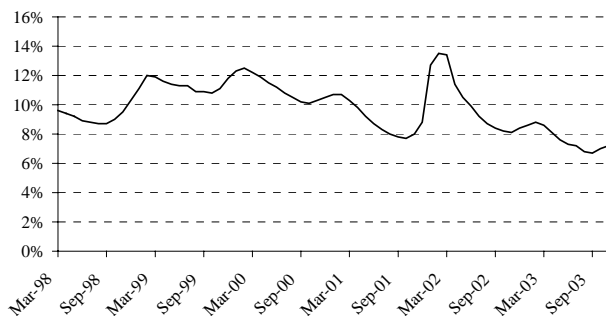
But, if Mr Nastase decides to run for the presidency, he could face a harder challenge than initially thought. A month ago Mrs Lia Roberts, a 54 year-old Romanian-born chairwoman of the Nevada Republican Party, took Romanian politicians by surprise when she announced her presidential candidacy. Her two main arguments are the privileged connections she has with politicians in Washington, President Bush included, which could translate into strong inflows of US capital to Romania if she was elected, and her determination to fight against corruption. To finance her election campaign Mrs Roberts could afford to spend US\$15 million of her own money. The sum is just enough to start a bank in Romania and is eight times higher than the amount a Romanian candidate is legally allowed to spend on his own campaign.

Whoever wins the presidential elections, however, is bound to press on with the EU integration process. Romania has, so far, closed provisionally only 22 negotiating chapters with some thorny issues such as agriculture, judiciary, energy, environment and financial services still under discussion. Compliance with EU regulations and standards is going to require substantial budgetary outlays and large public sector investments in infrastructure, agriculture, the environment and other sectors. Apart from these, other costs will arise from the payment of contributions to the EU budget after Romania joins. As a counterpart to such costs, the country is able to access the usual set of Structural and Cohesion Funds and will also benefit from transfers of the pre-Accession mechanisms, like the PHARE and SAPARD programmes. In early February this year the European Commission approved a financial package worth €10 billion which will be available to Romania for the 2007–2009 period if the country joins EU in 2007.

Fiscal policy has been prudent over the last years, with the general government deficit being cut from 5.4% of GDP in 1998 to an estimated 2.6% in 2003, but the need for reform could pile up pressure on the budget in the years to come. Undoubtedly, the greatest worry is the social security system. Within this, the pension system is probably in the most disastrous state and, unless it receives a swift overhaul soon, it is difficult to see how it can avoid a collapse. In 2001 Romania had 0.63 workers for every pensioner. In comparison, the ratio of workers to pensioners in Europe, already considered to be in the crisis zone, currently stands at four to one and is forecast to halve by 2040. However, in Romania the picture is distorted by the fact that, out of the country's working population of 11 million, only 4.5 million appear to be employed. With less than 1 million being unemployed the remainder of the labour force work either abroad or in the informal economy, which is estimated at around 40% of GDP.

Since 1996 the share of pensions expenditure within total government expenditure has grown from 5.2% to 13.3% in 2003. Pension costs will undoubtedly keep rising in the

Figure 3: Romanian Unemployment Rate



Source: NBR

years to come, and this phenomenon is likely to be further exacerbated by a declining birth rate and increased emigration with expected EU entry.

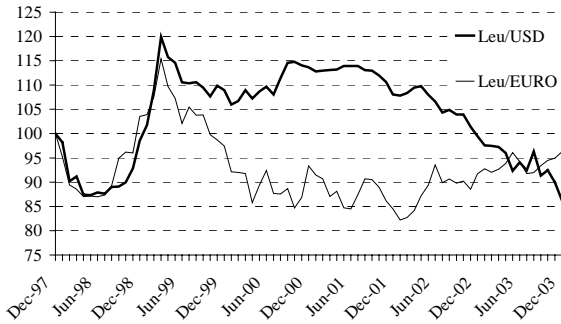
Addressing the pension system issue means reforming the existing pay-as-you-go (PAYG) system — where pension expenditure in any given year is financed by that year's contributions in the form of payroll taxes. Although there is a draft project law prepared by the Ministry of Work and Social Solidarity, progress with adopting the legislation has, so far, been slow. The project envisages the introduction of three pillars; the first would be based on a compulsory public sector system, the second would bring in private pensions while the third pillar would consist of company pensions based on voluntary workers contributions.

The agricultural dossier is a burdensome one. In Romania the share of agricultural employment in total employment is extremely high. Data released by Eurostat puts the 2001 figure at 44.5%. Although the agricultural sector's contribution to GDP is only 12%, around 85% of agricultural employment consists of self-employed workers who do not earn a wage. Thus, reforming the agricultural sector in order to comply with EU regulations is likely to be a challenging task.

Although joining the EU entails significant costs in the short run, this will, it is hoped, send a positive signal to foreign investors. With monthly average net wage around £100 and consumption good prices already at EU levels the domestic savings ratio is too low to finance the investment the country needs. To help attract foreign investment the government has enacted a new Labour code which will come into effect from 2005. The legislation is in line with EU standards and envisages the implementation of a flat income tax rate of 25%. Currently the top income tax rate stands at 40%.

The EU accession strategy will still leave the Romanian monetary and fiscal authorities with some dilemmas. Low budget deficits are needed to help the disinflation process but, on the other hand, there is a need for an increase in government spending to finance both public sector reform and costs related to EU entry. Furthermore, the disinflation

Figure 4: Real Exchange Rate
(December 1997 = 100)



Source: Author's calculation

process is likely to lead to real exchange rate appreciation, and worsen the trade balance.

An exponential increase in domestic credit last year has translated into excess demand which pushed the current account deficit to 6.2% of GDP last year. This made the NBR postpone its plans to fully liberalise the financial

services account. Currently foreigners cannot hold domestic currency denominated bank deposits.

For Romania it is important to maintain its current timetable for EU accession. As challenging as it may be, this is crucial for at least two reasons. Firstly, as Romanian history suggests, the implementation of reform has been painstakingly slow in the absence of external pressure. Continuous monitoring under the IMF and EU programmes has been a significant factor in the implementation of reform programmes, and subsequently in enforcing them. Secondly, sooner or later, these reforms would have had to be dealt with anyway. The EU accession deadline simply ensures that these are done sooner by effectively forcing the government to implement them. Clearly Romania still has some way to go in order to achieve both nominal and real economic convergence with its EU counterparts. But postponing its EU entry could be more costly in the medium and long term. Joining the EU could be the right political move, especially while the EU commitment to take in new members is still there, and might even pay off eventually.