

# Policy Warning and Forecast Report

## ROMANIA IN 2004

*edited by*

**Romanian Academic Society**



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**T**his year Romania will become a NATO member, will have to conclude the most difficult *acquis* negotiations chapters in order to be able to join EU in 2007 as scheduled, and will have to start, at last, the long-delayed privatization of its industrial hard core: the energy sector. On top of everything, there will be local, parliamentary and presidential elections. We are probably looking ahead to one of the most exciting and challenging twelve-month period of the transition era. This report brings to you our forecasts and analysis on the Romanian politics and economy in 2004.

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## What's inside

### 1. **ECONOMY: ROMANIA IN 2004**

SAR surveyed a panel of experts and brings to you their economic forecasts for the year ahead in a short introductory section.

### 3. **POLITICS: ROMANIA IN 2004**

What are the chances of the opposition to win? Will the government steal elections? What are the main threats for the democratic institutions in Romania today? Find out these, and more, in our **POLITICS** section.

### 15. **ECONOMIC POLICY CHALLENGES IN 2004**

Are the government's targets achievable? Will the CA deficit spin out of control? The trade-offs of economic policy and recommendations in a piece of analysis focusing on macro risks and developments.

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*Other reports on governance, studies on public opinion and public policy, as well as the political science quarterly PoiSci, all published by SAR, are available from*  
[www.sar.org.ro](http://www.sar.org.ro)

# FORECAST

In mid-January 2004 SAR surveyed a panel of economic experts<sup>1</sup> and asked what would be in their opinion the main macro evolutions this year. We have also included a number of open-ended questions regarding privatization and the EU integration. This introductory section presents a brief synthesis of their opinions.

## MACROECONOMIC FUNDAMENTALS IN 2004

	Average	Range (min-max)
Growth, %	4.75	4.5 – 5
Inflation rate, %	10.75	10 – 11.8
Current account deficit, %	6.1	5.5 – 6.5
Budget deficit, %	2.75	2.3 – 3.2
Unemployment rate, %	7.8	7 – 8.8

While the growth seems to continue, our panel believes that inflation will not be brought down to single-digit levels in 2004. Budget deficit appears to be the indicator most difficult to predict (it has the widest range of variation), probably as the result of uncertainties about the government's policies in an electoral year. Nothing much will happen with the unemployment rate, which is to say that massive industrial restructuring is unlikely in 2004.

## DO YOU THINK ROMANIA WILL GET THE STATUS OF FUNCTIONING MARKET ECONOMY THIS YEAR?

Opinions are split – roughly 66% Yes vs. 33% No, though there are shades of gray rather than a clear line between the two sides. Skeptics point out that a failure to privatize Petrom or some of the electricity or gas distribution companies can tilt the balance towards No. But other, exogenous factors may play a role, such as the European fatigue in

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<sup>1</sup> We are grateful to the following experts for responding to our invitation: Professor Daniel Dăianu, Bucharest School of Economics; Aurelian Dochia, director general of SG Corporate Finance; Valentin Lazea, chief economist at the Romanian National Bank; Radu Crăciun, senior analyst with the ABN Amro bank; Lucian Albu, director of the Institute for Economic Forecast; Cătălin Păuna, chief economist at the World Bank mission.

absorbing the first wave candidates, the desire to postpone the second wave in order to allow Croatia to catch up, or the dispute in Brussels between «enlargers» and «deepeners».

**DO YOU THINK ANY STRATEGIC INVESTORS WILL COME IN 2004 AT:**

• **Petrom?**

Yes, *if...* the outstanding asset ownership issues are clarified expeditiously; the government pulls itself together and manages the privatization more professionally than they have done it so far

Yes, *but...* the government will find unacceptable the remaining bidders and will postpone the privatization

• **BCR?**

No. Nobody is actively looking for it right now; it will take some time until the reorganization plans of the new shareholders (IFC and EBRD) will produce results

• **Any of the power distribution companies ?**

Yes, probably the first two regional distributors (70 to 100% chances)

In general our respondents feel very much will depend on the decisiveness and professionalism of the government when preparing privatizations (see the latest problems with assets evaluation at Petrom); and the extent to which the bidders country of origin and their financial offers match the expectations of the Romanian authorities.

**CAN NEGOTIATIONS ON CHAPTER 6 OF THE ACQUIS (COMPETITION POLICY) BE CONCLUDED IN 2004 ? WHAT WOULD BE THE EFFECTS FOR THE ROMANIAN ECONOMY ?**

"Chapter 6 can be closed in 2004, and it will probably be closed, but Romania will be monitored afterwards and potentially subjected to fines because it will try to avoid implementing what it has signed. Without state bailout, loss-makers will find new forms to stay afloat, mainly through arrears to suppliers".

"The negotiations can be completed in 2004, but implementation will be very difficult. The impact on companies will be minor as far as anti-trust rules are concerned, we already enforce them to a large extent. By contrast, there will be adverse implications for some of the companies benefiting directly or implicitly from state aid. In the long run, the impact on the competitiveness and attractiveness of the Romanian economy will be unquestionably positive".

"The biggest impact will be felt in the energy sector where prices will have to be brought above cost recovery levels, while cost reduction strategies will include layoffs. Given the significant social impact this will be among the most difficult chapters to be closed, probably in 2005".

# POLITICS

## IS POLITICAL CHANGE POSSIBLE IN 2004?

**Major electoral frauds in 2004 are unlikely, but the electoral competition is already highly unfair and democracy limits stepped over every day through the use of public resources by the ruling party**

Romania has a twofold prospect in 2004, which in the same time represents a twofold burden: elections at all levels (presidential, legislative, municipal), and the scheduled conclusion of all negotiation chapters with the European Union before a new Commission is appointed. The two tasks can hardly be seen as complementary: elections already dominate the domestic agenda, while EU negotiations are in no way a match for them. Moreover, some of the stumbling blocks of Romania's EU accession, such as the public administration reform, reform of the judiciary or a free competition environment necessitate political change, as they are currently stalled. This annual report and forecast explores the sources for political change, as well as the obstacles, and presents a number of scenarios for the after-elections period.

**WARNING**

*This report is therefore structured in 3 parts:*

1. *Analysis of the electoral structure and trends*
2. *Self and outer limits to political challenge*
3. *Scenarios for the future*

### **1. ANALYSIS OF THE ELECTORAL STRUCTURE AND TRENDS: A MODEL OF STATE DEPENDENCY**

Throughout 2003, there was little change in public opinion surveys regarding the popularity of the main political parties, with the government party enjoying a comfortable lead with 40-45% of votes. The recently-formed Truth and Justice alliance (formed by the Democratic and National Liberal Parties) enjoys about 25-29% of

preferences. In absolute figures, the government party has about the same slice of votes it had in 2000. The strong domination of postcommunists in the preference of the public throughout transition requires some in depth explanation. Romania is the only candidate country where Communism managed to operate a very deep change of the social structure. Social engineering policies successfully carried to their end in many regions included the forced urbanization and industrialization, the destruction of villages under the slogan of 'systematization' in the late eighties, the 'de-peasantisation' of peasants and the most extensive political mobilization in Communist Europe. Party membership in Romania (18% of the total population) was three times the regional average. As it has recently been uncovered, two networks of informants operated alongside each other in Communist Romania, one of the secret service proper (around 400,000 paid informants and twice as many occasional unpaid ones) and the second of the Communist Party, targeting its members, which accounted for another few hundred thousands<sup>2</sup>. Both nomenklatura and the informants were above the law in Communist times, enjoying privileged access to the scarce resources, and many were able to convert such resources in power or economic assets afterwards. Furthermore, this extensive recruitment took place especially amongst the most educated, another powerful explanation in accounting for the post-1989 difference in quality between Romanian and Central European political elites.

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**State  
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But when one analyzes Romania in comparative perspective yet another explanation emerges as extremely powerful. State dependency is the highest in Romania compared to its Central European neighbors, and state dependency is the crucial determinant of undemocratic and illiberal attitudes, themselves the main predictors of the vote for postcommunists. Two-thirds of Romanians are declared democrats, but fewer than a third are consistent in their opinions, holding values that reflect a deep attachment to democracy. This minority makes the constituency of anticommunists<sup>3</sup>.

The structure of dependency is threefold. On one hand, Romania has the highest percentage of peasants from the new would-be EU members (46%). More than half of them are engaged in subsistence farming and have voted consistently with the postcommunist party since 1990. Subsistence farming implies severe dependency on local authorities for various resources, from permits to collect wood to various licenses and aid in cash<sup>4</sup>. Therefore, not only the 'values' of

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<sup>2</sup> Romania is the only would-be NATO country where the archive of the Communist party is still in the hands of the Army and intelligence services, and thus inaccessible to the public. The figures on Party's informants are inferred from the archive of the Communist Party in Brasov, a public archive managed by the Romanian Institute for Recent History (IRIR).

<sup>3</sup> *World Values Survey Data*. The authors wish to express their gratitude to Hans-Dieter Klingemann for permission to use this database.

<sup>4</sup> See Alina Mungiu-Pippidi, Gerard Althabe: *The Sickle and the Bulldozer* (Polirom 2002, L'Harmattan 2004) for a detailed argument on local state capture.

peasants, but also the formal and informal arrangements, old and recent, explain to the voting behavior of the peasantry. The poor land restitution legislation, as well as the general situation of the Romanian countryside have turned the peasants into an easy prey for local predatory elites who control resources and, therefore, politics. While EU competition rules might diminish state capture in industry in a few years, it will take far more to reach the veritable 'black holes' of accountability in subsistence farming areas, which make islands of the Third World in a country poised to become a EU member in 2007.

Apart from its ten million peasants, Romania has a sizable population directly dependent on state welfare. With only 4 million people actively employed and a dependency ratio (active/assisted) of 0.66 the Romanian society has far too few autonomous individuals. Millions of pensioners, of which many early retirees, hang on tiny state pensions delivered by the postman and are mortally afraid of a regime which might endanger their safety net. Many pensioners, like many subsistence farmers, are below or around the threshold of poverty. Furthermore, Romania has the largest absolute number of Roma in Europe – between 1-1.5 million – another pool of captive voters for postcommunist parties. This population originating in the slaves liberated by mid-19<sup>th</sup> century has been the victim of disappearance of traditional jobs it used to live on, and of the collapse of demand for unskilled labor after Communist times. As they had had no land to benefit from restitution, they are the main losers of the transition and heavily dependent on social aid. The models in Fig. 1 explain the support for liberal democracy in Romania compared to the whole group of accession countries. The mechanisms emerge as similar, as the usual suspects, such as religion, prove to be insignificant, while rural residence, state dependency and collectivism are strongly associated with the lack of democratic commitment.

These two elements, the percentage of peasants in the total population and the percentage of active labor force, make an important difference between Romania and its Central European neighbors. They define the social basis of state dependency and emerge as important determinants of democratic and liberal attitudes. Other determinants, such as collectivism, are also grounded in this social structure. While in Central European countries the policies throughout transition focused on reducing dependency, in Romania the postcommunist governments sponsored dependency, especially between 1990 and 1996. This created a large constituency interested in preserving a large state and vast social redistribution. The correlation between the size of this group and the vote for postcommunists is both direct and through the intermediation of social and political values. It can be traced in every model explaining the vote for Ion Iliescu and PSD. In short, Romania's social constraints are far greater than those of its Central European neighbors and nearly all the progress in democratization that could have been done fast and by institutional means only was nearly achieved. The rest will lag behind until a new social structure will emerge out of Romania's slow and painful transition. As this 'new' social structure was all but helped by Romania's postcommunist governments, this end is nowhere in sight.

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**... while  
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**Fig. 1. Social constraints on democratic attitudes**

Independent variables	ROMANIA	All other candidates	Wording and scales
URBAN	.058*	.091***	(1=village to 8=city over 200 K)
ACTIVE	.121***	.091***	(Employed fully or partly and student=1, else=0)
WEALTH	.053*	.101***	Subjective evaluation of welfare from 1 to 10
RELIGION	--	ns	Scale based on likelihood denominations correlate with democracy according to Huntington: Muslim=1 Orthodox =2 Catholic=3 Protestant=4
CHURCH ATTENDANCE	ns		From 1=weekly or more often to 7=never
AGE	ns	-.030*	No years
EDUCATION	.070**	.091***	Age when finished school
STATE RESPONSIBLE VS. CITIZEN RESPONSIBLE	--	.089**	Scale from 1 to 10 with individual responsibility=10
CONSTANT		1.80** (.080)	B (Std error)
No.	1239	8559	
Adj. R <sup>2</sup>	5.8 (6.7)	6.9	

*World Values Survey data. Linear regression with commitment to democracy (scale from 1 to 4) as dependent variable. Pooled sample ALL includes all ten accession countries. Entries are standardized coefficients. p<0.5\* ; < 0.1\*\*; <0.01\*\*\**

How, then, was political change possible in 1996? A qualification and an explanation complement each other to account for that political swing. First, one must remember that anticommunists needed the postcommunist splinter PD to get a majority in 1996, and that the opposition PSD had a large share of parliament seats until its split a year after elections. Second, the change was the work of uneven mobilization, with the better off and urban constituency highly mobilized, and the poor and aged discouraged. To work a second time, such mobilization trends must be reproduced again.

Is this happening? Although it is difficult to predict mobilization six months before the nearest elections (local ones) and on the basis of surveys, this does not seem to be the case. Unlike in 1996, the lack of mobilization seems general in 2003. As a general rule, high mobilization favors postcommunist parties in East Central Europe, and low mobilization favors challengers. However, Romania in 2004 is exceptional on the account of the large number of temporary workers abroad (allegedly 2 million), who are unlikely to cast a ballot at all. Statistics on this group is scarce and every speculation far fetched until we know more on the demographics of migrants. What is certain is

**Democratization through quick institutional reform has reached its limits with the current social structure – and a new one takes time to emerge**

that the urban mobilization of the core anticommunist group is still moderate, with only 35% in favor of the two-party opposition coalition in Bucharest. With the most important event – the birth of the coalition – already spent, it is unlikely to have higher mobilization in 2004.

On the other hand there may be a demobilization of postcommunist voters, due to announced price increases and other socially painful reforms under way. Would this be enough to make a difference? Probably not. Rather, as populist versions abound, from better-known extremist Vadim Tudor to fringe new entrants like the millionaire Gigi Becali, many floating voters will get lost in unviable political alternatives, further reducing support for the two main challengers. 18% of the voters switched parties in 2000, mostly between PRM and PSD (in both ways), and such migration between populist nationalists and the government party is likely to occur again and be dependent on the performance of candidates in the TV debates. This is why the main political challenger – PD-PNL alliance – should present a duo with the PNL leader Stolojan for president and PD leader Băsescu for prime-minister. Băsescu is clearly, and despite the polls, the candidate with the highest potential among the main contenders, and this potential should be somehow capitalized even if he does not run for presidency himself.

## **2. SELF AND OUTER LIMITS TO POLITICAL CHALLENGE**

While support for postcommunists is constrained by the limitations of social structure described above, support for anticommunists has been fluctuating, due to the permanent competition among the many postcommunist parties and their difficulty to govern together in 1996-2000. However, it is not only for electoral reasons that the opposition in Romania has such low potential to challenge the postcommunist power establishment and propose an alternative vision to the Romanian society. Internal party limits are important and worth taking into consideration. The two opposition actors now grouped under the banner of Truth and Justice Alliance (DA) are restricted in their development by their inability to create a mechanism to attract, keep and promote the best people into politics, and become an alternative source of policy ideas. Most of their activity is limited to the Parliament, as they have too few resources to do more, and not once in the past year did the democratic opposition manage to contribute to the agenda with a proposal of its own. What happens instead is that the opposition is constantly reacting to an agenda created by the government or the media, to its great disadvantage.

To achieve more, it would need to have policy units organized and functioning in real time. But those do not exist yet, in spite of years of advice and assistance they have received from Western partners. The Romanian parties function with an outdated structure of policy committees of experts, who rarely meet, never publish anything, and end up as trash bins where lesser influential party politicians are dumped. Even assuming one such committee would one day come with a good policy proposal, they would still need to get support for it from where the real influence lies in the party. The opposition is not

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**The opposition is still unable to generate policy ideas and shape the public discussion agenda**

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nearing the moment when it could present a shadow government with each minister backed by a group of experts. Compared to the operating mode of successful oppositions in the recent past, such as the British New Labor, this structure is bound to fail. It does not attract expertise, it lacks a mechanism of easy decision-making and has no the potential to empower the best people. The opposition alliance should have invested in its rebuilding – but instead, it invested in sharing the spoils of the next elections (by means, for an instance, of an expensive opinion poll of doubtful utility), creating an uneven balance, which will impede performance and stir conflict among partners.

As SAR has recommended before, the DA Alliance could have increased its performance by:

- *Creating unified, not joint structures.* When structure such as policy committees work poorly in every party, giving them the supplementary task of coordination is not a good idea. The shadow ministers should be empowered to organize their own working groups. This would motivate politicians and experts both to invest time and energy in what is otherwise seen as a pure formal exercise – the development of an alternative party program.
- *Creating an alliance of equals,* not one in which one party dominates, as the National Peasants used to dominate the former CDR. Only alliances based on equality work. Even if Liberals would need to show some generosity in such a combination, as they do enjoy currently more electoral support, such behavior would eventually benefit them more than the alternative: the largest slice of a very small pie.
- *Giving up for a period of time internal democracy* and empowering the two party presidents to reorganize the local branches as one functional structure with executives appointed, not elected, and assigned clear performance tasks. Failure to undergo this painful change now means that it will have to be done after a possible defeat in elections. And then it would be even more difficult and less effective due to lack of credibility of leaders who lost an election.

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**But the main threats for the opposition are still external – the government use of electronic media, public funds and judiciary to silence its critics**

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Having said that, it is nevertheless true that the electoral success of the newly-formed DA Alliance is hindered more by outer than inner factors. Three of them are deeply concerning, as they threaten the fulfillment by Romania of the Copenhagen political criteria in the year negotiations with EU are supposed to be concluded.

**(i) Government control of electronic media.** Safe for the seldom occasions when opposition leaders are invited to talk-shows, criticism to the government, President or Prime Minister in prime time has de facto become impossible after being a widespread practice under the previous center-right administration. Control over TV stations, both public and private, is secured in many ways. Much of it is due to self-censorship by editors, as private TV network owners are badly in debts towards the state budget and therefore vulnerable (Fig. 2). However, direct telephone calls to editors to prevent certain opinion leaders to feature on TV, or to manipulate the circumstances when opposition

leaders are bound to be present, are also common. To escape political pressure, editors take refuge in light, tabloid-style news. In the last two years, TV news journals have become less political and more “yellow”, often featuring only rapes, violent crimes and traffic accidents. Although editors claim this is done to keep their ratings up, news are less and less watched, losing about 20% of the audience they had in 2000. The public TV is the only one still showing political news, but this means as a general rule showing the prime minister and government without any critical stand.

**Fig. 2. The debts to state budget of private TV stations**

	Payments due to state budget up to 30.09.2003 (ROL)	Observations
AMEROM TELEVISION SRL (parent company of Prima TV)	255,206,936,022	Procedure started for coerced payment
ANTENA 1 SA (parent company of Antena 1)	57,776,578,624	Rescheduling of debt under way
CORPORATIA PENTRU CULTURA SI ARTA INTACT SA (related to Antena 1)	51,257,023,493	Rescheduling of debt under way
MEDIA PRO INTERNATIONAL SA (parent company for Pro TV)	234,293,918,492	Rescheduling of debt under way
RIENI DRINKS SA (common ownership with National TV)	46,200,537,990	Rescheduling of debt under way
SCANDIC DISTILLERIES SA (common ownership with National TV)	43,151,393,401	Procedure started for coerced payment
ROSAL GRUP SRL (common ownership with Realitatea TV)	16,446,491,632	Rescheduling of debt under way

Source: Ministry of Finance website as of January 9, 2004; 1 bn ROL = 30,000 USD

Almost all private TV stations – anyway all the national ones – are in debt. The story of the money ProTV owes to the state and social security budgets has made its way into the 2003 *Freedom of the Press* international report by Freedom House. News monitoring reveals a weak presence of opposition parties on the screen in prime time: some opinion leaders known for their critical stand towards the government party are notoriously absent from every significant TV program. Prime Minister Năstase enjoys by himself over half of political appearances in TV news shows in the prime time, and non-government politicians fall well below a third<sup>5</sup>.

<sup>5</sup> Media Monitoring Agency, [www.mma.ro](http://www.mma.ro)

**(ii) Funding political corruption with slush funds from the state budget, and sponsoring political migration.** Corruption in Romania is inherently connected to the main resource worth having: the state. Starting with the influence that derives from getting oneself a position, or a connection to somebody, with influence – as no public service works but in a personalized way –, to the direct access to material resources, to cash for campaign logistics, the public resources are permanently abused. The participation of pure private funds to sponsoring corruption is insignificant by comparison. This implies that the main source of corruption is political, not economic. Political corruption is indeed identified by the public as a major problem. Most often it takes the form of traffic of influence, which culminates in phenomena such as political migration from one party to another by members of parliament and local officials.

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#### **HOW TO RECONQUER A LOCAL GOVERNMENT AFTER LOSING ELECTIONS**

*In Iași, Romania's third largest city, PSD has turned from an insignificant presence in the local council after the 2000 elections into a majority party, by individual recruitments and local mergers. The mayor, Constantin Simirad, was elected in 1996 under the banner of the anticommunist CDR, then in 2000 created a "regionalist" party as an electoral vehicle for himself, to then switch to PSD once elected in order to secure a nomination as ambassador, leaving his mandate unfinished. The local council appointed an interim mayor from the national government party, himself a migrant from PD, instead of calling for new elections. Due to political migration, the city is therefore ruled by a party it did not vote for and a mayor it has never elected. On top of this, the DA Alliance member parties intend to present separate candidates, diminishing their chances to win. Not only are these mayoral candidates questionable choices – they are also both migrants from each other parties. The PD candidate is a migrant from Liberals and the PNL candidate a migrant from the Democrats. This political farce is however tragic for voters, who see no meaning in local elections. There is none indeed if this is how politics works.*

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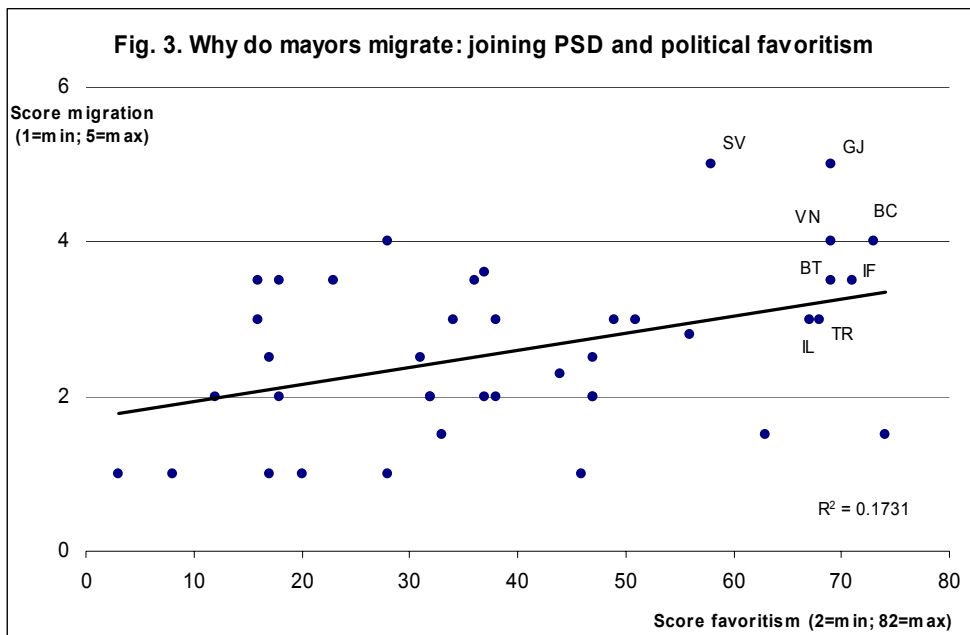
Political migration in Romania reached a magnitude unprecedented in Central European countries, not to mention established democracies. The situation is most serious in the case of mayors, who are directly elected. They switch party frequently, usually towards the government party or its satellites, as they perceive their legitimacy as personal and feel entitled to carry the constituency with them. By end 2003 PSD has nearly doubled its number of mayors compared with the situation resulted from the 2000 local elections, by recruiting from other parties. More than half of the Romanian mayors have changed their political affiliation in this interval, some more than once<sup>6</sup>. The practice

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<sup>6</sup> See SAR Policy Warning Report no. 3/2003 for MPs, and IPP Romania, <http://www.ipp.ro/altmateriale/IPP%20Mayors%20migration%202003.pdf> for mayors.

is more reduced in Parliament due to the electoral proportional system with party lists, but in case the system changes parliamentary migration risk skyrocketing from the current 14% towards the 50% level measured in the case of mayors. No statistics exist for local councilors, but certain cities are seriously affected.

Why do politicians get corrupted? Obviously enough, to get an ambassadorship, a higher position in the party, or simply enough money to build a constituency of political clients and get reelected. To illustrate this, Fig. 3 shows that there is a positive correlation, though weak, between the success of the county council leadership in attracting mayors into PSD, and the extent to which that particular county gets more money than it should from various central government grant funds<sup>7</sup>. But more important than the general correlation, the clustering of 8-10 counties, widely known for having privileged connections with the center, towards the high-end of the favoritism scale is telling in itself.



*Favoritism score = extent to which the respective county is financially privileged in the relation with the center, by getting more money than they should from the Roads Fund and the equalization grants pool (2002)*

*Migration score = political migration of mayors between 2000-03, average score by county*

**(iii) The use of the judiciary for political goals.** This is allegedly the most difficult to demonstrate. In fact it needs little demonstration. At the request of the Minister of Justice the opposition leader Traian Băsescu is again investigated for a case that was closed more than eight years ago, in spite of the lack of any new evidence. The only high rank political figure charged by the Anticorruption Prosecutor so far has been Ioan Mureșan, a minister in the former anticommunist

<sup>7</sup> SAR's analysis on data collected by SAR and IPP. The topic will be elaborated further in future PWR issues.

government. More recently, it took a whole judicial saga for the new DA Alliance to register legally after its appearance in 2003, being repeatedly harassed in Court under ridiculous pretexts<sup>8</sup>, until the case was eventually concluded in January 2004. And, the most outrageous case of all, the Bucharest police has just launched an investigation on 200 members of Popular Alliance, a small opposition party led by former president Constantinescu. Their guilt is that they submitted official requests for public information, based on the FOIA law passed in 2001, regarding an investment project run by the Ministry of Justice where they suspected some mishandling of funds. The Ministry complained to the police and the prosecutor office (the latter being actually subordinated to the Ministry) that some of the signatures on the requests may have been forged. However, they failed to explain what difference did it make if the signatures were real or given through intermediaries, and what law did these people broke since FOIA requests are not legal documents.

Why is it that no political alternative emerges for the better educated, committed democrats who make the lukewarm constituency of the DA Alliance? The answer lies in the absence of a yet mature alternative outside the Parliament. The electoral rules as designed in 2000 mainly by PSD with the inept help of Christian Democrats then in power have considerably raised the barrier at the entrance in the political system. From registering a party to getting a seat with the 5% threshold regime, life is not easy for a new political party. High hopes, especially from intellectuals, are invested in the Union for Reforming Romania (URR), a new party formed mainly by young urban professionals and business executives. But access to media of a party with no representation in Parliament and no high standing public figure is bound to remain low to inexistent.

### **3. SCENARIOS AND FORECASTS FOR 2004**

#### **A. Local elections**

Turnout in local elections will be low, as the frequent migration have rendered the local democracy meaningless in many cities of Romania. In villages, the domination of the government party is such that finding candidates willing to run, not voters, may be the main problem of opposition parties.

The extremist PRM may do better than in 2000 in some regions deeply affected by economic transition blues, and wherever PNL and PD will slate different candidates. By contrast, its results in national elections may be trimmed seriously by alternatives designed by opponents, such as Gigi Becali's New Generation.

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<sup>8</sup> Their acronym, DA, "yes" in Romanian, was judged by courts as a potential trigger of subliminal persuasion and the registering of the alliance was denied based on this reasoning.

PSD will have serious trouble in meeting its target of 50 %, as protest towards government policies will make urban areas turn increasingly to opposition parties, or even if to odd alternatives.

The Hungarian Alliance (UDMR) will face stiff competition in some key urban strongholds for the first time after 1990, and might lose some of them to smaller Hungarian challengers.

The newish URR might gain a few local councilor positions, but its overall performance will probably be below expectations.

## **B. General elections and government**

Turnout is likely to be lower than in 2000.

If the electoral system is the same, Romania will be governed again by a minority government, either formed by the current ruling party (PSD) or the opposition alliance (DA) which is not without chances if it bets on winning, not only increasing its share of parliamentary seats. The DA Alliance can improve its performance considerably and challenge PSD once a major change of strategy is implemented. This would require, however, giving up the separate contests in local elections and the bargain over seats, and putting forward a credible shadow government. Chances of an alliance of PSD with either DA or extremist PRM are slim, as PSD seems intent on treating the Alliance as the archenemy, not just as a political opponent. A coalition government with PRM is ruled out if PSD is to remain credible in the eyes of its international partners – primarily the Social International, which it fought so hard to join.

If the electoral system is altered in any way towards single-member constituencies, a combination of government-controlled gerrymandering and majority voting would ensure, however, an even stronger majority for PSD. This advantage for incumbents would be the greatest in the event of a double ballot voting system, which would push PSD and PRM into an electoral alliance, and ensure two thirds of the seats for PSD. It will be very strong in the event of a single ballot, pure majority system, where PSD would carry roughly 60% of the vote. Or it will be slightly stronger than in the current situation of proportional representation in any mixed variant.

Will the government fraud the 2004 elections? We at SAR do not think they will. There is no reason why we should suspect the Năstase government of such a gross and risky assault on democracy, which even the Văcăroiu government did not commit in 1996, when Romania was not a would-be EU member as it is now. The government is well aware of the importance of international opinion. But besides this, there is another serious reason why we firmly believe elections will not be stolen: there is no need for such a fraud. The domination of PSD is ensured through procedures which anyway step over the norms of liberal democracies each and every day. Discretionary allocation of funds for local governments, the use of law enforcement agencies to harass opponents, changing the results of elections through political migration, and rescheduling of the debts of electronic media

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**There will be no electoral fraud in 2004, but the erosion of institutions of voice and accountability will continue**

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companies as a tool for editorial control are things that should not happen in a modern European society. Still, they do happen in Romania. In 2004 the energy of donors and the civil society should be channeled into the fight against these undemocratic practices that tacitly but steadily erode laws and institutions, rather than into the chase for an elusive electoral fraud which is unlikely to happen.

# ECONOMY

## POLICY CHALLENGES IN 2004

What can one expect in 2004, in view of the specific conditions entailed by an election year, while the Government aims to conclude as many of the remaining chapters of negotiations with the EU as possible and get the status of a “functioning market economy” as an unambiguous statement? This section explores a series of economic policy issues for 2004, with particular focus on the macroeconomic agenda<sup>9</sup>. The challenges posed by the chapter negotiations with the EU – particularly the energy and agriculture dossiers – are not addressed here as they will be subjects of future reports by SAR.

### Focus

#### 1. THE OVERALL PICTURE

Romania has finished 2003 with a positive, but not unblemished macroeconomic record. Growth has been probably around 4.7%, inflation has come down to 14.1% (Dec on Dec), the budget execution has ended, apparently, with a deficit of 2.3% of GDP (less than the programmed one of 2.6%), and the reserves of the Central Bank have grown marginally to just below 8 billion euro (Fig. 1). Inward foreign direct investment also has risen to over 1 billion euro, though not in a spectacular fashion. These results were accompanied by upgrades made by the main rating agencies, albeit Romania is still several notches below an investment grade. What has spoiled the picture somewhat has been the big surge of the current account deficit, which is estimated to have reached about 6.5% of GDP (which is cca. 3% more than in the previous year). In addition, tensions related to an insufficient restructuring of the hard core of industry have continued to be felt and may have contributed to the rise of the trade deficit. An illustration of these tensions is the persistence of large arrears in the economy.

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<sup>9</sup> Important economic policy challenges, including issues linked with the privatization of BCR (the Romanian Commercial Bank) and Petrom (the oil state-owned company), were examined in previous reports. See also our prognosis for this year in the first section of this report.

**Fig. 1. Macroeconomic indicators**

	2000	2001	2002	2003*	2004**
Real GDP, % change	2.1	5.7	4.9	4.7	4.8
Inflation (CPI), end Dec	40.7	30.3	17.8	14.1	10
Budget deficit	-3.5	-3.3	-2.7	-2.3	-2.3
Current account deficit	-5.7	-5.6	-3.6	-6.5	-6
Total ext. debt,					
% GDP		31	32	32	34
% of exports		81	85	85	

Source: National statistics and own estimates

\*estimates, \*\*forecasts

Arguably, the economic year 2004 is important per se, but also for the direction the Romanian economy takes afterwards. This is so since disinflation is getting into a critical stage, whose further advance hinges essentially on fiscal and financial discipline; while the latter depend considerably on the restructuring of several key industrial sectors (such as energy generation and distribution).

## 2. WHY HAS THE CURRENT ACCOUNT DEFICIT GONE UP SO MUCH?

For those who have watched closely the dynamic of the trade deficit during the first half of 2003 its substantial increase should have been ominous. The summer time hopes that the deficit would moderate its rise were not vindicated, with big increases seen during the last quarter of the year. It is fair to say that, while the rise in the deficit is quite considerable (from 3.6% in 2002 to, probably, 6.5% of GDP in 2003), this evolution needs to be judged over a longer period of time. As a matter of fact, an average size of the current account deficit would be around 5% of GDP during the period 2000-2003. An inference would be that both 2002 and 2003 appear as opposite outliers. At the same time it is important to notice that, because of the insufficient level of inward foreign direct investment, a threshold limit for the safe financing of the current account deficit – in the case of the Romanian economy – appears to be around 7% of GDP. Whenever the deficit moved in the vicinity of that level its financing became pretty difficult and painful adjustment of the balance of payments were asked for. This situation is amply illustrated by the last decade.

What were the driving factors behind the rise of the current account deficit in 2003? A macroeconomic explanation would be the engine of economic growth last year, which was internal demand (and not exports, as in previous years). Other causes are to be found in the financial indiscipline and inefficiency of many actors (for arrears allow firms to import while not paying domestic creditors), heavy dependency of exports on imports of intermediate goods, the worsening terms of trade for the Romanian economy (oil has been more expensive), the severe drought which entailed additional imports

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**There seems to be a safety ceiling for CA deficit around 7% in Romania, due to low level of FDI; when this is reached, painful adjustments become unavoidable**

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of grains and other foodstuffs<sup>10</sup>, the low ability to produce competitive products, the real exchange rate appreciation of the domestic currency (and the euro's appreciation vs. the USD, which made imports from the US dollar zone extremely attractive), and last, but not least, the lowering of the general subsidy given to exporters since 2000<sup>11</sup>. Consumer credit, too, has made a contribution to this rise.

How should the stunning rise of consumer credit be judged in this context in view of the late public controversies in this regard? Commercial banks are justified in their wish to extend consumer credit as this product can generate handsome profits. Consumers, too, are happy to be able to buy on the basis of expected future earnings. Likewise, it is noticeable that consumer credit represents only about 20% of all non-governmental credit (about 2.4% of GDP), which would suggest that it is not the principal factor behind the ballooning trade deficit. That said, however, the speed of the rise of consumer credit has been stunning (by about 300% in one year), even if one considers the very low level from which it started and a simple fact, that only recently consumer credit has become available, as a mass financial product, to consumers. Therefore, some banks, which may have weaker internal prudential regulations, might face difficulties in the period to come, which can affect the banking system as a whole. Another worry is the one mentioned above, that the current account deficit is approaching a threshold level, which can question a sensible economic policy. Unless FDI finances the deficit to a larger extent<sup>12</sup> and the inflows of portfolio capital are less speculative, a deficit which goes beyond 6.5% of GDP would undermine policy credibility and pave the way for unpleasant surprises. This would be quite ironic in view of the series of upgrades Romania got from the main rating agencies lately.

### **3. POLICY TARGETS AND TRADE-OFFS IN 2004**

The assumed (some of them revised) main policy targets of the Government for 2004 are:

- bringing inflation down to a one digit level, to 9%;
- a 5.5% growth rate of GDP;
- a reduction of the current account deficit to 5.8% of GDP – albeit this figure is still being discussed with IMF experts.

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<sup>10</sup> The trade deficit for foodstuffs is likely to have exceeded 1 billion euro in 2003, which is about 60% higher than in 2002.

<sup>11</sup> This subsidy (a 5% profit tax for export oriented production, instead of the general one of 25%) was granted in 2000; subsequent commitments with the EU and the IMF have involved a gradual phasing out of this subsidy, which is to be terminated this year.

<sup>12</sup> The sales of large state-owned assets (such as BCR and PETROM) should not be seen as a means to finance the current account deficit. In general, it would be a mistake to use privatization revenues for consumption purposes unless terrible adverse shocks hit the country. These revenues should instead fund the production of public goods (including the reform of the pensions system)

The possibility to meet these targets has to be related to the pressures of an election year, the rise in the current account deficit, and structural constraints. Among the latter prominent are quasi-fiscal deficits, which can burden the budget exceedingly unless they are dealt with in due course. On the other hand, the aim of concluding negotiations with the EU would provide a good policy anchor.

There are two outstanding features regarding the policy targets. One is the highly ambitious disinflation rate (from 14.1% to 9%); the second is a looming conflict between the economic growth target and the need to control the current account deficit.

### 3.1. Achieving a single digit inflation level

The challenge of bringing down inflation at a one digit level should be examined in the context of an insufficient restructuring of the economy and the persistence of arrears. Previous PWR analyses have outlined this relationship, but the topic is so important that a reminder here is necessary. Hard budget constraints do not operate ubiquitously and loss making companies produce sizeable arrears/ quasi-fiscal deficits<sup>13</sup>. High inflation has been used by many companies as a means to stabilize arrears in real terms and, thereby, survive. Total arrears in the economy were about 38% of GDP at the end of 2002 (larger than in 2001 – Fig. 2). Reliable data are not yet available for 2003, but progress appears to be scanty. Interestingly, the share of the private sector has increased in total arrears, which is highly indicative of the intensity of moral hazard in the economy. Current disinflation strains increasingly loss-making firms and, unless restructuring makes considerable headway, persistent large quasi-fiscal-deficits would clobber the budget and, further, the economy in the period to come.<sup>14</sup> Disinflation would stalemate at one point in time unless hard budget constraints operate unabatedly.

**Fig. 2. Arrears of payment**

	1998	1999	2000	2001	2002
<b>National economy</b>	35.61	40.36	40.48	35.76	38.29
<b>To suppliers</b>	14.99	17.23	17.78	16.55	17.20
<b>To other creditors</b>	6.68	9.05	10.31	9.88	11.94
<b>To banks</b>	5.97	6.16	3.89	3.57	2.34
<b>To budget</b>	7.96	7.93	8.57	5.75	6.81
<b>Private sector</b>	15.37	18.66	17.71	19.28	20.9

Source: World Bank data

<sup>13</sup> Especially in the energy sector, where losses seem to be cca. 2.% of GDP yearly. Arrears (losses) are also significant in the petrochemical industry.

<sup>14</sup> Moreover, the persistence of large quasi-fiscal deficits would question the suitability of moving fast with the liberalisation of the capital account and the adoption of inflation-targeting in the near future. Adding quasi-fiscal deficits to the official public budget deficits has its own flaws methodologically (as a means to illustrate an actual "consolidated" public deficit), but ignoring/underestimating them would be a serious mistake.

### 3.2. Growth and macroeconomic balance

We believe that the pace of disinflation this year (to an annual rate of 9 percent) and the economic growth objective of 5.5 percent are clashing against the backdrop of the big surge in the current account deficit. One can imagine a scenario according to which the growth target would be least impaired by trying to stick to this year's current account deficit – in the hope that larger inward FDI and portfolio inflows would make financing relatively easy. The desire to maintain the economic growth objective of 5.5% looks quite attractive in relation with expected pressures during an election year. But this policy mix would jeopardize the macroeconomic balance by betting on highly variable factors. Consequently, a more sensible policy would try to diminish the current account deficit to below 6% of GDP. As a matter of fact, diminishing the current account deficit seems to have become a priority and policy is being reshaped to this end: liquidity has been squeezed by the Central Bank (which has made interest rates higher for RoI-denominated borrowing recently) and measures to restrain the expansion of consumer credit were announced by the central bank, the budget deficit target is going to be cut, probably, to 2.3% (from the envisaged 3%), and there is the intention of clamping down on quasi-fiscal deficits. All these measures are aimed at restricting domestic aggregate demand.

The bottom line is that bringing inflation down to a one digit level and reducing the current account deficit by a substantial margin (0.7-0.8% of GDP) would ask for containing domestic demand firmly, which, other conditions unchanged, would unavoidably bear on the GDP dynamic. Certainly, one needs to factor into all this picture the effects of the electoral year, which may cause policy slippages. There are premises for limiting collateral damage (coming out of populist measures) owing to the EU anchor (Romania wishes to conclude as many negotiating chapters as possible and get the status of a functioning market economy by the end of 2004). If policy slippages stay small a one digit inflation rate could be achieved together with a current account below 6% of GDP. Instead, a focus, primarily, on growth would harm the other goals. A policy mix which aims at optimizing under constraints would have to include a prudent liberalization of the capital account.

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**The targets for growth and disinflation in 2004 clash with the goal to reduce the CA deficit**

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### 3.3. Prudence in the liberalization of the capital account. Why?

Romania's economy needs capacity (instruments) to adjust to various adverse shocks because: quasi-fiscal deficits are large; the current account deficit has widened sharply in 2003; economic competitiveness is low and exports have been flagging lately (there are insufficient export products of high added value; there is a weak policy to stimulate exportable output, or to replace imports); dependence on private transfers from abroad is quite high (they stand at over 1.5 billion Euro and finance 30% of Romania's trade deficit); direct foreign investment is insufficient.

Unless adjustment capacity is adequate the budgetary policy would be overburdened. Overburdening of the budget policy can be easily detected in EU member countries as well, but in Romania's case it would be more severe. Total liberalization of the capital account would complicate the conduct of monetary policy and the exchange rate policy of the National Bank, and it could subject the economy to major shocks.. This is why it is welcome to see that the NBR has backed down on some of the programmed measures for 2004. Prudent liberalization would also help preserve a necessary degree of autonomy of monetary policy.

### **3.4. The impact of *acquis* implementation**

The relationship between inflation, financial indiscipline and, ultimately, economic growth would fall increasingly under the impact of the effects of the *acquis* implementation. Competition policy and state aid, in accordance with the provisions of the *acquis*, would put tremendous pressure on inefficient companies. It is true that arrears do not relate to state budget only and that this could soften the pressures resulting from implementing EU provisions, but the change of regime would be quite radical. Additional pressures would be felt via the gradual elimination of trade barriers and the need to comply with the *acquis* regarding environmental protection. Without massive restructuring and productivity gains many companies would have to bow out. On one hand, this would reduce pressures on the balance of payments; on the other hand, it could strain the economy socially. To reduce this strain job creation needs to be intense and, therefore, economic growth has to be durable. But durability of economic growth relies on deeper restructuring and financial discipline, on more inward investment. This is why restructuring is so important, in 2004 and in the years to come (for the implementation of the *acquis* would have to be speeded up after 2004). Thence, too, comes the high profile of FDI, as a means to help restructure the economy and supplement domestic investment.

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**The elimination of state aid and remaining trade barriers in the process of EU accession will drive many companies out of business**

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## **4. THE POLICY MIX FOR 2004**

### **Monetary policy**

Monetary policy has been tightened lately, for good reasons. The official euroization (dollarization) of the economy creates perverse effects to the extent people and companies raise their propensity to borrow in hard currency (when ROL-interest rates go up). If disinflation goes on successfully and there is sufficient fiscal support for it real interest rates would start coming down in a few months time. But much hinges on the Government not succumbing to populist pressures.

### **Exchange rate policy**

A closer linkage between the Romanian leu and the euro is appropriate for the sake of disinflation. But ROL's real appreciation can be deceptive unless quasi-fiscal deficits are reduced, wage policy is

prudent (despite the election year), and the budget deficit is under control.

### **Budget policy**

Budget policy needs adjustments in several respects. The budget deficit target for 2004 (3%) would have been scaled down in order to control the current account deficit. This adjustment should not be terribly painful due to better revenue collection – signs of which have been visible in 2003. Moreover, a diminution of quasi-fiscal deficits would enhance the work of lower budget deficit.

Budget execution has to be better implemented and correlated with the NBR's policy of controlling liquidity. The situation of last year, when only 0.7% of the programmed budget deficit (for the whole year), was executed by the end of last November should be avoided. This state of affairs has, quite likely, put additional pressure on the current account deficit in the last quarter, and it may complicate budget policy planning and execution in 2004.

Budget planning should account for the need to co-finance projects for which EU funding is available. This endeavor would be particularly challenging at a time when the implementation of the *acquis* starts to "bite" (think, for instance, about the costs implied by environmental protection) while NATO accession is pretty demanding for the military budget. A warning for what lies ahead is the fact that budget revenues have declined in the last three years<sup>15</sup>. Better tax collection, together with an adequate absorption of EU funds are a must for budget policy in the years to come.

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**Cofinancing EU-funded projects will create additional budgetary strains**

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### **Restructuring policy**

Restructuring at company and sector level is a must for reducing quasi-fiscal deficits. FDI would help in this regard, as well as the policy determination of authorities to impose harder budget constraints. Is it possible in an election year? This is a big question mark. There is some good news that segments of power distribution (gas, in particular) would get strategic investors this year; this is a field which demands massive investment for technological renewal and restructuring. On the other hand, failure to do it would undermine the quest to diminish quasi-fiscal deficits and, thereby, reduce the current account deficit in 2004.

### **Supply side measures are needed**

The agreements with the World Trade Organization and the European Union have left the country more vulnerable in the absence of adequate productivity gains. Moreover, available tariff barriers are used unsatisfactorily (there are many under-invoiced goods which enter Romania and not a few foreign exporters are practicing unfair

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<sup>15</sup> Romania's fiscal and non-fiscal revenues fluctuate around 30% of GDP (these are 35-40% in Central European and Baltic transition countries. The current medium term program of the Government forecasts a – somewhat surprising – tendency of stagnating or even declining budget revenues in the period 2004-2006

competition). Likewise, the protection of our markets via non-tariff means is quite inexistent. The enforcement of the *acquis* in the field of environmental protection and quality standards would entail additional costs on many Romanian enterprises.

Economic policy has to try to boost the competitiveness of domestic production, so that Romania exports goods of higher added value and domestic production substitute more imports. A policy designed to enhance domestic production does not entail fostering market competition only. Fiscal and financial instruments can be used. There is a need for financial instruments that would boost domestic saving and investment and, thereby, production. Giving up incentives for inward direct investments should, arguably, be delayed as much as possible (particularly, in the case of large investments). For Romania does not get into the EU in 2004 and one should use all available means to get the economy stronger before accession. The Commission in Brussels may disagree with such a policy stance, but realism and pragmatism have to imbue policy. The experience of some European and Asian countries is illuminating in this respect, while falling prey to economic fundamentalism would be harmful (fiscal neutrality in this case is a trap). Yet, it is essential that, by trying to boost domestic production, inefficiency and "rent-seeking" be not favored. Public-private partnerships should also be pursued in order to develop infrastructure and modernize the economy. PPPs could raise the investment ratio quite significantly and support economic catching up. Privatization in the energy sector should be accompanied by the implementation of an effective regulatory framework, which should protect both consumers and investors.

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**Supply side  
stimulants such as  
favourable  
regimes for FDI  
and agro-  
investments should  
be applied – and  
boldly negotiated  
with the EU  
Commission**

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Because commercial banks are highly reluctant to invest in the rural areas, while Romania has become, ironically, a large net importer of farm products and foodstuffs, special financial arrangements (financial entities) should be devised in order to finance farm production and the foodstuff industry, as well as modernize rural areas. More SAPARD funds could be used to this end. Again, the European experience, of younger or older vintage, should be used in this respected.

## 5. SUMMING UP

- 2004 will probably witness a trade-off between the growth target (5.5%) and the disinflation/current account deficit tandem goals.
- Sustained disinflation depends on reducing arrears/quasi-fiscal deficits. Inflation-targeting, itself, which the Central Bank intends to introduce in 2005, depends on the success in imposing hard budget constraints and achieving easy financing of external imbalances.
- The public budget deficit would better be scaled down (to 2.3% of GDP) for the sake of controlling the current account deficit. Diminishing quasi-fiscal deficits is essential for fiscal balance in the years to come (when Romania would have to bear additional costs entailed by the implementation of the *Acquis*). For this to

happen it is essential to restructure the energy sector and reduce the strain in the social security system.

- The costs of implementing the *acquis* could be overwhelming for not a few companies unless restructuring proceeds at a swifter pace.
- Rural development demands a much more coherent and financially consistent public policy; to this end there is need for specially created financial vehicles (which could use EU funds as well)
- Tighter pegging to the Euro and the real appreciation of the ROL would help disinflation, but it would ask for other effective means to reduce the current account deficit, unless inward foreign investment grows.
- Autonomy of monetary policy is needed for the sake of securing adjustment capacity to adverse external shocks. Therefore, liberalization of the capital account should be prudent.
- EU financial assistance (structural and cohesion funds) could make a big difference in supplementing budget revenues<sup>16</sup> and increasing the provision of essential public goods
- External negative circumstances for the conduct of our macroeconomic policy are, *inter alia*, increased foreign market volatility (competitive devaluations) and trade protectionism, which is on the rise in the world; a positive circumstance is the economic recovery under way in the main external markets for Romanian exports.

**Fig. 3. Medium term budget framework**

	2001	2002	2003*	2004**	2005**	2006**
total revenues	30.5	30.5	30.0	29.4	29.1	29.5
total expenditure	33.7	33.4	32.3	32.0	31.8	32.2

Source: National statistics

\*estimates, \*\*forecasts

<sup>16</sup> Budget revenues could be increased by EU funds to the tune of 2.5% of GDP.

### **Authors and contributors**

This report is brought to you by the following experts and collaborators of the Romanian Academic Society (SAR):

Alina Mungiu Pippidi (Politics section)  
Daniel Dăianu (Economy section)  
Sorin Ioniță (Issue editor, Forecast section)

*Layout: Emanuel Răuță*

Romanian Academic Society (SAR)  
15 Petöfi Sándor  
Bucharest 1, Romania  
++4021-2221868  
[office@sar.org.ro](mailto:office@sar.org.ro)