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Politics

CONFUSED

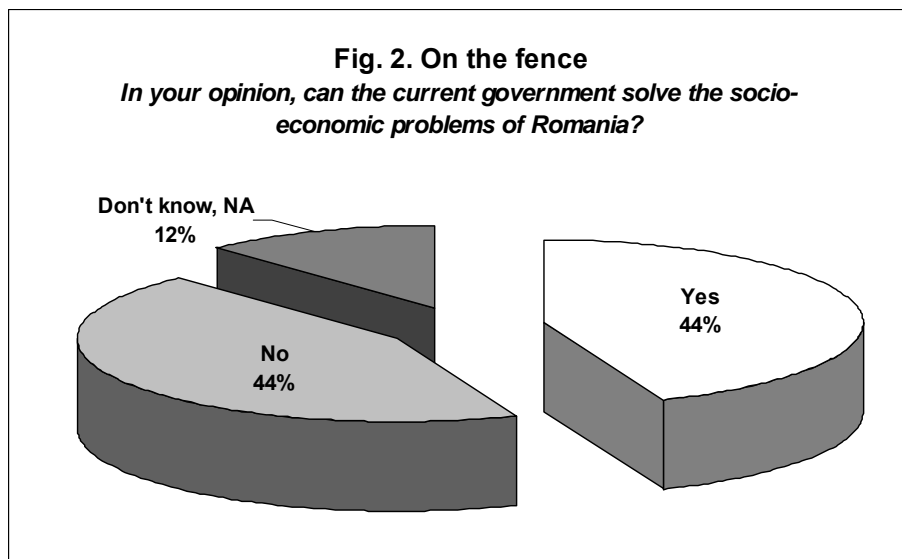
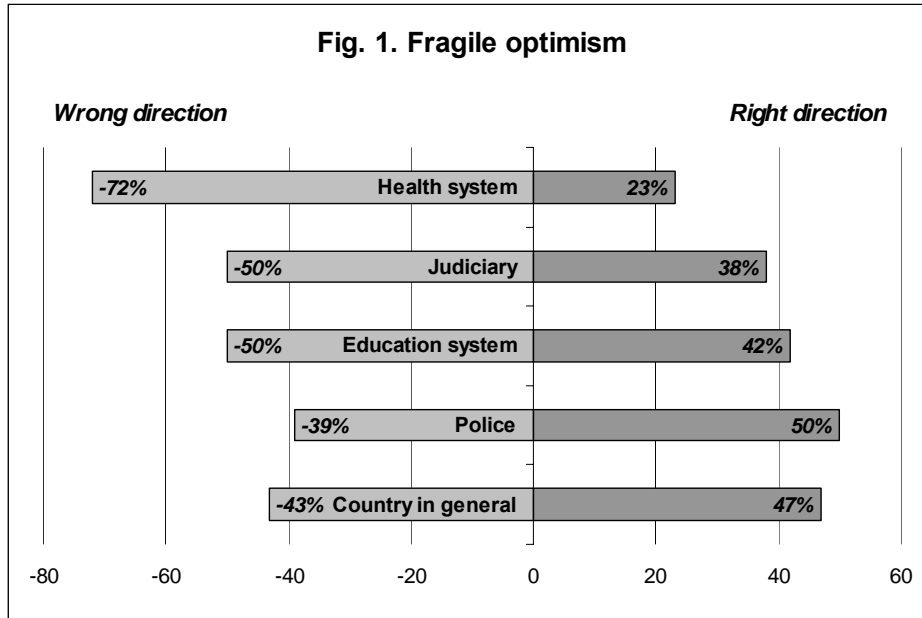
A Gallup Romania survey commissioned by SAR shows that despite public opinion not perceiving any major change in the country, the voting options are strongly in favor of the D.A. Alliance. The government however has reached a threshold, having as many supporters as skeptics towards its performance.

While waiting for the EC country report, the Romanian internal public opinion seems to be less affected by the incessant political scandals, as by the perception of the daily realities. Most of Romanians preserve their optimism, 47% considering that the country heads to the right direction, comparing to the 43% thinking that the direction is wrong¹. The opinion of the Romanians varies according to different segments: from institutions, the evolution of the police received the most optimistic appreciations, whereas the evolution of the health system is generally perceived pessimistically. The opinions concerning the education and justice remain still divided, with pessimists having the upper hand (Fig. 1).

Regarding the government's performance, the opinions are strictly divided. While half of the Romanians believe the government is able to solve the problems of the country, the other half does not. With only nine months in office and facing the winter ahead, the government could do much better. On the other hand, the two months debate on the political crisis and floods left their imprints.

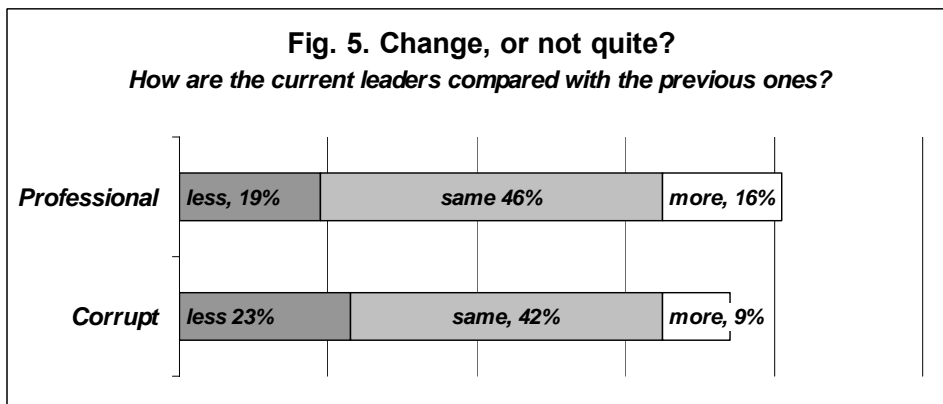
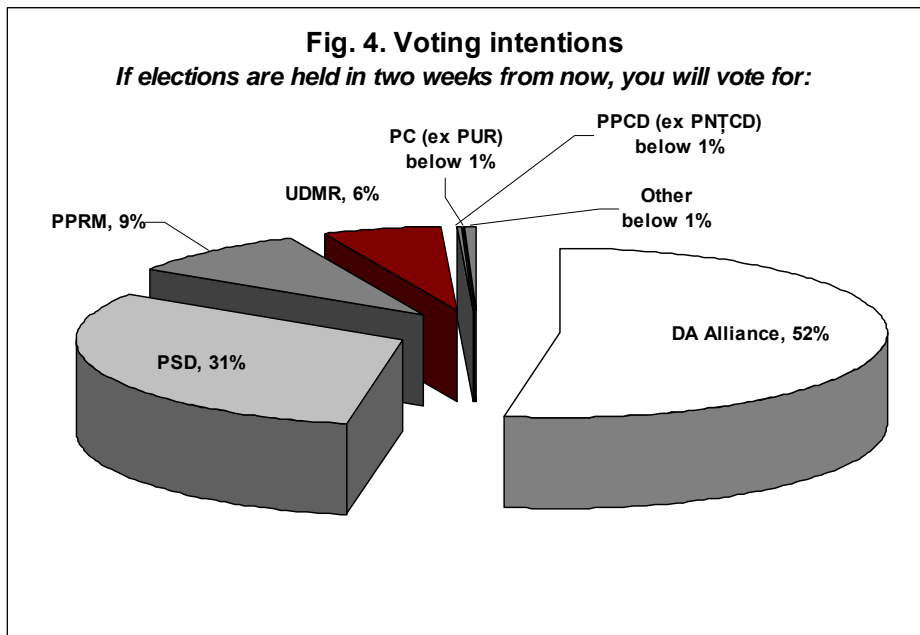
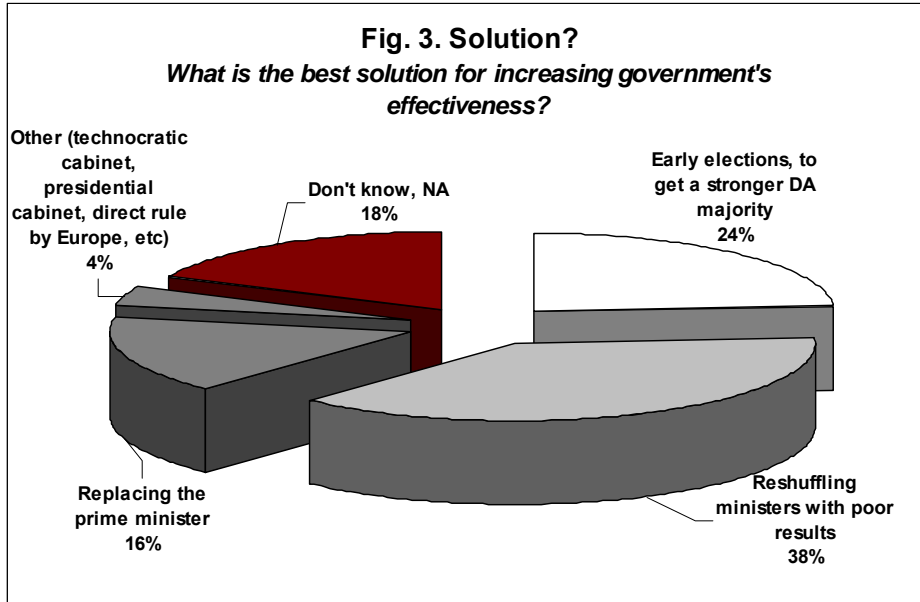
When we analyze the solutions suggested to improve government performance, the opinions are again much divided. The majority of those believing that the government does a good job consider as the best solution to reshuffle the ministers who are not good enough, while those having a bad opinion about the government prefer simply to replace the Prime Minister. The two sides, both for and against the government, are contributing in similar proportions to the group of those preferring to have early elections, which is actually the minority option for both groups.

¹ The results reported in the paper derive from a survey completed by Gallup Romania at the request of SAR. 1050 subjects were interviewed in the second week of September.



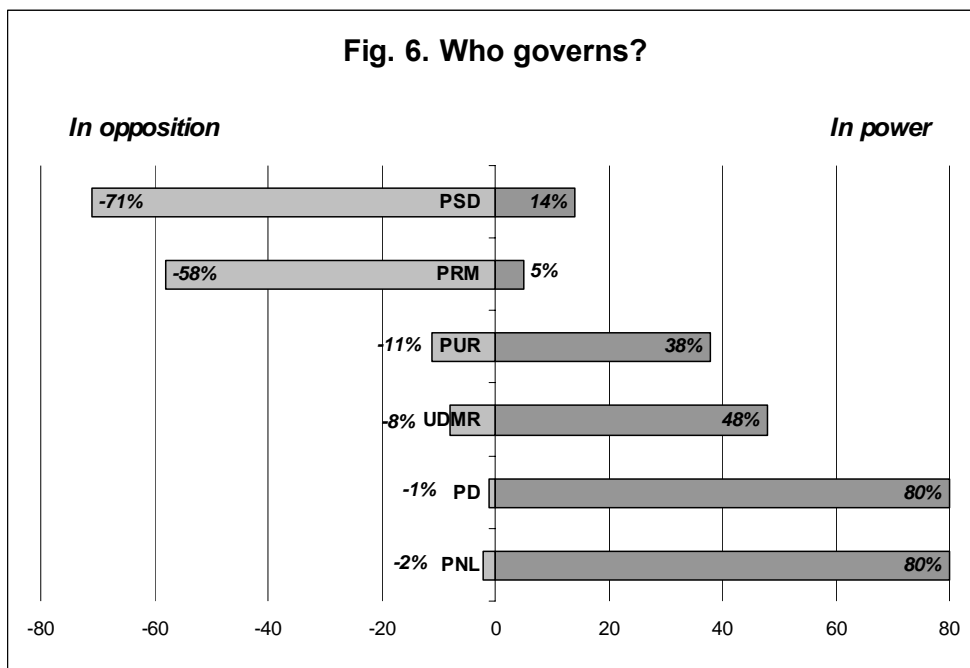
Finally, the option of reshuffling as you go is the most popular while it stands by itself, while the most radical options taken together (replacement of the Prime Minister, early elections, other options) gather more preferences. A significant part of those supporting the moderate option, which is the reshuffling, representing the largest group, would not vote in the eventuality of early elections.

Voting option shows a large majority for the D.A. Alliance which would have more than 20% ahead of PSD, and a fairly good performance for the Great Romania Popular Party (PPRM). Tomorrow's vote would appear more concentrated than yesterday's vote, with the two main parties gathering more than 80% of the votes. The turnout in case of early elections would be similar for both political camps.



The change is not perceived by the majority of the people, who does not see much difference between those governing the country nowadays and those governing it before the elections. There is a small majority at the level of those perceiving the present power as less corrupt, but for the majority of voters there are no major differences between the left and right parties regarding their integrity and professionalism.

The lack of interest towards the political events remains widespread. Even though 76 % state that they would come to polls in case of early elections, only one third reckon they have sufficient knowledge to cast an informed vote. 14% of Romanians still believe that PSD governs Romania, only 48 % are aware that UDMR is part of the government, and only 38 % only know that PUR is also part of the government.



Is it possible that a political clarification arises in these circumstances? Until now, the main actors have played only losing cards. Thus, the Prime Minister Tariceanu tried to compensate the lack of early elections by replacing the two oppositional presidents of the Chamber and the Senate and ended up by showing that the current govt coalition is not as professional as PSD in the art of parliamentary skirmishes. The President tried to promote the early elections, damaging meanwhile the reputation of the government as being controlled by various groups of interests. As PD could not go by itself to the early elections and it is bound to join PNL, the strategy of discrediting those pushed to elections is rather hazardous. PSD tried to emerge as a co-operative opposition force, but the way in which it blocked the two chambers of the Parliament showed that its force consists mostly in obstruction and no responsible government would commit itself to reforms in a Parliament having its agenda in the Parliament controlled by Mr. Năstase and Văcăroiu.

During the last week, there was an outburst of populist proposals, from the uninominal vote to a unicameral Parliament. These proposals suggest that the

emergency became again a reform of the political system. A debate is needed, but changes to political system should not be made into priorities or solutions to the problems, as their potential to solve the current problems is zero, because of the following reasons:

- Any constitutional change supposes a vote requiring the presence of two thirds of the reunited chambers of Parliament. It is hilarious to believe that a Parliament which does not have enough majority in order to introduce a reform on the agenda or to vote its own regulations, would meet the required consensus for deep constitutional changes.
- The main problem of the Romanian political class, and consequently of the government, lies in its incapacity to generate and support a public sector able to function on impersonal and objective grounds, instead of personal and subjective ones. This leads to an underperformance of the State apparatus in view of the good quality of human resources available in Romania. This problem affects similarly those nominally elected and those elected on the lists, the local and the central level of government. Therefore it is independent to the type of institution and consequently it can not be solved by continuously changing the type of Parliament, the electoral system, etc., even though numerous improvements may be theoretically undertaken to the above mentioned institutions.

What are the possible solutions? To address this problem, SAR recommends the following steps:

1. Reaching a consensus about the main problem to which we seek solutions, as the confusion expanded even in this matter. There is not anymore a realist and common vision on what the main problem is and without a hierarchy of the main issues, the different actors will keep on investing anarchically, in opposite directions.
2. Reaching a consensus on the immediate strategy to follow in order to solve the main problem, as well as on the long term strategies for the other issues.
3. Negotiating these solutions with the social partners, civil society, informing on time the public about the intentions of the government.

All these are basic issues. But somehow this is not how the government coalition operates presently. Therefore ***SAR recommends that any new reforms of the institutions should be looked on skeptically, as much more simple instruments within reach of politicians are not used.*** The government, the political parties and the presidency have enough instruments at their disposal to improve governance. Their good will is shown particularly by the nominations and the promotions they do, as well as by monitoring the people appointed in the office.

Regarding the political parties, they will have to build internal structures to monitor integrity. As long as the parties operate both at the central and local level with questionable people and are not interested in setting up a system of professionalism and integrity, they are not entitled to complain that other

political actors such as the President or the civil society undertake attempts to clarify them from outside and support their negative image. ***The reform of the political class cannot progress unless there is an internal reform of the parties.*** Not the State institutions should always be capsized, but the parties should be changed, probably also with the support of the future Agency of Integrity which will verify the conflict of interests and the properties of politicians and civil servants.

The undertaking of President Băsescu to force through a direct popular consultation the reform of the political system is legitimate, as the president himself was elected with such a mandate. But is the task a realistic one? Did the president properly weigh the instruments at his disposal and is he sure he will accomplish anything else but fuelling countless talk-shows in mass-media? During the reshuffling of the ministers, which is a minor reproduction of the early elections, the number of the state secretaries from the Foreign Affairs almost doubled, but the ministry has failed so far to deliver any concrete proposal in the realm of the famous zero priorities. The foreign policy is subordinated to the President, thus emerging the obvious question why doesn't he put into effect his influence in order to create an exemplary area of government, an example for the rest of central administration. It is obvious that the present administration is less corrupt than the Năstase government, but the increasing number of state secretaries, counselors or directors whose positions are justified only by the necessity of awarding offices to some clients with no expertise in these fields is a source of concern. Tax increases are planned in order to increase the budgetary income, without even a minimal examination of the waste in the central administration. Of course, having the European integration as main priority, a reform of the government comes only secondly. But even its future accomplishment seems impossible if today practices and individuals are encouraged which will become the main impediment to any future substantial changes.

Economy

ROMANIA'S JOURNEY TO LOW INFLATION: RECORD AND POLICY DILEMMAS

Romania's GDP grew by an annual average of over 5% during 2000-2004 and a similar rate is expected in 2005. Inflation came down to 9.3% in 2004 (from over 40% in 2000) and a further drop, to 8.3-8.4% is likely in 2005. Fiscal consolidation has been under way for several years now with budget deficits close to -1% of GDP lately. The private sector produces almost 70% of GDP while the banking sector is on a much sounder foot. Romania's accession in 2007 and catching up prospects hinge on furthering structural and institutional reforms.

Aspirant countries to EU accession are asked to comply with two fundamental requirements: to have a "functioning market economy"; and to withstand competitive pressures inside the economic and, eventually, the monetary union. The first requirement – "the existence of a functioning market economy"² – connotes an institutional set up (the functioning of basic market institutions) which would enable, *inter alia*, effective financial discipline (exit and entry market take place easily), proper law enforcement and protection of property rights, effective financial intermediation, an adequate policy mix framework, which ensures efficacy in dealing with powerful adverse shocks. The second demand takes cognizance of the dramatic reduction of the scope of national economic policy in a region where intra-trade barriers no longer exist, capital flows freely, in which a single currency and one monetary policy operates in 12 (out of 15) old member countries, and in which, in a softer form, the Exchange Rate Mechanism (ERM2) would constrain exchange rate policy in the new member states significantly, etc. Both exigencies are seen as essential for enhancing nominal and real convergence –without which the Union would be undermined from within.

As a matter fact, the lack of sufficient convergence inside the Union and competitive pressures from outside, as well as increasingly strained welfare systems point to a more complicated picture when it comes to explaining the

² A "functioning market economy" is quite curious terminologically; this notion cannot be found in an economic textbook, since all market economies are functioning, whether well or bad. What the experts in Brussels have, most likely, in mind is a "well functioning market economy", which relies on a sound institutional setup and low information and transaction costs for the sake of needed resource reallocation.

sources of economic performance and EU fitness. The Lisbon Agenda is a reflection of this reality check, but also of the inability of many of the EU member states to find adequate responses to global competition and social strain. Against this backdrop one can judge the growing mefience vis-à-vis further enlargement – to low-wage countries – among citizens of “Old Europe” and the more severe scrutiny Romania is going to face in its quest to join the Club in 2007.

There is an additional angle through which Romania's quest to join the Union can be judged –as a means to cope with a developmental challenge of long vintage. With an income per capita of cca 30% of the EU average Romania has a long way to go in this regard. Furthering structural reforms would enhance the ability to catch up economically.

I. Where does Romania's economy come from

The last decade presents a complicated story of transition in Romania. Major disputes concerning privatization, the pace of economic reforms, the attitude towards foreign capital, translated into political fighting that influenced the coherence and consistency of reform policy. Romania experienced a sinuous economic evolution, of the boom and bust type, with major fluctuations of output and persistent high inflation.

Economic recovery/growth since 2000

The year 2000 revealed signs of economic recovery; the fall of economic activity was reversed, inflation started again to come down and an export boom took place. The GDP rose by 2.1% in 2000 and inflation came down to 40.7%. Significantly, too, although Romania experienced troubles on its financial markets during that year, the banking system withstood the pressure and continued its convalescence (after the failures of two major state owned banks). As a matter of fact, a massive cleaning up of the banking system has taken place in the last few years. At the same time, the share of the private sector in the banking system increased considerably.³

Growth speeded up during 2001- 2003, when it hovered around 5%. In 2004 it jumped to over 8% owing to a remarkable harvest. For 2005 the growth rate is to stay around 5%. During all this period fiscal consolidation has been under way; the budget deficit came down to 1.1% in 2004, and quasi fiscal deficits have narrowed. For 2005 the budget deficit will stay close to 1.0% of GDP, which takes into account the effects of the big floods of this year.

The progress with disinflation is particularly commendable during the last few years, for Romania was an outlier in this regard until recently. Likewise, the rise in the reserves of the Central bank to over 17 billion euro (in September 2005) is a plus at a time when the capital account liberalization is almost complete. The Central Bank (National Bank of Romania) has weathered quite successfully the access of non-residents to local bank accounts and local currency denominated interest rates have been declining during this period. These results have prompted upgrades from the main rating agencies. Thus,

³ The last two state owned banks (Banca Comerciala Romaana, and the Savings Bank/CEC) are slated for privatization in the period to come.

Romania got investment grades from Fitch in 2004 (BBB-), and from S&P a year later.

A major novelty of 2005 is a fiscal policy reform, via a 16% flat tax, which has aimed at boosting inward FDI and making the economy more transparent. This reform can be judged on its own, but also, within the context of fiscal competition that is taking place throughout Central and Eastern Europe. A downside, however, of the fiscal reform is that it was done pro-cyclically, at a time when the economy was being fuelled primarily by domestic demand and external deficits were growing quite rapidly; this means that a fiscal stimulus was hardly welcome at this moment in time and, consequently, the Government was forced to adopt a series of compensatory measures in order to boost budget revenues and control expenditure. In addition, the fiscal reform did not touch social security contributions which, at 49.5%, are among the highest in the Region and do not enhance job creation in the official economy.

What has spoiled the picture somewhat in recent years is the surge of the current account deficit, which grew to 6.9% of GDP in 2004 (compared to 5.6% in 2003 and 3.6% in 2002); by including non-repatriated profits the deficit came close to 7.8% in 2004. The rise of the current account deficit in the first semester of 2005 is about 60% (as against the corresponding period of 2004), which may bring it to above 9.3% for the whole year. The major expansion of domestic credit (of hard currency denominated, in particular) and exchange rate appreciation are at the roots of this big rise. The surge in imports includes machinery and equipment, which is good for industrial renewal. However, the speed of the rise in external deficits should ring the bell.

The volume of FDI (which stood at over 12 billion euro at the end of 2004) is considerably below the volume registered in Poland, Hungary and the Czech Republic. Inward foreign direct investment is needed in order to restructure and modernize the real economy, energy production and distribution included.

Table 1: evolution of main macroeconomic indicators in Romania

	2000	2001	2002	2003	2004	2005*
-Real GDP, % change	2.1	5.7	4.9	4.8	8.3	5
-Inflation (CPI)						
End of Dec.	40.7	30.3	17.8	14.1	9.3	8.3
-Unemployment	10.5	8.8	8.4	7.4	6.2	5.8
-Budget deficit	-3.5	-3.3	-2.7	-2.3	-1.1	-0.8
-Current account deficit	-5.7	-5.6	-3.6	-5.8	-6.9	-9.3
-Total ext. debt, % GDP	30	31	35	32	30	32
% of exports	80	81	85	85	81	80

*Source: National statistics and own estimates; * own forecasts.*

II. Economic performance: pluses and minuses

Romania's economic performance has improved substantially in recent years; this motivated the European Commission to grant the status of a "functioning market economy" in 2004. But this status cannot obscure significant weaknesses with regard to financial discipline, enforcement of market regulations, transparency and stability of the regulatory framework, the public administration and the judiciary, the strain in the pensions system. The deepening of reforms has to make the economy stronger, capable of withstanding pressures inside the Union.

Economic progress to build upon

Romania's economic advance should be judged from two perspectives: one that looks at structural changes in the economy; and one focused on macroeconomic policy.

The steady expansion of the private sector in the economy has been accompanied by more entrepreneurial drive, more capital formation and export orientation. The private sector's contribution to GDP formation is nearing 70% while it accounts for over 55% of social capital in the economy and more than 70% of the employed population. There has also been a significant rise in foreign trade and integration into EU markets; trade with the EU means cca 2/3 of overall trade. Openness of the economy is also indicated by the share of foreign capital in the banking industry and telecommunication; energy markets have been also opening quite rapidly, incidentally, more than in some of the old EU member countries (though one has to stress here the importance of effective regulations so that new owners of public utilities should not abuse their market power).

The banking system is much sounder nowadays, after a massive clean up operation in the late 90s and the introduction of a new regulatory framework that fits the BIS new recommendations. This evolution has taken place on the background of increasing foreign ownership in the banking sector, which has meliorated corporate governance. The banking system has increased its capacity to provide effective intermediation between savers and investors, and lending and borrowing rates have decreased substantially. The range of financial products has increased remarkably and has fuelled non-governmental credit;⁴ the latter has boomed by over 70%, in real terms, in the last couple of years. It is noticeable that despite this rise prudential indicators are still in safe territory⁵. The non-banking financial sector has developed rapidly; the best indicator is the market capitalization of the Bucharest Stock Exchange: from 1.04% of GDP in 1999 and 3.3% of GDP in 2001, it moved to 8% of GDP in 2003 and cca. 14% of GDP in the first half of 2005.

An adequate macroeconomic policy mix has under-lie(d) disinflation (table 1). The Central Bank has focused more clearly on fighting inflation and fiscal consolidation has helped it. Albeit quasi-fiscal deficits still blurs this assessment

⁴ The annual yield for t-bills, which was a major attraction for banks' investment policy, decreased from 76.0% in 1999 and 35.7% in 2001 to 17.3% in 2002 and cca 8% in June 2005; this has prompted banks to orient increasingly toward consumer and production finance.

⁵ Even if some numbers are likely to be overstated the overall picture evinces a remarkable turnaround as against the late 90s.

it is encouraging that they have shown a tendency of decline lately. Likewise, budget subsidies have declined steadily and energy prices have come close to EU wide levels, which should improve resource allocation and cost management, though it is quite painful for low-income people.

Table 2: Key prudential indicators in the banking system

	1999	2000	2001	2002	2003 2004
Solvency rate (>12%)	17.9	23.7	28.8	25.0	21.09 18.79
Bad loans, as % of total assets	2.36	0.29	0.32	0.23	0.22 0.18
Credit risk rate	35.4	3.8	2.5	1.1	3.37 2.85

Source: NBR statistics (monthly bulletins)
Capital adequacy – net assets / total assets; Credit risk – unadjusted exposure relative to loans and interest under “doubtful” or “loss” / total loans and interest excluding off-balance sheet items

Table 3. Key macroeconomic indicators compared to Maastricht criteria: EU candidate countries one year before they got into the Union (2003) and Romania in 2004

	Budget deficit (% of GDP)	Public debt (% of GDP)	Inflation (%)	Interest rate on 10 years € bond (%)	Exchange rate stability
Target	-3	60	<2.8	<6.8	yes
Czech Republic	-7.8	34.5	0.4	4.63(23/6/2014)	No
Hungary	-5.5	56.8	4.7	5.5(6/5/2014)	No
Poland	-4.6	44.8	0.8	4.5 (5/2/2013)	No
Slovakia	-5.2	43.8	8.1	4.5(20/5/2014)	No
Romania	-1.1	27	9.3	-	No

Source: Countries' national banks

The openness of the economy has been broadened functionally by capital account liberalization (KAL), which is almost complete (access of non-residents to local bank accounts was allowed in April 2005). KAL has been quite complicated because of relatively high interest rate differentials and substantial speculative inflows. The Central Bank has been walking on a tight rope in this respect, but it has done it commendably. A negative fallout, however, is the surge of external deficits owing to the appreciation of the Romanian currency and the big rise of domestic credit. It should be said that KAL is a prerequisite for EU accession⁶ and relates to direct inflation targeting.

⁶ Capital account liberalization in Romania can be seen as optimization under severe constraints, for interest rate differentials and low monetization (share of financial intermediation in GDP) would have justified a more gradual process. But, EU accession demands full KAL at the time of entry.

The latter indicates the wish of the Romanian central bank (NBR) to bolster its operational independence and focus even more on reducing inflation.

It is instructive to compare the current state of the Romanian economy with the situation of some new EU member countries one year before they got into the Union (table 3)⁷: comparatively Romania does not fare much worse.

What clouds the sky

But serious weaknesses persist in the Romanian economy, which could harm macroeconomic conditions and GDP growth over the longer term unless they are addressed consistently. This caveat does not refer to unavoidable business cycle related fluctuations, but to a possible relapse into revived inflation and balance of payments difficulties. These weaknesses are rooted in:

- loss making companies that produce sizeable arrears and quasi- fiscal deficits. The current disinflation puts pressure on these companies, and unless restructuring makes more headway persistent large quasi-fiscal-deficits would clobber the public budget in the years to come.
- budget revenues are around 30% of GDP while financing needs are bulging. Unless tax collection improves considerably Romania faces a budget “shock” at the moment of accession because of inescapable financial obligations (co-financing of EU funds; the EU budget contribution; etc). Consequently, the budget deficit could rise again above 3% of GDP, which would worsen public finances; it would also involve a further rise in the current account deficit, which might be unsustainable and cause a sharp depreciation of the Leu, eventually, and an inflationary bout, consequently.
- the investment climate is plagued by administrative and red tape barriers, by corruption
- the pensions system is under increasing strain; it is unbalanced, with much of its financing coming from the health insurance budget. The problem is of a chronic nature, because the number of the retired population exceeds the number of statistically official employees (the ratio is nowadays 3:2, as compared to 1:2 in the early nineties). Intense migration also complicates the story. An unreformed pensions system would strain the public budget in the years to come.
- the agricultural dossier is burdensome and an issue of concern in Romania's relations with the EU. About 35% of the population lives in the rural area, while agriculture contributes a mere 12-13% to the GDP formation and hardly, if at all, to the public budget. The future of Romanian farmers is not a topic much present in the public debate, and the level of awareness of what EU accession involves is quite low. In the EU there is an increasing propensity to further reform CAP for the sake of reducing agricultural subsidies (and allocate more funds to advanced R%D related activities); Romania would be adversely affected by such a reordering of priorities.

⁷ For an insightful comparison between the New EU Member States, on one hand, and Bulgaria and Romania, on the other hand, see Koromzay (2004, pp 63-67). See also Lanzeni (2005)

- labor markets are still rigid; unemployment has been kept at a reasonable level because many Romanian found an outlet abroad. Some estimates put the number of Romanian citizens who work abroad well over 1 million. Hopefully, changes in the labor code and reduced social security contributions will help redress this situation

III. Policy dilemmas and challenges

The weaknesses mentioned above and developmental challenges create major policy dilemmas which Romanian policy-makers need to address carefully in the run-up to and after EU accession; the effectiveness of the policy needs to be secured amid a series of trade-offs such as:

- tight budget deficits that should help bring inflation down to cca. 3-4% by 2007/2008, while needed infrastructure and environment related projects ask for substantial public financing;
- minimal trade protection and substantial exchange rate appreciation could entail further rises in the current account deficit so that the burden of adjustment would fall on the public budget increasingly; overburdening of the budget policy would be deepened by inflation-targeting at a time when EU accession demands ask for higher budget revenues.
- strong exchange rate appreciation, because of substantial capital inflows (including growing remittances from Romanians who work abroad –ca. 2.5 billion euro in 2004), could cause a “Dutch disease”⁸ unless productivity gains are adequate. The Italian syndrome should be a lesson in this respect!
- interest rates cuts, while capital account liberalisation proceeds further, may widen external deficits;
- the current type of competitiveness (based on wage differential) vs. the innovation-driven type of economies, to which Romania is trying to converge (Romania’s spending on research and development is seven times lower than the Lisbon target of 3% of GDP)?.

The dilemmas sketched above constrain policy heavily; they suggest, at the same time, policy guidelines.

- In terms of economic and market structure there is need to harden budget constraints in the energy sector and streamline state aid –which should fit EU requirements. State aid is a policy item that can trigger the safeguard clause and delay Romania’s accession.

⁸ “Dutch disease” refers to a financial bonanza that befalls a country following the discovery of, let’s say, major oil fields. Greatly increased oil related export revenues would appreciate the national currency exceedingly and harm the manufacturing sector, ultimately, unless adequate productivity gains are achieved.

⁹ Though, one has to acknowledge that the crux of the matter for the Romanian economy (as an emerging economy) lies more in absorbing than in inventing new technologies.

- Privatization in the energy sector can bring in massive, badly needed inward foreign investment and help modernization and restructuring decisively. But energy markets (like financial markets) have to be well regulated so that market abuse be prevented –which is particularly important in a much less affluent society. The experience worldwide should be a lesson to Romanian policy-makers.
- Tax collection and the broadening of the tax base have to improve considerably so that the co-financing of EU funds and the provision of public goods respond to Romanian economy's needs; the latter are linked with coping with competitive pressures inside the Union without entailing a big rise in the budget deficit. It would be great to see budget revenues go up by, at least, 4-5% of GDP in a few years time¹⁰.
- Multiannual budget programming has to help policy set priorities according to judicious, long term based, cost and benefit analysis.
- The ongoing crisis of the pensions system puts an additional burden on the public budget; a new pensions system is required, that would include several pillars (like in Poland).
- Another big challenge is to increase the capacity to absorb EU funds. EU financial assistance (structural and cohesion funds) could supplement budget revenues substantially and increase the provision of essential public goods (infrastructure, education and health care). EU assistance would crowd in other funding, from private and public sources. But the track record of absorption is poor¹¹ and unless this capacity grows significantly EU funds may diminish in the future –against the backdrop of the dispute between donor and recipient countries over the structure of the Union's budget. Spain's experience in using EU funds should be studied by Romanian policy-makers. An idea to consider is to form a financial institution with the aim of using public and private funds in order to help develop infrastructure. Privatization revenues, capital raised by issuing long term bonds (on behalf of his institution) , plus other mobilized resources, would be channeled toward financing badly needed projects. The latter would have to be prioritized in view of the modernization challenges of the Romanian economy and its EU related obligations, and of the need to relieve the public budget of excessive strain.
- Romania needs to spend substantially more for education and R&D as a strategy for long term development (for endogenous growth), even if local research and development would be linked primarily to the assimilation of imported technology. This is quite normal in an emerging economy, that tries to capitalize on the world stock of knowledge. A challenge is to reduce the dependency on labor-intensive production (exports), which increasingly is dominated by low wage Asian manufacturers. The expected and unavoidable rise in wages in the years to come would price out many

¹⁰ There are pieces of analyses (including a recent World bank study) that show that with proper a reform of the tax collection system would bring in between 4-5% of GDP additional budget revenues in Romania; this would involve a broadening of the tax collection base.

¹¹ Currently, this capacity is quite inadequate; for instance, the absorption of ISPA funds (infrastructure and environment related projects) is a mere 12%!

firms (sectors) in labor intensive production unless productivity gains are commensurate and higher value added products are gaining share in output.

- A rapid expansion of rural credit mechanisms (that involves the efficient use of EU rural development funds) and land consolidation would be among the solutions for rural development. The fate of Romanian agriculture depends on how the Common Agricultural Policy will be shaped in the years to come and on how Romania will use the EU financial assistance oriented toward this sector.
- The Romanian economy has distinct characteristics that ask for a careful consideration of the appropriate monetary and exchange rate policies; low monetisation, the wide use of the¹² euro and the US dollar in local transactions, complicate the conduct of monetary policy. Likewise, the still large stock of arrears and potential future pressures on the government budget (such as the high cost of pensions expenditure or fiscal costs in the run up to EU entry) require an enhanced co-ordination of monetary and exchange rate policies with budget policy. NBR has introduced inflation targeting in August 2005. Arguably, a 'soft' form of inflation targeting (a gradual introduction) is appropriate¹³. This 'soft' monetary framework would focus on inflation but would consider shorter horizon (two-four quarters) than the medium term¹⁴, it would not neglect exchange rate completely and would work closely with the government on budget policy. The full opening of capital account would be done at the time of EU accession.
- The labor code has to protect workers against abuses. But it has to make labor markets flexible enough so that industrial/economic restructuring occurs at an appropriate speed. Romania should not get into a sort of a mess one encounters in some of the old EU member countries. The labor code issue brings to the fore the model the Romanian economy would evolve toward.

IV. Which European model

Arguably, the European model underlines the need for preserving social cohesion and extols the virtues of social solidarity. On the other hand, the welfare state, although in a varied form, is a ubiquitous trait of advanced capitalism worldwide. And some convergence among the patterns of functioning of capitalism has taken place in the last couple of decades under the spell of globalization. Likewise, inside Europe, too, there is significant social and economic variety, which makes people differentiate between a Scandinavian model (with its emphasis on social redistribution, but quite flexible labor markets), a "core" model in Germany and France, the British model (which is closer to the American model), and a Mediterranean model,

¹² See also Antohi et. al (2003) and Citu (2005)

¹³ Daianu and Kallai (2004)

¹⁴ This is because still intense required transformation in the Romanian economy complicates the tasks of econometric modeling –which is a must for direct inflation targeting.

which seems to be of a more “disorderly” sort (although the bulging budget deficits in Germany and France have cast some doubt on this view lately). Likewise, some new EU member countries (from Central and Eastern Europe) practice a more liberal (in the European sense) form of market economy.

The EU project does influence national public policies by spreading common standards and imposing common rules of policy-making and institutional set ups. However, the Union is strained by a highly visible contradiction between its entrenched welfare model and the need to make markets more flexible. This contradiction would not be so acutely felt in the absence of tremendous pressures exerted by globalization, by the competition from low wage economies (including eastern European neighboring countries). Globalization (the economic rise of Asia, in particular) undermines the lavish welfare state in western Europe. Social assistance and pension systems are being overhauled; this painful and politically very sensitive undertaking is taking place against the background of population aging. The experience of Finland, Denmark and Sweden (in going from welfare to workfare) provides interesting policy venues for other EU member countries.

Although globalization has a non-trivial ideological component the forces at work have acquired a powerful momentum of their own, which is driven by technological change and intensified competition. The latter can be restrained by bouts of protectionism (in trade and competitive devaluations) and security concerns, but its power seems to be unstoppable. The rise of China and India in the world economy changes hierarchies and can turn non-zero into zero-sum economic games; thence arises the fear of outsourcing/off-shoring. For it is quite impossible to compete with economies where labor costs are 10, or 15, even 20 times lower, other conditions being fairly similar.

Romania has to adopt EU rules. But it needs to do it in such a way that its economy improves its performance steadily and catching up becomes reality. Romania's labor costs are hugely lower than in most EU member countries, but similarly lower is its overall productivity. Therefore, which “European model” to evolve to is a relevant policy issue for Romanian policy-makers and heads of companies.

V. Final remarks: EU's role

In spite of the results of the referenda in France and Holland the EU is a stark, indisputable reality and it will stay as such for the foreseeable future. For most European non-EU member countries the big political and economic “game” is to join the Union.

The EU can play an exceptional part in Romania's transformation and modernization drive; it is an extraordinary chance to overcome the trap of backwardness, to accomplish a secular quest for modernization. It should be noted that Romania has an income per capita that represents roughly 30% out of the average of the European Union, being at the same time a country with a relatively large population (cca. 22 million), as compared to the average in Central and Eastern Europe. Under the hypothesis of an average rate of economic growth of 5%, over the longer run, while the EU average rate of economic growth would be 2%, and considering the Balassa-Samuels effect, Romania would need 10-12 years to reach half the average income

per capita in the EU. The catching-up of the average income per capita (at purchasing power parity) would take about two generations by assuming that a substantial growth differential (in Romania's favor) is maintained.

A sustained economic progress would require higher saving and investment ratios in Romania, a public policy geared to the development of human capital and infrastructure, and Romanians' using increasingly what the new ICTs offer¹⁵. Romania would have to absorb the EU structural and cohesion funds to the utmost. But such evolutions depend, in their turn, on the functioning of institutions: the strengthening of the judiciary (the rule of law), a competent, honest and innovative (central and local) public administration, a solid financial and banking system, good structures of corporate governance (orientated towards higher economic performances), an education system offering equal chances to children and adults, laws that enjoy social acceptability and a favorable social ethos. The quality of public policy itself depends on the functioning of our institutions.

It is pure naiveté to believe that openness towards a wider economic space where asymmetries, agglomeration effects and cumulative causality, volatile (unstable) financial markets are pretty much present, would ensure, *ipso facto*, economic development. In nowadays' world extraordinary opportunities can coexist with failures of large proportions. If one accepts that not any kind of integration brings about benefits¹⁶, it makes sense to judge EU accession as a possible solution to the secular desire of economic development and modernization of the country. This could provide the institutional and technological "Big Push" Romania needs in order to reduce the economic gaps that separate it from developed European countries¹⁷. But it does matter how Romania does accede into the EU and how it will fare afterwards, for which its public policy is highly accountable. The crux of the matter here is to make the benefits of accession countervail its costs to the utmost. The variety of performance inside the EU shows it amply.

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¹⁵ See "Romania and The Lisbon Agenda" (GEA-CEROPE Report, 2004, pp.30)

¹⁶ Rodrik (2000)

¹⁷ Writing in the British Economic Journal decades ago, Rosenstein-Rodan talked about the need of a "Big Push" for South east Europe, in order to catch up economically with the West.

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