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EARLY WARNING REPORT

SELECTED INDICATORS

	Q1-2001	Q2-2001	Q3-2001	Q4-2001	Jan-2002	Feb-2002	Mar-2002	Apr-2002	May – 2002	Trend
GDP growth (quarterly, annualized), %	4.8	5.1	5.1	5.4			3.1			↘
Devaluation of the Leu, monthly average, %	2.1	1.9	1.5	1.2	1.9	1.3	0.9	1.7	0.2	↘
Inflation, monthly average, %	2.7	2	1.8	2.4	2.3	1.2	0.4	2	1.9	↘
Interest rate (BUBOR, one week) %	3.4	3.2	2.6	2.6	2.7	2.5	2.5	2.4	2.4	–
Industrial output, % change	6.8	-0.3	-0.6	-3.0	4.6	3.8	5.6	1.7		–
Trade deficit, monthly average FOB/CIF (mil USD)	274	408	205	504	257	239	263	339.8		↗
Unemployment rate, %	10.7	9.3	8.1	8.1	12.4	13.2	13	11.1		↘
Average net monthly salary, USD	99.2	96.3	92.9	96.4	114.1	106.3	111	118.5		↗
State pensioners / employees	0.97	0.97	0.98	1			1.01			↗
Trust in government, % (The current government can improve things)	57	46	48**	42	45		38			↘
Pessimism, % (Country heading in the wrong direction)	54	52	44**	48	51		57			↗
Subjective welfare, % (Better off than last year)	18	19	19**	22	11		12			–

* *projection*; ** *urban population only*

ABSTRACT

Romania's government keeps growing, and this is not helping performance, warns the **Politics** Section. Many public agencies are created, with various mandates and purposes, but very few are ever dismantled. The result is duplication, poor coordination and more entry points for lobbyists – as is particularly the case with economic policies. Better give up the idea of creating a new Ministry for Enterprises, since it is not likely to bring any improvement, argues the article.

The government should be more careful in its dealings with local issues, or otherwise it may just create itself more domestic problems, whilst also losing in terms of external image. Recent mistakes and how to avoid new ones are also discussed in the **Politics** Section.

The **Social** Section warns against risky management of social security funds, and against the government's tendency to give in to trade union pressures. The 'solution' eyed for rescuing the pension fund is more of a problem in itself.

Disinflation is surely good, but may create some problems when it happens faster than expected. The government would be well advised not to postpone addressing these problems, or else the current positive macroeconomic trends will not be sustainable. And, after all, has inflation really decreased so fast? The last part of the **Economics** Section questions the methodology for calculating the Consumer Price Index, and proposes some changes to make it more accurate.

POLITICS

TREND: INSTITUTIONAL INSTABILITY

The central government keeps growing instead of improving its efficiency. Bad omens for the business environment.

Too many Institutions in Charge of Economic Policy

One year ago, in the first issue of the Early Warning Report, we were arguing for a downsizing and simplification of Romania's central administration¹. The main reason for this recommendation was not related to the potential savings resulting from such a measure – although this would undoubtedly represent a positive effect – but rather to the ineffectiveness of decision-making processes, caused by the expanded and unstable structure of the central government. In brief, the EWR's conclusions were that:

- The current Romanian government is by far the largest in the region, with 26-27 ministry portfolios (whilst the average size of cabinets in other EU candidate countries is 16).
- The large size of the cabinet is affecting the speed and coherence of decision-making, which contributes to the perception that Romania is a laggard in the process of reforms and EU accession negotiations.
- Many new public institutions are created, but very few are ever dismantled when they eventually accomplish their mission – or when they blatantly fail to do so. As a result,

¹ Focus: Central Administration Performance, in *Early Warning Report*, May 2001.

the policy-making bodies become increasingly fragmented, and there is an ever-growing overlap in their attributions.

- Instability of structures means that institutional memory is lost, staff becomes demotivated and permeable to political pressure, and policy making very much personalized. As a consequence, the real balance of power amongst public agencies does not rely on transparent rules, but rather on the personal influence and political control that their heads can exert informally.
- The excessive plurality of structures and their unclear mandates increase the probability of turf wars, rent-seeking behaviour and confiscation of public agencies by private interest groups. The more agencies deal with one issue, the more numerous are the entry points for lobbying. Fewer, larger central ministries would be able to integrate better many issues before bringing them on the cabinet's agenda, thus producing more coherent strategies, saving time and cutting down on the overhead costs associated with multiple ministries.
- Apart from the line ministries, which are numerous anyway, there are simply too many bodies in charge with economic policy and administrative coordination within the government. Some offices are redundant (e.g. the secretaries of state for the relation with the Parliament, since there is a special ministry for this purpose), others do not have a clear mandate (e.g. Ministry of SMEs, Ministry of Development and Prognosis – the prognosis component). The crosscutting attributions and the complex pattern of subordination approximate a matrix-management structure, which would require, in order to function properly, a higher administrative capacity than Romania's government currently has.

After making a comparative analysis of the structure and attributions of the Romanian government and of nine other CEE and EU governments, the EWR recommended that Romania's government be drastically reduced in size and simplified in structure. One suggestion made was that the PM's office take charge of – or delegate more clearly – three fundamentally important policy areas, namely economic coordination, institutional reform, and European integration. In particular, the EWR highlighted one year ago the urgent need to consolidate economic policy making, and offered an example of best practice from France, namely a single umbrella structure for economic strategic management, in the form of a Ministry of the Economy.

Sadly, things have not improved over the past year; on the contrary, the flaws identified then tend to aggravate. Fig. 1 presents the structure of economic coordination in comparative perspective. While the other CEE and EU cabinets have on average 2-3 positions in charge with economic policies, typically strong central ministries with clear

attributions and political responsibility, Romania has split this job among no less than six autonomous units (including the Trade Department, until now part of the Ministry of Foreign Affairs). Even the representatives of the junior member of the current ruling coalition (PUR) noted recently that parallel ministerial structures (SMEs and Development-Forecast in this case) lead to internal struggles for controlling the development programs.

Fig. 1. The ever-expanding Romanian government: autonomous units involved in economic coordination

Departments	OMANIA astase	ROMANIA Isarescu	HUNGARY	CZECH R.	BULGARIA	POLAND	ESTONIA	LITHUAN.	FINLAND	FRANCE	ITALY
Min. of Finance	X	X	X	X ¹	X	Xx ²	X	X	X		Xx ²
Min. of Economy		X	X		X	X	X	X		X ³	
Min. of Industry	X	X		X					X		X
Min. of SMEs	X										
Min. of Devt. and Prognosis	X										
Privatization (APAPS)	X	X	X		X	X					
Min. of Enterprise	X ⁴										
Prime Minister's Office:											
Economic coordination unit	X ⁴			X					X		
Dept. of Trade	X ⁵										
Total	8	4	3	3	3	4	2	2	3	1	3

Legend:

1 Finance and economic policy

2 State Treasury separated from Finance

3 Super-ministry of economy, finance and industry

4 To be set up in 2002

5 To be detached from the Ministry of Foreign Affairs (and formerly part of the Ministry of Industry)

As if the old structure were not complex enough, new innovations have been announced for 2002:

- the **Trade Department** will become an independent unit directly subordinated to the Prime Minister's Office;
- an **economic policy coordination unit** will also be established within the PM's Office;
- and a new **Ministry of Enterprise** will be set up "to reform enterprises and modernize their management".

Moreover, PUR, the junior member of the ruling coalition, also circulated the idea of creating a **Ministry of Energy and Resources**, following the pre-1990 tradition. It seems

that PSD is not yet convinced about the utility of this ministry. But the proposal has vocal supporters among the special interest groups connected with the old structure of “industrial directorates” (*centrale industriale*) and public companies in the energy sector, who want a more substantial state intervention in this domain than the one realized by the newly set up regulatory bodies. Such a creation will represent – again – a Romanian innovation resembling the command-and-control structures in CIS countries rather than the modern market mechanisms adopted by other EU candidates, and it will be at odds with the current reform and liberalization strategies.

With a Ministry of Energy or without it, the changes will push even further the fragmentation of the cabinet, raising the number of autonomous economic policy agencies to 8 (or 9), instead of 2-3 like in the other candidate countries. Right now not only the process of decision making, but even that of producing and circulating information is difficult enough among institutions that keep changing and relocating. Increasing their density would make the problem worse. And the failure of the previous institutions (APAPS, Industries, SMEs, Agriculture) to push the reform further will become even more apparent after the new duplicating structures are created to try again where the first have not succeeded.

The first measure mentioned above comes as a consequence of the failure to integrate the Trade Department within the Ministry of Foreign Affairs. The last two reflect the need for a unitary structure of economic policy coordination. However, neither is likely to produce stable arrangements: Trade is relatively large, with more than 200 staff, which will more than double the PM's apparatus. Their mission here, among other departments and offices they are not functionally integrated with, will be just as difficult.

The economic policy coordination unit, whatever its final name will be, is supposed to be headed by Mr. Eugen Dijmarescu, a technocrat, currently advisor to the Prime Minister. Its formal role and real power are yet to be seen, but they will depend very much on the personal relations of Mr. Dijmarescu with other government heavyweights, such as the minister of Industry. This is bad omens for the stability of the cabinet structure in the long run.

A Ministry for what Enterprises?

A Ministry of Enterprise is something revolutionary, even when measured against Romanian standards of institutional creativity. It is not clear yet whether its task will be

- a) to promote institutional reforms and contribute to improving the business environment in general, or

b) micro-manage public enterprises.

In the first case, the task can be accomplished without creating a new ministry. There are currently enough policy instruments and expertise at hand to make the business environment in Romania more transparent and user-friendly. Many commissions, foreign and domestic advisors and independent business associations have written studies and proposed action plans; the requirements of the international financial institutions and the EU acquis also cover most of this area. All that is needed is the political will to make things happen, and a new agency cannot contribute very much in this direction.

If the Ministry of Enterprise will have to reform companies' management, as the latest public statements of the government seem to suggest², it is not clear what would be its instruments for doing this, and why would it be more successful where the Ministry of Industry and the Agency for Privatization (APAPS) have failed. APAPS has actually sold most of its assets, and has enough power to restructure the firms left in its portfolio. The Ministry of Industry, legally controlling most of the public companies (regies autonomes) and other "strategic" industrial assets excluded from privatization in the early nineties, also has all the competencies it needs to implement whatever changes it wishes in their management procedures, reform them and eventually sell them. Since it is inconceivable that the new ministry will get involved in the management of private companies, it is hard to see what else is left in its exclusive competence. Most likely, it will become a competitor for power and influence to the two ministries mentioned before – actually, it might very well be that its creation has precisely this purpose, reflecting the cleavages within the ruling party.

However, there is an even more fundamental problem with the (b) approach. The question is: can the state improve the performance or corporate governance of firms by directly intervening in their management? And if it can, why didn't it do it earlier, when much more enterprises were still under state control?

This material argues that option (b) is wrong, and that the state just cannot micromanage enterprises on a large scale. Since the only companies where a new Ministry of Enterprises would be able to intervene directly are the ones that are still state owned, a good part of the economy will be outside the scope of its actions from the outset – which may actually be a good thing. But even for the rest, the assumptions of public intervention, and its instruments, are very different from what the Romanian government has in mind.

² The government has recently deplored the fact that, although it has proper instruments to intervene at the macro-economic level, it lacks such instruments for intervening at the micro level.

The latest comprehensive report of the World Bank on the transition countries³ proposes a useful test for the end of transition: the process is over when the historical differences in performance (more precisely, productivity) between the three main types of enterprises existing in these countries will fade away. The three types are: (i) old firms, still state-owned; (ii) restructured firms, part of them privatized; and (iii) new firms, established after the fall of Communism. In theory the last are the most efficient, whilst the first are the least efficient. According to this view, the ultimate goal of the reform strategy is to apply the best mixture of policies in order for the first two categories to catch up in terms of productivity with the third, to the benefit of society at large.

However, the situation is more complex than that – and here is where the institutional fundamentals of the society play a crucial role. **Because it is not necessarily the public or private status of a company that makes the difference, but its rent-seeking power.** Newly established or privatized firms can be just as welfare-destroying as the old, state owned ones, if they are allowed to behave uncompetitively, bend the market rules, steal resources from the rest of the society through direct or indirect subsidies (such as tax exemptions), or even colonize public institutions in order to shape public policies to their advantage.

Some attempts mentioned above to create new central agencies are probably not unrelated to the desire of such groups to advance their private business interests through a public institutional channel (for example, in the energy sector).

The first winners from the early market liberalization and privatization deals (often “oligarchs and insiders”, as the World Bank report calls them) have every incentive to lock the market in its current configuration and oppose further reforms that may destroy their competitive advantages. **Therefore, the conflict that the government has to arbitrage is not necessarily that between public and private, but between socially productive and parasitic agents.**

It is precisely in weak and over-extended states, with proliferating and ineffective institutions, that public and private rent-seekers thrive, at the expense of the rest of society. The Communist legacy makes the category of public parasitic firms very numerous; such firms can only live through subsidies from the rest of society. The transition in turn gave birth to private rent-seekers, through both privatizations and the setting up of new firms. Private buyers act rationally when they plunder public resources,

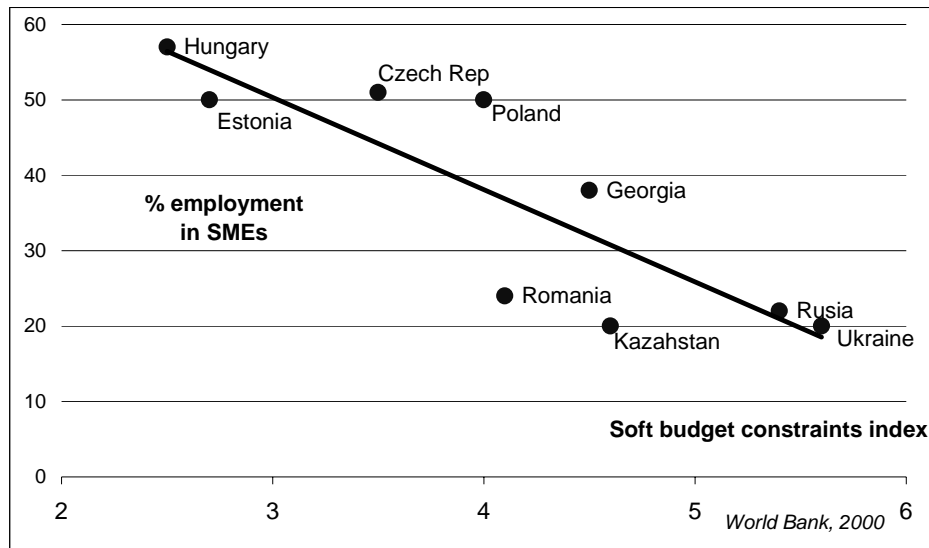
³ *Transition: The First Ten Years. Analysis and Lessons for Eastern Europe and the Former Soviet Union*, World Bank, 2002.

and cannot be blamed if they are allowed to continue to function in the same distorted structure inherited with the assets of a value-destroying firm. And no government office, no matter how much goodwill and effort it invests in the process, will ever be able to alter the behaviour of a large number of public and private parasitic agents, as long as the rules of the game are left unchanged.

This is an important fact that one has to acknowledge: **the government cannot do much when trying to micro-manage companies, even state-owned ones.** Quite often, it is precisely the well-meant public intervention that creates unintended effects such as public agencies' capture (especially in line ministries, where they are supposed to regulate a small number of powerful and specialized market actors – energy, IT, public works; or when the lobby structure is paid with public money – SMEs, trade unions, etc). But even when this does not happen, the government still cannot overcome the so-called principal-agent problem: the management of an organization has much better information about its day-to-day operations and will always be one step ahead the external owners or state agencies that try to control it.

There were many ways in which parasitic firms, public or private, were able to subtract value from society over the last decade in Romania. For many years the banking sector, mostly state owned, was the source of soft loans to various public companies and private business groups. As the privatization of the sector advanced, the direct soft loans were replaced by indirect credits – tax exemptions, preferential regimes, and arrears of payment. The state budget, pension fund and the energy sector thus became the new public creditors of value-destroying firms. As long as they will continue to function in this way, no command-and-control measures imposed by a Ministry of Enterprise will be able to discipline the economic agents. And there is no need for a new ministry in order to impose hard budget constraints. On the contrary, the more public institutions are created to design economic policies, the more entry points in the system the lobby groups will have.

That hard budget constraints improve, not decrease, the social welfare, is fairly obvious after one decade of transition. Though many small and medium enterprises (SMEs) can also be parasitic, in statistical terms they are more likely to be newly established, productive agents. Therefore, a high proportion of labour force employed in SMEs in transition economies is generally associated with a better overall economic performance. Fig. 2 illustrates precisely the consistent pattern of correlation between corporate discipline and economic performance, and thus vindicates the strategies of fast reformers in CEE.

Fig. 2. Financial discipline and reforms

Conclusions and recommendations

The main implication of the above considerations is that the government is not very good – and cannot be – at practicing clean corporate governance of firms. Its role should be limited to creating the conditions for good corporate governance, in public and private enterprises alike, through a transparent and neutral business environment. This objective is perfectly achievable with the current institutional framework, and there is no need to establish new agencies for this purpose.

- The government should eventually consider a **simplification of its structure** that is more than just a mere reshuffle. Ministries such as Industries, SMEs, Trade and Prognosis could be very well placed under one roof – a **Ministry of Economy**. Such a ministry would be responsible for Romania’s industrial and trade policy, and would be able to better integrate the policy making process in this field. The idea of setting up a Ministry of Enterprise should be abandoned.
- A special department within the new super-ministry, equivalent to the old Industry ministry, could remain provisionally in charge with the restructuring of the regies autonomes, especially in the energy sector. Divesting enterprises in sectors characterized by **natural monopoly** (where average production costs decrease with the scale of production, so that the society is served better by one or a few large enterprises) must proceed with caution. Fortunately, advances in technology make such sectors increasingly rare. But where they exist (gas, electricity etc.) the government must ensure

that an efficient regulatory regime pre-exists the divestiture. Otherwise, an inefficient public monopoly will turn into a poorly regulated private one.

- The business environment must be improved, but this cannot be done by ministries taking over firm management. Rather, **the discipline would be self-enforcing** if the government stops the multiplication of agencies and addresses instead long-neglected issues such as hardening the budgetary constraints on all economic actors, promoting rules against insider dealings and conflict of interests, introducing better creditor surveillance, improving auditing and disclosure standards, and improving the takeover, insolvency and collateral legislation. No new institution is needed to this effect. The job can be done in the current structure, with temporary task forces working on specific issues and on strict deadlines.
- Attention should be paid not only to drafting and passing legislation, as it often happens in Romania, but also to enforcing it. **The judiciary is actually more important for the quality of corporate governance in Romania than any conceivable ministry.** Unless the problems of the judiciary are sorted out – especially in the commercial court system – the self-policing potential of the business community cannot be fully mobilized.

WARNING: LOCAL GOVERNMENTS REFORM

Mishandling local issues may create a bad image in
Europe for the government – and prove
counterproductive at home

Starting with the end of 2001 the government has been perceived as pursuing a sustained campaign on local issues. It all started with the spectacular decision to dissolve the General Council of Bucharest, allegedly because too many local councillors were involved in murky deals with their own institution, which created conflict of interests situations. Subsequently, as the decision was contested in court by some of the councillors, the ruling party got entangled in a row with the general mayor of the Capital, Traian Basescu, over the split of attributions (ex. issuing building permits) or equalization funds between the general mayor and the six mayors of Bucharest sectors. Things got even more complicated when another issue became a matter of dispute: who should manage the

EBRD investment loans that had been negotiated and approved for improving the Capital's infrastructure.

It is not all about Bucharest. The draft Status of Local Officials, initiated recently by the government, was meant to create an oversight (disciplinary) council at the county level that would have the authority to impose penalties on mayors "who do not perform their duties properly", including, in the most serious cases, suspension from office. This proposal received a lot of public attention and was criticized unanimously by the local and foreign experts, and the media. As a result, the initiators backtracked. But since other legislation concerning the local governments is in the pipeline – such as a special law on the municipality of Bucharest, an older idea of the ruling party – it is worthwhile discussing here the relationship between the central and local governments in Romania.

It may not be immediately obvious, but local autonomy is a litmus test for the quality of democratic governance in Europe, and international organizations are very concerned about possible infringements of local autonomy. The Council of Local and Regional Powers (CLRP) affiliated with the Council of Europe is such a lobby group.

If the Romanian government makes unnecessary gestures that may be perceived as attempts to limit local autonomy, this will affect its international standing and its credibility to discuss and possibly reject proposals that may not be appropriate for Romania – such as regionalization. In October 2002, when CLRP will hold its conference on regionalization in Bucharest, only a government that has a proven record of promoting local autonomy will be credible when saying, for example, that setting up a third tier of local governments (regions) may not be a good idea in the case of Romania.

There are a number of issues that the Romanian decision-makers may want to pay attention to:

- The **disciplinary council**, as envisaged in the draft Status of Local Officials, would have been an additional administrative mechanism, besides the prefects and courts of accounts, to oversee the activity of elected mayors. However, Fig. 3 shows that even now there are enough instruments in Romania, more than anywhere in the region, to ensure the checks and balances in local governments and promote the legitimate interests of the county and central authorities. Already in place are the prefects (central government's representatives) to check the legality of decisions, the courts of accounts to check the legality of public spending, and counties that can intervene in money allocations to lower-level local governments. It is hard to see any justification for a fourth controlling instrument, which would single out Romania in the region.

Fig. 3. Accountability and control in local government

CONTROLLING BODY		OMANIA	UNGARY	ZECH R.	ULGARIA	OLAND	STONIA	RANCE
Citizens – elections	Political legitimacy	X	X	X	X	X	X	X
Central government representatives in territory	Administrative control	X				X		X
Upper local government (county, region)	Political control	X				X		
Local government bodies	Peer control	X						

▪ Moreover, no justification was provided as to why such a body was urgently needed: no examples of irresponsible mayors were given, or of cases where their carelessness was so blatant as to require outside, peer censorship. In such circumstances it is very difficult for the initiators to convince public opinion that their concern for the good of local communities was genuine.

▪ It may be tempting to proceed expeditiously when a crisis occurs and use whatever instruments are at hand to sort things out. This is what happened when the government **dissolved the General Council of Bucharest** on a technicality, while the real problem was corruption among councilors. But in a democracy the process is as important as the results coming out of it, and appropriate measures should be taken to deal with the source of the problem, not only with its effects. **In this particular case, a clear set of laws and regulations should be initiated to deal with conflicts on interests in the public sector – local governments included.** Simply removing the current councilors from office does not guarantee that the next ones will be cleaner, as long as the rules of the game remain unchanged. Moreover, such emergency measures only undermine the credibility of the local governing bodies, without solving anything – see the current drag over the issue while the case is slowly moving up in circuit courts. The messy handling of the whole affair by the ruling party reflects badly on its democratic credentials.

▪ A **special law for the municipality of Bucharest** may be an option to consider, if the draft is discussed thoroughly with opinion leaders, stakeholders, domestic and foreign experts and, most important, the citizens. The habit of producing overnight legislative pieces and adopt them quickly as emergency ordinances is unacceptable in this case, given the sensitivity of the issue. The problem may be that such a law is passed at a time when the current government and the Bucharest mayor are political opponents. True, in real world political rivalries often end up by shaping institutions, but there has to

be a limit to that. Stripping the general mayor's office of a significant part of its attributions may leave the capital city unmanageable, with very serious consequences in the long run. The over-activism of the Prefecture does not represent a good substitute, since prefects are not elected local government. Many CEE governments were tempted to do the same thing at one point or another, in order to cut down to size opposition mayors – in Budapest, Sofia, or Bratislava. It turned out that capital city administrators were surprisingly resilient and this unproductive trench warfare drained the resources of the central governments. **In the case of Bucharest, the special law should ideally be postponed until after the next elections**, when the composition of different tiers of government, and the relations amongst them, are likely to change.

- The spirit and the text of the laws regulating the activity of local governments (Law of Local Administration, Law of Local Public Finance) are quite clear about who should approve and manage **borrowing and investments**: the local council passes the budget and approves the documentation, and the executive (mayor's apparatus) runs the operations and signs financial documents. The attempt to create a special executive body subordinated directly to the Bucharest council to manage the EBRD investment loans is at odds with the current administrative practice in Romania, and may even be interpreted as a break of the public finance laws. While it is perfectly legitimate for the Council to prioritize investment objectives, and stick to its decision once it reaches one, the head of the local executive is responsible before the law for dully executing the projects.
- The government would be well advised to moderate **hyper-active prefects** who engage in activities that are much beyond their attributions, from enforcing ceiling prices of vegetables to patronizing local football teams. In Romania, Prefectura is an institution meant to oversee the legality of local governments' decision and acts. In addition to that, the prefect coordinates all the branches of central agencies that are represented at the county level, and heads the security and emergency services when a crisis occurs. If so, there is little point in prefects organizing inspections in outdoor markets, trying to hunt "speculators" and impose "fair prices". Such actions create expectations in the public that are impossible to fulfill, and undermine the separation of attributions in the public sector, which certainly is more socially damaging in the long run than a 10% increase in the price of eggs sold on a competitive market.
- The central intervention on the **local sources of revenue** must also be limited to a minimum. Many times the impression is that the public officials in Bucharest do not even realize what these are, and distribute generously tax exemptions at the expense of budgetary funds that are not theirs, but local governments' – which is very much like doing charity with your neighbor's money. This happened during the last negotiations between the government and the union confederations, where personal income tax (PIT)

cuts were again brought on the table. The problem is, about 90% of the PIT collection in goes to the local budgets. We do not discuss here that it's not PIT, but social security contributions that represents the heaviest taxes on labor; nor the fact that the corrections proposed by unions would make the PIT even more progressive than it currently is, going against the general strategy of the government. The point here is that the permanent interference in PIT and other income sources of the local budgets, without consulting all the interested parties, creates an uncertain environment for local governments in which the autonomy and professional budgetary planning become empty words.

- Another example is that of the discount food shops: businesses that were promised a favorable regime if they begin selling food at reduced prices to low-income groups. The idea was generous, but the special regime was to be created also by reducing taxes that happened to be local. Often mayors tacitly oppose such indirect subsidies, and so the policy becomes ineffective, generating confusion and distrust amongst the public. Such plans should be more carefully thought through from the very beginning.

- Finally, on the **spending** side, local governments should not be regarded as a dumping ground for unmarketable products manufactured by state owned enterprises. The government should refrain from pressing local governments into buying, for example, buses produced domestically, just to solve temporarily the problems of a failing bus company. This not only impoverishes the local communities (and asymmetrically, since money are transferred from buyers to the few large cities where the manufacturing plants are located, and which thus benefit from taxes on artificial salaries), who pay for poor and expensive products, but also distorts the business environment, running against another important objective of the government.

SOCIAL

WARNING: RISKY SOCIAL SECURITY MANAGEMENT

The Ministry of Labor had to deal with hot potatoes, one after another, in the last half year. It has stepped back at each encounter with opposition (specially from trade unions). Its veiled effort to solve things by confiscating health care money may backfire.

Reach high, settle low

Labor market and welfare reform issues have received the most attention of all the policy initiatives of the government. A large number of issues have come at the forefront of the political debate, and on each count the government has faced a strong flack of criticism, coming from media, trade unions, employers, and opposition parties. It ended up by backtracking, giving in specially to trade union pressure. However, the influence of trade unions looks quite inflated, as there are only 4 million legally registered full time employees out of the estimated 8 million Romanians who actually work, and only half of these 4 million are trade union members.

The labour code

Alarm bells initially rang over the newly created reserve fund aimed to guarantee the payment of wage liabilities. Whilst its creation is part of the EU acquis requirements in the social field, its size was questioned. The government backed down in front of media criticism and employers' pressure, and withdrew the draft. The cabinet has recently approved the draft of the labour code and submitted it for Parliament approval. It

preserves the controversial new fund, but ducks the question of its size, by postponing this decision for later legislation.

The labour code has been applauded by trade unions, and they even requested that the government transform its passing in a matter of parliamentary confidence, thus precluding any debate on and amending of the draft. On the positive side, the draft reduces the number of special labour group employees (i.e. employees that benefit of special retirement provisions) from 1,000,000 to 250,000, back to the pre-1989 situation.

However, the draft contains a number of controversial provisions. The critics portrayed it as heavily biased in favour of trade unions, and against the employers, and putting too much social responsibility (i.e. expenditure) on the shoulders of the latter. First of all, even the priority given to wage liabilities over other types of liabilities (e.g. taxes, bills) was criticized.

In addition, the decision to unify the tax treatment of part-time (*conventii civile*) and full-time labour contracts by levying full social contributions on both has aroused fears that it will result either in increased unemployment or in pushing jobs into the black market. What is indeed strange is that even if the part-time employees will pay the full rate of pension contribution, it will not be counted at all towards the minimum working period necessary to qualify for old age pension.

The part-time contracts play an important role in the plans of the government. Over the past twelve years, Romania has seen a marked decline in the number of full-time employees (i.e. contributors to social insurance). Fig. 1 presents the evolution of the dependency rate (i.e. contribution payers per pensioner). The situation is even worse if we add up the retired farmers – in 2001 there were 6,365,000 pensioners in total, as opposed to 4,505,000 full-time employees. While this trend is correlated with a marked increase in the number of pensioners, it is also true that some of the missing employees have resorted to less taxed part-time contracts. The Ministry of Labour relies on the taxes now to be levied on the part-time employees to help balance the pension fund budget, a major reason of concern (as is discussed later in this article, when addressing new developments in the pension reform). The problem is that the Pension Fund estimates at 1,200,000 the number of part-time contracts (of which only 100,000 currently pay the voluntary pension contribution). However, the more reliable statistic is the one coming from the Health Fund: the health contribution is mandatory for all part-time contracts, still the Health Fund receives contributions from only 650,000 part-time employees. The gap between expectations and reality will become even larger, as the high social contribution will force a number of part-time contracts to be cancelled.

Fig. 1. Dependency rate

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Dependency rate (contributors / pensioners)	3,43	2,69	2,17	2,10	1,91	1,75	1,63	1,48	1,32	1,16	1,05	0,98

Pension reform

The pension reform zillion-part soap opera is making a new turn. Last year the revised pillar I (Pay As You Go) has come into force. International donors had found it barely passable. Whilst its basic design was applauded, the parametric changes introduced were deplored:

- The increase in the retirement age is phased over 14 years, which makes it rather irrelevant – by the time it will take full effect, a new parametric evaluation will have to take place;
- In addition, the value of the pension point (decided yearly in the Budget law) is allowed to fluctuate (upwards) too much, which creates a window for election bribery by the government.

Now the Government is rumored to have finalized the draft for the next step of the pension reform: the introduction of pillar II (mandatory private insurance). Promised initially for the fall of 2001, the Law is scheduled for this year both in the agreement concluded with the World Bank, as well as in the one concluded with the European Union.

The second pillar had actually been introduced through Emergency Ordinance by the outgoing Isarescu administration in 2000, but was promptly suspended by the in-coming government of Adrian Nastase. The new draft by and large preserves the provisions of the ordinance. The private pension funds will be supervised by a new regulator, and not by the Insurance Supervisory Commission, as is currently the case. Pension funds will not be guaranteed by the Government, but mutual insurance in the industry will be mandatory – much on the model of the current insurance of bank deposits.

However, the big innovation is the coupling of pillars 2 and 3 – voluntary private insurance. The latter will be allowed to start immediately, as opposed to the 2nd pillar, which will become operational only in two years time. The third pillar is practically already in operation, under the form of private life insurance and pension plans. However, currently there is no specific regulation for them. The importance of the new draft consists in the fact that it will also allow the functioning of voluntary occupational pension schemes, non-existent so far in Romania. Occupational pension schemes consist of pension plans that involve all the employees of a company.

The reasons behind the suspension of the previous government's ordinance are not altogether clear. Allegations were made concerning the need for the governing party to have time to develop connections with the soon to be operators in such a large industry. The question marks over bridging the funding gap – the deficit in the PAYG pillar due to channeling contributions in the funded pillar – also played a part. Equally, there was strong opposition from the trade unions, interested in having access to the management of the pension funds. This access was practically denied in the 2nd pillar as set up by the Isarescu Ordinance, mainly due to the high capital requirement for market access. The new pension draft law preserves this restriction. However, occupational pension schemes (which provide an important role for trade unions) are allowed in the 3rd pillar. This leaves open a back door for the trade unions towards the high prize of the 2nd pillar. The trade unions will be able to start their occupational schemes at once, and gather enough experience and scale over the two years until the commence of the 2nd pillar (and by that time may also be in a stronger position to lobby for lifting the restrictions for access to the 2nd pillar market).

The government has hesitated for a long time over these issues. First of all, in a country traumatized by financial crashes over the last decade, building the credibility of the new pension industry will not be helped by the interference of trade unions. Moreover, the international experience provides a number of examples of occupational pension schemes that went awry, of which Enron is only the most recent. In spite of all these doubts, the government appears once again to have succumbed to trade union pressure.

Minimum wage

Pay policy is a new area where the Government made substantial concessions to trade unions. The most publicized was the hike of the minimum wage from less than 60 Euro currently, to at least 70 Euro in January 2003, and perhaps as much as 100 Euro in 2004. Such rises cannot be justified based on productivity growth. More important, they will have snowball effects in the economy: up to 2/3 of all employees are paid very close to the minimum wage, and a number of other wages and benefits are tied to the value of the minimum wage.

Apart from the dramatic increase of the minimum wage, the Government has also conceded to lift pay restrictions in public companies that are in the black, has promised pay increases above the inflation rates in the public sector, and breathed new life into the Indexation Commission, which is supposed to make sure that the minimum wage keeps pace with the value of a basket of consumer goods.

Tax reductions

The government has recently cancelled a number of tax facilities – e.g. the reduced profit tax for exporters and the VAT exception for tourism and building industries. There is a concern now that these tax hikes should be offset by decreasing labour taxation. The government has agreed with the trade unions that social contributions should be reduced by 5% (out of the current aggregated 57%) of the gross wage. Moreover, this reduction will come mostly from the part supposedly paid by the employee, and only a meager part from the employer's direct contribution. In addition, the government has also promised to reduce the income tax on lower wages and to increase it on the higher ones.

Enlarging the tax base

A solution envisaged by the government is the enlargement of the tax base. Here comes the replacement of part-time contracts with fully taxed labour contracts. Another measure is the announced elimination on the ceiling on contributions to social insurance (currently the amount on which the social contribution is levied is limited to three times the average wage). Finally, the government intends to crack down on (legal) tax avoidance: a number of companies reduce their tax exposure by paying insurance contributions or dividends to their employees, instead of wages.

Eyeing the health treasure trunk

As a consequence of these recent policies on the background of an already looming crisis, the Labour Ministry has to deal with:

- a large deficit of the public pensions fund;
- the impossibility to advance to the internationally mandated private funded system (2nd pillar) because the mechanisms for covering the funding gap (i.e. loans and bonds) require a lower deficit of the current pension fund;
- a commitment to decreasing social contributions.

Fig. 2. Chronic deficit of the pension fund (Million ROL)

	1991	1992	1993	1994	1995
Revenues	164073	468473	1315121	2811958	3925368
Expenditure	155069	404344	1174730	2760680	4090448
Pensions	119556	321676	1042464	2461126	3669164
General surplus / deficit	9004	64129	140391	51278	-165080
General surplus / deficit as % of GDP	0.41	1.06	0.70	1.03	-0.23

	1996	1997	1998	1999	2000
Revenues	5910161	13164176	23331989	37936470	51016388
Expenditure	6096920	13221909	26539398	39170766	55626915
Pensions	5547645	11663924	21936696	33105143	47068891
General surplus / deficit	-186759	-57733	-3207409	-1234296	-4610527
General surplus / deficit as % of GDP	-0.17	-0.02	-0.86	-0.22	-0.57

Fig. 3. Average number of pensioners (000s persons)

	1990	1991	1992	1993	1994	1995
Social insurance pensioners (excluding farmers)	2570	3018	3201	3253	3439	3600
For the work done and age limit	1859	2279	2376	2365	2480	2568
For disability	208	222	263	307	374	433
Successor allowance	503	517	562	581	585	599
Social insurance pensioners – farmers	1007	1016	999	1139	1478	1587
Social benefit ⁴	35	31	27	22	20	17
Pensioners IOVR (war invalids, orphans and widows pensioners)	67	66	65	62	58	54

	1996	1997	1998	1999	2000
Social insurance pensioners (excluding farmers)	3740	3875	4020	4181	4359
For the work done and age limit	2656	2753	2851	2961	3087
For disability	469	493	527	567	609
Successor allowance	615	629	642	653	663
Social insurance pensioners – farmers	1612	1649	1682	1713	1751
Social benefit ⁵	15	13	11	10	8
Pensioners IOVR (war invalids, orphans and widows pensioners)	50	46	42	37	35

The way out which is currently considered is redistribution between the social insurance funds. There are three major social insurance funds:

- the pension fund, that collects 35% of gross wages
- the health fund, collecting 14% of gross wages
- the unemployment fund, collecting 6% of gross wages.

The pension fund is in chronic deficit, while the other two register surpluses. The health fund has especially been targeted by successive governments: in spite of a growing financial crisis in the health sector itself, each year the Ministry of Finance has not allowed the National Health Insurance House to spend all the revenue collected. In addition, the surpluses had to be deposit in the Treasury, with below inflation interest rate.

⁴ Support allowance of pension type paid from social insurance funds.

⁵ Support allowance of pension type paid from social insurance funds.

The pension contribution (called CAS – social insurance contribution) actually funds a large number of other benefits, apart from the old age pensions (Fig. 3 presents the breakdown according to the number of beneficiaries):

- maternity benefit
- spa rest and treatment
- medical leave
- labour accidents
- invalidity benefits

A new special insurance fund is to be created for labor accidents, in accordance with the EU acquis requirements. As the argument goes, at least part of the other benefits could be transferred to the health fund. At a closer look, this proposal seems to be guided more by a Robin Hood logic, than by any rational argument. With the exception of medical leave, the other benefits are non-contributory, and therefore would make more sense to have them funded from the State Budget than from the Social Insurance Budget.

A unique social insurance fund?

The alternative chosen, at least by the Labour Minister Sârbu, is to create a unique social insurance fund, by consolidating the three existing ones. This decision is part of the protocol of understanding signed with the trade unions. It is however telling that the government was represented in these negotiations by the Labour and Finance Ministries, and is not clear to what extent the Health Ministry was consulted on such a crucial matter.

With World Bank blessing, the Government has already unified the inspection function for the three funds. It has further agreed with IMF that the collection for the three funds will be unified. This would have clear administrative advantages, both for the administration and for the employers.

However, **the idea of unifying the funds (i.e. money) presents a number of disadvantages.** First of all, it practically bails out the reckless management of the pension system, by using health tax money to fund irresponsible pension pledges. It also blurs the distinction between the social contributions paid by the tax-payers and the services they receive, reducing therefore the transparency and accountability. Most important, it is likely to starve of resources the health sector, which already faces a serious financial crisis, and which is anyway under-funded by both EU and regional standards.

There is another factor worth taking into account: the health fund records a much better contribution collection rate than the pension fund. There are a number of reasons that could explain this situation:

- First of all, back-payments are not allowed at the health fund, as opposed to the situation of the pension fund, where they are an established way of paying off the political clientele.
- Second, the pension contribution is much larger than the health contribution (35% versus 14%), which might deter contributions.
- Third, the threat of denying access to benefits for non-payment is more credible in the case of healthcare than of the distant pension.
- Fourth, there are trade union representatives in the boards of the regional health funds, and they are said to help persuade the managers to pay the contributions.

Finally, there is a difference in the legal treatment of the employee contribution and of the employer contribution: the employer non-transferring the employee contribution is a penal matter, whilst non-paying its own contribution could lead only to a fine. Therefore the collection rate is better when the part of the contribution paid by the employee is larger, as is the case of health contribution - 50%, compared with 33% in the case of the pension contribution.

Conclusions and recommendations

- The Ministry of Labour has got the habit of throwing itself in a large number of policies, and capitulating when it runs into opposition. This approach has led to a serious risk of derailing pension reform, undermining the health sector, and now presents a threat to wage stability.
- The idea of merging the social insurance funds should be abandoned. The merger of audit and inspection functions is a welcome development. The merger of collection also has some merits in terms of simplification and reducing administrative costs, although it is less certain what impact it will have on the collection rate.
- The prospect for a positive outcome will be improved if some of the advantages of the current health contribution will be preserved – e.g. the absence of back-payments, and a high component paid by the employee.
- In any case, the amalgamation of funding for the social insurance funds would practically redistribute money from the health fund to the pension fund, avoiding a head on

solution for the problems of the pension system, and bankrupting the healthcare system instead.



ECONOMICS

POLICY CHALLENGES FOR THE SECOND HALF OF 2002

By Daniel Daianu

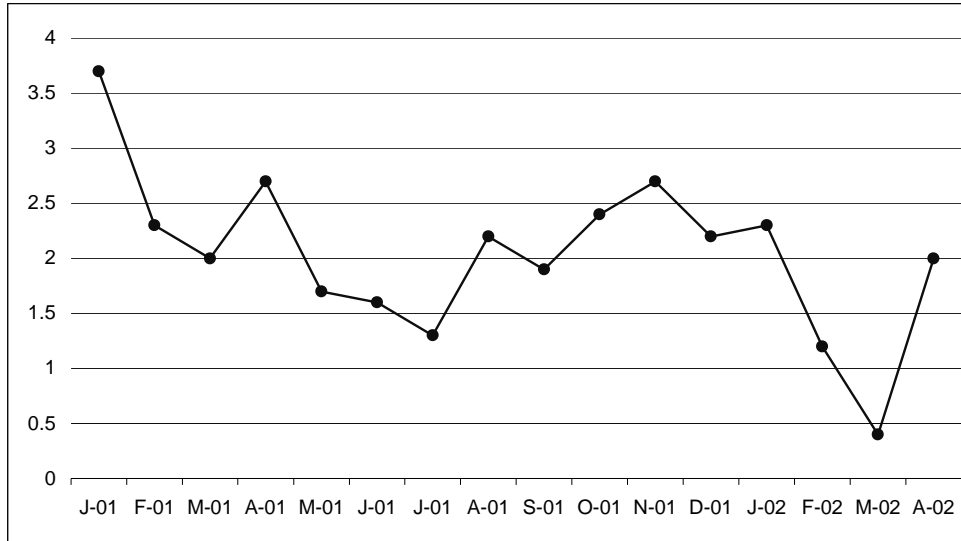
The good news

Economic recovery has been under way in Romania for the last couple of years; after a rise of 1.6% in 2000, the Gross Domestic Product grew by 5.4% in 2001. The latter was enhanced by a good agricultural year, but the growth tendency was indisputable. Moreover, GDP growth has continued in the first quarter of 2002, alongside continued increase in industrial output, although both at a slower pace than in 2001 (Fig. 1). Further good news is the continuing disinflation – it is worth reminding in this context that persistently high inflation has been a scourge of the Romanian transition in the past decade, and that a serious policy of disinflation has only begun in 2000.

As matter of fact, the pace of disinflation has puzzled many observers, in view of the big rise in the price of energy, which has started in the last quarter of 2001; this rise should have entailed, presumably, a significant corrective inflationary bout. Surprisingly, however, the cumulated inflation was only 8% in the first four months of this year (Fig. 2), against the backdrop of an official 22% inflation target for the whole year. Consequently, both the National Bank and the Ministry of Finance are considering a revision of the target, to about 20%. It is not the purpose of this article to investigate what lies behind the more rapid than expected disinflation, but, aside from some methodological problems, one can submit that, following the drastic increase in the relative price of energy,

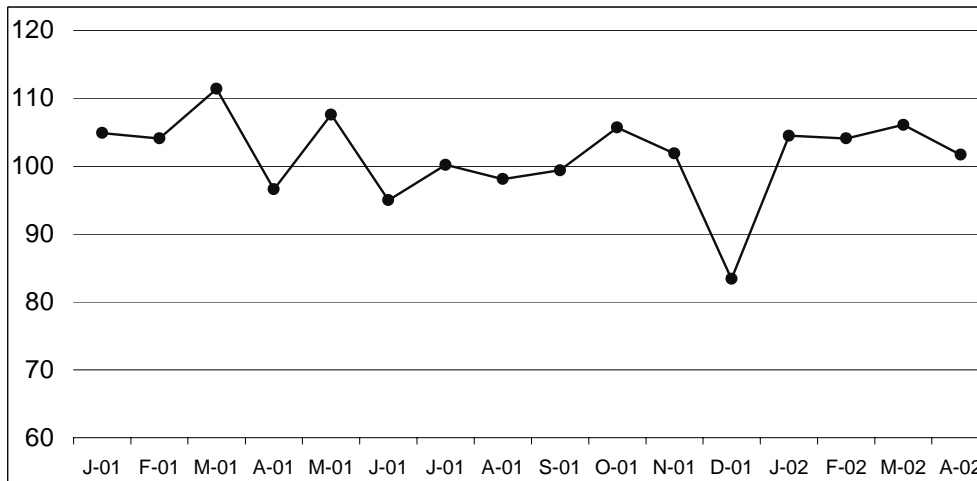
significant changes have occurred in the consumption structure of many citizens, which have affected price dynamics.

Fig. 1. Monthly inflation rate, January 2001 - April 2002



Source: INSSE

Fig. 2. Industrial production dynamics, January 2001 - April 2002



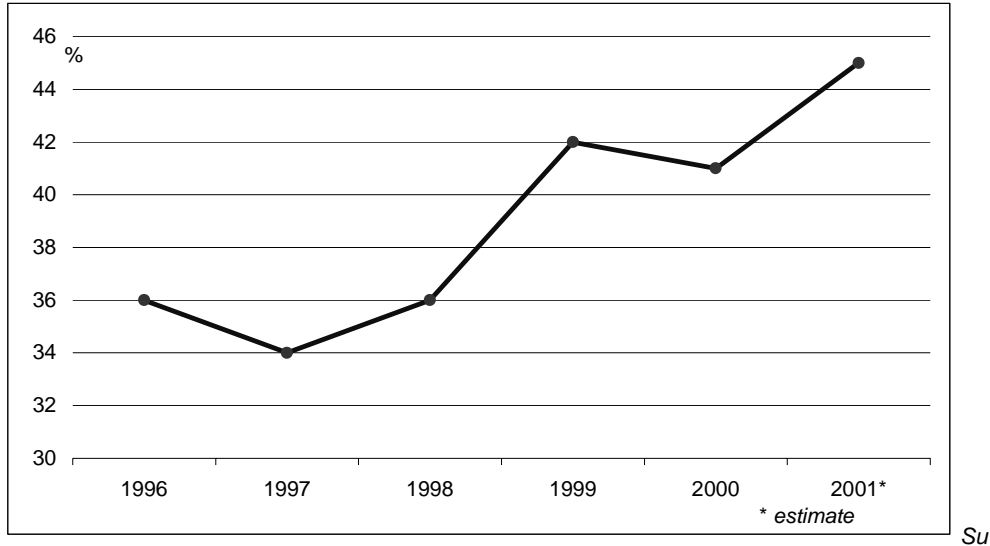
Source: INSSE

Overall, continuing economic recovery together with the decline of inflation and the bulging foreign reserves of the Central Bank (which went beyond US\$6.5 billion at the end of May, gold included) provide an appealing economic picture; to these features one can add the much sounder banking system (as compared to the late '90s) and an easy financing of the trade and current account deficits.

All this prompted rating agencies to upgrade Romania's sovereign risk and has eased the country's access to international financial markets. But there is also a less bright side of the story, which raises a series of policy challenges.

The less bright side of the picture: arrears and disinflation

Fig. 3. Arrears evolution, % GDP



rsa: INSSE

Although statistics are not yet available for the whole of 2001 (nor are they for the elapsed months of 2002), the available information – which covers the first half of 2001 – suggests that financial indiscipline has hardly improved (Fig. 3). Thus, financial indiscipline remains the Achille's heel of the Romanian economy, which also reflects a slow pace of restructuring. The sharp rise in the relative price of energy has been a sort of a “shock” to both consumers (households) and companies; for the latter, it means the disappearance of a general subsidy and a big pressure towards restructuring. How this restructuring takes place will be indicated by the financial statements of public (energy) utilities – with due allowance for those households, which cannot pay their additional bills.

The growth of arrears can be quite disturbing at a time of disinflation, when inflation can no longer operate as a *sui-generis* mechanism for stabilizing arrears in real terms.

Unless debtors are forced to pay their dues, more and more gridlocks would emerge in the economy and threaten its stability and growth. Hopefully, the ordinance adopted by the government to encourage the payment of current debts will have the expected effects, albeit its highly complex set of provisions may cause headaches.

The pace of economic activity, disinflation and the budget deficit

At the beginning of this year, the EWR warned that the government's target for GDP growth in 2002 may be over-optimistic, in view of the need to pursue disinflation and

control the budget deficit and the current account deficit. Our opinion was that the 5.1% official forecast was unrealistic, and that even 4.5% would be a pretty ambitious target. The data for the first months of 2002, the drought of this year, the less favorable external circumstances, all point to a pace of economic growth that is unlikely to exceed 4%. Under such circumstances, one is forced to think about various policy implications of a slower economic expansion. One such implication regards the execution of the public budget, which is made even more complicated by the more rapid than planned disinflation.

Without better tax collection, lower economic growth and more rapid disinflation will bring fewer revenues to the budget, and this will force the government to either undertake a painful budget rectification (reduce expenditure), or increase the budget deficit.

Disinflation and interest rates

At a time of disinflation it is not surprising to see real interest rates linger at high levels, which hinders the expansion of credit and, consequently, investment. Lately, government officials have demanded the National Bank (NBR) to do something about it, since consumption and net exports are less likely to drive the economy as they did last year. But relaxing the reins of monetary policy is not risk-free; the very goal of disinflation could be at stake when one overestimates the extent to which the monetary authority can ease its control of liquidity.

The spreads practiced by commercial banks are linked with several factors, which diminish NBR's ability to influence them; such factors are the degree of competition in the banking system, the efficiency of the banking activity, the size of obligatory reserves and their remuneration, the financing needs of the budget deficit, and, not least, the monetary sterilization operations of the Central Bank. Actually, the stock of deposits attracted by the NBR – in order to stem the rise in liquidity entailed by its purchase of hard currency in the forex market – soared from 24,835 billion ROL at the end of December 2001 at over 37,654 billion ROL at the end of April 2002. This increase illustrates the difficulties that NBR has encountered in controlling liquidity, because of the low monetisation (the size of the money supply as a share of GDP – Fig. 5) of the Romanian economy and of the heavy inflows of foreign capital (not necessarily FDI) lately.

Fig. 4. Average interest rates practiced by commercial banks vis-à-vis non-bank clients

	Lending rates	Deposit rates
1997	63.70	51.60
1998	56.90	38.30
1999	65.90	45.40
2000	53.48	32.74
2001	45.13	26.40
January	40.42	23.31
Febr.	39.12	22.75
March	39.55	23.48

Source: National Bank of Romania Bulletin, No.3, 2002, p.38

Fig. 5. Monetization in the Romanian economy

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
M2/GDP	27.4	20.1	13.8	13.3	18.1	20.5	18.1	24.9	24.8	23.2	22.4

Source: NBR

It is worth mentioning that bank lending to the non-government sector expanded quite rapidly in the first quarter of 2002, which should mitigate the concern about the impact of high interest rates on economic activity. But hard currency-denominated lending grew much more rapidly than lending in domestic currency, which, probably, is also a consequence of NBR's policy of ROL real appreciation. And the sharp appreciation of the Euro vs. the USD in May and June dramatically changed "the ball game" for those companies, which are not export oriented and borrowed heavily in Euros. Thence the rising concern of the NBR with the overexposure of some banks and firms to such lending (and borrowing, respectively).

Policy options

- The government is bound to revise its GDP forecast for this year and this should prompt a reexamination of budget revenues and expenditure; an option for averting a cut in expenditure is better tax collection, which should become a top priority for economic policy. Should interest rates decline more than what is expected, the smaller service of the public debt could release additional resources as a means for avoiding cutting expenditure. A slightly higher budget deficit is also an option, to the extent that monetary (credit) conditions allow it and the financing of the current account deficit is unproblematic.
- The government should lend top attention to financial discipline/arrears; unless arrears decrease in real terms, disinflation is likely to choke the economy; the financial situation of public (energy) utilities should be closely monitored in this regard.

- Should the NBR revise its inflation target to 20%? Probably not, in view of the leeway that the higher inflation target (22%) permits for a more flexible conduct of monetary policy; a lower target would entail a more restrictive stance of monetary policy, at a time when there is concern about the level of real interest rates. Likewise, the 22% target (assuming that the actual inflation will evolve towards an yearly rate of 20%) would allow a lesser real appreciation of the ROL; this would make the sterilization operations by the NBR easier and less costly.
- The NBR should monitor more closely the hard currency-denominated lending of the banking system, so that both firms and banks do not incur excessive risks. It would be good for banks and firms to encourage the introduction (expansion) of hedging operations for reducing exchange rate risks.
- The government and the NBR should opt for the introduction of the “hard ROL” in late 2003; such a timing would not affect the 2004 elections. Early euro-ization is a very risky option and should be discarded.

FOCUS: DISINFLATION -- SMALL IS BEAUTIFUL, BUT HOW DO WE MEASURE IT?

In recent months, the disinflation process seems to score success after success. Inflation is within target, but many question the methodology by which CPI (Consumer Price Index) is calculated. This material is not an academic study, and we are first to admit that more thorough research is needed. This is, however, a warning on two major issues: that the current methodology may underestimate inflation, and that further inflationary pressures are to be expected as the Romanian economy develops.

Components of inflation

What triggers inflation in emerging economies? Inflation sources can be grouped as follows⁶:

- fiscal imbalances (money growth, fiscal deficits, exchange rate)
- real economy structural problems (lack of restructuring or overheating)
- supply-side shocks (surging prices of specific items, either imported or previously subsidized)
- inflationary expectations.

Have these factors been active in Romania?

Contrary to what theory says, there is only a very weak correlation between fiscal deficits and inflation rate (CORREL=0.34), which is also consistent with other recent findings for developing economies. In transition economies like Romania's, the quasi-fiscal deficit is more relevant. Indeed, a very strong correlation appears between quasi-fiscal deficits (calculated as the algebraic sum of public debt flows and consolidated budget deficit) and inflation rate (CORREL=0.88). The quasi-fiscal deficit is a good indicator of back-door money creation. Nevertheless, in the last years, there seems to be a consistent trend of

decrease in the quasi-fiscal deficit, which can help explaining the decreasing inflation rate.

⁶ Prakash Loungani, Philip Swagel (2001) "Sources of Inflation in Developing Countries", IMF Working Paper pp.198.

Until recently, net domestic assets were preponderant in the composition of the monetary aggregate M2 (except for year 1997). The National Bank had to sterilize only what it had created itself. In 2001, and in 2002 alike, significant liquidity injections from foreign capital (direct investment, portfolio investment, remittances, unrecorded flows under 'errors and omissions') have induced inflationary risks. This phenomenon is illustrated by the fact that the deposits attracted by NBR, by the end of April 2002, were more than half of the monetary base M0 in the economy. Inflationary pressures appear nowadays less through the excessive creation of local money (often accompanied by quasi-fiscal deficits), than through foreign capital inflows. The NBR has to sterilize a lot, in order to prevent the real appreciation of the ROL.

Fig. 6. Correlation coefficients for the inflation rate

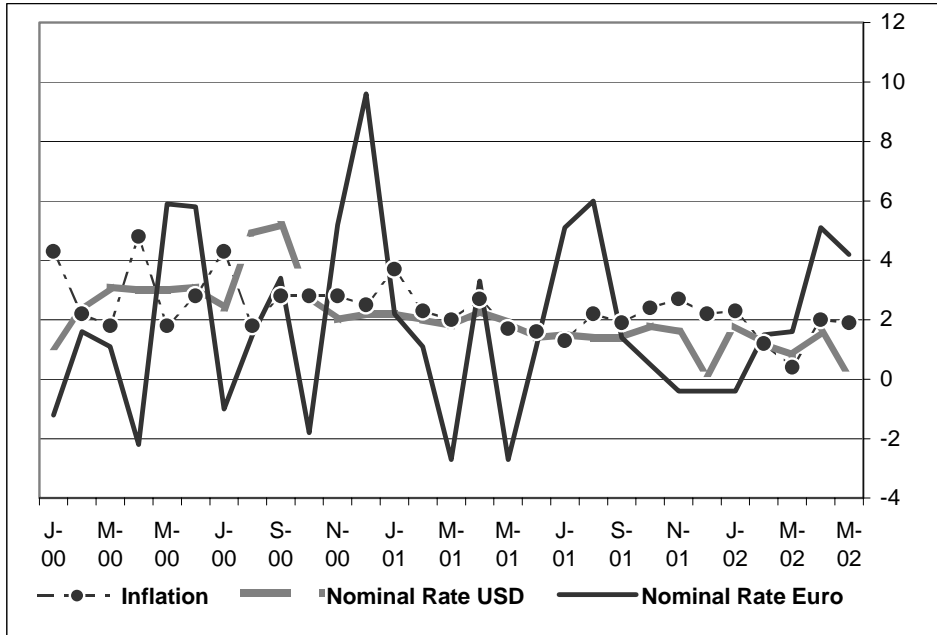
	Fiscal deficit	Quasi-fiscal deficit	M2 growth	ROL-USD nominal rate	ROL-EURO nominal rate	Unemployment
Pearson coefficient	0.43	0.88	0.67	0.43 (1 month lag)	0.31 (1 month lag)	- 0.17
Number of observations	11	10	11	29	29	11

Source: author's calculations

Real appreciation occurred nevertheless over the last two years, as nominal depreciation stayed below the inflation rate. The structural-driven inflation is, however, decreasing much slower than the monetary inflation. On the one hand, there is no correlation between inflation and unemployment, which is normal as hidden unemployment is thought to be large, pointing therefore to the delayed restructuring in real economy. On the other hand, the risk of overheating should not be underestimated, as part of the growth in recent years comes with the accumulation of stocks.

The cost-push inflation, through supply-side shocks, is deemed to play an increasing role in the composition of inflation, as relative prices in Romania are still far from the EU average. Substantial pressures are likely to appear, therefore, in the direction of reducing this gap in relative prices.

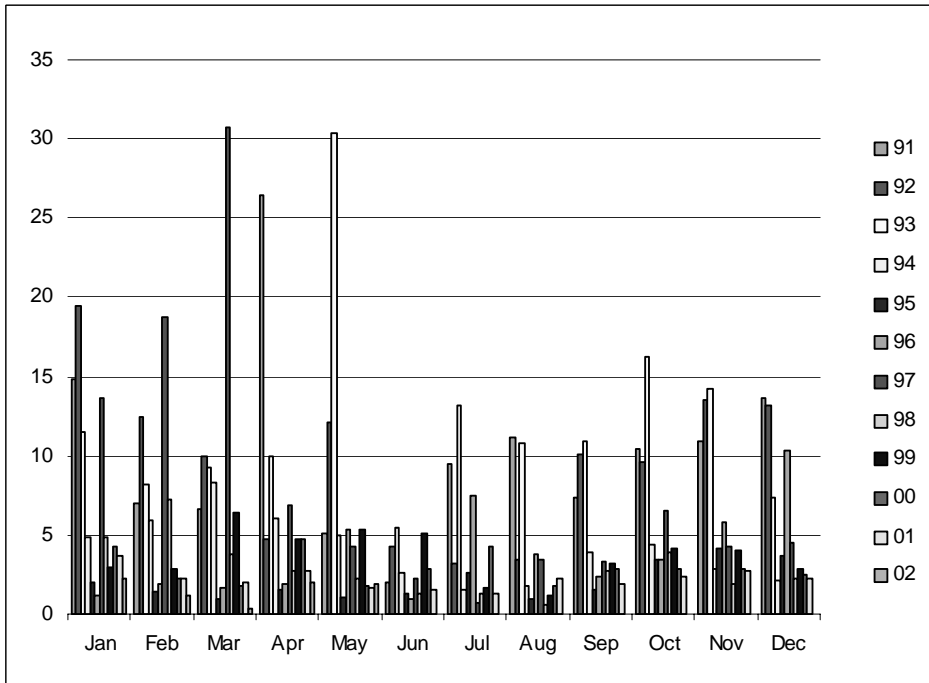
Fig. 7. Inflation and exchange rate, monthly data, 1999- 2002



So

Source: NBR data

Fig. 8. Inflation, monthly rate, 1991- 2002



Sou

Source: based on INSSE data

Most of the future movements in prices will reflect an adjustment process toward a new equilibrium set of relative prices; and this adjustment will be upward, as there is very limited downward flexibility of nominal prices in transition economies⁷.

There is also a structural element in the inflationary expectations. What some call a seasonal feature of inflation in Romania, actually reflects the insufficient change in the structure of production, in the mix of goods and services that are produced over one year. Fig. 8 shows a seasonal pattern of inflation, which is still visible after 11 years of transition (although the magnitude of seasonal fluctuations has been decreasing).

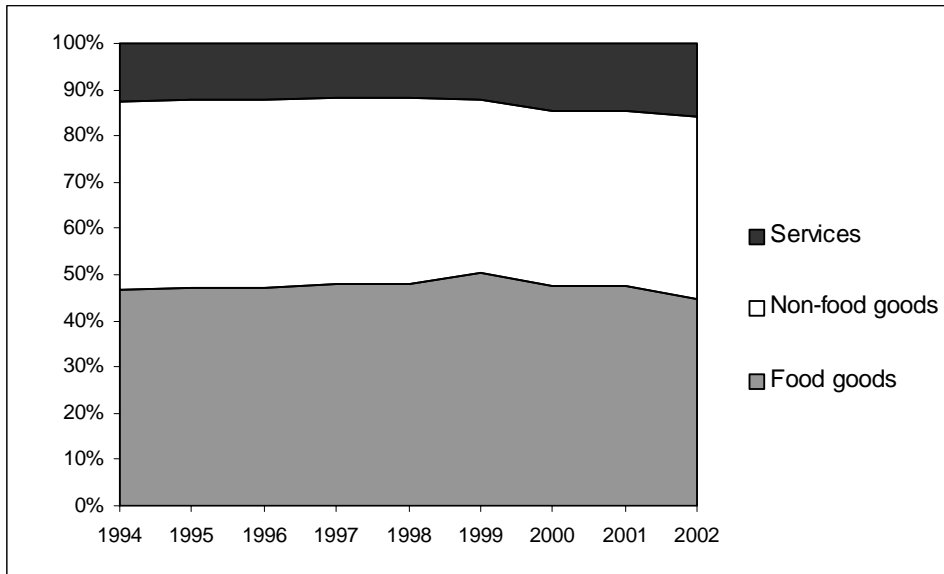
Remarks on the CPI composition

The Consumer Price Index (CPI) is computed by the official bureau of statistics (INSSE) as follows: prices are recorded by a selective survey comprising 68 centers, and then they are weighted based on the structure of direct consumption resulted from an annual households survey. To the best of our knowledge, there is no independent comprehensive survey of households' consumption, which could offer a basis for an alternative calculation of CPI.

The first striking thing when looking at CPI composition over time is that it varied in a very narrow band (Fig. 9). The fact that CPI composition suffered only marginal changes over time, as far as major groups are concerned, seems at least surprising. Over the period analyzed (composition is based on households' surveys of two years before, so that the period 1994-2002 in Fig. 9 actually reflects surveys carried out between 1992-2000), the country went through recession and growth, and, therefore, one would expect more significant changes in the consumption behavior. However, the only two significant changes that can be noticed in CPI composition are not between groups, but within them.

In food goods, there is a tradeoff between meat and bread (meat decreased its weight in CPI from 13.1% in 1995 to 9.6% in 2002, while bread increased its weight from 3.7% in 1994 to 8.4% in 2002). This substitution occurred as meat prices rose faster than those of bread, and people reoriented towards the cheapest product.

⁷ Martin Cihak, Tomas Holub (2001) "Convergence of Relative Prices and Inflation in Central and Eastern Europe", IMF Working Paper 124.

Fig. 9. CPI composition, 1994 - 2002

Source: based on INSSE data

In the non-food section, there is a tradeoff between clothing and energy, the latter including electric power, gas, and thermal energy (clothing's weight decreased from 9.1% in the CPI basket in 1995 to 4.4% in 2002, while energy's weight went up from 3.8% in 1994 to 8.6% in 2002). This substitution occurred because of households' budget constraints, as energy prices skyrocketed.

The current method of calculating CPI has a series of pitfalls, which risk isolating CPI figures from a more complex economic reality. The main questions that may be raised regarding CPI calculation are the following:

- 1. The CPI weighting does not make the difference between various times of the year, although consumption behavior changes a lot from one season to another.**

In particular, the case of energy is illustrative. Energy consumption during winter may represent around 40% of a household's expenditures. If it is weighted based on a monthly average, and prices skyrocket, as it happened last winter, then CPI fails to cover for a significant increase in prices, and substitutes it with another item whose weight is over-rated for that time of the year. Electric energy alone recorded a 15% price increase in the first five months (according to INSSE data), double than the total consumption basket. The result is an underestimation of the inflation rate.

The argument that this underestimation is subsequently balanced by an overestimation in other months of the year does not hold true, mainly because the initial underestimation of the inflation rate induces a bias in the inflationary expectations (helping them to converge towards a lower than normal level).

2. The CPI weighting does not make the difference between various income groups. The annual households' survey separates, indeed, between such groups, although these are defined based on their social status (i.e. employees, employers, retired, unemployed), but this is not perfectly consistent with the weights in the CPI.

As an example, the households' survey includes consumption from own resources (taking this into account, food goods represent about 60% of the basket), while the CPI leaves it aside; the survey considers energy in the services group, and weights it within it, while the CPI considers energy in the non-food goods group (and weights it within this group).

Particularly in transition economies, with raising inequalities, the consumption patterns vary a lot between different income groups; and even if similar products are consumed, different quality preferences exist, which in turn lead to different prices. An aggregated, uniform index may not capture these differences.

3. The CPI weighting is based on two-years-old household surveys (e.g., the CPI weighting in 2002 is based on a survey in the year 2000).

In a transition environment, that is still to undergo numerous price adjustments, product preferences may change significantly. Accounting for them two years later already induces a bias against the current year price changes, whose impact is likely not be fully recorded by a two-years-old CPI structure.

Warnings and suggestions

The downward trend of the inflation rate cannot be denied; for one, this is consistent with the decreasing quasi-fiscal deficits. Indeed, the CPI weighting contains a number of disputable aspects; by its nature, the official inflation rate may not capture all inflationary inputs, but it measures the same thing it measured before, hence the comparability of data is secured.

A cynical leader once said that it doesn't matter who votes, it only matters who counts the votes. In an economy, things are more complex: it matters both what causes inflation, and how you measure it. Keeping this in mind, we issue the following warnings.

First warning: the current methodology of CPI weighting may induce a bias towards underreporting inflation.

As detailed above, the CPI weighting is indifferent to season, income group, and time gaps. Therefore, it may be biased against seasonal consumption patterns, underestimating ex-post the inflationary component of a sudden price adjustment in a specific product (such as energy), while the amplitude of price increases in substitute products (in terms of basket weighting) may not fully compensate for the initial underestimation. By doing so, it also induces a bias in inflationary expectations, taming them down. Furthermore, it does not consistently account for the different consumption behaviors of different income groups. Last, but not least, it is also biased against the current year price changes, whose impact is likely not be fully recorded by a two-years-old CPI structure.

To address these methodological problems, we suggest that:

- the CPI weighting should vary on a quarterly (seasonal) basis.
- different CPIs should be reported for different income groups, and only then these separate indexes should be aggregated in an average index.
- the time gap between the moment when the households' survey is conducted and the moment when its results are applied should be reduced (one possibility would be to carry out two surveys each year).

These suggestions are consistent with the need to accurately record inflation in a fast changing environment with regard to price structures and levels.

Second warning: the disinflation process will have to face new challenges, arising from embarking on a pace of sustained growth.

As the economy is growing, and capital account is being liberalized, capital inflows will increase the inflationary pressures, and therefore the NBR will have to sterilize more. Also, relative prices are expected to converge in the medium and long run, further inducing inflationary pressures.

Third warning: underestimating inflation is not helping the disinflation process, because:

- it can raise social tensions, as wages will be compensated for a lower than actual inflation rate.

- it reduces budgetary expenses, risking to reduce consumption, hence reducing the instruments of growth.
- it induces inflationary expectations to converge to lower levels, leading to the appreciation of the local currency. This may attract large capital inflows, easily reversible in the context of liberalization of the capital account.
- the real interest rate may actually decrease. The effects are twofold. On the one hand, active nominal interest rates prove higher rigidity (to keep real interest rates from decreasing) – which actually happens. This may explain why interest rates do not follow fast enough the inflation rate – simply because the inflation rate is underestimated. On the other hand, people's deposits are remunerated at lower real rates.

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