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INTERNATIONAL MONETARY FUND

ROMANIA

Recent Economic Developments and Selected Background Studies

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Approved by the European I Department

December 13, 1995

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Romania: Basic Indicators

Area	238,391 square kilometers				
Population	22.7 million (1994)				
GDP in 1994	US\$16.4 billion				
	1990	1991	1992	1993	1994 1/
Population characteristics					
Total population (in millions)	23.2	23.2	22.8	22.8	22.7
Population growth rate (in percent)	-0.2	-0.1	-1.7	-0.1	-0.1
Number of employed persons (in millions)	10.8	10.8	10.5	10.1	10.0
Unemployment rate (in percent)	...	3.0	8.1	10.2	11.0
Population density per sq. km.	97.7	97.6	95.6	95.5	95.4
Life expectancy at birth (years)					
Females	72.7	73.1	73.2	73.2	73.3
Males	66.6	66.6	66.6	66.1	65.9
Population death rate (in percent)	1.06	1.09	1.16	1.16	1.17
Infant mortality under 1 year (in percent)	26.9	22.7	23.3	23.3	23.9
Food, health, and nutrition					
Calorie intake (calories per day)	3,038	2,832	2,758	2,959	2,953
Population per physician (excluding dentists)	555	551	536	565	567
Population per hospital bed	112	108	127	127	130
Education					
Percent of population between ages 15 to 18 in school	90.7	76.1	67.0	63.7	68.9
Primary school enrollment (in percent)					
7-10 years	90.9	92.4	93.8	96.0	99.4
10-14 years	91.4	88.8	86.1	86.5	84.6
GDP per capita (US\$ at current exchange rate)	1,648	1,244	859	1,158	1,320
Real economic developments (percentage change)					
Real GDP	-5.6	-12.9	-8.8	1.3	3.9
Real consumption	8.9	-16.5	-7.2	-0.3	2.7
Real gross fixed investment	-37.4	-36.7	19.3	-3.7	14.6
Consumer prices (period average)	5.1	161.1	210.4	256.1	136.7
Fiscal developments 2/ (in percent of GDP)					
Revenues	39.8	39.3	37.6	33.6	31.4
Expenditures	38.7	38.7	42.2	33.7	32.4
Balance	1.0	0.6	-4.6	-0.1	-1.0
External developments (in billions of U.S. dollars unless otherwise indicated)					
Imports	5.4	4.9	5.7	6.0	6.6
Exports	3.6	3.5	4.3	4.9	6.1
Current account balance	-1.8	-1.3	-1.5	-1.2	-0.5
(percent of GDP)	-7.9	-4.7	-7.8	-4.7	-1.8
Gross external debt	1.1	2.1	3.4	4.4	5.5
Gross foreign exchange reserves	0.5	0.5	0.7	0.9	2.0
(in months of merchandise imports)	1.2	1.2	1.6	1.7	3.7
Currency per U.S. dollar (end of period)	34.7	189.0	460.0	1,276	1,767
Monetary developments (percentage change)					
Broad money (end of period)	22.0	101.2	79.6	141.0	138.1

1/ Preliminary outturn data.

2/ Consolidated general government, the fiscal data provided in tables 34-35 of the Statistical Appendix reflect recent revisions by the authorities. The discrepancies in revenues and expenditures compared to those shown in the staff report are minor, apart from the 1991 revenue figure which was revised upwards significantly. The staff will investigate the sources of these revisions.

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I. Introduction

In late 1993, after three years of high inflation and declining output, the Romanian authorities initiated a forceful stabilization program, based on a sharp tightening of fiscal and monetary policy. These policies, together with a liberalization of the foreign exchange market effected in April 1994, were supported by a stand-by arrangement approved by the Fund in May 1994. During 1994, fiscal policy was kept tight, with the general government deficit on a cash basis being held to 1.0 percent of GDP. Monetary policy--including the introduction of interest rates that were positive in real terms--was used effectively from late 1993 to cut 12-month consumer price inflation from 295 percent in 1993 to 62 percent in 1994 and some 25-30 percent by late 1995. Furthermore, economic growth accelerated to some 4 percent in 1994 and is expected to reach 5 percent in 1995.

The main domestic economic indicators for the first ten months of 1995 showed a continuing improvement over performance in 1993 and 1994 (Chart 1): CPI inflation was reduced to 1.7 percent per month; industrial output increased by some 10 percent compared to the same period in 1994; and unemployment was on a downward trend, despite widespread labor shedding in industry. However, this success was jeopardized by a rapid deterioration in the balance of payments from early 1995. As imports surged, the current account deficit widened sharply, and is projected to reach some 4 1/2 to 5 percent of GDP in 1995 (compared with 1.8 percent of GDP in 1994). Concurrently, the net international reserves of the banking system declined by some US\$370 million, while net domestic assets increased by 58 percent between end-December 1994 and end-October 1995. In addition, the domestic payments arrears of the core "problem" enterprises in the state-owned sector, which appeared to come under control during 1994, began to expand rapidly in the first half of 1995.

The threat to the stabilization program can be traced to a number of factors: slow progress in enterprise and financial sector reforms--areas in which policy problems undermined the previous stabilization programs; the failure of the exchange rate to clear the market for much of 1995; the accommodation of pressure for directed credit to agriculture; the rapid expansion of credit, particularly in foreign currency; and the strong recovery of the economy. All of these factors, together with other significant economic developments, are examined in the following sections.

Section II provides an overview of key monetary and real sector developments so far in 1995, including the impact of agricultural credit on monetary control, the factors behind the growth in foreign currency credit, and the link between the current account deterioration and real sector developments. Section III examines fiscal policy and performance in the context of the tax reforms and improvements in expenditure management during the transition period, including progress in bringing implicit and "off balance sheet" subsidies within the scope of budgetary policy; this section also provides a discussion of social safety net issues. Section IV gives an

CHART 1
ROMANIA: ECONOMIC INDICATORS

Source: Data provided by the Romanian authorities.

1/ Monthly average wage deflated by the consumer and producer price indices.

account of structural issues including private sector development, enterprise and financial sector reform, estimated developments in the quasi-fiscal deficit in the enterprise sector, and privatization. Section V reviews external sector liberalization, including the foreign exchange market reforms, external borrowing, and foreign direct investment in Romania. Finally, Appendix I examines external sector performance, exchange rate policy, and competitiveness. A Statistical Appendix is being circulated concurrently.

II. Recent Economic Developments

1. Introduction

Monetary policy has been used effectively since late 1993 to reduce inflation. Although underlying inflation may be higher than the CPI headline figure (see section II.2), it is still well below the average monthly rate during 1993 and 1994 (Chart 1). With declining inflation, interest rates have been significantly positive in terms of contemporaneous inflation (Chart 2). However, monetary control has been jeopardized by a sharp increase in central bank directed credit, especially to agriculture, and a rapid rise in domestic bank credit, particularly credit denominated in foreign currency. These two factors are examined in detail in section II.3 below. In view of these difficulties in the conduct of monetary policy, indicators of confidence in domestic currency are examined in section II.4.

With regard to key real sector issues, given the current account deterioration, the rise in enterprise arrears, and the rapid growth of the economy, it is important to examine key economic variables in the potential problem sectors. Section II.5 examines detailed sectoral data on production and stocks in order to analyze the link between the current account deterioration and output growth, while section II.6 provides an overview of sectoral patterns of productivity, employment and wages in order to determine the degree of adjustment in each sector.

2. Inflation performance

Chart 1 and Table 1 provide monthly CPI and PPI inflation figures. Although CPI inflation during the first three quarters of 1995 was only 18.4 percent, underlying inflation was higher for a number of reasons. First, the interbank exchange rate was at a more appreciated level than justified by the stance of monetary policy (Chart 2), resulting in an artificial restraint of import prices. Second, the retail prices of a number of key agricultural and dairy products were kept artificially low by the imposition of profit margin controls. ^{1/} Third, the prices of services have been rising faster than the CPI average (by 30 percent to end-

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^{1/} These margin controls are for milk, meat, cooking oil, bread and poultry products.

CHART 2
Romania: Exchange Rates, Interest Rates and Reserve Money

Sources: Data provided by the Romanian authorities and staff estimates.

October 1995, see Table 1); the CPI weights, meanwhile, have not been revised for some time and services have a weight of only 16 percent in the CPI basket: given the growth of the services sector, this is likely to be an under-estimate and, hence, CPI inflation maybe under-recorded on this account. ^{1/} Finally, the above points are somewhat reinforced by the fact that the PPI increased by more than the CPI: 22 percent (versus 18.4 percent) in the first nine months of 1995. These elements suggest that underlying inflation may be higher than the headline figure, but it remains clear that monetary policy has achieved a major success in reducing inflation from the levels of 200-300 percent experienced in 1991-93.

3. Monetary policy

At present, the National Bank of Romania (NBR) allocates its refinancing credit primarily through two channels: directed lines of credit at the official reference rate (referred to as "structural credit" by the NBR) and a weekly refinancing auction. In addition, refinancing is provided through three other channels, which have generally been quantitatively less significant: (i) "special" lines of credit provided to banks under exceptional circumstances, such as when they are under the direct supervision of the central bank; (ii) overdraft credit when banks fail to meet reserve requirements (referred to as "Lombard credit" by the NBR); and (iii) preferential credit extended at very low interest rates--the volume of which has been kept to a very modest level since 1993.

The NBR reference rate is regarded as the floor for market determined interest rates in Romania; NBR lines of credit are extended at this rate. With regard to the weekly auction, the NBR announces the maximum volume and the minimum interest rate a day ahead of the auction. The interest rate on overdraft credit is usually substantially higher than the reference or auction rates. Interest rates on preferential credit are at a much lower level than the reference rate. In addition, a large proportion of credit lines and auction credit obtained by the banks from the NBR at the reference or auction rates is on-lent to the agricultural sector at much lower interest rates. Until recently, the interest subsidy was paid to a

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^{1/} For example, the railway tariffs were increased by some 50 percent. However, the railways reduced many local services with low fares per mile and increased inter-city ones which exact higher fares per mile. The increase in revenue for the railways was much higher than implied by the fare increase. This could have also affected the average consumption basket; however, it is not yet reflected in the CPI weights.

significant degree by the NBR, but interest subsidies have been shifted fully to the budget since 1995. ^{1/}

a. Credit to agriculture

Chart 3 provides an indication of the significance of directed credit in the NBR's refinancing activities. At the end of 1994, over two-thirds of the NBR's refinancing credit had been earmarked for specific sectors, i.e., agriculture, energy, and exports, through lines of credit. By far the largest share of directed credits was allocated to agriculture. In addition to this, a large part of the credit allocated through the auction is, in essence, for agriculture, as Banca Agricola (BA) has consistently received the largest share of auction credits. Since most of the agricultural lines of credit are also extended to Banca Agricola, a good estimate of the share of agriculture in total refinancing credits is the amount of NBR refinancing received by Banca Agricola (Chart 3).

At end-1994, 72 percent of the NBR refinancing credits was extended to Banca Agricola. Between end-December and end-July 1994, there was a concerted effort to reduce the ratio of NBR refinancing going to Banca Agricola. This ratio had declined to 59 percent by end-July 1995. However, financing for the large autumn harvest led to a sharp rise in credit to agriculture and by end-November 1995, 69 percent of NBR refinancing was extended to Banca Agricola, and directed lines of credit accounted for 52 percent of total NBR refinancing.

b. Money and credit

Monetary developments in the first ten months of 1995 were in sharp contrast to those in 1994. In 1994, the increase in broad money was accompanied by a large rise in NIR; however, by end-October 1995, with the NIR falling, the increase in NDA was larger than the rise in broad money, and the government recorded a deficit (Table 2). Indeed net domestic credit increased by 50 percent in the first ten months of 1995, with the bulk of this credit going to the nongovernment sector. Given the rigidity of the exchange rate, there was a very high leakage of this credit to the balance of payments, while the money supply (and in the short run, inflation) remained broadly on track.

A striking feature of the rise in NDA during the first ten months of 1995 was the sharp increase in foreign currency denominated domestic credit: measured in domestic currency terms, this doubled (while leu-denominated

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^{1/} In 1994 the interest subsidy was paid to the commercial banks. In 1995, the interest subsidy is to be paid to the farmers who then pay a market rate for their borrowing. Also, in 1994 the interest subsidy was financed through NBR profits which were transferred to the government. In 1995 NBR profits are expected to be much smaller and in any case are not earmarked for interest subsidies.

CHART 3
ROMANIA: NBR Refinancing Credits
(Billions of lei)

Source: Staff estimates.

domestic credit rose by 51 percent), and it accounted for about 40 percent of the increase in credit to nongovernment. 1/2/ It is important to explore the possible factors behind the rise in foreign currency lending, as it has the potential to jeopardize monetary control; moreover, a shift toward foreign currency denomination in domestic financial transactions is frequently associated with a loss of confidence in the domestic currency. The following points emerged from interviews with the key banks and an analysis of the data:

(i) The malfunctioning of the exchange market was indeed one factor behind the rise in foreign currency lending. During the first half of 1995, and again in October-November 1995, when the exchange rate was not at a market clearing level, many banks were unable to obtain exchange at the going rate and, consequently, transactions between banks dropped to insignificant levels (Chart 4, middle panel, and Chart 5). Concurrently, each bank rationed the available foreign exchange among its own clients (state owned companies were obliged to hold their accounts at only one bank). Faced with difficulty in obtaining exchange from the interbank market, firms may have turned to borrowing in foreign currency to finance imports of goods and services. (To that extent, however, the rise in foreign currency-denominated lending basically substituted for a drawdown of domestic currency deposits and for an increase in domestic currency lending.)

(ii) Another factor behind the rise in lending denominated in foreign currency rather than in leu was the very high level of domestic currency interest rates. Leu lending rates (at 50-85 percent per annum (Chart 6)), have been considerably higher than, say, dollar interest rates (at 5-10 percent per annum). Given this wide margin, those borrowing in foreign currency were either prepared to take on the depreciation risk in return for the availability of credit, or were hedged through export receipts. The fact that the exchange rate was, de facto, depreciating at a relatively gradual and predictable rate, may have encouraged banks' clients to take the exchange risk on foreign currency borrowing. (This would imply, however,

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1/ Measured in U.S. dollar terms, foreign currency-denominated credit increased by 59 percent. The Romanian Bank for Foreign Trade was responsible for over half of the increase in foreign currency lending (Table 3). The other major lenders of foreign currency were the Romanian Commercial Bank, Banca Agricola, Tiriac Bank, and Credit Bank (which is under direct supervision by the NBR).

2/ The valuation effect can be an important factor when considering the impact of foreign currency lending on NDA. As the exchange rate depreciates, the leu value of the stock of foreign currency lending increases, leading to a rise in NDA (the valuation adjustment is recorded under "other items net"). Therefore, the increase in NDA is somewhat exaggerated if the exchange rate is depreciating. (Broad money also increases as the value of foreign currency deposits rise, leading to an artificial decline in velocity.)

CHART 4
ROMANIA: Interbank Exchange Market
(In millions of dollars)

Source: Data provided by the Romanian authorities.

CHART 5
ROMANIA: Interbank Exchange Market and Exchange Rate

Source: Data provided by the Romanian authorities.

CHART 6
Romania: Interest Rates, Inflation and Bureau Premium

Sources: National Bank of Romania, and staff estimates.

that the financial market is very segmented; otherwise arbitrage would quickly have eliminated the perceived difference between returns on domestic and foreign currency assets and liabilities--see 11.4 below). The cost of foreign currency borrowing after allowing for actual exchange rate depreciation is shown in Chart 7. On the face of it there appears to be an inconsistency between this account of credit developments and the argument that the growth in imports reflected in part fears of devaluation. Indeed the literature on exchange market behavior suggests that such divergences of view between participants in goods and asset markets can play a significant role in explaining the adjustment process.

(iii) Both the Romanian Commercial Bank (RCB) and the Romanian Bank for Foreign Trade (RBFT) indicated that part of the lending in foreign currency has financed the import of raw materials, especially petroleum. However, they claimed that a significant portion of such lending was based on trade-related lines of credit extended by foreign banks to finance capital goods imports for credit-worthy enterprises in exporting sectors such as furniture and textiles. This re-lending or on-lending by domestic banks would contribute to an increase in imports, but not, of course to the rise that occurred in NDA. ^{1/}

The sustainability of current trends needs to be assessed, inter alia, in light of banks' sources of financing for foreign exchange lending. Banks can finance such lending through (i) an increase in customers' foreign currency deposits, (ii) reducing their foreign assets, or (iii) foreign borrowing on their own account or on account of clients. It is difficult to distinguish clearly between these cases from the available data (Chart 8). However, in the first ten months of 1995, foreign currency lending rose by US\$680 million ^{2/} while foreign exchange deposits increased by about US\$168 million. This is consistent with a US\$326 million decline in commercial banks' liquid foreign assets and broadly in line with the decline in NIR (Chart 8). In fact, until March this year, the total stock of foreign exchange deposits was higher than total lending in foreign currency by banks; since then, foreign currency lending has exceeded total foreign currency deposits by about US\$300 million.

In response to the rapid growth of foreign currency lending, the NBR substantially increased the reserve requirements for foreign currency deposits in November 1995. Foreign currency reserve requirements were more than doubled to 40 percent, if paid in foreign currency, and 20 percent, if

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^{1/} In the long run, trade-related credit lines from banks abroad should not affect NDA as they finance an increase in imports, leaving NIR unchanged. Therefore, imports would be higher than in the absence of such credit lines but they cannot explain the rise in NDA. If such lending is not off balance sheet, then it may lead to a rise in foreign currency lending, accompanied by a matching liability increase (an off-setting decline in "other assets net" in the case of nondeposit liabilities).

^{2/} The trade deficit was about US\$900 million in the first half.

CHART 7
ROMANIA: Cost of borrowing, 1994-95
(In percent per annum)

Sources: Data provided by the Romanian authorities and Fund staff estimates.

1/ Libor adjusted for the future 3 month depreciation of the leu; annualized.

CHART 8
Romania: Commercial Banks' Foreign Currency Deposits
& Lending, and Banking System NIR

Sources: National Bank of Romania.

paid in lei. The NBR also indicated that a prudential foreign exchange liquidity ratio is to be introduced by end-1995. Finally, the sharp depreciation of the exchange rate in late 1995 presumably increased significantly uncertainty about the domestic currency cost of borrowing in foreign currencies (ending the de facto "tablita") (Chart 7).

4. Confidence indicators

Given the delicate balance of payments situation, the difficulties in the exchange market, and the rise in foreign currency lending, the performance of indicators of confidence in the domestic currency is of particular interest:

(i) After declining sharply for several months during 1994, the velocity of circulation of broad money increased in January 1995 (Chart 9); since then it has declined modestly compared to 1994. The level of velocity in Romania, however, remains significantly higher than in the other transition economies (Table 4).

(ii) The ratio of foreign currency deposits to money has been fairly flat since the beginning of 1995 after declining significantly during 1994 (Chart 9, middle panel). However, real leu denominated household deposits rose continuously during the first eight months of 1995 (Chart 9, bottom panel) before declining during September and October. It seems somewhat puzzling that in spite of very high real interest rates (Chart 6), which have attracted household leu deposits, the ratio of foreign currency deposits in total money has not declined further in 1995; and more generally, as noted above, that there was not greater arbitrage between foreign and domestic currency-denominated assets and liabilities of residents. Chart 10 sheds some light on this matter. First, until recently, household leu deposits grew much faster than non-household leu deposits 1/, and the stock of household leu deposits now exceeds the stock of non-household leu deposits (Chart 10). 2/ Meanwhile, 80 percent of the stock of foreign currency deposits belongs to non-households: movements in the total value of foreign currency deposits are thus much more sensitive to enterprise, rather than household, behavior. These data thus suggest that enterprises were concerned to maintain high levels of foreign exchange deposits.

One reason why enterprises may have preferred to hold foreign currency rather than leu may lie in the malfunctioning of the exchange market. When the exchange market was operating as intended, between March and November 1994, both velocity and the foreign deposits ratio fell sharply (Chart 9).

1/ Since end-August, however, household U.S. dollar deposits have increased by more than the average monthly rate during the first eight months of 1995.

2/ At the beginning of 1994 it was half the level of non-household leu deposits.

CHART 9
Romania: Velocity, Foreign Deposits and Household Savings

Sources: Data provided by the Romanian authorities; and staff estimates.

CHART 10
Romania: Domestic and Foreign Currency Deposits

Sources: National Bank of Romania.

Subsequently, importing enterprises holding deposits may have believed that the exchange rate was over-valued (but presumably not those enterprises borrowing in foreign exchange--see above). However, prudential considerations may also have played a role. First, difficulties in accessing foreign exchange: holding deposits in foreign currency assured immediate access to foreign exchange in the event of shortages. Second: to the extent foreign exchange deposits are held not directly by enterprises but by their subsidiary/associate trading companies, then--if an enterprise has tax, interest or other arrears--its foreign exchange holdings are safe while its leu deposits may be vulnerable to seizure by domestic creditors.

(iii) Other relevant factors affecting confidence are inflationary expectations and perceptions of risk. During the first nine months of 1995, three to six month leu deposit rates declined from about 70 percent to some 40 percent, whereas dollar deposit rates ranged from 4 to 6 percent. Therefore, there were either large inflationary expectations, or a substantial risk premium associated with leu holdings, or both. While annualized monthly inflation declined to as low as 15 percent during the first ten months of 1995, year-on-year inflation declined from about 50 percent at the beginning of the year to about 25 percent by end-October. It could well be that people form expectations on the basis of past rather than current inflation; therefore, inflationary expectations may be higher than contemporaneous inflation.

One way of ascertaining inflationary expectations is to look at the yield curve over time (Table 5 and Chart 11). Given the imperfections in the financial system, the shape of the yield curve varies from bank to bank even for the same period; however, these curves have converged in recent months (Chart 11). For every bank, the yield curve shifted down between mid-1994 and September 1995, suggesting that inflationary expectations improved. By November 1995, as the current account continued to deteriorate and inflation picked up somewhat, yield curves started to move up at some banks. However, for most banks the shape of the yield curve continues to be fairly flat, indicating that inflation was not expected to fall from current levels--no doubt in part because inflationary expectations are slow to adjust.

5. Current account deficit and output growth

Table 6 illustrates that imports of all commodities rose sharply in the first half of 1995. However, the increases in imported raw materials, intermediate inputs, and petroleum were particularly marked. Most of the increase in the value of oil imports was due to a 44 percent increase in the volume of oil imported during what turned out to be a mild winter (see Chapter III). Three types of commodity groups: mineral products (half of which is petroleum), chemicals, and basic metals--which are primary or intermediary inputs--accounted for 40 percent of the total value of imports (the value of petroleum by itself accounted for 15 percent of the total value of imports). Another major category of imports was machinery and electrical equipment; accounting for 19 percent of the total value of

CHART 11
Romania: Commercial Banks' Yield Curves
 (In percent per annum)

Sources: National Bank of Romania.

imports. ^{1/} It is also interesting to note that imports far exceeded exports in only two of the above categories: mineral products, and machinery and electrical equipment.

It is difficult, through the available data, to trace directly the imports of the above commodities in the production chain and determine whether they are demand led or speculative, or if they go to viable or problem enterprises. However, a number of indicators may shed some light on these matters, albeit, indirectly. For example, if output in a sector is growing and stocks are rising it may indicate problems. On the other hand, if the rise in output is associated with declining stocks then we would have a simple demand led output growth with an associated rise in imports. Other useful indicators are ratios of stocks to output, exports to output, and stocks to exports. Developments in sectors such as chemicals, metallurgy, metallic construction, petroleum processing, power, and machines and equipment should be of particular interest since they would be key users of the major imported commodity groups mentioned above, and they include many problem enterprises.

Tables 7-13 provide an overview of output growth and sectoral developments during the first three quarters of 1995. Although industrial output increased by some 10 percent (compared to 1994:Q1-Q3), there were wide sectoral variations (Table 7). In communication equipment, paper, computers, fabrics, precision instruments, and furniture (none of which can be regarded as a problem sector), output was well above average, whereas in petroleum and gas extraction sector output actually fell. The problem arises when looking at a group of sectors such as metallic construction, machines and equipment, metallurgy and chemicals. Output in these sectors (which contain "problem" state-owned enterprises and are users of the major imported commodity groups), increased by more than the average rate.

Table 8 provides the change in stocks, the ratio of stocks to output, and the ratio of stocks to exports for each industrial sector. The data provide a snap-shot view of each sector and their quality cannot be assured, therefore they should be treated with caution. Nonetheless, the following points emerge:

(i) The increase in the average rate of stock-building appears rather high especially since the ratio of stocks to output is high in most sectors. The increase in stocks is partly seasonal judging by the past aggregate data (Chart 12).

(ii) With regard to the problem sectors, stocks in the chemical sector increased by an alarming 63 percent and the ratio of stocks to output is

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^{1/} This category includes both consumption and investment goods. Textiles were another major category of imports; however, the value of textile exports exceeds imports and some of the textile imports are for finishing and re-exporting.

CHART 12
ROMANIA: Inventories
(End of period)

Source: Data provided by the Romanian authorities.

rather high. In machines and equipment sector stocks increased by 56 percent and the ratio of stocks to output and stocks to exports are high. In the metallic construction sector, stocks rose by about the average rate; however, the ratios of stocks to output and of stocks to exports are rather high. In metallurgy, stocks rose by less than the average rate and the ratio of stocks to output, though high in absolute terms, is not high relative to the other sectors.

(iii) It is also interesting to note that, in spite of low production, stocks in both petroleum and gas extraction, and the petroleum processing sectors increased sharply in the first nine months of 1995 (by 72 and 63 percent respectively). So, despite the large imports of petroleum, it appears that the demand for oil was not particularly high relative to the same period last year. This confirms the view that the petroleum imports were either speculative because of the level of the exchange rate or they were simply for building strategic stocks and were not demand-driven.

Tables 9 and 10 provide output and stock-building data by product. Again, it is difficult to draw precise conclusions; however, the following points are worth noting:

(i) Stocks of a number of products (steel sheets, fertilizers) from problem sectors increased substantially with a commensurately high increase in output. This would be problematic unless the cause were seasonal (fertilizers may be seasonal but not steel sheets). 1/

(ii) Again, stocks of petrol and fuel oil increased substantially while production of these items increased modestly.

(iii) Stocks of a number of products fell (dairy products, synthetic rubber, synthetic fibers) while their output increased substantially, indicating strong demand.

In summary, it is exceedingly difficult to trace the rise in imports through the production chain; however, the following conclusions emerge from the above analysis: (i) the imports of oil were clearly not demand driven; (ii) the output rise in a number of problem sectors which are potential importers of raw materials, such as metallic construction, chemicals, and machines and equipment, has been associated with rising stocks. If this pattern is not seasonal, then any imports by these sectors were either speculative or else their output increase is not entirely demand driven (the arrears of a number of steel companies increased sharply in the first nine months of 1995); and (iii) in a number of sectors--many of which do not include problem enterprises--the increase in output, and any associated rise in imports, appears to be demand driven.

1/ Stocks of TV-sets, trucks and buses increased substantially; however, they began the year with low stocks and are unlikely to be from problem sectors.

6. Productivity, employment and wages

Tables 11-13 provide data on sectoral productivity, employment and wages in order to ascertain the degree of adjustment in each sector. Industrial employment fell by 129,000 (5.4 percent) between September 1994 and September 1995 (Table 11). There was significant labor shedding in some of the large problem sectors. For example, employment fell by 8,100 (6.7 percent) in the chemicals sector, 4,300 (6.1 percent) in metallic construction, and 9,000 (5.3 percent) in metallurgy. Consequently, productivity in these sectors improved (Table 12). Employment reduction was lower in some of the other sensitive problem sectors. In iron ore mining, employment fell by 2,200 (4 percent), and in other extraction activities employment declined by 700 (3.9 percent). Productivity in these sectors increased by less than the industrial average (Table 12).

Average net-wages increased by some 50 percent between September 1994 and September 1995 (Table 13). CPI and PPI increased by about 25-30 percent during this period; therefore, there has been an increase in the real wage of some 20-25 percent. The recent increases may have been due to a catch-up effect as by October 1995 real consumption wages were at the same level as in 1992. In addition, unit labor cost competitiveness does not seem to have deteriorated (Chart 13).

The highest wage increases were in the financial and public sectors. However, the latter reflects a one-off payment to public employees whose wages had fallen behind other groups and whose wage level remains one of the lowest in the economy. Wages in industry increased by about 50 percent in nominal terms (some 20-25 percent in real terms) during the September 94-September 95 period. The industrial distribution of wage increases is interesting: wages in both the mining and power sectors increased by much less than average, which is surprising given the strength of the labor unions in these sectors. Wages in metallurgy increased by more than average (59 percent in nominal terms). However, wage levels in mining, engineering, metallurgy and chemicals continued to be the highest in the public sector, well above those in public administration and education.

In short, there has been important adjustment in terms of labor shedding in the industrial sector. However, not surprisingly, the adjustment in some of the sensitive problem sectors, such as mining, has been slow. One potential problem is the rate of increase in wages. So far, this has not damaged competitiveness or led to higher inflation but it needs to be monitored closely in the coming months.

CHART 13
Romania: Real Exchange Rate Measures 1/
 (January 1991=100)

Sources: Data provided by the Romanian authorities and staff estimates.

1/ An increase in an index indicates real appreciation.

2/ January 1992=60.

3/ The observation for November 1995 is based on the actual exchange rate and estimated inflation.

III. Fiscal Policy in Transition

Fiscal policy in Romania has undergone major changes since the initiation of economic liberalization and market reform. Revenues have declined as the tax base was eroded, and the taxation system had to be adapted to the needs of a decentralized economy; expenditure policies had to be reoriented towards new priorities, and budget management systems had to be improved; finally, the social safety net had to be adapted in response to new challenges such as unemployment and inflation. This section discusses major trends in revenue and expenditure policies, reforms of the tax and expenditure management systems, and the evolution of the social safety net during the transition period.

1. Revenue developments and tax reform

During the first four years of economic liberalization, Romania experienced an extensive decline in revenues, which began to be reversed only in 1995. This experience was shared by most transition economies, and is in part related to the decline in output associated with the reallocation of resources following the end of the state-trading system among centrally-planned economies. In Romania, important progress has now been made in establishing a modern tax system, through a succession of tax reforms beginning in December 1989--the most recent of which have proved quite effective. These reforms have gradually transformed the former tax structure into a modern system, which includes a value-added tax (VAT) and an inflation-indexed profits tax. Two stages have marked tax reform efforts over the last five years.

a. Developments in 1989-93

During these years a number of taxes of the pre-reform period were eliminated while new taxes were introduced, in part in an ad hoc manner. At the same time, total revenue declined substantially--from 39.8 percent of GDP in 1990 to 33.8 percent of GDP in 1993 (Statistical Appendix tables 34 and 35).

Initially, several anachronistic turnover taxes were canceled, including, in particular, the turnover tax at the wholesale level. The rules regarding profitability, destination of goods, margins applied to consumer goods delivered to rural areas, and labor contributions to production were rescinded. By end-1990, the turnover tax was retained only at the retail level--a first step toward the ultimate replacement of turnover taxes with a VAT in 1993. 1/

1/ Further small steps were also undertaken in 1991 and 1992 to continue to simplify the turnover tax. The number of rates in gradually reduced first to 20 and then to 5.

In addition, in mid-1990, the confiscatory profits transfer tax was abolished, so as to reduce the tax burden on enterprises. In the first instance, it was replaced (retroactively to early 1990) with an entity-specific, progressive enterprise tax, which contained six brackets with rates ranging up to 58 percent. Subsequently, in early 1991, another profits tax was promulgated. In this second round of the reform of the profits tax, the archaic profits tax on state enterprises was abolished together with the agricultural profits tax on farming cooperatives. A new, multiple rate profits tax was adopted as a tax for all enterprises. ^{1/} An unfortunate feature of the new tax was the explicit promotion of tax incentives as instruments to attract investments. The new profits tax offered generous investment tax allowances and tax holidays for selective activities, which, in the event, acted like a sieve through which revenue would slip. Collection of profits tax fell from 7.2 percent of GDP in 1990 to 3.8 percent in 1993.

In early 1991, an individual wage tax was introduced, based on wage payments at the enterprise level, replacing the former wage tax based on an average gross wage at the economy level. Furthermore, to support the tax-based income policy that would be a major element in the government's effort to control wage-induced inflation during the transition period, a supplementary wage tax was introduced. Enterprises which continued to pay wages that exceeded an established limit, differentiated by industry, would be heavily penalized.

b. Developments since 1993

By early 1993, it became clear that previous ad hoc measures to reform the wage tax and profits tax were producing poor results in terms of revenue, and that stronger measures were needed to prevent a further collapse of tax revenue collection. A major effort in tax reform was launched by the new government, with two major tax laws--among other changes--contributing to a halt in the decline of tax revenues: the VAT and, finally, an effective reform of the profits tax.

The most important reform was the introduction of a 18 percent VAT in July 1993 to replace the inefficient turnover tax. While removing the cascading effect of the turnover tax, the VAT, being a tax on consumption, would also provide a better balance between the taxation of income and consumption in Romania. This would reduce the growing imbalance that had

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^{1/} By end-1991, to alleviate administrative encumbrances and prevent bracket creep, the rates which at introduction ranged from 2.5 percent to 77 percent--containing 67 brackets--were rationalized to only two: 35 percent for taxable profits under lei 1 million, and 45 percent for profits exceeding lei 1 million.

emerged in recent years. ^{1/} In late 1994, a new rate of 9 percent was introduced for certain goods, primarily foodstuff and medicine, which were previously exempt. Revenues collected from the VAT increased rapidly, and are expected to reach 5.5 percent of GDP in 1995, compared to 4.6 percent of GDP in the preceding year. Nevertheless, this level of collection remains low by international standards and also compared with other Eastern European countries.

The second major reform was the introduction of a new Profits Tax Law, issued as an Ordinance in end-August 1994. The new tax eliminated the structural weaknesses embodied in the old tax through the combined use of inflation adjustments, appropriate depreciation allowances, and with a severe reduction in the use of tax holidays. However, the new profit tax did not lead to the expected large surge in revenues, due to difficulties in the administration of the new tax; lower than expected effects from the elimination of tax holidays; and increasing difficulties in profit tax collection from state owned enterprises--again an experience shared with other transition economies. Moreover, the financial restructuring program among large state-owned enterprises sharply reduced banks' profits in the first half of 1995, resulting in commensurately lower profit tax revenues (revenue losses from this source will exceed 0.4 percent of GDP in 1995). Nevertheless, revenues from the profit tax are projected to reach 4.3 percent of GDP in 1995--the first increase in five years, albeit still almost 2 percent of GDP short of the initial budget projections.

Additional reforms were introduced in the agricultural income tax, local taxation and wage taxes. The wage tax was amended to reduce the tax burden on second employment income by 70 percent, the maximum penal rate of the supplementary wage tax on excess wages was raised to 500 percent on enterprises which pay wages exceeding an industry-based reference wage. Finally, plans are being developed to broaden the tax base further through the introduction of a global income tax.

The most important challenge for the near future will be to consolidate the gains from tax reform by strengthening tax administration. While the tax base for some taxes (VAT) can be broadened and others (excise taxes) streamlined, the strengthening of tax administration is needed urgently in order to stem the increasing difficulties in tax collection. High priorities at the present time include: simplifying administrative procedures, improving coordination between the central government and judets on tax-related matters, computerizing the tax system, providing more manpower to the tax administration unit, and intensifying the training of tax auditors.

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^{1/} The ratio of consumption taxes to current tax revenue fell from 36 percent in 1989 to less than 20 percent in 1992.

2. Expenditure policies and management

In the first two years following economic liberalization, few major decisions appear to have been taken to formulate a public expenditure strategy: total expenditure remained around 39 percent of (the much reduced) GDP. In 1992, an election year, expenditure rose to some 42 percent of GDP. Throughout this period, there was a need to broaden the definition of the fiscal deficit substantially, as expenditures were routed through extra-budgetary accounts. (Thus, for the 1994 stand-by arrangement with the Fund, a broad definition of the consolidated general governments has been used--see discussion of public expenditure management, below). As a result of these developments, the fiscal balance deteriorated sharply from a surplus in 1990-91 to a deficit of 4.6 percent in 1992. This contributed to a serious deterioration in macroeconomic performance.

An improvement in expenditure restraint in 1993-94 played a major role in supporting the authorities' stabilization effort. However, in 1995, it proved necessary to cut back spending plans at a relatively late stage in the year in response to a serious worsening in the external situation. This experience underscores, among other issues, that there remains scope to strengthen substantially the Ministry of Finance's capacity to assess and monitor key economic variables during the annual budget preparation and when assessing the mid-year budget.

a. Expenditure policy since 1993

A major attempt to control and redirect public expenditure was initiated in 1993. As a consequence of these policies, total government expenditure was reduced by almost eight percentage points of recorded GDP. (Such comparisons need, of course, to be treated with a degree of caution, given the substantial uncertainties attaching to the national income accounts during the transition period.)

The most drastic cuts were effected on subsidies, which fell by about 6 percent of GDP. Transfers to less productive activities in the agriculture and mining sectors were scaled back in favor of more productive activities in the transportation and construction sectors, and to free resources for welfare programs for the poor. A reduction in government spending on goods and services was decreed which led to a real cut in expenditures on these items of some 30 percent. This squeeze was not accompanied by a major cut in the number of services provided, and caused public sector productivity to decline as the general ability of the government to provide its services was markedly reduced.

The wage policy adopted in 1993 resulted in a reduction of some 25 percent of real wage payments over 1992, while there was no major reduction in the number of government employees. Sharp cuts in capital expenditure, in 1993, lead to a long overdue rationalization of the public sector investment program. The new investment approach sought to divert resources from investments with a low social rate of return (e.g., Casa

Republici) in favor of investments with high a social rate of return (e.g. irrigation projects, schools, and civil infrastructure). 1/

In 1994, a significant effort was made to redirect expenditure policies toward underpinning sustainable economic growth. More resources were allocated for capital spending, social safety net expenditures, and general goods and services while consumer subsidies were cut by a further 3 percent of GDP. Capital expenditure rose by 1.2 percent of GDP, and in order to increase the efficiency of public investments the Council of Reform was instituted to coordinate and evaluate all sectoral public investment proposals.

More resources were also allocated for social safety net expenditures in 1994. As the adjustment process got underway, the combined impact of job losses and rising prices caused an increasing number of people to seek social assistance. In response, increased resources were needed to assist the aged, the poor, and the unemployed. Benefiting from an established welfare delivery network, resources allocated to child allowances, heating allowances, job training and retraining, pensions, and unemployment benefits rose by some 1.1 percent of GDP to 10.8 percent of GDP. Measures were introduced to reform the wage policy and a small scale civil service reform, was initiated. 2/ However, all remaining government employees also received an unprogrammed average salary increase of some 23 percent in the last quarter of 1994.

In 1995, the initial budget envisaged a reversal of the expenditure compression experienced in the previous years. Public expenditure was projected to increase by more than 4 percent of GDP over the level of 1994, thus bringing total expenditures to 38.8 percent of GDP, back to the levels of 1990-91. Higher expenditures were planned for wages and salaries, other goods and services and transfer payments and capital expenditures. Subsidies were slightly lowered reflecting a continued effort to reduce subsidies, especially to the mining and agricultural sectors. This budget was approved by parliament in March 1995. At this same time the allocations for capital expenditures and other goods and services and subsidies were increased. Subsequently, a number of revisions were made to the 1995 budget at the mid-year stage.

Developments in subsidies however, need to be interpreted in light of efforts to cut implicit subsidies and bring them within the budget. First, a main feature of mid-year changes in the 1995 budget was the incorporation of enterprise restructuring expenditures (see also the discussion of revenue losses from bank provisioning, above). The enterprise restructuring plans

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1/ In the years preceding economic reform, government spending on capital investments had been very high. From 1985-90, capital expenditure averaged some 17 percent of GDP. However, the benefit to the economy of much of these investments appears to have been negligible.

2/ There was a reduction of some 2,300 government employees.

presupposed additional fiscal expenditure on employee severance payments amounting to 0.2 percent of GDP. Second, in addition to these narrowly-defined restructuring expenses, as part of an effort to cut and bring within the budget various implicit subsidies in the economy, expenditures in 1995 included a conditional transfer (amounting to 0.4 percent of GDP) to selected loss-making enterprises that were heavy energy consumers--the stipulation being that these amounts would only be paid if certain adjustment actions were carried out. Third, in the same spirit, the 1995 budget incorporated from the outset agricultural interest subsidies amounting to 0.2 percent of GDP that were formally provided by the NBR; thus all agricultural now are explicitly included within the budget.

As 1995 progressed, it became clear that the levels of revenue initially projected by the government would not be realized--and also that balance of payments developments were more strongly adverse than anticipated earlier. In light of these developments, it was determined in late 1995 that spending should be held below the original budgetary allocations (without reducing restructuring expenditures). Nevertheless, compared with the level of the previous year, overall expenditures of the consolidated government in 1995 are expected to increase by about 2.4 percent of GDP .

b. Expenditure composition

Expenditure priorities, and with them the functional composition of expenditures, changed markedly over the past three years (Statistical Appendix table 36). As noted above, expenditure policy afforded the highest priority for social expenditures--pension payments, unemployment benefits, and child allowances have consistently received the largest budget allocation throughout 1992-94 (about 9 percent of GDP). By contrast, as programs of income support to the mining sector were adopted, total spending on their sector fell from second place in 1992 (7.1 percent of GDP) to fifth in 1994 (2.6 percent).

Resources allocated for education and health--which held, respectively, fourth and fifth places in 1992 (3.6 and 3.3 percent of GDP)--moved up to become the second and third most important in 1994. Defense spending declined from 3.2 percent of GDP in 1992 to 2.4 percent of GDP in 1994, but remained among the six largest categories. Higher shares of resources were allocated for public order (e.g., reform courts) over the period while expenditure shares for community housing and recreational and cultural affairs have remained more or less constant. The expenditure composition in 1995 is expected to remain similar to the pattern observed in 1994, however, somewhat higher shares may be allocated to agriculture, education and pensions.

A number of projects on environmental protection were initiated; however, due to the difficult budgetary conditions only limited resources were allocated to this sector (on average about 0.2 percent of GDP over the period from 1993 to 1995). Meanwhile, a comprehensive environmental strategy and a draft environmental law is currently under discussion. Key

elements of the strategy include harmonizing environment policy and standards with those of the European Union, focusing attention on specified industrial polluters, implementing measures to reduce power consumption and enlarging Romania's protected areas.

Further scope exists for expenditure reform that would support efficiency and growth objectives. To maximize social economic returns of public spending, resources would need to be redirected to increase capital spending on schools, hospitals, and transportation, reinvigorate repairs and maintenance programs, streamline various entitlement programs under the social insurance schemes, trim public sector employment, and cut further existing subsidies to agriculture and mining. Moreover, while considerable progress has been made, substantial scope still exists to strengthen procedures for reviewing the overall public expenditure program--including the capital expenditure program.

c. Expenditure management and control

A number of significant changes have been introduced to improve the financial management capabilities of the government since the economic reform process was initiated. One of the most important institutional reform measures was the setting up of a Treasury Directorate in the Ministry of Finance. Established in the early days to oversee the Treasury operations, the treasury system has since been extended rapidly to local offices throughout the country. In the process, the cash management of the Treasury has improved and the flow of information from local offices to the Ministry of Finance has increased significantly, thereby enhancing the quality of financial decision making in the Ministry of Finance and facilitating budgetary execution.

In order to strengthen further the institutional structures, a Public Debt Directorate was established. Through it, the Ministry of Finance has become more effective in mobilizing domestic resources--through the issuance of treasury bills and government bonds--and in securing external funds for the financing of the State budget deficit. In addition, the Public Debt Directorate was set up to become a coordinator of the government's role as a "lender of last resort" for state-owned enterprises undergoing restructuring by overseeing the government loan guarantees program.

Major changes have been implemented in the organization and reporting of government expenditures. Since 1993, special extrabudgetary funds--traditionally not components of the annual Budget Law--have been made constituent parts of the Budget Law. Extrabudgetary funds are submitted for Parliamentary debate and approval, thereby, greatly improving the accountability of the government. The better coverage of the general government facilitated the assessment and monitoring of the fiscal position in Romania (Statistical Appendix table 37). In addition, to reduce the fragmentary nature of the Budget Law, efforts are under way to reduce a number of special extrabudgetary funds by consolidating earmarked resources with the State budget.

The quasi-fiscal operations of the NBR were curtailed with the passage of new profits tax law which imposes a tax of 80 percent on the National Bank profits. Furthermore, since 1994, the major quasi-fiscal activities previously undertaken by the NBR have been transferred to the State budget. This improved the transparency of government operations and made the consolidated fiscal budget deficit a better measure of the overall fiscal stance.

To improve explicit expenditure control, measures of expenditure sequestering have been adopted annually through the Budget Law since 1993. As an important component of macroeconomic stabilization, the Budget Law mandates an obligatory use of expenditure blocking against certain approved budgetary allocations--excluding wage payments, pensions, children allowances, and interest payments--in the event of a shortfall in either domestic revenue collection or external financing. Consequently, some 10 percent of allocated expenditure in the State budget was blocked for the first seven months of 1994, and expenditure sequestering was reintroduced in a revised budget in late 1994 which had allowed the Ministry of Finance to sequester up to 50 percent of blockable expenditures in November and December.

For 1995, up to 20 percent of allocated expenditure were to be blocked by this means and in August 1995 that share of blockable expenditure was raised to 27 percent. Although this system of expenditure sequestration has allowed the government to limit expenditures when revenues have fallen short of their projected levels, it may contribute to worsen expenditure composition and should be replaced by a more comprehensive budget management system.

3. Evolution of the social safety net

Social protection has undergone marked improvements in Romania since the beginning of transition to a market economy in 1989. In the pre-reform days in Romania, the key means of income support came in the form of job security for the able-bodied individual and pensions for the retiree. meanwhile, government subsidies on food, housing, and transportation had kept prices artificially low which--thus helping to compensate for low earnings and low, fixed pension income. With this philosophy, social assistance programs centered narrowly on the handicapped, orphans, and elderly needing special institutional care.

a. Social insurance

Two problems with the adequacy of the social insurance system became obvious at the outset of the transition: it was not structured to protect either the unemployed against the loss of earnings or the elderly against price increases on essential commodities.

As a first priority, therefore, the Unemployment Fund was established in 1990 to provide benefits to the increasing number of workers who were

laid off as output fell and enterprises began to adjust to market signals. Through Law 1/1991, benefits payable for the first nine months of unemployment would provide up to a maximum of 85 percent of the minimum wage. 1/ A reduced benefit of 40 percent of the minimal wage would also be paid for a period of another nine months if the individual remains unemployed at the end of the first nine months. A skills-for-job program was introduced to retrain and upgrade anyone interested in acquiring new skills. This program, albeit modest, expanded steadily. In addition, to bolster employment opportunities, the government established, through the Unemployment Fund in late 1994, a special facility that would lend up to 0.2 percent of GDP to small- and medium-size enterprises for job creation. In late 1993, the Fund provided technical assistance on the social safety net in conjunction with the government's stabilization program: a major focus of this assistance was an assessment of the possible fiscal impact of rising unemployment, and development of contingency measures to avoid a consequent worsening of the budget deficit.

Old-age and disability pensions also became partially indexed in 1990, to preserve the purchasing power of the elderly and disabled workers. Following years of ad hoc amendments, the pension system had become overcentralized, laden with bureaucracy, and fragmentary. 2/ New measures were thus quickly introduced to contain costs and reduce duplication. The number of pension schemes was reduced, plans for further centralization in administration and payments were abandoned, and a process to reform social insurance--with World Bank assistance--was initiated.

One measure, adopted in the early stages of reform, would seriously affect the long-term sustainability of the social security budget. In 1990, an opportunity was given to each worker who had completed the required length of service to retire five years earlier. This generous policy, conceived as a measure to alleviate the problem of rising unemployment, created a flood of new beneficiaries over a one year period, increasing the number of pensioners by some 400,000 or 13 percent. Consequently, pension expenditures would jump from an average of 5.1 percent of GDP in 1987-89 to an average of 7.5 percent in 1990-92. While part of the increase reflected higher pension payments following price liberalization, 3/ the culprit was clearly the ill-conceived policy implemented in 1990. Thus, between 1990 and 1992, contribution rates would have to be increased three times to pay for higher pension costs. In 1990, employer contributions would rise to

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1/ The exact benefits payable would depend on the length of service rendered before the worker loses his job.

2/ There were at least six large independent pension schemes and several smaller pension funds operating in 1989. Besides the State social security system, separate pension funds were established for farmers and artists, and by religious denominations.

3/ Replacement rate varies from 40 to 60 percent of monthly income depending on contributions made by each worker in the last years of his working life (10 years for farmers and 5 years for others).

20 percent from an average of less than 15 percent. In 1991, a further increase of 2 percent was mandated. In 1992, new rates were again established with an average contribution rate of 27.5 percent. ^{1/}

Further pension adjustment were effected in 1992 for retirees, disabled workers and maternity benefits. For retirees who had seen their fixed-income pensions eroded by rising prices in the early days of reform, the old-age pensions were adjusted more substantially since 1992 to safeguard declining purchasing power through partial indexation for inflation. ^{2/} It is estimated that a large percentage of retirees continue working in order to supplement their pension income. For disabled workers who had seen their disability pensions and work-related compensation largely frozen in the early 1990s, the benefits for work-related accidents and diseases and disability pensions were increased in 1992. For child-bearing women, maternity benefits were also raised in 1992. Paid maternity leave rose from 60 days to 112 days, and a paid leave of up to 65 percent of gross wage for a period of one year became available to any working mother wishing to take time off to care for a child of up to three years of age.

Finally, several measures were introduced to curb fraud and abuse. For example, to reduce the cost incurred by the social insurance budgets from high rate of worker absenteeism and malingering, a policy was adopted that would require employers to pay the cost of the first 10 days of sick leave claimed by each worker. Since employers are better placed than officials of the social insurance system to supervise their workers, this measure is expected to minimize abuse of the system.

b. Social assistance

As economic restructuring began to gather pace and the levels of unemployment and prices rose, the need to protect those individuals who were either inadequately or not covered by the social insurance system became a high priority. Thus, since early 1990, the goal for social assistance would evolve to become one which stresses the safeguarding of a minimum acceptable standard of living for the poor and vulnerable. The system now emphasizes children, minors in special situations, orphans, the handicapped, poor families with children, and the elderly. As in the case of social insurance, social assistance is also designed with specific target groups as

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^{1/} Today, the pension system, a pay-as-you-go system, has three basic rates for three distinct groups of workers. The social security tax levied on employers is as follows: 35 percent for Group I workers, 30 percent for Group II workers, and 25 percent for Group III workers. Employees contribute only 1 percent to the main social security funds and an additional 3 percent of gross wages to the SPF.

^{2/} Currently, old-age pensions are indexed through the annual Social Security Budget Law. Pension payments, however, are regulated so that real pensions are not permitted to fall below a specified threshold.

objectives. Several major initiatives were introduced since 1989 to lessen economic hardships.

Measures were adopted to protect children and poor families with children. For example, through Law 61/93 and Government decision 591/1993, the State allowance for children was raised to lei 6,400, while the maximum age of eligibility for assistance was increased from 16 to 18 years for those still attending school. In addition, social assistance for minors in special conditions was enlarged. The foster home program was bolstered by raising the foster parent allowance. The project was also expanded with a Romania Orphanage Trust pilot program to extend fostering to nonrelatives. The government approved a bill in late 1994 to retarget and improve its assistance to poor families with children. Thus, benefits to some 10 percent of the lowest income population (about 0.52 million families) were reformulated based on a size-related, minimal family budget requirement.

Several initiatives were introduced to improve the situation of the unemployed, poor elderly and handicapped. For the unemployed, in addition to receiving support through the social insurance system as noted earlier (unemployment benefits and retraining program), Government decision 290/1992 extended the social canteens food program to anyone in need of assistance thereby opening this program to the unemployed. ^{1/} For the elderly on fixed pension income, support was largely provided through the social insurance system. However, through social assistance programs, additional funds were periodically provided through the annual State Budget Law for old-age and special care institutions. Thus far, four colleges for social work have been established for the training of staff to care for the elderly and handicapped in specialized institutions. For the handicapped and those unable to work, special benefits were introduced to provide minimal support to them and their families. Each handicapped person receives a new special monthly benefit, while each adult who is unable to work and has no other income receives a quarterly benefit. In addition, small cash benefits may be extended on a case-by-case basis.

c. Remaining agenda

While a number of some important changes have been introduced in the social protection program, substantial challenges remain. In the area of social insurance, a central priority is the development of plans to improve long-term financial sustainability of the system. In this connections, the government issued a White Paper on social insurance and pension reform in December 1993 that set out policy options to ensure the viability of social protection in the future. Draft laws were submitted for Parliamentary

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^{1/} This program was originally conceived to help only those who cannot work (not those who are unemployed). With the new initiative, the social canteens food program expanded rapidly throughout the country, with five such facilities in Bucharest serving some 24,000 people daily.

approval in fall 1995 to unify the various pension schemes, create a streamlined system of benefits, gradually increase the retirement age, and encourage the development of a complementary private pension fund. A comprehensive study on the medium-term fiscal implications of the pension system should be a priority.

In the area of social assistance, scope remains to improve design of the system and to foster closer coordination among care providers. As regards program design, the State allowances for children, which are based on the concept of universality, are not adequately targeted to those children most in need of help. In addition, there is scope to improve the efficiency of the cash benefits program by relating the need for help to the real income of an individual through means testing.

IV. Structural Issues

Before the liberalization process began in 1989-90, Romania was one of the most tightly controlled and centralized economies in Eastern Europe. 1/ There had been no significant economic reforms for several years, leaving the administration of the economy tied to a Stalinist model that had been abandoned by almost all other countries in the region. 2/ The state sector was totally dominant, with high levels of market concentration, and a relatively large proportion of GDP being produced by heavy industry, operating under rigid quantity targets. The employment structure also heavily favored manufacturing.

Against this very problematic background, this section reviews, first, the scope of changes that have been taking place in Romania at the microeconomic level, with particular emphasis on the environment for private sector development. Next, the issue of large loss-making state enterprises is addressed, followed by the closely-related topic of the health of the banking system. Finally, the nature and experience of initiatives to accelerate privatization are discussed.

The design and execution of structural policies in Romania is of particular importance for macroeconomic performance in two respects. First, experience from other economies in transition shows that progress in hardening budget constraints for large state-owned enterprises is essential if threats to macroeconomic stabilization are to be avoided--including the threat of large and growing quasi-fiscal liabilities in the financial system. Second, progress in achieving high-quality growth does not depend

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1/ Demekas, Dimitri G., and Mohsin S. Khan, *The Romanian Economic Reform Program*, Occasional Paper 89 (Washington: International Monetary Fund, 1991).

2/ Daianu, Daniel, "The Changing Mix of Disequilibria During Transition, A Romanian Background". IMF Working Paper 94/73 (Washington: International Monetary Fund, May 1994).

only on macroeconomic stabilization and high level restructuring but also on adjustments at the microeconomic level and on an environment that is friendly to private sector initiatives.

1. Microeconomic adjustment and private sector development

A key objective of the transition process is to achieve an environment in which decision-making becomes decentralized and enterprises adapt to competition and changing market conditions. This implies relaxing many controls and replacing them with market disciplines. Among the largest enterprises--discussed below--issues of moral hazard and adverse selection may be so serious that direct state involvement is needed to ensure that activities are slimmed down--or at the least that scarce bank credit is not diverted on a systemic scale to unproductive uses. But this process of dealing with the largest problem enterprises--while most important in the Romanian context--is in essence an exception rather than a rule: the rule being the withdrawal of ministries and the central bank from direct involvement in industrial and commercial decision-making.

Since the change of regime in 1989, successive governments have declared their commitment to policies aimed at transforming the tightly controlled centralized economy in favor of a market-based system. The transition strategy has been based on a gradual approach to structural reforms and implementation has often occurred with considerable delay.

In the absence of rapid change of ownership of the productive assets, the lags in the adjustment process have been considerable and many rigidities still remain. Examples of such rigidities are obstacles for market entry and exit, high information and transaction costs, a legal framework still in need of further modernization (e.g., through the passage of the Competition Law), and insufficiently developed marketing and distribution systems. At the same time, the recovery in the economy over the past two years clearly provides evidence of spontaneous development, facilitated by the stabilization policies and an environment in which distortions have been largely removed from key prices (including the interest rate and, for significant periods, the exchange rate).

a. Deregulation and adjustment

The most important reforms undertaken after the change of regime were the phased process of price liberalization starting in November 1990, accompanied by the gradual elimination of the administrative allocation of resources and the devolution of decision-making power to enterprises. The share of administered prices on consumer goods and services has fallen to 3 percent in the middle of 1995, from 90 percent in 1989 (Statistical Appendix table 10). For industry, the changes are also major--moving from a total control of industrial producer prices and procurement prices on raw materials to a situation by end-June 1995 when the shares controlled were reduced to 7 and 27 percent, respectively.

Over time, the successive freeing of administrative prices and the substitution of price signals for traditional quantity rationing as the chief mechanism of allocating resources, have provided a new framework for enterprises to start reacting to changing market conditions and emerging competition. While many large state-owned enterprises continue to generate substantial losses and arrears and to resist corporate restructuring, many other enterprises, including small and medium-sized firms, owned by the state or the private sector, have taken advantage of the opportunities offered by free market conditions. Indeed, productivity is estimated to have increased during 1994 by some 8-9 percent; this improvement is believed to have occurred predominantly in medium and small firms, which are now generally subject to hard budget constraints.

By the end of September 1995, the Romanian enterprise sector consisted of 743,713 units (Statistical Appendix table 19), of which the privately-owned firms were numerically the vast majority but state-owned enterprises accounted for a dominant share of employment and output. A rough categorization of Romanian enterprises in 1995 in terms of their efficiency would provide the following picture. First, newly set-up companies, beginning in 1990, with private capital: many of these register high profits but they account for a low share in industrial production. Second, companies which have been privatized and carry out activities more efficiently than prior to privatization, and which are now more profitable. Third, companies with predominantly state-owned capital, having large production capacity, with a great number of employees--generally, above the number needed--which account practically for the whole industrial production of the country; many of the larger enterprises are inefficient and unprofitable; adjustment is particularly slow among these enterprises.

The economic results of enterprises vary greatly. Important differences exist both between these broad groupings and within each grouping. Many of the newly-established enterprises and the newly privatized companies are more profitable not because they have a better technological endowment, but mainly because they have better management. The small- and medium-sized companies tend to be the most flexible and adaptable enterprises in the Romanian economy. They are job-creating in a wide range of activities and extremely mobile, making a growing contribution to GDP. Productivity is high because they cannot afford over-staffing, as is often the case in the larger enterprises. Thus, it would appear that better corporate governance is a key explanation for the success of the small- and medium-sized enterprises and the private sector.

A critical issue has been the need to strengthen the accounting framework in Romania so as to be able to evaluate the true financial performance of enterprises (and indeed the true profitability of investment decisions). Evaluation of trends in the Romanian banking and the enterprise sectors has been seriously hampered by statistical and accounting inadequacies. The real financial situation of state-owned enterprises is not properly reflected in their accounts. Major flaws in the accounting system are creating distortions and vastly overstating the financial

performance of the companies; for example, unpaid sales and production to inventory or for internal consumption are recorded as revenues. Furthermore, enterprises have in the past not been allowed to make provisions for doubtful accounts receivable; the same enterprises may be building up arrears on their accounts payable. Since revenues tend to be overstated, enterprises show "profits" on which they pay taxes and dividends. These represent a real outflow of cash but as the enterprises profitability is illusory, this leads to decapitalization of the enterprises. Consequently, Romanian companies can be cash-starved, even when showing an accounting profit. The situation was further aggravated by the use of historical cost accounting in times of high inflation; for instance, during 1991-93 with CPI increases in excess of 200 percent annually.

Effective January 1, 1994, Romania implemented a new system of generally accepted accounting principles, more closely based on the French system. Under this system, enterprises are required to keep their accounts in accordance with an accounting system designed in conformity with European Union directives. These changes included new rules for valuing intangible assets and for making provisions for bad debt and losses on foreign exchange, all designed to bring Romanian regulations into line with practices in western Europe. The new rules also sought to make adequate allowances for the effects of high inflation by applying the guidelines on accounting practices under hyperinflation. In practice, many enterprises have not yet made the transition to the new accounting system.

b. Private enterprise sector

The liberalization of the price system has provided a critical incentive for the rise of private enterprise in Romania. Entrepreneurs are expanding into most sectors of the economy, often competing successfully with the much larger state-owned enterprises. In terms of trade dynamics, the private companies' performance is impressive: in 1993, some 27 percent of both exports and imports originated from this sector, while over the first nine months 1995 the private sector's contribution was 40 percent of exports and 45 percent of imports. Increasing market shares show that the private companies are considerably more efficient in cutting costs and producing value-added than the traditional state-owned enterprises. Surveys typically indicate that private sector productivity appears to be more than double that of the state-owned sector and results in significantly higher profits.

The competitive power of the new companies is indicated by the contribution of the private sector to GDP which increased from 16.4 percent in 1990 to almost one-third in 1993 and an estimated 37 percent at end-1995 (Statistical Appendix table 2). In 1994, roughly half of the private sector contribution came from the agricultural sector. In addition, the private sector shares of industry and construction have more than doubled since 1990 and 1991 respectively (Statistical Appendix table 18). The success of the private sector may, of course, be understated by official statistics on

production, to the extent these may largely reflect the performance of state-owned enterprises and fail to capture fully private sector activities; under-reporting of private activities no doubt also results from tax evasion.

As a result of the strong growth of the private sector during the last few years, its share of total employment has increased from below 6 percent in 1989 to almost half at the end of 1995. Employment opportunities offered by the weakening of the old control system which used to regulate entry to commercial activities are significant in a large number of sectors, the most important being agriculture and services.

Until 1989, the development of services in general and business services in particular was a neglected dimension of the economic dynamics of Romania. The economic system was not conducive to the development of services and economic policy was largely biased against services. Consequently, at the beginning of 1990, Romania was the least service-oriented economy among the former centrally-planned economies. Given this background, it is not surprising that most of the private sector expansion during the 1990's has taken place in services, typically retail trade and tourism. At the end of September 1995, the private sector share of Romanian retail sales had increased to 70 percent from 65 percent at end-1993.

c. State-owned enterprise sector

At the end of September 1995, there were some 6,300 state commercial companies and 83 régies autonomes (Statistical Appendix table 19) ^{1/}. The commercial companies are planned eventually to be privatized: they are either fully state-owned or have a state participation in excess of 50 percent. The régies autonomes are to remain under state ownership and report directly to line ministries and the Ministry of Finance. Régies autonomes are typically enterprises of a "hybrid" form with both commercial functions and some authority normally associated with government agencies; they are typically natural monopolies, utilities, "public interest" entities, or entities deemed essential for national security.

Although some smaller and medium-sized state-owned enterprises showed encouraging signs of adjustment in enterprise behavior, and a strengthening of financial discipline, particularly during 1994, many large state-owned enterprises have faced great difficulties in adjusting to changing market conditions. It has proven difficult to impose a hard budget constraint on these enterprises. In general, the necessary downsizing of excess production capacity or workforce and the divestiture of nonessential or low-productive assets has not taken place to the extent needed. This and other problems faced by a core set of state-owned enterprises are being addressed by the authorities under the auspices of a proposed World Bank Financial and

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^{1/} For discussion of enterprise privatization in Romania, see Section IV.4.

Enterprise Sector Adjustment Loan, FESAL, which is expected to be approved by the World Bank after Romania has reached an agreement with the Fund on continued support (see below).

d. Financing the adjustment

The microeconomic adjustment and expansion of the small and medium-sized companies appears to be largely self-financed through profits and private savings. To the extent recourse is taken to external financing, it is mostly in the form of short-term credits from suppliers. These trade credits appear to be voluntary (contrary to the situation in the state-owned enterprise sector where payments arrears remain rampant). Cash-based rather than credit-based financing reflects, in part, the direct financial discipline of living under a hard budget constraint. However, small- and medium-sized firms also tend to avoid taking credits from banks because of the complexity of procedures, their lack of experience and the high cost of credit. It is encouraging that, during 1994 and 1995, the commercial banks, led by the new private banks, have showed an increased interest in expanding their services to these types of enterprises (see Section IV.3 below). There are also different forms of concessionary financing available to these companies through nongovernment institutions as well as some forms of international support through EC/PHARE and USAID.

By contrast, the operating losses incurred by state-owned enterprises are typically financed through budget transfers and subsidies, through decapitalization of the companies, or, alternatively, through the build-up of arrears to suppliers, banks, or the budget (Statistical Appendix table 20). ^{1/} The payment arrears of the state-owned enterprises are expanding much faster than for private companies. Their arrears accelerated during 1994 by 139 percent, and continued growing during the first nine months of 1995 when they were equivalent to 13.9 percent of GDP. In particular, the arrears to the state and local budgets and to the extra-budgetary funds expanded and accounted for almost one-third of all arrears. It is notable that there was a sharp deterioration in the position of the core problem enterprises in early 1995, more than reversing the improvement in 1994 (measured relative to GDP, see tabulation in Section IV.2.e).

In the future, continued progress by the more dynamic enterprises would need to be supported by wider access to funding and equity through the creation of capital markets. In addition, the introduction of a Competition Law and the application of the new Bankruptcy Law will be important in removing obstacles to the entry and exit to and from markets and to strengthen financial discipline.

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^{1/} For a further discussion on payment arrears in Romania, see Section IV.2.

e. External aspects

Foreign capital has the potential of playing an important role in Romania's economic reform both by furnishing additional financial resources to raise overall productive output and by providing the managerial, technological and entrepreneurial skills to underpin free market reforms. As of September 20, 1995, there were 47,671 foreign investments in the country and the total value of these investments since 1990 amounted to US\$1,479 million (Statistical Appendix table 46).

During 1994 and 1995, a 51 percent investment by Daewoo of Korea in an automobile plant for US\$156 million constituted the single largest investment in Romania so far. Another major investment was carried out by Unilever by means of acquiring the majority share in a privatized chemical plant. However, by and large, foreign investments have been slow in materializing in Romania compared with other central and eastern European countries.

This general picture is confirmed also by comparative trade data. The significant restructuring achieved in the countries in transition in the last four years is evidenced, inter alia, by a massive reorientation of trade toward the European Union. The data on export performance suggest that the country that pursued mass privatization the most actively and credibly, the Czech Republic, has done the best in terms of restructuring its industries and reorienting them toward world markets. Those that pursued a gradual approach, such as Romania, also have undergone less change in the structure of exports. The two countries where the output collapse has been most severe, Bulgaria and Romania, also have the weakest overall trade performance. 1/

2. Enterprises with large losses or arrears

The initial stabilization efforts after 1989 were undermined by the failure to impose a hard budget constraint on large loss-making enterprises: in particular, initiatives were taken to clear payment arrears by multilateral compensation operations accompanied by an injection of credit ("global compensations"). Thus arrears were, in a sense, validated ex post. Moreover, interest rates in the economy remained, until late 1993, steeply negative in real terms. This resulted in very large transfers of a quasi-fiscal nature through the banking system to the least efficient parts of state-owned industry and agriculture.

1/ Hoekman, Bernhard, and Gerhard Pohl, "Enterprise Restructuring in Eastern Europe: How much? How Fast? Where? Preliminary Evidence from Trade Data", World Bank (Washington: World Bank, January 1995).

Thus, while there were not large fiscal deficits (except for the second half of 1992), the negative interest rate mechanism applied such a heavy tax to savings that the demand for money collapsed, and inflation accelerated rapidly. Similarly, a concern to shield producers and consumers from the full impact of exchange rate adjustment led the authorities to interfere with the functioning of the exchange market, again discouraging economic agents de facto from holding leu-denominated bank deposits. As a result, by late 1993, the failure to tackle the problem of the largest state-owned enterprises had indirectly brought the economy to the verge of hyper-inflation.

The discussion which follows relates to the "quasi-fiscal" problem of state-owned enterprises in industry and agriculture that have large losses and/or arrears. This comprises, of course, only one part of the quasi-fiscal deficit in the economy. Two important further areas were already reviewed in this paper: the use of extra-budgetary accounts (see especially the discussion of expenditure management above) and the role of the central bank (also discussed above under expenditure management, and in connection with reforms in the 1995 budget).

The stabilization effort launched in late 1993 was designed to address directly the problems of large state-owned enterprises with large losses or arrears, through agreement on plans to downsize their activities (while avoiding a renewed "global compensation"). In parallel, initiatives were prepared to begin limiting the exposure of the banking sector to these enterprises, and to facilitate recognition of the implicit losses carried by the banks (see the discussion in Section IV.3). Policy support for this process was provided by the World Bank through negotiations for a FESAL.

In late 1994 and early 1995 there was significant slippage in these endeavors. As a result, the successful macroeconomic performance initiated in 1994 proved vulnerable, in early 1995, to a combination of resurgent pressures from problem enterprises with the legitimate import and credit needs of enterprises increasing investment to take advantage of export markets and the recovery in domestic demand. By late 1995, however, significant progress had been achieved in developing plans to reduce the quasi-fiscal deficit and evaluating the related budgetary costs stemming from adjustment in large state-owned companies. Experience in dealing with these enterprises, and the current plans for restructuring them, are briefly summarized in the remainder of this sub-section.

a. Problem enterprises in industry

The enterprises that have been shielded from a hard budget constraint by virtue of their ability to command resources from the banking system and suppliers through an increase in forced net arrears are typically found in a few specific sectors: power, chemicals and petrochemicals, mining, metallurgy, machine-building, heavy engineering, and some agro-industries, in particular poultry farms and pig production plants.

In 1993, a study by an international firm of consultants identified "three troubled sectors" in Romania as a threat to the banking system with quasi-fiscal deficit repercussions on the budget. The selection of these three sectors, machine-building, metallurgy, and chemicals-petrochemicals, was based on their estimated share of losses and "bad" bank credit. This study helped to document the major cross subsidization process at work in the banking system, whereby through negative real interest rates private depositors and companies, the NBR, and the Government were subsidizing state-owned enterprises on a very large scale. These implicit subsidies were primarily directed to agriculture and to 180 large enterprises in the three most troubled industrial sectors. The magnitude of the cross subsidization throughout the economy in late 1992 was estimated to be at an annualized rate of almost 19 percent of GDP, with agriculture and industry accounting for approximately equal shares.

With the continuing failure, in 1990-93, to impose financial discipline on major state-owned enterprises, the principle of selecting a group of enterprises for more direct and demonstrable action by the Government and the State Ownership Fund was developed as a condition of the continuing support of multilateral lenders. To reflect the importance of such action to impose discipline on state-owned enterprises, the conditionality for the second tranche of the World Bank Structural Adjustment Loan, SAL, included the formation of a pilot group of 30 key state-owned enterprises with large losses or arrears to be monitored and subjected to immediate restructuring. One reason for this treatment was to prevent further contamination of banks and to reduce inter-enterprise arrears. In April 1994, the second tranche of the SAL was disbursed. Through Government Decision 301/1993, a new group of 30 companies was placed in "isolation" to be exposed to a hard budget constraint and submitted to basic restructuring of their operations with a view to eventual privatization or liquidation. As of December 13, 1995, six of these companies have been either privatized or liquidated and the remaining companies were still in the process of restructuring.

b. Enterprise problems in the agricultural sector

The quasi-fiscal problem in agriculture rests primarily with the *regie autonome* ROMCEREAL and a number of state-owned commercial companies in agro-industry such as poultry and pig farms and processing plants. ROMCEREAL, the state agricultural, processing and distribution giant, is the key integrator in agriculture, with branches in all of Romania's 41 regions. In return for receiving primarily wheat at a pre-determined low price, this enterprise offers farmers subsidized agricultural credit bundled with a number of near-monopoly services, including farm production inputs (seeds and seedlings, fertilizers, etc.) and collection, transport, handling, storage and distribution of grain. In June 1995, the Government approved the reorganization of ROMCEREAL by splitting the entity into a national grains and farm produce company and 41 regional commercial companies. Initially, these units will all be part of the state-owned sector but some of the regional companies may later be privatized. The break-up of

ROMCEREAL and unbundling of some of its functions is expected to increase competition and will facilitate the restructuring of these enterprises.

Under the proposed FESAL with the World Bank (see below), 77 of the most problem-ridden state-owned pig and poultry companies are part of the restructuring exercise. During 1995, plans were formulated for their financial restructuring by down-sizing and other measures are to be implemented to increase the efficiency of this set of companies in agro-industry.

c. Developments during 1994 and 1995

The most important measures to cut the quasi-fiscal deficit in the enterprise sector in Romania were the very sharp correction of the interest and exchange rates in late 1993-early 1994. This administered a major financial and psychological shock, and was reflected in a substantial change in inventory behavior. Importantly, the sharp increase in interest rates did not result in a real increase in arrears by enterprises in difficulties, as had been forecast by many observers: rather, arrears stabilized in real terms. The changed interest rate environment in fact raised the opportunity cost of holding (lending through) arrears, because bank deposits had become attractive as an asset, while the absence of an early bail-out diminished the "shadow value" of arrears. Thus, enterprises' willingness to sell on credit to problem enterprises appears to have diminished in 1994, as evidenced by a fall in the ratio to GDP of the payable arrears of the core problem enterprises (Statistical Appendix table 20).

After the removal of interest and exchange rate distortions, and with the background of the economic stabilization and renewed growth in the economy, it appears that quasi-fiscal pressures in the enterprise sector decreased during 1994, as indicated in the table below. Staff estimates--which are very tentative, but are believed to provide a broadly correct indication of trends in the economy--suggest a fall from some 18 percent of GDP in 1993 to some 12 percent of GDP in 1994. A large component of this adjustment appears to have been a shake-out of inventories in some enterprises and, more generally, a slowing of inventory accumulation.

Tentative Estimates of Sector Positions

(In percent of GDP)

	1993	1994
1. Quasi-fiscal deficit in enterprise sector		
Industrial	-8/-10	-5/-6
Agricultural	-8/-10	-5/-6
Sub-total	-16/-20	-10/-12
2. General government deficit	--	..1
3. Total fiscal and quasi-fiscal deficit (1 + 2)	ca. -18	ca. -12
4. External savings	5	2
5. Surplus of other sectors (= 3 + 4)	13	10
<u>Pro-Memoria</u>		
Investment in Inventories		
(- = use of savings)	-11	-7
Gross domestic savings	24	25

Source: Fund staff estimates.

The authorities agree that this presentation is broadly indicative of trends in the economy; however, undue reliance should not be placed on specific estimates, given the partial nature of the data from which they are derived. The estimates for 1993 are partially based on data from a study by private consultants on resource transfers through the banking system to industrial and agricultural enterprises, made available to staff by the National Bank of Romania. The estimates for 1994 were prepared by staff from data on lending to problem enterprises collected by the World Bank in connection with the FESAL, and from data concerning credit to agriculture and the arrears of agricultural borrowers to the banking system.

In formulating a strategy for enterprise reform to follow up on the monetary "shock treatment" and address directly the quasi-fiscal problem, the need was recognized to focus Government-mandated restructuring on a limited number of key enterprises in identified troubled sectors, to stem

corporate losses. ^{1/} In August 1994, in connection with waiver request under the stand-by arrangement with the Fund, the Government announced the establishment of a special regime of economic and financial surveillance with a mandate to impose tighter financial discipline over 32 large state-owned commercial enterprises and 5 financially troubled régies autonomes (together, these firms accounted for some 50 percent of losses and one-third of arrears in the state-owned sector). In addition, a pilot group of 30 other enterprises was included in this group under surveillance, as were 3 more régies autonomes, thereby constituting a group of 70 enterprises.

At the time of the issuance of the relevant legislation, in February 1995,--Ordinance 13/1995 (see Box A)--the Government decided that the special regime should be expanded to cover a larger group of state-owned enterprises. A list of 151 enterprises was finally established by Government Decision 212/1995 in April 1995 based on losses incurred, arrears accumulated and support received from the Government; covering 142 commercial companies and 9 régies autonomes. The progress of the surveillance would in the case of the régies autonomes be monitored by line ministries and the Council for Coordination, Strategy and Economic Reform; for 120 commercial companies by the Restructuring Agency; and for the final 22 commercial companies by the State Ownership Fund.

Already in 1992, had the Romanian Government and the World Bank had started discussing a comprehensive program of structural reform--the FESAL--with a view to strengthening market mechanisms in the economy, to further harden the budget constraints on loss-making state-owned enterprises, discourage payment arrears, and rapidly accelerate privatization. At the time of the start of the current stand-by arrangement, in May 1994, it was widely expected that the policy actions would be in place to allow conclusion of the FESAL negotiations by the Board of the Bank in late 1994.

In fact, only by end-September 1995, were policies in place that could form a basis for common understandings for the FESAL. In the meantime, based on data for the first six months of 1995, it appears that the quasi-fiscal pressures that subsided in 1994 returned to a significant degree (Statistical Appendix table 20). Payment arrears in the economy as a whole, which had declined in real terms during 1994, accelerated in the first half of 1995 by 23 percent in real terms at an annualized rate. At the same time, inventories in some of the key troubled industries, chemicals, petrochemicals, heavy machinery and steel, recorded a strong build-up. Several of the largest problem enterprises in these sectors are part of a group of 19 core enterprises whose arrears increased from 4.2 percent of GDP at end-1994 to 4.8 and 5.1 percent of GDP, respectively, at the end of the first and second quarters of 1995 (see tabulation in Section IV.2.e).

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^{1/} The inventory adjustment of 1994 was viewed as something of a "once-off" adjustment.

Box A.

Ordinance 13/1995 creates the legal framework for the following:

- * The selection of commercial companies and régies autonomes which will be required to produce financial recovery programs and to undergo a conciliation process with their creditors and debtors.
- * The objectives, process, time schedule, and expected outcome of the surveillance regime.
- * The respective responsibilities in the process of the management and the board of directors of the enterprises: the Agency for Restructuring, the State Ownership Fund, the Council for Coordination, Strategy and Economic Reform, the Ministry of Finance, the line ministries and the National Bank of Romania.
- * The process of conciliation with creditors and debtors, including banks and the budget, once financial recovery programs are accepted.
- * The deferment of debt service and the suspension of payment of penalties pending conciliation.
- * The legal possibility given to enterprises to cancel and reschedule debts.
- * The introduction of commercial paper in transaction among companies and the development of collateralization of credits granted by banks.
- * The legal possibility given to banks to swap debt for equity.
- * The restrictions on access to new credits for enterprises placed in the surveillance program.
- * The introduction of tax deductible provisions for doubtful accounts receivable for enterprises and for specific loan loss provisions for banks.
- * The creation, at the Ministry of Finance, of a Financial Restructuring Fund, which is an element of the mechanism to stop building up new arrears with RENEL and ROMGAZ.
- * The linkage between the financial recovery programs and the management contracts of the enterprises.
- * The proceeds of the sale of assets to be retained by the enterprises.
- * The severance payments for dismissed employees and other benefits.

The basis for proceeding with the FESAL in the area of restructuring comprises the following main points. The Ordinance 13/1995 enterprises from the identified troubled sectors were selected 1/ and these enterprises are being cut off from normal access to bank credit to ensure future banking system solvency. They are obliged to restructure their operations in accordance with special financial recovery programs approved by the authorities but designed by the core enterprises with external technical assistance. The objectives of these programs are to identify up-front actions that will reduce costs and improve corporate cash-flow, to identify performance targets and benchmarks that can be monitored to be achieved within a short time frame, and to assess the fiscal impact of the proposed measures. Operational restructuring implies slimming down commercial activities, divesting non-core activities, shedding excess labor, and improving operational efficiency. Also, part of the FESAL strategy is to accelerate the privatization process and to leave industrial restructuring and new investment in most enterprises to the new owners.

The financial recovery programs of the enterprises are of a relatively short-term nature with the horizon on 1995 and the beginning of 1996. They focus on the financial performance and situation of the enterprises, specifically: reduction of expenditures; increase in revenues; stabilization followed by reduction of arrears; reduction of indebtedness; and, ultimately, restoration of positive cash-flows. Government budgetary support for the enterprise restructuring programs is based on severance packages and the temporary provision of funds to certain purchasers of energy from RENEL, the power régime autonome, conditional on implementation of their agreed enterprise adjustment programs. The core enterprises already concluded a debt conciliation exercise with their creditors in September 1995, with the object of cutting their debt service to sustainable levels without initiating a Government bail-out.

The FESAL is scheduled for Board presentation in the Bank by January 1996, indicating a delay in directly addressing the quasi-fiscal problems of key state enterprises of almost one-and-one-half years compared with the expectations at the time of the stand-by arrangement. Under the 1995 FESAL, as presently designed, the main coverage of restructuring comprises the approval of financial recovery plans for the most important enterprises and the monitoring of employment reductions in connection with a floating tranche expected to be utilized in 1996.

When developing the enterprise restructuring plans for the enterprises covered by the proposed World Bank FESAL, the Government consulted with staff of the Fund as well as the World Bank concerning an appropriate

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1/ For practical reason, the Bank and the Fund have for their monitoring purposes selected a sub-set of the Ordinance 13/1995 group consisting of 19 core enterprises; 6 régies autonomes and 13 commercial companies.

macroeconomic cap to be placed on the access of these enterprises to financial resources in 1995 and 1996. The object of this was to clarify ex ante the hard budget constraint on the enterprises, and prevent further contamination of assets in the banking system. The key elements of this macroeconomic cap, which was arrived at on an iterative basis in discussions involving the World Bank and enterprise managements, are as follows:

Macroeconomic Caps 1995

	<u>lei billion</u>	<u>percent of GDP</u>
<u>Resource transfers</u>	2,893	4.2
of which:		
Budget:		
Subsidies	1,250	1.8
Severance payments	105	0.2
Conditional energy credits	245	0.4
State Ownership Fund transfers	493	0.7
Net increase of credit of the banking system to enterprises covered under ordinance 13/1995	800	1.2

d. Monitoring of arrears

In economies in transition, the existence of "soft budget constraints" on enterprises--allowing them to obtain credits from banks and other enterprises that would not be forthcoming under normal circumstances--implies that the lack financial discipline by such enterprises can be a major source of macroeconomic instability. In such circumstances, the price mechanism does not properly to guide the reallocation of resources. Creditors, meanwhile, are often in a position to impose major financial burdens on other enterprises by allowing payment arrears to accumulate over time. This process can then result in an excessively rapid growth of bank credit that a central bank might accommodate. The normal process of exit in a market economy is suspended and the disproportionate share of bank credit effectively going to refinancing of incumbents impede entry.

Payment Arrears, 1992-95

	<u>1992</u> Dec.	<u>1993</u> Dec.	<u>1994</u> Dec.	<u>1995</u>		
				Mar.	June	Sep.
(in percent of GDP)						
National economy	33.6	24.1	20.2	...	20.4	...
Private sector	5.1	8.2	7.1	... <u>1/</u>	6.6	... <u>1/</u>
State sector	28.5	15.9	13.1	13.3	13.8	13.9
of which:						
19 core enterprises	...	4.6	4.2	4.8	5.1	...

At the end of 1994, reported arrears across the economy remained substantial, although their level relative to GDP of 20 percent was well below the 46 percent attained in December 1991. 2/ The growth has continued; arrears grew in nominal terms by 144 percent during 1994, and by an additional 32 percent at an annualized rate during the first half of 1995. Enterprises have tended to use arrears to suppliers and-- increasingly--to the state and local budgets to finance their operations. At mid-1995, arrears to suppliers and government represent some 65 percent and 24 percent respectively of total arrears. The state imposes penalties on enterprises that are not paying their taxes or contributions to extra-budgetary funds on time, and the interest is higher than that of commercial banks. Typically, however, these penalties have not been paid.

Arrears to banks are of a much smaller magnitude, about 10 percent of total arrears. Under Romanian law, enterprises must keep their cash balances with lending banks. This means that the banks have immediate access to enterprise funds that are in the banking system. The banks use this access to pay themselves interest on loans and to settle bank arrears as funds are available. This possibility is not open to suppliers and although suppliers are allowed to charge penalty interest on overdue balances, this is typically not enforced.

1/ No data available for private sector arrears.

2/ Eric V. Clifton and Mohsin S. Khan, "Interenterprise Arrears in Transforming Economies". International Monetary Fund Staff Papers. September 1993.

The ceiling for the combined arrears to suppliers and arrears to the budget of the state-owned enterprises, as defined by the quantitative benchmark of the present stand-by arrangement, 1/ was not met in June 1994. Since then the situation has worsened considerably, with arrears at end-1994 growing at an annual rate of 151 percent compared to targeted 8 percent, reaching lei 7,087 billion (Statistical Appendix table 20). From end-1994, when the total arrears of state-owned enterprises amounted to lei 7,512 billion, there was an increase by 27 percent during the first three quarters of 1995 to lei 9,553 billion at end-September 1995. In absolute numbers, the mid-1995 total arrears in the national economy amounted to lei 13,341 billion or 20 percent of GDP. Under the policy approach to which the authorities are now committed, the arrears problem are to be addressed only through adjustment in key problem enterprises under close financial surveillance and restructuring. Some of these key enterprises are found in the energy sector where RENEL and ROMGAZ, (the gas *régie autonome*), have a dominant position. It is intended that this approach affect systemic behavior both through the key position of these enterprises in the economy (including the energy supply structure) and through the demonstration in effect of visible action to reform, rather than bail out, these key firms.

e. Legislative action

Insolvency legislation To combat financial undiscipline, legal measures are also being used as enterprise reform requires that more modern legal relationships develop among companies. An insolvency law in a market economy--and especially in an economy in transition--assists both creditors and debtors. It allows creditors to assert their rights collectively and protects debtors from individual claims of creditors which would disrupt their business and gives debtors time to attempt to reorganize their financial situation. Thus it both protects rights of creditors and defends rights of debtors. A common feature in many economies in transition has been the need for clarification and enforcement of the right of creditors against delinquent debtors, as well as protection of debtors against creditors while in reorganization or in the process of rehabilitation. Also in Romania, the enforcement of credit obligations has not been very efficient.

At the beginning of 1990, the only bankruptcy provisions were part of the commercial code from the time prior to the centrally-planned regime. In July 1992, a procedure was established through Law 76/1992 whereby creditors can sue debtors for overdue payments--arrears exceeding 30 days--and the actions they can take to settle their credit claims. The penalty interest rate on arrears was raised to 0.4 percent per diem. However, that law does not determine how a debtor firm can actually be put into bankruptcy.

Passage by Parliament of a modern bankruptcy law was originally a performance criterion for the first conditional purchase under the 1994

1/ This benchmark covered all payment arrears except arrears to banks.

stand-by arrangement. However, approval of the draft law was delayed by more than seven months as a result of amendments. Passage of the law was waived for the September 1994 drawing; submission to Parliament by October 15, 1994 became a performance criterion for the following purchase. Moreover, the passage of a Bankruptcy Law by December 31, 1994 became a structural benchmark, observance of which would be taken into consideration in the first program review. The process of amendment involved a very substantial input of technical assistance by the Legal Department of the Fund, since the authorities' original draft lacked a number of elements for an efficient bankruptcy law.

The Law on the Procedure of Judiciary Reorganization and Liquidation (Law 64/1995) was eventually approved in June 1995. The law, as eventually passed, compares relatively favorably with those that have been introduced in other transition economies as regards its basic legal provisions. However, the *régies autonomes* were removed from the application of the law: the law applies only to physical persons and commercial companies, leaving the *régies autonomes* to the general regime of public property. There is the intention to have a new and separate law for *régies*, under which their public property would remain untouchable but their commercial assets could be liquidated. Furthermore, the enterprises to which the Ordinance on Enterprise restructuring applies (see above) have been exempted from the Bankruptcy Law; given the practical difficulty for creditors other than the Government to impose discipline on these large enterprises, this exemption may not be a major defect, provided, however, that the process of restructuring under the Ordinance is pursued vigorously by the Government and the State Ownership Fund rather than enterprises finding that they can shelter in inaction behind the protection offered by the exemption.

Competition Law Promulgation of a Competition Law is structural benchmark for the first program review and a draft law was presented to the Senate in June 1994. The law aims at protecting, promoting, and stimulating competition in the economy and at eliminating negative phenomena such as unfair competition or artificial price increases. A competition authority, subordinate to the Government, was also proposed to be established. The Senate passed an amended draft in March and the Chamber of Deputies followed in November 1995. The competition authority is expected to be established in early 1996.

3. Financial sector reform

Very significant transformation has been achieved in the financial sector of the Romanian economy during the last six years. The structure of the banking system up to 1990 was typical of a centrally planned economy. Effectively, it comprised of state-owned institutions; the National Bank of Romania, NBR, which performed both central bank and certain commercial bank functions; the national Savings Bank, the repository for virtually all household deposits, which it redeposited with the NBR; Banca Agricola, which directed credits to the state farms and cooperatives, and the Romanian Bank for Foreign Trade which handled trade financing and foreign exchange

transactions, and the investment bank (subsequently renamed the Romanian Bank for Development) which provided long term investment loans to industry.

a. National Bank of Romania

The key to the change was the transformation of the role of the NBR into one more corresponding to a traditional central bank, on the one hand, and the evolution of a network of commercial banks, on the other. This reform of the banking system commenced in December 1990, with the separation of the commercial banking operations of the NBR and the subsequent creation of the Romanian Commercial Bank. A two-tier banking system was put in place in April 1991, with the passage of a Banking Law (Law 33/1991) and a Central Bank Law (Law 34/1991). Further institutional reforms culminating in the transfer of the management of foreign exchange reserves and the control of the foreign exchange system to the NBR, occurred in November 1991. The NBR has since made substantial progress in re-assuming the functions of an independent central bank, benefiting from substantial technical assistance from other central banks and from international institutions including the Fund.

b. Commercial banking system

Although the legal framework now allows all commercial banks to function as universal banks, taking deposits and lending to both households and enterprises, the banking system has in practice continued to be characterized by heavy market segmentation and specialization. For example, the Romanian Commercial Bank is still very much the dominating bank for the large state-owned enterprises, Banca Agricola remains the prime lender to agriculture and agro-industries, and the Romanian Bank for Foreign Trade is still the premier bank in the international field. It is worth noting, however, that the banking system is undergoing an evolutionary process as more private banks are established.

In 1990, private banks were once again allowed to operate in Romania and the first two of several new private commercial banks commenced their operations in 1991. At end-October 1995, 28 banking institutions operated within the Romanian banking system, the major types being:

Box B.

Total: 28 banks, of which:

- 1 Savings Bank (with special status)
- 27 Commercial banks, of which:
  - 14 Banks with foreign interests, of which:
    - 8 Branches of foreign banks
    - 6 Joint-venture banks with Romanian and international owners
  - 13 Local banks, of which:
    - 1 Wholly state-owned bank (specializing in export-import financing)
    - 5 Majority state-owned banks
    - 1 Joint state and private capital
    - 6 Private domestic banks

The new banks have increased competition in the banking system by their aggressiveness and contributed greatly to the modernization of bank operations and the marketing of financial services. However, the large state-owned institutions continue to dominate the banking sector by virtue of their size, branch networks, and long-established contacts with state-owned enterprise sector resulting in continued strong market segmentation.

During 1994 and 1995, several of the majority state-owned banks endeavored to diversify both their assets and liabilities, in light of their mandate to operate along commercial lines. Since these banks tended to be under-capitalized and under-provisioned, this process has not been an easy one. The problems of the state banks and state-owned enterprises tended to be closely interconnected and a large portion of bank loans to enterprises was nonperforming. Given also a widespread initial perception that the largest state-owned enterprises benefitted from an implicit Government guarantee, and the general view that household deposits are implicitly guaranteed by the state, the situation clearly has offered a text-book example of the scope for moral hazard. ^{1/} Hence, a major factor in healthy development of the banking system must be seen as the enforcement of strong bank supervisory standards. The regulations to serve as a basis for this are now mainly in place.

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^{1/} The liabilities of the Savings Bank are formally covered by a Government guarantee.

In the absence of a developed capital market which could provide alternatives for strengthening the capital base of the state-owned banks, a number of institutional factors contributed during recent years to the further decapitalization of these institutions. Provisions for losses and doubtful debt were understated and profits, therefore, tended to be overstated and taxed out of proportion to the banks actual earnings. Existing dividend policy and mandated profit sharing for employees, both regulated by law, withdrew needed capital from the banking system. Decapitalization of the banks was also continuing because of inadequate profits. Large cash operating losses also occurred at times due to declining spreads, a sharp drop in interest collections and an over-dependence on high cost funding.

In a number of these fields, measures have been taken during 1994 and 1995 as part of the reform of banking sector (see below). The banking sector reform strategy of the NBR for the future envisages that three areas should be given the highest priority: strengthening banking supervision, dealing with banks with serious problem credits, and promoting bank privatization.

c. Prudential supervision

The entry of private financial institutions, both foreign and domestic, has expedited the transformation of the banking system but has, at the same time, provided a considerable challenge to the NBR to improve the monitoring and inspection of banks operating in Romania. During recent years, the Banking Licensing and Prudential Supervision Department has been severely understaffed and has had considerable difficulties in hiring and keeping qualified personnel. However, the staffing of the supervision department is by the end of 1995 being increased to its full complement of 50.

However, the regulatory and supervisory framework of the NBR has been transformed during the last few years and considerable progress has been made in adopting prudential rules that are in conformity with general international agreements or European Union directives. This work continues with international technical assistance as does the building up of competence in the specialized NBR department in charge. The list of past achievements, present workload, and future assignments is long:

Licensing of banking companies Since 1995, the NBR has the obligation to control ownership of banks when a single shareholder acquires more than 5 percent of the shares, a "fit and proper" test (Rules 6/1995). If the NBR decides to act, the shareholder could lose the voting rights and eventually the shares could be disposed of through a forced sale. During 1995, the NBR intervened in one commercial bank by sequestrating the voting rights of the largest shareholder following reports of grave irregularities.

Bank solvency By Rules 4/1994 and 16/1995 (which replaced Rules 2/1994), the NBR issued guidance on the structure and way of calculating a bank's own funds as well as defined the solvency ratio and the risk weights

for balance sheet assets. Consequently, the Basle rules on calculating capital adequacy were implemented for the banks effective 1994.

Minimum capital of banking companies In 1995, the NBR issued Rules 5/1995 stating that the prudent share capital requirements for banks should increase from lei 8 billion to lei 12 billion by 1997 at the latest. Through this action, the Romanian capital requirements will be brought in line with European Union standards.

Prudent provisioning By Rules 10/1994, the NBR regulated that the banks' general loan provisions be a minimum of 2 percent and be fully tax deductible. The latter was accepted by Parliament in 1994 and came into effect in January 1995. Moreover, a revised credit classification and new loan provisioning system was regulated by the NBR in 1994 by Rules 3/1994 together with a recommendation that these specific loan provisions be fully tax deductible. Government Decision 335/1995 introduced the required tax deductibility of specific loan loss provisions, to be applied to loans classified "loss" (100 percent provision) and "doubtful" (50 percent provision) starting in fiscal year 1995, and extended to "substandard" loans (20 percent provision) as from fiscal year 1996. This has given banks the necessary incentives to adequately provision their portfolios and to work out their problem loans.

Payment of dividends by the banks Law 58/1991 provides that state-owned companies (including banks) pay a minimum dividend of 40 percent of profits after tax to its shareholders. Citing prudential concerns, the NBR issued Circular 35/1995 stating, inter alia, that banks must establish sufficient loan loss provisions, regardless of the financial consequences of setting up such provisions, and that until banks have established such adequate provisions and have achieved the minimum acceptable capital adequacy ratio of 8 percent of risk-weighted assets:

(i) Their new investments in fixed assets are limited to the remaining balance of their Development Fund reserves; and

(ii) They must set aside 50 percent of their profits after tax for the Development Fund thereby leaving only 40 percent for distribution of dividends to the shareholders and 10 percent for distribution to the employees.

Accounting and auditing The NBR has taken part in the elaboration of a new Accounting Law in which the standards are based on EU standards and is preparing a uniform chart of accounts for banks. The NBR is also supporting the independent external auditing of the banks' annual accounts according to international accounting standards and aims at harmonizing national standards with international standards.

Foreign exchange exposure By Rules 12/1994, the NBR regulated the supervision of the banking companies foreign exchange provisions and by

Rules 15/1995, the NBR amended the monitoring of banks' over-night positions in foreign currency.

Lending to shareholders By Rules 10/1992, the NBR regulated insider lending with effect from 1993.

Concentrated lending By Rules 5/1992, the NBR regulated effective 1993 that a bank's credit exposure to a single customer must not exceed 10 percent of the bank's capital and reserves or, in exceptional cases and after NBR permission, 20 percent in the case of an inter-connected group of clients.

Deposit insurance scheme One measure designed to increase competition between banks is to replace the Government's explicit unlimited deposit guarantee for the Savings Bank with a limited deposit insurance scheme for deposits by all individuals at all banks. As the Savings Bank has the largest share of household deposits and this bank lends on these funds to other commercial banks, household deposits are, de facto, implicitly guaranteed by the Government. During 1995, the NBR worked on a limited deposit insurance scheme compatible with European Union standards and with technical assistance by the EC/PHARE.

Credit information bureau The NBR is taking part in the work to establish a central credit register with information on credit exposures to facilitate loan decisions made by banks.

Collateralization of NBR credits In August 1995, the NBR issued Rules 3/1995 about the necessary collateral for extending credit lines to banks. The system for collateralization of central bank credit will stimulate banks to seek alternative funding and adverse selection is resisted.

On-site inspections In 1995, the Supervision Department has organized on-site inspection of new banks and has launched an inspection of one of the major state-owned banks. All large state-owned banks have also faced a semi-annual review of their portfolios and resulting requirements to adjust provisioning.

Work-out departments During 1995, the NBR was instrumental in establishing work-out departments in all the major banks with technical assistance financed by EC/PHARE as part of the effort to cope with the problem of sub-standard loans and the lack of an enforcement culture and skills in handling impaired credits.

d. Dealing with problem banks

As in many other countries in transition, several banks in Romania suffer from problems due to the poor asset quality of their loan portfolios. These "legacy loans" are typical for the older banks that had established

contacts with large commercial clients that now find it difficult to adjust to a market-based economy. 1/

In the NBR's strategy for handling banks with serious nonperforming credits, a distinction is made between the flow and the stock aspect of the problem. In dealing with the flow problem, focus is on the delinquent enterprises, which typically run large arrears or major losses. The key enterprises in this category have been identified by the Government and the World Bank in the context of the proposed FESAL. It has been agreed that these companies be isolated from normal access to bank credit while they take action to improve their cash flow and restructure their commercial activities through downsizing during a period of surveillance.

Through the FESAL, the problems of key enterprises of primarily two banks are addressed: the Romanian Commercial Bank for major industrial enterprises and Banca Agricola, the agricultural bank, for 77 poultry and pig farms and their processing plants. The enterprise restructuring in the FESAL mode started after mid-year 1995 and will continue during 1996. In addition to the FESAL exercise, the Banca Agricola will also be affected by the decision taken by the Government to break-up the agricultural giant ROMCEREAL. This will make it possible to address the individual problems of 41 new commercial companies as they may change commercial course and also eventually are privatized.

On the stock side, the problems will be addressed first through the "work-out" departments which have been created in all major banks. These will deal with a wide range of questions, from enterprise arrears and the need for debt collection to restructuring, possibly ultimately through liquidation or bankruptcy. As debt conciliation is a part of the FESAL restructuring process, this will also have an effect on the credit stock for the problem banks. It is at this point in time impossible to assess the total magnitude of the impact as the process has only begun. 2/ However, the initial impact of the conciliation process in September 1995 resulted for Banca Agricola in the writing-off of Lei 90 billion of interest accrued but not paid. For the Romanian Commercial Bank, Lei 71 billion of interest was written off and a further Lei 61 billion of principal rescheduled. There will be further impacts on both banks from problem companies outside the Ordinance 13/1995 group of enterprises. In the case of the Banca Agricola, there is another problem in addition to the exposures to ROMCEREAL and agro-industries in FESAL, namely the bundling of its commercial banking role *stricto sensu* with functions related more to policies of the Ministry of Agriculture and the provision of subsidized credits. This needs to be addressed before the bank can be put up for privatization. The prospects

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1/ Also as in many transition economies, spreads remain wide which reflects the banks' interest to rebuild capital given the magnitude of their problem loans. A staff study of spreads is a priority in the work program.

2/ A review is being initiated by the authorities concerning the likely remaining fiscal costs of bad loans in the banking system.

for a credible strategy for the two main problem banks will be much improved to the extent that the FESAL financial restructuring programs for their key loss-making clients are forcefully and consistently implemented. The Government and the NBR have indicated that recapitalization of banks is to be embarked upon only in the context of privatization.

e. Increasing bank privatization

Bank privatization is often seen as a key instrument in achieving a more robust and efficient banking system in the future for economies in transition. Through changes in governance and a clearer profit-oriented approach, privatized banks will increase competition in the loan and deposits markets and facilitate the introduction of new ranges of banking practices and services.

At the end of 1994, there were six banks with a majority of state shareholding, all held by the State Ownership Fund. The Government of Romania--in consultation with the NBR--submitted a draft of a specific Bank Privatization Law to Parliament in September 1995 as required by the Law on Mass Privatization (Law 55/1995). The draft law will enable future privatization of state-owned banks to different categories of investors, including foreign interests. In order to recapitalize the banks through this process, it is proposed as directed in the Law on Mass Privatization (Law 55/1995) that bank privatization will only take place against cash. Consequently, it is envisaged that the 30 percent shareholding that the Private Ownership Funds control will be exchanged for other shares by the State Ownership Fund and then immediately sold to new private owners. The draft law had not been passed by Parliament at the beginning of December 1995.

An additional objective is to initiate privatization of two major state-owned banks during 1995. The European Bank for Reconstruction and Development has expressed an interest in taking part in these bank privatizations by acquiring a substantial shareholding. One bank has been selected for initial privatization, the Romanian Bank for Development, and after due diligence procedures are completed, that bank is slated be privatized in the first half of 1996.

The second bank to be privatized is likely to be Banca Agricola, the largest commercial bank in Romania; however, an announcement about the selection of this bank had not been made at the beginning of December 1995. The intermediary steps are likely to take more time: this bank suffers from loan portfolio problems, and its "Government-agency" type functions need to be separated from its commercial banking activities. However, the bank has taken advantage of existing possibilities of stimulating private shareholding and in mid-1995 close to 48 percent of its shares were already held by private interests.

In the longer run, it is expected that more banks will be privatized, possibly in stages, and in that process the State may retain sizable parts

of the shares. It would appear likely, however, that two banks may not be privatized: the Export-Import Bank, and the Savings Bank--the latter not being a commercial bank, nor subject to the Banking Law (Law 33/1991).

f. Payments system reform

In order to reduce the costs of financial transactions and improve the development of the financial system, the NBR has taken the initiative to reform various parts of the nationwide interbank payments system in collaboration with the banks.

Low value funds transfer system A new multilateral clearing system for low value transfers was established in April 1995 under the aegis of the NBR. The system is fundamentally paper-based, using four types of financial instruments, primarily checks and payment orders but also bills of exchange and payment notes. The costs for financing the system are covered by a lei 5 fee for each instrument cleared. Through the introduction of this clearing system, the outstanding liquidity in this part of the payments system was initially reduced by 70 percent. It is expected that the paper-based system will in the future be replaced by magnetic tapes or diskettes for local computer processing. No concrete plans have been formulated to when this might happen.

Large value funds transfer system There are plans for the creation inside the NBR network of a computerized clearing system for minimum payments of lei 10 million. The discussion about the organization and ownership of a real-time electronic transfer system is continuing between the NBR and the banks. Plans pursued by Banc Post, one of the banks with majority state-ownership, of creating an electronic national giro system appears not to be accepted by the other commercial banks.

Interbank clearing system After changes implemented during 1994 and 1995, interbank transactions emanating from money market operations, foreign exchange trading, NBR credits to banks, or NBR interest on minimum reserve requirements are all settled on bilateral basis in the headquarters of the NBR through a special routine outside the normal paper-based clearing system. The system is handled by NBR staff which receives paper-based payment orders and settles the transactions daily during 8:00 a.m. to 6:30 p.m.

g. Securities exchange law

The promulgation of such legislation and its implementation, the establishment of a National Securities Commission and a securities exchange, by November 15, 1994, were structural benchmarks for the first program review. The relevant law was passed on June 21, 1994, and promulgated on time (Law 52/1994) but the setting up of a stock exchange was much delayed. After a forced interruption of 50 years, the Bucharest Securities Exchange resumed its activities on June 23, 1995. The first shares were traded on November 20, 1995. Tradability of shares is expected to encourage

concentration of ownership, which is a key priority in improving corporate governance. Introduction of investment funds is a high priority for the same reason. To promote secondary markets for shares of privatized enterprises, an over-the-counter market is also being considered.

4. Privatization

A significant aspect of the transformation to a market economy is the privatization of existing state-owned enterprises as this is as seen the key to improving corporate governance over the long run. In Romania, the state still controls huge sectors of the economy and state-owned enterprises are dominant, particularly in industry and agro-industry.

The Government has opted for a gradual privatization approach. Privatization is in this context considered effective when at least 51 per cent of the shares of a commercial company are in private ownership. The Prime Minister has expressed his Government's commitment to making the private sector the dominant arm of the Romanian economy.

The aim of the privatization program is to transfer into private hands, roughly over a seven-year period, property rights of some 6,300 state-owned companies. The privatization process envisages only state-owned units which have been converted into commercial companies under Law 15/1990.

The privatization process has been unfolding at a very slow pace. It has been faced with a range of impediments, among them lack of capital, the financial blockage, weak banking system, and disruption between implied institutions associated with inconsistencies of government policy. Actual progress in the field of privatization has been uneven with substantial privatization of land and the retail trade and far less progress in industry and the financial sector.

a. Land privatization

As a result of the Land Law (Law 18/1991), the cooperative farms were to be dissolved and land formerly under cooperative control was to be restituted. Physical distribution has taken place of agricultural land to former owners and their heirs. By end-1994, more than 80 percent of the arable land (about 9.3 million hectares) have been re-assigned to 5.5 million people. Due to technical and administrative difficulties, formal titles for former cooperative land had by October 1995 been distributed to less than half of the new designated owners. Privatization of state farms has proceeded more slowly and stalled during 1995 with a change in Government policy, which now aims at preserving them as units of production.

b. Enterprise privatization

The overall process of privatizing the state-owned companies can be divided into a few stages:

Starting in September 1990, conversion of state enterprises into two categories took place through the Law on the Restructuring of State-Owned Enterprises (Law 15/1990). The majority were transformed into commercial companies with share capital with a view to eventually be privatized. The remaining-part were turned into régies autonomes, enterprises of special national interest, and were to stay as state property under ministerial control. At the same time, the law provided for the allocation of a 30 percent ownership interest in the capital of these newly formed commercial companies to eligible Romanian citizens through ownership certificates, a form of vouchers.

In August 1991, Parliament enacted a Privatization Law (Law 58/1991) for the newly formed commercial companies. 30 percent of the share capital of these companies was transferred in July 1992 to five Private Ownership Funds and 70 percent to the State Ownership Fund. Moreover, Law 58/1991 also initiated a pilot privatization program. When it was concluded in August 1993, 22 commercial companies had been privatized out of 32 selected. Privatization through sale of assets, also part of the early privatization initiative, commenced in January 1992 and resulted in less than half of the assets--3,598--being sold as at November 20, 1995, out of a total number of 6,822 assets selected for sale (Statistical Appendix table 22). In this context, assets were defined as non-core activities which are organized and able to operate independently whereby the core activity of the mother company was not affected. Typical examples were retail shops, restaurants, hotels, handicraft workshops, and assets in the transportation sector.

c. Privatization techniques

The authorities have used a combination of several different techniques to carry out enterprise privatization. In its first wave of privatizations in 1991, the Government issued, without charge, privatization vouchers, called ownership certificates, of a total nominal value of lei 25,000 to 16.5 million eligible Romanians. Every certificate included a coupon for each of the five Private Ownership Funds representing their 30 percent share of Romania's 6,300 state commercial companies that had been allocated among these funds. Each certificate, which was in bearer form, had been allocated a nominal value of lei 5,000 units and could be sold at a discounted value on a secondary market. As an alternative, the certificates could be retained and eventually be changed into shares in investment funds, once the Private Ownership Funds were so transformed.

Sales of shares through direct negotiation, a type of sale of shares with pre-selected tenders, is in some ways a Romanian adaptation of the German Treuhandanstalt model. In this method, other conditions but the sale price may determine who gets to buy a company which is being privatized. This can include guaranteeing employment levels for a certain period, etc.

MEBOs, Management-Employee Buy-Outs at preferential rates, is a variety of direct negotiation and was at an early stage established as the Government's preferred form of privatization. With the combination of

particularly favorable payment terms and the preference given to insiders MEBO's have indeed, over time, become the most commonly used privatization form. Estimated 80 percent of all SOF privatizations through October 1995 were MEBOs. The adoption of Law 77/1994, extending the use of MEBOs to larger commercial companies, has resulted in an increase in privatization of medium-sized and large companies. The pace of MEBO privatizations of small companies for book net asset value only, however, came to a virtual halt for several months, as a result of the August 1994 decision to revalue state assets (Government Decision 500/1994).

The public offer method at a fixed price has so far not been much used in Romania. In November 1994, the State Ownership Fund and the Private Ownership Funds used this method to dispose of their shares in three profitable commercial companies. The Private Ownership Funds' 30 percent of outstanding shares payable in ownership certificates were heavily over-subscribed. However, the 70 percent of outstanding shares controlled by the State Ownership Fund, which were to be sold for cash, were grossly under-subscribed; for two companies only 5 percent of all shares were taken, while for the third almost 25 percent was subscribed. No companies have since been sold for cash using this method but during March through May 1995, 113 medium-sized and large companies were sold against vouchers using the public offer method. Auction sales of the classic type start from the book value or a more market based value assessed by the firms auditors.

d. Privatization institutions

The Government has created various institutions to handle parts of the privatization process. The major ones are the National Agency for Privatization, NAP, the State Ownership Fund, SOF, and the five Private Ownership Funds, POFs. In general terms, these institutions have divided responsibilities for the commercial companies, whereby the NAP is responsible for a pilot privatization program, the POFs are in charge of the restructuring and privatization of medium-sized commercial companies, and the SOF is in charge of restructuring and privatizing large enterprises.

The National Agency for Privatization, was established through Law 15/1990 to be responsible for preparing, organizing, and coordinating the overall privatization process and the ownership certificate program. According to the provisions of Law 58/1991, the NAP became responsible for setting the legal and institutional framework for the privatization process. In the subsequent division of labor, the NAP has also been put in charge of supervising privatization by asset sales undertaken by commercial companies (see section IV.4.b). By November 20, 1995, more than half of these assets had been sold for a total price of lei 126 billion (Statistical Appendix table 22). Concurrently with the sale of assets, the NAP ran a pilot privatization program by sale of shares. This pilot program ended on August 10, 1993 after 22--mostly small--firms had been sold to Romanian and foreign groups (Statistical Appendix table 21).

The State Ownership Fund was established by Law 58/1991 as a public legal entity under parliamentary control with the tasks of preparing commercial companies for gradual privatization while managing the stock it holds in them. The SOF began operations in October 1992 and initially held 70 percent of the registered assets of 6,291 commercial companies with state capital. The law states that privatizations through the SOF should be carried out at such a speed that at least 10 percent of the share capital administered is sold each year. Furthermore, the SOF is obliged to sell its ownership share of commercial enterprises, including up to 10 percent of the enterprises' capital to employees and managers through the public offer method or auction sales at a preferential reduction of price of 10 percent.

The SOF's responsibility for the restructuring of large enterprises is carried out by its Division for Selective Restructuring. During 1994, the SOF's expenditure on enterprise restructuring was some 0.5 percent of GDP, and directed primarily toward the slimming-down of inefficient enterprises. The institution specifies quantitative targets for completed market privatizations, specifying the minimum number of enterprises of varying sizes. For 1994, the SOF's own plan and budget called for privatization of 2,368 companies, of which 400 were to be medium-sized and large companies (see tabulation below). This was not reached as actual outturn was below 600. By December 7, 1995, the SOF had completed 655 privatizations as compared to the planned 1,500 for the year.

SOF Privatizations of Companies, 1994-1995

	1994		1995	
	SOF's <u>plan</u>	Actual <u>realized</u>	SOF's <u>plan</u>	Actual <u>Dec. 7</u>
Small Companies	1,930	502	1,350	355
Medium-Sized Companies	403	88	135	253
Large Companies	35	8	15	47
<u>Total</u>	<u>2,368</u>	<u>598</u>	<u>1,500</u>	<u>655</u>

Source: State Ownership Fund.

Since its inception and up to December 7, 1995, the SOF had privatized 1,519 commercial companies with some 600,000 employees and a registered capital of lei 3,900 billion (Statistical Appendix table 24). In its plans for 1995, the SOF targeted to privatize a total nominal corporate capital of

lei 2,668 billion, representing 1,700 units of which 90 percent are small, 9 percent medium-sized, and 1 percent large commercial companies. In anticipation of the acceleration of privatizations, lei 50 billion were set aside for this purpose. Furthermore, the SOF intended to extend privatizations into new sectors: banking and finance, machine-building, and chemical industries. Two banks were scheduled to be privatized (see section IV.3) and liquidation of six nonprofitable companies was planned.

The Private Ownership Funds begun operations in 1993 and were originally to develop privatization programs for medium-sized companies and began operations in 1993. Since then, the POFs' portfolios have come to include three main categories of holdings:

- (i) Small commercial companies slated for fast privatization, using standardized procedures.
- (ii) Medium-sized commercial companies, with fewer than 3,000 employees, where the full POF share of 30 percent has been assigned to an individual POF, the allocation being based on either geographic location of the company or the industry sector in which a POF has specialized its portfolio.
- (iii) Large commercial companies, especially those requiring restructuring before privatization, the SOF holds both its own share and, in trust, the POFs' shares. This arrangement reflects the need for more time and financial resources to privatize these companies.

e. Mass privatization program

Overall, the passing of the Privatization Law paved the way for the rapid privatization of small-scale entities and led to a rapid expansion of services activities. However, the expansion of the small privatization program to a wider circle of enterprises, originally scheduled for 1994, was delayed by political disagreements about which privatization strategy to pursue. In June 1995, this question was resolved when Parliament passed the Law on Mass Privatization (Law 55/1995), popularly called the Mass Privatization Program, aimed at a rapid transfer of ownership from the public to the private sector.

According to the law, 40 percent of the shares of 3,905 state commercial companies will be sold for cash to Romanian and foreign investors. The remaining 60 percent of the shares are to be given to company employees and 17.3 million Romanians over the age of 18 in exchange for new privatization coupons. The Government has set a lei 975,000 nominal price on the privatization coupons which have been distributed during the autumn of 1995. The new coupons are to be traded for shares in enterprises (but not exchanged for cash).

The next phase (after the initiation of voucher exchanges) in the proposed implementation process envisages splitting the commercial companies into four categories:

- (i) Trade sales through auction with pre-qualified bidders for about 300 particularly attractive commercial companies which are to be offered to strategic--domestic or foreign--investors;
- (ii) Viable companies where "open auctions" will be held for packages of 5-10 percent of shares and where the floor price is above nominal book value, to be based on the economic and financial situation of the enterprise as well as the present and future market trends;
- (iii) Poorly performing companies, where the shares will be sold through public offers at the nominal book value.
- (iv) Companies exclusively dealing with agricultural services (the Agromecs) where the employees in contractual relations are given the right of first refusal.

The third phase is a process of making firm-specific valuation reports for all the commercial companies, followed by another categorization into two groups depending on whether they will be sold for above or below 70 percent of their book value. Only those companies whose selling price is above the 70 percent threshold will provide a limited group of buyers (management, employees and farmers) preferential financing facilities (low interest, installment payment plans). The buyers will still have to make cash down-payment of about 20 percent. In the case of all other companies, where the assessment report justifies a selling price below 70 percent of book value, negotiations will have to be held individually with a buyer or a group of buyers and firm-specific constraining buyer's contracts entered into.

For the cash auction of shares, a series of auctions with an initial reserve price will be held. The law stipulates that the sale price may be reduced below 70 percent of nominal book value for all privatization cases only after an assessment report valuation justifies this. In these cases, the buyer needs to sign a contract which stipulates a commitment to maintain the same production profile, a certain volume of investments, assumption of pre-existing environmental liabilities, maintenance of pre-determined employment levels or new job creation, etc. The planned implementation procedures for the Mass Privatization Program are cumbersome; thus it remains to be seen to what extent they will in practice accelerate the transfer of effective ownership to the private sector or strengthen corporate governance.

V. External Sector Liberalization

1. Introduction

Romania has followed a gradualist strategy in external liberalization, but with the liberalization of external trade proceeding more rapidly than other elements. 1/ Early on in the reform process, the state monopoly of foreign trade was eliminated, the surrender requirement was reduced, the general public was authorized to conduct foreign exchange transactions through foreign exchange bureaus, and the dual exchange rate system was formally abolished. In the second wave of measures starting in early 1992, export and import licenses were largely eliminated, and a new more rational tariff code was implemented. In the following year, export bans and quotas were substantially reduced, and several temporary tariff exemptions and reductions were eliminated. As a result, the liberalization of the foreign trade regime was largely completed, and further measures implemented during 1993-95 either aimed at rationalizing the tariff structure, or reflected the obligations stemming from international agreements.

The reform of the foreign exchange system proceeded somewhat more slowly. The surrender requirement was abolished entirely in 1992, and after considerable problems with the operation of an auction system a fully-fledged direct-dealing interbank foreign exchange market was inaugurated in August 1994. Nonetheless, various restrictions and imperfections persist, and the complete unification of the exchange rate and of the foreign exchange markets is yet to be accomplished.

This section discusses developments in foreign currency convertibility and the reform of the foreign exchange market, in external debt, in foreign direct investment, and finally in the external trade regime.

2. Currency convertibility and foreign exchange market reforms

Over the past five years, the Romanian authorities have implemented a number of regulatory and institutional reforms which brought about a significant liberalization of the country's foreign exchange system. Today, the Romanian leu is convertible for most current account transactions, but capital transfers and external borrowing require authorization from the NBR. Foreign direct investment in Romania is generally unrestricted, but requires registration with the authorities. Domestic commercial banks are authorized by the NBR to conduct foreign exchange transactions abroad for current international transactions, and are permitted to have foreign banks as correspondents or to borrow directly abroad with NBR authorization.

1/ For a review of Romania's reform strategy in 1990-91, see Dimitri G. Demekas and Mohsin Khan, *The Romanian Economic Reform Program*, Occasional Paper 89 (Washington: International Monetary Fund, 1991).

Romania's foreign exchange system is also characterized by a considerable degree of internal currency convertibility. There is no surrender requirement, but domestic residents must repatriate 100 percent of their foreign exchange receipts, which can be deposited in the domestic banking system. ^{1/} In addition, the limited amounts of foreign exchange that can be purchased by individuals from the foreign exchange bureaus can be either used for making current international payments or can be deposited with the domestic banks. With the exception of transactions related to export contracts, all domestic transactions must be carried out in domestic currency. However, resident banks are authorized to extend foreign currency credits to resident businesses. All international transactions must be carried out in convertible currencies; only a small and declining volume of trade related to the expiring clearing arrangements is conducted on a bilateral basis in other units of account.

a. Key reforms

The liberalization of the foreign exchange regime began in 1990-91 when the surrender requirement was reduced to 50 percent of export proceeds and individuals were authorized to hold foreign exchange outside the banking system. In February 1991, an interbank foreign exchange market was established, and in August, individuals were permitted to conduct small transactions in foreign exchange through foreign exchange bureaus. The dual exchange rate system was abolished in November. However, the surrender requirement was entirely lifted in May 1992, and the exchange rate started to be determined daily through auction in the foreign exchange market only from June 8, 1992. Payments related to imports and exports of goods and services were liberalized on May 1, 1992, and in general are not subject to licensing, except for the goods subject to quantitative restrictions, and certain controlled strategic goods.

From the second half of 1992 until early 1994, the reform process stalled. The foreign exchange auction mechanism introduced in June 1992 did not function as intended, as official action prevented the rate from adjusting to market clearing levels. ^{2/} Throughout that period, enterprises experienced shortages of foreign exchange, and there emerged a significant spread between the effective rate prevailing in the foreign exchange bureau market and the auction rate; the rates in the "grey" market were also reported to be higher than the auction rate.

On April 12, 1994, Romania liberalized the foreign exchange auction system, with a view to allowing the exchange rate to clear the market. The volume of transactions was broadened to include all official transactions, including those for oil imports, except for transactions relating to debt-

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^{1/} Romanian physical persons who earn income in foreign currency abroad may keep such earnings in accounts opened with banks abroad.

^{2/} In the last quarter of 1992, the exchange rate remained immobile at 430 lei per dollar.

service payments. 1/ (See Statistical Appendix table 47.) All enterprises and domestic and foreign commercial banks in Romania gained access to the auction market.

In August 1994, the auction market was replaced with a fully fledged direct-dealing interbank foreign exchange market. All authorized dealers were permitted to purchase or sell foreign exchange directly from any other authorized dealer at freely negotiated rates without limitations, but subject to prudential limits on their net foreign exchange positions. 2/ The NBR committed itself to avoid intervening in the exchange market beyond normal smoothing operations and the need to build up official exchange reserves.

From June 1995, foreign banks can obtain license to become market dealers. In September 1995, the Government issued a decision permitting the state-owned enterprises (except for those under special surveillance in connection with the proposed World Bank FESAL) to conduct business, including foreign exchange operations, with more than one bank. Both these decisions are expected to enhance the functioning of the market.

b. The direct-dealing interbank foreign exchange market

The direct-dealing foreign exchange interbank market introduced on August 1, 1994, was set up as a decentralized market. Commercial banks may deal directly with each other, with natural persons, and with juridical persons (including foreign exchange bureaus). Foreign exchange bureaus may deal directly with banks and with natural persons. The official reference rate of the NBR is calculated daily as an average of rates in interbank and bank-client transactions. Transactions in the interbank market can be conducted both on behalf of banks' clients and among banks dealing on their own account (within prudential limits). A dealer's or broker's license can be obtained by applying at the NBR.

The leu exchange rate is generally quoted in the market against the U.S. dollar, in which the overwhelming majority of transactions is conducted, but foreign exchange dealings can be in any of the 22 currencies against which the NBR quotes exchange rates. Transactions are in the spot market and there are few forward transactions between market participants, although some banks now have begun regularly quoting forward rates.

The activity in the foreign exchange market in Romania--and particularly in the interbank market in Bucharest--is dominated by two state-owned banks, which account for some 50 percent to 70 percent of all

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1/ Foreign exchange transactions related to debt-service payments by the consolidated general government are carried out outside the market but at market determined exchange rates.

2/ For a description of the main features of this market, see page 2 in EBS/94/181, September 12, 1994.

transactions. This high degree of concentration has been attributed to government regulations that formerly prohibited state-owned enterprises from maintaining accounts and conducting foreign exchange operations with more than one bank. As a result, most state-owned companies were dealing with a state-owned bank, while the client base of the newly-created private banks, and also of foreign banks, was largely limited to a still small private sector. The lifting of the restriction on maintenance of accounts with various banks was removed in September 1995, and has the potential to enhance the competitiveness and indeed the transparency of the market.

Responding to the liberalization of the auction exchange rate in April 1994, the monthly volume of transactions in the foreign exchange market increased dramatically after the introduction of new arrangements, and during 1994 ranged from US\$330 million to almost US\$500 million. However, after late 1994, as temporary shortages developed, the transaction volume fell sharply. (See Statistical Appendix table 47, and Chart 14.) By April 1995 turnover dropped to a low of US\$253 million. This decline in the foreign exchange market activity was accompanied by a sharp increase in the premium in the exchange bureau market, and effective segmentation in the exchange market.

According to many market participants, the interbank market was not functioning properly at that time. Transactions among banks all but disappeared, and the banks designated as dealers were refusing to trade at the rates posted on market screens. Also, there were reports that transactions were in many cases concluded at more depreciated exchange rates than those quoted on the screens, and that banks faced with foreign exchange shortages had introduced informal queuing arrangements. In the following three months, the situation eased considerably and the volume of transactions rebounded to its normal levels, while the premium in the exchange bureau market nearly disappeared. However, market pressures resurfaced in October, as foreign exchange shortages intensified, leading to renewed segmentation, and a sharp rise in the bureau premium. In mid-November, the NBR intervened in the inter-bank market, and the official reference rate depreciated by some 10 percent.

In addition to the foreign exchange market, the supply of foreign exchange for international payments has been supplemented by foreign currency credits extended by domestic banks to residents. The value of such credits extended during 1994 amounted to US\$500 million, and to nearly US\$600 million during the first nine months of 1995. A considerable share of this lending was to private importers of consumer goods. To a considerable degree, such credits are granted to customers with foreign currency earnings, and some 80 percent to 90 percent are of short-term maturity. State-owned banks granted up to 50 percent of foreign currency credits to state-owned enterprises: a significant share of credits to these was apparently extended to customers without export earnings. The demand for foreign currency lending stemmed largely from a favorable interest rate differential (see Chart 7).

CHART 14
Romania: Exchange Rate Developments, 1994-95

Sources: Data provided by the Romanian Authorities.

c. Internal convertibility and the exchange bureau

In countries with limited currency convertibility, or when domestic interest rates are not set on market terms and depositors may not be compensated for the rise in domestic price level, internal convertibility provides residents with the possibility to seek an alternative store of value, and an effective hedge against domestic inflation. 1/ The key motive for introducing internal currency convertibility is to channel the existing foreign exchange holdings into the domestic banking system, and to integrate black markets to domestic economy. Of course, in the face of macroeconomic instability, internal convertibility may also facilitate the switching out of domestic currency assets by residents (contributing to a loss of official reserves).

Foreign exchange bureaus are an important institutional element of internal currency convertibility. When such bureaus can fully participate in dealings with all physical and juridical persons, then exchange markets are integrated and all domestic residents have access to the central bank's foreign exchange reserves. An impaired access to the interbank market by the bureaus is usually accompanied by a spread between the interbank and the bureau exchange rates.

A certain degree of internal currency convertibility, which has been an important feature of Romania's foreign exchange system, has been significantly expanded in recent years. Before January 1990, residents and nonresidents could legally have foreign currency accounts, but their ability to open new accounts or effect any transactions was very restricted. The provisions governing those accounts were significantly liberalized, first in January 1990, when domestic residents were permitted to hold foreign currency outside banks, and then, starting in August 1991, individuals were permitted to engage in small-scale transactions in foreign exchange through foreign exchange bureaus.

Currently, residents may freely use foreign exchange deposited in foreign exchange accounts for current and capital payments, but individuals are authorized to purchase no more than US\$500 per year from the foreign exchange bureaus for travelling abroad; these funds can also be deposited in foreign exchange accounts domestically. 2/ Such a restriction may create a

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1/ Internal convertibility is generally understood as the ability of residents to acquire and hold domestically assets denominated in foreign exchange. In Romania, all transactions among the residents must be made in domestic currency, but it is permitted to hold foreign exchange deposits in resident banks. For a review of related issues see, Joshua E. Greene, and Peter Isard, "Currency Convertibility and the Transformation of Centrally Planned Economies," IMF Occasional Paper No. 81, Washington, IMF, June 1991.

2/ Amounts in excess of that limit can be authorized by the Health Ministry, the Ministry of Education, or the Ministry of Culture, on the basis of submitted documents.

barrier raising the threshold of interest rate differentials inducing residents to switch between foreign and domestic currency deposits.

The authorization to open foreign exchange bureaus is granted by the NBR, and there are no limits on the number of offices that any company can open. In November 1995, there were 380 registered foreign exchange bureaus operating some 1,000 offices throughout the country. Foreign exchange bureaus can conduct transactions with the public in foreign currency bank notes and in travellers checks. From September 19, 1994, foreign exchange bureaus have been authorized to set their exchange rates freely, and in principle have free access to foreign exchange via their dealings with banks as well as with physical persons.

Since mid-1994, exchange bureaus not owned by commercial banks have handled a dominant share of all transactions, and the monthly volume of transactions reported by the foreign exchange bureaus has ranged from US\$60 million to US\$70 million. In the first nine months of 1994, all bureaus were net buyers of foreign exchange from the public. Starting in October 1994, however, the bureaus became significant net sellers of foreign exchange, and that was particularly the case of the nonbank-owned bureaus. This coincided with the emergence of a spread between the exchange rates quoted in the "bureau de change" and in the official interbank market. This premium reached nearly 16 percent by later February 1995, and subsequently fell to a 2 percent to 3 percent range in July and August. The premium in the bureau de change market began to rise again in September, to reach nearly 25 percent in mid-November.

The premium in the exchange bureau market emerged at the same time as there appeared symptoms of foreign exchange shortages in the interbank market. Foreign exchange bureaus reported difficulties in obtaining foreign exchange from the commercial banks, as well as considerable delays in concluding the transactions. When these difficulties practically disappeared during the summer months, the small premium that remained could be explained by the transaction costs of the foreign exchange bureaus (at times there was indeed a small discount in the bureau market for similar frictional reasons). Because the bureaus purchase foreign exchange from the banks at the banks' quoted selling rates, the buying and selling foreign currency exchange rates of the bureaus are structurally above the rates quoted by the banks at times when they are net buyers of exchange.

d. Bilateral trade and payments arrangements

Romania has continued to settle its outstanding obligations under bilateral trade and payments agreements with eight countries, most of which are very small, and are either inoperative or under liquidation; there are also outstanding transferable ruble balances from trade with the former centrally-planned economies. Taking into account the considerable claims on several of its clearing partners, Romania is in net creditor position. (See Statistical Appendix Table 48.)

Romania's efforts to terminate the outstanding balances with the former CMEA partners have continued since the 1990 meeting in Sofia, and the delays beyond the original schedule (1991) reflect largely the difficulties in resolving the timing and the suitable forms of settling those obligations. Since 1990, Romania agreed with some partners to extend the deadlines to allow for finishing the deliveries already in process, while some other partner countries declined to start new deliveries of goods under the agreements already signed but not yet effectively implemented. This left Romania with a relatively large net debtor position, in particular vis-à-vis Germany, Russia, Poland, and former Czechoslovakia. According to an agreement in principle reached with Poland, the remaining debt will be eliminated through goods' deliveries. The agreement with the Czech Republic will provide for a repayment of the remaining balance (TRb30 million) on a commercial basis. The debt vis-à-vis Russia has been practically eliminated.

Most of the remaining bilateral payments agreements are inactive, and will expire in the near future. At the end of September 1995, the outstanding stock of unsettled liabilities under the clearing arrangements amounted to US\$43.5 million. Romania's obligations to Ghana were cleared in early October, and effective steps have been undertaken to terminate the remaining active bilateral payments arrangement with China. Most of the outstanding balances will be eliminated by mutual deliveries of goods, committed in the earlier agreements, and the remaining balance will be cleared by cash payment before the end of 1996.

3. External borrowing and foreign direct investment

a. External borrowing and debt

Romania's external financing needs have been met predominantly from official sources, while modest access to private foreign financing has occurred only very recently. ^{1/} After 1989, the first large infusion of external financial resources to Romania was provided by the Fund during 1991-92, in the context of a stand-by arrangement, supplemented by resources from the compensatory and contingency financing facility. Subsequently, substantial balance of payments financing was also provided by EU/G-24, and disbursements from multilateral development banks began in 1992. During that period, a number of significant officially supported export credits was granted to Romania (under the government's guarantee), for the first time after 1989.

During 1994-95, external financing remained strongly dependent on disbursements from official sources, and in particular from multilateral financial institutions. In 1994, disbursements from the Fund, in the

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^{1/} Contracting and guaranteeing of external debt by the Government and the NBR must be authorized by the Parliament. Foreign direct investment in Romania is governed by a liberal foreign investment law.

context of a stand-by arrangement approved in May, reached \$350 million, of which US\$250 million under the systemic transformation facility. ^{1/} Total disbursements from the World Bank which amounted to US\$262 million in 1994, including a US\$150 Structural Adjustment Loan, declined to US\$93 million in the first nine months of 1995, reflecting both delays in project implementation, and in concluding negotiations on a Financial and Enterprise Sector Adjustment Loan. Disbursements from the EBRD and EIB amounted to US\$113 million in 1994, and to a similar amount in the first nine months of 1995.

In the past two years, financing from other than multilateral sources has been largely limited to project-related official and officially-supported export credits guaranteed by the Romanian Government. The total value of such bilateral flows during 1994 and nine months of 1995 amounted to almost US\$700 million, or less than a half the cumulative amount in the preceding two years, in part because general balance of payments financing declined to very small levels. A relatively small amount of financing not guaranteed by the Romanian Government consisted of trade-related interbank credit lines, and a few small loans extended by the EBRD.

Until early 1994, Romania had virtually no access to sovereign borrowing. Since then, the National Bank of Romania has successfully managed to arrange two loans from foreign commercial banks, and two additional facilities are already negotiated and are expected to be disbursed in the very near future. All of these loans are essentially short-term. The first loan (US\$60 million), signed in May 1994, was arranged by the Union Bank of Switzerland, bearing interest of 1.25 percent above Libor. Another short-term loan was arranged in early 1995 with a syndicate led by the Citibank, on less favorable terms at 2.75 percent above Libor. Initially targeted for US\$75 million, the loan was oversubscribed, and finally totaled US\$150 million. In early December 1995, the Parliament approved a law authorizing the National Bank of Romania to incur liabilities exceeding one year maturity. This opened the way for the finalization of an 18-month loan arranged by a Citibank-led syndicate. The loan was increased from US\$75 million to US\$110 million after a successful syndication, carrying a 2.25 percent spread above Libor. In addition, a US\$25 million above one-year facility has been arranged with Merrill Lynch.

As suggested by the discussion above, virtually all medium- and long-term external debt of Romania is owed to official creditors. Of the total stock of such debt outstanding at end-September 1995 (US\$4.7 billion), around 45 percent is due to international financial institutions; obligations to the Fund alone accounted for above 23 percent, and obligations to the World Bank for an additional 16 percent of medium- and long-term debt. The EU/G-24 constitutes the second largest group of creditors, accounting for 18 percent of debt. The share of official and

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^{1/} In view of the delays in completing the first program review no further disbursements have been made.

officially-guaranteed export credits in the total amounted to nearly 28 percent.

b. Foreign direct investment

Under the Law on Foreign Investment of May 3, 1991, there are no limits on foreign equity participation in commercial firms set up in Romania, and foreign investments can be made in all sectors of the economy, except in the areas designated as of national interest, for defense and environmental protection reasons. Foreign investors can transfer abroad their profits, and, with the authorization of the Ministry of Finance and the NBR, the total proceeds of their share from the liquidation of their investment, and of stocks, bonds, and other securities related to such investment.

Foreign investors that had established corporations in Romania by end-1994, and their stake was at least 20 percent of social capital and no less than US\$10,000 benefitted from certain tax holidays on corporate profits taxes ranging from 2 to 5 years, depending on the field of activity. Exemptions also applied to raw materials and other inputs supplied during the first two years of activity. Companies established after January 1, 1995, are subject to profit taxes at regular rates but under Government Ordinance 70/94, a 50 percent reduction in tax rates can be applied to re-invested earnings. In the industrial sector, companies with foreign participation of at least US\$50 million, can obtain a 7-year exemption from customs duties on all imported equipment, raw materials and inputs, and a 5-year exemption from tax on profits.

The flow of foreign direct investment in Romania was very modest during 1990-93, and increased significantly only in 1994-95, totaling some US\$625 million. During that period, several large investments were made, including by Daewoo of Korea. By the end of September 1995, the total stock of foreign direct investment in Romania reached US\$1,479 million. The largest investments originated from Korea (US\$158 million), Germany (US\$138 million), United States (US\$136 million) and Italy (US\$129 million). A significant contribution was also provided by EBRD. There were 47,671 registered investors, and most investments were made by small firms. (See Statistical Appendix table 46.)

4. External trade regime

Romania proceeded fairly rapidly to liberalize its external trade after 1989. Key measures included the elimination of state monopoly on foreign trade and of import licensing in 1990. Starting in January 1991, a new, simplified tariff code was introduced, and import tariffs are established ad valorem. Export and import licensing was eliminated on May 1, 1992, except for those maintained for health and national security reasons, or for goods subject to bans and quotas.

Romania's external trade regime is established by a Law voted by the Parliament, and its implementation is delegated to the Ministry of Trade,

which may introduce temporary quotas on imports only in case of an imminent threat to balance of payments position, to facilitate accumulation of foreign exchange reserves, and to protect domestic producers from undue competition. The Ministry of Trade may also introduce temporary bans on imports, or a monitoring regime for imports of certain products to protect public morality, health and human life, the environment and for the reasons of national security.

a. Imports

During 1994-95, import regime remained broadly unchanged. In 1994, there were no changes in quantitative restrictions nor in the tariff level or structure, and only some temporary additional "compensation" taxes were introduced in June. Also, the implementation in 1995 of the agreements stemming from the Uruguay Round did not result in an effective change in the import regime.

Following the completion of the Uruguay Round negotiations, Romania renegotiated its protocol of accession to the GATT. There were no additional concessions beyond those conceded during the Uruguay Round. Romania expects the Uruguay Round to have favorable impact on its economy. The effective implementation of the Uruguay Round took place in 1995. 1/ As of January 1, tariffs on manufactured goods were lowered to 35 percent and less, and new tariffs on agricultural goods were introduced on July 1, and maximum tariffs ranging from 3 percent to 350 percent. 2/ At the same time, however, temporary tariff reductions on certain agricultural goods were implemented, and they are also expected to be extended into 1996.

Imports of agricultural products are generally free of restrictions, but some surcharges were imposed temporarily during 1993. In July 1994, the Ministry of Agriculture established reference prices for 6 products (poultry meat, sunflower oil, potatoes, tomatoes, wheat, and barley); this measure was introduced on a temporary basis to protect domestic producers. 3/ This measure created an effective differential tariff covering the difference between a reference price and the declared invoice price. The reference price corresponds to an average production cost in Romania. This temporary measure was abolished on July 1, 1995, when a new tariff on agricultural products was introduced.

1/ The agreement establishing the WTO was ratified by Romanian Parliament on December 27, 1994, and adopted as Law 133.

2/ The new tariff on agricultural goods was adopted in the Government Decision No. 353 of May 30, 1995, which modified customs tariff published in Ordinance 26 of August 1993, and then approved as Law 102 on November 12, 1994.

3/ This applied the Government Decision No. 363 of July 27, 1994. Reference prices for imported wine were established in February 1994.

As in the past, tariff exemptions are granted on the basis of the Government Ordinance No. 40 of January 20, 1994, and according to the procedure established by Article 35 of the Ordinance No. 26 of 1993. There are also general exemptions for supplies to the agricultural sector under the Law 83 on the Development of Agriculture, as well as exemptions for imported machinery, equipment, installations, means of transport, and any other goods in kind that constitute foreign direct investment (under the Law on Foreign Investments).

b. Exports

A major relaxation of export restrictions took place during 1992-93, and there were no significant revisions in this area during 1994. Export bans and quotas are introduced as temporary measures, and so far have been introduced every year with some modifications. The number of products subject to export restrictions introduced in 1992 declined to twenty some items, and was continuously reduced. Some of the restrictions were introduced to protect the domestic market (e.g., edible oils), while others for environmental protection reasons as well as to guarantee adequate supplies for the domestic market (e.g., wood products). Most export quotas have been increased during 1994, and only on a few products the quotas were reduced. During 1995, export quotas were relaxed for cereals, sunflower oil and timber; measures affecting cereals were not considered as having any restrictive impact.

Export promotion remains one of the key priorities, and in particular in the form of TVA refunds, improvements in the duty drawback system, and through indirect support to exporters in the public and private sectors. This year, a Romanian Center for Foreign Trade is being developed to better diffuse information about foreign markets, provide technical assistance and help arrange participation in foreign trade fairs by the private sector exporters, to develop managerial skills and to familiarize with the relevant legislation. Also, subsidies for export credits totaling 250 billion lei have been approved in 1995.

c. Free trade agreements

Free trade agreements were negotiated with Moldova, and with the Czech and Slovak Republics (the latter two became effective in January 1995). These agreements provide for a three-year transition for removing restrictions on trade in manufactured goods, but they include only limited concessions on trade in agricultural products. Association agreements with EFTA are being adapted to take into account the expansion of the EU membership. In addition, free trade agreements are under negotiation with Bulgaria, Poland and Slovenia.

d. Association agreement with the European Union

The association agreement with the EU was signed on February 1, 1993. Although the agreement was ratified by Parliaments of all EU member

countries and went formally into effect in February 1995, its interim trade provisions became effectively implemented from May 1993. ^{1/} The Europe Agreement provides for the creation of a free trade area by the year 2002, involving a removal of all tariff and nontariff barriers to bilateral trade. This process is to proceed gradually and asymmetrically, i.e., the timetable of implementation will be faster for EU members than for Romania. Following decisions taken by the European Councils in Copenhagen (1993) and in Essen (1994), the EU has taken unilateral steps to open its markets to Romanian exports. Beginning in January 1995 for manufactured goods, and July 1995 for agricultural products, trade concessions granted to Romania were brought in line with those already agreed with the Czech and Slovak Republics, Hungary and Poland. Under the association agreement Romania is committed to relax all export restrictions to the EU before the end of the transition period.

Among manufactured goods, the only remaining quantitative restrictions apply to Romanian textile exports. It is estimated that some 60 percent of textile exports are not affected by these measures, and in any case, these restrictions are expected to be phased out before end-1997. Also, with regard to exports of steel products, Romania committed itself to monitor its exports to avoid an excessively rapid expansion of its market share. More generally, however, Romania's trade officials estimate that at present the degree of utilization of export quotas is very low, pointing to a very modest restrictive effect of these measures.

Key Changes in the Trade Regime in 1994-95

1994

Jan. 1	Export licensing introduced for live sheep, goats and goat meat, to comply with the EU Association Agreement.
Jan. 3	Export quotas for 9 tariff lines and temporary bans on exports for 150 tariff lines introduced.
Jan. 27	Export quotas established for additional 20 tariff lines.
March 16	Statistical monitoring regime for imports of 100 tariff lines was introduced.
May 12	Export quota for sunflower edible oil was increased.
May 14	Export quotas and export licensing requirements for 13 tariff lines were introduced.
May 21	New tariff quotas exempted from customs duties (Government Decision No. 225)

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^{1/} Romania formally applied for the EU membership on June 22, 1995.

- June 23 Export quotas for timber were increased.
- June 27 Reference prices and compensation tax system for certain agricultural and food products (39 tariff lines) were established.
- July 27 Quotas on exports of live animals to EU countries established for the second half of 1994.
- August 1 Temporary adjustment of customs duties for certain imports (Government Decision No.481).
- August 8 Export quotas for sunflower seeds increased.
- August 12 Quotas on exports of live animals to EU countries for the second half of 1994 increased.
- Oct. 5 Export quotas on some maize hybrids are increased and for others export bans are removed.
- Dec. 14 Export quotas for 1994 for timber are increased.

1995

- January 1 New tariff on manufactured goods takes effect.
- Jan. 28 Relaxation of export restrictions on cereals, sunflower oil and timber.
- July 1 New tariff on agricultural goods takes effect, and differential tariff based on reference prices is abolished; customs duties on selected agricultural products are reduced.

Key Changes in the Foreign Exchange System

1993

- August 6 Annual limit for purchases of foreign exchange by natural persons is set to lei 100,000 per year.

1994

- January 1 The maximum amount of foreign exchange a resident natural person can purchase from foreign exchange bureaus is set at US\$500 per year.
- January 7 Foreign exchange transfers among residents that are related to foreign exchange market operations of banks, dividend payments, international trade in goods and services, and the execution of projects abroad became again permitted. Other

transfers are not authorized, to restrict the "grey market" and to force transactions through the official exchange market (Circular 2).

- April 11 Modification of the foreign exchange auction system to establish the market clearing rate as the reference rate (Circular 14). A de facto complete liberalization of the exchange rate.
- August 1 Foreign exchange auctions are replaced with a direct-dealing interbank foreign exchange market.
- Sept. 19 New foreign exchange regulations consolidating the changes in Romania's foreign exchange system during May 1992 - August 1994 are issued. Foreign exchange bureaus may freely sell and buy foreign currency on the interbank market within the limit of their own funds.
- Oct. 14 Requirement to report sources of funds deposited in foreign exchange accounts is abolished (by Circular 41).
- Nov. 23 Commercial banks are authorized until June 1995 to directly carry out foreign exchange transfers between resident legal persons for transactions related to exports of goods and services, and the execution of projects.

1995

- March 7 Foreign exchange deposits of Romanian natural persons and of nonresidents are to be included in the base for calculation of reserve requirements.
- May 8 Regulations on foreign exchange operations among residents, and on domestic foreign exchange credits are issued (Circular 23). Foreign exchange bureaus must raise their paid in capital to 200 million lei.
- June 22 Foreign exchange transfers among resident juridical persons, as well as on works and services delivered abroad are extended through end-1995 (Circular 29).
- June 30 Foreign banking companies may be authorized to act as dealers in the interbank market, and their net positions cannot exceed the lei amount equivalent to US\$1 million.
- September State-owned enterprises (except those subject to a special monitoring regime) are authorized to open bank accounts and conduct foreign exchange transactions with more than one bank.

Table 1. Romania: Monthly Inflation, 1994–95

		Monthly CPI Inflation (in percent)	Food	Non-food	Services	Monthly PPI Inflation (in percent)
1994	January	4.9	3.9	5.7	6.1	8.3
	February	5.9	6.9	4.7	6.0	8.7
	March	8.3	11.1	4.9	8.0	7.0
	April	6.1	5.9	6.4	6.1	11.0
	May	5.0	5.5	4.1	5.7	7.0
	June	2.6	1.1	3.2	6.6	1.8
	July	1.6	0.6	2.7	2.0	2.2
	August	1.8	0.4	2.8	3.8	1.2
	September	3.9	5.0	2.7	3.7	3.4
	October	4.4	5.0	3.6	4.9	1.6
	November	2.8	3.2	2.6	2.3	2.7
	December	2.1	2.6	1.4	1.9	2.1
1995	January	2.0	3.0	1.1	1.1	1.3
	February	1.4	1.5	1.3	1.6	1.5
	March	0.9	0.2	0.9	3.6	0.5
	April	1.6	1.4	2.1	0.9	4.0
	May	1.1	0.7	1.0	2.6	2.5
	June	1.3	0.1	1.9	4.0	3.7
	July	2.6	3.1	1.9	2.7	3.3
	August	1.0	0.0	1.5	2.8	1.6
	September	1.6	1.2	1.6	3.0	1.9
	October	3.6	3.5	3.3	4.4	...
Dec. 93–Dec. 94		61.7	64.3	55.1	74.1	73.4
Jun. 94–Jun. 95		28.0	26.5	27.0	37.4	30.1
Dec. 94–Oct. 95		18.4	15.8	18.0	30.0	22.3 ^{1/}
Oct. 94–Oct. 95		24.3	22.6	22.8	35.6	30.2 ^{2/}

Source: National Commission for Statistics.

^{1/} January–September 1995.

^{2/} September 1994–September 1995.

Table 2. Romania: Monetary Developments, 1992–95

	1992	1993	1994				1995			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	October
Monetary aggregates										
			(In millions of lei)							
Reserve money	602,444	1,292,070	1,508,050	1,658,114	2,083,698	3,245,428	2,650,462	3,097,001	3,692,698	3,875,487
Currency outside NBR	460,276	1,124,033	1,171,628	1,511,803	1,895,029	2,397,753	2,231,235	2,709,759	3,215,124	3,331,342
Bank deposits at NBR	142,168	168,037	336,422	146,311	188,669	847,675	419,227	387,242	477,574	544,145
 Broad money	 1,856,091	 4,472,381	 5,056,075	 6,151,161	 7,889,113	 10,648,693	 11,191,209	 12,753,358	 14,546,456	 15,266,300
Currency held by nonbank public	411,462	1,048,742	1,050,232	1,386,163	1,763,984	2,200,587	2,016,385	2,501,773	3,088,537	3,166,674
Leu-denominated bank deposits	1,112,454	2,127,201	2,231,310	2,998,156	4,049,484	6,089,983	6,628,944	7,333,179	8,287,848	8,756,265
Foreign currency deposits	332,175	1,296,438	1,774,533	1,766,842	2,075,645	2,358,123	2,545,880	2,918,406	3,170,071	3,343,361
 Narrow money	 1,523,916	 3,175,943	 3,281,542	 4,384,319	 5,813,468	 8,290,570	 8,645,329	 9,834,952	 11,376,385	 11,922,939
 Money multipliers										
			(In units)							
Broad money	3.1	3.5	3.4	3.7	3.8	3.3	4.2	4.1	3.9	3.9
Broad money (lei only)	2.5	2.5	2.2	2.6	2.8	2.6	3.3	3.2	3.1	3.1
Narrow money	2.5	2.5	2.2	2.6	2.8	2.6	3.3	3.2	3.1	3.1
 Behavioral parameters										
			(In percent)							
Velocity of broad money 1/	4.8	7.7	8.7	8.1	6.8	5.5	5.7	5.3	4.9	4.8
Velocity of money 2/	5.8	10.8	13.4	11.4	9.3	7.1	7.4	6.9	6.2	6.2
 Foreign currency deposits ratio to										
Broad money	17.9	29.0	35.1	28.7	26.3	22.1	22.7	22.9	21.8	21.9
Narrow money	21.8	40.8	54.1	40.3	35.7	28.4	29.4	29.7	27.9	28.0
 Banks reserves as share of lei deposits										
End-of-period	41.4	52.8	52.5	50.4	46.8	39.4	33.7	37.0	38.8	38.0
 Currency of non-bank public as										
Percent of broad money	22.2	23.4	20.8	22.5	22.4	20.7	18.0	19.6	21.2	20.7
Percent of GDP 2/	46.3	30.6	23.9	27.7	32.8	37.3	31.5	37.1	43.6	43.2

Source: National Bank of Romania and staff estimates.

1/ Monthly GDP (annualized) divided by the end-of-period stock of money.

2/ Currency holdings of non-bank public divided by annualized monthly GDP.

Table 3. Romania: The Increase in Foreign Currency
Lending, January-October 1995

(in billions of lei)

<u>Total</u>	<u>2,043</u>
Romanian Bank for Foreign Trade	1,174
Romanian Commercial Bank	205
Banca Agrícola	113
Tiriac Bank	109
Credit Bank	108
Romanian Bank for Development	54
Dacia Felix	44

Source: National Bank of Romania

Table 4. Romania: Velocity of Broad Money, 1990-1994

(M2 Excluding Foreign Currency Deposits)

	1990	1991				1992				1993				1994			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Iceland 1/	4.5	...	...	...	4.2	...	...	...	3.7	...	...	...	3.9	...	...	...	3.9
Algeria	1.05 1/	...	...	...	2.77	...	...	...	2.26	1.86	2.18	2.00	1.99	1.73	2.35	2.56	2.77
Armenia 1/	3.1	3.2	4.1	4.5	4.1	4.7	4.9	4.5	5.8	6.8	8.9	9.7	10.8	13.4	11.4	9.3	7.1
Austria 1/	...	...	...	...	...	...	...	...	5.5	...	...	...	4.8	...	...	...	3.8
Bulgary 1/	2.59	...	...	...	2.52	...	...	...	2.28	...	...	...	2.48	...	...	...	2.70
Czech Republic 1/	...	...	...	...	1.61	1.43	1.48	1.48	1.43	1.45	1.48	1.45	1.33	1.33	1.34	1.37	1.26
Czech Republic 1/	...	...	...	...	...	...	...	...	1.70	1.72	1.75	1.76	1.69	1.79	1.84	1.80	1.69

1/ End of period.

Table 5. Romania: Commercial Bank Deposit Rates, 1994-95

(in percent per annum)

	1994				1995										
	Mar	Jun	Sept.	Dec	Jan	Feb	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.
Romanian Commercial Bank															
3-month	113.9	134.4	78.0	72.2	64.3	64.3	64.3	55.5	55.5	55.5	55.4	42.9	40.2	40.2	47.2
6-month	126.4	147.4	83.1	73.2	62.9	62.9	62.9	54.8	54.8	54.8	54.5	42.8	39.1	39.1	47.1
12-month	132.1	149.5	90.4	73.0	60.3	60.3	60.3	53.3	53.3	53.3	53.0	42.7	35.2	35.2	45.9
Romanian Bank for Development															
3-month	104.2	104.2	86.1	69.1	54.1	54.1	54.1	54.1	54.1	54.1	51.2	40.2	40.2	40.2	40.2
6-month	116.6	116.6	87.6	73.2	56.0	56.0	56.0	56.0	56.0	56.0	52.0	40.4	40.4	40.4	40.4
12-month	126.4	126.4	90.4	78.6	59.8	59.8	59.8	59.8	59.8	59.8	54.1	42.7	42.7	42.7	42.7
Banca Agricola															
3-month	113.9	113.9	78.0	69.1	63.8	63.8	61.4	61.4	56.8	56.8	52.5	37.8	37.8	37.8	51.0
6-month	126.4	126.4	90.6	73.2	60.4	60.4	60.2	60.2	58.5	58.5	54.5	38.0	38.0	38.0	51.6
12-month	142.4	142.4	96.4	79.7	62.5	62.5	62.5	62.5	59.6	59.6	54.1	40.5	40.5	40.5	49.1
Romanian Bank for Foreign Trade															
3-month		174.8	70.4	78.0	64.4	64.4	60.2	53.2	53.2	53.2	53.2	46.4	39.9	39.9	49.1
6-month		140.2	58.8	72.9	57.5	57.5	50.1	44.0	44.0	44.0	44.0	41.6	34.6	34.6	46.4
12-month		90.0	48.0	65.0	49.0	49.0	45.0	40.0	40.0	40.0	40.0	38.0	32.0	32.0	42.0
Dacia Felix															
3-month	230.7	230.7	113.3	95.6	85.7	69.1	69.1	69.1	69.1	58.3	58.3	58.3	54.1	54.1	54.1
6-month	205.1	205.1	92.8	92.8	61.0	53.0	53.0	53.0	53.0	45.9	45.9	45.9	45.8	45.8	45.8
12-month	167.8	167.8	63.2	63.2	48.0	39.3	39.3	39.3	39.3	39.2	39.2	39.2	38.0	38.0	38.0
Savings Bank															
1-year time	70.0	70.0	70.0	70.0	50.0	50.0	50.0	50.0	45.0	45.0	45.0	32.0	32.0	32.0	32.0
CD > 1-year	80.0	80.0	70.0	70.0	50.0	50.0	50.0	50.0	45.0	45.0	45.0	32.0	32.0	32.0	32.0

Source: National Bank of Romania and staff calculations.

Table 6. Romania: Exports and Imports by Commodity Group,
January-June 1995

	Exports FOB		Imports CIF	
	Value 1/	Change in percent 2/	Value 1/	Change in percent 2/
Total				
of which:	3,415.5	26.2	4,350.0	42.7
Live animals and animal products	78.2	-19.7	72.6	71.3
Vegetable products	31.0	24.4	82.4	28.4
Fats and animal or vegetable edible oils	25.9	28.4	15.3	52.8
Foodstuffs, beverages, tobacco	29.9	2.3	278.2	74.3
Mineral products	371.1	11.6	1,134.2	41.4
of which petroleum	--	--	631.0	79.3
Chemicals	335.0	79.0	403.1	69.2
Plastic, rubber and articles	119.0	119.5	153.9	55.5
Crude hides and skins, leather, furs, etc.	17.6	-24.2	96.6	44.6
Wood products, cork and wattles	83.7	-21.8	19.5	44.3
Pulp of wood, scrap paper, paper and articles thereof	35.6	182.1	95.3	62.8
Textiles and textile articles	617.6	25.8	524.7	37.4
Footwear	170.6	39.4	49.3	68.3
Articles of stone, cement, ceramics, glass, etc.	67.2	31.2	40.4	35.0
Basic metals and articles thereof	674.4	32.8	209.1	146.9
Machinery, appliances, and electrical equipments	281.2	25.4	819.5	32.4
Transport equipment	212.1	27.0	150.4	58.8
Miscellaneous	240.6	14.6	72.1	43.5

Sources: Romanian authorities; and Fund staff estimates.

1/ In millions of U.S. dollars.

2/ Relative to a corresponding period of the previous year.

Table 7. Romania: Indices of Industrial Production by Branch, January–September 1995
(January–September 1994 = 100)

Industry	
Unadjusted series	109.4
Adjusted series (for working days)	110.1
Communications equipment, incl. radio, TV sets	156.9
Pulp, paper and cardboard	136.1
Computers	135.0
Medical, precision, optical and watchmaking instruments	133.6
Fabrics, furs and leather goods	126.2
Electric machines and equipment	124.7
Metallic constructions and metal products	124.6
Furniture and other non–classified activities	122.9
Publishing houses, printing	122.8
Machines and equipment	121.9
Metallurgy	117.4
Other transport	114.9
Other products of non–metallic minerals	113.5
Leather and footwear	112.8
Chemical industry and synthetic and artificial fibres	112.2
Tobacco	107.7
Other extraction activities	106.6
Water captation, purification and distribution	106.2
Road vehicles	105.8
Textiles	104.5
Waste and recycling	103.9
Petroleum processing, coal coking and treatment of nuclear fuels	103.5
Iron ore mining and preparation	103.0
Food and beverages	102.5
Coal mining and preparation	102.1
Production and distribution of power	101.8
Wood industry	101.7
Rubber and plastics processing	101.3
Petroleum and gas extraction	99.1

Source: National Commission for Statistics.

Table 8. Romania Achieved and Invoiced Industrial Output by Branch, September 1995

(In millions of lei, producer prices)

Industry	Percent Change in Stock 1995 Q1-Q3	Stock/Output Ratios (Percent)	Stock/Export Ratios (Percent)	Export/Output Ratios (Percent)	Stock on 1/1/95	Stock on 9/30/95	Output in 1995 Q1-Q3	Invoiced Total	Of which for Export
Industry	34.1	70	367	19	2,141,731	2,872,150	4,096,556	4,055,340	783,437
Communications equipment, incl. radio, TV sets	131.9	86	2,010	4	8,120	18,834	21,776	20,811	937
Other transport	99.2	75	3,256	2	25,409	50,618	67,211	59,646	1,555
Publishing houses, printing	94.5	14		0	1,702	3,311	23,404	23,362	9
Pulp, paper and cardboard	74.4	57	307	18	20,275	35,367	62,578	58,632	11,504
Petroleum processing, coal coking and treatment of nuclear fuels	72.0	56	383	15	128,402	220,916	396,269	412,258	57,748
Chemical industry and synthetic and artificial fibres	63.1	94	285	33	197,064	321,509	343,605	325,637	112,888
Petroleum and gas extraction	62.9	18			16,658	27,129	149,970	150,351	
Machines and equipment	55.7	169	607	28	322,366	501,911	297,219	266,966	82,747
Other extraction activities	54.1	41	380	11	5,207	8,026	19,593	18,808	2,109
Wood industry	50.7	119	297	40	61,161	92,172	77,663	76,572	31,001
Road vehicles	47.3	54	416	13	55,103	81,183	149,900	137,332	19,501
Electric machines and equipment	42.4	85	352	24	54,365	77,422	90,595	95,002	21,984
Furniture and other non-classified activities	41.0	74	160	46	55,834	78,723	106,863	111,135	49,115
Metallic constructions and metal products	38.6	115	567	20	55,745	77,257	67,127	64,888	13,624
Medical, precision, optical and watchmaking instruments	35.6	177	1,402	13	23,558	31,935	18,067	17,835	2,278
Coal mining and preparation	33.9	27			19,072	25,528	95,555	91,314	
Fabrics, furs and leather goods	30.6	69	125	55	42,693	55,762	81,062	86,983	44,705
Leather and footwear	24.2	103	276	37	42,979	53,375	51,765	58,599	19,325
Metallurgy	20.6	72	512	14	326,362	393,634	547,823	558,229	76,944
Iron ore mining and preparation	14.5	190		0	26,716	30,597	16,137	17,774	67
Rubber and plastics processing	12.8	65	498	13	52,977	59,766	92,527	88,866	11,992
Production and distribution of power	11.3	1	49	1	228	254	37,715	377,676	521
Other products of non-metallic minerals	4.9	60	277	22	99,133	104,015	174,164	172,998	37,611
Textiles	2.8	114	446	26	181,091	186,129	162,801	169,563	41,778
Tobacco	1.2	22		-	5,345	5,410	24,263	27,351	
Computers	-2.5	121	241	50	2,689	2,622	2,168	2,213	1,089
Food and beverages	-3.7	57	1,157	5	341,480	328,744	578,735	564,541	28,407

Table 9. Romania: Output of Main Industrial Products, January–September 1995

(January–September 1994 = 100)

Synthetic rubber	160.4
Fresh milk products (3.5% fat)	155.0
Steel cold-rolled sheets and strips	137.7
TV-sets	133.7
Caustic soda	133.1
Paper	132.0
Electric motors of .25 kW and over	129.4
Soap	127.7
Fertilizers (100% A.S)	127.0
Butter	121.8
Tractors	120.8
Steel welded hot-rolled tubes	120.7
Metallurgical coke	120.1
Window glass (2mm thick)	119.9
Furniture	119.1
Aluminium and Aluminium alloys	119.0
Milk for consumption	118.5
Cotton and cotton type fabrics	118.0
Cement	117.0
Confectionery and pastries	116.3
Soda ash	114.9
Solid finished hot-rolled tubes	113.9
Raw steel	113.8
Household linen washing machines	112.6
Saleable trucks, autotractor and car frames	112.3
Refrigerators	111.9
Household vacuum cleaners	111.9
Electric motors under .25 kW	111.8
Basic macromolecular products (100%)	110.3
Commercial vehicles	109.9
Edible oils	109.4
Pesticides (100% A.S)	109.2
Synthetic fibres and yarns	109.2
Knitwear	108.3
Human medicines	107.9
Electric power	107.5
Cheese	106.8
Sulphuric acid (monohydrate)	106.2
Petrol	106.1
Bearings (excluding heavy Bearings)	105.9
Liquid gas (gas stove)	105.5
Footwear	104.6
Gas oil	104.5
Lead accumulator batteries and elements	103.6
Thermal power from thermal and heating power stations	102.3
Net coal (prepared)	101.9
Motor-tractor tyres	101.5
Power from thermal stations	100.9
Crude petroleum extracted	100.2
Town cars	99.0
Electric bulbs	99.0
Varnishes and paints	98.3
Carcass meat	97.9
Natural gas extracted (15 C deg., 760mm HG)	97.1
Clothes	96.6
Fabrics	96.5
Meat products	95.5
Beer	94.4
Timber	91.6
Artificial fibres and yarns	90.3
Paper: Newsprint	86.8
Fuel oil	77.4
Radio sets	75.6
Black and white TV-sets	63.7
Detergents	56.0
Electronic transformers and auto-transformers of .25k VA and over	45.5
Goods waggon (4 axes equiv.)	44.1
Land cars	--

Table 10. Romania: Stocks at Producers for Main Industrial Products, January–September 1995

(Product units)

		1995		Percentage Change
		January	September	
Paper: Newsprint	Tonnes	42	862	1,952.4
Tv sets	Thou. pcs.	1	8	700.0
Trucks, autotractors and car frames	Pcs.	29	156	437.9
Buses	Pcs.	7	29	314.3
Detergents	Tonnes	2,208	7,384	234.4
Fertilizers (100% A.S)	Thou. tonnes	37	94	154.1
Fuel oil	Thou. tonnes	63	122	93.7
Steel cold–rolled sheets and strips	Tonnes	5,898	10,402	76.4
Soap	Tonnes	368	600	63.0
Petrol	Thou. tonnes	142	231	62.7
Metallurgical coke	Thou. tonnes	100	156	56.0
Paper	Tonnes	10,723	16,208	51.2
Artificial fibres and yarns	Tonnes	1,160	1,604	38.3
Cars	Pcs.	1,441	1,864	29.4
Electric motors of .25 kW and over	Thou. KW	199	254	27.6
Meat products	Tonnes	460	572	24.3
Cotton and cotton type fabrics	Thou. sq.m	24,108	29,479	22.3
Crude petroleum extracted	Thou. tonnes	147	179	21.8
Steel welded hot–rolled tubes	Thou. tonnes	46	56	21.7
Electric motors under .25 kW	Thou. pcs.	128	153	19.5
Fabrics	Thou. sq.m	41,667	47,582	14.2
Solid finished hot–rolled tubes	Thou. tonnes	313	349	11.5
Net coal (prepared)	Thou. tonnes	918	1,018	10.9
Motor–tractor tyres	Thou. pcs.	152	162	6.6
Gas oil	Thou. tonnes	86	91	5.8
Timber	Thou. m3	258	263	1.9
Knitwear	Thou. pcs.	10,126	9,571	–5.5
Pesticides (100% A.S)	Tonnes	1,336	1,252	–6.3
Footwear	Thou. pairs	3,640	3,288	–9.7
Varnishes and paints	Tonnes	3,167	2,772	–12.5
Tractors	Pcs.	2,949	2,531	–14.2
Carcass meat	Tonnes	16,102	13,390	–16.8
Soda ash	Tonnes	26,662	21,931	–17.7
Refrigerators	Thou. pcs.	5	4	–20.0
Cheese	Tonnes	5,372	4,031	–25.0
Beer	Thou. hl	358	265	–26.0
Caustic soda	Tonnes	14,740	10,538	–28.5
Butter	Tonnes	2,393	1,591	–33.5
Cement	Thou. tonnes	442	279	–36.9
Synthetic rubber	Tonnes	2,406	1,415	–41.2
Synthetic fibres and yarns	Tonnes	4,148	1,887	–54.5
Window glass (2mm thick)	Thou sq.m	2,699	1,131	–58.1
Edible oils	Tonnes	9,314	3,575	–61.6
Town cars	Pcs.	2,708	636	–76.5

Source: National Commission for Statistics.

Table 11. Romania: Employment in Industry by Branch, 1994–95

	Percent Change Sep. 95/Sep. 94	Change in Employment Sep. 94–Sep. 95 (Thousands)	1994 September (Thousands)	1995 September (Thousands)	Memorandum: Capacity Utilization	
					Sep. 94	Sep. 95
Industry	-5.4	-128.6	2,403.1	2,274.5	83.7	84.9
Medical, precision, optical and watchmaking instruments	-13.2	-4.1	31.0	26.9	76.7	73.8
Textiles	-12.1	-24.7	204.2	179.5	79.5	82.4
Communications equipment, incl. radio, TV sets	-11.4	-1.5	13.2	11.7	76.8	79.0
Rubber and plastics processing	-10.9	-5.1	46.7	41.6	84.6	87.6
Leather and footwear	-9.3	-7.6	81.6	74.0	77.3	74.7
Tobacco	-9.3	-0.5	5.4	4.9	90.1	91.3
Machines and equipment	-8.1	-27.2	334.0	306.8	81.5	79.4
Other transport	-7.5	-7.2	96.3	89.1	84.8	84.6
Chemical industry and synthetic and artificial fibres	-6.7	-8.1	120.5	112.4	86.2	89.8
Petroleum and gas extraction	-6.7	-4.4	65.5	61.1	89.6	93.6
Wood industry	-6.5	-6.8	105.4	98.6	84.2	79.7
Metallic constructions and metal products	-6.1	-4.3	70.6	66.3	84.3	85.6
Metallurgy	-5.3	-9.0	169.3	160.3	89.1	90.6
Coal mining and preparation	-5.1	-5.1	99.8	94.7	83.9	84.8
Production and distribution of power	-4.4	-4.1	93.4	89.3	90.5	89.6
Other products of non-metallic minerals	-4.0	-4.6	114.9	110.3	84.3	85.1
Iron ore mining and preparation	-4.0	-2.2	55.3	53.1	87.7	87.5
Pulp, paper and cardboard	-3.9	-1.0	25.7	24.7	85.0	88.2
Other extraction activities	-3.9	-0.7	18.0	17.3	87.5	89.7
Publishing houses, printing	-3.4	-0.8	23.2	22.4	81.5	81.3
Furniture and other non-classified activities	-3.3	-3.7	113.6	109.9	80.4	86.3
Fabrics, furs and leather goods	-3.3	-3.8	116.7	112.9	85.9	84.1
Petroleum processing, coal coking and treatment of nuclear fuels	-1.9	-0.8	41.1	40.3	94.0	92.4
Computers	-	-	2.1	2.1	91.7	92.5
Food and beverages	0.4	0.8	187.7	188.5	82.3	86.1
Electric machines and equipment	1.0	0.7	71.6	72.3	85.3	89.3
Road vehicles	7.5	7.2	96.2	103.4	80.5	88.6

Source: National Commission for Statistics.

Table 12. Romania: Indices of Hourly Labor Productivity in Industry by Branch,
January–September 1995

(January–September 1994=100)

Industry	113.9
Communications equipment, incl. radio, TV sets	232.1
Medical, precision, optical and watchmaking instruments	156.9
Publishing houses, printing	139.8
Pulp, paper and cardboard	139.1
Metallic constructions and metal products	133.3
Computers	132.6
Machines and equipment	132.0
Leather and footwear	125.0
Other transport	122.4
Metallurgy	120.9
Chemical industry and synthetic and artificial fibres	120.1
Other products of non–metallic minerals	119.4
Electric machines and equipment	117.6
Fabrics, furs and leather goods	117.4
Furniture and other non–classified activities	117.2
Tobacco	113.6
Wood industry	108.9
Rubber and plastics processing	108.7
Production and distribution of power	108.5
Other extraction activities	107.8
Coal mining and preparation	107.8
Iron ore mining and preparation	107.3
Textiles	107.0
Petroleum and gas extraction	106.8
Food and beverages	104.2
Petroleum processing, coal coking and treatment of nuclear fuels	104.0
Road vehicles	96.3

Source: National Commission for Statistics.

Table 13. Romania: Monthly Average Wages, September 1995

	Average Net Wage 12 months change in percent	Average Gross Monthly Wage September 1995 (lei)	Average Net Monthly Wage September 1995 (lei)	Net Wage 1995 Q1 - Q3/ 1994 Q1 - Q3 (1994 Q1 - Q3)
Total	49.6	297,092	229,543	157
Financial institutions and banks	86.4	562,105	400,151	161
Insurance and pensions	76.1	416,451	316,121	179
Public administration	62.5	273,461	212,153	161
Post office and communications	62.0	369,373	282,426	169
Education	54.2	265,140	207,615	171
Hotels and restaurants	51.0	220,732	174,423	156
Wholesale and retail trade	50.9	248,457	193,587	161
Industry total	50.1	314,399	242,540	154
Extractive	41.2	486,999	358,021	144
Mining	37.4	456,751	338,949	150
Petroleum and Gas	47.4	552,352	399,226	131
Manufacturing of which:	52.9	290,982	226,783	156
Engineering and electric engineering	55.5	311,270	242,871	159
Metallurgy	59.0	422,246	317,414	158
Chemicals	54.8	353,238	271,189	159
Building materials	50.9	312,137	242,420	154
Wood	45.6	237,774	188,903	152
Light	42.9	206,121	164,738	149
Food	52.8	297,585	231,404	156
Electric and thermal power, gas and water	28.5	408,044	306,618	141
Health and social assistance	48.3	231,132	183,407	159
Agriculture	48.2	232,484	183,911	158
Construction	45.3	315,990	242,475	156
Transport	43.1	358,155	273,133	157
<u>Memorandum items:</u>				
Change in CPI	25.3			
Change in PPI	30.2			

Source: National Commission for Statistics.

External Performance, Competitiveness, and Trade Adjustment

The review in the main body of the background paper of Romania's external performance during the 1990s--and in particular of the performance in the last two years--highlights the role of the exchange rate policy in the context of transition to a market-based economy. An important feature of Romania's transition was that transformation and economic stabilization were implemented in the context of an exchange rate regime that was designed to be flexible. This regime was adopted after the first year of reforms, when the country's liquid external reserves were almost depleted. ^{1/} However, in the following years the exchange rate frequently departed from its equilibrium level, and there were several cycles of significant real exchange rate appreciation and subsequent correction. These cycles resulted from intermittent shifts in priority between domestic and external policy objectives, and were also reflected in high and resurgent inflation and substantial fluctuations in the country's net foreign assets. The relatively slow progress in the area of structural reforms and the associated delays in microeconomic adjustment also undermined the effectiveness of macroeconomic stabilization policies, in part by putting additional pressure on the exchange rate. In the sections below, this appendix provides an overview of recent balance of payments developments, and reviews key issues in Romania's exchange rate policy, including its impact on external competitiveness and external trade adjustment.

1. Overview of external developments in 1990-95

Romania entered the transition process in 1990 with an external position that differed considerably from most of other countries in the region. In the preceding year, there had been a current account surplus equivalent to 13 percent of GDP, the liquid external reserves were quite large at US\$2 billion, and the country had practically no external debt (Table 14). This was achieved mostly through a severe compression of import demand. In 1990, the state monopoly of foreign trade was abolished and foreign exchange regulations considerably liberalized. In parallel, the new government pursued expansionary fiscal and monetary policies through most of 1990, and introduced several measures focussed on improving the population's standard of living, including a ban on food exports, and limits on energy use by industry, all of which had important negative consequences for output growth and significantly contributed to a grave deterioration in the balance

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^{1/} A floating rate system is often implemented when foreign exchange reserves are low, and there is a need to safeguard the balance of payments position. For a review of general considerations regarding the choice of exchange regimes, see Aghevli, Khan and Montiel, Exchange Rate Policy in Developing Countries: Some Analytical Issues, IMF Occasional Paper No.78, (Washington: International Monetary Fund, March 1991).

of payments. 1/ A sharp swing into a large current account deficit that ensued, led to an almost complete drawdown of foreign exchange reserves in the course of 1990. 2/

In the following three years (1991-93), the level of current account deficits was largely determined by the availability of external financing, and the need to reconstitute the country's foreign exchange reserves. In that period, the exchange rate played a relatively minor role in restoring the external equilibrium, and there were repeated periods of foreign exchange rationing, while exports increased only marginally from the depressed level of 1991. At the same time, gross foreign exchange reserves increased modestly to US\$0.9 billion, largely on the account of external borrowing, including the use of Fund credit of US\$1 billion.

In 1991, given the very low levels of foreign exchange reserves, and the limited availability of external financing, the current account deficit contracted to US\$1.3 billion. Medium- and long-term capital inflows reflected mostly guaranteed suppliers credits and the repayments of credits extended by Romania; the overall balance of payments deficit was covered by the net use of Fund credit of US\$0.8 billion. In 1992, the disbursements of bilateral assistance increased significantly and together with continued financial support from the Fund, allowed for a further modest increase in gross international reserves, while the current account deficit widened to US\$1.5 billion. In 1993, in the context of expansionary monetary policy and the administratively set auction rate, and notwithstanding a sharp fiscal retrenchment in the second half of the year, the real exchange rate appreciated and contributed to severe balance of payments pressures. The current account deficit (US\$1.2 billion) was again restrained by limitations of external financing. The recorded capital inflows were mostly from official sources, and net international reserves of the banking system increased only very modestly.

By the end of 1993, monetary policy was tightened significantly, and interest rates rose sharply to positive levels in real terms. This was accompanied by a 19 percent devaluation of the official exchange rate in December, and then a two-step liberalization of the foreign exchange market in April and August of 1994. This new policy resulted in an important real

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1/ Fiscal and monetary expansion which took place in the context of the collapsing output, combined with several administrative measures to boost domestic absorption, were the primary factors that caused a US\$6 billion turnaround in the current account balance, to a US\$3.3 billion deficit in 1990. However, the external trade performance was also significantly affected by the Middle East crisis in the second half of 1990, as energy prices increased sharply while Romanian exports to the region were brought to a halt, and by the collapse of convertible currency trade with ex-CMEA countries.

2/ Foreign exchange reserves fell to US\$91 million at the end of March 1991.

exchange rate correction in the first half of 1994, and thus contributed to a very considerable adjustment in the external trade. For the year as a whole, the current account deficit contracted to US\$0.5 billion, and together with stronger capital inflows and the renewed Fund support, allowed for a very substantial increase in Romania's net international reserves. Starting in the last months of 1994, financial policies eased, and through most of 1995 the exchange rate failed to adjust to market clearing levels. The resulting demand pressures resulted in a very sharp widening in the current account deficit, which to a large degree was financed by a drawdown of Romania's foreign exchange reserves. The exchange market pressures resumed in October, and the trade deficit continued to widen.

2. Exchange rate policy and international competitiveness

In 1991, Romania adopted a floating exchange rate system, which after several modifications has formally remained in place until this day. Conditions in Romania corresponded closely to a textbook case for a floating exchange rate--foreign exchange reserves were low, domestic inflation was high and variable, and it was difficult to determine the equilibrium level of exchange rate, in particular after a period of repressed inflation, and in the face of major structural adjustment. Thus the primary objective was to safeguard the country's international competitiveness, and a sustainable balance of payments position. In the past five years, however, exchange rate policy in Romania was frequently inconsistent with those external objectives, responding to domestic policy considerations. More broadly, such considerations may reflect a desire to accelerate the achievement of domestic price stability, the need to "import" the international price structure, or to stabilize the level of domestic consumption. This last point resonated strongly in the context of Romania's political and economic transformation, against the background of a forced reduction in private consumption during the 1980s, followed by a dramatic fall in output during the early 1990s.

From early in 1994, after domestic financial policies were tightened, and the exchange rate was effectively liberalized, there followed an extended period of improving external performance. The following review of three groups of indicators, including of external competitiveness, trade performance, and monetary and foreign exchange market conditions suggests that in 1994 the Romanian leu was within the range of estimates of its equilibrium. However, there are also indications that devaluation expectations that re-emerged in 1995 have their foundation in the inconsistency of the domestic policy stance with the apparent authorities' intention of targeting the nominal exchange rate.

a. Indicators of international competitiveness

This section surveys the indicators of external competitiveness, based on various exchange rate and productivity measures. The basic finding is that during much of 1994, the exchange rate of the Romanian leu remained within a range of its equilibrium level, notwithstanding a fairly modest

shift toward real appreciation. When appropriate, the discussion below refers to the developments in early 1990s, but the analysis focusses on the trends in the past two years.

The evolution of the real exchange rate is the most common indicator of a country's competitiveness. The developments in the Romanian real exchange rate are based on consumer and producer price and unit labor cost indexes are shown in Chart 15 (upper panel). 1/ Following a sharp exchange rate adjustment in November 1991, all indexes moved closely together until May 1993 when consumer subsidies were eliminated, and price and wage increases contributed to the appreciation of the real exchange rate extending through the end of 1993. After the 19 percent step devaluation of the official exchange rate in December 1993, the leu resumed its trend toward appreciation in real terms. It is noteworthy, however, that in the following period, the external trade performance was quite robust, and export performance was improving dramatically, suggesting that the real exchange rate may have reached its equilibrium level sometime during that period. It is also worth noting, that the erosion in international competitiveness was less pronounced when measured by a real effective exchange rate index vis-à-vis the industrial countries (bottom panel in Chart 15).

The cumulative real appreciation from end-1993 to early 1995 was strongest when measured by the CPI-based index; in terms of the PPI-based index it was in fact quite modest since after 1993. Deflated by unit labor costs, the cumulative real appreciation, while quite steep, lifted the index only to its average 1993 level. These divergences reflect largely the fact that consumer prices may not provide an adequate basis for measuring changes in international competitiveness. 2/ Such indices are commonly biased upward, by giving too much weight to prices of nontradeable goods which are not relevant for the competitiveness of a country. The divergence in the movement of consumer prices of traded versus nontraded goods is shown in Chart 16 (upper panel). 2/ The movement of this index for Romania broadly tracks the behavior of other real exchange rate measures, and appears quite close to the unit labor cost based index. Thus we observe a strong real appreciation through May 1993, followed by a correction through the end of that year, and a subsequent appreciation. To some degree, a rise in that index, and the underlying rise in the price of nontradables relative to the price of tradeables, could signal a tendency to reallocate resources

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1/ The data on CPI and PPI cover the entire period, while the information on unit labor costs in industry is available only from 1992 onward.

2/ As discussed, for example, in Lipschitz, and McDonald, "Real Exchange Rates and Competitiveness: A Clarification of Concepts, and Some Measurements for Europe," IMF Working Paper WP/91/25, March 1991.

2/ The "internal terms of trade" index for Romania was computed from a disaggregated consumer price index, reconstructed into two composites. From October 1994, it is based on composite price indices of services and other (traded) goods.

CHART 15
Romania: Real Exchange Rate Indicators 1/

Sources: Data provided by the Romanian authorities and staff estimates.

1/ An increase in an index indicates real appreciation.

2/ January 1992=60.

3/ The observation for November 1995 is based on the actual exchange rate and estimated inflation.

4/ Vis - a vis industrial countries.

CHART 16
ROMANIA: Indicators of External Competitiveness, 1993-95

Sources: Data provided by the Romanian authorities and staffs estimate

- 1/ Ratio of prices of traded and nontraded goods. From October 1994, based on composite indexes.
2/ Romania data are not seasonally adjusted; based on monthly statistics
3/ Polish data are seasonally adjusted based on hourly data.

to the nontradeable goods sector, resulting in a deterioration in the trade balance. ^{1/}

Setting aside the policy-imposed influences on domestic prices, a rise in the ratio of prices of nontraded to traded goods can also be linked to a rapid increase in labor productivity in the traded goods sector. ^{2/} In such a case, a rise in the internal terms of trade index would be incorrectly pointing to a loss of competitiveness. ^{3/} Indeed, as shown in Table 15, productivity in the tradeable goods sectors in Romania increased sharply during 1993-94, reflecting a recovery in economic growth, apparently largely induced by strong exports. Productivity growth was particularly strong in industry, which was brought about mostly by substantial labor shedding (Chart 17, upper panel). This helps explain why a continued rise in the industrial sector wages in U.S. dollars terms was accompanied by a relatively stable index of unit labor costs (Chart 17, bottom panel). Nonetheless, industrial unit labor costs in Romania have followed a rising trend since 1991. That tendency compares unfavorably with the experience in Poland, which so far has been more successful in transforming its economy (Chart 17, bottom panel).

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^{1/} This index is also referred to as the real exchange rate. The limitations of this indicator are discussed in Wickham, "A Cautionary Note on the Use of Exchange Rate Indicators," IMF Paper on Policy Analysis and Assessment, PPAA/93/5, March 1993. The most serious problems are due to difficulties in obtaining reliable data on tradeable and nontradeable goods prices. A conceptually similar index may be obtained by using implicit sectoral value-added deflators from the annual sectoral national accounts data.

^{2/} This follows the proposition that price levels should rise with income levels, and the original argument referred to the differences in price levels in rich and poor countries. Because international productivity differences in nontradables are negligible, and prices of internationally traded goods are broadly equalized, higher labor productivity in the tradeables sectors would be associated with higher prices of nontradables. See, Bela Balassa, "The Purchasing Power Parity Doctrine: A Reappraisal," Journal of Political Economy, Vol. 72 (December 1964), pp.584-96.

^{3/} The implied real appreciation would be stronger the lower the degree of openness of an economy. This point is discussed in the context of a role of trade reform and inflation stabilization in Arora, and Kumar, "Trade Reform and Inflation Stabilization," IMF Working Paper WP/94/130, November 1994. The causes of real exchange rate appreciation in the context of economic transition in the Baltics are discussed by Richards, and Tersman, "Growth, Nontradables, and Price Convergence in the Baltics," IMF Working Paper WP/95/45, April 1995. They point out, that after the elimination of initial undervaluation a faster growth in productivity in the tradeables sector will result in increases in relative price of nontradables, and an appreciation of the real exchange rate, without serious implications for competitiveness.

CHART 17
ROMANIA: Competitiveness in Industry, 1993-95
(December 1991=100)

Sources: Data provided by the Romanian authorities and Fund staff estimates.

b. External trade performance

The external trade data provide a moderately favorable picture of Romania's competitiveness. The overall value of trade has not yet recovered to its record 1988-89 levels, although export growth strengthened over the past two years, leading to an improvement in the trade balance through end-1994. In the early 1990s, the relatively low rate of growth of foreign trade, and particularly the inability to rapidly regain export markets in the industrial countries, could be attributed to macroeconomic instability and to the delays in economic transformation, and in particular in privatization. The recent acceleration in export growth is both impressive and encouraging, although to some degree it reflects a delayed recovery after a collapse in exports during 1989-91.

Export growth has been particularly strong since early 1994, and the performance in the nine months of 1995 is very promising (Chart 18). As shown in Table 16, exports to the European Union continue to increase rapidly, approaching their historic levels, and this is accompanied by a contraction in exports to former centrally planned economies. Also, the share of manufactured products in total exports (including metals and steel products) increased relative to 1988-89, and exports of garments and textile products staged a spectacular recovery, exceeding the total value of such exports in 1989. Preliminary data on the composition of trade during the first half of 1995 indicate that export growth has been broadly based, with the exception of unprocessed agricultural products (Table 15). The surge in the total value of imports was accounted for mostly by increased purchases of raw materials, intermediate goods and petroleum.

Notwithstanding the recent improvement, Romania's export performance does not compare favorably with other countries in the region. Romania's market share in the European Union, the principal export market, began to recover only in 1993 (Table 17). By contrast, Hungary increased its market share by more than 70 percent, and Bulgaria and Poland doubled their market shares compared to the pre-transition period. It is noteworthy, however, that most of the improvement in Romania's export performance took place in the past two years.

The analysis of external trade performance could be usefully complemented by a discussion of a country's external terms of trade. An overall improvement in the country's terms of trade is generally associated with an appreciation in the equilibrium exchange rate. So far, however, there are no reliable statistics in this regard in Romania. Nonetheless, according to crude estimates produced by the National Commission of Statistics over the past two years there were no significant changes in Romania's external terms of trade. Furthermore, there are some recent additional indications that Romania's terms of trade are likely to improve in the near future. It is expected that Romania's energy imports for which international prices have increased over the last year will not substantially increase in volume terms above the recent level, reflecting largely an increase in domestic production. Moreover, following an

CHART 18
ROMANIA: Monthly Export Development in 1993-95

Source: Data provided by the Romanian authorities

exceptional harvest in 1995, Romania is about to become a major exporter of cereals, the prices of which are expected to remain very high after a recent sharp increase.

c. Foreign exchange market developments

In the context of a floating exchange rate mechanism, an adequate functioning of the foreign exchange market creates appropriate conditions for the exchange rate to converge to its equilibrium level. However, between late 1994 and June 1995 clear signs emerged that the exchange rate was prevented from adjusting to market clearing levels, as the demand for foreign exchange was not fully satisfied at the going exchange rate, the banking system's foreign exchange reserves declined by about US\$300 million, and a substantial premium developed in the exchange bureau market. The situation improved during July and August of 1995, and the NBR was able to purchase foreign exchange in the market without creating any disturbances, and the premium in the exchange bureau market fell to negligible levels (Chart 14). 1/ At that time, there was also a widespread perception among market participants that the interbank market was resuming normal functioning. However, the temporary return to normalcy was at the cost of a continued significant loss of international reserves of the banking system, suggesting that the exchange rate level may have been inconsistent with the stance of domestic financial policies and the achievement of external viability. 2/ Moreover, the situation in the foreign exchange market worsened considerably again, and by mid-October the premium in the bureau market began to rise, while the volume of transactions in the inter-bank market declined significantly.

d. Indicators of monetary and credit conditions

In 1995, a sharp credit expansion contributed to the weakening demand for money in the leu sector. In the first ten months of 1995 net domestic assets of the banking system expanded by some 58 percent, compared with an annual inflation target of 23 percent. In terms of rate of increase, the strongest expansion was in net credit to government, which initially ran down its deposits, and from March 1995 accounted for some 15 percent of total credit expansion through October. In terms of the volume of credit, however, the most sizeable expansion occurred vis-à-vis the nongovernment

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1/ The reduction in the exchange bureau market premium can be at least in part attributed to recent measures taken by the NBR to enhance the integrity of this market. These measures included a requirement to build up capital to initial levels (in U.S. dollar terms), and strengthened supervision to curb illegal operations.

2/ Since late 1994, the operating procedure for the NBR's exchange rate policy has all the appearances of a crawling peg. Under some form of a fixed exchange rate regime, any changes in the domestic policy stance are reflected in the level of the foreign exchange reserves of the banking system, or in the malfunctioning of the foreign exchange market.

sector, and nearly 40 percent of that was lending in foreign currency terms. This trend was already well entrenched in 1994. ^{1/} At the same time, the demand for money (measured by gradually declining velocity indicators) appeared strong, but it was not sufficient to prevent a decline in NIR in the face of a sharp credit expansion.

The insufficient flexibility in the exchange rate, combined with excessive credit expansion in domestic currency, predictably contributed to serious balance of payments pressures. In parallel, the sharp credit expansion in foreign currency terms created two additional, and less predictable important consequences. It contributed to a depletion of the banks' external foreign exchange reserves, and it undermined the effectiveness of domestic monetary management. With regard to the former, a fall in the country's net foreign assets (NFA) was effected through a drawdown of foreign exchange reserves. That meant that a decline in domestic saving was financed by a fall in NFA (a rise in external debt would have a similar effect), thereby indicating that the increase in aggregate demand was satisfied via the external sector. That is different, however, from a case of private capital inflows in the context of tight domestic monetary conditions under forms of pegged exchange rate, because that would not be accompanied by a change in the NFA, as nonbank sector's net foreign assets would fall, but the banking system's NIR would increase by a similar amount. In Romania, there was both a fall in the net foreign assets and in the net international reserves of the banking system.

However, there are indications that the expansion of domestic credit in the foreign currency segment was induced by the underlying interest rate differentials between the domestic interest rates. Romanian commercial banks have very large foreign currency liabilities to domestic residents, which until 1994 were largely matched by commercial banks foreign assets. However, starting in 1994, the increase in domestic deposits in foreign currency lagged behind the expansion in foreign currency credits to residents. This occurred in the context of a severe tightening in monetary conditions from early 1994. Against that background, a predictable rate of nominal depreciation of the official exchange rate rendered the international rates adjusted for the expected changes in the exchange rate considerably more attractive to both resident banks and domestic borrowers (Chart 7). This undermined interest rate policy and encouraged credit expansion which became difficult to contain without introducing very strong punitive measures. ^{2/}

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^{1/} In fact, domestic credit in foreign currency expanded (in dollar terms) during the first nine months by 51 percent, or US\$600 million, compared with a 57 percent increase, or US\$400 million, during a corresponding period of 1994. Over the comparable period, credit in domestic currency increased by 50 percent in 1994, and by 42 percent in 1995.

^{2/} In fact, in October 1995, the NBR nearly doubled (to 40 percent) reserve requirements on domestic deposits in foreign currency.

4. Conclusions

The above review of Romania's external performance brings forward two important messages. First, as recent experience has shown, notwithstanding all the structural difficulties, the Romanian economy responds strongly to favorable macroeconomic policies, and is capable of generating an impressive export performance when the exchange rate is at a competitive level. Second, during much of 1994 the exchange rate was within the range of estimates of its equilibrium, but in the following period the expansionary domestic financial policies combined with a undue rigidity in the nominal exchange rate resulted in serious balance of payments difficulties. For the external sector performance to substantially improve, the exchange rate must be maintained at a competitive level, and the market participants' confidence needs to be strengthened by an uninhibited functioning of the foreign exchange market.

Table 14. Romania: Selected External Sector Indicators, 1989-1995 1/

(In billions of U.S. dollars unless indicated otherwise)

	1989	1990	1991	1992	1993	1994	1995 <u>2/</u>
Current account	2.9	-3.3	-1.3	-1.5	-1.2	-0.5	-1.1
In percent of GDP	13.1	-8.6	-4.7	-7.8	-4.7	-1.8	-4.8 <u>3/</u>
Capital account	-1.5	--	0.5	1.5	1.3	1.6	0.7
Change in net international reserves	1.4	-1.5	-1.0	--	0.1	1.1	-0.4
Gross international reserves	2.0	0.5	0.5	0.7	0.9	2.0	1.6
In months of imports	8.0	1.1	1.2	1.7	1.7	3.7	...
External debt <u>4/</u>	0.8	1.1	2.1	3.5	4.4	5.5	...
In percent of GDP	..	3.7	9.9	17.6	17.0	18.9	...

Sources: Romanian authorities; and Fund staff estimates.

1/ Excluding transactions in transferable rubles.

2/ January - September

3/ Annualized.

4/ Including use of Fund credit.

Table 15. Romania: GDP by origin, 1990–94

	1990	1991	1992	1993	1994	1991	1992	1993	1994
	<u>(In billions of 1990 lei)</u>					<u>(Annual growth in percent)</u>			
GDP	858	747	681	690	714	-12.9	-8.8	1.3	3.5
Exports	144	139	172	195	244	-3.0	23.7	13.2	25.2
Industry	348	303	262	266	278	-12.8	-13.7	1.7	4.6
Agriculture	187	164	143	178	183	-12.3	-12.9	24.2	3.2
Construction	46	37	35	41	48	-19.4	-4.8	16.8	16.8
Transport	49	45	43	34	34	-8.8	-3.9	-21.5	-
Trade	53	40	36	30	30	-25.6	-10.0	-15.3	-1.7
Other	175	158	163	141	141	-9.3	2.8	-13.1	-0.1
<u>Memorandum items:</u>									
GDP									
Traded	535	467	405	444	461	-12.6	-13.4	9.6	4.0
Nontraded	323	280	277	247	253	-13.4	-1.1	-10.9	2.5
Employment									
Traded	7,255	7,008	6,743	6,651	6,566	-3.4	-3.8	-1.4	-1.3
Nontraded	3,584	3,777	3,715	3,411	3,302	5.4	-1.7	-8.2	-3.2
Productivity									
Traded	100	90	81	90	95	-9.5	-10.0	11.2	5.4
Industry	100	94	94	104	116	-5.7	-0.6	10.8	11.7
Nontraded	100	82	83	80	85	-17.8	0.6	-3.0	5.9

Source: National Commission for Statistics; and Fund staff estimates.

Note: Traded goods sector includes industry and agriculture, and nontraded all other sub-sectors.

Table 16. Romania: Export Developments, 1989–95

	1989	1991	1994	1995 1/ Jan. – Jun.	1989–91	1992–94	1995 1/ Jan. – Jun.
	<u>(In millions of US dollars)</u>				<u>(Change in percent)</u>		
Total Exports	10,487	4,266	6,151	3,426	– 59.3	44.2	26.2
	<u>(In percent of total)</u>						
By commodity group							
Agricultural products	5.0	6.1	6.5	8.3	– 50.6	52.8	– 2.4
Petroleum and products	17.8	12.4	9.7	10.9	– 71.8	13.5	11.6
Textiles, garments, etc.	10.4	9.5	18.8	23.1	– 63.0	186.1	28.6
Metals and steel products	14.7	14.5	17.1	19.7	– 59.7	69.7	32.8
Machinery and transport equipment	17.2	21.2	11.6	14.4	– 49.7	– 21.4	26.1
Chemical products	13.1	8.0	10.2	13.3	– 75.3	85.7	88.1
Other	21.8	28.4	26.1	10.3	– 47.2	32.7	6.7
By geographic area							
European Union	30.6	33.7	46.0	52.0	– 55.2	96.6	43.1
United States	5.4	2.9	3.1	2.6	– 78.1	54.4	39.1
Eastern Europe	17.4	14.2	7.2	5.3	– 66.7	– 27.5	8.0
Former USSR	22.6	23.3	6.7	5.2	– 58.1	– 58.5	– 18.8
Other	23.9	25.8	37.0	34.9	– 56.2	107.1	– 29.5

Source: National Commission for Statistics, and Fund staff estimates.

1/ Relative to first half of 1994.

Table 17. Romania: European Union: Geographic Distribution of Imports, 1988-95 1/

	1988-89	1990-91	1992	1993	1994	1995 Jan-June
(Quarterly averages, in billions of U.S. dollars)						
World	<u>307,537</u>	<u>390,639</u>	<u>411,868</u>	<u>349,177</u>	<u>396,319</u>	<u>469,195</u>
(In percent of total)						
Industrial Countries	<u>81.2</u>	<u>81.0</u>	<u>81.2</u>	<u>78.1</u>	<u>78.1</u>	<u>79.2</u>
European Union (12)	62.9	63.0	63.5	59.3	59.7	61.2
Germany	16.4	15.4	15.4	14.2	14.2	15.0
United States	7.4	7.5	7.2	7.8	8.1	7.5
Other	11.0	10.5	10.4	11.0	10.3	10.5
Developing Countries	<u>18.8</u>	<u>19.0</u>	<u>18.8</u>	<u>21.9</u>	<u>21.9</u>	<u>20.8</u>
Eastern Europe (4)	0.98	1.07	1.18	1.36	1.54	1.62
Bulgaria	0.05	0.06	0.08	0.09	0.10	0.11
Hungary	0.28	0.35	0.39	0.41	0.45	0.48
Poland	0.41	0.54	0.59	0.72	0.77	0.80
Romania	0.23	0.13	0.12	0.15	0.21	0.23
Newly Industrialized Countries 2/	2.7	2.8	3.0	3.4	3.4	3.2
China	0.7	1.0	1.3	1.7	1.7	1.5
Other	14.4	14.1	13.4	15.5	15.2	14.5

Source: Direction of Trade Statistics, and Fund staff estimates

1/ Twelve countries of the European Union, before the latest expansion.

2/ Malaysia, Singapore, South Korea, Taiwan, and Thailand.