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Developments and Future Prospects**

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# The Romanian Economy in Transition: Developments and Future Prospects <sup>\*</sup>

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## Abstract

We address the macroeconomic developments experienced by Romania in a decade of transition towards a market driven society. We focus on a descriptive analysis with the intention of offering a clear and broad picture of the main aspects distinguishing the Romanian economy. The paper also discusses perspectives for future growth and puts forward the need to develop within the prospects of European Union integration a strategy on a more sustainable basis.

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# 1 Introduction

Romania intends to gain EU membership in 2007.<sup>1</sup> EU accession negotiations with Romania have officially started in 2000 following Romania's submission for EU membership in 1995. The start of negotiations has been made conditional upon the drafting of a medium-term economic strategy. It is evident that a successful transition process and a rapid economic development are key issues for the prospects of joining EU in 2007. In this paper we provide a descriptive analysis of the Romanian economy in the 1990s and try to identify key factors of development in the medium-run.

Romania's economy in 1989 was not only marked by a history of central planning as other Central and Eastern European countries, but also by the effects of a policy aiming at a high degree of autarky. In fact, during Ceausescu's regime, Romania's economy was tilted more towards agriculture than that of most of its neighbouring countries (see Table A.1 in the appendix). In addition, the existing industry as well as the state-owned agricultural collectives and semi-industrial food production were extremely concentrated, with the industrial sector consisting of huge vertically integrated enterprises often bilateral monopolies, with only one supplier and a single customer, the government.

The 1980s were dominated by the quick repayment of approximately USD 10 billion in foreign debt before the due date, which, combined with enormous expenditures on large-scale prestige projects, wasted the economy's resources and exhausted its people. As exports registered no growth, in order to repay the debt, imports from developed countries were cut roughly in half over the decade, dramatically reducing the population's consumption choices (OECD, 1998). Moreover, the restrictions on foreign trade that gained importance, since 1975 until 1989, gradually isolated the country from the international economic flows that were exchanged both with the market and centralised economies (Ciupagea, 2001). A heavily distorted wage and price structure combined with outdated technology left its mark on the composition of labour and the value of goods produced in the economy. By 1989, Romania was one of the poorest countries in Europe.<sup>2</sup>

Therefore, liberal policies were regarded as extremely important in the transformation process towards a free, democratic and open society. However, the problems encountered by such a transition process rest mainly in the order of the liberalisation

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<sup>1</sup>Thirteen applicant countries are presently engaged in the process: Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Romania, Bulgaria, Malta, Cyprus, Turkey. Accession negotiations are under way with the first twelve. Romania is included in the group of the so-called "second wave" countries.

<sup>2</sup>In 1990, Romania was on the bottom list of Central and Eastern European (CEE) countries, with a GDP per capita of 3,525 international \$ that was higher only than the level registered by Albania (Maddison, 2001).

steps chosen by policy makers, and in the domestic and external weak credibility of all the measures implemented (McKinnon, 1993, as cited by Ciupagea, 2001). The lack of credibility would be partially attributed to the informational barriers that act against the principle of transparency guiding a market-driven economy. For this purpose, the paper intends to provide a clear and broad picture of the main macroeconomic developments experienced by Romania during a decade of transition. It is also worth noting that substantial improvements have been made in the reporting of data. IMF (2001a) finds that with the exception of government finance statistics, the statistics currently produced in Romania generally meet, and in many instances exceed, its General Data Dissemination System (GDDS) recommendations with respect to coverage, periodicity and correctness of dissemination.<sup>3</sup>

Another reason for lack of credibility in consistent policy making is the opposition to change and the obstruction of deep restructuring within leading parties and large segments of the population observed especially by multilateral lenders and expressed in particular during the first phase of transition. This could be explained by the strain and tension created by Ceausescu's strategy of resource misallocation and the brutal change in the 1990s of relative prices to new market-clearing levels, at which resources have flown from low to high productivity areas, generating considerable stress and opposition in the real economy (Daianu, 1999).

In addition, especially starting with 1997, most of the liberalisation steps have been indicated and financial disbursements have been conditioned upon reform implementation by international financial organisations such as the International Monetary Fund and the World Bank. Hence, a brief history of the involvement of these international organisations into the Romanian economy and the eventual success or failure in implementing the policy recommendations is also presented in this paper.

The rest of this paper is structured as follows. Section 2 concentrates on the real sector providing information on selected macroeconomic indicators, economic policy targets, the structure of the Romanian economy, which still is quite different from Western European standards, labour market characteristics and education issues. The external sector is covered in section 3, while the specific issue of international financial support is postponed to section 6 following the discussion of the fiscal and monetary policy stance in sections 4 and 5, respectively. Finally, section 7 is devoted to key factors of future growth of the Romanian economy and concludes by pointing towards the necessity of further analytical research, in particular with reference to the linkages between economic reforms and growth on a more sustainable basis.

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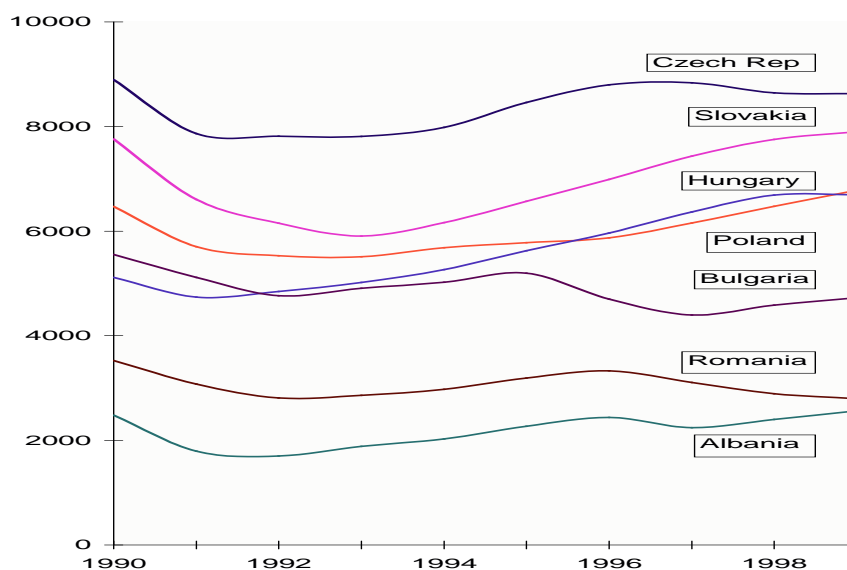
<sup>3</sup>We have undertaken preliminary basic econometric estimations of a simple consumption function and found that the data seems to be reliable (*i.e.* the elasticity of consumption with respect to income, as one would expect, was roughly equal to one).

## 2 The Real Sector

### 2.1 Macroeconomic developments

The transition process in Romania began from a much more difficult position compared to other Central and Eastern European countries. For example, pre-transition policies emphasized self-dependence, putting excessive focus on heavy industries, large infrastructures, production plans and inefficiency criteria, and unlike other transition economies, no attempts to reform had yet been tried (OECD, 1998). Owing to this difficult inheritance, but also to the lack of consistent policies and insufficient reform efforts, Romania's transition process was slow and uneven compared with other emerging economies from Central and Eastern Europe (Figure 1).

Figure 1: GDP per capita in selected East European Countries, 1990-99 (1990 international \$)



Source: Maddison, A, 2001, *The World Economy. A Millennial Perspective*, OECD.

The main factors that might explain the economic performance of countries such as Hungary, Poland, the former Czechoslovakia, and Slovenia, are functioning institutions and better public governance, which were already in place at the start of the transition process and which gave these countries a competitive edge after 1989 in comparison with Romania (Daianu, 1999).

In the first years of transition, the development of the Romania society was

characterised by changing governments and political unrest, until elections in 1992 confirmed a social democratic left-wing party (see Table 1 for succession of major events).

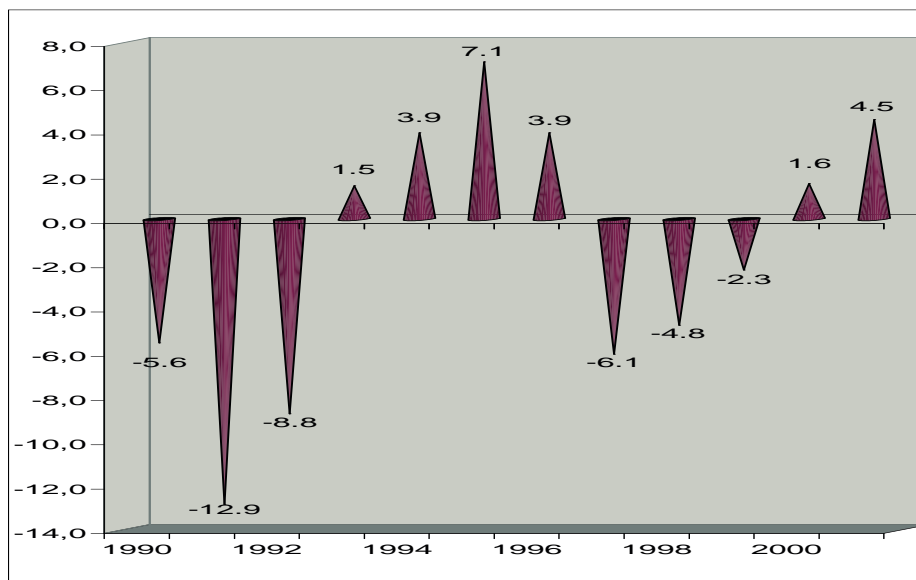
Table 1: Major events during a decade of transition in Romania.

1989, end	The fall of Ceausescu's regime
1992, end	Ion Iliescu confirmed as president running a social democrat left wing party and adopting a gradualist approach to the transition process;
1995, mid	Romania applied for EU membership;
1996, end	Emil Constantinescu elected as president running a coalition of right wing oriented parties and adopting a shock therapy strategy to the transition process;
1998, end	Reshuffle of the Government and appointment of a new prime-minister, Mugur Isarescu, governor of the National Bank of Romania, viewed by the international monitoring agencies as positive regarding the new administration's commitment to prudent financial policies and economic reform;
1999, end	The European Council of Helsinki decided to open accession negotiations with another six candidate states, including Romania;
2000, beginning	Romania's EU accession negotiations with EU officially began;
2000, beginning	The Romanian Government adopted the Medium Term Economic Strategy and submitted it to the EU;
2000, end	Ion Iliescu and its left wing party was re-elected expressing a strong commitment to the acceleration of structural reforms and continuation of the EU and NATO integration process.

From the economic performance point of view, the start of the transition period was associated with high negative real GDP growth rates reaching  $-12.9$  percent in 1991 (Figure 2). This initial output collapse partly reflects the disorganisation that followed the sudden end of central planning. The command centre was instantly abolished, while the firms, large and small had to provide for themselves, meaning either adopting market rules, or asking for state support, often both simultaneously (Wyplosz, 1999).

Romania also experienced massive inflation in the beginning of the 1990s, reaching an annual average peak of 256 percent in 1993 (Table 2). Although the burst of inflation followed price liberalisation, the latter is not the main and single cause of the former. Price liberalisation is "a once-off adjustment" and "its size corresponds partly to the monetary overhang inherited from goods shortage that characterised

Figure 2: Real GDP growth (percent), 1990-2001.



Source: National Institute of Statistics - Romania; National Bank of Romania.  
Notes: 1999 - semi-final data, 2000 and 2001 - provisional data.

central planning, and partly to the initial devaluation when establishing currency convertibility” (Wyplosz, 1999). For example, at the end of 1990, the total amount of savings represented around 50 percent of total monetary supply, while the value of the annual supply of goods and services was equal to only 10 percent of these savings (Charemza and Popescu-Turlea, 1999). However, once started, inflation tends to continue and often increase, mainly due to the deterioration of the price-wage relationship in the short run and the price accommodation policy undertaken by monetary authorities in the long run.

IMF (2001c) identifies three factors that appear to have generated and sustained inflation in Romania: cost-push pressures, demand-pull factors and relative price adjustment effects. Cost-push pressures have resulted from episodes of wage growth well in excess of productivity, owing fundamentally to a lack of financial discipline, as well as real depreciations of the national currency. Demand-pull factors have included monetary accommodation of fiscal and quasi-fiscal deficits again reflecting financial indiscipline and pervasive soft budget constraints at the enterprise level. Relative price adjustment had delayed effects (pushing inflation up to 155 percent in 1997) owing to the slow and occasionally reversed process of price liberalisation

Table 2: Unemployment and inflation rates

	Unemployment rate (% of labour force)	Inflation rate (CPI) (annual avg. % change)
1990	—	5.1
1991	3.0	170.2
1992	8.4	210.4
1993	10.4	256.1
1994	10.9	136.7
1995	9.5	32.3
1996	6.6	38.8
1997	8.9	154.8
1998	10.4	59.1
1999	11.8	45.8
2000	10.5	45.7
2001	8.6	34.5

Source: National Institute of Statistics - Romania; National Bank of Romania.

Notes: 1999 - semi-final data, 2000 and 2001 - provisional data.

that was mostly achieved only beginning with 1997.<sup>4</sup>

Like in all other CEE countries there was no official unemployment during the dictatorship as a result of the priority given to the socialist full-employment policy in an industrial state ownership environment (Ciupagea, 1999). Until the beginning of reforms in November 1990, the state-owned sector remained unaffected by any change and unemployment rate stayed slightly above zero for the whole year. The unemployment rate subsequently began to steadily rise with the implementation of further reforms (Table 2). However, unemployment was still much lower than for other emerging markets, possibly due to the soft budget policy aimed at supporting the state-owned sector, especially during the first years of transition (see Table A.2).

On the background of hyperinflation, the economy continued to deteriorate until 1993, when the country started to experience a short period of economic growth and lower levels of unemployment until 1996 (with a peak performances of 7 percent real GDP growth in 1995 and 6.6 percent unemployment rate in 1996 - Table 2). Still, this was less the result of structural change and macroeconomic adjustment but rather the short-term outcome of maintaining the subsidisation of loss-making enterprises

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<sup>4</sup>Administered and regulated prices accounted in 2000 for approximately 14 percent of the CPI basket compared to 40 percent at end 1996, when the government maintained direct wholesale and retail price ceiling on a number of sensitive items and also administered energy, utility transport and telecommunications prices (IMF, 2001c).

and agriculture through directed lending. The unsustainable backing of output and employment through large subsidies was reflected later in the average negative economic growth of -4.4 percent during the period 1997-1999 and the prominent balance of payments crisis in 1999. The period 1992-96 also witnessed a remarkable decrease in the inflation rate from 250 percent to around 40 percent. However, this was more the result of political intervention in the exchange rate market and less the result of credible monetary policies (the government allocated foreign exchange on a non-market overvalued official rate basis to favoured importing sectors gradually creating severe external balances disequilibria).

In late 1996, against the background of widening current account deficits and shrinking foreign exchange reserves, a coalition of mainly right-wing parties gained the majority vote and committed itself to a “shock therapy” programme of both macroeconomic and institutional reforms (Table 1). Among others, priorities included the liberalisation of some important prices under state control (energy, agricultural products and public services), the allowance of the exchange rate to be market driven, the elimination of subsidies and directed credits to agriculture. Although prospects seemed to be improving, the efforts were short-lived and economic imbalances deteriorated.

For 1997 as a whole, GDP fell by 6.1 percent, while unemployment has remained surprisingly low, less than 9 percent. This is in part because the private agricultural sector has played the role of a buffer (see Table A.3 in the appendix), but its ability to do so might not last long as restructuring advances and the capacity of rural areas to absorb the unemployed are reaching their limit (MacFarlan and Martins, 1998). Such an explanation is validated by the increase in 1999 of the unemployed to almost 12 percent of the labour force, roughly twice the level in 1996. Nevertheless, the figures should be treated with caution due to the existence of an important underground economy that is characteristic for most transition countries <sup>5</sup> (see Table A.4 in the appendix). The inflation rate dramatically increased to roughly 150 percent in 1997, partly due to the liberalisation of agricultural and energy prices, large overshooting of the local currency with the exchange rate unification, and a premature relaxation of monetary policy in the latter half of the year (*e.g.* extensive and abrupt wage indexation, redundancy payments to laid-off workers, and large amounts of money injection into bad-performing banks) (Daianu, 1999).

At the end of 1999, the Romanian economy still recorded negative economic growth although it was reduced to -2.3 percent. Inflation declined to 45.8 percent from 154.8 percent in 1997. Nevertheless, the marked worsening of investor sentiment towards emerging markets as a whole in the wake of the Russian default in

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<sup>5</sup>Rosser and Rosser (2001) argue that there is a strong correlation between the size of the underground economy and the degree of income inequality, as measured by the Gini coefficient, and recommend a serious reconsideration of policies with regard to income distribution in transition economies.

August 1998 combined with Romania's weak and deteriorating credit fundamentals cut the economy off from external finance, exerting huge pressures on the balance of payments in mid 1999.<sup>6</sup> However, after a reshuffle of the government in late 1998, Romania managed to avert the financial crisis and implement a stabilisation programme supported by the International Monetary Fund (see section 6.3). In addition, an invitation to Romania to start negotiations on EU accession was made at the end of 1999, following the country's application for EU membership in 1995 (see Table 1). This was regarded as a major step forward towards a developed economy that boosted the confidence of both society and investors.

In 2000, after three years of decline, GDP grew mainly driven by domestic demand by 1.6 percent in real terms, despite a sharp drought-related loss in agricultural production and stagnant low private investments.<sup>7</sup> The increase in demand is mainly attributed to increased final consumption of private non-profit institutions serving households, favourable changes in inventories and the contribution of gross fixed capital formation.<sup>8</sup> The year 2000 also witnessed attempts to make independent the economic policy strategies of the political groups in power, *i.e.* Romania approved the Medium Term Economic Strategy for EU accession and adopted an action plan and a macroeconomic framework in order to meet the objectives set out in the strategy. The main conclusion of the strategy was that Romania would accomplish the essential conditions for accession to EU by 2007, with perseverant efforts and solidarity of the social forces.

Overall, although modest progress was made, most problems remained unresolved. In addition, there was a large increase in poverty reflecting the economic difficulties encountered by the Romanian economy in its transition phase. By 1998, about one in three Romanians were living below the national poverty line of USD 2 per day, the absolute poverty line for the Europe and Central Asia region (up from 20 percent in 1996). By 1999, the poverty headcount had increased to 41 percent of the total population, reaching 44 percent at the end of 2000 (World Bank, 2001), (Government of Romania, 2001b).

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<sup>6</sup>According to data provided by IMF (2001c), direct investment and capital transfers halved from USD 2,129 mln. in 1998 to USD 1,051 mln. in 1999.

<sup>7</sup>In March 2002, the National Institute of Statistics released new figures on real GDP growth using a new methodology, compliant with the European System of Accounts - ESA 95. The new figures over 1999-2001 are -1.2 percent in 1999, 1.8 percent in 2000, and 5.3 percent in 2001 (World Bank Office, [www.worldbank.org.ro](http://www.worldbank.org.ro), Romania Weekly Updates, 2002).

<sup>8</sup>Domestic demand increased in 2000 in real terms by 4.2 percent and negative dynamics were only recorded for household final consumption. Domestic demand contributed to the increase in GDP with 4.4 percent, confined to the final consumption of private non-profit institutions serving households (1.8 percent), changes in inventories (1.9 percent) and gross fixed capital formation (1 percent). The increase in final consumption of private non-profit institutions serving households is due to increased expenses on behalf of political parties with the occurrence of local and presidential elections in 2000 (Government of Romania, 2001a).

As a consequence of deteriorating standards of living, in late 2000, the left wing party was re-elected (Table 1) and initiated a programme for the period 2001-2004, aiming at gradual disinflation (through exchange rate targeting) and containing the external account deficit, while accelerating structural reforms and strengthening growth prospects. It focuses on more restrictive income policies (particularly for utilities and state enterprises), faster privatisation, and tighter monetary and foreign exchange policies. Although the gradualist approach seems to be once again adopted, this time the programme gives the impression of fostering growth on a much more sustainable basis. In addition, the authorities agreed to continue the 2000-06 economic strategy approved by the EU and the previous government. The provisional data for 2001 indicate so far an effective implementation of the stabilisation programme, *e.g.* a significant increase in economic growth (4.5 percent), associated with a declining end of year inflation rate (measured by the CPI) of 30.3 percent (corresponding to an annual average of 34.5 percent - Table 2).

The further short-term objectives and strategies of achieving economic performance for 2002 are outlined in Table 3.

Table 3: Main elements of the Government's 2002 economic programme.

Objectives	Strategies
<ul style="list-style-type: none"> <li>• Reducing inflation to 22% by the end of the year</li> <li>• Real GDP growth of roughly 5%</li> <li>• Keeping the current account deficit below 6% of GDP</li> <li>• Increasing official reserves to the equivalent of three months of imports</li> </ul>	<ul style="list-style-type: none"> <li>• Supportive fiscal stance</li> <li>• Prudent wage policy</li> <li>• Reducing quasi-fiscal spending and losses in the energy sector and other public enterprises</li> <li>• Acceleration of privatisation</li> <li>• Tight monetary policy</li> </ul>

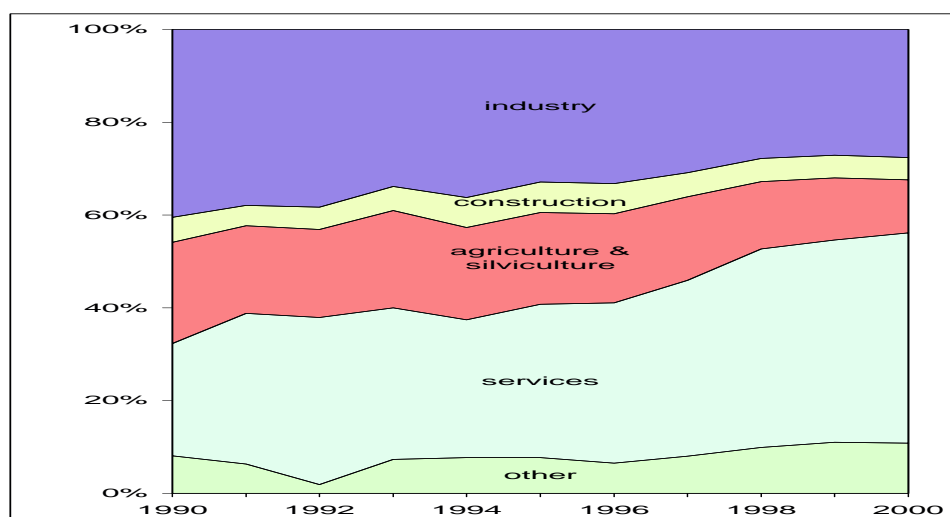
Source: Government of Romania, [www.guv.ro](http://www.guv.ro)

Thus the outlook seems to be favourable as long as the carrying out of the stabilisation and structural reforms envisaged in the programme is to be performed on a vigorous and consistent basis (future prospects for economic development are further discussed in section 7).

## 2.2 Economic structure

In recent years the services sector in Romania has become the main contributor to the formation of GDP, overtaking the contributions of the industrial and agricultural sectors. As Figure 3 displays, the weight of gross valued added into GDP of industry and agriculture has dropped from 40 percent, respectively 22 percent, in 1990 to roughly 27 percent, respectively 11 percent, in 2000, whereas the contribution of services to GDP has increased from 24 percent in 1993 to 45 percent in 2000. The contribution of the construction sector to GDP was more or less constant at around 5 percent over the whole decade.

Figure 3: Composition of GDP, 1990 - 2000.



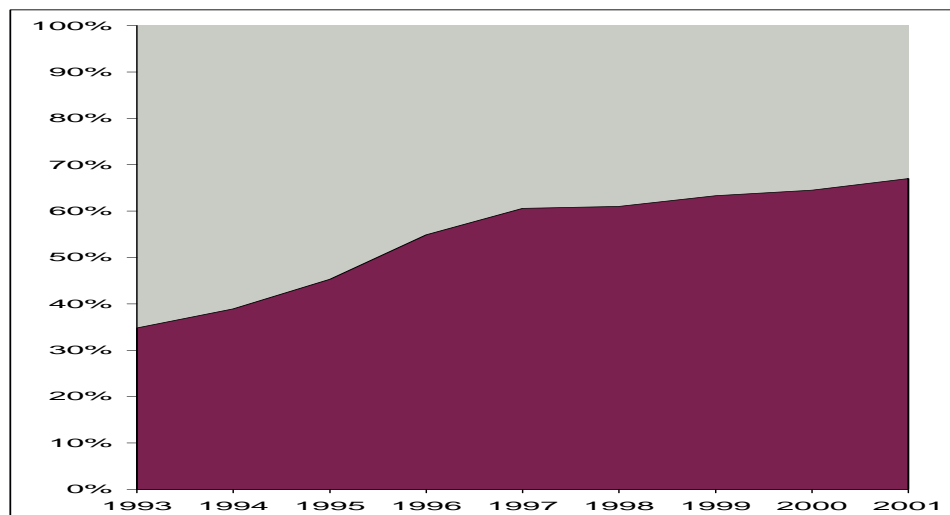
Source: National Institute of Statistics, [www.insse.ro](http://www.insse.ro);

Notes: 1998 - semi-final; 1999 - provisional; 2000 - estimated.

However, the Romanian economy still displays a substantial share of large public enterprises, mostly utilities and energy intensive heavy industries, and of agricultural activity. Thus, despite two rounds of mass privatisation during the first years of transition in Romania, only limited progress has been made in transferring economic activity to the private sector, especially until 1997. While agriculture has been privatised to some extent, advancement in restructuring and privatisation in the industry sector was slow, particularly in the energy-intensive heavy industry. However, the output produced by the private sector steadily increased over the years reaching roughly 67 percent of GDP in 2001 (Figure 4).

Still, privatisation in Romania has lagged behind other countries in the region

Figure 4: The weight of private sector in gross domestic product.



Source: National Institute of Statistics, National Bank of Romania;  
Notes: 1998 - semi-final; 1999 - provisional; 2000,2001 - estimated.

(see Table A.5 in the appendix). The state directly and indirectly still retains control over a considerable segment of economic activity. Combined with excessive bureaucracy and corruption,<sup>9</sup> this has discouraged foreign investment and hindered the formation of a new, competitive small and politically less connected business sector in the formal economy (World Bank, 2002).

Furthermore, agriculture in Romania still has one of the largest shares in GDP compared with other countries from Central and Eastern Europe (Table A.6 in the appendix). With 14.8 million hectares of agricultural land, Romania is the second largest agricultural producer in CEE, after Poland (OECD, 2000). Agriculture is also more important than in almost all the transition economies from CEE. For example, as of 2000, the agricultural sector accounted for approximately 40% of total employment, which was double the figure for Poland. This high share indicates that the agricultural sector has acted as a shock absorber against the socio-economic effects of the transition, taking in the labour made redundant by the industrial sector (OECD, 2000). One should also bear in mind that a rise in agricultural

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<sup>9</sup>Transparency International, an anti-corruption organisation, calculates a 1998 Corruption Perceptions Index according to which Romania receives a score of 3.0 out of a maximum of 10.0 (totally corrupt-free country) and a rank of 63 out of 85 (the country with the highest level of corruption). A score of 10.0 and rank 1 is attributed to Denmark, while Cameroon is perceived as the most corrupt country receiving a score of 1.4 and a rank of 85 ([www.transparency.org](http://www.transparency.org)).

employment coinciding with a fall in agricultural output indicates a fall in output per worker and suggests growing hidden unemployment in rural areas, contributing to low per farmer income and high poverty rates, and blocking the development of the agricultural sector in line with its comparative advantage.

## 2.3 Labour market and education

The labour market in Romania has been heavily influenced by the reform policies adopted since the onset of the transition process. The downsizing of the public sector has been undertaken at a much faster rate than the expansion of the private sector. This has led to job and capital destruction in the state-owned sector that exceeded the job and capital creation in the emerging private sector. Thus, a significant gap appeared after 1989 between job destruction and job creation in the emerging markets compared to developed economies (see Table A.7 in the appendix). For example, over the period 1990-97, employment declined in the state sector by around 7 million persons, from 91 percent to 30 percent of total employment, whereas employment in the private sector rose by roughly 4.5 million persons (Oprescu, 1999).

However, rapid development of the private sector employment has been less the result of new private sector emergence and more the outcome of processes such as land restitution in agriculture and lack of employment alternatives for those who lost their job and returned to subsistence farming. The movement of labour during transition towards not only services but also towards agriculture (“employer of last resort”) and, hence the overall growing rate of employment in agriculture in comparison with other CEE countries,<sup>10</sup> suggests the existence of a two-tier system in the rural area. This would consist of “a large number of people involved in low productivity jobs, small farming,<sup>11</sup> and subsistence agriculture coexisting together with large, potentially profitable, but in practice still state-owned and unreformed, groups of farms” (Pauna and Pauna, 2000). In addition, as previously mentioned, the rise in agricultural employment combined with declining real agricultural output is likely to indicate a substantial amount of hidden unemployment. This might also be revealed by the difference of roughly 10 percent between net job destruction and reported official unemployment rates (computed as an average over 1990-97).

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<sup>10</sup>For instance, Poland, a country with a large inherited agricultural sector, contributing with 27 percent to total employment in 1989, managed to reduce the number of people employed in this sector by almost 1.5 million reaching a share of 20.5 percent in 1997, compared to Romania where employment in agriculture increased from 27.9 percent in 1989 to 37.5 percent in 1997 (Pauna and Pauna, 2000).

<sup>11</sup>It would be interesting to analyse here the behaviour and competitiveness of these small, private owned farms with important environmental and social consequences within the prospects of Romania joining the EU and benefiting or not from the Common Agricultural Policy that heavily subsidises EU agriculture and EU exports of agricultural products. However, such an issue is left for future research.

Concerning education, Romania displays a similar pattern to that of other countries in transition, *i.e.* a high share of the low-skilled and a low share of the high-skilled. For instance, in 1997, the low-skilled represented 57.4 percent of the total labour force, whereas high-school and university graduates registered only 34.4 percent and 8.2 percent respectively (Oprescu, 1999). The weight of low-skill workers in total unemployment is significantly higher than that in the total number of employees, while that of skilled labour is much lower. This may be attributed to two main reasons. First, restructuring has hit the most the unskilled labour so that the skills of these workers do not meet anymore the requirements of the growing industries. Hence, although training and retraining are of great importance, the government unemployment policies performed poorly with regard to the efficiency of such strategies. And second, the skilled labour, not only had a better chance to find a job, but also benefited from better-designed unemployment policies, such as wage subsidies for new graduates.<sup>12</sup> Nevertheless, the government's support in helping graduates find a job is justified by the need of high-skilled labour to develop the market and by the prevention of a severe brain drain towards advanced economies.

Finally, overall educational indicators for Romania fare well in comparison with other CEE or CIS countries (Berthin, G. et al., 2001). This is especially relevant in the area of adult literacy rate, youth literacy rate, enrolment ratios for primary age groups, as well as tertiary students in sciences (see Table A.8 in the appendix). However, public expenditures on education are generally below CEE and CIS averages (see Table A.9 in the appendix), translating into a low level of modernisation of the educational infrastructure, poor capacity building and weak salary structure. In addition, while the number of those who attend a higher education institution seems to be on the rise, the attendancy rates in pre-university education are decreasing. For example, the 2000 National Human Development Report on Romania informs that in 1998 the attendancy rate in secondary schools reached 69 percent, 21 percent less than in 1991. Similarly, the attendancy rate to pre-school education has declined from 83 percent in 1991 to 63 percent in 1998.

The increased dropout trends would mainly reflect the restructuring process of the economy, the low standard of living, and the inability of succeeding governments to adapt the educational system to the emerging needs of an economy in transition. Such issues if not corrected might cause serious problems over the long run as education is very important for economic growth, and the great human potential of transition economies could easily be lost.<sup>13</sup>

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<sup>12</sup>Accordingly, companies hiring new graduates received a subsidy covering 60 to 70 percent of the minimum wage for a period of 9 months (Oprescu, 1999).

<sup>13</sup>Spagat (2001) stresses the importance of two key factors that underpin a long period of rapid economic growth in transition economies: sufficient financial resources for people with a willingness to invest in education and the provision by education systems of good opportunities for such people to acquire marketable human capital.

### 3 The External Sector

Simultaneously with the fall of Ceausescu's regime in end-1989, the Council for Mutual Economic Assistance collapsed and the foreign trade monopoly was abolished. Romania started to negotiate several trading agreements, and amongst the most important it signed in 1992 the European Free Trade Agreement, in 1993 the European Union Association Agreement, in 1995 the Uruguay Round Agreement implying that its trading policies were performed according to the rules and principles of the World Trade Organisation, and in 1997 it became member of the Central European Free Trade Agreement.

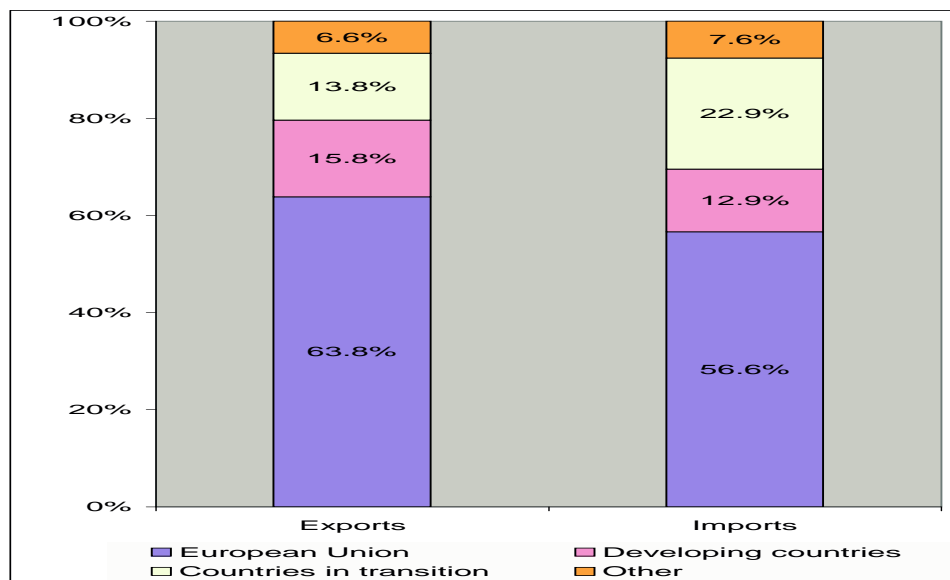
Throughout the transition period Romania has become a net agro-food importer (see Table A.10 in the appendix), despite its natural conditions beneficial to a thriving agricultural production, and abundant farm labour. This was mainly due to the lack of restructuring the upstream and downstream sectors, in particular the food-processing industry, which combined with infra-structural deficiencies undermined competitiveness (OECD, 2000). Foreign trade by type of commodities is dominated by the textiles, apparel and footwear group, as exported products and by the machinery, equipment and transport means sector, as imported products (National Bank of Romania, 2001). The foreign trade by group of countries is dominated by exports and imports with the European Union, followed by economies in transition and developing countries (Figure 5).

During the late 1980s, Romania registered no growth in exports in dollar terms, leaving in 1989 a current account deficit of around USD -3.3 billion and a scarce amount of around USD 25 million of foreign exchange reserves at the central bank (Figure 6).

The main risk of the gradualist approach undertaken by the political parties starting with 1992 was that structural reforms were delayed and, consequently, macroeconomic stabilisation could not be achieved. This has been overshadowed for a while by the resumption of growth and the apparent success in reducing inflation that were previously described in section 2.1. But the facts are that the export performance achieved in 1993-1994 could not be sustained as heavy industries that were dependent on imports of raw materials and energy were excessively subsidised. Towards the end of 1995, such a strategy combined with a very cold winter led to a significant deterioration in the external position in 1995 and an even worsening balance in 1996, when the current account deficit reached USD 2.6 billion (Figure 6). The foreign exchange reserves at the National Bank of Romania (NBR) remained very low during this period, reaching a maximum of around USD 0.6 billion in 1994. This can be mainly attributed, as aforementioned, to the unsound support of favoured sectors, such as the energy-intensive industries, to which foreign exchange was allocated on the basis of a non-market overvalued official exchange rate.

After the change of power in late 1996, the gradualist approach that had be-

Figure 5: The structure of foreign trade by group of countries as of year 2000.



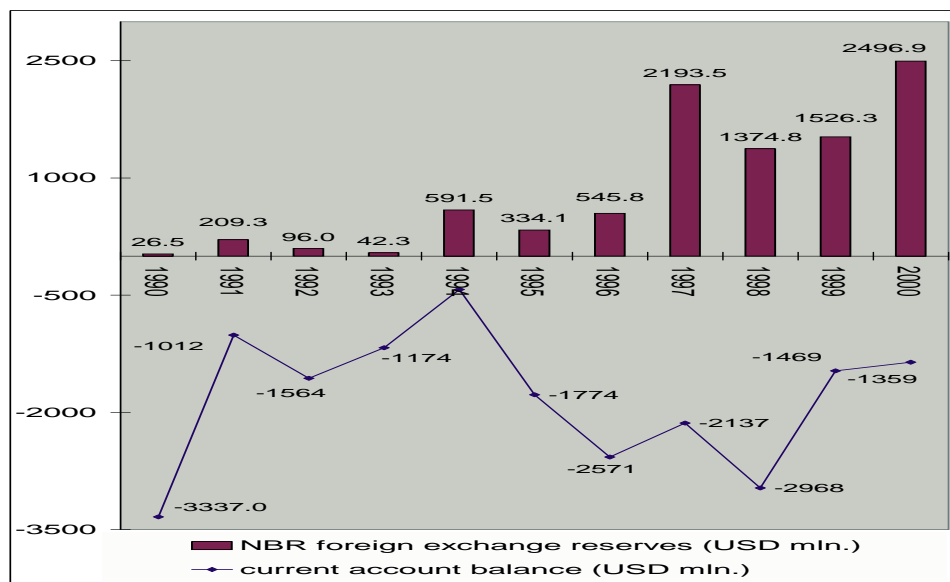
Source: The Romanian Government, 2000, *The White Book*.

come unsustainable was abandoned. A new and broad macroeconomic stabilisation programme was designed that envisaged amongst other measures, accelerated price liberalisation, the removal of subsidies, and the reduction of import tariffs. These measures were expected to reduce the current account deficit to under USD 2 billion, but despite improved prospects in 1997, economic performance continued to worsen in 1998 leading to a widening of the current account deficit to almost USD 3 billion. Foreign lenders and investors became increasingly reluctant to invest in the economy, especially following the 1998 Russian crisis.

This situation turned into an external debt crisis as a result of poor debt management. The government and the NBR had borrowed heavily from international capital markets in 1996 in order to finance large budget and current account deficits and this resulted in a severe bunching of debt repayments in mid-1999 (see Table A.11 in the appendix). Combined with the failure to tighten fiscal policy, excessive real appreciation of the ROL,<sup>14</sup> and severe structural weaknesses of the economy, Romania became vulnerable to a looming balance of payments crisis in the final quarter of 1998 and in the first half of 1999. However, the policies that were subsequently introduced managed to avoid the debt default, and as a result there was a large reduction

<sup>14</sup>Beginning with 1997, the National Bank of Romania conducted the monetary policy in the framework of a managed float, with the objective of avoiding excessive real effective appreciation.

Figure 6: Current account balance and NBR foreign exchange reserves, 1990-2000 (mln USD).



Source: National Bank of Romania;  
Notes: 1999 - semi-final; 2000 - provisional.

in the current account deficit, a strong rebound in exports, and a steady recovery of NBR foreign exchange reserves. Moreover, import contraction has more than halved the trade and current account deficits for 1999 despite the adverse impact on external trade of the Kosovo conflict (Fitch IBCA, 1999). The NBR estimated the negative impact on the trade balance of the Kosovo conflict to be USD 290 million (USD 230 mln in lost exports and USD 60 mln in additional import payments from higher transit costs). In 2000, as a result of favourable terms of trade effects and growing transfers, the current account deficit declined for the year as a whole to less than USD 1.5 billion, while the NBR forex reserves significantly recovered, increasing to USD 2.5 billion at the end of the year. Due to improved performance in the external sector, Romania managed to tap once again the international bond market in September 2000 and in 2001 its sovereign bonds ratings were upgraded.

However, according to recent estimates, although export growth remained robust, the current account deficit again widened considerably in 2001, reaching roughly 6 percent of GDP, compared to 3.7 percent of GDP for year 2000, owing to the continued effect of the drought and further strengthening of domestic demand (IMF, 2001b).

For 2002, the current account deficit is projected to decline only modestly, whereas the official reserves are projected to increase by approximately USD 1.0 billion (Government of Romania, 2001a). Foreign direct investment is projected to grow due to accelerated privatisation and green-field investment, but the financing of the current account deficits and the reserve accumulation as projected will also depend on continued public sector external borrowing as well as access to international capital markets. In addition, for the coming five years a low debt burden and a moderate and declining external debt service are expected (see Table A.11 in the appendix). This represents an important aspect contributing to macroeconomic stabilisation as external debt in Romania is the main component of total debt and, although Romania had an insignificant public debt at the beginning of the transition period, it experienced afterwards an unsafe accelerating trend in the conditions of poor macroeconomic policy management. Furthermore, in the case of Romania where public debt has been predominantly externally financed,<sup>15</sup> a declining external debt-service burden would give a positive signal to international financing institutions and investors, as the economy would rely less heavily on external resources and more on its domestic financial strength.

## 4 The Fiscal Sector

The main characteristic of the general government budgets of Romania after 1989, consists in rather small deficits varying between -0.4 percent of GDP in 1993 to -3.7 percent in 2000, with a maximum of -3.9 percent of GDP in 1996.<sup>16</sup> Nevertheless, this has not been a good measure of the overall fiscal stance in Romania because of extensive off-budget and quasi-fiscal activities in support of loss-making state-owned enterprises in industry and agriculture performed mainly through controlled interest rates and exchange rate. Thus, fiscal problems especially during 1992-1994 were concealed by shifting government expenses to the books of the central bank (NBR) and were supported, in addition, by the policy of overvalued exchange rate and very favorable debt dynamics, *i.e.* relatively high real growth rates and favorable interest rates (Budina and van Wijnbergen, 2000). The authors find that the indirect subsidies granted through the NBR were so large that the total public sector deficit

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<sup>15</sup>Over the period 1997-2000, external debt registered an average of around 20 percent of GDP, whereas domestic debt recorded an average of less than 10 percent of GDP.

<sup>16</sup>The figures are taken from the Government White Book (2001) and are given on a cash basis, *i.e.* receipts and payments are recorded as of the time of monetary settlement, whereas transactions recorded using the accrual method reflect the point at which a claim or liability arises or, respectively, becomes due. Thus the accrual balance reflects the government's full interest obligations, while the cash balance reflects actual interest payments.

was twice as large as the general government deficit.<sup>17</sup>

The following government that came into power in late 1996 tried to make transparent whatever subsidies were given (*e.g.* to the agricultural and energy sectors) and to budget them accordingly.<sup>18</sup> This led to a massive shift of the previous quasi-fiscal expenditures onto the budget in 1997. As a result, the general government budget deficit became more or less the same as the overall public sector deficit, amounting to -3.5 percent of GDP in 1997. Even so, although the NBR stopped providing such financing from 1996, quasi-fiscal operations continued via the banking system and toleration of tax arrears. Even more, throughout 1997 and 1998 the government was unable to improve the fiscal stance, mainly due to the slow pace of structural reforms and several shortcomings of the revenue collection system (*e.g.* poor infrastructure, lack of high performance special software, limited flow of information, lack of trained personnel and low job remuneration).

In addition, persistent public sector deficits have caused a dramatic increase in the public sector debt<sup>19</sup> and have reduced the country's national savings ratio to very small levels (see Table A.12 in the appendix). In other words, government dissavings encouraged by an expansionary fiscal policy during 1992-98 have crowded out public and private investments, failing to boost output and worsening sustainability indicators (Albu and Pelinescu, 1999).

Moreover, when fiscal tightening has taken place, this was mainly done using ad-hoc tax increases on the enterprise sector in response to low collection rates. This contributed to the development of the informal economy, which in its turn compromised the government's stabilisation objectives by fostering a vicious circle of savings. That is, worsening enterprise competitiveness due to an increased tax burden led to low savings in the formal economy and high real interest rates, which sequentially discouraged investments in the formal economy and postponed the improvement of enterprise competitiveness (Croitoru and Tarhoaca, 1999).

In 1999, a strong fiscal correction was inserted in a stabilisation programme supported by the IMF in order to address the balance of payments pressures that in

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<sup>17</sup>Budina and van Wijnbergen (2000) estimate using the total real public sector deficit in their model (including quasi-fiscal deficits) that the gap between funding requirements (financeable deficit) and funding sources (actual deficit) at 62 percent inflation rate in 1994 was 4 percent of GDP, revealing very large fiscal inconsistencies, compared to when using as a benchmark only the real general government budget deficit that appears to reveal only very small fiscal inconsistencies (0.7 percent of GDP).

<sup>18</sup>Although first serious attempts of fiscal adjustment were made starting with 1997, the cost of fiscal adjustment increased significantly due to augmenting debt related expenses that overburdened the budget.

<sup>19</sup>The dramatic increase in the public debt to GDP ratio in the transition period reaching around 35 percent of GDP in 1999 (from an insignificant level in 1989) was due to a very large increase of social consumption expenditures without a corresponding increase in tax revenue (Albu and Pelinescu, 1999).

combination with the currency depreciation improved competitiveness and reduced the current account deficit to sustainable levels. In order to meet the demands for higher budget expenditures, the fiscal tightening that brought a new major contraction of the state budget deficit in 1999 (to around 2.5 percent of GDP) was engineered through tax increases<sup>20</sup> and not expenditure cuts (Croitoru and Tarhoaca, 1999). Yet again, in 2000 the government loosened the fiscal stance, mainly due to the absence of wage discipline in public enterprises (the state budget deficit reaching according to recent estimates 3.6 percent of GDP). Also for the first eight months of 2001 the fiscal policy did not support the disinflation target, whereas towards the end of the respective year the current government in power approved a budget rectification and tightened the general government deficit to 3.5 percent of GDP (from an initial of 3.7 percent of GDP).

Further fiscal consolidation is envisaged for 2002 with the deficit declining to 3.0 percent of GDP and a tightening of the quasi-fiscal stance of around 0.75 percentage points of GDP (Government of Romania, 2001a).

## 5 The Monetary Sector

In terms of foreign exchange policy, until end-1991 a dual official and inter-bank exchange rate mechanism was used, for short periods, as an anti-inflationary anchor. The official exchange rate became applicable only to some of the foreign trade transactions. The foreign exchange market was then unified in November 1991 and starting from mid 1992 the exchange rate was determined daily through an auction organised by the National Bank of Romania, in which bids and offers had to be channelled through authorised banks. However, the employed price determination rule did not ensure that the price set in the auction was a market-clearing price (IMF, 2001b). This is because even though firms were allowed to use and trade their foreign currencies through authorised banks, prices of most imports of energy and raw materials were still controlled and set at the official, overvalued exchange rate.

In terms of monetary policy, although the first years of transition were characterised by a strong political will of maintaining price control, this was offset by a loose monetary policy (Charemza and Popescu-Turlea, 1999). In mid 1993, the government and the NBR adopted a macroeconomic stabilisation strategy that had as a main target the prevention of budget deficit inflationary financing. The role of the monetary authority was to gradually tighten its policy by rigorous control of the money supply and of the refinancing rate. Even though, the programme was judged

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<sup>20</sup>The revenue measures mainly consisted of increases in social security contributions, property taxes, and fuel excises, as well as delaying tax decreases approved earlier (Croitoru and Tarhoaca, 1999).

as being at most partially effective. “The positive effects of an already slow structural reform were weakened by the inconsistency of economic policies (periods of strict control on money supply and exchange rate liberalisation were interrupted by periods of monetary injections and use of the exchange rate as an anti-inflationary anchor)” (Charemza and Popescu-Turlea, 1999).

In 1994, the auction mechanism was modified to ensure clearing of the market and a decentralised direct dealing inter-bank market was established. In 1995, after dramatic price increases, NBR tightened once again monetary policy and the exchange rate was no longer used as an anti-inflationary anchor. Nevertheless, the functioning of the inter-bank market lasted roughly one year, and in the beginning of 1996 the NBR withdrew the licenses of the majority of bank-dealers, leaving only four state-controlled dealers. At the same time, the significant deterioration of the current account deficit led to a fall in confidence in the national currency, and the government was forced to finally accept a sharp depreciation of the official exchange rate.

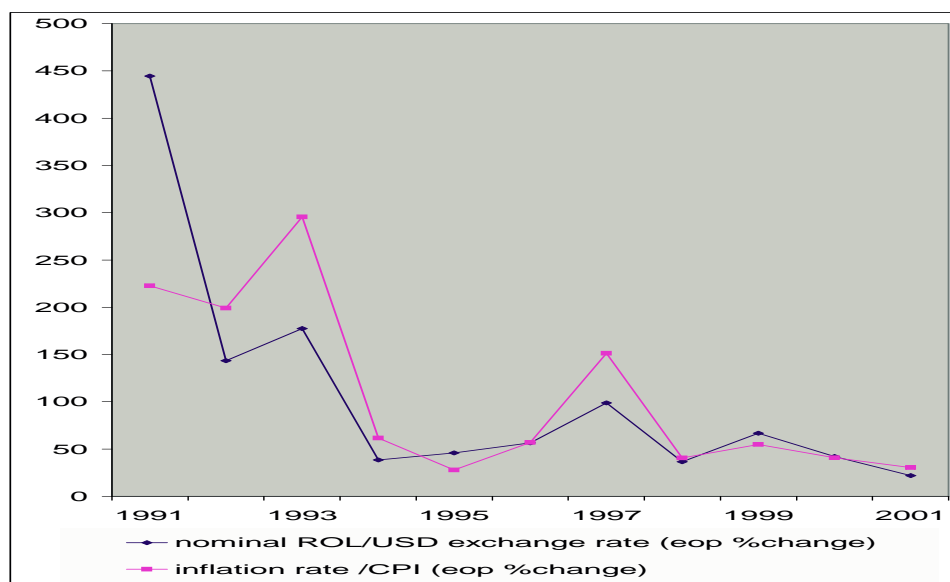
Thus, during the gradualist approach (1992-1996), the government allocated foreign exchange to favoured sectors and rationed it to other sectors on the basis of a non-market official exchange rate (OECD, 1998). This led to the formation of excessive demand for hard currencies and, subsequently, to the development of parallel black market exchange rates that became increasingly less related to the official market, affecting the credibility of the monetary sector. In other words, the monetary and exchange rate policies have been to a large extent politicised (*i.e.* exchange rate and price regulations), a fact that might be illustrated by the gap between the trend in the inflation and exchange rates during the 1991-97 period (Figure 7).

In 1997, the previous system of an official exchange rate was abandoned and the new-elected authorities adopted a framework of managed float for achieving disinflation, while not putting external viability at risk. That is, various forms of official and unofficial restrictions that have previously persisted on the foreign exchange market have mainly disappeared with the liberalisation of the market. NBR interventions were only designed to sustain equilibrium in the market.<sup>21</sup> For example, in 1997 the NBR had to intervene actively on the foreign exchange market in order to prevent an excessive appreciation of the real exchange rate and a drop in the country’s competitiveness due to large capital inflows brought about mainly by

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<sup>21</sup>To note that an important instrument used more frequently by the NBR to sterilise excessive capital inflows has been to attract commercial bank deposits, and less to engage in open market operations that were severely limited by its small stock of marketable treasury bills. Then again, dependence on such a mechanism implies a more cumbersome and expensive alternative for managing liquidity, fact reflected by drastic falls of NBR’s profits and even loss recordings (Fitch IBCA, 1999).

Figure 7: Trends in nominal exchange and inflation rates (end of period percentage change), 1991-2001.



Notes: Data taken from the National Bank of Romania, [www.bnro.ro](http://www.bnro.ro)

a new stabilisation programme.<sup>22</sup> Hence, the role of NBR in the foreign exchange market became marginal and the exchange rate was set nearly entirely by market forces. The gap between changes in inflation and nominal exchange rates tightened after 1997 possibly reflecting the liberalisation of the foreign exchange markets (and further price liberalisation), and a more credible monetary policy (Figure 7).

In the following period, the NBR confirmed its overall monetary policy objective, *i.e.* the stability of the national currency in order to ensure the stability of prices, through the issuance in 1998 of a new law regarding the statute of this institution. That is, the central bank has been following a managed float approach with the main purpose of avoiding excessive real appreciation and a drop in competitiveness, whilst pursuing disinflation, *i.e.* monetary targeting using the exchange rate with regard to the US dollar<sup>23</sup> as an instrument rather than inflation targeting (strategy

<sup>22</sup>Other underlying factors of increased capital inflows in 1997 include interest rate differentials, speeding up of the privatisation process, the development of the OTC and Bucharest Stock Exchange markets, and a favourable legislative environment.

<sup>23</sup>According to the monetary policy strategy for 2002 and beyond, the weight of the euro in the notional basket, used by the NBR to decide on interventions, will be gradually increased to provide more stability vis-a-vis the main trading partners.

clearly illustrated by the low volatility and uniform depreciation of the ROL/USD exchange rate compared to the high volatility and unpredictability of the ROL/EUR exchange rate in Figure A.1 in the appendix). However, the real appreciation due to a tightening of the monetary policy (*e.g.* increase in interest rates and increase in demand for local currency) has often proved to be excessive due to the slow tempo of structural reforms and large fiscal imbalances, and the NBR was forced on several occasions to sharply depreciate within the context of a managed float, compromising the disinflation policy. Thus the quantitative objectives for monetary policy to reduce inflation to 42% in 1998, 25% in 1999 and 15% in 2000, were largely overshoot (see Table 2 for recorded inflation).

However, in 2000 and 2001 extensive bank restructuring created conditions for more effective monetary policy that continued to be conducted in the current framework of a managed float, and the exchange rate's average monthly depreciation was lowered bringing the annual average inflation down to 35 percent in 2001. For 2002 the NBR agreed that should substantial pressures on the external position develop, it would defend the inflation objective (22 percent at end of year) and the exchange rate primarily by increasing interest rates, while interventions in the foreign exchange market would be limited with a view to safeguarding reserves.

The main conclusion with regard to the monetary sector that one can draw is that the monetary policy has not been much effective in stabilising the economy. This could be mainly attributed to the existence of persistent and significant quasi-fiscal deficits that have undercut the monetary policy, resulting in an inherent accommodation and causing enduring inflationary pressures and exchange rate crisis whenever the agricultural, energy and banking sectors recorded any financial deterioration.

## **6 Economic development and multilateral lending**

Romania joined the World Bank (WB) and the International Monetary Fund (IMF) in 1972. Since 1990, the WB has committed more than USD 3 billion and the IMF over 2 billion of SDRs in six Stand-By Arrangements. In addition, the new Country Assistance Strategy for Romania for 2001-04 envisages further financial support by the WB of up to USD 1.5 billion, depending on the absorptive capacity of the Romanian economy and the rhythm of reform and restructuring.

### **6.1 The beginning of multilateral lending**

Between 1990 and 1996, Romania had three Stand-By Arrangements (SBAs) with the IMF, none of them fully disbursed. SBAs are stabilisation programmes that customarily support one to two-year short-term balance of payments needs. Due to the poorly-conceived gradualist approach that did not seriously take into account the need for structural reforms, inflationary pressures, deteriorating loan portfolios, and a widening current account deficit started to build up, then became obvious and threatened stability in 1996. Meanwhile, neighbouring Bulgaria experienced a serious financial crisis and the multilateral lenders halted their financial support, predicting the same result for Romania if there were not immediate changes in the country's economic policies.

Shortly after a new government has been formed in end-1996 (see Table 1), the IMF and the WB were invited to start negotiations on a roadmap for economic reform. Romania instituted a stabilisation programme with the goal of reducing inflation, cutting down the fiscal and current account deficits and stabilising the value of the national currency. This was regarded as a fresh starting point and a new IMF SBA and two WB adjustment operations, the Financial and Enterprise Sector Adjustment Loan (FESAL) and the Agricultural Structure Adjustment Loan (ASAL) were negotiated and concluded. These last two lending schemes were structural adjustment loans (SALs) that had attached conditions related to the sectors of economic policy, agriculture and social protection (see box below). But the actual implementation of reforms turned out to be difficult.

**FESAL**

The loan aimed to support the government in addressing the main structural issues of the financial and enterprise sector. It displayed a two-pronged and integrated approach that would include the enterprise and financial sector. In the enterprise sector the main conditions were: - sharp acceleration of state-owned enterprise privatisation; - enforcement of hard budget constraints on remaining state-owned enterprises; - implementation of a strategy and action-plan to eliminate constraints to private sector development; In the financial sector the main conditions were: - bank restructuring and privatisation of at least two of the largest state-owned banks; - improvement of bank credit and risk analysis capabilities; - strengthening of the supervisory and surveillance capacity of the NBR; - introduction of a limited deposit insurance scheme for individual deposits.

**ASAL**

The objectives were to promote policy adjustments in support of the transition to a market economy and a more sustainable and efficient use of resources, to privatise a major share of the productive resources in agriculture, and to free up markets and enable the private sector to invest, produce and trade in line with Romania's comparative advantage. The conditions attached were briefly the following: - efficient use of resources through increased competition created by divestiture and privatisation of state-owned agricultural enterprises; - removal of subsidies and price controls and liberalisation of external trade; - improvement of providing rural credit; - promotion of the leasing of land and formation of genuine farm service co-operatives through revisions in the legislative framework.

Source: World Bank country website: [www.worldbank.org/ro](http://www.worldbank.org/ro)

## 6.2 Potential causes of failure

By 1998, the 1997 SBA and FESAL had been cancelled, whereas ASAL had gone through the first of several extensions to allow more time to meet unfulfilled privatisation conditions. Lack of structural reforms was at the core of the problem. The situation had deteriorated again because the loss-making enterprises (in industry and agriculture) had not been liquidated or restructured, where possible. State-owned banks that were already burdened with some of the highest shares of non-performing loans in the entire region had not been closed or restructured. Privatisation of banks, farms and enterprises had stalled. The foreign loans from 1996, incurred due to a severe lack of foreign currency, unpaid loans from domestic banks, increasing arrears to utilities and among enterprises, and growing tax arrears to the

Ministry of Finance provided a large share of the financing of these economic losses. The need to balance the budget also created very high interest rates (see Table A.13 in the appendix) and augmenting tax rates, both of which - combined with a bad business environment and administrative barriers - contributed greatly to the fact that no net creation of new enterprises took place after 1995.

### 6.3 Resumption of adjustment lending

A few months later, in mid-1999, even though a debt default seemed imminent, the Romanian authorities remained current on all their external and domestic debt obligations. A sharp real depreciation of the ROL and tighter fiscal and monetary policies that have narrowed down the current account deficit and increased the amount of official foreign exchange reserves combined with an easing of the external debt service burden in 2000 and with the IMF's demand that private creditors are "bailed-in" has receded the risk of default (see box below).

#### **Bailing in the private creditors: the IMF and Romania.**

The G7 and IMF are concerned that holders of international bonds, especially of eurobonds, have been shielded from the full risks of lending, creating moral hazard incentives. Consequently, a policy of "bailing-in" private creditors, in particular bondholders, has been evolving.

In the case of Romania, the IMF originally insisted that private creditors had to be "bailed-in" to the tune of USD 600 mln as a prior condition for the resumption of official financing. This was to be achieved either with new money or by "refinancing" the USD 675 mln of international bonds (a JPY 52 bln Samurai bond and a USD 250 mln eurobond) maturing in May and June 1999. Apparently a forced restructuring of the two bonds (*i.e.* default) would have been acceptable to the IMF in meeting the bailing in condition.

However, the Romanian authorities were only able to secure USD 130 mln (USD 108 mln 1 yr club loan and a USD 20 mln gain from an NBR swap transaction) by end-June, the deadline set by the IMF. The terms of the maturing bonds did not allow them to be voluntarily "refinanced". The Romanian authorities chose to honour these obligations so as to retain the prospect of returning to international capital markets at a later date and despite official reserves consequently falling below the level agreed with the IMF for end-June.

Source: Fitch IBCA, 1999, *Sovereign Report on Romania*.

At this stage in time, the IMF and WB approved new loans, an SBA and, respectively, a USD 300 million Private Sector Adjustment Loan (PSAL). These

were designed to create the macroeconomic framework needed for the successful implementation of structural reforms.

The SBA was approved in August 1999 wherein the IMF continued to insist on its “bailing in” condition. But plans to raise the necessary finance from international capital markets turned out to be too expensive and the IMF reconsidered and lowered the target.<sup>24</sup> Nevertheless, the IMF’s SBA was not respected, with the fiscal deficit, public sector wages, and arrears to the budget estimated to have exceeded the agreed-upon targets.

The PSAL supported government’s efforts to stabilise the macroeconomic situation through its four main components: financial sector reform and privatisation, state owned enterprises privatisation and the development of the business environment. The adjustment reforms significantly reduced the current account deficit due to fiscal correction combined with currency depreciation and improved terms of trade. In May 2000 the first increase in industrial output was recorded since 1995. The sale of one of the largest loss making state owned banks, progress in privatisation of state-owned enterprises, coupled with financial discipline and improvements in social safety net measures led to the completion of the PSAL programme in mid 2000.

A new project PSAL2 was prepared by the World Bank to continue and deepen reforms. Although it was ready in mid 2000, the project is at the date of writing this paper still in the pipeline. The structural adjustment loan aims for the same objectives as the previous project, but it also includes an important factor for social development, *i.e.* improving social assistance programmes for workers, which have been displaced as a result of the adjustment process.

Finally, in late 2001, the IMF approved the sixth Stand-By Credit to support Romania’s commitment to accelerate EU accession and to assist the authorities in implementing their programme aimed at ensuring macroeconomic stability and growth, and a more effective transition to a market-based economic structure (see section 7.1).

## 6.4 Conclusions

The World Bank (2002) stated in one of its news releases that the failure of so many countries in transition (including Romania) to adopt economic reforms that support discipline and encouragement is because people who benefited from early reforms like liberalisation and privatisation as they controlled state assets or enjoyed close ties with the old political elite tend to oppose subsequent reforms that would endanger

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<sup>24</sup>The initial “bailing in” condition was USD 470 million. But it was suggested that only 2 year bonds with a 17% annual coupon would have generated sufficient demand from international investors and thus the IMF lowered the target to USD 100 million (Fitch IBCA, 1999).

their initial gains. Structural reform recommendations made by multilateral lenders are repellent for much of the population and for many supporters of the party now in power, and reconciling these conflicts is an enormous political challenge.

Whilst, the recommendations made by multilateral lenders are vital to the improvement of Romania's economic performance, one should also question whether the policy mix that the conditionalities of international financial support were fostering have been the most appropriate set for positive performance. The following arguments might broaden the perspective upon the reasons why Romania has been following the pace of reforms in a zigzag manner:<sup>25</sup>

- Both the FESAL and ASAL programmes were overloaded and perhaps not sufficiently focused on a narrow range of objectives but tried instead to accomplish too much at the same time. Consequently, they overburdened implementation capacity on the ground;
- Although many economic deficiencies in Romania's society are the result of ill will, several such failures might arise from the lack of knowledge. Thus not sufficient investment in human capital has been awarded by the structural adjustment programmes;
- Private property and getting the prices right (*i.e.* liberalisation) are not sufficient to make a market work. Not enough emphasis has been put on the structure of the Romanian institutions, especially those necessary to provide social safety nets (only in the new PSAL2 that is still in the pipeline certain measures have been included), and hence the domestic suspicion of foreign takeovers of state industrial holdings;
- Insufficient emphasis on the implementation of an efficient rural credit market, which is a key point for a country where agriculture has a large contribution to GDP. To prevent individuals from returning to subsistence agriculture, it is necessary to support the creation of new enterprises in both the agriculture and manufacture sector.

Furthermore, besides plausible explanations given by the multilateral lenders of insufficient restructuring as the result of political failure and rent-seeking activities by the old elite, the stop-go policies (boom and bust cycles), resurgent inflation,

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<sup>25</sup>Part of the arguments are also applicable to other emerging and developing markets and can be found in White, H. and Leavy, J, 2000, "Economic reform and economic performance: Evidence from 20 developing countries", IDS Discussion Paper 376, Institute of Development Studies, University of Sussex, UK.

macro disequilibria and bank failures are also inevitable outcomes of fragile institutions and the legacy of resource misallocation<sup>26</sup> that have maintained intense strain in the system and has led to a bad path dependency (Daianu, 1999).

In conclusion, one should not argue against the restructuring and liquidation of big loss making enterprises, private sector growth and institutional and governance reform. However, one should consider the priorities and the pace of these reforms, the extent to which they are taken, the institutional capacity to implement them, while continuously observing the social impacts, including any environmental effects, and taking direct measures towards poverty reduction, transition cost minimisation and sustainable development.

## 7 Perspectives for growth - key issues

### 7.1 Medium-term outlook

Romania outlined its medium-term perspectives and strategies for integration into the European Union in its 2001 pre-accession economic programme. The forecasting scenarios are based on the “Dobrescu” macro-model of the Romanian transition economy that focuses upon economic policy options. The model reflects the features of a weakly-structured economy that depict the case of the Romanian transition economy.<sup>27</sup> It envisages a real economic growth of around 5 percent average over the period 2002-05, a reduction in the number of unemployed to roughly 8 percent of the labour force and a cut in inflation to single-digit rates by 2005 (Table 4). It also sets indicative targets for ceilings on broad money (for example 28.3 end of year percentage change for 2002) that appears to be consistent with the monetarist view of inflation (roughly equal to the sum of inflation rate measured by the GDP deflator, which is expected to be 24.5 percent in 2002, and real GDP growth, anticipated at 5 percent).

The programme comprises comprehensive measures and ambitious objectives, such as fiscal tightening, the reduction in the quasi-fiscal deficits and particularly in the large losses of the state-owned energy sector, containment of wage growth in less-productive state-owned enterprises, accelerated privatisation, and a prudent mone-

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<sup>26</sup>Daianu (1999) defines the dimension of the inherited misallocation of resources as the sheer scale of disequilibria, at the new relative prices, that indicates the magnitude of required restructuring as compared to the ability of the system to undergo wide-ranging and quick change.

<sup>27</sup>Such characteristics include the existence of massive inter-enterprise arrears, the large weight of the non-accounted economy, and frequent monetary distortions. The model is mainly used by the NBR, it is updated on a monthly and yearly basis, and it comprises 163 equations, of which 54 are behavioural ([www.profitromania.com](http://www.profitromania.com)).

Table 4: Main indicators of economic development, 2002 -2005.

	2002	2003	2004	2005
Real GDP growth (%)	5.0	5.2	5.5	5.1
Unemployment rate (%)	9.2	8.9	8.6	8.4
Inflation rate (annual avg. % change)	24.7	16.6	10.8	7.8

Source: The Romanian Government, 2001, *Pre-accession economic programme*

tary policy.<sup>28</sup> In this regard, important measures have already been implemented, for instance, early submission of the 2002 budget to Parliament, simplification of micro-enterprise taxation, more stringent regulations regarding the rescheduling of tax arrears and cancellation of associated penalties, strengthening of the financial discipline, some adjustments in energy prices<sup>29</sup> and the approval of the privatization strategy for the largest state-owned bank (BCR).

Thus, taking into account the aforementioned recent achievements and the estimated figures over the 2002-05 period, it is reasonable to say that the medium-term outlook for growth in Romania is positive. Furthermore, other macroeconomic models such as the LINK project used by the United Nations present favourable estimates and forecasts for the Romanian economy. For example, the LINK model estimates an increasing positive growth of real GDP, from 3.6 percent in 2001 to 4.1 percent in 2002 (United Nations, 2000). Nevertheless, other models such as the Hermin model for Romania (Ciupagea, 2001), predicts a stable path for GDP growth of around 2.4 percent per year, beyond 2002, but warns that this might be less than the world output predicted growth, and such a result cannot pose but worries to Romanian policy makers. In other words, if the Romanian economy will not restructure as soon as possible, it is very likely that it will diverge from the economic path followed by developed economies, and the income gap will increase. Hence, further commitment to reforms, in particular with reference to enterprise profitability, and well timed, vigorously followed and transparent implementation of scheduled measures will be crucial factors behind the success of the governmental programme in reaching its goals.

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<sup>28</sup>This is to say that the NBR will attach more weight to the inflation objective, while not putting at risk the viability of the external accounts. The NBR also envisages the provision of a wider room for fluctuation of the exchange rate to discourage short-term capital inflows. Furthermore, within the period 2002-03 the NBR attempts to replace the practice of monetary targeting with inflation targeting, while the country's competitiveness would be mainly driven by increased productivity and not by exchange rate devaluations (Government of Romania, 2001a).

<sup>29</sup>As a first step the Government has increased the electricity price by 15 percent, the heating producer price by 50 percent, the end-user heating price by 57 percent, and the natural gas price for households by 90 percent (IMF, 2001b)

For example, any delay in fiscal corrections in the face of weak growth recovering prospects and fast debt accumulation would only increase the gap between available resources and required funds to finance the deficit and would eventually undermine the monetary policy through increased inflationary pressures. Moreover, fiscal policy should be guided by simple and transparent rules implying major institutional adjustments and prudent strategies that would not weaken prospects for stabilization. Romania has heavily relied on ad-hoc tax increases that frequently led to, instead of improved tax collection, deteriorating enterprise competitiveness, declining non-governmental savings and, finally, to an expanding informal economy and, consequently, to stronger incentives to go underground (Croitoru and Tarhoaca, 1999). A recommendation made by the authors in this regard would be to undertake fiscal stabilization based not on tax increases, but on tax reforms and sustainable cuts of budget expenditures in accordance with a significantly revised role of the state in the economy. An alternative option would be to use a simple tax system based on a flat tax rate that might increase the flow of revenue channelled from the private sector to the government's accounts.

Besides prudent fiscal strategy, which is essential for any macro economic stabilization, an important policy recommendation is to increase the transparency of its public sector balances and account for all public sector expenditures in the budget (Budina and van Wijnbergen, 2000). This needs to be combined with a strengthening of the regulatory framework and an improvement in supervision, especially with reference to the financial system.

Nevertheless, a crucial problem with the Romanian economy is not the absence of good recipes and great plans, but effective implementation (Jackson, 2001). Early and current rent seekers that have benefited from certain restructuring measures have no intention to foster further reforms that would hinder their interests and may even attempt to prevent Romania's EU accession efforts. That is why Romania's faltering transition to a market economy reflects not only the terrible economic legacies of the Ceausescu regime but also the political and personal rivalries that have dogged successive governments since 1989 (Fitch IBCA, 1999).

Therefore, a key issue for continued growth and macroeconomic stability is the need for strong political will, honesty and coherence in adopting economic reforms that support discipline in less efficient sectors and encourage the formation of a vibrant efficient private sector. In other words, the government needs to sustain further liberalization, facilitate entry of new domestic and foreign competitors, and protect minority shareholders and creditors through consistent legislation (World Bank, 2002).

However, ineffective implementation of restructuring measures was fostered not only by political unwillingness, but also by institutional fragility. Inappropriate institutional capacities and disorganised markets hinders a smooth reallocation of resources and has an off-putting effect on performance at both the micro and

macroeconomic levels. This helps to explain the intense friction in the system, especially rising transaction costs, that arises during the passage between two regimes (Daianu, 1999). The author argues that sometimes the magnitude of the required resource reallocation and friction are so large that they undercut attempts to achieve durable stabilization. Thus, the success of a transition economy might rely on the ability of policy to deal with the magnitude of such required resource reallocation and friction, while not being “captured” by vested interests.

In any case, structural reforms are a key factor for sound economic development. For instance, real sector reform towards lower unit labour costs,<sup>30</sup> increased productivity and profitability in the enterprise sector would lead to improved competitiveness of domestically produced goods and would create scope for the monetary policy to better pursue its inflation targeting without relying on managed currency depreciations. Furthermore, restructuring, in particular of state-owned enterprises, would also diminish arrears in the system that have the potential to translate into macroeconomic instability once their capacity of absorbing economic losses is exhausted.<sup>31</sup> This would, consequently, ease the pressure that fiscal and quasi-fiscal deficits exercise on the monetary policy.

Finally, an issue that has not been much researched but is recently receiving increasing attention is that whilst economic reforms are vital for improved prospects for development and integration into the EU, the government and the international lenders must also address the complex poverty-environment-development linkages and pave the way towards growth on a more sustainable basis.

## 7.2 Reforms and sustainable development

The notion of sustainable development presents a challenge not only for policy makers in transition economies but also for developed countries. It argues that present growth should not be at the expense of future generations or of social equity both within and across countries worldwide. In other words, it raises environmental concerns about renewable resources and degradation of the ecosystem, as well as social issues regarding the marginalisation of the poor, unskilled workers and the increase in income inequality (Fortanier and Mahler, 2001).

The concerns raised by the concept of sustainable development become even more pronounced in the light of economic reforms and EU enlargement. Economic restructuring can promote many opportunities for win-win environmental improvements

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<sup>30</sup>IMF (2001c) provides econometric evidence that wage levels in Romania above those justified by productivity are the most plausible explanation of inflation in the long run.

<sup>31</sup>Rühl (1999) identifies four areas in which losses in the economy show up and names them shock absorbers because these are areas which absorb losses as long as they function, gradually building up into serious threats to instability, *i.e.* arrears in the system, the banking system, foreign debt and domestic debt.

and increased prospects for sustainable development. Without economic progress many important opportunities for the improvement of the environment and of the quality of life might be forgone. The implementation of economic reforms would create strong incentives for investment capital that could bring about environmental enhancement.<sup>32</sup>

In addition, sustainable development strategies also address pressing social needs that are especially identified in emerging markets like Romania, *i.e.* the need to reduce poverty and unemployment, through developing the social safety net system, channelling investments and creating special temporary employment programmes in poor and polluted areas.

However, one should also take into consideration the effects of economic restructuring on the institutional capacity to carry out sustainable development policies. While harmonization with EU legislation has straightforward positive impacts on the state of the social and natural environment, EU directives and regulations reflect a level of economic development that is quite different from the one prevailing in the rest of the CEE countries (Kaderjak, 1997). Thus, EU regulations should be implemented in transition economies with great awareness so that the occurrence of unfortunate situations be avoided and the prospects for improved welfare be enhanced (*e.g.* side payments and transfers from developed rich countries to transition economies, growth policies that ensure the benefits of growth reach the poor, and, in particular, creation of appropriate institutions).

Hopefully, changes in government policies such as liberalization, regulatory reforms and privatization accompanied by growing trading and international investment flows will increasingly integrate transition economies in the European Union and into the global economy. For both developed and emerging markets the internationalization of economic activities will pose opportunities and challenges for sustainable development.

Thus, extensive research is further needed to analyze the linkages between economic reforms, welfare and the environment in the context of EU enlargement. This would help identify the existing trade-offs and recommend solutions to reduce them or even propose alternatives for win-win type of policies. This would also be of great importance for future prospects of sustainable development in Romania, as the country is still in the process of intensive institutional reforming, in particular with respect to natural resource management and social protection.

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<sup>32</sup>Toman (1997) enumerates several sources of win-win environmental improvements. One source is through improved input efficiency and changes in the composition of GDP that reduces pollution loads. A second and related benefit of economic restructuring is greater capacity to buy and use both improved end-of-pipe abatement technologies and cleaner advanced process technologies. Furthermore, restructuring also provides opportunities for improved efficiency and enhanced protection in the use of natural resources through rationing access and charging appropriate prices.

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## A Appendix

### Main data sources

- Institute of National Statistics, Romania ([www.insse.ro](http://www.insse.ro));
- National Bank of Romania ([www.bnro.ro](http://www.bnro.ro));
- Government of Romania ([www.guv.ro](http://www.guv.ro));
- Ministry of Public Finances of Romania ([www.mfinante.ro](http://www.mfinante.ro));
- International Monetary Fund ([www.imf.org/external/country/ROM](http://www.imf.org/external/country/ROM));
- World Bank ([www.worldbank.org](http://www.worldbank.org))

### Further economic indicators

Table A.1: Percent of total labour force employed in agriculture (1989).

Poland	Czech Republic	Romania	Hungary	Slovakia	Bulgaria
26.8%	11.7%	27.9%	16.6%	13.8%	19.0%

Source: taken from Pauna, C. and Pauna, B., 1999, *Output Decline and Labour Reallocation in Transitional Economies; Where Does Romania Stand?*, Working Paper no.3, Romanian Centre for Economic Policies, Bucharest.

Table A.2: Official unemployment rate in selected Central and Eastern European countries, 1990-99 (% of labour force, end of period).

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Romania		3.0	8.4	10.4	10.9	9.5	6.6	8.9	10.4	11.8
Albania	9.5	8.9	27.9	29.0	19.6	16.9	12.4	14.9	17.7	18.0
Slovakia	1.5	11.8	10.4	14.4	14.8	13.1	12.8	12.5	15.6	19.2
Bulgaria	1.7	11.1	15.3	16.4	12.8	11.1	12.5	13.7	12.2	16.0
Poland	6.3	11.8	13.6	16.4	16.0	14.9	13.2	10.3	10.4	13.0
Hungary		7.5	12.3	12.1	10.4	10.4	10.5	10.4	9.1	9.6

Source: data on Romania obtained from the central bank - NBR 2000 Annual Report ([www.nbro.ro](http://www.nbro.ro)); data for rest of countries compiled from the IMF Country Reports ([www.imf.org](http://www.imf.org)); Notes: data comparisons should be treated with caution although the data was compiled respecting similar indicator definitions.

Table A.3: Employment in agriculture (as a percent of total employment).

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
28.2	28.9	32.1	35.2	35.6	33.6	34.6	36.8	37.4	40.6	40.8

Source: National Institute of Statistics, 2001, *Romanian Statistical Yearbook*, pdf format.

Table A.4: The underground economy (UE) in selected transition countries (as of 1994).

Country	UE (% of GDP)	Change in UE (1989-1994)
Bulgaria	28.4	6.7
Czech Republic	17.2	11.2
Hungary	28.1	1.1
Poland	15.8	0.1
Slovakia	15.4	9.4
Slovenia	25.0	1.7
Romania	16.9	-5.4
Russia	38.5	23.8
Ukraine	41.8	25.5
Belarus	15.0	-0.4
Georgia	62.2	37.7

Source: Rosser, J.B. and Rosser, M.V., 2001, *Another Failure of the Washington Consensus on Transition Countries. Inequality and Underground Economies*, Challenge, Mar 01, 2001, Vol. 44, Issue 2, p39-50.

Table A.5: Estimated private sector share in GDP in selected transition economies, 1991-99 (%).

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Romania	25	25	35	40	45	55	60	60	60
Bulgaria	19	26	35	39	48	52	57	57	57
Czech Rep.	15	30	45	65	70	75	75	75	80
Hungary	30	40	50	55	60	70	75	80	80
Poland	40	45	50	55	60	60	65	65	65
Slovakia	15	30	45	55	60	70	75	75	75

Source: IMF, 2001, *Bulgaria: Selected issues and statistical appendix*, IMF Country Report no.01/54.

Table A.6: Contribution of the agriculture, hunting, forestry and fishing sector to the gross value added in selected Central and Eastern European countries. (% of gva, calculated using current prices).

Year	Bulgaria	Czech Rep.	Hungary	Poland	Romania	Slovenia	Slovakia
1997	26.6	4.4	5.9	5.5	19.5	4.2	4.6
1998	21.1	4.6	5.5	4.7	16.1	4.1	4.2
1999	17.3	3.9	4.9	3.9	15.0	3.6	4.1
2000	14.5	3.9	4.1	3.3	12.8	3.2	4.1

Source: Institute of National Statistics - Romania, CESTAT Statistical Bulletin no.3/2001, [www.insse.ro](http://www.insse.ro);

Notes: 1999 - semifinal data; 2000 - provisional data

Table A.7: Job creation (jc) and job destruction (jd) in selected CEE countries and South OECD over the period 1989-1997 (%).

	Bulgaria	Czech Rep.	Hungary	Poland	Slovakia	Romania	S. OECD
jc	0.58	9.04	2.18	8.25	6.97	6.42	5.30
jd	-26.07	-17.11	-28.07	-24.28	-19.14	-23.98	-6.30

Source: Pauna, C. and Pauna, B., 2000, *Output decline and labour reallocation in transitional economies; Where does Romania stand?*, Working Paper no.3, The Romanian Centre for Economic Policies, Bucharest

Table A.8: Selected educational indicators for selected CEE and CIS countries, 1999.

	Adult literacy rate	Youth literacy rate	Net primary enrolment ratio (%)	Tertiary studs sc., math & eng.
Hungary	99.3	99.8	82	32
Poland	99.7	99.8	97	
Croatia	98.2	99.8	84	38
Lithuania	99.5	99.8	94	38
Latvia	99.8	99.8	93	29
Russia	99.5	99.8		49
Bulgaria	98.3	99.6	93	25
Romania	98.0	99.6	97	32
Moldova	98.7	99.8		44
Tajikistan	99.1	99.8		23

Source: UNDP, 2001, Human Development Report 2001.

Notes: adult literacy rate - percentage age 15 and above; youth literacy rate - percentage age 15-24; net primary enrolment - measures enrolments in the primary school (number of children enrolled divided by the number of children within the specified age group); data refer to the most recent year available within the period 1995-97; last column - as a percentage of total tertiary students and data refers to the most recent year available within the period 1994-97

Table A.9: Public education expenditure in selected CEE and CIS countries.

	As % of GNP		As % of total gov. expend.	
	1985-87	1995-97	1985-87	1995-97
Hungary	5.6	4.6	6.3	6.9
Poland	4.6	7.5	12.5	24.8
Lithuania	5.3	5.9	12.9	22.8
Latvia	3.4	6.5	12.4	16.5
Bulgaria	5.4	3.2		7.0
<b>Romania</b>	2.2	3.6	7.5	10.5
Russian Federation	3.4	3.5		9.6
Ukraine	5.3	5.6	21.2	14.8
Kazakhstan	3.4	4.4	19.8	17.6
Azerbaijan	5.8	3.0	29.3	18.8
Kyrgyzstan	9.7	5.3	22.4	23.5
Uzbekistan	9.2	7.7	25.1	21.1

Source: UNDP, 2001, Human Development Report 2001.

Notes: data refer to total public expenditure on education, including current and capital expenditures; data also refer to the most recent year available during the period specified

Table A.10: Imports (M) and Exports (E) of selected agricultural products (as a percent of total), 1993-1999.

	1993	1994	1995	1996	1997	1998	1999
live animals /animal products (M)	1.0	1.4	1.3	0.6	0.6	1.8	1.2
foodstuffs, beverages, tobacco (M)	6.1	5.5	5.7	5.3	4.0	4.4	4.0
live animals /animal products (E)	3.3	3.6	2.1	1.9	2.4	1.1	1.4
foodstuffs, beverages, tobacco (E)	1.0	1.1	0.9	1.3	1.2	1.1	0.7

Source: IMF, 2001, *Romania: Selected issues and Statistical appendix*, IMF Country Report no.01/16.

Table A.11: Dynamics of the external public debt (epd) as a % of GDP and the external public debt service (epds) in UDS mln., 1996-2005.

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
epd	17.5	19.7	18.3	21.6	22.3	21.0	21.7	21.4	21.1	21.0
epds	1031	1581	1519	2160	1331	1847	1952	1710	1599	1462

Source: National Bank of Romania, Ministry of Finance, IMF;

Notes: data includes public and publicly guaranteed debt; 2001 - estimated data; 2002-05 - forecast data; the forecast figures for external public debt over 2002-05 are taken from IMF, 2001, country report 01/204.

Table A.12: Gross national savings as a percent of GDP, 1993-2000.

	1993	1994	1995	1996	1997	1998	1999	2000
GNS	24.3	23.1	19.4	18.5	14.5	10.8	13.1	15.7

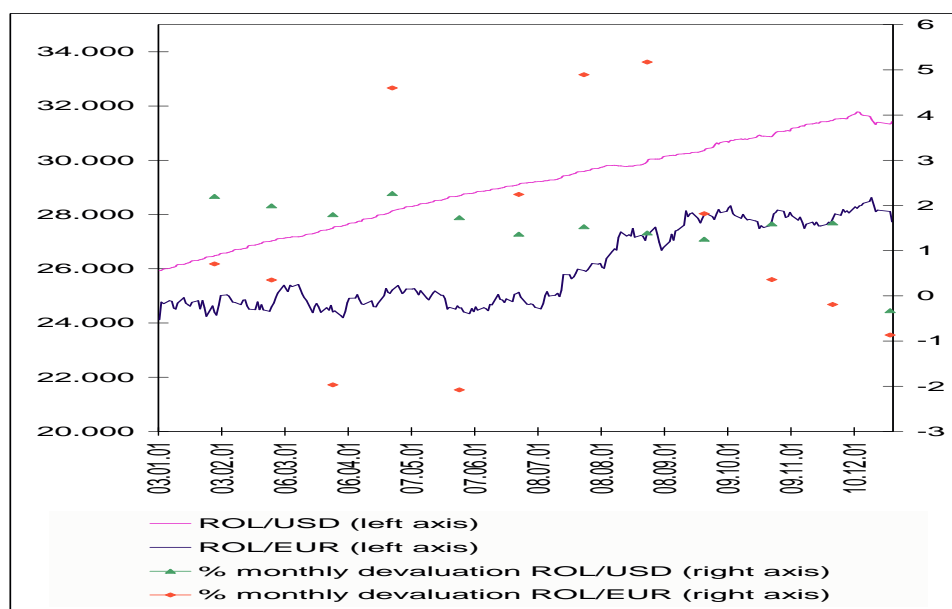
Source: IMF, 2001, *Romania: Request for a Stand-By Arrangement*, IMF Country Report no.01/204 and IMF, 2001, *Romania: Selected issues and Statistical appendix*, IMF Country Report no.01/16.

Table A.13: National Bank of Romania end of period interest rates (%), 1992-2000.

1992	1993	1994	1995	1996	1997	1998	1999	2000
44.0	416.0	78.0	67.0	66.9	138.8	105.0	88.7	60.1

Source: IMF, 2001, *Romania: Request for a Stand-By Arrangement*, IMF Country Report no.01/204 and IMF, 2001, *Romania: Selected issues and Statistical appendix*, IMF Country Report no.01/16.

Figure A.1: ROL/USD nominal exchange rate versus ROL/EUR nominal exchange rate, 2001.



Notes: The data on daily nominal exchange rate are taken from the National Bank of Romania, [www.bnro.ro](http://www.bnro.ro)

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