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DG INTERNAL POLICIES OF THE UNION

Policy Department Economic and Scientific Policy

# Romania

## Economic Policy Review

# Briefing Note

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# Romania

## Economic Policy Review

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## 1. Executive Summary

The current report aims to provide an assessment of the Romanian economy focussing on macroeconomic issues, corruption and financial services.[1]

The list of policies analyzed is by no means exhaustive, but attempts to reflect the remit of the European Parliament's ECON Committee.

**Political brief[2]**

The minority government, led by the prime minister, Calin Popescu Tariceanu, and comprising the National Liberal Party (NLP - ALDE) and the Hungarian Democratic Union in Romania (HDUR - EPP), survived a vote of no confidence brought by the opposition Democratic Party (DP - EPP) and the Liberal Democratic Party (LDP - ALDE) in June. The other opposition groups abstained from voting, thus preventing the motion from obtaining the two-thirds majority support required for success. The government controls only 22% of the seats in parliament and has relied on the support of the former communist Social Democratic Party (SDP - PES) for a parliamentary majority since April 1st, when Mr Tariceanu ousted the DP from the government.

The government is expected to remain in office with the support of the SDP because, with the exception of the DP and LDP, none of the other parliamentary parties favour an early election. As the SDP is by far the largest party in parliament it will be able to block any legislation it considers contrary to its interests and, as with the recent rise in pensions, promote its own agenda as the price of its support for the government.

On the other hand, the dominant mood inside the SDP is to pull away from Tariceanu's National Liberal Party (NLP), which is seen as in possibly terminal decline.

**Economic synopsis**

- **Growth moderates:** Real **GDP will grow this year by 6.7%** and by 6.3% in 2008, according to the European Commission's spring forecasts. Public investment and foreign direct investment inflows will fuel gross fixed capital formation, and rising real wages and household credit will also contribute to strong domestic demand.
- **Inflation:** Falling import prices and a relatively tight monetary policy will moderate consumer price inflation to about **4.5% in 2007** and 2008.
- **Strong domestic demand** will widen the **current account deficit** to **about 12% of GDP** in 2007. In the first six months, this had already more than doubled to 7.8 billion euros, from 3.7 billion euros in the year-earlier period. The National Bank of Romania attributes this to the removal of tariffs on EU imports from January as a consequence of EU membership, cheaper imports due to currency appreciation (in turn due to foreign investment inflows) and a consumer boom fuelled by lower taxes, rising wages and increased credit.
- **Fiscal Policy:** The government has budgeted for **a deficit of 2.8% of GDP.** It has ambitious plans for structural reform in transport and energy, and is likely to continue revising the budget over the course of the year. Control over the budget could loosen owing to political uncertainty. The European Commission predicts a deficit of 3.2 % of GDP.

[1] This briefing note draws heaviliy on information and policy briefs from the European Commission, The Economist Intelligence Unit, the IMF as well as national agencies in Romania.
[2] See Economist Intelligence Unit, Country Profile July 2007, Romania.

- Romania ranks as **84th on the Corruption Perception Index of Transparency International**, with a score of 3.1 in 2006. This is by far the worst of any EU country.
- The European Commission published a report on the Cooperation and Verification Mechanism with Romania on 27 June. The report indirectly criticizes Romania for failing to tackle organized crime and judicial reform. It stopped short of calling for sanctions, leaving this option open for next year's review. The criticism is certainly an embarrassment for the government, which is likely to reject the assessment as too harsh.

The following table sets Romania in comparison with some other central and eastern European countries in terms of some key economic figures:

*Table 1: Comparative Economic Indicators (2006), EU25=100*

| *EU25=100* | *Romania* | *Bulgaria* | *Hungary* | *Poland* | *Czech Republic* |
|---|---|---|---|---|---|
| | | | | | |
| *GDP p.c. PPP* | 36,3 | 35,7 | 63 | 51 | 76,6 |
| *Labour productivity per employee* | 36,9 | 34 | 71,1 | 59,2 | 68,7 |
| *Employment (17-64)* | 58,8 | 58,6 | 57,3 | 54,5 | 65,3 |
| *Unemployment rate* | 7,3 | 9,0 | 7,5 | 13,8 | 7,1 |

*Source: Eurostat*

## Table 2: Key Economic Figures, European Commission, Spring Forecasts

### Main features of country forecast - ROMANIA

| | 2005 | | | Annual percentage change | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| bn RON | Curr. prices | % GDP | 92-02 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
| GDP at constant prices | 288.0 | 100.0 | 0.7 | 5.2 | 8.5 | 4.1 | 7.7 | 6.7 | 6.3 |
| Private consumption | 200.0 | 69.4 | 2.0 | 8.4 | 14.6 | 9.6 | 13.8 | 11.9 | 9.9 |
| Public consumption | 52.4 | 18.2 | 2.1 | 7.7 | -4.9 | 9.0 | 2.5 | 4.8 | 5.1 |
| Gross fixed capital formation | 66.5 | 23.1 | 5.9 | 8.6 | 11.1 | 12.6 | 16.1 | 14.6 | 13.7 |
| of which : equipment | 32.4 | 11.3 | 7.6 | 18.0 | 8.2 | 12.9 | 14.5 | 13.8 | 13.5 |
| Exports (goods and services) | 94.9 | 32.9 | 11.2 | 8.4 | 13.9 | 8.1 | 10.6 | 9.4 | 8.1 |
| Final demand | 412.7 | 143.3 | 2.2 | 8.4 | 12.5 | 8.0 | 12.3 | 11.3 | 9.7 |
| Imports (goods and services) | 124.7 | 43.3 | 10.3 | 16.0 | 22.1 | 16.6 | 23.0 | 21.6 | 17.1 |
| GNI at constant prices (GDP deflator) | 279.7 | 97.1 | 0.6 | 3.9 | 6.4 | 5.5 | 7.5 | 6.9 | 6.6 |
| Contribution to GDP growth : Domestic demand | | | 3.7 | 8.8 | 11.1 | 10.9 | 13.8 | 12.8 | 11.3 |
| Stockbuilding | | | -2.3 | 0.1 | 1.9 | -2.2 | 0.3 | 0.5 | 0.2 |
| Foreign balance | | | -0.5 | -3.6 | -4.5 | -4.5 | -6.4 | -6.6 | -5.2 |
| Employment | | | -2.3 | -0.3 | 0.4 | 0.2 | 2.8 | 1.2 | 1.0 |
| Unemployment rate (a) | | | 6.2 | 7.0 | 8.1 | 7.2 | 7.4 | 7.2 | 7.1 |
| Compensation of employees/head | | | 84.8 | 22.7 | 17.8 | 19.3 | 17.8 | 16.7 | 14.0 |
| Real unit labour costs | | | -0.3 | -6.2 | -5.2 | 2.2 | 1.8 | 0.8 | 0.1 |
| Savings rate of households (b) | | | - | - | - | - | - | - | - |
| GDP deflator | | | 79.9 | 24.0 | 15.0 | 12.2 | 10.4 | 9.8 | 8.1 |
| Private consumption deflator | | | 79.6 | 15.2 | 13.9 | 7.1 | 5.1 | 4.3 | 3.8 |
| Harmonised index of consumer prices | | | - | 15.3 | 11.9 | 9.1 | 6.6 | 4.6 | 4.5 |
| Trade balance (c) | | | -6.8 | -7.6 | -8.7 | -9.8 | -12.1 | -13.9 | -14.8 |
| Current account balance (c) | | | - | -4.8 | -5.0 | -8.7 | -10.3 | -12.1 | -12.3 |
| Net lending(+) or borrowing(-) vis-à-vis ROW (c) | | | -4.0 | -4.3 | -4.1 | - | -10.3 | -11.2 | -11.4 |
| General government balance (c)(d) | | | - | -1.5 | -1.5 | -1.4 | -1.9 | -3.2 | -3.2 |
| Cyclically-adjusted budget balance (c)(d) | | | - | -0.6 | -1.7 | -1.2 | -2.2 | -3.5 | -3.3 |
| Structural budget balance (c) | | | - | -0.6 | -1.7 | -1.2 | -2.2 | -3.5 | -3.3 |
| General government gross debt (c) | | | - | 21.5 | 18.8 | 15.8 | 12.4 | 12.8 | 13.1 |

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.
(d) Including proceeds relative to UMTS licences (see for more details note 10 on concepts and sources).

## 2. General Economic Situation

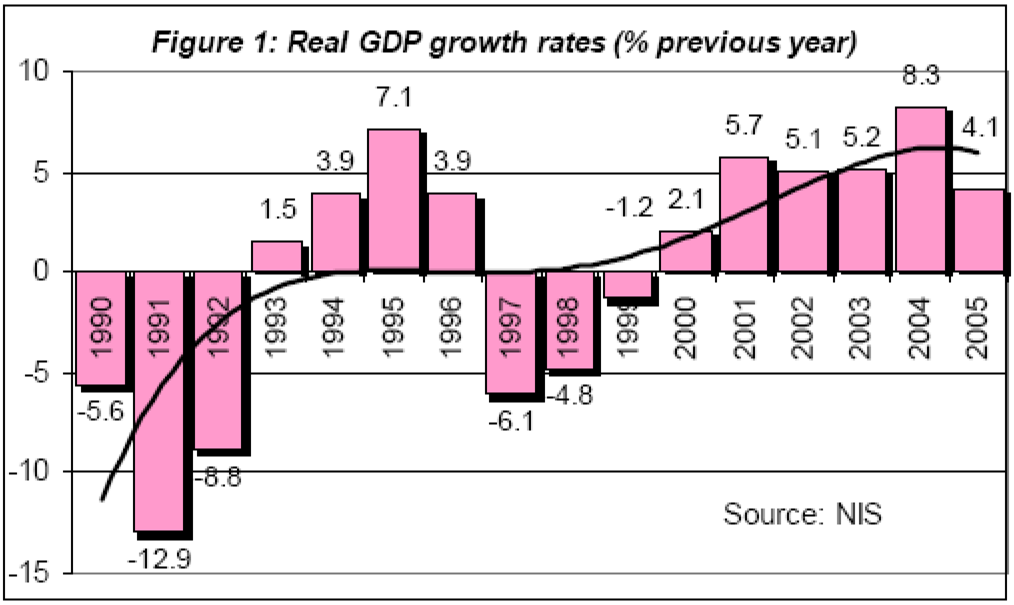
### 2.1 Political Environment and Economic Reform

**Transition and political turmoil**

The pace of economic reform in Romania was substantially slower in the 1990s than in the transition economies in central Europe that joined the EU in 2004. The governments between 1990 and 1996 were dominated by former communists, the Social Democratic Party (SDP). This government failed to implement critical market-economy-related structural reforms to the economy. The centre-right Democratic Convention (DC) between 1996 and 2000 tried to promote market-oriented policies, with limited success. At the end of 2000, the assessments of economic progress by both the European Commission and IMF were damning.

In 1997-99, Romania had experienced a severe recession, depicted with the following graph with the real GDP growth rates since transition.

*Figure 1: Economic Growth in Romania after transition*




*Source: National Institute of Statistics, Romania, from Zaman (2007)*

**Aggressive reforms and positive macroeconomic developments after 2000**

Since 2001 there has been some progress. The SDP government between 2001-04 proved to be more committed than its predecessors to implement prudent macroeconomic policies and impose financial discipline on enterprises. Output growth accelerated compared to the early years of transition, narrowing the income gap with the EU. The National Bank of Romania (NBR) achieved substantial disinflation, while macroeconomic stabilization and EU accession prospects helped boost investment, productivity, and potential output.

The economic policies of the coalition government that came to power at the end of 2004 have been largely determined by the pro-market policies of the government's largest parliamentary grouping, the National Liberal Party (NLP). The government introduced a 16% flat-rate tax on income and profits; revised the Labour Code, which was seen as one of the main factors contributing to labour market inflexibility; accelerated the liberalisation of the capital account; and shifted monetary policy away from exchange-rate targeting towards inflation targeting, largely to meet the targets required for EU accession in 2007.

**Lax fiscal policy and high current account deficit remain**

The potential threats to the Romanian economy currently concern relatively loose fiscal policy, which has made monetary policy more difficult. Macroeconomic stabilisation has been further complicated by the liberalisation of the capital account as capital inflows contributed to a significant real appreciation of the leu in 2005-06, which in turn pushed up the current-account deficit. Reductions in interest rates in 2005 encouraged an overly rapid expansion of consumer credit, which contributed to a surge in imports of consumer goods and led to the policy being reversed in 2006.

**Currently reform fatigue**

Enormous efforts to meet EU membership criteria have resulted in some form of reform fatigue at the moment. The political turmoil experienced in Romania in the spring has not been detrimental to the economy yet but this situation of disjuncture between weak politics and robust economic performance cannot last forever. Investor confidence in Romania’s prospects has been high, but ongoing political tensions may eventually impact investor sentiment.

## 2.2 Recent Economic Performance

### Growth has been strong[3]

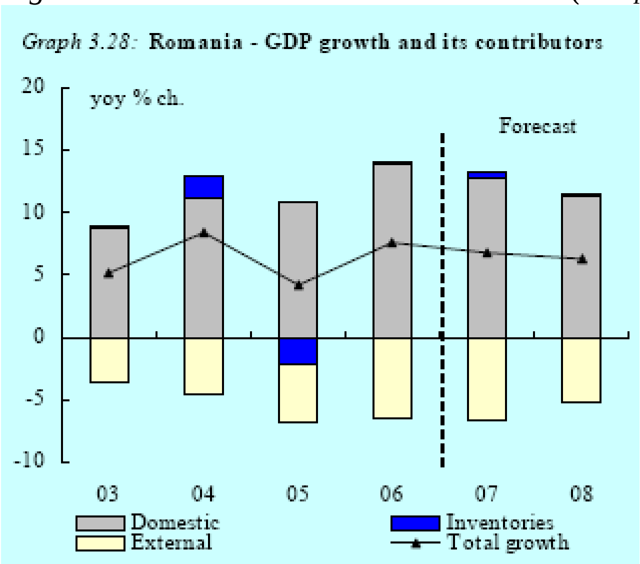
Economic growth in Romania in 2006 equalled 7.7%, and for 2007 a figure of 6.7% is estimated.

After a slowdown in 2005, mainly due to the negative impact of floods, real GDP growth picked up to 7.7% in 2006, as compared to 4.1% in the year before. This growth performance is mainly driven by strong domestic demand, especially private consumption, due to wage growth and a sharp increase in domestic credit availability. Also investment was strong, supported by considerable FDI inflows, flood repairs and the acceleration of public investment projects. On the supply side, services were the largest contributor to GDP growth, whereas the highest growth rates were recorded in the construction sector.

Strong domestic demand has resulted in a further widening of the trade deficit to 12.1% of GDP in 2006, up from 9.8% in 2005. Thus, net exports contributed negatively to growth, notwithstanding increasing current transfers from abroad.

[3] Chapter draws largely on European Commission Spring Forecast 2007.

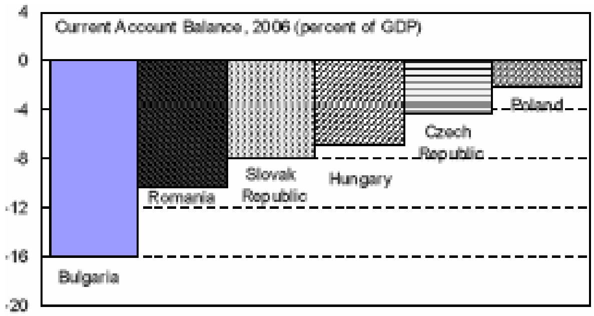
*Figure 2: GDP Growth and its contributors (European Commission, Spring Forecast 2007)*




## Current account deficit and fiscal loosening pose potential threats

The current account deficit has widened recently, reaching 10.3% of GDP in 2006 (12.1% projected for 2007), 90% of which was covered by FDI and capital transfers.

*Figure 3: The current account balance in 2006 in selected countries (% of GDP)*




*Source: IMF 2007*

As can be seen in the figure above, the use of foreign savings to finance the Romanian economy is still considerable, and higher than in most New Member States. Only the Bulgarian figure is even more exorbitant in this regard.

Although EU convergence requires increased investment and foreign savings, the ongoing widening of the external imbalance is disconcerting. Moreover, a pro-cyclical fiscal loosening exacerbates excess demand and heightens vulnerabilities. Rapid credit expansion is problematic. Currently pressures of overheating are present, but not imminent. There is some hope of this being corrected through privatization receipts and increasing national savings.

# 3. Economic Policy Areas

## 3.1 Monetary policy

**Inflation targeting regime**

Romania follows an inflation targeting regime (since August 2005). Inflation has been falling from 4.6% in 2006 to 3.8% headline inflation in June 2007. The year-end inflation targets are 4% for 2007, 3.8% for 2008, both within a 1%-band. The NBR warned in May that the fall in inflation experienced in the first half of 2007 will be reversed in the second half and in the first three quarters of 2008 due to laxer fiscal policy, productivity gains as well as increases in administered prices.

Consumer price inflation declined to 6.6%, but the disinflation process slowed despite the drop in food prices, the lowering of the world market price of oil and the fall in import prices caused by the real appreciation of the domestic currency.

The NBR expects the exchange rate to have a dampening effect on the inflation rate in the rest of 2007, but the opposite cannot be excluded.

**Controversial cuts in interest rates**

The National Bank of Romania (NBR, the central bank) has reduced its monetary policy rate (the maximum level for money market deposit-taking) from 8.75% to 7% in four stages in February, March, May and June 2007. Although the cuts in interest rates were stimulated by the better than expected falls in inflation over the period, real interest rates have fallen progressively since January, after rising between May 2006

The NBR also indicated that it would continue to partially sterilise excess liquidity through open-market operations, in order to deter volatile capital flows. The NBR's reference rate (the effective sterilisation rate at which the central bank drains liquidity from the market) has also fallen, from 8.75% in February to 7.25% in June. The IMF has indicated that it considers the interest rate cuts to be premature and has urged the authorities to increase interest rates in order to achieve its inflation targets.

**Exchange rates**

The leu has appreciated sharply against both the euro and the US dollar since the start of 2007. The currency is being driven up by large, speculative foreign inflows that are attracted by relatively high interest rates, the full liberalisation of the capital account, and the move away from exchange-rate targeting to inflation control. The target date for Romania's adoption of the euro is 2014. Romania does not plan to enter ERM II before 2012.

**The real exchange rate and competitiveness[4]**

The average real effective exchange rate increased by a cumulative 25.5% against a trade-weighted basket of currencies in 2005-06. A further significant appreciation is expected in 2007 and, with it, increased lobbying of the central bank by exporters to intervene so as to prevent an overly rapid appreciation of leu. There is also a risk of a sudden reversal of sentiment, should Romania's political crisis worsen, or in the event of an external shock, putting downward pressure on the leu.

[4] Draws largely on IMF, Article IV Consultation with Romania, Staff Report 2007

Equilibrium-based indicators of Romania's real exchange rate (RER) suggest that there is still room for further appreciation, albeit at a measured pace. Romania has long benefited from low wages vis-à-vis other economies. Research done by the IMF suggests that Romania's RER has been significantly undervalued throughout the 1990s, and that although the implied extent of undervaluation has narrowed since 2000, a gap of some 20 percent between the actual and the equilibrium wage remains.

Similar results are obtained from a PPP-based measure. When compared to a world wide benchmark, transition economies have shown undervalued exchange rates for most of the transition. This is not surprising, given that most transition economies started the 1990s with extremely competitive costs and significantly undervalued RERs. Most experienced a trend real appreciation over the past decade, and looking forward, Romania is likely to continue along a similar path. Recent exchange-rate developments form part of a larger, ongoing structural process, and should not yet be viewed with undue alarm.

## 3.2 Fiscal policy

**Deficit**

Despite higher revenues thanks to higher than expected growth, the 2006 general government deficit increased to 1.9% of GDP, compared with 1.4% in 2005, mainly owing to an increase in public wages, government consumption of goods and services and social transfers.

The 2007 budget foresees a procyclical expansion. The government is estimating a budget deficit for 2007 of 2.8% of GDP. However, the deficit may increase to 3.2% of GDP (European Commission, Maastricht criteria compatible ESA95 figure) and is expected to remain at the same level in 2008. The IMF warns that the deficit could even be as large as 3.7% in 2007 due to overoptimistic revenue targets and increased spending on social transfers and wages.

**Revenue**

Revenues from direct taxes are projected to increase relative to GDP, fuelled by favourable macroeconomic conditions and the continued efforts to broaden the tax base and to improve tax collection.

**Expenditure**

However, the increasingly relaxed expenditure policy will cause considerably higher current spending, notably on social transfers and wages, as well as in capital expenditure, even though implementation difficulties might not allow the government's ambitious investment programme to be met. Furthermore, uncertainties over the additional budgetary impact of the Property Fund scheme for compensation of citizens for the non-return of confiscated property may exacerbate budgetary pressures.

**Debt**

The stock of public debt is expected to remain stable at around 13% of GDP, mainly thanks to strong nominal GDP growth.

## 3.3 Labour market[5]

Despite the contraction of several labour-intensive industries (especially textiles and clothing), employment recorded a high growth rate in 2006 of 2.8%, the increase coming on the back of buoyant economic activity, sustained FDI inflows and a reduction of the informal labour market due to the tax reform in 2005.

**Labour shortages and skill mismatches**

The sharp fall in registered unemployment in the first four months of 2007 provides a statistical indication that Romania is starting to experience labour shortages, which could reignite inflationary pressures if fiscal and monetary policies are not tightened. The situation in the domestic labour market is further aggravated by the 2 million Romanians estimated to be working abroad. Most EU countries enforce a range of transitional arrangements on labour migration from Romania. As restrictions on Romanian migrants are progressively removed, labour migration to the EU is expected to increase, leading to calls for improved government incentives to persuade Romanian workers to stay at home.

**Crisis in construction**

The National Employment Agency (ANOFM) has reported a sharp mismatch between labour vacancies and the demands of job-seekers, together with shortages of job-seekers with the skills to fill higher-paid vacancies. The most serious shortages are in the booming construction sector, with some estimates indicating demand for a further 600,000-700,000 workers in addition to the 300,000 already employed.

**Participation**

According to a survey published by the National Statistical Institute (INSSE), the participation rate of 15-64 year-olds in the economy was only 57.4% in the fourth quarter of 2006, compared with a target of 70% for 2010 as set out in the EU's Lisbon strategy.

**Unemployment**

Unemployment is substantially higher in urban than in rural areas, reflecting the increased likelihood of self-employment in agriculture. Unemployment is also negatively correlated with age, with young people experiencing the highest rates, and negatively correlated with education, with the least educated hit hardest. Unemployment is highest among the urban young, with 29.1% of the active population in the 15-24 age group registered as unemployed.

[5] Draws largely on Economist Intelligence Unit, Country Profile, 2007

# 4. Financial Services

## 4.1 Banking

The Romanian market is still significantly under-banked generating continued high growth (+55%YoY in 1st quarter 2007). Mortgage lending penetration is low although the rest of consumer lending is taking off. SME lending is still not getting off the ground. A climate of regulatory relaxation as well as introduction of new products and improved cross-selling are all helping to improve the market competitiveness. The key challenges for the banking market are competition from foreign banks as currently 67 foreign banks have registered in order to provide services. For the Romanian banks this means a possible impact on their margins and market share. This is important as the Romanian financial markets are bank based as the capital markets are not very developed

A major development for the banking market is that the National Bank of Romania (NBR) is now also lowering capital requirements as from 1 January 2007 from 12% to 8%. Overall capital adequacy ratios are still very comfortable for the local banks which exceed this ratio by comfortable margins at an average of around 17%, for large banks this figure goes to 13% (NBR).

The main banks are: BCR; BRD (Groupe Societe Generale), Raffeissen, Unicredit-HVb-Tiriac; Transilvania and Carpatica. There are two state owned banks: The Romanian Savings bank (CEC) and the Export-Import Bank (EXIM) of Romania, the latter being present both in banking and insurance. All banks are supervised by the NBR.

**Payment Systems**[6]

The NBR has to oversee payment systems and is empowered to issue regulations concerning payment systems (Law No 58/1998).

In 2005, the NBR licensed the electronic system for the multilateral settlements of payments (SENT) which is operated by TRANSFOND (national company for funds transfer and settlement BNR together with a number of banks are stock holders).

In order to develop a payment system in Romania in line with the EU, the NBR carried out a project with PHARE Funds to develop an integrated electronic payment system (EPS). This became operational in October 2005.

E-banking and home-banking have also been increasingly developed in the last few years by 20 banks.

**Retail**

Currently Romania is at a credit/GDP ratio of 26.6% at the end of 2006, compared to an EU average of 43%. Romania seems to be heading for the higher leverage model of the Balkan countries rather than the more conservative Central European countries. Total banking assets grew by 34%YoY in 2006 driven by retail growth of 83%YoY[7].

Products that would seem to take off are mortgages, which in 2006 stood at only 2.3% /GDP. This will also be dependent on banks using mortgage securitisation in order not to use their balance sheets. Romania has 98% homeownership rate, thus much will depend on changes in the housing market with for example house prices rising.

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[6] ECB Blue Book August 2007

[7] ING Banking Report April 2007

Romanian banks have also been busy increasing their retail networks; in 2006 they opened 1200 outlets, bringing the total to 4300. This figure could reach 5700 by end 2007, which translates as 26 outlets per 100.000 inhabitants by end 2007, not far from the EU average of 32 (NBR).

Regarding mortgages the NBR has eliminated as of March this year an obligation to request a cash advance from customers seeking a mortgage.

**Wholesale**

Romania has significant levels of corporate loans of GDP; In Hungary SME's represent 45% of total corporate loans, suggesting that Romania could go towards this ratio too as EU accession is stimulating an SME led economy. The EBRD is currently doing much to stimulate the SME lending sector and on 28 August issued a press release regarding its support for Raiffeisen Leasing Romania with a loan of EUR 15 million to support the development of SME's. The loan will be used to on lend to local companies to help them acquire equipment for their business. This is part of an EBRD/EU led initiative on leasing.[8]

## 4.2 Insurance

In 1952, the Romanian insurance sector was nationalised under the Administration of State Insurance (ADAS). Several insurance classes were compulsory. This environment was changed after 1990 when the state monopoly was removed. The assets and liabilities of ADAS were split into 3 companies; Asigurarea Romaneasca, Astra and Carom created with 100% state capital until 1991 when 30% of their capital was privatised.

During the remainder of the 90's other insurance companies were set up; in 2000 the Insurance Supervisory Commission was set up and its members nominated for 5 years.[9] The main company in terms of market share of life insurance gross premiums is ING for almost half the total amount outstanding.

## 4.3 Securities

The Bucharest Stock market has evolved significantly since its reopening in 1995; in 1995 it organised one trading session per week with an average turnover of USD 200.000 and a total capitalization of USD 100 million. Currently volumes are in the region of an average daily turnover of USD 10 million with a capitalisation of USD 17 billion (BSE). In 2006 there were two IPOS. Compared to Bulgaria which although much smaller in terms of daily turnover and market capitalisation, Romania has been lagging in index evolution; 22.20 compared to Bulgaria's 48.30.[10]

The goal of the Bucharest Stock Exchange (BSE) is to achieve EU standards by increasing the quality standards and the indicators in order to safeguard a regulated environment. The RASDAQ electronic exchange (BER) dates from 1996, it merged with the BSE using its clearing system. According to the Law No 297/2004 on Capital Markets the BSE must externalise its registration, depository, clearing and settlement functions by creating a separate entity the CSD.

[8] EBRD Aug 28 Press release
[9] UNSAR report 30 June 2006
[10] ING Report Romania in the EU February 2007

In 2006 the new law on Capital Markets was the beginning of the process of changing the legal framework of the BSE; establishing a central depository and setting up an investor's compensation fund.

On the 14th of June 2007 the BSE was authorised by the Romanian National Securities Commission to establish a derivatives market, starting with futures on BET indexes.[11]As of August 20th, a new calculation formula for the indices was announced.

## 4.4 SPI Romania project; Convergence of Capital Market[12]

In July 2005, the World Bank and Italy joined in a partnership to promote convergence and financial modernisation for regulatory authorities and market participants in South East European Countries.

In Romania the NBR and the Romanian Banking Association set up a financial sector modernisation program. Issues that have been dealt with are credit information, electronic settlement of debit payment instruments, a regulatory impact assessment is used to accompany these measures.

[11] BET index=Bucharest Exchange traded Index first launched September 1997
[12] www.spi-romania.eu

## 5. Corruption and Judicial System Reform

One of the major remaining problems in Romania relates to corruption. The country ranks as the by far worst EU Member in the annual Corruption Perception Index (CPI) published by Transparency International. It has been ranked number 84, while the second worst EU members are Bulgaria (57) and Poland (61). In Annex 1 to this briefing a table is attached which sets out all EU members and applicant countries in the order and ranking in the CPI of 2006.

*Table 3: Transparency International CPI 2006, EU Countries + candidates*

| Ranking | Country | Score | | Ranking | Country | Score |
|---|---|---|---|---|---|---|
| 1 | Finland | 9,6 | | 28 | Slovenia | 6,4 |
| 4 | Denmark | 9,5 | | 37 | Cyprus | 5,6 |
| 6 | Sweden | 9,2 | | 41 | Hungary | 5,2 |
| 9 | Netherlands | 8,7 | | 45 | Italy | 4,9 |
| 11 | Austria | 8,6 | | 46 | Czech Republic | 4,8 |
| 11 | Luxembourg | 8,6 | | 46 | Lithuania | 4,8 |
| 11 | UK | 8,6 | | 49 | Latvia | 4,7 |
| 16 | Germany | 8 | | 49 | Slovakia | 4,7 |
| 18 | France | 7,4 | | 54 | Greece | 4,4 |
| 18 | Ireland | 7,4 | | 57 | Bulgaria | 4 |
| 20 | Belgium | 7,3 | | *60* | *Turkey* | *3,8* |
| 23 | Spain | 6,8 | | 61 | Poland | 3,7 |
| 24 | Estonia | 6,7 | | *69* | *Croatia* | *3,4* |
| 26 | Portugal | 6,6 | | **84** | **Romania** | **3,1** |
| 28 | Malta | 6,4 | | *105* | *Macedonia* | *2,7* |

*Source: ICGG, University of Passau*

On 27 June 2007, a European Commission report set out and made a detailed assessment of the progress made by Romania in the areas of judicial reform and corruption.[13] The following is an extract from the Commission memo in June:

> "In all areas, the Romanian authorities demonstrate good will and determination. They have prepared the necessary draft laws, action plans and programmes. However, the real test can only be met through determined implementation of these actions on the ground every day. There is still a clear weakness in translating these intentions into results. Romania has stepped up efforts at the highest levels in the fight against corruption. While recognizing these efforts much remains to be done. Progress in the short time since the Cooperation and Verification Mechanism was set up is still insufficient.
>
> Deeply rooted problems, notably corruption require the irreversible establishment and effective functioning of sustainable structures at investigative and enforcement level capable of sending strong dissuasive signals.

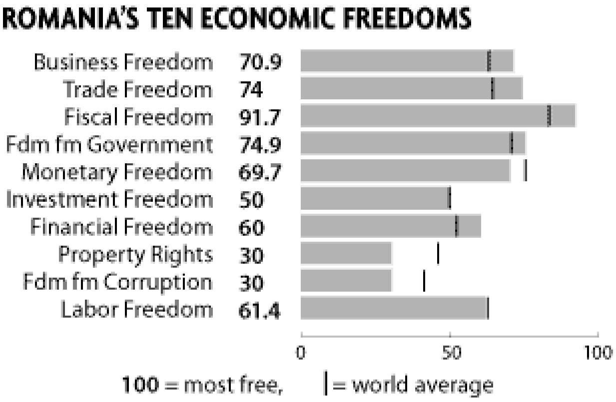
[13] On 1 January 2007, the Commission was asked to report on the accompanying measures on a regular basis. In the case of the Cooperation and Verification Mechanism, reports have been requested on a six monthly basis, starting in June 2007.

In addition, the structural changes which are needed impact on the society at large and require a step change which goes much beyond the mere fulfilment of the benchmarks. This requires a strong long term commitment by Romania and can only be successful if the strict separation of the executive, legislative and judicial power is respected and if stable political conditions and commitment are in place."

**Ease of doing business and economic freedom**

Several institutes publish indicators about economic freedom and ease of doing business in different countries. In the Ease of Doing Business Index of the World Bank, for example, Romania scores 49th in the world, and several other EU member states still score worse. However, the story gets more interesting when examining the detailed components of these aggregate indices. To give one example: the Index of Economic Freedom is published by the US based Heritage Foundation. Although its meaning should not be overvalued, it displays one interesting "relative" message. While Romania is an "average country" in most aspects of economic freedom, it clearly lags behind the world average in the area of securing property rights and freedom from corruption. This underlines the urgent need for change exactly in these very areas.

*Figure 4: Index of Economic Freedom*




*Source: Heritage Foundation, 2007*

MEPs had doubted Romania's readiness for EU membership from the point of view of corruption already in the report on "Romania's Progress Towards Accession" in 2004 (Rapporteur: Moscovici). Following this, the newly elected government took various initiatives, but the real impact has been modest. Prominent cases of corruption, which also EU officials have criticized loudly, concern some infrastructure projects such as motorways required for Romanian EU entry, which were given to overseas contractors without any public procurement procedures in place.

The question of corruption remains an imminent one in Romania. As all areas of economic and social life seem to be "infiltrated" with the need for corrupt practices, the correction of this is likely to be a long-term process going beyond the mere rewriting of laws toward a holistic change in "mindsets". Education of the people and the transparency of the public sector will be key to this challenge.

# 6. Economic Outlook[14]

**Strong domestic expansion and loose fiscal policy**

Real GDP growth is expected to decelerate from 7.7% in 2006 to 6.3% in 2008. Industrial activity is projected to remain resilient against the backdrop of the challenges posed by EU accession and the redirection of output growth towards higher value added sectors.

Strong domestic demand dynamics are foreseen to persist for the foreseeable future. Gross fixed capital formation is expected to grow robustly, by around 14% annually, outpacing the growth in consumption expenditure, on the back of continued FDI inflows and public investment. Private consumption growth will remain buoyant due to high wage growth and surging credit growth, both in leu and foreign currency. Public consumption is expected to record a steady expansion, mainly driven by an increase in wages and social transfers.

Annual average consumer price inflation is expected to gradually decline to around 4.5% in 2008, consistent with a relatively tight monetary policy. In addition, falling import prices thanks to the appreciation of the currency and a slow adjustment of administered prices towards cost-recovery levels will help contain inflation. However, the fiscal stimulus, the evolution of credit growth and the evolution of public sector wages will put some upward pressures on inflation from the demand side.

An increase in employment of about 1% is anticipated over 2007-08, which is lower than in 2006, but higher than the modest increases of around 0.3% in 2004-2005. The job creation process in the private sector will be sustained by high foreign investments and a further reduction of the informal economy, offsetting the ongoing lay-offs in state-owned enterprises and some labour-intensive industries.

Robust domestic demand, supported by buoyant credit expansion and the appreciation of the currency fuelling imports as well as the envisaged loosening of fiscal policy are likely to contribute to a further widening of the current account deficit, which is expected to reach 12.3% of GDP in 2008, in spite of increased EU transfers and higher remittances from abroad. Capital transfers linked to EU funds will mitigate the impact on the external balance.

[14] Largely following the Commission Spring Forecasts (DG ECFIN)