New Europe Economic Dossier aims to provide a structural view on the evolution of the various countries in the region, highlighting the main achievements and the open challenges. Each issue is dedicated to a specific country and includes an analysis of the economic situation plus an interview to a leading figure for the future of the country. The dossier is edited by the New Europe Research Network of UniCredit.

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Romania: new European destiny ahead

Romania was one of the first CEE countries to show commitment towards EU membership by the mid '90s, but it took more than a decade until the accession turned from a mere possibility into an expected reality.

The start of transition in Romania was quite costly. The side-effects of the transition to a market-driven economy (i.e. inefficient allocation of resources, low and ineffective regulatory environment) culminated at the end of the 1990s in an economic recession and banking crisis that dragged on for some years. As after 2000, Romania experienced a breakthrough to economic growth and banking recovery, boosted by the start of EU accession and acceleration of structural reforms. In 2000 the country recorded its first year of real GDP growth at 2.1 percent. With the strengthening of the economic upswing in 2001 – supported by strong export performance and a gradual increase in aggregate consumption and investment – Romania began to show tangible progress on the path of reform and restructuring. As a result, economic growth has averaged 5.7% in the 2001-2005 period reaching its peak to 8.4% in 2004 – the fastest growth in the post-Communist era.

A similar pattern of economic performance is also expected for the future as a precondition in catching-up the other EU economies. The increased dynamics of investments over consumption is marking a gradual shift from a consumption – driven economic expansion towards a more intensive, sustainable growth. Following the pattern of more advanced economies, services are becoming increasingly relevant, while agriculture and industry, although decreasing their importance still represented 10% and 28% of GDP, respectively at the end of 2005. Industry performance has been conditional over a late and slow privatization process (almost but not fully over) of the State – owned industrial giants. The important FDI inflows absorbed in the past years resulted in a gradual restructuring of industry, still below the potential performance.

The unconvincing reforms and the economic, legislative and institutional instabilities kept important FDI inflows out of Romania in the first decade of transition. As the macrostabilization process advanced, growing FDIs shifted to Romania which has become, since 2004, one of the countries with the highest potential in the region in attracting foreign investments. FDIs have been largely backed by privatizations and very recently also green field investments started to become relevant favored by EU accession prospects, still cheaper labor force, appealing taxation and improving business environment.

The switch from a relatively closed economy at the beginning of the 1990s to an increasingly opened one was necessarily followed by large external deficits. The reduced competitiveness of domestic products – although artificially supported by the exchange rate movements – resulted in low value-added exports while demand for imports remained high. These trends marked large deficits over the last years, typical for transition economies.

ECONOMIC AND MONETARY DEVELOPMENTS ON THE WAY TO THE EU

	2003	2004	2005f	2006f	2007f
Real GDP yoy %	5.1	5.2	8.4	4.1	5.5
Net Export Contribution to Growth %	0.9	-3.6	-4.5	-5.0	-4.2
Current Account/GDP	-3.3	-5.8	-8.4	-8.7	-9.2
Foreign Direct Inv./GDP	2.5	3.7	8.5	6.6	7.2
Unemployment Rate, avg	10.2	7.6	6.7	5.8	6.1
CPI yoy %, avg	22.8	15.3	11.9	9.0	7.8
RON/EUR, eop	3.49	4.11	3.97	3.68	3.49
Reference Rate, eop	20.40	20.41	17.96	7.5	9.5
Fiscal Balance/GDP	-2.5	-2.3	-1.2	-0.8	-1.0
Public Debt/GDP	28.9	25.9	23.1	19.8	18.4

Consequently, the increasing need for alternative sources determined a gradual expansion of the foreign debt from a zero base at the start of transition to 31% of GDP in 2005.

Monetary authorities have proved to be strongly committed in bringing down inflation to a level compatible with a stable macroeconomic environment.

The road to present 6.9% yoy inflation reported in April was cumbersome, with phases of hyperinflation experienced before 1998, inconsistent support on the fiscal side and the necessity for Central Bank to

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keep close control over both the monetary and foreign exchange policies in order to ensure macroeconomic stability. Accordingly, before the very recent switch to inflation targeting regime, Central Bank pursued a rather dual objective of preserving both prices and exchange rate stability. The past-year Central Bank achievements in terms of disinflation were notable, despite the repeated marginal departures from the established targets. The supply-side pressures resulting mainly from the adjustments of the administered prices and excise duties cumulated with an expansionary aggregate demand were the main factors to put considerable pressures on inflation in the recent years. Considerable disinflation advancements are still needed in view of EU accession. We believe the NBR could efficiently intensify the efforts towards setting the inflation on a path compatible with the nominal convergence process and support ERM-II entry by 2010-2012 and the overall real convergence process.

The fiscal policy encountered no major difficulty in keeping the budget deficit to sustainable levels. To this end, the long dependence on IMF financial resources and technical assistance played an important role in defining prudent fiscal policies. Apart from this, the authorities have so far lagged behind in terms of designing a clear medium to long term expenditure strategy and managing the insufficient budget resource problem. Consequently, the Government failed to deliver constant visible results over the necessary infrastructure and social securities programme. The greatest challenge the authorities are facing today is to increase the budgetary resources via better tax collection and increase in the taxation base, without operating any hike to major tax rates such as VAT or company tax. The latter option seems unavoidable in view of the resources needed to support the fund-demanding infrastructure process, to increase EU funds' absorption capacity and to meet the fiscal obligations resulting from the forthcoming EU accession. The latter event is expected to stimulate further improvements at all levels, although some temporary deviations might occur.

Following the beginning of EU negotiations in 2000, the subsequent efforts to meet the EU requirements translated into an acceleration of reforms and visible advancement at the macro level. In April 2005 the Accession Treaty was signed, with accession expected for January 2007 unless the general safeguard clause is activated in case of major shortcomings. The latest monitoring report published by the European Commission this May, keeps Romania on track with 2007 accession, although conditional upon further advancements. Although the progress made so far was widely acknowledged, there still remains four critical issues to be dealt with in the areas of paying agencies for agriculture, administration and control system in agriculture, food safety and tax administration IT system. Following accession, Romania is expected to face new challenges on the way to achieve compliance with the Maastricht criteria and speed-up the real convergence process.