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MEMORANDUM OF THE PRESIDENT

OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

AND THE

INTERNATIONAL FINANCE CORPORATION

TO THE

EXECUTIVE DIRECTORS

ON A

COUNTRY ASSISTANCE STRATEGY

OF THE WORLD BANK GROUP

FOR

ROMANIA

May 22, 2001

South Central Europe Country Unit
Europe and Central Asia Region

The International Finance Corporation
Southern Europe and Central Asia Department

The last Country Assistance Strategy for Romania was discussed by the Executive Directors in May 1997 (Report No. 16559 RO).

CURRENCY EQUIVALENTS

(Exchange rate as of May 11, 2001)

Currency Unit = Romanian LEI (ROL)
US$ = 28,412 ROL

GOVERNMENT'S FISCAL YEAR

January 1 – December 31

WEIGHTS AND MEASURES

Metric System

ACRONYMS AND ABBREVIATIONS

APL	Adaptable Program Loan
BCR	Romanian Commercial Bank
CAS	Country Assistance Strategy
CDF	Comprehensive Development Framework
CEB	Council of Europe Development Bank
CEC	Romanian Savings Bank
CEFTA	Central European Free Trade Agreement
CEM	Country Economic Memorandum
CGAS	Government Anti-Poverty Commission
CONPET	Commercial Enterprise for Crude Oil Transmission
DOTS	Directly Observed Treatment Shortcourse
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECA	Europe and Central Asia
EIB	European Investment Bank
EMS	Emergency Medical Services
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
FESAL	Financial and Enterprise Sector Adjustment Loan
FRY	Federal Republic of Yugoslavia
GDP	Gross Domestic Product
GEF	Global Environment Facility
GNP	Gross National Product
IAS	International Accounting Standards
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
ISPA	Instrument for Structural Policies for Pre-Accession
JPR	Joint Portfolio Review
M&E	Monitoring and Evaluation
MIGA	Multilateral Investment Guarantee Agency
MTES	Medium-Term Economic Strategy
NATO	North American Treaty Organization
NGO	Non Governmental Organization
OECD	Organization for Economic Cooperation and Development
OED	Operations Evaluation Department
PAL	Programmatic Adjustment Loan
PAYG	"Pay-as-you-go" Pension System
PCF	Prototype Carbon Fund
PDSR	Social Democracy Party of Romania
PER	Public Expenditure Review
P&PG	Public and Publicly Guaranteed
PSAL	Private Sector Adjustment Loan
PSC	Pension Supervision Commission
SAPARD	Special Accession Program for Rural Development
SBA	Stand-By Arrangement
SMEs	Small and Medium Enterprises
SNIF	State Land Reclamation Company
SOE	State-Owned Enterprise
SOF	State Ownership Fund
STD	Sexually Transmitted Diseases
TB	Tuberculosis
UK DFID	United Kingdom Department for International Development
UNDP	United Nations Development Program
USAID	United States Agency for International Development
WBI	World Bank Institute

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ROMANIA: COUNTRY ASSISTANCE STRATEGY

TABLE OF CONTENTS

TABLES:

TEXT BOXES:

ANNEXES:

THE WORLD BANK GROUP'S COUNTRY ASSISTANCE STRATEGY

FOR ROMANIA

EXECUTIVE SUMMARY

1. This document is presented to the Board at a time when Romania is turning away from its legacy of erratic macroeconomic management of the 1990s. After almost a decade of uneven reform efforts, the new Government that took office in December 2000 has begun laying plans for reforms needed for a successful economic transition, and eventual accession to the European Union (EU). The key challenge ahead is turning these plans into sustained actions.

Country Context

2. The starting point for the transition process in Romania was, in many respects, more difficult than in other countries in Central and Eastern Europe. Pre-transition policies emphasized self-reliance, which resulted in excessive focus on heavy industry and large infrastructure projects. During the 1980s, the rapid repayment of the US$11 billion foreign debt (20 to 30 per cent of gross domestic product (GDP)) imposed severe strains on the population, with deep cuts in imports and a widening of the technological gap. Towards the end of the 1980s the Romanian economy was on the verge of collapse and no attempts to reform had yet been made.

3. Given this difficult legacy, and seeking to protect vested interests and minimize the social costs associated with the transformation to a market economy, during the 1990s the Romanian authorities took a gradualist and piecemeal approach to reform. The imposition of hard budget constraints and privatization of state-owned enterprises were significantly delayed. While social concerns were understandable, this strategy failed to produce sustainable gains in either economic or social conditions. Given the experiences of the last ten years, the costs of a hesitant reform path have been higher than if a bolder approach to structural transformation had been adopted at the outset. Poverty has increased sharply, with the share of the population living below the national poverty line doubling in the second half of the 1990s, from 20 to 41 percent.

4. Lack of political will to reform, and constrained institutional and governance capacity are at the root of Romania's less-than-satisfactory economic performance and worsened social conditions. These two issues are evidenced by Romania's very high levels of enterprise arrears, that reached, at end-1999, 42 percent of GDP; frequent changes in legislation, with a strong reliance on emergency measures and few efforts to build the institutional capacity to enforce the new legislation, or to carry out new responsibilities; and an unattractive business environment. The instability in the legal framework and the delays in building needed administrative capacity have an acute impact on the delivery of health care and social assistance, especially to the poor, and on the business environment needed to attract foreign direct investment and private sector development. Many of these problems were reported during consultations held in 1999-2000, as part of the Comprehensive Development Framework (CDF) initiative, for which Romania is a pilot country. These consultations revealed a clear consensus among Romanians around the development objectives of poverty reduction and EU accession, and widely held views that

meeting these objectives would, in turn, require economic growth, strengthening of public institutions, greater access to opportunity, a strong social safety net, and sustainable development and protection of environmental and natural resources.

5. Cognizant of these widely held views, the newly elected Government has identified its priorities along the same lines. The Government's program lays the basis for a pragmatic approach to reforming the economy and raising living standards by improving the quality of Government services and creating an attractive business environment. An important milestone will be reaching agreement with the International Monetary Fund (IMF) on a Stand-By Arrangement, which would facilitate Romania's access to international capital markets, progress toward EU accession, and ability to attract foreign direct investment. Accordingly, the Government is in active discussions with the IMF on a macroeconomic framework and a possible Stand-By Arrangement.

6. In addition, the Government has taken action in a number of structural reform areas, including: (i) termination of all directed credit programs and all Government financing of rural and agricultural credit; (ii) a signed share sale-purchase contract for Banca Agricola; (iii) establishment of an Anti-Poverty Commission in the Office of the Prime Minister; (iv) and initiation of a 30 percent reduction in public administration staffing levels. In addition, the Government has committed to take action on several other fronts, in particular further privatizations.

7. Other important development challenges still remain, however, particularly with regard to further enterprise privatization, reform of the banking and financial sector, restructuring and deregulation of the energy sector, fiscal decentralization, land privatization and continued reform of the agriculture sector, access to quality education in rural areas, and reform of the pension system to ensure sustainability in the context of an aging population.

8. The Government needs to demonstrate a sustained commitment to accelerated reform and avoid reverting to a stop-and-go pattern of reform implementation, to secure complementary external financing. Romania's recent developments place the country in a particularly advantageous position to pursue accelerated reforms. After three years of negative real GDP growth rates, the Romanian economy began growing again in 2000, and is projected to reach around 4 percent real GDP growth rate in 2001. The economic recovery has been driven partly by a strong growth in exports, primarily the re-export of processed inputs from EU countries. The sustainability of the current economic recovery will depend on the new Government's ability to implement a coherent set of economic reforms, but will also be vulnerable to external shocks.

Country Assistance Strategy

9. The Bank Group's country assistance strategy presents two very distinct lending scenarios. If Romania reverts to pursuing a hesitant pace of reforms, Bank Group assistance will be very limited, centered on a few poverty-focused interventions, and significantly reduced from the levels of Bank Group support over the past four years (the low case). If, on the other hand, Romania sustains accelerated reforms, Bank Group assistance will support a broad set of structural and sectoral reforms to accelerate growth and pave the way for Romania's eventual

accession to the EU, in addition to an enhanced program of poverty focused interventions (the high case).

10. Adjustment lending would be important to support the accelerated reform scenario. Because of the Government's heavy structural reform agenda, adjustment loans account for about one-half of planned lending volume during FY02-04. The first such operation would aim at supporting reforms encouraging private sector development. This would be achieved through the proposed Second Private Sector Adjustment Loan (PSAL 2) program -- a follow-up to the PSAL 1 program. As a second stage, and post-PSAL 2, the Bank would support the Government's program of reforms of the institutional, regulatory, and governance framework, as well as continued reforms in the enterprise, financial and energy sectors. The Bank is considering supporting this reform agenda through a series of programmatic adjustment loans (PALs). The programmatic instrument would provide greater adaptability for step-by-step institutional reforms, capacity building that involves significant policy content, and an economy-wide scope that goes beyond individual projects. The use of a programmatic approach would depend on the country's ability to strengthen its procurement and financial management frameworks. Programmatic lending will be grounded in clear country commitment and capacity to reform, structured in a series of operations supporting a medium-term reform program, and disbursed on the basis of completed actions. Their content will be underpinned by the results of the Bank's advisory services (e.g., the forthcoming Public Expenditure Review). To prepare the ground for the possible use of programmatic adjustment lending, the Bank is assisting Romania to strengthen its procurement and financial management frameworks. Following the completion of the FY00 procurement assessment, a Country Financial Accountability Assessment is planned for FY02-03.

11. ***High-case lending scenario.*** Under this scenario**,** Bank commitments would increase to a maximum of $995 million during FY02-04, with three or four operations per year, in contrast to lending commitments totaling nearly $600 million during FY98-00 (including adjustment lending). This increase would be mainly due to adjustment lending (up to $550 million over the three-year period) to support the policy reform agenda associated with the accelerated reform scenario. Adjustment lending would be aimed at supporting private sector development and institutional and governance reforms, and would complement sector reforms under individual investment loans. Non-lending services in a high-case scenario would include at least four studies per year, plus several grants, technical assistance, and World Bank Institute (WBI) training in key areas of reform. IFC will complement the Bank's efforts in private sector development by focusing on four key areas: restructuring of municipal infrastructure, marshalling financing for post-privatization restructuring; supporting capital markets and SMEs development, and selected private sector investments in the forestry sector. Overall, the level of IFC activity will depend very much on the extent of improvements in the enabling environment for business in the country.

12. ***Triggers***. The high-case lending scenario would be triggered by Romania's progress in establishing a macroeconomic environment conducive to lower inflation and sustainable growth, as well as moving forward in the following key policy areas: (i) conclusion of the privatizations and work-outs initiated under PSAL 1; (ii) initiation of the privatization and work-out process for a number of remaining large state-owned enterprises; (iii) an agreement on a plan and timetable for reducing energy arrears; (iv) an irrevocable agreement on the method and timetable for

privatization of Romanian Commercial Bank (BCR) and the Savings Bank (CEC); (v) improvements in the financial sector legal and supervisory framework; (vi) an agreement on the process for developing an anti-corruption strategy; and (vii) the approval of agreed social assistance legislation (minimum income guarantee and social assistance framework law).

13. ***Low-case lending scenario.*** In the low-case lending scenario, Bank lending would be significantly reduced to a total of $60 million during FY02-FY04. The number of Bank operations would also be significantly reduced, to one or two per year. Lending instruments for FY02-04 would consist of one second-phase adaptable program loan, two technical assistance loans, and one investment loan. This minimal lending program would focus on reducing poverty and building capacity on a modest scale, and would be complemented by non-lending advisory services aimed at maintaining the policy dialogue with the authorities. This includes several fast turn-around policy notes (e.g., on energy sector issues), a Public Expenditure Review, and a Country Economic Memorandum focusing on EU accession.

Risks and Exposure Management

14. The Bank Group assistance strategy faces risks. The most important risk is political, and stems from potential divisions within the Government that would delay the articulation and implementation of a reform program. It took the previous Government nearly three years to put in place a reform program that could be supported by the international financial community, and this delay had an adverse impact on economic performance. If the new Government adopts a similar approach, it runs the risk of eroding the support of international financial institutions and access to credit markets, as well as triggering a steep deterioration in economic performance and, possibly, external financing difficulties. The new Government’s room to maneuver is much more circumscribed than in the mid-1990s because of the external debt build-up and the depletion of the country’s human and capital stock.

15. Political risk, while high, is mitigated by three factors. First, in contrast to the previous Government, the new Government is not a coalition and has shown signs of acting in a more disciplined and decisive fashion in some reform areas. Second, there is broad political consensus around the goal of Romania’s joining the EU. This should create additional momentum for reforms. Third, the international community has shown a clear commitment to continue to engage Romania in an active dialogue, including contacts at very high levels and regular participation in international events. The Bank in particular has maintained, and will continue to maintain, a strong presence in the country, including the provision of analytical and advisory services, even in the low-case scenario.

16. A fragile fiscal position and relatively large external financing needs over the next three years pose interrelated economic risks. Without early and decisive action to limit public spending and lending by state-owned banks, there could be a loss of confidence in economic management. These economic risks are exacerbated by the slippage in fiscal consolidation in late 2000 and early 2001 that eased pressures on state enterprises to restructure, and are likely to put additional strain on the balance of payments. Over the next few months, therefore, the international financial community is likely to assess the new Government’s commitment to reform by how well it manages its fiscal policy.

17. An important issue for the Bank Group is the composition of Romania's external debt, as the debt structure contains a high percentage of public and publicly guaranteed (P&PG) debt, particularly preferred creditors. Total debt outstanding (including short-term) was approximately $10 billion at the end of 2000 (or about 27 percent of GDP), of which nearly 70 percent was P&PG debt, and P&PG debt service accounted for 58 percent of total debt service, for a debt service ratio of 11 percent. The share of P&PG debt service is expected to reach 70 percent by 2002 in both the high-case and low-case lending scenarios, due to the undisbursed pipeline ($557 million as of January 2001).

18. The World Bank is the largest creditor, accounting for about 20 percent of the total debt outstanding and nearly 15 percent of P&PG debt service at end-2000. The Bank Group's CAS for Romania has been developed to ensure that further increases in exposure are closely matched by increases in overall creditworthiness as well as by proportionate burden sharing among the IFIs. The longer the high case is sustained, the more the Bank's relative exposure would be expected to decrease over time, as private sources of P&PG financing would be increasingly available under an accelerated reform program. In the low-case lending program, however, due to the undisbursed pipeline of $557 million (as of January 2001), and the likelihood of Romania's difficulty in accessing private financing, the Bank's relative exposure would remain high, even in the medium term.

Conclusion

19. While the new Romanian Government has taken a number of actions that signal its intention to accelerate the pace of reform relative to that of its predecessors, it will be important for this Government to demonstrate during the remainder of 2001 a sustained commitment to accelerated reform. It could make significant and sustained progress in fiscal management and structural reforms – particularly in the area of privatization – and hence adopt a program that could receive support from the Bank and the IMF. This would usher Romania into the high-case scenario by the end of this calendar year. Alternatively, the new Government could take a more hesitant approach to reforms, or even reverse past progress in some areas. This would result in a significant decrease in Bank Group support for two reasons. In the policy environment implicit in the low-case scenario, the Romanian Government should not commit its citizens to additional debt obligations, not least because Bank Group financing would not generate the growth needed to service the debt. In addition, there would be exposure and creditworthiness concerns on the Bank's side.

20. The Government will need to weigh the political as well as economic implications of its chosen pace of reform. However, with poverty reduction and EU accession as the long-term outcomes for which Romanians are striving, the Government is likely to conclude that the political and economic considerations converge rather than conflict. Should the Government pursue this conclusion in a sustainable way, the World Bank Group stands ready to support the Government's efforts to break critical bottlenecks in the reform process by ensuring improvement in the delivery of key services to the poor, moving forward on critical and irreversible steps of the privatization program, and helping to lay the foundations of key public sector institutions.

Agenda for Board Consideration

21. The Executive Directors may wish to discuss the following issues:

- Is the proposed dual scenario approach appropriate, given Romania's track record on reforms?
- Does the proposed World Bank Group strategy adequately support Romania's top priorities as identified during CDF consultations, namely, poverty reduction and EU accession?
- Are the proposed scenario triggers appropriate?
- Does the proposed World Bank Group strategy adequately address and mitigate against country and implementation risks?

**MEMORANDUM OF THE PRESIDENT OF THE
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
AND THE INTERNATIONAL FINANCE CORPORATION
TO THE EXECUTIVE DIRECTORS ON A
COUNTRY ASSISTANCE STRATEGY OF THE WORLD BANK GROUP
FOR ROMANIA**

I. COUNTRY CONTEXT

A. Introduction

1. The last Country Assistance Strategy (CAS) for Romania was presented to the Board on June 3, 1997. This CAS has been prepared jointly by the Bank and IFC with input from MIGA. The document was discussed in draft form with the Romanian Government, which endorsed the assistance strategy. The document also benefited from extensive in-country consultations with civil society (see Annex C).

B. Political Developments

2. The November 2000 elections brought back to power the center-left Romanian Party of Social Democracy (PDSR) that had governed the country from 1992 to 1996. The PDSR returned to power against the backdrop of worsening social and economic conditions for the Romanian population in the second half of the 1990s. The outcome of this election signaled expectations that a more cohesive and organized political grouping, such as the PDSR, would have greater success in achieving Romanians' broadly shared goals of poverty reduction and accession to the European Union (EU) (see paras. 14-15).

3. These objectives will need to be pursued, however, under significantly different political and economic circumstances than those that prevailed during PDSR's first tenure in office. The new Government can ill-afford to disregard the popular objective of EU accession. EU support of Romania's accession depends, in turn, on the Government's adopting reforms that will lead to Romania's becoming a functioning market economy – a condition it has not yet met, according to the latest EU regular report on Romania's accession (see Box 1).

Box 1: Relations with the European Union

The EU opened accession negotiations with Romania on seven of the 31 chapters of the *Acquis Communautare* in early 2000. Six of these chapters have been successfully closed, and the new Government is now elaborating position papers on eight other chapters. The new Government is also preparing an Action Plan for the Medium-Term Economic Strategy (MTES). The Action Plan will identify economic and structural reform measures broadly in line with EU policies, that could be supported by IMF and World Bank programs. This Action Plan for the MTES will guide day-to-day decision making on economic reform to move the Romanian economy toward becoming a functioning market economy. Romania is receiving substantial EU assistance under EU PHARE programs, and two pre-accession facilities (the Special Accession Program for Agriculture and Rural Development (SAPARD) and the Instrument for Structural Policies for Pre-Accession (ISPA)). Total disbursements under these three programs in 2001 could amount to as much as Euro (EUR) 650 million, or around 0.5 percent of Romania's GDP (see Annex D).

C. Social and Economic Developments

4. The starting point for the transition process in Romania was, in many respects, more difficult than in other countries in Central and Eastern Europe. Pre-transition policies emphasized self-reliance, which resulted in excessive focus on heavy industry and large infrastructure projects. This strategy led to the depletion of domestic energy sources, and induced a costly dependence on imports of energy and raw materials. During the 1980s, the rapid repayment of the US$11 billion foreign debt (20 to 30 per cent of GDP) imposed severe strains on the population. As there was no growth in exports (in dollar terms), imports from the west were cut roughly in half over the decade in order to repay the debt. The technological lag increased significantly as a result. Towards the end of the 1980s the Romanian economy was on the verge of collapse and no attempts to reform had yet been tried.

5. Given this difficult legacy, and seeking to protect vested interests and minimize the social costs associated with the transformation to a market economy, during the 1990s the Romanian authorities took a gradualist and piecemeal approach to reform. The imposition of hard budget constraints on the enterprise sector and privatization of state-owned enterprises (SOEs) were significantly delayed. While social concerns were understandable, this strategy failed to produce sustainable gains in either economic or social conditions. Given the experiences of the last ten years, the costs of a hesitant reform path have been higher than if a bolder approach to structural transformation had been adopted at the outset. Poverty has increased sharply, with the share of the population living below the national poverty line (defined as 60 percent of average adult equivalent consumption) doubling in the second half of the 1990s, from 20 to 41 percent (see Table 1 and Box 2).

6. The worsened economic and social conditions were the result of slow and at times erratic implementation of reforms. Only in mid-1999 did the previous coalition Government embark on an ambitious program of macroeconomic stabilization measures and structural reforms. The reform program was supported by the Bank (via the first Private Sector Adjustment Loan (PSAL 1)) and by the Fund (via a Stand-By Arrangement (SBA)). The centerpiece of the macroeconomic program was a strong fiscal correction, supported by tight monetary and incomes policies and an exchange rate policy designed to help restore external competitiveness. The Government's program also included improvements in the tax regime and to the legal

framework for financial transactions, the closure of Bancorex (the country's flagship state-owned bank, that at the time had 70 percent of its loans classified as doubtful or non-performing), and programs to mitigate the social impact of enterprise reforms.

Table 1: Poverty and Inequality in Romania

Year	**1996**	**1997**	**1998**	**1999**
GDP growth[a]	3.9	-6.1	-5.4	-3.2
Poverty (at national poverty line)				
Poverty headcount (percent)	19.8	30.8	33.8	41.2
Total number of the poor ('000)	4,488	6,945	7,609	9,252
Consumption shortfall as percent of poverty line	22.7	25.7	27	- - -
Extreme poverty headcount (percent)	5.1	9.5	11.7	16.6
Inequality (Gini Index, consumption)	0.30	0.28	0.30	- - -

[a] At market prices, calculated from 1993 prices
Source: National Statistical Institute and Romania Integrated Household Survey

7. The reform program resulted in an improved economic performance into the latter half of 2000. The large corrections in the fiscal deficit, the exchange rate and the tight monetary stance narrowed the current account deficit, and restored foreign exchange reserves to more comfortable levels. The banking system was stabilized and the privatization process was finally accelerated, which allowed the successful completion of the PSAL 1 program. Economic growth responded slowly to the program, but after three years of negative growth rates, the economy began to recover in 2000, with a 1.6 percent growth rate (that would have been higher, had it not been for a drought in the summer of 2000).

Box 2: Poverty Profile

The poverty profile that emerges from Romania is one where poverty is widespread but mostly shallow, with some deep pockets among households with many children and households headed by farmers, the unemployed, and ethnic Roma. The poverty incidence is also high in the Northeastern region of the country, where there is high concentration of farmers. Farmers account for 16 percent of the poor, with a poverty incidence of almost 60 percent. Households headed by unemployed account for about 11 percent of the poor, with a poverty incidence of almost 70 percent. Roma-headed households account for just under 7 percent of the poor, but their poverty incidence reaches almost 90 percent. Among pensioner-headed households, poverty is higher for those earning lower pensions (e.g., farmers, survivors) and pensioners who retired before 1997, when benefits were under-indexed to inflation. Among employee-headed households, the risk of poverty is highly correlated with the number of children in the household, although poverty is also high for households where the main income earner has a seasonal job, lower educational attainment, or a low paying job. The gender of the head of household does not appear as a determining factor in the poverty status.

8. Despite the initial promising results from the reform program, the coalition Government was unable to sustain progress on reforms past mid-2000 due to external factors (the drought and rising energy prices) and pre-election pressures. More importantly, the Government began to loosen fiscal policies and delayed structural reforms in the run-up to the elections. A higher-

than-programmed budget deficit resulted from excessive real wage growth in the public sector and from growth in arrears, and was a major reason for the cessation of the Government's agreement with the International Monetary Fund (IMF) late last year.

9. Stabilization remains a key challenge. Romania's annual inflation rate is still very high, at around 40 percent (see Table 2). This amounts to a very regressive tax on the poor and shortens the investment horizon of enterprises. While there were efforts to reduce the fiscal deficit in 1999, fiscal consolidation has been slower than required for macroeconomic stability, and many of the expenditure reduction measures introduced could be easily reversed, with adverse effects on the current account. The improvement in external competitiveness is due primarily to adjusting the exchange rate in lockstep with inflation.[1] This policy has allowed exports to recover and grow, and provided an opportunity to rebuild foreign exchange reserves.

Table 2: Main Macroeconomic Indicators

	1995	1996	1997	1998	1999	2000
GDP growth (%)	7.1	3.9	-6.1	-5.4	-3.2	1.6
GNP per capital (US$-Atlas method)	1,400	1,450	1,420	1,430	1,520	1,640
Current Account Balance (US$ million) [1]	-1,732	-2,611	-2,360	-3,112	-1,302	-1,200
Current Account Balance (% of GDP)	-4.9	-7.4	-6.7	-7.5	-3.8	-3.4
Consolidated Government Budget Balance (% of GDP)	-3.4	-4.8	-5.2	-5.5	-3.7	-3.8
Inflation (CPI, y-o-y % change)	32.3	38.8	154.8	59.1	45.8	40.7
Unemployment rate (%) [2]	9.5	6.6	8.9	10.4	11.5	10.5

1) Excluding non-convertible currencies.
2) As percent of total active civil population.
Source: Romanian National Commission for Statistics, 1999.

10. Lack of political will to reform and constrained institutional and governance capacity are at the root of Romania's less-than-satisfactory economic performance and worsened social conditions. These two issues are evidenced by (i) Romania's very high levels of enterprise arrears to the banking sector and utilities, (ii) frequent changes in the legislative framework, and (iii) an unattractive business environment. The Government therefore needs to accelerate privatizations and strengthen the legal framework as well as enforcement capacity.

11. ***Very high levels of enterprise arrears.*** Enterprise arrears reflect the politicization of the allocation of credit as well as weak creditor rights and institutional capacity to enforce them. Banks and utilities have been used to subsidize enterprises. At end-1999, enterprise arrears reached 42 percent of GDP. They were evenly distributed between state and private sector enterprises, and included arrears to the budget, the banking system, and suppliers. Arrears in tax payments and contributions to the social security system accounted for just over 8 percent of GDP, a significant subtraction of needed revenues from the budget. In addition to these indirect transfers, many enterprises receive direct budget transfers and preferential access to credit from state-owned banks. Enterprise arrears to the banking system, over two-thirds of which were arrears on principal repayments, accounted for just under 6.5 percent of GDP. The largest share of inter-enterprise arrears, however, was to suppliers (18 percent of GDP), primarily energy

[1] Two other factors contributing to growth in exports were the recovery of growth in EU countries, and the reduction in Romania's tax on profits from 38% in 1999 to only 5% in 2000.

utility companies that were unable or unwilling to enforce payment discipline on industrial consumers. This happened despite the price of energy inputs (oil, gas, electricity and district heating) being set below either world market levels (oil and gas), or cost recovery levels (electricity and district heating).

12. ***Frequent changes in legislation and weak institutional capacity.*** Due to a lack of political consensus, previous governments have relied heavily on emergency measures. Legislation has often been unclear and frequently modified, and there is too much discretion in interpreting the law. In addition, there has been little consideration of the need to build the institutional capacity required either to enforce the new legislation or to carry out new responsibilities. This has hindered public agencies' ability to implement new laws and regulations effectively, and has compounded the problem of scarce financial resources for their operations. In this maze of laws, regulations and overlapping Government agencies, corruption is perceived as a serious problem (see Annex E).

13. The instability in the legal framework and the delays in building needed administrative capacity have an acute impact on the delivery of health care and social assistance, especially to the poor, and on the business environment needed to attract foreign direct investment (FDI) and private sector development, in turn to promote growth.

- The allocation of resources for ***health care services*** has been disrupted by the transition from a centrally managed system that has no checks and balances to an insurance-based system. While revenues are collected from employees in an insurance-based system, expenditures are defined in the annual budget and usually set at around 85 to 90 percent of revenues. This allows the short-term surplus of the Health Insurance Fund to go towards reducing the public sector's consolidated deficit. It also allows the Government to keep the formula for redistribution non-transparent, as it uses redistribution primarily as a tool for addressing collection compliance problems in lagging regions rather than for increasing equity. Not surprisingly, Romania ranks among one of the lowest spenders in health care in Central and Southern Europe, and has significantly worse basic health status indicators than its neighbors. Romania's infant mortality rate in 1998 was 20.5 per thousand live births, which is very high when measured against 9.5 in Poland and 14.4 in Bulgaria (see Box 3). The maternal mortality rate was 40.5 per hundred thousand live births in Romania, compared to 4.8 and 18.7 in Poland and Bulgaria, respectively. These indicators also varied considerably across the country, with the infant mortality rate ranging from 14 in Bucharest to 27 in Tulcea.

- The delivery and, until recently, the financing of ***social assistance*** (cash transfers) have been delegated to local Government without due consideration to their administrative capacity or their ability to fund these programs. This has led to inequalities in the provision of these services across regions and among certain socioeconomic groups, especially vulnerable groups such as children, women, and ethnic minorities (see Annex F). Because many of these expenditure responsibilities are mandated, many local Governments are coping with these mandates by not funding the full obligation -- something that is allowed because the legislation is vague and there is little incentive to monitor the implementation of these programs. Furthermore, in those instances where mandates were being fully funded, it was found that cash transfers were poorly targeted, and coverage of the poor was modest, except for child allowances. Coverage is especially low in the case of the homeless and children at risk. An exception has been the provision of childcare services. Under socialism the Government placed an undue emphasis on institutional care. With the decentralization of these services there has been a shift toward community-based care.[2] The sustainability of this trend, however, will require strengthening the capacity of local Government to deliver social services, adequate financing, and greater involvement of communities and civil society.

Box 3: Gender Dynamics

While the figures on maternal mortality in Romania are appalling, there are many areas where the statistical data indicate a large degree of gender equality. For instance, in 1998 the enrollment rate across all education levels was 64.8% for females and 63.1% for males. The gross enrollment rate in higher education was 27.9% for women and 23.1% for men. The employment rate was 43.1% for women and 53.4% for men. The registered unemployment rate was 10.5% for women and 10.2% for men. There are other areas where more needs to be done to achieve greater equality, nevertheless. For example, the average wage differential (female workers earn about 80% of the average for male workers) leads to lower pension benefits for female pensioners, especially since women usually have shorter accumulation periods. This needs to be considered in the design of social protection policies. Also, more remains to be done to ensure equal opportunities in the work place by, for instance, increasing access to childcare (more readily available in the socialist era). The Romanian Government is aware of these problems, and recently adopted a National Plan of Action for Equal Opportunities for Women and Men. While many of the solutions to these problems require a long-term change process, this is amenable to acceleration under a high economic growth scenario and the resulting increased demand for skilled labor, especially in the service sectors.

- Weak institutional and governance capacities also undermine the ***business environment***. Private entrepreneurs report having problems with enterprise, land and tax registration, as well as in their dealings with the customs administration and the courts. Excessive taxes and regulations reflect the instability in the legal framework mentioned above, and provide fertile ground for the high levels of perceived corruption, as documented by the recent surveys conducted by the Bank, and the growth of the informal economy. Indeed, over the last decade, the size of the informal economy as a share of GDP is estimated to have climbed steadily, from 6.7 percent in 1992 to 21 percent in 1999. While informal activities are most prevalent in industry (accounting for 8.6 percent of GDP in 1999, compared to 3.3 percent in 1992), their growth has been faster in services such as wholesale and retail trade, and hotels and restaurants, with a combined contribution to GDP of 6.5 percent of GDP in 1999, up from 1.4 percent in 1992. The most important contribution of the informal economy is, however, in employment in rural areas. Many displaced industrial workers have taken up informal jobs in rural area activities that are neither taxed nor burdened by high payroll taxes. (Payroll taxes account for just under 40 percent of gross wages.) As a result, subsistence farming has increasingly become an economic safety valve for households, with just over one half of all households in Romania reporting owning farmland, even though holdings are frequently too small to be commercially viable. The labor force surveys report that approximately two-fifths of those employed are in agriculture, and that over half of their income results from production for their own consumption.

[2] This has been supported by the Bank-financed Child Welfare Reform loan.

D. CDF Findings

14. The Comprehensive Development Framework (CDF) initiative launched in Romania in 1999 has helped to shape the new Government's development agenda. Recognizing the difficulties that Romania has faced since 1990 in reaching consensus within the country on its medium- and long-term development priorities, the Bank agreed to the Romanian authorities' request that Romania be included among the pilot group of countries for the CDF. Accordingly, the CDF initiative in Romania has been specifically aimed at building consensus for a development strategy.

15. Romania's being a CDF pilot country gave members of its public, private and civil sectors the opportunity to articulate a shared perception of the main priorities for achieving sustained development over the next ten years. Extensive consultation sessions were held in 1999 and 2000 (see Annex G). These consultations revealed a clear consensus around the goals of poverty reduction and EU accession. More specifically, they revealed the following development priorities and constraints: frustration with the ineffectiveness of the legal framework in particular, and public institutions in general (this was seen by many as the most urgent problem); a keen desire to become part of Western Europe via EU accession; an urgent need to improve Romanians' access to economic and social opportunities; frustration with Romania's poverty in the midst of "natural wealth"; a plea for knowledge transfer on how to adapt production to market demand, and how to organize a market economy more generally; a legacy of distrust that impedes partnerships and risk-taking behaviors; and a continued reliance on Government, despite distrust of it. The findings are consistent with the Bank's diagnosis and have informed the Government's Development Program.

E. The Government's Development Program and Recent Policy Actions

Development Program

16. Immediately after being sworn into office in late December 2000, the new Government obtained Parliamentary approval of its "Governing Program for 2001-2004." This program sets out what the new Government intends to accomplish during the next four years, and draws from both the Medium Term Economic Strategy presented in 1999 to the EU (which the PDSR endorsed when it was in opposition) and the findings of the CDF consultations (in which the PDSR participated). The major objectives of the program are to restore economic growth, reduce poverty and unemployment, fight corruption, and accelerate integration into the EU and the North American Treaty Organization (NATO). The program lays the basis for a pragmatic, rather than abstract, approach to reforming the economy and raising living standards by improving the quality of Government services, including the regulatory functions and the judiciary, and creating a business environment which attracts foreign and domestic investors, including in new small and medium enterprises and in privatizing state entities.

17. The new Government's immediate priority has been to ensure economic stability. The previous Government's program, agreed with the IMF in August 1999 under an SBA, went off track in late 2000. The SBA expired in February 2001. The new Government is now in active discussions with the IMF toward reaching an agreement on a new program. The policy agenda has therefore been dominated by short-term measures to limit the public sector deficit.

Recently Policy Actions

18. Cognizant of the importance of moving quickly with implementing its program, the new Government has made recent progress in the following specific areas:

- ***Termination of all directed credit programs and all Government financing of rural and agricultural credit,*** as agreed in the context of the World Bank –financed Rural Finance Project, approved on March 29, 2001.

- ***Clarification of the ownership of the assets of the Commercial Enterprise for Crude Oil Transmission (CONPET, the national oil pipeline company)***. The new Government's decision on CONPET's assets, reached in the first days of its administration, made it clear that CONPET cannot be owned or operated by an enterprise involved in exploration, refining or supply of oil. This decision guarantees greater competition in the market. It is also consistent with Government plans to develop an action plan for the energy sector that identifies the closure of non-viable enterprises, the privatization of others, and the restructuring of enterprises that will remain in the state's hands.

- ***Signing of a contract for the sale of Banca Agricola.*** On April 13 the new Government signed a share sale-purchase contract to sell the agriculture bank, Banca Agricola, to a consortium including the Austrian bank, Reiffeisen Zentralbank Oesterreich, and the Romanian American Enterprise Fund. Banca Agricola is one of four remaining state-owned banks. It accounts for 4 percent of banking assets in the country. Its privatization is a major step forward in the Government's exit from the banking sector, and builds on the closure of Bancorex in 1999.

- ***Confirmation that the Government will proceed with privatization agreements reached under the first Private Sector Adjustment Loan (PSAL 1)***. After a slow start on the privatization front, the new Government has indicated that it will proceed with the privatization of at least 30 large state-owned enterprises from its current portfolio. These enterprises would be offered for privatization in pools of five enterprises to sales agents to be engaged using international tenders. The Government has also agreed on contracts for the technical closure and environmental work related to at least 10 coal mines and to the further reduction of losses incurred by six mining companies.

- ***Recent establishment of a Government Anti-Poverty Commission (CGAS) subordinated to the Office of the Prime Minister***. The key function of the CGAS is to evaluate and monitor the poverty reduction impact of Government and development partner programs. Building on ex ante analysis of the poverty and income distribution, this new commission aims to promote coherent and sustainable poverty reduction initiatives. CGAS officials have already been closely involved in the final stages of preparing the Social Sector Development project and are expected to play an important role in the implementation of this project.

- ***Trimming of public sector staffing levels across the board by 30% now under implementation, to reduce the fiscal burden of the public administration.*** While such dramatic reductions in staff inevitably raise concerns, they signal the new Government's intention to deal with the public sector wage bill by reducing staff rather than compressing wages. It is also consistent with the new Government's program, which identifies public administration reform as a central objective.

F. Romania's Unfinished Structural Reform Agenda

19. While the new Government is starting to take action on several fronts, a number of important development challenges remain, as discussed below.

20. ***Enterprise privatization***. While many small enterprises were privatized in the early years of the transition, including all the shops and service outlets, almost all large industrial enterprises remain under state ownership. This includes the *Régies Autonomes,* so-called strategic enterprises and public utilities, which represent around 20 percent of employment in the economy. These enterprises have not yet been included in the privatization program, and remain largely unrestructured. As a result, the state still holds shares in around 6,000 enterprises and accounts for about three-quarters of industrial output. While the private sector accounts for around 60 percent of GDP, most of its activities are in the service sector.

21. ***Banking and financial sector reforms***. While there are 40 licensed commercial banks operating today in Romania, the four state-owned banks account for about one-half of all banking assets, with most loans being made to loss-making state-owned enterprises. The Government still needs to make an irrevocable decision regarding how, and in what timeframe, it intends to privatize the Romanian Commercial Bank (BCR), and the Savings Bank (CEC). This will be an important step toward ending the practice of channeling funds from the banking sector to loss-making enterprises. Otherwise, the perception that the Government will always step in to deal with bad assets problems will only serve to perpetuate the problem of weak corporate governance. Also, actions to raise the private sector's participation in the banking system will need to move in parallel with the strengthening of bank supervision, and improvements in the legal framework and incentive structure to resolve commercial disputes.

22. ***Energy sector reforms***. Oil prices in Romania track world levels, albeit with a lag. Gas wellhead prices, which should be aligned with import prices, are by contrast one-fifth of the imported cost. Electricity and district heating prices are also heavily regulated, with prices to both household and industrial consumers significantly below cost recovery levels. The recent decision to postpone and scale down the adjustment in electricity prices and the announced decision to reduce natural gas prices raise concerns. An agreement reached with the previous Government had committed Romania to increase gas prices for domestic producers to world market parity by mid-2002. These continuing subsidies are one of the major factors contributing to Romania's fiscal imbalances. The fiscal situation and the weak financial position of Termoelectrica (Romania's SOE for thermal power plant operations) are exacerbated by the fact that the largest beneficiaries of these subsidies are state-owned enterprises which do not pay their energy bills, even at the subsidized prices. The new Government therefore needs to phase out energy subsidies (except district heating subsidies for the poor), improve tariff collection and enforce service cut-off for non-payment. The Bank is currently assessing the situation in more detail and working with the Government to develop a program of remedial actions.

23. ***Fiscal decentralization***. Fiscal decentralization began in earnest in 1998. While legislation has given local authorities control over their own revenue collection, there has been limited progress in providing local governments with autonomy concerning expenditures. The new Government's program specifically calls for acceleration of decentralization, with further allocation of responsibilities for the delivery and financing of public services to local Governments. This will require more specific policy initiatives, including laws that deal with control of – and associated expenditure responsibilities for – public property, whether national or local, as well as expenditure responsibilities for social assistance. Accelerated decentralization will also call for a more effective system of transfers, a more appropriate degree of consolidation of local governments, measures to build a professional and meritocratic civil service, and steps to strengthen and simplify the legal and regulatory framework for locally provided public services.

24. ***Land privatization and agriculture sector reforms***. While land privatization began early in the transition process (1991) through the restitution of land used by large cooperatives to the former owners, almost two-thirds of the land transferred through restitution went to elderly farmers, with the remainder to younger, generally poorer households. Most farms today are small semi-subsistence units of about two hectares, run by owners with limited farming skills and with weak integration into factor and commodity markets. The productivity of many households is further reduced by the limited physical capacity of elderly household heads. These structural problems will require public and private investment in rural marketing infrastructure, and increased research and extension aimed at integrating small households into commodity and input markets. Meanwhile, the privatization of state farms, which are chronic loss-makers, remains a critical unfinished task. These farms tie up substantial portions of arable land (17 percent in late 2000) that is the best in the country. While agricultural subsidy allocation was improved through the establishment of an input-voucher scheme, the new Government's decision to allocate most of the budget transfers to "advanced producers" with no ceiling on the transfer per beneficiary will benefit primarily large land holders. Allocations to state farms were also allowed, which may well have the result of slowing their privatization.

25. ***Education reform***. Romania's basic education indicators are quite favorable. There is almost universal access (95 percent) to compulsory education (grades 1 through 8), although it is lower in rural areas and among some ethnic groups. Gross school enrollment at all levels is 64 percent. The management of the system is evolving from a highly centralized structure where national authorities have responsibility down to the level of instructional implementation, to a system that gives local administrations more autonomy. At the county (judet) level, School Inspectorates are acting as de-concentrated branches of the Ministry of Education and Research. Elected local authorities have been asked to assume responsibilities for most pre-university school functions, such as rehabilitation and maintenance of school buildings and, more recently, teachers salaries and text books. While decentralization has been accompanied by measures to maintain central monitoring of outcomes (e.g., there is a national learning assessment exam), the results suggest that there are still significant disparities in access to and quality of education in rural versus urban areas. While 46 percent of Romania's school-age population lives in rural areas, only 6 percent of its secondary school students and 1 percent of higher education students come from rural areas. The new Government will need to put in place a cost effective, more equitable distribution system for education services. This will call for investment in teacher training, curricula development, and resource materials, to upgrade the quality of education in rural areas.

26. ***Pension reform***. Romania's old age insurance system is comprised of a publicly managed "pay-as-you-go" (PAYG) defined-benefit plan, including special regimes for certain categories of occupations, a contributory supplemental retirement plan, and a mostly non-contributory program for farmers. Participation in the old age insurance program is mandatory for all salaried workers. The self-employed and those with civil contracts are covered on a voluntary basis. Contributions currently average around 37.5 percent of gross wages, which are fully paid for by employers. The system absorbs 8 percent of GDP and faces three major problems: evasion, the abuse of early retirement and disability pensions which absorb eight percent of GDP, and preferential provisions for a large number of occupational categories. These factors have seriously compromised the financial viability of the pension system, with large deficits in the short term (particularly when the farmers' pensions are taken into consideration), and a doubtful long-term viability due to the imbalance between promised benefits and required contributions in the context of an aging population and a high dependency ratio. (For each pensioner in 1999 there were only 1.3 contributors.) Contribution rates would need to rise to 62 percent in 2050 to finance the current replacement rate (70 percent of average wages). To make Romania's pension system sustainable, the new Government will need to establish a multi-pillar system, i.e., one that includes privately managed pension funds. This, in turn, will require a significant reduction in inflation and development of capital markets, including a regulatory framework.

G. Economic Prospects, External Environment, and External Financing

Economic Prospects

27. After three years of negative real GDP growth rates, the Romanian economy began growing again in 2000, and is projected to reach, under accelerated reforms, around 4 percent real GDP growth rate in 2001. The economic recovery has been driven by a strong growth in exports, primarily the re-export of processed inputs from EU countries, and a moderate expansion of the economy in the run up to the elections and their aftermath. The setting of the real exchange rate at a competitive level, the achievement of some fiscal consolidation, and the initiation of bank and enterprise privatization have helped in this economic recovery.

28. The sustainability of the current economic recovery will depend on the new Government's ability to implement a coherent set of economic reforms. In the short run, such reforms would include implementing a sound fiscal policy that maintains primary surpluses, hardening the budget constraints for enterprises, and making visible progress on enterprise and bank privatization. This should spur growth by shifting resources – capital and labor –to the emerging private sector, and should lead to lower inflation, which in turn should improve the country's prospects for more equitable growth. Over the longer run, the sustained growth will depend on improving the environment for new investment, hence on implementing a governance reform program that would stress transparency and accountability in Government, improvements in public sector management, and strengthening of parliamentary and judicial oversight.

29. Under an ***accelerated reform scenario***, real GDP growth could average at least 4.5 percent per annum during the 2001-03 period. (See Table 3 and Annex B6a.) This growth would be driven initially by the sustained growth in exports, followed by supporting policies consistent with achieving and maintaining lower inflation and the increase in investment

necessary to rebuild the country's productive capacity. These supporting policies would include a tight fiscal policy, wage moderation, and improvements in competitiveness and efficiency**.** Increased production would cause a surge in imports and lead to a widening of the current account deficit. Higher foreign investment and access to financing from official and private creditors would, however, finance this deficit and sustain the economic recovery. A sustained recovery would encourage employment creation and enhance support to fiscal discipline and policies fostering investment. This would lay the foundation for continued growth, with workers moving from underemployment in agriculture and state-owned enterprises to jobs in the emerging private sector.

30. The realization of this accelerated reform scenario hinges on three factors:

- ***Progress in moving ahead with the stabilization and structural agenda,*** including short-term actions to ensure the achievement of agreed fiscal targets, and structural reforms that reduce sources of quasi-fiscal deficits and improve overall public expenditure management. The short-term actions include reducing arrears to the budget and state-owned utility companies, privatizing large commercial state-owned enterprises, and reforming the pension system that currently consists only of a "pay-as-you-go" defined benefit plan. The structural reforms include strengthening the Government's budget management capacity to improve prioritization and the efficient use of funds, as well as measures to improve the inter-governmental finance framework.

- ***Increasing the value added of Romania's exports to EU markets***. This in turn will depend on Romania's ability to attract foreign investment flows into industries with export potential, as well as its ability to reduce delays in customs procedures at various stages, caused by either cumbersome bureaucratic procedures or outright corruption. This is especially important since most of Romania's trade with the EU is based on processing of imported inputs for further export. Sustaining export growth will also depend on the country's ability to maintain external competitiveness in the face of larger capital inflows. This will require a sound fiscal policy, able to offset the aggregate demand impact of these inflows and a possible appreciation of the currency. This will require in turn an acceleration of the privatization program, especially of state-owned banks and large state-owned commercial enterprises. These enterprises continue to place large demands on fiscal resources either directly through budget transfers, or indirectly through the build-up of tax and inter-enterprise arrears.

- ***Raising private investment*** rapidly from the current very low levels, while gradually introducing measures to increase savings and ease private sector access to credit from the financial sector. To spur investment, the Government needs to take measures to improve the business environment by facilitating entry of new firms and eliminating barriers for the operation of existing ones. These measures include simplifying the tax system, streamlining procedures for enterprise registration, and discontinuing the current practice of channeling funds through the banking system to the state sector. Actions to increase domestic savings include moving forward with bank privatization, restricting the size of public sector deficits, and introducing a funded pillar (i.e., privately managed funds) in the pension system.

31. The ***slow reform path*** would result from the inability to carry out structural reforms to support macroeconomic stabilization, such as imposing hard budget constraints on large SOEs (e.g., in the energy sector) and eliminating politicized bank lending by divesting state banks. The Government's fiscal stance would significantly deteriorate, recovery would be choked off, and financial instability might ensue. This situation could manifest itself through a swift rise in inflation and/or a rapid worsening of the external current account. (See Table 3 and Annex B6b.) Access to international capital markets would be lost, and foreign direct investment flows would decline significantly from present levels. Without bilateral or international financial institution (IFI) support, the external financing gap would be bridged by dwindling external reserves. Even if a full-blown external crisis were avoided in the next three years, there would still be a sharp slowdown in economic growth.

Table 3: Macroeconomic Prospects

	Actual	Accelerated Reform			Slow Reform		
	2000	**2001**	**2002**	**2003**	**2001**	**2002**	**2003**
GDP at market prices, real growth (%)	1.6	4.0	5.0	5.0	3.4	0.5	-2.0
Current Account Balance as % of GDP	-3.8	-4.2	-4.8	-5.8	-4.9	-5.5	-6.1
Consolidated Budget Deficit (% of GDP)	-3.7	-3.7	-3.0	-2.5	-3.8	-4.3	-5.0
Consumer Price Index (% change)	45.7	30.0	22.0	15.0	33.0	32.0	38.0

Source: World Bank staff estimates.

External Environment

32. Romania's economic prospects will be strongly influenced by its external environment, given the importance of EU markets for the country's exports, its large external financing needs, and the contribution that external investors can make in bringing managerial and marketing expertise to new and existing enterprises. Four external factors stand out which would influence Romania's economic prospects over the next few years: (i) progress in integration with the EU; (ii) regional stability in the Balkans; (iii) possible terms of trade shocks; and (iv) access to international capital markets.

33. ***Integration into the European Union***. Romania's integration into the EU would have strong positive effects on its economy. The EU is already its main trading partner, accounting for 70 percent of total exports. It is also Romania's most important source of foreign direct investment. An economic slowdown in Europe would weaken the demand for exports, reduce investment flows, and possibly slow down the accession process (e.g., EU grant program funding might be reduced). To mitigate this risks, Romania needs to deepen trade links with the EU by making investments to meet quality standards and improve the business environment (see Annex H).

34. ***Regional stability***. Political instability and further escalation of conflicts in neighboring countries would have deleterious effects on Romania's growth prospects and disrupt the current economic recovery. These risks are mitigated, however, by recent events in the Federal Republic of Yugoslavia (FRY), which harbor the possibility of an improved environment for economic recovery. Romania will benefit from the enhanced opportunities for trade and from increased demand for economic services resulting from the end of sanctions, the potential reopening of

transport traffic along the Danube River, and the need for reconstructing FRY's infrastructure. An active role for the Stability Pact should also help lower these regional risks.

35. ***External Shocks***. Romania's dependence on energy imports – the country imports three-quarters of its oil and natural gas consumption – makes it vulnerable to increases in energy prices. A sharp increase in energy prices from current levels could hurt its balance of payments position and limit its ability to import needed investment goods. To alleviate this risk, the country needs to take steps toward aligning domestic energy prices to world market levels, and manage its external reserves prudently.

36. ***Access to international capital markets***. While Romania's foreign debt profile does not anticipate a concentration of repayments, there are still substantial financing needs over the next three years. A temporary loss in access to international capital markets, as in the first half of 1999, would lead to a slowdown in growth by forcing the country to use domestic savings to meet external obligations.

External Financing

37. Romania's ***external position*** has improved over the last two years. This is particularly true for the current account and the debt-servicing schedule. The former benefited from improved terms of trade following the sudden currency devaluation in March 1999. The Lei depreciated against the US dollar by 30 percent at that time (20 percent in 1999 vs. 1998), and has depreciated more or less in lockstep with inflation ever since and has kept its real value constant (see Annexes B6a and B6b). As a result, the current account deficit dropped from 7.0 percent of GDP in 1998 to 3.8 percent in 1999, and is estimated to have remained in that range for 2000.

38. The ***debt-servicing*** schedule has improved primarily because of the large repayment of external debt obligations in 1999 when, like other emerging market economies, Romania temporarily lost access to international capital markets in the aftermath of the Russia crisis. Increased access to grant funding from the EU has also reduced the country's external financing requirements. Since 1999, when Romania was invited to open accession negotiations, EU financial support to the country has followed an upward trend. Grants from the EU could reach as high as EUR 650 million yearly through 2006, to fund projects ranging from infrastructure and environment to agriculture and regional development. These grant funds are disbursed, however, only as eligible projects and programs are put forward to the EU (see Annex D).

39. Romania's external financing requirements are expected to remain high (see Table 4). Under an accelerated reform path, remaining external financing needs, including a build-up in reserves, would average US$4.6 billion per year over the next three years. Assuming increased access to private capital markets, and a doubling of foreign direct investment flow by 2003, official creditors would meet just over 12 percent of Romania's external financing needs, net of principal repayments. Under the sustained growth scenario, a rapid increase in FDI, which in turn would depend on significant progress in structural reforms, would contribute significantly to financing the current account deficit. Hence structural reforms and macroeconomic performance are closely linked.

Table 4: Romania's External Financing Requirements and Sources (2001-2003)

(US$ million)	Actual	Accelerated Reform			Slow Reform		
	2000	**2001**	**2002**	**2003**	**2001**	**2002**	**2003**
Overall External Financing Requirements	-3,287	-4,187	-4,382	-4,658	-3,406	-2,100	-1,545
Current Account Deficit	-1,400	-1,622	-1,926	-2,472	-1,830	-2,018	-2,210
Principal Repayments, of which:	-959	-1,564	-1,494	-1,351	-1,564	-1,494	-1351
IBRD	-91	-101	-119	-136	-101	-119	-136
Increase in Reserves	-928	-1,002	-962	-835	-13	1,412	2,016
Overall Financing Sources	3,287	4,187	4,382	4,658	3,406	2,100	1,545
Foreign Direct Investment	1,009	1,350	1,700	2,000	900	650	400
Disbursement of Long-Term Loans, of which:	1,744	2,037	1,983	1,658	1,807	1,150	745
IBRD	384	297	394	244	145	134	133
EU Capital Grants	40	350	400	450	350	250	250
Other Financing Flows	494	450	300	550	350	50	151

Source: World Bank staff estimates.

40. Under a slow reform approach, foreign direct investment and official creditors' financing flows would be much lower and lead to a sharp drop in external reserves, which would be almost completely depleted by the end of the projection period. (See paras. 88 - 94 for discussion of risks, which would have a direct impact on external financing).

II. WORLD BANK GROUP ASSISTANCE STRATEGY

A. Lessons of Experience

41. The 1997 CAS outlined four priorities for the World Bank Group's assistance strategy during the period FY98-01: (i) promoting structural reform and private sector development; (ii) fighting poverty and developing human capital; (iii) strengthening and rationalizing the role of the state; and (iv) protecting and enhancing the environment. While these priorities were shared by the Government, implementation of the CAS was constrained by the slow pace of economic reforms.

42. There was, however, some progress in specific areas. Under the Bank-financed PSAL 1 program, the largest state-owned bank (Bancorex) was closed, privatization was initiated for some of the largest SOEs, and a number of important reforms in agriculture were implemented. A social fund for community development was established and is proving to be an effective tool for poverty reduction in rural areas. Global Environment Facility (GEF) - supported efforts to establish a biodiversity conservation and management program with local participation have successfully introduced practices to ensure sustainability of natural resources.

43. This CAS takes into account two important lessons learned during the implementation of the 1997 CAS:

- ***Engage in meaningful participation and consultation in project preparation and overall policy dialogue***. This reflects the finding that more was accomplished when ownership of project objectives and the underlying reforms was strong. Engaging in dialogue with the Government, other interested parties, and society at large carries a high pay-off. Whether connected to specific lending operations (e.g., new privatization methods, bank restructuring) or to the design of overall reforms (the October 1999 Conference on Romania's ten years of transition), these investments to increase understanding on all sides have proven to help build broader consensus for reform.

- ***Take active role to support strengthening institutions for a market economy (governance, anti-corruption, and business environment)***. The activities of IFC and MIGA as well as the Bank have been constrained by an environment that is perceived by the private sector as being over-regulated, and where there are still unresolved property rights issues, and red tape and the perception of corruption are pervasive.

44. ***IFC***. At the time of the 1997 CAS, IFC indicated that it would support the development agenda in Romania through investment in (i) small and medium enterprise (SME) development with loan facilities, credit lines and leasing company investments; (ii) other capital market development via potential joint venture projects in bank and non-bank institutions; (iii) infrastructure development via innovative private sector investments and advisory work in privatization planning and specific privatization transactions; and (iv) investments in other private sector industries via equity and debt support. Most of the progress in these objectives was achieved during 1997-1998, however. After 1998 IFC activity in Romania slowed, limited by the pace of reform in the country. While developmentally beneficial private sector investments can be made even in a difficult environment, the pace of investment is constrained by the slow pace of reforms, particularly with respect to infrastructure investments and investments in the privatization of state-owned enterprises. A significant increase in investments will require substantial strengthening of the environment for private sector activities.

45. ***MIGA***. At the time of the 1997 CAS, MIGA had not yet issued any guarantees to foreign investors in Romania. Since then, MIGA has insured three projects in the financial, manufacturing, and services sectors, which together bring its total gross exposure to the country to only $54 million. While investors registered preliminary application for a total investment amount of about $500 million ($55 million in manufacturing, $200 million in services, US$45 million in finance, $100 million in infrastructure, and $100 million in oil and gas) since 1998, this significant amount of preliminary applications has never been realized, in part due to the poor business environment.

B. Country Assistance Strategy FY02-04

Strategic Focus and Programmatic Context

46. The Bank Group's assistance strategy for FY02-04 is built on the premise that while Romania is turning away from its legacy of erratic macroeconomic management of the 1990s, the new Government needs to demonstrate a sustained commitment to accelerated reform, in order to secure complementary external financing and to pave the way for eventual EU accession. If Romania reverts to pursuing a hesitant pace of reforms (see para. 31), Bank Group assistance will be very limited, and significantly reduced from the levels of Bank Group support over the past four years. Under these circumstances, Bank support would be limited to a few

targeted poverty interventions aimed at improving the delivery of key social services and revitalizing the rural economy. If, on the other hand, Romania sustains an accelerated pace of reform (see paras. 29-30), Bank Group assistance will be broader in scope, and support a sustained reduction in poverty; that is, not only targeted poverty interventions, but also bold structural and sectoral reforms to accelerate growth through private sector development and the strengthening of public sector institutional capacity, and to pave the way for Romania's eventual accession to the EU. In light of uncertainties about whether accelerated reforms will be sustained in Romania, Bank assistance is organized around two lending scenarios (high and low), one of which would be triggered by the end of 2001 (see Table 5 and Annexes B3a and B3b). Complementing the Bank's assistance for private sector development, IFC would focus on cutting edge areas of privatization, such as health care and the delivery of municipal services, and support private sector development by marshalling financing for post-privatization restructuring, assisting in capital markets development, and making selected private sector investments.

47. The Bank's non-lending services (see Annex B4) would be an important component under either assistance scenario. Both would include fast turn-around policy notes on relevant issues for economic management, as well as in-depth studies on long-term development issues. Topics that would receive in-depth attention include an assessment of poverty developments, a review of public expenditures, and an analysis of the reforms needed in Romania's accession to the EU. Other planned non-lending services include the program for monitoring and evaluation (M&E) capacity building, a country financial accountability assessment, and several WBI activities (see Annex I).

Lending Scenarios and Triggers

48. ***High-case lending scenario.*** Under this scenario, Bank commitments could increase to a maximum of $995 million during FY02-04, with three or four operations per year, in contrast to lending commitments totaling nearly $600 million during FY98-FY00. (See Table 5 and Annex B3a). Adjustment lending would be important (up to US$550 million) to support the policy reform agenda as outlined in the accelerated reform scenario. The first adjustment operation (PSAL 2) would aim at finishing the private sector development agenda, begun under PSAL 1, in the areas of privatization, banking, business environment, energy pricing, and social mitigation measures. The main constraint to completing this agenda is the political will to implement these reforms. A speedy implementation of the reforms supported by the PSAL 2 program would send a signal to the domestic and external investment communities that the new Government is committed to accelerating the pace of reforms.

49. As a second stage, and post-PSAL 2, the Bank would continue supporting the completion of the privatization agenda (including utilities), as well as reforms of the Government's institutional, regulatory and governance framework. This set of reforms requires careful sequencing and a step-by-step approach. The Bank would therefore consider supporting this component of the reform agenda through a series of programmatic adjustment loans (PALs). These could amount to up to $400 million through FY06 or FY07, focusing on institutional and governance reforms, completion of the privatization agenda, full transition to market-based mechanisms in the utilities, infrastructure, and other network industries, and environmental

policy reforms, structured in a series of three or four operations, the first two of which could be prepared during this CAS period.

Table 5: IBRD Lending Program: FY02-FY04 (US$m)

	FY02		FY03		FY04[1]		Total FY02-04
High Case	Private Sector Adjustment 2 (SAL)/ Private Sector Institution Building 2 (TA)	300.0 / 40.0	Irrigation Rehabilitation	75.0	Hazards Mitigation	150.0	
	Rural Development	40.0	Rural Education	60.0	Health Sector Reform 2 (APL)	20.0	
	Social Development Fund 2 (APL)	10.0	Programmatic Adjustment 1 (PAL)	100.0	Programmatic Adjustment 2 (PAL)/ Public Institution Building (TA)	150.0 / 25.0	
	Forestry Development	25.0					
Total		**415.0**		**235.0**	Total FY04	**345.0**	**995.0**
Low Case	Social Development Fund 2 (APL)	10.0	Rural Education	25.0	Environment (TA)	10.0	
	Forestry Development (TA)	10.0			Hazards Mitigation (TA)	5.0	
Total		**20.0**		**25.0**		**15.0**	**60.0**

1/ FY04 program also includes a possible stand-by operation (Regional Development) for $50 million.

50. The programmatic approach would provide greater adaptability for step-by-step institutional reforms, capacity building that involves significant policy content, and an economy-wide scope that goes beyond individual projects. Programmatic lending will be grounded in clear country commitment and capacity to reform, structured in a series of operations supporting a medium-term reform program, and disbursed on the basis of completed actions rather than future commitments.[3] The use of a programmatic approach would depend on the country's ability to strengthen its procurement and fiduciary frameworks. Each operation will be calibrated in line with evolving reform progress, and subsequent operations will build upon each other to support the medium-term reform objectives. Their content will be underpinned by the results of the Bank's advisory services (e.g., the forthcoming Public Expenditure Review). To prepare the ground for the possible use of programmatic adjustment lending, the Bank is assisting Romania to strengthen its procurement and financial management frameworks. Following the completion of the FY00 procurement assessment, a Country Financial Accountability Assessment is planned for FY02-03.

51. The above support would complement other sector reforms under individual investment operations. For example, public institution building and governance reform would (i) reinforce and facilitate reforms to be implemented under the proposed Rural Education Loan, and (ii) assist in capacity building to be supported by investment operations in the forestry and health

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[3] See Task Force on the World Bank Group and the Middle Income Countries March 27, 2001 (SecM2001-0204).

sectors, as well as in hazards mitigation. Also, financial and energy sector reforms to be supported by the proposed PSAL 2 and the subsequent PALs would create the enabling environment needed for the successful implementation of the Regional Development loan, and the privatization component supported by the same adjustment operations would similarly create an enabling environment conducive to irrigation sector reforms. Other investment operations would be targeted poverty interventions, particularly in rural areas. Non-lending services in a high-case scenario would include at least four reform studies per year, plus several grants, technical assistance, and WBI training in key areas of reform (see Annexes B4 and I).

52. ***Triggers***. The high-case lending scenario would be associated with a path of accelerated reform (see paras. 29 - 30). This scenario is predicated on the adoption and maintenance of a macroeconomic framework and financing plan agreeable to the Bank. It also includes significant progress in three key areas of the structural reform agenda: (i) enterprise and energy sector reform; (ii) financial sector reform; and (iii) governance and institutional reform. Actions across these three areas would constitute the structural reform program, and would be monitored as a program, rather than a series of actions identified under separate lending operations. This implies that performance throughout the CAS period will be measured broadly across all three areas. For example, in the pre-PSAL 2 phase of the program, moving to the high case would require progress in financial sector reform and governance and institutional reform, as well as in enterprise and energy sector reform. As some of the specific triggers listed in Table 6 are expected to be met only in the latter part of the CAS period, decisions on whether the triggers for the high case are met at any particular point in time will require a judgment on the extent of progress across all three areas. However, under the high-case scenario, the Bank would expect all of the specific triggers listed in Table 6 to be met by the end of the CAS period.

53. Progress on structural reforms will be measured initially by actions indicating that the country is moving toward the high-case lending scenario, and later by actions aimed at sustaining the high-case lending scenario (see Table 6). The precise actions indicating that the country is moving toward the high-case lending scenario include: (i) moving forward on the enterprise privatization agenda agreed under PSAL 1; (ii) making visible progress on tackling the problem of arrears in the energy sector; (iii) adopting social sector legislation aimed at mitigating some of the distributional impact of enterprise privatization and the increases in energy tariffs; and (iv) agreeing on the process for developing an anti-corruption strategy. Actions designed to sustain the high-case lending scenario would, inter alia, include: (i) making further progress on enterprise privatization, including the implementation of banking and energy sector privatization plans; (ii) ensuring that most large SOEs and all banks are compliant with international accounting standards for financial reporting; (iii) adopting and implementing an agreed anti-corruption strategy; and (iv) developing rule-based equalization formulae for the allocation of federal revenue grants to local councils.

Table 6: Lending Scenario and Triggers

High Case Lending to include adjustment lending (PSAL 2, then PALs) to support transitional budget expenditures, and investment lending in reforming sectors. FY02-04 lending to total up to US$995 million.	*The core conditions for moving to and sustaining the high case lending scenario are a macroeconomic framework and financing plan agreeable to the Bank. In addition, the high case would require specific actions on (i) enterprise and energy sector reform; (ii) financial sector reforms; and (iii) governance and institutional reform.* *Actions for moving to the high case (pre-PSAL2) include visible progress in the following areas:* **Enterprise and energy sector reform** • Privatization plan for large commercial SOEs identified under PSAL 1 (9 case-by-case, 5 work-outs, and at least 30 pooled); • Initiation of privatization/work-out process for large commercial SOEs (4 case-by-case, including PETROM, and 30 pooled); • Agreement on a plan and timetable for reducing the flow of energy arrears; • Cost reduction and energy tariff increases for electric power plants; and • Unbundling of electricity and gas industry SOEs and the adoption of acceptable regulatory legislation. **Financial sector reform** • Elimination of directed credit and rural/agricultural credit programs; • Divestiture of Banca Agricola, and an irrevocable agreement on method and timetable for divestiture of BCR and CEC; and • Improvements in financial sector legal and supervisory framework, including NBR supervision of credit co-ops. and plan for development of equity and capital markets. **Governance and institutional reform** • Adoption of agreed social assistance legislation (Social Assistance Framework Law and Minimum Income Guarantee Law); and • An agreement on the process for development of an anti-corruption strategy. *Actions for sustaining the high-case lending scenario (post-PSAL2) include visible progress on the above and in the following areas:* **Enterprise and energy sector reform** • Offering for sale the SOEs noted above; • Timely implementation of plan to reduce energy sector arrears, and agreement on, and subsequent implementation of, a plan to eliminate the overall stock of arrears; • Ensuring that most large SOEs and recently privatized SOEs are compliant with IAS for financial reporting; • Privatization of at least 25% of gas distribution sector; • Adoption of agreed privatization plan for electricity generation and distribution; and • Offering for sale the remaining state-owned utilities/network companies. **Financial sector reform** • Satisfactory implementation of a privatization plan for CEC Bank; • All banks compliant with IAS for financial reporting; and • Implementation of agreed tax legislation for banks. **Governance and institutional reform** • Adoption and subsequent implementation of agreed anti-corruption strategy; • Development of rule-based equalization formulae for allocation of federal revenue grants to local councils; and • Establishment of a Code of Ethics for civil servants.
Low Case Loans limited to targeted poverty interventions and technical assistance for institution building. FY02-04 lending to total up to $60 million.	*Any one or more of high-case triggers not met*

54. In the remainder of this calendar year, the Bank is prepared to assist the Government in meeting the triggers for moving to the high case scenario and the specific policy conditions for PSAL 2. This will require continuation of the Government's ongoing dialogue with the IMF and formulation of a macroeconomic program acceptable to the Bank. The Bank will continue to support Romania's efforts to move to the high case through several reform-oriented investment operations, in particular the Rural Finance loan (approved by the Bank's Board on March 29, 2001), the Social Sector Development loan (scheduled for Board consideration in June 2001), and the Rural Development loan (for which Board consideration is planned in the first half of FY02). The Social Sector Development loan supports pension reform, labor market adjustment, more targeted and cost effective social assistance programs, and capacity building for policy development and monitoring and evaluation. The Rural Development loan (see para. 63) supports decentralization and complements EU assistance for local infrastructure investment. By being actively engaged with the new Government in the context of these investment operations during this transition period, the Bank can more effectively support the Government's early momentum, which will, in turn, increase the likelihood of Romania's moving into the high case.

55. It should be noted that the investment loans made during this transition period would be self-regulated, so as to ensure their viability even if Romania were to fall into the low case after their being committed. For example, both the Rural Finance loan and the Rural Development loan are two-part adaptable program loans (APLs), with their own set of clearly delineated triggers for the second phase. If Romania were to move to the low case during the transition period in the remainder of this calendar year, these loans would be limited to their respective first-phase operation only. The proposed Social Sector Development loan would also be limited to activities that do not depend on policy reforms, such as capacity building for poverty monitoring and evaluation.

56. ***Low-case lending scenario.*** In the low-case lending scenario, Bank lending would be significantly reduced (see Table 5 and Annex B3b) to a total of $60 million during FY02-04. The number of Bank operations would also be significantly reduced, to one or two per year. Lending instruments for FY02-04 would consist of one second-phase adaptable program loan, two technical assistance loans, and one investment loan. This minimal lending program would focus on reducing poverty and building capacity on a modest scale, and would be complemented by non-lending advisory services aimed at maintaining the policy dialogue with the authorities. This includes several fast turn-around policy notes (e.g., on energy sector issues), a Public Expenditure Review, and a Country Economic Memorandum focusing on EU accession.

High-Case Program Instruments

57. The Bank Group's high-case program would focus on targeted poverty interventions, promotion of growth through private sector development, and governance and institutional reform.

(i) *Targeted Poverty Interventions*

58. The targeted poverty interventions would emphasize improvements in the delivery of key social and infrastructure services, especially in rural areas. This should address problems of inequitable access to education and primary health care services, as well as other community

services, across regions and among the most vulnerable groups -- children, women, and ethnic minorities. The planned instruments to achieve these goals include the Social Sector Development loan, a Health Sector Reform loan, a Second Social Development Fund loan, and four operations aimed at revitalizing the economy in rural areas. More specifically:

59. ***Strengthening of the social safety net***. The Social Sector Development loan would support improvements in social protection policy, poverty monitoring and evaluation, the transition to a multi-pillar pension reform (i.e., privately managed funds in addition to a "pay-as-you-go" defined-benefit plan), and retraining programs to facilitate labor market adjustment (also supported under the proposed PSAL 2 – see para. 64). It would also aim at strengthening the social assistance system through better targeting of cash benefits, including heating subsidies as the country moves toward aligning energy prices to world market levels under PSAL 2. Non-lending services would include a poverty assessment, poverty policy capacity building, and a pension reform study. Complementing the Bank's support for pension reform, IFC is assisting the Government with technical assistance to establish proper supervision and licensing for private pension funds, and is also exploring possibilities to invest in private pension funds, to support the reforms as they develop in this area.

60. ***Improving the delivery of health services***. The planned Health Sector Reform loan (a second phase of an adaptable program loan in FY04) seeks to support the transition to a decentralized, market-oriented health system. The operation would aim to improve capacity in the health sector for policymaking, finance, and management, to ensure efficient and equitable allocation of resources, and to address the problem of informal payments for health care services (common according to the recently completed Diagnostic Surveys on Corruption – see Annex E). It will also support quality and efficiency improvements for primary health care in selected poor and remote areas, beyond those targeted in the first phase of the project currently under way. Finally, the operation would support, in collaboration with other donors, the modernization of public health services in areas such as tuberculosis and AIDS/HIV prevention.

61. In addition, IFC is looking at the possibility of assisting the Ministry of Health in developing a national strategy for private sector participation in the country's hospitals, and implementing the strategy for metropolitan Bucharest. The objective is to introduce private sector participation in the country's public health care facilities by improving management and quality of care in public hospitals, and by attracting private sector capital in the construction, renovation and rehabilitation of public hospitals and clinics. MIGA is currently underwriting a project for the rehabilitation and expansion of a Bucharest hospital.

62. ***Strengthening community-based development***. Romania is one of the first countries in the Europe and Central Asia (ECA) Region to operationalize community-driven development concepts in Bank projects. The most prominent initiative has been the Bank-financed Romanian Social Development Fund, which is enabling the building of organizational capacity at community levels. Many community organizations have been formed and received SDF grants for financing small rural infrastructure and income-generating activities. In light of the success of this first-phase APL, a second phase of support for the Social Development Fund is planned for FY02. (See para. 79 below regarding the low-case.) In addition, through its ongoing Child Welfare Reform loan, the Bank will continue its support for phasing out the institutionalized system of child care with an integrated program aimed at preventing child abandonment,

supporting family reintegration, and promoting local adoption, foster care, and community-based group homes. Lessons from these operations would be reflected in the proposed Community Networks Study and would provide insights into how to improve community-based development initiatives that could be supported by future operations.

63. ***Revitalizing the economy in rural areas***. Poverty in Romania is deeper and more prevalent in rural areas. This reflects the collapse of agricultural production and the absorption of displaced industrial workers in small farming production. A large share of Bank-financed targeted poverty interventions over the coming years therefore focus on rural areas. These include:

- the ***Rural Finance*** loan (approved by the Bank's Board on March 29, 2001), which aims at facilitating income-generating activities, on and off-farm. This operation will be complemented by IFC activities supporting the financing of agriculture through investments in networks of processing facilities. Several potential opportunities have been identified. These projects would have strong linkages to local farmers and suppliers and would help upgrade the farm production base. Work under these activities would be complemented by the planned Rural/Urban Growth Study that would focus on the economic interaction between urban and rural areas through commodities, labor, and credit markets. This study aims at improving our understanding of the ways in which rural-urban interactions facilitate or hinder regional economic integration and poverty reduction, in particular for female-headed households. The findings would be factored into possible second phase Rural Finance and Rural Development operations (both planned for post-FY04).

- the ***Rural Development*** loan, which would build an initial capacity for rural development and provide funds for infrastructure activities in five judets (counties). Technical assistance would be targeted to poor communes, which should result in their accessing infrastructure financing. This loan will complement the EU's Special Accession Program for Agriculture and Rural Development (SAPARD) to maximize funding for rural infrastructure investments. It should also contribute to improved governance and more participatory rural development planning in poor communities.

- the ***Irrigation Rehabilitation*** loan, which would aim at increasing small farmers' competitiveness by financing physical rehabilitation of deteriorated irrigation schemes, as well as institutional reforms (such as development of water user associations, which in turn would enhance social capital and community-based development). This operation would also include property reforms to allow the transfer of management of on-farm irrigation facilities to users.

- the ***Rural Education*** loan, which would aim at reducing sharp disparities in quality of and access to rural compulsory education (currently grades one through eight, and as of 2003 to extend through grade nine). In the high-case program, this would be achieved through investment in the provision of teaching materials, equipment (including information technology), teacher training in reformed curricula, and monitoring and evaluation. The potential impact of this project is enormous, since forty percent of Romania's school-age population lives in rural areas, and yet only six percent of secondary school students and one percent of higher education students come from rural areas. The loan would also assist the Government in its outreach to ethnic minorities in rural areas. Work under this operation would be supported by the planned Education Sector Review, which would take stock of lessons learned from the Bank's three ongoing education projects and define the remaining sector reform agenda. (See para. 79 below regarding the low case.)

(ii) ***Private Sector Development***

64. The Bank Group's support to private sector development in the high case aims at laying the foundations for the private sector-led growth necessary to sustain the poverty reduction efforts. Higher growth will accelerate job creation and lift households living on incomes close to the poverty line. It would also place the Government's fiscal position on a more sustainable basis by reducing the burden of loss-making state-owned enterprises on the budget, and by broadening the tax revenue base. This additional fiscal space will help to sustain the targeted poverty interventions discussed above (see paras. 58 – 63). The program will focus on:

- ***privatization*** of the remaining state-owned enterprises, with emphasis on the unbundling and eventual privatization of ***infrastructure*** and ***energy*** enterprises, as well as on improvements in privatization procedures;

- adoption of market-oriented ***energy pricing policies and tariff collection*** mechanisms;

- ***reform of the financial sector*** through the privatization of state-owned banks, and strengthening of the supervision and regulation of bank and non-bank financial institutions;

- improvements in the ***business environment*** by lowering barriers to entry for firms and joint ventures, simplifying the tax code, implementing internationally recognized accounting and financial audit standards, introducing more effective and efficient procedures for bankruptcy and liquidation, and strengthening corporate governance; and

- expansion of ***labor redeployment programs*** to support privatization – including job counseling, retraining, support to microenterprise development, and short-term community public works programs.

65. The centerpiece of Bank support to private sector development is the proposed ***Second Private Sector Adjustment Loan (PSAL 2)*** and the complementary Technical Assistance loan. These operations are expected to support actions taken to meet the triggers for the high-case assistance program (see paras. 52 - 53). In addition, they will support initiation of privatization of remaining SOEs, to be completed under the PAL program. The implementation of continued structural reforms in the enterprise and financial sectors under this operation will enhance Romania's prospects for growth and reinforce the sustainability of its macroeconomic stabilization. These reforms combined with a wide range of efforts to mitigate the social costs of restructuring are expected to provide the needed resource cover for a smooth transition to a genuinely market-based economy. These measures are also consistent with Romania's quest to accede to the EU.

66. Subsequent to the PSAL 2 program under the high-case scenario, Bank assistance would consider support for the completion of the Government's privatization agenda, particularly privatization of the infrastructure and energy enterprises, as well as the remaining state enterprises, through a series of proposed ***Programmatic Adjustment Loans (PALs)*** **–** (see paras. 49 - 50). Support could also come, if appropriate, through the Bank's partial risk guarantee instrument.

67. After the structural reforms for promotion of growth are in place (i.e., post-PSAL 2), the proposed ***Regional Development*** loan would support private sector development in an area particularly hard hit by the economic transition, the Jiu Valley Region. This region is currently almost completely dependent on coal mining for its economic viability. With the closure of non-viable state-owned coal mines (supported by the Bank's ongoing Mine Closure and Social Mitigation loan), large numbers of miners are out of work with limited local opportunities for alternative industrial employment. The surrounding area does, however, have significant tourism potential. The proposed activities would support capacity building for the local authorities and other civil society stakeholders to work in partnership to articulate a local development strategy that builds on the region's natural and human resources. Infrastructure investment (including transport and waste management systems) and environmental clean-up of the Jiu River could also be considered.

68. ***Non-lending services*** in support of private sector development in the high case would aim at providing the underpinnings of the reform program under the proposed PSAL 2 and subsequent PALs. These include a Financial Sector Assessment, Energy Sector Technical Assistance, a Tax Policy Study, a Labor Market Assessment, and a Capital Markets Assessment. In addition, grant funding would be sought for the development of a Jiu Valley Regional Development Strategy that would help lay the groundwork for the Regional Development loan.

69. ***IFC*** will complement the Bank's efforts in private sector development by focusing on four key areas: restructuring of municipal infrastructure, marshalling financing for post-privatization restructuring; supporting capital markets and SMEs development, and selected private sector investments in the forestry sector. Overall, the level of IFC activity will depend very much on the extent of improvements in the enabling environment for business in the country. In the forestry sector, through a collaborative Bank Group approach, improvements in the legislative framework have been achieved, and resulted in substantial private sector investment in wood processing projects. In addition to investing in such projects directly, IFC will continue to catalyze the entry of FDI into the country, where possible. Support for the restructuring of municipal infrastructure enterprises could be achieved through the use of the concession model and funding mobilization already used by IFC in the contract for the Bucharest Water Supply Company. In another pioneering operation, IFC is considering the first privately structured deal for municipalities investing in co-generation plants. This is being prepared for two major cities in Romania and is based on ***carbon credit agreements*** under the Kyoto Protocol. This would allow substantial savings in financing and other costs, and would include technical advice on the privatization process in particular transactions.

70. ***MIGA*** will support the Government's efforts to attract FDI by offering technical assistance for the development of investment promotion capabilities. MIGA could also have an impact by issuing guarantees in the areas of banking (notably in support of SMEs and rural

finance) and infrastructure. Should the Romanian authorities make progress in their privatization program, MIGA's political risk insurance could help bring in additional bidders as well as additional financing by foreign banks. While MIGA has the ability to facilitate FDI, the level of its activities in Romania will depend upon progress in improving the country's legal framework and the business environment.

(iii) Institution Building and Governance Reform

71. The Bank Group's strategy to support institution building and governance reform in the high case aims at assisting the Romanian Government to break key bottlenecks in an accelerated reform scenario. These range from strengthening public expenditure management and improving the inter-Governmental finance framework, to supporting regulatory and judicial reforms, and assisting in anti-corruption strategies (see Annex E). The broad aim is to develop a culture of accountability in the public sector. A series of programmatic adjustment loans (PALs) mentioned above (see paras. 49 - 50) and several investment operations would support these efforts. Given the cross-cutting nature of the Bank's assistance strategy for institution building and governance reform, the relevant proposed operations fall into two broad categories, described below.

72. ***Government capacity building***. Critical to improving the efficiency of Romania's public sector and to strengthening its public institutions is the decentralization of service delivery across a range of sectors. In recent years the Government has undertaken a wide range of legislative and fiscal reforms in order to devolve public sector activities to local Governments. Recent laws on local public finance and local taxation have greatly increased the autonomy of local Governments. Nevertheless, a number of issues remain and, as Romania moves closer to EU accession, these will need to be addressed. The remaining inter-governmental issues fall into two main categories: those measures needed at the national level to create the appropriate incentives for subnational levels of Government, and those measures needed at the local level to strengthen capacity and help subnational Governments respond effectively to the increasing demands placed upon them. The PAL-supported program of reforms would focus on the institutional and regulatory framework, and aim at improving municipal management and delivery of local utility services. There is a strong sense of partnership in this area, both within the Bank Group and between the Bank Group and its bilateral partners. USAID has had a long presence in this area in Romania, and DFID has named Romania a priority country and is keen to support these efforts.

73. In addition to addressing inter-governmental issues, Bank support for institutional reform will focus on governance and anti-corruption efforts. PAL components would include the development of systems for policy formulation and coordination, stabilization of the legal framework, strengthening of public expenditure management, meritocratic and de-politicized human resource (civil service) management, judicial reforms, anti-corruption measures, and strengthening of monitoring and evaluation (M&E) systems that introduce accountability for reform results. Non-lending services include a Public Expenditure Review, a Country Financial Accountability Assessment, a follow-up governance surveys, and a Country Economic Memorandum focusing on EU accession.

74. ***Environmental and hazard mitigation management***. Environmental and hazard mitigation management will become particularly important over the next several years, as the Government completes enterprise privatization and land restitution. While legislation is being aligned to conform to EU requirements, enforcement has been lagging behind, and environmental management is largely delegated to the enterprises that focus primarily on achieving production targets, without due consideration to environmental standards. In this context, the country is ill-prepared to deal with the challenges posed by toxic spills and other environmental hazards to which Romania is prone, especially in mining areas in the Danube River Basin.

75. Bank assistance for environmental and hazard mitigation management would be delivered through one of the components of the PAL program as well as a Hazards Mitigation loan and three targeted, stand-alone projects related to environmental management. The ***PAL*** program would include an ***environmental liability component*** to address the need for building capacity, reforming environmental legislation, and establishing a consistent framework for environmental liability and clean-up. This would greatly facilitate the Government's privatization program. (See para. 80 below regarding the low case.) As part of its due diligence, IFC would continue to ensure that, in accordance with Romanian law, privatization transactions in which it is participating, either in a financial or advisory capacity, are done on the basis of a satisfactory environmental assessment.

76. The ***Hazards Mitigation*** loan, cofinanced by a GEF grant, would assist in Romania's efforts to mitigate the costs of damage from earthquakes (Bucharest is considered to be at high risk of major damage), floods, droughts, toxic waste, and other natural and man-made disasters which, taken together, regularly plague the country. In the high-case lending scenario, this operation would focus on disaster preparedness and strengthening Romania's existing rapid response capacity (including through information technology). This could include changes in land-use planning, community involvement and education, flood protection works, safety of flood control dams, some retrofitting of public buildings in Bucharest to meet earthquake building codes, and the establishment of a national catastrophe insurance scheme. (See para. 80 below regarding the low case.)

77. This IBRD operation, to be cofinanced by a GEF grant, would support the development and implementation of an environmental monitoring and flood warning system, as well as priority rehabilitation investments for addressing toxic pollution stemming from the use of dams to store mine tailings in the Danube River Basin.

78. In 1997, the export value of forest products was $860 million, and the sector's contribution to GDP was approximately 5 percent. This contribution could be significantly increased through improving the competitiveness of private sector forest industries. Romania is in the midst of restitution of a large portion of its forest land to private owners. Sustainability is therefore at risk. The ***Forestry Development*** loan planned for FY02 would finance institution building to ensure a smooth transition during the restitution process and sustainable forest resource management post-restitution, establishment of a national private forest owners association, the creation of a public-private partnership for business development and advisory services for wood products industries (inspired by the CDF consultations), support for public awareness campaigns, and provision of infrastructure (roads) compatible with the Bank's

environmental safeguard policies. (See para. 80 below regarding the low case.) Two other operations related to environmental management would include two GEF grants in the areas of ***Energy Efficiency*** and ***Agricultural Pollution Control***. In addition, there are several possible projects for funding by the Prototype Carbon Fund (PCF).

Low-Case Program Instruments

79. The Bank Group's low-case program would limit its support to a few small operations emphasizing poverty interventions, and institution building and governance reform. Included in the ***poverty-focused operations*** would be the second infusion of funds for the Romanian Social Development Fund (the same second phase APL as in the high case – see para. 62 above) and a Rural Education loan, much more limited in scope (e.g., primarily for teaching materials as opposed to teacher training and monitoring and evaluation capacity building) than the comparable high-case loan ($25 million versus $60 million), in light of the slow-down in reforms that would trigger the low case.

80. Bank operations supporting ***institution building and governance reform*** would consist of three loans in the area of environmental and hazard mitigation management:

- a Forestry Development loan limited to technical assistance for institution building and significantly reduced in dollar terms from the comparable high case loan ($10 million versus $25 million);

- an Environment loan limited to technical assistance for environmental regulatory capacity building; and

- a Hazards Mitigation loan limited to a small amount of technical assistance ($5 million) for natural disaster preparedness and rapid response capacity building.

Monitoring Outcomes

81. Success in the implementation of this CAS will depend to a large degree on the ability of Romania's new Government to articulate and implement a coherent social and economic reform program. If the scenario of accelerated reforms prevails, the indicators to assess progress in implementation of this CAS would be measured against Romania's desired outcomes of poverty reduction and EU accession, articulated during the CDF consultations. These indicators include a reduction in the poverty headcount ratio; a reduction in maternal and infant mortality rates; a narrowing of the gap between urban and rural secondary school enrollment; sustained real GDP growth; a net increase in the number of registered SMEs; and favorable annual accession progress reports by the European Commission (EC). The Bank will work closely with the Romanian Government to specify time horizons for these indicators, as well as for indicators measuring Romania's progress against the International Development Goals, in the context of the Government's forthcoming Action Plan. The Bank will also help introduce monitoring and evaluation systems for reform results. Monitoring will also be included in planned Bank-financed projects, in particular in the Social Sector Development loan, the Rural Education loan, and PSAL 2 and subsequent adjustment operations. In addition, the Bank will assess whether a

CAS update is warranted within the next 12-18 months, to take account of the Government's forthcoming Action Plan.

Selectivity and Partnership

82. The Bank's comparative advantages relative to other development partners active in Romania lie mainly in (i) policy advice and financial support for structural and sector policy reform (e.g., strengthening of the social safety net, governance[4], enterprise unbundling, institution building, regulatory frameworks, privatizations and enabling environments for private sector participation), and (ii) support for poverty-focused investments (e.g., social protection, community development), and investments in reforming sectors (e.g., rural finance, education, health, environment). Other partners such as the EU and bilaterals (e.g., USAID and DFID) are better suited to finance technical assistance, training, and public information activities, while the European Bank for Reconstruction and Development (EBRD) and European Investment Bank (EIB) are best placed to invest directly in large-scale activities (e.g., some municipal services) shifting from the public sector to the private sector, and in some activities specifically geared to compliance with very specific EU standards (e.g., national transport systems to be linked with those in Western Europe). The Bank plans to continue its collaboration with the UNDP in the areas of donor coordination, monitoring and evaluating capacity building, and regional development.

83. The Bank's interaction with Non Governmental Organizations (NGOs) in Romania has been generally positive during the past ten years. Until 1997, the degree of interaction was fairly low due to both the nature of the Bank's activity as well as the low capacity of the NGOs to engage with the Bank. 1997 was a turning point in the Bank's collaboration with Romanian NGOs, as the Bank increased its proactivity in consultations with NGOs as well as in engaging them in the preparation and implementation of Bank-financed operations in the social sectors. Another reason for the improvement of Bank – NGO relations was the decentralization of the Small Grants Program that has helped the Bank maintain consistent communication with the non-profit community. An important qualitative step in the relationship with the NGOs was the implementation of the CDF in Romania. The CDF consultations raised the quality and scope of consultations with civil society and with the NGO community in particular. This interaction was followed by regular meetings with Romania's representative on the ECANGO Committee as well as by CAS consultations.

C. World Bank Portfolio Management

84. Integral to the Bank's assistance strategy is continued intensive portfolio management, in order to improve the development impact of Bank lending. Since FY91, the Bank has financed 30 operations totaling US$ 3.2 billion in commitments, of which US$557 million remained undisbursed as of January 2001.

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[4] In the area of governance, the Bank is in a collaboration with the Stability Pact, Organization for Economic Cooperation and Development (OECD), Council of Europe, UN Center for International Crime Prevention, and several bilateral agencies, notably USAID and the UK's DFID. The Bank's comparative advantage in this regard is in diagnostics, analytical work and institutional reforms, while other partners focus on deterrence and law enforcement.

85. Romania recently graduated from the "high risk country portfolio" category, and as of FY01 the portfolio is rated 100 percent satisfactory for the first time in many years. Nonetheless, this progress remains fragile and continued vigilance is required. The Joint Portfolio Review (JPR) held in Bucharest in March 2001 identified five areas that are causing a number of operations to lag behind schedule: (i) implementation capacity[5], (ii) counterpart funding[6], (iii) financial management, (iv) project readiness, and (v) accountability. Specific actions to address each of these issues were agreed, including the designation of a high-level Government official to have Bank portfolio oversight responsibility.

86. The World Bank's Operations Evaluation Department (OED) has evaluated six projects in Romania during the last five years. OED rated two of the loans – accounting for 44 percent of dollars lent – as unsatisfactory or highly unsatisfactory (See Annex B2). OED's assessments of the early projects (approved in 1991) were indicative of the country's as well as the Bank's lack of experience with transition economies. Projects were large and complex relative to the Government's capacity to implement them. This resulted in less than favorable project outcomes and unlikely sustainability. Over time, the ratings have improved as the Bank and Government have gained more experience. For example, the Transport Project, approved in FY93 and closed in FY99, accomplished significant institutional reforms under the leadership of a highly professional agency empowered to implement the project. Unfortunately, the adjustment operation (FESAL) that followed was again too complex and did not have the Government's full support.

D. World Bank Group Decentralization

87. Bank Group management has recently decided to decentralize management of the Bank and IFC's Romania programs. By bringing decision making closer to the Governments, donors and stakeholders in Romania and elsewhere in Europe, this should improve the Bank Group's client responsiveness, turn-around time, and development impact. It should also produce further synergies among neighboring countries which face many of the same development challenges over the next several years, including in the area of closer integration with the European Union. The Bank's Country Director for South Central Europe (Bulgaria, Croatia and Romania) will be based in a regional hub being established in Zagreb, Croatia, while IFC's Director will be based in a regional hub in Istanbul, Turkey. This decentralization initiative is expected to be fully implemented by end-2001.

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[5] The cross-cutting issue of implementation capacity has in part been due to the inconsistencies and ambiguities in laws and regulations governing public procurement. The Bank had previously advised the Government on this issue in the context of a Bank Country Procurement Assessment Review in early 1999. The Bank, EU, and Government are now in discussions to finalize the legal framework for public procurement, to ensure its consistency with eligibility criteria for EU accession as well as with the Bank's Procurement Guidelines.

[6] Delays in provision of counterpart funds took on more significance this fiscal year, in light of the recent change in the Bank's cost-sharing limit for Romania, from 75 percent (for countries in Category II) to 60 percent (for countries in Category III). The Bank's country categories for FY01 are based on 1999 GNP per capita. Romania's GNP per capita rose to $1,520 in 1999, from $1,430 the previous year. While Romania remained within its previous limit of 75 percent, the newly reduced ceiling for Bank cost-sharing puts the current three-year rolling average at 62 percent, or slightly above the new limit of 60 percent. As with other countries moved from one country category to another, Romania has two years (FY01 and FY02) during which to transition to an average not exceeding 60 percent Bank financing of projects. The implication is that the Government will need to ensure a larger Government share and/or cofinancing from other donors for future lending, as well as timely provision of counterpart funds.

III. RISKS

88. The proposed Bank Group assistance strategy faces risks. The most important risk is ***political***, and stems from potential divisions within the Government that would delay the articulation and implementation of a reform program, and SOE privatizations in particular. Such delays could erode the support of IFIs and access to credit markets, as well as trigger a steep deterioration in economic performance and, possibly, external financing difficulties. The new Government's room to maneuver is much more circumscribed than in the mid-1990s because of the external debt build-up and the depletion of the country's human and capital stock.

89. Political risk, while high, is mitigated by three factors. First, in contrast to the previous Government, the new Government is not a coalition and has shown signs of acting in a more disciplined and decisive fashion in some reform areas. Second, there is broad political consensus around the goal of Romania's joining the EU. This should create additional momentum for reforms. Third, the international community has shown a clear commitment to continue to engage Romania in an active dialogue, including contacts at very high levels and regular participation in international events. The Bank in particular has maintained, and will continue to maintain, a strong presence in the country, including the provision of analytical and advisory services, even in the low-case scenario.

90. A fragile fiscal position and relatively large external financing needs over the next three years pose interrelated ***economic*** risks. Without early and decisive action to limit Government spending and lending by state-owned banks, there could be a loss of confidence in economic management. This in turn would result in a decline in the availability of external financing at favorable terms for the country and make its balance of payments position vulnerable. These economic risks are exacerbated by the slippage in fiscal consolidation in late 2000 and early 2001 that eased pressures on state enterprises to restructure, and are likely to put additional strain on the balance of payments. Over the next few months, therefore, the international financial community is likely to assess the new Government's commitment to reform by how well it manages fiscal policy.

91. In addition to sound fiscal and external financing management, keeping the current account deficit under control will require efforts to sustain exports and action to contain any surge in imports driven by excessive domestic consumption. This will require sound exchange rate management and progress on structural reforms, in particular enterprise adjustment and public sector wage restraint. While the Government has given some early indications that it intends to manage its fiscal situation carefully and pursue structural reforms, close monitoring from the international financial community (including via the lending scenario triggers contained in the Bank Group's assistance strategy) should mitigate these risks.

92. While further financial sector reforms are needed (see para. 21), the closure of Bancorex and several small private banks has contributed to the healthiest banking sector since the transition process began. Another factor that mitigates economic risks is the recent improvement in Romania's external indicators. Romania now ranks around the middle of the group of transition countries in indicators such as external debt to GDP ratio, the rate of growth of exports of goods and services, the current account deficit and the alignment of the real exchange rate. Romania also holds the same ranking on liquidity indicators, such as reserves to GDP, reserves

to imports, and reserves to short-term debt position. Finally, a considerable rebuilding of foreign exchange reserves took place in 1999 and 2000, and this trend appears to have continued thus far in 2001.

93. Despite these improvements, however, there are important risks of policy backtracking that cannot be ignored. As mentioned above, the fiscal situation remains fragile, and delays in addressing structural components of the deficit could easily lead to a deterioration of the balance of payments and external financing difficulties. The structural components of the fiscal deficit include large loss-making state-owned enterprises, such as the energy utilities, and the increase in state bank lending to enterprises in financial distress. Despite a moderate external debt burden, Romania has experienced liquidity difficulties in the past. While the country's financial situation is now more comfortable, liquidity difficulties could arise again in the future, particularly in the event of sustained policy slippage.

94. Another concern is Romania's ability to attract the necessary investment inflows. FDI flows to Romania have, so far, been very low, despite their having reached a peak in 1998, on the heels of the 1997 reform program. Through its sheer size, natural endowments and cost competitiveness, Romania ought to be an attractive destination for FDI, but this hope has been eroded by political instability, red tape, corruption scandals, and inconsistent economic policies (particularly toward foreign investors). The forecasts are therefore moderately optimistic on the grounds that the new Government will continue to engage the international community, and that investors will support the return of Europe's second largest transition economy (after Poland) to growth. FDI is essential for sustaining growth and the modernization of Romania's economy. It is also essential to provide a source of external inflows into the balance of payments. If for political or other reasons FDI continues to flag, sustained growth would not be possible.

IV. EXPOSURE MANAGEMENT

95. Romania started its transition in 1990 debt-free. Despite growth in its external debt, Romania's total outstanding debt is still modest and is likely to remain so in the short or medium term. As a share of GDP, external debt outstanding is now approximately 27 percent of GDP (or 82 percent of export revenues, a figure which is likely to decline gradually to about 76 percent by 2003 if GDP growth materializes as predicted in the accelerated reform scenario). To ensure debt sustainability and maintain external creditworthiness, Romania's key challenge is to restore fiscal and external balances to slow the rate of increase in foreign debt.

96. In the high-case lending scenario (see Annex B7a) total debt outstanding relative to export revenues would decline from 82.4 percent in 2000 to 75.8 percent in 2003, as Romania becomes increasingly integrated into the EU and Central European Free Trade Agreement (CEFTA) economic structures, with exports continuing to expand faster than growth. By contrast, in the low-case lending scenario (see Annex B7b), both total debt outstanding and export revenues would remain fairly flat through 2003.

97. For the Bank Group, an important issue is the composition of Romania's external debt, as the debt structure contains a high percentage of public and publicly guaranteed (P&PG) debt, particularly preferred creditors. Total debt outstanding (including short-term) was approximately $10 billion at the end of 2000 (or about 27 percent of GDP), of which nearly 70 percent was

P&PG debt, and P&PG debt service accounted for 58 percent of total debt service, for a debt service ratio of 11 percent. The share of P&PG debt service is expected to reach 70 percent by 2002 in both the high-case and low-case lending scenarios.

98. Because of the major role IFIs have played in Romania's external financing, preferred creditors (IBRD, EBRD, IMF, and EIB) account for a high percentage of P&PG debt service (see Table 7)[7]. Preferred creditors' share of P&PG debt service is expected to rise from the current 30 percent level to 33 percent in 2002 (31 percent in the low case scenario) and to 37 percent in 2003 (35 percent in the low case scenario).[8] It is worth noting that this upward trend is due to earlier lending decisions, made when Romania was facing difficulties in accessing private sources of external financing. Furthermore, under both lending scenarios, the preferred creditors ratio would be well below its level in the period prior to 1997, when the ratio was in the 60 percent range.

99. The World Bank is the largest creditor, accounting for about 20 percent of the total debt outstanding and nearly 15 percent of P&PG debt service at end-2000. The Bank Group's CAS for Romania has been developed to ensure that further increases in exposure are closely matched by increases in overall creditworthiness as well as by proportionate burden sharing among the IFIs, given the limited quantities of IFI financing available worldwide.

Table 7: Romania IBRD Exposure Percentage Ratios – 2001 - 2003

	Actual	High Case Lending Program			Low Case Lending Program		
	2000	**2001**	**2002**	**2003**	**2001**	**2002**	**2003**
Preferred Creditor Share of Public and Publicly Guaranteed Debt Service	30.5	26.0	32.9	36.9	25.2	31.2	34.9
IBRD Share of Total Debt Outstanding and Disbursed	19.6	20.0	20.8	20.4	19.2	20.0	19.9
IBRD Share of Public and Publicly Guaranteed Debt Service	14.6	10.2	11.9	14.2	10.0	11.5	13.7

100. The longer the high case is sustained, the more the Bank's relative exposure would be expected to decrease over time, as private sources of P&PG financing would be increasingly available under an accelerated reform program. In the low-case lending program, however, due to the undisbursed pipeline of $557 million (as of January 2001), and the likelihood of Romania's difficulty in accessing private financing, the Bank's relative exposure would remain high, even in the medium term.

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[7] Like the Bank, the EIB and the EBRD have significantly increased their exposure to Romania in recent years. EBRD's share of Romania's P&PG debt increased from 2 percent in 1993 to 13 percent (at $528 million) in 1999. The EIB, active in financing primarily infrastructure projects within the framework of the Stability Pact, has seen its share of Romania's P&PG debt increase as well, from 0.5 percent to 6.4 percent (at $411 million) over the same period. The IMF's exposure remains low, in part because Romania has not completed any of the past programs with the Fund.

[8] In the low case, since there would be limited options for external finance and the Bank's pipeline would continue to disburse, the preferred creditor ratio would continue to rise for several years and exceed the Bank's exposure guidelines. Under the high case, the preferred creditor ratios would decline in the medium term, despite the higher disbursements from preferred creditors, because of the increasing availability of other sources of external finance.

V. CONCLUSION

101. While the new Romanian Government has taken a number of actions that signal its intention to accelerate the pace of reform relative to that of its predecessors, the remainder of 2001 will be an important period for this Government to demonstrate a sustained commitment to accelerated reform. It could make significant and sustained progress in fiscal management and structural reforms – particularly in the area of privatization – and hence adopt a program that could receive support from the Bank. This would usher Romania into the high-case scenario by the end of this calendar year. Alternatively, the new Government could take a more hesitant approach to reforms, or even reverse past progress in some areas. This would result in a significant decrease in Bank Group support for two reasons. In the policy environment implicit in the low-case scenario, the Romanian Government should not commit its citizens to additional debt obligations, not least because Bank Group financing would not generate the growth needed to service the debt. In addition, there would be exposure and creditworthiness concerns on the Bank's side.

102. The Government will need to weigh the political as well as economic implications of its chosen pace of reform. However, with poverty reduction and EU accession as the long-term outcomes for which Romanians are striving, the Government is likely to conclude that the political and economic considerations converge rather than conflict. Should the Government pursue this conclusion in a sustainable way, the World Bank Group stands ready to support the Government's efforts to break critical bottlenecks in the reform process by ensuring improvement in the delivery of key services to the poor, moving forward on critical and irreversible steps of the privatization program, and helping to lay the foundations of key public sector institutions.

James D. Wolfensohn
President

By:

Sven Sandström Peter Woicke

Washington, D.C.
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