

**Document of
The World Bank**

Report No. 36147-RO

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

AND

INTERNATIONAL FINANCE CORPORATION

COUNTRY PARTNERSHIP STRATEGY

FOR

ROMANIA

FOR THE PERIOD FY06-FY09

May 16, 2006

**South Central Europe Country Unit
Europe and Central Asia Region**

**International Finance Corporation
Southern Europe and Central Asia Department**

CURRENCY EQUIVALENTS

USD 1 = RON 2.8712

FISCAL YEAR

January 1 – December 31

SELECTED ACRONYMS AND ABBREVIATIONS

AAA	Analytical and Advisory Activities	JPR	Joint Portfolio Review
APL	Adaptable Program Lending	MDG	Millennium Development Goal
AVAS	Asset Recovery Agency	MER	Ministry of Education and Research
BEEPS	Business Environment and Enterprise Performance Survey	MIC	Middle Income Country
BCR	Commercial Bank of Romania	MIGA	Multilateral Investment Guarantee Agency
CAE	Country Assistance Evaluation	MLSSF	Ministry of Labor, Social Solidarity and Family
CAP	Common Agricultural Policy	MoPF	Ministry of Public Finance
CAS	Country Assistance Strategy	NBFI	Non-Bank Financial Institution
CCR	CAS Completion Report	NMS	New Member State
CEC	Savings Bank	OECD	Organization for Economic Cooperation and Development
CEE	Central and Eastern Europe	OED	Operations Evaluation Department
CEM	Country Economic Memorandum	PAL	Programmatic Adjustment Loan
CLER	Country Lending Enhancement Review	PISA	Program for International Student Assessment
CPS	Country Partnership Strategy	PRG	Partial Risk Guarantee
DPL	Development Policy Lending	PSAL	Private Sector Adjustment Loan
EC	European Commission	QAG	Quality Assurance Group
ECA	Europe and Central Asia	SBA	Stand By Arrangement
EBRD	European Bank for Reconstruction and Development	SCF	Structural and Cohesion Funds
EIB	European Investment Bank	SIL	Sector Investment Loan
EU	European Union	SME	Small and Medium Enterprise
FDI	Foreign Direct Investment	SOE	State Owned Enterprise
GEF	Global Environment Facility	SWAp	Sector Wide Approach
GDP	Gross Domestic Product	TA	Technical Assistance
IBRD	International Bank for Reconstruction and Development	TIMSS	Trends in International Mathematics and Science Study
IFC	International Finance Corporation	VAT	Value Added Tax
IMF	International Monetary Fund	WBI	World Bank Institute
JIM	Joint Inclusion Memorandum	WHO	World Health Organization

<p>Vice President: Country Director: Task Team Leader:</p>	<p>IBRD Shigeo Katsu Anand K. Seth Albert Martinez</p>	<p>Acting Vice President, Operations: Director: Task Leader:</p>	<p>IFC Declan Duff Shahbaz Mavaddat Kaikham Onedamdy</p>
--------------------------------------------------------------------	---------------------------------------------------------------------------	--------------------------------------------------------------------------	-----------------------------------------------------------------------------

COUNTRY PARTNERSHIP STRATEGY FY2006-2009

TABLE OF CONTENTS

Executive Summary	i
I. Country Context.....	1
A. Political Developments.....	1
B. Economic Developments.....	2
C. Developments in Poverty Reduction, Gender Equality, and MDGs	8
II. EU Accession and Development Challenges.....	9
A. Country Objectives and the Priorities of the Government Program.....	9
B. Challenges of EU Integration.....	11
III. Bank Program and Past Strategy	19
A. Past Bank Assistance	19
B. Rationale for and Principles of Bank Support.....	21
C. Key Priorities for the CPS.....	22
D. Key Components of Bank Support.....	23
E. Bank Instruments.....	30
F. Partnerships.....	32
G. Lending Scenarios.....	33
H. Results Based Monitoring and Evaluation	35
IV. Risk Management and Creditworthiness	35

BOXES

Box 1: Anti-corruption Efforts in Romania

Box 2: EU Accession vs. EU Integration

FIGURES

Figure 1: Macro-Economic Indicators – Real GDP

Figure 2: Macro-Economic Indicators – CPI Inflation

Figure 3: Macro-Economic Indicators – Fiscal Balance

Figure 4: Macro-Economic Indicators – Current Account Balance

Figure 5: Macro-Economic Indicators – Registered Unemployment

Figure 6: Macro-Economic Indicators – National Poverty and Extreme Poverty

Figure 7: Agriculture Share in GDP and Labor Forces

TABLES

Table 1: Romania's Performance in Comparison with EU-8

Table 2: Millennium Development Goals

Table 3: Transition Indicator Scores for Financial Institutions

Table 4: TIMSS 8th Grade Student Assessment Results

Table 5: Estimated Losses From Quasi-Fiscal Activities in the Energy Sector

Table 6: Summary of Outcome Ratings of Bank Lending by CAS Objective

Table 7: Policy Performance Indicators

Table 8: IBRD Exposure Percentage Ratios for Romania 2002-2009

ANNEXES

Annex A1: Country-at-a-Glance

Annex B2: Bank Portfolio Performance and Management

Annex B3a: IBRD Program

Annex B3b: IFC Program

Annex B4: Non-lending Services

Annex B5: Social Indicators

Annex B6: Key Economic Indicators

Annex B7: Key Exposure Indicators

Annex B8a: IBRD Operations Portfolio

Annex B8b: IFC and MIGA Operations Portfolio

Annex B9: Results Matrix

Annex C: CAS Completion Report

Annex C/i: CAS Summary

Annex C/ii-a: Romania – Planned Lending Program and Actual Deliveries

Annex C/ii-b: Global Environment Facility (GEF) Program

Annex C/iii: Romania – Planned Non-lending Services and Actual Deliveries

Annex C/iv: Project Portfolio Rating

Annex D: Country Financing Parameters

Annex E: Note on Stakeholder Consultations

Executive Summary

- 1. This Country Partnership Strategy (CPS) is being presented at a time when Romania is at the threshold of European Union (EU) membership.** The Accession Treaty was signed on April 25, 2005 and entry is expected to take place on January 1, 2007. Romania faces the challenge of convergence with EU countries in terms of both incomes and living standards – its per capita GDP in 2004 is about one-third of EU-15¹ and it lags in several social indicators. To meet this challenge, Romania will have to build on its achievements and at the same time address risks to macroeconomic stability.
- 2. EU accession aspirations have enhanced macroeconomic stability and spurred renewed commitment to reforms in recent years.** The economy grew robustly at 4 to 5 percent per year during 2000-05, with inflation declining from above 40 percent in 2000 to 8.6 percent in 2005, the lowest level since the start of transition. Structural and institutional reform accelerated during the same period – private sector share of GDP has moved closer to EU-8² levels, more than 90 percent of banking assets are now held by the private sector, energy reform has resulted in a substantial reduction of quasi-fiscal deficits, and independence of the judiciary has been strengthened.
- 3. Nonetheless, Romania still has to complete the ongoing reform agenda which it will have to pursue to underpin growth and improve living standards.** The restructuring of the enterprise sector is by no means complete. Financial intermediation is still low compared to that of EU-8. Increasing productivity in the agriculture sector remains a major development challenge. Further improvements in the business environment include increasing labor market flexibility and reducing labor taxation. A skills mismatch with market needs will require a reorientation of the educational system. Poor governance and weak institutional capacity continue to be key concerns.
- 4. Fiscal risks to macroeconomic stability will have to be addressed and monitored closely by the Government, especially in a situation where there is no Fund arrangement in place.** Maintaining financial discipline, sustaining energy sector restructuring, reforming the social security system, and properly managing the substantial costs of upgrading infrastructure and environmental standards to meet EU requirements are priorities to reduce fiscal vulnerabilities. In addition, to improve allocational efficiency of public spending, bold reform of the expenditure planning and management systems is required. Finally, there is a need to upgrade the ability to mobilize revenues to co-finance the absorption of EU funds and provide resources for the reforms envisaged in several sectors.
- 5. While there has been significant progress in poverty reduction, benefits of renewed growth have to fully filter through to all segments of the population.** The gap between urban and rural living standards as well as regional disparities will have to be narrowed. The restructuring of the agriculture sector, which is likely to result in excess labor, will have to be accompanied by measures to mitigate the adverse social impact. Sustainable policies and programs supporting rural and regional development will have to be designed and implemented successfully. Coverage of social assistance programs needs to be improved and targeted poverty reduction measures will have to be well designed to ensure sustainability and impact.

¹ EU members prior to May 1, 2004.

² Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia. These eight countries, plus Cyprus and Malta, joined the EU on May 1, 2004.

6. **The CPS aims to support Romania in addressing the above challenges to facilitate its integration with the EU.** The Government has requested the Bank for support based on the recognition of the Bank's value added and deep knowledge of Romania. The strategic framework of the CPS, developed with the Romanian Government, builds on the Government Program, lessons from the EU-8, and Bank analytical work. The CPS has three pillars: (a) accelerating structural and institutional reforms to support sustainable growth; (b) addressing fiscal vulnerabilities and modernizing the public sector; and (c) targeting poverty reduction and promoting social inclusion. The CPS lists a set of principles that will govern the choice and design of Bank lending operations.

7. **Bank support will be characterized by greater flexibility and responsiveness within the strategic framework.** This means an evolution from the previous CAS to a new CPS that entails: (a) a more flexible approach to lending and non-lending activities in which broad priorities are established with a defined program during the first phase corresponding to the EU accession period and an indicative program to be more clearly defined by end-FY07 for the second phase covering the post accession period; (b) the use of policy performance benchmarks to trigger lending up to a ceiling and to define a minimum set of standards for sectoral engagement; and (c) movement towards alignment of Bank procedures with country systems. Bank programs in Romania will continue to incorporate elements of the Middle Income Country (MIC) agenda, including reducing project preparation time, accelerating project completion, and introducing new products and approaches.

8. **Bank lending will use a mix of instruments with strategic use of Development Policy Loans (DPLs) and programmatic approaches.** The program will be anchored to the ongoing Programmatic Adjustment Loan (PAL) series and the successor Fiscal and Governance DPL both of which will underpin the sectoral reforms supported by other operations. The Analytic and Advisory Activities (AAA) program will be frontloaded and will contribute important inputs to the design of lending operations. In addition, the Bank is offering a full array of financing and risk management products. To enhance assistance for institution building, the World Bank Institute (WBI) will include Romania as one of its focus countries in FY07. The CPS has a results framework accompanied by a monitoring and evaluation mechanism.

9. **A flexible lending program of \$450 to \$550 million per year is proposed to support the strategic objectives of the CPS.** Base case lending will be investment projects which are subject to pre-conditions of appropriate sector policy and acceptable medium term sector expenditure framework. High case lending will be a combination of investment and development policy lending where the latter will require maintenance of an appropriate macroeconomic framework as per Bank guidelines. A periodic assessment of the macroeconomic framework and performance will be done by the Bank in consultation with the Fund and the EU. This is especially important without a Fund arrangement in place. Should the assessment indicate that the macroeconomic framework has deteriorated such that investment lending would not achieve its objectives, there would be a low case scenario of AAA and global goods lending. Bank exposure is manageable and even at maximum lending, the Bank exposure will remain below the guideline thresholds with some exposure indicators declining.

10. **IFC and MIGA will support Romania's EU accession and integration agenda.** IFC's main goal in Romania is to support private sector development, helping local companies benefit from opportunities and meet challenges during the EU accession and integration period. IFC will further increase its volume and scope of investment and

advisory services in order to strengthen market forces and help Romania's economy integrate into the EU's single market, especially through support of large national-level privatizations in infrastructure, where IFC support and private sector involvement will help increase reliability and affordability of services for consumers. When feasible, IFC will complement the Bank's work in the energy sector. Also, Romania is a large market with a banking sector among the least developed in the region. IFC will seek to introduce new financing instruments and to develop non-bank financial institutions. MIGA will be open for opportunities to support foreign investors, particularly in the infrastructure sectors through the provision of sovereign and sub-sovereign political risk.

11. **The proposed program faces a number of risks.** First, failure to promptly address emerging weaknesses in the macroeconomic framework including fiscal vulnerabilities, especially in the absence of a Fund program, could affect adversely the absorption of EU funds and result in a deterioration of the policy environment of the proposed Bank operations. Second, slippages in the implementation of the reform agenda – due for example to the political impact of a delay in EU membership - would have an adverse impact on sustained growth and poverty reduction, and consequently on convergence with the EU members. Third, lack of attention to strengthening institutional capacity would put at risk program implementation. These risks are mitigated by the consensus on the EU accession and convergence objectives as well as the provisions of the Growth and Stability Pact, which would help focus Government attention on critical structural and institutional reforms.

Board members may wish to discuss the following aspects:

- Does the CPS adequately respond to the needs of Romania, balancing flexibility and client responsiveness with a strategic framework to guide and focus the program?
- Are the suggested principles for Bank lending engagement appropriate?