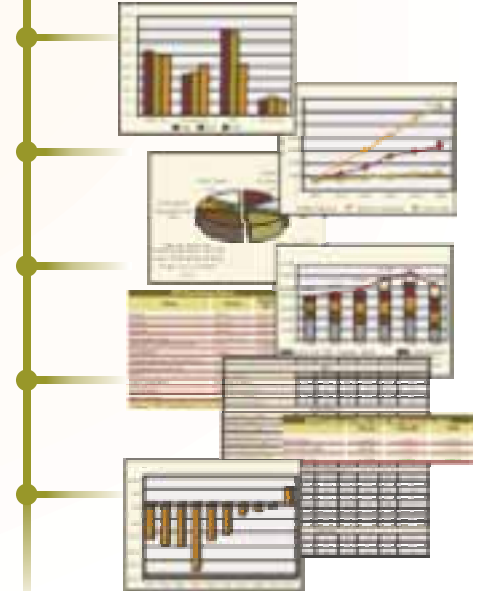


Romania: Country Overview

October 2003



ROMANIA: COUNTRY OVERVIEW



Executive Summary

Romania is the largest country in southeastern Europe by area and population and expects to join the European Union in 2007. Like many other countries in the area, Romania is on the path of reform. Over the past 13 years, the Romanian economy has been transforming itself into a market economy. During this transition period, Romania has experienced a sharp decline in GDP, high inflation rates, and worsened living standards.

Since 2000, stand-by agreements with the IMF and stronger government commitment to reforms allowed the country to carry out large-scale privatization, cut the fiscal deficit, and control

inflation rates. A favorable environment for foreign investment helped attract foreign capital and FDI volumes after 1998 have exceeded \$1 billion per year.

After a long recession, the Romanian economy began recovering in 2000. This was due to the stable, high demand on export markets (particularly in the EU) and increased activities in such sectors as construction and agriculture. In 2002, the inflation rate declined to 22.5% (compared to 54.9% in 1999), a sharp improvement over previous years. International reserves of the National Bank grew to \$6.13 billion, a 300% increase since 1999. Meanwhile, GDP continues to improve. In 2003, inflation is expected to decline further and GDP is expected to grow at 4.5–5.0% annually.

However, a number of international organizations caution that the government has to speed up the structural reforms of the economy in order to be able to comply with the criteria for EU accession. This will prove especially challenging in 2004, an electoral year.

The political situation in the country can be characterized as stable. Romania completed the full cycle of political transition with an orderly hand-over of power between parties at opposite ends of the political spectrum in 1996 and 2000. The next Presidential and Parliamentary elections will be held in 2004.

Over the past few years, Romania has significantly strengthened its relations with both Europe (EU accession) and the US. The Strategic Partnership established in 1997 between the US and Romania provided the framework for closer cooperation in regional political, economic, and military affairs. With the December 2000 election of a new government, the trend of close U.S.—Romanian cooperation continued. Both the government and opposition advocate integration into Euro-Atlantic structures.

In 2001, Romania's Parliament declared that Romanian participation in peacekeeping, humanitarian, and counter-terrorism operations was a major goal of the Romanian security and defence policy. Romania's active participation in multilateral operations began in 1991. Currently, Romania's troops participate in Operation Enduring Freedom (OEF) and the International Security Assistance Force (ISAF) in Afghanistan.

There are a number of additional positive factors that should spur growth in the future. Romania is a member of the WTO and received the official invitation to join NATO in 2004. Lastly, Romania is expected to become a member of the Security Council as well in 2004.

At the same time, the government of Romania expects to join the European Union in 2007 together with Bulgaria. For this to happen, the government must ensure the implementation of the program of economic and social reforms. If it does, as expected, the country will be attractive to investors for years to come.

Major Romanian Macroeconomic Indicators

PRODUCTION		1997	1998	1999	2000	2001	2002
GDP	ROLtrn	252,926	373,798	545,730	800,308	1,154,126	1,512,257
GDP	US\$bn	35.3	42.1	35.6	36.9	39.7	45.7
GDP Real Growth Rate	%	-6.1	-4.8	-1.2	1.8	5.3	4.9
Industrial Production Growth	%	-7.2	-13.8	-2.2	7.1	8.2	6.0
TRADE							
Exports (fob)	US\$m	8,431	8,302	8,487	10,367	11,385	13,869
Imports (cif)	US\$m	11,280	11,838	10,557	13,055	15,552	17,857
Imports (fob)	US\$m	10,411	10,926	9,744	12,050	14,354	16,482
Trade Balance (fob/cif)	US\$m	-2,849	-3,536	-2,070	-2,688	-4,167	-3,988
Export/Import Coverage Ratio (fob-fob)	%	81.0	76.0	87.1	86.0	79.3	84.1
Current Account Balance	US\$m	-2,137	-2,968	-1,469	-1,363	-2,317	-1,573
Capital and Financial Account Balance	US\$m	1,040	2,723	502	1,230	1,529	2,349
Direct Foreign Investment	US\$m	1,224	2,040	1025	1,048	1,435	1,090
Current Account Balance/GDP	%	-6.1	-7.1	-4.2	-3.7	-5.8	-3.5
BUDGET							
Consolidated Budget Balance/GDP	%	-3.6	-2.8	-2.5	-3.6	-3.1	-2.6
INFLATION							
CPI (year-end)	%	151.4	40.6	54.8	40.7	30.3	17.8
CPI (avg)	%	154.8	59.1	45.8	45.7	34.5	22.5
EXCHANGE RATE							
ROL/US\$ (year-end)		8,023	10,951	18,255	25,926	31,597	33,500
ROL/US\$ (average)		7,158	8,875	15,333	21,693	29,061	33,057
Devaluation	%	98.8	36.5	66.7	42.0	21.9	6.0
DEBT STOCK							
Foreign Debt Stock	US\$m	8,584	9,323	8,771	10,241	11,676	15,203
Public and public guaranteed foreign debt	US\$m	6,849	6,966	6,174	6,858	7,699	8,910
Central Bank's FX Reserves	US\$m	2,194	1,375	1,526	2,470	3,923	6,145

Background Information

Romania is the largest country in the region

Romania is the largest country in Southeastern Europe. It lies between Ukraine and Bulgaria and adjoins the Black Sea to the east. Romania is bordered by Bulgaria (by the Danube), Serbia and Montenegro, Hungary, Moldova, and Ukraine. The total area of the country is 237,500 square kilometers, with its capital in Bucharest. The country has 41 regions and one municipality. The population totals 22.3 million; of these, 68.8% are aged 15 to 64. More than 89% of the population is ethnic Romanian. The main languages in the country are Romanian, Hungarian, and German.

Historical reference

Romania first took shape as a country in the 17th century from the brief union of the three historical provinces majority inhabited by Romanians. From the time of its formation until the end of the 19th century, parts of Romania were under the influence of the Ottoman, Austro-Hungarian and Russian Empires, although most of the time the provinces were ruled by local princes. Romanian statehood developed in the current form in 1918.

After World War II, a communist dictatorship was established in Romania. The overthrow of Nicolae Ceausescu in 1989 marked a new stage in the country's development.

Oil and gas are the country's main resources

Romania has reserves of such raw materials as oil, gas, timber, coal, iron ore, and salt; it also possesses rich farmland. However, from an economic point of view, Romania is one of the poorer countries in Central and Eastern Europe.

Romania began its transition from communism to a market economy in 1990. Over the past 13 years, its economic reforms lagged far behind those of the other countries in the region. As a result, living standards in Romania declined: real salaries fell by approximately 40%.

A newfound reformist drive was initiated in 2000 following the Parliamentary and Presidential elections.

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POLITICAL SITUATION

Romania is a constitutional parliamentary republic with a multi-party, two-chamber system. The lower chamber, the Chamber of Deputies (Camera Deputatilor), includes 345 deputies. The upper chamber, the Senate (Senat), has 140 senators (representing 40 regions and the Bucharest municipality). Parliamentary elections are held every four years by nationwide voting, on a proportional basis.

The Head of State is the President (currently Ion Iliescu), who is elected by direct vote for a four year term. According to the Constitution, the President of Romania must not be a member of any party. After consultations with the Parliament, the President proposes a candidate for Prime Minister, who is to be approved by the Parliament. The Parliament also approves the list of members of the Cabinet of Ministers and its governing program. Members of the Romanian Supreme Court (the highest judicial body) are appointed by the President.

As a result of parliamentary and presidential elections in November 2000, a center-left government led by the Social Democratic Party of Romania came to power. The next elections will likely take place in November 2004 (according to the law, they could be postponed until March 2005).

Major Political Parties in Romania

Name	Leader	% of Votes in the Senate	% of Votes in the Chamber of Deputies
Social Democratic Party (PSD)	Adrian Nastase	37.1%	36.6%
Great Romania Party (PRM)	Corneliu Vadim Tudor	21%	20%
Democratic Party (PD)	Traian Basescu	7.5%	7.3%
National Liberal Party (PNL)	Teodor Stolojan	7.4%	7.3%

Source: Senate of Romania

The center-left Social Democracy Party of Romania (PDSR) did not manage to receive the majority of seats in the Parliament during the 2000 elections. However, its candidate, Ion Iliescu, won the presidential elections. The Parliament approved Adrian Nastase as Prime Minister; in spring 2001, he was also elected head of the party. In the same year, PDSR merged with Romanian Social Democratic Party (PSDR) and thus significantly increased its voting power both in the Senate and in the Chamber of Deputies.

The Greater Romania Party (PRM) is perceived as an extreme-right, nationalist party. In 2000, it received 21% of the vote in the Senate and 20% in the Chamber of Deputies. The party leader is Corneliu Vadim Tudor, who ran for President in the second round of elections, together with Ion Iliescu.

The Democratic Party (PD) is another formal social-democratic party; it received 7.5% of the vote in the Senate and 7.3% in the Chamber of Deputies. In 2001, Traian Basescu, General Mayor of Bucharest, became the leader of the party to replace ex-Prime Minister and Foreign Minister Petre Roman.

The National Liberal Party (PNL) received 7.4% of the vote in the Senate and 7.3% in the Chamber of Deputies. Teodor Stolojan, ex-Prime Minister (1991–1992) and the party's candidate in the last presidential elections, is the current leader of the party.

The Democratic Alliance of Hungarians (UDMR), representing interests of the Hungarian community in Romania, received 6.8% of the vote in each chamber. In late 2000, the Alliance signed a protocol on cooperation with PDSR; it supports the government in Parliament.

In the most significant domestic political development since the general elections in 2000, at the end of September 2003 PNL and PD struck a broad electoral alliance aimed at consolidating a viable opposition alternative to PDSR ahead of the general and presidential elections next year.

Another significant development is the expected vote on a new Constitution on October 19, 2003. The draft introduces a series of important changes, such as guaranteeing private property (which is "protected" in the current version) and the introduction of uninominal voting, instead of the current voting of candidate lists presented by political parties.

MACROECONOMIC SITUATION

Background

In the early 1990s, Romania faced the challenge of restructuring its centrally planned economy into a market economy following the collapse of the communist regime. During the first years of transition, the reform process was slow because of the difficult initial conditions the country's transition. Rapid repayment of Romanian foreign debt during the 1980s led the country's economy to stagnation and significant deterioration of living standards by 1990. Also, a number of large energy-intensive state-owned enterprises complicated the initial restructuring efforts. This made Romanian governments postpone unpopular reform measures for a long time.

As in most transition economies, Romania experienced a sharp contraction of economic output in the first years of transition. However, the country managed to return to positive rates of GDP growth by 1993. In that year, economic output picked up by 1.5% after an almost 9% decline in 1992. The further evolution of economic transformation in Romania can be divided into three distinct periods: from 1993 to 1996; from 1997 to 1999, and from 2000 to the present. Each of these three periods was closely linked to the reform agendas of different governments.

The conditions of the agreements Romania signed with the international financial institutions also played a role in the economic transformation of the country. The different programs initiated by the government in the first period of transition aimed at privatization of state-owned enterprises. Many small and medium enterprises were privatized in that period. However, imprudent monetary and fiscal policies implemented by the Romanian government in 1993–1996 resulted in significant macroeconomic imbalances. Exchange rate and price controls along with excessive subsidization of inefficient state-owned enterprises led to gradually increasing fiscal deficits, hyperinflation, and accumulation of external debt. In 1993 and 1994, the inflation rate was in the triple digits at 256% and 137% respectively. This caused a deterioration of social indicators—purchasing power declined and the unemployment rate increased to 11% in 1994. Although consumer prices growth slowed significantly during 1995–1996 (to 32–40%), undue fiscal practices contributed to another inflation upsurge in 1997 (155%).

Early in the 90s, Romania also signed several stand-by agreements with the International Monetary Fund (IMF), by which the government had to put into practice the macroeconomic stabilization plan recommended by the IMF experts. However, between 1991 and 1996, the implementation of the IMF stabilization plan was weak, and the Romanian economy remained plagued with significant macroeconomic imbalances.

In late 1996, the newly elected government implemented a number of economic policies, including exchange rate and price liberalization. Government subsidies to inefficient enterprises through Central Bank lending, which contributed to huge quasi-fiscal deficits, were eliminated. Despite these reforms, the Romanian economy experienced a three-year recession beginning in 1997. Real GDP declined by 6.1% in 1997, 4.8% in 1998, and 1.2% in 1999. The first positive result of the implemented economic reforms showed up in 1998 when consumer inflation dropped to 59% from 155% in 1997.

A major problem during this period was that the current account deficits remained far beyond sustainable levels, at 6.1% and 7% of GDP in 1997 and 1998 respectively. This was largely the result of a dramatic worsening of external competitiveness: dollar wages and relative unit labor costs rose sharply in 1998 (by 26% and 38%, respectively.) In 1998–1999, the Central Bank's foreign reserves shrank as a result of persistently high current account deficits and limited access to international capital markets. At that time, Romania could not count on borrowing from private creditors because of lack of investor confidence in emerging markets in the aftermath of the Russian financial crisis. In spite of a successful privatization program and an upsurge in foreign investment inflow in 1998–1999, GDP declined and budget deficits remained high. As the pace of privatization slowed, the inflow of foreign capital decelerated. At the same time, the stock of external debt continued to grow. In 1999, the state sector still accounted for more than 70% of industrial production, thus creating significant pressure on the budget. Romania's poor economic situation was also aggravated by the armed conflict in Kosovo, mainly due to disruptions in trade with its neighbors as well as transportation linkages in the region.

In 1999, on the verge of economic crisis, the Romanian government developed a comprehensive economic reform program. It envisaged tight fiscal and monetary policies, restructuring of large state-owned banks, and improvement of competitiveness of its exports. As a result, Romania witnessed economic recovery in 2000 due to the implementation of this reform-oriented economic program and favorable external conditions. Real GDP grew by 1.8% in 2000. Growth in 2000 largely reflected a strong export demand from the EU and modest growth in investment, whereas domestic consumption continued to stagnate. At the same time, the fiscal deficit remained rather high at 4% of GDP. On the back of growing exports, the current account balance posted only a 3.7% deficit in 2000 after 4.1% in 1999. However, annual consumer inflation remained persistently high—at about 50% in 2000, contributing to concerns about the financial stability of the country.

At the end of 2000, a new government came to power in Romania. It committed to putting Romania on the path of sound economic transformation that would eventually lead the country to EU membership in 2007. One of the major achievements in 2001 was the reduction of the fiscal budget deficit to a more sustainable level of 3.1% of GDP. Accession to the EU and invitation to join NATO are recognized as key external drivers for Romania, both in terms of reforms and future economic development.

Key Macroeconomic Indicators for Romania

	1997	1998	1999	2000	2001	2002
GDP, \$ billion	\$35.29	\$42.11	\$35.59	\$36.89	\$39.76	\$45.70
GDP Per Capita, \$	\$1,565	\$1,872	\$1,585	\$1,645	\$1,773	\$2,107
Real GDP Growth, %	-6.1%	-4.8%	-1.2%	+1.8%	+5.3%	+4.9%
Inflation Rate, average, %	154.9%	59.1%	45.8%	45.7%	34.5%	22.5%
Average Unemployment Rate, %	8.9%	10.4%	11.8%	10.5%	8.6%	8.1%
Average Commercial Banks Credit Rate, % annually	67.5%	55.1%	61.2%	46.2%	38.8%	28.8%
Average Monthly Salary, \$	\$90.0	\$119.9	\$101.4	\$100.2	\$105.1	\$118.7

Source: IMF, National Bank of Romania

Economic Growth

In 2002, the Romanian economy demonstrated healthy economic growth for the third consecutive year. Real GDP grew by 4.8% in 2002, slightly down from the 5.3% growth in 2001. To a great extent, the deceleration can be attributed to weak growth in the EU and other traditional export markets of Romania. Growth in 2002 was fuelled by a 7% increase in value-added in industry and construction, which compensated for a 5% decline in agriculture.

It is important to note that the GDP structure has markedly changed since 2000. In 2001–2002, a gradual movement from domestic consumption towards export as the main growth driver was seen. Domestic consumption remained strong, and private consumption rose by 6.4% and 4% in 2001 and 2002 respectively. Domestic investment also grew in importance in 2002 as a driver of economic recovery. Gross fixed investment grew by about 8% in 2002, dominated by private sector investments. Demand for modern equipment from newly privatized enterprises fuelled the growth in fixed investment.

In the first half of 2003, real GDP growth in Romania was 4.8%, a rate similar to that achieved in 2002. This relatively low rate was due to an industrial slowdown and lower than expected agricultural output. Weak external demand for Romanian exports contributed to deceleration of industrial production expansion. Real GDP growth in Romania is expected to reach about 4.5% in 2003. Fixed capital investment is forecast to grow at 10.5% in 2003, reflecting increased demand for capital goods from recently privatized enterprises. Growth of private consumption should also pick up due to high real wage growth and strong expansion of domestic credit.

As global growth strengthens in 2004 and production capacities of modernized private enterprises increase, real GDP growth should accelerate to 5%, under the reserve that 2004 is an electoral year and could result in the delay of implementing structural reforms.

Employment

Employment by Types of Activity, 2001

Activity	People employed	%
Agriculture, Hunting, Forestry, Fishing	4,527,000	42.3%
Processing Industry	2,025,000	18.9%
Trade and Maintenance	952,000	8.9%
Transport, Storage, Communications	519,000	4.9%
Construction	430,000	4.0%
Power, Gas, and Water Supply	199,000	1.9%
Mining Industry	150,000	1.4%
Hotels and Restaurants	131,000	1.2%
Real Estate and Entrepreneurship	124,000	1.2%
Finance	76,000	0.7%
Others	1,564,000	14.6%
TOTAL	10,697,000	100.0%

Source: Ministry of Labor and Social Solidarity of Romania

In 2002, unemployment fell to 8.1% in Romania, compared to 10.5% and 8.6% in 2000 and 2001 respectively. These figures are relatively moderate compared to unemployment registered in other CEE countries. This can be explained by the high share of public sector employment in the economy. On the other hand, high payroll taxes contribute to hidden unemployment. In the first half of 2003, the unemployment rate dropped 2.8pps y/y to 7.1%, reaching its lowest level in five years. However, the recent increase in minimum wages may trigger a rise in the unemployment rate. Also, a new Labour Code that came into effect on March 1, 2003 eased labor regulations for privatized companies. Although this Code will be beneficial over the medium term, in the short-term it may result in a temporary increase in unemployment. For 2004, the unemployment rate is forecast at 8.6%.

Fiscal Policies

In 2002, the Romanian government continued to pursue a tight fiscal policy, which resulted in the gradual reduction of the consolidated fiscal budget deficit. The budget deficit amounted to \$1.2 billion or 2.6% of GDP, after 3.5% and 4% of GDP deficits observed in 2001 and 2000 respectively. The narrowing fiscal deficits to more sustainable levels in 2001–2002 were achieved thanks to the imposition of hard budget constraints on state-owned enterprises. At the same time, an increase in private consumption contributed to an increase in indirect tax revenues. Also, subsidies to companies in the energy sector shrank after prices for electricity and gas rose.

Following the reduction of tax rates introduced in 2002, the structure of fiscal budget revenues underwent some changes. In particular, the share of revenues that come from direct taxes (income taxes) has increased from 18% in 2001 to 20% in 2002, while revenue from indirect taxes (VAT and excise) fell to 35% from almost 40% of the total budget revenue. The positive results in fiscal performance were also due to the linkage of budget expenditures to specific revenue sources.

In 2003, the government targets a further decrease of the fiscal deficit to 2.65% of GDP. Fiscal performance reported in the first half of 2003 provides hope that the government will meet its budget deficit target this year. In the first half of 2003, the budget deficit constituted 0.6% of the GDP.

The IMF recommends that Romania further reduce the fiscal deficit to 2.5% of GDP in 2004. This task, however, will be difficult to perform, as the government is likely to avoid significant fiscal strain during the pre-election period. The Romanian Ministry of Finance has already announced an increase in the 2004 deficit of 0.5–1% compared with 2003, which will bring the official deficit target to 3.15–3.65% of GDP. However, it is unlikely that this increase will actually be implemented, since many people in the government and the IMF are afraid that such an increase may trigger another cycle of instability in the country.

Romanian Fiscal Policy Indicators

		1998	1999	2000	2001	2002	Jul-03
State Budget(USD bn)	Revenues	7.58	6.07	5.55	5.10	5.42	4.23
	Expenses	8.75	6.95	6.88	6.33	6.86	4.60
	Balance	-1.17	-0.89	-1.33	-1.23	-1.44	-0.37
Local Budgets(USD bn)	Revenues	1.52	1.38	1.54	2.45	2.81	2.18
	Expenses	1.51	1.36	1.53	2.43	2.80	2.00
	Balance	0.01	0.02	0.01	0.02	0.02	0.18
Social Security Budget(USD bn)	Revenues	2.63	2.47	2.35	2.62	2.94	2.00
	Expenses	2.99	2.55	2.57	2.87	3.24	2.10
	Balance	-0.36	-0.08	-0.21	-0.25	-0.30	-0.10
General Consolidated Budget(USD bn)	Revenues	13.28	11.65	11.59	12.11	13.58	9.56
	Expenses	14.78	12.31	13.07	13.44	14.79	9.92
	Balance	-1.50	-0.66	-1.48	-1.33	-1.20	-0.36
% of GDP	Revenues	32	33.2	31.5	31.9	30	17.3
	Expenses	35.6	35.1	35.6	35.4	32.6	17.9
	Balance	-3.6	-1.9	-4	-3.5	-2.6	-0.6

Source: Ministry of Finance, SigmaBleyzer

The government's task is still challenging, although substantial relief to the budget is coming from falling interest payments on public debt. The short-term consequences of tax reform and industrial growth slowdown may complicate the execution of the revenue part of the budget, without taking into account the chronic under-collection of taxes. This situation gave rise to huge arrears, especially in the energy sector and is the main target of the reform and privatization programs planned under bilateral agreements with the World Bank and the IMF.

At the same time, expenditures are on the rise due to a higher wage bill for the public sector after the recent increase of minimum wages. Much will depend on the government's commitment to enforcing policies for fiscal and quasi-fiscal restraint. This includes restraining wage growth in the public sector, reducing losses in the state-owned energy sector, and improving tax enforcement. Although EU accession will, undoubtedly provide long term economic benefits, in the short term the need to finance pre-accession programs will generate additional fiscal pressure.

Monetary Policies

In recent years, the Romanian government has managed to significantly reduce the pace of consumer prices growth. Nevertheless, the level of inflation in Romania is still one of the highest in the CEE region. A gradual reduction in inflation was achieved since 1999. In 2002 the average annual inflation fell to 22.5% from around 35% in 2001. In earlier years, inflationary pressures were largely generated by high fiscal deficits that were financed by monetary emission. Inflationary pressures were reduced as the fiscal deficit was brought under control. In 2002, money supply (M2) grew in real terms by 17.2% YoY, representing a significant reduction from the level of 46% YoY M2 growth experienced in 2001.

In addition to fiscal discipline, the progress in cutting inflation in 2002 was also a side effect of the depreciation of the US dollar against the Euro, which directly affected energy prices. It is important to note that Romanian authorities took efforts to avoid the loss of export competitiveness

while tackling inflation. The central bank did not allow significant appreciation of the national currency (Leu) against the euro. In fact, the Leu depreciated in real terms by 6% against the Euro in 2002. At the same time, it appreciated by about 12% against the US dollar in real terms, as a result of the appreciation of the Euro against the US dollar. The central bank also cut the Leu interest rates to boost credit growth in 2002. As a result, lending to the private sector increased by more than 40% year-over-year (YoY) in 2002, most of which was made in foreign currency.

In the first half of 2003, annual consumer inflation made up a relatively modest 14.1% YoY. Although price dynamics in the second half of the year are likely to determine the end-year result, it is likely that 2003 CPI growth will be lower than a year ago. Romanian officials forecast CPI growth at 15% YoY in 2003. The risks for this optimistic forecast are increases in wage growth and continuing credit expansion in the economy. The fight against inflation is complicated by the fact that currency substitution is still widespread in Romania, making it more difficult for monetary authorities to conduct its policies. Also, it lowers the effectiveness of the monetary tools to fight inflation.

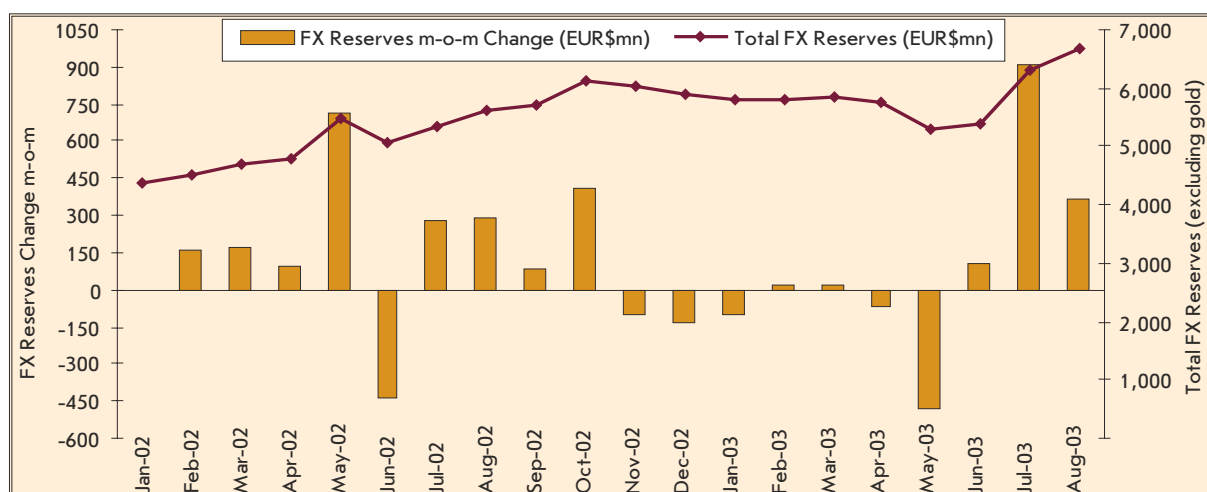
The National Bank continues to pursue policy aimed at gradual disinflation and preserving export competitiveness, thus avoiding significant real appreciation of the Leu against a basket comprising 40% USD + 60% EUR. The January–May 2003 data on monetary aggregates growth supports the view that monetary contribution to consumer inflation in 2003 is likely to be minimal, as broad money posted only 14% YoY growth. The central bank recently announced that it would pursue a policy of more limited interventions in the currency market this year, allowing the Leu to fluctuate within a wider band. In 2004, the central bank plans to move from exchange rate targeting to a policy of explicit inflation targeting, provided the conditions are appropriate. This change, however, is not expected to be implemented before 2005.

The election campaign of 2004 may complicate the control of inflation, increasing pressure on public spending. However, the Romanian government forecasts consumer inflation to drop to 8–9% YoY in 2004. Experts view these expectations as overly optimistic and claim that year-end inflation may reach 11% next year. Nevertheless, Romania's rate of inflation is likely to remain under control.

International Trade and Capital

Romania's external position improved in 2002. The current account deficit reached \$1.6 billion or 3.4% of GDP in 2002, representing a substantial reduction compared with the previous year. In 2001, the current account deficit was \$2.3 billion or 5.8% of GDP. The deficit narrowed largely due to an increase in transfers from Romanians working abroad, which reached more than \$1.3 billion in 2002. The inflow of capital contributed to improvements of the current account balance. Placement of sovereign bonds as well as financing from international financial institutions contributed

to the foreign exchange inflow into the country. Foreign exchange reserve holdings grew by \$600 million to almost \$7 billion in 2002.



However, the foreign direct investment inflow was below levels of previous years. Since 1997, FDI inflow to Romania has been constantly higher than \$1 billion. However, Romania attracted less than \$1 billion of FDI in 2002. One of the major reasons for the low FDI inflow in 2002 was the unsuccessful attempt to privatize the country's largest bank (Romanian Commercial Bank.) Besides, Romania's performance in attracting FDI has been much more modest than other transition economies in the region. Cumulative FDI inflows totalled \$9.8 billion at the end of 2002. This amounted to just \$452 per capita compared with an average of \$1,596 per capita in other Central and Eastern European countries. In Romania, the dynamic of FDI inflows highly correlates with the pace of privatization as foreign investors are reluctant to launch greenfield projects due to the existing bureaucracy and changing and often conflicting laws and regulations. The leading five foreign investors are France, Germany, South Korea, the Netherlands and the US.

In 2002, the trade balance also improved. The merchandise trade deficit decreased from almost \$3 billion in 2001 to \$2.7 billion in 2002. Goods exports grew at a high pace of 20% YoY, outpacing imports expansion, which reached 14.5% YoY growth in 2002.

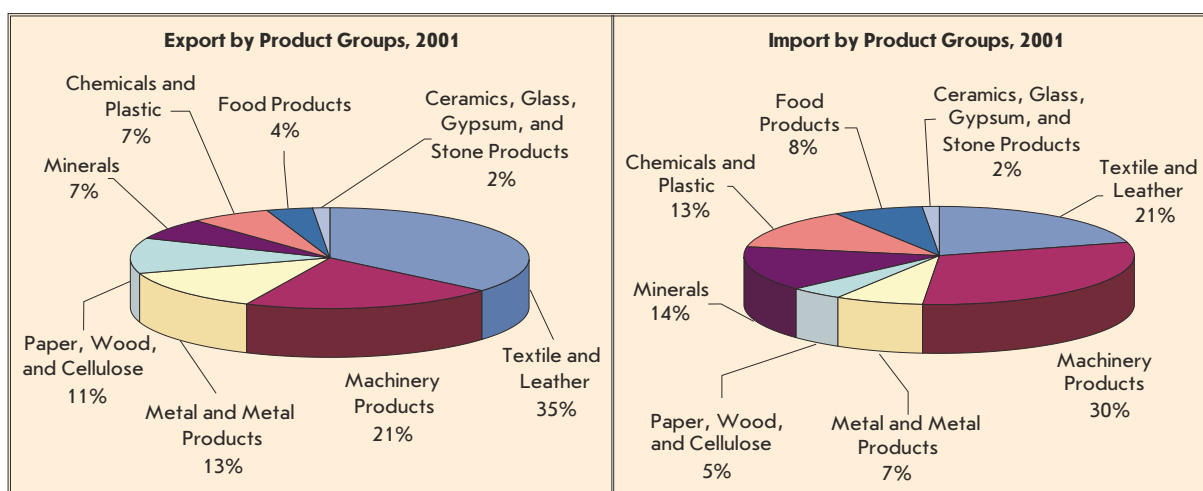
Foreign Trade

Index	1996	1997	1998	1999	2000	2001	2002
Exports, FOB, \$ billion	\$8.061	\$8.431	\$8.302	\$8.487	\$10.366	\$11.385	\$13.869
Imports, FOB, \$ billion	\$10.555	\$10.411	\$10.92	\$9.744	\$12.050	\$14.354	\$16.482
Trade Balance, \$ billion	\$2.494	\$1.980	\$2.618	\$1.257	\$1.684	\$2.969	\$2.613
Current Account Balance, \$ billion	-\$2.611	-\$2.137	-\$2.968	-\$1.469	-\$1.363	-\$2.317	-\$1.573
Current Account, % of GDP	-7.4%	-6.1%	-7.1%	-4.2%	-3.7%	-5.8%	-3.5%

Source: IMF. National Bank of Romania

Although export growth has been significant, the country is making efforts to develop its export potential in metallurgy and machine building in order to secure its foreign trade sustainability

over the long term. Currently, most export growth is caused by low value-added and labor-intensive goods like apparel, footwear and wood processing products, which account for almost 40% of all exports. In fact, most of these products are re-exports under outward-processing arrangements. This indicates that contribution of Romanian export growth to the overall economic expansion is significantly lower than in other countries. On the other hand, the slowdown in import growth achieved in 2002 may be largely attributed to the lower dollar value of imported energy materials rather than reduction of consumer goods imports. A large share of Romanian imports consists of energy and other intermediate goods. Imports of machinery and equipment accounted for only 23% of imports in 2001. The country's dependence on energy resources and imported inputs for major exporting industries represent major vulnerabilities of Romanian external trade.



Due to its geographical proximity, the EU accounted for almost 70% of Romanian exports, and for 60% of Romanian imports in 2002. The EU is the major supplier of imports of machinery and equipment, and also of textile materials for outward processing. Russia, which accounted for 9% of Romanian imports, remained the major source of imports of energy in 2002.

Romania's 5 Largest Trade Partners in 2002

Export		Import	
Country	%	Country	%
Italy	25%	Italy	20.7%
Germany	15.6%	Germany	14.8%
France	7.6%	Russia	7.2%
United Kingdom	5.8%	France	6.4%
USA	4.3%	United Kingdom	3.8%

Source: National Statistics Committee of Romania

In 2003, the external gap is expected to widen. For the January-May 2003 period, the current account deficit expanded by almost 50% YoY to \$1.13 billion, or almost 2% of the expected GDP for the entire year. The government and the IMF have agreed on a 4.5%-of-GDP ceiling for the

current account deficit in 2003. In order to achieve this target, the government may opt for further depreciation of the local currency.

International Debt

As a result of the implementation of the foreign debt repayment program of the 1980s, Romania had a very low debt level at the beginning of 1990. The total external debt of Romania constituted only 12% of GDP in 1992. Growing external deficits in the 1990s resulted in a new build-up of external debt, although its level is still modest compared to other emerging economies. By the end of 2002, Romania's sovereign debt represented 30% of GDP.

In mid-1999, on the back of a prolonged economic contraction and the closure of the international financial markets due to the Asian and Russian crisis, Romania was on the verge of a debt servicing crisis, but the government managed to cope with it. Since the end of 2000, taking advantage of the improved sentiment towards emerging Europe in the financial markets, the Romanian government has pursued a sound policy of long-term external borrowing that resulted in a healthy increase of the central bank's foreign-exchange reserves. Therefore, the gross foreign debt of the country rose from \$10.2 billion at the end of 2000 to \$14.2 billion at the end of 2002.

More than one third (37%) of external debt was owed to multilateral institutions, and about 30% to private creditors. It is worth noting that Romanian external debt has increased primarily on account of borrowings from private creditors during 2001–2002. In this period, a substantial upgrade of Romania's international credit ratings made it easier for the government to access international financing and to reduce the cost of borrowing. In 2001, bond issues made up almost \$800 million, while the Romanian government placed about \$700 million worth of Eurobonds in 2002. As a result, the stock of external debt owed to private creditors increased by more than 40% during this period.

Debt to multilateral and bilateral creditors continues to grow gradually as Romania has to meet its debt servicing requirements and finance its external gaps. Despite a marked increase in recent years, the level of Romania's external debt and debt service will remain within sustainable levels in 2003. In January–May 2003, the external debt service to GDP ratio was less than 20% of export revenues, while total external debt constituted 30% of GDP.

The improvement in the external financial position of Romania led to an improvement in Romania's rating. On September 17, 2003, S&P upgraded Romania's long-term foreign currency rating to BB from BB- previously and the long-term local currency credit rating to BB+ from BB previously. A week later, on September 24, Fitch placed Romania on "rating watch positive". On the positive side, a Fitch press release notes economic growth of around 5% over the past three years, a decline in inflation, an expected budget deficit of below 3% in 2003, reduction of the energy sector's quasi-fiscal deficit and progress in Banca Comerciala Romana (banking) privatization, to the backdrop of Romania's low external indebtedness, and comfortable levels of liquidity and solvency. The table below provides an overview of Romania's current credit rating by the main international rating agencies.

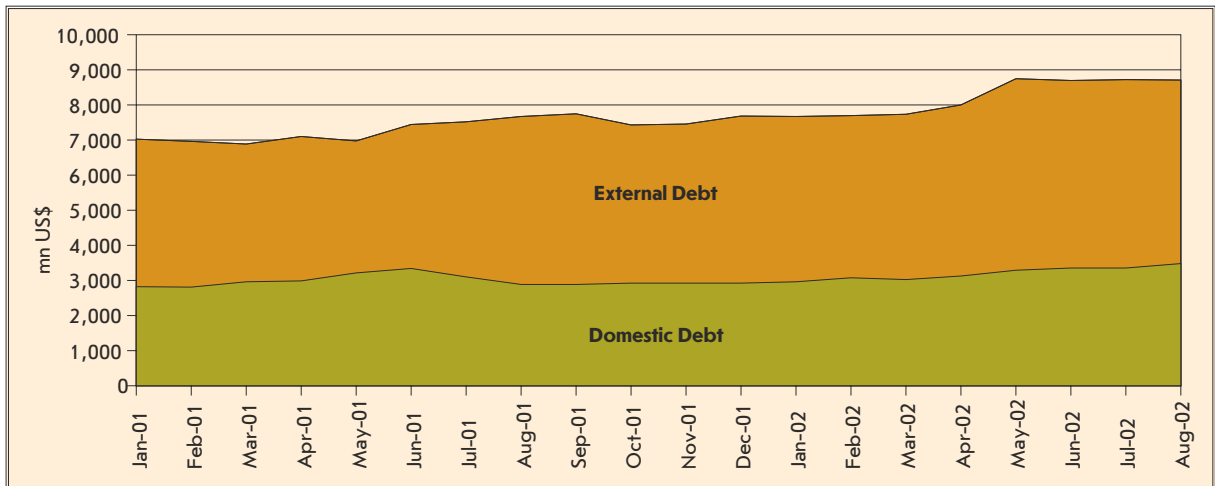
Current Credit Rating

Agency	Foreign Currency			Local Currency			Last Upgrade
	LT	ST	Outlook	LT	ST	Outlook	
S&P	BB	B	Positive	BB+	B	Positive	September 17, 2003
Moody's	B1	n.a.	Stable	B1	n.a.	Stable	December 16, 2002
Fitch	BB-	B	Rating watch positive*	BB	n.a.	Rating watch positive*	October 30, 2002

*Since September 24, 2004

Source: Rating Agencies

The current policy is aimed at lengthening the maturity of both domestic and external debt as well as increasing the weight of the external debt so as to reduce the influence of the fiscal deficit on inflation.



INVESTMENT CLIMATE

Romania has made good progress in the implementation of macroeconomic reforms since 1997. However, the pace of structural reforms to improve its investment climate has been increasing only gradually. Nevertheless, the private sector has expanded and now represents about 70% of GDP, compared to 55% in 1996.

In addition to macroeconomic stabilization, for sustainable economic growth the government of Romania needs to accelerate market reforms in order to improve the business environment and boost both domestic and foreign investment into the economy. The key challenges facing Romania on this path are to:

- fight corruption decisively
- provide a transparent and stable legal framework for private business
- promote institution building and public sector reform to create the right scheme of incentives and to develop a culture of accountability in the public sector
- accelerate the pace of privatization and restructuring of large state-owned enterprises
- reduce the fiscal burden of inter-enterprise arrears
- demonstrate progress in the deregulation and restructuring of the energy sector
- improve financial sector intermediation

The government is fully aware of these priorities, as these measures also comply with the requirements for gaining entry to the EU in 2007.

A study carried out by SigmaBleyzer identified the most important measures that a government can take to improve the business environment and attract foreign direct investments. The study reviewed 50 countries across the world and carried out statistical analyses to identify the policy measures that could have the greatest impact on the flows of FDI. Through benchmarking, it also identified best practices in economic reforms in a number of successful developing countries. Also, a model was built to predict the flows of foreign direct investments that the country could receive based on the implementation of these key "policy" investment drivers. The study concluded that "first generation" reforms-macroeconomic stabilization, achieved by sound fiscal and monetary policies-are essential pre-conditions to achieving a favorable business climate and attracting foreign direct investments. But they are not sufficient to improve the business environment and achieve increases in international capital inflows. Within this macroeconomic framework, a number of "second generation" reforms are needed. Benchmarking, statistical analyses and business surveys indicated that a significant portion of the variations in foreign direct investments in the group of 50 developing countries could be explained by nine economic policy drivers. Furthermore, studies showed that whereas there was a high correlation between the nine policy drivers and the flow of FDI, there was also a low correlation between FDI flows and the "natural characteristics" of a country (e.g., geographical location, country size, population, etc.) These key investment drivers were the following, in order of priority:

- (i) **Business liberalization and de-regulation policies** to permit firms to operate freely by removing barriers to market entry, barriers to operations and barriers to exit.

- (ii) Policies to **create a stable and predictable legal environment** with well-defined "rules of the game" for all businesses, without discrimination or preferential treatment and with capacity to enforce business contracts.
- (iii) Policies to develop **sound Corporate and Public Governance** that would protect ownership rights and shareholders, and avoid excesses of power by Government agencies.
- (iv) Policies to **liberalize foreign trade and international capital movements** to facilitate the exports and imports of goods and the transfer of capital internationally.
- (v) Policies to **create a healthy financial sector** capable of meeting the financing needs of growing businesses.
- (vi) Actions to **minimize corruption** and protect businesses from abuse of power by government officials.
- (vii) Actions to **minimize the effects of political uncertainties** on business activities.
- (viii) Actions to **promote and inform investors** about business opportunities in the country.
- (ix) Action to avoid distortions in incentives by **eliminating preferential targeted investment incentives** to companies, regions or sectors.

The performance of Romania regarding the above nine investment drivers is discussed below:

(i) Liberalization and Deregulation of Business Activities

During the last three years, the Romanian government has been taking important measures to liberalize business activities by eliminating excessive red tape and improving the regulatory system. Although a number of positive changes have been made, foreign investors believe that the Romanian regulatory framework needs further reforms for it to encourage development of the private sector. The recent report of the Foreign Investment Advisory Survey (FIAS) of the World Bank/IFC concludes that there are still a number of administrative barriers to the registration and operation of the private businesses in the country. One of the major problems is the overlapping responsibilities of various government agencies and their lack of institutional capacity to enforce new market-oriented legislation effectively.

One of the most important steps for a liberal business environment is easy entry and exit procedure. In Romania, a company's registration process is still cumbersome. The registration process is far from a "one-stop-shop" widely used in many market economies. Registration requires a significant amount of time to get approval from different agencies, and a vast amount of paperwork. Many business activities are subject to licensing, for which the formal obtaining procedures are cumbersome and time consuming. Although small and medium businesses abound, many are informal, and hampered by over-regulation.

Since 1999, Romania has had a comprehensive bankruptcy law, which is in line with international standards. However, it needs to be effectively enforced, especially with regard to state-owned enterprises. Many state-owned enterprises still enjoy soft-budget constraints and are heavily indebted. Successful restructuring or closure of such enterprises will contribute to the improvement of the business environment as a whole.

The investment climate in Romania has improved due to the positive changes in tax legislation that came into effect in 2000. Prior to these changes, Romania had one of the highest tax levels in

the region. In early 2000, a new global income-tax system was introduced in an attempt to broaden the tax base and bring the system closer to international standards. The corporate profit tax rate was cut from 38% to 25%, while a uniform value-added tax (VAT) rate of 19% replaced the previous reduced rate of 11% and full rate of 22%. A new VAT law became effective in mid-2002, eliminating exemptions and zero rating for house building, construction of railway infrastructure and tourism.

In July 2002, a new law on profit taxes came into effect, maintaining the general tax rate at 25%, but eliminating distortionary tax incentives, corporate profit tax holidays and exemptions, and replacing them with a uniform 20% investment tax allowance. The reduced 6% profit-tax rate for export activities was raised to 12.5% as of January 2003.

The aggregate level of payroll taxes still remains rather high compared with the regional average. In 2001, it was at 57%, but after two successive cuts in 2003, payroll taxes are now about 49%. Total labour cost, however, is higher, due to a variety of other taxes and contributions to special funds, which are paid by the employer on top of the gross salary. In an effort to reduce the burden on employees, the government began considering introducing an uniform 23% income tax. However, under pressure ahead of an electoral year, it decided to postpone its implementation until 2005.

Despite the recent major tax cuts, tax registration and payment procedures are cumbersome, needing further reforms. Labor regulations impose strict and sometimes confusing reporting requirements for employers not to mention high contributions to various social security funds. Thus, procedural problems are the most urgent issues to be addressed by the Romanian fiscal authorities.

(ii) Stability and Predictability of the Legal Environment

Romania has made progress in reforming its legal system in recent years. The country's legal framework now compares reasonably well with other transition countries. Based on the 2000 EBRD Legal Indicator Survey, the commercial and financial laws of Romania can be characterized as 'reasonably good' for supporting investment and other business activities. In addition, Romania's commercial laws have been gradually improving over the past three years. According to the EBRD, Romania's commercial law is perceived by lawyers in the field as broadly on a par with that of some of the more advanced transition countries of South Eastern Europe. Overall, harmonization of Romanian laws with EC legislation appears to be progressing. The EU Commission reported on progress made in company law, competition, public procurement and money laundering. However, the laws, regulations and norms change often reflecting the relative lack of experience of the parliament and different regulatory bodies.

However, the Romanian government has to do much more to improve the effectiveness of the judiciary. The European Commission has raised serious questions about the political neutrality of the judiciary, the inadequate qualifications of staff in the judicial system, and their lack of familiarity with EU law. The government has taken some steps to improve the efficiency of the judicial system. A revised version of the Civil Procedure Code came into effect in April 2001, aimed at speeding up legal proceedings and improving the enforcement of judicial decisions.

(iii) Corporate and Public Governance

Corporate Governance

Striving for EU membership, Romania is gradually shaping its corporate governance rules to comply with European standards. Although substantial progress has been made, there are still many problems that need to be adequately addressed. Until recently, one of the significant obstacles to investments was weak protection of minority shareholder rights. However, Romanian authorities amended the corresponding legislation in early 2003 with provisions envisaging fair compensation for minority shareholders in case they do not agree with decisions of the company's board. Some experts view this norm as excessive since it imposes costs to the majority owners. There are no requirements on publication of information about the founders of the company, on board decisions, etc. A positive development is that international accounting standards (IAS) are gradually being implemented in Romania. However, most of the companies are managed for cash and the accounting is distorted towards avoiding the payment of profit taxes.

Weak corporate governance in Romania is a consequence of the slow privatization process. Many large enterprises have remained in state hands for a long time, and the state has been the major stakeholder, thus transferring its own governance principles to these enterprises. Corporate governance crucially depends on the ownership structure of the company. The ownership of the major enterprises in Romania is consolidated in the hands of a few wealthy owners, while smaller enterprises have more diversified ownership structures. According to the private sector surveys published by international organizations, foreign investors in Romania tend to maximize their participation in the company's ownership, especially in greenfield investment projects. It is natural that foreign investors introduce the best corporate governance practices in companies with their participation, creating positive spillover effects for other Romanian enterprises. Although Romanian corporate governance culture is rather weak, it is considered to be 'reasonably good' compared to its peers in transition countries.

Public Governance

Romania's weak administrative capacity is a constraint on the implementation of economic reforms. The new government's activity program identifies public administration reform as a central objective. As part of this program, the government recently announced a 30% reduction of public sector staff across-the-board in order to offer more competitive wages to a smaller number of staff, while easing the fiscal burden of public administration. By offering more competitive wages to a smaller number of staff, the Romanian authorities expect to improve public sector capacity to deliver public goods, with more qualified civil servants. Nevertheless, there is a need to revise and rationalize the existing system of remuneration and incentives for civil servants, so as to attract and retain the most qualified staff. On the organizational side, Romania has made progress in consolidating government institutions to guarantee democracy and the rule of law. However, the Romanian government also needs to abstain from ad-hoc decision-making and legislative practices and to improve its cooperation with legislature.

The EU accession requirements impose external incentives for further public administration reform. The requirements include the need to improve the ability to elaborate strategic plans and long-term development programs, and allow for a greater partnership with lower tiers of

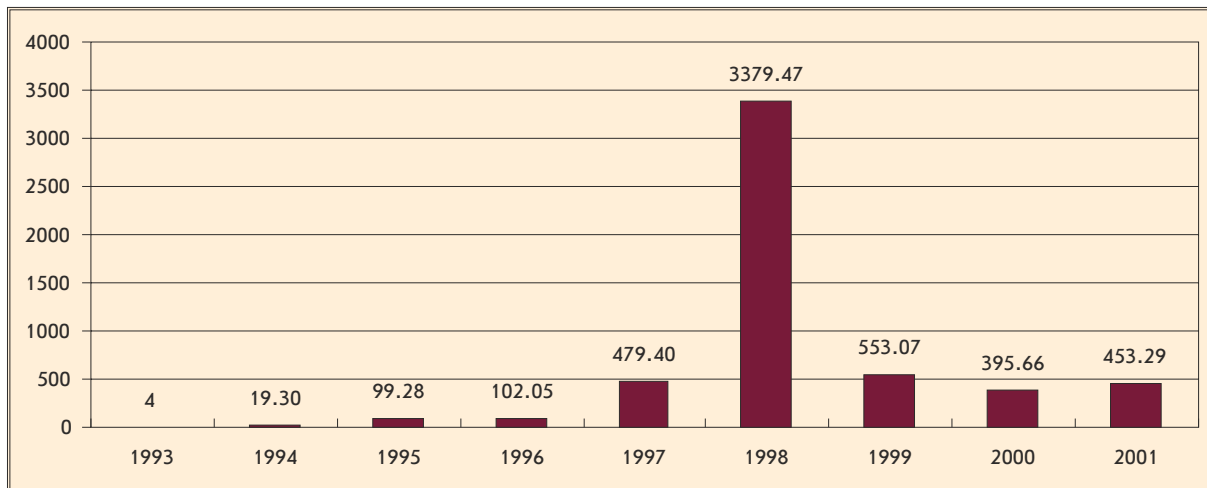
government and NGOs. In its administrative reform effort, Romania may benefit from the EU's official assistance under different pre-accession programs like the Phare and Ispa.

Privatization

In the first years of transition, privatization in Romania was a difficult and slow process. Although most small and medium-sized public enterprises were privatized in the early 1990s, large-scale privatization progressed only gradually. The State Property Fund of Romania was created in accordance with the law on privatization of enterprises, which was adopted in the second half of 1992. Its task was to ensure the transfer of state property to private ownership. Initially, the Fund's portfolio included almost 6,000 companies. Later, the government undertook a number of steps, including the revaluation of companies' land slots and the increase in their equity capital. The Fund's portfolio was then expanded to 8,500 companies. From December 1992 to December 2000, the State Property Fund privatized 7,244 companies.

To speed up the privatization process, Law #55 on mass privatization was adopted in 1995, allowing citizens of Romania to exchange privatization coupons for shares in approximately 4,000 companies. The plan was to privatize up to 60% of their equity capital in this way. The remaining 40% were supposed to be put up for sale to Romanian and foreign investors under a system of auctions and competitions. The privatization of large state enterprises was treated as a distinct matter, partially because of their weak financial situation (debts towards the state budget and dependence on financing from state owned banks), and due to the significant number of employees likely to be made redundant in an effort to improve efficiency. Accordingly, their privatization only started in 1998-1999.

Foreign Investment in Privatized Companies, \$ million



Source: State Property Fund of Romania

One of the particularities of this multistage privatization program is the creation of Financial Investment Companies (SIFs). These five funds were created as a means to indirectly privatize state owned enterprises: people were issued coupons representing participations in these funds which in turn were controlling stakes in various state companies, including all state owned banks.

The SIFs were organized on a combination of regional and sectoral basis. Although their legal status remained unclear for a long time, they transformed themselves in closed end investment funds and listed on the Bucharest Stock Exchange where they are among the most liquid stocks.

In late 2000, with the help of the World Bank the new government developed new privatization legislation that introduced a new approach to privatization envisaging acceleration of the privatization process. In 2000, the State Property Fund of Romania was transformed into the Authority for Privatization and Management of State Ownership (APAPS). Its main objective is competitive, transparent, and efficient privatization and restructuring of companies. In 2002, the government announced a new Law on Accelerated Privatization, which includes proposals to privatize loss-making firms for low prices. Among major successes in recent years were the sales of the bankrupt state bank, Banca Agricola, and several large industrial enterprises.

Methods for privatization sales are the following:

- Public offering
- Selling stakes on the stock market
- Commercial and non-commercial competitions
- Sealed bid auctions
- Placing deposit certificates on international capital markets

Largest Privatization Sales for Romania

Company	Operations	Buyer	Stake	Amount, \$ million
1998				
Romtelecom S. A.	National telecommunications operator	OTE Hellenic Telecommunication Organization	35%	\$675
Banca Romana de Dezvoltare	Leading commercial bank	Societe Generale S.A.	51%	\$200
Rulmenti S.A. Alexandria	Bearings production	Koyo Seiko company Ltd	51%	\$37
Petrotel S.A. Ploiesti	Oil refining	Lukoil	51%	\$52
1999				
BANCPOST S.A.	Commercial bank	General Electric Capital, Banco Portugues de Investimento	45%	\$92.8
Automobile Dacia S.A. Pitesti	Leading automobile manufacturer	Renault	51.05%	\$269.7
Astra Vagoane Arad S.A. Arad	Leading producer of freight cars	Trinity Industries Inc., USA	70%	\$100
2000				
Letea SA Bacau	Pulp and paper	SABA Investments Overseas Ltd., Cyprus	79.84%	No data
SANTIERUL NAVAL S.A. Tulcea	Shipyard	Aker Bratt Vang AS, Norway	70%	No data
Rulmenti S.A. Barlad	Bearings production	Kombassan Insaat Ticaret SA, Turkey	64.34%	No data
SANTIERUL NAVAL S.A. Braila	Shipyard	Scandinor AS, Norway	69.52%	No data
2001				
SC Sidex S.A. Galati	Metallurgy	LNH Holdings	90%	60/70
SC Rafo S.A. Onesti	Petrochemicals	SC Imperial Oil S.A. Bacau, Romania, Servicos LDA, Portugal	59.99%	No data

Banca Agricola S.A.	Commercial bank	Fondul Romano-American, Raiffeisen Zentrallbank Osterreich AG	98.83%	15+37
SC ELSID S.A. Titu	Metallurgy	SC Metal Eurorest S.A., Romania	70.71%	No data

Source: State Property Fund of Romania, APAPS

At the request of potential buyers, companies put up for privatization must provide free access to all required information. The starting price for the company at auction is usually equal to the nominal value of the stake; however, the minimum sale price is not stipulated by law. The final price is set by competition on auctions, irrespective of the privatization method.

Legal regulations of privatization provide for post-privatization monitoring of company development and control over new owners' activities in meeting obligations assumed under privatization contracts. If obligations are not met, the company could be taken back by the government and re-privatized.

As of July 1, 2002, the APAPS portfolio included 1,395 companies in all sectors of the economy with total equity capital of ROL 29,211 billion. According to the privatization program for 2001–2004, the tasks of the APAPS include completing the transfer of state property to private ownership through competitive and transparent procedures. The main goal of the APAPS is to complete the implementation of the Private Structural Adjustment Loan (PSAL) provisions. PSAL is a program developed by the government of Romania jointly with the World Bank and the IMF, who provided a loan of \$300 million for this purpose. The implementation of PSAL (PSAL I and PSAL II) is an essential condition for Romania's EU accession.

The privatization program envisages four key actions to speed up the restructuring and privatization process, namely:

1. Banking sector restructuring
2. Privatization of state-owned companies
3. Improvement of the business environment
4. Reduction of negative social impact

The PSAL II program is aimed at expanding the progress achieved by PSAL I to support financial stability of the country, required for EU accession. According to PSAL II, a large number of attractive large and medium companies will be put up for sale. Some 10 large companies will be restructured with assistance from external consultants.

In 2002, APAPS sold 60% of the companies included in PSAL I and received \$82 million from privatization. The plan for 2003 is to receive approximately \$75 and complete both PSAL I and PSAL II. Today, there are 390 companies in the APAPS portfolio with total equity capital amounting to 5% of the capital of all Romanian companies.

Therefore, apart from macroeconomic imbalances, other major obstacles to successful privatization in Romania were the strict investment and employment conditions attached to privatization contracts. Also, many state-owned companies offered for sale have huge debts that complicate their privatization. A major privatization challenge for Romania is to successfully sell the largest remaining state-owned bank and to perform energy sector privatization. The failure to sell this

state-owned bank in 2002 was the main reason for the IMF suspending its lending program to Romania. In early 2003, the Romanian government initiated negotiations with the EBRD and the IFC in order to facilitate their acquisition of a 25% stake of the bank, while the remainder of the state's share is planned to be sold to a strategic investor within three years. The contract with EBRD and IFC was signed in September 2003.

In 2003, the government also intends to privatize two major gas and two electricity distribution companies, and SNP Petrom, the state oil company (a stake of 51% is offered through a combination of selling part of the government existing stake and a capital increase). After receiving expressions of interest from 15 groups, the government announced a short list of bidders in October 2003 that are expected to submit binding proposals by February 2004. The signing of the contract is expected by the end of March 2004. Although the IMF views this privatization agenda as too ambitious, it supports the government's intentions.

(iv) Liberalization of Foreign Trade and Capital Movements

Romania has a relatively free trade regime. Since 1990, any company in Romania has had the right to perform foreign trade operations, which were previously subject to licensing. Most of the excessive licensing requirements and customs tariffs were removed in 1992. Further liberalization of trade and capital movements took place as Romania concluded international trade agreements. Romania's association agreement with the EU, which came into force in 1995, contributed the most to further merchandise trade liberalization. Since 1997, trade for all goods, except for agricultural products made in the EU, is free from tariffs. In 2001, Romania abolished all duties and ceilings on manufactured goods.

Romania has also signed other international trade agreements. In 1997, Romania signed the Central European Free Trade Agreement (CEFTA), which envisaged the creation of a free trade zone for manufactured products in Central Europe by 2002. In 1999, Romania became a member of the World Trade Organization (WTO). Thus, its trade policies fully comply with the commitments of the Uruguay round. The 2004 enlargement of the EU should also contribute to a more liberal regime for Romanian exports to the central European economies that are included in the process. The Romanian government is holding negotiations aimed at concluding free trade agreements with other countries, including non-EU members. According to the IMF staff estimates, the average overall effective barriers to trade in Romania are small, and the average effective rate measured by import duty revenue relative to imports is low (at 2% in 2001.)

According to existing Romanian commercial legislation, there is virtually no discrimination between foreign and domestic investors. Foreign investors have free access to domestic markets, and are given the right to participate in privatization. There is no limit on foreign participation in commercial companies. Foreign investors are allowed to participate in the management and administration of the investment, as well as to assign their contractual obligations and their rights to other Romanian or foreign investors. In 1999, the government suspended the investment incentives provided to large foreign investors following an agreement with the World Bank and the IMF. This move established an equal fiscal regime for both Romanian and foreign investors. Also, foreign investors may freely repatriate profits and dividends in hard currency. There is no limitation on the inflow or outflow of funds for remittances of profits, debt service, capital gains, returns on intellectual property or imported inputs.

In the area of capital movements and payments, the National Bank of Romania launched the three-stage liberalization program in July 1999, which envisaged relaxation of controls on capital transfers. However, there are still restrictions remaining on capital imports and exports. The purchase of real estate by non-residents is forbidden by the legislation. However, there is an exception for companies established in Romania, even if wholly foreign-owned, which are allowed to purchase land needed for the conduct of their business.

(v) Financial Sector Development

Banking System

Banking system reform in Romania began at the end of 1990 when all banks were state owned. By 1998, there were about 50 banks registered in Romania, 7 of which were state-owned. Despite the substantial increase in the quantity of the banking institutions since 1990, their performance as financial intermediaries has been weak. The main activities in which most Romanian banks were involved was lending to the government through purchase of treasury bills. In 1999, the country was on the verge of a banking crisis because large state-owned banks turned out to be practically insolvent after accumulating huge loan portfolios to inefficient state enterprises. After successful restructuring of its major state-owned banks, the Romanian government managed to overcome the banking troubles. In 1999, Romanian authorities liquidated Bancorex and sold Banca Agricola in 2001 to a consortium of foreign strategic investors led by Reiffeissen Bank (Austria).

In September 2003, after prolonged negotiations, a consortium formed by IFC and EBRD acquired a 25% stake in Banca Comerciala Romana (BCR) for USD220mn, while a further 8% stake will be sold to the employees. BCR is the largest bank in Romania, accounting for 31% of total banking assets.

A key challenge for further financial sector reform is the strengthening of the financial and management practices of the banking sector, including the consolidation of its capital base. In particular, the current rapid growth of banking credit in Romania raises concerns of IMF specialists, who doubt the ability of the central bank to effectively carry out the assessment of the banks' creditworthiness. Another issue of concern is that the level of lending to the private sector remains quite low as compared with government sector lending. On the other hand, with the decline in interest rates and the privatization program, lending to the government and majority state owned companies began to lose its attractiveness. Loans to the private sector increased 28% in 2001 and 32% in 2002 respectively.

In 2003, the government endorsed draft amendments to the main banking law of Romania to make its major provisions consistent with EU requirements. These amendments also seek to enforce tighter prudential regulations and more effective monitoring and supervision of the financial sector by the central bank.

Capital Markets

Non-banking institutions, such as stock markets, mutual funds and insurance, are still in their early stages of development. The mutual funds industry suffers from very poor supervision as was illustrated by the collapse of the largest mutual fund in the country in 2001, which created

significant losses for domestic private investors and a marked decline in confidence towards this type of investment vehicle. Consequently, the main activity on the Romanian capital market is issuance and sale of government securities, concentrated in the primary market. However, lack of investor interest in government and corporate bonds, resulting from their low real profitability, caused the revival in trade of other securities.

The development of the Romanian Stock Markets is related to the privatization program. Apart from the Bucharest Stock Exchange (BSE), RASDAQ was created as an OTC market aimed squarely at offering citizens a mean to cash out the shares they received during the various privatization programs. The shares of the state owned companies were listed automatically on Rasdaq and at one point over 5000 companies were listed although the daily amount of participating companies was only 500.

The trading on the two stock markets was limited until the early 1997, when a pro-reformist government came into power. Also on the back of positive sentiment towards the emerging markets, foreign investors poured in and drove up trading volumes and share prices. This period also witnessed the creation of regional and country focused investment funds. In late 1997 and early 1998, as reforms started to slow down and on the back of the Asian and Russian crisis, the Romanian stock markets entered a period of prolonged decline.

At the same time, the activity of foreign traders declined considerably, being only partially replaced by the activity of domestic financial and industrial groups. This activity resulted in a flurry of tender offers aimed at taking private former state owned companies, which were privatized. This activity affected mainly companies on the Rasdaq market, but also affected BSE listed companies (Arctic, Terapia). This activity, however, is not likely to maintaining market growth. The market participants believe that only by reducing inflation and bringing new companies to the stock market is it possible to considerably improve the situation on the market.

The recovery of the Romanian economy over the last two years, namely the recovery of its private sector, suggests that the Romanian stock market will grow considerably into the future. In early 2002, the Romanian government passed new legislation on the stock market (developed in compliance with the World Bank and EU requirements), which is one of the favorable factors facilitating the process. The Romanian stock markets were among the best performers during 2002. The table below presents an overview of the activity on BSE from 1996 until 2001 and a detailed overview of 2002.

Overview of the Bucharest Stock Exchange 1996–2001

Year	No. of Shares Traded	Avg. Daily Turnover (US\$)	Market Cap (US\$mn)	No. of Listed Companies
1996	1,140,000,000	62,850	61	17
1997	615,795,189	1,602,165	632	75
1998	986,804,827	758,080	357	126
1999	1,069,280,848	389,919	317	126
2000	1,828,468,521	337,425	366	115
2001	2,213,096,602	530,339	1,229	65

Overview of the Bucharest Stock Exchange during 2002

Romanian Stock Market size		
YE2002 MkCap (US\$ bn)	2.7	
YE2002 MkCap (Lei trn)	91.6	
Romanian Stock Market performance		
BET Index* (y-o-y, US\$)	104.8%	
BET-Composite (y-o-y, US\$)	111.4%	
Overall market turnover		
	Total (US\$mn)	Daily avg. (US\$ '000)
Market turnover in 2002	213.7	898.1

Top ten stocks by Market Capitalization

		Sector	MkCap (US\$mn)	Daily Turnover (US\$)	Float (%)
1	SNP Petrom	Oil & Gas	1,410.8	139,303	7.0
2	BRD	Banking	537.7	136,150	41.7
3	Alro Slatina	Aluminum	73.4	5,088	3.5
4	Banca Transilvania	Banking	67.7	99,408	85.0
5	SIF 4 Muntenia	Financial	63.5	29,550	100.0
6	SIF 1 Banat-Crisana	Financial	49.7	48,100	100.0
7	SIF 3 Transilvania	Financial	47.0	37,128	100.0
8	SIF 5 Oltenia	Financial	43.9	73,865	100.0
9	SIF 2 Moldova	Financial	39.3	65,169	100.0
10	Terapia Cluj**	Pharmaceuticals	39.1	46,088	100.0

Top ten performing stocks

		Sector	Y-o-y perf. (US\$)	Daily Turnover (US\$)
1	SIF 2 Moldova	Financial	153.30%	65,169
2	Arctic Gaesti ***	White goods	150.30%	87,581
3	SIF 1 Banat-Crisana	Financial	142.40%	48,100
4	SIF 5 Oltenia	Financial	140.80%	73,865
5	SNP Petrom	Oil & Gas	140.30%	139,303
6	Impact Bucuresti	Real estate	136.80%	7,714
7	SIF 3 Transilvania	Financial	121.30%	37,128
8	Sicomed Bucuresti	Pharmaceuticals	117.80%	15,704
9	BRD	Banking	112.50%	136,150
10	Antibiotice Iasi	Pharmaceuticals	82.10%	21,320

NOTES:

- * BET is a market-weighted index of the ten most liquid stocks trading on BSE
- ** In 2003 Advent launched a tender offer for Terapia shares and will delist it
- ** Excluding the Arcelik deal (US\$18mn on Oct 18) average daily turnover US\$9,837

(vi) Corruption

Corruption has been a serious concern among investors in Romania. According to the results of the opinion poll performed by a local polling agency on behalf of the Open Society Institute at the end 2002, 67% of people interviewed believed that corruption is pervasive in both the government and the parliament of Romania. Recognizing the need to address the problem of corruption,

the government has put anti-corruption initiatives and other public administration reforms high on their agenda. It believes that the development of a comprehensive and transparent anti-corruption program will help improve the efficiency and quality of government services and strengthen the trust in political and state institutions. To assist in developing an anti-corruption program, the Romanian government requested World Bank support. In early 2003, a new law was introduced to prevent and uncover corruption within public institutions and banks. The law is directed at officials who take part in government decision-making or are able to influence it in some way. In particular, the legislation requires top public officials to file detailed financial-disclosure statements and mandates members of parliament to resign from the management or boards of private and state-owned companies. International organizations praised the new package of anti-corruption legislation, but it remains to be seen whether that legislation will be enforced effectively. The level and pattern of corruption impose significant costs detrimental to Romania's development as it creates disincentives for investment and growth. However, given the overall positive climate for reforms in Romania, there are grounds to believe that situation will gradually improve in this area.

(vii) Political Risks

The positive economic results achieved by Romania since 2000 are due to the determination of the government elected in that year. The latest parliamentary elections in Romania were won by the Party of Social Democracy in Romania (SDP). Although the popularity of the ruling party fell from almost 60% in December 2002 to 43% in June 2003, the positive economic growth achieved by the implementation of economic reforms should maintain strong commitments to reforms by any political party that may win the next elections. The next presidential and parliamentary elections are set to take place in late 2004 or early 2005.

The main challenge for the incumbent government is to sustain the pace of reforms during the pre-election period and avoid popular policy actions that can be detrimental to the country's macroeconomic stability. Political analysts believe that this government is likely to stand firmly on track of reforms. As main supporting arguments, they name the strong political will of the government compared to its predecessors, and the need to comply with the strict EU membership requirements in time. Therefore, political risk is not considered to be a serious impediment to investment in Romania.

(viii) Country Promotion and Image

The country's image has improved dramatically over the last three years. The invitation to join NATO and progress on the road to EU membership contributed to the improvement of the Romanian international image. Based on its solid economic performance, the international bond rating agencies have recently upgraded Romania's sovereign rating. Currently, Romania's long term debt denominated in foreign currency is rated BB- by Fitch (recently put under "rating watch positive", so it will likely be upgraded), BB by S&P (upgraded on September 17), and B1 by Moody's scale.

(ix) Targeted Investment Incentives

In July 2001, a law on the promotion of investment was adopted, granting tax exemptions for Greenfield projects that exceed \$1 million. It was followed by a new initiative in March 2002 to create the Romanian Agency for Foreign Investment, which has to facilitate the work of foreign investors currently operating in the country and attract new investors to the field, to take steps to improve the country's international image among investors.

INVESTMENT FUNDS OPERATING IN ROMANIA

Foreign investment funds are among the most active players on the Romanian market. Their appearance on the market coincided with the consolidation of the private sector. Starting in 1996, investment funds became significant players in developing private businesses. The targeted companies were those with vast growth potential, stable markets, and competitive management. Most of the senior managers of operating investment funds are confident about the positive future development of the Romanian economy.

The activity of the investment funds is regulated by Regulation 5 issued by the National Commission for Securities in April 1998. An investment fund is defined as a venture capital association set-up as a closed investment fund or investment company, which manages the funds of individuals and legal entities. The Romanian venture capital industry is still very young; therefore, capital available for the funds is mainly raised abroad. Consequently, the market is highly dependent on expectations of external institutional investors.

Regional funds are becoming more active compared with country funds, which is connected to the large volume of deals. Nevertheless, the competition among the funds is not very intense. Banks are not yet a threat for the funds due to the relatively unstable economic climate and the higher risk of long-term development financing compared to operations on money markets or stock markets. Due to this, entry barriers remain low and investing remains profitable. As the capital market is still not developed enough, the most probable exit route to be used by those owning Romanian companies is via resale to strategic investors.

Summary of Major Investment Funds Operating in Romania

Name	Founding Date	Capital, \$ million
American International Group New Europe Fund	1998	\$320 (\$110 for Romania)
Oresa Ventures Fund	1997	\$70
Black Sea Fund	1998	\$62
Romanian American Enterprise Fund (RAEF)	1994	\$61
Advent Central & Eastern Europe II	1998	\$200 (\$60 for Romania)
Danube Fund Ltd.	Not available	\$30
Romanian Growth Fund	1997	\$25
SOLO FUND	Not available	\$20 (10 for Romania)
SEAF Trans-Balkan Romania Fund	2001	\$8

Advent Central and Eastern Europe II

Advent Central and Eastern Europe II, which manages \$200 million, was established in 1998 on the basis of Advent Central and Eastern Europe I, which had already invested \$70 million in the region. Investors in the fund are EBRD, IFC and American and European pension funds. The managing company is Advent International Corporation. It plans to invest all of the fund's money in Central and Eastern Europe. About \$60 million could be directed to the Romanian economy. The fund currently has two major investments in Romania: Mobifon and Euromedia. Another investment — a large brewery holding — was successfully exited during 2000. Advent's primary investment focus is on established companies that generate significant revenues, have good

management, and growth potential. The typical investment size is \$10–15 million (but not less than \$8 million). Investments can be of both controlling and non-controlling stakes. The fund actively assists company management in operational issues and seeks representation on the company's Board of Directors. It usually exits in 3–5 years. Advent does not invest in tobacco, spirits, real estate, weaponry, and new venture projects.

American International Group New Europe Fund

The fund was created in 1998. Its major objective is to achieve substantial capital appreciation by investing in companies that have the potential to become top market players in Central and Eastern Europe. The fund is managed by A.I.G.-C.E.T. Capital Advisors Ltd. The fund's major investor is A.I.G., which in addition to investing \$1 billion of its own assets in company stakes in emerging markets is also managing \$8 billion in third party assets of such investments. The regional fund manages capital of \$320 million, out of which \$110 million are available for Romania. The fund typically invests between \$10–30 million in a project. The targeted sectors are high tech, telecommunications, services (including financial), and fast moving consumer goods. Significant investments: MobilRom, Luxten, and Astral, totaling \$85 million so far.

Barings Central European Fund

BCEF is sponsored by Baring Private Equity Partners (BPEP), part of the ING Group. BPEP provides BCEF unparalleled access to ING financial and information resources. The fund has a regional focus investing in Romania, Bulgaria, Poland, the Czech Republic, Slovakia, and Hungary. Approximately 40% of the investment is concentrated in Romania. The targets are medium and large companies that require a minimum of Euro 7 million, and they are active in any promising sector except for the media industry. Exits take place after 3 to 5 years. Significant investments: Topway Craiova (exited through a trade sale to Orkla, a Nordic food processor) and Infopress.

Black Sea Fund

Established in August 1998, it is the fourth fund of Global Finance and is affiliated with the Greek Latzis Group. The Black Sea Fund, (main investors include the EBRD, IFC, and EuroBank) has an available fund for Romania of \$62 million. As of early 2002, the capital already invested was approximately \$40 million. The main investment criteria: minimum investment of \$2 million, significant position on the market, and quality management. Major investments were made in companies like Chipita Romania, Delta Romania, Sicomed, and Mobil Rom.

Danube Fund Ltd.

Danube Fund Ltd. is a venture capital fund investing mainly in Romania. The management of the fund is the Southeastern Europe Management Co., with headquarters in Athens and a branch office in Bucharest. The authorized capital is \$30 million, out of which \$19 million has already been subscribed as of the beginning of 2002. The investors are Alpha Bank Group, EBRD, IFC, Bankers Trust, other institutional investors and Greek industrialists with business projects in the region. The fund invests in companies, where it can buy a considerable minority stake with a strategic investor already involved. Investment size is between \$0.5 and \$2.5 million per project; the required annual rate of return is a minimum of 30% in dollar terms.

SOLO FUND

SOLO FUND is a private, closed-end fund managed by the Global Business Group (GBG), 100% owned by Philip Bloom. The capital is \$20 million out of which \$10 million is available for Romania. The targeted companies are state and private companies in the domain of real estate. Earlier, GBG acted as a counselor and an adviser to Bankers Trust.

Oresa Ventures Fund

This is a Swedish investment company that has been present in Romania since 1997 with a current net asset value of \$70 million. Major investments include Flanco International SRL, Churchill Media SRL, Medicovert, Motoractive, and Brewery Holdings Ltd (sold through a trade sale to BBAG for a reported 100% IRR).

Romanian American Enterprise Fund (RAEF)

RAEF is a private US corporation whose mission is to promote private entrepreneurship in Romania through investments and loans to local companies. RAEF was established in 1994. Its \$61 million capital was granted by USAID. The main investments include Policolor, Rolast, Tec Miaco, Titan Mar, and Banca Romaneasca (recently sold to National Bank of Greece).

RAEF operates in 4 areas:

- Major Transaction Program (MTP) — makes investments of \$1 million to \$5 million in medium and large companies with strong growth potential and strong management
- Capital & Trade Development Group (CTDG) — strives to increase volume and number of deals between Romania and the United States in the spheres of international investment and trade
- Small Business Investment Fund (SBIF) — investments from \$50,000 to \$350,000 in private companies nationwide
- Micro Loan Program (MLP) — extends loans ranging from \$2,500 to \$15,000 to small companies at a fixed interest rate. The program is operational in eight Romanian cities

Romanian Growth Fund

The fund was created in 1997 with a capital of \$25 million. The fund is managed by Global Euro Asia Management Company and the advisor in Romania is Global Valori Mobiliare. Fund investments do not exceed 33% of the company's equity. The targeted companies are operating in the automobile, petrochemical and consumer goods sectors. Since launching, the fund has registered a significant decrease of its net assets value, caused by the decline of Romanian stock indices.

Romania & Moldova Direct Fund

The fund began operations in 1999 with a capital of \$31 million contributed by private investors and the IFC. The fund has an 8-year life, with a possible extension of 1–2 years. The fund acquires both minority and majority stakes in perspective companies targeting sectors such as energy, construction materials, and services (including telecommunication). Significant investments:

Rompetrol S.A. (exited by selling its participation to OMV, the Austrian based regional petrochemicals group) and Sanex S.A.

Romanian Post Privatization Fund

The capital of the fund is EURO 44 million, EURO 32 million of which has already been invested in stakes of Romanian companies supported by a strategic investor (domestic or foreign). The investors of the fund are the EBRD, Romanian Post Privatization Foundation, and G.E.D. Eastern Fund I. The investment size ranges from Euro 0.3 million to Euro 4.4 million. It recently exited its investment in Vital Gaz through a trade sale to Pelagas.

SEAF Trans-Balkan Romania Fund

The fund entered the Romanian market in March 2001, by taking over the former K+ Venture Partners Fund. The management of this \$8 million fund is ensured by Small Enterprise Assistance Funds LLC, an American company specializing in investments in small- and medium-sized enterprises operating in developing markets. The major investors are the IFC, FinnFund, Norfund, Black Sea Bank for Trade and Development, and the governments of Germany, Holland, and Switzerland. The average size of investments made by the Fund is \$400,000. Type of investments: purchase of non-controlling stakes or convertible loans.

EBRD AND WORLD BANK ACTIVITIES IN ROMANIA

Romania is one of the EBRD founders. The EBRD office in Bucharest was set up in June 1992. To date, the EBRD has invested over \$2 billion in over 70 investment projects in Romania, which accounts for 11% of all investments made by the bank. By volumes of EBRD investments, Romania ranks third after Russia and Poland.

The EBRD invests in the following sectors of the Romanian economy: transport, telecommunications, banking sector, tourism, electricity sector, and municipal property. The Bank program includes both investing in private companies and in infrastructure projects. In 1999 and 2000, new projects in the pulp and paper industry, GSM-based cellular telephony, and the banking sector were launched. These projects included post-privatization financing of a paper-factory reconstruction, the largest bank privatization to date (Societe Generale Romanian Development Bank), and opening credit lines for Banca Transilvania and Romanian Commercial Bank within the framework of the EBRD-EU Horizontal Facility. Additionally, EBRD has stakes in several investment funds.

EBRD was the first to invest private capital in infrastructure development in Eastern European countries. The Suez Lyonnaise Timioara project was the first purely private concession for regional water supply and water disposal services. Over the last few years, however, EBRD has been increasingly focused on financing private companies: large scale industrial and bank privatization with strategic investors, venture projects, and investment funds.

The World Bank started its activity in Romania in 1991 by opening its first office in Bucharest. Over the subsequent 10 years, the Bank has financed 30 projects, 20 of which are not completely implemented yet. The aim of the World Bank lending program in Romania is to support and assist with reorganizing the social security system, the systems of education, health care, environment protection, and reforms in government authorities. From 1997 to 2002, the World Bank allocated loans totaling over \$1.3 billion. From 2002 to 2004, the Bank envisages loans totaling over \$1 billion.

OVERVIEW OF ROMANIAN INDUSTRY SECTORS

Agriculture

Romania possesses good conditions for cattle breeding, gardening, grains, and oil plants. About 62% of Romanian land (over 10 million hectares) is arable; another 28% of the territory is covered by forests. Romania ranks sixth in Europe by cultivated area and ninth by potatoes, fruits, vegetables, and melons production volume. Today, after land privatization, about 85% of agricultural land is in private ownership. As a result of the reform, there appeared a large number of small farms with an area of about 2 hectares and low productivity. The government initiated numerous long-term reforms in the industry and made its development a priority. There still exist a large number of state farms that are to be privatized (about 1.5 million hectares).

Food industry and Confectionery

This sector was the first to attract international capital, mainly due to the market size (ranking second after Poland) and prospects. Major investors on the market are Coca-Cola, Pepsi Co., Danone, Wrigley, McDonald's, and Kraft, which purchased Romanian companies during the privatization process and modernized them. At the same time, Romanian companies (Excelent Bucharest, Kandia Timisoara) have the largest market share. Since 1999, the confectionery market has been growing steadily at the annual rate of 5%–6%. This trend is expected to last through at least 2005.

Trade

Like in other Central European countries, new trade forms developed actively including supermarkets and hypermarkets, shopping centers, and cash carry stores. The major retailers are Metro (12 stores), Billa (9 stores), Mega Image (11 stores), REWE, and Gimma. Plaza Carrefour plans to open up to 20 hypermarkets within the next 10 years. In 2002, Cora, Leclerc, and Intermarche entered the market.

Production of Construction Materials

This market sector remains especially attractive for foreign investors. Today, about 80% of the companies in the sector are in private ownership (in 1990, only 5% belonged to private owners). The largest cement manufacturer, Rumcim, (which accounts for half of cement production in the country) was purchased for \$200 million by the Lafarge Group (France) during a privatization tender. The construction group Holderbank Financiere Glaris Ltd. (Switzerland) owns the Cimentul SA plant and plans to buy the Cimus SA plant. Heidelberg Zement invested about \$70 million. In response to the rise in demand for quality office buildings, Pilkington Plc. (Great Britain) plans to invest \$100 million in the construction of a glass manufacturing plant. In 2002, the Romanian construction materials market increased its sales volume by 7%.

Oil and Gas

Romania possesses considerable oil and gas resources and produces a wide range of petrochemical products. The EBRD and the World Bank support the sector's 20-year reconstruction program. The companies that already operate on the Romanian market are: Shell, Enterprise Oil, Paladin Resources, and Elf Aquitaine. Romania has vast experience in manufacturing, drilling and oil producing equipment. Expert staff, proximity of the Caspian oil and gas pipelines, and good relations with Russia and Arab countries are the positive factors for further growth in the sector.

Romania has a developed petrochemical sector. Its capacities are mostly used to process imported oil (today, the plants operate at 50% of their capacity). Reform in the sector started in 1997, when the national company SNP Petrom was created. Petrom is a vertically integrated company that includes an oil-producing company, three oil refineries, and the largest sales network on the market (Peco-Petrom). The third largest oil refinery in Romania (Petrotel) was purchased by Lukoil Europe (Russia) in 1998.

Electricity Sector

The reform of the monopoly power supply market started in Romania relatively late. In 1998, RENEL, a vertically integrated generating company, was divided into 5 separate companies: 3 power generating companies, 1 distributor, and 1 power supply company. The Romanian government made considerable investments in the completion of a nuclear power generating company in Cernavoda. The government plans to carry out further restructuring and privatization in the sector, implement market principles of the electricity market operation, as well as to cancel government subsidies and to attract foreign investments.

Metallurgy

The Romanian metallurgical industry is sufficiently developed and diversified, but its vast production capacities are vastly underused. The largest metallurgical companies remain in government ownership, yet there are restructuring programs aimed at higher efficiency with lower production volumes. Sidex is the largest European metallurgical combine; in 2000, its output was 3.6 million tons. Sidex was successfully sold in 2001 to LNM-Ispat (Great Britain-India), which boosted privatization in the sector. The companies producing aluminum are Alro (primary aluminum) and Alprom (processing). Both companies have been successfully restructured and privatized.

Light Industry

The light industry became the model of successful restructuring. Today, 98% of the sector is in private hands. The Balkan crisis attracted a lot of foreign investors to the sector. Considerable inflows of foreign direct investments caused an export boom that reached its peak in 2001 realizing \$4 billion (or 35% of total Romanian export), with textile exports accounting for a quarter of that sum. Further development is most likely to take the form of mergers and acquisitions.

Automobile Industry

The sale of Dacia, the largest Romanian car manufacturer, to Renault (France) in 1999, spurred the industry's rapid development. The company had a 5-year exemption of profit tax, customs duties, and VAT for imported component parts. A favorable climate was created for investing in spare parts production. The largest European manufacturers (Le Belier, Continental, Sylea, ThyssenKrupp, and Autoliv) invested over \$500 million in setting up new manufacturing departments.

Pharmaceutical

The Romanian pharmaceutical industry has been steadily developing over recent years. From 1999 to 2001, the average growth rate in the sector was 8.3%, (in 2001, it reached 18.1%). In 2001, the sales volume was over \$0.5 billion, yet government purchases accounted for half of the volume. About 65% of pharmaceutical products consumed in Romania are imported. The largest investors in pharmaceutical companies are GSK, Lek, Pfizer, Rhone-Poulenc, KRKA, and Eli Lilly — they own over 60% of the capital in the sector. In 2003–2004, the government plans to complete privatization in the sector by selling the last state antibiotic manufacturer Antibiotice Iasi.

Tourism

The government makes great efforts to attract investments in developing tourism in Romania. The largest project planned was the construction of Dracula Park — a recreation amusement complex. However, the location of the project was changed several times on environmental grounds, and the current status is uncertain. Development of recreation areas and resorts on the Romanian Black Sea coast and in the Carpathians also has been booming, along with more traditional health and treatment offerings

Information Technologies

The information technology sector has been actively developing and remains one of the most attractive sectors. There are a fairly large number of expert specialists in Romania, and the labour costs are considerably lower than in the Western Europe. There are also a lot of private companies that have experience working in the sector. The hardware market grows by 10%–12% per year. The application of modern electronic technologies to local governments, health service, etc. is a promising source of growth for the industry.

Telecommunications

In 2002, the total volume of the telecommunication services was over \$1.5 billion. The government plans to invest \$7–8 billion in upgrading telecommunication networks within the next 15 years. The program, sponsored by the EBRD and the World Bank, presupposes installing 500,000 new phone numbers and digital systems implementation. Foreign companies actively participate — in 1998, OTE (Greece) purchased a 35% stake in RomTelecom, a Romanian monopolist of

fixed communication (on January 1, 2003, the telecommunication market was liberalized). According to a \$100-million contract, Ericsson will develop Internet services for RomTelecom. Alcatel is currently building its fixed phone network. Investments in the project have already exceeded \$120 million. There are 4 mobile communication operators in Romania. About 20% of the population uses their services.

Cable television in Romania has developed rapidly. In 2001, about 45% of all families had access to cable TV. Development of cable TV networks and Internet access is financed mainly by venture funds, which still consider this segment very promising. Currently, about 13% of the Romanian population has Internet access.

RISKS AND OPPORTUNITIES

Based on the data received, we have conducted an analysis of the risks and opportunities of creating an investment fund in Romania.

Opportunities and Strengths of Romania:

- Stable political situation;
- Romania is in the second wave of EU accession, and is expected to join in 2007;
- There is tremendous pressure on Romania to stick to reforms and meet the 2007 accession date;
- Before EU accession it is possible to buy assets at comparatively low prices;
- As a result of accession, valuations are expected to significantly grow over the next five or ten years;
- Significant gains on macroeconomic stabilization , including decreasing inflation, resumption of economic growth and a sustainable external position
- Romanian industry is well developed and mostly export-oriented to EU countries;
- Legislation is focused on the support of foreign investments and leveling the playing field;
- There is still room for additional investment funds
- Improved credit ratings confirm the improved investment climate led by reforms of the Romanian government.

Risks and Weaknesses:

- Despite reforms, Romania is still one of the poorest countries in the region with low purchasing capacity;
- Privatization is not completed: the government owns many strategic companies;
- Competition among existing investment funds.

CONCLUSION

Since the election of a new government in 2000, Romania started a new and more comprehensive approach to economic reforms. The reform intentions of the Romanian government have been strengthened by external factors such as prospective membership in the EU, which is conditioned on effective implementation of economic reforms. The main lesson that can be drawn from Romanian transition experience is that the right combination of macro- and microeconomic policies is instrumental for the success of market-oriented reforms. Romanian reform history proved macroeconomic stabilization could not be sustainable without effective implementation of a comprehensive market reform package aimed at creating a favorable business environment. The European Commission's annual assessment of Romania's preparedness for EU membership, published in October 2002, came to mixed conclusions. On the one hand, the Commission stated that Romania fulfills the political criteria for membership, and praised macroeconomic stabilization efforts of the Romanian authorities. On the other hand, the EU did not grant Romania the status of a fully functioning market economy because the government of Romania has yet to strengthen enforcement of enterprises' financial discipline, to improve tax administration and to accelerate privatization. Also, the EU expressed concerns over the level of corruption in the country and the efficacy of the institutions intended to fight it.

However, given the strong commitment of the incumbent Romanian government to proceed with reforms, Romania is firmly on track to become an efficient free-market economy and successfully integrate into the European Union in 2007.

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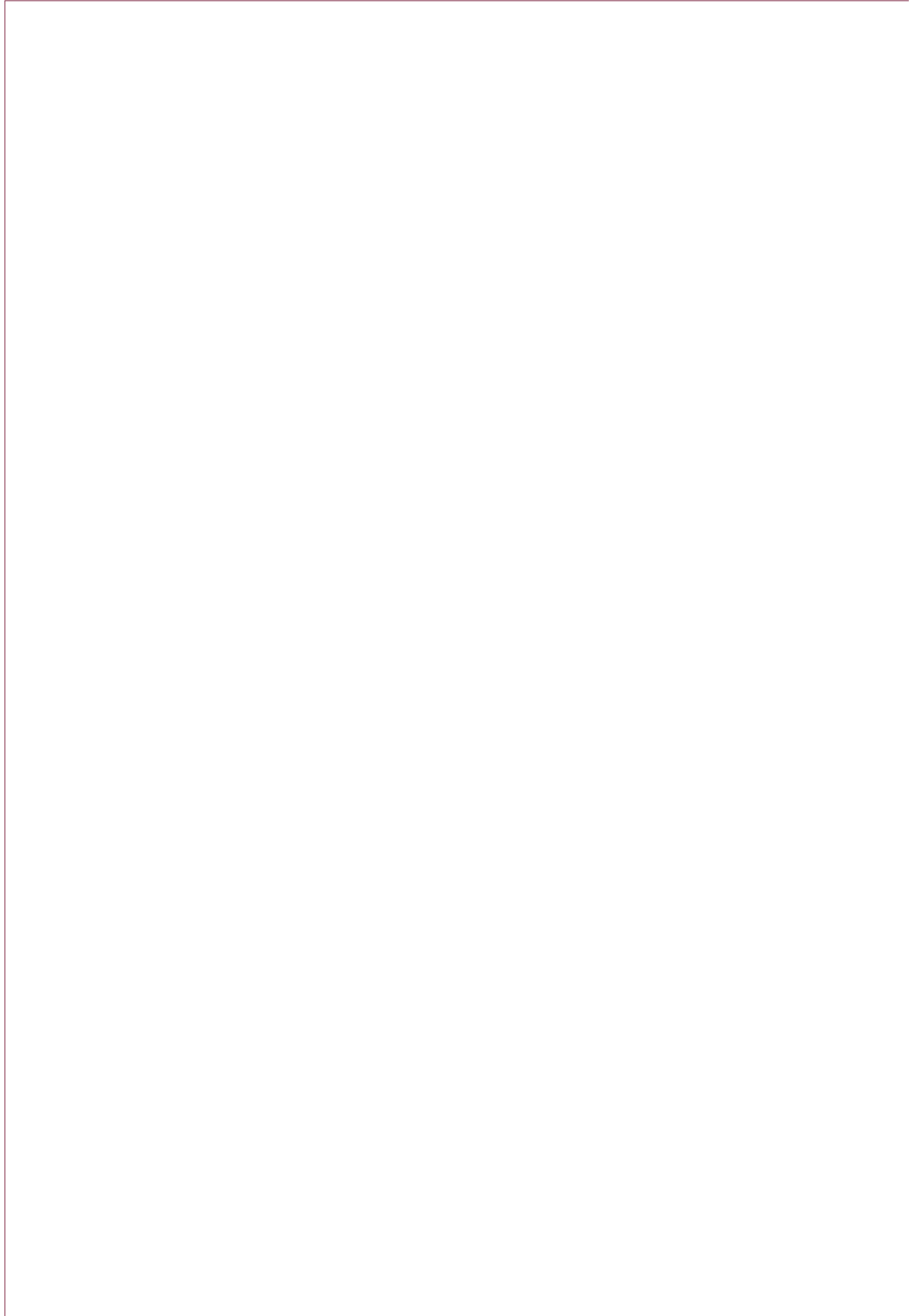
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APPENDIX

Romania: Key Economic Indicators

Year	Unit	1997	1998	1999	2000	2001	2002	2003 (e)
Population	mn, eop	22.55	22.5	22.46	22.43	22.4	21.7	n/a
Unemployment Rate	%, eop	8.9	10.4	11.8	10.5	8.6	8.1	8.9
Average monthly Salary	US\$	90.0	119.9	101.4	100.2	105.1	118.7	n/a
Real Sector								
GDP	US\$ bn	35.29	42.11	35.59	36.89	39.76	45.7	43.0
GDP per Capita	US\$	1,565.0	1,871.5	1,584.9	1,644.7	1,772.9	2,107.0	n/a
Real GDP Growth	% YoY	-6.1	-4.8	-1.2	1.8	5.3	4.9	4.5
Industry Share in GDP	%	30.9	26.3	24.8	25.2	25.8	25	n/a
Agriculture Share in GDP	%	18	14.4	13.3	11.1	13.4	12.5	n/a
Gross Domestic Investments/GDP	%	21.2	18.2	17.7	18.9	19	20	21
Domestic Savings/GDP	%	13.5	9.7	11.4	14.5	13.9	15	18
Public Finances								
Fiscal Balance (IMF method)	% of GDP	-5.2	-5.4	-3.6	-4	-3.1	-2.7	-2.5
Fiscal Revenues	% of GDP	28.6	29.7	31.9	31.4	30.5	30.0	36.7
Fiscal Expenditures	% of GDP	33.9	35.1	35.5	35.4	33.7	32.7	32.3
Monetary Statistics								
Consumer prices	% YoY, aop	154.9	59.1	45.8	45.7	34.5	22.5	15
Currency in Circulation	% YoY, eop	171.9	25.3	50.7	48.2	38.4	27.9	16.4
Money Supply-M2	% YoY, eop	104.9	48.9	44.9	38.0	46.2	17.2	26.6
Net Domestic Credit to Private Sector	US\$ mn	5,006	6,657	3,764	3,458	4,069	5,495	n/a
Foreign Exchange Rate	US\$, aop	7,168	8,876	15,333	21,693	29,061	32,691	n/a
Foreign Exchange Rate	EUR, aop	8,091	9,989	16,296	19,956	31,597	31,246	n/a
Balance of Payments								
Exports of Goods	US\$ bn	8,431	8,302	8,487	10,366	11,385	13,696	14,159
Imports of Goods	US\$ bn	10,411	10,927	9,744	12,050	14,354	16,430	16,710
Trade Balance	US\$ mn	-1,980	-2,625	-1,257	-1,684	-2,969	-2,734	-2,551
Trade Balance/GDP	%	-5.6	-6.2	-3.5	-4.6	-7.5	-5.9	-5.9
Net Services, Income & Transfers	US\$ bn	-157	-343	-212	321	652	1159	79
Current Account Balance	US\$ mn	-2,137	-2,968	-1,469	-1,363	-2,317	-1,573	-2,472
Current Account/GDP	%	-6.1	-7.1	-4.2	-3.7	-5.8	-3.5	-4.8
Net FDI Inflow	US\$ mn	1,224	2,031	1,041	1,037	1,157	900	1,000
Overall B/P Balance	US\$ mn	1,931	-455	645	1567	1,805	n/a	n/a
Gross International Reserves	US\$ bn eop	4,671	3,792	3,654	4,842	6,381	6,948	n/a
Public and Private Debt								
Public External Debt	US\$ bn eop	6,213	6,428	6,218	6,877	7,673	n/a	n/a
Private External Debt	US\$ bn eop	1,731	2,356	2,531	2,980	3,739	n/a	n/a
Total External Debt	US\$ bn eop	8,584	9,323	8,771	10,241	11,676	14,193	n/a
Total External Debt/GDP	%	26.9	23.5	24.5	27.7	29.2	30.4	30
Public Domestic Debt	US\$ bn eop	n/a	n/a	2.4	1.6	0.9	n/a	n/a

Source: IMF, World Bank, European Bank.



A FEW WORDS ABOUT US

SigmaBleyzer

SigmaBleyzer, an international investment company, was established in 1993. Founded by the Bleyzers, an American family from Houston, Texas, with Ukrainian heritage, the company is committed to providing a comprehensive range of financial services for those that do business in countries with transition economies, including Eastern Europe and the CIS region. SigmaBleyzer's worldwide network of industrial and financial contacts has ensured a strong investor base and strategic industry partners in the West. The main areas of activities of the company include investment banking, asset management, corporate finance and consulting services.

Michael Bleyzer, President and CEO of SigmaBleyzer, is a respected expert on developing countries and transition economies. Before co-founding SigmaBleyzer, he had a 15-year career with Exxon Corporation and Ernst & Young, which provided him with opportunities to work in management positions in Belgium, France, Germany, United Kingdom, Netherlands, and other countries in Europe as well as in Asia Pacific. He has the vision and drive that continues to propel the company ahead of the competition.

With the strength of the company's local infrastructure, implementation of western-style management and intimate knowledge of local market conditions, SigmaBleyzer has created one of the best investment banking organizations in Ukraine. Today, SigmaBleyzer's Ukrainian Growth Fund (UGF) portfolio consists of about 60 companies with estimated value of \$150 million. The most successful among them are Volia Cable — the largest TV-cable operator in Ukraine and one of the largest in the FSU, Softline — the leading Ukrainian software development company, Sevastopol Shipyard — a commercial shipbuilding, ship-repair and machine engineering facility, Poltava Confectionery — one of the largest and fastest growing companies in the industry, and many others.

The Bleyzer Foundation

The Bleyzer Foundation is an international non-government organization established in 2001. The Foundation was created by the Bleyzers, an American family with Ukrainian heritage. The President of the Foundation is Mr. Michael Bleyzer, President and CEO of multinational company, "SigmaBleyzer".

The Foundation's Managing Director is Mr. Victor Gekker, who is supported by a team of economists and business analysts. The Advisory Board of The Bleyzer Foundation is chaired by Dr. Edilberto Segura and provides advice and guidance to the activities of the Foundation.

The aim of the Bleyzer Foundation is to support the successful transition of developing countries and transition economies into healthy, democratic market economies. The Foundation provides informational and consultative assistance to developing countries on creating favorable market conditions, improving the investment climate, and ensuring sustainable economic growth. The Foundation helps these countries complete the transition process and become successful, prosperous nations, fully integrated into the global economic community.

The mission of The Bleyzer Foundation is to promote the development of the private sector and the use of best practices in government policies, which create capital-friendly environments and deliver improved quality of life through economic transformation and sustainable growth. The Foundation advocates open market economies, transparency, business liberalization, and the formation of honest partnerships between the government, business, and the community. It actively supports the creation of a stable, predictable and level playing field, which provides conditions for private-sector-led economic growth and development of international economic relationships.

A large portion of the world is in an unstable state of transition. The main goal of these countries is to successfully complete transitions and achieve stability, based on market economy, private business development and democracy. The developed countries hold the keys to this transition and must lead the effort.

There are three alternatives to consider.

Standoff — *basically where we are today, the status quo. The developed countries enjoy relative stability and prosperity, but attempt to isolate their economies. They mostly keep their wealth and their market economy know-how to themselves. The developing countries struggle to develop, but continue to be immersed in poverty, inequality, instability, and envy.*

Payoff — *the idea of "wealth redistribution" on a global scale. This would be accomplished through substantial increases in foreign aid, in order to avert possible future troubles in the world. While some believe you can simply pay your way to world stability, this approach will likely produce a global welfare system. Donors and recipients will be equally dependent on each other and motivated to maintain this dependency in perpetuity.*

Tradeoff — *joint application of best practices to manage changes in developing countries. On the one hand, the developed countries provide know-how and experience in building a market economy, better access to their markets, foreign direct investments, and precisely targeted aid. On the other hand, the developing countries fully implement necessary changes to make the business environment more attractive and trade in their commitment to build a market system, the rule of law, and a transparent and democratic society.*

The Bleyzer Foundation believes that only the last alternative — tradeoff — will achieve real, long-term results. The Foundation attempts to help refocus multilateral and bilateral assistance to developing countries on the creation of private business and market economies. Economic research on transition economies carried out by the Foundation help to identify best practices in government policies, which must be used in these countries.

To achieve these goals and to realize its mission, the Foundation's activities include:

- *Engaging governments in dialogue to influence economic policy in areas related to improving the business climate*

- *Monitoring and reporting on the evolution of key economic reforms and policies that affect the investment climate*

- *Assisting the activity of associations and alliances of businesses and non-government organizations that share the Foundation's goals*
- *Establishing cooperation with national associations and international organizations whose activities are similar to those of the Foundation*
- *Providing informational and advisory support to businesses in developing countries*
- *Advocating and promoting campaigns to create positive images of developing countries and strengthen their international reputations*
- *Promoting education and implementation of best practices in government policies, and building consensus on the major issues of economic development for transition economies*
- *Promoting the necessity of legal, administrative, economic, and other reforms in order to ensure the sustainable economic growth of developing countries*
- *Informing the community about the Foundation's activities, and advocating its ideas and objectives through the media*

