Evaluation of MFA to Romania

Final Report

Client: European Commission, DG ECFIN

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Abbreviations

BoP	Balance of Payments
CB	Central Bank
CEEC	Central and Eastern European Countries
CG	Consultative Group (meeting)
CPI	Consumer Price Index
DG ECFIN	Directorate General for Economic and Financial Affairs
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECA	European Court of Auditors
EFC	Economic and Financial Committee
EFF	Extended Fund Facility (IMF)
EIB	European Investment Bank
EU	European Union
FDI	Foreign Direct Investment
FESAL/C	Financial & Enterprise Sector Adjustment Loan / Credit (World Bank)
GCR	Global Competitiveness Report, World Economic Forum
GFS	Government Finance Statistics (IMF)
GoR	Government of Romania
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development (World Bank, non-concessional)
IDA	International Development Association (World Bank, concessional)
IFS	International Financial Statistics (IMF)
IEO	Independent Evaluation Office (IMF)
IMF	International Monetary Fund
MFA	Macro Financial Assistance (EC)
MoF	Ministry of Finance
MoU	Memorandum of Understanding (EC)
NBR	National Bank of Romania (Central Bank)
PC	Performance Criteria (IMF)
PRGF	Poverty Reduction and Growth Facility (IMF)
REER	Real Effective Exchange Rate
SBA	Stand-By Arrangement (IMF)
SMoU	Supplemental Memorandum of Understanding (EC)
SOE	State Owned Enterprises
ST	Short Term
WB	World Bank
WDI	World Development Indicators (World Bank)

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Responsibility for the opinions presented in the Report is exclusively of the authors and should not be attributed to the Government of Romania, to the European Commission or to the other IFIs.

Executive summary

Background

1. This report presents the results of the ex-post evaluation of the fourth Macro-Financial Assistance (MFA) provided to Romania by the European Commission (EC). The MFA was part of a larger package of international support.

2. The initial reason to provide MFA to Romania was the precarious balance-of-payments situation of Romania in 1999 which had been exacerbated by the Kosovo conflict. The MFA loan consisted of two tranches between 2000 and 2003. The first tranche amounted to € 100 million, while the second tranche comprised two sub-tranches of € 50 million each. Most of the conditions attached to the MFA conformed to the conditions included in agreements between the Government and the IMF and the World Bank. The second tranche conditions included as well conditions which addressed specific EU concerns. In total € 150 million was disbursed: € 100 million in June 2000 and € 50 million in July 2003. In 2004 MFA was 'de-activated', following a new precautionary IMF Stand-By Agreement.

Evaluation Objective and Approach

3. The objectives of this evaluation of MFA are to assess the impact of the MFA and to derive key lessons that can be applied to future MFA interventions. The evaluation questions focused on three types of impacts: (i) on macroeconomic stabilisation, (ii) on structural reforms, and (iii) on the sustainability of the external financial position. In these three core areas also unexpected and indirect effects are considered. Furthermore, the implications of the design and implementation of the MFA operation are considered.

4. For the assessment of the fourth MFA operation to Romania we particularly looked at three MFA objectives: i) to strengthen the official reserve position to ease external financial constraints; ii) to achieve a sustainable balance of payments situation and iii) to comfort the implementation of structural reforms.

Impact on Macroeconomic Stabilisation

5. The actual economic developments show a gradually positive trend. After a period of economic decline, the Romanian economy recovered in 2000. From 2000 till 2005 the economy experienced a period of positive growth and lower inflation levels. The current account balance recovered in 1999. From 1999 till 2002 the current account deficit was relatively modest. After that the current account deficit increased to

record levels. After 1999 direct foreign investments and other forms of capital flows increased significantly, especially when Romania regained access to the international capital markets and investors' confidence returned. The developments resulted in large increases in the international reserves. Relative low fiscal deficits and reduction of losses from quasi-fiscal activities contributed to macroeconomic stability.

6. Due to the international support programmes, *short-term* external financial constraints were relieved. Romania's reserve position was defended with the disbursements of funds of the comprehensive support package of the IMF, the World Bank and the EU in 1999 and 2000. Even though the balance-of-payments situation was not anymore worrisome in 2002 and 2003, international assistance was deemed essential since at that time there were still "*risks for policy reversals*". Furthermore, private capital flows were wobbly and reserves fell in the second quarter of 2003. The disbursement of the first sub-tranche of the second tranche of MFA and the release of the last IMF tranche of the 2001-2003 agreement reversed this decline. The EU MFA and the IMF SBA funds were also considered to instil confidence in the Romanian economy. Only after the second half of 2003 Romanian interviewees believed that the economic developments would not reverse anymore.

7. The role of the fourth MFA operation can be better assessed by examining a possible counter factual situation. The counterfactual is the situation in which no other (official) funds would be available to fill in the non-available MFA resources. No MFA in 2000 would mean a tougher adjustment. No MFA in 2002/2003 would imply borrowing from more expensive external private financial markets.

8. The absence of the first tranche of MFA would lead to higher debt service costs due to higher financial risk. This would widen marginally current account deficits leading to slower accumulation of official reserves. The direct impact on the balance of payment in the second quarter of 2000 would imply lower accumulation of external debt and exchange rate depreciation pressure. Part of the balance of payment adjustment would take place through lower accumulation of foreign reserves. However, tighter macroeconomic policies would lead to the contraction in aggregate demand reducing demand for imports while real exchange rate depreciation facilitates the adjustment. As a result, the current account deficit is slightly reduced. Restrictive macroeconomic policies would slow down growth.

9. The counterfactual scenario concerning the absence of disbursement of the 2nd MFA tranche during the second quarter of 2003 would assume a negative impact on market sentiment and specifically, widening of the spreads on foreign financing resulting in higher debt service costs.

10. Comparing the actual economic developments with the counterfactual one can assess the net impact of the MFA program. The net impact of the MFA operation and disbursement of the first tranche on macroeconomic stabilisation in 1999-2000 appears to be very limited, while the macroeconomic stabilization effect in case of the disbursement of second tranche in 2003 seems practically non-existent.

Impact on External Sustainability

11. All available indicators suggest a comprehensive improvement in the external financial situation in Romania since 1999 when the fourth MFA operation was launched. Positive developments can be seen in exports and income transfers dynamics, safe levels of official reserves and the increasing inflow of FDIs. Gross reserves have been growing systemically. External debt service as a share of exports of goods and services has been falling since 1998 and external debt to GDP ratio remained low. These positive trends are reflected in improving foreign currency ratings of Romania. However, several risks to the medium term external outlook remain. Firstly, FDIs, productivity and exports might fail to grow faster if privatisation, restructuring and improvement of the business environment are not implemented more forcefully. Secondly, expansionary fiscal policies and in particular rapid growth in public sector wages might stimulate excessively domestic demand and non-investment imports.

12. The 4th MFA operation in Romania is believed to have positively contributed to medium- to long-term external sustainability prospects, albeit this impact was likely limited and indirect. It is difficult to disentangle the role of MFA from that of other processes taking place simultaneously, such as progress in EU accession and the implementation of the IMF and World Bank programmes. The primary channel through which MFA contributed to medium- to long-term external sustainability appears to be reinforcement of structural reforms and improved overall macroeconomic management.

Impact on Structural Reforms

13. The fourth MFA operation in Romania was negotiated twice and therefore had two different sets of structural conditionalities. The conditions for the first tranche consisted of short-term goals, whose achievement would make the disbursement of funds possible in a relatively short period of time, while the second list grouped more politically sensitive and ambitious structural goals for the achievement of which the Romanian Government was supposed to need more time and encouragement.

14. The main conditionality for disbursement of the first tranche was the satisfactory conclusion of the first review of the IMF Stand-by Agreement. The second tranche comprised three broad categories of conditions related to (1) restructuring and privatisation; (2) fiscal and financial discipline and (3) the business environment. They reflected a combination of IMF-related conditionalities, World Bank-related conditions and EU own conditions which reflected specific European concerns.

15. The evaluation shows the broad relevance of the structural conditionalities and policy areas selected at that time. The review of possible alternatives available and discussed at that time broadly confirms in retrospect that the right choice was made in given conditions and with given constraints and no easy improvement can be imagined even with the benefit of hindsight. However, some interviewees indicated they only identified conditions as MFA-related, which were EU specific.

16. As far as *medium term* structural effects are concerned, according to the World Bank self-assessment attached to its implementation completion report, the PSAL II, to which the MFA was substantially related, has been *highly* successful in achieving its sector policies and private sector development objectives, while progress in institutional development can be deemed substantial. Also the business environment has also substantially improved through a modern tax system, the removal of several administrative barriers, an improved tax collection system and fiscal environment and the preparations made for a more effective system of bankruptcy and enterprise liquidation which should enter into force in 2006.

17. In its turn the IMF proved substantially satisfied with the improvement in fiscal discipline brought about between 2002 and 2003 by the SBA agreement and with the results of the provision hindering Central Bank direct financing of the public debt.

18. These favourable assessments are substantially reflected in the EBRD transition reports which did notice some improvements in large scale privatisation between 2003 and 2004 (when the bulk of RICOP and PSAL II-related privatisation was carried out) as well as some improvement in governance and enterprise restructuring between 2004 and 2005.

19. Results achieved in the more specific field of administrative barriers have also been quite impressive. Romania scores fairly well when it comes to starting a business while the cost of dealing with licences, although higher than the OECD average remains substantially lower than that of other comparable countries in the region, therefore creating a comparative competitive advantage for the Country. The only area where results achieved still appear insufficient is progress with tax delays.

20. In the evaluation we have assessed the net impact of MFA by identifying:
    - a *political* reinforcing effect (by signalling to the Government the importance of given reforms, maintaining the effect of tripartite policy dialogue, etc.),
    - an *operational* reinforcing effect (by speeding up the implementation of certain IFI measures, or widening their scope and therefore ultimate impact)

    Finally, the accession criteria themselves and in particular the functioning market economy status Romania needed to enter into the EU could have also played a major role in making the implementation of certain measures possible, and therefore ultimately contributed to the achievement of certain structural results and acted in synergy with the MFA original spirit, especially after it became a precautionary instrument.

21. There is an overwhelming consensus among interviewees that the MFA played a substantial political reinforcing effect on the credibility of the overall reform package agreed by the Romanian Government with the IFIs and the Commission, between 2001 and 2002. The EC operated in close cooperation and consultation with the IMF and the World Bank. This was also known to the Government.

22. As far the specific operational contribution of the MFA on the implementation of given conditionalities is concerned the picture is a bit more unclear. In one case the MFA had a clear operational reinforcing role. The vast majority of Romanian

interviewees could associate the fulfilment of the specific MFA-related IMF conditionalities with the IMF activities and pressure only. The MFA role is usually associated with the few clearly EU-related conditions.

23. The assessment of the contribution given by the MFA 2nd *sub tranche* conditionalities is a bit more complex, were not it for the simple fact the tranche has never been disbursed. At any rate in several cases a clear operational reinforcing effect was not made possible by:
    - *Timing consideration.* Two conditions became irrelevant because of the delayed signature of the MFA, and in one of these cases the condition for the first sub-tranche de facto came to coincide with the condition for the second sub-tranche.
    - *Confusion in monitoring.* In another three cases the condition was so generically formulated that the Commission found itself at odds in monitoring its compliance.
    - *Market considerations.* Investors' behaviour and market conditions proved not in line with expectations and made conditionality fulfilment impossible irrespective of any willingness of the Romanian Government.

24. The MFA positively contributed to the achievement of its intended structural effects in strategic and political terms, and as far as truly European conditions were concerned. Its success in operationally reinforcing the IMF non-core conditionalities was more limited. In a number of cases the IMF simply took over any possible "reinforcing" role of the MFA also in the eyes of the Romanian authorities.

25. The results from interviews and analysis of documents clearly show that the operational reinforcing effect of conditionalities is possible if it is perceived by the responsible implementing agency that should be put under pressure by a stringent reporting and monitoring mechanism. If little monitoring mechanism is in place, conditionalities are not necessarily perceived from within the Government.

26. The evaluation touches in detail on two case studies to understand better the cause-effect relationships. In the case of the RICOP conditions, it can be concluded that MFA played an effective operational reinforcing role in fostering the enterprise restructuring and privatisation process, although the instrument in itself did not prove strong enough of an incentive to deal with the most serious and complicated cases, especially where potential state aids problem were concerned. The MFA structural objectives on the business environment plan have been fully met also in terms of timing of action. However there is little perception of any direct MFA involvement in Romania.

Implications of the Design and Implementation of the Operation

27. The design and implementation of an MFA operation influences the extent to which the MFA objectives are achieved for a given cost to the EU budget. The following design and implementation features have been touched upon:
    - MFA objectives: The Loan and Supplemental Loan agreements included two objectives of the MFA instrument: easening external financial constraints on Romania and supporting the implementation of the necessary structural reforms.

While the first objective governed the first tranche, the second objective appeared to be more important for the second tranche.

- Two sub-tranches instead of one: The Supplemental Loan Agreement included two sub-tranches of 50 million each instead of one tranche only. The split was "*to motivate Romania*" and to keep the dialogue, but the economic consequences of a smaller tranche appeared to be less visible.
- Rules in renegotiating Memoranda of Understanding: Although formally remaining the same 4th operation, *de facto* the fourth MFA went into a second negotiation and approval process. No real difference can be seen with a possible genuinely separate 5th operation.
- Flexibility of relatively long negotiation and approval procedures: When negotiations for the 4th MFA started Romania didn't have the status of an accession country. When this happened in late 1999 a renegotiation of the MFA objectives to take into consideration this key political development would have been too cumbersome and costly procedure to quickly adapt the structural objectives to the new political environment.
- Monitoring and review: The monitoring of the MFA has been unsystematic and largely based on a collection of secondary sources from Government and IFI sources. The Commission is inadequately equipped to monitor structural conditions. The IMF and World Bank are key information sources for the EC.
- Selection of conditions: The selection of structural conditions was partly influenced by the limited availability or lack of preparatory studies in certain areas.

1 Evaluation objectives and approach

1.1 Purpose of the evaluation

The objective of Macro-Financial Assistance (MFA is to support the country's economic reform efforts and the transition towards a market economy by complementing financing of the International Financial Institutions (IFIs). MFA is only provided in the context of IMF supported economic programmes.

Under its Financial Regulation (Article 27.4), the European Commission (EC) is legally obliged to evaluate its main programmes, including MFA.

This evaluation will assess the effects of the *fourth* MFA operation in Romania from the year 2000 to 2005. The evaluation is both backward and forward looking. This will enable the EC to derive key lessons that can be applied to future MFA interventions and to identify the possible need for a reorientation of the present approach.

1.2 Evaluation approach and methods

The ex-post evaluation is based on five broad evaluation questions, but unexpected effects and indirect effects are also considered. Table 1.1 presents these evaluation questions which are in accordance with the Guidelines for the Ex Post Evaluation of MFA Operations.

Table 1.1 Generic evaluation questions from the Guidelines

No.	Evaluation Question
Q1	To what extent has the MFA been effective in terms of the short-term macroeconomic stabilisation of the country concerned?
Q2	To what extent has the MFA been effective in terms of supporting structural reform?
Q3	What have been the indirect and/or unexpected effects of the MFA?
Q4	To what extent has the MFA contributed to returning the external financial situation of the country concerned to a sustainable path over the medium to longer-term?
Q5	How has the way in which the MFA operation was designed and implemented conditioned its effectiveness and efficiency?

The generic evaluation questions are further divided in a number of sub-questions that provide the key elements required to answer the core questions.

The evaluation questions broadly focus on three core areas of effects:

1. effects concerning macroeconomic stabilisation;

2. impact of structural reforms on the economy;
3. sustainability of the external financial situation.

Each one of these core areas focuses on respectively the short, medium and long term effects over specific time horizons. Macroeconomic effects are assessed up to two years after the initial disbursement; structural effects on the economy and institutions up to four years after the initial disbursement and the sustainability of the external financial situation even up to three years or more after the initial disbursement.

For the attribution of the effects to the MFA operation, we follow a three-step approach in accordance with the Guidelines for Ex Post Evaluation of MFA. The *first step* is to identify the types of short-term macro economic effects, short and medium structural effects on the economy and on institutions and identify plausible cause-and-effect relations between assistance and its effects. The *second step* is to establish a counterfactual situation and the *third step* involves the determination of the effect of the operation, which is for the macro economic and structural effects, the difference between the observed effects and the counterfactual situation. Unexpected and indirect effects, as well as consequences of programme design are considered too. To quantify the net effects of the MFA intervention annual and quarterly simulation models are employed. The modelling approach helps to determine the counterfactual short-term macroeconomic outcomes in the absence of the MFA intervention. By comparing this counterfactual to the actual outcomes the net effects of the MFA intervention are established.

The evaluation employed five *main evaluation instruments*:
- Data collection and analysis;
- Literature review;
- A preparatory questionnaire survey;
- Structured interviews with key informants;
- Macroeconomic modelling.

During the evaluation the evaluation team faced a number of *challenges and risks*:
- Limited EU financial assistance provided in conjunction with IMF and World loans;
- No readily identifiable outputs;
- Implicit or imprecise formulated MFA objectives;
- Problem of timing for observing some intended effects;
- Incomplete recollection of the MFA intervention of the interviewees;
- Limitations of the quantitative modelling approach.

1.3 Structure of the report

This Draft Final Report is structured as follows.

Chapter 1 explains the evaluation purpose and approach. Chapter 2 describes the background of the fourth MFA operation and contains a historical overview of MFA events. The MFA intervention is discussed in the context of the international assistance to Romania, specially the interventions of the International Monetary Fund and the World Bank. Chapter 3 analyses macroeconomic developments in Romania. It describes as well the economic model to determine the effects of the counterfactual situation enabling to assess the net effects of the MFA. Chapter 4 presents the forward looking analysis of the impact on external sustainability. Chapter 5 discusses the impact of MFA on structural reforms. The concept of *reinforcing* effect is explained to allow assessing the net structural effects of MFA conditions which matched similar conditions in the IMF and World Bank agreements. Chapter 6 discusses the case studies that provide in-depth analyses of the cause-and-effect relations of two selected EU-specific structural conditions. Chapter 7 considers the implications of the design and implementation of the operation on its efficiency and effectiveness. It contains suggestions for potential future MFA operations in order to increase the instrument’s efficiency and effectiveness.

2 Background of the fourth MFA operation

2.1 Historical overview of the MFA intervention

Since 1991, the EU has supported Romania's transition process through Macro-Financial Assistance operations. The Commission concluded four MFA operations to Romania with a committed total of € 780 million (see Table 2.1). The fourth MFA to Romania comprised a long-term balance of payments loan facility of up to € 200 million that was approved by the EU Council on 8 November 1999.

Table 2.1 Overview of MFA operations to Romania

MFA operation	Date of Council Decision	Council Decision	Maximum Amount (in € million)	Maximum maturity in years
I	22.07.91	91/384/EC	375	7
II	27.11.92	92/551/EC	80	7
III	20.06.94	94/369/EC	125	7
IV	08.11.99	99/732/EC	200	10

The fourth MFA operation was agreed upon during an economic and political turbulent time. At the end of 1998 Romania found itself in an unstable economic environment. Romania had already felt the consequences of the Asian crisis. Furthermore, the Kosovo conflict endangered the already fragile external environment. Due to the Kosovo crisis, traditional transport routes were undermined and, as a result, important export markets were being lost. It was expected that the current account deficit would increase and capital flows would likely be affected by more unfavourable investment response. These developments contributed significantly to the creation of a large financing gap and there was a perception of a possible financial collapse of the country. In the first quarter of 1999 Romania was at the pick of external debt repayment. There was pressure for burden sharing. Even after the commitments made by the IMF and the World Bank, the financing gap remained considerable.

Given the fragile external situation, in the autumn of 1999 at the request of the Romanian Government, the European Commission and the World Bank organised a G-24 meeting with the view to secure complementary financing from official donors towards filling the financial gap estimated by the IMF. The IMF estimated initially the residual financial gap of the balance of payments of Romania at US$ 238 million. The revised estimates which took into account the preliminary analysis of the impact of the crisis in Kosovo amounted to US$ 322 million. After taking into consideration the IMF and World Bank contributions, estimates of the IMF showed still a considerable financing gap. Based on this estimate the EC considered the fourth MFA loan facility of € 200 million which corresponded to 67% of the (adjusted) residual financing need. The Commission considered that Romania needed support to overcome the difficult political and social circumstances, augmented by the Kosovo crisis. Moreover, the Romanian efforts in economic reform needed to be supported. The fourth MFA operation was intended as complementary to the IMF loan and the MFA conditions took into consideration the IMF criteria. The Loan Agreement and Memorandum of Understanding (MoU) were signed on 27 January 2000. The EU committed itself to make the MFA loan available to Romania in two instalments of € 100 million each. The first tranche was planned to be available on the basis of a satisfactory track record of Romania's macroeconomic programme in the context of the SBA agreement with the IMF.[1] The second tranche would be disbursed on the basis of a satisfactory continuation of Romania's adjustment and reform programme. It would not be disbursed before one quarter after the release of the first instalment.

Table 2.2 presents the time of MFA disbursements and the total amount of assistance.

Table 2.2 Overview of 4th MFA operation to Romania

Tranche	Loan amount	Amount disbursed	Time of disbursement
First tranche	€ 100 million	€ 100 million	June 2000
Second tranche	€ 100 million		
• *First sub-tranche*	*€ 50 million*	€ 50 million	July 2003
• *Second sub-tranche*	*€ 50 million*	-	
	€ 200 million	€ 150 million	

[Source: EC files]

After the release of the first € 100 million tranche in June 2000, the IMF programme went off track and eventually expired. No further disbursements of EU macro-financial assistance could therefore take place.

In October 2001, the IMF Board approved a new 18-month SBA for SDR 300 million (approximately USD 383 million), and in 2002, the World Bank concluded negotiations for a second Private Sector Adjustment Loan (PSAL) of USD 300 million. Following a request from the Romanian authorities, the EU Council agreed in principle in January 2002 to make available to Romania € 100 million, pursuant to Council decision 99/732/EC, in two sub-tranches, subject to the satisfactory implementation of the SBA and adequate progress in the country' structural adjustment process. The changed external environment and the new IMF agreement required, however, that the structural conditions of the second tranche of MFA would be considerably revised. After lengthy negotiations, a Supplemental Loan Agreement and a Supplemental Memorandum of Understanding (SMoU) were signed in November 2002. The second tranche was divided into two sub-tranches of € 50 million each.

[1] There was also a link between the World Bank structural adjustment programme (PSAL) and the IMF programme. The WB Board made it clear that PSAL 1 would become effective only after a new IMFStand-by Agreement had been approved by the IMF Board. PSAL 1 was accompanied by a technical assistance loan, the private sector institution building loan (PIBL). While this was a risky strategy and a highly *unusual* sequence of decision-making between the Bank and the IMF, it paid off. The IMF Standby was approved on 5 August and PSAL 1 became effective on 25 August 1999.

Following the general rules, the EU MFA should be conditional upon the satisfactory implementation of the IMF agreement as well as upon the observance of a set of structural adjustment conditions based upon the Government's economic programme. In this context, the MFA conditions were proposed to focus on the four focus areas as identified in Romania's 2001 Pre-Accession Economic Programme. The MFA conditions for Romania matched to a certain extent the IFI's conditions. However, MFA conditionality further reflected specific EU concerns. Conditions for the disbursement of the first sub-tranche of € 50 million of the second tranche were fulfilled in the first half of 2003 and disbursement took place on 17 July 2003.

The second sub-tranche of € 50 million of the last tranche has not been disbursed because there was no request for disbursement on the Romanian side. Therefore, similar to the IMF, the EU decided in 2004 to adopt a precautionary approach with its MFA operation. This assistance can be reactivated, should the need arise in the future.

Annex A.3 contains a more detailed historical overview of the MFA events.

2.2 International Support to Romania

The MFA was part of a larger package of international support to ease the external financial constraints and to lessen the impact of the Kosovo crisis. Table 2.2 and Table 2.3 present the combined package of IMF, World Bank and EU programs in the period 1996-present.

Table 2.2 Loan agreements (in 1000s)

Name, date of loan	Date	Amount agreed	Amount drawn	Amount outstanding
International Monetary Fund (SDR)	**Date of expiration**	1,251,500	560,350	192,890
SBA July 07, 2004 *(in SDR)*	July 06, 2006	250,000	0	0
SBA October 31, 2001 *(in SDR)*	October 15, 2003	300,000	300,000	192,890
SBA August 05, 1999 *(in SDR)*	February 28, 2001	400,000	139,750	0
SBA April 22, 1997 *(in SDR)*	May 21, 1998	301,500	120,600	0
World Bank (US$)	**Approval date**	10,30,000	930,000	100,000
FESAL *(in US$)*	January 1996	280,000	180,000	100,000
PSAL I *(in US$)* *	June 1999	300,000	300,000	0
PSAL 2 *(in US$)*	September 2002	300,000	300,000	0
PAL 1 *(in US$)*	September 2004	150,000	150,000	0
PAL 2 *(in US$)*				
European Union (€)	**Council decision**	200,000	150,000	50,000
MFA (€)	8 November 1999	200,000	150,000	50,000

* Effective since 25 August after IMF Board approval SBA on 5 August 1999

Note: SBA - Stand-By Agreement, FESAL - Financial and Enterprise Sector Adjustment Loan, PSAL - Private Sector Adjustment Loan, PAL 1 - Programmatic Adjustment Loan, MFA – Macro Financial Assistance.

Table 2.3 Disbursements

	1999	2000	2001	2002	2003	2004	2005
IMF (SDR)							
Disbursements *	**53.00**	**86.75**	**52.00**	**82.666**	**165.334**	**-**	**-**
World Bank (US$)							
PSAL I **	**150.00**	**150.00**	**-**	**-**	**-**	**-**	**-**
PSAL 2 ***	**-**	**-**	**-**	**150.00**	**-**	**150.00**	**-**
PAL 1 ****						**150.00**	**150.00**
PAL 2							
European Union (€)							
MFA ****	**-**	**100.00**	**-**	**-**	**50.00**	**-**	**-**

* Data source: extranp1pt.xls file available on IMF website; Disbursements for SBA 1999 (period 1999-2000) and SBA 2001 (period 2001-2003)

** Disbursed in two tranches: August or September 1999 resp. June 2000

*** € 339.8 million equivalent; Disbursed in two tranches: October 2002 resp. 7 July 2004

**** € 146.80 million equivalent

***** Disbursed: June 2000, July 2003

The size of MFA in the BoP financing has been relatively significant. The share of MFA in total BoP financing assistance in 2000 and 2003 was on average about 18% (see table 2.4).

Table 2.4 External financing Romania

	1999	2000	2001	2002	2003
Balance of payments financing, millions USD	**539**	**560**	**167**	**275**	**281**
• ***IMF***	***73***	***115***	***67***	***107***	***226***
• ***Other (including WB PSAL2 and EU loans)***	***466***	***445***	***100***	***168***	***56***
GDP, million USD		**37,060**	**40,188**	**45,760**	**56,950**
Share of BoP financing in GDP, %		**1.51**	**0.42**	**0.60**	**0.49**

[Source: IMF, Country report No. 04/221, July 2004]

Expressed as percentage of GDP the total BoP financing gap oscillated in the range of 0.4% to 1.5% during the evaluation period. The BoP financing gap as percentage of GDP diminished over time. MFA financing amounted to 0.3% and 0.09% of GDP in 2000 and 2003 respectively.

The MFA was also provided within the framework of a larger EC assistance package. The European Union supported the macroeconomic stabilisation, the acceleration of economic reform and the pre-accession process through a combination of various instruments mainly grouped in grants and loans. During 2000-2003 Romania received approximately 660 million Euros per year, through the three pre-accession instruments: PHARE, ISPA and SAPARD.[2]

[2] See http://ue.mae.ro

In the following Chapter we will discuss the macroeconomic effects of the policies of the Romanian government supported by the comprehensive package of stabilisation and structural adjustment programs with the international financial institutions and the European Union. We touch upon both short term and medium term effects.

3 Impact on macroeconomic stabilisation

3.1 Introduction

In this Chapter we present our analysis of the impact of MFA on macroeconomic stabilisation. Table 3.1 mentions the evaluation questions which will be touched upon in sequence as stated in the table. The conclusions will be summarised in section 3.8.

Table 3.1 Evaluation questions for analysing the impact on macroeconomic stabilisation

	Evaluation questions
Q1.1	What are the short and medium-term macroeconomic objectives of the assistance?
Q1.2	To what extent have the short and medium-term macroeconomic objectives of the assistance been achieved?
Q0.1	What arrangement would have been implemented if the MFA had not been granted?
Q0.2	What are the structural and macroeconomic effects of the most likely implementation scenario(s)?
Q1.3	What has been the contribution of the loans provided by the operation to the achievement of objectives?
Q3.1	What, if any, has been the contribution of actions resulting from the respect of structural conditionality criteria to the achievement of short and medium-term macroeconomic objectives of the assistance (i.e. the indirect effects of structural conditionality criteria)?
Q3.2	Has the assistance given rise to any unexpected short and medium-term structural and/or macroeconomic effects? What were they and how did they occur?

3.2 Macroeconomic objectives of intervention

Q1.1 What are the short and medium-term macroeconomic objectives of the assistance?

3.2.1 Macroeconomic objectives

For the assessment of the impact of the fourth MFA operation to Romania on macroeconomic stabilisation we will consider the realisation of the *general* goal of MFA, to ensure a sustainable balance of payments. In this context we will particularly look at the objectives linked to this goal: i) to strengthen the official reserve position to ease external financial constraints; and ii) to comfort the implementation of structural reforms, (this will be considered in Chapter 5). These objectives are stated in the original EC Council Decision 1999/732/EC which mentioned that "*A Community long-term loan to Romania is an appropriate measure to help ease the country's external financial constraints, supporting the balance of payments and strengthening the reserve positions and comforting the implementation of the necessary structural reforms*."

MFA has been provided to Romania "*to support the balance of payments and to strengthen the reserve position of Romania*."[3] The loan has been considered "*an appropriate measure to help Romania's external financial constraints*." Even though, the Loan and Supplemental Loan Agreements to Romania did not mention explicitly any quantified macroeconomic objective, it is explicitly linked to IMF stand-by agreements which focussed on both short term and medium term macroeconomic stabilisation.

For the purpose of this evaluation the short term macroeconomic objective of the MFA assistance to Romania is identified as: to support government efforts in achieving macroeconomic stabilisation. The medium term objective is recognised as: to assure medium-term external stability.

3.2.2 Effect indicators

A main condition included in the MoU was that the disbursement would be conditional upon a satisfactory implementation of the present IMF stand-by-arrangement, or of any subsequent arrangement between Romania and the IMF. Therefore, we assume that the MFA corresponded with the objectives of the IMF stand-by-arrangements in terms of macroeconomic stabilisation. A stand-by-agreement was concluded in August 1999 and had been extended. This stand-by-agreement was not completed due to policy slippages of Romania. A new stand-by-arrangement was approved in October 2001. This one was fully completed. The fulfilment of the 1999 and 2001 IMF agreements required actions concerning fiscal policy, monetary policy and structural reforms in order to contain the current account deficit at a sustainable level, to lower inflation and to bring the Romanian economy on a rapid and sustainable growth path (see table 3.2).

Table 3.2 Macroeconomic objectives in the SBA 1999 and SBA 2001*

Indicator	**SBA 1999 *original* estimates** for 1999	**SBA 2001 *original* estimates** for 2002
Real sector (% change)		
Real GDP	-3.5	5.0
CPI (end of period)	38.3	22.0
CPI (average)	41.4	26.0
Public finances (% of GDP)		
Primary balance	4.3	0.8 **
Overall balance	-3.6	-2.9 **
Balance of payments (in millions of US$)		
Current account	-2.2	
(in % of GDP)	*-6.9*	*-5.6*
Reserves (in months of imports of G & S)	2.8	3.2
Monetary base (% change)		

3 Loan Agreement between the European Community and Romania, 27 January 2000 and Supplemental Loan Agreement 11 November 2002

Indicator	SBA 1999 *original* estimates for 1999	SBA 2001 *original* estimates for 2002
Lei reserve money	30.7	
Broad money		28.3

* These were the original estimates which were revised later during the reviews

** The original estimates taking into account upward revision of nominal GDP

[IMF, Romania: Article IV Consultation, IMF Staff Country Report No. 00/159, December 2000 and Romania: Request for a Stand By Agreement, IMF Staff Country Report No. 01/204, November 2001]

The quantitative performance criteria and indicative targets in the two stand-by-agreements would support the realisation of the underlying macroeconomic objectives of the agreements. Table 3.3 provides a summary of these performance criteria and targets.

Table 3.3 Quantitative performance criteria and indicative targets in the IMF stand-by arrangements

	SBA 1999			SBA 2001				
	31-07-99	31-10-99	31-12-99	31-12-01	31-03-02	31-06-02	31-09-02	31-12-02
	(In billions of lei)			(in trillions of lei)				
Ceilings on net domestic assets of the NBR	13,944	14,037	14,804	-48.1	-56.2	-61.4	-67.0	-73.3
Ceilings on net credit of the banking system to the consolidated government	23,241	17,827	15,843					
Limits on the increase in assumption of enterprise debt to banks and guaranteeing of bank loans to enterprises from March 31, 1999	0	0	0					
Ceilings on domestic arrears to CONEL, ROMGAZ, PETROM	10,607	10,607	10,607					
- *CONEL*	4,116	4,116	4,116					
- *ROMGAZ*	2,443	2,443	2,443					
- *PETROM*	4,048	4,048	4,048					
Floor on net cumulative reduction of tax arrears to CONEL, ROMGAZ, PETROM	300	1,200	2,000					
Ceilings on aggregate wage bills *	24,082	33,619	39,752	40.7	9.4	21.3	34.9	49.5
				(in percent)				
Floors on cumulative aggregate collection rates (Distrigaz Nord, Distrigaz Sud and Termoelectrica)				95	97.5	97.5	97.5	97.5
				(in billions of lei)				
Ceilings on domestic guarantees extended by government				469	1,110	1,110	1,110	1,110
	(in millions of U.S. Dollars)							
Quarterly floors on net foreign assets of the NBR	499	609	593	3,527	3,601	3,816	3,924	4,094
Ceilings on contracting or guaranteeing by the government of non-concessional external debt, with sub-ceilings for the one- to three-year maturity range								
- *one-year or less maturity*	0	0	0	0	0	0	0	0
- *up to three-year maturity*	600	800	800	300	300	400	450	600
- *more than three-year maturity*	1,680	2,490	3,100	2,800	1,000	1,200	1,800	3,400
Ceilings on short-term external debt outstanding	1.7	1.7	1.7					

	SBA 1999			SBA 2001				
	31-07-99	31-10-99	31-12-99	31-12-01	31-03-02	31-06-02	31-09-02	31-12-02
Indicative target for floor on net foreign assets of the banking system	671	904	1,079					
Indicative target on stock of external payments arrears	0	0	0					
	(In billions of lei)			(in trillions of lei)				
Indicative target for ceilings on reserve money	21,874	23,464	25,495	63.1	62.2	69.4	73.3	79.4
Indicative target on ceilings on broad money	110,001	116,451	124,505	252.2	258.9	280.0	293.5	323.7
Indicative target on banking sector lending to the SOE				29.1	30.7	32.5	34.6	36.3

* SBA 1999 - of the state budget, regies autonomes, loss-making commercial companies; SBA 2001 - of monitored SOEs.

[Source: Letter of Intent and Memorandum of Government of Romania on Economic Policies (26 July 1999) and IMF Country Report No.01/204, Romania: Request for a Stand-By Arrangement – Staff Report, Staff Supplement; Press Release on the Executive Board Discussion; and Statement by Authorities of Romania, November 2001]

For purposes of monitoring of the EU MFA conditions, the (S)MoU required periodically updated quantitative data on a number of fairly common macroeconomic indicators (see box 1.3).

Box 1.3 List of monitoring indicators

Consumer price inflation
GDP, industrial output, output and value added by sector
Unemployment
Nominal monthly wages, on a gross and net basis
Nominal and real exchange rates
Fiscal indicators (revenue, expenditure and financing)
Monthly number of privatisation operations
Balance sheet of the National Bank of Romania, aggregated balance sheet of commercial banks
Balance of payments, current account balance, foreign trade
Realisation of the quantitative performance criteria under the IMF programme

Except for the quantitative performance criteria under the IMF programme, these macroeconomic indicators set for monitoring purposes were not accompanied with benchmarks or targets. We assume that explicit targets were not deemed necessary since the IMF stand by agreements and the associated Memorandum of Economic Policies of the Romanian government already contained quantified and measurable macroeconomic objectives.

Table 3.4 presents the macroeconomic indicators which we will use to assess the progress in achieving macroeconomic stabilisation.

Table 3.4 Macroeconomic indicators

Macroeconomic stabilisation	Effect Indicators
Macro economy	Growth rates in GDP and components Inflation
Public finance	Level of government revenue Level of government expenditure Deficit Financing of the deficit Existence of quasi-fiscal operations
Balance of payments	Current account deficit Inflow of foreign direct, portfolio and other investment International reserves
Financial volatility and BoP sustainability	Domestic and foreign debt Debt service payments Foreign-currency debt ratings Liabilities of banks

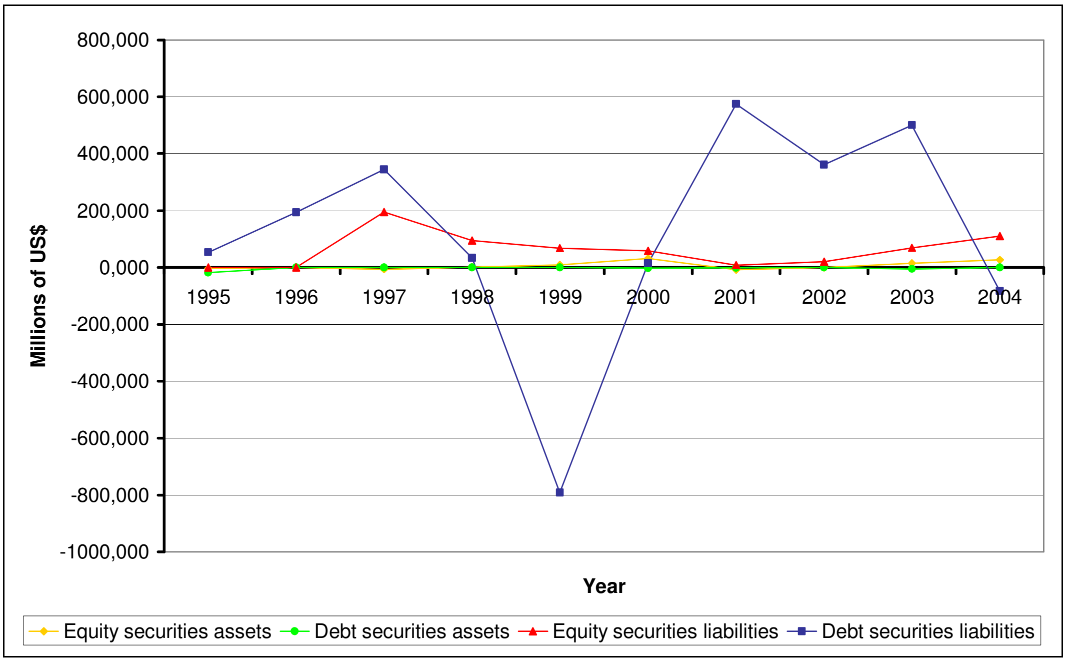
3.3 Gross impact - actual macroeconomic outcomes

Q1.2 To what extent have the short and medium-term macroeconomic objectives of the assistance been achieved?

3.3.1 Situation at the start

In 1998 and 1999 Romania faced a difficult economic situation characterised by large external imbalances, declining output and investment as well as by structural weaknesses in the banking and enterprise sector. Despite some achievements (i.e. progress in reducing inflation from 150% at the end of 1997 to 41% at the end of 1998), large external imbalances persisted. In 1999 Romania had to repay a number of loans of private creditors and the country had extreme difficulties in finding new bank loans. Figure 3.1 visibly illustrates the dramatic decrease of debt securities liabilities due to the repayments. Interviewed Romanians confirm that the external repayment problems had been the main concern of that period.

Figure 3.1 Change in debt and securities assets and liabilities



[Source: IMF, International Financial Statistics]

The Kosovo conflict in 1999 worsened the economic situation. Trade between Romania and its neighbouring countries and the transport connections in the region, particularly the river trade on the Danube, were affected. Romania's exports markets were affected immediately and contracted in the first few months following the start of the crisis. Also foreign investors became more hesitant and possible further deterioration of financial market sentiment, beyond that of the external payments problems, was feared.

To cope with the unstable economic situation, the Government formulated a comprehensive stabilisation and reform programme aimed at narrowing the current account deficit, lowering inflation, and ensuring a sustainable economic recovery. This programme was to be supported by an IMF stand-by arrangement in the amount of SDR 400 million. Also the EU through its fourth MFA operation and the World Bank by means of its PSAL 1 loan provided financial support.

In the following sections we will discuss the macroeconomic effects of the policies of the Romanian government supported by this comprehensive package of stabilisation and structural adjustment programs of the international financial institutions and the European Union. We touch upon both short term and medium term effects.

3.3.2 Economic developments

Macro economy

After a period of economic decline, the Romanian economy recovered in 2000, with growth rebounding to 2.1%, compared to a 5.4% decline in 1998. From 2000 till 2005 the economy experienced a period of positive growth.

Table 3.5 Macro-economic indicators

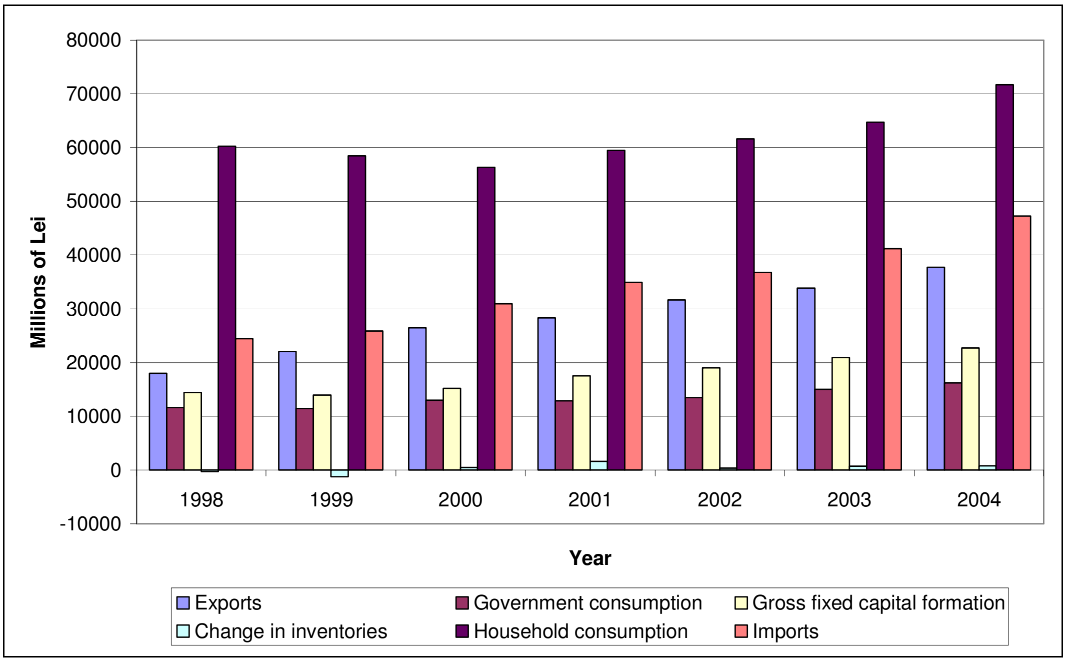
	1998	1999	2000	2001	2002	2003	2004	2005 *
Real GDP (change, %)	-5.4	-1.2	2.1	5.7	5.1	5.2	8.4	*4.1**
CPI (end of period)	40.6	54.8	40.7	30.3	17.8	14.1	9.3	*8.6***
CPI (average)	59.1	45.8	45.7	34.5	22.5	15.3	11.9	*9.0***

* Preliminary estimates

[Source: IMF 2006 Article IV Consultation Discussions; National Institute of Statistics, Monthly Statistical Bulletin, 2/2006]

In the recovery year 2000 growth was mainly driven by private fixed investments and government consumption. In the following years growth was driven by domestic demand, particularly private consumption, although gross fixed capital formation gradually increased its contribution and exports remained strong (though import dynamics was much higher determining negative net export contribution to GDP in all years except for 2002). In 2004 the economy increased even by 8.4% in real terms.

Figure 3.2 Real GDP components, 1998-2004



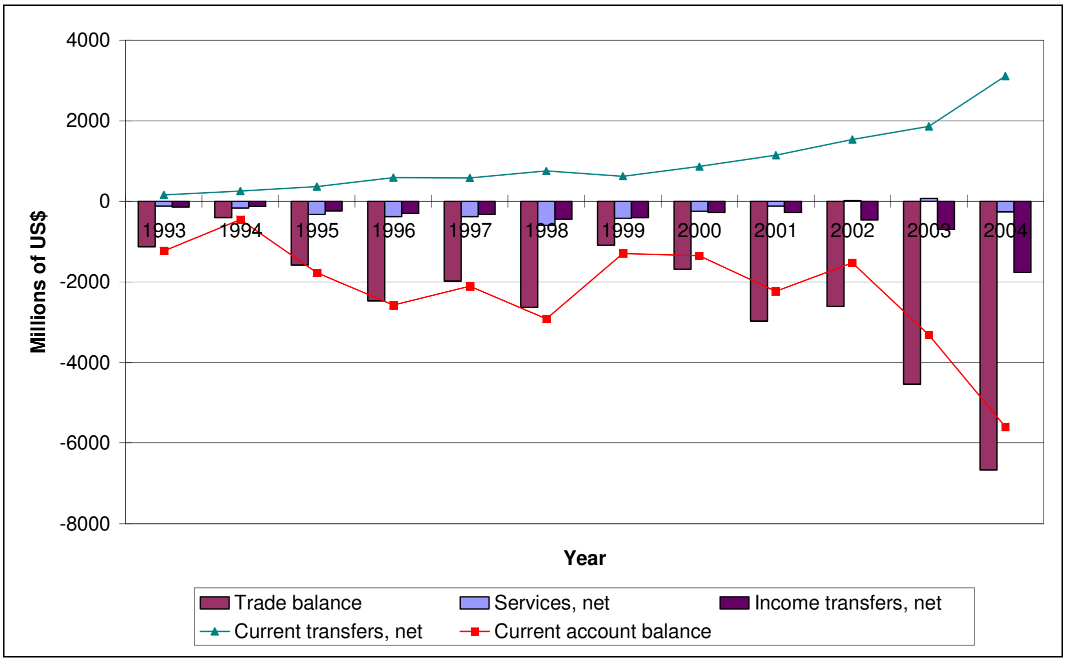
[Source: IMF, International Financial Statistics, Real figures calculated using GDP deflator, base year = 2000]

Besides sustained economic recovery Romania succeeded to bring inflation levels down, albeit disinflation was much slower than in other EU candidate countries. While 1997 still saw three digit inflation rate (154.8%), by 2004 it was reduced to 11.9% due to declining labour costs, mainly promoted by the use of the exchange rate as nominal anchor which moderated inflationary expectations and to some extent a policy of modest wage increases. Inflation decreased further to 9% on average in 2005.

Balance of Payments

While international response to the economic crisis in Romania was strongly visible only in 1999, the main balance of payments problems appeared earlier. In 1998 the current account deficit widened considerably and by 1999 a combination of policy measures and forced adjustment resulted in shrinkage of the deficit. From 1999 till 2002 the current account deficit was relatively modest. After that the current account deficit increased to record levels.

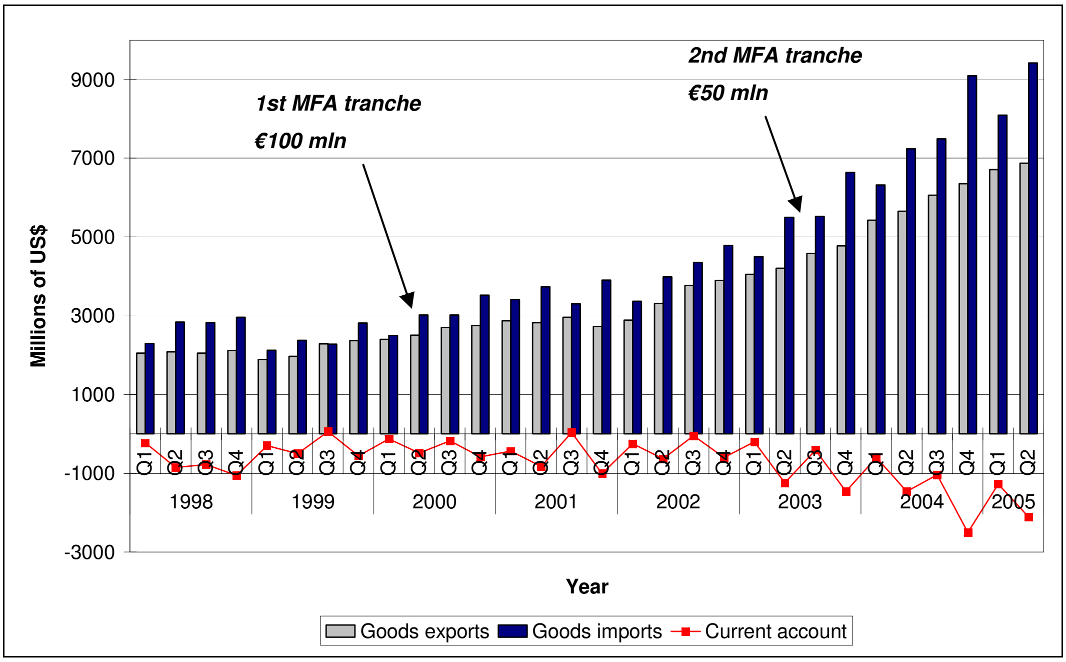
Figure 3.3 Current account, 1993-2004



[Source: IMF, International Financial Statistics]

While the impact of the Kosovo conflict was felt the first half of 1999, exports partly recovered already in the second half of 1999. The major assumption in estimating the ex-ante impact of the Kosovo crisis had been the duration of the crisis. Fortunately this effect proved to be shorter-lived than earlier expected. One interviewee indicated that "*Romania got relatively away*" The real impact on total trade flows was felt for two quarters. Exports recovered more rapidly than imports, partly due to depreciation of the exchange rate. Even trade with neighbouring countries restored practically within four to five quarters.

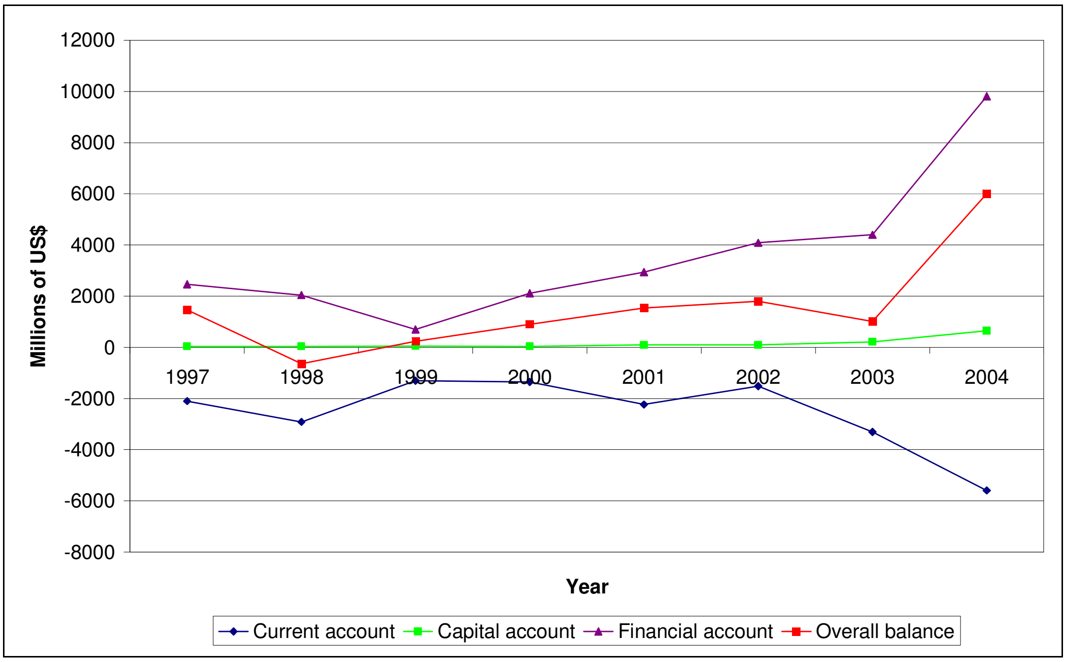
Figure 3.4 Trade and current account, Quarterly developments, 1998-2005



[Source: IMF, International Financial Statistics, Quarterly]

The developments in the current account in 1997-1999 were reflected in the overall balance. After that period direct foreign investments and other forms of capital flows increased significantly. The relationship between the current account balance and the overall balance became weaker. The improvements in the financial account enabled Romania to let its current account deficit grew to wider proportions than during the economic crisis before 2000.

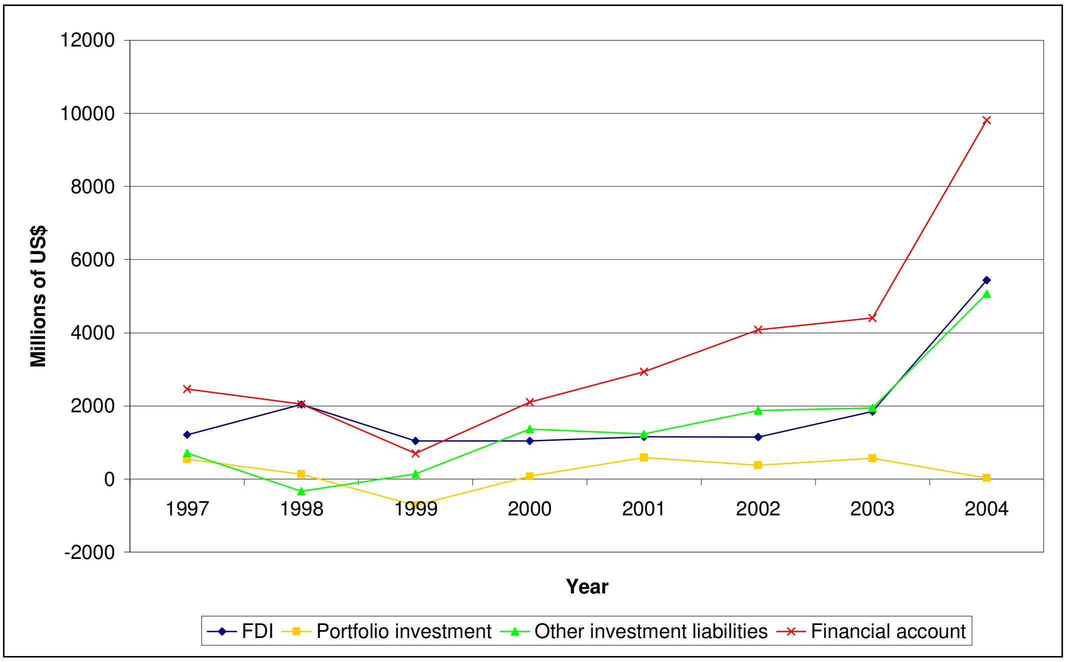
Figure 3.5 Balance of payments, 1998-2004



[Source: IMF, International Financial Statistics]

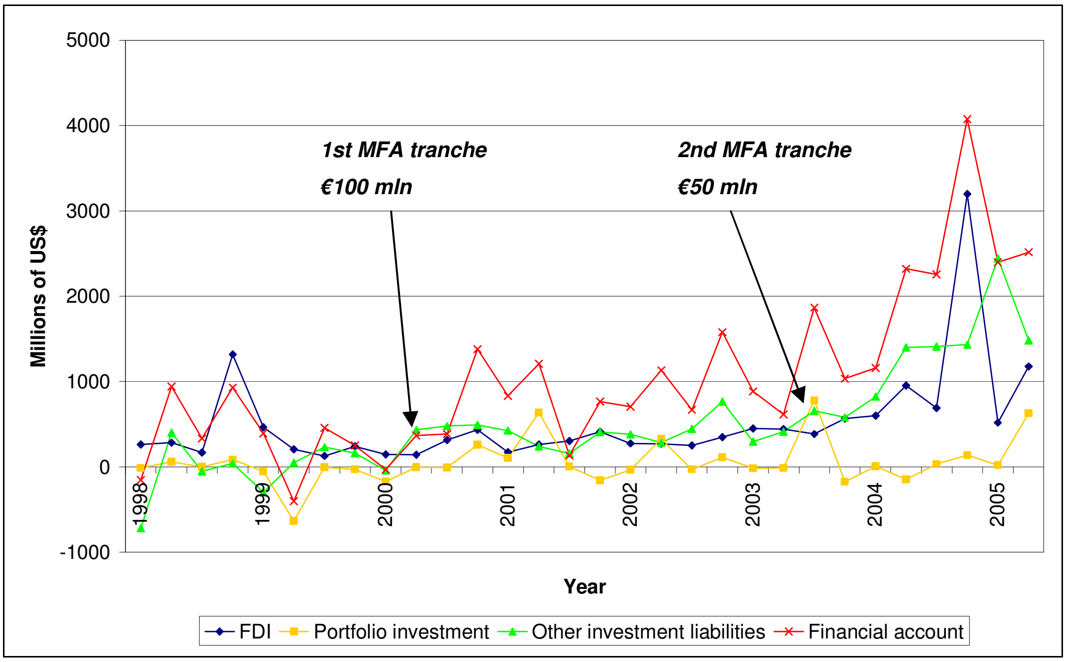
Capital inflows picked up especially when Romania regained access to the international capital markets and direct investors' confidence returned (see section financial markets below). Especially since 2003 the developments became favourable.

Figure 3.5 Financial account, 1997-2004



[Source: IMF, International Financial Statistics]

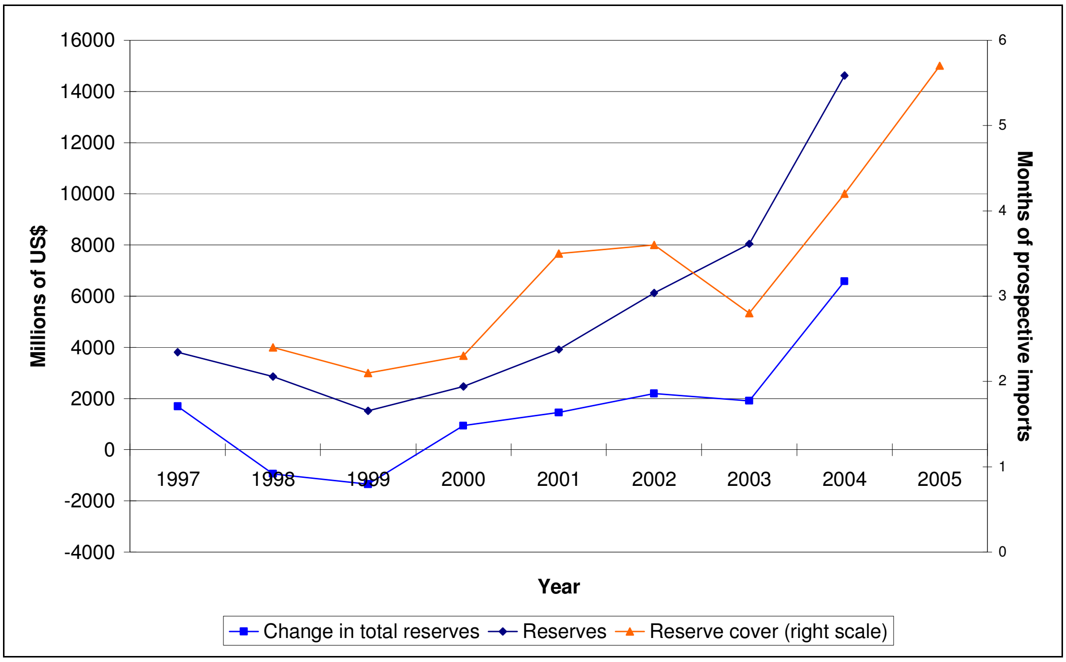
Figure 3.6 Financial account, Quarterly developments, 1997-2005



[Source: IMF, International Financial Statistics]

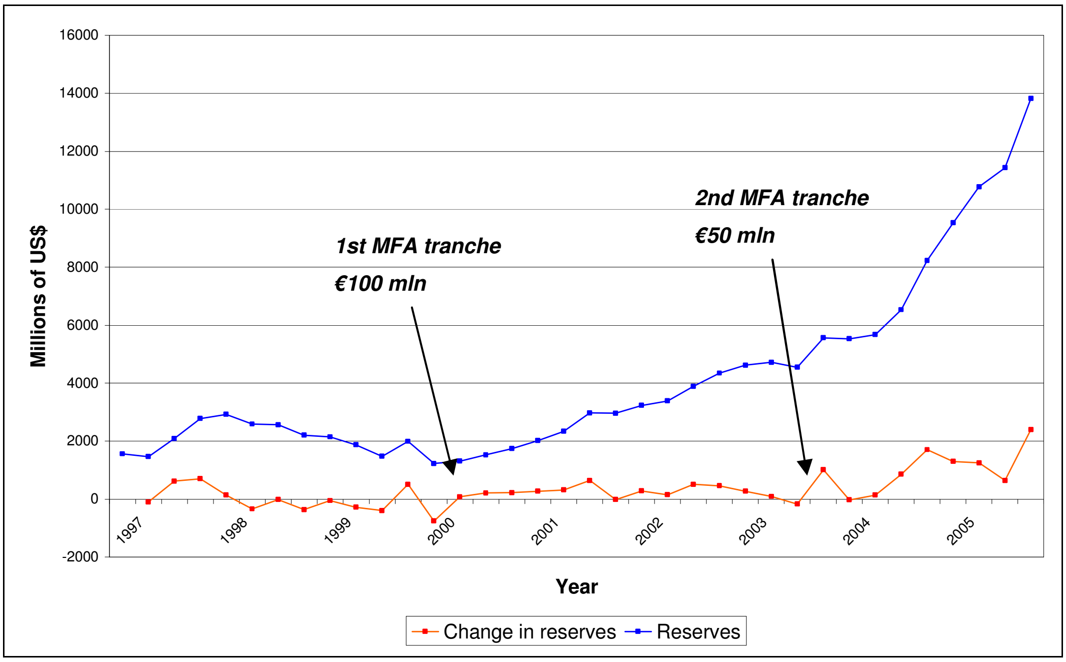
The developments resulted in large increases in the international reserves, to the equivalent of 4.2 months of prospective imports in 2004, while in 1999 import coverage was only half of this. Romanian interviewees indicated that coverage of between 4 and 6 month would reflect a secure reserve position.[4]

Figure 3.7 International reserves, 1997-2005



[Source: IMF, International Financial Statistics, IMF 2006 Article IV Consultation Discussions]

Figure 3.8 International reserves, Quarterly developments, 1997-2005



[Source: IMF, International Financial Statistics, Quarterly]

[4] This is an internationally accepted rule of thumb.

The release of IMF credit and the first tranche of the World Bank PSAL program lessened the depletion of the reserves in 1999, particularly in the second half. Both programs and the MFA first tranche disbursement of € 100 million contributed to the increase of the total reserves in 2000, especially in the second quarter. Even though the MFA money was disbursed in the second half of 2000 "*it was useful to overcome the difficult period at that time.*" After that the reserves increased substantially and Romania regained access to the financial markets.

The economic environment in 2002 and the first half of 2003 was markedly different than in 1999. In 2003 foreign direct investments started also to pick up. Although, the balance-of-payments situation was not anymore worrisome and Romania could borrow from the financial markets, MFA assistance was deemed essential since at that time there were still "*risks for policy reversals*" and uncertainty continued. Furthermore, private capital flows were quite wobbly during this period. Although reserves assets increased during 2003 as a whole, they actually fell by US$ 169 million in the second quarter. The disbursement of the first sub-tranche of the second tranche of MFA and the release of the last IMF tranche of the 2001-2003 agreement helped in a stronger build up of reserves. In the last quarter of 2003 the reserve position fell again, though only marginally, i.e. US$ 33 million. One interviewee claimed that "*a pull back of MFA could be a vote of no confidence*", emphasizing a political economic aspect. As such the EU MFA and the IMF SBA funds were considered to instil confidence in the Romanian economy (see section 3.4.2 for the discussion on potential consequences in case no support would have been available).[5] Various Romanian interviewees believed that after the second half of 2003 the economic developments would not reverse anymore. Overall, the year 2003 was a success year as Romania completed the IMF stand-by-agreement after a number of previous unfinished arrangements. Furthermore, and perhaps more important for (potential) investors, the European Council of 12 December 2003 endorsed January 2007 as the target date for Romania's EU accession.

Public finances

From the macroeconomic perspective, the Romanian public finances were a concern for two reasons: (1) the size of the deficit, (2) the pro-cyclical fiscal policy through public sector wage increases and reduction of tax burdens. Table 3.6 presents the government finance developments for Romania.

Table 3.6 Public finance (general government, % of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005*
Total revenue and grants	28.6	29.7	31.9	31.2	30.1	29.6	28.7	30.1	*30.3*
Total expenditure	33.9	35.1	35.5	35.3	33.3	32.3	30.9	31.1	*31.1*
Overall balance	-5.2	-5.5	-3.6	-4.0	-3.2	-2.6	-2.2	-1.0	*-0.8*
Primary balance	-5.2	-0.7	2.4	0.9	0.6	0.4	-0.2	0.2	*0.3*
Total public debt **	25.5	23.8	30.5	27.8	27.5	25.9	23.5	22.4	*18.9*
Financing	5.2	5.7	3.3	3.5	3.2	2.3	1.2	…	…
Domestic	1.4	3.9	1.6	-0.2	0.9	0.3	-0.7	…	…

[5] Romania also issued 7-year EUR 700 million bonds in July 2003.

	1997	1998	1999	2000	2001	2002	2003	2004	2005*
External	2.1	0.0	0.4	2.8	1.7	1.5	1.6	…	…
Privatization proceeds	1.7	1.8	1.3	0.6	0.3	0.4	0.2	…	…
Bank assets recovery	0.0	0.0	0.0	0.3	0.2	0.1	0.1	…	…

* Preliminary estimate

** Including domestic public debt and external public debt (public and publicly guaranteed)

[Source: IMF Country Reports, No. 01/204, November 2001 and No. 04/221, July 2004; and 2006 Article IV Consultation Discussions – Preliminary Conclusions of the mission, February 2006,]

While in 1997 and 1998 the fiscal deficit reached more than 5% of GDP, the subsequent fiscal policies of Romania supported by the stabilisation and structural adjustment programmes succeeded in bringing the deficit down step by step to -1 % of GDP in 2004. The primary balance decreased with 2.2%-points from 1999 to 2004, while the overall balance declined in the same period with 2.6%-points. This was primarily accomplished by expenditure reduction, in particular on public investments. The IMF stand-by-agreement was sometimes successful in containing increases in public sector wages, but to the particular performance criterion was not always adhered to.

Furthermore, Romania, following other countries in the CEEC region, reduced the income tax rates which resulted in a loss of direct tax revenue, which was partially compensated by increases in indirect tax revenues. The - at times - large increase of wages and reduced tax burden, resulting in higher disposable incomes, stimulated partially private consumption and contributed to increased imports. This pro-cyclical fiscal effect on the current account has been and continues to be a constant concern of the IMF.

The level of debt was not as such a serious concern and in % of GDP it even decreased. Public sector debt was primarily a concern in 1998 and 1999 when Romania practically lost access to foreign financing and large debt service payments were due. In both years privatisation receipts and domestic borrowing had to cover the deficit.

Quasi fiscal subsidies added to the public sector deficit was a more worrisome issue for the fiscal stance since poor financial discipline and losses from quasi-fiscal activities were a major risk to macroeconomic stability. There is no consistent set of data on quasi-fiscal deficit. However, various sources indicated a gradual improvement since 2001 and a more pronounced progress since 2002. The quasi-fiscal deficit decreased during the last three years from 3.53% of GDP in 2003 to 2.62% of GDP in 2004, and further to 1.39% of GDP in the first three quarters of 2005.[6]

The decrease in the quasi-fiscal deficit was achieved by restructuring and privatisation, including initiation of bankruptcy procedure for a couple of heavily indebted companies , reform in the energy sector and utilities price adjustment, and to some extent prudent wage policy in the public enterprises. The developments during 2003 and 2004 reflected mainly the decrease of losses and payments made from the State Guarantee Fund to the enterprises that benefited from loans contracted with state guarantees. In the first three

[6] See Government of Romania, Pre-Accession Economic Programme 2005, November 2005.

quarters of 2005 the main factor was the reduction of new arrears that decreased from 1.53% to 0.43% of GDP.

The major, though not the only, culprit was the energy sector (see table 3.7).

Table 3.7 Estimated losses from quasi-fiscal activities in the energy sector (% of GDP)

	2000	2001	2002	2003	2004*	2005*
Gas	3.6	3.5	1.9	2.3	1.5	0.9
Electricity and heating	1.1	1.3	0.6	0.5	0.2	…
TOTAL	**4.7**	**4.8**	**2.5**	**2.8**	**1.7**	**0.9**

* IMF projections

[Source: IMF Country Reports No. 04/113, April 2004 and 04/319, October 2004]

The IMF arrangements focused as well on energy sector reforms in order to address the quasi-fiscal deficit, not only for economic structural reasons, but also for macroeconomic concerns. Due to the relative sizeable reduction of quasi fiscal losses of the energy sector domestic demand was to certain extent contained resulting in a lower current account deficit in 2002.

The IMF has introduced in its 1999 and 2001 stand-by agreements conditions relating to electricity tariffs, arrears in gas and electricity collections. Also the World Bank programme and the EC RICOP programme addressed particularly this issue.[7] As a response to reforms in the sector, starting with 2001 energy sector losses fell from 4.7% of GDP in 2000 to 2.5% in 2002 due to energy price increases and improved collections, particularly in the gas sector. In 2003 delayed gas price adjustments temporarily halted further reduction of the quasi fiscal losses in the energy sector, but in 2004 further price adjustments led to a lower quasi fiscal loss.

3.3.3 Conclusions

We conclude that the objective of relieving *short-term* external financial constraints has been achieved. Romania's reserve position was defended with the disbursements of comprehensive support package of IMF, the World Bank and the EU in 1999 and 2000. In 2003, the initial situation was much better and the need for intervention was much less pronounced since the country regained access to private external financing. However, the international assistance still played a role to avert short-term reversals. Whether the objective of supporting the *medium term* position of the balance of payments had been accomplished, depends on the interpretation. The financial account continuously reflected growing levels of capital flows, including foreign direct investments. As a result, the overall balance improved over time. The current account deficit, however, rose to record levels. Chapter 4 will discuss in detail the sustainability of the balance of payments.

[7] The second sub-tranche of the second tranche of MFA included a RICOP related structural condition as well.

3.4 Counterfactual

3.4.1 Alternative arrangements

Q 0.1: What arrangement would have been implemented if the MFA had not been granted?

In defining the alternative arrangement in the counterfactual, we have to assess the most likely behaviour of other donors and policy response of Romanian authorities in the absence of the MFA.[8]

Interviewed World Bank representatives mentioned that the size of the PSAL loan of US$ 300 million was an absolute maximum. Romania's previous track record with three previous IMF stand-by-agreements and with FESAL, the absence of a SBA, no real leading WB programme led to cautious World Bank management who initially only wanted to have a US$ 200 million loan. After internal deliberations and consultations with the IMF, it was only willing to increase the amount to US$ 300 million if the PSAL loan would be part of a comprehensive support package from the IMF the World Bank and the EU. Therefore, the proposed counterfactual is the situation in which no other (official) funds would be available to fill in the non-available MFA resources. However, the access to private capital markets was quite different between first and second tranche (first sub-tranche) disbursement in 1999/2000 and 2000/2003, respectively.

In 1999 there were no foreign banks willing to lend more to Romania, which thus means a tougher adjustment. IMF representatives confirmed that the quantitative performance criteria in its stand-by-agreement would have been set more austere to enable the country to restore macroeconomic stability in case EU resources would not be available. Changes would have come in the macroeconomic framework and in the conditions to achieve the targets as set in the macro framework for 2000. The implications of a tighter IMF programme could be through the following channels:

1. faster reduction of the general government deficit through more nominal wage containment in the state sector (and thus lower current government expenditure) and higher tax rates and enforcement, incl. of tax arrears;
2. tighter overall credit conditions (through conditions ceilings on domestic assets and floors on foreign assets).

On the other hand in 2002/2003, in the absence of the MFA the Romanian Government would have the opportunity to tap relatively more expensive external private financial markets. Following interviews with Romanian policymakers, additional private sector borrowing seems to be more probable counterfactual arrangement as compared with tighter macroeconomic policies in case of the disbursement of the first sub-tranche of the second tranche.

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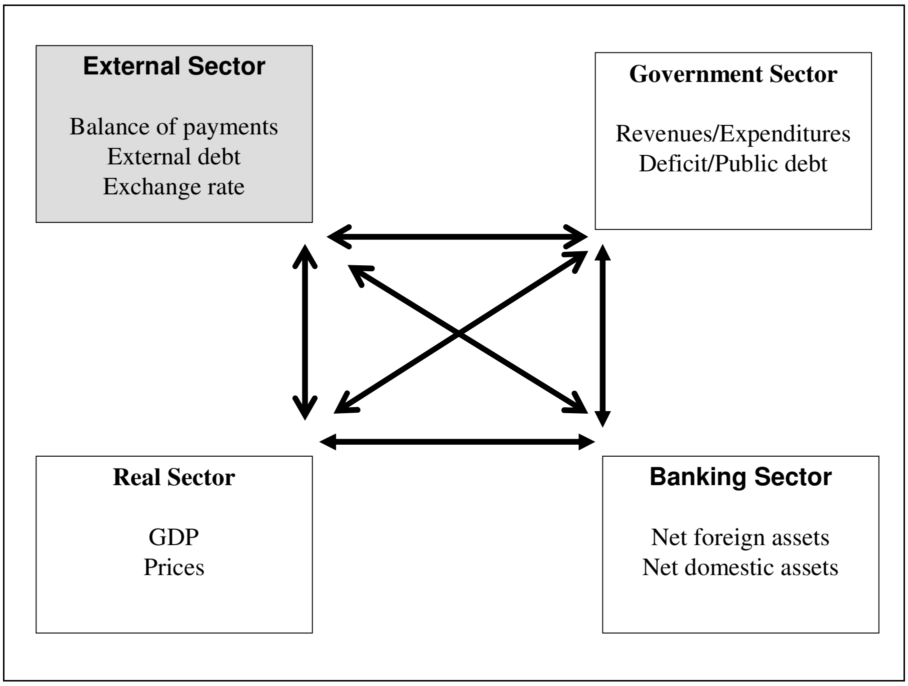
[8] In the Inception report we included the option that the EU would have granted 150 million instead of 200 million. We have not used this alternative option since the counterfactual outcomes would be even smaller than the selected option.

3.4.2 Outcomes

Q 0.2: What are the structural and macroeconomic effects of the most likely implementation scenario(s)?

In order to measure the macroeconomic effects of the counterfactual(s), the quantitative modelling approach has been used. Two distinct models were used – an annual model and a quarterly model. The basic structure of the annual model that recognizes links and ensures consistency among four basic economic sectors: real, external, government and banking is illustrated in box 3.2 below. This model has been calibrated using annual IMF data available through IMF International Finance Statistics (IFS) and recent IMF Country Reports and has been used to derive alternative paths of major macroeconomic variables in the absence of the MFA. This model is particularly useful to assess the counterfactual outcomes in case of first tranche disbursement in 2000, when the counterfactual involves a serious policy adjustment on top of the effect on market expectations and premia (widening spread) on Romanian debt instruments. In year 2003, the adjustment would mean simply the switch in the composition of external debt from official to commercial creditors with some increase in the cost of borrowing.

Box 3.2 Basic structure of the model



The quarterly model is consistent with the annual model. It has been mainly developed to analyse in more detail the development of the balance of payments. It relies on detailed quarterly balance of payment data that were provided by the National Bank of Romania and other relevant macroeconomic series obtained from the National Statistical Institute, the National Bank of Romania, Eurostat and IMF International Finance Statistics (IFS).

We note that all the estimates should be interpreted with caution as they are based on relative short time annual series and strong assumptions. Interpretation could be concentrated on signs and relative size of the effects, rather than particular numerical values. Annex A.5 provide additional information on the used models.

Counterfactual outcomes in 1999-2000 (MFA not announced, 1st tranche not disbursed)
Starting from the last quarter of 1999 and throughout 2000, the absence of the MFA affects the economic system though four channels. First, there is a direct impact on market sentiment following lack of decision on granting Romania MFA. In the model this is captured by upward revision of spreads on external financing. The analysed scenario assumed an initial effect of 100 basis points in the last quarter of 1999 gradually waning to zero over the following four quarters. The estimated impact on debt service costs is € 26 million over eight quarters starting in 4Q1999. This widens (albeit marginally) current account deficits in the analysed quarters and leads to slower accumulation of official reserves.

Second, there is a direct impact on the balance of payment in the second quarter of 2000 as the absence of an alternative capital account support implies lower accumulation of external debt and exchange rate depreciation pressure. The size of the MFA tranche amounted to above 1% of quarterly GDP in the second quarter of 2000. Part of the balance of payment adjustment takes place through lower accumulation of foreign reserves. However, generally tighter macroeconomic policies described above lead to the contraction in aggregate demand reducing demand for imports while real exchange rate depreciation facilitates the adjustment. As a result, the current account deficit is slightly reduced.

The third channel of impact operates through budgetary accounts. The absence of the MFA implies lower external financing opportunities for the budget deficit. While it is not impossible that this loss could have been substituted with domestic borrowing, we tend to believe that the government would rather fully adjust the budget deficit in line with a tighter IMF program. This adjustment would take place on both revenue and expenditure side as described above.[9]

Fourth, a more restrictive monetary policy involves lower net foreign assets and also less credit to the private sector.

This general contraction of macroeconomic policies would slow down growth in nominal output (consistent with the current account improvement). Although the size of the impact would be small, both real growth and inflation rates would be reduced.

Counterfactual outcomes in 2003 (2nd MFA tranche not disbursed)
The counterfactual scenario with an announcement on no disbursement of the 2nd MFA tranche some time during the second quarter of 2003 assumes a negative impact on market sentiment and specifically, widening of the spreads on foreign financing. Similarly to the situation during 1999/2000 (keeping the relative size of effects roughly similar) the analysed scenario assumed an initial effect of 40 basis points in the second

[9] We have simulated as well the possibility of a somewhat smaller fiscal adjustment on the expenditure side (0.1% of GDP). The main difference is that the government would be able to cover 0.1% of GDP from domestic sources at the expense of credit to the private sector. The effect on GDP would be + 0.1%-point.

quarter of 2003 gradually waning to zero over the following four quarters. The estimated impact on debt service costs is € 17 million over eight quarters starting in 2Q2003. This marginally widens current account deficits in the analysed quarters and leads to slower accumulation of official reserves. The size of the balance of payment effect is so small that we do not model adjustments of other macroeconomic variables as these would be nonexistent given the accuracy at which data are typically presented.

3.5 Net impact on macroeconomic stabilisation

Q 1.3: What has been the contribution of the grants and/or loans provided by the MFA operation to the achievement of MFA objectives?

The net impact of the announcement of the MFA program operation and disbursement of the first tranche on macroeconomic stabilisation in 1999-2000 was very limited, while the macroeconomic stabilization effect in case of the disbursement of second tranche in 2003 was practically non-existent.

In 1999-2000, MFA allowed for a slightly more expansionary macroeconomic policy that marginally improved growth performance. The main, albeit only marginal result of MFA loan disbursement in 2003 is somewhat lower cost of debt service due to better financial market sentiment and faster build-up of reserve assets of the central bank.

The significance of a separate signalling effect of MFA is unlikely to have been relevant from the perspective of macroeconomic stabilisation. A few interviewees mentioned that "*MFA in terms of signalling to financial markets did not really matter, only through an IMF stand-by-agreement*". The quantitative simulation in the quarterly model confirms that even assuming MFA impact on the terms of foreign borrowing, the macroeconomic implications are hardly visible.

Table 3.11 Net impact of MFA – Annual developments

Annual developments		1999	2000	2001	2002	2003
Capital account, USD million	Actual	2 120	2 750	3 992	2 729	3 337
	Counterfactual	2 120	2 658	3 992	2 729	3 337
	Net impact	0	92	0	0	0
Current account, USD million	Actual	-1 475	-1 355	-2 223	-1 525	-3 368
	Counterfactual	-1 475	-1 327	-2 223	-1 525	-3 368
	Net impact	0	-28	0	0	0
Net foreign assets accumulation, USD million	Actual	645	1 395	1 769	1 204	-31
	Counterfactual	645	1 330	1 769	1 204	-31
	Net impact	0	65	0	0	0
Medium and long term external debt; official creditors, USD million	Actual	6 936	7 678	8 432	10 363	13 111
	Counterfactual	6 936	7 586	8 342	10 269	12 941
	Net impact	0	92	90	94	170
Medium and long term external debt; commercial creditors, USD million	Actual	1 835	2 595	3 482	4 907	6 111
	Counterfactual	1 835	2 595	3 482	4 907	6 168
	Net impact	0	0	0	0	-57
Government revenues, % of GDP	Actual	31.9	31.2	30.1	29.7	30.0
	Counterfactual	31.9	31.3	30.1	29.7	30.0
	Net impact	0.0	-0.1	0.0	0.0	0.0
Government expenditures, % of GDP	Actual	35.5	35.3	33.4	32.3	32.3
	Counterfactual	35.5	35.0	33.4	32.3	32.3
	Net impact	0.0	0.2	0.0	0.0	0.0
Government balance, % of GDP	Actual	-3.6	-4.0	-3.2	-2.6	-2.3
	Counterfactual	-3.6	-3.7	-3.2	-2.6	-2.3
	Net impact	0.0	-0.3	0.0	0.0	0.0
Net credit to the government, % of GDP	Actual	8.0	4.7	2.1	1.4	-0.1
	Counterfactual	8.0	4.7	2.1	1.4	-0.1
	Net impact	0.0	0.0	0.0	0.0	0.0
Net credit to non-government, % of GDP	Actual	10.6	9.3	10.1	11.9	16.1
	Counterfactual	10.6	9.2	10.1	11.8	16.0
	Net impact	0.0	0.1	0.1	0.1	0.0
GDP growth rate, %	Actual	-1.2	2.1	5.7	5.0	4.9
	Counterfactual	-1.2	2.0	5.7	5.0	4.9
	Net impact	0.0	0.1	0.0	0.0	0.0
Inflation rate, %	Actual	54.8	40.7	30.3	17.8	14.1
	Counterfactual	54.8	40.5	30.3	17.8	14.1
	Net impact	0.0	0.2	0.0	0.0	0.0
Exchange rate, lei per USD	Actual	18 255	25 926	31 597	33 500	32 595
	Counterfactual	18 255	25 958	31 597	33 500	32 595
	Net impact	0.0	-32	0.0	0.0	0.0

Table 3.12 Net impact of MFA – Quarterly developments

Quarterly developments		4Q99	1Q00	2Q00	3Q00	4Q00	1Q01	…	2Q03	3Q03	4Q03	1Q04
Current account												
actual	mln EUR	-599	-122	-520	-192	-659	-472	…	-1142	-369	-1293	-688
counterfactual	mln EUR	-601	-125	-487	-196	-663	-476	…	-1143	-371	-1295	-690
net impact	mln EUR	2	2	-33	4	4	4	…	1	2	2	2
Current account												
actual	% GDP	-5.9	-1.7	-5.7	-1.7	-5.4	-5.9	…	-9.9	-2.5	-7.9	-6.6
counterfactual	% GDP	-5.9	-1.7	-5.3	-1.7	-5.4	-6.0	…	-9.9	-2.5	-7.9	-6.6
net impact	% GDP	0.0	0.0	-0.4	0.0	0.0	0.0	…	0.0	0.0	0.0	0.0
Capital & financial account (ex reserves)												
actual	mln EUR	219	-25	501	423	1530	897	…	631	1878	1113	1259
counterfactual	mln EUR	219	-25	401	423	1530	897	…	631	1878	1113	1259
net impact	mln EUR	0	0	100	0	0	0	…	0	0	0	0
Capital & financial account (ex reserves)												
actual	% GDP	2.1	-0.4	5.5	3.7	12.5	11.3	…	5.5	12.8	6.8	12.1
counterfactual	% GDP	2.1	-0.4	4.4	3.7	12.5	11.3	…	5.5	12.8	6.8	12.1
net impact	% GDP	0.0	0.0	1.1	0.0	0.0	0.0	…	0.0	0.0	0.0	0.0
Change in reserve assets												
actual	mln EUR	-108	-89	-293	-271	-369	-399	…	236	-1287	100	-258
counterfactual	mln EUR	-106	-87	-226	-267	-365	-395	…	237	-1285	102	-256
net impact	mln EUR	-2	-2	-67	-4	-4	-4	…	-1	-2	-2	-2
Reserve assets level												
actual	mln EUR	3356	3445	3738	4009	4378	4777	…	7772	9059	8959	9217
counterfactual	mln EUR	3355	3441	3667	3934	4299	4694	…	7680	8965	8863	9119
net impact	mln EUR	2	4	71	75	79	83	…	91	93	95	98

Note: In the quarterly table, GDP ratios refer to quarterly rather than annual GDP

3.6 Indirect effects of structural conditionality

Q.3.1 What, if any, has been the contribution of actions resulting from the respect of structural conditionality criteria to the achievement of short term and medium term macroeconomic objectives of the assistance (i.e. the indirect effects of structural conditionality criteria?)

Based on available evidence there is just one instance in the 2002 negotiations of a clear quantifiable link between structural reform-related goals and macroeconomic stability objectives, and namely the fact that the conversion of the so-called civil code labour contracts (that paid no social security contributions up to that point) to normal labour contract would contribute to bridge the 1% GDP gap in the Pension Fund.

At any rate in 1999 a fragile fiscal position and relatively large external financing needs posed interrelated risks. Without decisive structural action to limit public spending and force state enterprises to restructure an additional strain on the balance of payments could have resulted. As discussed in section 3.3.2 quasi-fiscal losses significantly reduced, including those in the energy sector. IMF, World Bank and MFA conditions pressed the Romanian government to deal with these losses, both from structural and macroeconomic points of view. A separate MFA effect is not measurable since the conditions of these institutions matched.

3.7 Unexpected macroeconomic results

Q3.2 Has the assistance given rise to any unexpected short and medium-term structural and/or macroeconomic effects? What were they and how did they occur?

There are no real unexpected macro economic effects of the comprehensive international assistance package.[10]

3.8 Summary

The EC provided Romania the fourth MFA in a period when the macroeconomic stability in the country in 1999 was severely threatened. The country faced significant loan repayment problems. The Kosovo crisis stimulated the international community to support Romania with a comprehensive and coordinated package of stabilisation and structural reform programmes from the international financial institutions and the EU. These programmes combined brought Romania economy recovery and improved the structure of the economy through privatisation and restructuring.

Comparing the actual values of the macroeconomic variables with their values in our counterfactual scenario, we end up with net effect of the MFA. The most plausible

[10] Though not directly MFA related, interviewees recognise direct consequences on the balance of payments through the abolishment of the visa regime for Romanian citizens in 2003. Remittances rose almost immediately. This unexpected effect cushioned to a small extent the increase of the trade deficit.

counterfactual for MFA is a scenario of no MFA. Our analysis of the effects of this scenario shows for 2000 a slightly lower accumulation of foreign reserves and higher debt service costs. Restrictive fiscal and monetary policies would reduce domestic demand and imports. Together with exchange rate adjustments, this would lead to a small improvement in the current account. Although the size of the impact would be small, real growth and inflation would be reduced. No MFA in 2003 would result in somewhat higher debt service cost as a result of worse financial market sentiment and a slower build-up of reserve assets of the Romanian central bank.

We could identify only one possible indirect effect of structural conditionality that could be attributed to the MFA. The conversion of the so-called civil code labour contracts to normal labour contract would contribute to bridge the 1%GDP gap in the Pension Fund as now social security contributions had to be paid. Through its emphasis on privatisation and restructuring MFA contributed, together with the IMF and World Bank programmes, to building up pressure to the Romanian government to address quasi-fiscal losses which decreased in the period of MFA.

4 Impact on external sustainability

4.1 Introduction

This chapter focuses on the contribution of the fourth MFA operation to the sustainability of the external financial situation in Romania. Table 4.1 mentions the evaluation questions which will be touched upon in sequence as stated in the table.

Table 4.1 Evaluation questions for analysing the contribution of the MFA on external sustainability

	Evaluation questions
Q4	To what extent has the MFA contributed to returning the external financial situation of the recipient country to a sustainable path over the medium to longer term?
Q4.1	How did the external financial situation of the recipient country evolve prior to and during the MFA operation?
Q4.2	What are the main internal and external factors on which the current trend in the country's external financial situation and its prolongation into the future are conditional?
Q4.3	How is the country's external financial situation likely to evolve in the 5 years following the final disbursement given the likelihood of changes to current conditions?

4.2 Gross impact – actual evolution of external sustainability indicators

Q4.1 How did the external financial situation of the recipient country evolve prior to and during the MFA operation?

The peculiar policies of the final years of the Ceausescu regime and the nature of economic reforms in Romania in the early 1990s resulted in an untypical external financial situation in the first years of the transition process. By 1989 Romania paid off almost all of its foreign debt obligations and until 1995 remained a net creditor nation (due to claims on other post-communist countries) without credit rating and without access to international capital markets. Accordingly, the building up of external obligations in this period consisted primarily of trade-related debt and obligations towards bilateral and multilateral creditors.

The situation changed after Romania obtained credit ratings in 1995. The country borrowed from foreign institutions in international capital markets rather than through the domestic market (by issuing treasury bills), which was closed to foreigners until the end of 1998 when Romania practically lost access to external sources of financing, both official and private. The deterioration of the external financial situation that culminated in 1998-1999 resulted from a combination of factors. The unfavourable maturity structure of debt (e.g. large debt service costs in 1996) was addressed by heavy use of short-term debt instruments, which in turn implied large principal payments due in 1998-1999 at the time when the Asian and Russian financial crises significantly worsened terms of access to markets for all emerging economies. This coincided with a major deterioration of the economic situation in Romania. In 1997, Romania entered into a deep recession, with 6% GDP contraction. The fiscal situation was particularly difficult and the banking sector (mostly state owned) was in serious troubles. The Kosovo crisis was an additional negative external shock to Romania undermining its balance of payments position in this period.

Compared to this difficult situation, all available indicators suggest a comprehensive improvement in the external financial situation in Romania since 1999 when the fourth MFA operation was launched (see tables 4.2-4.4 below). Accordingly, as indicated in chapter 2, the current risk to external stability appears low. The fundamental cause is the relatively positive developments in exports and income transfers dynamics, safe levels of official reserves and – perhaps more importantly – the composition of the deficit financing flows. Investor sentiment has turned more positive as Romania progressed in its accession negotiations with the EU. Of particular importance is the increasing inflow of FDIs, which provide non-debt creating financing of the current account deficit (around 75% of the deficit in recent years) but more importantly lead to improved productivity and enhanced export potential. These positive developments were supported by relatively prudent fiscal policies (read: low fiscal deficit) preventing (at least until the turn of 2005/2006) real exchange appreciation of the magnitude proceeding the 1998/1999 quasi financial crises.

As a result of these positive developments, the external debt service as a share of exports of goods and services has been falling since 1998. External debt to GDP ratio fluctuated in most recent years but remained low compared to international standards and does *not* raise concern about external debt sustainability.

Other indicators also point to Romania's sound external financial situations. It secured better liquidity position and therefore is less vulnerable to potential instability in short term capital flows that is reflected in the debt ratings and spreads. Gross reserves have been growing systemically with a particularly strong accumulation during 2004-2005. This trend is visible both in absolute terms, and relative to monetary aggregates. The particularly rapid improvement is observed in the measure widely believed to be the important predictor of financial crises. The ratio of short-term liabilities to gross reserves fell from 1.27 in 1998 to around 0.44 in March 2006. These positive trends are reflected in improving foreign currency ratings of Romania (investment grade from Standard & Poor's since September 2005) and fall in spreads from 1300 basis points in the aftermath of Russian crisis to 168 at the end of 2003 and below 50 points in 2005.

Table 4.2 External debt: stock and debt service

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Total external debt (in percent of exports of G&S)*	88.7	93.4	101.3	87.7	86.8	93.3	87.6	85.3	86.7	85.1
External debt / GDP	24.5	26.9	23.5	25.6	29.8	32.8	32.8	34.1	36.3	34.5
External interest payments (in percent of exports of G&S)*	3.7	5.0	6.0	5.1	3.8	3.8	3.0	2.7	2.4	2.5
External amortization payments (in percent of exports of G&S)*	9.9	15.9	18.0	23.6	9.5	13.6	15.4	12.2	12.0	10.3

* IMF forecast for 2004/2005

[Source: IMF, Romania, Country Reports, No. 01/16 and No. 04/319 and Article IV Consultation Discussions, Preliminary Conclusions, 6 February 2006]

Table 4.3 International liquidity indicators

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Gross official reserves (in months of imports GNFS of the following year)	1.5	2.9	2.4	2.1	2.3	3.5	3.6	2.8	4.2	5.7
Gross reserves of the banking system (in months of imports GNFS of the following year)*	3.0	4.4	4.0	3.2	3.2	4.1	4.4	4.2	5.0	4.6
Official reserves/Broad money (M2)	19.7	39.5	27.2	23.7	52.2	56.8	65.5	66.9	73.4	77.8
Official reserves/Narrow money	49.9	237.7	107.1	102.5	201.5	431	537	531	634	590
Total short term external debt by remaining maturity in percent of GDP*	7.4	7.4	7.0	5.6	6.2	8.1	6.3	6.9	6.7	6.3

* IMF forecast for 2004/2005

[Source: IMF, Romania, Country Reports, No. 01/16 and No. 04/319 and Article IV Consultation Discussions, Preliminary Conclusions, 6 February 2006 and National Bank of Romania]

Table 4.4 Financial markets, ratings and spread

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Moody's foreign currency debt rating	Ba3	Ba3	B3	B3	B3	B2	B1	Ba3	Ba3	Ba1
Standard and Poor's foreign currency debt rating	BB-	BB-	B-	B-	B-	B	B+	BB	BB+	BBB-
Spread of benchmark bonds (basis points, end of period)	364	350	1300	780	406	400	282	161	53	35

[Source: IMF, Romania, Country Reports, No. 01/16 and No. 04/319 and Reuters]

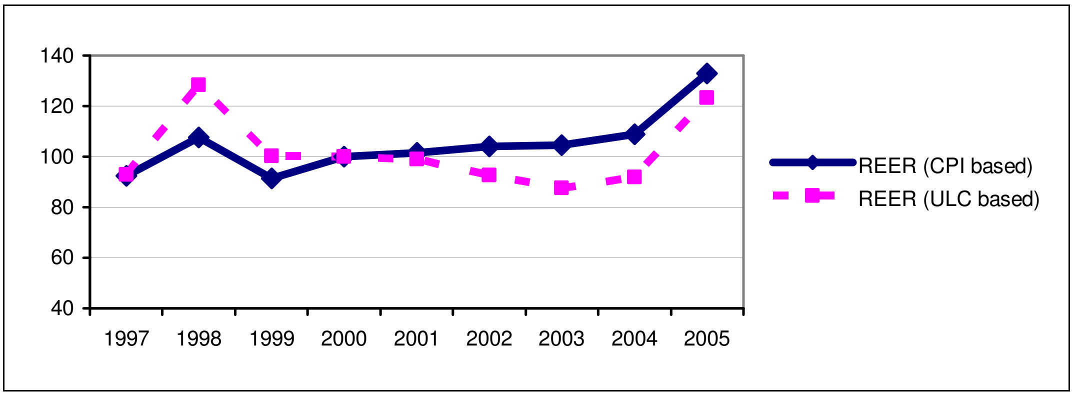
4.3 Identifications of major risk factors

Q4.2 What are the main internal and external factors on which the current trend in the country's external financial situation and its prolongation into the future are conditional?

The upcoming EU accession substantially reduces the vulnerability of Romania to changes in international capital markets sentiment, while trade integration with the EU reduces exposure to potentially more unstable export markets in the Balkans and CIS countries. Despite this positive anchoring role of the EU accession several risks to medium term external outlook remain as evidenced by the current account deficits that widened significantly in the last few years, primarily due to a much higher dynamics of imports than exports. If such tendencies intensify, the soundness of external position might be undermined. In this respect, there are two major risk factors for the medium term external situation and both relate to domestic policymaking.

Firstly, FDIs, productivity and exports might fail to grow faster if privatisation, restructuring and improvement of the business environment are not implemented more forcefully. Secondly, expansionary fiscal policies and in particular rapid growth in public sector wages might excessively stimulate domestic demand and non-investment imports. In fact relaxation of wage policy contributed to the acceleration of appreciation of the real effective exchange rate in 2005 creating difficult dilemmas for monetary policy and slowing down the disinflation process (because of the perceived trade off between inflation and competitiveness). While the nominal exchange rate against the Euro has depreciated over time (until the turn of 2003/2004) and the nominal effective exchange rate followed the same trend, the real effective exchange rate in fact slowly, but consistently *appreciated* over the period 1999-2005 (see figure 4.1). However, it should be noted that the trend of real appreciation of currencies is typical for almost all countries that recently acceded the EU (see figure 4.2).

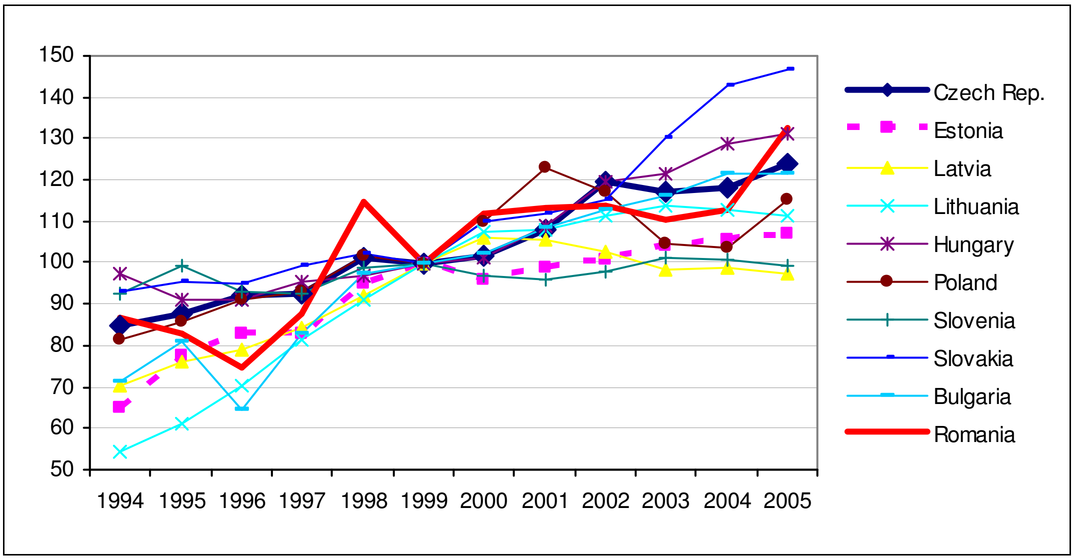
Figure 4.1 Real effective exchange rate developments in Romania, 1997-2005 (index, 2000 value = 100)



Note: 2005 data refer to September 2004-September 2005 period. The scale of real appreciation for the 2005 as a whole was slightly lower.

[Source: IMF, Article IV Consultation Discussions, Preliminary Conclusions, 6 February 2006]

Figure 4.2 Real effective exchange rate developments in CEE countries, 1994-2005 (index, 1999 value = 100)



Note: Real effective exchange rates relative to 41 trading partners based on CPI indices.

[Source: Eurostat]

4.4 Projections of external sustainability – baseline and sensitivity analysis

Q4.3 How is the country's external financial situation likely to evolve in the 5 years following the final disbursement given the likelihood of changes to current conditions?

In the medium term, the external situation will be most strongly influenced by economic fundamentals and progress in the European integration process. As discussed , the positive medium term outlook depends on the continued effort of maintaining prudent fiscal and economic policies conducive to growth and macroeconomic stabilisation. Improved access to financial markets in the context of EU membership implies that the importance of traditionally defined financing gaps and official interventions would be falling in medium term. FDI inflows and other capital inflows enable Romania to run increasing current account deficits. While the pattern of high import of goods and services and rising capital inflows can be expected from a country at the brink of EU accession, it is not easy to assess ex ante the likely (and desired) scale of these effects. Relevant insights can however be provided by the experience of less developed EU member states, many of which experienced long spells of high and sustainable current account deficits (see box 5.1).

Box 4.1 Current account in catching-up countries of the EU

Large current account deficits are not uncommon among other Central and East European countries and other less developed EU member states. In fact significant deficits, in some cases exceeding the levels currently recorded in Romania have been quite typical for this group of countries. The key question pertains to the *sustainability* of these deficits. In order to attempt an answer to this question one should understand the determinants of current account balances in less developed (but catching-up) countries financially integrating within a more developed region.

Existing empirical work on determinants of current account position in catching-up countries does not provide clear-cut conclusions and there remain substantial controversies. Nevertheless a striking observation is that several of the new EU member states and accession countries have been running substantial current account deficits in the last decade or so. A similar situation emerged in Ireland between mid-1970 and late 1980, and in Portugal and Greece from mid 1990s till now. The common feature of these (long lasting) episodes is that two processes coincided:

1. strengthened economic and financial integration of the countries considered with the EU; and
2. catch-up growth, surpassing average levels in the EU.

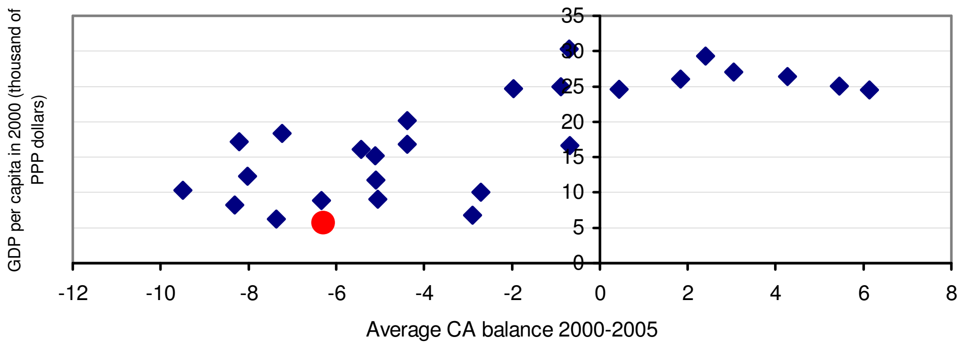
The current account developments should be understood in the context of a standard intertemporal optimisation model: countries with better growth prospects should be expected to run current account deficits during the catch-up phase. This, however, can only be sustainable (and thus actually observed) when sufficiently strong economic integration takes place so that the risk of volatile market sentiment does not prevent countries from relying on foreign savings in financing investment at home.[11]

Figures below confirm a strong pattern among EU and EU candidate countries: current account deficits were common among less developed and faster growing economies. The situation of Romania did not differ from these patterns[12].

[11] See discussion in: Blanchard, O. & F. Giavazzi (2002), 'Current Account Deficits in the Euro Area: The End of the Feldstein-Horioka Puzzle?', *Brookings Papers on Economic Activity*, 2002/2, 147-209; Euroframe 2004, Spring Report 2004: Annex 3 Current Accounts Sustainability in Acceding Countries, www.euroframe.org; Herrmann S. & A. Jochen (2005), 'Determinants of current account developments in the central and east European EU member states – consequences for the enlargement of the euro area', Deutsche Bundesbank Discussion Papers, No 32/2005

[12] Compared to the average from 2000-2005, Romanian current account deficit widened further towards the end of this period reaching around 9% of GDP in 2005. Still, similar and even higher levels of deficits were recorded in the Baltic States, Bulgaria, Hungary and Portugal.

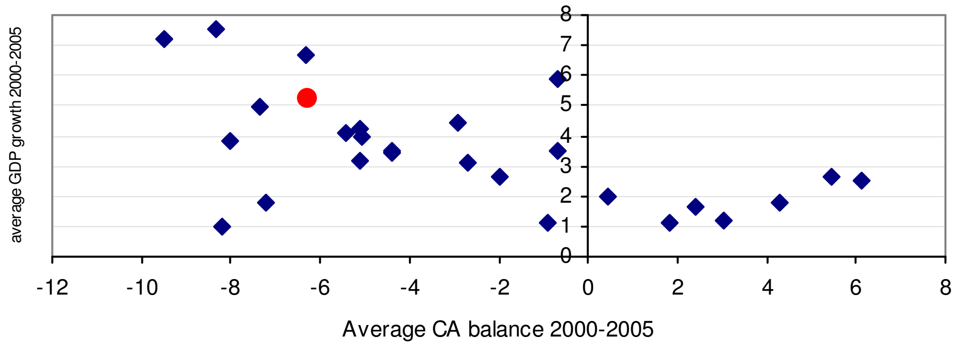
CA positions and GDP per capita in European countries, 2000-2005



Note: Romania marked by a red dot.

[Source: IMF, World Economic Outlook database September 2005]

CA positions and GDP growth in European countries, 2000-2005



Note: Romania marked by a red dot.

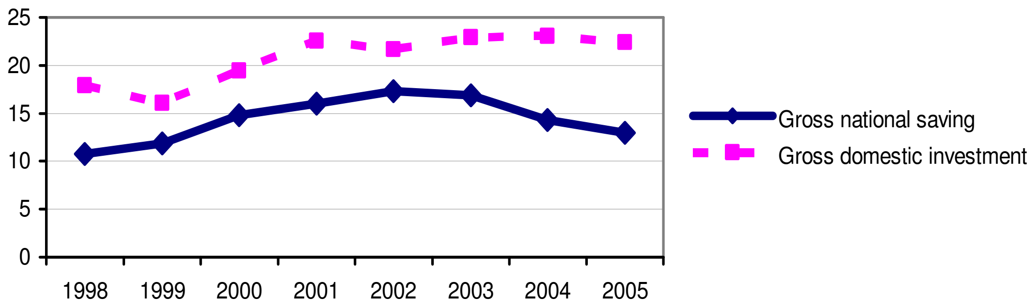
[Source: IMF, World Economic Outlook database September 2005]

Economic integration with the EU can be viewed as a (partial) *insurance* against the volatility of investor sentiment. However, this does not imply that domestic policies do not matter any longer. While persistence of deficits may not require fundamental policy reversals, certain risks attached to this remain. These are primarily related to potentially unsustainable position of public finances, possible banking crises (e.g. related to weak supervision or excessive optimism during credit booms), asset price bubbles, and also exchange rate crises (e.g. stemming from incoherent exchange rate / monetary policy regimes), etc. Nevertheless, persistence of sizeable current account deficits as such can hardly be judged by the criteria that were historically typically applied to developing / emerging economies.

It has always been difficult to assess the sustainable levels of current account deficits. The exercise carried by Euroframe (2004) suggested that in none of the analysed Central and East European countries current account deficits appeared unsustainable. In the medium- to long-term the possibility to maintain current account deficits will hinge on the investment climate and ensuing FDI flows, prudent domestic policies (fiscal constraint, price stability, efficient financial supervision, etc.). From the policy perspective this implies that structural policies are key for the sustainability of the balance of payment. This corresponds to the approach taken by the IMF, World Bank and the EU, where structural conditions played an important role.

The relative optimism concerning the current account developments and sustainability of deficits in Romania is supported by the fact that the investment rate has remained relatively high while a decline in savings was gradual (see figure 5.3) which suggests medium-term sustainability of the external situation. Investment remained strong primarily on the back of robust private investment outlays. Public investments – while relatively low – have showed strong dynamics until 2002. More recent fiscal restraint suggests more constrained public investment, although detailed data are not (yet) available.

Figure 4.3 Saving and investment rates, 1998-2005 (% of GDP)



[Source: IMF, Article IV Consultation Discussions, Preliminary Conclusions, 6 February 2006]

4.5 Contribution of the MFA to the medium- to long-term external sustainability prospects

There are various channels through which the MFA operation can impact on medium- to long-term perspectives of external sustainability. MFA can result in building an environment more conductive to stronger and/or more stable economic growth in the medium- to long-term. These in turn have a direct impact on the external balance, e.g. by improving debt and debt service to GDP ratios. Furthermore, MFA can lead to improved macroeconomic management and structural reforms. More prudent and coherent fiscal and monetary framework should help in keeping debt dynamics in check. This last point is strongly related with structural reforms focussed on reducing the scope of quasi-fiscal operations, bringing sustainability to public finances, avoiding excessive wage growth, etc. Finally, the primary declared objective of the MFA is to ensure sustainability of the balance of payment position and thus to prevent short-term financial disturbances with potentially long term negative impacts (such as mini or full-fledged financial crisis).

In section 3.4 of the report we argue that direct impact of MFA on economic growth in Romania has been marginally positive in the short term. It is difficult to assess to what extent structural reforms, partly motivated by MFA conditionalities (together with conditions related to IMF and World Bank programmes) have allowed for improvement in the medium- to long-term growth prospects. The definite judgment on this needs to be avoided; some positive effect is likely, albeit its scale should not be overestimated.

The period of MFA operations has coincided with general improvements in macroeconomic policies and implementation of several structural reforms. These have clearly improved external sustainability prospects. However, as discussed in chapters 3 and 5 of this report, it is very difficult to assess the importance of MFA as a separate instrument in supporting such a policy improvement. We conclude that MFA played a substantial political reinforcing effect on the credibility of the overall reform package. MFA emphasis on privatisation and restructuring contributed, together with the IMF and World Bank programmes, to building up pressure to the Romanian government to address quasi-fiscal losses. These in turn contributed to improving medium- to long-term sustainability prospects of the country.

As far as the role of MFA in preventing Romania from a short-term macroeconomic instability is concerned, the conclusions of this report are that such a role (independently from other instruments, such as IMF programmes) has been very limited. Some marginal effect can be identified only in the case of the first tranche, yet it is mostly confined to the 'announcement' effect, since first tranche disbursement took place when Romania was already in a much better situation. During 1999-2000 MFA was one element of the 'stabilisation package' offered by the IFIs. Later, market sentiment had most likely been more affected by the prospects of EU accession than by the existence the fourth MFA operation.

Summing up, the 4th MFA operation in Romania is believed to have positively contributed to medium- to long-term external sustainability prospects, albeit this impact was likely limited and indirect. It is difficult to disentangle the role of MFA from that of other processes taking place simultaneously, such as progress in EU integration agenda and IMF and World Bank programmes. The primary channel through which MFA acted in this respect appears to be reinforcement of structural reforms and improved overall macroeconomic management.

4.6 Conclusions

Romania's balance of payments recent developments do not differ much from the experience in a number of other CEEC countries and relatively low income EU member states. Although the current account deficit is widening, the gap is covered by foreign direct investment, other capital inflows and exports.

The risks to external financial situation are not excessive at the moment and they are related to domestic policies, specifically to potential slippages in structural, competitiveness-enhancing policies and fiscal and wage policies stimulating excessive consumption drive.

5 Impact on structural reforms

5.1 Introduction

In this chapter we will analyse the impact of the structural criteria of the MFA. Table 5.1 presents the evaluation questions which we will address in the given sequence.

Table 5.1 Relevant evaluation questions for analysing the impact of structural reform

	Impact of structural reforms
Q2.1	What are the short and medium-term expected structural effects of the assistance (in the context of the recipient country's reform programme)?
Q2.2	How relevant are the short and medium-term expected structural effects of the assistance to the needs of the recipient country?
Q2.3	To what extent have the short and medium-term expected structural effects of the assistance (in the context of the recipient country's reform programme) occurred as envisaged?
Q0.1	What arrangement would have been implemented if the MFA had not been granted?
Q0.2	What are the structural and macroeconomic effects of the most likely implementation scenario(s)?
Q2.4	What has been the contribution of actions resulting from the respect of structural conditionality criteria to the occurrence of expected structural effects?
Q2.5	To what extent have structural effects been enhanced, if at all, by complementarities between the MFA and other EU instruments?
Q3.2	Has the assistance given rise to any unexpected short and medium-term structural effects? What were they and how did they occur?

5.2 Structural objectives of intervention

Q2.1 What are the short and medium-term expected structural effects of the assistance (in the context of the recipient country's reform programme)? Or explicit objectives if they were identified.

Findings and analysis

The fourth MFA operation in Romania was negotiated twice and therefore had two different sets of structural conditionalities attached, agreed with different Governments at different periods in time, notably one before and one after the accession process started. There were separate lists of structural conditions for the release of funds attached to each tranche. Typically, the conditions for the first tranche consisted of short-term goals, whose achievement would make the disbursement of funds possible in a relatively short period of time, while the second list grouped more politically sensitive and ambitious goals for the achievement of which the Romanian Government was supposed to need more time and encouragement.

In 1999 the MFA actually envisaged, as its only conditionality for disbursement of the first tranche, the satisfactory conclusion of the first review of the IMF Stand-by Agreement, i.e. a condition of a strongly operational nature aimed at reinforcing IMF negotiating position vis-à-vis the Government and only indirectly related with structural effects. The MFA conditions for the second tranche were of a clearer structural nature and included a selected subset of the IMF SBA conditionalities, plus a special provision to induce Romania to have a clearer reference mid-term economic reform programme. In fact, Commissioner Verheugen proposed on October 26th, 1999 to establish a tripartite working group between the EU, the IMF and the World Bank to work alongside the Romanian Government in the preparation of a mid-term economic strategy, and the existence of such strategy was a key EU concern in the view of the subsequent December 1999 Helsinki summit decision of inviting Romania to negotiations for the accession.

The number and importance of purely structural conditions increased with the 2002 MFA re-negotiations, as demonstrated in the Table 5.2 below. All in all these structural conditions can be grouped into three broad categories: i.e. conditions related to (1) restructuring and privatisation; (2) fiscal and financial discipline and (3) the business environment. In particular, a few key policy issues were raised both in 1999 and 2002, although in slightly different terms: a) the privatisation of the banking system and b) a major privatisation programme of large SOEs. In 2002 these were compounded by the new emphasis given to the liberalisation of the energy market and the creation of a friendlier business environment.

Table 5.2 The structural conditions attached to the 4th MFA in Romania

MOU (2000) Subsequently renegotiated	SMOU (2002) 1st sub-tranche *(released in 2003)*	SMOU (2002) 2nd sub-tranche *(never disbursed)*
Restructuring and privatisation		
• Privatisation of at least 45 large enterprises and 850 small and medium State owned enterprises, representing at least 9% of the total equity portfolio of the State Ownership Fund. Liquidation or appointment of liquidators for enterprises generating at least 12% of the losses of the State Ownership Fund. • Effective beginning of the privatisation process for Banca Agricola and Banca Comerciala Romana, in particular the set-up the privatisation commission and the appointment of the privatisation advisors. • Appointment of the international investment banks in charge of privatisation of five large State owned enterprises.	• Announcing privatisation tenders for two electricity distributors *(IMF+WB).* • Pre-selecting investors and launching a formal call for binding proposals with respect to the privatisation of BCR (Banca Comerciala Romana) *(WB).*	• Announcing privatisation tenders for two gas distributors and advancing privatisation procedures for two more electricity distributors *(IMF+WB).* • Selling the companies listed in Annex III that were subject to privatisation under the RICOP programme. For those for which privatisation is not possible, start divesting through the sale of assets or start formal liquidation procedures *(EU specific).* • Signing the contract for the privatisation of the state shareholding of BCR *(IMF+WB).* • Implementing the CEC restructuring plan in accordance with its timetable with a view to the removal of the blanket guarantee on its deposits *(WB).*
Fiscal and financial discipline		
• Reduction of 25% of the accounting losses from operations (including subsidies) of six mining companies. • Strengthening of the banking supervision department of the National Bank of Romania, in particular through the integration of all its supervisory functions in one department.	• Adoption and implementation of a law converting civil contracts into regular part time employment with a view to extending the social security tax base *(IMF).* • Submission to Parliament of a law providing for the unified collection, audit and enforcement of health, pension and unemployment social security contributions *(IMF).* • The Romanian government undertakes not to resort to any direct public sector financing by the central bank, pending	• Implementing a substantial increase in the reduced profit tax rate for exporting activities from the present 6 percent to at least 12.5 percent *(IMF+EU).* • Establishing and starting effective operation of a large tax payers directorate for the Bucharest area *(IMF).* • Approving a law providing for the unified collection, audit and enforcement of health, pension and unemployment social security contributions *(IMF).* • Adopting a plan for the

MOU (2000) Subsequently renegotiated	SMOU (2002) 1st sub-tranche *(released in 2003)*	SMOU (2002) 2nd sub-tranche *(never disbursed)*
	the planned legal changes to bring the Romanian legislation in line with the *acquis communautaire* in the area *(IMF)*	improvement of bankruptcy legislation and procedures with an associated implementing schedule *(EU specific).*
Business environment		
• Elimination of the import surcharge by end-1999, removal of the excise reduction for Romanian-produced tobacco products and freeze on the number of import duties exemptions.	• Progress towards reducing delays in VAT refunds, in particular by approving the criteria for selecting the companies for which compulsory ex-ante controls will be replaced by ex-post controls *(EU specific).*	• Effective progress in reducing delays in VAT refunds, in particular by switching to ex post controls for eligible companies, and by approving legal provisions for the mandatory payment of interests on overdue VAT reimbursements *(EU specific).* • Timely implementation of the government programme for the removal of the administrative barriers for the business environment *(EU+WB).*

It is worth noting there was a significant change in the nature of MFA structural conditionalities between 1999 and 2002. While in 1999 the MFA simply replicated the IMF ones, in 2002, after the accession had started, they became a combination of IMF-related conditionalities (broadly taken from the SBA), World Bank-related conditionalities (sometimes explicitly reinforcing the PSAL II conditions) and EU own conditionalities directly negotiated by the Commission services. Table 5.2 above briefly summarises the origin of the various conditionalities that will be explained in more detail in the next sections.

Moreover, the 2002 conditions were defined within the framework of a broader strategic agreement reached by the Government with the IMF, the World Bank and the EU which was confirmed in 2001 by the newly-appointed Government in exchange for a new US$ 1 billion total assistance package. This explains why the MFA 2002-agreed conditionalities, not only include the usual relatively easy micromanagement conditions to allow quick disbursement of the first sub-tranche, but also extend to more ambitious (strategic) medium term policy goals that can be summarised in the following way:

Medium Term (strategic goals)
- Reducing the weight of the State in the energy, manufacturing and banking sectors;
- Increasing tax and pension fund revenues;
- Enforcing hard-budget constraints through bankruptcy procedures;
- Making entrepreneurship and enterprise creation easier.

The achievement of these medium term goals was to be made possible by a number of intermediate *short-term* (tactical goals) of a more operational nature including:

- Concrete steps in the privatisation /restructuring of the banks / electricity distributors;
- Changes in the legislation / administrative procedures;
- Other proactive Government behaviours.

Over and above the core structural reform matters included in the reform package a few 2002 MFA conditions were also motivated by more specific European concerns and the protection of European business interests. This reportedly happened because the MFA instrument was deemed a more flexible and effective negotiating tool to put pressure on the Romanian Government than the ordinary arbitrage procedures envisaged in the European Agreement that were deemed too long and cumbersome. To the extent the protection of European interests actually coincided with promotion of free trade and circulation of capital, there actually was no real contradiction or conflict of interest between raising these European issues and supporting the Government reform programme. In fact, the same issues had been raised also by the IFIs themselves, although with a lower emphasis.

More in particular, the protection of European interests played some role in the definition of conditionalities on (1) VAT controls, which was not only a business environment issue, but where discriminatory practices against foreign-owned firms had been reported and, most importantly on (2) the reduced profit tax rate on exports, a provision that was deemed clearly in breech of both the European agreement and the WTO rules, and as such had also become an explicit matter of IMF concern. Finally, a desire to have Romanian legislation in line with the EU acquis on State aids was at the origin of the MFA clause on the removal of the State blanket guarantee on CEC deposits, especially since a recent European Court decision on state aids in German saving banks had dramatically highlighted the issue.

The shift from short-term to medium-term structural conditionalities that are not typically monitored by the IMF in a quantifiable manner also had some consequences on the nature of the objectives themselves. Contrary to what happened in 1999, when agreed goals, by fully reflecting IMF conditionalities, also included some quantifiable targets, none of the 2002-agreed MFA structural conditions lent itself to be considered a *quantifiable* target, as all of them were related to the accomplishment of mere facts, and represented, if the World Bank terminology is used, *triggers*. There is also evidence that the anticipated difficulties related to capacity bottlenecks in monitoring quantitative targets played some role in the selection of objectives themselves and therefore preference was given to triggers monitorable through a simple yes/no checklist, more or less in line with World Bank usual practice.

There were a few cases where the phrasing of the conditionality was left generic on purpose[13] to allow the Romanian Government more room of manoeuvre in demonstrating

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[13] During the monitoring of the 4th MFA operations, there happened also some misunderstanding about the sheer meaning of conditions, as this had not been made clear enough in the text of the agreement, in our understanding not necessarily on purpose. For instance, privatisation was interpreted as either a public share lower than 50% or the State no longer holding a controlling stake, much in the same vein the improvement in the bankruptcy procedures could refer to legislative changes, generic institutional strengthening and/or statistics about actual cases and their duration.

the achievement of certain goals and the Commission itself a bit more discretion in the appreciation of the actual degree of progress reached in given political conditions. However, this also means that in a few cases structural objectives were not easily *verifiable*, or at any rate subject to subjective interpretation. This was clearly the case for the "advanced privatisation procedures" of electricity distribution companies or for the "progress towards reducing delays in VAT refunds".

Conclusions.
In the Romanian 4th MFA operation a notable shift from short-term to medium-term structural objectives can be noticed between 1999 and 2002. This was made possible by the existence of a clearer reform package agreed by the Romanian Government with the EU, the World Bank and the IMF within the framework of the accession negotiations. This feature has been highly appreciated by all involved Romanian stakeholders who could work on a medium-term reform platform agreed with both the EU and the IFIs and is generally considered a highly successful aspect of the MFA objective-definition process in Romania.

5.3 Relevance of structural objectives

Q2.2 How relevant are the short and medium-term expected structural effects of the assistance to the needs of the recipient country?

Findings and analysis
No specific comments can be made on the relevance of the 1999 MFA *first tranche* conditionalities, as these simply amounted to progress in the IMF SBA review. Much in the same vein, assessing the rationale behind the selection of the 1999 *second tranche* conditionalities *de facto* amounts to questioning the relevance of the IMF structural adjustment strategy at that time, which remains a highly speculative question, as the IMF agreement went off-track for other reasons and was superseded by subsequent political developments, including first and foremost the accession negotiation process and the related Medium-Term Economic Strategy.

A much clearer policy reference framework for assessing MFA relevance is available starting from when Romania became an accession country, including first the medium-term strategy and then the September 2001 Pre-accession Economic Programme. In 2002 the selection of the MFA priority areas was made on the basis of the pre-accession programme. It was officially introduced *for the first time* in Romania the principle that MFA structural conditionalities should reflect specifically identified EU priorities, and namely: 1) restructuring and privatisation, 2) financial discipline, 3) the improvement of tax collection and 4) the enhancement of the business environment, and be, in principle at least, something different from the parallel IFI conditions. The principle was stated that straight repetitions of IFI conditions would be avoided, but in exceptional cases of common concern, such as the privatisation of the Romanian Commercial Bank BCR and the restructuring of the Savings Bank CEC.

Generally speaking, consensus was found among all interviewees on the broad relevance of the structural conditionalities and policy areas selected at that time. The review of possible alternatives available and discussed at that time broadly confirms in retrospect that the right choice was made in given conditions and with given constraints and no easy improvement can be imagined even with the benefit of hindsight. The issue of poor enforcement of bankruptcy procedures for State farms had already been reportedly dropped by the WB itself from PSAL II to be dealt with separately. Some Commission services proposed tougher benchmarks for implementation of the land reform, stronger progress in competition policy and State aids legislation and public administration reform. The first topic would have implied putting in place a complex monitoring system of quantified targets in isolation and without IFI's support, the second was already qualitatively monitored as European *acquis* and therefore dealt with as part of the accession negotiations, while for the third there was no reference study available allowing a detailed formulation of objectives. With the benefit of hindsight many Romanian interviewees agree that the MFA could have focused more on government (and corporate) governance reform. However, this would have simply amounted to anticipating subsequent World Bank PAL effort.

On the positive side, substantial consensus was found on the fact that the MFA choice of reinforcing the energy conditionality was particularly appropriate at that time, as the matter would prove crucial in making the whole privatisation process possible. As one interviewee put it "*it was the energy sector a big generator of arrears in the system and one the real practical obstacle to whole privatisation process*". Moreover, most interviewees agree that in 2002 times were not politically ripe enough to further raise the issue of state aids and competition.

The intention of having MFA structural objectives, as something separate from the IFI ones was abided to only in part, as substantial overlapping remained inevitable. The MFA specific and original contribution to structural reforms actually appears fairly limited and substantially amounts to:

- The privatisation of the RICOP companies listed in a separate annex (see case study), that, however, to some extent overlapped with the enterprises included for privatisation under WB PSAL II;
- The issue of VAT reimbursement that was at any rate *de facto* included in the business environment reform project supported by the World Bank and as such represented a non core PSAL II conditionality;
- The improvements in the bankruptcy legislation and procedures[14].
- An invitation to take the CEC State blanket guarantee issue into consideration when restructuring the bank.

All other MFA conditions were *de facto* reiterating and reinforcing existing IFIs' conditions, as they included: (1) one IMF structural benchmark, (2) several IMF non-core measures - i.e. measures mentioned in the IMF programme but not subject to an explicit conditionality, (3) conditions variously interlinked with policy measures (i.e. non core conditions) or core conditions under the World Bank PSAL II[15]. As such they were

[14] The Romanian Government had previously approved the appointment of an advisor on bankruptcy issues within the framework of a PSAL conditionality.

[15] In turn, several IMF conditions were *de facto* steps in the fulfilment of broader PSAL II conditions and this because of the strong link established by the two international financial institutions in managing their assistance programs in Romania. For instance, already at the time of PSAL I the WB board had made it clear that the loan would become effective only after a

mainly taken from the first draft Supplemental Memorandum of Economic and Financial Policies (SMEFP) the Romanian Government was submitting to the IMF within the framework of its 2001 SBA review process. Table 5.3 below summarises the relations between the MFA structural conditions and the IFIs conditionalities.

Table 5.3 2002 Re-negotiated MFA Conditionalities – Overlapping with IFI Measures

SMOU (2002) 1st sub-tranche (released in 2003)	**SMOU (2002) 2nd sub-tranche (never disbursed)**
• Announcing privatisation tenders for two electricity distributors – *an IMF structural benchmark by end June 2002 within the framework of a broader WB objective.* • Pre-selecting investors and launching a formal call for binding proposals with respect to the privatisation of BCR (Banca Comerciala Romana) *a step in IMF and WB objectives*.	• Announcing privatisation tenders for two gas distributors and advancing privatisation procedures for two more electricity distributors- *an IMF non core condition within the framework of WB core conditions.* • Signing the contract for the privatisation of the state shareholding of BCR – *a core condition for the WB*. • Implementing the CEC restructuring plan in accordance with its timetable with a view to the removal of the blanket guarantee on its deposits- *a core condition for the WB.*
• Adoption and implementation of a law converting civil contracts into regular part time employment with a view to extending the social security tax base *IMF non core condition.* • Submission to Parliament of a law providing for the unified collection, audit and enforcement of health, pension and unemployment social security contributions- *linked to an IMF non core condition.* • The Romanian government undertakes not to resort to any direct public sector financing by the central bank, pending the planned legal changes to bring the Romanian legislation in line with the acquis communautaire in the area - *IMF core condition*	• Implementing a substantial increase in the reduced profit tax rate for exporting activities from the present 6 percent to at least 12.5 percent *an IMF non core condition.* • Establishing and starting effective operation of a large tax payers directorate for the Bucharest area – *IMF non core condition* • Approving a law providing for the unified collection, audit and enforcement of health, pension and unemployment social security contributions - *IMF non core condition.*
	• Timely implementation of the government programme for the removal of the administrative barriers for the business environment – *WB non core condition*

new SBA had been approved. "*The overlap between Bank and Fund conditionality has been substantial, reflecting the unfinished structural reform agenda and mixed reform ownership. Bank technical expertise was used as key input for the design of Fund programs. In areas that are crucial for macroeconomic stabilization the Fund incorporated Bank conditionality into its own programs when this facilitated faster implementation. While not conducive to reducing the number of conditions in Fund programs, this approach successfully increased pressure on the authorities to maintain the reform momentum.*"

The identification of specific European conditions in a country undergoing the accession process is a rather complex task where the Commission must walk a thin line between overlapping with the IFIs and reiterating matters already covered under the *acquis*. On the one hand the definition of European conditions requires not only co-ordination with the IFIs on leadership in providing technical assistance in given policy areas, but also the availability of preparatory studies to allow the sheer identification of the conditionality. These studies are either made available by the IFIs themselves (as was the case with the WB study on bankruptcy in Romania) or somehow presuppose that a division of policy areas of interest pre-exist to the definition of structural conditions themselves. On the other hand, overlapping with the *acquis* would mean the Commission has some special reason to speed up the adoption of certain parts of the *acquis* itself through the MFA.

The difficulty in identifying specific European structural conditionalities contributed to the client's wrong perception that the MFA was a relatively mild instrument, not particularly demanding in terms of structural reforms, as these were linked to the other IFIs conditions only. To make a comparison the 2002 € 100 MFA operation included a total 16 conditions, of which five for the first sub-tranche, ten for the second and one general provision, but of these only three were to some extent really MFA-specific and therefore perceived as something different from what had already been negotiated with the IMF and the WB. The parallel US$ 300 million WB PSAL II included 25 original relatively tough core conditions, of which 12 for the *second tranche* only.

Conclusions
Generally speaking, all MFA structural conditions appear as highly relevant to Romania reform needs at the time and embedded in the Country's own reform programme. In retrospect the emphasis given to energy reform appears a key releasing factor for progress in the implementation of other structural reforms.

Interviewees indicated that in many cases they did not identify conditions as MFA-related, except for a few ones, mainly those being EU specific.

5.4 Gross impact - actual structural reform outcomes

Q2.3 To what extent have the short and medium-term expected structural effects of the assistance (in the context of the recipient country's reform programme) occurred as envisaged?

Findings and analysis
A triangulation of sources composed of the IFI's own self-assessments, commonly used available indicators, and results from the interviews in the field have been used to assess the degree of attainment of the MFA structural effects. As far as *medium term* structural effects are concerned, according to the World Bank self-assessment attached to its implementation completion report, the PSAL II, to which the MFA was substantially related, has been *highly* successful (the highest possible score) in achieving its sectoral policies and private sector development goals, while progress in institutional development can be deemed substantial (the second best possible score). This largely favourable assessment is underpinned by the following considerations:

- The final elimination of the State ownership of banks with the privatisation of BCR in late 2005 and that of CEC presently ongoing;
- The reform of the energy sector envisaging the privatisation of a total four electricity distribution companies between 2004 and 2005 and that of two gas distribution companies in October 2004;
- The accomplishment, beyond expectations and anticipated targets, of a large privatisation programme encompassing over 300 State-owned enterprises with a total revenue for the Romanian Government of some € 1 billion, plus additional technological investments worth € 580 million and € 330 million worth of working capital and environmental improvements.

On top of this, the business environment has also substantially improved through a modern tax system, the removal of several administrative barriers, an improved tax collection system and fiscal environment and the preparations made for a more effective system of bankruptcy and enterprise liquidation which should enter into force in 2006.

In its turn the IMF proved substantially satisfied with the improvement in fiscal discipline brought about between 2002 and 2003 by the SBA agreement and with the results of the provision hindering Central Bank direct financing of the public debt.

These favourable assessments are substantially reflected in the indicators commonly available in the market, at least to the extent conditional lending can have a somewhat appreciable if not properly measurable impact on final outcomes. For instance the EBRD transition indicators (see Table 5. below) did notice some improvements in large scale privatisation between 2003 and 2004 (when the bulk of RICOP and PSAL II-related privatisation was carried out) as well as some improvement in governance and enterprise restructuring between 2004 and 2005.

Table 5.4 EBRD Transition Indicators in Romania 1995-2005 – Selected items

EBRD transition indicators 1)	1995	1998	1999	2000	2001	2002	2003	2004	2005
Large-scale privatisation	2	3-	3-	3	3+	3+	3+	**4-**	4-
Governance & enterprise restructuring	2	2	2	2	2	2	2	2	**2+**
Banking reform and interest rate liberalisation	3	2+	3-	3-	3-	3-	3-	**3**	3

[Source: EBRD]

Results achieved in the more specific field of administrative barriers have also been quite substantial. According to the World Bank Doing Business database (see table 5.5 below) Romania now scores fairly good when it comes to starting a business while the cost of dealing with licences, although higher than the OECD average remains substantially lower than that of other comparable countries in the region, therefore creating a comparative competitive advantage for the Country. The only area where results achieved still appear insufficient is progress with tax delays. According to a 2004 World Bank FIAS Survey carried out on behalf of the Romania Business Environment Unit, the average delay for VAT refund was 58 days, down from 64 in 2002, but still well above the 45 maximum envisaged in the law (such maximum was actually increased. It used to be 30 days in 2002). Moreover, it is still possible a VAT refund takes a maximum 90 days. However this slightly worse than average assessment can depend on a bias in the benchmark time reference. While all other goals have been assessed as of 2006, VAT refunds is the only item for which 2006 data are still not available. This is a factor to be taken into consideration, if one considers that a number of other structural effects (including bankruptcy for instance) would have appeared in a less positive way if assessed with reference to the year 2004 only.

Results from the interviews have broadly confirmed the sources reported above: the weight of the State in the energy, manufacturing and banking sectors has been dramatically reduced; enterprise creation has been made easier, and starting from 2006 enforcing hard-budget constraints through improved bankruptcy procedures should be easier and more effective.

Table 5.5 The Cost of Starting a Business and Dealing with Licenses in Romania

Starting a Business (2005)			
The challenges of launching a business in Romania are shown below. Entrepreneurs can expect to go through 5 steps to launch a business over 11 days on average, at a cost equal to 5.3% of gross national income (GNI) per capita. There is no minimum deposit requirement to obtain a business registration number.			
Indicator	**Romania**	**Region**	**OECD**
Procedures (number)	5	9.6	6.5
Time (days)	11	36.4	19.5
Cost (% of income per capita)	5.3	13.5	6.8
Min. capital (% of income per capita)	0.0	49.1	41.0
Dealing with Licenses (2005)			
The steps, time, and costs of complying with licensing and permit requirements for ongoing operations in Romania are shown below. It takes 15 steps and 291 days to complete the process, and costs 187.7% of income per capita.			
Indicator	**Romania**	**Region**	**OECD**
Procedures (number)	15	21.4	14.1
Time (days)	291	251.8	146.9
Cost (% of income per capita)	187.7	668.9	75.1

Conclusions

The bulk of the MFA expected structural effects have successfully been attained, although probably through after a longer period of time than originally envisaged. In fact, it is after the MFA had become a precautionary instrument that a number of strategic goals were finally reached. This is not a surprise since usually it takes a number of years before effects of structural reforms can be markedly observed.

The only policy area where success still appears fairly limited concerns VAT delays, but this assessment is based on benchmark data related to 2004 and therefore evaluation results are to be considered still inconclusive.

5.5 Counterfactual

Q0.1 *What arrangement would have been implemented if the MFA had not been granted*
Q0.2 What are the structural effects of the most likely implementation scenario(s)?

As far as structural effects are concerned the counterfactual hypothesis is very difficult to as it is on subjective assessments not necessarily corroborated by facts. In fact, possible alternative courses of action were never seriously considered at the time and analysed in all its possible implications.

Based on available evidence and interviews we conclude that the MFA money did not change the IMF structural conditionalities in 2000 and the existence of the MFA also did not influence the IMF and World Bank behaviour in 2002. An exception could seem the VAT issue. However, one is inclined to believe the VAT issue would also have been covered, had not the MFA been into place. Without MFA the arrangements between the Romanian government and the IMF and World Bank would have been broadly the same.

As the CEC privatisation demonstrates the CEC State blanket guarantee would have been considered a state aids issue all the same, provided Romania could meet the accession criteria.

Therefore, as far as structural conditionalities are concerned the counterfactual scenario does not substantially differ from the MFA scenario. The mid-term structural effects of the most likely implementation scenario without the MFA do not substantially differ from what actually happened. Since most of the MFA conditionalities were included under other IFIs programs, and they would have been achieved at any rate. This has been confirmed by the vast majority of interviewees.

5.6 Net impact on structural reforms

Q2.4 What has been the contribution of actions resulting from the respect of structural conditionality criteria to the occurrence of expected structural effects?

Approach towards analysing net impact of structural reforms
The MFA conditionalities largely matched the IFI's conditionalities and it is therefore difficult to disentangle the MFA specific contribution from the IFI ones. Based on results of the interview programme and review of files, an analytical model based on three factors can be used.

It is assumed the MFA could have had:
1. a *political* reinforcing effect (by signalling to the Government the importance of given reforms, maintaining the effect of tripartite policy dialogue, etc.),
2. an *operational* reinforcing effect (by speeding up the implementation of certain IFI measures, or widening their scope and therefore ultimate impact)

Finally, the accession criteria themselves and in particular the functioning market economy status Romania needed to enter into the EU could have also played a major role in making the implementation of certain measures possible, and therefore ultimately contributed to the achievement of certain structural results and acted in synergy with the MFA original spirit, especially after it became a precautionary instrument.

Findings and analysis – First sub-tranche

First of all, there is an overwhelming consensus among interviewees that the MFA played a substantial political reinforcing effect on the credibility of the overall reform package agreed by the Romanian Government with the IFIs and the Commission, between 2001 and 2002. The EC operated in close cooperation and consultation with the IMF and the World Bank and this was well known and understood by the Government.

As far the specific operational contribution of the MFA on the implementation of given conditionalities is concerned the picture is a bit more unclear and requires substantial specification and a careful analysis in the light of the complex sequencing of actions taking place in 2002. The MFA sets of conditionalities were negotiated in April 2002 with a view to their fulfilment respectively by mid and end year. At that time the Romanian Government was preparing a Supplementary Memorandum of Economic and Financial Policies (SMEFP), and Technical Memorandum of Understanding for the IMF SBA to allow completion of the first and second review and to request postponement of the BCR privatisation structural performance benchmark from end-December 2002 to end-February 2003.

As prior actions to that SMEFP the Romanian Government had agreed to:

- approve a new *VAT law* which would become effective on June 1 2002, eliminating all VAT exemptions and zero rating;
- approve a new *profit tax law* which would enter into force on July 1, eliminating distortionary tax incentives, where it was envisaged to raise the profit tax rate for exporting activities from 6 to 12.5 percent as of January 1, 2003, and to the standard rate as of January 1, 2004.

Moreover the SMEFP finally signed in August 2002 also included a written commitment to continue the reform of the tax administration based on the recommendations of the Technical Assistance mission of the IMF's Fiscal Affairs Department, and specifically, to:

- immediately subordinate all tax administration functions under one Secretary of State in the Ministry of Finance;
- establish a large taxpayer directorate in Bucharest by January 1, 2003, at the latest;
- create a unified and separate tax administration department reporting directly to the Minister of Public Finance by end-June 2003, at the latest.
- to integrate the three existing administrations for the collection, audit and enforcement of social security contributions into a single new administration under the Ministry of Public Finance on January 1, 2004, at the latest.

To achieve this objective, a project manager would be appointed by mid-September 2002, and new legislation would be approved by end-September 2002. The original 2001 Memorandum of Understanding with the IMF also stated that the new VAT law would ensure the institutional framework necessary for reducing delays in VAT refunds to no more than 30 days.

The MFA IMF-related conditionalities appear therefore a way *to give core-conditionality status* to a number of commitments the Romanian Government was making with the IMF. However, the appreciation of their actual effectiveness is made difficult by subsequent developments and delays.

First of all, following an exchange of letters with the Ministry of Finance the final agreement on the text of MFA conditionalities was reached only in August 2002, more or less simultaneously with the new SMEFP. But by that time it was already more or less clear Romania would miss the structural targets for the third review and this could have meant either that the SBA would go off-track or a new Memorandum of understanding would be needed. In this situation the Commission delayed the official signature of the new MFA memorandum of understanding till as late as November 2002, i.e. with a much longer delay than in 1999, also in order to avoid sanctioning an agreement possibly doomed to be immediately cancelled by an IMF decision to consider the SBA off-track.

The IMF itself in October 2002 (therefore before the MFA was finally signed) decided to change the status of several of its non-core conditions by upgrading them to prior actions for its own SMEFP II, without which the third review could not be accomplished and the SBA would go off-track. By acting in this way the IMF had *taken over the reinforcing role* of several MFA conditionalities.

In particular, the SMEFP II included as prior actions[16]:

- the approval of an Emergency Ordnance by November 20, 2002, specifying the intermediate steps for establishing a common agency for collection, audit, and enforcement of social security contributions under the Ministry of Finance on January 1, 2004;
- the approval of an Emergency Ordnance cancelling Articles 1–7, and Articles 15, 16 (b), 18, and 20 of Law 130/1999, thereby eliminating the legal basis for "civil contracts";
- the announcement by November 10, 2002, of privatization tenders to acquire a majority share of at least 51 percent of two electricity distribution companies[17].

As a result the 2002 MFA first sub-tranche conditionality found itself composed of:

- the pre-selection of investors for BCR which had already failed several times because of apparent lack of sufficient market interest and that already had forced the Romanian Government to renegotiate supplementary memoranda with the IMF;
- the announcement of the privatisation tenders of two electricity distribution companies which had been upgraded by the IMF as a prior action to be fulfilled by November 10th and that de facto had become a kind of prior action also for the Commission, as the MFA was finally signed the following day on November the 11th
- the previous IMF non-core conditions on fiscal and financial policy that had already been taken over in the meantime by the IMF themselves as prior actions for the third SBA review and related SMEFP II

[16] See http://www.imf.org/External/NP/LOI/2003/rom/01/040903.pdf

[17] This was actually announced on November 10th, but conditions were made known to potential investors on January the 8th which can be considered the real date the conditionality was met.

- the only European condition left, i.e. the “progress towards reducing delays in VAT payments”.

Therefore, apart from the VAT-related conditionality that remained MFA-specific, the MFA, when it was finally signed, found itself in a position where little or no operational reinforcing effect was any longer possible and actually in just one case the MFA had an operational reinforcing role. This also explains why the vast majority of Romanian interviewees could associate the fulfilment of the majority of conditionalities with the IMF pressure only and why the MFA role is usually associated only with the few clearly EU-related conditions. Table 5.6 below summarises and explains this complex situation conditionality by conditionality.

Table 5.6 Status of the MFA First Sub Tranche Conditionalities Over Time

Conditionality	Expected MFA Completion Day	Change in IFI Conditionality Status	Actual Completion Date	Presumable MFA contribution/ reinforcing effect
Announcing privatisation tenders for two electricity distributors – *an IMF structural benchmark by end June 2002 within the framework of a broader WB objective.*	June 2002	Became an IMF prior action for SMEFP II	Anticipated on November 10 then announced to investors in January 2003 and published in international press in February 2003	Became a de facto MFA prior action, as MFA signed on November 11.
Pre-selecting investors and launching a formal call for binding proposals with respect to the privatisation of BCR (Banca Comerciala Romana) *a step in IMF and WB objectives*.	July 2002	An intermediate step for IMF and WB core condition	First selection failed in summer 2002. Second attempt also failed in early 2003. EBRD and IFC bought a minority share in October 2003	EU had to waive condition because of lack of investor demand. No operational reinforcing effect because of *force majeure,*
Adoption and implementation of a law converting civil contracts into regular part time employment with a view to extending the social security tax base *IMF non core condition.*	June 2002	Upgraded to IMF prior action for SMEFP II	Law approved in December 2002 as part of the Labour Code. Entry into force on March 1st 2003. SMEFP II signed only after	IMF key player. Actual fulfilment of condition remained long dubious and controversial. IMF had the final say in giving the green light and EU followed IMF decision.
Submission to Parliament of a law providing for the unified collection, audit and enforcement of health, pension and unemployment social security contributions- *linked to an IMF non core condition.*	June 2002	Upgraded to IMF prior action for SMEFP II	Government Decree issued by Government in October 2002 then approved by Parliament in January 2003. Entry into force from January 2004	IMF got a key decree, but law finally formally approved in line with MFA requirements.
Progress towards reducing delays in VAT refunds, particularly by approving the criteria for selecting companies for which compulsory ex ante control were replaced by ex post controls *(IMF non core measure)*	Summer 2002	None	First action taken in June 2002 with a new regulation on VAT controls. Possible discrimination of foreign firms addressed in January 2003	A matter clearly perceived of EU interest and closely monitored by the Commission. Starting from January 2004 a new tax code came into force.

Conditionality	Expected MFA Completion Day	Change in IFI Conditionality Status	Actual Completion Date	Presumable MFA contribution/ reinforcing effect
The Romanian government undertakes not to resort to any direct public sector financing by the central bank, pending the planned legal changes to bring the Romanian legislation in line with the acquis communautaire in the area - *IMF core continuous condition*	Continuous	None	Always complied	Too strictly linked to a core IMF condition.

Findings and analysis – Second sub-tranche

The assessment of the contribution given by the MFA 2nd *sub tranche* conditionalities is a bit more complex and controversial, were not it for the simple fact that the tranche has never been disbursed and it cannot be easily maintained that the MFA could have any direct operational reinforcing impact starting from when it became precautionary. At any rate in several cases a clear operational reinforcing could not be detected because of:

- *Timing consideration.* Two conditions became irrelevant because of the delayed signature of the MFA, and in one of these cases the condition for the first sub-tranche de facto came to coincide with the condition for the second sub-tranche.

- *Confusion in monitoring.* In another three cases the condition was so generically formulated that the Commission found itself at odds in monitoring its compliance. In two of these cases, also because monitoring started much later than expected and relevant staff who had taken part to the negotiations were no longer there, the sheer understanding of the subject matter of the conditionality got somehow lost in the reporting process, so that relevant Romanian counterparts never came to know about MFA involvement.

- *Market considerations.* Investors' behaviour and market conditions proved not in line with expectations and made conditionality fulfilment impossible irrespective of any willingness of the Romanian Government.

Table 5.7 below summarises the situation.

Table 5.7 Status of the MFA Second Sub Tranche Conditionalities Over Time

Conditionality	**Original intervention logic and expected MFA completion Day**	**Actual Accomplishment**	**Final comments on presumable MFA contribution/ reinforcing effect**
Announcing privatisation tenders for two gas distributors and advancing privatisation procedures for two more electricity distributors- *an IMF non core condition within the framework of WB core conditions.*	To speed up the accomplishment of certain steps in the WB energy reform programme by end 2002. "Advanced privatisation procedures" means no tender requirement	Gas privatisation strategy approved in October 2003 and tenders announced in December 2003. Progress in the privatisation of two further electricity distributors reached by winter 2003.	The 2002 non-tender based negotiations failed and the energy matter is not even always reported by the Romanian Government among MFA conditions.
Selling the companies listed in Annex III that were subject to privatisation under the RICOP programme. For those for which privatisation is not possible, start divesting through the sale of assets or start formal liquidation procedures (EU).	To continue the fulfilment of a conditionality agreed under the EU RICOP grant project.	Objective 86% reached by mid 2006. Some structural difficulties proved insurmountable for any conditionality.	MFA substantially contributed to the achievement of PSALII target.
Signing the contract for the privatisation of the state shareholding of BCR *– a core condition for the WB and IMF*	To reinforce a WB condition to be accomplished by end 2002	Privatisation finally signed in winter 2005	MFA had already been de-activated when condition met
Implementing the CEC restructuring plan in accordance with its timetable with a view to the removal of the blanket guarantee on its deposits- *a core condition for the WB.*	To reinforce a WB condition to be accomplished by end 2002 and tackle a potential state aid issue for the EU.	WB TA to implement restructuring plan in place from July 2003 to July 2004. Privatisation now ongoing, but state aid issue not addressed yet.	Some reinforcing effect possible, although no evidence found. EU-specific concerns not yet addressed.
Implementing a substantial increase in the reduced profit tax rate for exporting activities from the present 6 percent to at least 12.5 percent *an IMF non core condition.*	To reinforce an IMF non core fiscal condition that was supposed to enter into force from January 1st 2003; and so to indirectly address trade issues.	Law approved as early as June 2002 allowed fulfilment of IMF condition in 2003.	Condition became almost irrelevant because of delays with first sub tranche disbursement. No strengthening effect of what already agreed with IMF in Spring 2002 reached.
Establishing and starting effective operation of a	To reinforce an IMF non core condition with a view	Legislation approved in mid 2002 to make	Tactical objective substantially reached in

Conditionality	Original intervention logic and expected MFA completion Day	Actual Accomplishment	Final comments on presumable MFA contribution/ reinforcing effect
large tax payers directorate for the Bucharest area – *IMF non –core condition*	for its early implementation in late 2002 - early 2003.	directorate operation from January 1st 2003.	line with expectations.
Approving a law providing for the unified collection, audit and enforcement of health, pension and unemployment social security contributions - *IMF non core condition*	Upgraded to IMF prior action for SMEFP II	Parliament approval in January 2003 and entry into force in January 2004.	Any reinforcement effect de facto already reached with the first sub-tranche because of IMF intervention.
Adopting a plan for the improvement of bankruptcy legislation and procedures with an associated implementing schedule (EU).	To ensure implementation of the recommendations of an assessment of the bankruptcy and collateral legislation (WB TA in the framework of PSAL II) finished in spring 2002 .	10% of WB recommendations adopted between 2002 and 2003. The bulk of the reform delayed and linked to a PHARE 2002 technical assistance project finally accomplished in 2006.	Condition inadequately formulated and difficult to monitor. Huge delays in implementation due to bureaucratic obstacles but also to the political sensitivity of the issue. Fulfilled in 2006 long after MFA has been de-activated. MFA operational role limited, although it contributed to the strategic orientation of EC TA support[18]
Effective progress in reducing delays in VAT refunds, in particular by switching to ex post controls for eligible companies, and by approving legal provisions for the mandatory payment of interests on overdue VAT reimbursements (EU).	To bring VAT implementation in Romania in line with EU practices by early 2003	A legal basis for VAT reimbursement in place since 2003 and nominally applied from April 2003. The issue lost relevance with the new tax code in force from January 1st 2004.	Formal compliance achieved. Monitoring of actual implementation difficult for the Commission. Figures and statistics never provided to EU although available at the Business Environment Unit.
Timely implementation of the government programme for the removal of the administrative barriers for	To reinforce a WB non core conditionality.	75% met when MFA was approved. Fully complied with in 2003.	Monitoring of actual implementation difficult for the Commission. Romanian implementing staff unaware of MFA role.

[18] Support for the implementation and the enforcement of legislation and judicial decision on bankruptcy.

Conditionality	Original intervention logic and expected MFA completion Day	Actual Accomplishment	Final comments on presumable MFA contribution/ reinforcing effect
the business environment – *WB non core conditionality*			

As can be seen from the table above, the contribution to the achievement of the EU-specific conditions is mixed with one clear positive case and another one showing delays in implementation and an ambiguous formulation of the conditionality itself.

However, from a broader strategic point of view it cannot be neglected how the MFA original negotiating process substantially contributed to the achievement of structural effects in the field of bank privatisation, irrespective of any direct operational impact. In fact, the Commission stuck to the principles agreed in the tripartite consultations with the IMF and the World Bank in 2001 for its own operational definition of "functioning market economy", i.e. the Copenhagen criterion Romania had to comply with in order to access the Union. And one is left to wonder the extent to which this fundamental criterion ultimately acted as the crucial incentive for BCR privatisation and CEC restructuring, therefore making PSAL II disbursement itself possible.

Conclusions

The MFA positively contributed to the achievement of its intended structural effects in strategic and political terms, and as far as truly European conditions were concerned. Its success in operationally reinforcing the IMF non-core conditionalities was more limited, also because the MFA had no such thing as prior actions to co-ordinate with the more flexible IMF conditionality management process. In a number of cases the IMF simply took over any possible "reinforcing" role of the MFA also in the eyes of the Romanian authorities.

In the Romanian case, while the IMF was seen as more short-term instrument, the MFA conditionalities were perceived as part of a longer medium to long-term EU strategic effort to support Romanian structural reforms. However a balance-of-payment instrument is not supposed to have conditionalities to be met in a four-year term. To some extent, this fundamental ambiguity was already there in the different negotiating positions of the two parties and subsequently influenced any realistic contribution to the achievement of the structural effects.

The results from interviews and analysis of documents clearly show that the operational reinforcing effect of conditionalities is possible if it is perceived by the responsible implementing agency that should be put under pressure by a stringent reporting and monitoring mechanism. If little monitoring mechanism is in place, conditionalities are not necessarily perceived from within the Government especially given the MFA limited visibility in the media.

It should be noted that any possible higher visibility of the MFA instrument appears difficult to achieve due to the fact that high profile had been given to the accession process.

5.7 Impact of complementarity with other EU instruments

Q2.5 To what extent have structural effects been enhanced, if at all, by complementarities between the MFA and other EU instruments?

Findings and analysis

One of the most evident instances of complementarity between MFA and other EU instruments in Romania is the case of bankruptcy legislation. The MFA conditionality on "the adoption of a plan for the improvement of bankruptcy legislation and procedures" made implicit reference to the results of a World Bank study on the subject accomplished in early 2002. As a follow up to this study the World Bank consultant was supposed to draw up an action plan to consisting of four parts: (i) amendments of the current legislation, (ii) solutions for speeding up the resolution of the insolvency cases, (iii) improvements of the institutional framework, (iv) training needs for judges and administrative staff, which was to be assisted by a US$ 280.000 World Bank loan. The MFA condition somehow assumed and gave for granted this action plan would be elaborated by the end of May 2002. This was also the assumption under a parallel Phare TA project that had just been put in the pipeline. But the action plan never took place as intended.

Therefore the TA project found itself to directly build on the results of the World Bank study and to complement its missing parts, i.e. proposals for legislation amendments. This had some unintended consequences. Moving plan finalisation away from World Bank to Phare TA also meant that any subsequent development would take place later due to the contracting procedures. Therefore, if by saying "the adoption of a plan" it was meant quick concrete actions resulting of the World Bank study, the parallel unforeseen need to develop the study results through a Phare TA project also had the effect of delaying any follow up by at least two years. Moreover the resulting no longer entirely clear meaning of the MFA condition, made the subsequent monitoring of fulfilment difficult and somehow confused[19].

To sum up, the World Bank study never turned into an action plan officially endorsed by the Government. According to Romanian sources, the recommendations of the World Bank study could not be immediately implemented, but by some 10% and further technical assistance was needed to come to concrete proposals, as was finally the case when the Phare project was successfully fielded in 2005.

[19] When it became clear that the World Bank would have no follow up supplementary confusion on the criteria to be used to check for MFA condition fulfilment was created. As the wording of the condition was generic enough to allow alternative interpretations of its meaning and nobody acknowledged that the sheer lack of a Government action plan following up a World Bank study amounted to breech of conditionality. The condition was (extensively) understood as the bankruptcy benchmark of the functional market economy criterion of accession but its monitoring became exceedingly generic and almost impossible in practical terms.

One more example of complementarity is the PHARE technical assistance provided between 2001 and 2002 to CEC restructuring and operational audit, which preceded the subsequent WB-financed restructuring exercise.

Conclusions

The enhancement of MFA structural effects by complementarity with other Commission instruments has been possible in Romania in at least one notable case, where MFA conditionality was linked with subsequent TA action. However, this unplanned synergy had unexpected operational consequences, as the time-to-field of a TA project proved much longer than the time horizon originally envisaged for the conditionality. However the phrasing of the condition was however improperly linked to a policy development somehow taken for granted, but that never actually took place in the terms originally envisaged.

5.8 Unexpected impact on structural reforms

Q3.2 Has the assistance given rise to any unexpected short and medium-term structural and/or macroeconomic effects? What were they and how did they occur?

Findings and analysis

The implementation of MFA structural conditions in the field of banking and privatisation suffered from the difficult international market conditions prevailing in 2002-2003 after the September 11 crisis. This had obvious negative effects on the pace of privatisation of both banks and enterprises, as IFI themselves are ready to acknowledge. In several cases, the privatisation agency had to offer enterprises on sale several times, or as in the case of BCR the Government had to develop alternative solutions to remedy the lack of alternative investors.

According to some Romanian sources the sheer fact of explicitly naming given companies in a conditionality document (such as the RICOP list) that at any rates leak to the market makes these difficulties even more serious, as potential investors know the Government is “obliged” to sell a given company before a certain deadline and they therefore bargain for the lowest possible prices. This in the end could amount to lower fiscal revenues, unless still existing directly or indirectly associated quasi-fiscal losses reduced as well. However, since the sample of companies involved is too small and overlapping with parallel WB list substantial no hard evidence could be found of this.

Conclusions

It is possible that explicitly naming companies to be privatised in a closed list with a given deadline without leaving the privatisation agency room of manoeuvre in the identification of the best timing for the best opportunities can ultimately result in decreased revenues for the budget. For instance, deadlines for privatisation – when this information is available to public – put pressure on the negotiation of authorities with investors. This can reportedly result in low quality of investors or lack of competition. However further investigation is needed to confirm this.

It is true that the way the conditionality was formulated gave little flexibility on the best possible approach to privatisation (i.e. to consider to restructure an enterprise and then to put it for privatisation). It is unclear whether this played any substantial role as a reason why in a number of cases privatisation failed and companies were brought back to state ownership with a view for their final liquidation, as Romanian sources claim.

6 Case studies

6.1 Case Study – The Programme of Industrial Restructuring and Professional Reconversion (RICOP)

Findings

In 1999, following the World Bank PSAL Romanian authorities asked the EC to support the country as it was faced with massive lay-offs caused by the inevitable industrial restructuring. After two years of negotiations Romania was finally granted € 100 million of 1999 PHARE funds to support enterprise restructuring and ease the problem of massive lay-offs in selected areas (the so-called RICOP regions). The Programme included 5 components to cover: (a) the immediate budgetary costs of enterprise closure, (b) social measures to cope with loss of jobs, (c) advisory services for retraining, (d) public works, and (e) a micro enterprise grant programme and credits to SMEs. RICOP was made conditional to the actual privatisation/restructuring/liquidation of a number of large SOEs in those regions.

The start of RICOP was difficult. A first € 50 million tranche of RICOP was disbursed in 2001 following the privatisation of SIDEX, a company that was also included in the World Bank PSAL list. In 2002 it became clear that the implementation of the RICOP financing memorandum was lagging behind schedule and there was the possibility that the remaining funds would be de-committed. And as a result of the low performance of some monitoring indicators[20] the budget was decreased to about € 86 million. In order to avoid de-commitment it was proposed to switch a substantial part of remaining RICOP unfulfilled conditions to MFA. In the end RICOP money was de-committed all the same, but the idea of extending related unfulfilled conditions to the MFA remained.

RICOP originally addressed 69 companies with a total expected 51,000 redundancies. 55 of them were proposed for privatisation and another 14 were to be further restructured or liquidated. By March 2002 just 30 companies in the privatisation list had been actually privatised while another 25 were at different stages of the privatisation process or in one case about to be liquidated. After negotiations with the Romanian Government it was decided to include a specific list of 23 former RICOP enterprises to be privatised as one of the MFA conditionalities. Twenty of the 23 companies included in the MFA conditionality were also included under PSAL II as they had been under PSAL I. Only three companies were not included in the WB PSAL I or PSAL II and namely,:

[20] Monitoring of privatisation was being done according to the restructuring/privatisation plans. At that moment it appeared that privatisation was not being carried out according to the plan. Particularly in respect to lay-offs. Since people were laid-off immediately, before restructuring/privatisation commenced, the monitoring of indicators revealed lower figures than expected on number of lay-offs. This fact led to the decrease of the RICOP program funds.

- Chimcomplex, Borzesti
- MAT, Craiova
- Brafor, Brasov

At the moment 20 out of these 23 companies have been privatised and two difficult cases (already included in PSAL I) are still going on. Out these privatised companies three enterprises are proposed for liquidation, and two were liquidated. As of early 2006, one more has gone bankrupt and another two are in serious debt conditions. Table 6.1 presents more detailed information on the privatisation development of these companies.

Table 6.1 Status of RICOP MFA enterprises

Enterprise	Privatisation status	Comments	Investment commitments[21]		
			Technology	Environment	Working capital
Chimcomplex, Borzesti	2003	Privatisation contract is being implemented. The company received state aid before 2004.	22,000,000 €	1,354,000 €	0 €
Fortus, Iasi	2003	Privatisation contract is being implemented. Unclear whether the investor is able to fulfil his obligations according to the privatisation contract. This created some divergences on the share of state aid to be granted. Considered a social case because located in an area already affected by massive lay-offs.	4,008,245 €	910,830 €	2,500,000 €
Nicolina, Iasi	(2002)	Privatisation took place in 2002 but came back to AVAS portfolio in 2004 since the price could not be paid. At the moment the enterprise is proposed for liquidation.			
Moldosin, Vaslui	(2003)	After being privatised in 2003 the enterprise is currently proposed for liquidation.			
Terom, Iasi	…	The enterprise came back to AVAS portfolio in 2006. Currently the enterprise assets are being sold after which the enterprise will be liquidated.			
Carom, Onesti	2003	There are some problems with the shareholders. Possibility of liquidation is being considered.	1,000,000 €	3,542,000 $	1,000,000 €

[21] The investment commitments are from privatisation contracts.

Enterprise	Privatisation status	Comments	Investment commitments[21]		
			Technology	Environment	Working capital
Celhart Donaris, Braila	2003	Privatisation contract is being implemented. Existing problems relate to the state aid which has not been granted yet.	6,140,000 €	3,515,000 €	3,500,000 $
Aro, Campulung	2003	Privatisation contract is being implemented. This privatisation is unsuccessful due investor 's lack of financial power to carry on the privatisation. About 98% of the committed state aid was granted. The enterprise is under reorganisation and bankruptcy law for almost one year. It is expected to be liquidated in 1-2 months. Reorganisation was rejected because it was not financially justified and the investor did not accept other options.	11,900,000 $	600,000 $	3,000,000 $
COST, Targoviste	2002	Privatisation contract is being successfully implemented.	13,772,000 $	7,300,000 $	4,500,000 $
Electroturris, Turnu Magurele	2002	Privatisation contract is being implemented.	345,709 €		111,519 €
MAT, Craiova	2003	Privatisation contract is being implemented.	1,100,000 €	20,000 €	100,000 €
Biosin, Calafat	(2002)	Enterprise is under liquidation since the investor could not pay the price.	150,000 €		25,000 €
Alprom, Slatina	2002	Privatisation contract fulfilled.	9,262,810 €	304,246 €	
Uzinele Sodice, Govora	2002	Privatisation contract is being implemented. Slow progress related to the debt swapped into shares. About 47% of the shares were supposed to be transferred to AVAS portfolio by end 2004, but were actually transferred only in march 2006.	3,000,000 $	400,000 $	300,000 $
Electroputere, Craiova		Huge historical debt (app. € 30-40 million of which app. 80-90% to the state budget) is the major problem in the privatisation of this enterprise. Privatisation of this enterprise is high priority in the Privatisation Program for 2006.			

Enterprise	Privatisation status	Comments	Investment commitments[21]		
			Technology	Environment	Working capital
Alro, Slatina	2002	Privatisation contract is being implemented.	45,000,000 $	16,500,000 $	
Romvag, Caracal	2002	Privatisation contract is being implemented well.	2,100,100 €	816,000 $	
Corapet, Corabia	…	Privatisation Contract is fulfilled. Enterprise is under liquidation.			
Brafor, Brasov		Enterprise is under volunteer liquidation.			
Tractorul, Brasov		A Priority the Privatisation Program for 2006. Privatisation Contract is being negotiated. Enterprise debt to state budget is app. € 160 million.			
Rulmentul, Brasov		Priority No.1 in the Privatisation Program for 2006. The enterprise was put for privatisation three times but failed. The main problem is the huge historical debt of app. $ 80 million.			
Subansamble Auto, Sf. Gheorghe	2002	Privatisation contract is being implemented.	1,494,200 $	60,000 $	90,000 $
Viromet, Victoria	2002	Privatisation contract is being implemented.	1,540,000 $	350,000 $	1,000,000 $

In 2002 ten enterprises from the MFA list were privatised (two of which were later liquidated), and in 2003 eight enterprises were additionally privatised (from which one is under liquidation). However with a 20 out of 23 ratio the RICOP list has scored slightly better than the PSAL II list which achieved 40 out of 50, out of an anticipated 30 out of proposed 50. The RICOP list contributed to 50% of PSAL II successful privatisations.

Conclusion

It can be concluded that MFA played an effective operational reinforcing role in fostering the enterprise restructuring and privatisation process, although the instrument in itself did not prove strong enough of an incentive to deal with the most serious and complicated cases, especially where potential state aids problem were concerned.

6.2 Case Study – Removal of the Administrative Barriers for the Business Environment

Findings

In 2000 the Romanian Government with the assistance of the Foreign Investment Advisory Service (FIAS) of the World Bank conducted a study on the administrative barriers to investment in Romania. This study was part of the government effort to improve the business environment and encourage private investment. The resulting report of the study identified a number of areas in which serious administrative barriers appeared to impede investment, and provided a long list of recommendations for improvement.

In 2001 an inter-ministerial Working Group was established to develop an Action Plan for implementing reforms aimed at removing/reducing administrative barriers to investment. This action plan was finally approved in March 2002 and its implementation became the subject of the MFA conditionality.

The Government first designated the Ministry of Development and Prognosis as the coordinator of the Action Plan implementation, and established a special Business Environment Unit (BEU) within the Ministry to provide the day-to-day Secretariat support to the Working Group. In the following years the BEU itself moved from the Ministry of Development and Prognosis, to the Ministry of Economy and Trade and then to the Prime Minister's Office.

The action plan approved in 2002 included 71 measures in 15 fields of activity and its implementation was made possible. Moreover, a generic reference to the improvement of the business environment had been included by the World Bank among its non core PSAL II conditionalities. This first plan was implemented in a relatively short period of time. By the end of 2002 when the MFA was finally signed, 58 measures out of 71 suggested measures in the Action Plan had already been successfully implemented, and the remaining 13 were underway. Results about the implementation of the Action Plan were summarized in the March 2003 MODP report, "Governmental Developments for Improving the Business Environment in Romania". However when MFA started monitoring the implementation of the conditionality, the specific link with the plan somehow got lost and generic considerations were made about the business environment in Romania, including further developments, as if the original condition had not been substantially fulfilled by early 2003.

Between end 2002 and early 2003 FIAS was already in a position to carry out an evaluation of the implementation of the Action Plan to Remove Administrative Barriers. The findings of this evaluation contributed to the establishment of a second Action Plan consisting of 36 actions in six priority areas[22]. Support to plan implementation continued under World Bank PSAL II first and the World Bank's Public and Private Institutional Building Loan (PPIBL), and the Swiss Trust Fund.

In 2004 FIAS re-assessed the improvements achieved in the following way:

- A substantial improvement in the registration process of a company. The percentage of those who consider that the registration of a company is a problem decreased from 61% in 2002 to 32% in 2004.
- Some improvements in the procedures regarding taxation, but need for upgrading remained in VAT procedures including the number of days necessary for VAT reimbursement

[22] These included reportedly for the first time the issue of bankruptcy and insolvency legislation, and it was as a result of *this* plan that in 2003 simplified procedures were introduced.

- Serious concern for custom procedures for import/export remain, especially regarding "unofficial payments".
- Inspections remained a major concern for investors and required a further special attention for the reform priorities.
- A special attention and further investigation needed for the buy/lease of land and work regulations, both being heavily criticized by investors.
- Generally speaking, the managers in Romania still spent too much time for administrative matters and corruption remained a major concern.

A further monitoring survey to assess improvements is being replicated these days under the framework of a PHARE TA project.

Conclusion
From an objective point of view the MFA structural objectives on the business environment plan have been fully met also in terms of timing of action. However there is little perception of any direct MFA involvement in Romania. Relevant Romanian staff are mainly unaware of the link with MFA and on the contrary insist on the importance of having negotiated the reform with the World Bank as a non core condition.

Moreover it is worth noting that no institution involved in the MFA monitoring from both the Romanian and the EU side fully realised that the administrative barriers implementation plan mentioned in the 2002 conditions is the document fully implemented and evaluated in March 2003.

7 Implications of the design and implementation of the operation – Findings, conclusions and recommendations

7.1 Introduction

The design and implementation of an MFA operation influences the extent to which the MFA objectives are achieved for a given cost to the EU budget. In this chapter we will respond to the following question to provide a basis for assessing the efficiency of the fourth MFA intervention in Romania.

Table 7.1 Relevant evaluation questions concerning implications of design and implementation

	Implications of the design and implementation of the operation
Q 5.1	In what way the design and implementation of the MFA conditioned the performance of the MFA operation in respect to its cost and its objectives?

This chapter will end with general conclusions and recommendations which will contribute to a future meta-evaluation of several MFA operations with a view to drawing more strategic lessons about the instrument.

7.2 Design and implementation features - Findings

Q5.1 In what way has the design and implementation of the MFA conditioned the performance of the MFA operation in respect to its cost and its objectives?

Based on the field interviews and our analysis of the existing documentation, the following design and implementation features will be touched upon:

MFA objectives
The Council Decision, the Loan and Supplemental Loan agreements mentioned three objectives of the MFA instrument: ensuring a sustainable balance of payments, easening external financial constraints and supporting the implementation of the necessary structural reforms.

The set of conditions of the first tranche facilitated the swift release of the funds at the time when the economic and the balance of payments situation was still unfavourable, though some positive trends could already be noticed. Besides the time used for re-negotiation of the second tranche conditions, the fulfilment of the second tranche conditions still required major government effort. Even though the release of the funds for easening short term financial constraints still played a role, compared to the first tranche disbursement, the need was less critical. The attention seemed more on supporting structural reforms.

Romanian interviewees indicated that the non (timely) compliance of the privatisation of BCR prevented them to request the disbursement of the second sub-tranche of the second tranche. At that time foreign exchange reserves grew already drastically.

Two sub-tranches instead of one
The Supplemental Loan Agreement included two sub-tranches of 50 million each. The Romanian authorities initially preferred one tranche only. Romanian interviewees validate that the split of the initial one tranche into two sub-tranches was done "*to motivate Romania*" and to keep the dialogue. This had been a political signal. However, the economic consequences of a smaller tranche appeared to be less visible when they are expressed in the conventional economic indicators, especially in a relative large economy as Romania.

Lack of clear rules in renegotiating Memoranda of Understanding
The link of the MFA to two different IMF SBA operations had an impact on the way the Commission discounted the verification of the structural conditions agreed in 2000. In practice the new 2001 IMF programme together with the appointment of a new Government allowed the discretionary decision to consider the continuation of the 2000 operation as an *ex novo* exercise. As a consequence only rough verifications were made of the degree of fulfilment of the 1999 structural package whose conditions "*seemed"* [emphasis added] to have been fulfilled to a significant extent" but never checked in detail. As far as impact on costs is concerned the MFA, although formally remaining the same 4th operation, *de facto* went into a second negotiation process including separate approval from the Council. No real difference can be seen with a possible genuinely separate 5th operation.

Limited flexibility of relatively long negotiation and approval procedures
When negotiations for the 4th MFA started Romania didn't have the status of an accession country. When this happened in late 1999 a renegotiation of the MFA objectives to take into consideration this key political development would have been too cumbersome and costly procedure to quickly adapt the structural objectives to the new political environment. Moreover true accession negotiations started in February 2000 only. The same phenomenon happened to a much more limited extent also in 2002, when IMF SMEFP II developments were not taken in consideration to renegotiate MFA conditions accordingly.

Monitoring and review
An interviewee mentioned that *"Without clear programme and without tight monitoring and review the country would not be able to integrate successfully into the EU"*. This comment was, however, made referring to World Bank PSAL programs. The monitoring of the MFA has been unsystematic and largely based on own missions in the country, a collection of sources from Government and IFI sources. Many interviewees, including within the EU, agree the Commission is inadequately equipped to monitor structural

conditions. This also means that Government counterparts are not necessarily informed of the fact that progress in a given policy field is considered a conditionality by the EU and cannot therefore perceive any operational reinforcing effect attributable to the MFA.

Selection of conditions

It seems that the selection of structural conditions was partly influenced by the limited availability or lack of preparatory studies in certain areas. In this respect there appears to be a striking difference with World Bank conditions that can substantially rely on the input provided by a number of preparatory missions.[23]

Some evidence could be found that possible practical difficulties to monitor conditions of a quantitative nature, at least in the area of soft budget constraints and financial discipline, played a role in the sheer identification of EU conditions in 2002. This caused a bias against conditions based on quantifiable objectives.

Lack of prior action concept in MFA

Some Romanian interviewees noted a major operational discrepancy between the EU MFA and the IMF SBA negotiation approach that makes co-ordination between the two instruments difficult. Since the EU Council approves the MFA operations together with the conditions and there is no such thing in MFA as IMF prior actions, i.e. conditions to be fulfilled before having the loan approved by the Board, MFA operations are structured in a way to have relatively easy conditions at the beginning to allow a first disbursement of funds while tougher conditions are postponed to a second phase. In the words of a Romanian interviewee *"the IMF sanctions difficult actions before the programme is launched, the EU after"*.

7.3 Conclusions and Recommendations for future MFA operations

Based on our analysis and interpretations in this ex-post evaluation of the fourth MFA operation for Romania, we draw general conclusions on the performance of MFA. We also suggest recommendations addressing identified weaknesses and/or reinforcing strengths of MFA. These general conclusions and recommendations should contribute to a future meta-evaluation of several MFA operations with a view to drawing more strategic lessons about the instrument.

1. *MFA Objective*: The Council Decision stated the objectives of providing MFA to Romania. In the Council Decision, Article 1 used the wording "with a view to ensuring a sustainable balance of payments situation." The Council Decision and the subsequent Grant and Loan and Supplemental Loan and Grant Agreements did mention as well objectives of easening financial constraints and support for the implementation of structural reforms. Furthermore, it was not evident from the present formulations which objective was a "goal" in the sense of a higher-level

[23] Moreover, World Bank officials indicated that the success of the PSAL programmes had been facilitated by the existence of very closely developed technical assistance programme (PIBL) that supported the Romanian authorities in achievement of the WB conditions.

objective and which objectives were to play a 'supporting' role helping in the achievement of the higher-level objective.

Recommendation: The objectives of MFA should be clearly specified and presented more explicitly to all MFA actors involved. Also the possible hierarchy of objectives should be set more clearly.

2. *Conditions 1- Time focus of conditions:* The rationale for an MFA intervention is the need to fill a foreseen residual financing gap, an objective normally requiring timely and speedy action. In contrast, most structural issues require more time and addressing these issues through MFA should normally be given secondary importance. However, based on our analysis and assessment of the events related to disbursement of the MFA tranches, we get the impression that during implementation of some tranches the rationale of MFA was shifted from residual gap filling to the structural issues and conditions. For a number of conditions only an indirect and qualitative link could be established between the possible effects of fulfilling the conditions and the balance of payments. Furthermore, a number of conditions could only be attained over a medium term period and thus not addressing timely the short-term financing need. While it can be argued that these structural conditions should be considered as instruments to enhance macroeconomic stability, its timing of (possible) fulfilment appeared to be unaligned to the pressing short run needs. Furthermore, we note that both IMF programmes and EU-MFA are addressing pressing short term issues, while World Bank programmes and other EC instruments are much more focussed on addressing medium to long-term issues.

   Recommendation: We suggest including primarily conditions that have directly measurable links with the core objective of MFA, i.e. filling a foreseen residual financing gap.

3. *Conditions 2 - Cross conditionality*: Given the role of the EC within the donor community and the limited capacity within DG ECFIN and other DGs to deal in depth with all structural reform areas in MFA countries, its choice for cross conditionality appears to be logical and pragmatic. As a result, the MFA provided a general reinforcing effect on the conditions set by the IMF and the World Bank. Nevertheless, within each of the reform areas, we found limited evidence for operational reinforcing effects.

   Furthermore, the formulation of MFA conditions in terms of intermediary steps to achieve IFI's conditions has not proved to be very successful, because in most cases a monitoring mechanism is not in place while also the visibility of these MFA conditions in the implementing ministries and/or agencies was limited.

   Recommendation: More selective use of cross conditionality could improve the reinforcing effects.
   Furthermore, the use formulation of MFA conditions in terms of intermediary steps to achieve IFI's conditions seems an unfeasible approach.

4. *Conditions 3 – EU specific conditions:* The results from the evaluations clearly point to the limited operational reinforcing effects of EU specific conditions. Operational effects are only possible if the conditions are clearly understood, not only by the Ministry of Finance but also by all other implementing ministries and agencies involved. These actors should be encouraged by a stringent reporting and monitoring mechanism. The capacity of the European Commission to design and monitor effectively is, however, limited. This hinders fulfilment and visibility of the conditions concerned.

   Recommendation: If the EC would have explicit preference for more EU-specific conditions within MFA, then it should ensure that other EU programmes could provide technical assistance to help in the design and monitoring of these conditions.

5. *Flexibility*: The MFA procedures are relatively rigid. In the case of Romania, when the country negotiated the 4^{th} MFA, it did not have the status of an accession country. When Romania obtained this status in late 1999 a renegotiation of the MFA agreement would have been too cumbersome and costly procedure to adapt the structural conditions to the new political environment. The same phenomenon happened to a much more limited extent also in 2002, when the IMF upgraded the status of initially non-core conditions to core conditions.

   It appears that IFIs have more flexibility in their procedures, and are able to modify conditions within the framework of the original agreements. The flexibility of MFA appears to rest mainly in a general formulation of the conditions allowing room for interpretation whether a particular condition was fulfilled, broadly fulfilled or not fulfilled.

   Recommendation: It needs to be repeated that the rationale for an MFA intervention is to fill an external financing gap and to reduce short-term macroeconomic imbalances. Clarity in objectives and clearness in the formulation of conditions are important. It should be investigated to what extent MFA procedures could be made less rigid to allow modification of some terms and conditions within the original Agreement (e.g. granting waivers, changing conditions, targets, etc.).

6. *Two sub-tranches instead of one:* The Supplemental Loan Agreement included two sub-tranches of 50 million each. The Romanian authorities initially preferred one tranche only. Romanian interviewees validate that the split of the initial one tranche into two sub-tranches was done "*to motivate Romania*" and to keep the dialogue. This was a political signal. However, the economic effects of a smaller tranche appeared to be less measurable when they are expressed with the help of conventional economic indicators, especially in a relatively large economy of Romania.

   Recommendation: The European Commission should carefully consider the necessity of small tranches in the case of support to large economies. Splitting up tranches should be carefully taken into account as it might reduce its intended (economic and non-political) effects.

7. *Absence of clear end-date in the Agreement*: Romania's balance of payments situation has been stabilised and there will be no need for further balance-of-payments support to the country. Formally, the MFA agreement is still valid, since no end-date is mentioned. We understand that since 2002 MFA agreements do include end-dates.

7.4 Final conclusions and recommendations – Two dilemmas

The evaluation show that there are two type of dilemmas related to the MFA instrument:

- **Dilemma 1:** MFA has been used to achieve two types of objectives simultaneously with one instrument: short term and medium to long term objectives. As indicated above, we suggest that the present "two-headed" MFA instrument should primarily address short-term balance of payment problems and other objectives should be explicitly given secondary importance.

- **Dilemma 2:** MFA assumes country or Government ownership for the implementation of structural reforms. Reform ownership is recognised universally as the key determinant of the compliance with programme conditionality. The recent Joint Evaluation of General Budget Support[24] concludes that conditionality usually creates managerial, not political pressure. It focuses on the *when* and *how* and not on the *what* of reforms. If it works, it helps to maintain the pace of reforms. It does not create the (political) will to implement them. Also in the case of MFA, conditions could contribute to enhancing macroeconomic stability, but they cannot effectuate this stability. They could contribute to accomplishing individual actions, but are unlikely to bring about the (necessary) change processes. We therefore suggest that the ambition concerning (the possible effects of) conditions in the framework of MFA should be modest and reasonable.

[24] Evaluation of General Budget Support: Synthesis Report, May 2006, available on http://www.oecd.org

Annexes

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A2. List of people interviewed in Bucharest and Washington DC

	Name Interviewee	Current position / Involvement in MFA
Delegation of the EC in Romania		
1	Giorgio Ficarelli	Delegation of the EC in Romania, PHARE Coordination
2	Dragos Negrescu	Delegation of the EC in Romania, Economic Advisor
3	Mrs Cristina Manescu	Delegation of the EC in Romania, SME Task Manager
4	Mrs Simona Nanescu	Delegation of the EC in Romania, Task Manager Financial Services
5	Mrs Aura Raducu	Delegation of the EC in Romania, Coordination & PHARE Infrastructure Team Leader
Romanian Authorities		
6	Mr Tanasescu	Member of Parliament, Former Minister of Public Finance
7	Gheorghe Gherghina	National Bank of Romania, Consilier, Department of Statistics, Former State Secretary of Public Finance
8	Valentin Lazea	National Bank of Romania, Chief Economist, Former State Secretary of Public Finance
9	Paul Ichim	ING Bank, Bucharest, Manager Financial Institutions, Wholesale Banking Clients, Former State Secretary of Public Finance Responsible for Treasury and External Public Relations
10	Mrs Otilia Frolu	Ministry of Public Finance, General Department for External Public Relations, Deputy General Director
11	Mrs Mioara Ionescu	Ministry of Public Finance, Advisor to the Minister of Public Finance for Programs Coordination, Former General Director at MoPF
12	Mrs Georgia Babici	Ministry of Public Finance, General Department for External Public Relations, Senior Expert
13	Dragos Andrei	President of Valsa *(private company)*, Previous Ministry of Public Finance
14	Florin Georgescu	National Bank of Romania, First Deputy governor
15	Mugur Tolici	National Bank of Romania, Office of the Governor, Head of Office
16	Ion Gizdan	National Commission for Economic Forecasting, President
17	Dorin Mantescu	National Commission for Economic Forecasting
18	Adriana Ciuchea	Romania National Institute of Statistics, General Director of National Accounts and Macroeconomic Synthesis Department
19	Dr. Daniela Elena Stefanescu	Romania National Institute of Statistics, General Director of European Integration and International Cooperation Department
20	Mr. Mandrut	Authority for State Assets Recovery, Vice-President, Post Privatisation Department
21	Mrs Adriana Miron	Authority for State Assets Recovery, Division of International Relations, Director
22	Mr. Hategan	Authority for State Assets Recovery, RICOP Coordinator
23	Mrs Carmen Teodorescu	Authority for State Assets Recovery, Division of International Relations, Senior Financial Expert
24	Mrs Diana Popescu	Ministry of Justice, A/O involved in development of bankruptcy legislation
25	Mrs Claudia Rosianu	Ministry of Justice, Normative Acts Department
26	Cornelia Maria Simion	Government of Romania, Business Environment Division, Director
27	N. Manole	Government of Romania, Business Environment Division

	Name Interviewee	Current position / Involvement in MFA
28	Anca Banulescu	Government of Romania, Business Environment Division, Expert on privatisation, labour, capital markets and non-banking sector
29	Dan Matei	PAL – Project Implementation Unit, Expert on Public Services, Previous Expert of Ministry of Public Finance
30	Mrs Daniela Stanica	PAL – Project Implementation Unit
31	Mihai Turtureanu	PAL – Project Implementation Unit
32	Gabriel Mirecea Neagu	PAL – Project Implementation Unit
Romanian Resource Persons		
33	Prof Dr. Moisa Altar	Professor of the Romanian Academy of Economic Studies, reputed researcher in Romanian Macroeconomics
34	Dr. Lucia Claudiu Anghel	Commercial Bank of Romania (BCR), Treasury Department, Deputy Executive Director
35	Mrs Maria Constantinescu	Commercial Bank of Romania (BCR), Treasury Department, Treasury Expert
36	Mrs Loredana Rautu -	Commercial Bank of Romania (BCR), International Relations and External Financing Division, Head of Department Monitoring External Programs
37	Mrs Cristina Maria Marin	Commercial Bank of Romania (BCR), International Relations and External Financing Division, Head of Department External Programs for SME's
International Financial Institutions		
38	Andreas Westphal	IMF, European Department, Senior economist
39	Gerwin Bell	IMF, European Department, Southern Eastern I Division, Deputy Division Chief
40	Nikolay Gueorguiev	IMF, European Department, Southern Eastern I Division, Senior Economist
41	Stephane M. Cosse	IMF, Senior economist, Trade Policy Division, Policy Development and Review Department, Former IMF Resident Representative in Romania
42	Jeroen Kremers	IMF, Board Member on behalf of Netherlands Constituency (including Romania)
45	Khalid Sherif	World Bank, Washington DC, responsible for PSAL
43	Hiran Herat	Consultant for the World Bank, Previous World Bank, Washington DC, responsible for PIBL
44	Mrs Tatiana Segal	World Bank, Washington DC, responsible for PSAL and PIBL
46	Mrs Arabela Sena Aprahamian	World Bank Office Romania, Deputy Country Manager
47	Mrs Catalin Pauna	World Bank Office Romania, Economist

A3. Historical overview of the events related to 4th MFA operation

Date	Event
24 March 1999	Kosovo conflict *(start NATO action)*
21 April 1999	Consultative Group Meeting G-24
10 May 1999	Note for the ECFIN Council on possible MFA to Romania recommending that the EC should respond positive to the new request of the Romanian authorities for further MFA
28 July 1999	EC adopted Proposals for Council Decision making available further EC MFA to Romania
5 August 1999	IMF SBA approved in the amount of SDR 400 million
September 1999	Consultative Group Meeting G-24
27-29 September 1999	Mission to Bucharest
September 1999	Council Decision on EC MFA approved by European Parliament
8 November 1999	**Council Decision 199/7 32 EC on € 200 million loan**
27 January 2000	**Loan Agreement of € 200 million and Memorandum of Understanding signed**
15 February 2000	EC started Accession negotiations with Romania
29 June 2000	**Disbursement of the 1st tranche (€ 100 million)**
	IMF programme went off-track
End of 2000	Parliamentary and presidential elections
31 October 2001	IMF approved a 18-month SBA for SDR 300 million covering the period September 2001 - March 2003 (prolonged by 6 months)
31 October 2001	Mr Tanasescu (Public Finance Minister) wrote Commissioner Solbes requesting the release of EUR 100 million of outstanding EU MFA to Romania
2001	Special Report of the Court of Auditors on the implementation of MFA (and MEDA SAFs)
January 2002	Council concludes to allow disbursement of second tranche in two sub-tranches
4 February 2002	Commissioner Solbes wrote a letter to Minister Tanasescu proposing the dates for a mission to Bucharest to discuss revised terms and conditions for the disbursement of EU MFA (This mission was delayed since no agreement with IMF was met)
7 February 2002	IMF mission to Bucharest to review the SBA left the country with no agreement on the full set of measures needed to redress the slippages and delays occurred in implementation
22-26 April 2002	Commission's mission in Bucharest to discuss the revised terms and conditions for the renewed mobilisation of the EU MFA granted to Romania
5-6 June 2002	Negotiations of a Supplemental Loan Agreement between Romania and the EC
14 June 2002	Letter of Minister Tanasescu making some final proposals concerning the draft SMOU for the 2nd tranche
24 July 2002	Letter of Minister Tanasescu making final proposals concerning the draft SMOU for the 2nd tranche
7-18 October 2002	IMF mission to Bucharest to review the SBA and to hold the regular annual consultation
28-31 October 2002	Mission of the desk officer to Bucharest to collect information on the status of conditionality for the 1st sub-tranche of the 2nd tranche
11 November 2002	**Supplemental Loan Agreement and Supplemental Memorandum of Understanding signed**
13 January 2003	Letter of Minister Tanasescu informing on the positive outcomes of the structural; reform conditionalities requesting disbursement of the 1st sub-tranche
7 February 2003	Letter from EC to Minister of Finance describing the outstanding MFA issues
6-20 February 2003	IMF mission in the context of the 3rd review of the SBA (reached understanding on a

Date	Event
	Supplementary Memorandum of Economic and Financial Policies (SMEFR II)
27 February 2003	Romanian Cabinet approved and Emergency ordinance regarding the speeding-up of the restructuring, reorganisation and privatisation of State Owned Companies.
28 February 2003	Letter of Minister Tanasescu to EC on the latest relevant developments and results of the IMF mission
21 May 2003	The Economic and Financial Committee had been consulted on the proposal of releasing a tranche of € 50 million under Decision 1999/732/EC providing supplementary MFA to Romania (ECFIN/293/03 – EN)
17 June 2003	DG ELAG was consulted before the release of the 1st sub-tranche
July 2003	**Disbursement of the 1st sub-tranche of the 2nd tranche (€ 50 million)**
7 July 2004	Approval by the IMF Board of a Precautionary SBA (SDR 250 million) concluded between GoR and IMF
July 2004	MFA operation “de-activated”

A4. Relevant to MFA milestones in economic development in Romania during 1998-2005

1998:

- Towards the end of summer 1998, in the light of the sharp worsening of the current account deficit, the National Bank of Romania abandoned its policy of ensuring some real exchange rate appreciation to support the fight against inflation.
- Towards the end of 1998, the authorities re-launched structural reforms and large-scale privatisation in order to prevent a looming crisis and restore access to official financing.
- External financing was called into question when the deficit peaked at 7.1% of GDP in 1998 against the background of a severely misaligned exchange rate, a rising trade deficit, dwindling reserves, a bunching of debt repayments and adverse international financial conditions.

1999:

- On June 18, 1999 the Supreme Defence Council adopted a new National Security Strategy where membership of the European Union was identified as one of the core priorities for Romania.
- Parliament approved a tough austerity budget in early 1999, based notably on an increase of revenues, including much higher excise taxes on fuels and property taxes.
- in April 1999 of the National Office for the Prevention of and Fight against Money Laundering and the entry into force of the Law on Money Laundering was established.
- Through the IMF stand-by arrangement, the World Bank Private Sector Adjustment Loan substantial additional support had been mobilised for the restructuring process. To support these efforts, the Commission has adopted a significant programme of economic restructuring and privatisation to be financed through the 1999 Phare programme. This combined assistance should enable the government to accelerate the process of structural reform.
- Privatisation accelerated, in particular for large-scale enterprises: 48 large companies were sold in the second half of 1998 and 68 in the first eight months of 1999, compared to only 37 in 1997.
- Privatisation of banks started: two small public banks were sold to foreign investors in late 1998 and spring 1999. The government initiated privatisation procedures for two other large public banks.
- A new law on local public finance was introduced as of 1 January 1999, which introduced a large degree of fiscal decentralisation.
- In July 1999 a law was adopted which introduced an important simplified registration procedure for new enterprises.
- In 1999 new regulations on Customs Valuation entered into force.
- The framework of the managed float regime was adopted in 1999.

2000:

- Romania's National Plan for Agricultural and Rural Development, which forms the basis for implementation of the SAPARD programme in Romania, was approved in December 2000.

- Parliamentary and presidential elections were held in November 2000.
- A section for anti-corruption and related organised crime at the General Prosecutor's Office was established in October 2000.
- In the closing months of 2000, privatisation sales ground to a halt and the decision to cap energy prices at their August 2000 level undermined previous efforts to strengthen enterprise sector financial discipline. As a consequence, enterprise arrears increased dramatically during the first half of 2001.

2001:
- In June 2001 Romania presented a revised National Programme for the Adoption of the Acquis (NPAA), in which it outlines its strategy for accession, including how to achieve the priorities of the Accession Partnerships.
- In September 2001, the Romanian Government adopted a “General Strategy Regarding the Acceleration of Public Administration Reform”.
- In March 2001, a new Law on Local Public Administration was adopted in order to extend and clarify the decentralisation process.
- A revised version of the Civil Procedure Code entered into force in April 2001.
- In the summer months of 2001, energy prices were raised, to more closely reflect production costs, and tied to the exchange rate, to protect their real value.
- As evidenced by the rise in non-interest expenditures, fiscal policy has become more expansionary in 2001 against the background of a largely accommodating monetary policy.
- A long-awaited “National Strategy for Energy Development” was adopted in June 2001.
- In mid-August 2001, a single regulated price for all gas consumers was established, reducing greatly this price distortion and ensuring cost recovery.
- In July 2001 the Government approved the industrial strategy document “Industrial Policy of Romania”.
- in July 2001 a law on the promotion of investments was adopted.
- An “Action Plan for the Abolition of Certain Barrier to SMEs” was adopted in May 2001.

2002:
- In April 2002, Romania launched its first ten-year bond on the international market, reaping the benefits of various upgrades granted by rating agencies since 2000 and of its improving vulnerability indicators.
- New challenges emerged with strong capital inflows forcing the central bank to engage in costly sterilisation operations.
- In view of the faster than expected disinflation in the first half of 2002, however, the authorities allowed real policy interest rates to drop after letting real money market rates rise over 2001. Various measures were also taken recently in an attempt.
- After peaking at 4.5% of GDP in 2000, the general government deficit was cut to 3.4% of GDP in 2001 thanks to a tightening of policy in the second half of the year. This restored a moderate primary surplus and made it possible to achieve the target agreed with the IMF despite lower-than-planned revenues.
- Since mid-2001 the prices for electricity, heating and natural gas have been brought progressively closer to international and cost recovery levels. To protect this achievement, electricity and heating tariffs were tied to the US dollar in July 2002.

However, this important relative price adjustment was not fully fed through the economy because of a worsening in the collection rates of energy enterprises over 2001.
- As a result of the enduring difficulties encountered in privatisation, the authorities missed the privatisation targets agreed with the IMF and the World Bank for the first half of 2002.
- A revised Profit Tax Law was adopted in June 2002.
- New legislation on excise duties entered into force in January 2002.
- A strategy to improve the administrative capacity of the tax administration was approved in February 2002.
- In March 2002, new legislation was adopted to speed up the privatisation process.
- An accession roadmap was developed in close consultation with Romania and adopted in November 2002.
- Reflecting the growing support for reform, Romania for the first time successfully completed a stand-by arrangement (SBA) with the International Monetary Fund (IMF).
- While in 2002 economic growth was accompanied by greater external stabilisation, this trend was reversed in 2003.
- Privatisation of the insurance sector was completed in 2002.

2003:
- Romania continued to successfully tap the international financial markets, most recently with a 7-year EUR 700 million bond issue in July 2003.
- Monetary policy was tightened in the course of 2003.
- The Ministry of Public Finance had been engaged in a major process of restructuring, aiming to unify the Tax administration under a single department in the ministry. In February 2003 the ministry created the Tax Administration Department.
- In order to improve revenue collection, an Office for Large Taxpayers in Bucharest and Ilfov County was established in January 2003 and staff numbers at the Ministry of Public Finance were increased.
- In August 2003 the National Agency for Fiscal Administration was established.
- In January 2003 Romania increased market opening in the gas sector from 25% to 30%.
- As a part of the government reorganisation in June 2003, the Ministry for SMEs and Cooperatives was dissolved and became the National Agency for SMEs and Co-operation under the authority of the Prime Minister. The Ministry of Development and Prognosis was also disbanded and its functions with regard to promoting improvements in the business environment were given to the new Ministry of Economy and Commerce.
- Adoption of the Civil Service Statute in March 2003.

2004:
- Parliamentary elections in November 2004.
- The accession negotiations concluded on 14 December 2004.
- Following a major reorganisation in June 2003, a further restructuring of the government took place in March 2004.
- A public administration reform strategy was launched in May 2004.

- In the area of remuneration, a two-step pay reform had been agreed by the Government: a short-term interim reform, which provided for a salary increase as from 2005, and a medium-term comprehensive review of the pay and grading structure, aimed at ensuring a transparent, equitable and reliable remuneration system, which should be in place by 2006.
- A Code of Ethics for civil servants was adopted in February 2004.
- Credit to companies and households expanded sharply in recent years and rose by nearly 50% in real terms in 2003. As a response, the central bank raised its reference interest rate on several occasions and implemented prudential measures by 1 February 2004 aimed at slowing the credit growth and limiting banks' risks relating to consumer and mortgage loans. Credit growth to the non-government sector moderated considerably, and since June 2004 the central bank cut its reference rate four times. In order to limit the risks stemming from a rapid growth of credit denominated in foreign currency, minimum reserve ratios for foreign currency deposits were also raised.
- In 2004 the authorities stepped up their efforts to combat non-payment of arrears of SOE to general government, which led to a considerable increase in the recovery of taxes due.
- A new Public Finance Law was adopted.
- The VAT system was further reformed.
- In July 2004, a coherent policy-mix was embedded in a two-year precautionary stand-by arrangement with the IMF, aiming at containing the current account deficit and supporting disinflation through tightened fiscal policy, prudent monetary policy and continued structural reforms.

2005:
- In January 2005 the Law on the Methodology for the preparation of Normative Acts was amended.
- A vast harvest gave a strong impetus to growth in 2004, while widespread floods caused damage to agricultural output in 2005.
- Going hand in hand with the envisaged switch to inflation targeting as of August 2005, the central bank opted in November 2004 for a more flexible exchange rate policy by limiting forex market interventions and abandoning the pre-announced target for the annual real exchange rate appreciation.

A5. Methodology of Counterfactual modelling

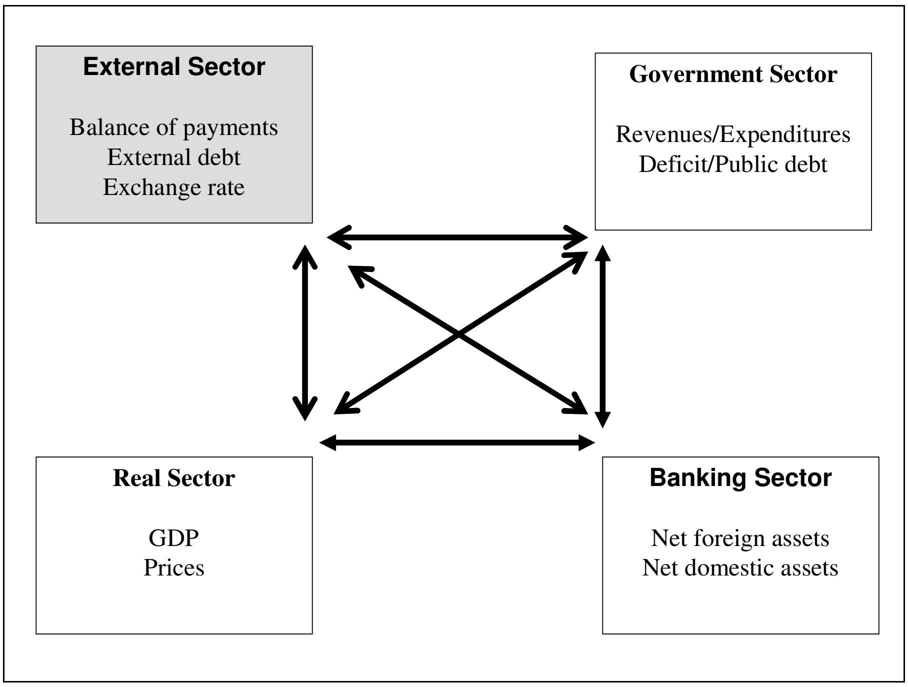
In order to illustrate the macroeconomic effects of the counterfactual(s), the quantitative modelling approach has been used. The basic structure of the model that recognizes links and ensures consistency among four basic economic sectors: real, external, government and banking is illustrated in figure A5.1 below.

The main part of the model has been calibrated using annual IMF data available through IMF International Finance Statistics (IFS) and recent IMF Country Reports and has been used to derive the alternative path of major macroeconomic variables in the absence of the MFA.

In addition, the quarterly model has been developed to analyse in more detail the short-term effect of MFA on the balance of payments and on costs of borrowing. The quarterly model, that is consistent with annual framework, is based on detailed quarterly balance of payment data from the National Bank of Romania as well as data on spreads obtained from Bloomberg.

The modelling is particularly useful in assessing the counterfactual outcomes in case of the first tranche disbursement in 2000, when the counterfactual involves a serious policy adjustment on top of the effect on market expectations and premia (widening spread) on Romanian debt instruments. In year 2003, the adjustment in the counterfactual means simply the switch in the composition of external debt from official to commercial creditors with some increase in the cost of borrowing, therefore the need for comprehensive macroeconomic model in assessing the counterfactual is weaker.

Figure A5.1 The basic structure of the model that recognizes links and ensures consistency among four basic economic sectors: real, external, government and banking



Key features

The absence of the MFA affects the economic system though four channels. First, there is a direct impact on the balance of payment in the quarter and the year of disbursement. The second channel of impact operates through budgetary accounts as the absence of the MFA implies lower external financing opportunities for the budget deficit. Third, more restrictive monetary policy involves lower net foreign assets and potentially also less credit to the private sector. Finally, there is a direct impact on market sentiment and therefore pressure on higher spreads following lack of decision on granting Romania an MFA or disbursing the second tranche.

Differences from actual

All channels described above are explicitly modelled to capture differences between counterfactual and actual scenarios. The model is linear and accordingly, most equations used in the model describe the difference between counterfactual and actual values of variables. For example, the equation for a variable X that is determined by some two other variables Y and Z has typically a form:

DIF (X) = F[DIF(Y), DIF(Z)]

where DIF (…) is the difference between counterfactual and actual value of a variable and F[] is selected function form (identity or behavioural equation as discussed below)[25]. The advantage of such specification is the strong focus on variability related to the MFA intervention and the straightforward interpretation of obtained results in terms of net impact of the intervention.

Identities and behavioural equations

There are two basic kinds of equations used in the model: identities and behavioural relations

Identities are equations that must hold by definition to ensure accounting consistency (e.g. balancing balance of payment, financing budget deficit, equating assets and liabilities of the banking sector). The only necessary assumption in simulating counterfactual in case of identities is the determination of size of adjustment of each of the variables entering the identity in response to the shock. Often this choice is conditional on policy response or external factors such as access to international financial markets.

In case of behavioural relations (e.g. determinants of GDP growth, inflation and imports), the equation has stochastic character and reflects the economic impact that should take

[25] Sometimes the percentage difference between counterfactual and actual values is also used and then it is denoted by %DIF (…) in the discussion below.

place according to the economic theory, ideally confirmed by available statistical evidence. The modelling assumption involves the choice of the variables that are best in explaining dynamics of independent variable and quantification of the size (elasticity) of the impact. The elasticity can be estimated, calibrated or simply assumed.

Although the model consists of larger number of equations, we describe below three most important identities and three behavioural equations that are at the core of the simulation of the counterfactual.

BOP identity

The first essential equation necessary for establishing the counterfactual is the identity describing the balance of payment. Below we show stylized version of actual equation that illustrates the character of modelling choice in determining the type and strength of BOP response in the counterfactual scenario.

DIF (CA items) + DIF (MFA loan + other KA items) = DIF (reserve accumulation)

where DIF is the difference between counterfactual and actual value as defined before, CA is current account and KA is capital and financial account. The absence of the disbursement of the MFA is reflected in a drop in external loan disbursement in capital and financial account. As balance of payment has to balance ex post, resulting tighter BoP constraint must lead to adjustment in other items. These adjustments are believed to take very different forms across two tranches. In 2000, the Government of Romania had very limited or no access to international financial markets, therefore the adjustment involves combination of lower foreign reserve accumulation and current account adjustment. Reserve accumulation is subject to the discretion of the NBM, and we assume that roughly two thirds of the additional BOP constraint is reflected in lower accumulation of foreign reserves in the counterfactual. The rest of the adjustment takes place through current account items, primarily through the slowdown of imports. The balance of payment adjustment in 2003 is more straightforward, as the counterfactual involves the switch in the composition of external debt from official to commercial creditors with some increase in the cost of borrowing (as described below),

Budget identity

The second core identity used in the formulation of the counterfactual describes budgetary accounts. The stylised version of this equation is shown below

DIF (Gov Expenditures) – DIF(Gov Revenues) = DIF (MFA loan + other Deficit Financing items)

The absence of MFA assistance is recorded in the budgetary identity as lower external deficit financing. In order to balance its books, the government needs to adjust its expenditures program and/or revenue collections and/or identify alternative sources of deficit financing. In this respect, the counterfactual is fully determined by availability of alternative sources of financing and policy decisions about fiscal tightening. In case of first tranche in 2000, the access to alternative financing is very problematic and we assume that fiscal deficit is fully adjusted instead, mainly through cuts in expenditures (two thirds in adjustments) with smaller role played by revenue adjustments. Quite differently, the counterfactual to the second tranche disbursement in 2003 assumes that the government switches to alternative sources of external financing with fiscal deficit, revenues and expenditures unaffected. (The impact on market sentiment and costs of borrowing is modelled separately in the quarterly model – the estimated scale of macroeconomic effects does not justify their analysis in the annual model.)

Banking sector balance sheet identity

The third core identity describes the accounts of the banking sector. This stylised presentation illustrates key linkages with balance of payment situation that determines through series of auxiliary identities the net foreign assets (NFA), and budgetary accounts that determine the size of credit to the government (NDC government), with adjustment in other items of net domestic assets (NDA) determining the change in money supply.

DIF (NFA) + DIF (NDC government) + DIF (NDA other) = DIF (Money Supply)

The adjustment to these disturbances in the counterfactual depends mainly on policy response. It is assumed that the National Bank does not sterilize the lower foreign reserve accumulation through faster growth of net domestic assets, what leads to lower overall money supply in the counterfactual. However, credit to the private sector of the economy is not seriously affected, as additional deficit financing from the domestic banking sector has been assumed away.

Real sector behavioural equations

The set of core identities described above, together with other auxiliary equations constitute the logical framework of the model and indeed produces most presented results. However, in order to quantify the impact of counterfactual arrangement on the real sector, behavioural equations have to be introduced. This is a challenging task since the character and strength of the linkages from balance of payment, fiscal and monetary developments to real sector are highly speculative - neither standard theory, nor available econometric literature provides precise insights about the size of these effects. Due to short time series and structural breaks it is also not possible to properly estimate relevant elasticities. In that situation, selected elasticities are selected within the range typically found in other countries or assumed in similar models. They thus reflect economic common sense supported with very crude estimation techniques.

The first central behavioural equation predicts real GDP growth rates under the counterfactual scenario with elasticities derived from the back on the envelope estimation of annual variables. These crude calculations do not meet standards of econometric scrutiny; nevertheless provide support and point estimates for specification, in which the impact of the MFA intervention on the GDP real growth rate is channelled through the combination of tighter balance of payment constraint, less expansionary fiscal policy and reduced credit growth.

DIF (real GDP growth) = 0.25* %DIF (imports) + 0.1* %DIF (government expenditures) + 0.05 * %DIF (net domestic credit to private sector)

The second central behavioural equation that predicts counterfactual inflation rates is based on standard theory of inflation, where price increases are related to money stock and real incomes – in the specification below, additional inflation in the counterfactual is determined by the additional money growth net of additional GDP growth. Such a specification is typically found to be relatively robust in explaining the money – inflation nexus, at least in the long run, reflecting the famous insight by Milton Friedman that '*inflation is always and everywhere a monetary phenomenon*'.

DIF (inflation rate) = DIF (% money growth) - DIF (real GDP growth)

The last equation is the reverse of the import demand equation that allows deriving nominal exchange rate response in the counterfactual that is consistent with the import development (as predicted by the BOP identity) as well as real GDP and price dynamic (as predicted in two equations above). Again the point estimates of elasticities are based on back of the envelope estimates that are in line with economic intuition.

DIF (depreciation rate) = DIF (inflation rate) + 2.5 * DIF (real GDP growth rate)
- 2.5 * %DIF (imports)

Quarterly model

To fully appreciate the short-term effect of MFA on balance of payment, the quarterly model has been also developed. Its core is constituted by the BOP identity that is fully consistent with the annual model. The important reason for implementing the quarterly framework is the attempt to quantify the impact of expectations on market sentiments and the financial burden associated with the need to borrow at increased spreads. Such exercise requires some arbitrary assumption about behaviour of financial markets that make sense only at frequencies higher than annual.

We make speculative but realistic assumptions about the potential impact of lack of MFA disbursement on spreads of Romanian external debt. Initial spread widening by roughly 1/8 of actual values is assumed and it is applied to gross external borrowing at the moment when it becomes clear that MFA intervention (or disbursement of the second tranche) will not take place. The increase in spread is gradually waning to zero over the period of 4 quarters but affects all new debt issued during this period. Afterwards, the debt service costs are affected for another 4 quarters before the short-term debt is fully rolled over. As we do not differentiate among different categories of debt when considering increased spreads, our analysis provides upper bound estimate of the impact of absence of MFA on costs of borrowing.

Sensitivity analysis

Tables in the main text of the report present point estimates of potential impact of the MFA intervention that are obviously dependent on specification and assumed parameter values. Interpretation of results should therefore be concentrated on signs and relative size of effects, rather than on particular numerical values. Nevertheless, the qualitative results are quite robust to modifications in the parameter values within the reasonable range, in particular net effects remain small for virtually all plausible parameters.