ICEG EC

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# FOREWORD

*With the support of Corvinus Rt., ICEG European Center launches a new series, called ICEG EC – Corvinus SEE Monitor, or shortly SEE Monitor. This publication will basically focus on seven Southeast European countries. These are Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Former Yugoslav Republic of Macedonia, and Serbia and Montenegro. The bi-weekly published papers will deal with the most important economic issues related to this region, which can be useful for the readers.*

*We believe that there is an increasing interest towards SEE region both from politics and economics. Undoubtedly, these countries will be Member States of European Union sooner or later. Some of them are well advanced in European integration process and some of them are at the early stage. However, the number of candidate countries from the SEE region will increase gradually. For the European Union, the integration of this neighbouring region is also a medium and long-term priority. On the other hand, FDI inflows have also been increasing in this region, which reflects the increasing interest of economic agents. We believe that these trends will continue in the future. That is the reason why we think that the launch of this series is timely.*

*Preparing the first volume, we have tried to find relevant and practical issues that can be helpful for broad circle of readers. That is why we chose the topic of European integration of the region. This is an always-relevant topic, while, the Regular Reports published at the beginning of October 2004 also made this topic current. Besides this, the first publication deals with the increasing public debt in Croatia, the changes of monetary policy in Romania and the decreasing Corporate Tax Rate in Bulgaria.*

*We wish you a good reading!*

*The Staff of ICEG European Center*

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# CANDIDATE COUNTRIES CLOSER TO EU

On 6 October 2004 the European Commission (EC), the EU's executive arm released its Regular Reports on the candidate countries' progress towards accession. All these countries had been waiting for these reports eagerly. On the one hand, Bulgaria and Romania expected the reaffirmation of the target date of accession (2007); furthermore, the latter candidate also expected that Romanian economy would be assessed as a functioning market economy, which is an important requirement of the fully-fledged EU-membership. It was important because Bulgaria has been granted the functioning market economy status for several years. On the other hand, Turkey has been waiting for the green light to start the accession negotiations.

The Reports were favourable for all these three candidate countries: the official target date of the next enlargement round remained January 2007, if they are ready. However, the report also recommends a "safeguard clause" that could delay the entry of either Romania or Bulgaria by a year if their economic and administrative reforms falter. It is obvious that the EU will closely monitor how these two economies fulfil their commitments made in their negotiation process.

## BACKGROUND

Now, as it was mentioned above, both Bulgaria and Romania fulfil the criterion of being a functioning market economy, as well as the Copenhagen political criterion. The EC assessed the two countries as they will be able to cope with competitive pressure and market forces within the Union, if the reforms started and their implementations continue in the following years.

Bulgaria and Romania have also continued to make good progress in adopting the "acquis" and in case of Bulgaria all the negotiation chapters have been provisionally closed, while the progress of Romania's negotiation is also advanced. The latter candidate still has three open negotiation chapters, as well as parts of Chapter 31 (Other issues). To put it in a nutshell, both candidate countries are on track to complete the required legislative transposition by the accession provided that the current pace of progress is maintained.

However, the Commission made some criticism too. The EC underlined that particular attention should be paid by Bulgaria and Romania to improve their judicial and administrative capacity in order to be ready for membership by January 2007. Especially in case of Romania, corruption is a serious and widespread problem. Romania has anti-corruption legislation, however, its implementation is still not adequate.

In case of Romania, the remaining three open chapters are: Justice and Home Affairs, Competition and Environment. The Environment chapter is also at an advanced stage of negotiation, but more detailed plans must be drafted prior to provisional closing. Romania hopes that these three negotiation chapters can be closed this year which means that the accession process will advance in a new stage next year when the Accession Treaties can be signed. After signing them a one - one and a half-year-long process begins when the current Member States need to ratify the Accession Treaties of Bulgaria and Romania. If Bulgaria and Romania continue the commenced reforms, the two candidate countries can be members of the EU in January 2005.

**Negotiation Chapters**

| | Bulgaria | Romania | Croatia | Turkey |
|---|---|---|---|---|
| 1 Free movement of goods | closed | closed | x | x |
| 2 Free movement of persons | closed | closed | x | x |
| 3 Freedom to provide services | closed | closed | x | x |
| 4 Free movement of capital | closed | closed | x | x |
| 5 Company law | closed | closed | x | x |
| 6 Competition policy | closed | open | x | x |
| 7 Agriculture | closed | closed | x | x |
| 8 Fisheries | closed | closed | x | x |
| 9 Transport Policy | closed | closed | x | x |
| 10 Taxation | closed | closed | x | x |
| 11 Economic and Monetary Union | closed | closed | x | x |
| 12 Statistics | closed | closed | x | x |
| 13 Employment and social policy | closed | closed | x | x |
| 14 Energy | closed | closed | x | x |
| 15 Industrial policy | closed | closed | x | x |
| 16 SME's | closed | closed | x | x |
| 17 Science and research | closed | closed | x | x |
| 18 Education and training | closed | closed | x | x |
| 19 Telecommunications and information technologies | closed | closed | x | x |
| 20 Culture and audio-visual policy | closed | closed | x | x |
| 21 Regional policy and co-ordination of structural instruments | closed | closed | x | x |
| 22 Environment | closed | open | x | x |
| 23 Consumer and health protection | closed | closed | x | x |
| 24 Co-operation in the field of justice and home affairs | closed | open | x | x |
| 25 Customs union | closed | closed | x | x |
| 26 External relations | closed | closed | x | x |
| 27 Common foreign and security policy | closed | closed | x | x |
| 28 Financial control | closed | closed | x | x |
| 29 Financial and budgetary provisions | closed | closed | x | x |
| 30 Institutions | closed | closed | x | x |
| 31 Other | closed | x | x | x |
| **Total closed chapters** | **31** | **27** | **-** | **-** |

*Source: European Commission; x – not opened*

From the aspect of Croatia, the EC had no really important news for the latest Western-Balkan candidate country. The Commission recommended that the accession negotiations should be started in early 2005. It was not surprising news, the European Council in June 2004 also concluded that accession negotiations with Croatia shall begin in early 2005. Certainly, Croatia will advance on the same accession path as the New Member States, or Bulgaria and Romania, the same Copenhagen criteria will be the main criteria that Croatia needs to fulfil. On the other hand, Croatia, as a candidate country, can benefit from all three pre-accession funds (PHARE, ISPA and SAPARD), which mean a much larger amount of support than CARDS connected to Stabilisation and Accession process. For 2005 and 2006, the Commission recommends EUR 105 million and EUR 140 million respectively, which is significantly more than the amount of CARDS between 2001 and 2003. The EC will prepare Regular Report on Croatia in autumn 2005, for the first time.

Turkey is not among the SEE countries that we are focusing on in the SEE Regional Monitor; however, we need to write some statements related to this issue, too. Turkey applied for EU membership for 17 years. Turkey became a candidate only 12 years later in December 1999. While the accession negotiations have started with the Central and Eastern European transition countries and with Cyprus and Malta, the negotiations with Turkey has not begun. The reason for that were the deficiencies in the fields of human rights and the protection of minorities. Last time the Council rejected the beginning of the negotiations with Turkey on the 2002 Copenhagen Summit, it concluded that: *"the Union encourages Turkey to pursue energetically its reform process. If the European Council in December 2004, on the basis of a report and a recommendation from the Commission, decides that Turkey fulfils the Copenhagen political criteria, the European Union will open accession negotiations with Turkey without delay."* Ergo, Turkey is now even more eagerly waiting for the December 2004 Summit when the Council will decide on whether the negotiation process will begin with the huge Eurasian country.

## Conclusions

The 2004 Regular Reports were favourable to Bulgaria and Romania, the January 2007 target date of accession was confirmed. This agenda is feasible only if these two economies continue the commenced reform process and realize the commitments made during the negotiations.

A year ago, we have expected that the next enlargement round may be delayed due to the quite slow progress of accession negotiations of Romania. A year ago, Romania had 20 provisionally closed chapters, while Bulgaria had 26. Since than, Bulgaria closed all the remaining chapters and the process of Romanian negotiations also accelerated. Now only 3+1 chapters remained open, thus, it seems that the Accession Treaties can be signed in 2005 which is an important requirement of January 2007 accession.

However, a little delay in accession process is imaginable, if the reforms will not advance in the desired pace. In that case, the so-called safeguard clause could come into force, and the accession of these two countries can be delayed to 2008.

The case of Croatia is special. The Western-Balkan country became a candidate country only in the mid-2004 and in early 2005, the negotiation process will begin. It seems the political support will ease and speed up the negotiation process, the integration of the country is really important to the EU (and certainly to Croatia). The integration of Croatia would be a good example to the other Western-Balkan countries, which would be a motivation to start and continue the political and economic reforms. On the other hand, Croatia is not really lag behind Bulgaria and Romania from economic aspects. Moreover, Croatia is comparable with the New Member States from some aspects (for example GDP per capita, productivity, wages, etc.). We expect that Croatia can be an EU member in this decade, between 2008 and 2010. In case of delaying accession of Bulgaria and Romania and a really rapid negotiation process of Croatia, the three candidates could become Member States in the same year; it is also an imaginable upshot.

In case of Turkey, the 2004 Brussels Summit is crucial when the Council will decide on whether the negotiations begin with Turkey. It is expected that the Council will decide on starting the negotiations in mid-2005. It seems that the majority of the Member States support the launch of negotiations. It means that the EC will start the negotiation with two "new" countries. In the meantime, we expect a really long process of accession negotiation in case of Turkey, longer than in case of Croatia.

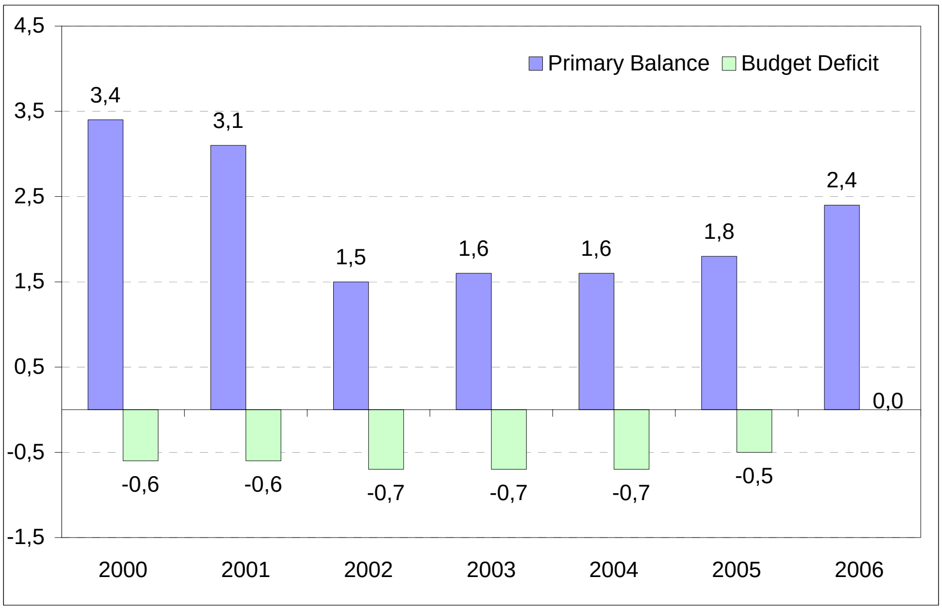
# BULGARIA 2005: TAX CUTS IN ELECTIONS YEAR

A reduction by 4.5 percentage points of the corporate income tax rate and by 2 percentage points of the VAT rate from the beginning of next year has already been approved by the Bulgarian Parliament at first reading of Budget 2005. Decreasing of the profits tax to 15% from the current 19.5% comes to no surprise given the tax strategy of the government declared two years ago. The VAT rate move, however, gives rise to more questions about the timing and the economic argumentation behind, especially in the light of the forthcoming general elections in 2005.

## NO RISKS FOR THE BUDGET

Improved revenue collection and generally restrictive expenditure side of the consolidated state budget helped Bulgarian government maintain a budget deficit within the range of 0.6-0.7% of GDP in the period 2001-2004. Projections are for a deficit of 0.5% in 2005 and achieving a balanced budget in 2006. The latter account for the effect of the decreased profit tax rate, but will eventually be negligibly changed in the negative direction if the VAT rate reduction takes place indeed. Yet the Parliament and the government have to reach an agreement about the VAT reduction before the final vote on Budget 2005, since this change was initiated by the Parliament and not by the Finance Ministry.

**CONSOLIDATED FISCAL DEFICIT AND PRIMARY BALANCE**
(2000-2006, AS % OF GDP)



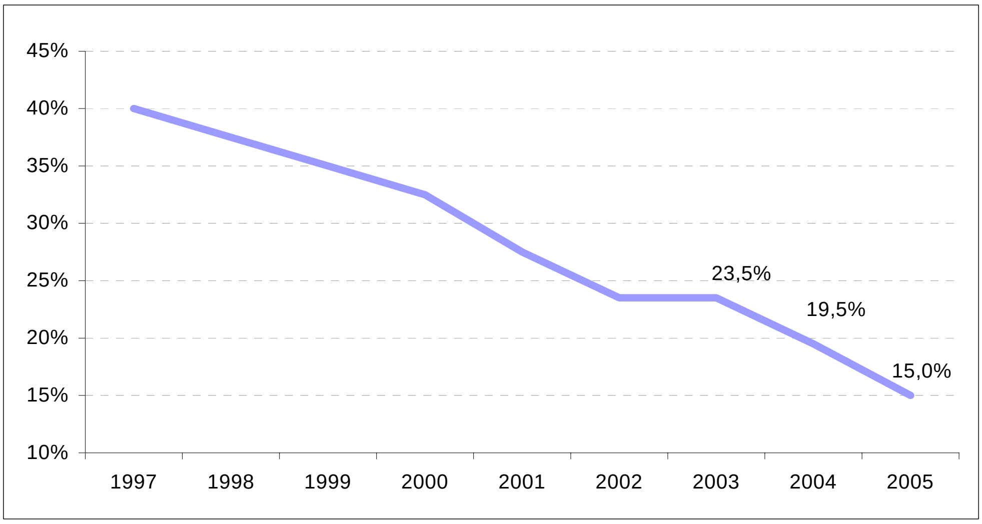

*Source: Ministry of Finance of Republic Bulgaria, "Report on the 2004 State Budget Act"*

The VAT in Bulgaria is now at a uniform rate of 20%. It is the biggest single source of revenues for the state budget giving roughly one-quarter of the Total Revenues for 2004. The proposed change is for lowering the rate to 18%, starting from year 2005, and for implementing differential rates for certain groups of goods (5% for bakery products, 7% for medicines, milk products, eggs and chicken, 10% for children's food and some inputs for the agriculture). In retrospect, Bulgaria already had such VAT-regime when the tax was first introduced in 1994. The general rate was sharply increased to 22% in the eve of the financial crisis in 1996 to help the socialist government bridge its huge budget gap. Two years later the subsequent rightist government proposed to the Parliament to lower the rate to the current 20%. The incumbent government of the former king Simeon Sax-Coburg-Gotha has the comfortable cushion of a Fiscal Reserve, which currently overshoots the required for the Currency Board regime[1] level by respectable amount equal to about 10% of GDP. Accompanied by a strong revenue inflow in the budget this gives reason for reduction of the overall tax burden but does not effectively justify the decrease exactly of the VAT rate. Such move could prompt an import-oriented consumption growth, which might result in further worsening of the current account deficit[2], although it looks appealing on populist grounds. Not the least, implementing a differential structure of the VAT regime will complicate its collection and might enforce schemes for evasion of the higher rate from some of the business agents who originally do not fall into the "favoured" categories. It is also a step-back in the tax history of the country and a step-away from the EU directives for a common tax rate of VAT.

## PRO-BUSINESS BUT NOT EXACTLY

Generally, the decrease in the corporate income tax rate is a clear sign that government cares for the investment climate in the country. During its four years in power the current Bulgarian government cut the profits tax three times by overall 12.5 percentage points. Undoubtedly an impressive track record! However, one should not forget that Sax-Coburg-Gotha won last elections with promises for a "zero-tax on the profits", which later on naturally faced the insuperable opposition of the International Monetary Fund.

### CORPORATE INCOME TAX RATES, 1997-2005




*Source: Ministry of Finance of Republic Bulgaria, "Report on the 2004 State Budget Act"*

The corporate income tax rate of 15%, as planned for the next year, will be at its lowest level from the beginning of the transition in Bulgaria, and certainly at one of the lowest levels in Central and Eastern Europe. However, the overall tax burden in Bulgaria still remains relatively high due to the high social insurance payments.

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[1] In mid-1997, Bulgaria established a Currency Board regime fixing its national currency (the Lev) to the Deutschmark at a ratio 1:1 (respectively 1.95583 Levs per 1 Euro), and covering with foreign exchange reserves the "Base Money" monetary aggregate plus a certain amount of Government deposit (Fiscal Reserve) at the Bulgarian National Bank (BNB).

[2] For the first eight months of 2004 the current account deficit stands at 2.8% of GDP, which is considerably less than the 4.3% of GDP for the same period of 2003 (Source: BNB).

Currently, the total monthly contribution for social and health insurance amounts 42.7% over the wage of the employee[3] of which roughly three-quarters are paid by the employer, and the rest by the insured[4]. Thus, the tax-burden on the entrepreneurs is increased much over their obligations under the Corporate Income Tax Act. In this sense a real pro-business approach would be to implement combined reduction of the profits tax rate and the social contributions paid by the employers. The proportions of such a decrease should be tailored in a way that would not leave the State Pension and Health Funds under-financed or put undesirable pressure on the government budget but at the same time will relieve some of the burdens on businesses. As cross-country evidence shows, cuts in the profits-tax favours the existing businesses but not the starting ones, at least in the short-run. However, both "old" and "new" firms are obliged to do social insurance payments for the staff they employ. Certainly, the high social contributions remain one of the biggest flaws of the business environment in Bulgaria, and regardless of which party wins the Elections 2005 it will have to deal with this issue apart from any populist temptations.

[3] Minimal insurable income levels are defined with respect to the different professions (See: http://www.noi.bg/English_pages/index.html)

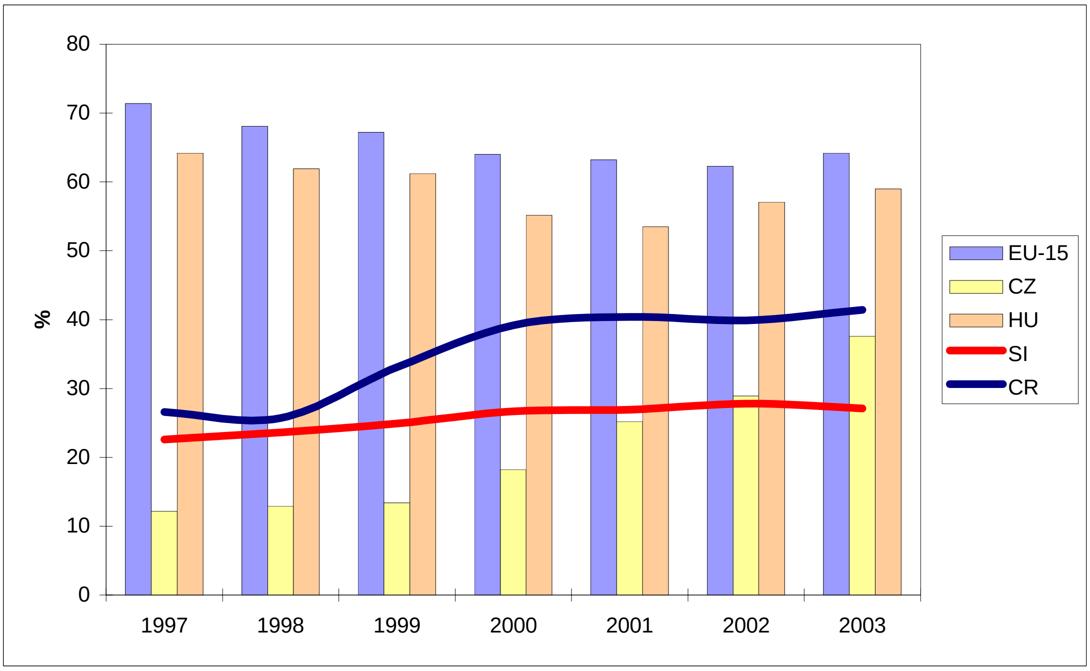
[4] It is envisaged this ratio to gradually reach 50:50 by year 2009.

# PUBLIC DEBT IN CROATIA

## CROATIAN PUBLIC DEBT: EVOLUTION AND COMPARISON

While the level of public debt to GDP in comparison with several New Member States and transition economies is not particularly high, the speed of debt accumulation has been disquieting macroeconomic development in Croatia in recent years. Total public debt to GDP ratio in 1997 was 26,1%, it rose to August 2004 to 45,7%, increasing especially fast between 1998 and 2000 and then in the current year.

**CROATIAN DEBT/GDP RATIO IN INTERNATIONAL COMPARISON, 1997-2003**




*Source: Eurostat (2004), CNB (2004)*

The accumulation of public debt has been accompanied by increase of public guarantees, which are given by the government mainly to the loss making public companies in the utilities, transport sectors to cover their expenditures. The level of guarantees increased between 1997 and 2003 almost sevenfold from 1,5% of GDP to 11,5%. While guarantees are contingent liabilities, their growth should also be accounted for. If public sector guarantees are added to the debt of the general government, than gross debt reaches 53,2% in 2003, a sizeable increase compared with 31,6% for 1997. Simultaneously with the increase of guarantees there has been a very fast decline of arrears stock of the general government.

The growth of public sector indebtedness has been accompanied with changes in its composition. While in 1997 almost half of the debt was foreign, it increased to 59% by the end of 2003. Public sector indebtedness was financed from foreign borrowing due to interest rate differentials, differences in the maturity structure of Kuna and foreign currency denominated debts (the so called "original sin" problem), lack of well-developed domestic securities market, and the low level of domestic savings, which disallowed the build-up of a more active debt management policy.

As a result the growth of public debt has coincided with increasing gross and net foreign debt. By the end of 2003 external debt of the Republic of Croatia reached USD 23.6bn equalling 83,2% of GDP, and within the external debt government one accounted for the largest part with its 36% share. The level of public foreign debt to GDP was 25.8% in 2003, which corresponds to a 1.5 percentage point increase compared with 2002.

## Factors affecting debt dynamics

The major factors leading to public debt accumulation have been linked to high fiscal deficit and increasing non-deficit related debt financing. Croatia has been in the recent decade a country with firm and predictable monetary and exchange rate arrangement coupled with unsustainable, frequently modified fiscal policies. The country ran high general government deficit, which has appeared in the growth of both public and total foreign debt levels. Sometimes governments initiated adjustment policies, but they proved to be short-lived and weak, which resulted in further increase of debt. The latest contribution of fiscal policies to debt stabilization was prior 2002, when a strong fiscal adjustment program was launched to achieve sustainable fiscal position and weaken the expansion of domestic demand, which threatened the sustainability of both current account and foreign debt.

As a consequence of fiscal adjustment domestic demand pressures began to ease, but fiscal discipline disappeared before the last November election. Both capital and current spending—particularly on highway construction - exceeded target levels, and there were sizeable off-budget fiscal operations, in the form of hidden subsidies to the Croatian Railways. As a result, fiscal deficit reached 6.3 % of GDP in 2003 compared with the target of 4.5%.

The new government, which has been in office since January, has resumed fiscal consolidation, aiming at reducing general government deficit to 4.5% of GDP in 2004 and 3.7% in 2005. A related task has been the containment of external imbalance and external debt-to-GDP ratio stable in 2004-2005. The measures included partly one-off revenue measures, and reduction in wage and related expenditures, but the government also took steps to improve transparency in the fiscal accounts, rein in quasi-fiscal operations, and strengthen public expenditure and debt management.

### General government figures in % of GDP, 2002-2004

| | 2002 | 2003 | 2004 |
|---|---|---|---|
| 1. Government revenues | 46,4 | 46,4 | 47,4 |
| 2. Government expenditures | 51,4 | 52,7 | 51,9 |
| 3. General government balance (1.)-(2.) | -5 | -6,3 | -4,5 |
| 4. Balance with quasi fiscal operations | -5,2 | -7 | -5 |
| 5. General government debt (August.2004) | 39,8 | 41,5 | 41,7 |
| 5a. Domestic debt | 16,7 | 17,1 | 18,1 |
| 5b. Foreign debt | 23,2 | 24,3 | 27,6 |

*Source: IMF (2004) CNB (2004)*

As a result of underlying macroeconomic developments and fiscal adjustment mentioned, revenues increased in the first half of 2004 by almost 7% mainly due to the rise of VAT revenues. At the same time expenditures rose by almost 10% mainly driven by the increase of capital expenditures related to the ongoing highway constructions. As a result, deficit exceeded so far the planned level and was financed by debt creation and debt was mainly financed from domestic sources due to high liquidity and increasing placements of public debt in the markets.

## POLICIES FOR SUSTAINABLE DEBT POSITION

While the level of public debt in European comparison belongs to middle one, its pace of increase in recent years and especially coincidence with high foreign debt may cause macroeconomic costs. Croatian authorities need to address the issue of growing public debt and several measures will be required to slow down and eventually reverse its growth.

The underlying fiscal position requires much stronger adjustment. After missing the fiscal target for 2003, Croatian authorities announced a fiscal adjustment for 2004-2005 amounting to 2,7% of GDP, which was seen as the minimal needed adjustment to stabilize the external debt/GDP ratio. While developments in 2004 may result in a fiscal deficit of 4,5% meaning some adjustment in fiscal balances, there are several difficulties with the underlying fiscal policy.

First, the role of one-off measures in achieving this adjustment in 2004 seems to be very significant: while the weak starting position was an exogenous condition explaining this reliance, it may hit back when long-term adjustment is required. Second, the adjustment did not affect the size of quasi-fiscal operations at the level of general government, which should also be taken into consideration. While the expected level of quasi-fiscal operations may decline in 2004 compared to 2003 (0,7%), its 0,5% GDP level remains still high in international comparison and distorts the transparency of fiscal operations.

Third, the government should take much more ambitious measures to improve primary balance of the general government. The primary deficit of 2-3 % of GDP reflects on the longer term an unsustainable fiscal position and significant turnaround in primary balance is needed. In order to achieve this, governments must respond to challenges facing both the revenue and expenditure sides of the general government. On the revenue side the problem of increasing tax avoidance and tax evasion is important, as Croatia had to experience some decline in VAT and personal income tax revenues amidst growing tourism inflows, rising domestic consumption and incomes. While this is partly linked to concessions provided in the VAT and PIT regime for several beneficiary groups, the figures, as well as reports of the National Bank and IMF indicate an increasing tax evasion and narrowing tax base. The decided postponement of the reduction of VAT rates planned for 2005 is a step towards the direction of protecting the tax base.

On the expenditure side governments must proceed with further reduction of the level of general government expenditures. This level declined in the second half of 1990s but remained unchanged in 2000-2002 around 52% of GDP. This is high in international comparison and its composition is also quite unfavourable. There are two areas of concern: one is the wage expenditures, which remain high due to wage increases that occurred in recent years. Second is the fast rise in capital expenditures, which strongly improves the composition of expenditures, may have positive spill-over effects on the economy, but may question long-term sustainability of public finances. In order to keep capital expenditures rising, government should reduce other expenditures, particularly current ones.

Besides the short-term adjustment measures, the government should make further efforts to put government finances on a more sound and sustainable basis. This would imply at least two things. First, following the pension reform other areas of public finances should be reformed. Particular attention should be devoted to the reorganization, restructuring and partial sell off of the public utilities, which remain a huge drain on public finances. Second, in order to keep the growth of public expenditures within limits and improve fiscal balance, the government should adopt a medium term expenditure-planning framework, which would give a frame for the growth of fiscal expenditures.

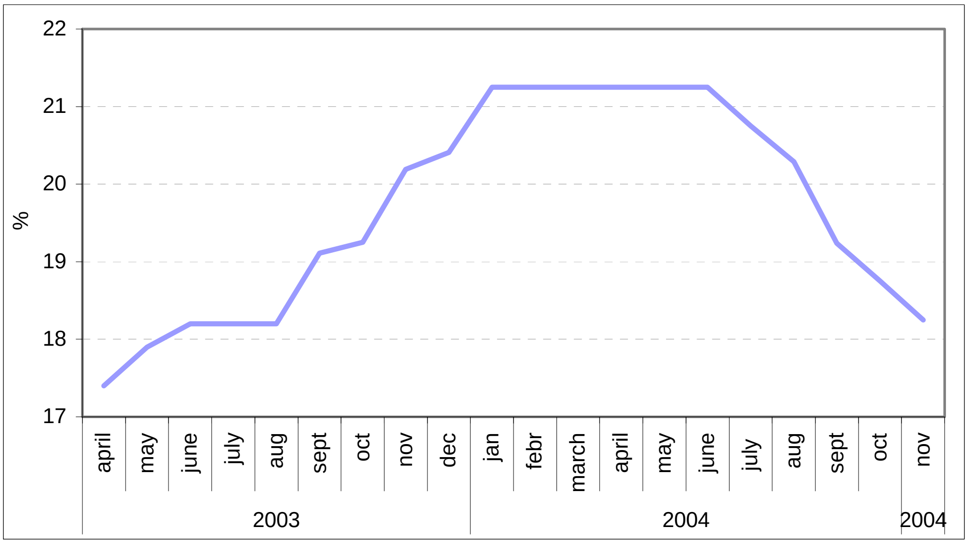
Finally, while improving fiscal balances, there is a definite need to proceed further with the shift in the structure of debt financing. While recently (at least in 2004) there has been an increase in the share of domestic debt, foreign pubic debt kept on growing further and as shown, foreign debt reached significant levels. There is a need to reverse the growth of foreign debt and shift meeting public sector borrowing requirements towards domestic sources. A close co-operation with the CNB is needed in this issue and the Central Bank should play a supporting role, managing closely domestic bank liquidity and introducing open market operations to facilitate the shift of government financing to domestic sources. While this may be more costly in the short-term, this structural shift should occur fast and will be beneficial in the longer-term.

## A MORE FLEXIBLE EXCHANGE RATE REGIME IN ROMANIA

The Romanian Central Bank (BNR) has moved towards a more flexible exchange rate regime by limiting FX interventions and abandoning real appreciation targets for the Leu. The move can be regarded as a milestone step towards opening up short term foreign capital inflows ahead of Romania's 2007 EU entry. The Central Bank also cut the base rate by 50 basis points to 18.25%, citing the recent fall of inflation.

Before the move BNR had a pre-announced appreciation course for the Leu, and the bank used frequent interventions under the managed float system (the target for this year was a 2-3% real appreciation). The Central Bank has never published the level of indicative currency basket and did not target the real exchange rate on a day-to-day basis. Leu has been convertible on the current account deals since 1998, but 80% of the capital account transactions are still permitted. On the way to the EU accession the Central Bank is obliged to withdraw the remaining restrictions by 2007 at the latest. EU Commission is pushing for an earlier liberalization and it seems that non-residents will be allowed to deposit money with commercial banks in Romania by the first quarter of 2005.

**BASE RATE OF NBR**



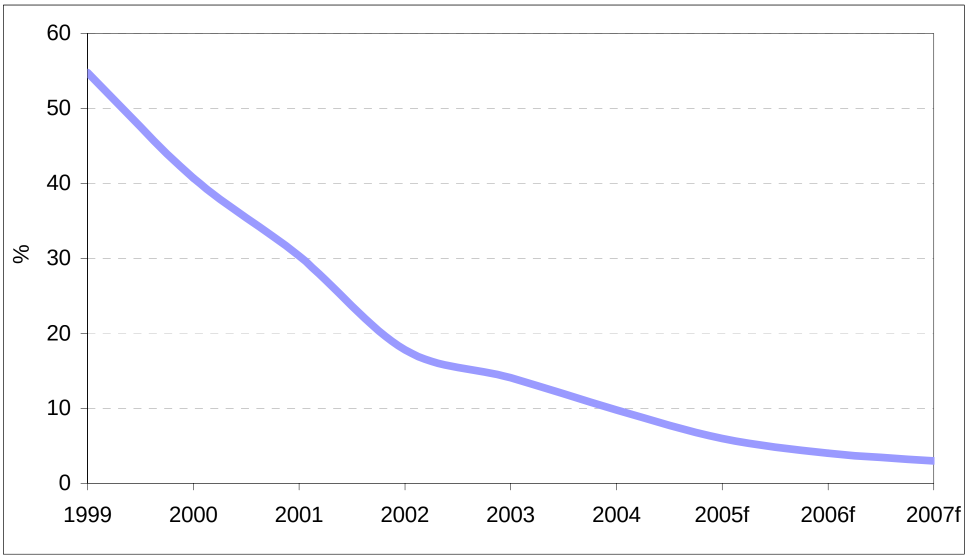

*Source: NBR*

Liberalizing the capital account makes inevitable to allow greater volatility of the Leu exchange rate. However, Romanian Central Bank needs to keep the key rate high in order to curb inflation, which is one of the highest in the region. The law of „impossible trinity" says that a small, open country cannot have both independent interest rate policy and fixed exchange rate, amid a liberalized capital market. As a result of these, Romania, just like the other Central Eastern European countries opted for a more flexible exchange rate system and planning to introduce the inflation targeting system in early 2005. The statement of the BNR says that „the greater flexibility of the exchange rate is complementary with the new monetary policy framework, and with the next steps in the capital account liberalization."

Despite the change of the policy framework BNR had not fully ruled out the possibility of the FX interventions. BNR Deputy Governor Cristian Popa referred to the new situation as a „hands off policy", and said that the narrower spread between the Euro and the Leu interest rates, together with greater volatility of the Leu would help to reduce the speculative inflows. BNR had also cut the base rate by 50 basis points to 18.25%. The Central Bank has already slashed the key rate by 250 basis points this year due to the ongoing appreciation pressure and the continuing disinflation.

Traders started testing immediately whether the new "hands-off" policy was already in place. Leu appreciated almost by 4% against the Euro, and short-term money market rates edged down to 17/18 from about 17.3/18.7% of the previous day. According to the traders everybody was anxious to see the level when the NBR would step in, but interventions did not take place on Tuesday, the day of the announcement. The Leu kept firming on Wednesday, November 3, and reached 39.430/450 versus the Euro in the late morning trade. According to some traders the NBR stepped in and brought the Leu back around the psychological 40.000 level. Others said that the swings were just due to the volatile trading, the Central Bank refused to comment whether there had been any interventions on Wednesday. Traders say that the high volatility is likely to remain, because the NBR did not prepare the market at all for the policy change.

**CONSUMER PRICE INDEX (1999-2007)**



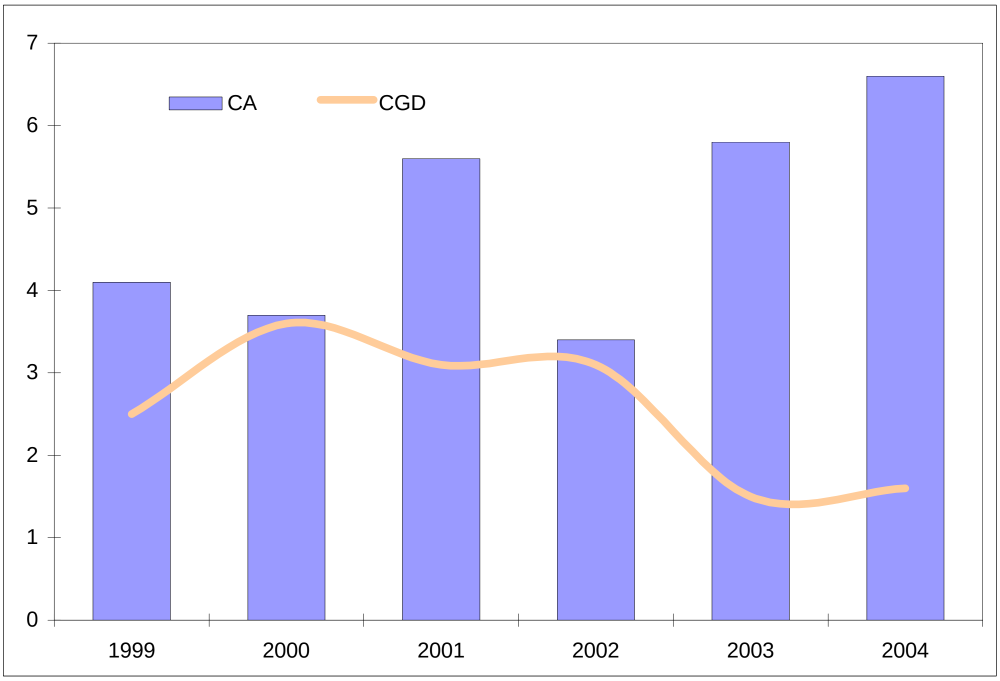

*Source: NBR; f: forecast*

NBR said that foreign inflows were already significantly higher in the first nine months of the year compared to last year's figures. Despite the fact that winter related imports usually reduce the hard currency surplus on the market, the Central Bank bought net 218 million Euros in October. NBR has increased its foreign exchange reserves by more than 3.5 billion Euros to 9.5 billion Euros since the beginning of this year. Following the policy change NBR indicated that interventions will be limited, but not completely scrapped in the future. Disinflation process will likely to rest on an exchange rate appreciation, since the transmission mechanism is based on the exchange rate channel, while the interest rate channel is rather ineffective.

Romania achieved significant results with its disinflation process in the past few years. Inflation has dropped to 11.1% in September compared to the 14.1% of the same period last year. Even though NBR will certainly not meet its 9% end year target, the inflation will not exceed 10% in 2004. Missing the target is due to the higher oil prices and the rising wages of the civil servants, Central Bank Governor Mugur Isarescu said. The central banker's comments were in line with the statements of the Finance Minister Mihai Tanasescu, who said that CPI was about to rise by 0.8% m-o-m on average over the last quarter of the year, securing a single digit inflation figure by the end of the year. NBR's inflation target for 2005 is 6%, and Isarescu added that the bank hopes to push inflation to 3% in 2007, after a 4% in 2006. The path looks quite optimistic, and the pace of the disinflation might be a bit enforced. Central Bank Governor referred to the Polish model, however the success of that model is not that obvious. In Poland the strong disinflation at the beginning of the decade caused severe losses for the real economy and contributed to the high unemployment. Disinflation process based on heavy nominal appreciation also showed its drawbacks in case of Hungary. Concerning future developments Mr. Isarescu said that private consumption was set to increase due to the growing lending and wages, while higher budget revenues would lead to the increase of the public consumption. „All horses are set to start running and we have to hold tight on the reins."

**CURRENT ACCOUNT AND CONSOLIDATED GOVERNMENT DEFICIT**

(AS % OF GDP, 1999-2004 )




*Source: NBR*

The biggest problem that could arise from the appreciation of the Leu is the deterioration of the current account. The current account developments have already caused severe problems, the deficit has shown little moderation this year. Romania promised the IMF to slash the shortfall to 5.5% of the GDP this year following last year's 5.8%. Despite NBR efforts to curb the private credit growth, the rate still remains high at over 40% in real terms. Current account deficit reached 1.8 billion Euros in the year-to-July, which meant a 25% increase compared to the same period last year. The main reason for the deteriorating current account deficit is the poor performance of the trade balance due to the high import growth, driven by the strong household consumption (up by 9% in the first half of the year). Romania's trade deficit already widened to 3.2 billion Euros over the January-September period, compared to the 2.4 billion Euros gap in 2003. Import rose by 23%, far outpacing the export growth rate. 90% of the Romanian export is raw materials or low value-added products, which could be severely hit by any significant appreciation. Textiles consisted 25% of the merchandise export in 2003, and the trade surplus of that sector improved significantly the overall trade balance. The competitiveness of the textile sector will likely to be challenged by the Chinese producers, and result in widening of the current account gap by 1.5% of the GDP in the near future. Current account developments will be crucial regarding the NBR's disinflation process, based on the nominal appreciation of the Leu. Fiscal policy has made a positive contribution so far, budget deficit target has been reduced to 1.64% of the GDP for this year and the government agreed to cut the deficit further to 1.5-1.6% of the GDP in 2005. Government also tries to contain the wage growth of the SOE. Since the government and the SOE generate 75% of the current account deficit, the recent measures could offset the negative impact of the real appreciation. However, the approaching parliamentary elections in the end of November could pose some risks for the prudent fiscal policy.

Making the exchange rate regime more flexible was a necessary move on the way towards the EU accession. However Romania will certainly face similar problems to the ones the CEE countries already experienced. Heavy inflows due to the convergence trade could cause significant concerns for the Central Bank, which is trying to push CPI down through higher interest rates. As the regional experience showed the viability of the inflation-targeting regime is also doubtful. The overwhelming appreciation of the Leu could cause further problems because of the external imbalances, however FDI inflow will likely cover the main part of the gap.