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CELEBRATING 50 YEARS WITH TWO NEW PROVOCATIVE MEMBERS

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Abstract

Romania and Bulgaria were admitted into the European Union. Their perspectives in the European Union depend mostly on their previous economic evolution and on their efforts to become European competitive economies. Given the political chaos that has taken hold in other eastern European countries, most of them much richer and stronger than the two newcomers, it is clear that the Balkan pair's road to EU prosperity and stability will be hard.

On 1st January 2007, Romania and Bulgaria were admitted into the European Union, after they have been made further progress with macroeconomic stabilization, economic reform and completed membership preparation. Their perspectives in the European Union depend mostly on their previous economic evolution and on their efforts to become European competitive economies.

Although united by weak institutions and their poverty, Bulgaria and Romania differ in size, history, politics and economic structure. Romania, with some 22 million people, is the second-biggest eastern European country after Poland. Bulgaria is just over a third as big. This could be a plus, as small countries' elites often work better. But Romania's political class has recently outscored Bulgaria's. Big countries also matter more to foreign investors.

Joining the EU has meant intense pressure to meet Brussels standards, which neither country yet does. The biggest worry is lawlessness. In Romania this takes the form of corruption; in Bulgaria, of organized crime. Criminal-justice systems are weak and high-level sleaze widespread. Romania has made more progress. Bulgaria has moved more slowly. Some politicians still seem untouchable, as do some organized-crime groups. A recent OECD study rates Bulgaria higher for investment promotion, but Romania higher on anti-corruption and business integrity.

Pre-accession period for Bulgaria

Bulgaria experienced a decade-long delay in its transition to a market economy. Its delay in proceeding with reforms left the country far behind other transition economies. In early 1997, the country experienced a severe economic and financial crisis. In July 1997, after several months of chaos involving a sharp decline in GDP and per capita incomes, the collapse of the banking sector, and a major foreign exchange crisis, Bulgaria

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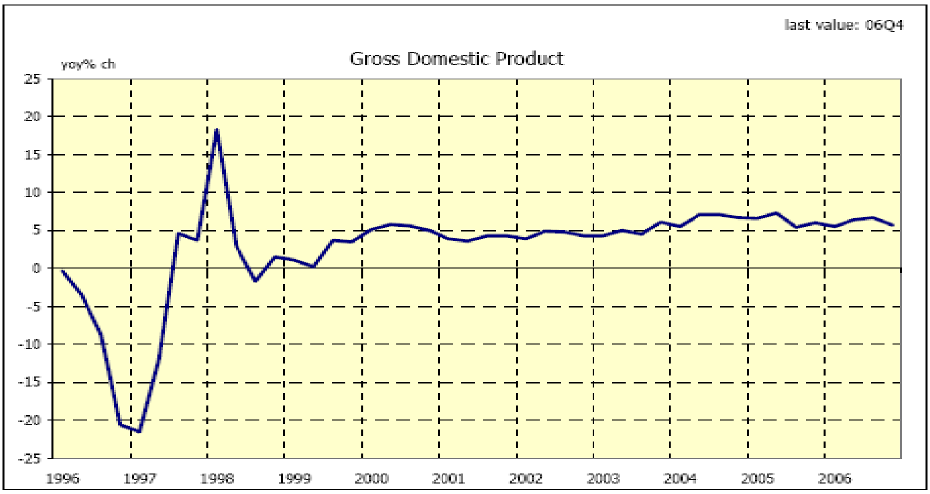
adopted a Currency Board Arrangement. The devastating effects of the economic crisis on the social conditions of the country placed considerable strain on many vulnerable groups, and poverty became a serious and widespread problem. In 1997, the year of the crisis, the government adopted a comprehensive economic reform program supported by international financial institutions and other development partners. Wide-ranging reforms included major trade and price liberalization, social-sector reform, and restructuring of the financial, enterprise, agriculture, and energy sectors, including the divestiture of state-owned enterprises. The implementation of the program lowered inflation, improved investor confidence and helped transform Bulgaria into a market economy.

Since 1997, the country has recorded sustained economic growth of more than five percent per year.



Note: yoy % ch - growth rate compared to the same period of previous year

Phase one of Bulgaria's structural reforms resulted in the private-sector share of gross value added to the economy reaching 79 percent in 2005. The financial system is now fully privatized.

Current government reforms build on the gains of the past six years and focus on promoting growth and reducing poverty. Accordingly, the government has embarked on a strategy of creating an investment climate that encourages private investment, increased productivity, and sustained growth.

Consumer price inflation, one of the most important indicators for Bulgaria’s accession at the Euro zone, remained at above 8% in the first and the second quarters of 2006, mainly due to the hike in excise duties on alcohol and cigarettes and also of a price overhang from oil and food price increases in the second half of 2005. As the impact of this higher oil and food price is starting to wane, inflation has started to fall since July 2006 at above 7% at the end of the year.

New social sector reforms are emphasizing the development of human capital to complement investments in physical capital. They include social-protection programs that target high levels of long-term unemployment and entrenched poverty.

Bulgaria's perspectives

Growth in domestic demand will ease slightly over the forecast period. This, together with the strength of the euro, will cause real GDP growth to slow from 6% in 2006 to an annual average of closer to 5% in 2007-08. Real GDP growth will slow further to an average of around 4% per year for the rest of the forecast period, as Bulgaria's poor demographic situation increasingly weighs on the economy's ability to expand quickly.

Increases in excise duty pushed up prices in 2006, but inflation is forecast to fall sharply in 2007 as a result of strong base effects, and more gradually in 2008-10.It's expected that Bulgaria to adopt the euro in 2010 or 2011. The current-account deficit is estimated to have risen close to 16% of GDP in 2006. It is forecast to decline gradually over the forecast period, as more moderate growth in domestic demand and lower oil prices lead to a slowdown in import growth. However, the deficit will still be around 10% of GDP in 2011.

As there is little scope for discretionary monetary policy under the currency board, excessive growth in domestic demand is the main economic risk. The BSP's desire to avoid a repeat of the 1996-97 economic crisis should ensure that fiscal policy remains cautious, although the size of the budget surplus is set to fall from the high level in 200

(3.8% of GDP). However, if domestic demand were to grow more strongly than expected, an even more restrictive fiscal policy might be required. If this should prove politically impossible and the current-account deficit increases further, doubts could arise about the sustainability of the currency board.

Key indicators	2006	2007	2008	2009	2010	2011
Real GDP growth (%)	6.0	5.4	4.9	4.4	3.7	3.8
Consumer price inflation (av; %)	7.3	5.6	3.3	3.0	2.8	2.9
Budget balance (% of GDP)	3.5	2.0	1.4	1.2	1.0	1.0
Current-account balance (% of GDP)	-15.7	-13.4	-12.7	-11.7	-11.0	-9.8
Short-term central interest rate (av; %)	2.9	3.8	4.0	4.0	4.0	4.0
Exchange rate Lv:US$ (av)	1.56	1.46	1.44	1.51	1.54	1.55
Exchange rate Lv:€(av)	1.96	1.96	1.96	1.96	1.96	1.96

Pre-accession period for Romania

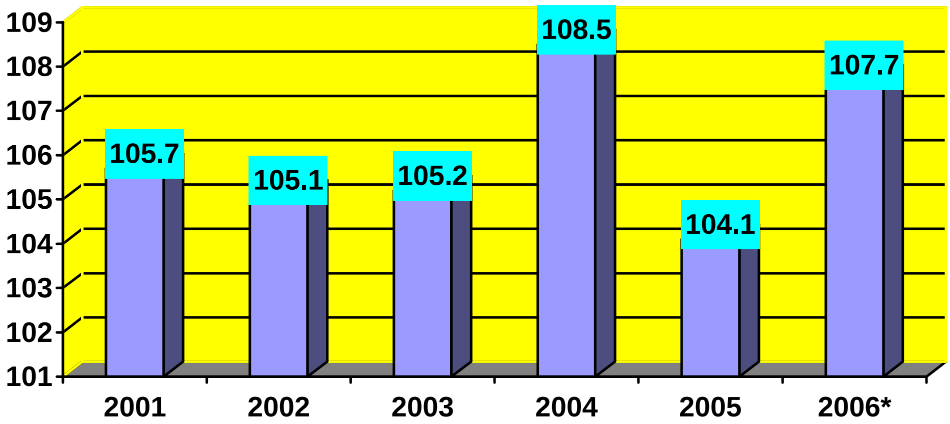
Romania's transition, which started in 1990, was more difficult than that of the other CEE countries in many respects. By the late 1980s, Romania’s economy was on the verge of collapse after 40 years of rigid central planning that emphasized self-reliance, an excessive focus on heavy industry, and large, inefficient infrastructure projects.

In an attempt to minimize the social costs of transition and often to placate vested interests, the Romanian government initially hesitated to impose tight fiscal constraints and to privatize large loss-making enterprises. In the late 1990s, attempts to impose macroeconomic stability without full structural support led to negative economic growth and to doubling of the poverty rate from 20 percent in 1996 to 41 percent in 1999.

Since 2000, the government has implemented macroeconomic policies which are supportive of growth. A disciplined fiscal policy, which complemented a tight monetary policy and was augmented by strong advances in structural reforms, led to improved financial discipline in the enterprise sector and has placed public finances and the financial system on much firmer footing.

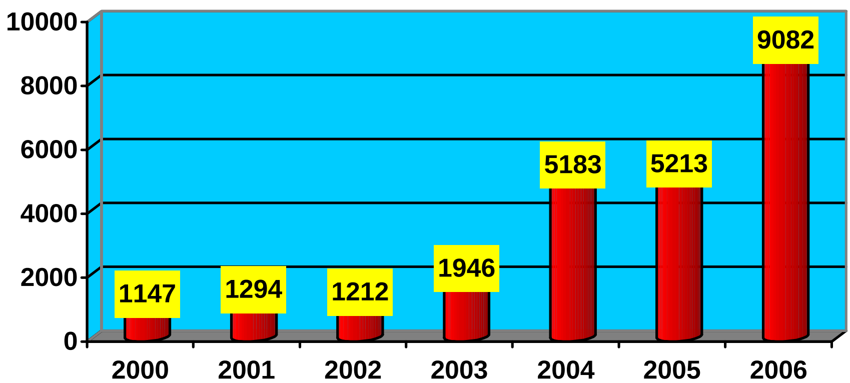
These improvements resulted in robust GDP growth for five consecutive years. In addition, inflation and interest rates declined steadily, the fiscal deficit was brought under control, foreign exchange reserves increased to historic highs, and external debt was held to comfortable levels. Export growth remained vigorous, fuelled by private investment and the initial competitive depreciation of the lei currency. The competitiveness of the enterprise sector was boosted by productivity gains.

GDP evolution for Romania



Romania is now a visible and attractive destination for international investors as a result of better sovereign ratings and improved access to international capital markets. As a result, after two years of stagnation (2004, 2005) the FDI value increased from above 5.000 million Euro to 9.000 million Euro. In Bulgaria, Foreign direct investment reached a record high of € 2400.4 million in 2005, corresponding to 11.2% of GDP.

FDI in Romania mil. Euro



Source: Romanian National Bank

Romanian economic policy will focus in the short term on the remaining large privatizations, restructuring the energy sector and investing in health, education and infrastructure. Fiscal consolidation will become more important after 2008, once the parliamentary election is out of the way, as the authorities seek to contain external deficits.

Strong domestic demand will result in real GDP growth of 6.4% in 2007, following estimated growth of 7.7% in 2006. Growth is expected to average more than 4% per year in 2008-11. There will be a slowdown in 2010-11, owing to efforts to bring down inflation, as Romania strives to meet the criteria for euro adoption, although Romania is not likely to enter the euro zone until around 2013-14.

The perspectives for Romania

It is expected a further rise in the current-account deficit in 2007-08, and a modest decline thereafter to just over 10% of GDP by the end of the forecast period. Coverage of these deficits by foreign direct investment (FDI) will decline markedly after 2007, increasing Romania's dependence on the international capital markets.

Key indicators	2006	2007	2008	2009	2010	2011
Real GDP growth (%)	7.7	6.4	5.6	4.4	3.8	3.7
Consumer price inflation (av; %)	6.6	4.4	4.6	4.0	3.2	3.0
General government budget balance (% of GDP)	-1.7	-3.0	-3.0	-2.2	-2.1	-1.6
Current-account balance (% of GDP)	-10.9	-12.3	-12.9	-11.7	-11.3	-10.5
Commercial bank lending rate (end-period; %)	13.5	15.0	12.6	11.0	9.0	8.0
Exchange rate Lei:US$ (av)	2.81	2.61	2.62	2.65	2.68	2.66
Exchange rate Lei:€(av)	3.52	3.47	3.54	3.43	3.40	3.35

Human development in these two countries

As a result of this solid economic growth, the unemployment decreased in the last five years at above 5% in Romania and 10% in Bulgaria, but it is necessary to take into consideration the relative high level of emigration encouraged by low pay, poor working conditions and bad public services witch may create serious problem. As many as 2,000,000 Romanians and 800,000 Bulgarians live abroad. Entry into the EU may stimulate emigration, though most existing members have slapped on temporary labor-market restrictions. That is partly because immigrants from Poland and other countries were more numerous than expected. EU member states such as the UK and Ireland, which had previously pursued an open-door policy with respect to immigration from new member countries, have imposed restrictions on migrant workers from Romania. This may turn out to be a blessing in disguise for Romania, which already faces labor shortages in some sectors. In order to minimize the macroeconomic, demographic and social negative effects of the emigration, both countries should implement coherent policies.

In order to have a complete view about the quality of life in these two countries it's interesting to compare their Human Development Index, a comparative measure of life expectancy, education and standard of living for countries worldwide. Taking into consideration these criteria, Bulgaria is on the 54^{th} place with HDI of 0.816 and Romania on the 60^{th} place with an index of 0.805, both countries falling into the first category of countries with a high human development which includes 62 countries.

A low evaluation of the quality of society in Bulgaria and Romania has its roots in the economic, social and political context of these two countries. The countries' transition has led to profound changes in economic and social structures, which are often associated with negative processes such as a weakening of social control, increased crime, widespread corruption, and greater income inequalities and polarization. All of these factors, in turn, seem to have affected the feelings of people in Bulgaria and Romania in relation to the quality of the society in which they live

The accession of Bulgaria and Romania opens new opportunities for Europe, but also significant challenges. The EU of 27 Member States will become even more heterogeneous in terms of cultures, political traditions, level of economic development and living conditions. The research has revealed large discrepancies in quality of life between the two candidate countries and the EU25, especially with regard to material living conditions, quality of employment and working conditions, health and subjective well-being.

Challenges

Bulgaria faces a number of challenges, such as the following:

- *Increasing employment opportunities.* Reducing unemployment based on private sector-led growth requires a better business climate for job creation, improved skills among the population through education and training, increased labor-market flexibility, and the implementation of well- targeted employment services.
- *Improving governance.* Weak governance is limiting investment and constraining the business climate. Governance needs to be improved through aggressive implementation of anti-corruption measures, public administration and judiciary reform, and the strengthening of local government.
- *Modernizing education and health services.* Like many transition countries with aging populations, inadequate delivery systems, and excess infrastructure, the modernization of education and health services poses a major challenge. Substantial reforms and investment in the education and health sectors will be required to reverse the deterioration in social indicators and to improve Bulgaria's competitiveness.
- *Investing in physical infrastructure.* Strengthening transport infrastructure would enhance Bulgaria's competitiveness. Management and delivery of water, management of waste water and waste services should be improved at the municipal level.
- *Tackling poverty.* Despite overall poverty reduction, pockets of poverty persist among certain groups, particularly the unemployed, the ethnic minorities (mainly the Roma), and large households. While the growth agenda is expected to have a positive impact on poverty, accompanying initiatives to address regional disparities, increase employment, and improve the living standards of vulnerable groups through targeted poverty interventions will be needed to mitigate the impact of reforms.
- *Improving external balances.* Large current account deficits over the past five years are likely to continue. A continued inflow of foreign investment is needed to finance the current account deficit and sustain an adequate level of reserves.

As Romania strives to alleviate poverty and to meet its EU integration commitments, it faces a number of challenges, such as the following:

- *Accelerating structural reforms.* Key challenges include completing the privatization agenda, improving the business climate by eliminating administrative barriers, and implementing a transparent, predictable and efficient tax system. These reforms are aimed at enhancing revenue collection in order to co-finance the absorption of the EU Structural and Cohesion Funds that Romania would receive after accession.

- *Reforming public institutions and improving governance.* Public services need to be delivered in a manner which benefits the population. This can be achieved through the development of a merit-based civil service that is adequately remunerated. A supportive legal and regulatory framework is also necessary.
- *Reforming the legislative process and the judiciary.* In the past, reforms were impeded by frequent changes in legislation and the lack of capacity to implement new laws. It is therefore essential to streamline existing legislation and develop an effective system to pass new laws. In addition, the professionalism and integrity of judges must be enhanced and the independence of the judiciary strengthened. The judicial process also needs to be improved through greater speed and efficiency in the courts.
- *Reforming the pension system.* Despite recent parametric reforms, the public pension system faces significant challenges deriving from the aging of the population, the demographic structure, and poor revenue collection performance. Further reforms are needed to ensure medium and long term financial sustainability and higher pensions.
- *Developing rural areas and reducing poverty.* With the majority of Romania's poor living in rural areas, agricultural sector reforms are essential to reduce the country's high levels of poverty. Although Romania has fertile agricultural land, vast tracts of forest and a rich network of rivers, its rural areas suffer from inadequate infrastructure and inefficient agricultural production. In addition, access to education and social services in these areas must be improved.
- *Reforming the energy sector.* Although energy sector reforms have been impressive, the restructuring should continue mainly in the generation sector. The privatization of electricity generation companies has been delayed, affecting the sector efficiency and the competitiveness of the power sector within the European market.

The European Union is increasingly being characterized by a variety of economic, social and cultural differences among its Member States. Thus, an important focus of EU social and economic policy is to foster economic and social cohesion in order to reduce the inequalities that are currently visible across Europe, lowering the gap between older and new Member States with respect to living and working conditions.

Romania has the advantage of size, demography and newly confident elite that wants to put the country on the map of Europe. Bulgaria has a stronger industrial base. But given the political chaos that has taken hold in other eastern European countries, most of them much richer and stronger than the two newcomers, it is clear that the Balkan pair's road to EU prosperity and stability will be harder. The only question is how much.

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