ROMANIA

Bucharest battles against the crisis

The austerity programme has hit hard but IMF support appears to have stabilised the currency

State employees shout anti-government slogans as they protest at a law that sharply cuts their wages AFP

There is more elbow-room in the upmarket night clubs of northern Bucharest than this time last year. Flashy bars spent recent years competing to outdo each other in opulence. One installed chandeliers, another hired international DJs, until a third outdid them by installing a swimming pool. They came to symbolise the extravagance of Romania's boom years.

After decades of oppression under Nicolae Ceausescu, the communist dictator, the 1990s were a time of disorder and wasted opportunities, when the country missed out on the foreign investment that buoyed its central European neighbours.

When the boom finally came, young professionals oin Bucharest had more money than ever before. As newly-arrived banks, manufacturers and property investors sent salaries and real estate prices soaring, people flocked to these self-consciously extravagant places, often spending sums that would make Londoners blush.

That was then. The country has suffered badly in the fallout from the credit crunch. Household lending, which had been growing at 60 to 80 per cent a year over the past three years, collapsed as markets lost confidence in the banks' ability to continue the credit expansion. Exports fell sharply, and the economy shrank 6.2 per cent year-on-year in the first quarter of 2009 and was down 8.7 per cent in the second, losing all the gains it had made during the final half of 2008.

However, while there may be more room, the clubs are far from empty: Romania may have turned to the International Monetary Fund and the European Union for a €20bn bail-out in the spring, but it seems to have escaped the worst effects of the crisis. "I'm reasonably optimistic about the numbers," says Dominic Bruynseels, chief executive of BCR, a subsidiary of Erste Group, the Austrian bank.

Industrial production has risen slightly, he notes, and with an IMF package in place to stabilise the currency, a degree of certainty has returned to business planning. But 2009 is still going to be tough.

By the government's own estimate, the economy could shrink 8.8 per cent overall this year and the projected budget deficit, after several revisions, is now expected to hit 7.2 per cent. Others are more pessimistic.

Liviu Voinea, a partner at the Group for Economic Analysis, a think-tank, says: "We had the largest GDP growth in our history last year, and now we are falling from the peak. We could fall 10 per cent this year."

When the crisis passes, the factors that made the country an attractive investment destination will remain. With a population of 22m, Romania has a GDP per capita of 15 per cent of the EU average, compared with 25 per cent in Poland and 35 per cent in Hungary. Its domestic credit levels are also low, at 42 per cent of GDP against 7 per cent in Poland.

It is the second largest of the EU's new member states and has an under-developed market: the country has just 167 passenger cars per 1,000 population, compared to 351 in Poland and 566 in Germany, leaving plenty of room for growth. The €30bn in funding that the EU intends to provide before 2014 should help.

Even if it proves to be a temporary dip, the end of the boom came at a bad time for the man most closely associated with it – Traian Basescu, the president. He will probably stand for re-election in November after completing one five-year term.

An impulsive and divisive figure, he made himself popular at home and abroad with his strident talk of getting to grips with corruption. But along with much of the political class, he lost credibility after insisting the country would not be affected by the crisis and would not need to turn to the IMF.

He remains the favourite to win, but many business leaders privately express the hope that a less impetuous successor might produce some stability. Yet even his challenger, the social democrat Mircea Geoana, acknowledges that any successor will have to be as frenetically activist as Mr Basescu.

"He changed the character of our republic for good," says Mr Geoana, who argues that the "pro-cyclical" policies of the past five years have left the country more indebted and in worse shape than is necessary.

With elections imminent, the government, a grand coalition of Mr Basescu's democrat liberals and Mr Geoana's social democrats, has little room for manoeuvre. Led by Mr Basescu's ally, Emil Boc, as prime minister, it is struggling to implement the spending cuts demanded by the IMF.

Inevitably, this is not a pain-free process. Although public sector protests have been relatively muted, one group with the power to create trouble has done so. Despite a consensus among legal experts that their action is illegal, judges have laid down their gavels in a court strike that started at the beginning of the month. Lidia Barbulescu, president of the supreme court, says the conditions under which judges have to work are a "humiliation" and that proposed public sector pay cuts will merely make conditions worse.

Mr Voinea worries that without real structural reforms, Romania will emerge limping from the crisis. "Our backs are to the wall," he says, adding that the public-sector wage bill has to be cut severely.

An inefficient public administration has difficulty co-ordinating investment projects, meaning that years of boom-time earnings have been squandered on salaries and consumer spending. The country still has only two motorways, at a time when businessmen say poor infrastructure puts the country at a disadvantage.

There are a number of signs that the government is having trouble paying its bills: Small businessmen complain that tax inspectors are over-reaching in their eagerness to raise revenue, while banks report that small business clients are being driven to the brink of bankruptcy by long delays in VAT reimbursement – although the government says a computer system has speeded things up.

Mugur Isarescu, governor of the National Bank of Romania, says: "Economic growth was based in large part on a high level of imports, which created huge VAT revenues. But if imports fall 50 per cent, revenues will fall sharply."

The IMF is satisfied with the progress Romania has made since signing up to a two-year support programme in March, although the ride has been rougher than anticipated.

"The government is making progress on the economic programme. The targets had been met at the end of June, but additional budget adjustments are needed because the recession was deeper than most people expected," says Tonny Lybek, country director for the IMF.

Nonetheless, perhaps bowing to the inevitable, the IMF has agreed to transfer its next tranche of funding directly into the cash-strapped finance ministry's accounts, rather than channelling it through the central bank, as is customary.

Mr Isarescu says: "It doesn't make much difference, because it ends up in an account at the central bank anyway, but it makes it much easier."

Dorel Sandor, a public affairs consultant, says the government has performed acceptably, given the financial constraints and the upcoming elections: "Mr Boc is a good caretaker, and that's not a bad thing in a crisis."

For some, though, the prospect of a few hard years is salutary. Dan Pascariu, chairman of the Romanian subsidiary of Unicredit, the Italian bank, says: "This younger generation, who were children until the revolution [against communism in 1989], have seen only growth in their adult lives.

"I see in them a sense that they deserve and know everything. This cold shower is welcome, because we're learning crisis-management."

This report was written by Thomas Escritt, the FT's correspondent in Bucharest

State has few options in face of judges' strike

JUDICIARY

There is unrest in the court system as the government moves to cut its spending

When Romania's government announced a package of pay reforms to cut public sector wages, nobody was surprised when employees threatened industrial action.

But it still came as a shock when the Supreme Council of the Magistracy, the professional organisation and regulatory body that represents Romania's judges actually followed up on its threat after securing for themselves legal rulings that they were entitled to a pay rise.

Most experts regard the strike, which began on September 1, as illegal, but with the courts not sitting, there is little chance of a ruling.

Laura Stefan, a legal affairs expert at the Romanian Academic Society, a thinktank, says: "If the police strike, then the courts can rule that it's illegal. There's nobody to rule on the illegality of the judges' strike."

Since the strike began, most judges have refused to preside over low-priority cases that do not involve minors or arrests.

The judges are striking over the effects of a public sector pay law introduced to deal with the hole in Romania's public sector finances. The government is seeking to implement this law with the encouragement of the multilateral lenders behind a €20bn bail-out package it signed last year.

The unitary public sector pay law will tie all public employees to a wage scale defined in terms of multiples of a base salary of 700 Romanian lei (€165) a month. The scale tops out with the president's salary, at 12 times the base wage.

"It's a blunt instrument," admits one official involved in the bail-out package, "but with elections coming up it's no use just warning the government to cut wages. If the government makes a soft commitment, then nothing will happen."

But the case of the country's judges is particularly sensitive. For years, Romania has been under pressure from the European Union to improve the quality of its judicial system in the fight against corruption.

Successive governments have strengthened the judiciary, increasing its independence from the justice ministry and raising the pay of judges and prosecutors to the point where they are among the best-paid public employees.

Currently, a starting judge earns some €600 a month – comparable to the pay of a senior emergency doctor, and more than a university professor.

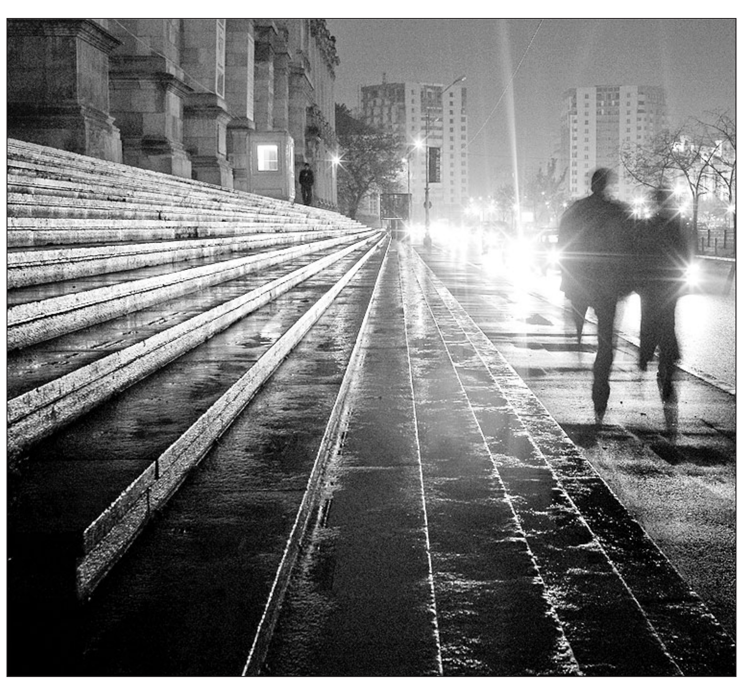
Until 2000, judges also participated in a scheme under which public employees received salary top-ups to compensate for burdens specific to their jobs. Under the scheme, officials required to respect confidentiality as part of their work were entitled to a specific bonus, as were those whose job involved particular levels of stress. Until recently, even using a computer as part of a job merited a specific top-up.

The bonuses, which were introduced during the 1990s as private sector pay began to outstrip that of public employees, have contributed to significant public sector wage inflation – the public wage bill grew 86 per cent over the past three years.

Since 2000, when top-ups for judges were abolished as their salaries began to outstrip those of the rest of the public sector, individual judges have sought rulings from their colleagues saying that their exclusion from the bonus system amounted to discrimination.

> The judges' unique position in society leaves the government with few tools at its disposal to resolve the conflict

Collectively, the Supreme Council of the Magistracy, with the support of the judges of the country's Supreme Court, are demanding back-payment of the salaries in full.



Scant justice: the Supreme Court (above) will hear only urgent cases

Catalin Predoiu, the justice minister, has pledged that the back-payment claims will be met, though not immediately.

Payment of the judges' claims in full would cost about €3m, at a time when the government is forecasting a budget deficit of 7.2 per cent for this year against a backdrop of an economy that could shrink by as much as 10 per cent.

Matters are complicated by the fact that the most senior judges, those on the Supreme Court and the Supreme Council of the Magistracy, have already had their claims met, since their budget comes directly from the finance ministry and not from the embattled justice ministry.

As Ms Stefan says: "We have a situation where the best-paid judges are getting all they ask for, while the lowest-paid are getting nothing."

Lidia Barbulescu, the president of the supreme court, says that the spectacle of judges ruling on their own compensation levels only creates the "appearance" of a conflict of interest. "Judges didn't rule on their own situation personally. We tried to solve this misunderstanding in a decent manner."

She argues that the judiciary needs to be given independent control over its own budget to avoid similar conflicts in the future.

The judges' unique position in society leaves the government with few tools at its disposal to resolve the conflict.

Mr Predoiu says: "All we can do at the ministry of justice is talk to them, show them our arguments. All the powers share responsibility for the good functioning of the state. The top of the legal profession has to understand our needs as well as those of the judicial system."

Old skills needed in tougher times

BANKING

Many senior bankers are convinced that the bursting of the bubble was for the best

After three years of breakneck growth, Romania's bankers are having to relearn old skills to cope with the more difficult environment.

In the latter years of its post-millennium boom, Romania – with an economy growing at 8 per cent a year, low levels of banking penetration and a credit-hungry domestic market of 24m people – looked an irresistible target to western European banks. They wanted their share of the profit from Romania's gradual convergence with the European Union.

Between 2005 and 2008, the banking system grew by about 1,000 branches each year, and the banks hired some 20,000 people each year to work in them. At the peak of the boom, Portugal's Millennium Bank planned a €300m spending spree to enter the market from scratch with 100 new branches.

That optimism may have vanished but many senior bankers are convinced that the bursting of the bubble was for the best.

"It's a good thing when you realise that you have to rationalise and cut costs. It was unhealthy growth and an unhealthy mentality," says Dan Pascariu, chairman of Unicredit Tiriac, the Italian bank's Romanian subsidiary. "The approach to risk management in the sector has changed. Sellers have had to turn themselves into restructurers, and they are starting to see the other side of the business. When they sell in future, they'll know the other side of the coin."

The slowdown also put paid to wage inflation; at one point, competition for staff was so intense that some staff in head offices were earning more than their counterparts in Austria. Retrenchment followed.

Dominic Bruynseels, chief executive of BCR, the largest Romanian bank, owned by the Austrian bank Erste Group, says: "At the end of last year the workforce did announce a strike because of our offer to link Christmas and holiday bonuses to the bank's performance." Staff eventually accepted the offer.

This sober assessment stands in sharp contrast to the alarm with which many analysts regarded central and east Europe's banking systems in the first quarter of this year, when collapsing exchange rates led many to expect borrowers to default in droves on loans made in foreign currencies. Some forecast that mother banks in western Europe would come under strain as they were forced to prop up their eastern subsidiaries as they experienced a sharp rise in non-performing loans.

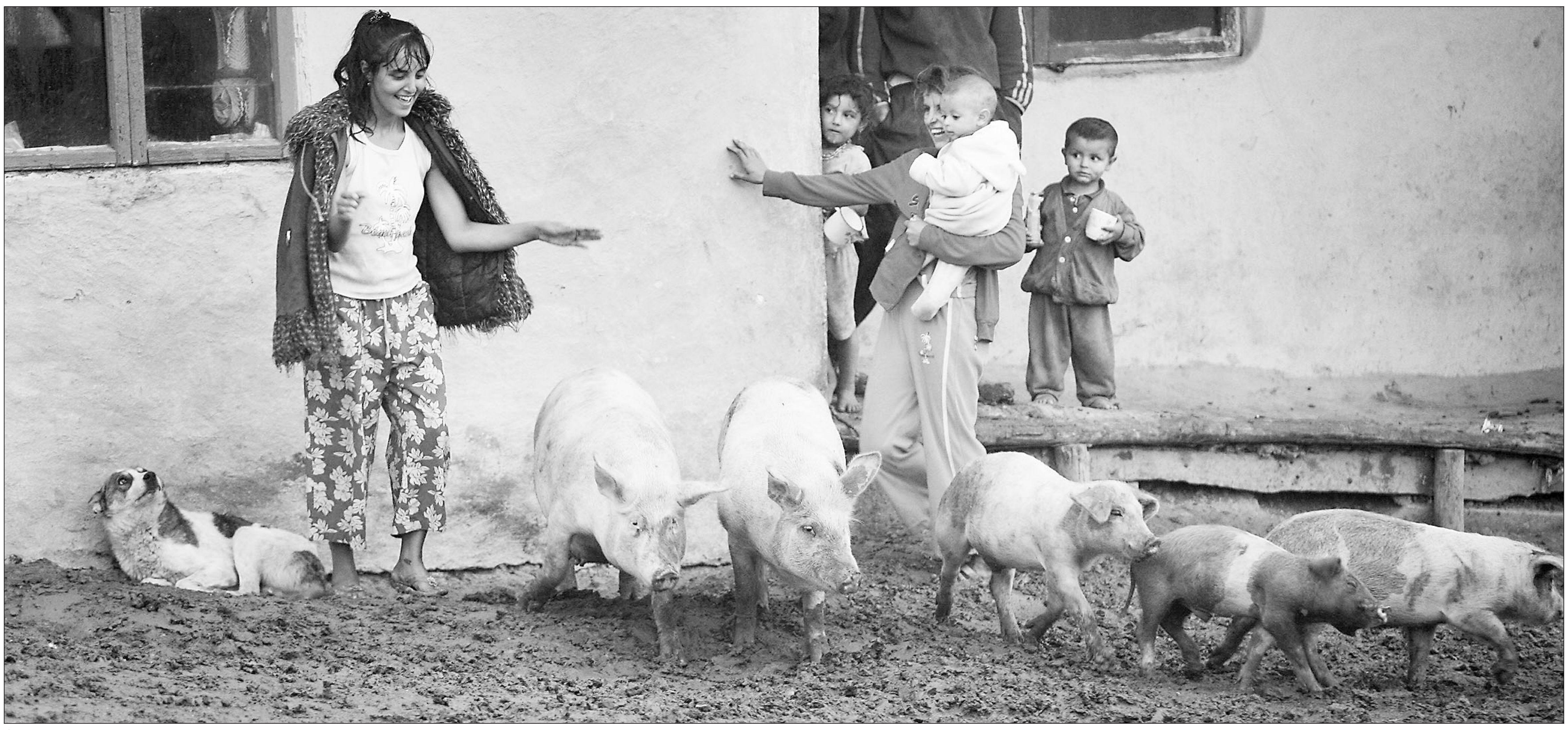
In the event, only Israel's Leumi Bank, one of Romania's

Continued on next page

Foreign investors are bullish about pigs

AGRICULTURE

Banks are showing growing interest in extending loans to competitive farmers



Subsistence farming: renewed interest from investors in the agricultural sector has not yet brought prosperity to the 4m smallholders

Getty

Everybody is talking about farming, with bankers, politicians and businessmen extolling the virtues of a homespun sector that should be an area where the country has a genuine competitive advantage.

Mircea Geoana, leader of the Social Democratic Party and its candidate for president in elections to be held in November, says: "We have enormous potential in agriculture and yet we are importing 70 per cent of our agricultural products."

"Our agricultural land could feed 80m people," his adviser chimes in, reinforcing the new pride Romanians are taking in a sector that looked stodgy and unexciting during the boom that ended with the onset of the financial crisis last autumn.

The government, a coalition between the Social Democrats and the right-leaning Democrat-Liberal Party, has taken up the chorus, with Cristian Diaconescu, the foreign minister, recently announcing that Romania should seek to win the agriculture portfolio when the new European Commission is appointed this autumn.

Part of the enthusiasm stems from an increasingly desperate hunt for returns in a tougher economic environment. Last summer saw the end of an eight-year asset price boom that began with the millennium and lasted through accession to the European Union in 2007.

At its peak, land and property prices in Bucharest hit levels not far off those to be found in wealthier western European capitals.

Meanwhile, other sectors, from automotive components to banking, were attracting investment on an ever greater scale. In 2007, Erste Group, the Austrian bank, paid almost €7bn for BCR, a leading Romanian commercial and corporate bank, while manufacturers such as Dacia, a Renault subsidiary, were fostering a growing list of component suppliers.

Against this backdrop, Romania's rickety agricultural sector, with only 35,000 farms large enough to be run as agribusinesses and attract EU subsidies and a further 4m near subsistence-level smallholdings looked distinctly unappealing during the good years, for investors, lenders and employees alike.

But this year, with an austerity programme in place as part of the country's bail-out deal with the International Monetary Fund, the real estate market frozen, and many employers struggling, investors and lenders are taking another look at the neglected sector.

Increasingly, banks are showing an interest in agriculture. Unicredit Tiriac, the Italian bank's Romanian subsidiary, has moved from lending little to agricultural producers last year to setting up a department targeting agribusiness this year.

Dan Pascariu, a banker and entrepreneur, is clear that the hunt for better returns is driving this enthusiasm. "Agriculture wasn't sexy. The yields weren't good enough, but today agriculture is a competitive advantage [for Romania]."

> The challenge is not to make small farms more efficient but to make them market participants

He adds: "Though the sector has a very atomised ownership structure, all banks are taking a fresh look at it because of the tremendous potential and the flow of EU structural funds."

Mr Pascariu has put his own money where his mouth is.

The business case for his pig farming business is straightforward: "Romania imports 4m pigs a year, and yet pork is a staple," he says. "We have 70 farms, producing entirely to meet domestic demand, and there is enough demand for another 80."

Despite the high interest rates they are paying on loans, the farms are profitable. But it will take more than capital to build a secure future for Romanian agriculture. Gabriel Popescu, an agricultural economist at Bucharest's Academy of Economic Sciences, points out that capital investment is only relevant to producers with a connection to the market.

"The 4m subsistence farms are closed systems," he says. "They produce for their own consumption. These smallholdings produce only for their own subsistence, meaning nobody has any interest in their efficiency.

Capitalisation is only relevant for the 35,000 farms large enough to count as agribusinesses. The challenge for public policy is not to make the smallholdings more efficient, but to open the system and make them market participants."

The 4m smallholdings are cut off from the market and too small to be eligible for EU funding, making them a challenge for social, not economic policy, he adds.

But, whatever the current political enthusiasm for the sector, the government should tread carefully, he says: "We've had three agricultural reforms in the past 20 years, when co-operative farms were created in 1991, when state farms were privatised in 2000, and when we joined the EU in 2007.

"Each reform is like surgery and it takes 15 years to recover."

Meanwhile, large forces, such as the US livestock farmer Smithfield, remain bullish about the country.

"Once, Romania was known as the breadbasket of Europe," the company says. Smithfield, which has annual sales of $145m, has invested $600m since arriving in the country in 2004, and has just announced a further $35m greenfield investment in pig farming.

Contributors

Thomas Escritt
Romania and Hungary Correspondent

Tom Griggs
Commissioning Editor

Steven Bird
Designer

Andy Mears
Picture Editor

For advertising details, contact:

Marylou Gregorecu on:
+40 21 224 2270;
fax: +40 21 224 2295;
e-mail:
marylou.g@actionprgroup.com
or your usual Financial Times representative

Logan's run: success of Dacia has attracted Ford to invest in the country

In the run-up to Christmas, the production lines at Dacia's car factory in Pitesti were shut down for periods totalling a month, as demand collapsed in Romania and abroad.

In 1999, when France's Renault bought Dacia, the then-ailing state car company, the outlook looked bleak for Romania's manufacturing sector, which had not attracted western investment on the scale of nearby countries such as Hungary or the Czech Republic.

Starting from the premise that there was a need for a car tailored for developing countries that was easily user-serviceable and had raised suspension needed for dealing with rough roads, Renault set about manufacturing the Logan, a car that would sell for as little as €5,000.

The Renault subsidiary saved the Romanian auto industry and was producing 1,340 vehicles a day at its peak last year; but when the downturn came, and domestic demand fell 60 per cent year on year in the final quarter, production was suspended for weeks on end to adjust stock levels to the grimmer circumstances.

Salvation came in the form of west European car scrapping schemes. When the German government introduced a €2,500 rebate to bolster flagging car demand during the downturn, its aim was to support the German car industry. But Dacia proved an unexpected beneficiary when consumers realised the rebate could spare them as much as half the price of a new Logan. Export demand soared and, after spending much of the winter at home on 80 per cent pay, the company's workers are now back in the factory, which is once again running at full capacity.

Whereas before, Dacia was producing the Logan primarily for the domestic market, it can now be seen driving on the streets of western Europe.

Dacia production line

"Some 85 per cent of our production is for export now," says Francois Foumont, the company's general manager. Germany accounted for 40,000 sales in the first six months of this year, France for 25,000, while only 23,000 were bought in Romania. Last year, Dacia had revenues of €2.8bn, accounting for some 2 per cent of the country's gross domestic product.

Over the past two years, Romania has come a long way in catching up on the investment it lost to richer central European neighbours in the 1990s. In September, another milestone was passed with the arrival of Ford, the US carmaker, which bought a state-owned plant in the southern city of Craiova, where it plans to manufacture a new Transit van and, eventually, a new budget car, details of which are still under wraps.

Romania's emergence as a manufacturing centre, however, has not been without problems. The western city of Cluj was confident of being chosen as the site for a new Daimler plant last year – before being pipped at the post by Hungary. In the end, analysts reckoned the neighbouring country's better-developed motorway network made the difference.

The core western European markets are still as much as 20 hours away from Romania by road. And this shortage of infrastructure is the biggest complaint of the two car manufacturers.

"It's a problem wherever we go," concedes Nadia Crisan, of Ford in Romania. "[But] in Romania, roads are the number one priority at this point."

But Dacia's and Ford's wishlist – which includes new roads linking Craiova, Pitesti and the capital, as well as improved rail links and upgrades to the port of Constanta – may take a while to be fulfilled.

With an eight-year boom behind it, the country still has only two motorways and little progress has been made on the Transylvania Highway, which would bring Bucharest to within eight hours of Vienna, after five years of construction. At a time of recession and IMF-imposed cuts, little progress is expected in the next few years.

But if an underdeveloped infrastructure remains a deterrent to some investors, the two existing foreign investors remain confident enough to invest further. Dacia plans to launch a four-wheel-drive version of its Logan in 2010, and is investing €160m in a new research and development site in Romania that will allow it to move its vehicle testing from France to Romania, and Mr Foumont remains optimistic about the sector's future.

"Ford's arrival proves what Dacia has being showing: that Romania is a real industrial country."

Together, he hopes, the two manufacturers will be able to press for improvements to the country's infrastructure.

Old skills needed in tougher times

Continued from previous page

smaller banks, chose to withdraw from the market.

"None of the established banks will withdraw," says Mr Pascariu, "although we might see some mergers".

There is still room for consolidation. While the Royal Bank of Scotland was unable to find a buyer for its Romanian subsidiary, bankers privately agree that larger forces are likely to buy up some of the smaller banks when the price is right.

Others, however, fear that banks have become too cautious. Mugur Isarescu, governor of the National Bank of Romania, says: "Some foreign-owned subsidiaries moved in a direction they discovered to be unstable, relying on credit lines from the mother banks, so now they are more focused on extending their deposit bases than on extending credits. It was an over-reaction.

"They were too generous before the crisis and today they are too pessimistic, and it will take some time to find a way of addressing the issues properly."

But Mr Pascariu dismisses suggestions banks have cut lending. "There is a myth about the banks not lending, but demand for lending has fallen by 90 per cent for retail and by 50 per cent for corporate customers," he says.

This is in part a reflection of the struggles of the customer base. With small and medium-sized enterprises suffering, few are looking to raise new finance.

"The small and medium enterprise base in particular is suffering – there has been a big rise in non-performing loans," says Mr Bruynseels.

The level of non-performing loans among SMEs has risen steadily this year, hitting 2.9 per cent as a share of lending to non-bank clients in July, according to the central bank, up from 1.4 per cent last December.

Mr Pascariu expects this level to continue rising, topping out at 6 per cent.

However, both he and Mr Bruynseels insist the sector has the liquidity to cover even that contingency. "We have no issues with liquidity," says Mr Bruynseels. "Our credit line with Vienna has remained the same."

A decision by the central bank to cut the minimum reserve requirements for lending in foreign currency from 40 per cent to 30 per cent has created further liquidity – although much of that has been absorbed by a club loan made by Romania's commercial banks to the government.

"The IMF loan restored central bank reserves to a pre-crisis level and allowed us to ease reserve requirements," says Mr Isarescu. "Part of the money liberated by cutting the reserve requirements led to the club loan."