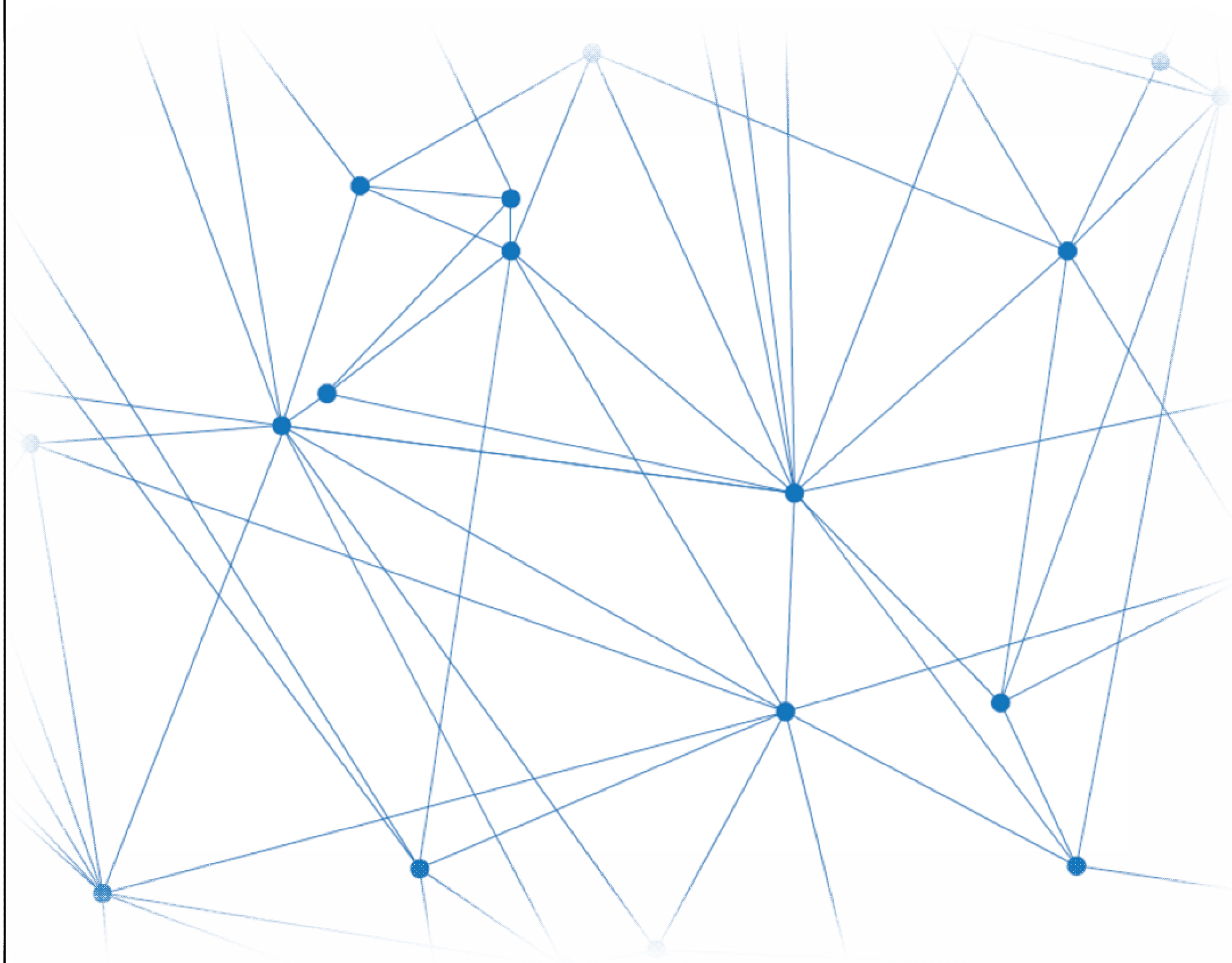
AN ASPEN INSTITUTE ROMANIA CONFERENCE REPORT

ADDRESSING NEEDS, LEVERAGING RESOURCES IN FINANCING NON-EURO ZONE ECONOMIES



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NOTE ON THE REPORT

Building on the work of its Economic Opportunity and Financing of the Economy Program, Aspen Institute Romania included in its 2014 series of policy roundtables and conferences an event dedicated to financing the economy.

'Addressing Needs, Leveraging Resources in Financing Non Euro-zone Economies' conference took place within the auspices and premises of the National Bank of Romania on March, 18th, 2014.

The current report is a synthesis of the convened discussions held during the March 18 conference of the conference support documents. The report should serve as a starting point for further national strategic actions.

BACKGROUND INFORMATION AND INTRODUCTORY REMARKS

This report provides a snapshot of the challenges and opportunities in leveraging resources in the region and highlights some recommendations and observations that could be perceived as inputs for a new growth model for the Romanian economy. It is a synthesis of the discussions held within several panels during the '**Addressing Needs, Leveraging Resources in Financing Non Euro-zone Economies**' Aspen Institute Romania conference that took place under the auspices and at the premises of the National Bank of Romania on March, 18th, 2014.

The report unfolds with a description of the geopolitical and socio-economic challenges for non Euro-zone countries and sequentially taps into ways to address the needs of a growing economy: the EU multi-annual financial framework 2014-2020, development banking, pension funds, capital market and venture capital. Policy priority areas as well as infrastructure investment priorities are highlighted throughout the chapters. Many of the considerations are valid for all the non—Euro-zone countries, however the focus of the event is on Romania, its economy and policy options.

The report should be interpreted as a transition step towards further consistent practical approaches for financing the economy that will be developed based on t**he establishment of the Romania Gateway Unit in 2014.** Stemming from a wide set of policy approaches promoted by the **Aspen Institute Romania and its partners, Romania Gateway creates the institutional space for unprecedented public-private cooperation and coordination.** Its adoption as an official policy by the Romanian Government makes a watershed moment for policy convergence and public private partnership in achieving financing targets and linking them to lasting development.

The Romania Gateway is recognized as a strategic project of national interest, **being implemented through a dedicated public-private**

team – the Gateway Unit and should contribute to the development of the New Silk Road concept that aims to revitalize the ancient Silk Road via a combination of modern highways, rail links and energy pipelines connecting Europe, Asia and Middle East.

The East-West Gateway Unit has several objectives: **(i) identifying strategic projects for Romania; (ii) analysis of all projects identified from a cost-benefit perspective; (iii) providing a clear prioritization of these projects based on their importance, impact and resources required for implementation; (iv) structuring a viable financing and partnership mechanism for large-scale projects; (v) developing a coherent communication and progress monitoring strategy at Government / Prime Minister level.**

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EXECUTIVE SUMMARY

Context and challenges:

The global economic prospects are finally looking up at a new dawn after a crisis that exposed several weaknesses in the growth formula of Europe's western economies. The same applies to the non Euro-zone economies in Europe. **Countries within the CEE region need to mobilize sustainable savings for future growth and to design new growth models to attract foreign direct investments into areas of comparative advantage.**

At the same time CEE countries need to participate actively in the designing of the new normal following the crisis. Whether this refers to the new macroeconomic standards inside the EU or its trade negotiations with the world, energy policy or regional development, governments and business need to adapt and engage Brussels and national capitals in this policy conversation. Increasingly this involves a number of European associated and partner countries that are vital to the coherent economic development of the region, but also to issues like immigration, energy security, trade and intern-regional transport.

In an increasingly interconnected world, financial resources, goods and services, and labor flows, as well as international political relations are interweaved in a fragile yet evolving equilibrium that can be easily and significantly disturbed. The recent outburst crisis in Ukraine, escalated by Russia's annexation of Crimea, has steeled Moldova to step up its efforts to reform its economy and political system, in the process of getting closer to the European Union. Sharing common history and European values with neighboring Moldova, **Romania should more significantly support Moldova's development aspirations.**

Equally, the ongoing Ukrainian crisis has underlined **the importance of pan European economic and energy policies** that need to include a reconsideration of relations with Russia. While there are many reasons to consider Russia a valuable and important economic actor, its policies and actions make it very difficult to treat the coming years in the "business as usual" logic.

The main risk for the region comes form instability that may drive away investment, and in particular large-scale, long-term investment. The opportunity is to create the framework for an alternative reading and for **this region to become a major investment destination** precisely because of its stability inside the EU and NATO. This in turn requires a set of domestic choices.

Improving the long-term competitiveness of the Romanian economy will be the key challenge for the policymakers when they design and implement macroeconomic policies. In this respect, some critical priorities for the Government in the years to come are: **(1) financing the real economy; (2)**

supporting sectors of strategic importance; (3) increasing the absorption of EU funds; (4) financing the infrastructure development.

Whether infrastructure and regional development, urban development or industrial policies are at stake, Romania needs to have a clear perspective for financing the economy. A clear financing strategy is a priority for ongoing and future projects in order for Romania to continue on a sustainable path of growth. Romania should take advantage of its current easy access to financing sources on the international capital markets, absorb EU funds and deliver on the existing partnerships with international financial institutions.

Romania's current macroeconomic foundation is strong taking into account a good record of managing the financial crisis and good macroeconomic management that led to one of the lowest public debts and fiscal deficits in the EU. Nevertheless, there is **a need for Romania to restart and deepen some of the ongoing structural reforms** for public sector companies but also at the government level, especially regarding EU funds, research, development and innovation (RDI) and human capital.

Romania has enormous location and endowment advantages in the **agriculture, energy and transport sectors** that remain untapped. Spillover effects on further economic sectors could be generated, provided the adequate reform measures are undertaken on state-owned enterprises that dominate the main sectors.

The EU funds are an opportunity for Romania to increase the level of capital investment and alleviate bottlenecks to growth in infrastructure and public services. Romania's medium-term development strategy should aim to converge to EU living standards and align with the broader European Union's "Europe 2020" strategy, which sets the concept of "sustainable, smart and inclusive growth" as a key for societal and economic development and sets specific targets for the EU as a whole and for each Member State.

The role of a development bank in the Romanian economy is evident. EximBank could assume the development bank role. This could be imagined via a specialized subsidiary supporting the Government's reform of the Romanian economy. Given its proven track record, both as a State agent and as a commercial bank, EximBank can increase its contribution to EU funds absorption and provide direct support to strategic sectors of the economy as it is well positioned to play an important role in supporting infrastructure development.

Romania should aim at upgrading its capital market from the peripheral status to the emerging one. Moreover, investment funds and pension funds financing potential should be put to work for the development needs of the Romanian economy.

There is also an urgent need to develop a coherent and foolproof development plan for infrastructure to address **PPP opportunities and attract FDI**. Georgia's success story may well serve as a model and an impetus for countries willing to step on the pathway of accelerated inflows of foreign direct investments. Georgia has designed one of the most liberal policy frameworks in the world, most notable for its labor regulations and trade regime and is a success-story worth replicating. A PPP fund was the vehicle to drive government co-financing towards attracting FDI and developing profitable investments.

Additional regulatory reforms can help **attract private equity investments and encourage entrepreneurship**. Increased investments in innovation, research and development from both private and public sources will help improve regional competitiveness and **develop industry clusters and knowledge-hubs** involving university collaborations and start-up support.

Romania has the potential to become the regional economic powerhouse. A new Romanian growth model will increase investments, expand exports, focus on higher value-added activities, and finance growth via renewed FDI and higher domestic savings, while maintaining a balanced trade, unleashing and accelerating productivity growth.

Main Recommendations Stemming from the Report

Finance-related

- **Establish a National Development Bank** either by creating a new vehicle or redesigning/re-assigning a part of EximBank / CEC Bank
- **Create a dedicated sovereign investment fund for infrastructure**
- **Ensure better spending of EU funds** in highest impact areas and large infrastructure projects
- **Improve PPP mechanism**; create equity and debt national investment vehicles
- **Increase savings through reform of the pension model** and support portfolio diversification of pension funds for financing infrastructure
- **Upgrade the capital market** to investment grade by continuing reforms and removing barriers
- **Apply leverage on a well-planned, clear infrastructure development strategy,** attracting state budget financing, **EBRD / EIB / IFC contributions**, large **international investment funds**, private developers and **syndicated loans from banks**

Priority areas

- **Develop the agriculture infrastructure and food processing sector** and combine nature's gifts with the affordable labor force conditions.
- Transport infrastructure: **improve roads, railways, and ports** to reduce the cost of transport and trade and boost exports.
- Energy sector: continue reforms, **improve the governance framework** for state-owned enterprises, **privatize the non-strategic companies** and **render the IPOs** for strategic companies.
- **Conduct education reforms to enhance skills** and ensure a better matching between labor supply and market demand through vocational training and university investments.
- **Improve the regulatory environment** by streamlining administrative procedures and adopting new legislation to help attract investment and encourage entrepreneurship.

- **Increase investments in R&D** from both private and public sources. **Develop industry clusters in knowledge-intensive industries**, increase industry collaborations with universities, and provide support for startups.
- Design an investment mechanism to foster bilateral economic relations with Moldova

Additional messages

- Large infrastructure projects should be delivered based on national consensus and should not be politically colored, overcoming electoral cycles.

- Experienced human capital and competent management are compulsory for developing optimal private and public sector involvement mechanisms for funding infrastructure.

- **The key to success relies in the establishment of a transparent and credible, meritocratic environment**, that would nourish on the experience of top-level professionals

SESSION I: FINANCING EU'S ECONOMIES – THE CHALLENGES FOR NON EURO-ZONE COUNTRIES

"The storm may be over but the skies remain dark and ominous. Deep, ingrained structural problems related to economic governance but also the framework for financial and economic union remains a threat to both economic growth and financial stability. The social impact of many of the measures is now threatening political acquis that took decades for Europe to build. The risks are of equal magnitude to those of the economic crisis that hit Europe a few years ago. While politicians of all colours bear the main responsibility to address this, it is also up to financial and economic policymakers to insure that the underpinnings of Europe take this into consideration. With the Euro zone out of the critical area of the crisis, we can look at the long term. For the EU, this means looking into competitiveness and productivity mechanisms as well as social growth and not only the general financial stability. Pondering about the options and implications for the EU's non-Eurozone economies is a critical part to this. Questions related to financing, debt and competitiveness remain central to EU cohesion and convergence."

[Aspen Institute Romania, March, 2014]

GEOPOLITICAL CHALLENGES

Regional stability can play a significant role in boosting or decelerating growth as attention and resources may be put to work consistently or diverged towards less constructive efforts. During the session, special attention was paid to current geopolitical developments in the region: **(1) the outburst of the international crisis**, having as lead actors Ukraine, backed by the western world in asserting its right to sovereignty, territorial integrity and self-determination, on one hand, and the Russian Federation, reacting increasingly aggressive to perceived prospects of losing influence in the region, on the other; **(2) the adequacy of the international and European reactions to conflict escalation** and **(3) the potential negative impact of the conflict on Ukraine** in the first place **–** as prospects of a state division between a democratic, pro-European and Western values-oriented part and a Russian dominated one do not seem so remote or improbable any longer **– on the neighbouring economies and states**, including Romania, Poland the Baltic states or Moldova, **and on the EU and the world, in general.**

In an increasingly interconnected world, financial resources, goods and services, and labour flows, as well as international political relations are interweaved in fragile yet evolving equilibrium that can be easily and significantly disturbed. Economic, financial or military crisis are such examples of external shocks that extend their effects rapidly and often unpredictably to countries, economies and societies. In what follows, such interdependencies are briefly noted in the context of the recent regional conflict.

The European Union and Russia have a strong trade relationship as Russia is an important player in the international relations arena. EU-Russia bilateral trade reaches 480 billion EUR annually or 1% of the EU's GDP and 15% of the Russian GDP.

One third of the quantity of natural gas used in the European households and companies (183 billion cubic metres, annually) has Russian origin. Almost half of the quantity (81 billion cubic metres, annually) transits the Ukrainian piping system in its way to the EU consumers.

Russia can play a significant role in the Syria, Iran and North Korea files or can be increasingly isolated by the international community reactions to its attitude in the Ukrainian conflict. It is in neither party's interest to re-enter the realm of cold war or worse, of open conflict and dialogue; diplomatic solutions should instead be sought for. **However, Russia must understand that from the Western perspective it is unacceptable to use energy and other resources as military weapons against other countries.**

From a slightly different perspective, due to the ongoing regional conflict, Romania and its neighbours, including Moldova, have become increasingly relevant geopolitical actors and it is up to their leaders to turn an inherent risk into a development opportunity. In time, Romania has proven that when broad national consensus upon development priorities was reached and when major objectives were clearly assumed - such as NATO or EU accession - political, social and economic domestic forces acted concertedly and successfully towards goal meeting, no matter the inherent difficulties. Being a member of EU and NATO today clearly demonstrates the security advantages Romania enjoys in the context of the current geopolitical crisis. Similarly, such advantages have to be wisely employed in order to meet our social and economic development potential. Romania should have the courage to depart with its historic periphery condition and aim to transform itself into an East – West gateway. As unacceptable as it is, the ongoing Ukrainian-Russian conflict has the potential to unfold new perspectives on a New Silk Road for Romania and for some former Soviet Union countries, as well.

Sharing common history and European values with neighbouring Moldova, Romania should more significantly support Moldova's development aspirations as well as those of other countries in the region, whether Ukraine or Georgia are concerned. A Romania-Moldova investment fund could be created in order to foster bilateral economic relations or even an international conference of donors can be imagined in order to help finance Moldova's economy as the one organised in Georgia's interest when 1 billion USD were collected for investment purposes.

Republic of Moldova – at the Verge of Crossroads

The recent outburst crisis in Ukraine, escalated by Russia's annexation of Crimea, has steeled Moldova to step up its efforts to reform its economy and political system, in the process of getting closer to the European Union.

On the verge of crossroads, Moldova has recently adopted a series of measures that might prove to be decisive for its future development direction. As of May 2014, citizens of the Republic of Moldova possessing biometric passports will be able to travel to the Schengen area without a visa, through the Visa liberalization regime announced by the Council of the European Union. On June 27 2014, Moldova will also sign the European Union Association Agreement, together with Georgia. The Agreement includes provisions establishing the Deep and Comprehensive Free Trade Area (DCFTA). The signing of the Association Agreement will help strengthen the trade and political ties between the EU and the two countries. For Moldova, this is a very important step that could ensure stability for the business environment and attract more foreign investors to glance beyond existing opportunities related to legislation, technology and environment and acknowledge a country where political forces and government officials do their best to create a safer and more secure investment destination.

Moldova still needs to address many pressing challenges. Fighting corruption and enabling reforms in the Justice area are top priorities. A better business environment should be developed by **creating new improved state-aid legislation.** Although Moldova receives financial and knowledge support from EU countries and particularly Romania, much can still be done to attract investors, especially from Romania – a country that shares the same language, history and culture. Romania's Government recently adopted a financial mechanism for the implementation of a governmental agreement with Moldova on a programme of technical and financial assistance, providing non-refundable financial aid worth 100 million EUR. Most of the allocated money will be used for infrastructure and for the development of the educational system. The main cross border energy transport infrastructure project between the two countries at the beginning of 2014 was the Iasi-Ungheni gas interconnector. The primary role of this new pipeline is to improve Moldova's energy security, bring commercial benefits to both Moldova and Romania and contribute to the physical integration of the European gas market. The pipeline would also diminish the Russian influence and could facilitate Moldovan integration into the European energy market, giving impetus to the country to update secondary legislation in accordance with the EU acquis.

Moldova has specific legislation and procedures for financing projects. One project stemming from the Ministry of Economy is the Programme for Attracting Remittances into the Economy of Moldova (PARE 1+1), initially launched in 2010. The aim of the programme is to mobilize human and financial resources of migrants and their first degree relatives for the development of small and medium enterprises in Moldova. The Programme acts on the 1+1 principle, i.e. 1 Moldovan leu invested by the migrant is coupled with 1 Moldovan leu as a grant invested by the state, with a maximum amount for the matching fixed at 200,000 Moldovan lei. The government of Moldova is also focused on developing new criteria which can shorten the time spent for the applications and the governmental decisions.

Moldova has the potential to become a connector between the East and the West. The general population of Moldova speaks both Romanian and Russian; this provides opportunities for business expansion both towards west to Romania and the European Union and towards east to Ukraine and Russia. Moldova has in place an important steel industry and steel free-trade agreements with countries such as Russia, Kazakhstan and Ukraine as well as other former USSR countries. In addition, there are various entrepreneurial zones, where residents of those areas are entitled to privileged tax and legal treatment. The signing of the Association Agreement with EU would also open a wide-range of business opportunities and could attract increasing foreign direct investments. However, political stability is vital for Moldova, in order to successfully attract investors. **It is now the moment for political forces to engage in constructive dialogues and long-term planning for Moldova to become an actively-sought investment destination.**

SOCIO-ECONOMIC CHALLENGES

A recent McKinsey Global Institute study[1]on Central and Eastern Europe (CEE) highlights both the region's[2] outstanding growth and economic progress prior to the onset of the global financial crisis and its ongoing struggle to regain momentum in the context of a demand that has remained weak since the end of the global recession. The report also proposes a new growth model for the region that favours investments and exports over consumption, while investigating those policy measures and priority intervention areas that can ensure a solid foundation for such model such as raising the productivity of lagging economic sectors, improving the financing capacity of the economies, investments in infrastructure, education and innovation, as well as regulatory and institutional reforms.

In terms of recent economic developments and prospects, according to a recent International Monetary Fund Survey[3],

> *"Growth decelerated in emerging and developing Europe in the second half of 2013 as the region contended with large capital outflows. Despite positive spillovers from advanced Europe, the recovery is expected to weaken slightly in 2014. Fragilities in the euro area, some domestic policy tightening, rising financial market volatility, and increased geopolitical risks stemming from developments in Ukraine pose appreciable downside risks. Policies aimed at raising potential output remain a priority for the region."*

Similar conclusions were drawn by the participants during the '**Addressing Needs, Leveraging Resources in Financing Non Euro-zone Economies**' conference sessions.

Nevertheless, GDP growth rates of 4.6% to 5% without jeopardising the macroeconomic stability are not beyond reach for Romania in the coming years - Romanian officials asserted during the conference. Ten-eleven years of average annual economic growth of 5% would bring Romania's GDP up to 221 billion EUR, amounting to a leap in the world ranking of economies from the position 52 to 35 and from position 17 to 13 in the European ranking, propelling Romania to a GDP per capita of 77% of the European average, among the group of medium-sized European economies. During the last quarter of 2013, Romania's GDP increased by 5.1%, which was a significant performance across Europe. Sustaining high economic growth rates in the future, however, will require thoughtful intervention measures.

[1]McKinsey Global Institute, *A new dawn: Reigniting growth in Central and Eastern Europe*, December 2013
[2]Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia
[3] International Monetary Fund, *World Economic Outlook – Recovery Strengthens, Remains Uneven, April* 2014

BUDGETARY AND FISCAL CHALLENGES AND OPPORTUNITIES

When assessing the financial needs of the Romanian economy in the near future, positive recent developments have to be taken into account and according to Government officials these can be summarised as follows:

The financial needs of Romanian economy will decrease by 10 billion RON (approx. 2.26 billion EUR) in 2014 and additional 14 billion RON (approx. 3.17 billion EUR) in 2015 due to further reduction of the budget deficit in 2013 and 2014, lower financing cost and increased maturity of available loans.

The roll-over risk (associated with refinancing operations) **has been decreasing** due to the extension of the loans maturity; in the event of external shocks, such as the current regional conflict, a lower roll-over risk has a positive impact on the financing capacity of a an economy; the shortest maturities (two months maturity) should have as small as possible a share in the total value of borrowing operations and this weight has decreased from 24% to 19% in Romania's case.

The liquidity of the government securities (the ratio of monthly transactions volume to government securities volume) **doubled last year**, from 26% to 59%. The liquidity of the government securities is a fair indicator of confidence in the Romanian economy.

Romania's easy access to financing sources on the international capital markets is a significant gain that has been achieved during the last two years; five years ago, a less favourable situation forced Romania to resort to the financing agreement with the International Monetary Fund (IMF), European Commission (EC) and the World Bank (WB); all Romania's bond emissions on the international capital market during 2013 and 2014 were oversubscribed; Romania has had a successful first emission of bonds denominated in USD with a 30 years maturity.

During 2013, Romania contracted both RON and foreign exchange denominated loans at historical minimum yields due to a mix of positive factors like: monetary policy, favourable international context and structural and macroeconomic undertaken reforms, as well.

Romania aims further improvement of its public debt management through various reform policies, including the **revision of emission policy** with an emphasis on liquid benchmark government securities and refinancing of treasury notes by means of Euro denominated government securities, financial derivatives and secondary market government securities operations.

The existing partnership between Romania and the international financial institutions will be kept. In order to finance its budget deficit, Romania has drawn 700 million EUR from the World Bank in 2013, at a 3.55% cost and with an 18 years maturity. Following the Polish model, Romania will analyse the opportunity of having a budget deficit financing line of 700-800 million EUR annually, with the World Bank.

As far as the direction of the funds is concerned or the investment priority areas, **the government is determined to only finance those public investment projects that meet strict utility and efficiency criteria**. In order to reduce the financing costs to a minimum, **the priority order of accessing financing sources will be: European funds, external loans and state budget**.

In order to help Moldova's economy and to boost the competitiveness of Romanian companies, the government intends to design a **guarantee scheme for investment projects developed by Romanian companies in Moldova**.

The Government also intends to implement performance based budget programming. Result indicators are to be settled for all publicly financed projects. The pilot programme for the 2015 fiscal year will include the Ministry of Health and the Ministry of Education.

In terms of fiscal priorities Government officials mentioned their commitment to (1) foster strong and sustainable economic growth, (2) decrease tax evasion practices and (3) increase voluntary tax compliance. For each fiscal priority area several policy measures were mentioned.

In order to foster a strong and sustainable growth and to improve the competitiveness of companies operating in the Romanian economy, the Government representatives have expressed their commitment to implement a **tax exemption measure for companies reinvesting their profits**, to **decrease the social insurance contributions by five percentage points** and to **keep unchanged the flat 16% tax on companies' profits.**

However, under tight budgetary constraints or in the absence of fiscal space, such stimulating measures cannot be implemented. **The improvement of income collection at the state budget** comes as a natural priority. First, in order to reduce tax evasion and avoidance, the Government undertakes to continue the **modernization of fiscal authority (ANAF)** including its transfer pricing department and to create a modern tax risk assessment department. Furthermore, **capping the cash payments** is intended to reduce tax evasion and money laundering practices in the Romanian economy. Second,

Increasing voluntary tax compliance is the second direction of action in order to improve the income collection rate. Prior requirements have to be met and therefore policy intervention areas will include **the increase of public spending transparency**; **improvement of public communication** regarding fiscal policy measures adopted and open dialogue with tax payers; **tax law simplification, stability and predictability** and last but not least **the improvement of the tax payment methods for citizens**.

POLICY PRIORITY AREAS

During the session, panellists investigated the problem of development financing, with particular reference to non-Euro zone. **There were three messages that the World Bank representative delivered** on the issue of financing growth in Euro zone and non-Euro zone countries **(1) all the global economic prospects are finally looking up**; however, there are significant dangers that lie underneath the surface and one cannot assume a steady economic recovery yet. This has implications for all the new Member States, including Romania; **(2) all the Member States should undertake to rebalance the sources of financing growth from external towards domestic savings; also, new growth models have to be imagined** and employed since the model driven by relatively cheap and available credit invested in non-tradable sectors is not sustainable; such requirement has very specific implications for the new Member States and for the Romania; **(3) Romania's current macroeconomic foundation is strong** taking into account a very good record of managing the financial crisis and very strong macroeconomic management; nevertheless, **there is a need for Romania to restart some and deepen other ongoing structural reforms: in the public sector companies but also at the government level; regarding EU funds, research, development and innovation (RDI) and human capital.** This is essential in order for Romania to maintain strong rates of growth, to go forward and converge with the EU.

Global Economy Recovery and Associated Risks

Global growth is expecting to accelerate from about 2.5% last year (2013) to slightly more than 3.2% this year and 3.5% in 2015. These are the World Bank`s global economic prospect numbers and they are consistent with IMF forecasts. However, this growth scenario is not without risks for at least three reasons: **(1) the extraordinary monetary support that has been coming to emerging economies from the US Federal Reserve System is coming to an end** and this is not without consequences as many developing countries continue to be vulnerable; **(2) notwithstanding that the Euro-zone – which weighs over 25% of the global economy – has stepped out of recession on the whole, there is significant variation within the Euro-zone economies** and per capita income in the Euro-zone is still declining, while unemployment is still growing; **(3) Romania lies in a sensitive geographic area where conflict situations may burst out and ongoing ones could very easily escalate**; we are in a part of Europe where Ukrainian-Russian conflict does not seem to fade away despite the efforts of international community. Markets' sentiment is conflict sensitive and stability uncertainties might have side effects on the European and global economic recovery; economic growth prospects of the new Member States of the EU and financing such growth prospects are further affected.

Financing Growth within New Development Models

First, economic growth in the region will have to be financed differently from the past and this rebalancing towards domestic savings has partly begun. The internal and external adjustments that have taken place in response to the financial crisis have improved saving rates in the new Member States, with particularly sharp increases in the Baltics, but also in Romania. This means, to some extent, reducing the reliance on foreign savings. However, this does not mean that foreign savings are not needed, it only signals out an occurring rebalance and this is a good thing. If funding is to rely increasingly on domestic resources, mobilization and direction of savings into investments will need to occur differently than in the past. **There is a clear need to restore health in the banking system**.

There is also a need for development of the domestic capital markets as this is something on which many new Member States lag behind. There is also another very important source of domestic savings in countries like Romania and neighbouring countries that have large states-owned sectors and state-owned enterprises. **Restoring state-owned enterprises to financial health** and allowing them to invest appropriately should be an important part of any savings mobilization agenda.

In addition to mobilizing savings for growth, all countries will need to think of another growth model and in particular attract foreign direct investments (FDI) into areas of comparative advantage. Large amounts of foreign direct investment (FDI) inflows such as Romania had up to 2008 and the easy credit that led to a boom in non-tradable sectors, as the real estate sector, are unlikely to return. Domestic demand, particularly driven by investment, needs to take the lead to generate growth. The new sources of growth have to be different for each country. In a country like Romania there are number of untapped sources. **Romania has failed to take advantage of complete integration with some of the Euro-zone supply chains that are now leading the recovery of countries such as Germany.** Many of the EU MS benefited from this significantly, but Romania lags behind and such opportunities should be turned to profit. **Romania also has enormous location and endowment advantages in both energy and transport** sectors that remain untapped. These, in turn, may have positive spill-over effects on further economic sectors provided that reform measures are undertaken especially regarding the state-owned enterprises that dominate these sectors. These are short-term sources of growth.

In the longer term, there is no substitute for high quality of human capital as a source of growth and here Romania lags significantly behind. The latest results of the PISA (Programme for International School Assessment) were released last year. The good news is that Romania has been improving since 2006. The bad news is that the improvements are not good enough. Looking at the skills of a 15 year old pupil in Romania in terms of reading, maths and science leads to a concerning conclusion: the Romanian pupil is about 1.5 years behind a same aged OECD pupil in terms of schooling. The average 15 years old is in the 7th or 8th grade. The Romanian pupil would be in the middle of the 5th or 6th grade, compared to a same aged pupil from an OECD member country. This reflects a significant skills gap, a human capital gap and future quality of labour force gap that needs to be addressed if one looks for long-term growth.

Horizontal Policy Objectives

Given that the global economy is uncertain, the financing of growth needs to be rebalanced towards domestic savings and a country like Romania needs to look for new sources of growth. What is it that the authorities need to focus on? Compared to other EU members that have more limited access to markets, Romania has demonstrated through the crisis a very strong record of macroeconomic management. This is an asset that the country has and that is respected by investors and the market. To capitalize on that, Romania needs to deepen the reform process particularly on those areas that will mobilize savings and will unlock new sources of growth. **The three most important areas some of which the World Bank (WB) is engaged in are: (1) the strengthening of macroeconomic and public sector management; (2) the lasting development of human capital through education and training and (3) the improvement of doing business climate.**

The first policy priority should aim to strengthen the macroeconomic and public sector management. It is absolutely critical for Romania to maintain its good access to the markets and to build financial buffers for any future volatility. This must be built on a strong tax collection performance and on a very careful public expenditure management. State-owned enterprises reform is part of such improved public sector agenda in order to improve their fiscal situation but also to unlock productive forces and attract foreign direct investments (FDIs) in the areas of energy and transport in which Romania has very strong location and endowment advantages.

The second policy priority should target human capital where Romania severely lags behind. Romania's scores for PISA (Programme for International School Assessment) are mentioned above. Tertiary education completing rates are also of deep concern for Romania's long term development prospects as they relate to highly skilled young labour force. Little less than 22% of Romanians in the relevant age group (22 – 35 years old) complete tertiary education while in most EU Member States the share is around 40%. This defines the scale of effort that is required. If one combines this statistic with previous ones, showing that 15 year olds are already 1.5 years or grades behind their counterparts in EU15 and the fact that Romania has a very small amount of people trained, one can get a clear picture of the skills gaps in the Romanian labour market. Addressing this problem has to be the second policy priority area. Equally important are the demographic developments. Since Romania is experiencing fast shrinking of its population, making each individual more productive should be another priority if sound economic growth is to be achieved. Having a large share of working age population that has not completed school or has completed school poorly is simply not conceivable for a competitive EU Member State. Minorities and Roma people are especially affected and providing proper education to these categories and including them in the labour market would transform into social and economic benefits.

The third priority area is improving the climate for doing business. This is critical if Romania wants to have investment-led growth. It is critical to attract the kind of foreign direct investments (FDI) that it needs and advancing reforms in this area would be a positive sign to the external markets. In terms of World Bank (WB) "doing business" indicators, prior to EU accession Romania was a top performer. After the EU accession this process decelerated and nearly stopped. The ranking on "doing business" indicator depends not only on how much one country improves the climate for doing business, but also on what all other countries are doing. One can fall behind even when doing well, provided everyone else is doing better - this is the situation that Romania finds itself in.

SESSION II: FISCAL SPACE FOR GROWTH - ADDRESSING THE NEEDS OF A GROWING ECONOMY

> *"Creating the space for effective financing of large scale infrastructure projects in areas like transport, energy and urban development: multi-annual budgeting and growth perspectives; the role of a development bank: public and private financing for strategic projects; prioritizing public investments."*
>
> *[Aspen Institute Romania, March, 2014]*

The current chapter includes contributions on EximBank's role in the economy, by Nicolae Albu and the role of a new development bank by Bryan Patenaude.

EU MULTIANNUAL FINANCIAL FRAMEWORK OPPORTUNITY

The multiannual financial framework (MFF) provides the financial programming across EU and budgetary discipline, conferring EU spending predictability within agreed limits. The framework expresses priority areas for EU investments and also ensures the effectiveness of common policies by spreading over a longer period of time.

During the 2007-2013 MFF programming exercise, Romania was allocated roughly 20 billion EUR through Cohesion Funds. At the end of 2013, Romania had an absorption rate of less than 34% for social and cohesion funds, the lowest in the EU. Additionally, Romania obtained the highest rate of financial corrections in the EU (around 20%) by the end of 2013. There are hopes for near future improvements in the absorption rates for the 2007-2013 programming exercise, as the time-span for using the monetary resources for the commitments made by Romania in 2011 and 2012 expanded until the end of 2014 and 2015 respectively, at EU Council decision-level, in an effort to reduce the risk of automatic de-commitment of funds from the 2007-2013 national envelope. Nevertheless, important grant resources will be left behind, unattained, bypassing opportunities to better support the economic growth and create an improved fiscal space.

The 2014-2020 cohesion funds framework allocates around 22.9 billion EUR for Romania. The principles and priorities of the cohesion policy are fine-tuned through the process of consultations between the European Commission and the EU member states. Romania was the 13th member state to officially submit its Partnership Agreement (PA), while on-going consultations are being held for the draft operational programmes (OPs). The Romanian PA frames the use of the 2014-2020 EU funds and identifies a number of priorities for the country: (1) competitiveness; (2) people and society; (3) infrastructure; (4) resources; (5) administration and government; the priority areas were defined based on the analysis of the current context and on the identified development needs, expected results and future actions. Most of the indicative allocation of the EU structural and cohesion funds goes to infrastructure, including transportation, energy and environment (with an approx. total of 9.5 billion EUR), while regional development is second with 6.7 billion EUR.

The EU institutions recently approved further reductions in national co-financing by increasing EU co-financing rates up to 95% for several Member States, among them Romania. Thus, projects have to be funded domestically with 5% - a temporary rate considered relatively low and thus adapted to a challenging economic context**. The challenge and invitation of accessing these funds at better co-financing rates, combined with domestic investment capital should ultimately translate into a much more significant outgrowth for Romania.** Additionally, rules have been relaxed, with a longer period granted for implementing projects, an important element that should ease the delivery of expected results and transform opportunities into impactful-investments. There is a wide range of sectors in which these funds can be invested. The focus is on basic infrastructure, including transport, energy and environmental infrastructure, but there is a growing emphasis on areas such as human capital, improving the competiveness of small and medium sized enterprises, research and development, capacity building and strengthening public administration.

Research and Innovation

One of the most dynamic parts of the EU funds in the last years is directed to research and innovation (Horizon 2020). Horizon 2020 is the biggest EU research and innovation programme ever, with nearly 80 billion EUR of funding available over the next 7 years for all member states. Horizon 2020 is positioned as a mean to drive economic growth and job creation. Combined with other available funding sources - such as JEREMIE (Joint European Resources to Micro and Medium Enterprises) joint initiative launched by the European Commission and the European Investment Bank Group to improve access to finance for SMEs in the EU within the structural funds framework - it should **enable the opportunity to fund start-ups, boost SMEs, and provide young researchers the necessary resources to spin off ideas from universities to the market.** Ideally, these financial mechanisms should provide an uninterrupted chain of support from the very first start-up, to the growth stage and first exporting activities of a company.

Challenges and Opportunities for the Near Future

The past financial crisis has sharply slashed the 2001-2008 years of convergence and strong growth for Romania and at the same time exposed profound weaknesses that need to be addressed by reforms, effective policy formulation and capacity building. Until now, EU absorption was hindered because of several systemic challenges, among them numbering the poor administrative capacity for public investment management. **The EU funds are an opportunity for Romania to increase the level of capital investment and alleviate bottlenecks to growth in infrastructure and public services.** Up until now, the troublesome bottlenecks in transport could and should have been addressed using EU financing, rather than national resources. The increased use of EU funds would also contribute to the reduction of the negative fiscal stimulus without increasing the public borrowing requirement or the structural fiscal deficit, thus eliminating barriers to prospective future growth.

Romania's medium-term development strategy should aim to converge to EU living standards and align with the broader European Union's "Europe 2020" strategy, which sets the concept of "**sustainable, smart and inclusive growth**" as a key for societal and economic development and sets specific targets for the EU as a whole and for each Member State. It is now the time for Romania to take a decisive move and increase its efforts towards economic modernization and long-term competitiveness. In the current context, with the aggressive, continuous deleveraging, budgetary adjustments and the fiscal constraints caused by the commitment to meet the European Fiscal Treaty, structural reforms are very important for Romania, so that it can reach the balanced real convergence in the following years.

Romania has the chance of getting back on track towards a relatively rapid growth and race towards narrowing the gap with the EU average. It can do so by implementing new policies and structural reforms under a stable and sustainable fiscal and macroeconomic framework. **Structural reforms to improve the infrastructure, business environment, labor market and the human capital skills are vital for growth as economy can reap short-term to long-term benefits.** The EU structural and cohesion funds provide enriching opportunities to address these needs and improve the effectiveness of public spending, while accelerating Romania's convergence with other Member States.

EXIMBANK ROLE IN THE ECONOMY - A PATHWAY TOWARDS A NEW DEVELOPMENT BANK[4]

A Snapshot of the Current Context

Despite the significant GDP growth recorded in 2013 and the good prospects for 2014, Romania needs to continue its efforts towards the modernization of the economy and the increase in its long-term competitiveness, with the aim of reaching real convergence with other EU member states economies.

Before the economic crisis hit the Romanian economy in late 2008, massive foreign capital inflows, mainly directed into the banking sector, supported the fast real convergence of the Romanian economy toward EU standards. However, the financial crisis revealed the weaknesses of this growth-financing model, as well as the risks of relying too much on the banking sector to finance the economy.

Within the context of aggressive, continuing deleveraging in the local banking sector (since the end of the Vienna Initiative at the end in 2011 until the end of January 2014, foreign banks withdrew from the country about EUR 7 bio), as well as the reduced lending appetite of the local private banks, the Romanian policy makers have had to find alternative solutions to fuel the economic engine.

Given the challenges posed by the financial and economic crises, policymakers from around the globe resorted to various degrees of state interventions in their economies, mainly to spur the growth needed to fix their budget and fiscal imbalances and reduce unemployment (particularly among youths).

In Romania, this was an opportunity for the Government to significantly increase its presence in the economy through the activity of EximBank, its state-owned bank.

[4] This report subsection was compiled by Nicolae Albu

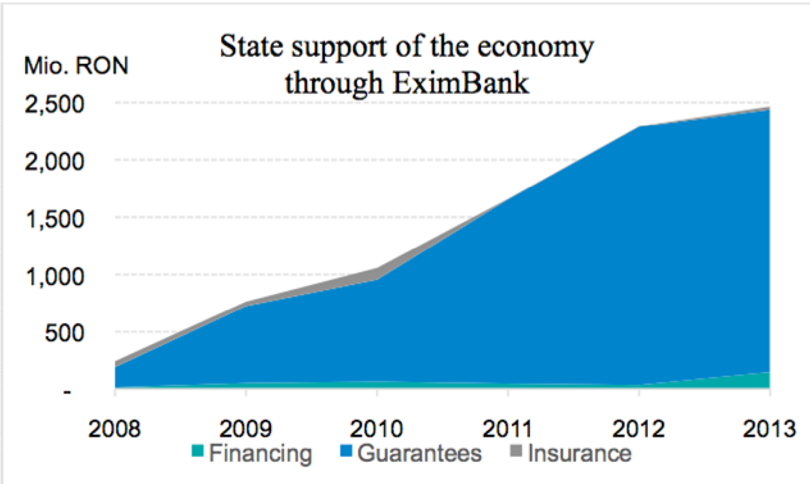
EximBank Support of the Romanian Economy as a State Agent

According to the provisions of the law governing its activity, EximBank, in its capacity as State agent, uses funds allocated from the State Budget to support the local business environment through a mix of instruments including financing, guarantees and insurance products. State support targets key areas of the local economy, including exports, infrastructure, utilities, regional development, research and development, environmental protection, human resources, SME and foreign trade.

Since the outbreak of the financial crises, the State support to the economy through Eximbank increased dramatically, from below RON 250 million in the autumn of 2008 to RON 2.344 million at the end of 2013.

Over this period, the most dynamic instruments were the state guarantees and the financing schemes: State exposure through guarantees issued to support the business environment increased 12 times, while through financing products increased 10 times. The insurance component in the mix of instruments decreased 48%, since almost all Romanian exports after 2007 went to EU countries, not covered by this state-support instrument.

In terms of relative weight, at the end of 2013 state guarantees accounted for 93% of the state support of the economy, up from 73% at the end of 2008.



Source: EximBank

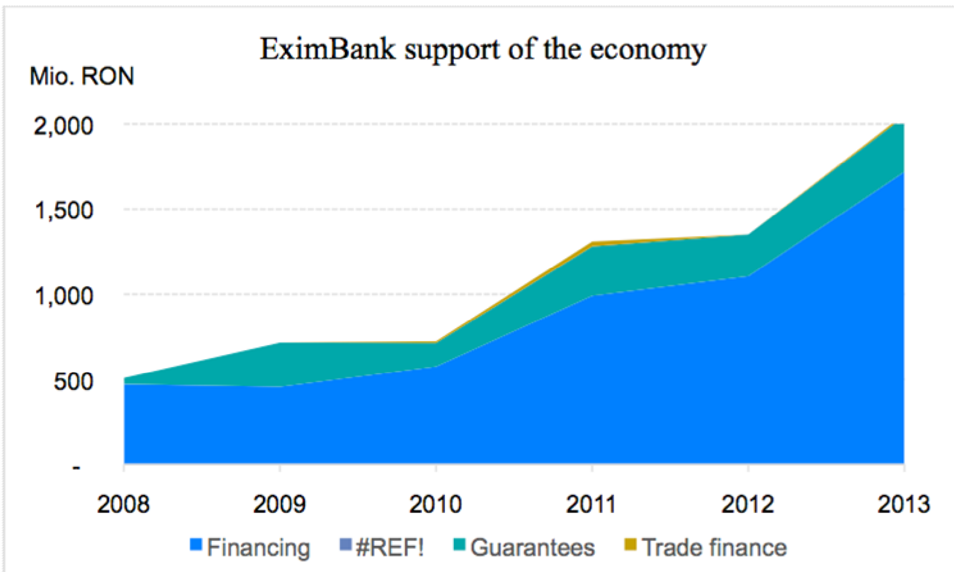
EximBank Support as a Commercial Bank

The country's economic development needs, the identification of new strategic areas to support and the challenges brought by the financial crisis, particularly the need to fill the financing gap stemming from private banks deleveraging, made the Romanian Government rethink the role EximBank can play in supporting the economy.

Having demonstrated strong capacity and efficiency in managing the State funds to achieve the stated objectives, better organization and strong risk control processes, the State has expanded the mission of EximBank, asking it to develop a commercial banking business on top of the State agent mandate.

Acting as a commercial bank, EximBank significantly increased its support to the local business environment, from RON 507 million at the end of 2008 to RON 2.010 million at the end of 2013. The most important instrument of support were the lending facilities, whose value almost quadrupled during the period (from RON 471 million to RON 1.823 million) and accounting for 84% of total support at the end of 2013.

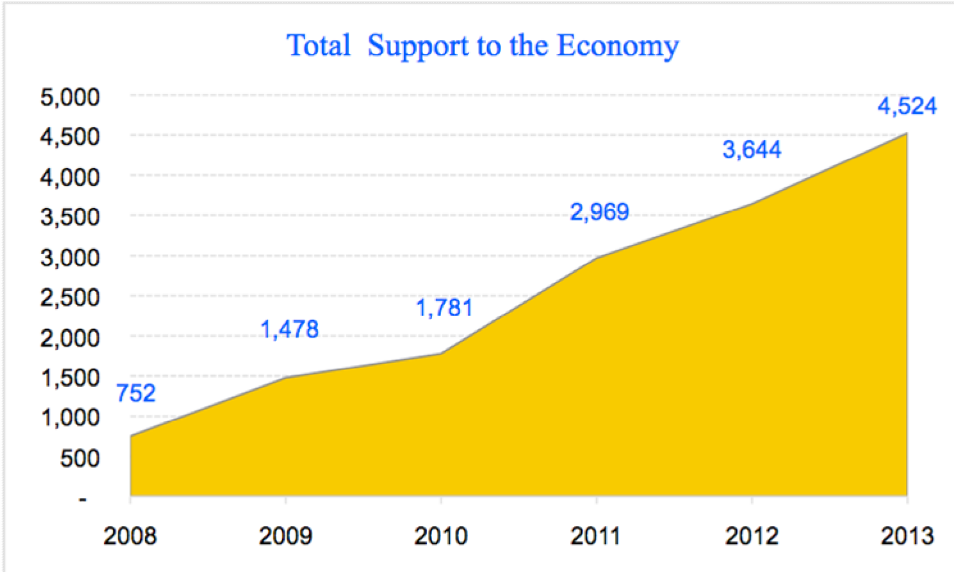
In is important to mention that for the past two years, EximBank went through an important restructuring process, reshaped the organization of its activities, improved the quality of services provided and expanded the range of products offered to customers. EximBank managed to fulfill his mandate despite this restructuring process and the challenging economic environment: the value of lending facilities granted increased by 73% from the beginning of 2011 till the end of 2013.



Source: EximBank

Overall Support of the Economy

The Romanian State has managed across the years to successfully increase the positive impact of EximBank activities in the local economy.



Source: EximBank

The State support through EximBank to the local economy increased 5 times between 2008 and 2013, from RON 752 million to RON 4.524 million. More importantly, the State achieved a very efficient complementarity: while State funds are used to back the guarantees issued by EximBank on behalf of the State, financial resources raised as a commercial banking allow EximBank to finance directly the business environment.

At the end of 2013, 51% of EximBank exposure to Romanian economy comes from letters of guarantee issued on behalf of the State, while 38% are represented by credit lines provided to local companies on its own behalf.

Future Opportunities

Improving the long-term competitiveness of the Romanian economy is a key challenge for the policymakers when they design and implement macroeconomic policies. In this respect, some **critical priorities for the Government** in the years to come are: **(1) financing the real economy; (2) supporting sectors of strategic importance; (3) increasing the absorption of EU funds; (4) financing the infrastructure development.**

Within this context and given its proven track record, both as a State agent and as a commercial bank, **EximBank can play a critical role in supporting the Government's reform of the Romanian economy.**

From the traditional objective of supporting exporters and foreign trade, **EximBank has developed during the latest years into a reliable partner to the local business community**. Using a varied set of instruments, **EximBank is now well positioned to support efficiently economic sectors of strategic importance** (industry, agriculture), **to increase the efficiency of macroeconomic policies** (increase in exports and diversification of export markets, increase in EU funds absorption rate) **and to finance the real economy** (from SMEs to large companies).

Supporting and Financing the Economy

During the past years, the most efficient instruments to support and finance the economy were the guarantees issued by EximBank on behalf of the State and the credit facilities provided by EximBank as a commercial bank.

There is further scope to boost the use of these instruments to achieve Government's goals:

- EximBank developed strong expertise and sound risk policies in managing the credit risk undertaken through the issued State guarantees;
- EximBank acquired good knowledge, deep insights and valuable know-how on companies operating in various industries;
- EximBank has a strong balance sheet and a profitable business, allowing it to raise funding competitively from the interbank markets and to tap capital markets with corporate bonds issues;
- The State funds provided to EximBank to back the letters of guarantee issued by EximBank as State agent do not impact the state budget deficit;
- The State funds provided to EximBank to back the letters of guarantee issued by EximBank allow it a moderate, controlled leveraging of business;
- The State funds will be invested in very liquid, low risk Government papers, to be easily converted to cash if needed, meanwhile financing the public debt.

Financing and Supporting Large Infrastructure Projects

In order to reduce the development gap to the other EU economies (real convergence) and to create the premises for a long-term sustainable growth in the future, Romania needs to implement large infrastructure projects. As such, hard infrastructure (highways, railways, airports, power plants, etc) will stay on top of the Government agenda for the years to come.

The successful implementation of large infrastructure projects requires not only a proper legislative framework and excellent project management, but also large investments and/or State guarantees.

EximBank is well positioned to play an important role in supporting infrastructure development, once the viability of the projects is determined, since: (1) **it has a strong balance sheet and a profitable business**, allowing it to unlock the potential of borrowing from the capital markets in order to match the long-term project financing needs; (2) **it can issue State guarantees in favor of companies participating in infrastructure projects**; (3) given its expertise in foreign trade and international finance, **EximBank can facilitate communication with foreign investors, share knowledge and specialized know-how.**

EU Funds Absorption

The absorption of EU funds remains a top priority for the Government for the next financial perspective. EximBank contributed to EU funds absorption both in its capacity as State agent, by issuing guarantees to support the EU-funded projects of beneficiaries, and by co-financing or guaranteeing those projects as a commercial bank.

In 2013 only, in its capacity as commercial bank, EximBank contributed over RON 190 million to the absorption of EU funds allocated for Romania. Co-financing and guarantees supported a wide range of beneficiaries from various sectors of the economy: SMEs (52%), research and development centers (29%), large agribusiness and regional development operators (11%) and local administration (8%).

In the future, **EximBank can increase its contribution to EU funds** absorption since: (1) **it has a complete set of effective instruments to finance and guarantee the projects funded from EU budget**; (2**) it has developed strong expertise and sound risk policies** in managing the risks associated with EU-funded projects; (3) **it has the organizational capacity, the managerial skills and the needed human resources** to manage the EU-funded projects of beneficiaries from varied industries and sectors of activity.

Development Bank Mandate

In its development bank role, EximBank could intensify and further diversify its support for the implementation of Government economic policies. **Two areas where EximBank expertise can easily be deployed are the management of EU funds and the direct support to strategic sectors of the economy**.

EximBank is prepared to fulfill such a mandate since:

- It proved a good track record in supporting the priority sectors of the economy identified in the law governing its activity;
- It has the efficient network coverage, good organization and experienced human resources needed for an effective coordination of regional development and management of EU funds;
- It has a strong capital base, well above the banking sector average, which provides a strong foundation for further leverage to support additional financing of the economy;
- It has a very strong balance sheet and a profitable business, which allow it to borrow competitively and conveniently from the capital markets;
- It can benefit of further capital injections from the State (both equity and debt) to support the implementation of strategic projects for the Romanian economy.

The Rebirth of Local Development Thinking

In a recent working paper[5] - with its conclusions delivered during the conference - Bryan Patenaude examined Romania's relationship with EU funds and how a development bank could fit into the context and contribute to the local rebirth of development thinking. Among the author's propositions is the establishment of a development bank on the structures of the existing EximBank and CEC Bank. This would enable the creation of a subgroup in charge of managing EU funds, specifically aimed for longer term development projects and would put in the same household the risk assessment procedures, the prioritization process and the approval of projects. Possible methods to capitalize such an institution are conferring it EU funds management, issuing bonds on foreign markets, or partnering with the European Investment Bank and the World Bank. **The most successful development banks**

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[5] Patenaude, Bryan (2014) **-** *Reinventing Development Banking in Frontier Economies: The Case of Romania,* Global Economic Governance Initiative – GEGI Working Paper, Boston University Global Development Economics, Feb 2014

abroad have several common characteristics, namely: clear and defined mandates that are flexible but very much relevant to long term goals; transparent assessments; connections with the private sector; private sector management style; and monitoring by third parties.

The mission of the development bank should emphasize long-term investment and coordinate the development by prioritizing investments that maximize positive external spillovers. A development bank would first initiate the process of investing in SMEs and projects, but should have very clear frameworks for how to proceed into the future. The development bank should have clear cut-out points, stated to both the public and private parties, preventing fears of hindering the development of private capital markets. When companies are stable and profitable enough, they should cease the relationship with the development banking institution and succeed in raising funds in private capital markets.

Patenaude provides relevant case studies of development banking from Brazil, France, China and Croatia and underlines the common key traits that these successful development banks have developed: (i) clearly defined mandates; (ii) sizeable share of total assets; (iii) demonstrated profitability; (iv) risk assessment techniques similar to the private sector; (v) a quasi-independent nature, subject to a regulatory body and (vi) separation from political volatility. The author notes that:

> *While achieving the scale and scope of these leading development banks is beyond immediate future possibility for Romania, their models for demonstrate clear paths to success rely on sound risk assessment and diversification training, a tangible and clear mission statement, and a variety of sources for development financing.*

In the end the author concludes that:

> *in order for Romania to realize its goals in terms of financing development in the 2014-2020 period and progressing toward convergence with European standards it should: (i) centralize and depoliticize the management of EU funds by consolidating the numerous managing authorities into a development bank composed of both CECBank and ExImBank; (ii) publically state the mission of a new development bank to emphasize long-term investment and coordinate development by prioritizing investments that maximize positive external spillovers; (iii) standardize prioritization and risk assessment procedures used in program selection; (iv) create a regulating watchdog body to monitor the use of funds by the development bank; (v) offer time and merit based rewards to attract long-term skilled employees.*

IMPROVING THE PRIORITIZATION PROCESS OF PUBLIC INVESTMENTS

Establishing strict institutional procedures is a must in order to prioritize public investments and, according to governmental officials, it involves a long-term process. In 2013 a new department for evaluating public investments in Romania has been established at government level and a new government ordinance has been passed to regulate the principles and criteria of prioritization for investments. As a next envisioned step, a new government decision should regulate the methodological norms.

Up until now, the process of financing a new project investment followed several steps. First, a feasibility study had to be conducted and the Line Ministries decided whether to approve it. Next, an inter-ministerial committee decided upon the faith of the project. After the project investment proposal successfully passed the inter-ministerial committee, a government decision on the economic indicators would was required. After this decision, the responsible Ministry was entitled to include the investment proposal in the budgetary lines. However, as experience reveals, the annual investments depended on funds availability without having any guarantee that a previously government-approved project would receive enough funds to be completed in the foreseeable future.

Several recent changes have altered this long-established procedure of funding projects, in order to ensure that public resources are allocated more efficiently. Ordinance 88/2013 regulated the functioning of the national system of verification, monitoring, control and reporting of financial statements, legal commitments and budgets of public entities and the criteria for prioritizing significant public investment projects. Through the ordinance, all pre-feasibility studies for new investments would have to be approved by the Ministry of Public Finances. Once approved, the Line Ministries would start the feasibility study. By setting-up this mechanism, officials estimate that a third of all new projects would be cancelled in this early screening process, spare valuable funds and ensure the financial sustainability of critical ones.

The government has also set up a unit for the evaluation of significant public investments, for projects larger than 100 million RON, within the Ministry of Public Finances and has improved the legal framework for public investments through the same Ordinance 88/2013. For all projects that exceed 100 million RON, Line Ministries together with local authorities, state-owned companies and public-private partnerships would have to make a list of priorities based on detailed points and criteria. The Ministry of Public Finances would check whether the list has been correctly applied and integrate priorities from all the Line Ministries before presenting a memorandum to the government. The government would then need to approve the list of prioritized investments, which would represent the basis for next year’s budget. If the government disapproves of one particular project, the entire list would be rejected and a new list would have to be submitted. A new government decision that would oblige to give points to each project is also envisioned. If a project receives less than 55 points, it will be stopped and sent for further analysis. These new set of rules should push several projects to the finish line, rather than constantly delaying them. Additionally, an improvement in the recording system has been effective as of early 2014, so that the Ministry of Public Finance could get more in-depth information on how the funds for projects would be allocated to specific spending categories and thus allow for a better use of public funding. It is envisioned that as of July 2014, the system will be able to reject payment orders that are in excess of what was allocated in the budget; consequently, a changing in the funding allocation would require a budget rectification.

The existing schemes for state-aid will expire at the end of the first semester of 2014 and new ones have to be approved. A new scheme was announced as part of a package of measures designed to stimulate domestic demand, offering state-aid for any company that creates at least 20 new jobs. The state would repay half of the total wage bill for the newly created jobs. A company would first need to hire at least 20 new people before being repaid by the state half of the wage bill, on a quarterly basis.

According to governmental officials, other state-aid schemes are under advances considerations and refer to investments in the Republic of Moldova, designed to increase competitiveness and exports.

The recent measures undertaken by the Romanian Government aim to enhance the returns of the public investment, contribute to positive economic growth, and create additional fiscal space for new projects.

SESSION III: GROWING THE PIE - DEVELOPING THE FINANCIAL SECTOR

> *"Public financing and long-term evolution perspectives for the EU and euro zone economies; what course for Romania in striking a balance between short-term solutions and a long-term strategy for financing the economy?; developing the financial sector and effectively using new financing opportunities and instruments; the banking sector – solutions for non-performing loans and resuming active lending."*
>
> *[Aspen Institute Romania, March, 2014]*

The previous section concentrated on addressing the needs of a growing economy from an institutional construction perspective while questioning on the availability of the financial resources. The current one reflects the discussions held during the third session of the conference under the proposed guidelines of tackling both institutional reforms and the absorption capacity of the economies in the region with a particular focus on the Romanian one.

FINANCIAL SECTOR OVERVIEW AND PUBLIC POLICY INITIATIVES

The Vienna Initiative 2.0 mission statement[6] mentions:

> *"The financial crisis has brought conflicts of interest between the banking sector's home and host countries sharply into focus. Countries where foreign banks' subsidiaries or branches are systemic face particular challenges in safeguarding financial stability and ensuring adequate credit supply for their economies. The countries of Central, Eastern and Southeastern Europe (CESEE) are important hosts to foreign banks headquartered predominantly in Western Europe. The ongoing Euro zone crisis has highlighted the risk of disorderly deleveraging of western parent banks vis-à-vis their affiliates in CESEE and difficulties in cooperation between home and host country authorities."*

The Romanian banking system, with a foreign presence of over 90%, is particularly exposed to such risks and so is the region on the whole, as the IMF pointed out in their April 2014 World Economic Outlook. **The main objectives of the Vienna Initiative 2.0** are to: **(1) avoid disorderly deleveraging**; **(2) ensure that potential cross-border financial stability issues are resolved** and **(3) achieve policy actions, notably in the supervisory area, that are taken in the best joint interest of home and host countries**. All these should counteract estimated risks and foreign banking professionals in Romania expressed their optimism during the conference that Romania will not be

[6]http://vienna-initiative.com/wp-content/uploads/2012/08/Vienna-Initiative-2.0-Mission-Statement.pdf

affected by the materialization of deleveraging risks and foreign banks will preserve their exposure in the Romanian market provided that clear destinations for financing resources are identified.

Moreover, it was stated that the problem of the Romanian market is not offer but demand related. There is liquidity in the market but not enough demand for loans due to low consumer confidence levels, high uncertainty in both international and national arena (i.e. regional conflicts, elections etc.). It should be mentioned, however, that the financing needs of the government sector have crowded out the private sector's financing needs during and after the crisis. Identified weaknesses for the Romanian economy also included: **(1) the lack of equity which cannot be covered via banking loans**, **(2) low administrative capacity** in general and EU funds absorption related, in particular, **(3) underdeveloped local capital market** and **(4) weak financial supervisory capacity**.

Government officials referred during the session to **the public policy priorities aiming to alleviate the lack of equity in the private sector and to boost private investments** which included **the creation of needs addressing state aid schemes** and **the development of the Romanian capital market.**

The first priority area in financing the economy includes the creation of state aid schemes: (1) one type would employ grants covering either investment needs of private operators or human capital development needs, aiming at partly financing the wage bill for operators in strategic sectors such as IT services providers and RDI producers, for limited periods of time; (2) the second type of state aid scheme would employ state guarantees for on par default risk sharing with banks providing the SMEs with working capital or state guarantees that would ensure the state taking over the first loss risk in favour of banks.

The second policy priority area refers to the development of the capital market and aims at (1) privatization of the state owned companies or enabling capital enquiries of the state-owned companies using the local stock exchange; (2) creating small denominated investment instruments for small and medium investors looking for portfolio diversification such as 1,000 EUR government bonds; (3) increasing the securitization of capital market by creating EU funded innovative financing instruments.

BANKING SECTOR OVERVIEW

Banking Sector Before, During and After the Crisis

Romania's banking sector has undergone significant changes during the transition period. **Three critical weaknesses of the banking system were the cause of its underperformance during 1993 and 2003: the poor quality of banks' shareholders, management and legal framework that allowed for political interference and inefficiency.** The cost of restructuring the banking system, without counting for the interest paid to government securities and loans offered by the National Bank, was significant. Privatization towards foreign investors was considered the best option for addressing ingrained inefficiencies of an incipient and mainly state-owned banking sector. The quality of the banking system has gradually improved. However, it is the state owned banks and those with

Romanian (private) major share capital that performed unexpectedly well during the 2008 crisis and post-crisis, until 2013. Without questioning the opportunity and positive results of previous privatization process, or ignoring the necessity of further reforms, the role that state-owned banks could play in a significantly improved banking system could be revisited.

Confirming the common wisdom, **during 1992 and 2003 the state proved to be a poor manager of the banking system**. Two major state-owned banks[7] required costly restructuring measures and other banks with Romanian private major shareholders performed no better, with eight out of 13 banks having gone bankrupt[8]. The toll of restructuring the failing banking system on the Romanian economy amounted to 7.5% of GDP in the first round.

The decision to allow foreign capital to flow in changed the structure of Romania's banking system. Today more than 90% of the banks operating in Romania have foreign major shareholders whereas the EU average is about 24%.

As already mentioned, **state owned banks and banks with Romanian private major shareholders performed well during and after the crisis**. When investigating the banks behaviour during the crisis for Romania's case it is useful to take into account three assessment criteria: **(1) the pro- or counter-cyclical orientation of financing policy**; **(2) the degree of responding to financing needs of strategic sectors in the economy** (i.e. production of tradable or high-tech products) and **(3) the quality of risk administration or the risk-turnover proportion**. All three criteria were favourably met by state-owned and banks with Romanian private major shareholders during and after the crisis.

First, the state owned banks had a less pro-cyclical or a counter-cyclical approach on their financing policy. This should come as no surprise since such behaviour of state-owned banks is generally mentioned in established literature. However, the same approach was displayed by the banks with Romanian private major shareholders. Such behaviour may be explained by the *loan to deposits indicator* which, for this category of banks, was in the range of 60%-80%, whereas in the case of Romanian banks with foreign private major shareholders the indicator was in the range of 120%-140%, more loans being offered than the value of attracted deposits.

Second, state owned banks were more active in financing the tradable sectors of the economy (i.e. industry and agriculture) against non-tradable sectors (i.e. construction and services sectors). State owned banks even increased the share of financing directed towards industry and agriculture after 2008 and this cannot be observed in the case of banks with foreign private major shareholders. Additionally, state-owned banks also directed their financing services towards companies operating in *high-tech*, *medium high-tech* and *knowledge intensive services sectors,* and sustained the innovative companies whereas affiliates of foreign banks were more reluctant to finance such strategic sectors of the economy.

[7]Banca Agricolă and Bancorex

[8]Banca Albina, Columna, Credit Bank, Banca Comercială Unirea, Banca Internaţională a Religiilor, Banca Română de Scont and Banca de Investiţii şi Dezvoltare

Third, in terms of risk administration, state owned banks confronted with the most accelerated raise of non-performing loans (NPLs), of 23%, being followed by private banks with Romanian major shareholders (19%) and branches of foreign banks in Romania (11%). However, banks that registered the most rapid growth of NPLs were protected by above the average solvency and profitability rates. *Return on equity indicator* registered higher values in the case of state-owned banks. The outcome is intuitive since higher risk requires higher profitability, and the risk-profitability ratio does not seem to differ significantly across investigated bank categories.

All of the above mentioned developments suggest a clear improvement of the modus operandi of the state owned banks and of those with Romanian private major shareholders, and would suggest such banks are eligible candidates to efficiently tackle part of the long term financing needs of Romanian economy. Nevertheless, sustainable progress in the banking system should be assessed with regard to the **three parameters that determined inefficiencies in the past: (1) the quality of the shareholders; (2) the quality of the management** and **(3) the quality of the legal framework.**

The quality of the Romanian shareholders in the banking system has not improved significantly. Significant shareholders still have judicial problems while others have first line businesses in sectors other than banking.

The quality of the local banking management has improved significantly during the latest 15 years. Foreign banking professionals are also active in the system, and this was not the case at the inception of the Romanian banking system.

In terms of legal framework, the system is better-off than in the past[9]. Involvement of the banking system in the Government's support programmes recently developed[10] had an optional character and such approach should not be changed and politics should not interfere with the banking system.

Although displaying the positive developments of the state owned banks and of the banks with private Romanian major shareholders during and after the recent crisis, and without particularly elaborating on the risks associated with the current structure of the Romanian banking system, the National Bank representative delivered a message urging equilibrium when taking into account further involvement of the Government in the banking system.

NON-BANKING FINANCIAL SECTOR

The non-banking financial sector plays an important role in financing the needs of an economy and current windows of opportunity should be more daringly accessed by countries in need of development financing sources. Equilibrium should be sought for short, medium and long run financing solutions as financing working capital, business investment needs or sustained economic growth cannot and should not be met by the banking sector alone. Long term needs should be

[9] Excesses allowed by Law 20/1996 on financing the 1996 agriculture spring campaign, are no longer possible.
[10] The First Home Programme and the SMEs Guarantee Programme designed by the Government were accessed by the banks on a voluntary basis.

addressed by accessing long term financing sources as owners' capital (equity) and loan capital are equally important.

As already mentioned, there is enough liquidity both in national and international markets and Romania has made significant progress of late in gaining credibility on the international markets[11].The available resources should be diversified for optimization.

Future improvement of financing sources accessibility could be achieved, especially that of SMEs, individual small and medium investors and municipalities (other than Bucharest) by developing the local capital market. Access to international financial markets of major state-owned enterprises in the energy sector could be improved and necessary investment projects thus financed provided that Government actively involved in improving the financial management of such enterprises. Furthermore, development banks could act as moral guarantor for large foreign investors.

Investment funds and pension funds financing potential could be put to work for the development needs of the Romanian economy. In terms of asset value, worldwide pension funds hold the largest share of assets, ahead of mutual funds, insurance companies, currency reserves, sovereign wealth funds, hedge funds, or private equity. Although usually displaying more conservative investment policies, with largest share of assets in low risk government issued securities, pension funds do look for higher yields and portfolio diversification and long term low risk large infrastructure projects could be financed by such institutional investors.

Pension Funds

As was the case of other former socialist countries in the region, Romania entered the transition period with a *pay-as-you-go* pension system in which the pensions paid to retired persons in one period were funded by social contributions of employees in the same period of time and the level of individual pension was correlated with previous wage incomes of pensioners and not with their own overall previous contributions. As the pension system was gradually reaching its sustainability limits, due to a systematic decrease of workers-pensioners ratio, the reform of the state managed pension system in Romania began in 2007 the on-going process aimed at a smooth transition from the intergenerational solidarity principal towards the principle of correlating pension income levels with the amounts saved during working life.

Currently, the private pensions system in Romania is designed on two pillars: **one voluntary pillar**, rather weak in size and consolidation rates – even though it was the first to be set up – which holds less than 100 million EUR in total net assets and **the mandatory pillar**, the most important pillar in terms of participants and assets, that is giving critical mass to the system and which has now more than 3 billion EUR in net assets and around 6 million participants. According to current legal provisions, part of the employees' pension contributions (4.5% applied to the base rates) is directed to the privately managed individual pension accounts of employees or to the mandatory pillar. The share of

[11] Recent government bond offers were five or even six times oversubscribed on the international markets and Romania's government bonds were included in well-established indices such as JP Morgan's.

pension contributions directed to privately managed accounts is to increase to 6% by 2016, both in terms of net assets and participants. ING manages the largest private pension fund in Romania, with around one third of the total number of participants and assets.

Pension funds in Romania are investing mainly locally – around 95% of the total available funds being placed in Romania – with treasury notes, local denominated bonds or Eurobonds representing around 70% of the total investments. Pension funds are a significant partner of the Romanian Ministry of Finance. About 450 million EUR are invested through the local capital market, which makes pension funds the largest class of institution investors present in the local market today. **The future increase of pension contributions mandatorily directed to privately managed funds is expected to further raise the amount of pension funds' investments in the local capital market to around 500 million EUR**.

Although pension fund investment policies tend to be more tightly regulated and conservative, with a preference for long term, low risk investments in government securities, large investment projects developed by governments tend to meet such investment criteria and the need of pension funds for portfolio diversification and their further availability of funds for investments in the capital market should be grasped as financing opportunity for such large investment projects. Pension funds could play the role sovereign funds play elsewhere, without having to develop other institutions from the ground.

Capital Market

Romania should aim at upgrading its capital market from the peripheral status to the emerging one. Currently, the local stock exchange[12] holds a non-investment grade but ongoing reforms are expected to bring an upgrade to investment grade. This, in turn could multiply by 10 the total value of transactions as it would raise the attention of major international institutional investors. Higher demand for Romanian securities could, in turn, mean higher market value of the Romanian securities. With an increase of 43% against previous year, 2013 was the second best year of Bucharest Stock Exchange in terms of transactions' value: The daily average transactions value increased from 7 to 10 billion EUR.

Although the Romanian capital market could have been the second largest in Central and Eastern Europe and the largest in South-Eastern Europe, it is rather far behind other regional counterparts. Ongoing efforts to develop focus on removing already identified barriers and alleviating unnecessary burdens referring to: (1) local market; (2) fiscal conformity of investors; (3) enforcement of corporate rights; (4) dividend payment procedures; (5) cost of market participation (6) fiscal treatment of transactions; (7) primary market; (8) bond market.

Such barriers are briefly described below:

[12]Bucharest Stock Exchange, http://www.bvb.ro/

1. **Access to local market –** opening of an investing account in Romania can take up to six months whereas in more developed markets in the region it only takes a few hours;
2. **Fiscal conformity of investors –** the Romanian process is complicated and costly;
3. **Poor enforcement of investors' corporate rights –** the process of voting in general shareholders' meetings is cumbersome;
4. **Lack of dividend payment procedure harmonized to international standards -** the process of receiving dividends is not uniform for different categories of investors or and listed companies and is generally burdensome;
5. **Excessive cost of market participation –** intermediary and supervisory commissions are higher than in other countries which impairs the market competitiveness;
6. **Unclear fiscal treatment of capital market transactions –** there are different fiscal treatments for different transaction types and generally unclear fiscal provisions;
7. **Primary market –** currently, initial price offering requirements are more formal and burdensome than in other competing regional markets;
8. **Bond market –** the legal framework governing the local bond market is obsolete and does not offer enough incentives for development.

The removal of the above mentioned barriers is expected to positively contribute to the development of the local capital market.

Additional measures include **the continuation of the listing process of state owned companies** such as Electrica, which is expected to be the largest initial price offering in the history of the local market. Romgaz listing enabled the Romanian Government to finance its fiscal needs without increasing the public debt and brought increased value to the same company shares remaining in its portfolio.

Finally, the Romanian Authority for Financial Supervision, one of the most important integrated supervisory bodies, critical to the development of the local capital market should be kept out of political influence as much as possible.

SESSION IV LEVERAGING RESOURCES AND FINANCING INSTRUMENTS – DEVELOPING INFRASTRUCTURE

"Identifying key items that stopped Romania to develop sizeable infrastructure projects; exploring the need for a cross party, long-term, strategic multi-annual master plan backed by multi-annual budgets and focus, and supported by the civil society at large aimed at infrastructure investments; addressing the challenge of missing local equity."

[Aspen Institute Romania, March, 2014]

DEVELOPING INFRASTRUCTURE

The Rollercoaster of Failed Promises

Lack of adequate infrastructure has been a deterrent for attracting consistent investments in Romania over the past years. Despite low labor costs and existing technical capabilities in the automotive industry for Romania, several major foreign investments in various industries (e.g. the automotive industry), totaling billions of euro potential deals, have bypassed Romania. Investors have chosen to go to other Eastern European countries with better infrastructure networks. Nowadays, Romania stands far behind countries such as Poland, Czech Republic, or even Hungary when it comes to road infrastructure. These gaps in the transportation sector are translated into high costs for companies and prevent proper economic and regional development. Unless significant improvements are quickly attained, multinationals could easily be tempted to refocus and relocate their local business towards neighboring countries and regions where growth poles are empowered.

There is an urgent need to develop a coherent and sound-proof development plan for infrastructure to address PPP opportunities. The internal financing capacity has not been a strong point so far for Romania, translating into an unstable pool of equity in the country and lack of diversified financial instruments to serve infrastructure development, such as pension funds, which are much more developed in other countries. Romania's state budget structure is also significantly different in comparison to other EU budgets, having a high percent of total expenditures going to social protection, pensions, etc. The limited resources available for infrastructure underlines the urgent need to develop a coherent and sound-proof development plan for infrastructure to address PPP opportunities.

Learning From Best Practices

Success stories could be drawn from several EU or Asian countries. In Spain and Portugal, national companies for building infrastructure have been successfully financed with equity through

IPOs or syndicated money from diversified sources; this alternative, backed-up by professional management could translate into successful investments and less burden on the state budget and the debt ceilings, contributing to long-term financing. Other financing sources, apart from the state budget are increasingly available, waiting for the right plan and business proposition to access them, such as EU structural funds, EIB and EBRD financing, private equity pools, concessions, etc.

The case of Malaysia pictures a Public Private Partnership Unit that was established in 2009 under the Prime Minister's Department to spearhead private sector participation and stimulate private sector investment through public-private partnerships (PPP) in the national development agenda. Malaysia's PPP unit has been specifically designed to act as the central agency in charge of planning, evaluating, coordinating, negotiating and monitoring the implementation of PPP projects, thus bridging the viability gap of projects with strategic impact for the country and has so far been successful in consistently advancing in infrastructure development.

Without any doubt, one of the most notable success stories of the last decade on attracting significant inflows of foreign investment for large infrastructure is the story of Georgia.

Georgia – a Chess-play on How to Attract FDI and Finance Large Infrastructure Projects

The Georgian Government has taken consistent measures to improve the country's business environment over the last decade. In 2006, in a report by the World Bank[13], reporting on the ease of doing business in a country, Georgia was ranked 112th. Currently[14], Georgia is ranked 8th, after Singapore, Hong Kong, New Zealand, United States, Denmark, Malaysia and Republic of Korea, despite not being either an EU or NATO member and always being faced with the Russian geopolitical influence threat. A number of undertaken **reforms were vital for attracting FDIs to finance infrastructure projects**. In 2005 a new tax code was passed, reducing tax rates and the number of types of taxes imposed on business and individuals. A year later, in 2006, the customs code was passed, reducing hurdles in trading by decreasing the number of customs categories and overall tariff levels for both imports and exports. Similar liberalization measures were taken in the areas of licensing and permits and labor regulations. Soon, **Georgia has designed one of the most liberal policy frameworks in the world, most notable for its labor regulations and trade regime**. Nowadays, a company can easily be registered within hours, customs can clear services in one day and properties can be registered in the same day. Reforms have also drastically reduced corruption by improving transparency in public and private institutions.

As a consequence of the simple regulations and relaxed tax environment, several European and Asian car-makers have invested in Georgia, building local infrastructure, important parts of highways and massive storage facilities in order to set-up manufacturing operations. The cars manufactured in Georgia would later be sold on the international market, in countries such as Armenia, Azerbaijan and others.

[13] World Bank Group (2006) – *Doing Business Report, Creating Jobs*
[14] World Bank Group (2013) - *Doing Business 2014, Understanding Regulations for Small and Medium-Size Enterprises, 11th edition*

Currently, Georgia has a grossed fixed capital formation (gross domestic fixed investment) of 25% of GDP. Georgian officials stress the importance of developing government financing schemes through which consistent parts of GDP growth should be allocated to investments, rather than social expenditure and thus increase the ratio of investments financed from the state budget. While some projects should solely be realized by the private sector investments, large infrastructure projects could be co-financed through these specific budgetary investments. Public-private partnership (PPP) projects have been on the spotlight in Georgia in the past years. While several past profitable projects in Georgia could have been financed by the private sector, the total investment amount was too high in comparison to the Georgian GDP for some of the projects. Thus, the private sector was reluctant to invest in these projects, unless the government also contributed. **A PPP fund was the vehicle to drive government co-financing towards attracting FDI and developing profitable investments** in large ports, railway companies, oil and gas business and high voltage lines. State-owned companies also underwent IPOs and invested the money raised into infrastructure projects.

Georgia has well proved its successful vision of attracting more foreign direct investments, by creating one of the most liberal policy frameworks in the world, relaxing labor regulations and incentivizing the trade regime through smart-policy making and developing sound financial vehicles for infrastructure investments. **Georgia's success story may well serve as a model and an impetus for countries willing to step on the pathway of accelerated inflows of foreign direct investments.**

Moving Forward – Infrastructure Investment Priorities for Romania

Romania's geographical location provides fruitful endowments for land and water use. **By combining nature's gifts with the affordable labor force conditions, Romania could develop significant comparative advantage in agriculture and in the food processing sector.** The structural weaknesses have deterred investments and hindered the adoption of modern technologies that boost productivity and improve competitiveness. As a result, export levels in agriculture have been way below the country's potential. Once a top performer in Eastern Europe, Romania currently imports approximately 70 percent of its food, and its agriculture sector accounts for roughly 5 percent of the GDP. Moreover, Romania has the lowest farm labor productivity across the European Union. Romania should use the available EU funds and agricultural policy tools to address the bottlenecks in this sector such as land titling and consolidation, knowledge transfer deficit and irrigation infrastructure.

Transport infrastructure is a top priority for Romania: improving roads, railways, and ports to reduce the cost of transport and trade would boost exports and capitalize the growth potential. Over the last 20 years approximately 250 km of new motorways have been constructed and roughly 200 km of railway have been upgraded for higher-speed trains. The slow-paced progress resulted in expensive and inefficient transportation. EU funds are a way to accelerate the road-building while rail transport should attract more private investments for improved rail service management.

The energy sector needs to continue its rapid progress and reforms, improve the governance framework for state-owned enterprises, privatize the non-strategic companies and render the IPOs for strategic companies. The gas and electricity road maps should also be implemented and drive Romania closer to its participation in the EU energy market. By implementing its energy reform agenda, Romania should aim to increase its energy security and become an important player in the EU and regional energy market.

Next Steps

Infrastructure projects should be delivered based on national consensus and should not be politically colored, overcoming electoral cycles. An increased tendency to announce infrastructure projects that are not even close to being delivered has been observed over the past years in Romania, as part of political games, but with dire consequences for the economy.

A stable framework for PPPs, without frequent changes of rules would also stop the hindering of the financing process. Commercial banks have been reluctant in financing infrastructure due to lack of sound-feasibility studies, lack of know-how to deliver business cases and lack of overall planning. PPPs could first start with small deliverable projects that fulfill all necessary standards (environmental, technical, etc.). The projects should not be dragged on the early announcement agenda so that no political plays interfere before consistent steps are being made. Austria for example provides an example of big infrastructure projects developed in smaller, consecutive stages, such as the case of cross-mountains roads leading to neighboring Italy. The regional project planning should help align the national infrastructure with the EU existing wide-spread infrastructure.

Romania lacks a proper institutional structure that would allow initiating, financing, monitoring, governing and successfully exiting large projects. The on-going dependence on the political agenda has led to sub-optimal resource allocation for the majority of past infrastructure projects and to the consequent present deficits. Large infrastructure projects in key areas such as agriculture, transport, energy – are vital for boosting competitiveness for Romania and should be developed in national, regional and urban areas.

As a viable next step, Romania should **focus on developing an investment fund** that would allow local capital participation (both public and private), state budget participation, local and international development banks and EU funds and invest in special purpose vehicles for specific projects.

Leverage applied on a well-planned, clear infrastructure strategy should be the norm, attracting state budget financing, EBRD/EIB/IFC contributions, large international investment funds, private developers and syndicated loans from banks. Plans should not be excessively complicated, but rather follow a simplification pathway (e.g. the procurement process).

Professional management should take charge in executing the projects and deliver top-notch outputs from the business planning phase to the feasibility studies and the implementation. Governance should rely on **strategic resource allocation** that should be delivered by Romanian or international established experts that need to be placed in council boards, similar to private equity funds or sovereign wealth funds. All teams involved, from the strategic level to the implementation phase, need to work in an integrated manner and set clear priorities, guided by the good and virtuous management. **The key to success relies in the establishment of a transparent and credible, meritocratic structure, that would nourish on the experience of top-level professionals**.

We live in an increasingly inter-connected world, where infrastructure capabilities have a key role to play. Transportation has been on top of the infrastructure agenda in Romania as its inadequate development has often pushed the brakes for economic growth, while the government is limited in the investment capacity because of imposed budget deficit targets and agreements with international donors. The good news is that there are modern, sophisticated methods to raise the investment capital that do not translate into deficits. However, the price Romania needs to pay in order to avoid future deficits is building competences. **Experienced human capital and competent management are compulsory for developing optimal private sector involvement mechanisms for funding infrastructure.** It should actually not be seen as a price paid, but rather as a smart investment for the future. With this in mind, large infrastructure projects should transcend election cycles and become long-term goals and indicators that should lead Romania towards new smart policy-making and enable the country to converge to global markets.

Financing infrastructure with both private and public sector participation has translated into many success stories abroad. It is essential to replicate these success stories on large infrastructure projects in Romania as well, in order to improve the perception of donors and private investors. Romania has now the chance to prove that its ongoing projects and future governmental pipeline projects can transcend into success stories by attracting the much-needed private support. For Romania, the time has come to exit the vicious circle and enter the virtuous one.

SESSION V: VENTURE CAPITAL & SME'S

"Under the conditions of limited alternative sources of capital for growth, is venture capital a solution for Romanian SME's? What are the factors that influence venture capital investment activity in Romania? Identifying solutions for the development of the venture capital market; challenges Romanian companies face in attracting venture capital."

CONCEPTUAL CONSIDERATIONS

Venture capital is a narrower investment category of private equity. Private equity usually includes assets such as equity securities and debt in operating companies that are not publicly traded on organised capital markets.

Typical investors in private equity include: buyout funds[15], venture capital funds[16], growth capital funds[17], and mezzanine capital funds[18]. Other classifications of private equity, according to the business life cycle of the beneficiary of investment, distinguish between **(1) venture capital investments** directed strictly to start-ups and early-stage business development and **(2) other private equity investments**, directed to later stages of business development, including expansion capital, gross equity and buy-out operations which can be small, medium or large.

From the investors' goal perspective, **private equity** companies generally look to invest majority stakes in underperforming companies that have high growth potential. Additional intervention for business growth includes management improvement support for the beneficiary: working with the company's management team to improve strategic direction, designing and implementing necessary investment plans and improving operational activities. **Venture capital** firms invest in companies in earlier stages of business development, in concepts and start-ups. Venture capitalists invest their capital and expertise to develop new products and technologies in areas such as clean technology, digital media, life sciences, internet and other new technology, new marketing concepts and new products that do not have a proven track record or stable revenue streams.

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[15]Buyout fund: A fund whose strategy is predominantly to acquire controlling stakes in established companies. (EVCA, 2012 Pan-European Private Equity and Venture Capital Activity, Data on Fundraising, Investments and Divestments)
[16]Early-stage fund/ venture capital fund: A fund focused on investing in companies in their primary development stage.(EVCA, 2012 Pan-European Private Equity and Venture Capital Activity, Data on Fundraising, Investments and Divestments)
[17]Growth fund: Funds whose strategy is to invest in relatively mature companies that are looking for capital to expand or restructure operations.(EVCA, 2012 Pan-European Private Equity and Venture Capital Activity, Data on Fundraising, Investments and Divestments)
[18]Mezzanine fund: A fund that provides (generally subordinated) debt to facilitate the financing of buyouts, frequently alongside a right to some of the equity upside.(EVCA, 2012 Pan-European Private Equity and Venture Capital Activity, Data on Fundraising, Investments and Divestments)

Both private equity and venture capital firms are long-term investors (with average period of involvement above five years). This reflects a commitment to building lasting and sustainable value in the businesses they invest in. Private equity and venture capital investors' gain is realised when their stake in the improved business is sold to a higher than the acquisition value. Generally, investors will sell their stake in a company by listing on the public markets or selling to a strategic buyer. In terms of financing sources, private equity and venture capital firms raise funds to invest from sources such as pension funds, endowments and sovereign wealth funds.

BRIEF OVERLOOK ON PRIVATE EQUITY MARKET

In terms of size, investments in private equity in 2012 at the European level were similar to those of the USA (around 0.28% of GDP). The corresponding ratio of private equity to GDP is 14 times smaller in Romania (0.02%) and decreased to less than half from previous year. For benchmarking purposes, the private equity to GDP ratio in Central and Eastern Europe is four times bigger (0.08%) and Bulgaria, with a 0.2% ratio, is close to the European level.

Furthermore, in developed countries, the share of venture capital in total private equity, ranges between 40% and 60%; Romania's share of venture capital in private equity is 12%, significantly behind that of neighbouring Bulgaria which is more close to the European average. Only one from eight private equity transactions in Romania is a venture capital transaction and this has persistent causes and consequences to the economy in general.

The upturn prospect of the Romanian economy is not outside the risk-zone yet. Moreover, the recent economic crises severely affected the economic substance of companies, especially that of SMEs. Since such financing gaps cannot be generally closed by banking instruments, the low level of private equity in Romania represents lost financing opportunities and lost growth opportunities. Having in mind the above mentioned conceptual distinction between private equity and venture capital, during the panel dialogue it was stated that literature shows that an increase of venture capital investments of 0.01% could lead to a 0.1% economic growth. The second mentioned benefit referred to strategic gains. Venture capital usually finances ideas and businesses that are riskier than the average and also provides strategic orientation to target businesses. Beyond financial support, venture capital makes ideas happen.

BARRIERS, OPPORTUNITIES AND INITIATIVES FOR IMPROVING SMES ACCESS TO FINANCING SOURCES

For Romania's case, transforming venture capital into growth instruments requires not only barriers removal - such as relaxing the pension funds investment policy regulations - but, more importantly, nurturing the conditions for the development of sound entrepreneurial and financial ecosystems. Previous JEREMIE[19] experience with EU funds for SMEs could be used for capacity building. One

[19] JEREMIE - Joint European Resources for Micro to Medium Enterprises, is an initiative of the European Commission developed together with the European Investment Fund. It promotes the use of financial engineering instruments to

institutional development could include the creation of a fund capable of attracting investments for specific industries such as IT, early-stage businesses. Public funds are initially necessary for such institution, but international financial institutions such as the European Bank for Reconstruction and Development (EBRD)[20] or the European Investment Fund (EIF)[21] could be subsequently involved in leveraging public funds by attracting private sources.

Liberty Technology Park – Cluj, Romania

Liberty Technology Park Cluj, the first technological park in Romania, is a park for creative ideas built in an environment designed to offer nurturing conditions for early-stage development companies operating in such areas as IT&C and R&D. The project developers intended to replicate existing international experience with innovative ecosystems that bring in special vicinity tertiary education institutions, R&D companies, business incubators and accelerators etc. Following the Silicon Valley example, but having in mind its non-repetitive character, further developing stages of the ecosystem focus on bridging the processes of ideas generation and market validation. Enabling access to high quality mentoring services and expertise for the residents of the technology park is seen as critical. As one speaker noted, further steps should include adding the necessary but missing chain links between start-up, gross equity and buy-out investment phases, as large venture funds of the size of Silicon Valley (400-800 million USD) typically invest in 30 to 60 million USD per transaction and early stage business generally do not qualify for such levels of transactions.

Even though Romania lacks such investment links, historically, Europe lacks significantly behind the US in this area. Statistics of previous 32 years of private equity investments show that *net internal rates of return* for venture capital investments typically revolve around 1.27%, whereas *net internal rates of return* for buy-out investments reach 11.6%. Few European investors have comparable skills to their American counterparts and this is one of the reasons for which Silicon Valley phenomenon is unlikely to be replicated in Europe. Romania is endowed with a significant pool of technological talent but lacks the investors of adequate size for large investment projects in innovative areas with proven competitive advantage such as the IT industry. Such investment gaps could be closed by large European investment players such as EBRD and EIF who meet the necessary conditions in terms of existing expertise, credibility and size to facilitate financial leveraging.

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improve access to finance for SMEs via Structural Funds interventions. EU countries can use part of their European structural fund allocations to invest in revolving instruments such as venture capital, loan or guarantee funds which, in turn can support : (1) creation of new business or expansion of existing ones; (2)
access to investment capital by enterprises (particularly SMEs) to modernise and diversify their activities, develop new products, secure and expand market access; (3) business oriented research and development, technology transfer, innovation and entrepreneurship; (4) technological modernisation of productive structures to help reach low carbon economy targets; (5) productive investments which create and safeguard sustainable jobs (http://ec.europa.eu/regional_policy/thefunds/instruments/jeremie_en.cfm#2)

[20] EBRD fosters transition to market economies in countries from Central and Eastern Europe to central Asia and the Southern and Eastern Mediterranean. EBRD provides project financing for banks, industries and businesses, both new ventures and investments in existing companies. We also work with publicly owned companies.

[21] EIF is European Investment Bank(EIB) Group's entity. EIF is the Group’s specialist provider of risk finance to SMEs across Europe. By developing and offering targeted financial products to EIF partners, EIF enhances SMEs access to finance. To this end, EIF fosters EU objectives as (1) entrepreneurship, (2) growth, (3) innovation, (4) research and development, and (5) employment.

EBRD Financing Opportunities for SMEs

With 359 projects totalling 6.7 billion EUR in net investment and gross disbursements of 5.5 billion EUR, the European Bank for Reconstruction and Development (EBRD) has been active in the Romanian economy for over 22 years.

According to its 2012 country strategy, in the coming years, the EBRD aims to develop projects that will assist Romania in maintaining stability in the financial sector, to support further growth of Romanian enterprises and small and medium-sized enterprises (SMEs). The Bank will support Romania's transition to a low-carbon economy and enhance its energy efficiency and security and will promote commercialisation, competition and private sector involvement in infrastructure. To assist micro-enterprises and SMEs, the Bank will offer dedicated debt facilities (credit lines) to banks, micro finance institutions and leasing companies, and investments in and alongside private equity funds, especially those focused on local companies and investments in less advanced areas. Local enterprise facility developed by EBRD is not sector oriented and targets investment projects ranging from 3 to 10 million EUR.

3TS Catalyst Romania Fund

Private equity and venture capital firm 3TS Capital Partners is one of the leading private equity and venture capital firms in Central and Eastern Europe operating across the whole region through offices in Bucharest, Budapest, Prague, Vienna and Warsaw. 3TS Capital Partners launched in 2012 a 25 million EUR fund called 3TS Catalyst Romania to target Romanian small and medium enterprises active in technology, internet, media, and communications and services sectors. 3TS investment strategy targets high growth sectors in need of expansion capital and buyout investments. Latest investment of Catalyst Romania Fund has been made in the local telecommunication company SIMARTIS TELECOM. SIMARTIS is specialised in marketing technology business to business solutions and already has clients in three continents and 3TS expects their capital injection to help the company to further diversify its client and product portfolio.

The fund has been set up with the support of the EIF through JEREMIE initiative of the European Commission, which allows financing for SMEs through structural funds. The share of EU funds in the total resources of the fund is 70%. In Romania, the JEREMIE initiative is funded by the Sectoral Operational Programme „Increase of Economic Competitiveness" 2007-2013, through European Regional Development Fund.

EIF and the JEREMIE Initiative

3TS Capital experience with Romanian JEREMIE initiative was not an extremely smooth one, being affected by inherent difficulties, typical of a new beginning. Main barriers to the establishment of venture capital funds include overly strict regulations regarding the expenses eligibility criteria and difficulties in attracting private sources due to tight European regulations regarding state aid. The EU funds share in venture capital funds cannot exceed 70% of their total value. The remaining 30% of financing sources have to be attracted from the market and, in the case of 3TS, despite initial investment interest displayed by a major local pension fund, the financial market regulatory body eventually forbade the conclusion of the transaction.

Although the interest of pension fund contributors should prevail and a fair degree of conservativeness in the investment policy of a pension fund is understandable, the actual investment efforts, compared to total held assets, would probably not jeopardise the low risk profile of pension funds' investment policies. Similar barriers were met in Bulgaria by other investors.

In spite of implementation difficulties, the panellists agreed that accessing the JEREMIE initiative was beneficial and such arrangements clearly display advantages in term of professional management approach. Due to the underdeveloped feature of the local capital market, governments in the region may lack resources, including expertise, in acting as efficient private equity investors. Available public resources may be more professionally managed by long established major international financial institutions such as EIF (within its JEREMIE initiative), EBRD or EIB. Additional benefits include the decrease of potential political interference in fund allocation. Strategic directions may be established by governments, control over operational activities may also be exercised, but arbitrary intervention in actual fund allocation or investment beneficiaries would be significantly reduced.

Local venture capital investors have already addressed to government representatives an investment instruments strategy proposal for the 2014-2020 multiannual financial exercise, in which financial ecosystem building blocks from businesses accelerating to buy-out instruments are added to more traditional guarantee and risk takeover instruments. EIF, EBRD or EIB, could offer valuable expertise in institutional development and contribute to increasing the quality of governmental investments. Various institutional arrangements, involving development and commercial banks and government institutions could be imagined.

The necessity of local entrepreneurial and knowledge upgrade in order to facilitate local enterprises' access to sophisticated financial sources, markets and opportunities is also an important aspect. Last but not least, the panellists asserted the importance of professionalism, transparency and independence of operational activity for any successful investment fund initiative.

FURTHER BOOSTING ROMANIA'S GROWTH AND COMPETITIVENESS: ROMANIA EAST-WEST GATEWAY UNIT

Starting with 2009, the Aspen Institute Romania has organized an annual international large-scale conference designed to explore the challenge, responsibilities and opportunities stemming from Romania's geography and its EU and NATO membership. In 2012, the Aspen Institute Romania has merged some of the work in its National Interest Program and Economic Policy Programs and created **Bucharest Forum, the largest international gathering focusing on the needs of economic and strategy policy decision makers in the region between the Adriatic, Black Sea and the Caspian Sea.**

Bucharest Forum's mission is twofold: to **create in Bucharest a regional platform for economic policy and political dialogue for governments and business on the New Silk Road**; and **to serve as an influential dialogue platform between the Romanian business sector and political decision makers in order to strengthen the country's economic governance and competitiveness.**

Following the 2013 second edition of Bucharest Forum, the Government of Romania has decided to transform the idea of an East West Gateway Project, presented by a number of Aspen Romania members from the corporate sector, into a national strategic project.

The establishment of the Romania East-West Gateway Unit in 2014 creates the institutional space for unprecedented public-private cooperation and coordination. The Romanian East-West Gateway is recognized as a strategic project of national interest, **being implemented through a dedicated public-private team - Gateway Unit** and should contribute to the development of the New Silk Road concept that wants to revive the ancient Silk Road via a combination of modern highways, rail links and energy pipelines connecting Europe, Asia and Middle East.

In practical terms, Romania needs to leverage the competitive advantages of its geographical positioning, resources and infrastructure and become the East-West Gateway on the New Silk Road, through strategic focus areas: **(1) financing the economy and fostering economic opportunities; (2) manufacturing, skills and industrial policy convergence; (3) energy infrastructure and sustainability; (4) transport infrastructure and multi-modal logistics; (5) information technology and high-value added creative industries.**

The East-West Gateway Unit has several objectives: **(i) indentifying strategic projects for Romania; (ii) analysis of all projects identified from a cost-benefit perspective; (iii) providing a clear prioritization of these projects based on their importance, impact and resources required for implementation; (iv) structuring a viable financing and partnership mechanism for large-scale projects; (v) developing a coherent communication and progress monitoring strategy at Government / Prime Minister level.**

Romania has the potential to become the regional economic powerhouse. A new Romanian growth model will increase investments, expand exports, focus on higher value-added activities, and finance growth via renewed FDI and higher domestic savings, while maintaining a balanced trade, unleashing and accelerating productivity growth.

ANNEX
CONFERENCE PARTICIPANTS

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