INVESTMENTS

THE COLUMN FOR A SUSTAINABLE ECONOMIC DEVELOPMENT IN ROMANIA

25 Years of Impact
AmCham Romania
American Chamber of Commerce in Romania

Introduction

This document aims to provide a pragmatic perspective on the need to use investments as an active tool for capital growth in the Romanian economy and to foster a model of sustainable economic growth and balanced development.

The document is structured into 5 chapters. Thus, the first chapter presents the role of investments in the functioning of a sustainable model of economic growth.

The second chapter offers an overview of the investment process in Romania, from a macroeconomic perspective, emphasizing both the performances so far as well as the existing shortcomings.

The third part examines policies to encourage investment, reviewing the challenges and solutions for capital supply and demand.

The fourth chapter defines several priority sectors to support national competitiveness, while the last chapter discusses the relevance of public investment as a driver of economic growth.

The central idea of the document is that of risk capital. The framework of analysis, concepts and solutions proposed is based on this hypothesis.

We consider that the operationalization of this concept at the level of the national economic policies would represent a significant evolution of the way of analyzing and designing economic policies in Romania.

Chapter

1

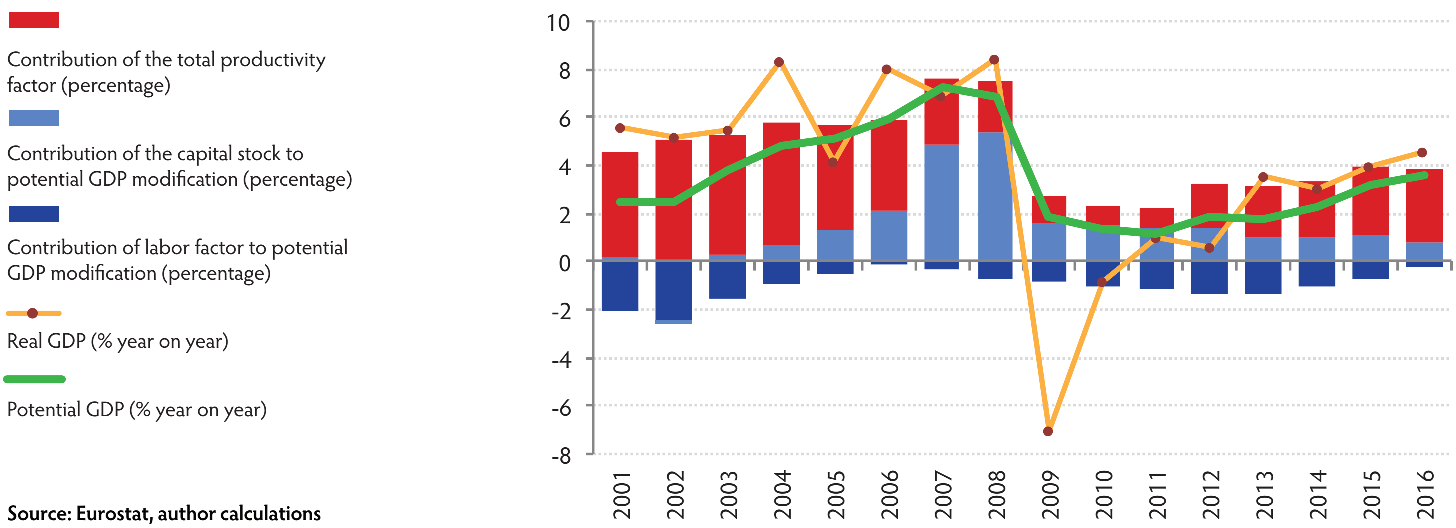
INVESTMENTS – DEVELOPMENT ENGINE

Although we do not have a generally accepted theory of economic growth, there is still a working approach to this issue. Most economists call for the production function to explain the relationship between the amount of goods and services produced in an economy and the combination of production factors used. Therefore, the production function, $Y=A^{L^{\alpha} K^{\beta} N^{\gamma}}$, highlights the importance of the production - labor factors, capital, nature, and the total productivity of production factors (A) [1] - in economic activity. Therefore, there is a direct relationship between the quantity of each production factor used and the result achieved. Investments lead to capital formation, and this, allocated to productive uses, can lead to economic growth. Referring to capital, we bring to discussion both the intangible capital and human capital, not just the physical or financial capital. These forms of capital require investment, especially in the context of information and knowledge being included as new production factors in an economy passing through the fourth industrial revolution.

Having said that, what is the situation in the Romanian economy? For now, we see a reluctance on the part of private investors to allocate more resources to investment projects. If we focus on gross fixed capital formation in the private sector, expressed as percentage of GDP, data shows a downward trend over the past 4 years. [3]. Also, domestic policies adopted (wage increases, tax rates to give just a few examples) cause uncertainty for investors, as stated at the Bucharest Forum held on 4-6 October 2017, and Patricia Wruuck, economist at The European Investment Bank, on the basis of the study [4], arguing that focus should be shifted from consumption to investment in order to talk about sustainable long-term economic growth. This trend is also correlated with the behavior of the public sector, which allocates additional resources to consumption at the expense of investments, leads to limiting the potential for economic growth at national level and accentuates the macroeconomic imbalances. The primary role of investments in an economy is to strengthen the ability of the economy to meet demand, first of all domestic demand. Without this capacity, supply pressures trigger rising prices (up to the level of import prices in the case of an open economy), thus inflationary pressures as well as imbalances in the trade balance and implicitly of the current account. Just by comparing the first quarter, 2016 and 2017, we see a 120% approximate increase in the current account deficit (data which can be analyzed on Trading Economics) [5]. Also, a fall in investment can also lead to an increase in the trade deficit, which continues to have an upward trend (increasing consumption leads to an increase in imports, as domestic supply cannot meet the additional demand driven by consumption). The trade deficit structure is also relevant. Thus, a structure of the trade deficit dominated by capital goods over consumption is generally preferable. This marks the orientation towards productive allocations of available resources, which may generate a transient trend from the trade deficit to a new balance.

Commercial deficits generally put pressure on the national currency in the sense of devaluation. All these trends are evident in the national economy in the contemporary world.

Chart 1: Contributions of production factors to potential GDP dynamics



Source: Eurostat, author calculations

[1] Total Productivity of production factors is a residual factor introduced in the form of the production function to characterize factors that influence the evolution of production and can not be explained by the production factors considered.
[2] World Bank, World Development Indicators, Romania, Gross Fixed capital formation, private sector (% of GDP) https://data.worldbank.org/indicator/NE.GDI.FPRV.ZS?end=2015&locations=RO&start=1995&view=chart
[3] https://tradingeconomics.com/romania/foreign-direct-investment

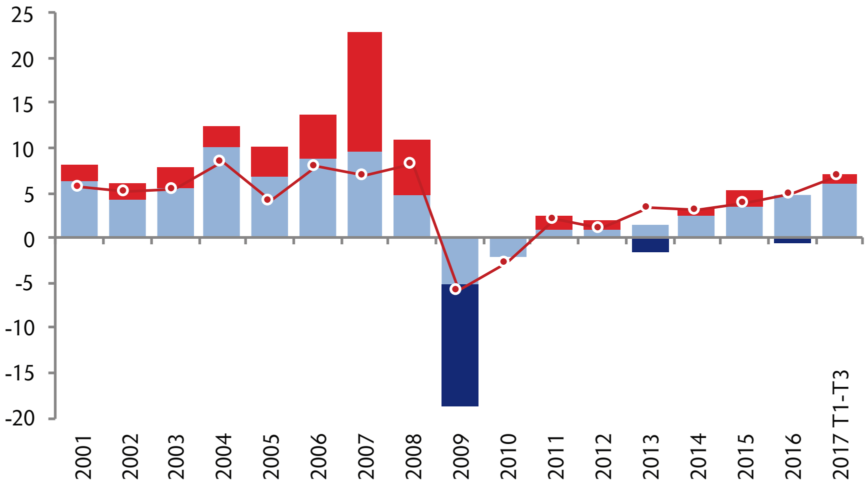
Chart 2: Contribution of population consumption and investment to GDP dynamics

Contribution of investments to GDP dynamics (percentage)

Contribution of population consumption to GDP dynamics (percentage)

Real GDP (% year on year)

Source: European Commission estimates of November 2017



Thus, a sustainable economic growth model that generates welfare for citizens focuses both on public and on private investment, the systematic development of capital in all its forms, and the active capitalization of the competitive advantages of the national economy. These concepts also generate regulatory and development priorities for the next period. Thus, the development of intangible capital, the human capital, financial markets, as essential infrastructures for attracting foreign capital and increasing the productive allocation of the national one, the reorientation of the (public) spending structure towards productive allocations and the encouragement of saving are examples of such priorities.

Although Romania is "facing" consumption-based economic growth (see Chart 2), the question arises as to whether this economic growth reflects and is reflected by welfare and prosperity. Beyond the quantitative approach in the current dialog on the evolution of economic growth, an increasingly important role is given to the qualitative approach. Thus, the welfare of the individual, the purchasing power of the national currency, the quality of life, the quality of public services, the infrastructures and services to which they have access are more important as an expression of welfare in an economy than the GDP size or the nominal wage (see graph 1). Romania can make this leap in the projection and manner of reporting to the result of the economic activity and the qualitative dimension of the distribution of this result. This quality orientation will generate public policies that will provide the basis for the sustainability of high living standards and the quality of citizens' lives.

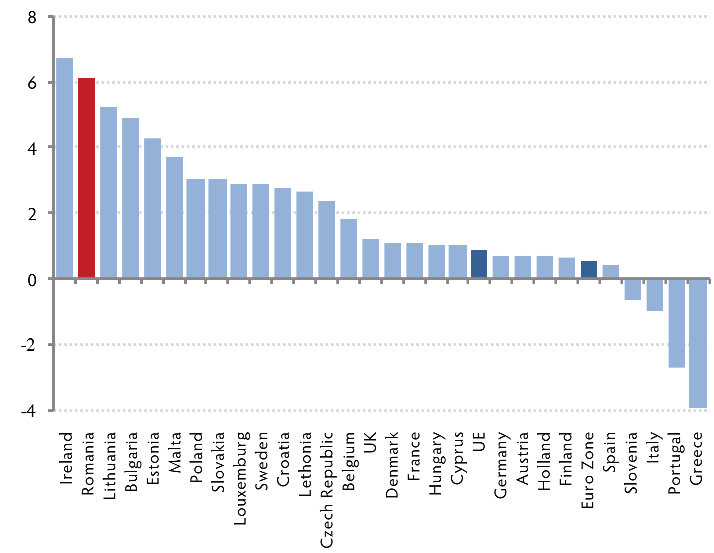
Chapter 2 DYNAMICS OF INVESTMENTS IN ROMANIA

Analyzing the evolution of investments in Romania in 2001-2016 [6], we find that Romania was the country with the second fastest investment dynamics in tangible assets (6.1% on average per year) in the European Union (after Ireland). This dynamic is highlighted in Chart 3:

In this multi-annual approach, covering a complete economic cycle, Romania was the economy that recorded one of the highest investment rates in the European Union, with an annual average of 25% of GDP. The share of investment, as shown in Chart 4, was at the upper limit of EU values for both the private sector (20.5% of the average annual GDP) and the public sector (4.5% of GDP). However, despite positive quantitative performance, current assessments indicate an insufficient level of investment in fixed assets. This is all the more evident when it comes to key infrastructure elements.

Chart 3: Gross fixed capital formation (average annual change 2001-2016, in%)

Source: Eurostat, author calculations



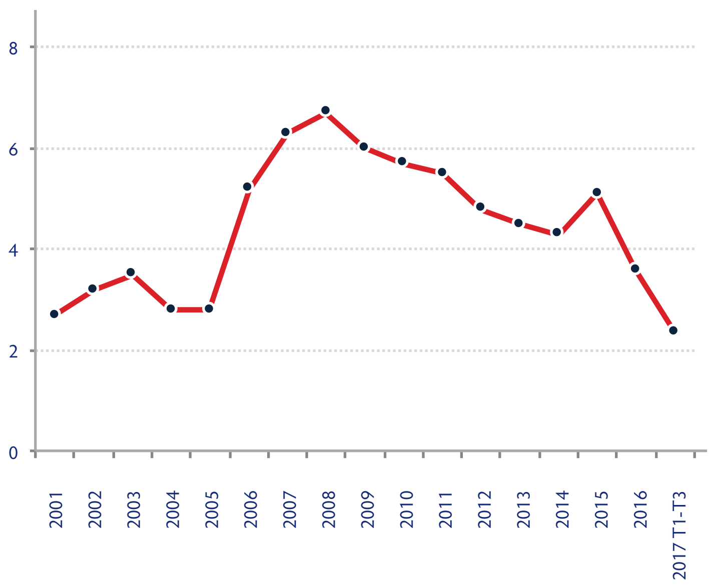
4 http://www.eib.org/attachments/efs/economic_investment_report_2017_en.pdf
5 https://tradingeconomics·com/romania/current·account

On the one hand, the rapid growth of investment was made from a very low starting level, which explains the current low level. On the other hand, particularly in the public sector, the efficiency of investment spending was low. Also, the quality of public spending raises questions by looking at their effects. There were also inefficiencies in the case of private sector investments due to pro-cyclical exuberant behavior (e.g. the boom in the residential and non-residential building sector in the years leading up to the crisis). Investment financing was made to a high extent by contracting debt when the non-financial companies had a financing deficit. Part of these loans had as a counterpart the increase in external debt, resulting in an increase in the vulnerability of the economy to external shocks.

The economic crisis triggered in 2008 led to a redeployment of investment priorities and their forms of financing. Some of the factors that prompted growth in pre-crisis investment - EU membership, the favorable regional context characterized by large inflows of foreign capital into CEE countries, exuberant investment behavior - ceased to manifest. Additionally, imbalances generated before the start of the crisis in the economy and the companies sector (expense financing by debt contracting) had to be corrected. In this context, in the last years (2014-2017), Romania recorded one of the lowest dynamics of investments in fixed assets (an increase of 2.9% on average per year) in the European Union. The investment rate has declined substantially in the private sector, while the government has massively reduced its investment to support fiscal consolidation (2010-2015) or limit the growth of the government deficit (2016-2017). The low absorption rate of European funds at the beginning of the new 2014-2020 budget period is another factor that has led to a reduction in investment in recent years. Last but not least, the change in the structure of the economy towards increasing the share of services - a sector characterized by a lower investment in tangible fixed assets - also supported the reduction of the investment [7] rate (see Chart 5).

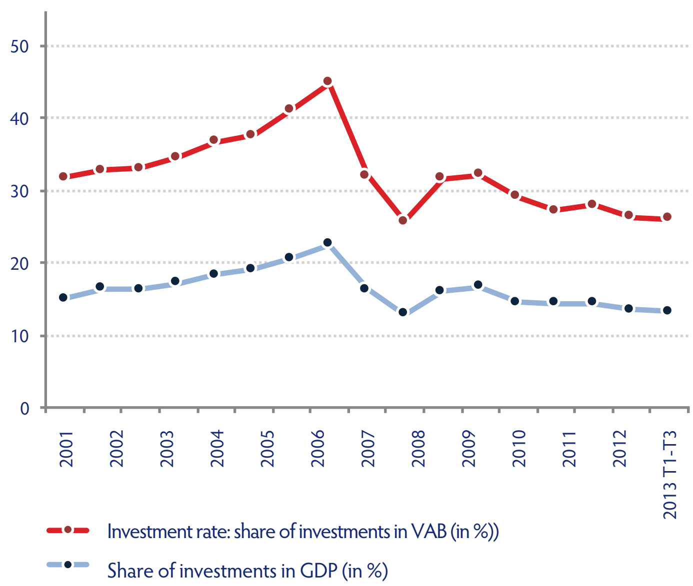
There are important company discrepancies in their ability to support the investment process and these discrepancies have become increasingly apparent in the recent period when access to financing has become more difficult (reducing foreign capital inflows and funding by banks) or was done in a more prudent way. Large companies have sound financial positions and have easier access to finance, being the main driver of the investment process. Many of the small businesses are in delicate financial situations and have a higher indebtedness, making their access to finance difficult or impossible.

Chart 4: Evolution of public investment in Romania (% of GDP)



Source: Eurostat, author calculations

Chart 5: Evolution of investment by non-financial companies



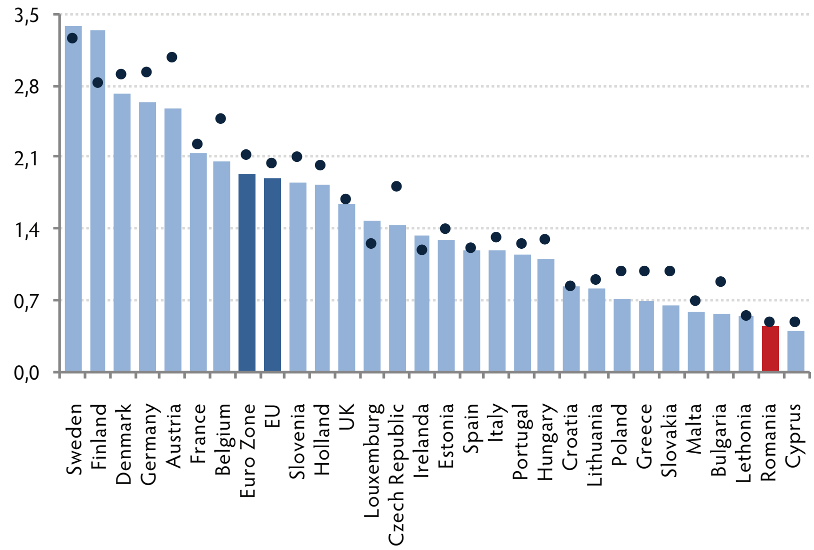
Source: Eurostat, author calculations

Although overall Romania recorded high investment rates since 2001, the performance was very small in the case of investments specific to the new knowledge-based economy. Between 2001 and 2016, Romania was the EU Member State with the lowest share of research and development spending in GDP (see Chart 6, 0.45% of the average annual GDP compared with 2% of the EU average annual GDP). In addition, the size and quality of human capital have deteriorated (population decline and aging, deterioration in the quality of the educational process, brain drain process). Romanian enterprises have a reduced capacity for innovation and, moreover, the share of innovative companies has been decreasing in recent years [8]. These developments suggest that the potential of the economy to actively face technological progress over a long period has not improved but has rather deteriorated.

[6] We have chosen as the reference period the 2001-2016 period for which more complete data are available, and to remove previous periods characterized by frequent and major structural breakdowns, steep inflation and a high volatility of economic activity.

[7] The lack of accounting and tax regulations and methods to highlight investments in intangible capital items make the level of investment in services to be modest. Companies in this field invest mainly in intangible capital.

Chart 6: Research and development expenses in the European Union



Research and development expenses (% of GDP, average for 2001-2016)

Research and development expenses (% of GDP, average for 2015-2016)

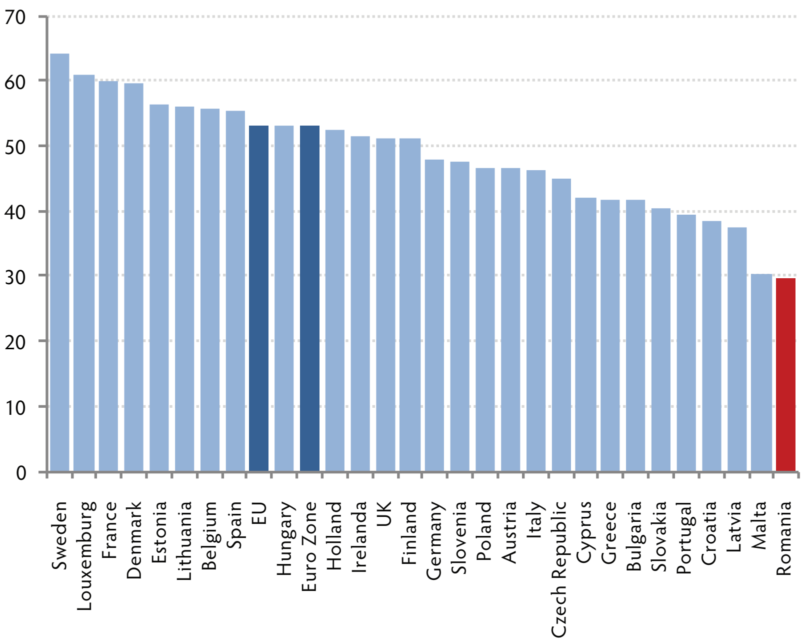
Source: Eurostat, author calculations

Chapter 3

INVESTMENT ENCOURAGING POLICIES

Investments are essentially a capital accumulation or acquisition, and in this report, we aim to treat capital in its broad sense of any good or service that is not consumed today but is used to create a surplus in the future. Therefore, we include here not only fixed assets and not just fixed assets but also intangible assets such as Research, Development and Innovation products, employee training services, databases, engineering designs, copyrights, etc. (for a more detailed approach and a classification of intangible assets, see Corrado at al., 2005) [9]. In a world in which every product and service is assigned a task to be fulfilled, the task of capital investment is to produce yield in the future. According to the theory of finance, we cannot talk about yield without talking about risk, the two being closely connected. Therefore, investments are risky enterprises made by people predisposed to take risks. In Romania we often forget this, which may explain why the accumulation of capital and especially equity (the riskiest form of capital in its sense of balance sheet liability) is still significantly different from other European Union countries. This is also evident from Chart 7, where the equity ratio is presented in relation with total financial liabilities for EU countries.

Chart 7: Share of equity in total financial liabilities of companies (2016)



Remark: Financial liabilities of companies including equity and financial liabilities

Source: Eurostat, author calculations

[8] See also the recently published data of the INS on the share of innovative enterprises, which in the period 2014-2016 fell to 10.2% from 12.8% in the period 2012-2014, while the EU average is close to 50%. For details: http://www.insse.ro/cms/sites/default/files/com_presa/com_pdf/inovatie_afaceri16r_0.pdf.

[9] This inclusive definition is a necessity in the current context of the "knowledge economy", in which such intangible capital can prove to be even more productive than the tangible capital. See: Corrado, C., Hulten and D. Sichel (2005), "Measuring capital and technology: an expanded framework", in Measuring capital in the new economy, C. Corrado, J. Haltiwanger and D. Sichel, eds., Studies in Income and Wealth, Vol. 65, Chicago: The University of Chicago Press.

As mentioned in Chapter 2, risk-taking behavior in anticipation of high returns is an intrinsic aspect of capital investment, hence the effort to increase investment in economy should take into account the appropriate incentives to encourage such investment behavior, but in a sustainable manner. The recent financial crisis has been caused by the excessive risks taken by a large part of investors in the financial market, so one of its consequences was an increase in risk aversion, both among financial savings owners and among regulation institutions. Romania was not far from this trend, an evidence for this being the super-incidence of low-risk saving instruments (bank deposits, government bonds or mutual funds with exposure on the two previous instruments) in the public portfolios. It is true that the role of financial markets is to channel at least some of these savings invested in low-risk and short-term instruments into more risky and longer-term ventures, all within a transparent and regulated framework. However, in Romania, this role is predominantly fulfilled by banks, which, by their very nature, have a limited ability to take risks (generally lend only money to those are mostly guaranteed), a capacity which has been even more restricted in recent years due to the scars left by the financial crisis and the economic recession, as well as the tightening of banking regulations, especially those at European level.

Under such conditions, public policies designed to encourage investment should pay particular attention to improving the incentives for a more direct risk-taking, both for those who have savings or capital to invest (generally the population, but also local or foreign institutional investors), as well as those who have plans to employ capital in productive activities but need financing (decision-makers from non-financial companies, respectively managers, shareholders, or to use a more generic term, entrepreneurs). In other words, investment policies should consider increasing the chances that capital supply will meet capital demand in an efficient manner, a process that is currently running cumbersome.

3.1. Stimulating capital demand

Capital demand comes from entrepreneurs, who by definition are more likely to take higher risks than others. This risk-taking does not mean only crazy courage or a dreamer` s mind. On the contrary, investments are almost always preceded by a business plan, which requires a thorough analysis and a lot of realism. This analysis also requires a careful assessment of economic, social, fiscal or financial uncertainties. Therefore, a first result that we believe authorities should always consider is the public asset called predictability, removing from the investment paths those bureaucratic, administrative and legislative uncertainties that would prove to be unnecessary. It is relevant to mention that uncertainty about the future is cited by the participants of the European Investment Bank Investment Survey 2017 as the most important long-term investment barrier (three quarters considering it a major issue). Frequent changes of an already too complicated legislative and regulatory framework as well as increasing the complexity of the fiscal framework are recent trends in the Romanian context, which obviously have the effect of discouraging investment. The Romanian business environment has found an even stronger voice in the recent past.

Therefore, a next step should be reversing such trends and stetting concrete objectives for simplifying the legislation, reducing bureaucracy and increasing the transparency of the legislative and administrative process in the economic and fiscal field.

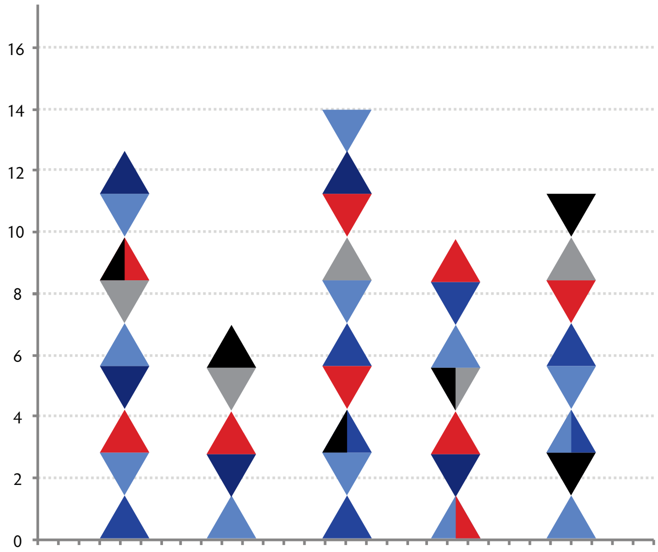
Given that the need for investment in Romania comes not only from the private system, but also from the public infrastructure sector, a second step would be to include the above-mentioned objectives in a larger project of a National Investment Plan, following the model of the Investment Plan for Europe launched in 2014 by the European Commission [10]. Such a plan should include, as in the case of the European one, a pillar for the establishment and financing of strategic investments for Romania, especially from the public sector, from projects already undertaken, such as the Master Plan in Transport, such as and the list of strategic projects eligible for European funding. This part of the investment plan should include necessarily a prioritizing effort and a realistic and honest financial planning. Ideally, this effort should be cross-party, and the result

[10] Creating such an Investment Plan would represent a national project worthy of celebrating the centenary of the Great Union, but also an excellent preamble for Romania to take over the presidency of the EU Council in 2019.

should have a broad assumption and support from the political, business and social environment.

A second pillar should include coordination, counseling and information, providing technical assistance, but also a private information platform, thus facilitating funding opportunities or various other business opportunities. Some projects that might be included here would be, for example, the promotion of areas of activity or opportunities for specialized foreign investors, or, because another major problem of the business environment is finding skilled labor, this platform could contribute to the creation of counseling centers with labor market specialists to serve both employers and potential candidates. Thus, at least for a few strategic areas with good growth prospects of the economy, it would be possible to reduce the uncertainties specific to the various areas of activity in which entrepreneurship is committed.

Finally, the third pillar would include measures to improve the business environment, reduce bureaucratic barriers and investment barriers.



In addition to coordinating investment efforts by creating a coherent national framework, it is important not to forget the issue already mentioned for Romania's case, the low level of equity in the balance sheets of many companies, a problem that also affects the eligibility for financing by bank loans investments of these companies [11]. Thus, the issue of stimulating the financing of companies through direct investments, or by equity participations is raised. Of course, in Romania reinvestment of profits and in general financing from domestic sources was the main source of financing of direct capital investments, perhaps due to related tax incentives (such as the tax exemption for reinvestment of profits). A concrete proposal in this respect could be the expansion of tax incentives for reinvestment of profits and for investments in intangible capital items. This would require the prior development of tax and accounting legislation to recognize the existence of these elements and to provide them with appropriate tax treatment. However, the fact that this source has increased its share in financing investments, according to data provided by NIS reaching 78% in 2016, a peak of the post-crisis period, makes us believe that its potential for growth is something more limited. Foreign direct investment, on the other hand, is an inexhaustible potential source of funding, but accessing it often puts Romanian firms in a position to give up business control. At the same time, we believe that the implementation of the above mentioned National Investment Plan would create favorable conditions for the attraction, including active, of foreign direct investment. In this respect, the functional development of the legislative framework and the institutional capacity to evaluate, analyze and manage PPP projects could be a solution to attract such investments.

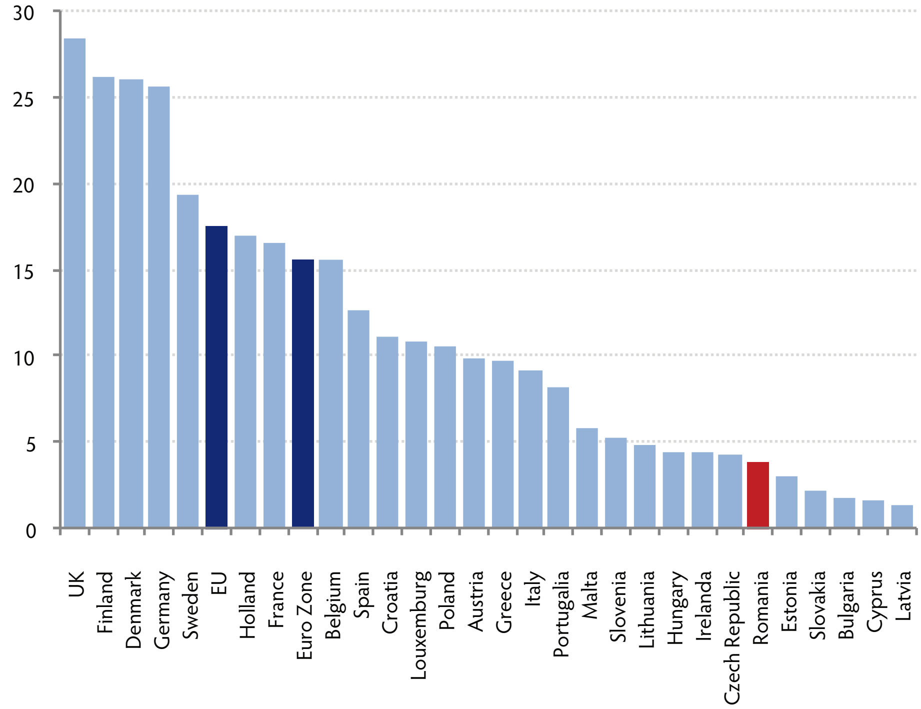
A source of funding that is certainly under-exploited in Romania is the capital market. Its role in financing the Romanian economy is still a marginal one, although some countries in the region, like Poland, have managed to use this leverage to boost the economy and investment. There are fundamental reasons why entrepreneurs do not resort to the capital market, which can be more difficult to overcome in the short term, such as the costs of additional transparency and the change in governance required for the market or the reluctance to transfer the control of the company even to minority shareholders. However, we believe that there are issues where the incremental improvement could facilitate access to funding for entrepreneurs. Among these, we mention the increase in the efficiency and liquidity of the capital market and, in general, the package of measures that would qualify the Romanian market for the emerging market status, a Bucharest Stock Exchange project, supported by the ASF, which we believe should materialize in the near future. This status would open access to the Romanian market for specialized investment funds whose long-term entry on the local capital market would allow a price adjustment and a further improvement in liquidity, as was the case with the inclusion of Romanian government bonds in bond indexes representative for emerging markets.

More attractive stock prices mean that entrepreneurs who want to attract money from the stock market sell their expensive goods (stocks), and the increase in liquidity and the bigger spending allocation of investors ensure that the sales process takes place quickly and efficiently, as well as the fact that higher price levels are more sustainable (as opposed to larger fluctuations in border markets). All this would encourage a more active use of the stock market to finance corporate investment, as evidenced by the rise in private listings on the capital market in 2017, a year in which we also witnessed the increase in liquidity and stock market prices. Chart 8 shows the value of shares of listed companies, as a percentage of GDP, having as a reference point the end of 2016. Unfortunately, the current trend in state-owned companies, which still dominate the stock market, appears to be a reversal of corporate governance reforms, reversing the growth of private sector involvement in these companies, including listing additional packages or new companies and, in general, reduction of decision-making transparency at management level.

It is therefore necessary to resume the positive trends that have led most of the listed state companies to show positive

[11] See the Report on financial stability of the NBR no. 1/2017, available at http://www.bnr.ro/Publicatii-periodice-204.aspx

Chart 8: Value of shares of stock market listed companies (% of GDP, end of 2016)



Source: Eurostat, author calculations

financial results and attractive growth prospects in recent years, which is reflected in market prices and contributing to the status of the Romanian market as one of the most interesting in the central and south-eastern European region. In this context, the planned set up of the Sovereign Development and Investments Funds (FSDI) holds the opportunity of a review of the corporate governance of the companies to be incorporated in the Fund, and the prerequisites that should be observed in this process must include competency, strategic coherence, stability and management accountability. Bringing some of the most performant and most important state-owned enterprises under the same umbrella, could also facilitate a better coordination between the companies' management and the shareholders, as represented by the FSDI leadership. At the same time, a transparent alignment is needed between the Fund's interests and the public and or private interest of the state, or, put differently, it is necessary for the FSDI governance to observe the same principles applicable to the SEO's management. A clear and detailed investment mandate of the FSDI, built on the best practices in its field, is needed to achieve its intended role.

3.2. Stimulating capital supply

The above discussion has already led us slightly in the area of capital supply, where we tackled the problem of internal sources of financing for companies and attracting direct foreign investment. We also discussed the idea that what seems to be inadequate in Romania is the supply of direct capital investment rather than loan capital. This raises the issue, on the one hand, of stimulating domestic saving, especially of the population, and on the other hand, the channeling of savings to capital equity. It is, moreover, a paradox of recent years that, despite the extremely low levels of interest rates, the savings of the population and local institutional investors remained in the low-risk area, high risk aversion which I mentioned was an essential factor in the decision to allocate resources to this type of investors. Where could interventions be made to change this situation?

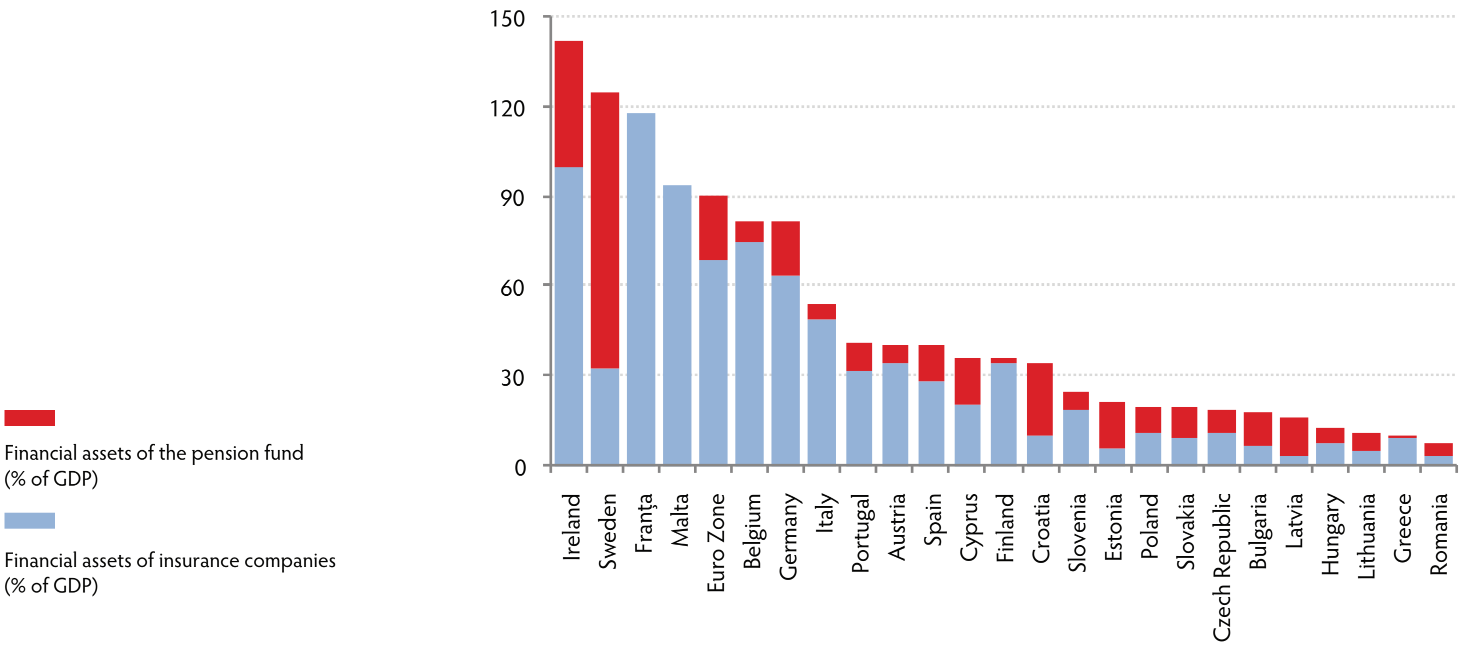
Firstly, we consider more important incentives for long-term savings as a necessity, because when people think for longer term, they seem more willing to take additional risks. Current tax incentives for saving in the form of voluntary pension or life insurance products with an investment component seem too low to lead to significant long-term saving behavior, as evidenced by the low level of assets accumulated in such products. In addition to expanding these facilities (for example, by increasing the annual tax deductibility cap on optional pensions), we believe that they could be added other incentives, such as tax exemptions and / or contributions for savings in long-term investment special accounts (a feature that exists in a number of other countries, the closest example being Hungary), respectively amounts invested for at least 5 years in instruments of choice and depending on the risk profile of each investor. Thus, another example of this would be policy in England, where each individual can invest annually in 2017-2018 up to 20,000 pounds deductible from tax. In addition to tax exemptions, interventions could also be geared to the cost of equity purchases on the capital market, at least by individuals, especially since the share of commi-ssions charged by the Financial Stability Authority is disproportio-nately high compared to countries in the region, although the turnover in the stock market is very small by comparison.

Secondly, we believe that in the private pension funds there is a significant source of capital insufficiently used because of the current regulatory framework (and partly in other local institutional investors). Thus, although the private pension system has assets of about 5% of GDP, less than 20% of it is invested in shares and these are largely only in the shares of large companies (see Figure 9). Taking into account that the investment horizon of these funds is very long, we believe that this share of shares is suboptimal, including from the perspective of participants in the system, especially since it is expected that in the next period the yields on fixed income instruments, which predominate pension funds' portfolios, will decline as interest rates rise. In order to increase the share of these investments, the regulations relating to the risk coefficients for each class of financial assets and the risk limits imposed on pension fund portfolios need to be changed and the provision requiring pension funds to bear the capital market trading commissions, this provision being able to turn pension funds into passive stakeholders on the capital market, also reducing their contribution to increasing market liquidity.

Private pension funds bring the stability needed in the local financial markets, for its future development as it represent a capital source for long term projects and investments.It would also be desirable to broaden the spectrum of investment instruments by allowing investment in higher risk instruments within reasonable limits, such as alternative investment funds or private equity funds.

Thirdly, we believe that new forms of financial intermediation, of crowdfunding, micro-credit or robo-adviser type, as well as other embodiments of the financial integration trend, deserve to be pursued and perhaps technological advances even encouraged internally - a trend commonly known under the term fintech. Such forms of intermediation have begun to increase in some countries and to knock at the door of Romania. We believe that authorities should also look at them as opportunities to improve financial intermediation, especially in market segments where other traditional players cannot reach. An early effort for easy regulation[12] and careful risk monitoring would be desirable in order to give a signal of credibility to the sector but also to avoid slippages that are later difficult to correct and turn these new lines of business to destructive forces.

Chart 9: The assets of insurance companies and pension funds (end of 2016)

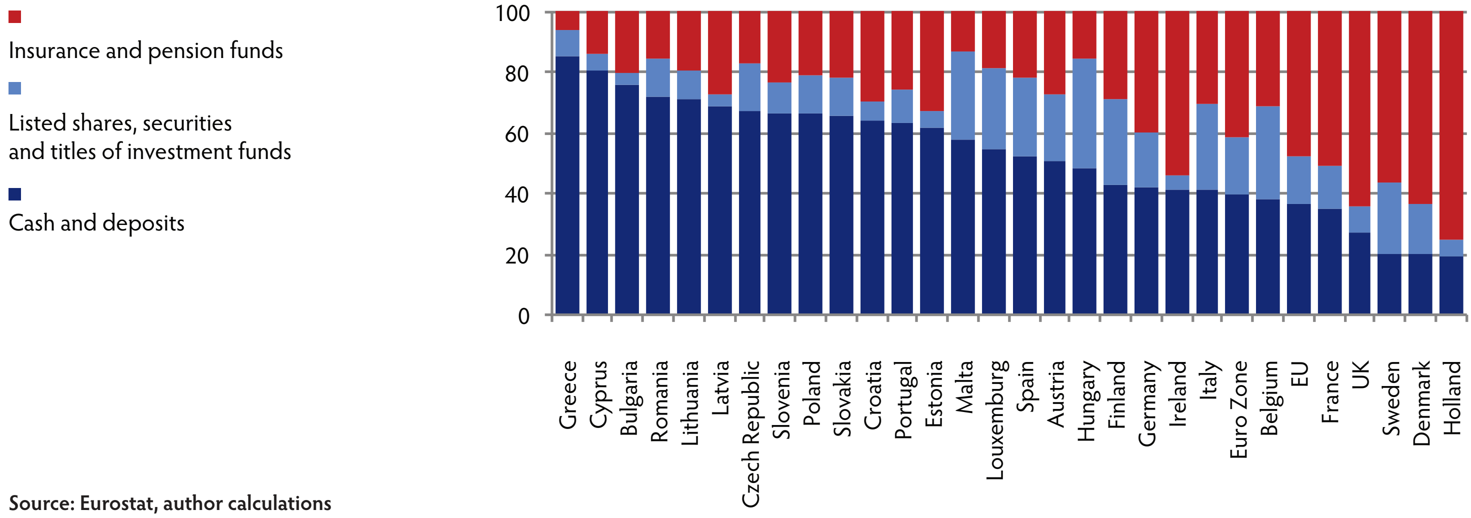


Source: Eurostat, author calculations

[12] To be interpreted in the sense of the term "light regulation" used by the European Commission.

Finally, but certainly not in the end, it is necessary to intensify the financial education efforts, a chapter where the Romanian population is unfortunately still deficient compared to the countries of the European Union, as shown in Figure 10. In addition to encouraging financial education programs initiated by various private-sector players, the authorities could also make a contribution by facilitating access to rural populations or urban areas less targeted by campaigns funded by private actors. Generalized introduction of optional or even compulsory financial education subjects in schools would also be an important step that would improve the understanding of the financial phenomenon by the coming generations. Financial education programs should have as an important component the assimilation of basic concepts on financial markets, the characteristics of the various types of saving and investment instruments, especially the risk-versus-yield coordinates. These notions would allow for more informed investment decisions, decisions that would normally lead to a more diversified allocation of saving resources of population than is currently the case.

Figure 10. Structure of financial investments of population (% of total, end of 2016)



Source: Eurostat, author calculations

Chapter 4

INVESTMENTS WITH HIGH IMPACT ON FUTURE

The fundamental problem of any investor is therefore to identify those assets that will generate positive yields in the future with a risk considered acceptable in relation to the expected yield. This problem applies to both public and private investors.

Global reality indicates extremely powerful vectors such as significant geo-political changes, massive urbanization, with emphasis on intelligent cities, demographic developments, the technology tsunami with projection on extensive inter-connectivity, but also critical challenges such as climate change, the widespread risk of terrorism, new technologies and the sustainable use of resources, the crisis of refugees or the fourth industrial revolution as forces that will shape the economic landscape in the future and will lead to developments in economic power centers. All these forces and trends will generate structural changes to the current power ecosystem and will lead to significant differences in the balance of global powers.

Under the pressure of global, European and regional changes, Romania's competitive positioning efforts must be amplified and strategically substantiated for a more efficient synchronization with accelerated geopolitical, economic and technological developments. Current economic growth is an asset, but complexity intervenes in the area of economic competitiveness, and the sustainability of this growth becomes crucial, especially with regard to flagrant discrepancies of the low levels of living, uneven regional development, poor quality of public services and development gaps of infrastructure and public services.

Taking into account the global competition for attracting investments, creating new jobs and development, Romania's investment policies must be based on visionary structural elements:

- a medium- and long-term operational strategy identifying sectors with high competitive potential, national priorities with cross-systemic impact and qualitative and cost-effectiveness standards for such investments;
- catalysts needed to boost value-added investments, such as tax incentives for research-development-innovation, localization facilities, systematization, connection and de-bureaucratization, specialized education of the labor force;
- an institutional platform dedicated to identifying, implementing and monitoring strategic investments;
- promoting complex projects at national level with sustainable cross-sectional impact, stimulating productivity growth and socio-economic development;
- special measures for the modernization and development of critical infrastructure;
- advanced and calibrated economic policies to narrow the gap between regions and capitalize on domestic capital;
- transparency, predictability and equidistance in the government act, beyond electoral cycles.

AmCham argues that:

- stimulating investment in key export industries, and creating support systems for local and foreign investors based on new technology deployed, on the number of jobs created and on high added value export capacity;
- using European funds to develop physical infrastructure to strengthen Romania's competitiveness and sustainable economic growth;
- encouraging research and development and advanced technologies;
- accelerating the pace of structural reforms, strengthening public institutions and increasing the performance of state-owned enterprises.

We believe that the following areas have high competitive investment potential:

Agriculture

Rehabilitation of irrigation infrastructure, also through the use of renewable energy sources, smart power grids, digital platforms and applications;

Adopt legislative and fiscal measures to encourage **farmers' association and land consolidation** along with tax measures to discourage raw material exports and encourage value-added production in Romania;

Promoting biological agriculture and preserving national plant genetic resources.

Power

The next steps for developing an independent, strategic position in the energy field should include accelerating the effective implementation of the national energy strategy that prioritizes the modernization of this sector, following the needs and objectives of the national economy in the medium and long term and materializing the advantages of the strategic position in the interconnection of the regional and European markets. The national energy strategy will have to ensure, through legislative measures, a high level of energy independence that is directly correlated with the available energy resources at national level and with Romania's energy security.

Digitization

Under the implementation of the national strategy for the digitization plan for Romania - AmCham Romania considers that the strategic directions in the field of information and communication technology (ITC) are the following:

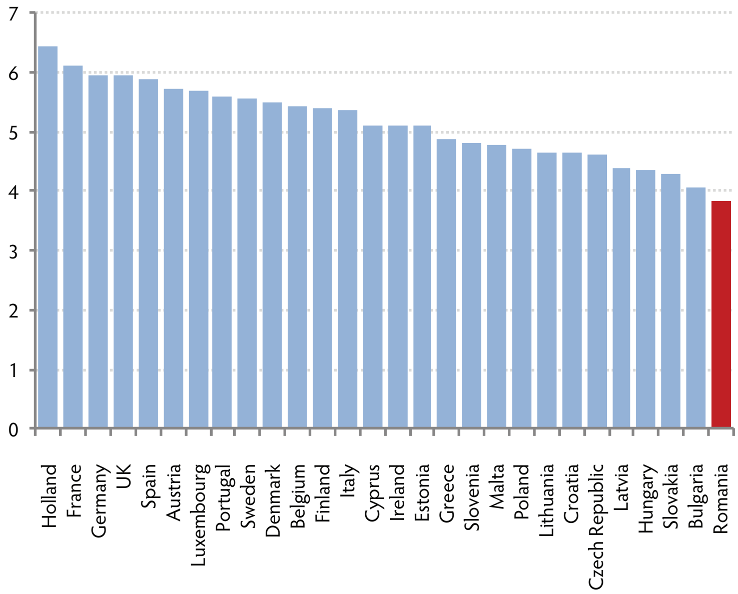
- Implementing a **national IT infrastructure** to ensure the interoperability of systems and services with central and local public administration;
- Adopt and implement a **national strategy** to digitize the public sector by expanding digital administration and introducing cloud services;
- Implementation of a **data classification system** based on the freely available data rule;
- Implementing modern **cyber-security** policies and systems;
- Increasing the level of **digital education and digital competences** in Romania as a platform to support the country's medium and long-term growth.

Transports

Romania already has a Master Plan of Transport and should focus on implementing and identifying funding sources, even if this Master Plan can be improved. The priority must be a qualitative and efficient implementation, but it depends on the acceleration of the absorption of European funds, the allocation of funds from the budget, the development of public-private partnerships and the development of technical skills and the management of large projects.

The implementation and funding of the Master Plan should take into account the positive priorities and effects it might have in areas such as tourism intensification, the discovery of the potential of some regions, increased attractiveness for investment or the competitiveness of exporters. We emphasize that our recommendations relate to all modes of transport, including rail, river, water and air. It is very important for Romania to benefit from the European projects for the development of the TEN-T network and to support the development of multimodal infrastructure in the regions designated for development. Chart 11 shows how infrastructure quality is assessed in Romania compared to other European countries.

Chart 11: Perception of the infrastructure quality



Remark: Value 7 describes the best scoring that can be obtained

Source: World Economic Forum - The Global Competitiveness Report 2017-2018

Chapter 5 PUBLIC INVESTMENTS

In the reference period for this survey, 2001-2016, Romania experienced one of the highest investment rates in the EU, i.e. an annual average of 25% of GDP for the analyzed period. The structure between private and public allocations is 20.5% of GDP per year, or 4.5% of GDP per year. Also, in line with the annual average economic growth, the growth rate of fixed asset investment was also one of the most accelerated in the EU, i.e. 6.1% on average per year. Despite these sustained efforts, the effects felt in the perceived quality of public infrastructure and services are insignificant. Thus, from a global perspective, Romania ranks 128th (out of 138 states) in terms of infrastructure quality and 79th in terms of quality of road infrastructure. Similar situations are also seen from the perspective of the quality of public services such as health and quality of public institutions. [13]

According to the analysis of the European Commission, the degree of infrastructure development and the functioning of public institutions are factors that significantly limit the competitiveness of the national economy as well as Romania's economic growth potential [14]. In an economic context characterized by pro-cyclical economic policies, the severe limitations of the economic growth potential can lead to overheating the economy and undermining the sustainability of economic growth.

Thus, the Romanian economy seems to be captive in a series of paradoxes. On the one hand, we allocate in nominal terms higher amounts for public investment [15] and, on the other hand, the effects on the economy are limited; the impact on the quality of public infrastructure and services is modest. For an economist, Romania appears to be experiencing friction in the functioning of institutions and markets in the respective economic sectors. These generate additional costs and inefficiencies in the process of creating public goods and services.

But Romania is not a "black swan"[16] in the regional landscape. The experience of the new EU Member States [17] has shown that investing in intangible assets such as administrative capacity, the predictable legal framework, training of the human capital and the process of evaluating and implementing investment projects, ensuring the quality of public investment, and multiannual budgeting are factors that contribute significantly to solve the problems outlined earlier. It should be noted, however, Romania's constancy in addressing the relevance of intangible capital. As these elements are not recognized in the case of private capital, their value is also neglected in the case of public capital. However, opportunity costs are supported in a non-discriminatory manner by all citizens.

That being said, it is obvious that the investment need is high in Romania and the solutions for meeting them are limited. As the economic cycle evolves, the context limitations will play an even more important role in reducing the degree of freedom and the fiscal space for policy-makers. In this context, Romania can begin to consider the use of capital markets as risk management tools generated by investment in key areas. Such an approach involves firstly the internalization of concepts such as the use of risk capital for public (public) investment projects and the appropriate development of the legislative framework and the administrative capacity to operate such instruments. In this context, the development and operationalization of an adequate regulatory framework for Public -Private Partnership (PPP) projects as well as the administrative capacity needed to evaluate and implement such projects is essential for Romania.

[13] European Commission, Country Report of Romania for 2017, in the context of the European Semester, available at https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-report-romania-ro.pdf

[14] European Commission, Country Report of Romania for 2017, in the context of the European Semester, available at https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-report-romania-ro.pdf

[15] Although the percentages allocated from GDP are expressed as an annual average, this value is applied to a GDP value that grows year on year. Romania records in the analysis period one of the most accelerated rates of economic growth in the EU.

[16] We use the term in the N. Nassim Thaleb concept in the Black Swan book. Very Unlikeliness Impact, 2010, Curtea Veche.

[17] The new Member States of the European Union are the ones that joined UE in the last wave.

Another option open to Romania is to speed up absorption of European funds and attract direct foreign investment. Although Romania has 49.5 billion euro [18] available for the current programming period, only 10.01% has been absorbed from the FESI and 35.25% from the FEGA.[19]

Foreign direct investment has seen positive dynamics since 2011, correlated positively with the resumption of economic growth. However, the positive evolution did not reach the levels recorded before the economic crisis. [20] The lack of predictability of economic policies, the legislative evolution and the administrative capacity of public institutions, the modest development of the capital market and the competitive constraints that the national economy is characterized are obstacles to foreign investment. These resources, the use of which does not generate public debt, become very important in the next period in the context of the current economic cycle approaching its end, and the capacity of the public environment for counter-cyclical intervention will be limited during the depression and possible crisis by the degree of public indebtedness that has increased significantly.

CONCLUSIONS

This report aims to define a conceptual framework for addressing investments and the role they play in an economy. The approach was not intended to be exhaustive, but rather to bring the topic into the public debate on economic issues and to provide the stakeholders with operational benchmarks and action tools to tackle the proposed theme.

The document starts from defining and substantiating the essential connection between investment, economic growth and development process, highlighting the importance of coherent economic policies, decision-making processes and institutions throughout this process. It also highlights the role of the markets in the capital allocation process and the costs / inefficiencies that weaknesses such as an imperfect regulatory framework or the malfunctioning of institutions can produce.

The first chapter explains the role of investments for economic growth and aims to define the approach of towards investments to be analyzed in this report.

The analysis includes in the second chapter the investment competition benchmarks, highlighting the vulnerable position of Romania as well as solutions to address some of the issues discussed.

One of the important traits of the past evolutions in the Romanian economy was the structure of the economic growth, which it based on consumption and which was supported by procyclical fiscal policies.

This approach contributes to the deepening of the macroeconomic imbalances, which makes it unsustainable. In this context, our proposal is a shift in the focus of the public policies so that they will ensure the sustainability of the economic growth through the management of the macroeconomic imbalances and will be aimed at competitiveness. The further development of the national economy needs special attention and a focus on increasing the purchasing power and the quality of life.

The third chapter reviews investment encouragement policies and analyzes both capital demand and supply. The essential point around which the argument is built is the need to introduce and operationalize the concept of venture capital. The solutions presented in this chapter, such as the development of the capital market, the existence of a National Investment Plan and its sources of financing start from this concept.

The recommendations for the development of the capital supply mainly point to the need to increase the quality of the relevant institutions, by way of removing administrative and procedural obstacles that raise the cost for accessing capital for the local entrepreneurs. Also, financial education is essential for all market participants to understand and assess the risks they undertake by accessing the available financing solutions as well as the options they have in order to attract capital for their operations.

The fourth chapter gives a perspective on the sectors considered as priorities for the National Investment Plan and the last chapter analyzes the subject of public investments and their role for the functioning of a sustainable model of economic growth. The criteria used to select these fields include cross-sectorial reform

[18] Under the Romania-EU Partnership Agreement, including the national contribution of 7.5 billion euros
[19] The Ministry of European Funds, Absorption stage for programs financed from Structural and Investment Funds (FESI) and payments made from the European Agricultural Guarantee Fund (EAGF) on 19 January 2018
[20] According to World Bank, World Development Indicators, Romania - Foreign direct investment, net inflows as% of GDP available at: https://data.worldbank.org/indicator/BX.KLT.DINV.WD.GD.ZS?end=2016&locations=RO&start=1

measures, sectors that currently hinder the economic growth and sectors with high potential for economic growth. Measures to support the economic competitiveness are included in the first category, along with measures to increase the absorption of EU funds and measures to incentivize research and development, while the second category refers to measures for increasing investments for the development of physical infrastructures, especially transportation infrastructure. The third category outlines measures related to investments in the area of public services, digitization and agriculture.

The fifth chapter draws a picture of the evolution of public investments during the analyzed period and concludes that despite significant allocations, the real impact on the development of infrastructure and public services are being modest. In this context our recommendations focus on the need for public policies that will not only pursue a quantitative increase of the resources, but also the impact generated by using such resources. One of the proposals refers to investments in intangible capital, such as increasing the quality of public institutions, consolidating the administrative capacity, the human capital and the legislative framework. Also, a focus on sources that will not generate further public debt is needed in order to finance investments, such as FDI inflows and EU funds absorption. Finally yet importantly, the report emphasizes the increasing role of the capital market as a mechanism for allocating resources towards productive operations.

The essential point of the document is that without a coherent investment process there can be no sustainable economic growth. Without the latter, the lasting improvement of living standards for all Romanian citizens remains only a chimera.

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The American Chamber of Commerce in Romania (AmCham Romania) is for 25 years a leading representative of the business community in Romania, and is acknowledged as a promoter of the private-public dialogue on matters related to the business climate, public policies that impact Romania's economy and competitiveness or the economic ties between Romania and the U.S.

Currently, AmCham Romania's over 430 members – U.S., international and Romanian companies allow AmCham to engage in promoting the business priorities for many industries, through dedicated working groups, such as: Capital Markets, Corporate Governance, Competition and State-Aid, Education, Energy, Environment, Health, ICT, Infrastructure, Labor, Structural Funds, Public Procurement and PPP, Real Estate, Taxation and Tourism.

Through consistent efforts during its 25 years of activity, AmCham Romania has contributed to the modernization of the legislative and fiscal framework in Romania, by offering decision makers access to its members' expertize, by promoting best practices used internationally, and by recommending measures needed to increase Romania's economic competitiveness.

Values such as integrity, professionalism, transparency and objectivity have guided the organization's activity at all levels and have consolidated the trust and reputation that AmChams enjoys among its members, in the business community at large as well as among decision makers and counterparts.

A constructive and balanced approach and an agenda set on improving the business climate have strengthened AmCham's leading position as a business association and its relevance in time, even amidst the numerous changes that the organization has faced during its 25 year presence in Romania.

For companies, affiliation with AmCham is an expression of their commitment and responsibility towards the quality of the investment climate in which they operate and towards their contribution to Romania's overall social and economic development. AmCham Romania's connection with the international business is granted by its accreditation by the U.S. Chamber of Commerce and its affiliation to AmChams in Europe. In Romania, AmCham enjoys a great institutional collaboration with the U.S. Embassy in Bucharest and is a member and contributor to Coaliţia pentru Dezvoltarea României, the informal consultation platform supported by business associations that share the same objectives.

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AmCham ROMANIA

American Chamber of Commerce in Romania