

Romania



Bank Lending To Small and Medium Sized Enterprises in Rural Areas; an Analysis of Supply and Demand

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**Food and Agriculture Organization
of the United Nations**



**European Bank
for Reconstruction and Development**

ROMANIA

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Currency Equivalents (2005)

1 Euro = 40,125.5 Romanian Lei (ROL)

1 US Dollar = 30,731.0 Romanian Lei (ROL)

Abbreviations

CDE	Centre for Economic Development
EUR	Euro
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
IFI	International Financial Institution
MAFF	Ministry of Agriculture, Forestry, and Fishery
MFI	Micro Finance Institution
NBR	National Bank of Romania
NGO	Non-Governmental Organisations
PPS	Purchasing Power Standard
ROL	Romanian Lei
RCGF	Rural Credit Guarantee Fund
RDA	Rural Development Associations
SAPARD	Special Accession Programme for Agriculture and Development
SME	Small and Medium Enterprises
UNDP	United Nations Development Programme
US\$	United States Dollar

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EXECUTIVE SUMMARY

Overall Economy and Rural Business Environment

i The economic situation in Romania has improved over the last years and starting in 2001 the growth rate averaged some 5 percent per year. Also the development of the financial sector has gathered pace and domestic and foreign direct investments, in view of the country's accession to the EU in 2007, are rapidly picking up. These favourable trends, however, are far from being evenly distributed over the territory: Bucharest and a few other big towns in more favourable regions account for the bulk of the growth, while a large part of the country's economic potential, representing small cities and rural communities, is not fully utilized. One of the reasons that financial resources allocated to rural areas remain under-utilized is the inadequacy of financial services to match the needs of local business, notwithstanding the number of specially designed financing programs in this respect

Small Enterprise Finance

ii The main source of finance for starting a small business are own funds from savings or remittances. However, reliance on limited own financial resources and lack of access to external funds have condemned many SMEs to low operational efficiency and a limited scale of operations, thus affecting their further development. Moreover, existing small and medium-sized enterprises (SMEs) in Romania, in order to comply with the new EU norms and standards and to expand and to diversify their activities, normally are not able to accumulate enough internal resources from retained profits to make major investments in the required restructuring of their facilities and to obtain new equipment. These enterprises require for this purpose access to outside funds in order to pursue their development. External funds may come from various sources such as commercial business suppliers, banks and leasing companies, equity investors and capital markets (although normally not accessible for SMEs) and others like government, international financial institutions and non-governmental organizations. Bank loans, a potential important business financing source, still covers only a small percentage of the financing needs of SMEs in Romania (some 10% in 2002)

Bank Lending

iii Commercial banks are by far the strongest players in the Romanian financial system: 30 banks and eight branches of foreign banks operate in Romania and majority foreign-owned banks account for almost two thirds of the total bank assets. Bank credit to non-government in real terms grew by 50% in 2003 and, in particular, consumer lending but also leasing finance and, more recently, mortgage lending are expanding rapidly. Still, the money supply and non-government credit in Romania as percentage of the GDP are lower than in any other accession country and it is often argued that the supply of bank loans to SMEs is weaker than the potential demand for such services. In this study no attempt has been made to quantify the unmet demand for credit by SMEs in rural areas, since the effective demand typically depends on the price and other terms at which bank loans can be supplied in a sustainable way. Instead, emphasis has been given to an assessment of the determinants of the demand as well as to the factors which constrain the supply of bank loans to rural SMEs.

iv Banks are selective in choosing their clientele and potential borrowers see bank lending terms as unfavorable. Average lending rates exceed 26% p.a. for domestic currency loans, although the inflation rate is expected to move to a single-digit figure by the end of 2004; conventional loan collateral, normally mortgage, is required at a value that may be 250% of the loan value; and short-term loans (up to 12 months) predominate. Differences exist, however, between larger and smaller more aggressive banks: the first ones may offer better lending rates and have a wider choice of loan products, including with longer maturities, but small clients complain that large banks are not acting like business partners; small banks, on the other hand, normally charge higher lending rates and do not offer term loans for investments, but they tend to treat their small clients better.

v Lending terms are even more unfavorable for SMEs in rural areas, in particular, in those smaller communities where banks do not have branches or agencies. Few rural SMEs apply for bank loans and even less of them are successful in receiving loans. In July 2004, credit to agriculture, forestry and fishery (Taken as a proxy for rural credit, although admittedly it does not include credit for farm-related and non-farm rural economic activities) represented a mere 2.6% of the total bank loans above EUR 5,000 that were extended. The major reasons quoted for the under-representation of rural credit in the overall loan portfolio of banks are:

- absence of bank branches in smaller rural communities due to the high transaction costs and non-profitability of rural lending;
- bankers' perception of rural clients as being risky due to their low repayment capacity and credit discipline;
- a lack of trust that rural people have in banks and bank services;
- lending terms of banks which do not correspond with the specific features of rural clients and types of investments in rural areas; and
- non-compliance of potential rural borrowers with the loan application requirements of banks, including their lack of capability to prepare adequate business investment plans.

Rural Credit Supply Constraints

vi High transaction costs and risks are the main factors which affect the supply of bank credit in rural areas.

Bank Transaction costs

vii The presence of banks in smaller rural communities is weak and they are reluctant to open new bank branches or agencies in rural areas, because large cities offer plenty of profitable business opportunities and room for expansion. In fact, transaction costs of banks in rural areas are high without being compensated by corresponding high revenue levels and the bottom line is reached when the total costs of operating a small retail bank outlet with a low volume of transactions are not compensated by earned income. Banks which inherited a large branch network (the case of the Raiffeisen Bank, but also Banca Comerciala Romana and BRD-Groupe

Société Générale) keep shrinking their presence in small communities. The World Bank Rural Finance Project which was launched in 2001 has been also until now not successful in its attempts to enlarge the network of retail bank units in rural localities by offering to finance the incremental expenditures incurred and to provide related staff training and technical assistance.

Bank Credit Risks

viii In particular, agricultural production loans are subject to both high physical risks (unfavorable weather and large outbreaks of crop pests and animal diseases) and economic risks (depressed markets and prices), which affect the profitability and repayment capacity of farmer borrowers. These loans, and even more so investment loans which are characterized by increased uncertainty due to longer time horizons, require specific risk management mechanisms at farm level such as the availability of irrigation facilities, good farm and business management practices, farm enterprise diversification and insurance coverage. A distinction should be made between:

- individual borrower risk (problem of asymmetric information between lender and borrower); and
- general or systemic risks related with lending to a new type of clientele such as rural SMEs (overall lack of information, ineffective loan supervision, and collateral problems); risks that affect a whole region (physical risks in agriculture) or are related with a specific economic activity or sector (for instance, the competition threat of Asian countries, in particular China, in the textile industry); and risks of a policy or political nature such as the new norms and standards that are required for Romania's accession to the EU or the use of non-transparent national subsidy programs.

ix Systemic risks, which are largely beyond the control of financial institutions, will have, in particular, a severe effect on those institutions that have an undue concentration of their loan portfolio on a specific clientele, geographic region or economic sector. This explains the normal prudential character of banks in selecting their clientele, matching the maturity of their assets and liabilities, and diversification of their loan portfolio.

Loan Collateral

x Collateral refers to the assets that are pledged by the borrower to the lender until the loan is fully repaid. Banks can reduce to a certain extent their information-related problems and credit risks by the use of collateral which has two main functions. First, it serves as a screening device of potential borrowers who intend to make good faith efforts to fulfill their loan repayment obligations and thus makes willful loan default less probable. Second, it reduces credit risks by providing the lender with an additional source for loan repayment by liquidation of the collateral asset in case of actual loan default. SMEs In Romania perceive the excessive reliance on conventional collateral (normally, mortgage is required) and a high collateral value (250% or higher than the loan value) as the main constraints to bank loans for investments. In fact, the

determining factor for rural SMEs in selecting the source of loan finance that they need is the lower collateral requirement.

xi The usefulness of rural collateral to lenders, however, is negatively influenced by uncertain legal procedures related with foreclosure in case of loan default and the difficulty to sell seized rural assets such as farm land, houses and machinery. As a result, rural fixed assets are evaluated very conservatively by banks, while they often insist on mortgage of urban real property. On the other hand, micro finance institutions in Romania such CHF International and also the Miro Bank, adopt in their rural lending a much more flexible approach, while they use also a combination of different collateral types such as mortgage (above a certain loan value and for investment loans), movable assets, and personal guarantors. For instance, for CHF the combined collateral value for both standard business loans (up to USD 20,000 and 2-year duration) and short-term business loans (up to USD 5,000 and 3 months maturity) equals to 120% of the loan value plus interest. In the case of the Miro Bank, for rural business loans (up to EUR 50,000 and 5-year duration) the total collateral value is 110% of the loan value of which 70% should be mortgage (for loans above EUR 25,000), while for farmer loans (up to EUR 10,000 and 2-year duration) there is no need for mortgage.

xii Some priority actions for Government authorities and banks in the field of loan collateral would be:

- To complete the issuance of ownership titles for farm land and to develop an active land market by establishing a countrywide land registration system; in this context consideration may be given to subsidize for small farmers the excessive high land registration fees as well as the required notary fees for mortgaging and land ownership transfer.
- To support a wider adoption by banks of rural movable assets as collateral by complementing the utilization of an already existing electronic database of movable guarantees with improvements in the corresponding legislation and better law enforcement mechanisms of contracts.
- To facilitate in the context of the already developed warehouse legislation system the use of negotiable warehouse receipts of crop inventories as loan collateral by establishing a special Indemnity Fund and by widening the number of participating qualified warehouses. This will contribute to the development of both agricultural lending and agricultural commodity exchange markets for grains and other products.
- To increase the capital base of the Rural Credit Guarantee Fund and to widen the current scope of guarantees to all viable rural economic activities.
- To support banks with technical assistance and staff training to improve their current evaluation methods of rural collateral assets and to facilitate the combined use of different types of collateral in rural lending.

Leasing Finance

xiii Leasing operations represent a fast growing market in Romania with an expected turnover in 2004 of EUR 1.8 billion. Car business still represents more than 90% of the local

leasing transactions and equipment imports used to be financed through offshore leasing companies. However, in the last two years a small but increasing share of the domestic leasing market has been directed to equipment. Potential SME clients in rural areas look at leasing finance of required machinery and equipment as an attractive alternative to bank lending due to the serious constraints that they encounter in complying with bank loan collateral requirements.

Credit Guarantee Funds

xiv Credit guarantee funds have been established to facilitate the difficult access of small clients to bank loans by sharing the loan default risk between the borrower, the lending bank and the guarantee fund. The Rural Credit Guarantee Fund (RCGF), one of the three existing guarantee funds in Romania which have been set up with international assistance, is the most relevant one for SMEs in rural areas. It guarantees investment loans up to 70% of the loan value for which a commission fee is charged to the bank. Normally this fee is passed on to the borrower with the exception of individual farmers and farmer associations for whom the commission fee is borne by the Fund. Since mid-2002, improvements in the guarantee conditions have made the RCGF more attractive to banks and the guarantees have increased by almost six times between 2002 and 2003, exceeding EUR 44 million. However, two problems for which concerted action between the Government/donors and banks are required, remain to be resolved:

- Increase of the existing capital basis of the Fund (currently some EUR 12 million, mainly provided by the EU), in order to be able to expand the guarantee operations in accordance with financial prudential norms;
- Widening of the scope of the RCGF to include all types of viable rural economic activities, since the Fund currently does not extend guarantees for rural industries or services other than farming and agro-processing.

Rural Finance

xv Lessons from the World Bank Rural Finance Project and other lending activities of banks in rural areas (The IFAD Apuseni Mountain Project, the German – Romanian Fund, and the Miro Bank) show that embodied restrictions regarding the target clientele (insisting, for instance, that only small rural communities and new bank clients should be included), the scope of the credit (e.g. excluding the financing of the purchase of land or buildings), and on lending through a large public bank instead of using NGO-based micro finance institutions or small banks in order to lend to small farmers and rural business, should be avoided as much as possible.

xvi SAPARD grant funding in Romania is based on an annual EU/Government allotment of EUR 204 million over the period 2000-2006 and it constitutes the major source of finance for investments in rural areas. The various types of eligible public and private investments (so-called “Measures”) reflect the priorities of the national agricultural and rural development program of the Government. SAPARD finances half of the total costs of private investment projects (100% for public investments like rural infrastructural works), with the remaining 50% coming from the investors’ own money and bank loans. Investments may include development of specific farm

enterprises, sustainable environmental agricultural production activities (like organic farming), diversification of rural economic activities, agro-processing and marketing, forestry development and rural tourism. The absorption capacity of the SAPARD funds has been slow with the exception of the financing of rural infrastructural investments. SMEs in rural areas complain that SAPARD is political and bureaucratic, painfully slow and costly (timely business investment opportunities are missed) and mainly meant for larger investment projects: e.g. agro-processing investments require a minimum SAPARD financing amount of EUR 30,000 but have a ceiling of up to EUR 2 million. Moreover, the benefit of co-financing a SAPARD project with a bank loans is not obvious due to the risk that a bank incurs when, after having pre-financed first the SAPARD funds, at the end the investment eventually results not to be approved.

Small and Medium-sized Enterprises (SMEs)

xvii SME statistics in Romania are not up-to-date: the most recent figures refer to 2002, while the data for 2003 will not be available before the end of 2004. No separate statistics exist for SMEs in rural areas and the information used in this report comes from the estimations of few studies that have been carried out on this subject. Official figures on registered SMEs include, apart from small and medium-sized enterprises, also micro-enterprises, since the distinction by enterprise size is made only on the basis of the number of (permanent) workers. In fact, there are no marked structural differences between micro- enterprises (less than 10 permanent workers) and small enterprises (between 10 and 50 workers). In 2002 there were in total 341,168 privately owned registered SMEs (with between 0-250 workers) and, out of these, micro-enterprises dominated the market (89%) against 9% small and 2% medium-sized enterprises. As could be expected, the largest numbers of micro-enterprises are found in the services sector, in particular, in small trading activities. Small enterprises operate also mainly in services followed by manufacturing activities, while medium-sized enterprises predominate in the various industrial activities. SMEs are responsible for a significant share of the total private enterprise activities as is evidenced by the economic indicators on their turnover, gross value added, gross profits, and gross investments, which account for at least some 60% of the total results of all private enterprises. An exception are the exports of SMEs, which represent only 15% of the total private enterprise exports. This indicates that SMEs predominantly work for the domestic market, although the export share of SMEs in some more export oriented sub-sectors, such as in wood and furniture, textiles and garments, and glass and ceramics, can be substantially higher.

Demand for Finance by Types of Rural Investments

xviii According to estimations of a World Bank study dated January, 2001 which uses data from 1998, there were some 80,000 registered rural SMEs. In small rural communities with up to 50,000 inhabitants, normally the main economic activities that are carried out include farming and services activities such as small trade, workshops and handicrafts. However, rural business includes also agriculture-related processing activities (agro-processing) which is often concentrated in larger communities in or close to higher potential agricultural production areas, and location-specific, non-farm rural economic activities. In order to assess the different investment requirements and to examine the potential loan demand features of SMEs in rural areas, a comparative analysis has been made of those economic activities in rural areas which are considered to present comparative benefits and are favored by specific policy measures and

financial support schemes. An initial focus of bank lending on these rural economic (sub) sectors may result to be most profitable.

Rural economic sectors and sub-sectors – Potential bank loan demand by SMEs

<i>SUBSECTOR</i>	<i>POTENTIAL</i>	<i>CONSTRAINTS/RISKS</i>	<i>INVESTMENTS / BANK LOANS</i>
AGRICULTURE			
<i>Agricultural production</i>	<i>High but under-utilized potential (land and labor) for grains, oil crops, fruit & vegetables, wine, forestry. Fast expansion of organic farming.</i>	<i>Excessive land fragmentation and subsistence farming Low capital use, technology level and produce quality Low added value of agricultural exports. Land mortgage collateral problem. Lack of agricultural insurance tradition.</i>	<i>Integration of farming in food chains needed. Investments: inputs, crop varieties/ animal breeds, buildings, equipment, irrigation. Profitable activities: grains, soybean, fruits, wine, organic/niche products, local pig production (sausages)</i>
<i>Milling & Baking</i>	<i>Grain products are a main part of the food basket. Over 4,900 SMEs and ongoing enterprise consolidation.</i>	<i>Local production of grains does not meet demand of processors. Lack of storage. High competition.</i>	<i>Linkages needed with local grain producers. Investments in storage, restructuring of plant facilities, equipment, and quality control.</i>
<i>Fruit & Vegetables</i>	<i>Local consumption/ export tradition and competitiveness (low labor costs). SAPARD finances new greenhouses.</i>	<i>Farm fragmentation and subsistence production. Lack of regional wholesale markets of fresh products for processing. Long gestation period of new orchards and seasonal cash flow.</i>	<i>Investments needed in long-term land use, orchard renewal, specialization of processing, new equipment, quality standards for exports, better packaging.</i>
<i>Vineyards & Wine</i>	<i>Good production and export potential in terms of price/ quality relation of various wine types.</i>	<i>Weaknesses along whole chain of vineyards, wineries and domestic & export marketing. Long gestation of new vineyards</i>	<i>Investments in long-term land use, vineyard renovation, wine processing and promotion/marketing.</i>

SUBSECTOR	POTENTIAL	CONSTRAINTS/RISKS	REPAYMENT CAPACITY
DAIRY			
Milk & Dairy Products	Regular income for small farmers from direct market sales. Large FDI in dairy industry: growth of local demand for processed products.	Self consumption and low milk supplies to plants. Fresh milk quality does not comply with EU norms.	Strong integration needed between milk farms & dairy plants. Investments in milking equipment, cold storage & milk collection system.
MEAT PROCESSING			
Meat Processing	Low but growing local meat consumption, in particular of sausages and chicken.	Limited supply and quality of local raw meat for processing Hygiene & quality main EU issues: (threat of closing slaughterhouses)	Major investments for restructuring and new equipment in 2005/06 of slaughterhouses & processing plants as SAPARD priority.
TOURISM			
Rural Tourism	Many micro- and small enterprises (bed & breakfast). Good value/cost ratio of rural, health and cultural tourism.	Lack of concerted efforts between private and public sectors (promotion, marketing, ITC, road infrastructure). Lack of collateral.	Finance needed for refurbishment of accommodations, internet facilities (online reservations) and better business support services.
TEXTILE AND OTHER			
Textile & Garments	Fast growth of SME garment manufacturers contracted by West European stores. Competitive skilled workforce in design and manufacturing.	Threat of Chinese price competition after liberalization of textile market. Low profit margins Inadequate bank lending to adjust to fashion changes.	Priority to CAD and CAM equipment and internet facilities in bank lending to remain competitive/ to keep ahead of the demand changes in main international clothing markets.
Wood & Furniture	Competitiveness (large forest lands and cheap labor). Good tradition and growth potential for production/exports	Low capital use and lack of bank finance for SMEs in wood harvesting/cutting due to a lack of collateral assets.	Wood & furniture are Government priority. Investments for compliance with EU environment norms, restructuring & new equipment needs.
Glass & Ceramics	Competitiveness of tableware and decorative product exports (not for industrial glass).	Issues: high capital intensity, cost containment, cash flow, and foreign competition.	Investment needs for upgrading of kiln and furnace and new equipment exceed USD 100,000.

Type of Rural SME Borrowers

xix A first observation to be made is that rural areas and the location of registration or operation of SMEs should not be defined too restrictive (i.e. limiting to only those SMEs whose core activity is carried out in communities up to 50,000 inhabitants), as this would mean that then mostly only farms and small-scale services activities such as trading and workshops would be covered. Many SMEs in food and agro-processing, but also some non-farm rural business activities like glass & ceramics and textiles & garments would be thus excluded. Agro-processing and farm activities are, however, closely linked and, in fact, the current ongoing process of forming farm/agribusiness groups and integrated food chains is of crucial importance for the necessary development and modernization of agricultural production in Romania as well as beneficial to producers, consumers and the economy as a whole. At the same time, in particular, food processing SMEs are faced with major investment needs in view of Romania's accession to the EU in 2007. In case they are not able to comply with the high EU hygienic norms and food quality standards in 2005/06, they will be forced to close down with the effect of substantial losses in added value and local employment. A second point is that, in view of the low profitability of a single activity and the seasonality of some business activities, rural SMEs often are engaged in more than one activity and have different income sources. This diversity is normally the cause of lower enterprise efficiency and profitability but also of lower risk, since the firm can use to varying degrees different income sources for loan repayment.

Priority Regions

xx One may expect that banks which decide to extend their business lending operations to rural areas will concentrate their operations initially in specific geographical regions where they have existing bank branches or agencies, or, where for various regions, they have already decided to open new bank retail units. In these regions they may decide to select individual rural SME borrowers on their own merit covering various types of potential economic activities, or they may focus on a limited number of clusters of more profitable rural economic (sub) sectors chosen among farm enterprises, agro-processing, and non-farm rural economic activities and gradually build up their knowledge of these sectors. In all pilot lending operations it makes much sense for a bank to start first in more favorable regions for rural business activities and to capitalize on the most economic use of a limited volume of loan resources. This approach has clearly the potential to reduce the bank risks and to increase the value added as compared to an alternative strategy geared to a more balanced territorial distribution of the bank loans.

Loan Repayment Capacity

xxi Before a bank decides to lend to SMEs in rural areas, it needs to be pretty sure about the probability of repayment of loans by potential borrowers and for that reason banks will closely examine:

- The financial performance of a SME/loan applicant: The rural business firm has to prove that it has registered a profit, at least for the last operational year, and that it has no outstanding debts to the state in the form of taxes and social security payments.
- The collateral offered by the enterprise should be able to secure loan repayment: for investment loans (but even for short-term loans) banks in Romania, normally, insist on

mortgage of urban real property and an appropriate balance between mortgage and other solid securities which may include letters of guarantee.

- Investment profitability: The enterprise has to demonstrate, through financial documents prepared for the bank, that the investment is profitable i.e. projections of the expected business results should show a positive cash flow during the loan duration.
- Financing sources for loan repayment: The company has to prove that it has firm client orders and signed commercial contracts. In general, deposited export orders/contracts are considered a good guarantee for loan repayment.

xxii In interviews with rural entrepreneurs the FAO team was not presented with any financial statements, while, apart from the provision of some rough estimations of positive business results, no firm evidence was collected on the profitability of the visited SMEs. It was also observed that conventional loan collateral i.e. mortgage predominates in the loan decisions of Romanian banks and rural assets such as owned land, buildings and equipment are evaluated very conservatively; the required collateral value often represents up to 250% of the loan value. All SMEs which are engaged in rural business activities with a low capital intensity (the majority of the examined economic sub-sectors above with some exceptions for medium-sized commercial farmers, grain mills, dairy plants, meat processing factories, wineries/bottling plants, wooden furniture making, and glass & ceramic plants) will have problems in meeting the conventional collateral requirements of banks. A closer examination of rural SME in the Timis county (which firms received business loans of up to USD 20,000 and with a maximum duration of 2 years from CHF International, a micro finance institution) showed, however, positive cash flows and current ratios of (far) above 1.5, indicating that these enterprises have no trouble in paying back fully their business loans as well as short-term, commercial creditors.

Financial Products of banks

xxiii The results of the survey of SMEs in Romania published by the National Agency for SMEs and Cooperatives in October, 2004 show a traditional use of bank products: the large majority of SMEs had opened current bank accounts and about 20 percent (small enterprises) to 30 percent (medium-sized enterprises) had savings accounts; some 20% of medium-sized enterprises used credit cards. Short-term credit from commercial suppliers varied between 18 and 25 percent. The main source for investment finance remains own capital (88% in the case of larger investments and 77% for small investments) and only between 7 and 9 percent of the SMEs had received investment loans from banks, normally with a duration between one to two years. Of the agricultural production SMEs only 5.4% plan to use bank loans in addition to own funds and they expect to have access also to Government support programs. Only 11% of the SMEs said that they intend to apply for SAPARD finance. Determinant factors in selecting the source of finance for large investments are low interest rate (55%), simple and rapid procedures (52%) and low collateral requirements (32%). The maturity of bank loans is considered too short and grace periods are needed for loans which finance investments with a certain gestation period. Bank inflexibility was mentioned, meaning that a borrower can have only one loan at the same time, although there is a need for both investment and working capital loans. Bank procedures and bank products are as not adapted to the specific features and financing needs of rural SMEs. In general, banks are perceived as discriminating against small enterprises, conservative and not pro-active. This last point together with the finding of the FAO Survey of rural SMEs that a high proportion

of the SMEs appear to be poorly informed about the bank requirements for loan applications and on loan appraisal and approval procedures would indicate that there is much need for active marketing programs of banks. The FAO survey found also that the range and quality of non-financial business advisory services that are currently available to rural SMEs is very limited and needs urgently to be further developed and to be made sustainable over time.

xxiv Sequencing of loan products and graduation of clients are practices which are normally used by micro finance institutions and banks which plan to extend their lending operations to SMEs in rural areas may want to use these experiences. In fact, to start with the provision of short-term production or working capital loans may be a good way to build up the credit history records of new borrowers as well as knowledge on loan repayment behavior, specific rural economic activities and local conditions. Moreover, new rural SME borrowers who have had already current bank accounts and, in particular, savings accounts for some time, may be granted more flexible overdraft facilities for their working capital needs of which the ceiling can be gradually expanded. In particular, in the case of more risky agricultural loans it may be recommendable for banks to extend short-term emergency loans or to reschedule existing loan repayments in order to respond to acute liquidity constraints on the part of the borrower. After a number of rounds of short-term working capital loans (which may increase in loan size over time) existing borrowers may eventually graduate to longer-term investment loans. These may be distinguished between medium-term loans (normally between 1-5 years) to be used for enterprise expansion and diversification and acquisition of machinery/equipment and long-term loans, for instance, for land purchase, construction of buildings and renovation or establishment of perennial cultures such as vineyards and orchards.

1. INTRODUCTION

1.1 The Romanian financial sector remains rather weak, albeit progress has gathered pace in the last few years. Rampant inflation, a poor regulatory framework for non-bank financial institutions, and several scandals involving banks and other financial institutions have all contributed to that situation.

1.2 In recent years, however, the overall economic situation and that of the financial sector have significantly improved. The country's economic growth rate averaged some 5 percent starting 2001, and will possibly exceed 7 percent in 2004; inflation is set to decline to a single-digit figure by end-2004; bank credit in real terms grew by 50 percent in 2003 and by 20 percent in 8 months this year, while other financial services such as consumer and mortgage lending and leasing finance are in full swing. The European Commission has reconfirmed the year 2007 as the target for Romania's accession to the EU, thus paving the way for growing foreign direct investments and stronger economic expansion – much needed for reducing the gap with the EU countries' average economic level.

1.3 Major international rating agencies have not yet upgraded Romania to investment grade as far as long-term debt is concerned, however, the markets' perception of Romania has markedly improved. Hence, Romanian sovereign bonds are traded on secondary market with spreads varying between 60 and 80 basic points and the demand for Romanian debt instruments is high.

1.4 Favourable tendencies, however, are far from being evenly distributed over the territory. Bucharest and the surrounding area, and a few other big cities account for the bulk of the growth, while small cities and rural communities are largely left aside. Thus, a significant part of the country's economic potential is under-utilised. While own capital is the main financing source for starting an enterprise, for existing SMEs in Romania, who need to invest, in particular, in restructuring, expansion or diversification of their activities, internal resources from retained profits will not be enough and they will need access to outside funds in order to pursue their development. External funds may come from various sources such as commercial suppliers, banks and leasing companies, equity investors and capital markets, and others like governments, international financial institutions (IFIs) and non-governmental organisations (NGOs). Bank loans, a potential important business financing source, still covers only a small percentage of the financing needs of SMEs in rural areas in Romania,, while the situation is a bit better for larger enterprises and in bigger towns.

1.5 IFIs and NGOs have launched special programmes dedicated to supporting disadvantaged rural communities, but much remains to be done before these areas will be fully integrated in the overall economy and their sustainable connection to the country's economic expansion is achieved. The new EU/EBRD SME Rural Credit Facility (henceforth the Facility), analysed in this report, is meant to be such a programme. The Facility is earmarked for small- and medium-sized enterprises (SMEs) located in rural communities. SMEs in Romania are defined as companies with between 10 and 250 permanent employees and an annual turnover of up to €8 million. The programme defines "rural" in Romania, in accordance with the EU, as communities of up to 50,000 inhabitants (NUTS 5 level).

1.6 The EBRD aims at extending lending resources through commercial banks and, possibly, eligible leasing companies. Moreover, the new Facility is intended for well-established businesses with an indicative loan size ranging from as low as €15,000 up to €250,000. Micro credit and credit to individuals are not included in the scope of the Facility. Such an approach seems appropriate, considering the limited size of the Facility and the commercial nature of the credit. However, in the event of future expansion of similar facilities for financing SMEs in rural areas, the scope could be widened, as far as both financial intermediaries and the size of the loans and enterprises are concerned. The Facility also incorporates a technical assistance (TA) grant, designed to develop this type of loan business.

1.7 The present report is structured as follows. After this introduction the second chapter assesses the supply of rural credit for the intended users of the Facility with an emphasis on banks. An overview of the macroeconomic conditions in the country sets the ground for recommendations regarding the Facility and the future strategy of the EBRD versus rural finance in Romania. The potential role of leasing companies and micro finance institutions (MFIs) in the Facility is also treated in the same section. Main programmes and mechanisms and experiences with agricultural and rural credit in Romania are presented.

1.8 The third chapter focuses on the potential demand for bank credit by SMEs in rural areas. While available information and statistics are rather unstructured and not up-to-date and, in general, do not perfectly match the target group of SMEs in rural areas, one may assume that the picture is sufficiently accurate and supportive of the proposals that are made. The main conclusion is that the demand for credit by rural SMEs is growing and the disbursement of the loan resources to be provided under the Facility may not be delayed too long. Flexible conditions, long loan maturity, the availability of TA, and the possibility to use the funds under the Facility as pre- and co-finance together with SAPARD investment projects will also speed up its disbursement.

1.9 The fourth chapter is devoted to the conclusions and recommendations regarding the design of the Facility as well as discussing relevant policy issues related to widening the scope of similar future facilities, assuming that the EBRD is interested in continuing its catalytic role of stimulating the growth of less favoured rural regions in emerging transitional economies.

1.10 The results of a FAO survey of SMEs in rural areas, interviews with banks and SMEs during the missions of the FAO team and assessments of relevant rural economic sub-sectors are illustrated in both the main report and more in detail in dedicated annexes. They are meant to broaden the picture and to provide additional information on the topic in discussion.

2. ASSESSMENT OF THE SUPPLY OF CREDIT TO RURAL SMALL AND MEDIUM-SIZED ENTERPRISES

2.1 Recent Macroeconomic Developments and their Impact on Credit Supply

2.1 Romania has one of the lowest GDP per capita among EU accession countries, representing about a quarter of the EU-15 average in 2002 in purchasing power standard (PPS) terms. However, the country has experienced rapid growth rates in recent years (around 5 percent during 2001-2003 and probably above 7 percent in 2004.) Exports through 2003 and domestic demand in 2004 have been the main contributors to this expansion.

2.2 Rather high current account deficits (5.8 percent of GDP in 2003 and probably well above 6 percent in 2004) and high, albeit declining, annual inflation rates (11 percent in 12 months through September 2004 compared with a 9 percent target at end-2004) have led to tight financial conditions in Romania. Thus, the overall government deficit is set to decline from 2.3 percent of the GDP in 2003 to less than 1.6 percent in 2004, while the monetary policy of the National Bank of Romania (NBR) is very restrictive: the NBR rate for attracting deposits from banks stands currently at 18.75 percent p.a., and reserve requirements have been set at 18 percent for banks' liabilities in local currency and 30 percent for liabilities in foreign currency with a maturity shorter than 2 years. Consequently, banks are interested in foreign exchange resources with a maturity significantly longer than 2 years, typically 5 years or longer. If the Facility is granted for 7-10 years, the banks will stand ready to take part.

2.3 In spite of large external deficits, the domestic market has recorded a significant surplus in foreign exchange, thus triggering a remarkably stable exchange rate (at end-September 2004, the Euro was practically flat, compared to end-2003; the real appreciation of the Leu against a basket consisting of 75 percent EUR and 25 percent US\$ was 6.1 percent at end-September 2004 compared to end-2003) and surging reserves of the Central Bank. Under such circumstances, it appears that fundamental factors lead towards continuing appreciation of the local currency and credit in foreign currency is increasingly appealing for domestic users. In this respect, the Facility follows the market tendencies.

2.4 A large and rapidly growing number of Romanian citizens work abroad, mostly in EU countries. They total more than 2 million people (about 20 percent of the labour force) and they send considerable amounts of money to their country of origin. The balance of payments in 8 months of 2004 has recorded €1.2 billion under "other current transfers", 38 percent higher than in the similar period of 2003. It is likely, though, that official statistics understate the level of such transfers. An indication of this is given by the level of "errors and omissions", which displays net inflows in excess of €50 million. At this magnitude, the phenomenon has important macro- and micro-economic implications. For the purpose of our topic, it is worth noting that a significant part of remittances reaches small cities and rural communities and provides financial resources for both the existing and start-up business opportunities of their inhabitants. Although no relevant study has not yet been carried out, anecdotal evidence shows that remittances are used first for home appliances, second for restructuring or construction of new houses, and third for starting some sort of local business. Therefore, the ground for new economic activities in rural areas is

already set and additional external financial resources, such as the Facility, are expected to have a good catalytic role.

2.5 In October 2004, the European Commission acknowledged that Romania had a functional market economy and restated the year 2007 as target for the country's accession to the EU, together with Bulgaria. This political decision has very important implications on developments expected in the years to come. It is likely that both financial inflows and foreign direct investments (FDI) will grow. However, their territorial distribution will remain uneven and rural communities will benefit much less from that trend. Therefore, there are good reasons to draw in advance the main characteristics of the Facility and eventual similar future rural credit facilities, whose scope and further downscaling could be gradually widened. The issue is discussed in Chapter 4.

2.2 Commercial Banks

2.2.1 Overview

2.6 Banks are by far the strongest player in the Romanian financial system. They have a good legal framework – fully in line with EU standards – and their prudential indicators are way above the minimum requirements, which are, in their turn, more demanding than those prescribed by the Basel Committee. Basel II standards are set to enter into force by next year. There are 30 banks and 8 branches of foreign banks operating in Romania. The top 5 commercial banks gather 61 percent of the total assets in the banking sector, while majority foreign-owned banks account for some 60 percent of the total assets in the banking sector.

2.7 Throughout the period since 1990, high and volatile inflation has led to the lowest monetisation and financial intermediation among EU accession countries. Thus, in December 2003, money supply and non-government credit represented only 24.4 percent and 16 percent of the GDP respectively – lower than in any other accession country. Due to this fact, the supply of financial services is somehow weaker than the potential demand for such services. The rules of the game are basically set by banks, which are selective in choosing their clientele and most of them are reluctant to spread out their activities to rural areas. An exception is represented by those banks with plans for an aggressive expansion of their activity and for better positioning in a market perceived as having a promising potential.

2.8 Credit to non-government, in particular consumer lending, expanded rapidly during the last couple of years, confirming the catching-up trend. Real growth was 50 percent in 2003 and another 19 percent in 8 months of 2004. Such an expansion stretches banks' administrative, human and financial resources close to their limits and, to a certain extent, diminishes the interest in the new Facility.

2.9 Bank lending terms are unfavourable to borrowers. Interest rates are high (the average lending rate currently exceeds 26 percent p.a. for domestic currency credit), collateral requirements are tough (normally, mortgage is required at a value that may represent 250 percent of the loan value) and they significantly increase the overall cost of borrowing from banks. Credit in foreign exchange is preferred both by lenders (who get this source of money from abroad and transfer the exchange rate risk to the borrower) and borrowers (since the nominal interest rate is

significantly lower, while the perception of the exchange rate risk is low.) This type of credit represents more than 60 percent of the total non-government credit.

2.10 By maturity, short-term credit (up to 12-months) accounts for 52.5 percent in local currency and 43.5 percent in foreign currency; medium-term credit (1-5 years) accounts for 43 percent in local currency and 35 percent in foreign currency, and the balance (4.5 percent and 21.5 percent respectively) is long-term credit with a duration of more than 5 years. One of the main reasons for the under-representation of long-term loans is the mismatch in resources; therefore, banks are interested in attracting funds with longer maturities in order to diversify their loan portfolio. In fact, in recent years, most banks have used external resources for their loans, extended by their parent foreign banks or with their parent bank support, at very competitive terms. Therefore, banks are cost conscious and selective in attracting new external sources as well.

2.11 Striking differences between banks can be detected. In general, larger banks apply somewhat better lending rates and offer a wider choice of loan products, including credit with longer maturities, but smaller clients complain that they are not treated well, and large banks are far from acting like a business partner. Small banks, on the other hand, tend to treat their clients better, but charge normally higher lending rates and typically do not offer long-term loans for investments, because they have less resources available and insufficient expertise in term lending.

2.2.2 Bank Credit to Rural SMEs: Too Many Constraints

2.12 Lending terms are even more unfavourable for SMEs, particularly those in smaller rural communities, where banks have either no network of branches or agencies or a very limited one; typically, additional interest rate margins are charged to rural customers, and the evaluation of loan collateral is very conservative. Few rural SMEs dare to apply for bank loans and even fewer are successful in receiving loans. In July 2004, credit to agriculture, forestry and fishery represented a mere 2.6 percent of total loans above €5,000 that were extended by the banking system. It is true that rural credit covers more than just agriculture, but the overall picture does not change significantly. Therefore, the usefulness of the Facility would be jeopardised if it were limited to new bank customers only and not extended to include existing clients who are seeking first time term loans for restructuring and expanding their current business activities, or diversifying into new activities.

2.13 Several reasons and conditions concur to give rise to the under-representation of rural credit in the overall loan portfolio of banks. First, the banks' presence in smaller communities is weak. For profit considerations, but also because large cities offer plenty of business opportunities and room for expansion, banks are reluctant to open new units in rural areas. Transaction costs of banks in rural areas are high without being compensated by correspondingly high revenue levels. While bank automation may reduce staff costs, it also increases the required equipment and communication costs. The bottom line is reached when the total costs of operating a small retail bank outlet with a low volume of operations are not offset by their earned income, which limits the interest of banks in this type of activity. It is a fact that banks who inherited a large branch network keep shrinking their presence in small communities (as is the case with Raiffeisen Bank, as well as with Banca Comerciala Romana and BRD-Groupe Société Générale). It is worth mentioning that attempts to reverse this trend have met with little success, so far. Thus, the World Bank Rural Finance Project, launched in 2001, has earmarked an important amount of almost

US\$17 million out of a total WB loan of US\$80 million for financing the expansion of banks into small communities and enlarging the network of retail bank units. There have been, however, just two applications from banks to access that component. One of them, Banca Transilvania, intends to develop its infrastructure in smaller communities, while the other (Banca Carpatica) only plans to purchase and install ATMs.

2.14 Second, from the experience of earlier decades, which has not been changed by developments over the last 15 years, bankers continue to believe that rural clients in general, and farmers in particular, have little financial discipline and normally do not have the capacity to repay their loans. Besides, providing credit services in rural areas is problematic. An evaluation of the creditworthiness of a potential borrower can hardly take place 50 km away from the location of the loan applicant, so banks simply choose to decline the transaction.

2.15 Third, the culture to work with a bank is limited in rural communities. Thus, according to “The Rural Euro-barometer”, 67 percent of the rural population have little, very little, or no trust at all in banks, and only 20 percent trust them much or very much; 9 percent of rural families hold a bank account and only 5 percent of families have a family member with a bank card; a mere 0.2 percent of the rural population works in a financial institution or insurance company. Therefore, the limited presence of and lack of familiarity with banks and bank products in rural areas is mirrored by the lack of trust in using bank services.

2.16 Fourth, assuming that entrepreneurs in rural areas are able to overcome the widely spread lack of trust in banks, potential borrowers still have huge difficulties in meeting banks’ tough conditions to get a loan. On the one hand, high real interest rates and short grace periods exclude many eligible investment projects right from the beginning due to insufficient profit rates and/or uneven cash flow. With interest rates exceeding 15 percentage points p.a. in real terms, few projects in rural areas are able to qualify and prove their profitability and repayment capacity in advance. To a certain extent, foreign currency loans offer somewhat better conditions, in particular for investment projects, but a critical consideration in this case must be that no disruptions in the exchange rate will take place over the duration of the loan. On the other hand, collateral requirements are very demanding. In most cases, mortgages on real estate assets are the preferred collateral. Valuation of assets is usually extremely conservative, land in rural areas is not accepted, the ratio between the loan value and the replacement value of the collateral can easily reach 1:4, and the costs of evaluation and notary registration are also high. Such features add on to the costs of credit and to the discomfort of potential borrowers.

2.17 Fifth, assuming that all the constraints listed above are overcome, drafting a business plan and submitting a loan application file according to the banks’ demanding requirements are often beyond the capability of common rural entrepreneurs. Surveys, as well as own findings of the FAO team, show that the larger the bank, the lower the interest rate on loans, but also the less friendly the behaviour of the bank towards potential clients.

2.18 The above-mentioned constraints are valid for all rural businesses, but agriculture, with its assumed high risks, is by far the most disadvantaged. The fact that “Banca Agricola”, which was most exposed to agriculture, ended up on the brink of bankruptcy and had to be supported with a massive last-minute capital bailout by the government before privatisation and take over by the Raiffeisen Bank contributed to this attitude. Moreover, bankers generally have a rather limited knowledge of the agricultural sector, which impacts on their ability to appraise

farmers' loan applications. Banks therefore remain reluctant when it comes to getting involved in financing agriculture.

2.2.3 Banks' Interest in the Facility

2.19 The FAO team met with representatives of 6 banks that may be interested in the new facility. They were selected from among the banks with a good track record of cooperation with the EBRD, a sound financial standing, and lending experience with SMEs. These banks are: the **Romanian Commercial Bank (RCB)** (the largest bank in the country, which is in its first stage of privatisation as supported by the EBRD and which has a high exposure to the EBRD but at the same time also has a high equity base); **Banca Romaneasca (BR)**; **Alpha Bank (AB)**; **Robank (RB)**; **Banca Transilvania (BT)**; and **Miro Bank** (in the last two, the EBRD is a shareholder). Some main issues discussed with the banks are presented in **Annex 1**. Although the Romanian Banking Association (RBA) stands ready to organise a meeting with representatives of other interested banks, the limited initial size of the Facility does not seem to make it necessary to carry out such an initiative immediately.

2.20 All the interviewed banks expressed their interest in the Facility, being prepared to negotiate specific conditions with the EBRD. The reason for this interest varies from one bank to another. Thus, the largest bank, RCB, is interested in international lending resources to complement other investment schemes that it co-finances (notably SAPARD) and in receiving TA and support for training of additional staff in dealing with SMEs. Banks with a strong foreign parent owner (as with AB) are interested in increasing their visibility in the Romanian market, while smaller banks (RB and MB) find it a good opportunity to expand their business in rural communities and/or to develop investment financing schemes. All banks, except BR, are interested in receiving training support and TA for developing specific procedures in order to deal with the type of credit and clients envisaged by the Facility, while BR stands ready, based on its experience, to bid for becoming technical assistance provider to other financial institutions in this field.

2.21 Some banks openly expressed their interest in a comprehensive set of procedures to assess the creditworthiness and bankability of investment projects of rural SMEs, since their expertise is rather poor in that particular field. Ideally, such procedures should include developing credit scoring models in order to improve the loan application appraisal and loan approval process.

2.22 The banks would envisage a Facility with little, if any, strings attached. In particular, they intend to also be able to finance land and building purchases, to finance both investment and working capital, to pre- and co-finance other schemes such as SAPARD, and to have full decision-making power over the projects they choose to finance. The suggested loan size range of between €15,000 and €200,000 is considered acceptable but should be seen as indicative. The possible loan volume is seen as ranging between €3-10 million per individual bank, subject to further negotiations regarding the specific terms of the Facility.

2.3 Other Financial institutions

2.3.1 Leasing Companies

2.23 The potential interest of leasing companies in the new facility was tested out with the “Association of Leasing Companies in Romania” (ALCR), which consists of 34 leasing companies that hold some 56 percent of the total leasing market in the country. The association is a member of “LEASEUROPE”, an acronym for the “European Federation of Leasing Company Associations”. According to ALCR, the fast-growing Romanian leasing market will reach some €1.8 billion in 2004. However, car leasing is the main leasing activity so far. Potential SME clients in rural areas look at leasing finance of machinery and equipment investments as an attractive alternative to bank lending due to the serious constraints that they face in complying with bank loan collateral requirements.

2.24 The response of the leasing companies to the prospect of participating in the Facility was not over-enthusiastic. One of them (**Romexterra Leasing**, fully owned by the Banca Romexterra) eventually developed an interest and it mentioned agro-tourism as a potential sub-sector in which it could get involved. Assuming that the EBRD wants to diversify the financial intermediaries that will take part in the Facility, further discussions should be held, primarily with leasing companies owned by banks. Possible candidates who the EBRD may want to contact include Unicredit Leasing and Motoractive, with whom the WB Rural Finance Project works, and the various leasing companies who already receive finance from the EBRD as well as participating in the EU/EBRD SME Credit Facility, Phase II. They are more likely to be able to meet the eligibility standards required by the EBRD, although their current exposure to international credit funds may be too high.

2.25 Leasing companies would be a good alternative for those SMEs who are interested in purchasing new equipment, since leasing procedures are quite streamlined and collateral requirements are not a main problem (most leasing companies would accept the equipment itself as the sole collateral). The new Facility offers the additional advantage that it can be extended for periods longer than 3-4 years – typically the duration of a leasing contract. The FAO team is of the view that the Facility should explicitly exclude private car purchase from the EBRD rural credit utilisation, but leasing of the business transportation means of SMEs would be eligible.

2.4 Micro Finance Institutions (MFIs)

2.4.1 MFIs in Rural Areas

2.26 In recent years, non-governmental organisations (NGOs) have become more numerous, and their fields of activity have widened. Some of them are, in particular, engaged in rural development. There are no overall surveys of NGOs that provide rural credit and which quantify the total disbursed loan amounts and the regions serviced. However, eight NGOs out of a total bidding list of 34 NGO/MFI Service Providers were short listed by the WB Rural Finance Project and of those, three have already started their operations under the project. A brief presentation of those three MFIs follows:

- **CAPA Foundation Romania** has been operating since 1997. Rural loans (about 25 percent of the total loan portfolio) include loans for livestock purchase, vegetables for sale, cereal crops (maize and wheat), reconstruction of buildings (stables, houses) and purchase of equipment. Besides rural lending, the NGO provides training and advisory services to clients for the development of their business and management skills. While start-up capital was provided by the international NGO, World Vision, most of the capital used by CAPA has been acquired at market interest rates. The foundation has shown an outstanding capability to adapt to and to work under commercial conditions. Future plans include, besides expansion in traditional activities, the setting-up of a separate financial company to which the lending operations will be transferred.

- **CHF International** (Community Habitat Finance) has been operational since 1994 with a mission mandate of community enhancement, economic growth and micro finance development. It currently operates in 19 counties, most of them located in the western and the central part of the country and by end-2004 it plans to expand in 6 other counties, located in the south-east region. It has an outstanding loan portfolio of some US\$5 million. Capital sources include USAID (since March 2003 CHF has been managing a five-year, US\$13.3 million programme for SMEs in Romania. Both up to 2-year standard business loans with a maximum size of up to US\$20,000 and short-term loans, up to 3 months and maximum US\$5,000 can be provided), Overseas Private Investment Corporation, and the Romanian American Enterprise Fund. CHF appears interested not only in widening the scope of its micro-credit activity, but also in contributing to an adjustment of the legal status of MFIs, in order to transform them into market-based companies, specialised in financial intermediation.

- **The Centre for Economic Development** (CDE) is a Romanian non-governmental organisation, member of the Soros Open Network in Romania. Its main objective is to provide SMEs with a one-stop shopping place for information, business development services, financial services and related support services which facilitate the start-up, development and expansion of business activities. Since the inception of its micro-credit operations in 1999, CDE has set up a network of 38 local village groups with over 1,965 members. These groups are used as intermediaries for the implementation of the credit programme. The programme focuses on expanding the creation of retail financial intermediaries at village level, the so-called “Rural Development Associations” (RDAs) for the disbursement of small loans. RDAs are responsible for selecting their members and leaders with basic guidance provided by CDE staff. This self-selection process has proven to be effective in ensuring a good screening of group member loan applicants – a fundamental task in the loan appraisal process of any type of lending programme. Group members share a joint liability for loan repayments.

2.27 The importance given in all the above cases to community enhancement deserves special mention here. Involvement of communities in sustaining and fostering local economic development has proved to be beneficial. The most successful MFIs have become market niche players who provide a missing link in the relationship between commercial banks and rural households and/or micro and small enterprises.

2.28 Most of the active MFIs succeed in reaching low loan default and very high repayment rates (reportedly above 97 percent.) They typically charge high interest rates (that could exceed 18 percent p.a. for dollar loans) for loans ranging from US\$700 to US\$10,000, but their collateral requirements are much less stringent than those of banks, and clients perceive MFIs as their business partner and in many cases they are reluctant to switch from MFIs to banks in order to meet their expanding financing needs.

2.29 Due to their limited financial resources (each MFI holds own funds of around US\$5 million and borrowed funds that do not exceed US\$10 million) most MFIs have not yet reached their breakeven point. However, they keep improving their performance and appear close to becoming profitable entities. Critical points are the legal status of MFIs, their capital base and the continuity of their international funding sources.

2.4.2 MFIs' Potential Role in the Facility

2.30 At this juncture, MFIs do not qualify as financial intermediaries for the Facility. On the one hand, their legal status and funding basis are rather uncertain, especially if we consider the long-term horizon of the Facility; on the other hand, MFIs typically handle projects with lower individual loan values than envisaged by the Facility and which fall under micro-credit activities.

2.31 However, they could connect banks with SMEs as potential borrowers and also provide TA to entrepreneurs to develop business plans and to prepare the required documentation for loan applications. Such SMEs could be current or former borrowers of MFIs who are graduating to become bank clients for larger and longer maturity loans or other SMEs that the MFIs have met as part of their programmes in rural areas. Against a reasonable fee, possibly covered from the non-reimbursable TA component of the Facility, MFIs could be used for establishing the crucial relationship between SME clients and banks and they could also serve as a marketing agent for the Facility. That possible role was brought up by the FAO team with the country director of CHF, who appeared very interested in the concept. The issue will be further discussed in Chapter 4.

2.5 Credit Guarantee Funds: The Rural Credit Guarantee Fund (RCGF)

2.32 The credit guarantee funds function is based on the risk sharing principle. Their goal is to facilitate the access to credit by SMEs and to protect banks against loan default – a risk perceived as high – when crediting SMEs. There are 3 functional guarantee companies in Romania, all of them set up with assistance from IFIs, namely: the Romanian Loan Guarantee Fund for Private Entrepreneurs (RLGF) established in 1993; the Rural Credit Guarantee Fund (RCGF) established in 1994; and the National Loan Guarantee Fund for SMEs (NLGFSME), whose activity started in 2002.

2.33 The most important IFI for the topic in discussion is the RCGF, operational since 1994. It was established as an attempt to resolve one of the key problems in the financing of agriculture: the limited ability of farmers to provide bank loan collateral. Besides the subscribed capital owned mainly by three commercial banks, the Fund's resources come from an €9 million grant contribution of the European Union as part of the PHARE programme, together with accrued interest (equivalent to more than €3 million). The Fund guarantees investment loans up to 70 percent of the loan principal (up to 50% for working capital loans), based on the applicant's business plan, once it is approved by the lending bank and the RCGF. The Guarantee Fund does not require collateral from the borrower, but it receives a commission fee from the bank which is charged to the borrower. For private farmers and farmer associations, the commission fee is borne by the Fund from the interest accrued on the EU grant.

2.34 This is a welcome mechanism, because one of the main reasons why agricultural lending from banks is not attractive to either farmers or banks is the limited ability of the borrower to meet the bank requirements for conventional collateral. In addition, the structural design of the RCGF has a number of features that guarantee its viability. Of these, two are especially important:

- While the Fund guarantees a major part of the loan principal, this share does not include the collateral provided by the borrower or the foreclosed guarantees by the bank in the event of loan default. Consequently, the bank shares a significant part of the risk and accordingly is expected to perform a thorough appraisal of the loan application.
- The procedures used to appraise loan applicants are clear and relatively simple, thus reducing the amount of work per application and allowing the Fund to operate as a central unit. The same can be said for the guarantee settlement with the financing bank in the case of a bad debt. In conclusion, the Fund's operational costs are modest and they will further decrease, if the activities of the RCGF continue to grow.

2.35 Up to 2002, the number of guarantees remained at a modest level overall, and the Fund's role was marginal. However, starting mid-2002, an improvement in the conditions provided for guarantees led to a higher attractiveness for banks. A sizeable increase in guarantees has been registered since then. Thus, in 2003, the total annual ceiling of guarantees was set at €37.5 million (three times the level in 2002), while the actual amount exceeded €44 million, almost 6 times the actual number of guarantees granted in 2002.

2.36 There are two drawbacks to the Fund's capacity to provide guarantees for new investment loans in rural areas:

- (a) The outstanding amount of credit guarantees is quite close to the prudent limit that can be used by RCGF on the basis of its own capital and the EU grant, so most of the new guarantees are extended when old guarantees mature. Ideally, private entities and possibly the EU should increase the resources that the RCGF is able to manage.

- (b) The RCGF does not extend guarantees for industries other than farming and agro-processing. Therefore, a good chunk of new investments expected in rural areas is not eligible for the RCGF guarantees. In the best case scenario, additional funding would also enable a widening of the scope of the current Fund's uses to all rural economic activities.

2.6 Lessons from the World Bank Rural Finance Project

2.37 The World Bank (WB) Rural Finance Project provides a good experience whose general conditions for credit are not very different from those intended by the Facility. The WB loan is extended to the Romanian Government for 12 years with an 18-month grace period (The same conditions are transferred to participating on-lending banks), at 6-month LIBOR plus 90 basic points and an up-front fee of 1 percent of the loan. Banks and other lenders (leasing companies and micro finance institutions) on-lend the credit resources to final borrowers using their normal loan appraisal procedures, while they apply market-based lending rates.

2.38 There are a number of embodied restrictions in the scope of the credit and the disbursement procedures: the credit cannot be used to purchase land or buildings; tobacco, alcohol, and environmentally damaging industries are not eligible; loan applications in excess of US\$500,000 need to be reviewed first by the WB prior to approval; the final borrower has to observe the WB procurement procedures for loan contracts exceeding US\$1 million. However, new Greenfield investments, co-financing and pre-financing of private investment projects benefiting from other financing schemes such as SAPARD, as well as working capital finance, are all eligible under the WB rural credit and leasing component.

2.39 The overall WB project loan agreement, an amount of US\$80 million, was signed back in 2001. The initial procedures included the Raiffeisen Bank as "treasurer bank", whose simultaneous position as Project Implementation Unit entitled it to get confidential information from other banks, thus favouring it in competing on the same market. Under such conditions, all potential participating banks declined their involvement. In September 2003, the whole mechanism was revised: a Project Management Unit (PMU) was created in the Ministry of Public Finance, the Raiffeisen Bank kept only the treasurer bank function and the definition of "rural" was significantly widened, implying that everything is rural except 12 large cities (rural economic activities and enterprises as well as individual beneficiaries are eligible for rural credit and leasing in communities up to 200,000 inhabitants, while support to new retail bank units is eligible in localities up to 100,000 inhabitants). Both existing as well as new bank clients can benefit. Disbursements started in 2004 for 3 participating banks (Banca Romaneasca, Robank, and Banca Transilvania), 2 leasing companies (Unicredit Leasing and Motoractive Leasing), and 3 MFIs (CED, CHF International, and CAPA Foundation Romania). Two other banks (Carpatica and Ion Tiriac) applied recently for their inclusion among participating banks.

2.40 One year after the recalibration of the programme, around 40 credit projects through banks and some 1,400 micro loans through MFIs with a total amount of just US\$11 million have been disbursed. While the programme appears to have been gathering pace in recent months, the idea of a one-year extension (initially the WB loan was scheduled to be fully disbursed and closed by end January-2006) appears most likely.

2.41 The performance of the WB rural finance project has been weak and this might suggest that rural business has a limited capacity to absorb loans. In fact, slow absorption is due to the general constraints discussed in section 2.2 above, which were not addressed in the specific design of the project, while participating banks have limited branch networks. Besides this, the WB has imposed additional steps before banks can access the credit, thus adding on to the period of time between loan applications and loan disbursements. Such constraints should be avoided in the design of the Facility in order to increase the likelihood of well-timed disbursements. Suggestions in this respect are discussed in Chapter 4.

2.7 SAPARD

2.42 SAPARD (Special Accession Program for Agriculture and Rural Development) is a special financial support scheme offered by the EU to the 10 accession countries of Central and Eastern Europe, which enables them to make structural improvements to their agricultural and rural environment. The legal basis was established by several initiatives that were adopted by the European Commission in 1999 and 2000.

2.43 SAPARD support is to be granted in accordance with the national agricultural and rural development programme of the applicant country during the period 2000-2006, on the basis of the principles which apply to EU Structural Funds. The content of each country's programme reflects the priorities established by the national authorities and depends on the needs of each country within the limits set by the basic Council Regulations. It is worth noting that, whereas other pre-accession programmes such as PHARE and ISPA have at least some key instruments managed by the Commission, this does not apply to SAPARD, not even for project selection.

2.44 SAPARD offers candidate countries the possibility of funding projects in the following areas, the so-called "Measures":

- Investments in farms;
- Improvements in the processing and marketing of agricultural and fishery products;
- Improvements in the structures for veterinary and plant health control, the quality of foodstuffs and consumer protection;
- Agricultural production methods which are designed to protect the environment and to preserve the countryside;
- Development and diversification of rural economic activities, leading to multiple economic activities and alternative income sources;
- Establishment of farm relief and farm management support services;
- Creation of producer associations;
- Renovation and development of villages and the protection and preservation of rural heritage;

- Reclamation of land, consolidation of farm parcels, development and updating of land registers;
- Improvements in vocational training;
- Development and improvement in rural infrastructure;
- Management of agricultural water resources;
- Forestry development, including forestation of agricultural areas, investment in forest holdings owned by private entities, and the processing and marketing of forestry products;
- Provision of technical assistance for the measures covered by EC Regulation No. 268/1999, including studies, assistance in the preparation and monitoring of the programme, and support with information and publicity campaigns.

2.45 The main objectives of SAPARD are to assist the agricultural and rural sectors in the accession countries to become more competitive within the context of increasingly open global trading regimes and to develop new strategies which aim at promoting the economic development potential of rural areas.

2.46 Romania will receive from the EU during the 7 years of the SAPARD programme a total of €1,072 million, or more than €153 million¹ on a yearly basis, in the form of non-reimbursable funds, which will be distributed as grants to co-finance investment projects in agricultural and rural development. The Romanian Government will supplement this amount with a total contribution of about €350 million over 7 years or about €51 million per year (25 percent of the eligible EU and Government financing). Financing of private investment projects takes place through a combination of investors' own and borrowed bank funds (50% of the total investment costs) and SAPARD grant funds (the remaining 50%, of which the EU provides on average 75 percent and the government 25 percent). Public investments, on the other hand, such as in the case of rural infrastructure, may benefit from a 100% EU/Government grant funding, provided the project is not substantially income generating.

2.47 The SAPARD Agency in Romania, whose official accreditation took place in 2002, as a public institution subordinated to the Ministry of Agriculture, Forestry, and Fishery (MAFF), is the authority charged with the financial and technical implementation of the SAPARD programme. The Agency has two functions: (i) to implement the "Measures" under the programme and (ii) to make payments to beneficiaries. The Agency headquarters is in the MAFF and it has 8 Regional Offices in Iasi, Alba-Iulia, Craiova, Timisoara, Constanta, Satu Mare, Targoviste, and Bucharest. A comprehensive set of rules and procedures has been defined, which aims at ensuring full transparency and establishing an level playing field for all potential beneficiaries.

¹ Considering that the programme funds of EUR 1,072 million are available for a period of seven years, but are actually spread over a shorter implementation period, it is assumed that the annual amount will exceed EUR 153 million.

2.48 While the procedures may be perceived as overly bureaucratic, they represent an obvious occasion to set general rules rather than deciding on the specific allocation of funds. Moreover, the SAPARD programme is an important step forward for improving capabilities at both individual and institutional level. Written manuals are supposed to establish clear and comprehensive procedures for the separation of duties, carrying out of controls before projects are approved (appraisal procedures), compliance with public procurement procedures, carrying out of physical reviews, authorising and verifying payments, keeping payment records of the SAPARD programme, system control, exerting internal and external auditing, supervisory activities, and reporting and monitoring procedures.

2.49 The actual performance of the SAPARD programme implementation has been mixed, so far. More than two years since the SAPARD Agency was set up, the capacity to absorb EU funds is proving to be rather low. Thus, only in October 2004 did the authorities announced that funds earmarked in the programme for 2000, amounting to €204 million, had been completely disbursed, less than three months from the moment when unused funds would have been cancelled. The reasons for this situation range from limited capacity to identify viable projects and to draw a business plan according to the EU tight procedures, to reported cases in which the access to funds was unduly conditioned to the use of a certain consultancy agency, which overcharged the potential beneficiary of non-reimbursable funds. Even in well documented cases and complete observance of the required conditions, beneficiaries of funds complain that disbursement is painfully slow (can take up many months), and timely business investment opportunities are thus missed. Interviewed rural SMEs complained that SAPARD is mainly meant for banks and foreign investors and that larger projects are preferred. For instance, the measure to improve agricultural processing and marketing has a minimum eligible financing amount of €30,000 but the ceiling is up to €2,000,000.

2.50 Such drawbacks notwithstanding, SAPARD remains a huge opportunity to develop rural areas. Banks, NGOs and other institutions provide complementary support to potential users of the SAPARD programme and recent acceleration in disbursing funds is detectable. The Facility may complement SAPARD-financed investment projects with pre- and co-financing funds from banks. Such projects have the advantage of thorough screening and thus offer a higher likelihood of loan repayment. As pointed out above, the overall envelope of the SAPARD programme is very large indeed. Moreover, in 2005 and 2006 it is also expected to disburse part of the total amounts that were earmarked for previous years and have not yet been utilised. Thus, most funds earmarked for 2001-2003 are yet to be disbursed, and financing for 2004 has not even started. The new EU/EBRD rural credit facility represents just a small fraction of the total amount expected to be disbursed in 2005 from SAPARD and, therefore, the absorption capacity for the Facility credit funds appears not to be under question.

2.8 Other Experiences in Agricultural and Rural Credit

2.8.1 The IFAD Apuseni Mountain Development Project

2.51 This 5-year rural development project with a total IFAD loan contribution equivalent to US\$16.5 million, which became effective in November 1999, has a revolving credit fund component for the financing of a range of improved individual farming activities and village-level based community enterprises. The project started slowly and a subsidiary loan agreement with a commercial bank, in this case the majority state-owned BCR, was not signed until August, 2000.

In general, serious problems and long delays were experienced in the project implementation due to difficult coordination and communication with the different stakeholders, restrictions to government budget contributions, centralised project management, multi-faceted constraints encountered in mountainous areas, unfair competition with government-subsidised agricultural credit programmes and a limited experience of BCR in dealing with small-scale rural lending.

2.52 Although performance has picked up somehow in 2002, IFAD has found out that the management of a credit fund through a bank, in particular a state bank, is not the best way to reach potential borrowers in disadvantaged rural communities in Romania. A major problem of bank lending in rural areas is that small farmers are not able to comply with the conventional collateral requirements of banks and available assets like farm homes and land are either not evaluated at all or only at a very low market value. Inadequate attention was also given to the provision of TA both to BCR in assisting the bank to reach down to small-scale rural borrowers as well as to small farmers in the preparation of viable loan applications. Based on this project experience, IFAD has shifted its development focus in Romania to the promotion of local initiatives such as by providing support to the organisation of farmers associations for collective marketing of their produce. Moreover, the IFAD Apuseni project has adopted an alternative rural lending approach by collaborating with the Economic Development Centre, a NGO-based micro finance institution in Romania which has piloted with group-guarantee lending. This lending methodology has been used in the IFAD project area for the financing of village-level based community enterprises.

2.8.2 The German - Romanian Fund

2.53 On the basis of a loan agreement contract with KfW, Banca Carpatica is managing an €2.3 million credit line for SMEs as part of the German-Romanian Fund. The maximum loan amount is €60,000 and loans are offered both in foreign and local currency.

2.54 Carpatica, a new and fast growing and, in the view of the FAO team, a somehow risky bank (A Romanian business man without a banking background is the majority single shareholder), has 41 branches and operates in Bucharest and various towns throughout the country. Last year, KfW carried out a study on the supply and the demand for rural credit (which study was not shared with the FAO team) and, presently, Carpatica is carrying out a pilot rural credit project in Sibiu and two other cities. KfW has made available a total of €8 million and some 25% of that amount seems to have been disbursed already. Rural loans up to €10,000 can be provided (the average loan size is €7,500), both to SMEs (only existing enterprises with no financing of start-ups) and physical persons as final borrowers.

2.55 Recently, Carpatica has also applied for participation in the WB Rural Finance Project, which request is under consideration.

2.8.3 Miro Bank

2.56 The background of the Miro Bank is a NGO-based micro finance institution that in mid-2002 was transformed into a bank; the bank has as international shareholders: IPC, Commerzbank, DEG, KfW, EBRD and IFC. The number of staff, branches, general banking services, savings/deposits and the volume of lending operations, including to SMEs, have expanded rapidly. Notwithstanding an initial focus on urban areas, the experience as a MFI make

this bank well suited for lending to SMEs in smaller cities and rural areas. A study on the demand for rural and agricultural credit was carried out in September 2002 and the bank started a pilot rural lending project at the beginning of 2003 in Timisoara.

2.57 During the pilot phase both working capital loans and investment loans were granted and the loan size was gradually increased from as low as €2,500 up to a current ceiling of €50,000. Agricultural and micro rural loans are provided to small farmers and micro-enterprises, the majority of which have an individual as the single owner: with loans up to €10,000, 2-year loan duration, interest rate of 35% on loans nominated in local currency, and acceptance of pledges on movable assets plus personal guarantors as loan collateral with no requirement of mortgage. On the other hand, rural business loans are provided to larger farmers and rural SMEs: with a loan size from €10,000 up to 50,000, 5-year maturity, interest rates between 10-16% on foreign currency loans, use of 70% mortgage as collateral for loans above €25,000, and a flexible loan repayment schedule based on the projected cash flow of the SME.

2.58 Micro and SME loans each make up about half of the total loan portfolio, but the first account for 80% and the second for 20% of the total number of borrowers. In the meantime, the Miro Bank has become profitable in the last two months and it is scheduled by November to take the name of Procredit, as similar banks in a number of other East European countries, including Bulgaria. The bank would qualify thus for the new EU/EBRD Facility. The total number of loan officers in September 2004 was 67, of whom 4 were agricultural and 7 combined agricultural/rural loan officers. The total outstanding agricultural loan amount was about US\$1.2 million (250 loans) and the outstanding rural loan amount was US\$1.5 million (45 loans); this on a total of near 10,000 outstanding loans of the bank.

3. ASSESSMENT OF THE DEMAND FOR CREDIT BY RURAL SMES

3.1 SME Sector and Rural SMEs in Romania

3.1.1 Main Features of SMEs

3.2 The Romanian definition of micro, small and medium-sized enterprises is broadly in line with the one used by the EC, although turnover is defined more restrictively: up to €8 million versus up to €40 million for medium-sized enterprises as defined by the EC. The Romanian authorities argue that this is more realistic considering the economic conditions in Romania:

Definition of the enterprise size	Micro	Small	Medium
In Romania			
Maximum number of employees	< 10	<50	<250
Maximum total turnover in million Euro	<8	<8	<8
Maximum capital voting rights held by non SME shareholders	25%	25%	25%

3.3 An analysis of the composition of enterprise registrations shows that micro-enterprises dominate the sector. In 2002, the National Institute of Statistics (INS) reported in total 343,148 active SMEs (including micro-enterprises), out of which 341,168 were privately owned and 1,980 were public. As shown below, about 89% of the private active SMEs are micro-, 9% are small and 2% are medium-sized enterprises. As could be expected, the largest number of micro-enterprises are found in the services sector, in particular in trade.

Economic sectors, 2002	Total SMEs	Micro	Small	Medium
Industry	65,150	51,283	9,954	3,913
Agriculture	10,540	8,770	1,492	278
Construction	17,083	13,124	2,969	990
Services, of which:	248,395	231,247	15,106	2,042
<i>Trade</i>	172,815	161,953	9,948	914
<i>Tourism</i>	2,600	2,120	353	127
<i>Transportation</i>	15,867	14,363	1,214	290
<i>Other Services</i>	57,113	52,811	3,591	711
Total	341,168	304,424	29,521	7,223

Source: INS, 2003¹

¹ Statistical data for 2003 will be available only by the end of 2004.

3.4 The SME sector in Romania is responsible for a significant share of the total enterprise activities in the economy, as indicated in the table below, showing some main economic and financial indicators by enterprise size class and by type of ownership. As can be seen, with the sole exception of exports, the SMEs account for an important part of the results of the total enterprise sector.

Main Economic and Financial Indicators of Enterprises by Size, Class and by Type of Ownership at Current Prices, in ROL billion

Size class, by average number of employees	2002				
	Turnover	Gross Investment	Direct Exports	Gross Value Added (at factor cost)	Gross Result of Exercise
Total enterprises Out of which:	2,670,076	411,125	282,541	579,521	4,668
Total enterprises with private majority	2,177,587	252,847	243,648	438,910	36,277
Total SMEs (0-250) with private majority	1,485,075 68.1%	160,128 63.3%	69,114 15%	249,590 56.8%	36,631 101%

Source: INS, 2003, Table 12.11

3.5 Moreover, the SME sector in general and micro-enterprises in particular, normally include a high proportion of entities that operate within the so-called “grey economy” and whose activities, consequently, fall outside the formal, economic data base. As a result, the actual number of SMEs is normally understated. While the INS estimated that the grey economy is equivalent to 21% of the total GDP, other independent research estimates are higher, measuring it at about 30% of the GDP. Taking the 30% ratio as being more realistic, this indicates that the total number of registered and unregistered SMEs in Romania would be approximately 445,000 entities¹.

3.6 Total gross profits of private active SMEs have increased by over 25% between 2000-2002, whereas gross profits in the agricultural sector (although representing only 2.6% of all private SMEs) have registered the highest growth of all (75%). See the table below:

¹ The estimate of the grey economy, being only 30% of the formal GDP, is low by developing countries' standards.

**Gross Profits of Private Active SMEs by Economic Sector and Enterprise Size at Constant Prices (CPI),
in billions RO**

Sector of the Economy	2000				2001				2002			
	Total SMEs	Micro	Small	Medium	Total SMEs	Micro	Small	Medium	Total SMEs	Micro	Small	Medium
Industry	17,678	2,919	6,446	8,312	21,996	4,786	7,079	10,131	21,230	5,666	6,121	9,444
Agriculture	1,172	336	461	375	2,098	803	693	602	2,052	1,001	581	471
Construction	6,161	774	1,971	3,416	7,756	1,792	2,499	3,465	7,692	3,161	2,115	2,416
Services of which:	37,281	17,659	13,657	5,965	46,100	25,144	14,879	6,077	47,061	30,498	11,401	5,162
<i>Trade</i>	24,321	12,388	9,008	2,925	27,960	15,541	9,663	2,756	25,655	16,557	6,672	2,427
<i>Tourism</i>	609	111	242	256	901	262	276	363	1,234	596	292	346
<i>Transportation</i>	1,999	689	648	662	2,789	1,074	993	721	4,926	2,517	1,354	1,055
<i>Other</i>	10,353	4,471	3,759	2,122	14,450	8,267	3,947	2,237	15,246	10,828	3,083	1,335
Total	62,293	21,689	22,537	18,067	77,950	32,525	25,150	20,275	78,036	40,325	20,218	17,493

3.7 With regard to the geographical location of SMEs their share varies significantly across regions and ranges from 8.3% in the West through almost 20% in Bucharest and the Ilfov County, the most dynamic region in the country.

3.8 The country economy and economic growth are dominated by large cities. In-depth studies such as the World Bank Poverty Map show that even within the same county the discrepancies are very large. For instance, Timis, one of the most dynamic counties in the western part of the country, still shows great gaps in terms of economic development and growth between Timisoara (the county capital) and the rest of the county (small towns and rural municipalities). Smaller municipalities (with up to 50,000 inhabitants) are indeed still on a very slow development path.

3.1.2 SMEs in Rural Areas

3.9 A World Bank study entitled "Financial Markets, Credit Constraints and Investment in Rural Romania", January, 2001, using 1998 data, showed that there were about 80,000 registered rural SMEs, which figure is adjusted for GDP growth and unregistered entities.

3.10 In small rural communities, normally the only economic activities that can be found are farming and services such as small trade, workshops and handicrafts. Rural economic activities should also include, however, agro-processing enterprises which are normally concentrated in agricultural areas with higher potential and larger communities as well as location-specific, non-farm rural economic activities such as wood processing, glass and ceramics, rural tourism and other rural industries. The main features of the different rural economic activities in Romania (agricultural production, agro-processing and non-farm rural economic activities) are presented below.

Agricultural production

3.11 With over 40% of the total population living in rural areas and with 15 million hectares of total farm land, agriculture is the traditional backbone of the Romanian economy. Farm households, associations and cooperatives, commercial farms and large business groups, agribusiness enterprises, agricultural producer associations and agro-processing associations employ 42% of Romania's total workforce.

3.12 The major structural problem of the Romanian agricultural sector is the marked dichotomy in farm size and the way of farming. On the one hand, there is the vast bulk of 4,759,229 small farms with an average farm size of 2.9 ha (in 2003) that own two-thirds of all arable land, have little market orientation, and produce mainly for own consumption. They could better be called peasant farms or home gardens. On the other hand, according to information from the Ministry of Agriculture, Food and Forestry¹ and based on the classification of the Farm Operations Law 166/2002, in the year 2004 a total of over 169,000 commercial farms have been recorded. Among these there are 7,700 crop farms, 30,300 livestock farms, 90 fish farms, and 91,022 mixed farms. The average size of a commercial farm is quite large: 270 hectares of crops, 134 bovine heads, 1,260 pigs and 230 sheep. Since out of the total number of commercial farms there are 1,733 large-sized farms (with more than 1,000 ha land), the majority of the commercial farms would be SMEs.

3.13 For the majority of the small farms the low capital intensity and the current state of used technology have a negative impact on their production volume, cost effectiveness and product quality. In fact, many food processing companies complain that the supply of raw materials from domestic agricultural sources is insufficient and unreliable, relatively costly (small farmers can sell their fresh or primary processed products more profitably directly to consumers) and is often of low quality.

Agro-processing

3.14 According to data from the Ministry of Agriculture, Food and Forestry there are 14,509 agro-processing companies in total, of which 99% are private. The sector employs over 240,000 people, representing 5% of the total active population, while accounting for 26% of the total gross agricultural production value and 4.6% of the GDP. For details on the agro-processing sector and the various sub-sectors, see *Annex 2*.

3.15 The number of enterprises that produce *milling, bakery, and flower products* has increased each year. At present, there are almost 6,500 enterprises, of which over 4,900 are small enterprises with private capital.

3.16 At the beginning of the transition period in 1989, 100 companies were active as industrial *fruit and vegetable processing factories*: 40 enterprises with a capacity ranging from 2,000 to 30,000 tons of finished goods per year could be classified as large processors, while 60 smaller units had a rated capacity of below 2,000 tons per year. Many fruit and vegetable processors cover the supply of raw materials from their own horticultural production, while only relatively few other farmers supply them with sizable quantities of raw materials. The enterprises have similar patterns of production and they produce a broad variety of canned fruit and

¹ Data presented in "The Sustainable Development Strategy", May 2004.

vegetables, thus foregoing the cost-reducing effects related with specialisation and economies of scale as well as the advantages of a specific favourable location (in terms of climate, soil type, specific products). In spite of the fierce competition, no attempts have been made to specialise in processing canned fruit or canned vegetables exclusively. In general, the products of processing plants are often also not properly packaged or labelled and protected: the reason is undoubtedly to minimise costs, but it could also be partly due to the lack of awareness of quality and sanitary standards.

3.17 The Romanian *wine industry* has great growth potential and could become an important sub-sector in the food and beverage industry of the country. However, the competitiveness of the wine sub-sector is low, while it faces serious problems due to numerous weaknesses along the production chain from vineyards and wineries to distribution and trade.

3.18 Hygiene is the main issue for *slaughterhouses and meat processing* plants and of all enterprises, the meat sector needs to make the most adjustments to survive during the process of the EU accession. Similarly, about three quarters of the Romanian national milk producers are not respecting the tight sanitary requirements that have been imposed. Poor milk quality is a serious limiting factor for the *dairy industry*, because of the high bacteria content that is caused by the insufficient availability of cold storage facilities and the use of unsuitable sanitation and milk handling practices.

3.19 According to data from INS, in 2002 there were 10,540 registered and active SMEs in the whole food and beverage industry, of which only 1,492 were small enterprises and 278 were medium-sized enterprises (as per the standard definition of the number of permanent employees), while the remaining major part were micro-enterprises. It can be remarked that, apart from the number of permanent employees, there are no great structural differences between small- and micro-enterprises, while INS indicators in the table below show that the most dynamic firms are the 8,770 micro-enterprises.

Food and Beverage: Private Active SMEs in 2002, Gross Profits and Gross Losses by Size at Constant Prices (CPI)

	Food and Beverage		
	Number of SMEs	Gross profits *	Gross losses *
In 2000			
Total SMEs	6,376	1,172	2,067
Micro	5,112	336	626
Small	1,024	461	784
Medium	240	375	657
In 2001			
Total SMEs	7,195	2,098	2,324
Micro	5,950	803	912
Small	1,025	693	656
Medium	220	602	756
In 2002			
Total SMEs	10,540	2,052	4,499
Micro	8,770	1,001	2,330
Small	1,492	581	1,070
Medium	278	471	1,098
* at constant prices (CPI) in billions ROL (based on INS, 2003)			

3.20 *Non-farm rural economic activities.* The activities of rural SMEs, however, are not limited to only agriculture production and agro-processing. Based on their specific geographical location, other rural economic activities, both manufacturing and services, are relevant. Economic activities considered in this study include: wood and furniture, glass and ceramics, textile and apparel, and rural tourism. See *Annex 3* for details.

3.21 There are more than 8,000 small- and medium-sized enterprises operating in the *wood and furniture* sector and some 85% of the wood-cutting and processing, and 95% of the furniture manufacturing companies are micro-, small and medium-sized enterprises. Most of them are located far away from the main urban areas.

3.22 As most of the forests are located in the northern and central part of the country (mainly spruce, fir, oak, beech), two regions show a high concentration of wood processing and furniture manufacturing activities: the NE area from Suceava and down through Iasi to Bacau and the NW area from Baia Mare and Satu Mare and down through Cluj to Targu Mures.

3.23 In the *garment and textile industry*, approximately 4,724 enterprises operate and of these, 3,300 are small and medium-sized enterprises. Approximately 70% of the companies which are active in this sector are SMEs, and they employ 50-60% of the total 460,000 people employed in the sector. Currently, the majority of SMEs in the textile industry are engaged in the production of garments, as opposed to the production of textile fabrics.

3.24 According to industry experts of the Ministry of Commerce and Trade, in the combined activities of *glass and fine ceramics* there are 44 large companies, 55 small and medium-sized enterprises and 221 micro-enterprises.

3.25 In the *glass industry*, major clusters of enterprises have been developed in locations that have deposits of the required raw materials, sand and alkaline, while in former times also wood from nearby forests was used to heat the furnaces for glass-melting. These areas are in or near Targu Jiu, Buzau-Scaieni, and Dorohoi and in a number of areas in Transylvania, including Tarnaveni, Turda, Sibiu, and Medias. The largest producers of container glass, however, are located in Bucharest and Sighisoara.

3.26 In *ceramics*, the major industrial activities for sanitary and tabletop ceramic and porcelain production are located in Transylvania, specifically in Cluj Napoca, Alba Iulia, Sighisoara and further north in Baia Mare. An additional centre for porcelain production is located in Curtea de Arges. The bulk of traditional Romania ceramics are produced in four centres: Suceava, Horezu, Corunt, and Baia Mare.

3.27 The small and medium-sized enterprises in the glass and ceramics industry share the same common features:

- A *small enterprise* is owned by a former worker of a state-owned company. The plant is typically located adjacent to the owner's home and the firm may have up to 10 years of incremental growth, usually self-financed. Equipment has been bought second-hand. Export contacts are made through the Chamber of Commerce and entrepreneurs believe that attendance of trade fairs will give them better opportunities to access new markets. Managing of cash flows and energy costs are the top priorities of these firms.

- *A medium-sized company* is owned by a former manager of a state-owned company. Those enterprises operating at the smaller end of the scale may still be located on the owner's land and additional land may be available for expansion, but capital is needed for investments in buildings and equipment. The firm has successfully expanded its production capacity to meet demand; owners and managers regularly attend trade fairs; and the managers' main concerns are pricing, cost containment, and foreign competition.

3.28 In the tourism industry there are approximately 10,147 companies, of which approximately 80% are SMEs. SMEs often operate local tourism agencies, small hotels, restaurants, and "bed and breakfast" facilities. *Rural tourism* can be found in many areas of Romania but it has its major concentration in the hilly and mountainous regions and in the Danube Delta. This type of tourism provides modest accommodation in rural areas which allow for a more leisurely pace of life. Rural tourism took off only after the changes in the country, but today it can already accommodate up to 10,000 tourists, mostly in smaller family-owned boarding houses. At present, there are 4,000 of these rural and agro-tourist boarding houses. SMEs in the tourism sector have various backgrounds. In rural and eco-tourism, almost all the companies are family-operated SMEs who commenced with small amounts of own capital. Others started through the privatisation of state-enterprises.

3.2 Comparative Analysis of Specific Economic Sectors

3.2.1 Agricultural Production

3.29 Positive factors for investments and financing are:

- (i) Good potential (large agricultural land area, fertile soils, cheap labour force, long agricultural tradition, in particular, in grains, vegetables and fruit), but currently under-utilised.
- (ii) Importance of agriculture in the overall economy: as of 2002 the agricultural decline has stopped and the share of agriculture has gone up slightly from 11.2 % in 2002 to 11.7% in 2003. The sector employs more than one third of the total active population. Labour costs are low but so, too, is productivity.
- (iii) Physical yields of durum wheat per hectare are above the EU average level and have attracted foreign investors.
- (iv) In view of the EU accession, the Ministry of Agriculture, Food and Forestry, with the help of the EC, produced an agricultural and rural strategy in February 2003; main targets are to improve the economic performance, the competitiveness and the sustainable development of the sector, with the help of external and domestic finance.
- (v) Romania is pioneering the farming of biotech crops, in particular soybeans, and the increase of the area under organic farming from 18,690 to 43,000 ha (the objective is to reach 140,000 ha) shows the development potential.

- (vi) The last few years, 2002-2004, have registered an increase in livestock production and its share in overall agricultural production, but farm production is rather directed at home consumption and primary processing and retailing.
- (vii) A positive trend in milk production has been registered in the last few years.
- (viii) Romania's rural areas offer various ecotourism opportunities.
- (ix) The existing large mountain areas are important providers of services at national level (water resources, biodiversity, recreation facilities).

3.30 On the other hand, agricultural sector development is faced with negative factors and challenges:

- (a) Excessive fragmentation of farm plots and a polarised farm structure: co-existence of a large number of very small and economically unviable production units and a relatively small number of large commercial farms with few inter-linkages.
- (b) Agricultural production has a predominantly subsistence character: according to estimations based upon data supplied by the INS from the Producer Balances, the share of self-consumption in product utilisation in the year 2001 was still high (for wheat, maize and barley it ranged from 48% to 55%, while it was about 60% for milk, 70% for pork meat and eggs, and over 80% for poultry meat).
- (c) Few modern agricultural inputs, equipment and services are used, mainly due to a lack of financial resources. For instance, while the tractor and combine fleet has increased, a large share of the existing machinery is old and technically obsolete. In 2001, the existing machinery for cereal cultivation represented only half of the equipment needed. Low operational efficiency and the high cost of tractors are the result of frequent repairs and a high consumption of fuel and lubricants.
- (d) Agricultural exports are dominated by raw materials and products with a low degree of processing (added value): live animals, cereals (highly variable annual amounts), oil crops, wine, summer vegetables, wild mushrooms, truffles and fruit nuts.
- (e) Low labour productivity: €2,200 per employed person in 2001 which is only 6% of the corresponding value in the EU in the same reference year. The agricultural output value per ha amounted to €248 in 2002 as compared with €2,000 in the EU in 2001. Comparison of the average Romanian crop yields in the period 2000-2002 with the EU-15 figures (2001) reveal a 60-70% gap, except for durum wheat (+15%) and sunflower (+40%). Average milk yields in Romania are about 3,000 litres per cow as compared to the EU-15 average of 5,800 litres.

3.31 Agricultural inputs (fertilisers, seeds or planting material), equipment and irrigation and better-bred animals and buildings are only some of the investments that are much needed in the agricultural production sector. Although estimations of the total agricultural investment demand are hard to make, it is obvious that the potential demand greatly exceeds the current financing supply. The bank branch network in rural areas, however, is little developed and current bank procedures and bank lending conditions are not adapted to the specific conditions of potential farmer borrowers. In particular, most smaller farmers do not have conventional bank collateral and, at present, it is difficult for them to comply with the lending eligibility criteria of banks. Banks, meanwhile, consider agriculture a risky business and they require insurance coverage which is not widespread.

3.32 Despite this, a strong integration process is taking place in the food industry, whereby large private farming business groups invest in food processing facilities, while food and beverage companies invest in agricultural production and develop linkages with farmers to increase the quantity and quality of the raw materials that they need. While contract farming financing arrangements and commercial supplier credit from input and equipment dealers are increasing, it is not expected that they can substitute for bank lending, in particular, not for farm investments.

3.33 Potentially profitable crops and products for bank lending could be:

- Export crops cultivated on irrigated land such as alfalfa and soybean.
- Production of high value products that have an identified international market niche demand such as in the case of honey, wild fruits, summer vegetables, and spicy herbs.
- Production of biotech crops that meet international organic certification standards.
- Production of processed meat such as sausages from locally produced animals.
- Limited land-based and labour- and capital-intensive greenhouse production, utilisation of thermal waters and sterile soils, production of potting soils, flower production, and fish farming.

3.2.2 Agro-Processing

3.34 The food & beverage sector is a core industry in Romania, second only to oil processing. It accounts for 8% of the total gross value added in the economy and employs 170,000 people. The demand for food is rising each year (expected to reach some US\$26 billion in 2004) and while the food processing industry is making impressive gains, agricultural production is not keeping up and a large amount of food has to be imported in order to satisfy local demand. The following aspects highlight the specific features of the Romanian food processing market:

- Food expenses account for no less than 57% of the average overall household budget in Romania versus 44% in Bulgaria and less than 30% in other Eastern European countries which have already joined the EU.

- Food consumption is dominated by basic products: no less than 22% of the food budget is spent on bakery products. Last year's average meat consumption was only 52 kilograms per capita as compared to 69 kilograms in Bulgaria and, for instance, 90 kilograms in Hungary. The consumption of vegetables by Romanians is higher with 162 kilograms per capita and potatoes, beans and cabbage constitute the largest share.
- Until the end of March, 2002, the grades and standards, which existed were neither respected nor controlled. With the new order of the Ministry of Agriculture, Food and Forestry, processors will have to observe grades and norms. Most of the standards used in the vegetable and fruit sector are not yet harmonised with those of the EU.
- Food prices fluctuate according to the supply situation. Due to an almost complete lack of market information and the use of many marketing channels, price information is often erratic and definitely not transparent. Poor grades and standards are another reason for the lack of transparency in the price formation process. Seasonal price fluctuations are very marked due to the lack of sufficient storage facilities.
- Most processing factories were built to serve both domestic and export markets. Used equipment is of Romanian origin and often more than 20 years old. In order to comply with EU and international quality and packaging standards, the food industry urgently needs investment in the restructuring of facilities, in up-to-date technologies and in new equipment for sterilising, control and packaging. Development of integrated food chains of agricultural production, storage and processing is only in the early stages, but will lead to higher quality food products.
- Due to a low scale of operations and a poor state of technology, national processors are not able to compete with international brands.
- In 1997, the changes to the price and support policies in agriculture affected the milk and dairy industry, in particular. After the full liberalisation of all milk prices and the removal of bonuses, a sharp increase in prices occurred in the first two months (by about 2.5 times), in the next month prices stabilised, and only by the end of the year did prices increase again, but this time in line with those of other food products.
- Millers and bakers buy wheat directly from agricultural producers, but only for 2-3 months after harvest. After this period, wheat is bought from wholesalers, associations or producers who store only small quantities of wheat. Some larger grain processors even prefer to import wheat and corn, as the supply and expenses related with buying from domestic sources are not reliable and too high or the quality of the Romanian grains does not meet the demand requirements.

- Most animals are raised in stables that have long exceeded their useful life, affecting productivity and causing losses due to poor sanitary and veterinary conditions. High price fluctuations and poor domestic animal quality direct meat processors to imports.
- The unfair competition of small (illegal) slaughter units, together with a low number of animals raised in the country, triggers an under-utilisation of the installed production capacities of larger-sized slaughterhouses and makes it difficult for them to invest in upgrading their facilities required to comply with the EU norms and to stay in business.
- A poor quality of existing genetic animal materials produced in the country which is mainly meant for small farmers.
- Domestic animal fodder suppliers, due to a lack of a good control system and correspondent legislation, often deliver animal feed of uncertain quality.

3.2.3 Non-Farm Rural Economic Activities

3.35 *Textile and apparel:* Textile in Romania is a US\$2.76 billion dollar industry which grew by 30% from 2001 to 2002 and is expected to have an annual growth rate of 9-10% until 2010, significantly higher than the estimated 5.6% growth rate of the total economy. An average annual increase of US\$120 million in the value of exports from the textile industry is expected until 2010.

3.36 SMEs constitute approximately 70% of the total number of textile companies and the majority is engaged in the production of garments. There is a growing trend for existing larger companies to split up their operations into smaller and more flexible units so as to be able to adapt to rapidly changing tastes in the fashion industry. SMEs specialise in only one or two parts of the production process, while they outsource the rest. Increasing differentiation at Western European clothing shop and store level requires many small-to-medium sized manufacturers who are sub-contracted exclusively by stores and produce clothing under strict codes of secrecy. The SMEs provide the agility, quick delivery and security that specialty stores are now demanding. Smaller companies, with a multi-skilled workforce and up-to-date computer assisted design and computer assisted CAD/CAM manufacturing facilities, including Internet connections to main consumer markets in the world, should be given priority in bank lending for investments.

3.37 *Wood and furniture:* Romania has a long tradition in wood products and furniture manufacturing and before 1990 was a major exporter of furniture. The sector accounts for an increasing percentage of the total exports of Romania. In 2002, furniture production amounted to US\$731 million, of which US\$474.2 million were exports (5.6% of the total Romanian exports), generating a net contribution of US\$415.5 million to the national trade balance.

3.38 The exports of furniture from Romania have a good competitive potential, witnessed by the significant growth following re-entry into markets like the USA and the Former Soviet Union (FSU). These markets have an estimated demand potential of US\$250 million and US\$150 million respectively for furniture imported from Romania, of which volume little is currently covered. Increases in furniture production from US\$614 million in 2002 to US\$1,120 billion in

2010 (as planned) will trigger off corresponding growth in all areas of the sector with positive direct impact on the employment of the rural population. Exports of wood products other than furniture, mostly timber, represent only 30-35% of the production; the rest is absorbed by the domestic market for use in other products, furniture, construction, etc. The volume of exports of these products increased from US\$554.7 million in 2001 to US\$625.4 million in 2002.

3.39 Notwithstanding the general challenges that the SME sector in Romania faces, small- and medium-sized companies in the wood and furniture industry have significant competitive advantages based on large forests and low labour costs as compared to other countries in the region. Outside Bucharest, where most of the wood and furniture activities are located, unemployment rates are high and enterprises have in general no problems in attracting cheap labour from rural villages. The number of people employed by the wood cutting and processing industry is expected to grow to 75,000 in 2004 and will continue to grow in the next two years due to an expected increase in work and the instalment of new production capacities. Access to bank financing, already difficult and expensive, is especially difficult for SMEs engaged in wood harvesting and cutting, as they use mostly old equipment and technologies and have no valuable fixed assets which they can offer as collateral.

3.40 *Glass and ceramics:* In Romania, the annual sales of the glass industry amount to more than US\$190 million, while for ceramics they are about US\$116 million. Glass and ceramics exports account for about 1.5% of the Romanian total export value with about US\$60 million glass tableware exports (mostly hand made) and approximately US\$45 million exports of porcelain/ceramics tableware and decorative products. For glass production, Romania disposes of local supplies of sand and soda ash.

3.41 Currently, only 15% of the glass and ceramics products are made by small- or medium- sized enterprises, but their number is growing as former state-owned factories tend to be privatised and downsized. Many SMEs are exporting directly and, while they face numerous challenges, they seem to be able to manage key business issues such as price negotiations, freight options, packaging, and payment options. The tableware glass sector in Romania experienced three consecutive years of negative growth from 1999 to 2001, but in 2002 exports did grow again and surpassed the 1998-sales levels. Growth in exports of float glass indicates that there are good external markets for production expansion.

3.42 Based on sales and employment estimates, the annual productivity per worker in the glass and ceramics industry is approximately US\$8,310 which compares favourably with Romania's average industrial productivity of an estimated US\$5,296. For textiles the average productivity is US\$6,000, for wood products US\$7,029, and for tourism US\$5,172.

3.43 *Tourism:* According to the INS, the number of tourists coming to Romania was 4,793,700 in 2002; approximately 2.9% lower than in 2001. The tourism industry in Romania is a US\$600 million-dollar industry expected to grow by 4.3 percent p.a. over the next 5 years. Romania offers a wide range of tourism products ranging from rural tourism and cultural visits to key historical sites to beach vacations at the Black Sea.

3.44 Development of *rural tourism* has benefited from certain incentives that were offered in the context of the "Law on Rural Tourism" that was passed in 1998. The incentives consisted of a tax holiday on profits derived from the running of tourist boarding houses. In rural and eco-tourism, almost all the companies are SMEs which started with small amounts of own capital and

the business is family-owned and -operated. Families who run bed and breakfast facilities have additional sources of income.

3.45 One of the main factors that impede the development of rural tourism is the poor transport infrastructure of roads, rail and air. Other problems are a lack of previous tourism experience of the operators and low business management skills. High collateral requirements of banks are the main constraint for obtaining bank loans in order to finance the refurbishment of accommodation and/or to make other required investments.

3.2.4 Strengths and Weaknesses of Non-Farm Rural SMEs

3.46 According to assessments of industry experts, non-farm rural SMEs share, irrespective of their field of activity, several positive features:

- (a) Potential for economic growth and further expansion of exports: many SMEs are already exporting and there are few barriers to exporting.
- (b) Sufficient supplies of required raw materials (timber; natural fibres; sand and ash) are available from domestic sources.
- (c) Ample and relatively cheap labour supply.
- (d) Familiarity with the need for high quality products in some sectors.
- (e) Availability of skilled labour (In the textile industry the “Lohn” system has contributed to the development of skilled labour, introduced new technologies, and made management export-orientated) and the existence of strong traditional skills e.g. in glass blowing, decorations, painted glass.
- (f) The EU access will bring a number of benefits (vast EU market, foreign investors, structural financial aid), but will simply costs (the need to restructure and replace old technologies and equipment with up-to-date ones; the required investment costs of the SMEs may prove difficult without adequate external support).

3.47 Main problems and weaknesses of the rural non-farm SMEs are:

- Inadequate manufacturing facilities (under-utilisation of installed capacity, obsolete equipment, lack of proper packaging equipment and packing, wasted energy problems).
- Limited marketing and sales capacity (lack of customer knowledge, ignorance of required quality standards for target markets, inadequate packaging for shipping), and low business management skills.
- Transportation costs to overseas markets, expensive working capital loans from banks, limited services from business support organisations.

3.2.5 Business Support Organisations (BSOs)

3.48 There are two categories of business support organisations in Romania: professional business associations and employers' associations. Over the past three years, BSOs in all economic sectors have grown both in number and importance. These organisations are well regarded by the government, as they facilitate the dialogue and partnerships between the public and the private sector. They also attract international support in the form of business development projects for specific sectors.

3.49 Business support services are available from local chambers of commerce; international business or economic development programmes funded by different donors; and business associations and private business consultation companies. The range and effectiveness of these services are still rather limited. A recent survey revealed that over 85% of all enterprises are members of at least one chamber of commerce or a business association/employer organisation. Members demand multiple services like: information about technologies and markets (58.9%); networking contacts (40.6%); professional services (17.4%); support in accessing bank finance (14.2%); representation of common interests with public authorities (13.5%); and training services (only 5%).

3.3 Credit Demand Constraints of Rural SMEs

3.3.1 Survey of the National Agency for SMEs and Cooperatives

3.50 A recent survey¹ of a representative sample of SMEs in Romania has identified the following main financing constraints as reported by the interviewed SMEs:

- Cash flow problems are encountered by 44% of the enterprises in the agricultural sector and by 40% of the micro-enterprises. Of the small- and medium-sized enterprises, 36% report occasional cash flow problems, while 8% of the medium-sized enterprises report continuous cash flow problems. The larger the enterprise, the greater appears the probability that the enterprise faces liquidity needs.
- The preferred strategy to counter liquidity needs, followed by most of the SMEs (40.6%), is to delay payments to suppliers. Less preferred options are delays in paying salaries and social contributions to workers.
- Leasing is declared as a preferred mechanism to acquire equipment, vehicles and hardware by 34% of SMEs; in the event of important investments, half of the SMEs would choose leasing instead of cash payment.
- Declared investment plans (Distribution in %):

¹ "Situation and needs – SMEs' opinions" - survey organised by the National Agency for SMEs and Cooperatives, published in October 2004. Out of the total 1,200 questionnaires, 993 were validated. Enterprises were selected based on their size and 7 other specific sector criteria.

	Small investments	Large investments	None
Agriculture and fishery	64	2	34
Industry and energy	54	20	26
Constructions	69	6	25
Commerce	52	20	28
Hotels and restaurants	67	0	33
Transport and communications	73	3	24
Other services	52	15	33
Micro-enterprises	55	15	30
Small enterprises	57	25	18
Medium-sized enterprises	55	31	14
Total	55	16	29

- The highest small investments are planned for transport and communications (73%), construction (69%), hotels and restaurants (67%), and agriculture and fishery (64%).
- Planned large investments (highest for medium-sized enterprises) will create up to 10 new jobs (75% of the cases), up to 34 new jobs (10%) and more than 100 new jobs (8%).
- The main source of finance for investments remains own capital (87.5% in the case of large investments and 77.4% for small investments), bank loans are less important, while a third source is government development programmes.
- In terms of a combination of financing sources, for larger investments, entrepreneurs would combine own finance with bank loans and funding from capital markets. SMEs have a limited capacity to finance investments on the capital market (through the emission of bonds or the issue of stock options).
- Enterprises in agriculture and fishery (87.8%) declare that they envisage realizing investments with own funds; only 5.4% plan to also use bank loans, while 4.5% expect that to have access to government financing programmes.
- Medium-sized enterprises (30.4%) plan to use a combination of own funds and bank loans, while 47.6% expect to use only their own financing; 7.2% of the medium-sized enterprises and 11% of the small enterprises say that they will invest solely on the basis of bank loans.
- Determinant factors in selecting the source of finance for large investments are: simple and rapid procedures (52%); low interest rate (55%); low collateral requirements (32%); prestige (16%); and maintaining their independence (8%). For all the types of investments, SMEs will select the source of finance on the basis of a low level of interest rate (51.1%); simple and rapid procedures (39.8%) and low collateral requirements (22.2%).
- Collateral is perceived as a serious barrier and credit guarantee funds could play a larger role in supporting SMEs in increasing their access to bank credit.

- Main financing products are the traditional ones: about 95% of the enterprises have opened a current account in a bank; 32.7% of medium-sized enterprises and 21% of the small enterprises have bank deposits; 19% medium and 1.4% small enterprises use credit cards; 24.5% of the medium and 18.2% of the small enterprises receive commercial loans from their suppliers, and 9.3% of the medium and 7.1% of the small enterprises have investment loans.
- Only 11% of the SMEs said that they plan to prepare an investment project proposal and intend to apply for non-reimbursable grant funds such as SAPARD.
- One type of investment that the Government may want to stimulate through fiscal policies is the acquisition of modern technologies (71.9%).
- SMEs see the Government as having an important role to play through specialised financial institutions. However, this perception is strongly influenced by the former central planning role of the Government; for instance, 51.8% say the Government should become involved in subsidising lending interest rates; 21 % mention that the Government should play a role in training and advisory services; 18.8% see the Government as playing a role in facilitating business contracts; 17.2% want the Government to guarantee their bank loans, and about 11% look to the Government for the provision of good market information.
- Improvements in the overall business environment: 60% of the SMEs insist on easier access to financing and 44.4% ask for specific government development; enterprises in agriculture and fishery say that they need more special government support programmes (63,5%); 45% want easier access to financing; and 36% would like to receive better training for their workforce.
- For 42.4% of the SMEs, regulatory changes are required in order to increase investment and to expand economic activities: discipline in complying with existing norms and rigorous enforcement of contracts are clear priorities.
- For 34.8%, improvements in the labor legislation are second in the hierarchy.
- 29.6% of the interviewed enterprises mention the need for reduced red tape and simpler procedures for enterprise licensing and authorisation.

3.51 It may be concluded that in order to support SMEs in their development it is important to resolve both external problems (related to the overall business environment) and internal problems (which depend on the way in which SMEs are organised and perform their activities).

3.52 A non-exhaustive list of **external problems** of SMEs includes:

- (a) High interest rates and commission charged on bank loans, making these funds prohibitive for both the financing of current operations and planned investments.

- (b) Discriminatory treatment of SMEs, micro-enterprises and individual entrepreneurs by banks as compared to larger private or state-owned companies.
- (c) Narrow range of bank products that are offered as compared with the specific features and needs of rural SMEs.
- (d) High level of taxes and social contributions that need to be paid by SMEs which arrive at an accumulative figure of 60-70% of the total turnover (Value Added Tax: 18%; salary related taxes and contributions: up to 35-50%; tax on profits: 25%; other taxes).
- (e) Discontinuity in the fiscal regime and regulations, affecting the capacity of SMEs to adopt long-term business and financial plans.
- (f) Scarce access to appropriate, up-to-date technologies, as most of the SMEs have developed their production process on the structure of former state-owned enterprises and have inherited old, technologically poor equipment.

3.53 While **internal problems** of SMEs include:

- Poor internal organisation and operational performance of the enterprise due to initial low managerial skills and a lack of knowledge of modern business management, marketing, finance and accounting principles.
- Reliance on limited own financial resources and lack of access to external funds have condemned many SMEs to low operational efficiency and a limited scale of operations, thus affecting their further development.
- Poor access to useful market information, resulting in a limited knowledge about alternative potential markets, customers, clients and the overall business environment.

3.54 Strong points in the **demand for credit** by rural SMEs are:

- (i) A high unmet investment demand by commercial farmers for inputs, equipment and irrigation facilities; in the agro-processing industry there is an urgent need for large-scale investments in plant restructuring and new equipment in order to be able to comply with the sanitary and product quality standards of the EU accession, in particular, for slaughterhouses and meat processing plants, dairies, greenhouses, vegetable and fruit processing units, and certified organic production. Non-farm rural economic activities (wood and furniture, textile and garment, ceramics and glass, and rural tourism) also need investment funds in order to maintain their competitiveness and to enter into new export markets. A rough estimation of the above total investment needs is some US\$7.5 billion.
- (ii) A good credit culture of loan repayments among Romanian entrepreneurs, in particular in the rural areas.

- (iii) New Government strategies towards the development of SMEs and the agricultural and rural sectors, including the food and agro-processing industry.
- (iv) The expanding operations of the Rural Credit Guarantee Fund which works in close collaboration with banks.
- (v) Increased awareness and confidence of SMEs that have benefited from SME financing schemes in applying for new bank loans.
- (vi) Increased interest and motivation of banks to diversify the bank products that they target to rural SMEs.
- (vii) Graduation of successful rural micro-entrepreneurs who have received small business loans from micro finance institutions towards banks for larger loan needs.
- (viii) Interest of micro finance institutions in developing collaboration agreements with banks for providing loans to SMEs in rural areas.

3.3.2 SME Demand for Bank Loans: SWOT Analysis

3.55 Major factors which **constrain** the rural SME demand for bank loans include:

- Constraints identified by potential borrowers in their relationship with banks:
 - ✓ Applying for a loan takes too much time and involves much red tape.
 - ✓ Lack of confidence that a loan application will be approved.
 - ✓ Too short loan maturity.
 - ✓ High interest rate.
 - ✓ Lack of a grace period.
 - ✓ Banks are perceived as discriminating against small firms, conservative and not pro-active.
- Cultural constraints on the part of potential borrowers: reluctance to incur debts.
- Business constraints:
 - ✓ Insufficient profitability of the business to repay the loan principal plus interest.
 - ✓ Cannot comply with collateral requirements of banks.
 - ✓ The inability to receive more than one bank loan at the same time, e.g. investment and working capital loans together.
 - ✓ The requirements for the SME applicant to have a positive net worth, to be registered, and to have paid all its taxes.

- ✓ Lack of business management skills.
- Other constrains:
 - ✓ Poor marketing of bank products.
 - ✓ Lack of adequate business support services.
 - ✓ Lack of a rural bank branch network.

3.56 **Opportunities** for increased loan demand by rural SMEs include:

- Increased demand for investment loans in view of the EU accession (compliance with product quality, sanitary and environmental standards).
- Coordination between different donor financing programmes for SMEs: A special UNDP-coordinated Donor Task Force would avoid duplication and allow better targeting.
- Over the next two year period, the Government has targeted the development of business advisory services with funds to be provided by the new PHARE programme.
- Extension of micro credit operations under the new Law on micro finance institutions (currently under consideration and expected to be approved by the Parliament before the end of 2004).
- Amendments to the Leasing Law expected for next year.
- Investment demand in order counter increasing competition on internal and external markets.
- Investments in agriculture production and the scheduled privatisation of state-owned agriculture companies will stimulate the further development of private SMEs in rural areas.
- A more stable and favourable overall economic and business environment will encourage increased investments by SMEs.
- A new Government initiative for establishing a special capital facility.

3.57 Main threats are:

- The scheduled 2007 EU accession date may trigger off a faster death rate of SMEs, in the event that they do not succeed in complying with the EU norms.
- Lack of bank procedures and bank products that are adapted to the specific features and financing needs of rural SMEs.

- Extension of grant finance schemes may undermine the entrepreneurial culture and loan repayment discipline of rural SMEs.
- Lack of own capital from retained business profits for needed investments.

3.4 SME Profiles and FAO Survey of SMEs in Rural Areas

3.4.1 General Features

3.58 The FAO team gained some first-hand knowledge of investment and financing issues of SMEs in rural areas by interviewing a number of rural entrepreneurs and farmers during the country missions. Particular attention was given to the different sources for financing, the perceptions of these sources and the potential credit demand for future investments. SMEs were visited in the relatively well-developed Timis County in the western region where the city of Timisoara is located (the 4th largest city in Romania, with some 700,000 inhabitants) and the poorer Calarasi County in the south-eastern region (Calarasi town has approximate 70,000 inhabitants).

3.59 *Annex 4* shows the profiles of the visited SMEs. Due to a lack of formal financial statements and scarce details received from the interviewees on the profitability of their enterprises, only cash flows could be produced. Positive cash flow values show the typical SME feature of low labour costs and other expenses of enterprises that have already passed the difficult start-up phase.

3.60 Moreover, the FAO national consultant carried out a survey among SMEs in rural communities, using a random sample of 102 clients from banks and credit cooperatives. The specific purpose of the survey was to get a better insight into the perceptions of clients on bank credit. Out of a total of 102 interviews, 93 questionnaires were validated in three regions: the western part of the country (Transylvania – the most developed region), the southern part (Muntenia – a poorer developed region) and the north-eastern part (Moldova – the least developed region). *Annex 5* shows the questionnaire and detailed results of the analysis. Main findings from both the SME profiles and the survey are:

- Most enterprises are limited liability companies, family-owned and -run (the majority have 2 partners – husband and wife). Own capital has been the main source of finance for getting started and for current operations: in general, the role of bank credit is marginal.
- Consolidated small rural enterprises usually have a fairly long business experience, but over time they have not grown much and they remain small.
- In the event of liquidity shortages, the main solution used is to delay payments to suppliers and employees.
- Business and financial management practices, in general, are not well developed: only half of the managers/owners use a business plan. Formal

financial statements, apart from mandatory balance sheets, are not kept and none declared to have had its financial accounts audited.

- SME managers show little interest in financial data, or at least do not want to share them with outsiders: one third did not answer questions regarding the subscribed capital and the turnover of the enterprise.
- Subscribed capital is low and understates the strength of the enterprise. The calculated average per respondent is slightly above €20,000 – an amount that may be indicative for the minimum loan amount to be extended by banks under the Facility.
- A high proportion of the SMEs appear to be poorly informed about the requirements of banks for loan applications and about loan approval procedures, which would justify the provision of specific TA directed to the marketing of the Facility to rural SMEs.
- Financial discipline among the rural SMEs appears encouraging: all respondents declared that they have observed their loan repayment schedule with the banks.
- The determining factor for respondents in selecting the source of loan finance is the lower collateral requirement.
- Main banking products used are “current and savings/deposit accounts”, while “commercial credit” from business suppliers in the form of deferred payments for delivered goods is the main source of external finance.
- Banks are perceived as conservative and not pro-active towards rural SME clients, discriminating between small entrepreneurs versus larger local companies and foreign investors.
- Existing SME financing programmes are considered to be bureaucratic and slow, and even corrupt, in the case of SAPARD.
- The range and quality of business advisory services that are currently available to rural SMEs appear limited and need to be further developed. An example could be the low amount of resources that is spent by the Calarasi Chamber of Commerce on providing advice on business legal procedures and business plans. Similarly, the provision of donor-funded business advisory and lending services depends on the continuity of the financial resources: if these funds dry up, the focus may shift away from rural SMEs.

3.4.2 Credit Demand Constraints

- Most entrepreneurs relied on own funds for starting their business. External resources, apart from contributions from family and friends and commercial credit from suppliers, appear to have been non-existent. Assets already in their

possession (in particular, land) together with profits from other existing business and accumulated savings were used to start the new business.

- Working capital is provided not only by the family who owns and operates the enterprise but also by the employees. Delaying the payment of salaries and social securities, in the event of liquidity need, appears the easiest solution.
- SMEs in the Timis County, which were all clients of the NGO-based micro finance institution, CHF International, have not normally accessed any commercial bank loans for investment, even when they have profitable business and bank accounts.
- The main constraints¹ of bank loans as perceived by the SMEs include: excessive reliance by banks on conventional collateral and high collateral requirements (250% or higher of the evaluated replacement value of fixed assets), high interest rates and bank commissions, excessive bureaucracy (complex and lengthy loan application procedures), bank inflexibility (only one loan at any one time), and short maturity of the loan. The most significant reason for not applying for bank loans is the cumbersome loan approval process, while high interest rates come second.
- Although lease payments are high due to the shortening of leasing periods over the past few years, SMEs often find leasing more attractive than bank loans for the financing of required equipment: no collateral is required, and in the case of leasing obtained from abroad, only after 4 years does VAT need to be paid on the residual value of the leased asset.

3.4.3 Potential Demand for Financial Services by Rural SMEs

3.61 The demand for financial services by SME is varied, and normally includes loans, savings, and miscellaneous financial services. According to estimations there were about US\$215 million of funds for the provision of loans to SMEs available in Romania in 2003, and some fund providers extended loans of up to €500,000 to medium-sized enterprises.

¹ The main reasons for not applying for a loan as identified by the FAO survey on SMEs in rural areas (see details in the annex) are:

- too long process and involving much red tape (100)
- too high interest rate (89)
- loan maturities shorter than envisaged (59)
- non-compliance with the collateral requirements of banks (59)
- lack of trust that a loan application will be approved (41)
- reluctance to incur debts (37)
- insufficient profitability to repay the loan plus interest (22)
- lack of knowledge on the loan application procedures (15)
- sufficiency of own income sources (15)

3.62 In addition to bank lending, there is also some grant funding available for SMEs. For instance, under the EU PHARE programme, a grant scheme has been established that is targeted at micro-enterprises and provides start-up capital to prospective entrepreneurs. The grant capital will be tied with technical assistance and the total available amount is €40 million. The National Agency of SMEs also provides grant funding to 13 targeted industries, including textiles, wood and woodwork, and metallurgy. Other funding sources, such as venture capital and leasing are also available, but they are likely to be accessible more to the upper-end of the medium-sized companies in the SME sector.

3.63 International experience suggests that a considerable proportion of the potential applicants are not creditworthy, especially if loans are extended to start-up entities. When banks were questioned about this, it appears that loan declination rates ranged from 5% to 35% of the total applications, with an average of 20%. Using this average figure as a base, approximately 80% of those willing to borrow would be creditworthy.

3.64 Not all rural SMEs, however, either want or need to borrow. A World Bank study of financial markets in rural Romania¹ estimated that only 50% of all private sector rural enterprises had a need of loans. It may be assumed that the demand for credit by SMEs in rural areas, while differing considerably, is smaller than the credit demand in urban and peri-urban areas, while the individual loan amount also tends to be smaller than loans extended in urban areas. The Transylvania region seems to average rural and urban areas more than in other regions of the country and also, with the exception of Bucharest-Ilfov, rural SME loans are projected at 22% of the total potential loan demand of SMEs.

3.65 In conclusion, by far the largest demand for term loans for investments in the forthcoming years is expected to occur in the agricultural sector and the agro-processing industry, this in view of the forthcoming EU accession. In fact, the continued existence of SMEs in these two sectors depends to a large extent on their ability to adapt to the regulations and the norms of the EU. In particular, most of the animal production and food processing SMEs will need to restructure their working facilities and to renew their equipment in order to conform to the new norms and standards on product quality and sanitary conditions.

3.5 Potential Rural SME Borrowers and Priority Regions

3.5.1 Potential Borrowers

3.66 Final borrowers under the Facility are eligible according to the definition of rural as specified by the EU and EBRD for Romania, i.e. "SMEs whose core activity is carried out in communities with less than 50,000 inhabitants". While this definition of rural may be considered suitable for SMEs engaged in agricultural production and other typical non-farm rural economic activities, it does not seem, realistic or even desirable for the important agro-processing sector in the country. In fact, many small and medium-sized enterprises in food processing are located in larger communities, although their activities are closely linked with agricultural production, while the development of effective food chains is of crucial importance both for producers and consumers as well as for the economy as a whole. At the same time, in Romania, food processing SMEs, in particular, are subject to strict requirements related to the EU accession and they

¹ Financial Markets, Credit Constraints and Investment in Rural Romania, January 2001.

urgently need to restructure their current plant facilities and to invest in new equipment in order to comply with the new regulations and norms. In the event that they are not able to finance these investments and will not comply with the EU hygienic norms and food quality standards in 2005 and 2006, they will be forced to close down with resulting substantial losses in added value and local employment. In the view of the FAO team it is therefore necessary to include agro-processing SMEs as eligible final borrowers under the Facility and to adopt for this purpose a more flexible definition of rural areas by, for instance, extending the coverage of rural communities from less than 50,000 up to 100,000 inhabitants. In the Conclusions and Recommendations chapter, specific eligibility criteria will be proposed for agro-processing SMEs.

3.5.2 Priority Regions

3.67 In order to allow the banks full discretion in the type of rural investment and the specific rural location of the SME that they will choose to finance, in general, no priority regions or targeting of specific rural economic sectors should be set. Based on the existing branch network of participating banks in the Facility and, in the event that the use of intermediaries like MFIs is accepted, one would expect to see the actual bank credit under the Facility concentrated in certain clusters, defined as a specific geographical area or even a specific rural economic sector or industry, as described in the third chapter of this report. Such an orientation appears also to be in line with the pilot character of the Facility, according to which it would make a lot of sense for a bank to start initially in more favourable regions for rural business activities and to thus capitalise on the most economic use of a limited volume of loan resources. This approach may reduce the bank risks and increase the value added as compared to an alternative strategy geared to a more balanced territorial distribution of the bank loans. Moreover, the SAPARD programme, which this Facility as much as possible will co- and pre-finance, has a strong focus on investment projects in specific agricultural production and agro-processing activities, which have been as defined by the government as priorities in view of the EU accession.

4. CONCLUSIONS AND RECOMMENDATIONS

4.1 Main Findings on the Supply and Demand for Rural Credit

4.1 Throughout the paper, the strengths and weaknesses of rural SME financing have been highlighted. There is good and consistent evidence that economic growth in Romania has gathered pace and rural areas are not excluded from this general tendency. However, resources allocated to rural areas remain under-utilised. One of the reasons for this is the inadequacy of financial services to match the needs of local business, notwithstanding the number of specially designed financing programmes.

4.2 At this juncture, current resources to finance SMEs, earmarked for rural areas, vary within wide limits. There are non-reimbursable grant funds, such as SAPARD and, to a lesser extent, PHARE, but also government-financed grant programmes; access to such funds is typically subject to lengthy and, at times, prohibitively cumbersome procedures. Some potential investors go to great lengths to become eligible for non-reimbursable funds, but such efforts often lead to delays and make the timely capturing of investment opportunities impossible. There are more and more credit programmes, with sources provided either by international financial institutions or directly by Romanian banks' foreign parent institutions, which are subject to standard bank practices and are granted at market conditions. Access to these credit programmes, however, is often rather cumbersome and can be quite costly. The demand for such bank credit is, therefore, not very high, unless it comes as co- or pre-finance with grant investment funds. Lastly, there are the micro-credit programmes of MFIs or credit cooperatives, which typically provide lower loan amounts and at higher cost than bank credit, but which are more readily available to clients who have little access to other financing schemes.

4.3 Information is critical to ensure the adequate use of existing financing programmes or facilities. While rural SMEs make efforts to obtain better information, they are not well positioned to take advantage of such information. Thus, government institutions, donors, NGOs, and banks issue various documents – public reports, booklets, posters – to get the general public acquainted with the programmes and with the conditions required for applying for the facilities. Such information is also available on the Internet with a multitude of sites that provide data and links to these programmes. One such site is “www.finantare.ro” that has been developed by a number of NGOs with the support of the Information Centre of the European Commission in Romania. It provides a wide range of information regarding available grants and credit facilities as well as presenting links to other sites that give more detailed information on specific issues.

4.4 However, rural SMEs can hardly compete on an equal footing with other market participants. Printed documents seldom reach small rural communities where there are no bank branches; access to the Internet, albeit available virtually everywhere across the country, has not yet entered into the day-to-day practice of rural entrepreneurs. Consequently, word of mouth communication plays a pre-eminent role in rural communities and such a tradition can be detrimental to accurate and up-to-date information.

4.5 The proposals that are formulated below refer to the design of the Facility and are meant to improve access to financial resources by well-established rural SMEs and to generate a

demonstration effect among rural entrepreneurs. In this respect, both lenders and potential borrowers need to adjust their current practices. A second group of proposals is related to the future involvement and strategy of EBRD versus the Romanian rural financial market. They are in response to the challenge of adopting a new approach to EBRD support programmes in emerging transitional economies and they often require legal adjustments or just the enforcement of an existing piece of legislation.

4.2 General Design of the New Rural Credit Facility

4.6 The Facility is meant to provide credit resources to rural SMEs. As outlined in the report, the potential demand for such resources is assumed to be high. Probably, the most obvious utilisation is to pre- and co-finance SAPARD investment projects with bank credit. However, the Facility could also have more ambitious goals and the availability of a non-reimbursable technical assistance (TA) component supports such an idea. Moreover, if carefully designed, the Facility could ensure quite rapid loan disbursements with a simultaneous positive impact on the adoption of market-orientated practices, and have a favourable demonstration effect in rural communities.

4.7 From this perspective, there are two avenues possible for the implementation of the Facility. The traditional approach is to concur with the banks on the general loan terms and conditions and to allow the participating banks to on-lend the received loan funds to potential final borrowers. The non-reimbursable TA component would, in this case, favour the lender only, thus increasing interest in the Facility on the part of the banks. The main benefit of such an approach would be that banks, in addition to loan funds, can dispose of TA support. Hence, the number of bank credit officers who learn how to deal with investment loans for SMEs in the rural areas can increase. Over a longer period of time, such a development could be valuable, assuming that credit officers make proper use of their newly-gained knowledge. However, such an approach encompasses the risk of rather slow loan disbursements, since it does not really tackle the main constraints that currently limit the access of rural SMEs to bank credit. For instance, it has taken the World Bank Rural Credit Facility twelve months to disburse just US\$11 million and three more years may be needed to exhaust the total rural credit and leasing facility of US\$58 million as part of the total WB loan of US\$80 million for the project.

4.8 The very existence of the TA component in the EBRD/EU Facility provides a unique opportunity to adopt a second avenue in which part of the non-reimbursable TA component of the Facility will be used for making bank loans more attractive to rural SME borrowers. The proposals that follow under this avenue remain fully in line with the EBRD principle that bank credit should be on-lent to final borrowers at market terms. In order to put SMEs on an equal footing with other borrowers and to make them more interested in accessing the Facility, it is proposed to cover some costs that loan applicants incur prior to loan approval and disbursement from the TA grant component of the Facility. One of the important benefits of such an approach is that it would make the credit facility more attractive to final borrowers and could significantly speed up its disbursement. The marketing of the Facility would be structured in such a way that it better highlights the benefits to the final borrower. If this approach is accepted, several measures should be taken in order to establish the missing links in the crucial bank/client relationship. These measures are discussed below.

4.3 Establishing the Missing Links in the Relationship between Banks and Rural SMEs

4.3.1 TA Services to be Provided by MFIs

4.9 As outlined in this report, banks and other financial institutions often express their readiness to grant loans to SMEs, while SMEs are interested in receiving loans for investments that they intend to make and that they consider bankable. For various reasons though, banks and potential borrowers often do not manage to find common ground in this respect. A possible solution would be to use the services of a third party or an agent who intervenes between a bank and a SME and facilitates the access to bank loans. First of all, such an intermediary should act as a market information agent and provide clear and concise information on the credit facility to potential borrowers; direct acquaintance with the agent's representative could reduce the lack of confidence that the rural entrepreneur has in the real possibility of obtaining a bank loan. Second, the agent could support the SME in drawing up a business plan and preparing all documentation that is required by the bank to apply for the loan and subsequently to appraise the loan request. Third, the agent could also support the SME in managing and maintaining its cash flow as scheduled and thus help it to overcome liquidity problems. And finally, if agreed with the bank, the agent could also periodically follow up on the outstanding loans and draft monitoring reports for the bank.

4.10 All the above could be conducted by a micro finance institution (MFI) with whom the SME has already worked. For a small fee, which could be covered by the non-reimbursable TA component of the Facility, the selected MFIs would exert this support role as part of their overall work with rural communities. The idea was discussed with the country director of CHF International, Mr. William Seas, who expressed the interest of his organisation in taking part in this activity. He underlined that CHF and other successful MFIs have accumulated a good knowledge of the Romanian rural sector and SMEs and that they would certainly be able to identify good bank clients and to distinguish promising SMEs from less promising ones. In fact, there are numerous micro- and small-enterprise borrowers who could "graduate" from the MFI financial support and who would need more substantial loan amounts than are available from MFIs. This "graduation" process would take place more smoothly, if the SME could obtain its first bank loan through the intermediation of a MFI with whom the enterprise has already been acquainted for a long period.

4.11 Such a technical assistance approach would speed up the disbursement of loan funds under the Facility, improve relations between banks and rural SMEs, and have a demonstration effect on other rural SMEs. The traditional word of mouth knowledge and communication which are used in rural areas could thus be turned into a useful instrument for establishing better relationships between banks and clients.

4.12 Some of the above functions could also be provided by other organisations such as professional and territorial business associations or private TA providers. Banks themselves could identify potential agents to whom they would like to charge such functions. The intermediation fee should not be disproportionately high: an indicative level could be 2 percent of the loan amount, payable only if and when the loan is approved and disbursed. For loan amounts above €100,000 the fee percentage should be lower. Preliminary discussions with the country director of CHF International suggested that the recommended fee level would be reasonable and a more detailed proposal could be prepared, if the EBRD/EU is in agreement.

4.3.2 Ways of Interesting Rural SMEs in Accessing the Facility

4.13 Firstly, the business plan, the projected cash flow, financial statements, and all other documentation that is required by a bank for the appraisal of a loan application could be prepared by the potential borrower with TA provided by a third party (an MFI or other organisation), as suggested above. The main merit of this approach is that it eventually creates a direct relationship between banks and rural SME clients and thus addresses one of the existing major constraints in rural finance. According to this line of thinking, a SME could benefit from this opportunity only once. Should it want to apply for a new loan under the Facility in subsequent years, it will need to comply with the bank's loan application requirements on the strength of its own resources.

4.14 Secondly, bank loan collateral requirements are currently especially burdensome for rural SMEs. There are two main options for a SME. The bank either accepts mortgage on rural real estate and/or pledges on moveable assets of the enterprise at a sufficiently high market value or it obtains for a fee (which is passed on to the borrower) a credit guarantee from a specialised institution. In either case the overall transaction costs can be rather high – amounting to 2-3 percent of the requested loan amount – and it goes without saying that the lower the loan value, the higher the relative transaction costs. In order to reduce these costs, the SME could be reimbursed for a part of the total cost that it pays for such a purpose. In principle, SMEs should be eligible for this support under tight conditions (for instance, support of no more than, say, 1.5 percent of the approved loan amount, and for investment loans alone, and only if the SME does not benefit from other grants such as SAPARD).

4.15 Thirdly, agricultural projects are often required to get insurance coverage for specific risks. Such insurance typically carries a rather high premium, since agriculture is subject to higher risks than other industries. At times, these premiums are perceived by SMEs as prohibitively high and may deter them from carrying out profitable investment projects however well they may otherwise be founded. It is also true that the practice of reducing risk through the payment of insurance coverage does not belong to the traditions of rural people. Covering part of the insurance premium during the first year, using for this purpose a small fraction of the TA component of the Facility, would support the execution of viable agricultural investment projects as well as stimulating a new attitude towards the adoption of insurance policies and instilling a more market-orientated approach among entrepreneurs in smaller rural communities.

4.4 Proposed Features of Loan Agreements between EBRD and Banks

4.4.1 General Remarks

4.16 The overall envelope of the Facility consists of €50 million loan funds and a €10 million non-reimbursable TA grant. Since the envelope is meant both for Romania and Bulgaria, it is assumed, notwithstanding the general principle of first-come-first-served, that Romanian financial institutions will be allotted some 60 percent of the above-mentioned total amounts.

4.17 On the basis of the interviews by the FAO team, some six banks and one leasing company have shown interest and may be eligible for the Facility pending their current exposure to EBRD. Individual loan agreements may vary between €3 to 10 million for each bank and up to €1 million per leasing company. The loan maturity could be 10 years with an 18-month grace period for banks and up to 7 years and a 12-month grace period for leasing companies. Specific

conditions (interest rate, fees, and commissions) in the loan agreement contracts with banks would be based on the normal practices of EBRD, but they should take into account the competitive rates, in particular those practised under a similar rural credit and leasing facility by the World Bank Rural Finance Project. Conditions significantly less favourable might prevent banks from taking part in the Facility. Leasing companies are subject to less favourable conditions consistent with the view held by the EBRD of a higher financial risk of such loans. According to the FAO team, the idea of also extending loans under the Facility to leasing companies in the present circumstances mainly serves as a pilot test case rather than being intended as a genuine on-lending channel of EBRD loan funds to rural SMEs.

4.18 The design of the Facility clearly depends on the time span within which the EBRD intends to have disbursed the full credit facility. With few or no specific measures taken to speed up the process, the total amount would likely be disbursed in 18 to 24 months. Taking into account the relatively small total credit amount, there is the risk that the Facility will be launched but will remain rather unnoticed with little or no impact on the improved functioning of the rural financial market in Romania.

4.19 Fortunately, however, the Facility benefits from a substantial TA component and an effective use of these grant funds can make the difference, significantly increasing the impact that the Facility might have on investment lending and business development in rural areas. The FAO team recommends that the goal pursued by the new EBRD/EU Facility be precisely to launch a bank lending programme for small- and medium-sized enterprises that will have the strongest possible impact and a high demonstration effect on other actors. It can also be expected that the new Facility would be followed up by other credit schemes on a wider scale that will support the better utilisation of investment opportunities and thus promote competitive business development in rural areas. The recommendations that follow are geared towards such an ambitious goal.

4.4.2 Proposed Timetable of the Facility

4.20 *November/Mid-December 2004:* to interested banks and, possibly, leasing companies, the EBRD launches its preliminary offer of a credit facility targeted at rural SMEs, indicating minimum and maximum credit line amounts per bank and financial conditions (interest rate, maturity, grace period, commissions, and other regular features in a standard EBRD loan agreement). The offer should also broadly describe the types of potential final borrowers and the main purposes and loan size range that might be considered for the on-lent amounts. Moreover, it should specify the possible uses of the non-reimbursable TA component from which both banks and final borrowers would benefit, and outline the main features of the bidding process for TA service providers, details of which, however, should remain open at that stage.

4.21 *Mid-January to End-February 2005:* Specific credit negotiations with the banks and leasing companies qualifying for the Facility.

4.22 *End-February 2005:* Contracts with banks are concluded. TA programmes tailored for each participating bank and starting of the bidding process for TA service providers.

4.23 *March 2005:* Preparation of the overall publicity campaign and the marketing programmes of participating banks for the launching of the Facility.

4.24 *End-February 2006*: The whole sum of the loans has been fully disbursed and on-lent to final borrowers; banks will continue to on-lend amounts under the Facility based on repayments from the existing loans.

4.4.3 Specific Conditions of the Facility

Final borrowers

4.25 The FAO team is of the opinion that as few restrictions as possible should be attached to the loan agreements between the EBRD and the banks. The latter should have full discretion for accepting or rejecting loan applications, provided that the final borrowers are eligible according to the definition of rural as specified by the Facility, i.e., “SMEs whose core activity is carried out in communities with less than 50,000 inhabitants”. While this definition of rural may be considered feasible for SMEs engaged in agricultural production and other typical non-farm rural economic activities, it does not seem, however, realistic or even desirable for SMEs in the important food- and agro-processing sector in Romania. In this sector the majority of the small- and medium-sized enterprises are often located in larger communities. Moreover, they urgently need to carry out major restructuring of their plants and to invest in new equipment in order to comply with the norms and regulations of the EU accession. In the event that they are not able to finance these investments and do not comply with the new norms in 2005 and 2006, they will be forced to close down with the effect of substantial losses in added value and local employment to the country as a whole. It may also be remarked that a number of these SMEs, as part of their efforts to develop a competitive integrated food chain, have close links with market-orientated farmers as suppliers of raw materials to whom they provide important support services such as agricultural inputs and TA. The FAO team therefore recommends the EU/EBRD to adopt greater flexibility in the eligibility of agro-processing SMEs under this Facility and proposes the following specific criteria:

- Allow the inclusion of communities with more than 50,000 inhabitants (as set by EBRD) but less than 100,000 inhabitants (as under the WB RFP).
- Target indicatively small enterprises and the lower end of medium-sized agro-processing enterprises with up to 100 permanent employees (as set by EBRD). Note: seasonal workers are not included in this figure.
- Target agro-processing SMEs with a total asset value of up to €5 million (as set by EBRD).
- Prioritise co-finance between SAPARD and the Facility with the provision of bank loans under the Facility up to a loan size of €250,000.
- Finance agro-processing SMEs which have established forms of vertical integration with market-orientated farmers for the regular and reliable supply of high quality raw materials and which provide to these farmers with essential support services such as inputs and TA.

Loan products

4.26 Indicatively, three quarters or more of the amount on-lent by a bank should be earmarked for investment loans, while up to one quarter could be used for financing (permanent) working capital requirements, though only in conjunction with an investment project. Financing of land and buildings (as insisted upon by the interviewed banks), as well as pre- and co-finance of investments together with other financing schemes (grants or credit) should be allowed. Typically, the size of a bank loan to a rural SME could range from between €15,000 and €250,000 and banks should have full discretion to grant loans within this range.

New and existing bank clients

4.27 The FAO team supports the view expressed by all interviewed banks that the Facility should not be restricted to only new bank clients, but that existing bank clients should also be able to benefit from the Facility. In the latter case, however, borrowers should not have received term loans before, while the intended new investments should aim at expanding or diversifying their current production activities with the generation of new permanent jobs. In general, no start-up enterprises will be financed under the Facility.

4.28 All lending terms (interest rate, commission, maturity, grace period, etc.) between the bank and the final borrower will be set at market rates according to the bank's standard practices and discretion.

Loan collateral

4.29 The Facility aims to contribute to improving the access of rural SMEs to bank lending. Since the cost of credit will not be altered by the Facility, other conditions – and especially the collateral requirements – should be improved as compared to current practices in the banking industry. In this respect, the contract between the EBRD and each bank should explicitly state that collateral conditions for the loans extended under the Facility should be established according to best international practices and the use of different types of collateral should be further developed with TA to be provided to the participating banks.

Priority regions and rural economic activities

4.30 In order to allow the banks full discretion on the type of rural investments that will choose to finance, in general, no targeting of priority regions or specific rural economic sectors or industries should be set. However, if the use of intermediaries like MFIs is accepted, one could expect to see the actual bank credit under the Facility concentrate on certain clusters, defined as a geographical area or a specific rural economic sector or industry as described in the third chapter of this paper. Such an orientation appears to be in line with the pilot character of the Facility and it would make sense to start initially in the most favourable rural regions and to capitalise on the most economic use of a limited volume of loan resources. This approach may reduce the risks to the bank and increase the value added as compared to an alternative strategy geared to a more balanced territorial distribution of the loans. Moreover, the SAPARD programme, which this Facility as much as possible will co- and pre-finance, has a strong focus on investment projects in specific agricultural production and agro-processing activities which have been defined by the government as a priority in view of the EU accession.

4.4.4 TA to Banks

4.31 Romanian banks have a rather limited experience in dealing with SMEs, particularly those located in rural areas. While they acknowledge the need to devote more loan resources to this clientele, in practice banks keep focusing on urban clients with a strong emphasis on lending services for individuals (consumer and mortgage lending). Therefore, the Facility becomes attractive to those banks that are prepared to expand their activity to smaller rural communities, particularly thanks to the TA component.

4.32 However, conditions are very different from one bank to another, and specific TA should be designed for each participating bank. Thus, RCB has the largest loan portfolio to SMEs and it runs a good range of specially designed lending programmes using various sources of funds, including those received from EBRD. The large branch network of the bank also provides the opportunity for a more rapid disbursement of loan funds with local bank branches generally having a higher authority to approve loans, while the cost of the credit makes it quite attractive to potential borrowers. However, the bank's procedures are not adequately adapted to SMEs, whose specific features are not being considered in the loan application requirements and procedures. The whole lending operation process of RCB is excessively cumbersome, and clients often complain about the lack of an active "partnership" with the bank. Therefore, in the case of RCB, it would be useful to define better lending practices and procedures specifically tailored to rural SMEs, and these should be incorporated in the contract with the EBRD and may qualify for TA support under the Facility.

4.33 Smaller banks, on the other hand, usually treat their customers in a more personal way, but they charge higher interest rates and/or bank commissions. Branches typically have less authority level to approve a loan and, at times, they have little experience in providing investment credit. For such banks, the focus should be placed on TA for term lending for investment projects and again this should be specifically mentioned in the loan agreement contract with the EBRD. For instance, one of the potentially participating banks (RB) openly expressed its interest in receiving, as TA, better designed lending practices and procedures for credit officers as well as support in the development of credit scoring models for the investment projects of rural SME clients.

4.34 Above and beyond that, TA for banks could also address some of the drawbacks that hamper their relations with clients. A couple of suggestions in this respect are outlined below:

- (a) It has become tradition in Romania to accept as collateral buildings and real estate only. Such practice is very costly to rural borrowers (evaluation, notary, and registration fees are high and banks require a multiple of the loan value as collateral) while it is still far from reassuring to banks. One could even argue to the contrary that since the bank focuses on the collateral rather than on the client's business plan, repayment capacity and cash flow, it may end up as a real estate manager. Clients from small rural communities, in particular, are more disadvantaged, since their collateral is very conservatively evaluated by banks. Therefore, in order to make the Facility more attractive, TA should also consist of supporting banks in defining and using other forms of collateral, according to best international practices.

- (b) Banks tend to require an enormous number of documents prior to deciding on whether to grant a loan. Some of these documents are already in the client's files, others are simply irrelevant for the loan appraisal. In order to streamline the loan procedures and to adapt them to the special features of rural SME clients, TA to banks should consist of providing support to rationalise the required paper work and to focus only on important information and key issues in the loan applications that are relevant for the loan appraisal (e.g. by including adequate risk and cash flow analysis) and the loan approval decision.

4.5 Marketing of the Facility

4.35 In order to meet the ambitious disbursement schedule outlined before under 4.2, two conditions should coincide. The first is to implement the set of measures discussed in this paper in order to establish the missing links in the relationship between banks and rural SME clients. The second is to launch a publicity campaign and to develop comprehensive marketing programmes for each participating bank in order to acquaint potential final borrowers with the financing terms and TA opportunities provided by the Facility. Among the marketing activities to be carried out are the following:

- Organisation of one or more press conferences, to be held by the local EBRD office, possibly together with representatives of the European Commission.
- Calling of meetings between each participating bank and professional or territorial business associations, MFIs and other potential intermediaries.
- Preparation of posters and other written materials that highlight the main features of the Facility and lending terms as adopted by each participating bank and displayed in its bank branches.
- Participation of one or more relevant bank official in TV broadcasts and radio programmes dedicated to rural business and finance.
- Sending of letters by the headquarters of each participating bank through its branches to both existing and potential rural SME bank clients who are eligible and might apply for loans extended under the Facility. Such letters should outline the main features and terms of the bank loans as well as indicate both the advantages and the responsibilities of the clients should they decide to apply for loans.
- The posting of the main features of the Facility on relevant websites.

4.36 All costs associated with the marketing of the Facility can be covered using the TA component. The minimum required amount is estimated to be not below €100,000, while the maximum total amount may go up to €300,000.

4.6 Policy and Strategy Recommendations

4.37 Some relevant policy issues are related with an eventual enlarging of the Facility in the future, assuming that the EBRD is interested in continuing its catalytic role of stimulating the growth in less favoured rural regions. Recommendations made below have as a common feature the aim to overcome in a more systematic way the current constraints with which rural financial markets in Romania are confronted.

4.6.1 The Role of Credit Cooperatives

4.38 The FAO team is of the opinion that the expansion of bank operations in rural areas in Romania will remain quite limited for a number of years to come. Ultimately, banks' costs remain rather high as compared to the potential income that they expect to earn from small rural bank branches. The main interest of banks is obviously focused on expanding their operations in large urban towns which offer a wider and more profitable spectrum of banking business opportunities. However, over time, once the potential for further growth of urban banking services becomes less evident and in accordance with an increasing competition among banks for the same clientele groups, banks will probably start to reconsider a careful expansion into smaller cities and rural communities with some economic potential. The time frame required for such a development, however, would not be, realistically speaking, shorter than five years. Meanwhile, business opportunities in rural areas will be financed by using methods that are already put in place, including the use of specific financial resources from IFIs that are targeted for such a purpose. Even so, this approach will not resolve the main constraint of a general under-utilisation of available financial resources, since banks are not the best mechanism for accessing dispersed rural clients and their rural lending amounts will remain rather small.

4.39 A possible way to overcome this constraint is to use credit cooperatives (CC) as a means for on-lending the resources provided by IFIs. CCs are better represented in rural areas and their presence could grow significantly in the years ahead. It should be pointed out that the legal status of CCs has markedly improved recently and they are now fully in line with EU standards; thus, at least 50 credit cooperatives are required to create a network and to establish a so-called "central house". There are tight capital requirements for each CC network, which will fall under the supervision umbrella of the central bank. The overall situation of CCs is expected to evolve further. Currently, there is only one active network, while a second one is in sight. A timetable for CCs to meet new and much higher capital requirements is already foreseen and will be achieved in phases.

4.40 All in all, one may assume that by mid-2005 CCs could become a prospective reliable counterpart for IFIs and their potential should be exploited and enhanced by using IFI resources. However, such collaboration should be strictly limited to rural areas – in which CCs have a comparative advantage and banks have a less immediate interest in developing their own bank operations.

4.6.2 The Potential Role of MFIs

4.41 MFIs have been active in Romania since the mid '90s, most of them are financed from external sources. They have a good knowledge of the Romanian economy and their expertise has become particularly valuable in sectors and geographical areas that are relatively less

attractive for profit-orientated capital. Over time, most of them have expanded their scope, increased their turnover, and some are near the breakeven point towards fully covering their costs. Their legal status, while improved over time does not yet fully support an eventual transformation of the best-performing MFIs from NGOs into fully-fledged, profit-orientated businesses.

4.42 A steering group which consists of international legal experts has drafted a specific piece of legislation whose enactment is expected to pave the way towards the strengthening of MFIs. The bill removes, in particular, the weaknesses of the current legislation regarding the fiscal regime of MFIs and the loan amounts that can be borrowed from MFIs and it establishes clear procedures for registering MFIs as commercial companies. At present, the bill is being reviewed by the various Romanian institutions concerned (the Ministry of Justice, the Ministry of Public Finance, the National Bank). Once the legal status of MFIs is clarified, some of them could become reliable counterparts to IFIs in market-based financial arrangements. Currently, the few MFIs that are actively involved in the implementation of various financing programmes can do so only with government guarantees.

4.43 As far as rural finance is concerned, several MFIs have gained a valuable experiences which is beneficial for both a better use of rural resources and the building-up of market-orientated practices in less favoured communities. Such experience could and should be further harnessed by providing MFIs with larger volumes of financial resources that are provided at market conditions. If this proposal is accepted, the role of MFIs could change from being an intermediary between banks and SMEs towards the role of direct lender, thus reducing the number of layers and with that the level of the financial intermediation costs.

4.6.3 Programme Manager of the Facility

4.44 The appointment of a Programme Manager (PM) or otherwise a working group between the EU/EBRD, participating banks and TA providers could contribute to the better performance of the Facility, assuming that such schemes are intended to provide larger amounts of loan funds over a shorter time span than a “traditionally” designed project. The main tasks that the PM/working group could have are: (i) assessing the needs of participating banks for TA tailored to each bank’s specific requirements; (ii) drafting and overseeing the implementation of the marketing programme for bank lending services; (iii) organising meetings with business associations and SMEs in order to directly assess the programme performance and to explore the various potential improvements; (iv) reviewing with the participating banks the progress and the impact of disbursing loan funds under the Facility and suggesting solutions for improved performance.

4.45 The PM function could be carried out by a reputed independent bank expert who has a good knowledge of bank standards in the country, as well as of rural SME activities. S/he should act as a catalyst for attaining the best performance of the Facility.

ROMANIA

**BANK LENDING TO SMALL AND MEDIUM SIZED ENTERPRISES IN
RURAL AREAS; AN ANALYSIS OF SUPPLY AND DEMAND**

ANNEX 1

ROMANIAN BANKS' INTEREST IN THE NEW FACILITY

ANNEX 1

ROMANIAN BANKS' INTEREST IN THE NEW FACILITY

The Romanian Commercial Bank (RCB)

1. The largest Romanian bank, with 294 branches across the country and a 30 percent market share. About 45 percent of the bank's lending goes to SMEs.
2. Since 1992, the bank has been heavily involved in various international financing schemes and it has gained good experience in managing them. The experience extends to combining various financing schemes to make them more attractive.
3. For some of the programmes in progress, the funds are exhausted, and new loans are extended based on repayment of the old ones. Long waiting lists are common for such programmes.
4. EBRD supports the bank's privatisation process (owning 12.5 percent of RCB) and is heavily involved in various financing schemes of RCB. The bank is close to the limit of EBRD exposure to a single debtor.
5. RCB would be interested in a new financing scheme earmarked for rural SMEs and appears confident that clients would be able to borrow under usual conditions. Additional training, however, would be welcome.
6. While the bank generally offers larger loan amounts at more favourable terms than other banks, the clients' perception is that RCB is overly bureaucratic and its procedures are not adapted to meet the special features of SMEs. This is thought especially true if the client is also rural.
7. Thanks to its large branch network, RCB has the best means to disburse a large part of the credit facility component over a short period of time. TA could and should be used to simplify RCB's loan application and appraisal procedures. Unless such a pre-condition is specifically inserted in the loan agreement contract between EBRD/EU and RCB, the latter will stick to its current procedures, and the Facility will not make a real difference in the rural SME clientele's perception of and access to bank credit.

“Banca Romaneasca” (BR)

8. The bank has recently been acquired by the National Bank of Greece from its original owner, the Romanian American Enterprise Fund (RAEF), financed by the American Congress. The bank has 26 branches and agencies, mainly in big cities, and its assets account for 1.1 percent of the total assets in the Romanian banking sector.
9. The main focus of the bank is on SMEs (some 95 percent of its total corporate lending) and it participates in many international financing schemes (EU, FMO, IFC, KfW, and the WB Rural Finance Project). BR states that it does not need additional TA for lending to rural

SMEs, but it stands ready to provide TA, i.e. to share its knowledge with other banks and to bid under the Facility for TA provider.

10. Due to its good track record and improved strength after the takeover, BR is able to get external funding at very competitive terms (EURIBOR + 50 basic points). Therefore, the bank would not be interested in the Facility if the terms are less favourable terms or with too many strings attached.

11. BR would be also interested in becoming fund manager for the Facility, in providing TA and training, and in on-lending to other banks and smaller financial institutions (such as credit cooperatives), which would not directly qualify to work with the EBRD but are strong in rural areas.

12. BR is seen by some as more supportive to clients than other banks and somewhat less bureaucratic. However, its lending terms (both duration and cost) are less favourable than those of the larger banks. Besides, delegated loan approval authorities are very limited at branch level, as most of the loan applications are approved at the bank's headquarters.

Banca "Transilvania" (BT)

13. The largest bank with headquarters outside Bucharest. BT was launched in 1994 as a bank with local ambitions in the Transylvanian region. Over time, the bank has expanded significantly in all aspects: number of branches, territorial presence, capital, volume of assets, and staff. The bank is one of the blue chips noted on the Romanian stock exchange.

14. BT has 105 territorial units and its market share, rapidly growing, had reached 2.8 percent by mid-2004.

15. EBRD is the largest shareholder of the bank with 15% of its share capital.

16. BT has acquired good experience in dealing with SMEs. Apart from the bank's own resources, 3 dedicated projects are currently implemented by BT using EBRD credit for a total amount of €15 million, while it manages two other projects with German lending resources with a total amount of €15 million. Moreover, BT participates in the WB Rural Finance Project for a total US\$10 million, of which US\$9 million have already been disbursed.

17. BT is one of the most active banks in the country with an outstanding performance and ambitious plans. With its network and already gained experience, the bank would fit the new Facility perfectly. In fact, the bank stands ready to take part with as much as €10 million, an amount for which the bank's management is confident to find suitable projects.

18. There remains one point to be checked –exposure to EBRD might already be close to its standard limits. In view of the bank's potential, though, the FAO team suggests that EBRD should consider accepting BT for the Facility, for an amount consistent with the bank's performance.

Alpha Bank (AB)

19. The bank is a member of the Alpha Bank Group – an international bank with its headquarters in Greece and listed on the London and New York Stock Exchanges.
20. AB has 19 agencies, of which 7 are in Bucharest, while the remaining are in big cities across the country. With assets worth some €700 million, AB has a greater than 3.5 percent market share.
21. Large companies are its original target, but a couple of years ago it expanded its operations to individuals and small business and it intends to further increase the latter.
22. The bank is already involved in two EBRD financing schemes for SMEs for a total value of €20 million. It also pre- and co-finances SAPARD programmes.
23. While the size of the new facility under discussion is considered rather small, the bank would be interested in taking part in it, for two main reasons: to benefit from the know-how associated with it; and to increase the bank's visibility in the SME sector. However, a final decision is pending on the terms of the facility, and the prior approval of the bank's board.

Robank (RB)

24. It is the smallest among the 5 pre-selected banks, with 14 branches and 0.8 percent of the total assets in the banking system. However, the new owner of the bank, OTP (from Hungary), has ambitious plans to widen its activities and to expand in the next 4 years to as many as 80 branches, while keeping its current focus on small businesses and individuals.
25. The bank currently manages an EBRD loan for export pre-financing and it participates in the WB Rural Finance Project from which it has drawn US\$3 million loan funds for on-lending to final borrowers.
26. RB usually lends for the short-term (mostly trade financing), but it would welcome opportunities to expand into investment lending. The current management appears to be largely in favour of such an EU/EBRD facility, provided that it is approved by the new bank's owners. Special training for the staff and TA for developing credit scoring models for rural SMEs would constitute an important "sweetener".
27. In order to be attractive for the final borrower the Facility should allow rural SMEs to buy land and buildings as part of the credit.
28. Moreover, in order to make the Facility attractive to rural SMEs, part of the TA should be earmarked for the final borrower, while the credit should be able to co- and pre-finance other projects, in particular SAPARD.

Miro Bank

29. Notwithstanding an initial focus on urban areas, the recent experience of the bank in agricultural and rural lending (outstanding agricultural loan amount of US\$1.2 million and outstanding rural loan amount of US\$1.5 million) make it well suited to operations in smaller cities and rural areas and for lending to SMEs, in particular on the lower size end.

30. Moreover, the Miro Bank has become profitable in the last two months and would qualify thus for the new EU/EBRD Facility. It is scheduled to take the name of Procredit next November (like similar banks in other East European countries).

31. The FAO team could not assess the interest of the bank in the Facility, as both the CEO and the second-in-charge were in Germany. However, based on the discussions with the agricultural credit coordinator in Bucharest, FAO suggests to EBRD to consider a possible future participation of Procredit in the Facility, in view of its valuable experience and skills in micro finance and small rural and agricultural business finance.

ROMANIA

**BANK LENDING TO SMALL AND MEDIUM SIZED ENTERPRISES IN
RURAL AREAS; AN ANALYSIS OF SUPPLY AND DEMAND**

ANNEX 2

AGRO-PROCESSING

ANNEX 2

AGRO-PROCESSING

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ANNEX 2

AGRO-PROCESSING

1. Existing agro-processing SMEs in rural areas tend to be product orientated and allocate few of their resources to management and networking. Rural SMEs specialise mainly in traditional, rather than hi-tech, production. The following sector and sub-sector analysis offers the key features of each component.

The Food and Beverage Sector

2. This sector represents 26% of total gross agricultural production and 4.6% of GDP. There are 14,509 companies of which 99% are private companies. The sector employs over 240,000 people, representing 5% of the active population.

3. There has been an increase in production of main food and beverage products in 2004 compared to 2000 as follows:

- Milk and related products: 95 %
- Meat and meat products: 21 %
- Oil: 4 %
- Juices and non-alcoholic drinks: 17 %
- Sugar and sugar products: 1 %

4. The average consumption per inhabitant also registered increases in 2004 as compared to 2000 as follows:

- Milk and related products: 17 %
- Meat and meat products: 33 %
- Oil: 9%
- Juices and non-alcoholic drinks : 18%
- Sugar and sugar products: 17%

Legislative framework:

- 57 new normative acts have been elaborated and incorporated in the Romanian legislation to harmonise it with the EU legislation. They enter into application in 2004.

5. Last year, Romanians spent US\$24 billion on food, beverages and cigarettes according to the Economist Intelligence Unit. That is, 57.4% of the aggregate household expenses. Estimates see the food market rising to US\$30 billion by 2008, which would imply an annual growth rate of 4.6% in USD. The National Statistics Institute data indicates that the overall volume of expenses incurred by the total population of Romania (including indirect expenses made through public institutions – hospitals, schools, etc.) amounted to US\$44 billion in 2003, of which US\$18.5 billion (42.3%) was spent on food and beverages. While the food & beverage industry has been undergoing significant changes, the primary agricultural sector has remained in a rather rudimentary stage. With 30% of the gross value added created by the processing industry (five times more than in the metallurgical industry, for instance) the food & beverage industry is a core industry in Romania, second only to the oil processing industry, and it accounts for 8% of the

overall economy. In turn, agriculture accounts for a little more than that: 12-15% of the gross value added achieved economy-wide, depending on the weather. Nevertheless, agriculture produces this 12-15% with nearly 4 million people, while the food & beverage industry requires only 170,000 people to produce its 8% share of the gross added value.

6. Last year's trade deficit in the food & beverage sector amounted to €1 billion, that is, 2% percent of the GDP. Moreover, this figure is based on prices as they are at customs checkpoint without VAT and other additions, which means that the actual price paid by the end-user is more or less double. Significantly, processed products (with high value added) accounted for 43% of imports and for only 23% of exports. In other words, Romania exports raw materials and imports finished products in this sector. And the imbalance was even greater in previous years. The food & beverage trade deficit, including raw materials and finished products has averaged 1.4% of the GDP over the past ten years. For comparison purposes, the mineral resources deficit (oil and gas) averaged 3.6% of the GDP in the same time interval. In principle, both the food & beverage and the energy deficit need to be compensated in the aggregate payment balance either by a trade surplus in other sectors or by capital inflows (foreign investments, loans etc). While little can be done to reduce the energy 'bill,' there is plenty of room for improvement in the farming sector and the food & beverage industry: the transition from deficit to surplus is possible, but it is obviously a function of efficient organization of the overall industry, an adequate institutional framework, macro-economic stability and especially the regulations associated with the EU accession.

Grain Milling and Bakeries Subsector

Grains Specification	UM	1995	1996	1997	1998	1999	2000	2001	2002	2003
Cultivated land	Thousand ha	2480,8	1781,7	2406,8	2016,5	1674,1	1937,9	2453,2	2294,5	1454.15
Average production	Kg/ha	3090	1765	2972	2570	2780	2290	3038	1923	1719
Total production	Thousands	7666.5	3143.8	7152.5	5176.6	4659.1	4430.6	7725.4	4 412.6	2436

7. According to data provided by the Ministry of Agriculture only 32 private commercial farmers cultivate cereals on farm areas above 5,000 ha, as follows: Arad 1; Braila 3; Calarasi 10; Dolj 2; Galati 2; Giurgiu 1; Ialomita 4; Olt 2; Teleorman 2; Timis 1; Tulcea 2; Vaslui 1 and Vrancea 1. The total area cultivated by these farms is 294,697 ha.

Corn and Sorghum Specification	UM	1995	1996	1997	1998	1999	2000	2001	2002	Estimate 2003
Area	thousand ha	3109.2	3277	3037.7	3128.9	3013.4	3049.4	2947	2894.5	3143.1
Average	Kg/ha	3184	2926	4171	2756	3627	1603	3066	2902	2808
Total production	thousand tons	9923.1	9607.9	12687	8623.4	10935	4897.6	9119.2	8399.8	8826.1

8. Consolidation of the milling and baking sector is in full swing through the development of groups of companies that have recently become active in the field. Competition is on the increase, which makes big operators on the market seek new means of development, either by diversification or by entering new market segments or expanding sales. The number of enterprises that produce milling, bakery, and flower products has increased every year. At present, there are almost 6,500 enterprises, of which over 4,900 are small companies with private capital.

9. In the entire milling and baking industry, investment in new technology has amounted to about US\$100 million. At present, the modernised capacity within the milling sector is 4,500 tons/day, in the pasta industry 160 tons/day and in the biscuits industry 180 tons/day. New technology consists mainly of equipment for peeling and milling cereals, automated lines for pastas and biscuits, production lines and equipment for marking and packing the finished products.

10. There is a strong need for significant improvement in the cereal-based processing industry, in order to harmonise the regulations regarding quality requirements and food safety along the entire product chain. This will include the adoption of all EU standards and quality requirements from the stage of agricultural production, collection, transport, processing, packaging and marketing of agro-food products.

11. The *main features* of the milling and bakery industry in Romania are:

- Due to low labour costs, the unit price of bread is about 16 percent lower than in the EU, as Romanian factories are producing bread in higher quantities, having economies of scale advantage.
- Millers and bakers are buying wheat directly from agricultural producers, but only for 2-3 months after harvest. After this period, wheat is bought from wholesalers, associations or producers who keep only small quantities of wheat.
- It is important in order to keep the production constant throughout the year to have raw materials regularly supplied. In this case, the main constraint is the fact that Romanian commodity exchanges for goods are institutions that exist, but do not operate well: some of the big processors prefer to import wheat and corn, as the expenses implied by buying raw materials from domestic sources are too high or the quality of Romanian raw material does not meet their demands.
- Unfair competition on the bread market, due to those operators who sell bread without paying related taxes and fees, which gives very narrow production margins to processors who do pay their taxes and fees.

Fruit and Vegetable Subsector

12. Following the political changes in Romania, the main impact has been the fragmentation of farm production and the increase of the agricultural population, with production levels falling back to that of subsistence for the majority of growers. As a consequence, direct marketing plays a predominant role and the marketing channel at wholesale level is not well established.

Fruit Orchards

Fruit	UM	1995	1996	1997	1998	1999	2000	2001	2002	2003
Area	Thousand ha	225,9	218,2	214,0	211,8	208,9	195,0	195,9	188,9	200,0
Average	Kg/ha	4.001	7.420	6.554	4.894	4.400	3.872	3910	2732	6500
Total production	Thousand tons	903,7	1.619,3	1.402,6	1.022,4	922,3	755,0	765,9	516,3	1300

13. The effective demand in the domestic market is limited to the urban population and there is a high level of seasonal imports due to limited proper storage facilities for local products. Since there is a lack of capital for renewal and adequate maintenance, of the total area of orchards, only about 5% (estimated) are properly maintained. There are cases where progressive farmers are establishing new orchards, but even here the intensity of trees per hectare, as well as the quality and quantity, has been below EU standards. The number of pesticide companies has increased, but not all producers can afford to buy chemicals, because of high prices and lack of information. Also, growers obtain insufficient information about production methods and techniques: there are too few specialists in the agricultural extension service.

14. A further constraint is that taxes are different for commercial individuals and producers: producers do not pay VAT, although prices of inputs bought include VAT (a cost which cannot be deducted). Steps therefore need to be taken to reduce the VAT on agricultural products.

15. Given the fragmented structure of production, direct marketing demand (street markets) plays a predominant role in selling local products. In the urban centres, wholesale activities, which developed followed the political changes, have in the beginning served to import products and they now need to be developed for local products as well. In order to cut the costs of marketing, distribution and transport, to reduce physical losses and to maintain product freshness and quality, the effective operation of well-organised marketing channels should be facilitated. This includes the establishment of producer organisations (in line with the EU regulation 2200/1996) for the assembly of produce in a cost effective way as well as the organisation of appropriate wholesale facilities for the effective execution of the function of bulk marketing and distribution.

16. In general the products of local producers are also not appropriately packaged or protected: the reasons are undoubtedly to minimise costs and can be partly explained by the lack of awareness concerning quality and hygiene.

Fruit Processing

17. At the beginning of the transition period, 100 companies were active as industrial manufacturers in the field of fruit and vegetable processing: 40 enterprises with a capacity ranging from 2,000 to 30,000 tons of finished goods per year could be classified as large processors, while 60 smaller units had a rated capacity of below 2,000 tons per year.

18. The most serious problem in this sector results from the collapse of traditional export markets (Russia, Arabia, etc) as well as the loss of supply sources after the dismantling of collective farms.

19. Many processors cover the supply of raw materials through their own horticultural production, while only relatively few smallholders provide sizable quantities of supply.

20. All companies have the same pattern of production and produce a broad variety of canned fruit and vegetables, thus missing the cost-reducing effects of economies of scale through specialisation, as well as the advantages of a favourable location (e.g. climate, soil, specific raw material quality). In spite of the fierce competition, no attempt has been made to specialise in processing canned fruit or canned vegetables exclusively. The experience from other countries in Eastern Europe clearly shows that specialised factories (e.g. manufactures of apple juice or tomato concentrates) have a better financial performance.

21. The processors are far less able to pay high prices for their crop purchases than operators in the fresh market, because of the larger volume of raw materials required per kilogram of processed output and because of additional costs of production. The difficulty in having to compete with the fresh market is that the processors are forced to pay more for their fresh product purchases than the value of their final products justify (so as to still make a profit). Therefore, all the fruit and vegetable processors suffer from the inability to buy raw material supplies at prices that accord with affordable consumer prices for their end products. An opportunity for many processors will be to improve their product quality in order to substitute imported products (processors are confronted with fierce competition from high-quality imported products) and to penetrate identified export markets with special products.

Vegetables

Vegetables	UM	1996	1997	1998	1999	2000	2001	2002	2003
Area	thousands ha	217.3	204.9	221.6	231.7	234	228	235.3	242.2
Average	Kg/ha	12182	11488	12426	12930	10944	12207	11660	
Total production	Thousands tons	2647	2353.9	2753.7	2995.9	2691.8	2784.3	2743.7	3000.0

22. The major types of vegetables grown in Romania are: tomatoes, onions, cabbages, cucumbers, peppers, tomato peppers, eggplants, watermelons, melons and potatoes (potatoes are included in technical plants, but summer potatoes are included in vegetables). From a climatic point of view Romania is known for the quantity and quality of the production of vegetables and, in former times, in some counties the growing of vegetables constituted a main source of income (e.g. Timis, Dolj, Galati, Braila, Calarasi, Ilfov).

23. A major impact has been the fragmentation of farm production, with production falling back to self- subsistence level for the majority of farmers. In former times the size of a state vegetable farm was between 50 hectares and 3,000 hectares, while currently an average of 5 hectares is classified as a big vegetable grower. There are some exceptions, whereby former state

companies have been taken over by one or more private entrepreneurs. Other exceptions are the cases of horticulture engineers who rent land plots from other private owners or from the state.

Greenhouse Production

24. In 2003 the total area under greenhouses was 1,378 ha. 6 stock companies own about 418 ha with heated greenhouses (the 6 companies are: SC Leoser SA; SC Berser SA; SC Codlea SA; SC Orser SA; SC Agroser SA and SC Leader International SA). There are two crop production cycles and 65% of the costs represent thermo energetic costs. Main cultivated vegetables are: tomato, cucumber, cabbage, pepper and others.

		1991	2000	2001	2002	Estimates 2003
Vegetables-Green houses*	Thousand ton	203.5	48.4	49.4	56.9	68.0
Imports, total		58	83	115	87.5	
Exports, total		22	13	25	19.9	

25. In 2003 the Government provided total subsidies (Government Decision 187 of 2003) of Lei 150 billion for a production of 50 thousand tons (heated greenhouse production). By Government decision 1584/2004, the subventions in 2004 increased to Lei 240 billion for a production of 80 thousand tons.

26. SAPARD programmes are currently offering over €27 million for modernising and construction of new greenhouses in Romania (both for vegetables, flowers and others) and it is expected that over 300 ha of greenhouses will be financed in the next 2 years.

Wine Subsector

27. The Romanian wine industry has great growth potential and could become a major agro-food industry in the country. However, current competitiveness is low and the industry faces serious problems due to numerous weaknesses along the whole chain from vineyards and wineries to distribution and trade. Retail sales of wine have decreased in Romania, both in volume and value terms. This reflects the consumer switch to cheaper, lower quality table wine, largely attributed to reduced purchasing power, high excise levels and low wine grape production. In addition, the fast growth of beer consumption and reduced beer excises are responsible for a large reduction in domestic wine sales. The importance of homemade wine increased during the transition period due to the large number of subsistence farm households, land fragmentation, decline in real incomes as well as the slow implementation of economic reforms. Self-consumption accounts for a large proportion of the total wine consumption.

28. The Romanian vineyards present a great diversity of wine grape varieties and offer the wine industry the chance to produce a large range of quality wines. Romania has up to 402 different types of wine, of which 11 types are for normal consumption, 42 types are the so-called Superior Wines (VS), 118 wine types are controlled denominations of origin (DOC), and 231 wine types are controlled denominations of origin and grades of quality (DOCC).

Regulatory Context

29. Wine is included, unjustifiably, among alcoholic beverages. The value added tax of 19%, and the high excises (see below) have led to a decline in the consumption of wine in favour of other alcoholic drinks, especially beer and vodka, which have benefited from aggressive and expensive marketing campaigns.

30. The levels of wine excises are:

Vermouth & fortified wine	€2.50 /hl/1 alcoholic degree
Sparkling wine (Champagne type)	€3.0 /hl/1 alcoholic degree
Sparkling wine	€1.0 /hl/1 alcoholic degree
Table wine	€0.60 /hl/1 alcoholic degree

31. The common European market organisation of the wine industry that is envisaged for the near future will have a further impact on the wine market in Romania, as is now happening everywhere on the European market. It is necessary to note, however, that the adopted stabilisation measures, which were meant to reduce the expanding surpluses through the abandonment of wine-growing areas, compulsory and voluntary distillation, and a reduction in the support price of surplus wine, have not proved to be effective. The new measures should be made in line with the WTO regulations and be centred more on adapting the supply to the demand, as opposed to solely financing the reduction of wine production surpluses.

The International Market

32. The international market has similar characteristics to the European one: declining demand and expanding surpluses with a shift towards lower consumption, but of higher quality wines. Though a positive growth trend in markets such as the Far East is evidenced, this cannot counterbalance the decline of traditional markets. The most important elements here are the emerging non-EU wine producers such as Argentina, the United States and South Africa and the East European countries, such as Romania, Hungary and Bulgaria, which have established themselves as important exporters of wine of good quality and price. Some fear that that this trend, supported by the forthcoming measures of the WTO, could have a negative impact on the European wine industry, as a whole, in the near future. However, considering the impending EU enlargement and the inclusion of the above-mentioned East-European countries in the global EU market, the outcome could be just the reverse.

Prospects for the Romanian Market

33. The wine market trend in Romania depends on the following main factors:

- The renovation of vineyards which would lead to improvement of grape varieties and yield increases with a reduction of production costs;

- The establishment of stricter control measures on the production and distribution process, especially with regard to non-standardized bulk products and reduced retail prices;
- Company strategies geared to the improvement of quality, a better organized production process, reduction of production costs, and reorganization of distribution and marketing promotion, both in the domestic and international markets.

34. The domestic market consumption is expected to increase, especially if:

- The current advocacy actions of the WEPA (Wine Exporters and Producers Association of Romania) for the reduction of wine excises is be successful;
- Market controls are enhanced and counterfeit wines are eliminated;
- Marketing systems are improved and better coordinated vertically;
- Sales outlets are multiplied and distribution channels are better structured.

Major Constraints

35. The major identified constraints can be grouped as follows.

At grower's level:

- (a) Degradation of existing vineyards (i.e. continuous reduction of the vineyard area; unsatisfactory variety composition of existing vineyards with limited areas planted with high-quality and high-sales potential vines; growth of areas planted with direct producing hybrids; limited new planting area, much below the level needed to maintain the existing vineyard area).
- (b) Weak financial position (lack of financial means for the proper maintenance of existing vineyards, required renovation of vineyards, or use of modern agricultural inputs).

At wineries level

Inadequate production facilities characterised by obsolete equipment, use of traditional production techniques and, generally, a low technological level of processing (including storage) with low investments for up-grading existing wineries or establishing new ones.

At policy and business environment level

- (a) Lack of an appropriate agricultural credit system, sufficient guarantee funds for rural credit and affordable insurance coverage against unfavourable weather conditions.

- (b) Lack of appropriate government financial support to growers, wineries and exporters (with no direct payments to producers; no price support for acquiring the required inputs; no tax breaks for farmers; only limited price subsidies for new planting materials).

36. A series of other constraints have been identified, such as: an unstructured domestic wine marketing system; poor wine quality; poor quality of bottles and poor presentation of the finished product; lack of quality control at each level along the added value chain; lack of consumer education; prevalence of bulk exports instead of bottled wines.

37. In conclusion, greater emphasis should be given by all stakeholders (authorities, growers, distributors, wine producers and exporters) on local market development and on the promotion of exports. Considering that the opportunities to reduce production costs are rather limited (due to the overall situation of the vineyards and wine processing facilities and the need for imported technologies and costs of packaging materials), it is important to exploit fully the international market potential by the concerted efforts of both the corporate sector and governmental authorities. A decisive and positive contribution can be made by the public sector through the implementation of a more effective and integrated policy for the whole wine industry.

Vineyards

38. In terms of total vineyard area and grape and wine production, Romania belongs to the top 10 wine producing countries of the world. Compared with other European countries, Romania holds the following positions:

- 5th position in total vineyard area, i.e. a coverage of 5.8% of the total vine surface in Europe after Spain, France, Italy and Portugal.
- 6th position in grape production, 3.6% of the total grape production in Europe after Italy, France, Spain, Germany and Greece.
- 6th position in wine production, 2.9% of the total European wine production after Italy, France Spain, Germany and Portugal.

39. After 1990, the combination of privatisation and land restitution has led to major changes in the ownership structure of vineyards:

- 2% of the total vineyard area belongs to vine & wine Research Stations and is fully state-owned;
- 77% of the total vineyard area of 180,786 ha belongs to individual farmers (of which 55% through privatization). Average vineyards do not exceed 1 ha in surface area and there is an acute lack of capacity to ensure high-quality grape and wine production. The situation is worsened by the lack of required investment funds and ready access to appropriate credit schemes for financing the uprooting of unsuitable hybrids, vineyard re-conversion and renovation, use of proper grafted vine varieties and other necessary inputs.

- 21% of the total vineyard area, i.e. 46,605 ha, belongs to former state farms, which have the best vines and are subject to privatization.

40. For 2004-2005, the Ministry of Agriculture foresees a slight increase in the vineyard area, which will reach 247,500 ha, of which 129,000 ha are planted with hybrids. It is worth mentioning that, although Romania possesses of a great diversity of high quality vines, the areas planted with hybrids still represent over 50%, a situation which will create difficulties in the forthcoming negotiations with the European Commissioner on Agriculture.

Major Wine Regions

41. Romanian vineyards are spread throughout the country, particularly in the hilly areas, where they benefit most from the favourable climatic conditions, but also in the South, along the Danube River. There are seven major wine regions in the country, namely, Moldova (34% of the total vine area), Muntenia (28%), Oltenia (17%), Dobrogea (10%), Crisana and Maramures (4.6%), and Transylvania (4.5%).

Main Grape Varieties

42. During the last few decades (and especially in the 80's), Romanian vineyards were planted with so-called *mass-production grapes*, as the main orientation was towards quantity instead of quality. The most valuable types of grapes with export demand (e.g. Pinot Noir and Cabernet Sauvignon for red wines, and Chardonnay and Sauvignon Blanc for white wines) were cultivated in smaller areas. Extensive cultures, such as Feteasca Regala and Italian Riesling, however, are cultivated on larger surfaces.

43. The variety composition of Romanian vineyards presents a great diversity and offers the wine industry the chance to produce a wide range of quality wines. Unfortunately, apart from the exported wines, the wines produced and sold on the domestic market are of a mediocre quality, primarily because of the hybrids and the use of obsolete equipment and processing technology in wineries. In addition, local consumers lack the necessary knowledge for appreciating and demanding high-quality wines.

Vine Yields and Farm Inputs

44. The grape yields are generally mediocre, varying between 2 and 11 tons/ha in the case of wine grapes, and between 7 and 18 tones/ha in the case of table grapes. In contrast to the small farms, both the upstream supply of inputs (e.g. fertilizers, chemicals, seeds, machinery) and the downstream processing facilities are based on large scale production methods that were favoured during the Communist era. Although working far below their installed production capacity and most often not profitable, these operators have a virtual monopoly on wine production, thus excluding the small farmers. Land consolidation has been considerably hindered by unclear ownership rights, legal restrictions on buying and selling land, the expenses of land transactions, and, perhaps most of all, the difficulty that small farmers face in obtaining credit. The major constraint on access to credit for small farmers is the refusal of banks to accept farmland as collateral for loans. Indeed, the lack of farm credit facilities and the modest interest from foreign investors has hindered the modernisation of the wine industry and the capitalisation

of vineyard production (as observed in the infrequent use of adequate planting material, fertilisers, chemicals, irrigation and machinery, and in the more intensified use of labour and animal power).

45. Restoring the capacity of existing grafting vine nurseries (200 ha) and creating new ones (700 ha), together with the modernisation of existing grafting capacities (50 million buds) and the production of new ones (30 million buds), represent a high priority in the vine and wine sector for the period 2002-2010, implying the need for significant financial support estimated at Lei 188.8 billion. Most small farmers hire tractor services to work their land and the current ratio of tractors to cultivated land is about 1 tractor for 56 hectares, with a total tractor fleet of about 167,000. Most farms, especially small and medium farms, lack the financing power to purchase new agricultural machinery, despite several government measures taken after 1999 (e.g. OG 36/1999, regarding state support provided to agricultural producers for purchasing tractors, combines, agricultural equipment and machines, as well as irrigation equipment).

Major Constraints

46. The major constraints identified so far at growers' level can be grouped as follows:

<p>Degradation of existing vineyards</p>	<ul style="list-style-type: none"> • Continuous reduction of area planted with vineyards. • Unsatisfactory variety structure of existing plantations, consisting of large areas planted with high-yield, but inferior quality varieties, and limited surfaces planted with high-quality and high-sales potential varieties, such as Cabernet Sauvignon, Pinot Noir, Chardonnay, Sauvignon Blanc. • Increase of areas planted with HPD (Direct Producing Hybrids). • Slow pace of vineyard renovation, less than 500 ha/year, i.e. about 0.2 % of the total area, significantly less than the 3.5 % per year necessary for maintaining the existing vineyard area.
<p>Financial Constraints</p>	<ul style="list-style-type: none"> • Lack of financial means of growers for insurance coverage against unfavourable weather conditions or disease due to improper maintenance of the plantations (insufficient spraying, lack of irrigation). • High cost of maintaining and properly operating vineyards (€1,000 – 1,200/ha). • High cost of establishing new plantations (€0,000/ha) • Lack of appropriate government financial support to growers (no direct payments to producers, no price support, no tax breaks). • High cost of inputs for farmers. • Lack of an appropriate farm credit system or sufficient rural credit guarantee funds. • Limited subsidies for supporting the purchase of plant materials from nurseries for new plantations.

Wine Production

47. Romanian wines, like other East European vintages, are widely perceived as cheap and cheerful, suitable for unsophisticated occasions. This reputation has made the selling of high-quality wines at reasonable prices abroad difficult. As one of the world's largest wine producers, Romania has long been present in foreign markets with significant exports to Europe and the US. Wine production in 2003 amounted to 5 million hectolitres, of which a significant proportion was

sold abroad. Exporters have made their profits, however, on volume and narrow margins. Low labour costs in vineyard cultivation have allowed winemakers to export over 1m bottles of wine to Britain this year (at wholesale prices of less than €2 per bottle). On the domestic market, last year, Romanians purchased €40m worth of wine, most of which was produced at home. Imported wines are characterised by high prices, lack of variety and poor value for money. However, per capita annual wine consumption has been losing its share to other alcoholic beverages, down from 27 to 23 litres.

Supply and Demand on the Wine Market, 2001-2004

	UM	Achieved in 2000	Market Years			
			2001	2002	2003	2004
1. Supply – total	‘000 hl	3,317	3,310	3,340	3,670	3,850
Vineyards planted with noble vines	‘000 ha	111	111.0	111.5	111.8	111.9
Average yield of noble wine grapes	Kg/ha	5,850	5,860	5,870	5,900	5,940
Total production of wine grapes	‘000 to.	649	650	655	660	665
Total production of noble wines	‘000 hl	3,247	3,250	3,280	3,610	3,790
Wine imports	‘000 hl	70	60	60	60	60
2. Demand – total	‘000 hl	3,247	3,250	3,280	3,610	3,790
Human consumption and processing	‘000 hl	2,024	2,050	2,100	2,200	2,300
Wine exports	‘000 hl	253	600	650	680	690
3. Final stock	‘000 hl	970	600	530	730	800

Domestic Wine Consumption and Export Availabilities, 2001-2004

Description	UM	1996-2000	Programme			
			2001	2002	2003	2004
Table grapes consumption	‘000 tons	116.4	118.0	120.0	122.0	125.0
Table grapes exports	‘000 tons	0.14	3.0	3.0	5.0	10.0
Wine consumption	‘000 hl	5,710	6,000	6,380	6,500	6,600
Wine Exports	‘000 hl	509	600	650	680	690
	Million USD	41.6	49.1	55.3	59.8	62.1

Wine Production Structure (%)

Structure	2000	2001-2004
Red wines	30	79-84
White wines	70	16-21

48. Wine quantities in stock represented 30% of total wine production in 2000 and between 16-21% in the period 2001-2004.

49. The following are the major constraints at the winery level:

<p>Inadequate Production Facilities</p>	<ul style="list-style-type: none"> • Low technological level of existing wineries and obsolete equipment, mostly organised for mass production with large processing and bottling units – so-called “combinats” – unsuitable for high quality wines. • Low volume of investment in the wine industry for up-grading existing facilities or developing green field projects destined for the high end of the market.
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50. Although wine is rarely advertised, some advertising is undertaken for sparkling wines and vermouths, but publicity expenditure is low compared to beer and spirits. By far, white wine dominates the domestic market, both in volume and value terms, followed by red wine and, to a much lesser extent, by rosé wines. Table wines dominated the market over the review period and they are expected to remain dominant for the near future. As many Romanians cannot distinguish between original wines and fakes, products of doubtful origin are still present on the market, with original labels and corks. This may be another reason for the drop in sales through the retail channel and the increased consumption of self-produced products or those purchased directly from small producers.

51. Summarised, the key elements to be taken into account are:

<p>Critical Success Factors</p>	<ul style="list-style-type: none"> • High quality vine grapes. • New and modern equipment and technology. • Adequate processing methods and know-how. • Appropriate storage facilities.
<p>Limitation Factors</p>	<ul style="list-style-type: none"> • Grape variety and quality • Inappropriate picking methods and transportation conditions. • Inappropriate storage facilities. • Obsolete and outdated equipment.
<p>Key Issues</p>	<ul style="list-style-type: none"> • Quality of vine grapes. • Up-to-date level of equipment and technology used. • Appropriate know-how and technical skills.

Marketing and Competition

52. There is free competition in the Romanian wine industry and no single producer dominates the market. Most of the well known vineyards have their own processing facilities and they concentrate on improving their standards in order to maintain existing customers, rather than to strive for new ones. The marketing methods used for wine exports are better adapted to client needs, benefit from more attention and funds, and are carried out in a professional way by qualified personnel. In contrast, the domestic wine marketing system is less structured and lacks vision and coherence. Wine grape growers and, to a certain extent, the wineries are neither aware of the benefits of modern marketing tools nor are they adequately equipped to promote their products in a more efficient manner.

53. Although there have been improvements in wine marketing over the last few years, the wine industry still lags behind accepted standards in other industries. The general public remains to be 'educated', although there is a great reluctance to allocate the necessary funds for this purpose. As a result, consumers cannot differentiate between low and high quality wines, while low purchasing power pushes them towards the lower-end wines (table versus superior wines). As there are thousands of wine producers and wine types, the transparency of different wines is low and it is not easy for the consumer to differentiate specific individual brands from the multitude of competitors. Today, wine marketing is mainly based on the geographical origin (reputation of the wine producing area) and the type of grape variety, and it is imperative to develop brand recognition in Romania. The Government Department for Foreign Trade is promoting a programme called "AURO" – the Romanian Seal of Quality for all Romanian goods and services which distinguish themselves through excellence, and this includes wine.

54. In order to succeed, any marketing strategy which tries to influence consumer tastes and habits should focus on two main aspects:

- (a) **A clear market segmentation** based on income level and consumer attitudes and consumption habits, and targeting of special market niches (the "connoisseurs");
- (b) **Better product positioning:** based on type (white, red, rose), taste (dry, sweet, medium sweet), quality (mass, superior, premium wines), age of the premium wines (fresh, matured).

55. The main elements to be taken into account at this level are the following:

Critical Success Factors	<ul style="list-style-type: none"> • Market segmentation (low income, medium income, high income customers; "connoisseurs"). • Product positioning (e.g. different quality: mass, superior, premium wines). • Targeting.
Limitation Factors	<ul style="list-style-type: none"> • Lack of brand awareness. • Pricing linked to purchasing power. • Low rate of loyalty to a particular brand.
Key Issues	<ul style="list-style-type: none"> • Overall decreasing wine consumption level. • Poor understanding of market needs. • Absence of marketing strategies developed by wine producers.

Role of the Wine Exporters and Producers Association

56. WEPA, the Wine Exporters and Producers Association of Romania, was set up in 2001 as a non-profit legal entity, meant to represent, defend and promote members' rights and interests, both locally and internationally. Its creation responded to the wine industry's need to take its development into its own hands, to promote a proper own identity and to offer its members a range of relevant services, such as information and direct advisory services. The need for a dynamic and articulate professional organisation stemmed from the fact that, especially during the last decade, nobody seemed able to stop the vine and wine sector's continuous decline due to the lack of an enabling legal and economic business environment, necessary vision,

strategic planning, cooperation, expertise, funds and, last but not least, an advocacy mechanism of common interests versus government and local authorities.

57. With the new Vine and Wine Law, to which WEPA contributed substantially in close collaboration with well known experts from universities and authorities (i.e. Ministry of Agriculture, Food and Forestry, the Parliament, and the negotiators with the EU), the sector is expected to benefit from long-awaited government promotional measures.

58. WEPA provides information, documentation, and consultancy services to its members and since August 2001 it has been distributing a full-colour, 4-page, monthly Newsletter, which provides useful information on the wine industry worldwide. It also supported the setting up of ONIV - the National Inter Professional Wine Organisation – whose intention it was to group all the professional associations which operate in the Romanian wine industry under the same umbrella, be they from vine growing, wine processing, distribution or trade. In August 2001, WEPA became a member of the Chamber of Commerce and Industry of Romania, and in this capacity it has already benefited from some useful services, primarily in the range of signalled business opportunities.

Recommendations

At Institutional Level

- (a) Wine should be defined as an agro-food commodity and not as an alcoholic beverage and the Government should treat it as such and act accordingly;
- (b) The production of vine grapes should be included by MAFF on the list of agricultural products of national importance, benefiting from the Government incentive programme for such products; the production of vine grapes and wine production should be financially sustained by the Government, where feasible;
- (c) Negotiating of the Wine Dossier with the European Union, in the interest of the Romanian vine growers and wine industry:
 - Preserving the existing total vineyard area of 250,000 ha;
 - Obtaining a transition period of eight years from the 2007 date of EU accession for the re-conversion of an area of 122,259 ha, which is planted with hybrid vines;
 - Allowing a transition period of four years for the putting in place of the vineyard register and cadastre;
 - Negotiating a subsidy of €40 million from the EU for the implementation of the vineyard cadastre (more than 51,000 vine plots should be measured on site);
 - Negotiating direct support from the EU for re-conversion of the hybrid vines;
 - Qualification of Romanian vineyards according to the EU zoning principles;

- Encouraging through tax-breaks the cultivation of ecological and organic wines;
- Support to wine research institutes for special programmes of premium export wines;
- Networking of small farmer wine cooperatives in Romania with similar successful wine marketing organisations in the EU member countries' cooperatives for exchange of experience and development support.

At Fiscal Legislative Level

- (a) Changing the current fiscal legislation that penalises viticulture, the wine industry, and the sale and exports of wines;
- (b) Consider the feasibility of the government abolishing excise taxes from wine producers;
- (c) Wine should not be included in the system of surveillance of products that are liable to excise tax. This should be achieved through the elimination of fiscal stamps on wine bottles, elimination of restrictions on selling of wine in bulk, elimination of the restrictions regarding the compensation payments for wine deliveries – Law 521/2002 and OMF 1111/02.09.2002;
- (d) Consider the feasibility of eliminating the para-fiscal tax – a special health fund constituted by a 2 % levy on the turnover of wine producers;
- (e) Elimination the restrictions regarding the limited period for cash payments of export sales (the present legislation does not allow the export of wine on credit) – OG 18/1994, BNR/MF instructions 1/1995.

At the Business Organisational Level

- (a) Encouragement and support of wine growers associations by the Government by considering the feasibility of adopting legislation that exempts such associations from paying VAT on the buying of inputs and the selling of grapes and wines;
- (b) Sustaining business organisations such as associations of producers, traders, and exporters;
- (c) Institution and capacity building support for the National Inter-Professional Organisation for Wine and the Wine Council;
- (d) Setting up of a Wine Promotion and Marketing Centre as a public/private partnership initiative;
- (e) Creation of a Romanian Wine Fund, based on the contributions of wine growers and wine producers, and government support of the “Romania Fund”

for setting up specific standards of production and, in general, for the promotion of Romanian wines;

- (f) Encouraging the twinning of EU-Romania at the level of business organisations for a better implementation of the “acquis-communautaires” in the wine industry.

At the Marketing Promotional Level

- (a) Implementation of the common brands/seals of excellence for quality wines – the AURO brand project. Establishing the standards, the criteria for qualification, a control system, a management system of the brands, the specific launching and the general promotion of brands at international level;
- (b) Issuing a Vineyards Map of Romania with specification of major wine regions in Romania;
- (c) Editing and publishing a Wine Atlas of Romania;
- (d) Editing and publishing promotional materials for the general promotion of Romanian wines – brochures, vineyard map folders, CD-ROMs, video-cassettes, documentary films, etc.;
- (e) Development by WEPA of a Romanian wine portal with links to the Internet sites of all the major wineries of Romania and with as second step the creation of a wine industry intranet;
- (f) Promotion of Romanian wine tourist itineraries in conjunction with food, folk art and music events;
- (g) The launching by WEPA together with the Ministry of Tourism (possibly also with the Ministry of Culture) of the project : Romania Wine Land/ Wine Routes of Romania;
- (h) Supporting the Wine Brotherhood of Romania, the Sommeliers Association and the Wine Tasters Association and involving them in wine promotion at local and international level;
- (i) Institutionalisation of wine promotion events such as the Wine Olympics, Regional and National Wine Queen Contests;
- (j) Encouraging and supporting the creation of Romanian wine clubs at local and international level;
- (k) Wine courses and encouraging TV channels to broadcast on wine related topics;
- (l) Special educational and training programmes for wine consumers with particular emphasis on young and adult segments of the population.

Milk and Dairy Subsector

Milk		2001	2002	2003	2004
Total animals	Thousands heads	2,800	3,878	3,000	3,150
Average production	litre/head	3,014	3,230	3,260	3,280
Total production, of which: commercial	Thousands hl	51,000	52,761	54,800	56,000
Subsidies, % of total production	Thousands hl	10,156	10,815	10,950	12,180
	%	9.8	14.2	15.0	19.5

Agricultural Support Policy

59. In order to balance the domestic production prices with the EU prices several subsidy programmes have been adopted, such as:

	2001	2002	2003	2004
OUG nr. 29/2000	Lei 500 /l			
OUG nr. 18/2002		Lei 1,400 – 1,800 /l (summer- winter)	Lei 1,400 – 1,800 /l (summer- winter)	Lei 1,400 – 1,800 /l (summer- winter)
Law 442/2002		Lei 1,680 – 2,160 /l (summer- winter)	Lei 1,680 – 2,160 /l (summer- winter)	Lei 1,680 – 2,160 /l (summer- winter)

60. Milk production is the second most important agricultural enterprise activity after meat production. The overall market value increased from €300 million in 2002 to €305 million in 2003 (bulk prices, imports included). In terms of end-user prices, the market value amounted to €290 million in 2002. The market concentration rate has been increasing over the past few years, with the top 10 players now holding 55%.

61. The number of cows used for milk production decreased slightly during 2002, but reached 1.6 million at the end of 2003; mostly (98 percent) in private ownership. Farm households with 1-2 milk cows hold the majority of the total production (about 80 percent). Farms supplying milk to dairy processors can be classified into three groups: large farms with more than 100 cows (most of them formerly state owned farms); medium-sized farms averaging 50 heads; and small farmers with up to 10 milk cows.

62. The milk market recovered during the 2001-2003 period, following a serious slump in the mid- 1990s. Less than 40% of the milk produced in the reference period was in line with EU quality norms (some three quarters of the Romanian national milk producers are not respecting the tight sanitary requirements imposed as part of Romania's EU accession process: milk quality is a serious limiting factor for dairy processors, because of the high bacteria content caused by insufficient cold storage facilities and the use of unsuitable sanitation and milk handling practices).

63. The appreciation of the EU currency to the national currency and increased local consumer purchasing power acted in a contradictory way last year, and therefore the estimated production value for 2003 is similar to that seen in 2002, accounting for 5.2% of the GDP. The milk processing industry processes a mere 1.2 million tons per year from a total gross production of some 5 million tons (Romania produced 5.1 million tons of milk last year or 240 litres per capita). Milk production has risen by 30% in the past ten years, while processed milk dropped by 65% due to the dismantling or decline of large state owned farms and milk processing plants. The explanation for this reduction is the following:

- (i) The prices offered by dairy processing plants are lower than the milk production costs.
- (ii) The average selling price on the free market is higher than the prices offered by processors; furthermore, payment is made immediately in cash.
- (iii) The high percentage of sales on the peasant market can be explained by the fact that small producers, lacking financial means, prefer to receive immediate payment.

64. There are regional dairy companies (most of which are former milk processing plants), countrywide companies and new start-ups. Because of their limited financial capacities, local processing companies generally compete in the regular or average quality market segments, while they avoid the demanding and specialised market niches (e.g. fruit yoghurts and desserts). This means that their rate of differentiation is low. While the dairy retail sector has developed significantly in the past few years, the farming sector has not benefited from much investment. As a result the bargaining power of retail companies dealing with producers is rising. The present atomised structure of the milk farming sector has led also naturally to low productivity: per capita milk production stands at 2,620 litres, half of that registered in the EU and lower than the average of the other EU accession countries. This is due to the lack of modern technology and the few large dairy farms. Another key difficulty stems from inadequate milk collection from producers.

65. The declined production of processed dairy products is determined by various causes, both objective and subjective, along the production-processing chain, such as:

- Lack of legal documents (setting out quality standards) in line with those existing in the European Union. These should include all the parameters of raw milk as well as protect brand names used in the marketing of milk and dairy products.
- Low quality of raw milk and consequently low processing productivity.
- Lack of financial support for the appropriate storage of perishable dairy products.

- High VAT (19%) – not at the same level as in certain Western European countries. Lower VAT will result in the reduction of milk sold directly to the population on the free (black) market under inadequate hygiene and sanitation conditions. More raw milk entering the commercial processing and sale circuit will also more than compensate the state for the lowering of the VAT percentage.

Livestock and Meat Processing Subsector

66. In Romania, more than 95% of meat consumption is represented by pork (60%), poultry (25-28%), beef (8-10%), and mutton (3-4%).

67. The average consumption of beef per inhabitant of 7-9 kg is far below the European average (about 25-30kg), even considering that the veterinary and sanitary conditions of the last few years have generated a dramatic drop in beef consumption in Europe. Traditionally, beef in Romania was never much in demand and cattle is mainly raised for milk production. Only those animals that are no longer efficient, as far as the production of milk is concerned, are finished of in slaughterhouses.

68. Supply of raw meat to the meat processing industry is a core problem, as domestic meat is often more expensive than imported meat. The market value (evaluated in bulk prices) amounted to €25 million in 2002 and decreased to €80 million last year. If evaluated in end-user prices, the market value amounted to €20 million in 2002. The market concentration rate is approximately 31%, held by the top ten meat companies – smaller than the 55% rate in the dairy industry and approximately the same as the rate in the baking industry (among of the lowest in the economy).

69. As part of the required classification of all food processing plants for the EU accession, slaughterhouses and meat processing factories will have to adopt restructuring strategies as of 2005 until the end of 2006 in compliance with the new regulations and norms. Due to a shortage of necessary investment funds, but also due to poor management and the absence of good industry practices, today only 10 slaughterhouses and 10 meat processing plants fulfil the conditions imposed by the EU norms and are authorised to export their goods to EU member countries (based on non-compliance, 93.7% of the slaughterhouses and 88% of the meat processing units are in fact threatened with closure). Today, most of the investment funds designated for restructuring of facilities is obtained from the SAPARD grant financing. The current situation is:

- Hygiene is the main issue confronting slaughterhouses and meat processing plants.
- 380 small red meat slaughterhouses (beef/horse/game meat) do not have any restructuring programmes (67.8%).
- 364 small red meat processing plants are without restructuring programmes (63.8%).

- 10 small slaughterhouses (chicken processing units) do not have any restructuring programmes (24.5%).

Cattle and Beef market

		2001	2002	2003
Total number of animals	Thousands	2,800	2,878	3,000
Total production of meat	Thousands tons	295	318.6	366
Average weight	kg/head	208	258	330
Minimum weight accepted for subvention	kg/head	-	380	400
Total subventioned quantity	Thousands tons	-	45.6	25.0

70. Support programmes are directed towards encouraging cooperatives and farm associations to increase production for sale and to improve breeding and meat quality. Special subsidy programmes of the Romanian Government are the following:

	2001	2002	2003	2004
HG nr 54/2002		Lei 4,000 /Kg (Lei 182.4 billion)		
HG nr 1556/2002			Lei 4,000 /Kg (Lei 100 billion)	
HG nr 416/2003			Lei 6,000 /head (Lei 804,000)	Lei 4,000 /kg (Lei 60 billion)

71. During the period that followed the political changes of December 1989, the keeping of cattle faced a number of problems that have together determined the following decline:

- (a) Co-operative farms were dissolved and the cattle and other livestock were divided among the members.
- (b) State farms without the periodic financial support that they used to get in order to cover their losses, faced severe cash problems that led their management to slaughter animals or to sell them to cattle raising farm households.
- (c) Cattle owners agreed to sell young cattle at any weight and age, attracted by the cash payments of intermediaries. The need for money convinced many people to give priority to the selling and to pay less attention to the renewal of their livestock.
- (d) The system of artificial insemination became disorganised, which has had a negative impact on the productivity of both milk and meat production.

- (e) Lack of organisation on the part of cattle raisers (associations or co-operatives) kept them away from modern knowledge about specialised animal breeds for meat production, feeding conditions, shelter, market information, etc.
- (f) The absence of a system for cattle identification, similar to the one applied in the EU, has led to disorganised trading and the loss of tax income due to the failure to register the considerable quantities of meat sold, and even live animals.
- (g) A lack of financial resources for investments in machinery and equipment needed for the preparation of fodder for the winter period.
- (h) Restrictions on the required export weight of young bulls prevented farmers from selling their animals at will. However, since these administrative rules were difficult to control, it generated only corruption with the authorities unable to stop the export of young animals.

Pork Market

		2001	2002	2003	2004
Total number pigs	Thousands	4,447	5,058	5,600	6,000
Total meat production	Thousand tons	613	634.9	640	650
Average weight	kg/head	117	119	109	110
Minimum weight for subventions	kg/head	-	90 – 110	90 – 110	90 - 110
Total subventioned meat production	thousand tons	-	160	109	110

72. Special subsidy programmes of the Government in order to balance the production costs of pork are the following:

	2001	2002	2003	2004
HG nr. 585/2001 (genetic source)	Lei 28.2 billion			
HG nr. 756/2002 (genetic source)		Lei 0.24 billion		
HG nr 54/2002		Lei 4,000 /Kg (Lei 640 billion for 160 thousands tons)		
HG nr 1556/2002			Lei 4,000 /Kg Lei 7,000 /kg (Lei 624 billion for 109 thousands tons)	Lei 7,000 /kg (Lei 770 billion for 110 thousands tons)
HG nr 416/2003			Lei 400,000 /head (Lei 46 million)	

73. Pork ranks first in total meat consumption and accounts for 60% of market demand. Traditionally, it is by far the most preferred type of meat among Romanian consumers. Recently, however, mainly due to low purchasing power, the consumption of pork has gone down, although its share in the total meat consumption levels has remained the same. The campaign against the consumption of pork due to sanitary problems, however, has not affected Romanian consumers. Official production statistics do not include the home consumption of pigs (which is common in most rural areas and even small towns during Christmas), or the slaughtering of household animals and the selling of meat outside organised markets.

74. Heavy investments are needed for the restructuring of production facilities and equipment in order to comply with the EU regulations regarding high production quality standards and sanitary norms for safe consumption. Of course, investments should be made only in those enterprises which have a good chance of achieving European standards. In fact, some 9-10 large slaughterhouses and probably 40-50 smaller ones could efficiently cover the domestic demand for pork, both from a quantitative and geographic distribution point of view.

75. Major constraints are:

- (a) Most pigs are kept in constructions that have long since exceeded their useful life, which results in low productivity and animal losses due to poor sanitary and veterinary conditions.
- (b) The animal feed supply in Romania is of uncertain quality due to the lack of an adequate control system and corresponding legislation.
- (c) The quality of the genetic animal material produced in the country is rather poor, as it is mainly meant for small farms.
- (d) There are few commercial, medium-sized pig farms (with 100-1,000 heads) which specialise either in rearing or fattening activities and the majority of small farms are characterised by high sanitary, veterinary and environmental risks and a low economic performance.
- (e) High price fluctuation of pigs occurs during the different periods of the year, due to a lack of correspondence between supply and demand on the market. Furthermore, the poor quality of the domestic supply directs the demand of pork processing plants towards imports.
- (f) The lack of a system of carcass classification does not stimulate quality nor eliminate from the market products that do not meet required standards.
- (g) The low utilisation rate of the installed production capacity of larger slaughterhouses results in a low disposal of financial resources which are needed for the required upgrading and adaptation to the EU regulations and norms.
- (h) The lack of adequate market mechanisms and price information puts pig farmers in a poor negotiation position as compared to traders and processing plants, and results in low farm gate prices.

Poultry Market

		2001	2002	2003	2004
Total number of poultry	Thousands	71,413	77,379	80,000	82,000
Total meat production	Thousands tons	363	431.6	455	465
Average weight	kg/head	1.7	1.8	1.9	2.0
Total subsidized meat production	Thousands tons		100	140	150

76. Special subsidy programmes of the Romanian Government are the following:

	2001	2002	2003	2004
HG nr. 585/2001	Lei 31,896 billion			
HG nr. 756/2002		Lei 38,404 million		
HG nr 54/2002		Lei 3,000 /Kg (Lei 300 billion for 100,000 tons of meat broiler)		
HG nr 1556/2002			Lei 3,000 /Kg Lei 4,000 /kg (Lei 524 billion for 140,000 tons of meat broiler)	Lei 5,000 /kg (Lei 750 billion for 150,000 tons of meat broiler)
HG nr 416/2003				

77. Poultry consumption ranks second in the total meat consumption of Romania and with 12-13 kg consumed annually per inhabitant, it represents 25% of total meat consumption. Most of the consumption is of chicken (around 75%), with the remainder from hen and turkey meat. Around 2/3 of the total chicken production is obtained from small farm households which use 80% for self-consumption and sell the remaining 20% on the market. Most chicken shelters are old and create serious sanitary and veterinary risks, while the technology used does not correspond with the ecological trend promoted by the EU.

ROMANIA

**BANK LENDING TO SMALL AND MEDIUM SIZED ENTERPRISES IN
RURAL AREAS; AN ANALYSIS OF SUPPLY AND DEMAND**

ANNEX 3

NON-FARM RURAL ECONOMIC ACTIVITIES

ANNEX 3

NON-FARM RURAL ECONOMIC ACTIVITIES

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ANNEX 3

NON-FARM RURAL ECONOMIC ACTIVITIES

1. In order to assess the potential demand for technical assistance and credit by non-farm rural enterprises, in 2003 the Competitiveness Component of USAID and the Enterprise Development and Strengthening Program of CHF carried out studies of four selected economic sectors, each made up largely of rural economic activities: glass and ceramics, wood and furniture, textiles and apparel, and tourism. The assessment studies address various aspects such as location, enterprise structure, sales and export potential, competitive advantages, investments and financing, and services from business support organisations.

Glass and Ceramics

Location

2. Major clusters of enterprises have been developed in locations that have deposits of raw materials: sand and alkaline, and, in former times, also near forests where wood was obtained to be used to heat the furnaces for glass melting. These areas can be found in or near: Tirgu Jiu, Buzau-Scaieni, Dorohoi, and a number of locations in Transylvania, including Tarnaveni, Turda, Sibiu, and Medias. The largest producers of container glass are located in Bucharest and Sighisoara.

3. For ceramics, the major industrial activities of sanitary and tabletop ceramic and porcelain production are located in Transylvania, specifically in Cluj Napoca, Alba Ilulia, Sighisoara and further north in Baia Mare. An additional centre for porcelain production is located in Curtea de Arges. The bulk of traditional Romania ceramics are produced in four centres: Suceava, Horezu, Corunt, and Bahia Mare.



Enterprise Structure

4. According to industry experts of the Ministry of Commerce and Trade, in the combined activities of glass and fine ceramics there are 44 large enterprises, 55 small and medium-sized enterprises and 221 micro-enterprises. A typical firm of micro, small and medium size may have the following features:

5. Micro-enterprise: up to 10 employees engaged in the production of decorative traditional ceramics. This assessment does not consider these firms, since the study focuses on SMEs and, based on experience in the 1990s of support programmes for artisans, it was concluded that traditional potters are not in a strong position to grow through exports.

6. Small enterprise: up to 50 employees and owned by a former worker of a state-owned company. The plant is typically located adjacent to the owner's home and the firm may have up to 10 years of incremental growth, usually self-financed. Equipment is bought second-hand. Export contacts are made through the Chamber of Commerce and attendance at trade fairs is a common goal, since entrepreneurs believe that attendance will give them access to new markets. Managing their cash flows and energy costs are the top priorities for these firms.

7. Medium-sized enterprise: between 50 and 250 workers and owned by a former manager of a state-owned company. At the smaller end of the scale, the plant may still be located on the owner's land and additional land is available for expansion, but capital is needed for

building and equipment. The firm has successfully expanded its production capacity to meet demand; owners and managers regularly attend trade fairs; and the main concerns are the issues of pricing, cost containment, and foreign competition.

Sales Estimates

8. In Romania, the glass sector reaches annual sales of over US\$190 million, while the ceramics sector is about half that size with US\$116 million. In both segments, close to half of the sales come from tableware products. Tableware products of glass and ceramics are largely exported, while products that are used for industrial or construction purposes are sold on the domestic market or are sold to multi-national manufacturers who may then export the finished goods.

Glass Sector ¹

Sales in USD 000s

Glass	1999	2000	2001	2002	Export Assumptions
Tabletop	75,934.8	73,329.5	68,790.6	78,041.8	80%
Flat	20,328.8	29,109.8	37,704.0	48,371.4	50
Container	17,983.0	27,694.0	41,053.0	35,765.0	10
Technical	Na	14,400.0	17,200.0	17,200.0	25
Other – Fibre Glass	9,386.7	9,794.9	10,963.6	11,887.8	100
Total Sales	123,633.3	154,328.2	175,711.2	191,266.0	

Source: Romanian Foreign Trade Centre and team analysis.

Ceramics Sector

Sales in USD 000s

Ceramics	1999	2000	2001	2002	Export Assumptions
Tabletop - Porcelain and Ceramic	53,071.8	55,010.5	55,960.3	57,472.7	80%
Industrial	3,686.3	3,813.1	4,523.9	4,374.2	20
Construction	1,271.80	1,492.10	1,440.50	1,784.70	0
Sanitary	34,929.3	32,819.0	39,891.4	53,077.2	50
Total Sales	92,959.2	93,134.7	101,816.1	116,708.7	

Source: Romanian Foreign Trade Centre and expert team analysis. For the industrial segment, the Ministry of Finance website.

¹ Total sales for these sectors are not recorded in Romania. Therefore, these sales are estimated based on export data from the Romanian Foreign Trade Centre and the Shorebank's best estimate for the proportion of sales that are exported. The expert team's export estimates are based on information obtained from interviews with twenty-four firms and estimates from leaders Business Support Organizations. They may underestimate sales, particularly in the glass container and ceramic construction segments on which activities the evaluators did not focus their inquiry.

9. Based on the sales and employment estimates, the annual productivity (annual sales/employee) in the combined sectors is approximately US\$8,310.

10. This compares favourably to other sectors: in tourism the labor productivity is US\$5,172, in textiles it is US\$6,000, in wood products US\$7,029, in information technology it is US\$9,560, while the overall average labor productivity in Romania is estimated at US\$5,296.¹

Exports

11. The tableware glass sector in Romania experienced three consecutive years of negative growth from 1999 to 2001. In 2002, however, the segment's exports did grow, surpassing the sales of 1998.

12. In flat glass, there has been a surge in production and exports as a result of the increased capacity at Romania's only float line facility (Ges, in Scaeni). Growth in the export of float glass indicates that there are good external markets for sales expansion from the installed production capacity.

13. Container glass production has been in decline in Romania for most of the last decade, with production falling from 319 thousand tons in 1989 to just over 100 thousand tons in 2002.² Increases in imports for the flat and container segments support the conclusion that flat and container glass production is far below the necessary level to meet domestic needs: flat glass imports grew by 176% between 1997 and 2002, while container glass imports increased by over 300% over the same period.³

Glass Sector						
Export Sales in 000						
USD	1997	1998	1999	2000	2001	2002
Tableware and decorative	59,753.0	61,505.4	60,747.8	58,663.6	55,032.5	62,433.4
Flat	16,799.6	13,758.7	10,164.4	14,554.9	18,852.0	24,185.7
Container	7,985.7	6,303.5	1,798.3	2,769.4	4,105.3	3,576.5
Technical	na	na	na	3,600	4,300	4,300
Other - Fibreglass	7,599.3	8,720.7	9,386.7	9,794.9	10,963.6	11,887.8
Total	\$ 92,137.60	\$ 90,288.30	\$ 82,097.20	\$ 89,382.80	\$ 93,253.40	\$ 106,383.40

Source: Romanian Trade Centre, 2003; Ministry of Commerce and Trade for technical glass.

14. In the ceramics sector, export growth has been driven by sales in the sanitary segment, which have grown by 50% over the last four years. In the tableware segment, total exports have grown only 8% over four years. The composition of sold tableware products has also changed with ceramic tableware taking some share of the total from porcelain and decorative items.

¹ Paul Klein, "Growth and Competitiveness in the Romanian Textile, Wood, IT and Tourism Sectors," 2003.

² Ministry of Commerce and Trade, 2003.

³ Romanian Foreign Trade Centre data, 2003.

Ceramic Sector				
Export Sales in 000 USD	1999	2000	2001	2002
Tableware	42,457.5	44,008.4	44,768.2	45,978.1
Industrial	737.3	763.6	904.8	874.8
Construction	1,271.8	1,492.1	1,440.5	1,784.7
Sanitary (incl. bath tiles)	17,464.6	16,409.5	19,945.7	26,538.6
Total	61,931.18	62,673.59	67,059.22	75,176.23

Sources: Romanian Trade Centre, 2003. National Commission for Planning, 2003, Ministry of Finance website for industrial ceramics (Assumed exports are 20% of the total sales).

15. According to industry insiders, until recently, the Romanian law prohibited individual firms from entering into direct export negotiations. The law required exporting companies to have a license - and licenses were not granted easily. The licensed export companies therefore became the primary communication channel with the end customer and the official seller of huge quantities of Romanian glass for export; large glass and porcelain companies continue to rely on export companies for 60-80% of their total export sales.

16. While large firms have been slow to develop export skills, many SMEs are exporting directly. While there are still many outstanding challenges, SMEs appear to be capable of managing all the basic issues that are related with export, including price negotiations, freight options, packaging, and various payment options.

Investments and Financing

17. In the SME segment, some indebted producers were hurt by the hyper-inflation in the mid-90s, and they are very cautious about taking loans to finance expansion. This reluctance may be warranted in some cases, particularly in the case of younger firms that do not have a stable client base. However, barring a complete deflation of the glass or ceramic tableware markets (which does not appear very likely), firms with a proven track record and strong client relationships may want to consider increasing their debt leverage.

18. Many firms also expressed confidence that they could gain access to loans if they needed them. The strongest producers have already established strong banking relationships and, as one entrepreneur stated, "Banks are hunting good borrowers now." Interest rate expectations of interviewed entrepreneurs are around 12%.

19. Growth requires investments. Without a change in marketing strategy in the short-term (which is strongly recommended), one may assume that many Romanian firms will continue to compete for a price-sensitive market share. In an inflating cost environment, these firms are not likely to have sufficient cash flows to make the required investments for growth from own funds. Debt or equity capital will therefore be needed.

20. Capital needs differ according to the size of the firm. Due to the capital-intensive character of glass and ceramics production, the level of capital needed for both equipment upgrades and kiln/furnace maintenance tends to exceed US \$100,000.

Firm size	Expansion capital needed
Small	US\$100,000 - US\$250,000
Medium	US\$100,000- US\$1,000,000
Large	Up to US\$5,000,000

Competitive Advantages

21. Although low wages and subsidised energy costs make Romanian glass and ceramics products attractive from a price perspective right now, that advantage will evaporate as soon as China becomes active in both sectors. A more sustainable advantage for SMEs is the execution of a well-defined market niche strategy or product line differentiation (e.g. high price/quality products versus medium and low). For example, high quality decorative tableware glass largely centres on skills and on an advanced position on the learning curve of glassware production. Skills for which Romanian firms are known include: blowing of glass of large dimensions, quality glass painting, many-layered coloured glass, and acid-etching techniques.

22. In comparison to Chinese producers of decorative glass, Romania has a lead in terms of quality, but this is changing fast. Industry experts estimate that Chinese producers need 3-7 years to learn to blow glass of the same quality as Romanian firms.

23. In industrial glass, current SMEs do not have a discernable comparative advantage over competitors and, in fact, they are hampered by semi-obsolete equipment;¹ however the applications for industrial glass are various, and end-use industrial customers (like automobile or small appliance manufacturers) often require outsourcing on a regional basis, so it is possible that substantial and sustainable markets will continue to exist for some Romanian producers.

24. The products that appear to be competitive on export markets under current conditions, in terms of price and quality, are:

Glass	# SME	Ceramics	# SME
French nouveau glass products	10-20	Ceramic tableware	0-1
Art glass of various types	6-10	Porcelain tableware	5-10
Painted/decorated glass	20-40	Porcelain decorative*	60 +
Processed flat glass	0-1	Electric insulators	1-2

* The competitiveness for SMEs in this segment is currently under considerable pressure. The segment is vulnerable to aggressive Chinese competition on the domestic market and limited trade name recognition for Romanian products on the external market. Exports of porcelain products for instance have declined by almost 1/3 over the last 3 years.

¹ For flat glass production, the technological standard is the *float* technique whereby panes of glass are drawn across the surface of a bath of tin. Romanian flat glass is almost exclusively produced using a *drawn* glass technique. There is one float glass production line in Romania, the Ges plant in Scaieni.

Business Services Organisations (BSOs)

25. There are four primary business services organisations for glass and ceramics producers in Romania. Efforts to coordinate commercial activities through these trade and professional associations appear to have been undergoing substantial changes over the last few years. New organisations have been formed, cooperative marketing efforts are being tried and changes in leadership have occurred.

	<u>Members</u>	<u>Dues/Quarterly</u>	<u>Service Focus</u>
Union of Ceramics Producers	35 firms 36 indiv.	Large: Lei 3.5 million Medium: Lei 1.5 million Small: Lei 750,000	Feasibility studies and other market research as requested by members.
Association of Glass Producers	32	Large: US\$300 Medium: US\$150 Small: US\$100	Strategy formulation.
STICEF	36	NA	Labor negotiations.
Union of Fine Artists	5,000	US\$1.50	Artist promotion.

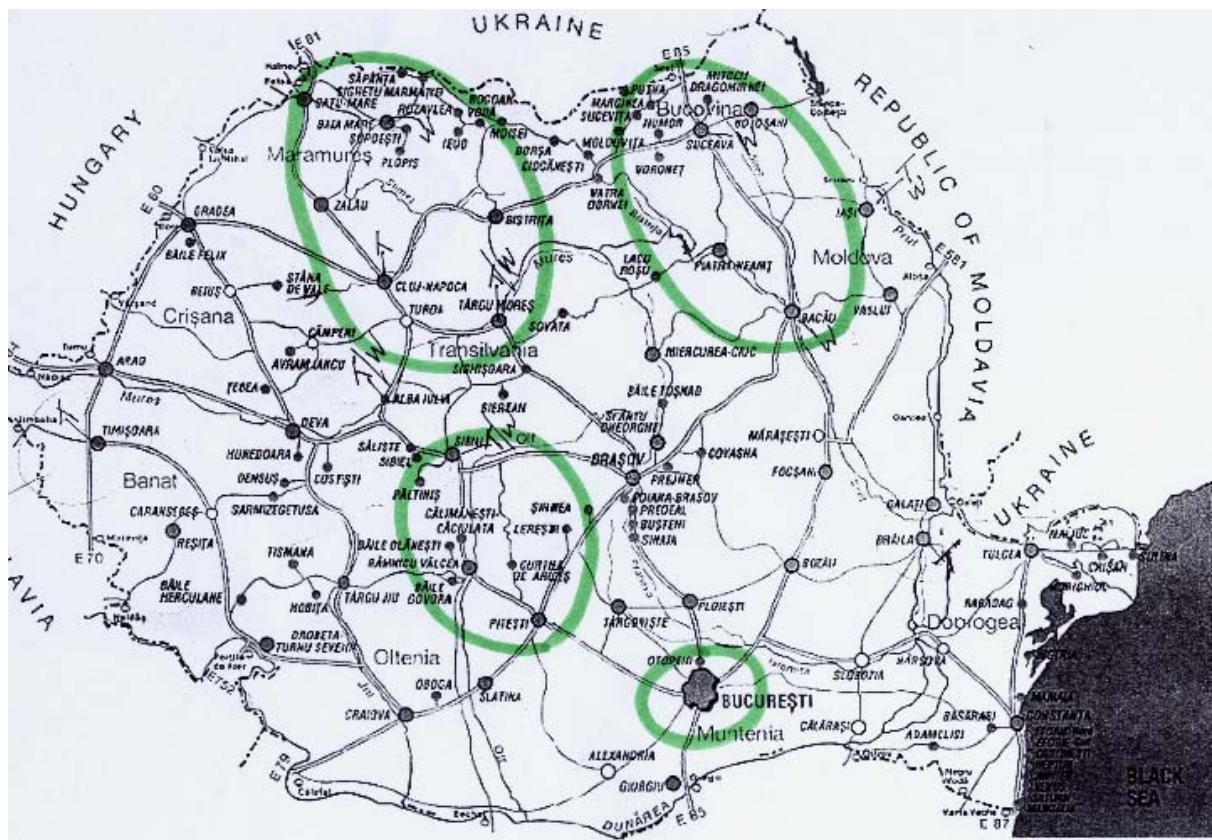
26. Although each organisation has membership fees, the value of provided services is not clearly perceived by member firms. Fewer than 10% of the interviewed firms could give concrete examples of valuable services provided to them by the industry organisations. At the same time, the organisations have an impressive depth of knowledge about various issues facing the sectors. Their ability to attract paying members and to organise relevant services that members value, is, however, less evident.

Wood and Furniture

27. In 2002, furniture production stood at US\$731 million, of which exports totaled US\$474.2 million (5.6% of the total Romanian exports), generating a net contribution of US\$415.5 million to the national trade balance.

Location

28. As most of the forests are in the northern and central part of the country (mainly spruce, fir, oak, beech), two regions show a significant concentration of wood processing and furniture manufacturing operations: the NE area from Suceava and down through Iasi to Bacau and, respectively, the NW area from Baia Mare and Satu Mare and down through Cluj to Targu Mures. Besides these areas, and less dependent on the availability of wood in the same region, a significant concentration of furniture facilities can also be found around Pitesti in the South, and of course around Bucharest, the capital city, which concentrates one third to one half of almost any type of economic activity in the country.



Enterprise Structure

29. There are now more than 8,000 small and medium-sized companies that operate in the sector. 85% of the wood-cutting and processing, and 95% of the furniture manufacturing companies are micro-enterprises or small or medium-sized companies. Most of the companies in the sector are located far away from the main urban areas.

30. Additionally, some large companies set up by foreign investors have had a significant impact on the development and production of new value-added products in Romania. The tendency is to establish new micro-, small- or medium-sized enterprises, while at the same time to divide existing large companies into smaller, more flexible and more efficient units. Foreign direct investment has in some cases been directed at the implementation of new, modern sawdust or woodchip collection and recycling facilities, and this trend is likely to continue. Recycled wood products are cost-effective and have a high local demand. In addition, international (mostly EU) special programmes are likely to contribute to the co-financing of upgrading of facilities, which will have a positive impact on the environment. The investments realised during 1990-2002 totaled US\$1.526 billion, of which US\$920 million came from foreign capital. Some large production capacities were started, or are currently being started, by foreign companies during 2003-2004.

31. The number of SME's in the wood and furniture sector is expected to grow. To reach the optimum size of a furniture manufacture, it is necessary to employ around 150-250 employees and to be able to cope with sufficiently large orders that will keep the operational costs to a minimum and exploit the flexibility of the production capacity to a maximum. However, these firms suffer from a lack of sufficient management skills, modern processing equipment and access to markets.

Sales and Profitability

32. The dynamics of furniture production (expressed in equivalent USD) over the past 12 years is presented in Figure 1 below. In 2002, wood processing, excepting furniture, reached a production volume of Lei 23,827 billion (2.5% of total national production). The level of labour productivity of the Romanian wood processing and furniture industry (produced units per worker in a period of time) remains significantly lower (1.5 – 2.0 m³/person) than similar indicators in the EU countries. However, the wage level “compensates” for the difference, as the average monthly net salary varies from US\$70.00 to US\$200.00 equivalent. It can be assumed that with training and the introduction of new technology, productivity will grow in the future.

Figure 1. Romanian Furniture Production

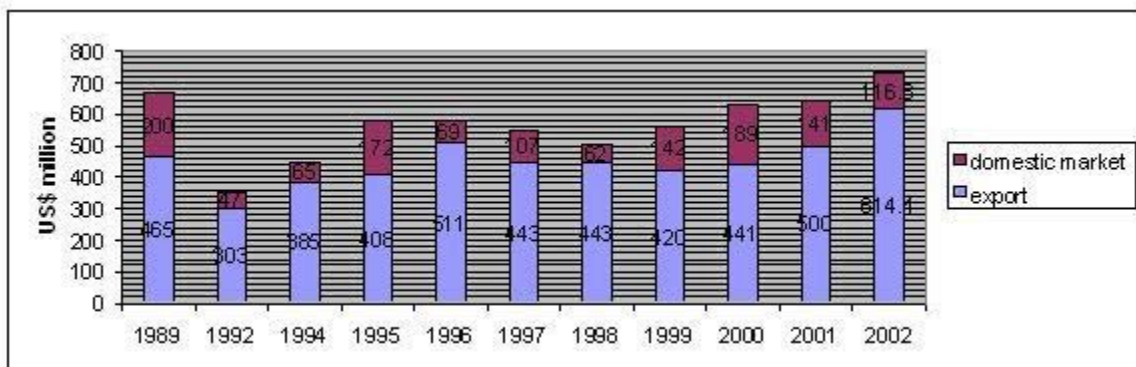
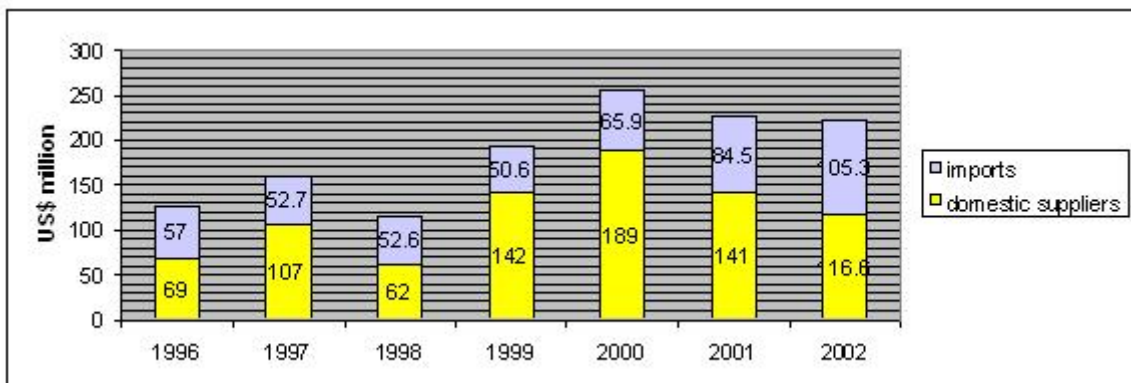


Figure 1. Romanian furniture production



33. With appropriate levels of support, significant results can be achieved quickly. In order to increase furniture production from US\$614 million in 2002 to US\$1.120 billion in 2010 (as planned), growth should occur in all areas of the sector, for example an increase in the volume of processed round wood of approximately 1.3 million cubic meters will be necessary. The number of people employed in the forestry sector and wood industry is expected to grow to 75,000 in 2004 and to keep growing in the following two years due to an expected increase in volume of work and new production capacities in forestry. The furniture industry currently employs some 104,000 people and is expected to generate approximately 15,000 new jobs by 2010.

Exports

34. Export of wood products other than furniture, mostly timber, only represents 30-35% of total production; the rest is absorbed by the domestic market for use in other products, furniture, construction, etc. The volume of export of these products increased from US\$554.7 million in 2001 to US\$625.4 million in 2002.

Exports of wood products, including furniture and others, in US\$ million in 2001 and 2002:

Exports	2001	2002
Wood products, except furniture	554.7	625.5
Furniture	500	614.1
Other wood products	10.3	10.6
Cellulose, cardboard, paper	80.5	105
Total	1145.5	1355.2

35. Exports of furniture from Romania have real potential witnessed by their significant growth following re-entry into markets like the USA and the Former Soviet Union (FSU). These markets have an estimated potential of US\$250 million and US\$150 million worth of furniture imports from Romania respectively, with little of that potential currently reached (approximately only US\$22 million of exports to the USA and US\$7 million to the FSU). Growth of the respective shares of Romanian furniture exports is expected to be as high as 30% over the next few years.

36. Additional exports will most likely be based on the most competitive products such as high-end solid oak and beech “antique” furniture, high-end solid walnut and cherry bedroom and dining room furniture, bentwood chairs, solid oak and beech panel bookcases and bedroom furniture, and chipboard and fibreboard office furniture.

37. The greatest potential for expansion of exports depends primarily on an increase in production. Most of the mills surveyed are currently exporting a great percentage of their production and can not export much more without investments in additional production capacity¹.

¹ According to the USDA, timber in Romania is being cut at a rate less than that authorised by the government i.e. at half the rate of growth. This indicates that there is sufficient raw material supply for a considerable amount of additional production. In addition to this, the installation of more efficient machinery will result in better utilisation of the raw materials.

Development and support is required of both production and marketing, especially for entering into new markets and developing appropriate distribution channels. Government Ordinance no. 120/2002 allocates resources to support the export efforts of some economic sectors, among which wood and furniture have top priorities. The adoption of the EU *acquis communitaires* will bring a number of benefits as well as implying additional costs. Potential benefits include free access to the vast market of the European Union, favourable access to markets of third countries with which the EU has agreements, increased attractiveness of Romania for foreign investment in the wood and furniture sector, and structural financial aid programmes after Romania's accession to the EU in 2007.

38. The expected costs are related, among others things, to the need for restructuring and modernising of the wood and furniture industry in order to comply with European norms such as the Directive 94/62 EEC on waste management; the Directive 88/378 EEC on wood packaging waste, and the adoption and harmonisation of more than 87 % of the European standards regarding wood and wood products. The additional exports will demand additional production of furniture, and this in turn will make new investments attractive. Moreover, more European companies are expected to outsource production to countries in Eastern Europe, especially to Romania. Therefore, investments will be needed for upgrading existing production facilities as well as for establishing new ones.

Investments and Financing

39. The challenges that the SME's in the wood and furniture sector face include taxation, better economic performance, access to financing, fair business practices and transparency in the regulatory business environment. Interviews with SMEs and related associations in the wood sector show that access to financing, already generally difficult and expensive, is especially difficult for SMEs since commercial banks do not accept a good business plan as an important guarantee for a loan and they tend to over-collateralise. Small wood harvesting enterprises, however, mostly use old equipment and technologies and they do not possess large fixed assets and find it very difficult to get access to adequate bank financing. As for any other industrial sector in Romania, financing is both difficult and expensive. Easier access to financing would increase companies' capacity to invest in larger areas of forest for wood production, expand timber inventories, acquire more modern harvesting and drying equipment, and carry out market research and trade promotion.

40. In order to successfully compete on international markets with differentiated and high value products, the Romanian wood and furniture sector needs in particular to invest in R&D. Development of new, high-quality products, responding to the specific demands of certain markets can only be achieved through market research that requires financing. Production facilities where foreign investment is present often have state-of-the-art technology, but obsolete equipment is still widely used. Especially frequent are inefficient wood harvesting and sawmill equipment and inadequate drying facilities, especially in plywood and multi-layer wood product companies.

41. Forestry and wood harvesting are currently the components with the lowest levels of investment and, accordingly, the lowest levels of technologies and productivity. Investments in the forestry sub-sector will lead to higher quantities of wood supply and a better use of wood in product lines that are currently hardly accessible or under-utilised, as well as bringing about a significant increase in the quality of the harvested wood. This, in turn, will ensure higher added value for the excess timber that will become available in larger quantities for export to foreign furniture manufacturers, as compared to the current situation in which most of the exported timber is of low quality or is sold at low prices for construction.

Business Support Organisations

42. Business support services are available from local chambers of commerce, international business or economic development programmes funded by the US Government, the EU and European governments, and private consulting companies. Apart from some minor local employers' associations, there are two major national employers' associations, and one regional association which group together companies in the wood and furniture industry: ASFOR – the Association of Employers in the Forestry Sector; APMR – the Romanian Association of Furniture Manufacturers and PROFOREST – the Association of Foresters in the Bacau County. Some local chambers of commerce like the ones in Iasi, Suceava, Bacau, Neamt Targu Mures, Sibiu, and Constanta provide support services to wood and furniture companies in their respective counties, which include access to information on national and international financing schemes, support for the participation in trade promotion events, and general advocacy.

43. Although the current impact of business support services on the improvement of the overall business environment is still low, it is growing. The main reasons for the low impact are two-fold: the culture of actively seeking and implementing business advice is still young in Romania, and consequently, the range and effectiveness of available support services still needs a good deal of strengthening. Over the past three years, the different business support organisations in the sector, with support and guidance from international programmes, have significantly grown both in membership and in strength and are now accumulating credible and well-structured information on the industry. Some have also initiated strong partnerships with similar organisations abroad and they now provide a wider range of valuable business development and advocacy services to their member-companies.

Textiles and Apparel

44. The textiles industry in Romania is a US\$2.76 billion dollar industry¹, which grew by 30% from 2001 to 2002 and is expected to increase at a higher rate than the average GDP growth in the near future². Romanian fabric production units, however, have been slow to adapt their supplies to the needs of a growing number of SME garment manufacturers. In fact, since the bolts produced by the fabric makers were too big for SMEs to handle, those enterprises decided to purchase fabrics from abroad. Only lately have the Romanian fabric producers begun to modify the size of the bulk fabrics that they supply in response to the needs of the smaller garment producers.

¹ 2002 data derived from the National Institute of Statistics.

² CEEBIC Romania Country Commercial Guide 2003.

45. Today, clothing production is very much based upon contract production for companies in Western European countries. Clothing is produced on an outward processing basis (OP) known as the “LOHN” system. Under a typical LOHN transaction, a Western European producer ships fabrics and clothing designs to a Romanian factory which then transforms the raw materials into finished apparel, which is exported back for sale. The system has ensured the survival of many Romanian textile companies to date, but recently it has led to a decreasing profitability of the Romanian companies.

Enterprise Structure

46. There are approximately 4,724 enterprises in garment and textile production¹. Of these, 3,300 are small and medium-sized enterprises.² Approximately 70% of companies which are active in the textile sector are SMEs.³ SMEs in the sector employ 50-60% of the total of 460,000 employees in the whole sector.⁴ Currently, the majority of SMEs in the textiles industry are engaged in the production of garments as opposed to the production of textiles. There is a growing trend for existing large companies to break down their operations into smaller and more flexible and efficient units. SMEs often specialise in only one or two parts of the production process, and they outsource the rest. They remain small and flexible and are able to adapt to the rapidly changing needs of fashion in the clothing industry.

47. The growth of SMEs in the textiles industry may offer a competitive advantage to Romania. Increasing differentiation at the clothing shop and store level requires many small-to-medium enterprises which are sub-contracted exclusively by these stores and produce clothing under strict codes of secrecy. The need for secrecy about new fashion or product lines can only be maintained if the garments are made in factories that are devoted to one retail company. The clothing manufacturing industry in Romania has followed this development trend with a moving away from large factories, which employ a thousand or more people, to small units of 100 or less workers. SMEs can provide the agility, fast delivery and security that specialty clothing stores now demand.

48. Smaller enterprises with a multi-skilled workforce and up-to-date computer assisted design and computer assisted manufacturing CAD/CAM facilities, including Internet connections to the main consumer markets in the world, should be given priority in the allocation of investment and training funds.

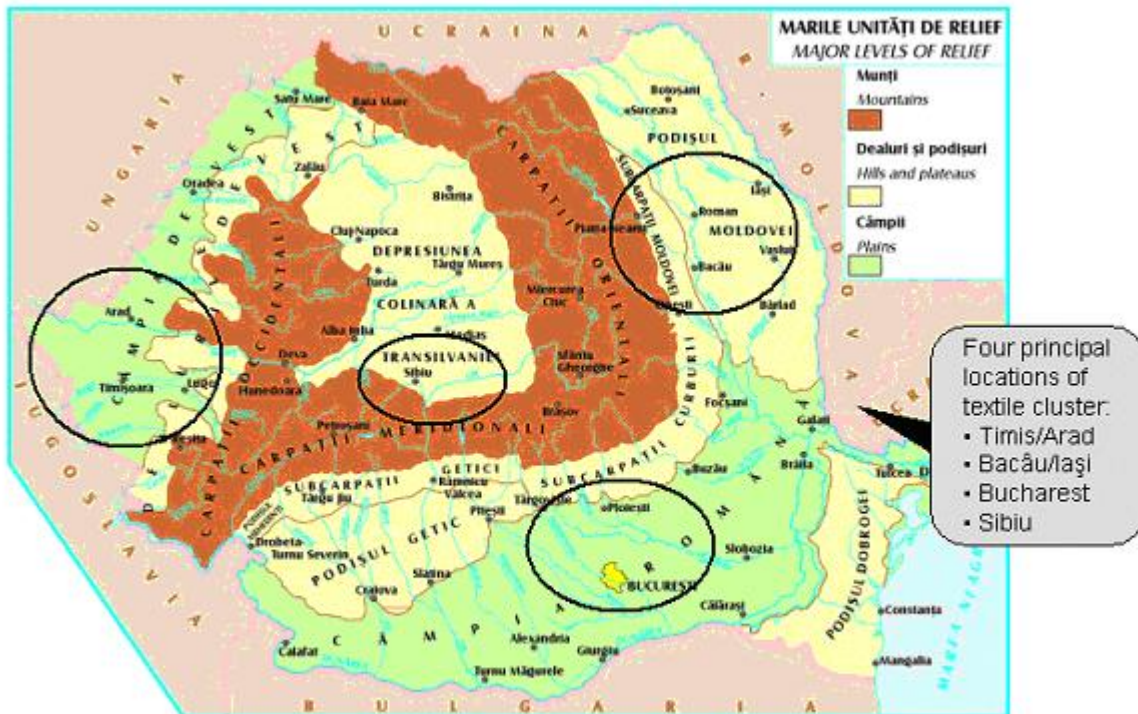
¹ Federation of Employers Associations in the Light Industry.

² Federation of Employers Associations in the Light Industry.

³ Estimates based on interviews with government agencies, SMEs and BSOs.

⁴ Estimates of the expert team based on interviews with government agencies, SMEs and BSOs.

Geographic Location



Source: Team Analysis, Interviews
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Adani, Couton, Joelson, Kiugi (2003)

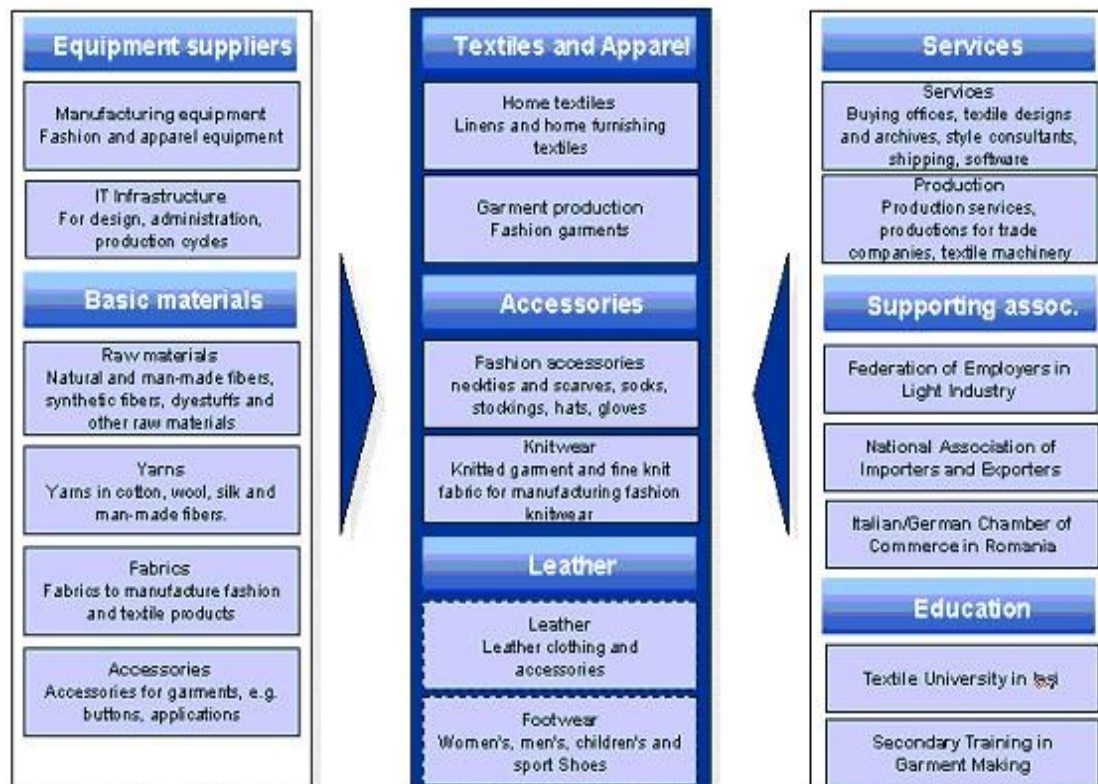
49. Production levels of the various textile products are listed below:

Production Level, 2001 (Romanian Statistical Yearbook)

<i>Products</i>	<i>Value</i>	<i>m.u.</i>
Cotton and cotton-type yarns	29,000	tons
Wool and wool-type yarns	10,000	tons
Flax and hemp yarns and flax- and hemp-type yarns	4,000	tons
Cotton fabrics	154,000,000	sqm
Wool fabrics	17,000,000	sqm
Flax, hemp, and jute fabrics	200,000	sqm
Silk fabrics	25,000,000	sqm
Unwoven textiles	14,000,000	sqm
Cotton knitwear	5,000,000	pieces
Wool knitwear	20,000,000	pieces
Silk knitwear	10,000,000	pieces
Socks and stockings	138,000,000	pairs
Textile clothing	47,103	billion Lei

50. Some examples of major industry segments and their interaction and integration are presented in the chart below.

Detailed composition of the Romanian textile and apparel cluster



Source: Team Analysis, <http://www.romtextiles.com>, Interviews

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Adani, Couton, Jbelson, Kugi (2003)

Sales and Profitability

51. Textiles have been an important and profitable industry for Romania. From 1996-2000, on average, the growth rate was 7.1% p.a. Productivity per employee has also increased. The table below shows the changes over the years in the both textiles and garment sub-sectors.

Textiles		1989	1992	1994	1996	2000	2001	2001 of 1989
Textiles - total production	US\$ mil	2,357	1,064	924	1,170	939	1,004	42.60%
<i>Cotton</i>	US\$ mil	753	329	267	379	201	214	28.42%
<i>Wool</i>	US\$ mil	586	269	229	259	189	202	34.47%
<i>Hemp & flax</i>	US\$ mil	223	82	74	56	33	30	13.45%
<i>Silk</i>	US\$ mil	197	84	67	67	50	48	24.37%
<i>Knitwear</i>	US\$ mil	598	300	287	409	466	510	85.28%
Export	US\$ mil	382	149	200	263	424	505	132.20%
Import	US\$ mil	455	454	672	1135	1,790	2,042	448.79%
<i>Textile supplies for garments</i>	US\$ mil	199	316	494	906	1,470	1,690	849.25%
<i>Imported textiles supplies</i>	US\$ mil	256	138	178	229	320	352	137.50%
Balance (export minus import of textiles)	US\$ mil	126	11	22	34	104	153	
Employees	Thousand	412.4	328	221	189	95	94.5	22.91%
Profit on turnover	%	12.6	5.6	2.3	1	0.5	5.5	43.65%

Garments		1989	1992	1994	1996	2000	2001	2001 of 1989
Garments- total production		1,643	627	1,337	1,821	2352	2,763	168.17%
<i>Textile garments</i>	US\$ mil	1543	557	1,277	1,771	2310	2,720	176.28%
<i>Leather & fur garments, gloves</i>	US\$ mil	100	70	60	50	42	43	43.00%
Export	US\$ mil	649	429	908	1,436	2082	2,493	384.13%
Import	US\$ mil	239	385	593	1,072	1728	2,040	853.56%
<i>of which "Lohn" supplies</i>	US\$ mil	212	360	557	1,026	1662	1,973	930.66%
Balance	US\$ mil	410	44	315	364	354	453	
Employees	Thousand	247.3	206	208	203	261	262.4	106.11%
Profit on turnover	%	15.2	19.1	11.4	15.7	9.8	11.9	78.29%

52. According to estimations of the Ministry of Planning and Development (2003), the textiles and garment industry is expected to have a growth rate of 9-10% until 2010, significantly higher than the estimated 5.6% growth of the overall Romanian economy. Footwear and leather goods are also expected to grow at a rate of 7%, while the knitwear and the fur and leather garments sub-sectors are expected to grow at a rate similar to that of the economy average. Growth is also expected for the spinning and weaving sectors at a rate of approximately 4%. Growth of employment in the textiles industry is also expected for the future.

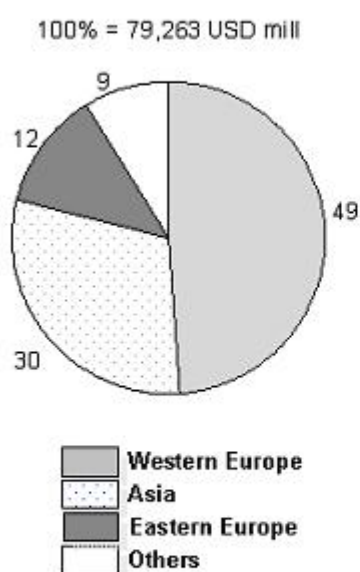
Exports

53. Garment exports, based on key product imports (in US\$ million), show a dynamic growth rate of 36.01% in 2001, as compared to 1999, while imports grew by 34.25%.¹ Exports of textiles overall, of textile products, and of the apparel sector in Romania grew significantly²: exports of textile products in 2001 were US\$505 million and exports of textiles, fur, and leather wearing apparel in the same year amounted to US\$2,493 million. As the industry moves into the 21st century, the links between customers and manufacturers will grow even closer. For instance, computer-based technology permits the rapid transfer of data, including design sketches, around the world. Therefore, if the Romania garment exports are to remain competitive, they will need to increase their technological capabilities.

54. Romania has the potential to expand the production and export of clothing in the short to medium term, more so through the local and Eastern European markets than in Western Europe. A development plan for exports from the sector has been formulated with the input of key stakeholders. The plan calls for an average increase in the value of exports from the textiles sector of US\$120 million every year until 2010.

Clothing imports in European Union by supplier country in 2001

in Percent



Rank	Supplier Country	% of total	Annual % change
1	EU	39.5	- 4
2	China	10.6	+ 3
3	Turkey	6.8	+ 5
4	Romania	3.7	+24
5	Tunisia	3.2	+ 8
6	Bangladesh	3.1	+ 4
7	India	3.0	+ 4
8	Morocco	3.0	+ 7
10	Poland	2.2	+ 1
12	Hungary	1.3	+ 1
13	Bulgaria	1.1	+23
22	Czech Republic	0.7	+ 3
23	Slovak Republic	0.6	+ 5

Romania largest Eastern European supplier of clothing to EU with high growth rate

Source: WTO
41

Adani, Couton, Joelson, Kugi (2003)

¹ FEPAIUS.
² FEPAIUS.

55. Hundreds of flexible, small- and medium-sized companies, and some 450 major suppliers of accessories and services, make up an increasingly strong cluster that can challenge most of the world's dominant suppliers. According to Wolfgang Limbert, programme coordinator of the German organisation IBD/GTZ, there is no doubt that Romania in the near future will strengthen its position as a main garment maker for Europe.

56. According to figures, if the average price per minute of CMT-priced goods presently offered by Hong Kong garment manufacturers is about US\$0.32 and that of Chinese mainland CMT producers is US\$0.05, Romania's offer stands at US\$0.09. Currently, Romania and other Central and Eastern European countries can export garments to the EU duty and quota free, which is an important advantage compared with the competitor Chinese mainland and Hong Kong firms. CMT prices in Romania are significantly lower than in Poland (US\$0.16) and Hungary and the Czech Republic (both US\$0.18). Although they are slightly higher than in neighbouring Bulgaria (US\$0.08), Moldavia (US\$0.07), Ukraine and Belarus (US\$0.06). In these countries the garment industry clusters are less well developed than in Romania.

Investments and Financing

57. Over the past eleven years, an equivalent of US\$1,335 million have been invested in the Romanian textiles and apparel industry, of which US\$720 million investment has been financed by companies from their own resources (including 31 million of state guaranteed loans), and US\$615 million from foreign direct investments.

58. Below are presented some of the investment projects that the government planned for 2003. The figures following each project represent the estimated value of the investment in million US\$¹:

<u>S.C. STOFE BUHUSI S.A. – BUHUSI</u> Production and distribution of a diverse range of semi-finished and finished products: washed wool, wool and type carded yarns, etc.	Modernisation of spinning and weaving section	7.2
<u>S.C. TRAINICA S.A. Pucioasa</u> Cotton and cotton-type yarns and fabrics, garments.	Modernisation of the weaving and spinning mill	4.0
<u>S.C. MEDIMPACT S.A. Medias</u> Manufacturing and trading of leather goods.	The increasing of production capacity for saddler articles	0.7

59. Romanian textile and garment SMEs have limited access to the financing which they need, in particular, for making investments to increase their technological capabilities. In fact, access to capital is one of the most serious constraints to the growth of the SME textile industry sector in Romania.

¹ Ministry of Industry and Resources.

60. Virtually no external funding, apart from some limited venture capital, is available for new start-ups. Conventional bank lending for the expansion of existing SMEs is virtually non-existent, due to lingering conservatism on the part of banks in the light of the serious bank crisis in the late 1990s. Although some funding is available from entities such as the Romanian American Enterprise Fund, they only scratch the surface of the current need for capital. The lack of access to capital is exacerbated by a limited knowledge of modern business principles. There appears to be a general need for basic training in the development of business plans, the keeping of financial statements, the preparation of budgets, and the analysis of cash flow.

61. In general, bank loans are difficult to obtain, as banks have high collateral requirements which far exceed the value of the loans. Moreover, loan repayment periods are short and the financing of long-term investment with loans of a longer maturity is almost non-existent. Financing is inadequate to ensure the continued development of textile companies. Garment companies, especially SMEs, do not have the own funds to buy the new equipment needed in order to increase their design and cut capabilities. While having the most modern equipment may not be crucial at the moment, due to low labour costs, in a short time it will become a major constraint.

62. Financing resources need to be directed towards investment projects that will give a high return on the invested capital and expert advice will be needed to ensure the profitability of planned investments. During 2003, a team of textile consultants visited several textile companies and observed that managers often demanded financing for investment projects that appeared not to be very profitable. For instance, some textile factory owners wanted to invest in new and more modern equipment, but the use of such machinery would require the factory to purchase higher grades of yarns and fibres in order to ensure that the machines would not breakdown. In fact, modern machines work at a faster rate and require better yarns so that they will not jam. The consultant team visited one factory where a good portion of the new equipment was down because of the problem that lower quality yarns had been fed through high-speed modern Italian equipment. The team explained that Romanian garment companies can refurbish some of their older equipment at much lower costs instead of replacing it with modern equipment. They also met one factory owner who had been able to repair and upgrade existing equipment for US\$1,000, rather than purchasing new equipment which would have cost him US\$100,000.

63. In another example, one factory manager suggested that he needed financing to buy additional space for expansion. However, the factory was working on only one shift, although it was stated that there was sufficient skilled labour available in the area. The consultants suggested that rather than investing in additional space, the factory could have a second shift and hire more labour, resulting in the same increase in production at a much lower required level investment and financing. Instead, available financing should be directed towards the purchase of CAD/CAM technology, which is important for companies which want to break with the LOHN system. As garment operations become more sophisticated, companies need to invest much more in the design part of the process. Creating unique and exciting designs quickly is an important way to remain competitive in the fashion garment business.

Business Support Organisations

64. During the past seven years, and especially the last three, an increasing number of employers' associations have been formed as an alternative to the traditional employees'

associations. These associations represent the views of enterprise managers and investors and their focus is on promoting increased growth and productivity in the sector. There are now six national associations which represent the whole industry and the various sub-sectors: ROMCONF; OCIMM (small and medium-sized garment manufacturers); TEXTILANA (wool industry companies) TRICONTEX (companies in the knitwear sub-sector); APPC (socks and stockings manufacturers); PINC (leather garments, footwear, and other leather products manufacturers).

65. The six associations have formed a Federation of Employers of Light Industry in Romania, FEPAIUS. This federation has been one of the strongest and most successful representative organisations of the private sector in Romania over the past three years, and it has over 300 member companies. The number might seem low as compared to the total number of companies which are registered in the sector, but they account for 62% of the current production volume and the exports of the sector. Also important for the industry are some local chambers of commerce like the ones in Iasi, Braila, Sibiu, Timisoara, Targu Mures, and Bucharest.

66. Business support services are available from three categories of organisations: local chambers of commerce; international business or economic development programmes funded by the US government, by the EU and European governments, and private business consulting companies.

Tourism Industry

67. The tourism industry in Romania is a US\$600 million industry which is expected to grow by 4.3 percent over the next 5 years. Romania offers a wide range of tourism products from cultural visits to historical sites to beach vacations at the Black Sea to mountain areas and the Danube Delta.

Enterprise Structure

68. There are approximately 10,147 companies in the tourism industry. Of these, 3,127 provide accommodation for tourists with a capacity of 287,268 beds. Approximately 80% of the companies which are active in the tourism sector are SMEs. While large state-owned companies have traditionally employed many of the approximately 100,000 people engaged in tourism, recently, many smaller private enterprises have emerged in the sector. SMEs often operate tourism agencies, small hotels, restaurants, and “bed and breakfast” facilities. The Black Sea Coast, in particular, is dominated by large, state-owned and formerly state-owned companies, while SMEs are scattered throughout the country. SMEs dominate the rural tourism industry, which caters to tourists who are interested in spending modest amounts of money for accommodation facilities in places that are not crowded and still unspoiled.

69. SMEs in the tourism sector have different backgrounds. Many small enterprises were formed by private entrepreneurs with small amounts of capital. Others, especially micro-enterprises, are family-owned and -operated businesses such as bed and breakfast facilities. Often the families who run these places have other sources of income in addition to the renting out of rooms. In rural and eco-tourism, almost 100% of the companies are SMEs which were started with small amounts of own capital and they are mostly family-owned and -operated businesses. Finally, some SMEs were started by the privatisation of ex-state companies.

70. All the types of SMEs that are found in the tourism sector share similar weaknesses, but for different reasons. SMEs that were formed through privatisation may have more disposable capital, but they were often purchased and managed by people who had no previous experience in the tourism industry. Many of these new tourism managers have experiences in other industries and they invested the profits that they gained in other economic activities in tourism. They often lack industry specific knowledge and know-how.

71. Many of the SMEs that were formed during the privatisation process required relatively low capital investment. Domestic investors who had good access to information and an ability to assess the risks of investments purchased many of these ex-state properties. The modest selling prices were certainly an incentive to domestic investors, but meant also that the State collected small amounts of money from the privatisation process. Also, foreign know-how was generally not infused into these companies.

72. Up to now SMEs in tourism have failed to coordinate their efforts in order to attract foreign tourists. A coordinated effort, however, will be needed to raise awareness about towns and regions which are unknown to tourists who live outside Romania. Foreign tour operators capture much of the value in the tourism market. Major tour operators abroad, especially in Europe, book tour packages for their clients. Some of these major European tour operators who serve Romania are Neckerman from Germany and Thomas Cook from Scandinavia. Local tour operators capture another piece of the foreign tourist market, but they rely heavily on foreign partners for clients. The foreign and local tour operators have a strong bargaining power over smaller hotels and pensions. The possible role of Business Support Organisations in bypassing such operators and connecting tourists directly with SMEs would enable local small enterprises to capture more of the value of each transaction.

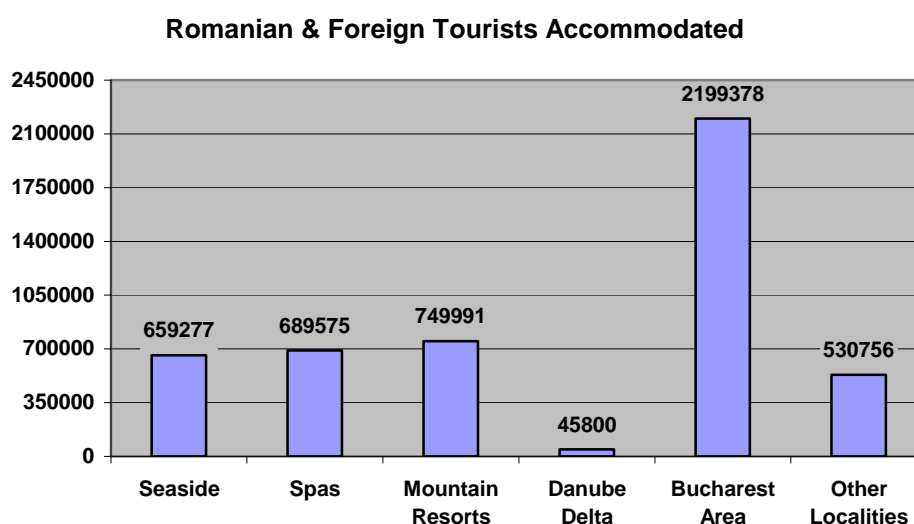
Competitiveness

73. There are several tourist products that have good potential to be of interest to foreign tourists, to create jobs in small and medium-sized enterprises and to attract foreign direct investments. A recent USAID study identified the following as the main products that are able to compete on the market in terms of attractiveness:

- Cultural tourism - The cultural spots in Romania are attractive and fairly unique.
- Health spa tourism - Romanian spas offer access to clean mineral water sources at modest prices.
- Rural and eco-tourism - Romania has expansive and unspoiled nature, often close to cultural attractions.
- Urban tourism – For instance, the city of Bucharest has many sites of architectural interest, fine museums and cultural entertainment, while Brasov, in Transylvania, has a beautiful town square with historic buildings surrounding it.

Location

74. The figure below presents the location of tourist accommodation in the main tourist areas:



75. While all the above listed products and locations have some attraction for foreign tourists, of the six products listed, four are more attractive for foreigners and have the highest potential for growth: cultural tourism, adventure tourism, spas and health tourism, and city tourism. Romania's main competitor in beach and cultural tourism is Bulgaria, while Hungary and the Czech Republic are main competitors for city tourism. Eco- and rural tourism, as well as spa and health tourism, are products which offer more opportunities for growth and which would need investment and financing. Rural tourism is offered in many areas of Romania but is concentrated mainly in the hilly and mountainous regions, the Black Sea coast and the Danube Delta. This type of tourism offers modest accommodation facilities in the rural areas of Romania which allow a more leisurely pace of life in the nature.

76. Rural tourism established itself as a tourism product only after the collapse of communism in 1989, but already today it can provide accommodation to 10,000 tourists with stays in smaller family-owned boarding houses. At present, there are 4,000 such tourist and agro-tourist boarding houses in Romania. Many domestic tourists are also interested in rural tourism, because it is generally less costly than other tourism products.

77. Eco-/Adventure tourism is located in the numerous mountains and forests all over Romania and around the Danube Delta. Many of the mountainous areas are virgin lands, still untouched by pollution, with abundant fresh air and beautiful sites. The mountainous regions, most notably the Carpathian mountain range, offer good quality ski resorts and a full programme of winter sports. Main leisure activities consist of hiking, hunting, and fishing. There are also numerous caves in the area, some with easy access and others more suitable for people interested in adventure tourism and sports. Tourists in mountainous areas stay either in hotels, motels, hostels, villas or at camp sites. This type of tourism has some overlap with rural tourism.

78. There is also tourism along the Danube, including the Danube Delta which, although not well known to foreigners, is a unique natural reservation area of 5,640 square km. The reed islands, inland lakes, oak forests, lianas and creepers, and desert dunes make the Delta shelter an ideal natural area for more than 300 species of birds. Fishing, hunting, and bird watching are major activities in the Delta, which has a great potential for growth.

79. Cultural tourism is focused around four locations: the painted monasteries of the Bucovina region; the castles and houses in the Maramures region and in Transylvania; and the art galleries and historical and contemporary sites in cities such as Bucharest. The main cultural attraction in Romania is the group of painted monasteries located primarily in the Bucovina region. These monasteries, which exhibit beautiful iconography on their outer walls and which are under the special protection of UNESCO, are considered as sites which belong to the cultural heritage of Europe. Visits to Maramures also offer displays of old Romanian folk traditions and festivals. Transylvania is noted for its rich multi-ethnic heritage, as it has been home to a mix of Germans, Hungarians and Romanians for hundreds of years, especially when the region formed part of the Austro-Hungarian Empire. Numerous ancient sites with medieval fortresses and castles are dotted over the Transylvanian region. Some of the sites that attract most tourists are the Bran or “Dracula” castle and the castle/fortress in Sigisoara.

80. Health/Spa tourism: currently, there are over 70 health resorts in Romania. Many of these places are located near the more than 3,000 mineral water springs that are found in the country. In addition to providing mineral water springs, the resorts also offer therapeutic mud and other spa treatments.

Tourism Market Structure

81. The Romanian tourism market is characterised by a relatively small number of large players with 3-4 star hotels – mostly located in Bucharest and the Black Sea region – and large numbers of independent smaller players offering 2-star or modest motels, pensions, guest houses and bed & breakfast rooms. The larger players compete with each other for a market share of the foreign tourism, while the smaller tourist facilities cater to a completely different market segment and, in general, do not compete with large foreign tourism operators or large, high quality hotels.

Turnover and Profitability

82. According to the National Institute of Statistics (NIS), the number of incoming tourists in Romania in 2002 was 4,793,700, approximately 2.9% lower than in 2001. Revenues of the tourism industry in 2002 were US\$4.7 billion, while the World Travel and Tourism Council (WTTC) estimated that tourist revenues in 2003 would grow by 6.6%. The WTTC also projects a 4.3% real growth rate per annum in the period from 2004 to 2013. Some of the most profitable companies in the tourism industry are located in the major resort areas. According to the Romanian Statistical Yearbook, in 2000, 93,000 people were employed in tourism, which represents 1.15% of the total Romanian labour force. This figure refers to direct employment in tourism. The WTTC estimated also that in 2003, the tourism industry would generate 116,174 direct jobs, while generated indirect employment would be 466,093. In 2002, 1,032,900 tourists arrived from EU member states, which accounts for 21.5% of the total number of foreign tourists. Between 2001 and 2002, the number of EU tourists increased by 5.3%.

Foreign Tourists

83. In terms of export readiness of the tourism sector, there are several areas which need to be improved. First, significant efforts must be made by both public and private sector players in order to promote Romanian tourist products to foreigners. Second, foreign tourist market players need to improve their customer services and quality products in order to attract and retain foreign tourists. Third, infrastructural improvements, in particular of roads, are required to provide better and easier access to the main tourist attractions.

84. Although the Romanian tourism market has the potential to be competitive, it is currently not competitive in marketing its products. In particular, the low level of ICT technology makes tourism less competitive: Romania has the second lowest rate of computer use in Europe, second only to Albania. Outside the capital of Bucharest, computer availability and access to the Internet are scarce. In fact, without the existence of a more sophisticated network of tour operators and also smaller hotels with access to the Internet, the ability to take advantage of online promotions and reservations will not be captured.

Investments and Financing

85. Many SMEs are unable to get the necessary financing to refurbish their accommodation and to make other necessary investments. Excessively high bank loan collateral requirements are one of the main barriers to accessing external financing resources which can complement own funds. Romania should develop its private tourism sector (including rural tourism) by increasing its share of traditional and large tourism markets (Germany, Hungary), while at the same time it should try to widen the breadth of its international markets. In order to better promote tourism, regional promotion & visitors bureaus should be set up in each county and should work together with local communities, the county tourism industry, chambers of commerce and other interested parties in promoting regional tourism. Such centres should also have information offices at border points.

Business Support Organisations and Business Service Providers (BSOs and BSPs)

86. A fairly large number of BSOs and BSPs are active in the tourism industry. While their number may seem impressive, in reality, only a few BSOs and BSPs really represent their members or provide valuable and effective support services. The following is a list of the most important BSOs and BSPs in the tourism sector:

- The National Association of Rural, Environment-Friendly and Cultural Tourism
- The Association of Travel Agencies
- The Bed & Breakfast Association
- The Romanian Hotel Industry Federation
- The Tourism Employers' Federation

87. The Bed & Breakfast Association was only formed in 2002, but seems to have emerged at the right moment. There are over 10,000 beds in the B & B sector and the B & B Association has as its mission the service of the needs of B&B owners. In order to increase the business volume of its members, the Association has started a professional and effective, interactive online reservation system. Each member must be fully licensed and operate in a legal and ethical manner. Member accommodation must also possess the relevant classification of its premises. The prices of members' B & B accommodation are set individually, but must be related to the level of classification that each premise has. The listing by classification and price make it easier for foreign tourists to use the B&B website. In addition, to provide its members with Internet listing, the B & B Association provides quality training aimed at raising the standards of the members.

88. The National Association for Rural, Environment-Friendly and Cultural Tourism (ANTREC) is a non-profit association that identifies, develops and promotes Romanian rural tourism. ANTREC was established in 1994 and has 30 branch offices throughout Romania. There are 3,250 members, including guesthouses and agro-tourism boarding houses, in 800 locations and the ANTREC network includes 1,965 units of rural accommodation. While the membership numbers may seem impressive, it should be noted that not all members are "active". Also, ANTREC offers its members only a very narrow range of rural tourism promotional services and it will be necessary to widen its focus by creating additional business through the development of an effective online reservation system.

ROMANIA

**BANK LENDING TO SMALL AND MEDIUM SIZED ENTERPRISES IN
RURAL AREAS; AN ANALYSIS OF SUPPLY AND DEMAND**

ANNEX 4

SME PROFILES

ANNEX 4
SME PROFILES

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ANNEX 4

SME PROFILES

4.1 Service Sector – the Motel Laonis

Region / County Registration Location

Timis county; Mandruloc village (1,200 inhabitants), between the towns Arad and Deva.

Legal Status – Management Structure

SRL – Limited Liability Company with two partners (husband and wife).

Subscribed (Paid-in) Capital

Initial capital was Lei 2,000,000; it has now been increased to Lei 75,000,000.

Starting Year

The family started from scratch, investing in the motel from 2002, finalising the construction of the facility in November 2003. The motel was then ready to open in 2004.

Number of Permanent / Seasonal Employees

The family employs three more staff all year round (5 in total).

Main Activities and Services Offered

This is a full-service 14-room motel that offers bed & breakfast service¹, cable television and private baths, light buffet, laundry service, telephone/email/fax and a 30-person conference room².

Assets Owned

The family owned the land and the house in which they live nowadays; extra space owned and available next to their house was utilised to build the motel. The company does not own the motel, but pays a monthly rent (below market price) to the individual to whom the motel is registered (in this case husband and wife).

Financing Strategies and Loan History

Loan (micro finance) amounts to only 3% of the initial capital needed. Personal savings originate from the previous activity carried out by the husband (a transportation company in 1994 and a second-hand vehicle dealer business during the same period).

- Initial investment was the following: €300,000 for construction. Repayment is expected to be completed over the next 5 years.
- Furnishings were acquired through commercial credit from suppliers, with only 30% paid in advance (a 10% discount would have been applicable if total payment had been made in cash).
- Loan was made available by a Credit Agency (CHF) / friends / own capital.

¹ Prices of rooms with breakfast included are the following: Single = €20, Double = €35, Triple = €50.

² A web site has also been implemented (www.motelioanis.home.ro)

1. The amount and conditions made available by the CA were:

Loan amount	US\$ 10,000
Period	24 months
Interest rate	16%
Collateral required	Land + car
Value of Collateral (estimated at market price)	120% (covers loan + interest)

Past Cash Flow - Projected Liquidity

2. The following table shows the cash flow comparison based on balance sheet data (which is the only financial statement required by law in Romania) between the pre-micro lending period (on a 6-month basis) and future projections during the loan availability year. There was no data available on the present economic & financial health of the company; therefore we will not examine the profitability of the business.

Table 01 LEI ('000)

Items	Jan - June 2003 (pre-lending)	July 2003 (loan start)	Aug - Dec 03 (projection)
Initial balance	3,009	17,723	-
Gross Income	2,310,901	133,531	1,895,870
Fixed expenses	663,306	143,720	1,404,814
Investments (ex. machinery/car/office space, etc)	196,881	0	363,000
Loan payments (Banks or CA)	0	0	51,161
Variable expenses	1,436,000	0	0
Total cash flow	17,723	7,534	76,895

3. This forecast cash flow statement predicts that there is enough money coming into the firm to pay all of its expenses.
4. The figures below show the previous economic state of the company (expressed in LEI '000):

Current assets as of July 2003	2,027,950
Current debts (liabilities) as of July 2003	1,318,536
Current ratio	1.54
Profit / Loss as of July 2003	879,089

5. The working capital ratio (current ratio) indicates if a firm has enough short-term assets to cover its immediate liabilities and is therefore technically solvent. A ratio between 1.2 and 2.0 is sufficient; this Company seems to be comfortably in this area and should therefore have no trouble in repaying creditors (short-term obligations)¹.

6. Actual figures weren't available through the accounting practice but, according to the interview carried out, these are the average amounts for 2004:

Table 02 LEI ('000)

Actual / average monthly	
Gross Income	250,000
Expenses	85,000

7. The table below suggests a future prospective of the business and results acquired:

<i>Strengths and opportunities</i>	The company has recently been certified ISO 9001 compliant. The demand for local / foreign tourism is growing and apparently there are not many local competitors yet. The occupancy rate calculated is around 65%.
<i>Weaknesses and threats</i>	They would like to request non-reimbursable funds but access has been meandering and time consuming.
<i>Future investment expectations</i>	Acquire more space and equipment to develop a restaurant: this would mean rearranging space where the kitchen area is (no need to build an extension). The whole investment would amount to US\$80,000 (Investment Capital only).

4.2 Production Sector – Dan Paper LTD

Region/County Registration Location

Timis county; Covasint village, near Arad town.

Legal Status – Management Structure

LTD – Limited Liability Company with two partners (husband and wife).

Subscribed (Paid-in) Capital

Initial capital was Lei 2,000,000 ; it has now been increased to Lei 75,000,000 .

¹ An access of current assets over current liabilities acts as a buffer against losses that may occur in selling inventory, collecting accounts receivable or liquidating current investments. In general, a business with less inventory and more collectible accounts receivable can operate safely with a lower current ratio than a company having a high percentage of current assets in inventory: the quality of the current assets and the nature of the current liabilities must therefore be considered (ex. work-in-progress inventory has a higher realisation risk than finished goods). Data gathered in the field makes these in-depth analyses inapplicable at this stage.

Starting Year

The owner started from scratch in 1998 when the house basement was set up for the activity. The owner previously acquired sector knowledge when he was working in a printing house.

Number of Permanent / Seasonal Employees

The Company employs 16 permanent staff (including husband and wife).

Main Activities and Services Offered

This is a printing house offering a wide range of products: notebooks, posters, small magazines, etc. Clients are spread over 4 counties including bookstores, individuals and accounting firms. In 2002, the company was the 3rd reseller in the whole county for school products. Approximately 30 more medium-sized companies operate in the same sector. The company has lately expanded into distributing stationery like pencils, rubbers etc. The production is partially based on orders (20%) and on spontaneous demand (stock is therefore traced). The paper bought by the company is Romanian (approx. 25 tons every 20 days).

Assets owned

Land, house and second-hand machinery.

Financing Strategies and Loan History

Personal savings originate from the previous activity carried out by the owner (worked in Germany for a printing house).

- Initial total investment needed to finance equipment and working capital was: DM 55,000 (Deutsche Mark). Amount was supplied using personal savings.
- Managed to obtain a credit line from Banc-Post of Lei 35 million (credit capital); commission was due every quarter, although not breaking into the amount: he therefore decided to close the line. Credit was given to this entrepreneur only because he had promised a job to one of the bank staff.
- Commercial credit with main suppliers is 60 days (while 30-45 days credit is provided to his resellers).
- Initial loan was made available by a Credit Agency (CHF): the company obtained 4 loans during the 1999 period up to now, plus five short-term loans, mainly to finance investment capital.

8. The amount and conditions made available by the CA concerning the last loan in 2003 were:

Loan amount	US\$ 20,000
Period	24 months
Interest rate	14%
Collateral required	House
Value of Collateral (estimated at market prices)	120% (covers loan + interest)

Past Cash Flow - Projected Liquidity

9. The following table shows the cash flow comparison based on balance sheet data (which is the only financial statement required by law in Romania) between the pre-micro lending period (on a 6-month basis) and future projections during the loan availability year. There was no data available on the present economic & financial health of the company; therefore we will not examine the profitability of the business.

Table 01 LEI ('000)

Items	Jan - June 2003 (pre-lending)	July 2003 (loan start)	Aug - Dec 03 (projection)
Initial balance	17,060	21,010	10,588
Gross Income	1,647,117	232,131	3,008,418
Fixed expenses	1,032,641	113,020	1,370,490
Investments (ex. machinery/car/office space, etc)	162,270	31,565	397,719
CHF Loan payments	300,980	32,020	377,174
Bank loan payments	21,776	5,948	110,335
Variable expenses	125,500	60,000	720,000
Total cash flow	21,010	10,588	43,288

10. This forecast cash flow statement predicts that there is enough money coming into the firm to pay all of its expenses.

11. The figures below show the previous economic state of the company (expressed in LEI '000):

Current assets as of July 2003	2,227,714
Current debts as of July 2003	369,773
Current ratio	6.02
Profit / Loss as of July 2003	- 40,529

12. The Current ratio is greater than 2, in which case the enterprise can meet its liabilities 6 times over: too much money may be tied up in non-earning ways. Investments for a longer period should therefore be considered.

13. Actual figures weren't available through the accounting practice, but according to the interview carried out, these are the average amounts for 2004:

Table 02 LEI ('000)

Actual / average monthly	
Gross Income	200,000 – 800,000
Expenses	Approx 80% of Income
Wages	Approx 10% of Income
August 2004 Turnover	650,000

14. The table below suggests a future prospective of the business and results acquired:

<i>Strengths and opportunities</i>	Continue product diversification and market expansion.
<i>Weaknesses and threats</i>	The demanding of higher quality products has now become more noticeable: improving the machinery is seen as a necessity. Leased equipment still has a high cost compared with second-hand machinery (ratio is 1:5).
<i>Future investment expectations</i>	Acquire new or second-hand equipment to meet EU standards: this would mean a total investment of US\$ 100,000 (the purchase of two second-hand machines has been postponed). Labour conditions for employees are perceived as a need, and must be strengthened.

4.3 Transport Sector – Auxerre Trans LTD

Region / County Registration Location

Timis county; Lugoj town (49,860 inhabitants).

Legal Status – Management Structure

LTD – Limited Liability Company: 2 partners (husband and wife).

Subscribed (Paid-in) Capital

Initial capital was Lei 2,000,000.

Starting Year

Started the activity in 1997; the owner was previously working in trading stores.

Number of Permanent / Seasonal Employees

The Company employs 12 permanent staff (including husband and wife, 8 drivers and 2 administrative personnel).

Main Activities and Services Offered

This is an International Carrier company; goods are transported mainly throughout Italy, Germany and Poland (toys, second-hand parts, wood and construction material, non perishable goods). Annual contracts with clients make up 70% - 80% of the turnover.

Assets Owned

At the moment the total fleet is 5 trucks.

Financing Strategies and Loan History

Personal savings, originated from previous activity, helped the company buy one second-hand truck in 1997. Trucks are all leased for 4 years (leasing will end next year): the down payment is between 10% – 15%. The initial value of each truck is approx. €70.000: after 4 years the remaining value is 20%.

- Commercial credit is 45 days (after transportation).
- Obtained a lease line from Raiffeisen Bank for 1 truck (the other trucks are under different leasing institution agreements).
- Commercial credit with main suppliers is 60 days (while 30-45 days' credit is provided to the company resellers).
- Loan was made available by a Credit Agency (CHF): the company obtained a loan to finance working capital.
- Further un-quantified funding for working capital was provided by Tiriac Bank.
- Same-day transactions made possible by opening savings account in the same bank used by clients (Raiffeisen Bank).

15. The amount and conditions made available by the CA concerning the last loan in 2002 were:

Loan amount	US\$15,000
Period	24 months
Interest rate	15%
Collateral required	2 Vehicles
Value of Collateral (estimated at market price)	120% (covers loan + interest)

Past Cash Flow - Projected Liquidity

16. The following table shows the cash flow comparison based on balance sheet data (which is the only financial statement required by law in Romania) between the pre-micro lending period (on a 6-month basis) and future projections during the loan availability year. There was no data available on the present economic & financial health of the company; therefore we will not examine the profitability of the business.

Table 01 LEI ('000)

	Jan - June 2002	July - Dec 2002	Jan - Dec 2003
Initial balance	32,987	119,848	188,755
Income	8,167,927	8,712,454	21,101,272
Fixed expenses	3,729,394	5,414,885	11, 970,008
Investments (ex. machinery/car/office space, etc)	1,426,708	1,584,609	5,106,646
CHF Loan payments	198,000	198,000	287,100
Bank loan payments	853,685	636,922	1,921,547
Other expenses	1,873, 279	809,131	1,821,000
Total cash flow	973,533	825,677	2,105, 273

17. This forecast cash flow statement predicts that there is enough money coming into the firm to pay all of its expenses.

18. The figures below show the previous economic state of the company (expressed in LEI '000):

Current assets as of December 2002	1,417,910
Current debts as of December 2002	709,543
Current ratio	2.00
Profit / Loss as of December 2002	252,219

19. This current ratio is at the most desirable level: the enterprise can meet its liabilities twice over. There is assurance that current liabilities can be paid.

20. Actual figures weren't available through the accounting practice, but according to the interview carried out, the table below shows examples of average amounts for 2003:

Table 02 EUR

Actual / average monthly	
Gross Income	40,000
Fuel Expenses	6,000
Wages	5,000
Insurance per truck (also covering goods)	300 – 400
Phone expenses	1,000
2003 Turnover	Lei 15 billion
2004 expected Turnover	Lei 20 billion

21. The table below suggests a future prospective of the business and results acquired:

<i>Strengths and opportunities</i>	Company is situated in a favourable location in the vicinity of the border and of the region in which it is registered.
<i>Weaknesses and threats</i>	No ISO certificate was ever granted (ex. ISO 9002 certificate in 'Domestic and international road transport, forwarding and logistics'). All authorisations (licenses) must be obtained in Bucharest: with the EU accession licences will be abolished and only a general one-time license from the Romanian government will be needed.
<i>Future investments expectations</i>	Main investment in the near future will be renting a garage. All trucks are EURO 3 compliant: in order to meet the EU EURO 4 requirements new trucks should be bought / leased.

4.4 Commerce/Trade Sector (Shop)- Solar M&M LTD

Region / County Registration Location

Timis county; Lugoj town (49,860 inhabitants).

Legal Status – Management Structure

LTD – Limited Liability Company: 2 partners (husband and wife).

Subscribed (Paid-in) Capital

Initial capital was Lei 2,000,000.

Starting Year

1999.

Number of Permanent / Seasonal Employees

The company employs 6 permanent staff and 1 part-time accountant.

Main Activities and Services Offered

This is a multi-purpose shop with more than 140 product categories, mainly household articles. The Company has 3 sales outlets: the shop visited, plus a second store reselling electrical appliances and a third commercial space which is not yet operational.

Assets Owned

The family owns the space due to a US\$30,000 pre-emption which occurred in 1999: the entrepreneur (the wife, in this case) worked from 1965 in the cosmetic / porcelain sector, and acquired and privatised the shop from the previous commercial space owner.

Financing Strategies and Loan History

Loan (micro finance) amounts to only 3% of the initial capital needed. Personal savings originate from the previous activity carried out by the husband (a transportation company in 1994 and a second-hand vehicle dealer business in the same period).

- Loan was made available by a Credit Agency (CHF) / friends / own capital.
- RDB (Romanian Development Bank): financed initial investment with a US\$30,000 loan supplied in 2 months and provided 3 loans (US\$8,000 each) for the recurrent production (working capital). The collateral required was the apartment, car and land.
- Commercial credit from suppliers is 45 days (approx. 140 suppliers in total).

22. The amount and conditions made available by the CA were:

Loan amount	US\$15,000
Period	24 months
Interest rate	15%
Collateral required	Apartment
Value of Collateral (estimated at market price)	120% (covers loan + interest)

Past Cash Flow - Projected Liquidity

23. The following table shows the cash flow comparison based on balance sheet data (which is the only financial statement required by law in Romania) between the pre-micro lending period (on a 6-month basis) and future projections during the loan availability year. There was no data available on the present economic & financial health of the company; therefore we will not examine the profitability of the business.

Table 01 LEI ('000)

	Total 2003 (pre-lending)	Jan 2004 (loan start)	Feb - Dec 04 (projection)
Initial balance	127,523	56,360	26,291
Income	11,518,793	616,210	12,094,733
Fixed expenses	925,097	563,444	972,850
Investments	5,292,111	0	5,470,874
CHF loan payments	176,250	14,670	501,870
Bank Loan payments	4,847,011	68,165	4,822,787
Other expenses	349,487	0	300,559
Total cash flow	232,610	40,961	553,954

24. This forecast cash flow statement predicts that there is enough money coming into the firm to pay all of its expenses.

25. The figures below show the previous economic state of the company (expressed in LEI '000):

Current assets as of January 2004	3,017,681
Current debts as of January 2004	889,950
Current ratio	3.39
Profit / Loss as of January 2004	82,563

26. The current ratio is greater than 2, in which case the enterprise can meet its liabilities nearly 3.5 times over: too much money may be tied up in non-earning ways. Investments for a longer period should therefore be considered.

27. Actual figures weren't available through the accounting practice, but according to the interview carried out, these are the average amounts for 2003:

Table 02 LEI ('000)

Actual / average monthly	
Net Income	Lei 181 million
Expenses	Lei 85,000
2003 Turnover	Lei 800 million

28. The table below suggests a future perspective of the business and results acquired:

<i>Strengths and opportunities</i>	This is the only shop of its kind in town. The economy is gradually growing, thus families feel the need to renovate their homes using better quality products; plus the country is facing a major boost in the amount of construction, which is expanding the real estate market.
<i>Weaknesses and threats</i>	None emerged
<i>Future investments expectations</i>	Open the third shop; working capital will be acquired through commercial credit. Buy a Van.

4.5 Calarasi County Chamber of Commerce

29. During a joint meeting in the Calarasi Chamber of Commerce, Industry and Agriculture between the FAO team and some 10-15 agro-processing SMEs, each enterprise gave a short briefing:

- Vegetable and Fruit Processing SME (Name?): Located in a small city of 30,000 inhabitants. Established in 2003 with operations starting in August, 2004. Canning of local vegetables. Number of permanent workers has already increased from 20 to 40. Received a bank loan equivalent to US\$20,000 from BCR. Planned annual turnover of €500,000.

- Fructopan fruit and vegetable processing enterprise in Mitreni (Inhabitants?): The SME has a flourmill (80% of the enterprise's total annual turnover); a vegetable and fruit processing plant (annual turnover of US\$1 million; an export contract with a French company for the past 10 years); and a 6.5 ha farm for the biological cultivation of fruit and vegetables, plus a greenhouse. Total of 12 permanent workers plus seasonal workers (50-60). Planned investments: expanded plus continuous processing (currently, seasonal) throughout the year plus packaging equipment for flour products.
- Meat Processing Donald SRL (veal + pork): 64 permanent workers. Meat imported from Western European countries. Annual turnover of US\$2 million. Existing slaughterhouse needs US\$200,000 investments in restructuring and modernisation of the slaughter and processing facilities in accordance with EU norms – to be financed with own capital. Bank loans depend on collateral and good business plans are not taken into consideration. Co-finance of bank loans is needed with other funding sources.
- Farmer: has rented 1,000 ha in the commune. Started in 1994; in 2000 obtained ecological certificate for exports. Production: wheat, barley, sunflower, peas. Annual turnover of €1 million. Has had during the last 2 years contracts with a Dutch company (not satisfactory and suspended, resulting in unused product stock) and a Greek company. 12 permanent workers. Received over 50 bank loans (See the previous preferential subsidised Government credit programmes). BCR bank services are rather prompt and the farmer considers the Rural Credit Guarantee Fund effective. Last received bank loan of €275,000 at favourable conditions from the Oiko Bank in the Netherlands, used for the financing of storage facilities. Due to production failures (limited irrigation capacity!), rescheduling is needed of loan repayments. Investment plans: animal production; cultivation of alfalfa; irrigation modernisation; new plant for the processing of alfalfa pellets to be used for animal feed. The farmer intends to apply for a SAPARD investment grant for agricultural machinery.
- Agrosud: livestock farm (100 milk cows, 700 sheep, 200 goats) with shelter facilities for an additional 1,000 animals; vegetable cultivation (1,000 ha rented land); and a private slaughterhouse for cows, pigs and sheep (Investment plan to modernise the slaughterhouse in order to comply with the EU standards). Applied for a SAPARD investment grant, but the minimum required investment amount of €600,000 was too big and the farmer did not have sufficient own capital and bank loans to co-finance the investment; 52 permanent workers (for the past 5 years). Annual turnover of €1 million. Last bank loan from BCR is still outstanding and Lei 2.8 billion (less than US\$100,000) has to be repaid next year. Bank loan collateral problem: 120-160% of the value of the bank loan. Used the Rural Credit Guarantee Fund, but considers that the commission fee of 2-6% is too high, while instead of having to pay the guarantee in advance, it should be allowed to be paid in monthly instalments. The view is that SAPARD is not meant for farmers, but for banks and foreign investors. Farmers also need technical assistance for the preparation

of good business plans, in particular, in the case of loan applications to banks for investment finance.

4.6 Agro-Processing: Cramel SRL – Vineyard plus Winery

Region / County location

Recas: small village in the Timis County.

Legal Status – Management Structure

SRL – Limited Liability Company. Management: One British plus two Romanian partners (former management staff of the privatised state wine farm).

Starting Year

Privatisation started in 1998 and lasted until 2000.

Number of Permanent / Seasonal Employees: 150 permanent, plus seasonal workers.

Main Activities and Services Offered

Winery: processing, storage, bottling, large cellar, tasting facilities and sales shop. Annual wine production: 5 million litres with 4 million bottles in 2003. Exports: 75% of the annual production; worldwide (UK, USA, Canada, Asia).

Assets owned

750 ha vineyards with 15-20 ha renewal per year. Modern technology and equipment from Treviso, Italy are used.

Financing Strategies and Loan History

A first SAPARD grant of €725,000 received for modernisation of facilities and equipment. Investments will be completed in March, 2005. A second SAPARD application of €250,000 for the renewal of vineyards is under process.

30. The table below presents investment plans and constraints:

<i>Investments plans</i>	The company has several home banks: BRD and Raiffeisen Bank, with no particular preference. No long-term investment loans received from banks. The company would be interested in the Facility for financing of required investments, in particular for the renewal of the vineyards and vineyard/winery equipment, provided there is not too much time delay in receiving bank loans.
<i>Weaknesses and threats</i>	SAPARD procedures take more than 8 months.

4.7 Agro-Processing: Lioprest SRL – Cheese Making

Region / County Registration Location

Calarasi city; Calarasi county

Legal Status – Management Structure

SRL – Limited Liability Company: One family entrepreneur with a previous trading background of import/export of animals during the period 1990-95.

Starting Year

1998

Number of Permanent / Seasonal Employees

32 permanent employees, of which 14 work in the visited, small but efficient cheese processing plant (working in two shifts).

Main Activities and Services Offered

Multi-activity company: cheese processing and vineyard/winery (only sold on domestic market). Purchase of raw milk: 10 tons of milk per day, which is collected from an average distance of 70 km. Production: 25 tons of cheese per month (mostly soft cheese, both from cow and goat milk). Selling of cheese: 10% local and 90% in Bucharest.

Financing Strategies and Loan History

A first investment loan from the Tiriac bank in 1998: US\$100,000 (50% of the total investment costs) obtained in 1 week's time; collateral: 200% of the loan value, consisting of mortgage of the factory (US\$160,000) and other guarantees (US\$40,000). Loan maturity: extended from 1 to 2 years. Initial bank commission fee of 1% and charging of current bank lending rate.

- Value of investments in equipment: €300,000.
- Annual turnover of about US\$1 million

31. The table below suggests investment ideas and strong points and constraints of the business:

Strengths and opportunities	The only cheese processor in the county, with good traditional product quality. Full compliance of the plant with EU standards.
Weaknesses and threats	Not interested in SAPARD grant investment finance, as allocation is considered political (<i>Note</i> : Not known if the enterprise was maybe not eligible for SAPARD finance).
Investments plans	Planned investments over 2 years: factory in another location, plus new equipment with an estimated total investment value of €1 million.

4.8 Agro-Processing: Prodinpest SRL – Fish Processing

Region / County Registration Location

Calarasi city; Calarasi county

Legal Status – Management Structure

SRL – Limited Liability Company: two families as partners. Background of partners: commercial/legal and technical (former employee of ex-state fish company).

Number of Permanent / Seasonal Employees

The company employs 17 permanent workers (half women) and 1 part-time accountant.

Main Activities and Services Offered

Supply of raw fish: 30% fresh local fish and 70% imported fish from N. Europe.

Production: 20 tons of processed fish per month and 13 tons of fresh fish per month. Wide product assortment with different packaging modes (jars, plastic, cellophane) and with company labelling.

Assets Owned

Own transport vehicles for the distribution of the products in 6 different counties.

Financing Strategies and Loan History

A SAPARD investment grant application would not be successful due to the collateral problem (lack of sufficient fixed assets) of 50% bank finance. For this reason, the entrepreneurs suggested that the new EU/EBRD Facility explore the possibility of leasing (no collateral required) and suggested the Motoractive Leasing SA a company which operates in the county.

32. Turnover in 2003: €1 million with as clients: 10 supermarkets (annual contracts) and many smaller retailers.

33. The table below presents ongoing and future investment plans:

<i>Investment plans</i>	For its new location, the company has just bought the large abandoned buildings (7,000 square metres) of an ex-state meat factory in Calarasi, close to the current plant. The site is in the process of gradually being refurbished with refrigerators, cooling stores and new fish processing facilities and all will be brought up to EU standards. For the required investments own capital will be used, while a loan of €500,000 is sought.
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4.9 Agro-Processing: Aldis SRL - Meat Processing

Region / County Registration Location

Calarasi city; Calarasi county.

Legal Status – Management Structure

SRL – Limited Liability Company owned by one family (husband and wife).

Starting Year

1991

Number of Permanent / Seasonal Employees

700

Main Activities and Services Offered

Started as a small meat processing plant (200 square metres) operating only in Calarasi county; now an impressive large and modern enterprise complex (18,000 square metres), selling nationwide. Is not an SME but a large enterprise (700 permanent workers) with an annual production of 18,000 tons of processed meat for the domestic market. Uses German machinery. Imported meat is used as raw material.

Financing Strategies and Loan History

Bank finance from the home bank, BCR. An application was made to SAPARD for an investment grant of €2 million, which was not approved because the location of the factory in the Calarasi city is not rural. In general, SAPARD procedures are bureaucratic and take too much time. High investment made in up-to-date technology and equipment like refrigerators and cold stores and with production facilities for processing, seasoning, smoking, storage (aging + curing), packaging and labelling. Owns a large and well-equipped truck fleet for a countrywide distribution network (in 30 counties and with 32 warehouses in large cities). Currently in the process of installing own slaughterhouse facilities (depended before on another slaughterhouse in Calarasi, Donald SRL).

34. The table below presents results achieved and ongoing investments:

<i>Strengths and opportunities</i>	It is the foremost company in the county and it has national coverage. Very high hygiene standards and modern facilities.
<i>Investments</i>	Restructuring of the existing factory according to EU standards will be completed by the end of 2004.

4.10 Farming and Agro-Processing: Agrosud SRL

Region / County Registration Location

Calarasi county; Oltenita town (45,000 inhabitants): enterprise headquarters and slaughtering/processing facilities plus a farm in the Spantov commune.

Legal Status – Management Structure

SRL – Limited Liability Company

Subscribed (Paid-in) Capital

Lei 50,000,000,000

Starting Year

1994

Number of Permanent / Seasonal Employees

52 permanent workers

Main Activities and Services Offered

This is an agribusiness/farm enterprise: dairy animal and vegetable farm and a slaughterhouse (for goats, cows, pigs and sheep). The company pasteurises, packs and sells milk on the Bucharest market. Goat's milk is also processed to make cheese. Vegetable production is more profitable than animal farming and for this reason the company intends to extend this activity in the near future.

Assets owned

- 20 bulls
- 110 milk cows (1,000 litres milk/day)
- 500 sheep
- 110 goats
- Slaughterhouse
- Dairy farm (capacity for 1,000 animals)
- Stables
- Transport vehicles
- Agricultural machines
- The company is renting 900 ha with a 49-year concession.

Turnover

<i>Year</i>	<i>Annual turnover (thousand Lei)</i>	<i>Annual turnover (equivalent Euro)</i>
2001	56,788,439	2,183,113
2002	47,792,923	1,529,569
2003	38,182,766	1,006,452

Note: 83% of the annual turnover comes from production and the remaining 17% from trading.

Financing Strategies and Loan History

Last loan amounted to Lei 2.5 billion from the Banca Commerciale Romana.

35. The table below presents the results of the business and investment plans:

<i>Strengths and opportunities</i>	Develop and improve the animal farming business.
<i>Weaknesses and threats</i>	A major issue in the county is the chain development of animal feeding – processing – selling. Applied for SAPARD investment grant without result.
<i>Investment plans</i>	Financing required for refurbishing of space for 1,000 additional goats (worth €300,000). Other necessary investments, worth €250,000, for: <ul style="list-style-type: none"> ■ Fixing stables and irrigation system ■ Renting of 866 ha of additional land (contract for 49 years) ■ 200 cows ■ 2,000 pigs ■ Machines (worth €100,000)

4.11 Organic Farming and Agro-Processing – Fructopan SRL

Region / County Registration Location

Calarasi county, commune of Mitreni (4,500 inhabitants)

Legal Status – Management Structure

SRL – Limited Liability Company

Subscribed (Paid-in) Capital

Information not available

Starting Year

1990

Number of Permanent / Seasonal Employees

12 permanent workers (plus temporary workers during peak production seasons).

Main Activities and Services Offered

Processing of organic horticulture (jars of beans, tomatoes, peppers, cucumbers, egg plants).
Grain and corn flour mill.

Assets Owned

- Flour mill (160sqm) –estimated value Lei 5 billion
- Vegetable preservation factory: 6,000 sqm land (estimated value: Lei 103 million), building (Lei 7 billion), equipment and machines (Lei 530 million), truck (Lei 100 million), thermo-isolated car (Lei 100 million)
- 4 greenhouses
- 7.5 ha land for crop cultivation (Lei 130 million)
- 1 ha land (Lei 12 million)
- Note: Forest land surrounding the farm which provides protection against possible crop diseases (is not property).

Financing Strategies and Loan History

Personal savings from a previous activity (shop) were used for the start-up of the business.

- Loan of Lei 7,000,000 in 1991 from Banca Agricola (without the need to provide collateral).
- Lei 66 million provided in 1992 from Banca Agricola for building the mill.
- Lei 400 million in 2001 from Banca Comerciala Romana for building the vegetable processing factory.

36. The table below presents the market perspectives of the enterprise:

<i>Strengths and opportunities</i>	The Romanian market will become increasingly interested in organic products. No competitors in the county at this time.
<i>Weaknesses and threats</i>	Production is seasonal. The company has only one contract with a French distributor who decides which products should be processed. At the same time, primary ingredients like oil and lemon are bought from the French contractor. The Romanian final consumer on the domestic market is not yet prepared to pay extra costs for organic food and all production is for export.

37. ***Investment plans:*** Machine for closing jars plus concentration machine (EU standards): €150,000. Other future investment ideas are: micro heating plant; another warehouse; small tractor.

4.12 Agro-Processing - CPF Tomato SRL

Region / County Registration Location

Calarasi county, Oltenita town (45,000 inhabitants)

Legal Status – Management Structure

SRL – Limited Liability Company

Subscribed (Paid-in) Capital

No information available

Starting Year

2003

Number of Permanent / Seasonal Employees

20 permanent workers

Main Activities and Services Offered

This is an agro-processing plant: tomato/compute (CAEN Code 1533) with a daily production capacity of 20,000 jars.

Assets Owned

The enterprise owns the plant and warehouse and all machinery.

Thermo electric micro-plant.

2,007 sqm of land.

Financing Strategies and Loan History

Last loan in 2003 was from Banca Commerciale Romana under the special National Employment Agency Program (ANOFM Calarasi); amount and conditions of the loan were:

Loan amount	US\$20,000 (Lei 600,000,000)
Period	3 years
Interest rate	5.0475% /year
Collateral required	House and savings deposit

38. Proposals to improve the financial services are:

- Lower interest rates for investment loans
- Accept product inventories as collateral

39. No actual accounting figures were made available, but estimated average results for 2004 are:

Average / monthly	
2004 planned Income	€12,000
2004 planned expenses	€10,000
2004 estimated profit	15% of Income

40. The table below presents the situation of the business and investment plans:

<i>Strengths and opportunities</i>	Only 1 competitor in the same county. The entrepreneur will start with concentrate juice processing.
<i>Weaknesses and threats</i>	Need to diversify production assortment.
<i>Future investments expectations</i>	Hire 20 new employees. Necessary investments are: <ul style="list-style-type: none">■ Water filter■ Refurbish the warehouse■ Buy an adjacent building for the administrative office. An initial investment amount of €150,000 would be needed.

ROMANIA

**BANK LENDING TO SMALL AND MEDIUM SIZED ENTERPRISES IN
RURAL AREAS; AN ANALYSIS OF SUPPLY AND DEMAND**

ANNEX 5

SURVEY OF SMEs IN RURAL COMMUNITIES

ANNEX 5

SURVEY OF SMEs IN RURAL COMMUNITIES

1. A survey was carried out of SMEs in rural communities between 10 and 25 August, 2004. The sample was chosen at random, primarily from among clients of banks and credit cooperatives. This has undoubtedly biased the perception of bank credit received by the respondents as compared to the general situation of SMEs in rural areas, but the aim was to get a better insight into bank credit on the part of clients. The survey was not intended to get statistically representative responses, as the main objective was to assess the potential demand for credit and the perception of the relationship between banks and entrepreneurs who are seen as more active in their communities. A second objective was to evaluate the extent to which SMEs are accustomed to observing standard requirements for obtaining bank loans and to provide adequate business plans for their intended investments and all other required documents.
2. Questionnaires were used for 102 entrepreneurs in 23 out of the 41 counties in Romania. In most cases, the respondent was the manager/owner of the business. 93 questionnaires were validated (in 9 cases, the answers proved to be highly inconsistent and they were therefore annulled) and they are distributed as follows:
 - 56 in 10 counties in the Transylvania and Banat regions (the western part of the country) – subsequently referred to as “Region I”.
 - 28 in 9 counties in Muntenia, Oltenia, and Dobrogea (the southern part of the country) – referred to as “Region II”.
 - 9 in 4 counties in Moldova (the north-eastern part of the country) – referred to as “Region III”.
3. This distribution observes, to a certain extent, the degree of development by region (except the capital city and the surrounding area) with regions II and III as the recognised poorer areas in the country.
4. The age structure of the enterprises, as far as the duration of the economic activity performed is concerned, is presented in Table 1. A quarter of the respondents started their business in the last 3 years, almost a third between 1996 and 2001, and 41 percent before 1996. Three percent of the respondents did not answer the question.
5. The legal status of the enterprises is presented in *Table 2* below:
6. It can be remarked that the respondents did not make a clear distinction between the type of business (e.g. farm, company, cooperative, other) and the legal status of the enterprise (single owner, association, registered company and different legal types of companies).
7. The main activities of respondents are summarised in *Table 3*. As some respondents are engaged in more than one activity, the number of answers is higher than the number of respondents.
8. Most respondents are engaged in agricultural activities or agro-processing. Mention should be made though that, in our sample, the structure by activity does not observe the statistical distribution in the country, since non-agricultural rural business holds a larger share in

the sample. However, such a distribution may be closer to the effective demand for credit that comes from rural SMEs.

9. Table 4 shows the number of respondents who are engaged in more than one activity. In most cases, the second activity is trade – mainly in the same field as their primary activity.

10. The subscribed capital of the enterprises is generally low and understates their real strength. In our sample, the average per respondent is slightly above €20,000 – an amount that may be indicative of the minimum loan size to be extended to final borrowers under the Facility. However, the picture is different when taking into consideration the turnover of the same enterprises. The average in the sample is €178,000 in the first half of 2004, with the following territorial distribution:

- Region I: €229,000;
- Region II: €71,600;
- Region III: €38,000.

11. It should be mentioned that 29 percent of participants did not respond to the question regarding the subscribed capital, while 16 percent did not respond to the question on turnover in the first half of 2004. For the previous years, the non-response rate was even higher, which proves that the managers show little interest in financial data or at least are reluctant to share this information with outsiders.

12. The structure of the respondent enterprises, by group size, can be summarised as follows:

13. 81 percent of the respondents reported that they employ permanent workers (meaning that the remaining 19 percent have either no employees or did not respond), while 44 percent also have seasonal workers – a quite common feature in agriculture. The average number of permanent employees is 23.6, while the number of seasonal workers is 12.1 (when applicable). The size structure of enterprises by number of permanent employees and by region is presented in Table 6.

14. As far as the financial accounts of the enterprises are concerned, the respondents declared that they kept balance sheets (81 percent), profit and loss accounts (76 percent) and annual reports (69 percent). However, only 50 percent of respondents carried out a business plan, and none declared that their accounts had been audited. The territorial structure of responses is detailed in Table 7.

15. Assuming that all business plans are adequately calibrated for eventual bank loan applications (a hypothesis which is rather heroic in itself), the maximum number of loan applications for the financing of intended investments that could be produced by the SMEs is 50 percent of the sample. Such a proportion is significantly lower than the proportion of SMEs which have already filed a loan application (81 percent of respondents) or intend to apply for a new loan (74 percent of respondents). It is not surprising, therefore, that there are quite a few managers who complain that their loan applications are not approved. It appears that the proportion of loan applicants who have distorted views regarding the loan application procedures is rather high. Such a situation seems to justify the need for specific TA to be directed at SMEs.

16. An important part of the survey is devoted to questions on the demand for credit and the credit history of the respondents. In 2004, 40 percent of the respondents were granted at least one loan from a bank, credit cooperative or micro finance institution. Most respondents did not specify the exact source of the loan, but they stated subsequently that they primarily had bank loans in mind. The average loan amount was equivalent to €8,000. The table below indicates the currency nomination of the loans that were received in 2004.

17. In previous years, the number of respondents that were extended loans was lower. The overall tendency is favourable, since SMEs have become less reluctant to work with banks and other financial institutions.

18. The answer to the question on loan repayment leads to the same conclusion: all respondents, representing 62 percent of the sample, declared that they had observed the repayment schedule. This response is at odds with the long-established view held by banks that rural borrowers show less financial discipline. Even if the sample is not statistically correct, and some of the respondents may have omitted to mention minor repayment incidents (such as delays shorter than one month), it appears that rural clients have become more reliable customers of banks and other financial intermediaries.

19. 29 percent of respondents declared that they did not apply for a loan. Considering that the most frequent reason given came from 100 respondents, the following structure is not surprising: the main reasons invoked are that applying for a loan takes too long or involves a lot of red tape (100) and interest rates (plus bank fees) are too high (89). The incidence of loan maturities being shorter than envisaged and the impossibility to comply with the collateral requirements of banks come lower (59 for each). The third group of reasons refers to the lack of confidence that a bank loan application will be approved (41) and a reluctance on the part of SMEs to incur debts (37). The last group of reasons includes insufficient profitability to be able to repay the principal loan amount plus interest (22), the lack of knowledge regarding the loan application procedures, or a sufficient level of own income sources (15 for each). Table 9 gives details regarding the geographical distribution of each reason.

20. This distribution represents mostly perceptions rather than actual causes. Thus, it is likely that “in real life” the insufficient profitability to repay credit has a higher incidence on the decision not to apply for a loan. However, it is worth noting that the most significant cause for not applying is the cumbersome loan application and approval process, while high interest rates come second.

21. The average size of the requested loans slightly exceeds €20,000 for loans both in local and foreign currency, and it matches the envisaged indicative size of the loans to be provided under the Facility. Table 10 provides a breakdown of the loan applications by region.

22. If the responses to the questionnaire were converted into actual loan applications, then the 93 SMEs included in our survey stand ready to request some €6.8 million credit, mostly for investment purposes. Such numbers should, of course, be considered very cautiously, as long as a good number of the applicants continue to face various barriers before their plans come to fruition. However, the responses give a good indication that rural SMEs are becoming more market orientated and are ready to capture investment opportunities that come forth from a growing demand for their output, both locally and abroad.

Questionnaire for the evaluation of SME activity, size, and investment intentions

Date: _____ / 2004 Starting time: _____ Ending time: _____

Surveyor: _____

Region: _____

Municipality: _____

Distance from the nearest commercial centre: _____

Banks present in the nearest commercial centre: _____

Respondent's name: _____

Position in the enterprise: _____

Profile: _____

Type	Family business	Company/Firm	Cooperative
	Farm	Other	

1. GENERAL INFORMATION

1.1. Description of the enterprise

Legal status:

- Sole traders
- Partnership
- Registered Company; type: _____

What is the management structure of the company (describe)?:

Subscribed (Paid-in) Capital (in Euro or local currency): _____

Year when started activities: _____

Financial history:

- What type of records company has:
 - o Balance sheet? Y / N
 - o Income statements? Y / N
 - o Annual reports? Y / N
 - o Business plan? Y / N
- Have the accounts been audited by external/internal auditors (choose one)?: External / Internal
- If audit was done externally, which is the firm that audited those accounts (put name):

For how many years back have accounts been audited (put number of years): _____

Number of permanent employees: _____

Number of seasonal employees: _____

Main activities:

Agro-Processing

.....
.....

Agricultural production Cereals

 Cereals for fodder

 Oil crops

 Wine

 Fruits

 Vegetables

 Dairy products

 Meat

Agri-Tourism

Manufacturing

Textile

Services (hairdressers, garages...)

Other

2: ASSETS OWNED

How many of the following assets does the company own?

Info collected from questions

Asset Owned	Value when acquired / Purchase Price (Euro):	Replacement	Value:
-------------	--	-------------	--------

How was the item acquired?

1 = cash

2 = credit

3=other If credit, what was the source of the loan?

1=supplier

2=relative or friend

3=money lender

4=trader

5=financial institution:.....

6=other:

Time Period of Loan (months)

- 1. Land**
- 2. Buildings**
- 3. Plant(s)**
- 4. Equipment/
Machinery**

5. Motor vehicles

6. Shop/Workshop

2. Farm equipment (if enterprise is farm)

- Tractor**
- Trailer/cart**
- Plough**
- Weeder**
- Harrower**
- Other**
(Specify) _____

3. LOAN HISTORY

Please provide information on loan applications by company during the past three years. It would be particularly interesting to know if they applied and if they already benefited from any support from any of EU-funded credit lines (in case of agri-sector, particularly SAPARD programs).

YEAR Institution that was approached?

1= commercial bank (name of the bank)

2= moneylender

3= other financial institution (name)

..... For what purpose was the loan intended?

1= working capital investment (<12 months)

2= longer-term investment (>12 months)

3= repay other debt What was the size of the loan?

What was the interest rate of the loan?

Repayment schedule / term of repayment

Collateral used by the bank

2004

2003

2002

3.1 If no applications are listed above, why not?- please circle as many as necessary

1 = Own income sources sufficient (do not really need loans)

2 = Reluctant to get into debt

3 = Interest rates too high

4 = Term too short

5= Do not have enterprises that would make a sufficient profit to repay the loan

6= Did not satisfy collateral requirements imposed by the bank

7= Not aware of the application process; do not know how to apply

8 = Application process too time consuming or bureaucratic

9= Do not believe loan application would be approved (no collateral, do not trust the financial institution)

10= Other (specify)

.....

3.2 If one or more loans have been received from the same source, please complete the following table:

Loan Size of Initial Loan (R) Has the borrower since taken out more loans of the same type?

1=yes

2=no If yes, what was the size of the most recent loan? (R) To what use was the initial loan put? To what use was the most recent loan put?

3.6 Repayment

3.2.1. Have there been any events that made it difficult for the borrower(s) above to maintain loan repayments? Yes / No

3.2.2. If yes, what? _____

3.2.3. What were collateral requirements: _____

SECTION 4: SUGGESTIONS FOR IMPROVEMENTS OF FINANCIAL SERVICES

4.1. What have been the main problems with your present sources of financing?

.....
.....

4.2. Is there interest/demand for more/different kind of loans (long-term, short-term/working capital etc.) in the banks? Yes/No;

4.3. If yes, for which purpose?.....

4.4. How/from which income source would you repay an additional loan?

.....

4.5. How should loans be improved to better suit your needs:

Frequency of repayment.....

Term.....

Collateral.....

Interest.....

Technical assistance in preparation of loan applications and business plans
.....

Other.....