

DEFICITS AND GROWTH FROM ROMANIA'S PERSPECTIVE

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Abstract

In the last eight years Romania has encountered a significant growth of the GDP. However, the economy does not seem capable to value this growth by balancing the budget and reducing the current account deficit, problems that are persistent during the last period.

In 2008 the Romanian economy had the highest level of budget deficit since the 90's. There is an important debate between the economists on this issue and we have to see if there is any reason to worry, having in mind the current global financial crisis.

This paper tries to analyze the problems of budgetary deficit, current account deficit and economic growth. We will take a look on last period statistics and on specific literature, see how those variables evolved over time and in different cases and we will try to identify possible connections between them.

Introduction

Last year, Romania recorded the highest level of budget deficit since the 90's, and caused a fervent debate at the level of politicians. Having in mind that in November 2008 we had election going on, and that the level of deficit was used to win votes, we tried to take this debate to the level of economics and finance and conduct a research on the evolution of some financial indicators. We decided to tackle the problems of budgetary deficit, current account deficit and economic growth, in order to make a broader image of the situation.

The first part of the paper focuses on the indicators mentioned above and their evolution in the past years. Another issue that appeared on the public agenda due to the large deficit recorded is that Romania may be subject to the "excessive deficit procedure".

On the other hand we tried to give an answer to the problem of deficit: should its level be a matter of concern?

Finally, we studied possible connections between the evolution of the budgetary deficit, the current account deficit and economic growth, through "the twin deficits hypothesis", and see how the variables affect each other.

1. Romania: figures and facts

Starting from the year 2000, Romania has recorded a yearly average of 5.8 % of Gross Domestic Product growth, with a peak of 8.5% attained in 2004 (Table 1).

Table 1: Romanian macroeconomic indicators

		Romania			
		2005	2006	2007	2008
GDP mp	(million RON)	288,955.0	344,651.0	412,762.0	503,959.0
Growth rate of GDP	% change from previous year	4.2	7.9	6.2	7.1
Government deficit (-) / surplus (+)	(million RON)	-3,344.0	-7,474.0	-10,466.0	-27,295.0
	% of GDP	-1.2	-2.2	-2.5	-5.4
Government expenditure	% of GDP	33.5	35.3	36.6	38.5
Government revenue	% of GDP	32.3	33.1	34.0	33.1
Government debt	(million RON)	45,626.0	42,583.0	52,292.0	68,532.0
	% of GDP	15.8	12.4	12.7	13.6

Source: "Eurostat newsrelease, euroindicators", 56/2009

Data released by Eurostat shows that in the last years Romania along with Slovakia, Estonia and Latvia had one of the highest levels of growth in the EU. In 2008, due to the financial crisis, Estonia and Latvia did not manage to maintain the growth path of the economy. The latest forecasts of International Monetary Fund expect Romania to have a negative percentage change in GDP of - 4.1% in 2009 and stagnation in growth for 2010.

In 2008 Romania registered 5.4% of GDP budgetary deficit, the highest since 90's. According to Eurostat, Romania has been confronted with the third of the highest level of budgetary deficits after Ireland (-7.1%), the United Kingdom (-5.5%).

On the other Romania recorded, at the end of 2008, 13.6% of GDP government debt, the second of the lowest ratios in the EU zone.

We choose to present these indicators in order to be able to tackle the problem of excessive deficit procedure that may concern Romania due to the high deficit recorded in 2008.

The Stability and Growth Pact opens the way for the Council to penalize any participating Member State that fails to take appropriate measures in order to reduce and control (the "excessive deficit procedure"). Initially, the penalty would take the form of a non-interest-bearing deposit with the Community, but it could be converted into a fine if the excessive deficit is not corrected within two years. However, there is no formal rule concerning these penalties: the council decides penalties, taking into consideration the gravity of the situation and the economic circumstances faced by that state.

The excessive deficit procedure is governed by Article 104 of the Treaty establishing the European Community, under which the Member States are forced to avoid excessive deficits in national budgets.

The Protocol on the excessive deficit procedure, annexed to the Treaty establishes the reference values of macroeconomic indicators for any European Union Member:

- 3% for the ratio of the planned or actual government deficit of GDP at market prices;
- 60% for the ratio of government debt of GDP at market prices.

The European Commission launched the excessive deficit procedure and adopted so-called "excessive deficit reports" against Greece, Spain, France, Ireland, Latvia and Malta, because all of them overcome the 3% of the GDP barrier.

Several European countries have already been subject to this procedure – Portugal and Germany – 2002, France – 2003, the Netherlands, Greece, Malta, Cyprus, Slovakia, Czech Republic, – 2004, UK, Italy, Portugal again in 2005. In the case of these countries, the procedures were closed by Council decisions with no penalties.

Hungary and the UK are facing ongoing procedures under excessive deficit procedure. In their case there are decisions of the EC on existence of excessive deficit – July 2004 – Hungary and July 2008 – UK. The deadline for correction is 2009 for Hungary and financial year 2009/2010 for the UK.

As the statistical data for 2008 shows, Romania has exceeded the reference value of 3%, and could be subject of a recommendation to rectify the situation within a given period. However the low level of government debt (13.6% of GDP) related to the 60% threshold could be an advantage that Romania has over other countries in similar situations.

Some economists questioned the efficiency of the Stability and Growth Pact: Is this Pact still in effect with the deficit limits being regularly broken? (Stiglitz, 2006)

2. Are deficits bad? Theoretical approach

- Classical and Keynesian approaches on deficits

The Classical approach considers that the budget deficit has negative impacts on the economy. One of those is the higher fiscal pressure that will be laid on the following generations to pay the future debt in order to finance the state budget deficit. Moreover the state's need to borrow money increases the credit demand. In this situation the banks rates of interest increase and affects the level of inflation.

The conservative approach considers that reducing the budget deficits will be good for the economy. When the government runs a budget deficit, it spends more than it collects and it has an immediate effect on the level of investments. In the same time the low level of investments will have a negative effect on the economic growth.

In conclusion the main effects of budget deficit are lower investments and higher interest rates and it has a bad influence on the economy on the long term.

One of the most important turning points in economics was the insight of John Maynard Keynes that government could help countries to recover from economic recession, by spending more and lowering taxes and interest rates (Stiglitz, 2006).

John Maynard Keynes in its *General Theory of Employment, Interest and Money* (1936) considered capitalism as unstable. However, he thought that there is no need to nationalize the economy, to impose price-wage controls, and to interfere with the supply and demand. He agreed that the government should intervene and settle the situation when things are going bad.

Many of Keynes's followers saw fiscal policy as a lever that can be twisted in order to control economy. In their opinion, a larger budgetary deficit means a stimulus for economic growth, through which unemployment could be reduced and the economy would get back on track. In addition, a smaller budget deficit or a surplus could be useful for overheated economies in order to slow growth rate and reduce the inflation danger. (Samuelson, 2000)

The classical approach considered an action on prices and wages, but Keynes saw the solution in deliberately running federal deficits and spending money on public works that eventually would expand aggregate demand and restore confidence in the economy. Once the economy recovers, Keynes thinks that the government would no longer need to run deficits (Scouse, 2007).

Friedrich Hayek and the London School of Economics believed that the economy was self-adjusting and was in favor of wage reductions and balanced budgets as solutions to the depression (Stiglitz *et al.*, 2006).

Actually, Keynes criticized Friedrich Hayek and the London School of Economics for believing that the economy was self-adjusting and for urging wage reductions and balanced budgets as solutions to the depression (Scouse, 2007).

The Keynesian approach suggested that reducing deficits can be bad for both the economy and confidence. Keynesians though that rescheduling debt can provide funds for a country to finance expansionary fiscal policy, and capital control might allow a country to maintain lower interest rates. In this view, restoring strength to the

economy is far better for building confidence than the conservative measures (Stiglitz *et al.*, 2006).

Keynes did not agree with the classical solution – “tighten one’s belt” by cutting prices, wages, and wasteful spending while waiting to get out the recession. As we can see in the paragraphs above, he thinks different and recommended deliberate deficit spending by the US federal government to jump-start the economy during the depression of the 1930s. He actually said that government spending could be totally wasteful and it would still help – “Pyramid-building, earthquakes, even wars may serve to increase wealth,” he proclaimed. Of course, “It would, indeed, be more sensible to build houses and the like,” but productive building was not essential. According to Keynes, spending is spending, no matter what the objective, and it has the same beneficial effect – increasing aggregate demand (Scouse, 2007).

Samuelson is another advocate of the benefits of budgetary deficits. During the time he was a close advisor to President J.F. Kennedy he helped steer through US Congress a Keynesian program designed to stimulate economic growth through deliberate deficit financing. The effects of this policy were positive, as the US economy flourished through the mid-1960s (Scouse, 2007).

3. Modern approaches

The modern approaches on budget deficits are based especially on the way budget deficits are financed and on the problem of the sustainability of the deficit.

In the matter of the budget deficit financing there are several options that states can take into consideration (Vit, 2004):

1. Government bonds selling
2. Borrowing from abroad
3. Monetization
4. Selling of state assets.

First we tackle the options that concern Government bonds and borrowing.

Considering the first alternative mentioned, bond selling leads to an increase of demand for private funds in the economy. Higher deficit leads to higher interest rates, and the higher interest rates reduce private investment (Stiglitz *et al.*, 2006). This means that more funds the government deficit demands, a lower amount of money will remain for the private investments. The excess demand for money will determine a rise in interest rates. The higher interest rates will stimulate private sector and households to increase savings and shift some investments towards the future. In this case we say that public expenditures (deficits) crowd out private investments – crowding out effect.

Some authors believe that international borrowing by governments may be more bad than good. This is possible because the ability to borrow from abroad will exacerbate a political bias toward budget deficits and an intrinsic tendency to accumulate too much debt (Roubini and Setser, 2004).

The third option to finance budget deficit is monetization. This method of budget deficit financing is actually forbidden in many industrialized and some developing

countries because it can lead to hyperinflation. We used the quantitative equation of money to identify the negative effects of monetization as a source of financing budget deficit.

Irving Fisher's quantitative equation of money points out the relationship existing between the money stock, the velocity of money and the volume of transactions (Irving Fisher – „The purchasing power of money“ 1911):

$$M*V = P*T$$

where:

- M – money supply;
- V – velocity of money;
- P – price level (average);
- T – transaction level.

Based on this formula of this equation, at a given transaction level, an increase in the money supply in circulation (inclusively as a consequence of new money issuing for financing the budget deficit) is directly reflected in a raising level of prices. The increase of the level of prices, at a constant level of the individuals' income, will cause the reduction of their real income, traduced in a decrease in the purchasing power of these persons.

Considering the fourth option of budget deficit financing, countries can reduce their deficits by cutting down forests, selling national assets, giving away their natural resources at a fraction of the full value (Stiglitz, 2006).

Asset sales (including sales of natural resources and privatizations) are misleadingly being used to make deficits looking lower than they otherwise would be. This could be the case of Romania which in the last years "benefited" from the privatization of important state-owned companies and banks – Petrom, Commercial Bank, and Romgaz.

Another response from the government to increase level of deficit, besides financing, is represented by the fiscal policy.

Some economist argue that governments should not be forced to counteract the deficit increase by tightening fiscal policy, especially during a recession, because fiscal deficits naturally widen during an economic slowdown as tax revenues fall and the need for government expenditures rises in event of social protection programs being put in place. Standard macro-prescriptions hold that government should respond to a downturn by counter-cyclical fiscal policies – increasing expenditures or cutting taxes (Stiglitz *et al.*, 2006).

In their work, "Stability with growth – Macroeconomics, Liberalization, and Development" Stiglitz, Ocampo, Spiegel and French-Davis and Nayyar identified two possible risks that governments are facing up during the budget deficit periods – *the risks of deficit fetishism* and *the risks of excessive debt*.

The risk of deficit fetishism assumes that policy-makers should respond to a crisis by cutting back on government expenditures to reduce the deficit. The argument is that reducing the deficit enhances confidence in the economy and the country's government

and results in more investment, leading to stronger long-term economic growth. Analyzing the case of some developing countries that applied cut-back policies, it has been found that in most countries, such cutbacks actually affect public investment and long-term growth (Stiglitz *et al.*, 2006).

The risks of excessive debt involve a large amount of debts than can affect future economic growth, especially when the deficit is financed abroad. The countries become hostage to the vagaries of the international financial market and lose the ability to engage in counter-cyclical monetary and fiscal policies if the debt is short term (Stiglitz *et al.*, 2006).

Another point of view over deficits and their financing method is Roubini's and Setser's model, that puts in debate the credibility of governments, and their ability to borrow. They said that countries can sustain current account and budget deficits as long as they have the capacity to issue new debt. In their opinion a credible government can run larger fiscal deficits in the face of a temporary adverse shock without creating concerns about its future solvency. A government with large debt stocks, large fiscal deficits, and a primary balance insufficient to assure long-term debt sustainability may be able to lower its borrowing costs if assures its long-term solvency (Roubini and Setser, 2004).

As a conclusion of the three perspectives analyzed (classical, Keynesian and modern) we can say that:

- the problem may not be the existence of deficits, but whether the deficit and the capital flows that finance it are sustainable; whether the financing of the deficit is sustainable over a period of time;
- it depends very much on how the money is spent if a particular level of borrowing is sustainable;
- deficits can be sustained if the funds are spent on investment.

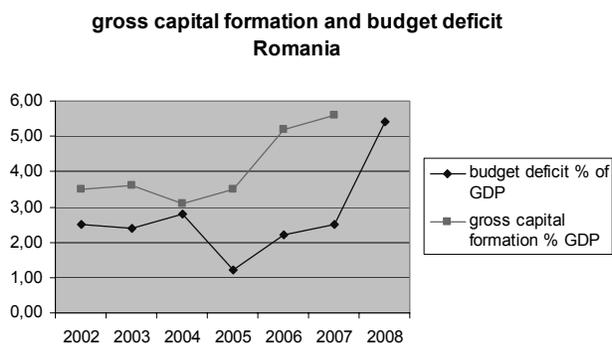
As the main statistical indicators show, Romania recorded budget deficits for a long period of time. We concluded that the problem may not be the existence of deficits, but whether they are sustainable, and that is possible if the funds are spent on investment.

In order to see, as much as possible, if the budget deficit was spent on investment we analyzed the evolution of two variables Budget Deficit and Gross Capital Formation (GCF). In the absence of relevant data referring to the level of public investment as a percentage of GDP, GCF was the best option available.

Gross Capital Formation (GCF) is one of the main aggregates in the Eurostat expenditure classification. Gross Fixed Capital Formation (GFCF) is the largest component of gross capital formation and it measures the level of net new investment in the domestic economy in fixed capital assets, during an accounting period.

Analyzing data related to Government expenditure by function we noticed an increase in GCF during the period 2002-2007.

Correlating the GCF's evolution with budget deficit in the same period we can observe that the trend of the two variables is somehow similar. The fact that government



Source: Eurostat

Figure 1: Budget Deficit and Gross Fixed Capital Formation.

expenditures in capital formation is rising could be an explanation for the level of budget deficit. This could mean that the expenses that led to the level of budget deficit financed investment and they should positively influence economic growth.

By this, Keynes assumption which saw budget deficit as positive as long as spending is made on public investment would be verified in the case of Romania.

4. Twin Deficits Hypothesis

Starting with the mid 1980's the 'twin deficits' theory was very popular among economists. This was based on the observation that current accounts deficits and government budget deficits tend to work together. The theory is based on the evolution of US budget and current account deficits – from being balanced in 1980, the deficit increased to nearly 3.5 per cent of GDP in the mid-1980s before returning to balance in 1990 (Iley and Lewis, 2007).

The twin deficit hypothesis suggests that a larger fiscal deficit, through its effect on national saving and consumption, leads to an expanded current account deficit.

According to the twin-deficit hypothesis, when a government increases its fiscal deficit – for instance, by cutting taxes – domestic residents use some of the income windfall to boost consumption, causing total national (private and public) saving to decline. The decline in saving requires the country either to borrow from abroad or reduce its foreign lending, unless domestic investment decreases enough to offset the saving shortfall. Thus, a wider fiscal deficit typically should be accompanied by a wider current account deficit (Bartolini and Lahiri, 2006).

Stiglitz agreed with the twin deficit hypothesis, with an exception. He considered that fiscal deficit – the difference between government's revenues and its expenditures – is simply negative savings. He explained that when the fiscal deficit goes up, then overall national savings is reduced; this is possible, unless household or corporation savings goes up. In the conditions of an unchanged level of investment, it will be a shortfall of funds, so the country has to increase its loans from abroad. That is why the fiscal and trade deficits move in tandem if investments or private savings do not change simultaneously (Stiglitz, 2006).

Iley and Lewis on their analysis over the US budget took into consideration the importance of the theory in the context of the widening the US current account deficit in recent years. Their argument is that a budget deficit implies a decrease in national saving, which is the sum of private saving aggregated with the government fiscal balance. When national saving falls and it is insufficient to finance investment, it requires loans from abroad, so the current account is in deficit (Iley and Lewis, 2007)

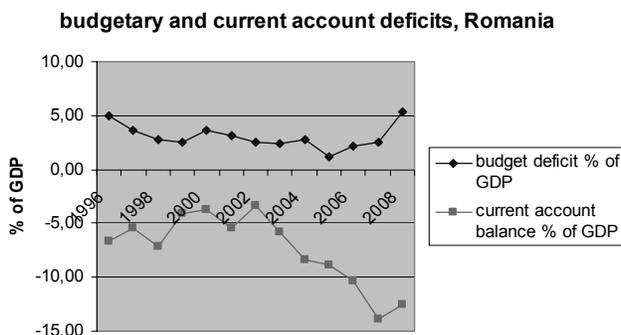
The current account balance is determined by the difference between national (public and private) savings and investment according to Roubini and Setser. A budget deficit is equal to public dissavings (excess of public spending including interest payments over its income – i.e., revenues), and leads to a current account deficit unless private savings rise or private investment fall (Roubini and Setser, 2004).

Iley and Lewis concluded about the twin-deficits argument that, in theory, budget deficit and current account deficit should work together. They also, like Robini and Setser, considered that fiscal deficits are a form of dissaving, and reduce the availability of domestic saving to fund investments. Unless matched by an equal reduction in domestic investment, the net demand for foreign saving and the current account deficit will rise (Iley and Lewis, 2007).

According to Stiglitz' point of view over the twin deficits, Iley and Lewis think that the budget balance and the current account balance would not necessarily move in the same direction in the face of a large productivity-driven increase in investment (Iley and Lewis, 2007).

Stiglitz summarized the twin deficit hypothesis and has seen that trade deficits and external loans are two sides of the same coin. The trade deficit will grow up if the external loans go up. This means that if government loans go up, unless private savings go up commensurately (or private investment decreases commensurately), the country will have to borrow more from abroad, and the trade deficit will increase. That is why economists often talk about the twin deficit problem: when government loans increase – the fiscal deficit increases – and it is likely that the trade deficit will increase (Stiglitz, 2006)

At first glance, post-1996 data on fiscal and current account deficits of Romania, offers some support for the twin-deficit hypothesis.



Source: IMF statistics

Figure 2: Budget and current account deficit, Romania.

Taking a look at the data, starting from 2004, the deficit of the current account balance is rising over the threshold of 10% of the GDP. The peak of the current account deficit, almost 14% of GDP was reached in 2007 and in 2008 remained at a level over 12%. The data of the last quarter of 2008 and the first quarter of 2009 shows a significant reduction in the level of current account deficit, and the perspectives of 2009 are good in this matter.

The available data shows that between 1996 and 2008 most of the changes in fiscal and current account balance are accordingly with the predictions of the twin-deficit view.

An empirical analysis on the twin deficit hypothesis regarding the case of Romania is needed. Further work in this area is a must in order to offer sustainable arguments and validate the hypothesis. Econometric empirical methods are needed to evaluate the validity of the twin deficits hypothesis.

5. Conclusions and remarks about the current situation

A study conducted by Aleksander Aristovnik from the Faculty of Administration, University of Ljubljana, analyzing most important economic indicators of countries in transition from Europe sustain the assumptions in this article. The data analyzed covered the period 1992-2003, and included Romania.

The findings of the study revealed that economic growth has a negative effect on the current account balance, implying that the domestic growth rate is associated with a larger increase in domestic investments than savings. The study confirmed the “stages of development hypothesis” which states that poorer countries in the region revealed higher current account deficits.

Furthermore, the study validated the “twin deficit hypothesis” in the region – public budget deficits are likely to be accompanied with current account balance deterioration, by this confirming the significant positive relationship between the government budget balance and the current account (Aristovnik, 2006).

Another study conducted by Christopher Adam and David Bevan examined the relation between fiscal deficits and growth for a panel of 45 developing countries, including Romania. The results of the study finds evidence of a threshold effect at a level of the deficit around 1.5% of GDP. The empirical analysis suggested a statistically significant non-linearity impact on growth by the budget deficit at around 1.5% of GDP. The implication is that for values of the deficit less than or equal to 1.5 % of GDP a marginal increase of the deficit is locally growth-enhancing: an increase in the deficit of one percentage point (for example from a balanced budget to 1% of GDP) would increase the average annual *per capita* growth rate by around a quarter of one percent. By contrast, at levels of the deficit greater than the threshold the effect is reversed (Adman and Bevan, 2002).

The present study manages to attain its objective of proving the connection between economic growth, budget deficits and current account deficits. The growth recorded in the last period raised the wages and retail prices and favorised the imports and, by this current account deficit increased.

A major factor in the crises of recent decades has been trade deficits; when countries import more than they export, they have to borrow the difference. Romania should have a prudent policy in this matter and maintain an adequate level of current account deficit to GDP.

Roubini and Setser consider that long-term solvency requires, at minimum, that the country's external debt to GDP ratio (or the government debt to GDP) should not exceed certain limits (Roubini and Setser, 2004).

Until 2008, Romania managed to maintain a low ratio of government debt to GDP – 13.6%, but the latest evolution – the loan package of almost 20 billion euros from the IMF, World Bank and European Union contracted in 2009 could negatively affect long-term solvency. On the other hand this is a sign of the credibility that Romania benefits from the main international financial institutions.

Considering the budget deficit problem, some economists suggest that an excessive deficit should be temporarily allowed in the case of the small and less developed country, in order to improve economic convergence and wages within the European Union (Alfonso and Alves, 2006).

Fiscal and trade deficits mean that the government and the country is increasingly in debt. Both can be a problem, especially when countries or governments spend what they borrow on consumption rather than investing it (Stiglitz, 2006).

The hypothesis that public investment leads to stronger long-term economic growth was proven to be correct in most cases. It is a challenge for Romania to validate this assumption in the following period by raising the level of government investment.

In the face of limited public support for policy actions, this could be a test for the Romanian government in a worldwide context characterized by deteriorating financial conditions and weakening economies.

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