STRAIN AND ECONOMIC ADJUSTMENT.
ROMANIA' TRAVAILS AND PAINS[1]

By

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Almost ten years time of post-communist transition have elapsed. Much of the initial euphoria and illusions are gone. People, including the academic professionals realize that this historical endeavor is a very complex and complicated affair. The state of transition compels one to scrutinize more carefully the process of change, to go beyond stereotypes, myths, and oversimplifications. As a World Bank official working on post-communist countries stated, a few years ago, one should judge a policy on its own merits by skewing intellectual prejudices.[2] This prodding was strongly reinforced by J. Stiglitz recently.[3]

This paper discusses economic change in Romania and links it to two major issues: the legacy of resource misallocation, or what can be termed inherited *structure*, and institutional fragility. The legacy of resource misallocation leads to very intense *strain* in the system when there is a brutal and dramatic change of relative prices to market-clearing levels. At the new prices resources should flow from low to high productivity areas, a process which can generate much pain and friction in a real economy. The strain or tension involved explains why there is much opposition to change, and why coalitions of interests emerge to hinder deep restructuring. *Strain* also explains why large quasi-fiscal deficits are a feature of post-command economies, which creates an endemic proclivity to high inflation.

Some analysts relate inflation, primarily, to the breakdown of the political process and rent-seeking activities by old elite[4]. While this is not implausible, the approach adopted in this paper emphasizes the magnitude of the required resource reallocation, which is sometimes so large that it undermines attempts to achieve durable stabilization. It is arguable that the success of the leading transition economies is due, primarily, to policy being able to deal with the magnitude of required resource reallocation while not being 'captured' by vested interests.

Institutional fragility is another dimension of the transformation process which underlines the complicated nature of change, restructuring included. The lack of institutions, of organized markets, hinders a smooth reallocation of resources and has a negative effect on performance at both the micro and macroeconomic levels; it also helps to explain the intense friction in the system, especially rising transaction costs, that arises during the passage between two regimes. This line of reasoning finds substantial analytical support in recent work.[5]

Together with *strain*, institutional fragility helps to explain stop-go policies, as well as many of the setbacks and inconsistencies in the transition process. Fuzziness and a lack of transparency characterize the realm of public finance. For example, banks are frequently the vehicles for the granting of subsidies. Primitive banking systems, in the grip of redundant structures, are likely to perpetuate much of the old pattern of resource allocation (or misallocation) and engage in significant quasi-fiscal operations, with the latter showing up in high rates of inflation or of bank failures.

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[1] Paper presented at the Fifth Dubrovnik Conference on Transition Economies, "Ten Years of Transition: What Have We learned and What Lies Ahead", Dubrovnik, 23-25 June, 1999. This paper relies heavily on the author's previous research and his work for the UN/EEC, in early 1999. In this respect see the section on Romania in *Economic Survey of Europe*, UN/EEC, Geneva, no.1, 1999, pp. 70-81

[2] A. Gelb (1996), "From Plan to Market: A Twentyeight Country Adventure", *Transition*, vol.7, np.5-6, p.2

[3] J. Stiglitz remarked that the failures of reforms "are not just due to sound policies being poorly implemented…failures go deeper, to a misunderstanding of the foundations of a market economy as well as a misunderstanding of the basics of an institutional reform process" ("Whither Reform? Ten Years of Transition" paper prepared for the Annual Bank Conference on Development Economics, Washington DC, 28-30 April, 1999). One need not fully agree with Stiglitz in order to see that he has a point.

[4] Boone, P. and J. Hoerder (1998), "Inflation: Causes, Consequences, and Cures" in P. Boone, S. Gomulka and R. Layard (eds), *Emerging from Communism. Lessons from Russia, China and Eastern Europe*, pp. 42-72.

[5] Blanchard, O. (1997), *The Economics of Post-communist Transition*, Oxford, Clarendon Press.

Romania's experience is a highly relevant example of how *strain* and institutional fragility condition macroeconomic stabilization.

In the following analysis of economic developments during 1990-1998, stop-go policies, resurgent inflation and macro-disequilibria, as well as bank failures, all emerge as an inevitable outcome of a feeble pace of restructuring and fragile institutions. It is emphasized that without large inflows of foreign direct investment (FDI) and the creation of appropriate institutions, the economy is unlikely to be able to escape from the grip of the old structures. It is also clear that a more rapid rate of privatization would help to increase the inflow of foreign capital. The slow pace of restructuring has maintained intense strain in the system and has led to a bad "path dependency". Romania started the transition process at a disadvantage, with significantly worse initial conditions than those prevailing in the leading reform countries,[6] which suggests that her policy-makers have also had less room for maneuver[7]. Nonetheless, the end result is that they have not yet been able to find a clear way forward to a well-functioning market economy. Under the current unfavorable conditions in the world economy it will be increasingly difficult for the Romanian economy to escape from this path dependency.

Part one deals with two major underplayed issues: institutional fragility; and the magnitude of the required resource reallocation, which engenders the so-called *strain.* Part two focuses on economic developments in Romania between 1990—1998. Part three contains final conclusions.

1. Two major underplayed issues

There are two issues, which are of utmost importance for coming to grips, analytically and operationally, with the reality of post-communist transformation; both, in my view, have been underestimated. One issue regards the relative backwardness of the former command systems and a related institutional fragility; the other issue refers to the magnitude of required resource reallocation in relation to the new relative prices dictated by liberalization and opening of the economy.

1.1 The legacy of backwardness

Knowledgeable professionals can often be heard making judgements on the transformation process, while seeming to neglect the legacy of backwardness of most of these societies – a state of affairs which goes back deeply into history. A note of caution is nevertheless required. The post-communist societies of Europe are societal entities that show common (structural) traits, but also major discrepancies; the latter can be linked with the different pre-communist legacies (the former Czechoslovakia, as a leading industrial country during the inter-war period, is the most conspicuous example) and the different brands of national central planning, in terms of relaxation of direct controls and economic policy choices. The different histories explain widely different incomes per capita (with Romania as one of the poorest post-communist countries in Europe), why market institutions vary qualitatively among the national environments and why macro and micro-disequilibria differed among them on the eve of 1989. Undoubtedly, Hungary, the former Czechoslovakia and Poland had a substantial competitive edge in starting the process of managing transition. Unsurprisingly, all these countries have fared better than the rest in their stabilization programs, although their recipes were not similar, as some would argue.

Backwardness should be seen as bearing considerably on the potential for overcoming the performance deficit of societies with poor institutional arrangements; it points, on one hand, at the lack of specific knowledge of individuals and of society as a whole and at the constraints for genuine institutional change and, on the other hand, it suggests that there is much scope for a system to get outside what can be conceived as an ideal tunnel of evolution. The stress put on the burden of the past is meant to warn against its dragging effects and an unfavorable *path dependency*, from which it may not be easy to break away.

Backwardness makes it harder to overcome the fragility of the emerging market institutions and enhances the potential for the dynamics of change to get out of control. Institutional fragility was much underestimated by policymakers and their advisers.[8]

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[6]Romania practised late Stalinism until the very end of the communist regime. Initial conditions can be related to the magnitude of resource misallocation, the institutional ingredients of a market environment, the existence of a private sector, to a certain industrial culture, etc.

[7] See also S. Estrin, M. Dimitrov, and X. Richet, "State Enterprise Restructuring in Bulgaria, Albania and Romania", *Economic Analysis*, vol.1, no.3, 1998, pp. 239-255. The authors conclude that " when one looks at differences in terms of progress of restructuring it seems likely that these can best be explained by preconditions than current progress in reforms" (pp.250)

[8] As Peter Rutland rightly points out 'in a travesty of Hayekian logic, it was assumed that market institutions would be self-generating', "Has Democracy failed Russia?", *The National Interest*, winter,

Similarly inadequate is the neglect of the extreme complexity of the process under way. Gross oversimplifications and reductionism of the type 'black vs. white' (with no shades in-between), and the lack of understanding of how interests are socially articulated – particularly in a transition period – cannot but obscure real processes and lead to hasty and inadequate decisions. 'The elite failed to understand that society was a far more complex organism than what they had thought, that simple, well-meaning declarations were not effective in politics, that ideas and programmes would have to be sold to the public, and that institutions were necessary for the routinised exercise of power' [9]. Besides, 'Imperfect and costly information, imperfect capital markets, imperfect competition: these are the realities of market economies – aspects that must be taken into account by those countries embarking on the choice of an economic system'[10]. The implication is clear in the sense of the stringent need to consider how market economies actually function.

On a more general level it is high time to take cognizance of an extremely important fact: the post-communist countries are in a period when the basic constructs of the future systems are put in place and this can be seen as an historical opportunity for designing viable societal aggregates.

The sintagma of *institutional fragility* has already been implied. Apart from the insufficient analytical attention paid to the institutional build-up in the transforming societies in Europe, one has to consider the seeds of instability produced by this fragility. The poor capacity of immature institutions to perform needs to be mentioned in this context. For example, the debate on universal vs. narrow banks (on whether and how banks should be involved in resource allocation) is quite relevant for the concern immature market institutions create in terms of enhancing instability and uncertainty in the system[11].

From a broader perspective one can pose the issue of the *governance capabilities* of the political and economic elites of these countries – to what extent these elites are capable to induce and manage change (transformation) when so much fuzziness, volatility and uncertainty is prevailing. One can also assume that institutional fragility will bear significantly on the nature of capitalism in the region.

1.2 The magnitude of resource reallocation: the emergence of *strain*

Another issue which is not sufficiently highlighted in the professional and public debate is the dimension of the inherited misallocation of resources– i.e. the sheer scale of disequilibria, at the new relative prices, that indicates the magnitude of required restructuring as compared to the ability of the system to undergo wide-ranging and quick change. The structure of the economy, the legacy of resource misallocation, have put the system under exceptional *strain* once the combination of the internal shocks (engineered by reforms, or, simply, triggered by the uncontrolled processes of system dissolution) and external shocks occurred. Appendix 1 provides an analytical explanation of strain, which is buttressed by an empirical analysis done by OECD experts.

At the dramatically changed relative prices and should financial discipline be strictly imposed many enterprises (the inefficient ones) would have to be out of the economic circuit; they may try to survive by reducing X-inefficiency[12] but, in the end, should potential efficiency gains be evenly distributed (ubiquitous), they would have to bow out. To put it in short, the array of structurally inefficient enterprises forms a silent 'conspiracy' against change; they represent entrenched personal stakes, which oppose restructuring for obvious reasons. Together with other factors (including insufficient policy credibility) the lack of capacity to pay triggers a chain reaction of inter-enterprise debt, of arrears. The latter can be seen as *temporary quasi-inside money,* which undermines the effectiveness of monetary policy.[13] Appendix 2 uses a simple model in order to illustrate how arrears affects

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1994/95, p.11.

[9] G. Schopflin, "Post-communism: The Problems of Democratic Construction", *Daedalus*, vol.123, no.3, summer, 1994, pp. 130

[10] J. Stiglitz, "Whither Socialism", Cambridge, MIT Press, 1995, pp. 267

[11] One can talk about an enhanced "financial instability hypothesis", in the vein of H. Minsky's, " A Theory of Systemic Fragility" (in E.I.Altman and A.W.Semetz (eds.): "Financial Crises: Institutions and Markets in a Fragile Environment", New York, John Wiley and Sons).

[12] H. Leibenstein, "Allocative Efficiency vs. X-Efficiency", American Economic Review, vol.56, no.3, pp. 392-410, 1966

[13] If the equation of exchange (PY=MV) is put in a dynamic form by using logarithms: $\dot{p}+\dot{y}=\dot{m}+\dot{v}$; where $\dot{p}, \dot{y}, \dot{m}$ and $\dot{v}$ are the rates of change of prices, output, money supply and money velocity, respectively. When monetary policy is tightened, $\dot{m}=0$, and $(\dot{p}+\dot{y})$ is above zero, $\dot{v}$ needs to be positive in order to alleviate the expected decline of output. In this case, arrears appear as if they modify money velocity. If arrears are considered temporary quasi-inside money and velocity is kept constant, the relationship becomes $\dot{p}+\dot{y}=\dot{m}$ (c, a), where c is cash and bank credit and (a) represents arrears. When $\dot{c}=0$ because of the dear money policy, $\dot{p}+\dot{y}=\dot{a}$. See D.Daianu (1994),

stabilization policy. Arrears reduce the relevance of low official budgets deficits - since quasi-fiscal deficits are large. It should be said that quasi-fiscal deficits have been looming ominously over economic policy in Romania in the years of transformation.

What are the major implications of *strain*? One is that these economies can easily become exceedingly unstable and that their capacity to absorb shocks is quite low; these economies have a high degree of vulnerability! Another implication is that policymakers face extremely painful trade-offs and that, in most cases, unless policy is clever and sufficient external support is available, the room for maneuver is in practice, quite limited. Finally, macroeconomic stabilization in certain countries hides deeply seated tensions which, sooner or later, come into the open unless deep restructuring takes place.

Strain needs to be seen in relationship with unemployment. Current unemployment rates in the transforming economies are not exceedingly high in comparison with the European levels of the mid-nineties and this could assuage the perception of *strain*. However, the yardstick used is itself questionable taking into account the unemployment problem in Western Europe. Secondly, the weakness of safety nets acquires particular significance in the poorer post-communist countries, where the consequences of a ‘new type’ of poverty could be extremely serious[14]. And another factor is the fact that restructuring of large companies – which mostly need to shed labour in order to become profitable – is very slow, or, in practice, not taking place; this means that potential unemployment increases are still very significant.

Strain should be linked also with an intense *distribution struggle*, and an erosion of the consensus for societal change when many individuals appear as losers – once market forces start to reward people in accordance with merit, effort, good ideas, and inspiration, but also as a result of some workers’ misfortune to have jobs in bad (unprofitable) enterprises. This also explains why some governments see inflation as a redistribution device when *strain* is extreme.

There is another dimension to this distribution struggle which needs to be highlighted for its exceptional character in human history, and for its effects on system transformation. It is the process of privatization, which means a massive (total) redistribution of state assets. As we know, economic textbooks take as a *given* the initial distribution of assets among individual private owners; this distribution is almost God given, and it underpins the whole reasoning on how best to allocate resources and achieve Pareto optimality (highest welfare). In the case of post-communist countries, ‘God’ has decided to come down from heaven – for what we are witnessing currently is an extraordinary process, without precedent in the history of mankind. In the next few years, much of the fate of tens, if not hundreds, of millions of living individuals (and of their descendants) is going to be shaped by the mechanics and dynamics of privatization. What took many hundreds of years in the advanced capitalist countries is supposed to occur, through various procedures (more or less legal), in the post-communist countries, in a snapshot on the scale of history. It is not, therefore, surprising that everything surrounding this process is so highly charged emotionally – why so many hopes, dreams, reckless and ruthless actions, misbehavior, and delusions are linked to it. All individuals want to be on the winning side, but markets cannot make them all happy.

The nature of capitalism in the post-communist countries will be decisively influenced by the actual results of privatisation as a process. If privatisation results in the development of a strong middle class as the social backbone of the new economic system, stability and vigour will be secured, and democratic institutions will develop. Otherwise, the new system in the making will be inherently unstable.

There is a feature of communism that needs to be emphasized in order to understand better the social tension engendered by post-communist transformation, and the intensity of the distribution struggle. Communism – as an economic system – functioned as a kind of poor and steadily declining (suffering from *economic euthanasia*) but, nonetheless, ‘premature welfare state’[15]. As in Western countries, where there exist powerful vested interests which

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“Inter-enterprise Arrears in a Post-command Economy. Thoughts from a Romanian Perspective” , *IMF Working Paper*, 94/54. For the history of arrears in Romania see also Clifton, E.V. and M. S. Khan (1993), “Interenterprise arrears in Transforming Economies. The Case of Romania”, *IMF Staff Papers*, Vol.40, No.3, pp.680-696. C. Carare and E.R.Perotti argue that arrears, in Romania, are a result of inconsistent reform policies and the underdevelopment of financial markets (“The Evolution of Bank Credit Quality in Romania since 1991”, in S. Zecchini (ed.), “Lessons from the Economic Transition”, Dordrecht, Kluwer Academic, 1997, pp.301-314). Consequently, they argue in favour of hardening budget constraints. But, as other analysts, they do not explain why reform policy is inconsistent and the structure of incentives for banks so hard to change. Thence comes the relevance of *strain*.

[14] About labor *hysteresis* and its implications for Romania see J.S. Earle, C. Pauna, “Incidence and Duration of Unemployment in Romania”, *European Economic Review*, 40, 1996, pp.829-837

[15] J. Kornai, “Lasting growth as a top priority”, *Discussion Paper* no.7, Budapest, Collegium, Institute for Advanced Study

oppose economic adjustment, in post-communist countries those who cannot compete on the markets have turned into a coalition of interests which can slow down, or even arrest reforms. This mass of individuals is most likely to fall prey to populist slogans. Robert Gilpin's observation, that adjustment is very difficult in welfare states, applies *mutatis mutandis* in the case of post-communist countries[16].

2. Judging Romania's economic transition
2. 1 The burden of the past

In comparative analyses of the transition economies insufficient attention has been paid to the initial conditions prevailing when the transformation process got under way.[17] Communist Romania, particularly in the 1970s and 1980s, provides an interesting and instructive case of "immiserising-growth" which was caused by the logic of the system, in particular, the rush to speed up industrial growth and to increase ties with market economies on a very weak functional basis (by totally ignoring market mechanisms). In the literature, this phenomenon is explained by the existence of various price distortions which harm resource allocation, worsen the terms of trade, and lower welfare.[18] But it can also be argued that it was the way the economy functioned as a whole (including the genesis of wrong industrial choices) which constituted *the* distortion that led to immiserising growth. It has been shown that the inner dynamics of the system - its incapacity to cope with increasing complexity and its inability to assimilate and generate technological progress - led to a "softening" of output, characterized by its expansion with a strong bias towards low value-added industrial goods, which led to a steady deterioration of the terms of trade.[19]

Since "immiserising growth" limited the potential to increase exports, the targeted trade surpluses in the 1980s – required to pay back the external debt – were achieved through very large cuts in hard currency imports. Apart from the reduced level of investment, growth possibilities were also impaired by a sharp reduction in imports of machinery and equipment from the western countries. The heavy overtaxation of domestic absorption that took place during this period subsequently resulted in lower growth rates of production, reduced welfare (consumption), and bigger domestic imbalances (both visible and hidden). In addition, shortages were rising in both production and consumption.

The immiserising nature of "growth" in communist Romania is well illustrated by its income per capita (which has remained one of the lowest in Europe) and the very high energy intensity of its GDP.[20] Another telling fact is that whereas the GDP grew allegedly by almost 28 per cent during the 1980s exports decreased over the same period.

The structure of industry also revealed a strong bias towards the creation of gigantic units, with no regard for the important sources of flexibility in an economy, namely, the small and medium-sized enterprises. Thus, in 1989, 1,075 enterprises with more than 1,000 employees each, represented more than 51 per cent of all units, provided jobs for 87 per cent of all industrial workers and supplied almost 85 per cent of all industrial output; enterprises with over 3,000 workers (which accounted for about 16 per cent of the total) supplied over 50 per cent of total industrial output and provided jobs for 53 per cent of all employees in industry. At the same time, the small and medium-sized enterprises (with less than 500 employees) accounted for 4 per cent of all workers and 6 per cent of total industrial output.

[16] R. Gilpin, The Political Economy of International relations", Princeton, Princeton University Press, 1987

[17] An IMF report of 1997 acknowledges that "Romania emerged from communism with an economy that was suffering from considerably more deep-seated structural problems than most former communist countries in the region". IMF, 'Romania – Recent Economic Developments', *IMF Staff Country Reports No. 97/46*, Washington D.C., 1997, (p.7).

[18] Bhagwati, J., "Immiserising Growth – a Geometrical Note", *Review of Economic Studies*, 25, June, pp. 201-205. Johnson, H., "The Possibility of Income Losses from Increased Efficiency of Factor Accumulation in the Presence of Tariffs", *Economic Journal*, vol.77, pp. 151-154.

[19] Daianu, D. (1985), "A Case of Immiserising Growth", *Revista Economica*, 20 (in Romanian).

[20] The energy consumption per unit of GDP is in Romania twice as high as in Hungary, and more than 4 times larger than the OECD average (EBRD, *Transition Report*, 1995, London, p.77).

The forced reduction of the external debt in the 1980s (actually a *sui generis* shock-therapy), accentuated the decline in the competitiveness of the economy, exacerbated imbalances among sectors, increased shortages, and generally lowered the welfare of the people.

2.2 The high inflation period, 1990-1993

The early years of post-communism in Romania were marred by severe economic difficulties, including a very large fall in output (table 1), an institutional interregnum,[21] and "systematic" policy incoherence. Institutional hiatus refers to the melting down of much of the old institutional structures without a rapid build up of market-based institutions. This, obviously, contributed to increasing uncertainty, fuzziness, and volatility in the national economic environment. At this stage the entrenched structures are being broken and changed, which means that the quantity of friction in the system goes up considerably and important energies (resources) are consumed in order to accommodate change. A lot boils down to a change of the organizational behavior of actors, to the build-up of new organizational capital. In this phase *of* transition there exists a territory over which ...market coordination failures combine with an "abandoned child" feeling of many enterprises, which are no longer able to rely on central allocation of resources and customers. For these enterprises information and transaction costs skyrocketed.[22]

In spite of its tortuous path some institutional change did take place during those years; through spontaneous processes, such as massive land privatization and the emergence of a private sector (which preceded Law 54 of 1990 on the setting up of private enterprises),[23] as well as measures "from above" initiated by Government. Among the latter are the start of the two-tiered banking system (in 1990), the commercialization of state-owned enterprises (Law 15 of 1990), and the privatization Law 58 of 1991 which aimed at giving 30 per cent of the equity of commercial companies to Romanian citizens.[24] What happened with the privatization law is symptomatic of the vacillations and inconsistencies of reform policies during that period; Law 58 of 1991 created much confusion regarding the actual structure of property rights and the need for enhanced management of assets. What was lacking was a concern for building institutionally organized markets for factors of production.

Overall and in a formal sense, it can be said that policy-makers practiced a sort of "institutional mimetism" by trying to adopt, although in a highly inconsistent way, institutions found in the western world. A problem with institutional mimetism, however, is that it cannot deal with the fine print of reforms (institutional change) and, frequently, it lacks substance since the real functioning of institutions is driven by vested interests.

After December 1989 there was tremendous *pressure from below* to consume tradeables, to reduce exports and boost imports of both consumer and intermediate goods, after the years of severe deprivation in the 1980s. The switch in favor of tradeables was almost instantaneous and virtually unstoppable; it was also strengthened by a "shunning of domestic goods" syndrome. In 1990 the boost in consumption was financed primarily by dissaving (the depletion of foreign exchange reserves).

However, there is another side of the story that needs to be highlighted, namely, that policy-makers complicated the state of the economy both by commission and omission. By commission, since they faltered in the face of pressures from below and were influenced also by the prospect of elections in May 1990. This resulted in the concession of large wage rises[25] and the introduction of the five-day

[21] See also Kozul-Wright, R. and P. Rayment, 'The institutional hiatus in economies in transition and its policy consequences', *Cambridge Journal of Economics*, Vol.21, No.5 (September 1997), pp. 641-661.
[22] Daianu, D. (1994), "The Changing Mix of Disequilibria during Transition. A Romanian Background"", *IMF Working Paper*, 94/73. See also S. Estrin et. al. (ibid., p. 249)
[23] In 1991 the number of private companies rose quickly to 72,277; they operated mainly in trade and services. By the end of 1995 the number had risen to almost half a million. It should be recalled that, in contrast with Hungary or Poland, the communist regime in Romania did not allow any form of private property.
[24] It should be said that commercial companies represented only 60 per cent of state assets; the rest belonged to the so called '*régies autonomes*', which were created according to the French model.
[25] This development should be seen in the context of the elections in May 1990. Measured real wages rose by 11 per cent between December 1989 and October 1990, while output continued to fall. The

workweek, despite the fact that output was plummeting, together with the maintenance of wide-ranging price controls, a greatly overvalued exchange rate, and mismanagement of the foreign exchange reserves. By omission, for there were no serious attempts to deal with macroeconomic imbalances before November 1990. Events during that year revealed a fundamental flaw in the transformation process, namely, the considerable decision-making power of enterprises when they do not face hard-budget constraints.

Confronted with a rapid deterioration of the economy and unable to contain growing disequilibria (unsustainable trade deficits, rising prices, vanishing investment) a stabilization plan, supported by the IMF, was introduced at the start of 1991.[26] The middle-of-the-road, gradualistic stabilization programme that took shape included the following: a tightening of fiscal and monetary policy (although real interest rates remained highly negative), a tax-based incomes policy, a new devaluation and introduction of a two-tier exchange rate system (through the initiation of an interbank foreign exchange auction system, in February 1991). The programme failed to stop inflation.

At the end of 1991 there were growing tensions in the system: for example, an overvalued official exchange rate; artificially low prices for energy and raw materials which encouraged their overconsumption; and insufficient inflows of foreign capital to compensate for the low levels of domestic saving and the weakness of fixed investment. Many exporters and importers found a way out of the *impasse* in making barter deals, which introduced an *implicit* exchange rate into the functioning of the economy; this rate mitigated the pernicious effects of overvaluation but entailed considerable information and transaction costs. However, capital flight and insufficient exports were becoming matters of major concern.

In the spring of 1992 policy-makers were compelled to act. Interest rates were raised considerably, the refinance rate of the National Bank reaching 80 per cent; the exchange rate was devalued substantially and exporters were granted full retention rights in the hope of overcoming their mistrust of policy-makers and encouraging the repatriation of capital. The full retention measure was thought necessary since enterprises still had a vivid memory of the "confiscation" of their hard-currency holdings at the end of 1991. But the policy turnaround was incomplete and interest rates remained negative as a result of a large array of preferential credits and very low deposit rates - the latter reflecting a high propensity to shun the domestic currency in favor of the dollar. Political factors, resulting from the elections of September 1992, also weakened the determination of the government to pursue a consistent policy.

Table 1 Macroeconomic indicators, 1990-98

Indicators		1990	1991	1992	1993	1994	1995	1996	1997	1998
1.GDP (annual change)	%	-5.6	-12.9	-8.8	1.5	3.9	7.1	3.9	-6.6	- 7..3
2. Unemployment rate (end of period)	%	-	3	8.2	10.4	10.9	9.5	6.6	8.8	10.3
3.Inflation										
-average	%	5.1	170.2	210.4	256.1	136.7	32.3	38.8	154.8	59.1
-Dec./Dec.	%	37.7	222.8	199.2	295.5	61.7	27.8	56.9	151.4	40.6

removal of price controls began in November of that year.

[26] See also Demekas, D. G. and M. S. Khan (1991), "The Romanian Economic Reform Program", *IMF Occasional Paper*, No.89

4.M_2 (end of period)-growth rate	%	22	101.2	79.6	141	138.1	71.6	66	104.9	48..9
5. Nominal devaluation										
-average	%	50.3	240.5	303.1	146.8	117.8	22.8	51.6	132.5	23.8
-Dec./Dec.		140.4	444.5	143.3	177.4	38.4	45.9	56.5	98.8	36.5
6.M_2/GDP	%	55.7	27.4	20.1	13.8	13.3	18.1	20.5	18.1	
7.Budget deficit*/GDP	%	1.0	3.3	-4.6	-0.4	-1.9	-2.6	- 3.9	-3.7	- 4.0
8.Current account/GDP	%	-8.5	-3.5	-8	-4.5	-1.4	-5	-7.2	-6.7	- 6.6
9.Real wage index	%	5.1	-18.3	-13.0	-16.7	0.4	212.6	9.5	-22.2	6

* Consolidated budget
** Exchange rate variation deflated by the ratio between Romanian PPI and US PPI

Source: National Bank of Romania

2. 3 A policy breakthrough, 1993-1994: "the interest rate shock"

Rising inflation and the persistence of a large trade imbalance eventually forced a reconsideration of policies. A breakthrough occurred in the last quarter of 1993 when several key decisions were made in order to contain and reverse the dynamics of inflationary expectations, to start the remonetisation of the economy and to create a transparent, functioning foreign exchange market. The major omission in the whole strategy, however, was privatization, which would have had a major influence on the size of capital inflows and on the scope and intensity of restructuring.

The main decision, a dramatic rise in nominal interest rates, led to positive real interest rates. Thus, the National Bank's average refinancing rate rose from an annual rate of 59.1 per cent in September 1993 to 136.3 per cent in January 1994 and remained at that level for another three months. Commercial banks' lending rates followed suit with a two-month lag. This measure had two major consequences: first it stemmed the flight from the leu and started a rapid rate of remonetization; and, second, it greatly helped the formation of a transparent foreign exchange market and, thereby, strengthened the potential for an export drive. The scale of remonetization explains why the policy shock of 1994 did not lead to a decline of output as was the case in 1997 (when the economy was subject to a credit crunch).

Another key decision was the substantial devaluation (in several stages) of the official (inter-bank market) exchange rate which lowered it to more or less the rate prevailing on the grey market; this also increased the transparency of the foreign exchange market which in turn reduced considerably the entry costs for those in need of foreign exchange.

The third measure involved a stricter control of base money and consequently a reduced rate of money creation. And finally, the fiscal stance was tightened to aim at a low budget deficit when corrected for the removal of explicit and implicit subsidies.[27]

The results of this policy breakthrough were much as expected. Inflation fell to an annual rate of 62 per cent (December on December) in 1994 and there was a large reduction in the trade deficit to $411 million.[28] The

[27]The budget deficit was actually higher in 1994 (4.3 per cent) than in 1993 (1.7 per cent), but many implicit and explicit subsidies had been removed, which was a key objective.

[28]It can be argued, however, that the *ceteris paribus* condition does not apply in this assessment since there were favorable external 'shocks' as well.

economy absorbed the shock of high positive real interest rates and of the exchange rate unification which meant the suppression of some implicit and explicit subsidies to inefficient producers – and there was no decline of output. The removal of implicit subsidies explains why the budget deficit went up to 4.3 per cent in 1994, with a large part of its financing being obtained from external sources.

The export drive played a major role in the recovery, but it cannot explain why so many enterprises in the weak sectors also did well in 1993, especially as arrears did not "appear" to be rising sharply in 1994.[29] Several explanations can be suggested. One is the existence of important market imperfections, such as monopolies that can extract rents and which operate in the less efficient sectors. Another is that there are huge amounts of "X-inefficiency" in the system. This means that potential micro-efficiency gains are ubiquitous and that, when under pressure, even firms in the backward sectors can realize some of them and cope with the situation. But accepting this explanation requires an evaluation of the resilience of *organizational routines* in the system. An implication of the X-inefficiency explanation is that the pressure for fundamental restructuring begins to bite only when most of the efficiency reserves are exhausted. A third explanation is that there was more reliance on self-financing, although in fact many companies were plagued by a lack of working capital. Last, but not least, unwarranted bank lending (rollover of loans) may have played a significant role in supporting the weaker enterprises.

2. 4 Fragile growth and relapse into inflation, 1995-1996

In 1995 there was a rapid growth of GDP in Romania, 7.1 per cent against just under 4 per cent in 1994 and under 2 per cent in 1993; at the same time the inflation rate at the end of 1995 was about 28 per cent. The remonetization of the economy continued, as indicated by the expansion of the money supply (71 per cent) far exceeding the rate of inflation (table .1). While exports continued to grow rapidly (by over 20 per cent) imports increased by more than 30 per cent, causing the trade imbalance to increase again to more than $1,200 million and putting pressure on the foreign exchange (inter-bank) market.

What caused the trade imbalance to deteriorate again, bearing in mind that the real exchange rate did not appreciate in 1995 (although it did so in the second half of 1994) and that there were no major changes in the terms of trade in this period? One explanation is that an import and consumer spending boom started in the last months of 1994, which, arguably, might have been encouraged by perceptions that the exchange rate was unsustainable. But this explanation would have to be reconciled with the fact that in 1994 the trade and current account imbalances improved dramatically and the foreign exchange reserves of the banking system (including the Central Bank) increased substantially, which might have suggested that the exchange rate was in fact sustainable. It is also possible that the various economic agents were unused to stability of the nominal exchange rate and therefore anticipated an inevitable depreciation which, paradoxically, may not have been justified by the economic fundamentals. Another conjecture is that some of the improvement in the trade balance in 1994 was caused by temporary factors; their removal in the following year then put additional pressure on an exchange rate that was already overvalued. Without dismissing these factors, the more important explanation is probably that the higher growth rate of the economy, driven by highly import-dependent branches, led to overheating and the rapid growth of imports.

In 1996 there was a clear link between inflation and the way the budget deficit was financed. Whereas the target for the consolidated budget deficit was 2.2 per cent, it turned out to be 5.7 per cent, on an accrual basis. More significant was that its financing was inflationary as a result of the commercial banks buying an increasing volume of three month T-bills. The scale of inflationary financing was augmented by the injection of base money in order to cover the quasi-fiscal deficit which arose because of the losses of agriculture and of the *régies autonomes*. Together with the quasi-fiscal deficit the fiscal imbalance reached 8.4 per cent (on an accrual basis) in 1996 (table 2).

The process of remonetization had supported the efforts to subdue inflation in 1994 and 1995. Regarding remonetization several aspects should be emphasized:

a) it facilitated the subsidisation of various sectors of the economy (agriculture, energy) from the Central Bank's resources, allowing the Central Bank to pursue simultaneously the reduction of inflation. The sectoral financing mirrored the existence of major structural disequilibria in the economy;

b) it "helped" put off dealing resolutely with the two failed banks - Dacia Felix and Credit Bank; more then 1,700 billion lei (c. $400 million) were injected in both through special credits during 1995-1996. If money demand had not grown for most of 1995 and 1996 the size of the special credits would have certainly fuelled inflation. The reason for this injection was that there was no insurance scheme for small depositors and so it was felt necessary to forestall a run on the banks, and, therefore, a possible systemic crisis;

c) it involved the expansion of base money through the increase of net domestic assets, and not through the accumulation of net foreign assets. Ideally, remonetization should have taken place as an outcome of a rise in net

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[29]Caution is required with the numbers since arrears can be obscured by inefficient activities being kept afloat by bank lending (via rollovers). Ultimately, these 'hidden' arrears will show up in a deterioration in the portfolios of the banks. This is what appears to have happened in 1996 and thereafter.

foreign assets - that is, as a result of capital inflows or of net exports and not, primarily, via base money injections which supported the expansion of domestic credit;

d) it can be argued that this remonetization slowed down the development of monetary policy instruments, namely open market operations. This is because the Central Bank did not face the pressure to cope with a surge of liquidity as would have been the case with substantial capital inflows. The main reasons why such inflows did not occur are the feeble pace of privatization during 1994-1996, the poor functioning of the domestic capital markets, and the credibility problem surrounding domestic policies.

By the end of 1996 several worrying tendencies had emerged: a very sharp rise in the monthly inflation rate which was in double-digits in the last quarter of the year; the sharp rise in the trade and current account deficits, although the growth rate of GDP was lower than in 1995 (3.9 per cent as against 7.1 per cent); and still greater distortions in relative prices due, especially, to the delay in adjusting energy prices and to the administrative control of the exchange rate. Overall, the macroeconomic stabilization programme was losing steam. The inflation rate at the end of the year was 57 per cent. Furthermore, in spite of heavy borrowing (over $1.5 billion) on the international capital markets,[30] the foreign exchange reserves of the National Bank stood at about $700 million at the end of 1996. The external debt of the country was rising rapidly with peak payments looming in the following years. In addition, the policy mix being pursued by the Government (multiple exchange rates, price controls, subsidies, etc) was making it unlikely that it would be possible to reach a new arrangement with the IMF. Such developments were clearly leading to a dead-end and a policy change was urgently required.

The events of 1995 and 1996 underscored both the importance of privatization for inducing autonomous capital inflows and for enhancing restructuring, as well as the danger of "populist macroeconomics".[31]

Table 2. Fiscal and quasi-fiscal deficits

As per cent share in GDP

	1993	1994	1995	1996	1997
Budget balance					
Total					
Cash	-0.4	-1.9	-2.6	-3.9	-4.5
Accruals	-0.4	-1.9	-3.0	-5.8	-3.5
Primary					
Cash	80.6	-0.5	-1.2	-2.2	-0.5
Accruals	0.6	-0.5	-1.6	-4.1	0.5
Quasi-fiscal deficit NBR refinancing	-3.1	-3.6	-0.3	-2.6	0.0

[30]During 1995 Romania was rated BB- by the principal western rating agencies (and BB+ by JCRA), which helped the raising of money on the international capital markets. These accommodating capital inflows fended off a major balance of payments crisis in 1996.
[31]The elections of 1996 clearly had an impact on macroeconomic policy and, subsequently, on the performance of the economy.

Budget balance including quasi-fiscal deficit					
Total					
Cash	-3.5	2-5.5	-2.9	-6.5	-4.5
Accruals	-3.5	-5.5	-3.3	-8.4	-3.5
Primary					
Cash	-2.5	-4.1	-1.5	-4.8	-0.5
Accruals	-2.5	-4.1	-1.9	-6.7	0.5
Memorandum item: Interest payment	0.9	1.4	1.4	1.7	2 4

Source: National Bank of Romania

2. 5 The "policy shock" of 1997 and its consequences, 1997-1998

At the end of 1996 the economic situation was as follows: the monthly inflation rate was over 10 per cent; the consolidated budget deficit and the quasi-fiscal operations of the Central Bank were in excess of 8 per cent of GDP; the current account deficit was about 7.4 per cent of GDP; and foreign exchange reserves were down to some $600 m, less than a month's imports in spite of the large loans than had been raised in the international capital market. At the same time, financial indiscipline (total arrears) had reached a magnitude that was causing serious concern (about 34 per cent of GDP), while inadequate steps were being taken toward privatization and restructuring. Last but not least, the remonetization of the economy had allowed massive subsidies to be given to agriculture and other sectors in 1995 and 1996 without raising inflation; as the remonetization process came to a halt in the latter half of 1996, maintaining subsidies without igniting inflation was to prove an impossible endeavor.

What happened in 1997? The new government's first step was to liberalize the foreign exchange market and the prices of certain goods which were still administratively regulated. Paradoxically, in a year when renewed efforts were made to achieve macroeconomic stabilization, the expected annual inflation rate, 90 per cent, was much higher than in 1996 (57per cent). The explanation of this paradox lies in the magnitude of the effect of liberalizing prices and the anticipated devaluation of the leu.[32] Nevertheless, the

[32]From some 4,000 lei/$1 at the end of December 1996 the rate rose sharply to about 9,000 lei/$1 in

assault upon several of the major imbalances led to some positive results: the foreign exchange market began to function adequately; the consolidated budget deficit (including formerly quasi-fiscal operations) was reduced to 3.7 per cent of GDP;[33] the current account deficit shrank a little, from 7.2 per cent to 6.6 per cent of GDP; and the Central Bank's foreign exchange reserves soared to about $2.6 billion.[34] The size of the fiscal adjustment should also be seen against the backdrop of the sharp fall in output, which greatly reduced the tax base. But despite all this, there was another side to the coin: the actual inflation rate was 151 per cent and GDP fell by much more than expected (6.6 per cent as against 2 per cent). Both demand and supply shocks were behind the decline of the economy.

One consequence of the programme, which is not often mentioned, was its severe impact on the emerging private sector. The large contraction of real credit lowered considerably the prospects for many small and medium-sized companies and was a major factor in the fall of output. Thus, total real credit (in domestic and foreign currency) declined by 52.5 per cent and its non-government component by as much as 61.3 per cent. This should be set against the growth of real credit in previous years when the non-government component increased by 19.7 per cent, 35.6 per cent, and 4.1 per cent in 1994, 1995, and 1996, respectively.[35] In many sectors sales fell by 20-25 per cent. This development was the reason behind the growing chorus of demands in the private sector for fiscal relaxation, demands which became very intense during 1998. Ironically, a programme which was meant to advance reforms, affected negatively the emerging entrepreneurial class and encouraged the expansion of the underground economy because of the degree of austerity involved.

There are several factors that explain the high rate of inflation. First, the corrective component of inflation (price de-control plus a rise in some administered prices) came strongly into play in March when inflation reached almost 30 per cent. Secondly, the overshooting of the leu. Thirdly, the programme underestimated the role of monopolies and the slow response of supply as sources of inflation. Another factor lay in the economic policy slippage in the latter half of the year when there was a premature relaxation of monetary policy: there was an extensive and abrupt indexation of wages, redundancy payments were granted to laid-off workers, and large amounts of money were pumped into banks that were in difficulty. It was obvious that the macroeconomic policy mix was not well balanced and that the supply side response had been greatly overestimated.

Belated moves were made to restructure some of the major "producers" of arrears. The delay was due to the inherent problems of undertaking such an operation in a year when the economy was in steep decline: on the one hand, the overall measures aimed at restructuring implied the need for layoffs, but on the other hand, the troubles confronting the small and medium-sized enterprises in the private sector, a direct consequence of the austerity measures, were discouraging the creation of new job opportunities. Privatization of

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late February 1997, after which a nominal appreciation took place and the rate stabilized at around 7,000 lei/$1.

[33]This is an overstatement to the extent that arrears stood at a high level and even increased. The bail-out of Banca Agricola and Bancorex in 1997 indicated how serious the problem of arrears was and how they can obscure quasi-fiscal deficits.

[34]Significant amounts of portfolio capital entered the country, which tested the ability of the Central Bank to sterilize them when base money represented no more then 4.6-4.7 per cent of GDP.

[35]National Bank of Romania data.

large enterprises dragged on at a snail's pace and as for bank privatization, the various projects were left in abeyance. Such a situation could not provide incentives for direct foreign investment nor promote restructuring.

In the last months of 1997 the big losses of state banks, accumulated over a long period and mirroring the state of the real economy, attracted increasing attention. In the last quarter of the year, the Central Bank and the Ministry of Finance converted 8,000 billion lei ($1 billion) of poor credits granted by the Agricultural Bank and Bancorex into government bonds as a way of recapitalizing the two banks. While the Dacia Felix and the Credit Bank failures were caused by large-scale fraud and embezzlement, the failure of the state banks was the result of a chronic misallocation of resources and of poor performance in a number of large economic sectors, which in turn was due to slow restructuring and feeble capital inflows.[36]

GDP continued to decline in 1998, according to preliminary data, by almost 7% per cent. At the end of the year unemployment stood at about 10 per cent (as against 6.6 per cent in December 1996). Inflation in December (year-on-year) fell to 40.6 per cent, and the consolidated budget deficit was kept to just below 4 per cent. The latter should be seen against the background of a further reduction of the tax base (because of the fall in output) and the implications for government spending of the rescue package for the two state-owned banks. Actually, the budget deficit was kept under control by a very severe cut in public expenditure undertaken in August.

Real interest rates stayed high in 1998[37] as a result of the tight monetary conditions and a lack of sufficient credibility in macroeconomic policy. Their level indicated how small was the room for maneuver available to policy-makers. Interestingly, real credit started to grow again in 1998 although output did not. Between December 1997 and November 1998 real domestic credit rose by some 24 per cent with the non-government component increasing even more. A note of caution is needed here, however, since over the same period, the net foreign assets of the banking system fell by almost a half and the real money supply shrank (see table 1) --which indicates no resumption of remonetization.

Based on consumer prices, the exchange rate appreciated in real terms by about 30 per cent since mid-1997 (after the sharp devaluation at the start of that year), which helps to explain the rising trade and current account deficits in 1998. The foreign exchange reserves of the National Bank declined to less than 1.9 billion at the end of the year, a result of its interventions to stem the fall of the leu. It should also be mentioned, that excessively lax income policies also help to explain the size of domestic absorption in a year when there was a further contraction of output. Real wages actually grew by about 4.7 per cent in the year to December (table 1).

The fallout from the financial crisis in Russia led to the postponement of new external bond issues, and cast doubt on the possibility of rolling over a portion of the external debt in 1999. Because of the size of payments due in 1999 (about $2.9 billion) there is a threat of a financial crisis and default unless an agreement with the international financial

[36]Behind these developments was the slow pace of privatization which therefore failed to attract capital inflows and thereby help restructuring.
[37]In the second half of the year *ex post* US dollar returns on three-month T-bills hovered at about 50 per cent.

organizations is reached early in 1999. This threat explains the considerable efforts to conclude privatization deals at the end of 1998 (Romtelecom, Romanian Development Bank, etc.) and the attempt to close down large loss-making companies.

2.6 A comparison of the two stabilization programmes, 1994-1995 and 1997-1998

There are several features which differentiate the two attempts at macroeconomic stabilization in 1994-1995 (hereafter policy A) and in 1997-1998 (policy B). These differences help to explain why output grew, albeit on a very fragile basis, during the first attempt whereas it declined in 1997 and 1998. It should be stressed that in both cases the pace of restructuring was feeble.

Both policies were accompanied by interest-rates shocks. However, policy A did not involve a credit crunch; on the contrary, M2 grew rapidly and so did lending. As was mentioned already, this was due to the rapid remonetization of the economy, which was enhanced by a psychological factor: for the first time people found it worthwhile to put their savings into banks (because of positive real interest rates). Consequently, bank deposits grew rapidly. The psychological-cum-savings reorientation factors were no longer strong in the second period, and the sharp rise in interest rates (in 1997) could not be accompanied by remonetization. Policy B, as a matter of fact, involved a major credit crunch.

It should also be emphasized that the process of remonetization came to a halt in the second half of 1996, which created a major constraint for policy in 1997. The increase in the velocity of money forced policy-makers to consider a much tighter monetary policy. The issue at stake was how much tighter it should be.

Policy B involved exchange rate unification via a large overshooting of the leu, which magnified inflation and the decline of money balances in real terms. Policy A included multiple exchange rates and controls on key prices such as energy.

Policy B involved a major fiscal adjustment, including a large reduction in explicit and implicit subsidies, which affected certain sectors more heavily than others.

Policy B used as a nominal anchor base money (which actually recovered its 1996 December level in the second quarter of 1997), whereas policy A was quite eclectic, relying on both the control of the money supply and a certain degree of stability in the exchange rate[38] during the phase of intense remonetization.

Macroeconomic imbalances persisted, or even developed, over the 1994-1996 period. Arrears rose to over 34 per cent of GDP in 1996 (from an average of 22-23 per cent in previous years), which was increasingly worrisome since, as the economy had been growing, restructuring should have been encouraged. A factor here is that policy-makers ignored the need for a restructuring policy, an industrial policy conceived as a damage-control device.[39] The growth of arrears indicated the unsound basis of economic growth. The rising trade deficits in 1995 and 1996 were financed by substantial compensating capital inflows, which created a dangerous situation for the following years. With the benefit of hindsight, one can imagine various scenarios against the backdrop of the world financial crisis.

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[38] The plural “exchange rates” is emphasized since a *de facto* quasi-unification of the rates occurred during 1994. The relative stability of the rates helped the stabilization effort at that time.

[39] An industrial policy, seen as managing the gradual phasing-out of chronically inefficient companies, was advocated in my ‘Transformation and the Legacy of Backwardness’, *Économies et Sociétés*, No.44, May 1992, pp. 181-206.

Policy B tried to speed up privatization and used the Stock Market to this end. This explains the large inflows of portfolio capital in the first half of 1997 and the accumulation of foreign exchange reserves by the Central Bank. In 1997 Romania, for the first time, received substantial autonomous capital inflows, which tested the sterilization capacity of the central bank. These flows later subsided as policy ran into an impasse.

An apparent puzzle comes out of comparing the two programmes. In the period 1994-1996 the trade and the current account deficits rose in the wake of the expanding economy. With the very severe compression of domestic absorption in 1997 and 1998 an improvement in the current account deficit might have been expected. There was a slight reduction of the deficit in 1997 (as against 1996), but it started to grow again in 1998. The fact is that, after a fall in GDP of more than 13 per cent in just two years, the current account deficit remained in the vicinity of 7 per cent of GDP. The immediate explanation is that this was due to the real appreciation of the exchange rate and the lax incomes policy in 1998.

Whether the fall in output could have been smaller, or even avoided, in 1997 can only be a matter for speculation. It is clear nonetheless that, owing to very tight credit conditions, a continuation of growth was hardly possible and this is why the programme anticipated a decline of 2 per cent in GDP. One policy issue for analysis is the appropriateness of the nominal reduction of base money in the first quarter of 1997, instead, for instance, of keeping Mo fixed for a while. The reasons for the reduction – a rising velocity of money and the desire to mitigate the size of the correction in the price level – are plausible but not indisputable. In addition, the appropriateness of moving at the same time on two tracks, the cut in Mo and floating the exchange rate, can be questioned. It is possible to conceive of a sequence of moves so that the floating of the exchange rate would have followed the correction of the inflationary surge that had been set off by the too rapid expansion of base money in late 1996. There might also have been a closer and more critical look at the size of tariff reductions proposed for agriculture. The conclusion is that policy-makers underestimated the scale and extent of supply rigidities in the economy.

As for the 1994-1995 programme, it should again be emphasized that the slow pace of privatization and restructuring damaged its effectiveness. A faster rate of privatization, and consequently more capital inflows, especially of FDI, could have changed significantly the structure of the economy. Even if the then Government had not allowed the official exchange rate to float, a dual system – a commercial rate with rationing, and a free rate for financial transactions – could have created an exit window for potential foreign investors in the local equity market. The Government might have also used the favorable circumstances of an expanding economy to deal with the large loss-making units. The failure to do so represents a missed opportunity.

2.7 What next?

In early 1999 Romania faces three major inter-linked threats and policy challenges: the risk of an external payments default;[40] the danger of a banking crisis owing to the scale of bad loans in the banking system and the size of the foreign exchange reserves of the central bank, which were less than base money and insufficient to stem a run on the banks;[41] and a possible financial crisis as a result of persistently high real interest rates and the consequences of a further bail-out of Bancorex (about $400 million in December 1998). Other important constraints on policy are social and policy fatigue,[42] and an increasingly unfavorable external environment.

In February 1999 the Parliament approved a budget that envisages a deficit of 2 per cent of GDP and which relies on a rise in taxation and further cuts in expenditure.[43] The letter of intent signed with the IMF, in April, condones a bigger deficit, of 2.7%. The big unknown in the whole picture, however, is the real quasi-fiscal deficit in the economy which is hidden by arrears and the accumulation of bad loans to enterprises. What happened with Bancorex and Banca Agricola is an illustration of the result of years of weak restructuring, which shows up in the balance sheets of the banks[44] and, ultimately, in the consolidated budget deficit when the "day of reckoning" cannot be postponed any longer.

In the short run, in order to avoid default on external payments, it is essential for the Government to reach an agreement with the IMF and the World Bank. The difficulties of concluding such agreements stem from the requirements of further drastic cuts in the consolidated budget deficit and of finding resources to finance substantial restructuring in a year when GDP is expected to fall again. As already mentioned, a very critical challenge for policy is to avert a banking crisis. Over the longer term, the Government needs to design a strategy which will help the export-orientation of the economy, lead to better management of the external debt, and create conditions for sustainable economic growth.

3. Concluding remarks

A command system allocates resources inefficiently because of the impossibility of economic calculation. Consequently, the freeing of prices and the functional opening of the economy put the latter under tremendous *strain* when resource reallocation cannot take place quickly enough and without friction. *Strain* is augmented by congenital institutional fragility.

The magnitude of the required resource reallocation can seriously undermine the attempt to pursue a low inflation rate in the short run, particularly if the lack of capital markets, the presence of large and growing budget deficits, low savings rates, and meagre foreign capital inflows and external aid are taken into account. In a system subject to substantial strain there are strong forces that create a high propensity to generate inflation as a way of diffusing tension by spreading out, or putting off, the costs of adjustment; another effect of strain are massive inter-enterprise arrears, which appear as a *sui generis*, and unintended financial innovation and create a structural trap for stabilization policy. The *inflation tax* and *negative real interest rates* are implicit subsidies for those that are unable to make ends meet financially in a competitive environment.

Analysts have frequently highlighted the relatively tighter financial discipline in countries such as Hungary, Poland and the Czech Republic, as compared with the Russian Federation, Ukraine, or Romania. It is suggested here that an explanation is provided by looking at the *structure* of the former economies,[45] their ability to export to western markets and to attract foreign investment, their size, their economic policies, and not least, geography. Furthermore, *structure* is influenced by whether or not there was a history of partial reforms (that, in some cases,

[40] Despite a moderate level of external debt (which does not exceed 30 per cent of GDP), it has nevertheless been increasing rapidly. Questions, however, can be raised about the management of the external debt, with a peak payment approaching $2.9 billion in 1999.

[41] At the start of 1998 the $500 limit to the purchase of hard currency by individuals was lifted. This measure may increase the risk of a run on the banking system.

[42] The result of an austerity policy under way for two years in which GDP has fallen by more than 13 per cent.

[43] Particularly worrisome are the low shares in the state budget of expenditure on education and healthcare, and the plunging share of capital expenditure (especially on infrastructure).

[44] According to data made public by the National Bank, non-performing loans were above 60% of total outstanding loans in June 1998, with much of it belonging to the large state owned banks.

[45] A World Bank study shows the median number of employees in a sample of firms in Romania to be 1,327, whereas in other countries it was very low: Slovenia, 213; Poland, 820; Hungary, 241; Bulgaria, 291.

brought about several of the ingredients of a market environment), the degree of concentration of industry, and the prior existence of a private sector. Policy credibility can be singled out as a major explanatory factor, but credibility itself depends on how much structural adjustment can be brought about by that policy over a stated period; and the *capacity to adjust* is influenced by the initial *structure* and the scale of *resource misallocation* that it contains.

If it is accepted that the roots of financial indiscipline are to be sought in *structure* however multifaceted and the *strain* to which the economy is subjected, the obvious conclusion is that both *structure* and *strain* have to be targeted by policy. Dealing with *structure* includes a focus on both property rights and corporate *governance*. Also attention must be paid to the development of appropriate and effective market institutions and to finding ways to erode the existing economic power structure and to change enterprise behavior. *Strain,* which reflects the scale of the required resource reallocation, should be approached by starting with the simple truth that structural adjustment is always difficult even in an advanced market-based economy and even when reform is credible.[46]

The Romanian experience is a glaring example of the importance of structural reforms, of reducing the structural distortions of the economy for durable macroeconomic stabilization. At the same time, is proof of the pains of such reforms. Unless financial discipline (hard budget constraints) is (are) imposed, the pressure on the central bank and on the banking sector in general, becomes a constant feature of the way the system does function, which also proliferates into wide-ranging rent-seeking (demand for cheap credit). Here one sees the combination of the pressure exerted by those who cannot pay at the new relative prices with that of those who do not wish to pay for 'it pays not to pay' (the moral hazard issue). Another lesson of this experience is the link between privatization, capital inflows, and restructuring. With the benefit of hindsight it can be asserted that the magnitude of required resource reallocation assigns a special role to foreign capital in helping reallocate resources and in imposing financial discipline in the system.

Where policy is inconsistent, privatization is slow, and foreign direct investment is non-significant, high strain persists; it undermines macroeconomic stabilization and preserves the *flow problem* of the banking industry. Here a dangerous vicious circle can be at work between macroeconomic policy and the state of the banking system. Thus, unless there is deep restructuring of the economy, both tightening and expansionary policies can be ambivalent as to their impact on banks; expansions can be accompanied by poor lending and unsustainable trade imbalances (as it happened in the second half of 1995 and in 1996), whereas high real interest rates (as during 1997-1998) can damage the payment capacity of banks and enterprises and unleash mounting pressure for forgiveness.

Unless authorities can create and maintain a momentum of policy steadiness, the feeling of overall uncertainty and volatility is unlikely to be mitigated. Although stop and go measures can hardly be avoided under the circumstances, large policy fluctuations are detrimental to economy; they entail large income transfers among economic sectors and groups of population, and unnerve expectations instead of stabilizing them. Think only about the dynamic of inflation in recent years: from about 200% and 295% in 1992 and 1993, respectively, to cca. 62% in 1994, 28% in 1995, 57% in 1996[47] , 151 in 1997, and 40.6% in 1998. This dynamic was accompanied by dramatic shifts in interest rates - from highly negative, during 1990-1993, to highly positive levels in 1994 and in subsequent years.

If the level of positive real interest rates would continue to be quite high (in the absence of substantial restructuring and of the reduction of the fuzziness of the environment) this will be detrimental to long-term investments and would skew the composition of foreign capital inflows in favor of portfolio capital. It would also damage the longer-term prospects for banks since high spreads do not help their clients and intensify *adverse selection.*

Without deep restructuring high real interest rates will maintain intense strain in the system and make it prone to instability. In this context, the situation of potentially viable enterprises, but which are burdened with heavy debts, should be considered more creatively. It should be kept in mind that many companies are heavily in debt because they were under-capitalized (without working capital) by design, and not by choice, as was the case of firms in South East Asia. The fact is that tight monetary conditions and high real interest rates can kill even potentially viable companies. One way of reducing this risk would be to distinguish between past and current payments. On past debts the interest rate paid could be composed of two elements: the registered inflation rate and the real interest prevailing on international markets; whereas current interest rates should apply only to current payments.[48] Something along this line could mitigate the plight of many potentially sound companies.

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[46] M. Bruno, (December 1992), "Stabilization and Reform in Eastern Europe: A Preliminary Evaluation", *IMF Staff Papers*, Vol. 39,4, pp.753.

[47] Inflation rates are recorded end of the year.

[48]See my article "What to do about high real interest rates?", *Ziarul Financiar* (in Romanian), 24 March, 1999. Martin Feldstein has proposed something similar for Asian companies hurt by the high real interest rates resulting from austerity measures. M. Feldstein, "All is not lost for the won", *Wall Street Journal*, June 4, 1998.

Apart from the extraordinary pressure exerted by strain the *fuzziness* of the environment impacts people's behavior and causes short-termism *Fuzziness* and uncertainty explain also why banks have a very low propensity to provide long-term credit, a phenomenon enhanced by low domestic savings[49].

Large policy fluctuations can easily lead to a *boom and bust* evolution of the economy. The economic dynamics in post-communist Romania show the difficulty the policy-makers has had in setting a corridor of policy steadiness and its reactive stance most of the time.

Institutions determine ultimately economic performance. Institutions, understood as socially accepted rules and procedures, determine the quality of economic policy and of its choices as well. However, institutions cannot be created by 'hocus pocus economics'; particularly in the case of post-communist economies, one can detect the tension between constructivism and organicism in fostering institutional change.

Romania's experience shows that *natura non facit saltus,* that making institutions function properly takes time, and that there is a grip of *structure* - as the product of history - that is hard to loosen. It would be naive to assume that the institutions of the post-communist economies can quickly and easily perform according to the various role models of Western Europe or North America; they need time to develop in order to perform effectively. Realism is needed not only in designing policies, but also in making balanced judgements as to "what constitutes good performance" and "what is to be done next".

Appendix1: Strain in a transforming economy. A formal analysis

In a transforming economy, the origin of strain can be traced to two main sources: the fragility of institutions in the making and the magnitude of the required reallocation of resources (Daianu, 1994, 1997). In what follows the focus is put on the second factor, namely, the ability of the system to react rapidly - via resource reallocation - to the new set of market-clearing prices.

The magnitude of the required resource reallocation can be illustrated by the ratio:

$$(2)\quad J = \frac{\sum p_i^* \left| q_i^* - q_i \right|}{\sum p_i^* q_i^*} 0$$

where (p*) and (q*) refer to equilibrium values, whereas (p) and (q) correspond to the current (distorted) resource allocation. J can be viewed as a measure of aggregate disequilibrium (in the system) as against the vector of equilibrium prices and quantities.

The size of the above ratio measures the *strain* within the system and reflects the magnitude of aggregate disequilibrium. It can be assumed that the possible level of unemployment is related to the degree of *strain* in the system: the higher is *strain* (resource misallocation) the higher is the unemployment that would be brought about by the required resource reallocation –when job creation is not intense. This is a major reason which lies behind the temptation to tolerate high inflation rates as a way to diffuse the tension within a system. S*train* can be mitigated by: inter-enterprise arrears, monopoly pricing, explicit and implicit subsidies, spill-over effects, the elimination of negative value-added activities, *learning*, and last, but not least, the efficiency reserves of producers, exporting it.

The more numerous are those who would lose their jobs because of the needed resource reallocation the more intense would be the opposition against it, against restructuring.

Another way of portraying *strain* is to focus on the scope of the required process of overall income (wages) readjustment, which should fit the new market-clearing prices. The modified form of J' that builds on wages is:

$$\textit{(2)}\quad J' = \frac{\sum n_i \left| w_i^* - w_i \right|}{\sum n_i w_i} \textit{0}$$

where n denotes labour in sector (i), and w_i* and w_i refer to equilibrium and actual wage, respectively, for the sector (i). $\Sigma n_i = N$, where N refers to all labour resources. For the inefficient, subsidized (explicitly, or implicitly) sectors actual wage exceeds the marginal productivity of labour: $w_i > dq_i / dn_i$. The higher is J', i.e., the higher is strain, the more fierce would be the distribution struggle. The difference between equilibrium and actual wages reflects the resource transfer (subsidies) practiced by the system; the higher is this difference the stronger will be the forces that oppose change.

[49] In 1998 aggregate savings were cca.9% of GDP in Romania.

In an OECD study[50] the level of *strain* in labor market adjustment is compared with other countries (Table 3). The equilibrium level was defined, in a somewhat arbitrary way, as the structure of relative wages (on the price side) and employment (on the quantity side) in the U.K. for the year 1994 (latest data available). Another benchmark country could be used; the essential results do not change dramatically if, for example, France was chosen instead of the U.K. The results suggest four main points:

i) As expected, the distance between the U.K. and the transition countries, in particular Romania, is much higher than the distance vis-à-vis a country like France. It is important to confirm this basic and intuitive result before pursuing further the interpretation of the indicator.
ii) The level of strain in Romania is much higher for the employment structure than for relative wages. Somewhat surprisingly, Romania had by 1995 a much closer relative wage structure to the UK than other countries in transition.
iii) However, the overall required adjustment (combining the price and quantity sides) is the highest in Romania.
iv) Finally, without the agricultural sector, the structure of the Romanian economy would appear much closer to the other countries in transition.

This indicator confirms some of the features of the Romanian economy. Notably, the legacy of the previous economic structure appears to be particularly heavy in Romania at least when compared with other transition countries in central and Eastern Europe. This may explain why there has been so much resistance to structural change; and, also, why inflation and inter-enterprise arrears have become a way of diffusing the pressure in the system when unemployment was not allowed to exceed a certain upper limit (for political reasons) and when non-inflationary means for financing the budget were hardly available.

[50] "Romania- Macroeconomic stabilization and restructuring, social policy", OECD Economic Surveys, Paris, 1998, pp.169-172

Table 3 Levels of *strain* in labour market adjustment

	Romania		Hungary		Poland		Czech Rep.		Slovakia		Slovenia		*Franc*	*UK*
	1990	1995	1992	1995	1992	1995	1991	1995	1991	1995	1993	1995	*1992*	*1994*
Relative wages (average monthly earnings = 100)														
Agriculture and forestry	**104.2**	**81.6**	68.9	76.8	82.3	90.6	97.2	84.2	99.7	81.7	105.3	95.5	*72.5*	*77.9*
Industry	**98.6**	**107.6**	99.0	104.0	98.7	108.9	104.5	99.2	101.4	104.3	84.9	85.0	*111.1*	*116.5*
Constructions	**110.9**	**106.4**	90.2	84.4	106.1	92.5	106.2	108.0	102.4	104.8	83.0	82.5	*98.6*	*109.2*
Trade, hotel and restaurant	**86.1**	**78.2**	97.0	90.0	90.3	88.9	85.8	88.2	89.3	94.0	102.2	99.8	*90.9*	*69.9*
Transport, communications	**108.5**	**121.0**	105.8	106.5	102.1	101.2	102.1	100.7	102.1	108.4	115.0	110.9	*105.4*	*144.6*
Financial banking and insurance, real estate and other services	**109.3**	**126.8**	144.7	137.4	147.7	137.3	99.9	130.7	103.9	131.4	143.8	124.6	*128.0*	*136.8*
Education, health and social assistance	**96.5**	**85.3**	93.5	86.5	86.9	81.7	93.2	91.2	97.6	87.2	111.8	109.6	*75.8*	*53.0*

Public adm. and defense, other branches	**88.9**	**88.6**	118.0	111.3	115.7	108.9	88.5	103.8	103.4	102.5	127.8	132.7	*91.0*	*93.6*
Index of “strain” on prices	**23.0**	**9.8**	24.1	19.7	18.3	17.0	21.1	19.1	23.8	17.2	33.9	33.1	*11.7*	
(excluding agriculture)	**21.2**	**12.9**	26.0	21.3	22.9	18.1	21.2	20.0	24.0	18.6	34.5	34.8	*12.0*	
Employment shares (%)														
Agriculture and forestry	**29.0**	**34.4**	11.4	8.1	25.5	22.6	12.1	6.6	15.8	9.2	10.7	10.4	*5.2*	*2.0*
Industry	**36.9**	**28.6**	30.2	27.1	25.2	25.9	41.0	33.2	35.9	30.3	38.7	38.0	*20.6*	*20.2*
Constructions	**6.5**	**5.0**	5.4	6.0	6.6	6.1	5.7	9.2	8.2	8.6	5.4	5.1	*7.2*	*6.4*
Trade, hotel and restaurant	**6.87**	**10.4**	14.8	15.9	10.7	13.6	7.8	15.7	8.1	13.1	14.6	15.4	*17.4*	*20.8*
Transport, communications2	**7.0**	**5.9**	8.6	8.8	5.5	5.8	9.0	7.7	5.5	7.8	6.5	5.9	*5.8*	*5.8*
Financial banking and insurance, Real estate and other services	**3.9**	**4.2**	5.2	5.9	1.3	2.0	5.4	6.7	5.4	5.8	4.6	6.1	*10.8*	*12.5*
Education, health and social assistance	**6.7**	**8.1**	13.6	15.6	13.1	13.3	13.8	12.1	16.5	14.5	10.2	11.4	*6.9*	*14.5*
Public adm. and defense, other branches	**3.1**	**3.4**	10.6	12.5	12.1	10.7	5.1	8.8	4.6	10.7	9.2	7.6	*26.2*	*17.9*
Index of “strain” on quantities	**91.4**	**76.6**	47.6	37.2	60.4	56.7	68.1	47.1	68.7	45.9	62.2	56.7	*13.8*	

(excluding agriculture)	**76.4**	**57.5**	41.5	33.7	46.0	42.4	63.1	44.4	63.4	43.2	52.9	48.3	*21.8*	
Indicator of total "strain"	**94.2**	**77.2**	53.3	42.1	63.1	59.2	71.3	50.8	72.6	49.0	70.9	65.6	18.1	
(excluding agriculture)	**79.3**	**59.0**	49.0	39.9	51.4	46.1	66.6	48.7	67.8	47.0	63.2	59.5	24.9	

Source: OECD Economic Surveys, Romania, Paris, 1998, pp.171

Appendix 2: A symptom of *systemic strain:* inter-enterprise arrears

Inter-enterprise arrears reflect *strain i*n a post-command economy. As *temporary quasi-inside money*, inter-enterprise arrears endogenize the money supply growth in a perverse way and emasculate monetary policy to a significant extent. Concerning inter-enterprise arrears in post-command economies, there are other explanations to highlight: the fuzzy state of property rights (Khan and Clifton, 1993), the primitive state of the financial system (Ickes and Rytermann, 1992), the real credit squeeze (Calvo and Coricelli), and the lack of policy credibility (Rostowski, 1994). In what follows I will use a very simple model in order to underline *strain* in explaining inter-enterprise arrears.

Let us suppose that the output of an agent is an increasing function of market *discipline* visualised as a public good, or as a *positive externality* – as a means for easing the efficient allocation of resources. *Market (financial) discipline* emerges as a public good and as a *positive externality* because of collective (generalized) good behavior. The state does not supply it, though it can influence its production by the enforcement of bankruptcy procedures and the provision of other institutional means. Nonetheless, the state action (policy) of enforcement becomes irrelevant when collective good behavior is impossible for various reasons, and, as it is our contention, because of *strain* in the main.

Were market disciplines perfect and resource reallocation fast enough, inter-enterprise arrears would not exist; any inefficiency would be promptly penalized. Should inter-enterprise arrears arise however, they would harm creditors – a fact which would be reflected by their output. Taking as a working hypothesis *immediate resource reallocation*, it can be assumed that the production of agent (i) is:

$q_i = q + c \cdot g$ for the agents who do not cause arrears

$= q$ for the agents who cause arrears

Another assumption is that the level of *financial discipline* (g) – seen as a positive externality – is determined by n and t, where (t) indicates whether agents pay their debts, and (n) refers to those who do not cause arrears. A final assumption is that $c<1<N$, where $N>1/c$.

Multiple equilibrium situations can be imagined depending on agents' behavior and the existence of financial discipline as a public good. If agents pay their debts in due time, their incomes show up as $q+c\ g-t$, whereas if they produce arrears, their earnings appear as simply (q). The decision for an enterprise is to cause arrears if $c \cdot g = c \cdot nt < t$ or, $n<1/c$, i.e., when the number of those who pay in due time is low. A conclusion would follow: when policy credibility is low, and when financial discipline is widely disregarded, agents are tempted to produce arrears. Instead, if $n=N$ agent N is stimulated to pay debts since $n=N>1/c$, as our assumption says.

It would seem that everything boils down to *policy credibility*, to the functioning of market discipline. However, a critical question arises. What is going to happen, and what can be done if the number of those who do not pay is high and, what is even more important, non-payment is the result of the lack of capacity to pay. This means that non-payment is not an opportunistic response to the existing circumstances concerning market (financial) discipline, or the low policy credibility. Consequently, whichever is the determination of decision-makers to pursue a policy course, the sheer number of those who cannot pay makes $n<1/c$ – and thus, the vicious circle of arrears comes into being.

Moreover, the working hypothesis should be made more realistic by assuming that resource reallocation is slow. In this case, a *complete exit* of the inefficient but, still, positive value-added enterprises would mean that output is substantially less than

if arrears emerge in the system. Consequently, the short-run production function of an agent could be redefined as:

$q_i = q + c \cdot g$ no arrears and immediate resource reallocation

$= q$ arrears and no, or very slow reallocation of resources

$= q - k$ no arrears and no, or very slow reallocation of resources – the case of an efficient agent

$= 0$ no arrears (full exit) and no resource reallocation - the case of an inefficient agent

where k indicates the fall of output when there is full *exit*. It is clear that, under the circumstances, the second situation (that includes arrears) appears as a preferred solution for the short term. It should be stressed that the choice of agents is influenced – in most cases – by their wage fund-centred goal function.

Therefore, when resource reallocation is very slow and when the number of those who cannot pay – because of the lack of capacity to pay – is high, *policy credibility* cannot be the main factor behind the growth of arrears; the main factor is represented by the large number of enterprises which, at the new equilibrium prices, would have to get out of the economic circuit. Since such a huge *exit* is impossible inter-enterprise arrears emerge as a symptom of *strain* in the system and as a way to diffuse *strain*.