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The Romanian Economic Reform Program

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Abstract

With the start of the process of its transition to a market economy in early 1990, Romania joined the ranks of other reforming Eastern European countries. At the starting point of its reform program, however, Romania was in a deep economic and institutional crisis and had no experience in even modest attempts to reform its economy. This paper outlines the main characteristics of the Romanian economic system before the reform, and presents the evolution of the reform program, as well as its achievements in the first year or so since it was launched.

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I. Introduction

In December 1989, with the fall of Nicolae Ceauşescu, Romania reached a turning point in its history. The provisional Government that took over announced immediately a sharp and permanent break with the past, both politically and economically. With respect to the latter, Romania was to abandon the central planning model it had operated under since the late 1940s, and to move as rapidly as possible to the establishment of an economic system in which private sector activities would be given maximum scope and market forces would play the predominant role in economic decision-making and allocation of resources.

The provisional Government proceeded to design and implement a comprehensive reform program aimed at achieving the desired transformation of the economy. It was recognized that the task of moving from an economic system that was tightly controlled and repressed--possibly more so than in any other Eastern European country--to a market economy was to be a daunting one. Yet there was a consensus among the political leaders that there was no alternative but to proceed toward this goal, and thus a major reform program to restructure the economy was launched in 1990. Two features of this program are particularly noteworthy. First, it was wide-ranging in nature, touching on all the important aspects of the economy. This is not to suggest that the Romanian reformers were in possession of a well-defined blueprint for reform; indeed it is apparent that the reform process has been as much of a learning experience for the reformers as it has for the economic agents. Second, the program was essentially "home-made", in that it was developed almost entirely by the Romanian reformers themselves. The overall strategy and the main elements of the program were put together without the assistance of foreign advisers and multilateral institutions. It was only after the basic groundwork had been laid that external support and detailed advice was solicited and obtained.

With the start of the reform program in 1990, Romania joined the ranks of the other reforming Eastern European countries. Broadly speaking, the goals and many of the policies undertaken were similar to those in other countries in the region, but there were important differences in the details. However, in contrast to the attention that has been given in the literature to the experiences of the other countries in the region--notably Poland, and to a somewhat lesser extent Hungary and Czechoslovakia--very little is available describing the Romanian reform program. The purpose of this paper is to outline the main elements of this program against the background of the system that was in operation in Romania over the past forty years. This historical perspective is necessary for the reader to appreciate the scale and magnitude of the efforts that have been made and that are still needed if Romania is to realize its fundamental goals. While the Romanian reformers have moved decisively to transform the economy and much has been achieved over the past year or so, the reform process is still in a fragile state and the road to a fully market-based system that gives pre-eminence to the market is fraught with risks. This paper highlights the strengths and weaknesses of the Romanian economic reform effort both at the conceptual and operational levels, but does not come to an overall judgement on the program, precisely because it is not clear yet what the final fruit of this effort will be.

The reformers recognize that their efforts can only succeed in an environment of macroeconomic stability. Accordingly, in January 1991 they launched with the support of the IMF a strong and comprehensive macro-economic adjustment program to complement their reform effort and put the economy on a sound non-inflationary path. The main components of this adjustment program are tight fiscal, monetary, and incomes policies; an appropriate exchange rate policy; and the implementation of a social safety net to give partial protection to the population from the dislocations and costs arising from the transformation of the economy. However, since the primary focus of this paper is the structural reform policies, the macro-economic adjustment program--which is still underway--is not examined in any great detail here. The elements of the authorities' macroeconomic strategy are covered only to the extent that they have a bearing on the overall economic reform program.

The remainder of the paper proceeds as follows: Section II describes the situation prior to the start of the reform program to set the stage for the analysis. The overall design of the program is discussed in Section III, focusing on the economic, legislative, and institutional initiatives that were taken. The operationalization of the main objectives of the reform program--i.e., the introduction of market forces in economic decision-making; the transfer of ownership of state assets to private agents; and the reduction of the role of government in the economy--is taken up in Section IV. The concluding section summarizes what has been achieved to-date, and offers some views as to where Romania stands in the spectrum of reforming economies.

II. The Situation Prior to the Beginning of Reform

To understand what the reform program is trying to achieve, it is necessary to describe the main aspects of the centrally planned system in Romania and its development in the 1970s and 1980s. 1/ This section covers first the developments in the economy from the early days through the 1970s, and then focuses on the decade of the 1980s.

1/ The discussion here focuses exclusively on the economic aspects of the Romanian system. Descriptions of the political developments during this period can be found in, among others, Behr (1991), Fischer (1989), and Shafir (1985).

1. The evolution of the Romanian economic system

a. The origins of the centrally-planned economic system in Romania

During the post-war years, the economic system of Romania developed in ways similar to that of other centrally planned economies. Virtually all means of production were owned by the state, except for a small proportion of land cultivated by private farmers. Detailed planning of all economic activity was the responsibility of the State Planning Committee (SPC), which prepared the physical plan targets based on Communist Party directives. Once the plan was approved, its implementation was monitored--and economic activity was managed--directly by the Government through the branch ministries. The branch ministries, each covering a different sector of the economy, also allocated inputs and decided on product use (i.e., consumption or investment) and distribution. A three-tier planning process was used, with five-year, annual, and special sectoral plans.

Prices were strictly regulated and did not play an allocative role. They were determined in the context of the plan on a mark-up basis. Moreover, until the early 1970s, only labor and intermediate products were taken into account in the calculation of costs: no charge was made for capital, land, or natural resources. Over time, consumer prices were kept fairly stable, while producer prices were occasionally adjusted to reflect changes in costs. The only prices that were market-determined--although occasionally also subject to restrictions--were those of agricultural produce sold by private farmers in the so-called peasant markets, which were limited in size.

Wages and the allocation of labor were also tightly regulated. Wages were differentiated according to the type of employee (white- or blue-collar) and according to economic branch, hardship, and other parameters. "Base wages" (i.e., remuneration per unit of time) were established centrally for all categories of employees. In addition, "norms" (i.e., output per unit of time) were also established for those categories of workers whose output was measurable. Based on the output target for each enterprise and these base wages and norms--where applicable--the plan determined the wage bill and the internal wage structure of the enterprise, and placed separate constraints on the number of blue- and white-collar employees. The management of the enterprise could not raise wages to attract more labor, and their authority to fire workers was severely limited. Labor was directed to desired industries and regions by controls on mobility.

The distribution of raw materials, capital goods and intermediate products was determined on the basis of material balances. The material balance was a planning tool for ensuring that the total sources and uses of a certain product would be in balance. It prescribed the distribution of a product among different economic uses, as well as among different administrative units, such as branch ministries and districts. Consumer goods were also distributed among districts using a similar system.

Foreign trade was managed exclusively by state-owned and controlled foreign trade organizations (FTOs) supervised by the various branch ministries. All transactions in foreign currencies were conducted through the Romanian Bank for Foreign Trade. Import decisions were taken centrally in the context of the plan, by comparing the needs of the domestic economy and the resources available to fulfill the plan, and export targets were set in order to finance the imports. Import and export targets were integrated into a detailed foreign trade plan. Domestic producer and consumer prices remained unchanged in the face of changing world prices by means of a so-called price equalization fund. This fund covered the differences between international and domestic prices of traded goods through a system of taxes and subsidies on exports and imports, resulting in a vast number of implicit exchange rates. Two exchange rates of the Romanian leu vis-à-vis convertible currencies were quoted officially, but had limited application. One was the valuta leu, reflecting the official gold price of the leu and used only for statistical purposes; the other was the noncommercial rate, used mostly for tourism. The exchange rate of the leu vis-à-vis the transferable ruble was set in the context of the arrangements with the countries of the Council of Mutual Economic Assistance (CMEA).

Financial policies were designed to ensure consistency between physical plan targets and intersectoral financial flows. Thus, the physical plan was the basis for drawing up the so-called synthetic financial plan. The financial plan was prepared at the Ministry of Finance for the economy as a whole. This plan was essentially a balance sheet for the whole economy, consolidating the relevant financial information and checking the consistency of the physical plan. The prices used were the ones prevailing at the time of the preparation of the plan. The financial plan was updated to take into account current price information, especially changing world prices and trade volumes, in order to ensure the consistency of foreign currency flows on a year-to-year basis, and was the basis for the state budget. In the context of the financial plan, there was no scope for active monetary or fiscal policies. There were no financial markets, and interest rates, although adjusted occasionally, were not meant to be an instrument for fund allocation, which was handled by the Government. The banking system consisted of a number of specialized banks and the National Bank of Romania, which served as a central bank but also had commercial functions. The banks had limited discretion regarding the size and allocation of credit. Use of bank credit for investment by state enterprises was, in any case, limited; the bulk of such investment was financed directly from the state budget.

In theory, the physical and the financial plans were meant to be fully consistent, so that the value of the sales of consumer goods at the plan prices was equal to the money income of the population (i.e., the aggregate of wages, pensions, etc.). In practice, however, as physical plan targets were often unrealistic, the shortage of consumer goods combined with the lack of different forms of financial savings caused a steady increase in money holdings of the population. These money holdings were essentially forced savings, in the sense that they reflected mainly the failure of the system to provide the desired consumer goods.

b. The Romanian economic system in the 1970s

In the late 1960s and early 1970s, while other Eastern European economies were making their first attempts at economic reform, several measures were also taken in Romania with a view to improving economic management within the centrally planned framework. These measures, however, did not go as far as in other countries, and left the way in which the system operated essentially unchanged. It is interesting to note that while Ceauşescu was considered in the west to be somewhat of a "maverick communist" in foreign policy matters, especially in the wake of his outspoken opposition to the Soviet invasion of Czechoslovakia in 1968, in economic affairs he remained an unreconstructed Stalinist throughout the period of his rule. To him, the need for state control of the economy was unquestionable and the planning mechanism sacrosanct. A good example of Ceauşescu's thinking on this subject is found in a speech delivered in July 1974, when he said: 1/

> "To give everyone the freedom of spending society's money on whatever, and however it might strike one's mind--this is not possible. We have a planned economy. Nobody has the right to build or produce what is not provided for by the Plan."

The Law on the Organization and Functions of the SPC of 1968 gave the SPC more responsibilities than before in overseeing plan fulfillment and making adjustments to the targets if necessary. At the same time, it attempted to decentralize the planning process by giving enterprises a greater role in preparing the plans. The preparation of the draft plan was now supposed to commence at the enterprise level, and the SPC would combine the proposals in the final draft. Moreover, with the establishment of the Department of Technical-Material Supply within the SPC in 1969, the Committee was given a central role in allocating inputs. Prior to this, allocation of inputs was primarily the responsibility of the Council of Ministers, which in 1967, for example, allocated centrally over 200 raw materials and intermediate products. An additional 1,300 inputs were allocated the same year by the branch ministries (Spigler, 1973).

A further reform was the addition in 1969 of a new administrative layer between the branch ministry and the enterprise: the centrala, which combined all enterprises with similar activities in a certain geographical area. Between 1969 and 1972 some 200 centrale were created, covering all the enterprises in industry, mining, and construction. The average centrala

1/ Taken from Behr (1991).

had a total of about 8,000 employees in its enterprises, although a few had as many as 100,000 employees (Granick, 1975).

The centrala had an important role in the planning process. Once the plan was voted into law by the National Assembly, the production targets were "nominalized"; in other words, specific quantitative indicators and constraints were placed on branch ministries. They, in turn, distributed these targets among their centrale, as well as "nominalized" some additional ones. The same process, in turn, took place between the centrale and the enterprises. The centrala had wide discretion for specifying different types and qualities of products to be produced by its enterprises, for "nominalizing" additional targets in addition to those set by the branch ministries, and for revising enterprise plan targets if necessary.

The price system was revised with the promulgation of the Law on Prices and Tariffs of 1971, which was amended in 1977. Although the mark-up rule remained in place, a more comprehensive accounting of costs in the formation of prices was stipulated by the Law. Most producer and consumer prices, which had remained unchanged since 1963, were re-evaluated in 1973-76 based on this revised framework (Tsantis and Pepper, 1979). The Law also introduced restrictions on prices in peasant markets in the form of price guidelines ("mercurial" prices), around which peasant market prices were supposed to fluctuate. Enforcement of these guidelines, however, was weak, especially in the countryside.

Since wages could not be used to affect the allocation of labor among industries or regions, during the 1970s direct controls on labor mobility increased, mainly through the stricter use of the "employment card" and the introduction of the system of "closed cities". The former was the practice, usual among enterprises, not to hire any applicant who did not have his employment card certified by his previous employer. In this way, although the right to quit was in theory unrestricted, in practice each enterprise could pressure the worker to stay, or to postpone his departure, by delaying the certification of the employment card. For the same reason, there was virtually no mobility between small private farms and the state sector. In addition, in order to move out of an agricultural cooperative, a worker needed the permission of the manager.

The system of closed cities began in 1976, when legislation restricting migration to 14 large cities was promulgated. Only those who had a resident spouse or relatives, or had some predetermined "necessary skills", could obtain permanent residence permits for these cities. By the late 1970s, virtually all cities with more than 100,000 population were closed. Nonresidents were not allowed to move or work there. Temporary residence permits were granted by the municipality, usually for less than one year, with possibility of renewal. In this way, labor could be directed to those enterprises and cities that would otherwise suffer from labor shortage.

In order to improve the management of foreign trade transactions, in 1973 the Government established a commercial exchange rate (also known as the internal conversion coefficient) set at lei 20 per U.S. dollar, to be used for comparing foreign with domestic goods prices. Although all foreign trade transactions continued to be conducted at the implicit rates resulting from the operation of the price equalization fund, the commercial rate was supposed to represent an efficiency indicator for these transactions.

As regards capital flows, Romania was one of the first centrally planned economies to introduce legislation in 1971 permitting the establishment of joint ventures involving foreign equity participation. Although this legislation was rather liberal compared to that in other Eastern European countries at the time, it placed quite restrictive conditions on foreign investment: the foreign share could not exceed 49 percent; profits could be repatriated in foreign currency only after the deduction of foreign currency imports; and the tax rate on profits was initially set at 30 percent, with an additional 10 percent charge on profits transferred abroad.

Finally, with the Financial Law of 1972, which standardized bank lending practices, there was an attempt to increase the use of bank credit for financing of enterprise investment and, at the same time, reduce the budgetary burden. However, the amount and allocation of credit were under central control and banks had no discretion in their lending activities.

These measures did not change the basic way in which the Romanian economy operated, and in some instances led to tighter central control. Central planning remained the mechanism through which production, input allocation, distribution, investment, and pricing decisions were taken for the economy as a whole. Although the preparation of the plan in theory commenced at the enterprise level, in practice the SPC continued to prepare the draft plan based on Party directives, as in the past. Even the attempt to decentralize the planning process with the introduction of the centrala did not enhance enterprise autonomy, because as the centrala took over many enterprise functions, enterprises were actually left with less power to make decisions. Moreover, although the price measures led to a revision of most producer and consumer prices, they did not enhance their allocative role, nor did they increase their flexibility. The single commercial exchange rate introduced in 1973 had simply an indicative value, as the policy of keeping domestic prices stable and the operation of the price equalization fund kept it from becoming an important policy instrument. Controls on labor allocation increased during the 1970s. Finally, the law on foreign ventures did not have the intended effect: only six joint ventures were established in the early 1970s, while the restrictive nature of the legislation and the economic difficulties facing Romania in the late 1970s and early 1980s deterred new investment (Granick, 1975).

c. The New Economic and Financial Mechanism of 1979 and the development of the economic system in the 1980s

The main revision in Romania's system of economic management was the introduction in 1979 of the "New Economic and Financial Mechanism" (NEFM). The objectives of the NEFM were to improve economic efficiency in the context of the planning system, to promote enterprise autonomy, and to increase enterprise participation in the planning process. The NEFM was a general framework for reform, in the context of which additional systemic measures were taken throughout the 1980s. 1/ Also, a three-year stand-by arrangement was negotiated with the IMF in 1981, which lasted until 1984.

In the area of planning and enterprise management, important changes were the replacement of the physical output targets with targets for net production (a concept akin to value added); the introduction of additional quantitative indicators; the imposition for the first time of quality standards and control; and an emphasis on forward contracting by enterprises for inputs and outputs. In spite of these changes, however, the nature of planning and economic management remained the same as in the pre-NEFM years. The state retained its firm control on economic activity. The SPC, apart from determining the plan targets, continued to monitor closely plan implementation by receiving quarterly production reports for some 300 products, as well as monthly, weekly, and daily reports for a smaller number of products. The number of targets and indicators included in the plan increased substantially during the 1980s. At the level of the SPC alone, by 1989 the complete annual plan included material balances for 400 products, and up to 452 targets and indicators for each one of an additional 2,000 products. Additional material balances and indicators were elaborated at the level of branch ministries and centrale.

To discourage production without sufficient regard for the needs of final users and, at the same time, to stop the practice by enterprises of overstating production by overstating stockbuilding of finished products, the NEFM introduced a system of forward contracting among enterprises for inputs and outputs as a basis for formulating production plans at the enterprise level. Enterprises were henceforth permitted to produce only on the basis of negotiated contracts with buyers, except in the case of production for exports. The forward contracting system was soon rendered ineffective, however, because of the distortions of the planning system. Underlying the forward contracting system was the assumption that enterprises would fulfill their plan targets. As these targets were increasingly unrealistic, the system could not function properly. Moreover, the forward contracting system provided the incentive for overstating the stockbuilding of exportable goods, since this had become the only way for enterprises to overstate production.

1/ A summary of the operation of the NEFM is presented in Secţia Propagandă şi Presă al Partidului Comunist Român (1987).

In an effort to reduce enterprise reliance on the budget for investment financing, the NEFM placed much greater emphasis on enterprise self-financing and the budgetary outlays for investment were correspondingly reduced in the period 1980-83. In addition, interest rates on investment credit to enterprises were substantially raised in 1983, in an attempt to increase the efficiency of resource use and to make enterprises more cost-conscious. The same year, a capital charge was imposed on funds advanced from the budget for investment.

The success of these measures was limited. Although enterprises were made responsible for financing a larger part of their investment, their own resources were limited due to the overstatement of their profits and the excessive tax burden on enterprises during the 1980s. In addition, they were not able to invest their own funds as they wished; investment projects had to be approved by the SPC. Consequently, the allocation of investment funds probably did not become more efficient. Similarly, as increased interest costs were taken into account in the plan and were reflected in lower planned profits and remittances from profits to the budget, the use of investment funds probably did not lead to greater efficiency. In any event, the role of the budget in investment financing, after declining in the period 1980-83, started growing rapidly again. Finally, in 1984, after the program with the IMF lapsed, the authorities lowered interest rates, restoring them to their earlier levels.

The policy of maintaining price stability in the face of changing world prices in the late 1970s caused large discrepancies to arise between domestic and world prices expressed in lei at the commercial exchange rate. To offset this effect, the authorities introduced gradually over the 1970s additional "commercial" exchange rates, each applying to a different category of trade transactions. To correct these distortions a number of measures were introduced in the early 1980s in the context of the NEFM and the stand-by arrangement with the IMF. All commercial exchange rates were unified and depreciated against the U.S. dollar in the period 1981-83; major domestic price adjustments took place in the same period; and the price equalization mechanism was modified.

As regards the price equalization mechanism, whereas in the past both exporters and importers were completely insulated from world price movements by means of the price equalization fund, starting in 1981 exporters were exposed more to world prices. The foreign trade plan began to include explicit export price targets in foreign currency terms. If the target export price was indeed realized but, when converted to lei at the commercial exchange rate, was still below the domestic price, the price equalization fund paid a subsidy to the exporter. If, however, the target export price was not realized, the shortfall was covered by the exporter's profits. Conversely, if the world price converted at the commercial rate was higher than the domestic price, the difference accrued to the exporter if it was due to a realized export price higher than targeted, and to the price equalization fund otherwise. This system was intended to create incentives for exporters to achieve high export prices through better quality control and more careful marketing. The system of price equalization applying to imports, however, remained essentially unchanged.

These measures did not change the role played by prices in the Romanian economy, and the allocation of resources continued to be determined by the plan. Rather, these changes were supposed to increase incentives provided to exporters and to correct the large misalignments between domestic and world prices. Even these limited objectives, however, were not achieved. The pervasiveness of planning, as well as the increasingly unrealistic character of the export targets included in the foreign trade plan in the 1980s, did little to improve export performance. Moreover, most of the price adjustments of 1981-83 were reversed in 1984 and the exchange rate was appreciated. Finally, the enforcement of guidelines for prices in peasant markets was stepped up sharply starting in 1984.

In the context of the NEFM, the system of remuneration of labor was revised in 1983 and 1985 in an effort to link labor incomes more closely with plan fulfillment. A system of incentives was put in place (the system of "global contracts"), specifying the performance targets and the corresponding levels of salaries of each work unit within the firm. In the event of plan over/under-fulfillment by a certain unit, its members' salaries could be increased or cut accordingly. Similar incentives, based on a number of performance indicators, were established for white-collar workers and managers. Furthermore, a system of distribution of a fixed share of profits to managers and workers was introduced to provide additional incentives to enterprises for profit maximization. Planned profits were allocated in varying proportions--determined centrally--to loan repayments, various enterprise funds (for development, working capital, employee benefits, and employee profit-sharing), and remittances to the budget. If actual profits were below the plan, payments to the budget and to the enterprise development fund had priority, in that order. If actual profits were above the plan, payments to workers and managers were higher.

The enhanced incentives that the system of global contracts and profit distribution created were plagued by severe problems. First, the incentives were more penalty- than reward-oriented. Second, inputs other than labor continued to be determined centrally through the plan. Finally, the different indicators, criteria, and conditions were complex and occasionally contradictory. For example, exports and efficient use of inputs often had different weights in the contract for the management of an enterprise and in the system of allocating above-plan profits.

The controls on labor mobility pre-dating the NEFM, notably the practice of the "employment card" and the system of "closed cities", remained in place in the 1980s. In addition, in the late 1980s, the Ceauşescu Government introduced the program of "systematization of localities". This program was intended to compel the reallocation of labor from small agriculture to state farms and industry by eliminating a large number of villages and moving the inhabitants to large agro-industrial centers. As implementation started relatively late in the decade, this program did not have a significant effect on the allocation of labor. 1/

Despite the changes introduced with the NEFM, and the brief association with the IMF in the context of a stand-by arrangement, the nature of the planning process and the economic management system in the 1980s not only remained essentially unchanged, but the state's firm control on economic activity and the strict central planning framework increased. The emphasis on self-financing, the various bonuses and incentives for plan fulfillment, and the forward contracting system did not succeed in effectively increasing the autonomy of state enterprises and encouraging competition between them because the Government continued to absorb the bulk of profits, to determine the use of investment funds and bank credit, and to limit contact with foreign suppliers. Similarly, the changes in the price and exchange system, as well as the wage system, did not enhance the allocative role of prices and wages in the Romanian economy. The plan continued to allocate resources and determine exports, imports, and domestic sales of enterprises. Finally, the pervasiveness of the foreign trade plan and the unrealistic character of many of the targets meant that the modification of the price equalization mechanism for exporters failed to achieve its objectives.

In summary, the Romanian economic system at the end of the 1980s was one of the most tightly controlled and centralized in Eastern Europe. The Ceaușescu regime deprived the country of the experience of any significant economic reform, leaving the administration, the managers, and the institutions tied to a Stalinist model that had by that time been abandoned by almost all other countries in the region. In addition, the economic policies of the regime resulted, inter alia, in distorting further the economic system. As plan targets became more and more unrealistic, policies gradually lost touch with reality, misreporting of plan fulfillment grew, forced savings in the hands of the population increased, and the economic system fulfilled its function less and less. 2/ This led to a vicious circle of tightening of controls, greater disorganization, and further tightening of controls which, by the end of the decade, had eroded the credibility and effectiveness of the economic management system and had driven the country into an economic and institutional crisis.

2. Economic developments in the 1980s and the situation at end-1989

The evolution of the Romanian economic system during the 1980s, as well as the policies followed during the decade, caused economic stagnation and, toward the end of the decade, created the conditions for an economic crisis. The productive capacity of the country, especially in industry, was eroded as the capital equipment grew obsolete and energy intensity increased; and the standard of living of the population deteriorated substantially.

1/ However, it is estimated that some 1,000 villages were destroyed as part of this policy.

2/ The causes and symptoms of the increasing disorganization of the economic system in the 1980s are discussed in Ronnås (1991).

Under the Ceauşescu regime, economic statistics were systematically falsified at different levels. As a result, one of the first tasks of the provisional Government in early 1990 was to begin far-reaching revisions in the economic statistics for the past. As of early 1991 revisions were still underway, but some reliable data, notably for the national accounts, have become available (Table 1). On that basis, output over 1980-87 appears to have increased by an average annual rate of about 2.5 percent (Chart 1). Consumption, however, increased by less than one percent per annum, due to the increasing share of net exports of goods and nonfactor services, which rose from -2.8 percent of GDP in 1980 to 7 percent in 1987. These trade surpluses, especially toward the latter part of the decade, reflected the policy of rapid repayment of all foreign debt.

The policy to repay--and in many cases prepay--the external debt became the overriding policy concern in the late 1980s. This policy reflected an unwillingness to pay high interest rates and place the country in what was perceived by Ceauşescu as an economically dependent relationship with foreign creditors, as well as the difficulties encountered in rescheduling Romania's debt. Its implementation required the accumulation of large current account surpluses, which was achieved mainly through severe import compression and a policy to promote convertible currency exports at all costs (see Chart 1). The debt repayment followed closely a rescheduling of commercial bank loans that had been agreed in 1986, which provided for the rescheduling of 100 percent of the amount falling due in 1986 to be repaid in 1989-90, and of 85 percent of the amount falling due in 1987 to be repaid in 1991-92. Prepayments amounted to about US$0.5 billion in 1987, US$2.9 billion in 1988, and US$1.2 billion in 1989, at which time the entire medium- and long-term external debt had been repaid. Starting in 1987, Romania ceased to avail itself of credits from commercial banks and the World Bank, and use of credits from bilateral sources had almost stopped by 1989. A decree promulgated in 1989 actually made it illegal for Romanian entities to contract external debt. Only short-term capital movements continued, reflecting mainly developments in short-term export credits granted by Romania.

In 1988, real GDP fell by 0.5 percent, mostly due to a decline in industrial output caused by a relatively large increase in material costs. Despite the decline in national income in 1988, however, the net foreign balance continued to increase and reached its maximum level of the decade (9.5 percent of GDP) as the Government decided to generate a large current account surplus to continue the repayment of external debt. To that effect, draconian restrictions were imposed on the household use of energy, so that industry would have an adequate supply.

By March of 1989, nearly all of the external debt had been repaid, with less than US$500 million of short-term credits still owed to foreign creditors. In 1989, however, GDP suffered a further and more significant decline of 5.8 percent, due to growing shortages of inputs and the increasing inadequacy of an aging capital stock. A large part of the fall in industrial value added was concentrated in the last quarter of 1989.

Chart 1

Romania: Key Macroeconomic Indicators

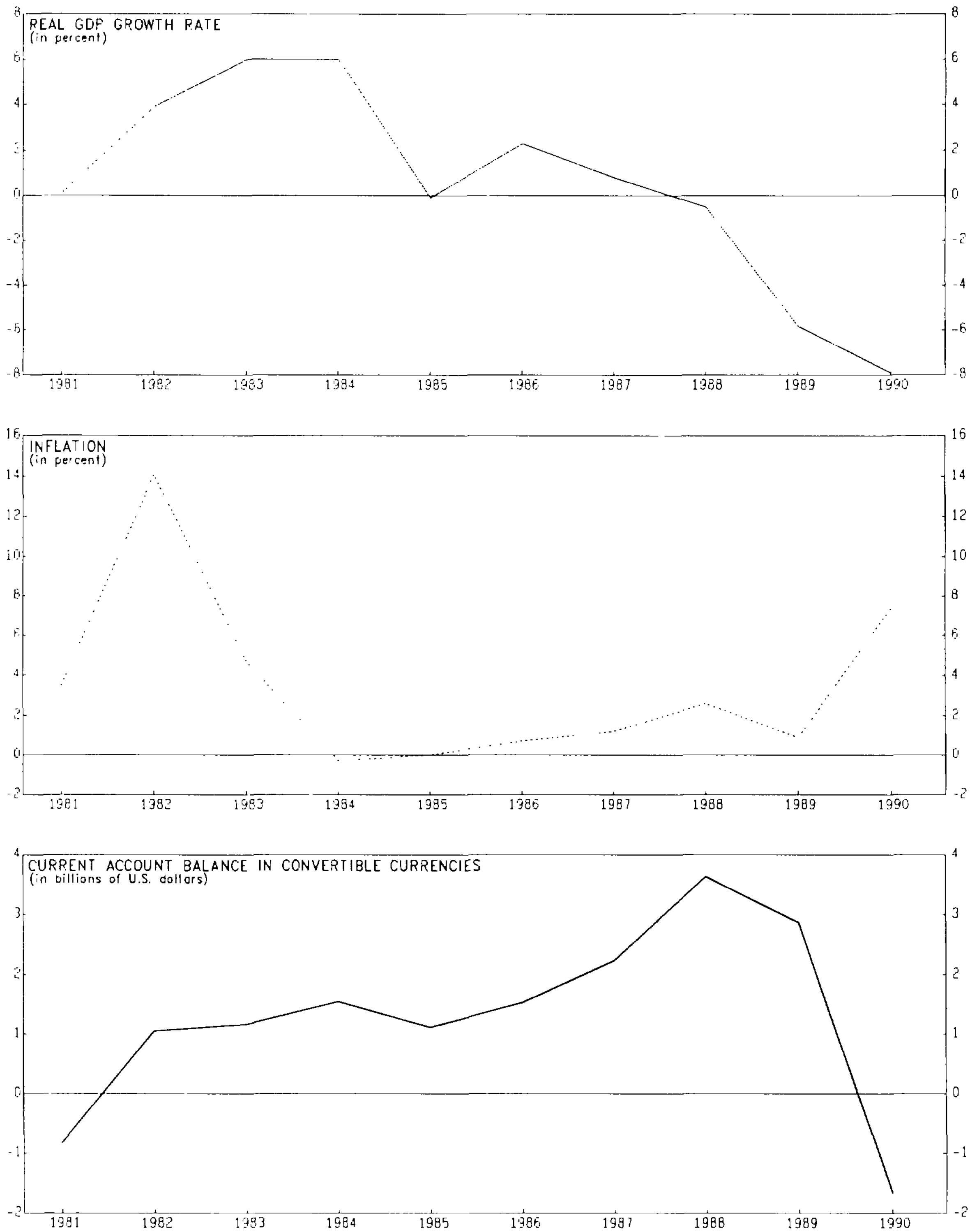

Table 1. Romania: GDP by Origin and Expenditure, 1980-90
(*In billions of lei, at current prices*)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990 Prel.
GDP	616.9	623.7	727.4	768.7	816.1	817.4	838.6	845.1	857.0	798.0	844.0
By origin											
Industry	325.3	311.2	365.4	411.4	445.1	433.0	460.5	461.8	459.9	421.9	407.0
Agriculture and forestry	78.0	91.6	125.7	107.9	110.7	114.3	106.8	103.4	115.6	110.9	151.9
Construction	47.4	44.7	47.2	52.2	53.5	57.9	59.5	60.8	60.4	50.6	47.9
Transport and telecommunication	43.6	44.8	48.9	49.9	53.1	55.4	57.0	58.0	60.3	60.0	56.5
Trade	36.4	38.1	39.5	33.3	35.3	39.9	39.5	43.2	46.9	48.2	59.3
Other	86.2	93.3	100.7	114.0	118.4	116.9	115.3	117.9	113.9	106.4	121.5
By expenditure											
Consumption	388.3	411.7	468.4	463.6	493.8	492.0	497.2	516.8	532.2	541.8	652.9
Gross domestic fixed investment	212.8	209.3	216.4	230.7	244.7	246.3	249.0	245.5	240.2	236.4	168.4
Changes in stocks	32.9	17.1	28.9	30.8	34.1	23.5	39.4	23.4	3.1	-23.2	120.9
Net exports	-17.1	-14.4	13.7	43.6	43.5	55.6	53.0	59.4	81.4	43.0	-98.2

Source: Government of Romania.

The decline in the growth rate of output from very high levels in the first half of the 1970s to negative growth by the end of the 1980s, was not due to the changing size of the labor force; indeed, the population of working age has increased at an average annual rate of 0.7 percent since 1975. The deterioration in economic performance was due instead primarily to a decline in the quantity and quality of investment. During the decade, gross domestic investment declined from 35 percent in 1980 to less than 30 percent in 1989 (Table 1). At the same time, the material intensity of output rose mainly due to the increasing use of lower quality inputs and inefficient machinery, which was either domestically produced or imported from CMEA countries and was increasingly used in place of imports from the convertible currency area, as the latter were compressed in the course of the decade.

The domestic counterpart of the current account surpluses needed to repay the debt was a large domestic savings surplus. This, in turn, was partly accomplished by the substantial fiscal surpluses generated by heavy taxation of enterprises and tight control of social spending. The tax burden on enterprises became excessive toward the end of the decade, especially as the plan targets--based on which the tax liability of each enterprise was determined--became unrealistic, resulting in large enterprise losses that were financed by bank credit and inter-enterprise arrears. Bank credits extended to finance these losses became very quickly unserviceable: at end-1989, an estimated lei 300 billion (almost 40 percent of 1989 GDP) of outstanding bank loans were classified as unserviceable. 1/

Relying on an administratively controlled trade and exchange system and preoccupied with the repayment of external debt, the authorities had not attached priority to maintaining substantial international reserves. In the second half of the 1980s, these fluctuated in a broad range of about US$0.5-1 billion. As the policies of import compression and export promotion continued even after the virtual repayment of the external debt by the first quarter of 1989, however, international reserves increased sharply in the remainder of 1989 and reached almost US$2 billion at end-December 1989.

Finally, during the 1980s, standards of living declined substantially (Table 2). Consumption per capita stagnated throughout the decade but, more importantly perhaps, the shortages of basic consumer goods in the latter part of the decade meant that welfare probably fell by more than indicated by the consumption per capita statistics. Particularly harsh restrictions were placed on the consumption of energy by households: in most parts of the country, only a few hours of electricity and heating were allowed per day, even during winter, in order not to disrupt the supply of energy to industry. At the same time, most social indicators took a turn for the worse: the average caloric intake of the population and the access to

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1/ This amount of unserviceable bank loans had accumulated despite earlier loan write-off operations for agricultural cooperatives under Ceauşescu.

Table 2. Romania: Selected Social and Demographic Indicators

	1980	1985	1989	1990
Population characteristics				
Total population (millions)	22.2	22.7	23.2	23.2
Population growth rate	0.8	0.4	0.5	0.3
Number of employed persons (millions)	10.4	10.6	10.9	11.1
Population density per sq. km.	93.5	95.6	97.7	97.7
Life expectancy at birth (years)				
Women	71.8	72.7	72.4	72.7
Men	66.7	66.8	66.5	65.6
Population death rate (percent)	1.04	1.09	1.07	1.07
Infant mortality (under 1 year)	29.3	25.6	26.9	26.9
Food, health, and nutrition				
Calorie intake (calories per day)	3,259	3,057	2,949	3,067
Population per physician	678	567	552	555
Population per hospital bed	114	112	112	112
Access to safe water (percent of population)				
Rural	...	...	16	16
Urban	...	...	100	100
Education				
Percent of population between 15-18 in school	...	...	79	74
Primary school enrollment (percent)	...	...	97	93
GDP per capita (US$ at commercial exchange rate for exports)	2,446	1,336	1,567	1,227

Source: Government of Romania.

doctors and hospital beds declined in the period 1980-89, as did the life expectancy for men. 1/

III. Mapping the Transition: The Design of the Reform Program

1. The initial conditions and their impact on the reform process

a. The conditions at the beginning of 1990

The provisional Government that came to power in the last days of 1989 after the violent overthrow of Ceauşescu faced, as discussed in the previous Section, an economic and institutional crisis. 2/ On the one hand, years of economic mismanagement and the self-imposed isolation of the country in the latter part of the 1980s had undermined the productive capacity and led to an erosion of the standard of living. On the other hand, the institutional framework was probably one of the most antiquated in Eastern Europe, and the country's administrative and managerial apparatus had no experience with even limited economic reform. At the same time, as tight controls on emigration were in place throughout the 1970s and 1980s, Romania--unlike other Eastern European countries--did not have a large expatriate community that could act as a channel of foreign expertise and advice.

In addition to this crisis, the provisional Government was also faced with social turmoil following the December events that led to the overthrow of Ceauşescu, which aggravated the disorganization of the economy. The turmoil was manifested in various ways. Perhaps the most disruptive for the economy were worker absenteeism and lack of discipline and a breakdown of law and order. 3/ Also, in many enterprises workers decided to eject their managers, whom they associated with the old regime, and hold new elections to replace them. These elections were often disorganized and had to be repeated until, in early February, the provisional Government decided to put an end to this practice. 4/ These factors disrupted further the already problematic supply network of state enterprises.

The combination of the economic and institutional crisis and the socio-political circumstances prevailing in the country at the beginning of the

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1/ Anuarul Statistic, 1990. An account of the deterioration of the standards of living in Romania during the 1980s is also offered in Teodorescu (1991).

2/ For a detailed discussion of the Romanian revolution of December 1989 see Behr (1991) and Codrescu (1991).

3/ In early January, the Deputy Minister of the Interior of the provisional Government General J. Moldoveanu reported a "renewed outbreak of offenses accompanied by violence in the past few days", including pilferage of the emergency aid received from abroad (Romania - News of the Day, No. 8/1990, January 11, 1990).

4/ Romania - News of the Day, No. 35/1990, February 12, 1990.

transition period had three major implications for the Romanian reform process. First, the economic collapse it caused required an immediate policy response by the authorities without allowing for a "pre-reform" period--in the sense used by and Calvo and Frenkel (1991) and experienced in other Eastern European countries--during which the elements and priorities of the reform program are negotiated, the population is informed and educated, and a broad consensus on the strategy is reached before any structural measures are actually introduced. Several measures intended to unblock the productive structures were introduced before a coherent reform program was formulated; as a result, many of these measures had to be modified or replaced later, making the reform effort--at least in its early stages--a process of "trial-and-error". Secondly, the release of the population's pent-up demand for consumer goods and the dramatic decline in living standards influenced considerably the early decisions of the provisional Government. On the one hand, it made the adequate provision of basic consumer goods--especially food, heating, and electricity--a necessary condition for the population's consent to policy changes, and made the improvement in living standards an immediate policy objective. On the other hand, it focused the Government's attention from the outset on the importance of an adequate social safety net to shield the most vulnerable groups from the burden of the transition to a market economy over the medium term. Thirdly, the combination of the collapse in output with the policy of boosting the population's real incomes to improve the living conditions caused a rapid deterioration of the macroeconomic situation in 1990; this forced the authorities to change somewhat the priorities of their reform program in mid-course.

b. Economic developments in 1990

The disorganization of the economic management system and the obsolete capital equipment and production techniques inherited from the previous regime, together with the further supply disruptions and the diversion of energy from industry to the population in early 1990, caused output to collapse. Production in state industry in January and February 1990 was 22 percent and 20 percent, respectively, below its level in the corresponding months of 1989, and averaged almost 20 percent below for the year as a whole. Gross Domestic Product is estimated to have fallen by almost 8 percent in real terms in 1990, on top of a 5.8 percent decline in 1989 (Chart 1).

In the face of these developments, the authorities introduced very early in 1990 a number of supply-side measures intended to contain the downward trend in economic activity. Many of these measures were of a structural nature, but were introduced in haste, without adequate preparation, and preceded the elaboration of a coherent program of reform. The most important of these measures were: the complete liberalization of peasant markets in January in order to increase the supply of food; the abolition of the State Planning Committee in January, and its replacement by a Ministry of the National Economy, with mainly coordinating functions; the abolition of certain provisions of the turnover tax that were particularly burdensome on enterprises; 1/ the introduction in February of decree-law 42, 2/ allowing agricultural cooperatives to distribute land to their members and to other peasants for "long-term use", and of decree-law 54, allowing small-scale private enterprises with up to 20 employees; the introduction in March of decree-law 96, liberalizing the regime governing foreign direct investment in Romania; and the abolition of the state monopoly in foreign trade and the partial liberalization of foreign exchange regulations. All these early structural measures--although they were pointed in the right direction--turned out to be inadequate and incomplete, with the exception of the liberalization of peasant markets and the modification of the turnover tax, and had to be supplemented or replaced by improved versions later, when a more coherent reform strategy emerged. The Ministry of the National Economy was closed within a few months of its establishment, and its functions were partially taken by a new National Commission on Prognosis; decree-law 54 had to be complemented by additional legislation and regulations, including a privatization law, in order to perform its function as the major vehicle for reforming the ownership structure of the economy; and decree-laws 42 and 96 had to be replaced by a comprehensive land reform law and a new foreign investment law, respectively, in 1991.

In order to satisfy the population's demand for basic consumer goods, notably energy and food, as well as to improve living conditions, the authorities decided to divert energy resources from industry to the population, adding to the supply disruptions in state industry. In addition, they pursued expansionary fiscal and monetary policies through most of 1990. These policies, combined with the output collapse, aggravated the domestic imbalances and caused a sharp deterioration in the balance of payments. This deterioration was further exacerbated by the reversal of the policy of import compression of the previous regime; the introduction in January 1990 of a ban on food exports in order to improve the availability of food domestically; and the deterioration of the external environment in the second part of 1990 due to the Middle East crisis. 3/

On the fiscal side, revenues declined as a result of the simplification of the turnover tax in January 1990, as mentioned above, as well as the replacement of the system of remittances from profits--the other major factor resulting in the excessive tax burden on enterprises in the 1980s --by a profit tax later in the year. Expenditures also declined somewhat, mostly due to the sharp reduction in investment outlays, which reflected

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1/ These provisions, introduced in 1988 to boost tax revenues, had come to be known as the "Ceauşescu tax" (see Section IV for more details).

2/ Legislative acts passed under the provisional Government were called decree-laws, as there was no elected Parliament to promulgate them. After the May 1990 elections, legislative acts of the new Parliament were called laws.

3/ This crisis caused a jump in the cost of imported energy, a virtual cessation of exports to the region, and a freezing of Romanian assets, particularly in Iraq, which currently owes Romania about US$1.7 billion.

the cancellation of several of Ceauşescu's showcase projects. Current expenditures, however, increased dramatically, mainly as a result of doubling the outlays for subsidies, pensions, and transfers. These increases were, to some degree, inevitable: under the previous regime, some benefits to which civil servants were entitled were simply not paid, 1/ and promotions were unlawfully delayed. The bulk, however, was due to increases in employee benefits, subsidies to producers of consumer goods--notably food--and transfers for social assistance. These increases were considered by the provisional Government to be necessary in order to ensure social peace by improving the living standards, especially of the most disadvantaged groups. As a result of these fiscal measures, the general government accounts registered a surplus of less than 2 percent of GDP, down from over 8 percent in 1989. In addition, accumulated unserviceable bank debts of state enterprises and cooperatives were written off against government bank deposits resulting from fiscal surpluses of the past, all but eliminating these deposits by the end of 1990 (for more details on this operation see below and in Section IV).

Monetary policy was also expansionary, as banks were initially instructed to extend credit to enterprises to meet higher labor costs. Even later in 1990, when commercial banks had become nominally independent, the financial system was not yet market-oriented and bank supervision was imperfect. As a result, broad money in 1990 as a whole increased by over 22 percent. Moreover, wage increases granted during the early months of the year (before a wage moratorium was agreed between the Government and trade unions in July), as well as higher benefit payments, contributed to an increase of about 3 percent in the average real wage in the economy in 1990. This monetary expansion took place while output was collapsing and before prices were fully liberalized and, as a result, it added to the stock of forced savings, or monetary overhang, created as a result of the planning system, thus exacerbating inflationary pressures in the economy. Although it is extremely difficult to produce even a rough estimate of the monetary overhang due to the fundamental changes in the demand for money that take place in a situation of systemic upheaval and great uncertainty like the one in Romania in 1990, the pattern of income velocity of money can be suggestive: income velocity of broad money at end-1990 in Romania was about half its level during the late 1970s and early 1980s, indicating that perhaps up to 50 percent of the money stock was involuntarily held.

On the external side, in order to improve the domestic supply of food and energy (the latter, unlike in most other Eastern European countries, was

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1/ This practice was also enforced in the state enterprise sector as well. Although the eligibility for some bonuses (e.g., for work in hazardous or toxic conditions) had been established by law, the total number of recipients of these bonuses was arbitrarily limited in each enterprise in order to contain labor costs, regardless of the actual number of eligible workers.

imported mostly from the Middle East), 1/ one of the first decisions of the provisional Government was to discontinue the policy of import compression followed by the previous regime and to ban food exports. These measures, the rapidly growing domestic imbalances, and the Middle East crisis in the second half of the year, were reflected in a swing of the convertible currency current account balance from a surplus of US$2.9 billion in 1989 to an estimated deficit of US$1.7 billion in 1990. This took place despite two devaluations of the leu in February and November 1990, which together moved the official exchange rate from lei 14 to lei 35 per U.S. dollar. As external financing--other than trade financing--was not available, mainly as a result of the self-imposed alienation of the country from the international financial markets in the late 1980s, the convertible currency current account deficit in 1990 was financed almost entirely by the country's foreign exchange reserves, which were all but exhausted by end-year. The trade balance in transferable rubles with the countries of the CMEA also deteriorated from a deficit of TR 0.5 billion in 1989 to a deficit of almost TR 1.7 billion in 1990.

This sharp deterioration in the macroeconomic situation of the country during 1990, besides being a concern in itself, also forced the authorities to reconsider the priorities of their reform program. First, during the year there was a shift in the emphasis put on macroeconomic stability. The early reform statements simply noted the danger of inflation and the need for a stable macroeconomic environment during the transition. Gradually, however, macroeconomic stabilization became a central part of the Government's program and a pre-requisite for further reform. This led to negotiations with the IMF for a 12-month stand-by arrangement which became operative in 1991. Second, there was a rethinking of certain elements of the reform program directly related to the macroeconomic situation, notably price reform. While initially the approach to price reform was timid, it soon became evident that such an approach would have budgetary implications incompatible with the tight fiscal policy necessitated by the worsening macroeconomic situation and, in addition, would delay all other aspects of reform; as a result, the price reform was accelerated.

The need for immediate structural measures to contain the collapse in output, the lack of a consensus-building pre-reform period, the trial-and-error approach to reform, and the partial re-ordering of priorities and the change of pace of reform in mid-course made the Romanian reform effort appear somewhat haphazard from the outside. At no point, however, was there hesitation as to the ultimate objective of the authorities' reform program; these features reflected rather the conditions in which the program was launched and the absence of any received wisdom on how best to proceed with such a reform.

1/ Owing to political factors, Romania's access to oil from the U.S.S.R. through the CMEA payments arrangements was very limited.

2. The evolution of the reform strategy

Although the ultimate objectives of the Romanian reform program were clearly stated at the outset, the strategy underlying the program evolved gradually in the course of 1990-91, influenced by the economic and institutional conditions in the country. This gradual evolution was punctuated by three specific events, which can be considered as landmarks in the development of the Romanian program: the publication of the provisional Government's "Outline of Strategy for Transition to a Market Economy in Romania" in May 1990; the Prime Minister's report to Parliament on the status of the implementation of economic reform on October 18, 1990; and the Prime Minister's report to Parliament on the progress of the reform and the Government's program for 1991 on February 26, 1991. Aside from specific measures introduced during this period, these events also reflect the major turning points in the evolution of the authorities' reform strategy.

In February 1990, the provisional Government set up a 20-member Commission to prepare a proposal for a program of transition to a market economy. 1/ This Commission produced a preliminary draft report on March 1 (Government Commission, 1990a), setting forth an outline of the program and specifying areas for further study, and submitted its final draft to the provisional Government in April (Government Commission, 1990b and 1990c). The Commission consisted mostly of administration officials, but in all about 1,200 Romanian academics, enterprise managers, trade unionists, scientists, and civil servants contributed to the report. The provisional Government discussed and endorsed the Commission's proposals on April 19, and published the final version of the report in early May. 2/

This report was unique in Eastern Europe as an official public statement by the Government of its reform plan. In addition, given the remarkably short time in which it was produced and the relative isolation of the country, it was entirely "home-made". The objective of the economic reform process, as well as its urgency, was stated clearly already in the first draft of the Commission's report:

> "The transition to a market economy is desired not only by the Government; there is now a national consensus on that point. All those who understand the complexity of the question agree that the transition must be prepared economically, financially, organizationally, and also in the area of legislation. But the various measures cannot be delayed because they aim at medium- or

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1/ "Government Commission for the Elaboration of a Program of Transition to a Market Economy in Romania", henceforth referred to as Government Commission or simply Commission.

2/ Schiţă privind Strategia Înfăptuirii Economiei de Piaţa în România, May 1990. Also appeared in Council for Reform (1990). Unless otherwise stated, all references are to the translated versions of the Commission's reports.

long-term purposes, for delaying them would render the tasks of the future Government much more difficult, and it is also known that any delay would increase the social costs of transition immeasurably." (Government Commission, 1990a, pp. 3-4).

Even in the early drafts, the Commission's report was notable in its sense of perspective and its comprehensive approach to the issue at hand. Perhaps more importantly, the transition to a modern market economy was placed in the context of a wholesale transformation of the country toward political pluralism and multi-party democracy (Government Commission, 1990a, pp. 6-8). At the same time, transition was envisaged as a process embracing all facets of economic activity. Indeed, all aspects of economic reform were discussed in the Commission's report: decentralization and reduction of the role of the state; ownership reform, including land reform; price liberalization; financial sector reform; currency convertibility; liberalization of trade and capital flows; macroeconomic management, including tax reform; institutional and legal reform; accountability of state enterprises during the transition, including increasing managerial responsibility and enforcing bankruptcy regulations; changes in the statistical system; and the social and environmental dimensions.

The report presented the transition to a modern market economy as a two-stage process: first, the reform of the existing economic and institutional structures to those of a market economy; and second, the modernization of the economy. These two stages overlapped, but their time horizons differed, with the former being a prerequisite for the success of the latter. Economic reform was envisaged as a short-term task, to be completed in at most two to three years, while modernization was to be a longer-term process, at the conclusion of which--near the end of the century--standards of living in Romania would be comparable to those of Western European countries. Aside from this initial reference to long-run goals, the report was focused almost entirely on the short-term economic reform tasks ahead.

As regards the pace of reform, the Commission's report, noting the controversy between shock treatment and gradualism, opted for a "gradual reform introduced at a rapid pace, [starting with] an accelerated introduction of the legal and economic mechanisms strictly necessary for the functioning of a market economy". 1/ This choice of terms reflected the Government's concern with the social aspects of transition and the need to maintain popular consensus on its objectives. The report stated that "the period of transition should be reduced to the possible minimum" (Government Commission, 1990a, p. 10), but emphasized that "transition [...] is to be accomplished in terms acceptable to the people, along with absorption of crises and without affecting adversely the standard of living (Government Commission, 1990b, p. 3).

1/ Schiţă privind Strategia Înfăptuirii Economiei de Piaţa în România, p. 11.

The report included a discussion of the objectives and content of structural measures in specific areas, as well as a tentative timetable for their implementation over the period 1990-92 (Government Commission, 1990c). In terms of sequencing, the report put priority on ownership reform, the reduction of the role of the state in resource allocation, and social protection. The liberalization of prices, trade, and capital flows, although already started in the first months of 1990, was envisaged as a more gradual process, to be completed by the end of the two- to three-year reform period. The financial sector was to be reformed in order to help improve the allocation of resources, starting with the break-up of the monobank system. Interest rates were to be increased but remain controlled until the end of the reform period, when the basis of a capital market would have been created, making enterprises less dependent on banks for financing. During the period, careful fiscal and monetary policies were called for to ensure price stability and, together with appropriate exchange rate action, balance of payments equilibrium.

The emphasis on social protection was one of the most prominent characteristics of the Commission's report. Its objective was to ensure that living standards for the entire population be protected during the transition, and indeed that they start improving immediately. Therefore, although it targeted special measures to disadvantaged groups (e.g., mothers with many children, orphans, disabled), it was not focused on any particular section of the population but included measures affecting all citizens. These measures included, among others, reductions in the working week, additional holidays, housing subsidies for young couples, improved social insurance, scholarships for students, professional training, and a minimum wage law.

The Commission's report reflected the authorities' thinking and priorities in the early months of 1990, in the economic and social conditions prevailing at the time. It stated clearly that the ultimate objective of the reform process was the transition to a market economy. It stressed the need for a comprehensive approach, with action taken simultaneously in all areas, and offered specific policy proposals in each area building on the measures already taken. It recognized the importance of maintaining a social consensus on the reform objectives during the transition and of protecting the most vulnerable groups. Remarkably, drawing up this blueprint for reform was achieved virtually without foreign assistance, in about three months, following a violent change of regime in a country with no previous experience of reform. In retrospect, however, the report failed to see that many of the structural measures introduced by the provisional Government were insufficient. The report also underestimated the degree of price distortions, the disequilibrium between aggregate demand and supply inherent in the existing monetary overhang, and its inflationary potential. Partly in consequence, the proposed price reform was timid, especially given the ambitious target for developing private economic activity, including privatization of state enterprises and foreign direct investment; the report did not see that these targets would not be achieved before prices distortions were removed. Further, the report failed also to see that the macroeconomic disequilibrium would only grow as a result of increases in wages, benefits, and transfers. In this connection, the social protection scheme advocated by the report, although arguably necessary in Romania's socio-political conditions of the time, ran contrary to the stabilization policies required under the circumstances. Finally, although the report discussed privatization at some length, it did not focus on making state enterprises autonomous and accountable before they were privatized.

The publication of the final version of the Commission's report marked the culmination of the reform effort of the provisional Government. In the elections that followed on May 20, the National Salvation Front (NSF)--which had run the provisional Government--won a large majority in both houses of Parliament. A Government under Prime Minister Petre Roman was formed in late June, retaining many members of the economic policy-making team of the provisional Government. The new Government was to serve until a draft new constitution was adopted by Parliament, at which point--at end-1991 or early 1992--new elections would be held.

The new Government endorsed the general strategy outlined in the Commission's report and started the process of its implementation. From the beginning, the NSF Government understood the importance of building the appropriate legal framework for a market economy, especially in the circumstances of Romania, which had just emerged from an excessively centralized central planning system. To this end, a Minister of State (of Deputy Prime Minister rank) on Relations with Parliament was appointed with the sole responsibility of elaborating and coordinating a detailed legislative plan, and a Council for Reform was formed, 1/ consisting, inter alia, of legal specialists and economists, to assist the Government in the drafting, interpretation, and implementation of laws. Foreign assistance was received from various institutions in this regard. The Government's legislative plan for the period through June 1992 appeared in August 1990 (Council for Reform, 1990), and during the ensuing months the legislative effort assumed impressive proportions. 2/

One of the most important laws for the reform program was prepared very quickly and was passed by Parliament in August 1990. Law 15 on the Restructuring of State Economic Units--essentially a privatization law--also included other critical provisions on trade and exchange policy, the break-up of monopolies, the abolition of the centrale, and foreign capital inflows. The Law brought the issue of ownership reform in the forefront, and was a clear signal of the Government's intentions vis-à-vis the state enterprises. Aside from its many positive points, this major piece of legislation shared to some extent the defects of some earlier acts of the

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1/ "Council for Reform, Public Relations, and Information", henceforth referred to simply as Council for Reform.

2/ Information on laws presented herein comes mainly from translated versions of the laws as published in the Monitorul Oficial al României (the official gazette). Several important laws have also appeared translated in Council for Reform (1991) and Ministry of Trade and Tourism (1991).

provisional Government: it had been hastily prepared, and many provisions were unclear or difficult to operationalize. As a result, it had to be clarified by and supplemented with an additional privatization law, as well as a land reform law, later on.

During the spring and summer months of 1990, the size of the output collapse had started becoming more and more evident, as did the growing domestic imbalances and the mounting pressures on the balance of payments. This influenced the Government's unfolding reform program in three major ways. First, the Government was forced to focus more on the macroeconomic situation and to accelerate the pace of the reform strategy outlined in the Commission's report and endorsed by the provisional Government. As an early step toward reducing the inflationary pressures in the economy--which had not yet been reflected in prices, as most prices were still controlled--the Government called in late June for a moratorium on basic wage increases throughout the economy. Second, the Government became increasingly aware of the critical role of price liberalization for the success of virtually every other reform initiative, and proceeded to reorder its priorities and modify the sequencing of structural measures. The Government also realized that a jump in the price level would be inevitable following a price liberalization, because of the existence of a monetary overhang. Finally, the Government realized the need for consistency between its social and macroeconomic policies and started rethinking the social objectives.

The Government's awareness of and concern with these issues were evident in the Prime Minister's report to Parliament on the status of implementation of economic reform on October 18, 1990 (Rompres, 1990). Noting in his report the decline in output and investment, as well as the increase in money incomes and the attendant inflationary pressures, the Prime Minister stated that "the acceleration of the reform is an absolute necessity. The crisis in the economy calls for exceptional, emergency measures" (Rompres, 1990, p. 33). Following his request, Parliament granted the Government exceptional powers in the area of reform; the Government had now the power to introduce new economic measures, accelerate reforms, and negotiate foreign credits pending Parliamentary approval, provided that these measures were consistent with the Government's existing reform program. The Government used these powers to liberalize trade policy later in the year, and to begin negotiations with commercial banks and multilateral organizations with a view to mobilizing external financing.

The Prime Minister's report to Parliament reflected a substantially more realistic approach to reform than the one in the Commission's report. Price liberalization was given a central role, the pace of reform was accelerated, and social policy became somewhat more targeted. In addition, the Government realized the urgent nature of the macroeconomic situation. Despite this progress, however, the Government's macroeconomic policy and reform strategy remained disparate: there was no attempt to integrate them in a coherent program. Further, there seemed to be a lack of awareness of the weaknesses of important pieces of legislation that had been quickly prepared and enacted. Finally, the Government had not yet fully realized that changes in the legal framework alone were necessary but not sufficient to instill market discipline into the existing state enterprises.

The 1990-91 winter months saw three major developments in the area of the authorities' reform strategy. First, the Government's persistent legislative effort gained momentum; in the process, the authorities realized the defects of earlier structural reform laws and proceeded to amend or complement them with improved versions. Second, the Government built around its 1991 Budget a coherent program for the year, integrating its macroeconomic and structural reform policies. The 1991 program not only emphasized macroeconomic stabilization, but included consistent structural reform policies, such as further price and trade liberalization, and a realistic and well-targeted social safety net. Third, the Government undertook a major price reform on November 1, that liberalized about 50 percent of prices in the economy, and raised others substantially.

In the legislative area, the Government's efforts assumed impressive proportions. In the eight months to February 1991 that the Government had been in office, some 90 laws had been drafted and submitted to Parliament and 46 of them had been promulgated. Many of these laws pertained to the functioning of the economic system and covering a large number of subjects, including labor legislation, tax reform, civil service employment and salaries, reorganization of state enterprises, banking reform, international treaties--such as joining the International Finance Corporation--and the 1991 Budget. These laws were by and large carefully prepared, often with foreign technical assistance. In addition, new privatization and foreign investment laws, as well as a land reform law, complementing inadequate existing legislation, were submitted to Parliament in the first half of 1991.

The Government's integrated reform and adjustment program for 1991 was presented by the Prime Minister to Parliament on February 26, 1991, on the occasion of the debate on the 1991 Budget. The Prime Minister's report (Rompres, 1991) started with a critical assessment of the experience of the first twelve months and then discussed in detail the 1991 program, entitled "Program for Reform, Adjustment, and Stabilization".

The report acknowledged mistakes during the first year of transition, notably the unwarranted optimism of the early reform plans of the provisional Government and the insufficient steps taken at the outset to inform the population of the objectives and costs of transition. The former, according to the report, was due to several factors. First, the size of economic imbalances had been underestimated. Secondly, the provisional Government was not able to fully resist populist pressures on the eve of the May 20 elections. Thirdly, it had been assumed that changes in the institutional framework alone would be enough to set the economy on the right track; as the report put it, however:

> "The economic reform was primarily achieved on an institutional plane, while managerial structures both at the macrolevel and in the area of palpable processes of economic activity were not changed radically. The shortage of managers, the insufficient communication with those who could become true managers, and the incompetence of some managers within the governmental apparatus who would not let go of their managerial chairs slowed down or blocked the course of reform." (Rompres, 1991, p. 14).

The core of the Government's "Program for Reform, Adjustment, and Stabilization" for 1991 was a macroeconomic stabilization package, carrying the support of the IMF, that reflected the realization that stabilization had become a top priority, as well as a test of credibility for the Government's intentions at home and abroad. At the same time, the structural reform policies put forth were consistent and complementary to the stabilization program, notably in the areas of price reform, trade and exchange system reform, financial discipline for enterprises, and the social safety net.

As regards price reform, the Government implemented the second round of price liberalization affecting prices of basic consumer goods and services on April 1, 1991. The official exchange rate of the leu was devalued from lei 35 to lei 60 per U.S. dollar, and imported intermediate goods prices were adjusted accordingly.

The creation of an open trading system to minimize price distortions and contribute to opening the Romanian economy to the rest of the world, which was from the beginning one of the major goals of reform, was fostered in early 1991 by the abolition of all quantitative import restrictions and the rationalization of the existing tariff system. At the same time, in order to make progress toward currency convertibility, an interbank foreign exchange market started daily auctions on February 18, 1991. These measures were not only important steps in the transition to a market economy, but by reducing structural distortions and opening up markets would also directly promote the aims of macroeconomic stabilization.

The Prime Minister's report focused a great deal on enterprise financial discipline and restructuring. Realizing that the promulgation of a privatization law could not, by itself, reduce losses or force state enterprises to operate efficiently, especially given the time needed for effective transfer of control to the private sector through privatization, the Government decided to follow a twofold enterprise restructuring strategy in the short term. First, old enterprise debts, caused by the distortions and the excessive tax burden of the central planning regime, were to be written off so that both enterprises and the banking system could start with a clean slate. Second, financial discipline on enterprises was to be imposed with the means the Government had in its disposal: taxes and subsidies, bank credit, and bankruptcies. In the longer term, as privatization progressed, financial discipline would be reinforced by the exercise of private ownership rights.

The operation to write off old unserviceable enterprise bank debts had begun in early 1990. As discussed earlier, at first the unserviceable debts were written off against accumulated Government deposits at the banking system from past fiscal surpluses. In 1990, a total of lei 265 billion (about one-third of 1990 GDP) of unserviceable enterprise debts were written off this way, exhausting the stock of Government deposits, and another lei 125 billion (equivalent to about 15 percent of 1990 GDP) were refinanced by the National Bank of Romania. The authorities decided in 1991 to replace the latter with non-negotiable government instruments, thus cleaning up once and for all the books of the entire banking system from these bad assets.

To avoid the re-emergence of losses and bad debts once the existing ones had been eliminated and prices were largely liberalized, the Government made financial discipline of enterprises an essential ingredient of its reform program. Financial discipline was to be ensured by a combination of measures: the restructuring of the tax system in early 1991 so as to allow the firms adequate retained earnings to finance investment; strict bank supervision to stop the extension of credit to unprofitable activities; and enforcement of existing bankruptcy procedures while a new bankruptcy law was being prepared. To encourage viable enterprises to restructure, however, temporary budgetary support was promised to enterprises undertaking a sound restructuring program.

Finally, the Government's 1991 Budget incorporated a social safety net that was substantially different from the one in the early reform documents. The new social safety net was not only better targeted at the most vulnerable groups rather than the entire population, but was also consistent with the tight fiscal policy required under the 1991 stabilization program. In addition, the Government acknowledged that even for those groups adjustment will have costs: the social protection given to the least well-off segments of the population would "fall short of [the Government's] desire" (Rompres, 1991, p. 55).

In summary, although the objectives and ingredients remained unchanged, the strategy of the Romanian reform program evolved during the first year. Both the experience with introducing structural measures and the developments in the Romanian economy had their influence on the pace and sequencing of reform envisaged by the authorities: as regards the former, it quickly became clear that an accelerated pace would shorten the period of uncertainty and enhance the credibility of the reform program; and as regards the latter, price liberalization and enterprise financial discipline came to be regarded as pre-conditions, rather than simply components of a successful transition. This evolution, although it occasionally caused the Romanian reform program to appear erratic and lacking a clear direction, was to a great extent a natural consequence of the initial conditions in which the reform effort was launched, the state of the Romanian economy at that time and, perhaps most importantly, the fact that policymakers were themselves learning about transition as the process was going on.

IV. Principal Objectives of the Romanian Reform Program

The main objectives of the Romanian reform program, as discussed in the previous section, fall broadly into three categories: the introduction of market forces in the economy, notably by liberalizing prices, trade and the exchange system, and interest rates, and allowing them to guide economic decision-making; the transfer of ownership to the private sector; and the reduction of the role of the Government in the economy. This section presents the specific policies and measures taken to achieve each of these objectives.

1. Introduction of market forces in economic decision-making

a. Price liberalization

Price liberalization is a central element in the process of economic transformation. Under central planning, prices did not play an allocative role but were used instead mainly for controlling income distribution (Hinds, 1990). As a result, several distortions arose. In many cases production costs were different than sales prices, thus distorting resource allocation. In the case of goods deemed to be "essential", production costs were higher than prices, necessitating subsidies for the producers to continue operating. These subsidies, as well as the great need for funds to finance investment from the budget, resulted in an excessive tax burden on enterprises and complicated tax systems, which further distorted prices. At the same time, the domestic economy was sheltered from the rest of the world by pervasive quantitative restrictions and the operation of "price equalization funds", which taxed profitable exporters and importers to subsidize unprofitable ones. 1/ Finally, the use of prices as a tool for income distribution and the channelling of resources to the capital goods sector under central planning were at the root of the emergence of a large monetary overhang in these economies. As production was guided by planning rather than the price system and resources were channeled to the capital goods sector, excess demand conditions developed in many consumer goods markets, since the quantity and mix of consumer goods available were not what the consumers desired. As consumer prices were not allowed to adjust, these goods were effectively rationed through queuing--a familiar sight in centrally planned economies. The counterpart of this, however, was the accumulation of large excess money balances by households.

Correcting relative prices and eliminating the monetary overhang in an orderly way is a prerequisite for the achievement of the other objectives of economic reform. The massive transfer of property to the private sector cannot be achieved in an environment of distorted relative prices, because profitability criteria cannot be applied to state enterprises that are to be privatized. On the other hand, price distortions--and the attendant need

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1/ It should be noted that being profitable in an environment of widespread price distortions is not the same as being efficient in an opportunity cost sense.

for subsidies--as well as the perpetual threat of hyperinflation inherent in the monetary overhang make it extremely difficult for the Government to reduce its role in the economy and move to indirect methods of macroeconomic control. At the same time, however, abrupt price liberalization in such an environment poses the risk of sustained inflation if the financial policies in place are not geared toward macroeconomic stabilization.

The approach of the Government of Romania to price liberalization evolved over time. In the beginning, as evidenced in the early reform documents, the Government was planning to liberalize prices gradually and differentiate between prices of capital and intermediate goods and prices of consumer goods. Some important measures to liberalize prices in certain markets, however, were already taken even before the provisional Government's reform program was finalized. Prices of agricultural products *sold directly in "peasant markets" by producers were liberalized, and newly* created private firms and firms with foreign equity participation were allowed to determine the prices of their products freely.

From the outset, the general objective of the authorities was to create a system where prices are determined by supply and demand. This liberalization, however, was to be careful and gradual, because the economy was marred by grave distortions, reflected in serious disequilibria in some markets and large differences between domestic and world market prices. According to the program outlined in the early reform documents, by the end of the transition period prices of all products were to be completely market-determined, except for the prices of a category of key intermediate and final products. This category included products of the mining, fuel, and energy sectors; metallurgy; the chemical industry; forestry; basic branches of the machine-building industry; the main products of the food industry; and transportation, postal, and telecommunication services. Prices of goods and services in this category would continue to be set administratively even after the transition period was over, and would be adjusted using world market prices as a reference whenever possible.

The prices of the rest of the products were to be gradually liberalized during the transition period. These prices were divided into two groups: wholesale prices and prices of raw materials and intermediate products on the one hand and retail prices of consumer goods and services on the other. Prices in the first group were to be liberalized faster than those in the second group, and in the following order: (i) prices of goods produced by more than one producer, goods of nonstandard design, goods made to order, products with local characteristics, and some services rendered between enterprises, would be liberalized first; and (ii) prices of goods produced by monopolies, or of products for which there was a significant demand-supply disequilibrium, would be subject to government-imposed ceilings, until the disequilibria disappeared. During the transition period, these ceilings would be adjusted using, inter alia, world market prices as a reference. Prices in the second group, that of consumer goods and services, would be determined during the transition period as follows: (i) prices of products "essential for the standard of living" (food products marketed through state outlets, energy, fuels, basic drugs, some articles for children, transportation, rent, and standard design housing units) would be administratively set; (ii) prices of certain other products, such as fabrics, garments, footwear, furniture, durable consumer goods, cars, hotel and tourist services, etc. would be subject to government-imposed ceilings; (iii) prices of a few "special imports" (luxury goods, cosmetics, cigarettes and beverages) would be set administratively, with a view, inter alia, of controlling the total amount imported; and (iv) prices of all other consumer goods and services would be freed. All retail consumer prices subject to administrative controls or ceilings during the transition period were to be adjusted to reflect changing costs resulting from changes in wholesale prices, and to be completely liberalized in 1992.

This complicated schedule for price liberalization was never implemented. The Government realized that more decisive steps in this direction would be necessary, and in his address to Parliament on October 18, 1990, the Prime Minister announced an accelerated price liberalization scheme in two rounds on November 1, 1990 and January 1, 1991, respectively. The new scheme reversed the order of liberalization envisaged in the early reform documents for wholesale and consumer goods: the latter were now to be liberalized faster.

In the first round of price liberalization that took place on November 1, 1990, accompanied by a devaluation of the leu from lei 20 to lei 35 per U.S. dollar, a large number of prices were decontrolled. In general, all prices of goods and services produced by three or more producers were freed, except for prices of: (i) a group of 77 basic domestic and imported raw materials and intermediate goods, whose prices were generally increased to reflect world market prices at the new exchange rate (except for 20 mineral products, whose prices were not increased); and (ii) 40 basic consumer goods and services, whose prices were kept unchanged, including household energy, local transportation, and food items. Prices of goods produced by only one or two producers were to be set in negotiations between producers and the Ministry of Finance. In all, about half of the prices in the economy were freed, although if weighed by the volume of transactions, probably much less than 50 percent of all transactions were to take place at market-determined prices. The Government also introduced a system of partial indexation for wage-earners and pensioners to compensate them partly for the price increases.

The second round of price liberalization was postponed from January 1 to April 1, 1991. It was also accompanied by a new devaluation of the official rate of the leu from lei 35 to lei 60 per U.S. dollar. An interbank foreign exchange auction market, however, had already started operating in February 1991, where the rate was fluctuating around lei 180-200 per U.S. dollar. In the second round, the prices of controlled domestic and imported raw materials (with the exception of the same limited list of minerals as before) were increased again broadly in line with the devaluation; the prices on household energy products were kept under control but were increased; and the controls on basic food items were abolished. Indicative ceilings were announced for only 12 food products (including meat, butter, milk, bread, cheese, eggs, sugar, and edible oils). These indicative ceilings were set at the level of prices that obtained for the same products in the free peasant markets, implying increases of 100-150 percent vis-à-vis the previous prices, and applied only to products of standard quality sold through state stores. Prices of products of different quality were freed, while prices of the same products sold in peasant markets had already been liberalized in early 1990. The ceilings were indicative in the sense that producers could challenge them and the Ministry of Finance could allow prices to exceed the ceilings if cost conditions warranted it, on a case-by-case basis.

At the same time, the system of price controls on goods produced by less than three producers introduced in the first round of price liberalization to protect consumers from monopolies exercising their monopoly power had become increasingly cumbersome to operate. Continuous price adjustments throughout the economy made the prices set for these products jointly by the Ministry of Finance and the producers irrelevant only weeks after the conclusion of the negotiations. Further, the system was considered by domestic producers to be unfair, because it did not apply to joint ventures. Most importantly, the system created pressures for subsidies on the Government, as loss-making enterprises claimed that their financial difficulties were due to the price controls. In light of these developments, this system of controls was quietly abandoned. This action, combined with the second round of price liberalization, implied that about 80 percent of prices in Romania were freed by mid-1991. Finally, in July 1991 the authorities completed the final stage of price liberalization which resulted in controls being applied to only 14 categories of products that are critical for the consumption of the population (i.e., 5 basic food items and 9 other categories, including home heating fuels, local transportation, rents etc.). It is noteworthy that in a short space of 8 months Romania went from a system of complete price controls to one which compares favorably with many market economies.

b. Trade liberalization and reform of the exchange system

Convertibility of the domestic currency through the reform of the trade and exchange systems is considered to be a key component of the overall reform strategy. 1/ Generally speaking, trade liberalization has been advocated for two main reasons. 2/ The first is that it helps to raise economic growth and increase employment generation by improving resource allocation and economy-wide efficiency. The argument here is based on the well-known principle of comparative advantage and the benefits of exploiting economies of scale and specialization. The connection with growth rests on the notion that a liberal trade regime, in addition to improving static efficiency, will also tend to increase the efficiency of investment, thereby stimulating growth. The second main benefit of trade liberalization is that it helps to improve the balance of payments by strengthening the competi-

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1/ See, for example, Genberg (1991) and Greene and Isard (1991).
2/ For a discussion of the benefits of liberalization, see Corden (1987); more recent evidence on the subject is contained in Thomas et.al. (1990).

tiveness of the external sector and expanding exports and efficient import substitutes. Because import protection increases the costs and reduces the availability of inputs used in the production of exports, thus driving up the (real) exchange rate, it creates a bias against exporting activities and in favor of inefficient import substitution.

Overall, the available evidence from countries that have engaged in trade reform programs suggests that trade policy and other structural reforms have contributed to the growth of output and exports (Thomas et. al, 1990). Furthermore, when the real exchange rate has depreciated during the process of liberalization, the evidence also suggests that import liberalization is associated with improvements in the external current account position.

An important issue in the process of trade liberalization relates to questions of sequencing, i.e., which measures should be adopted first. It is generally accepted that nontariff barriers, such as quotas and import licensing, should be removed first. Because quantitative restrictions depend on discretionary decisions by the authorities, they make the system of protection less transparent and predictable and encourage lobbying, corruption, and rent-seeking activities. Even with little or no decrease in protection, a reduction in nontariff barriers can have major salutary effects. For example, a switch from quotas to tariffs providing roughly equivalent protection establishes the link between domestic and international prices, ensuring that they move in the same direction and do not diverge by more than the amount of the tariff, as well as provides revenue to the Government.

Once nontariff measures have been sharply reduced, bringing about more uniformity in the tariff structure should be given high priority. In addition to minimizing production distortions for a given protection level for importable goods, a more uniform tariff structure also has the advantage of being less subject to lobbying from diverse interest groups. Once greater uniformity has been achieved, the final stage of the process, in which the overall level of protection is gradually reduced, should ideally begin.

The Government of Romania moved decisively to liberalize the foreign trade sector. The first step in this direction was to abolish the state monopoly for foreign trade. Starting in February 1990 under decree-law 54, private enterprises became free to engage in foreign trade transactions, and state enterprises ceased to be subject to central plan directives and were no longer required to conduct their foreign trade transactions through specified foreign trade organizations. Following the abolition of the state monopoly for foreign trade, a large number of newly-created private enterprises, including joint-venture companies, registered as foreign trade operators. These enterprises, most of them quite small, co-exist with about 50 large former foreign trade organizations (FTOs). The FTOs are state owned, but it is intended to open them up to private participants for up to one third their value, in line with the Government's privatization strategy.

From early 1990, import control was to be effected through a system of licenses issued by the Ministry of Trade and Tourism, and an import license was to be a prerequisite for opening of letters of credit by the Romanian Bank for Foreign Trade. The licenses issued were to be based on balance of payments considerations and sectoral priorities. Specifically, the Government intended to introduce three categories of import licensing. The first category would be applicable to raw materials and inputs. For these products, licensing would be automatic and would be required only for data gathering purposes. The second category of licenses would apply to about 100-200 products such as tools, machinery, and agricultural products that were produced domestically. Quotas for such products would be established in consultation with producers and consumers of the respective products. The third category of licenses would be applied to goods for which the Government did not have clear information as to the import needs or domestic production capability. For these products, the license applications would be approved after consulting with the relevant ministries.

On the export side, it was also the intention to introduce three types of licenses. The first category would be for products for which there existed excess domestic supply. The purpose of quotas in this case was to ensure that domestic consumption would not be disrupted. The second category of export licenses would apply to products for which the Government had no information as to the domestic consumption needs. For the remainder of exports licenses would be issued automatically.

This licensing system was regarded as a temporary solution to managing trade in conditions of radical transformation of the economy, particularly as there was a complete lack of data on import needs and export availability. In the event, the Government decided that licensing of imports and exports was inconsistent with their aim of an open and transparent trading system, and in 1991 abandoned the scheme completely insofar as imports were concerned. Licenses were to be used only for statistical purposes and were to be issued automatically. For exports, licenses were maintained for only those products receiving subsidies from the Government or subject to domestic price controls.

Protection of the domestic economy was now to be achieved solely via tariffs and exchange rate policy, and starting January 1991 the Government undertook a number of modifications to the existing tariff code to make it more compatible with the overall objectives of the reform program. First, generalized exemptions from tariffs granted to inputs used by the public sector were revoked; only energy products were exempt from duties. Second, no distinction was to be made between imports of inputs and final products or among different uses of the same product. Third, the highest tariff rates were cut significantly so that the maximum rate was 40 percent, with the rates for some 95 percent of line items less than or equal to 30 percent. Notwithstanding these reforms, the Government regarded the existing tariff code as inadequate to meet Romania's long-term need for a rational and transparent tariff system consistent with an outward-looking development strategy. Accordingly, it began to develop a new tariff code to be implemented in 1991. The new tariff structure is based on several general principles. First, the nomenclature of the new code was harmonized with those of other Western European countries. Second, the rates were determined on efficiency considerations alone, implying that the fiscal consequences of any particular structure were not regarded as important. Third, the tariff code would be used to create incentives in the economy for improving efficiency. This means that products for which Romania was clearly not internationally competitive would not be protected. Thus, protection would be limited to those products deemed to need the chance to develop on a sound basis without disruptive foreign competition. Specifically, in this new system tariff rates are grouped into three basic categories depending on the degree of protection granted. Products with low protection face tariffs of up to 10 percent, those with medium protection face rates of 10-20 percent, while the most protected items face tariffs of up to 30 percent. The assignment of products to different categories is to be made on the basis of several factors, including the domestic and international prices of the product, domestic production and consumption, import requirements, as well as sectoral development strategies. The new tariff system was submitted to Parliament in mid-1991, and was awaiting enactment at the time of publication of this paper.

The liberalization of trade was accompanied by a policy of allowing greater access of agents to foreign exchange. Prior to January 1990, although foreign currency accounts were legal for residents and non-residents, the ability of residents to open or effect transactions through such accounts was severely restricted. Interest was paid in domestic currency at an appreciated exchange rate. In January 1990, the provisions governing foreign currency accounts were substantially liberalized. It also became legal to hold foreign exchange outside the banking system, though the requirement to effect all foreign exchange transactions only through authorized agents remained until August 1991.

From September 1990 exporters were no longer compelled to surrender all foreign exchange earnings to the Government. Instead, all exporters became eligible for a minimum uniform retention of 50 percent of their gross export earnings. The use of retained foreign exchange was free from restrictions on payments and transfers for current account transactions, and thus could be used for imports of goods for their own use or for resale. Joint venture firms were exempt from the surrender requirements and were free to use foreign exchange as they wished. 1/

In February 1991, the Government also instituted an interbank exchange market open through participating banks--acting as brokers--to all enterprises. The supply of foreign exchange to this market comes primarily from the 50 percent retained earnings of exporters and the Government. Foreign exchange is made available freely for all bona fide current account

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1/ This exemption naturally led to a sharp increase in joint venture firms formed with minimal foreign capital, allowing exporters to avoid easily the surrender requirements.

transactions, with the exception of limits on profit remittances by nonresidents. Starting August 1991, small-scale transactions in foreign exchange by individuals via exchange houses were also permitted. The access of these exchange houses to the interbank market is to be intermediated through the participating banks.

The dual exchange rate system, combining a fixed exchange rate for a limited set of transactions with a freely floating interbank rate, is considered to be a temporary arrangement. The Government is committed to--and announced this intention in July 1991--an early unification of the two markets. The regime to be chosen after unification, namely fixed or floating, will depend on a number of factors, in particular balance of payments and inflation developments and prospects, as well as on the level of international reserves.

c. Interest rate policies

The liberalization of credit markets, in particular allowing interest rates to reflect market conditions and determine the allocation of credit, generally accompanies the liberalization of prices and exchange rates in reforming economies. Interest rate deregulation is necessary to prevent higher prices from distorting saving and investment decisions, with adverse consequences for efficiency and growth. 1/

In the light of the experience of several Latin American countries in financial sector reform, however, it is now acknowledged that there may be risks involved in liberalizing interest rates. If the liberalization occurs before the economy is stabilized, the profitability of enterprises improved, and the system of prudential regulations over the banking system strengthened, there could be an immediate run-up of real interest rates on deposits and loans and increased uncertainty about the future cost of funds. As a consequence, interest rates lose their value as a signalling device, and long-term investment and growth can suffer. Economic stability and effective bank supervision are thus fundamental prerequisites to successful liberalization of interest rates over a short time interval. Provided these preconditions are met, there is merit to moving rapidly to a system of free interest rates that the government can influence only indirectly to achieve monetary policy objectives.

Until late 1989, interest rates in Romania were very low and their structure was complicated. Household deposit rates at the Savings and Loan Bank (SLB) averaged 2.5 percent in 1989, while the SLB received 3.0 percent on its deposits at the National Bank of Romania (NBR). Other banks paid between 1.5-1.8 percent for credit obtained from the NBR in 1989. Enterprise deposits were remunerated at 1.5 percent to 1.8 percent in 1989.

1/ For a survey of interest rate policies in the context of financial sector reforms, see Villanueva and Mirakhor (1990).

On April 1, 1990, the provisional Government simplified the structure of interest rates and increased their level. Households began to receive 3.5 percent on all types of savings deposits at the SLB, which in turn received 3.6 percent on its deposits with the NBR. Interest rates on all enterprise deposits were raised to a uniform 3.0 percent, as were rates on credit from the NBR to the specialized banks.

Although the increases in deposit rates in 1990 may have reduced somewhat excess demand pressures and the existing monetary overhang, they were clearly insufficient to eliminate the increase in excess demand and inflationary expectations since the beginning of the year. Partly for this reason, and partly to be consistent with its exchange rate policy, the Government decided in early 1991 to liberalize interest rates. As of April 1, 1991, the NBR permitted deposit and lending rates to be freely determined between banks and their customers. This policy was designed to complement the flexible exchange rate policy. While interest rates are expected to exhibit some rigidity in the short run, because banks will adapt slowly to the new environment or may even collude in the setting of rates, over time interest rates will become solely market-determined. The interest rate policy was set in the context of a strong adjustment program, and bank supervision is a priority with the Government. To prevent interest rates from rising to an excessively high level, the NBR intends to monitor the spread between lending and deposit rates, and has retained the option of intervening if it believes this spread is too large or likely to become so.

2. Transfer of ownership to the private sector

A central element in the transformation of the formerly centrally planned economies in Eastern Europe is the transfer of state-owned enterprises to private ownership. It is generally agreed that privatization is essential for producers to respond to market signals in making production and investment decisions. 1/ The reason is that private ownership provides incentives for producers to minimize costs (by maximizing profits) and have output respond to market indicators as opposed to the dictates of the central plan. Private ownership also facilitates the objective of monitoring, evaluation, and control over the performance of those managing and operating enterprises, minimizing the impact of political considerations. In addition, private ownership makes it easier to subject enterprises to the threat of bankruptcy and to foster a competitive business environment by eliminating the Government's interest in protecting state-owned enterprises. Finally, and perhaps most importantly, privatization is believed to make the process of transformation to a market-based economic system irreversible. For these reasons, every reform program in Eastern Europe has included measures to facilitate the rapid transfer to private

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1/ For a survey of privatization schemes in Eastern Europe see Borensztein and Kumar (1991). Other studies highlighting the role of privatization include Fischer and Gelb (1990), Lipton and Sachs (1990a, 1990b), Hinds (1990), and Tirole (1991).

ownership of state enterprises. Most programs have also included measures to privatize state-owned housing and agricultural landholdings.

Despite the acceptance of the need for privatization, issues have arisen regarding the content of privatization programs. Although there is broad agreement about the desirability of selling smaller enterprises directly to potential owners, the direct sale of large enterprises remains somewhat controversial. Some observers contend that such sales, if made early in the transformation period, may result in substantial undervaluation of the disposed properties, providing windfall gains to the purchasers. Questions have also arisen about the appropriateness of "inside sales" of enterprises to workers and managers, which may transfer valuable assets to well-placed individuals, including those in the previous communist hierarchy, the so-called nomenclatura. To ensure widespread private ownership of the enterprises, many privatization plans in Eastern European countries have called for the free distribution of shares in large enterprises to all citizens, with each citizen obtaining a voucher for an equivalent number of shares. 1/ This approach has been criticized, however, as providing inadequate supervision over enterprise management, because no individual would hold enough shares in any one company to control its officers or directors. To remedy this problem, several economists have proposed creating in each country several large holding companies, each of which would hold shares in a number of enterprises. 2/ Large blocks of shares in the privatized enterprises would be allocated among the various holding companies, and the shares of these holding companies would in turn be distributed broadly among the country's citizens.

Because privatization may lead to increased tensions between workers and management, several plans would encourage workers to support productivity-improving measures by allowing them to buy a portion of their enterprise's shares at preferential prices. Another issue that has arisen is the need to encourage direct investment from abroad to finance modernization and improve the competitiveness of domestic enterprises. To promote such investment, countries have been advised to liberalize their investment laws, so that foreign as well as domestic companies and individuals can acquire shares in privatized enterprises, either on their own or in joint ventures with domestic partners. In addition, countries have been urged to liberalize at least some of their restrictions on external capital transfers, so that nonresidents can freely repatriate investment capital, retained earnings, and salaries, pensions, and other compensation from employment in domestic firms.

To facilitate the allocation of savings to newly-privatized firms, the transforming economies have been urged to establish stock markets in which shares of enterprises and holding companies can be traded. It is an open

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1/ See Borensztein and Kumar (1991) for a discussion of the pros and cons of the "giveaway" element embodied in the voucher scheme.

2/ Lipton and Sachs (1990a) and Blanchard et al. (1991) are among the proponents of such an approach.

issue, however, how soon citizens should be allowed to sell or trade their initial allocations of enterprise or holding company shares. On the one hand, it can be argued that these shares be non-negotiable for a limited time period, to prevent well-financed traders from acquiring large blocks of shares at low prices during the early period of these adjustment programs, when reductions in real incomes may be particularly severe. On the other hand, such restrictions would prevent individuals and firms from acquiring sufficient blocks of shares to exercise effective supervision over enterprise managers.

As part of its reform program, the Government of Romania took a number of steps to facilitate privatization. Since November 1990, many small enterprises have been sold to domestic owners and joint ventures between domestic and foreign partners. In addition, there has been a vigorous program to promote leasing of state-owned assets, including both equipment and structures. For large enterprises, a two-stage process was developed in the context of Law 15 of August 1990. With the exception of strategic sectors such as defense, mining, and telecommunications, in which enterprises became state-owned autonomous entities ("régies autonomes"), most enterprises were converted into commercial companies that will eventually be privately owned and operated. Commercial companies were then required to inventory and value their assets and then transfer shares equal to 30 percent of their value to the National Agency for Privatization (NAP), a government agency created under the same law, which in turn was to arrange for the eventual free distribution of these shares to all eligible citizens. Another 10 percent of the shares of commercial enterprises was to be made available for sale to the enterprise's employees at preferential prices, with the remaining 60 percent retained by the Government for eventual sale to private parties, either domestic or foreign.

Law 15 had several shortcomings, which the authorities came quickly to realize. As a result, a new privatization law was drafted with extensive foreign assistance and was enacted by Parliament in July 1991. This new law will create five holding companies, called Private Operating Funds (POFs), to serve as the immediate holders of shares equivalent to 30 percent of the share capital of each commercial company. The board of governors of each POF will initially be chosen by the Government and approved by the Parliament. The actual certificates in the POFs will be distributed to Romanian citizens in bearer form and will be tradeable between Romanian citizens after 12 months. These certificates cannot be transferred to foreigners for 5 years. The certificates will initially carry no voting rights, but within 5 years each POF's board must determine a procedure for the owners to elect a new board. Income and other proceeds received by the POFs may be deposited in interest-bearing accounts, paid out in dividends, or used in other commercial activities.

The Government's share of commercial companies, initially equivalent to 70 percent of capital, will be held by the State Ownership Fund (SOF). The board of directors of the SOF will be appointed by the Parliament. The SOF is obliged to reduce over time its ownership share of commercial enterprises and to report to the Government and Parliament on its activities. The SOF can use income and other proceeds it receives, inter alia, to deposit into interest-bearing accounts, to make equity investments, to extend credit to purchasers of state-owned assets (including employees of state firms), and for expenditures related to the privatization process.

Consistent with Law 15, the new privatization law provides for the preferential distribution of up to 10 percent of a commercial company's shares to employees and managers. In general, shares sold on a preferential basis to employees will be sold at a discount of 10 percent of the price paid by third parties.

The new law establishes simplified regulations for the creation and sale of small-scale operations, such as retail trade establishments. Part of the draft law on privatization allows for the sale of government assets. This will allow the NAP to start privatizing small businesses without waiting for the entire privatization infrastructure to be developed. Under government decision 1228, which permits leasing activity, the administration of many small-scale entities has already been passed into private hands. As of mid-1991, out of a total of 25,400 commercial units existing in Romania 12,193 units have been transferred to private administration by franchise contracts. In tourism, from a total of 2,384 units, owned by 135 companies, 1,049 units have been passed to private administration. Leases are given for up to two years after which the new owners of the property take control. In regard to private sector activity more generally, as of April 1991, there were 134,143 authorized private entities operating in Romania.

Under the new privatization law, the NAP is responsible for developing the privatization strategy with a view to promoting a more competitive industrial structure through enterprise restructuring. In addition to issues of financial restructuring, the NAP is developing a strategy for dealing with state enterprises that are heavy polluters; the NAP intends to ensure that the responsibilities of new enterprise owners in this area are set out in detail. After the SOF and the POFs have been constituted, they will have the right to chose the management of the enterprises they own according to their respective holdings of shares.

As discussed earlier, to strengthen the financial position of privatized enterprises and enable them to start on a more equal footing, the Romanian Government has moved to eliminate enterprise bank loans that were used to cover past enterprise losses. The remaining loans are scheduled to be replaced by end-September 1991 with non-negotiable government instruments to be held by the NBR. An enterprise restructuring fund, financed by the sale of state assets and a tax on inventory revaluations, will help service and retire the above government instruments or, in some cases, eliminate outstanding unserviceable loans directly. To provide further incentives for privatized companies to operate commercially, the Government is moving to enforce existing bankruptcy provisions and to end subsidy payments to loss-making enterprises. In addition, new bankruptcy legislation is under consideration.

Besides commercial companies, Romania's privatization program includes measures on housing and agricultural land. The Government has begun selling state-owned housing units to foster labor mobility, improve incentives for maintaining the housing stock, and help absorb the monetary overhang. As of mid-1991, some 50 percent of state housing had been sold to the public. In addition, the Government has approved a land reform program under which certain citizens--those with prior claims on particular plots--will be entitled to acquire a minimum plot of land. This measure is designed to promote the decentralization of large and inefficient collective farms and to give unemployed workers an alternative to remaining in urban areas. The return of agricultural land to previous owners is an important aspect of the Government's intention to make its reforms irreversible and to make ownership of state assets as widespread as possible. The Government expects that by 1992 over 80 percent of the farmland will be privately owned.

3. Reduction of the role of the Government in the economy

The third main objective of the Romanian reform program is the reduction of the size and the role of the Government in the economy and the development of indirect tools of macroeconomic policy. The Government took significant steps in this direction in two major areas: fiscal and financial sector reform.

a. Fiscal reform

In the context of financial planning as practiced in centrally planned economies, as discussed in Section II, fiscal policy is entirely passive and subordinate to the economic plan. The main roles of the government budget and the various extra-budgetary funds are to ensure the transfer of resources between sectors called for by the plan, and to achieve redistributive goals (Kopits, 1991).

Centrally planned economies in transition have focused on fiscal reform as a necessary ingredient of their transition to market economies. Thus, large-scale tax reforms have been initiated, while the burden of taxation has been reduced to encourage greater financial autonomy for enterprises and to avoid stifling the newly-emerging private sector. These changes, however, are made more difficult by the increased need for government revenue in order to cover expenditures for the social safety nets introduced to shelter the most vulnerable groups from the costs of transition. Cuts in expenditures for investment and subsidies, as prices are liberalized in the economy and enterprises are made more financially independent, help only partly to accommodate the increased need for funds. An additional constraint most of these countries are facing is the lack of experienced staff in the administration to design and implement the ambitious tax reform measures. For this reason, external technical assistance is often solicited in this area.

In Romania during the late 1980s, the share of the Government in economic activity, as measured by government revenue, grew to about 60 percent of GDP. The bulk of the government revenue came from the turnover tax, the tax on the wage fund of enterprises, and a system of remittances from profits. The latter was based on planned, rather than actual profits and, given the unrealistic plan targets, resulted in enterprises realizing large after-tax losses while the budget was in surplus. These losses were covered by automatic extension of bank credit, which left banks with unserviceable loans in their books, as discussed in Section II.

The first tax reform measures introduced immediately after the change of regime in late 1989 were intended to reduce the excessive tax burden on enterprises. Specifically, the turnover tax levied at the producer level--known as the "Ceauşescu tax"--and the system of remittances from profits were abolished effective January 1, 1990. The provisional Government replaced them with a new remittance mechanism, intended to transfer to the treasury any profits in excess of 10.5 percent of total costs.

On the expenditure side, the provisional Government decided to cancel many of the investment projects started by the previous regime, as well as slow the rate of implementation of other investment projects, due to energy shortages and low labor productivity. Expenditures for direct subsidies to enterprises, by contrast, increased substantially as a result of increased labor costs and higher agricultural procurement prices, for which the Government compensated agro-industrial enterprises. Finally, subsidies for the population were increased partly to compensate for previous deprivations, and partly to cushion the vulnerable groups from the costs of transition and adjustment.

In the course of 1990 and early 1991, the Government engaged in a comprehensive tax reform. The turnover tax was fundamentally revised on November 1, 1990. First, the base was substantially expanded from domestically produced final goods intended for domestic consumption to all goods and services, whether domestically produced or imported, except those intended for exports. Second, the rate structure was simplified, the rates were transformed from specific to ad valorem, and the number of rates was reduced to a total of 20, ranging from 1 to 90 percent. Finally, to reduce the negative impact of cascading, rates on intermediate goods were set substantially below those on final goods. The system of direct taxes was also overhauled. A proper profit tax was introduced in July 1990 to replace the profit remittance scheme, and the tax on the wage fund of state enterprises was replaced by a tax on wage income, extended to many previously tax-free nonwage benefits.

As in other areas of the reform effort, early fiscal reform measures were the result of a "trial-and-error" process. A case in point, the system of taxation of profits was changed in early 1990, when the profit remittance scheme was revised; in July 1990, when a profit tax was introduced; again in January 1991, when the profits tax was simplified and revised; and further changes are planned for early 1992.

The Government took these measures in the context of a medium-term strategy to reform the tax system and bring it in line with those in developed market economies. The turnover tax is to be replaced by a value-added tax (VAT) in early 1993, and the profit and wage taxes by a general income tax in early 1994. The design and timetable of these major tax reform measures have been elaborated with extensive foreign technical assistance. Perhaps the greatest impediment to swift and successful introduction of these measures in Romania, however, is the lack of trained staff to enforce the new tax laws and regulations. This means that the legislative effort--as in many other areas--has perhaps moved faster than the institutional changes necessary to support it.

b. Financial sector reform

In a typical centrally planned economy, there is one bank--the National Bank--that has monopoly over money creation. In addition, there are specialized financial institutions that channel credit from the National Bank to particular sectors but do not have a substantial deposit base, and--in many cases--a savings bank that attracts deposits of the population but does not engage in credit operations. This mono-banking system ensures direct and complete control of the quantity of money by the central authority, and reflects the two distinct financial circuits that exist in the centrally planned economy: one serving the household sector, which receives incomes and effects payments in cash only, and one serving the enterprise sector, which receives and makes payments only through bank accounts (with the exception of wage payments). In this way, the operation of the financial sector is completely subordinated to the physical plan. The volume of enterprise credit is set at the level necessary to finance inter-enterprise transactions at the level of gross production targeted in the plan, and the volume of currency in the economy is set at the level necessary to finance wage payments and, at the same time, household consumption. Interest rates have no allocative role in this system (Sundararajan, 1990).

In the context of the transition to a market economy, this financial sector needs to be completely overhauled. First, the National Bank has to be broken up and a genuine two-tier banking system, made up by a central bank and commercial banks, developed. Second, the commercial banks need to be given autonomy and start operating on a profit-making basis, which requires primarily competing for deposits and assessing client credit risk. This, in turn, implies that interest rates have to be liberalized and become tools for allocating funds. Third, the payments system needs to be unified and streamlined, and the capital market developed so that enterprises can raise funds directly from the population. Finally, the central bank must take on supervisory functions and develop indirect tools of monetary control.

As is evident, these reforms require not only a substantial amount of legislative work and skill- and institution-building, but also profound changes in attitudes. An additional complication is that in many cases these reforms have to be initiated in an unstable macroeconomic environment, which in turn requires tight monetary policies. In such cases, the development and introduction of indirect means of monetary policy may need to be delayed in order to ensure that the objective of monetary control is not compromised in the short run.

Under central planning, the financial sector in Romania was similar to that in most other Eastern European countries at the time. Flows of funds were targeted in the context of the financial plan, as discussed in Section II. Control over these flows was exercised centrally. In addition to providing credit and accepting deposits, the banking system had the responsibility of monitoring the implementation of various aspects of the physical plan at the enterprise level. The clear division of responsibilities between the state-owned specialized banks was designed to facilitate the fulfillment of these tasks, but also resulted in an absence of bank competition. There were no domestic financial assets other than bank deposits and currency, and no financial markets, and effective reserve requirements of 100 percent--after costs and currency needs were met--prevented secondary money creation.

The banking sector consisted of five institutions, namely the National Bank of Romania (NBR) and four specialized banks--the Romanian Bank for Foreign Trade (RBFT), the Investment Bank (IB), the Bank for Agriculture and Food Industry (BAFI), and the Savings and Loan Bank (SLB). The NBR fulfilled some central bank functions as it was the issuer of currency and held accounts of the state budget, but it was also a commercial bank, taking deposits from state enterprises and extending short-term loans to them. In addition, it channeled excess deposits from the SLB directly or through the other three specialized banks into domestic credit. The RBFT served foreign trade organizations and was the main financial link to foreign countries and the primary holder of Romania's foreign exchange assets. Funds required by the RBFT for extending domestic credit, including export credits in lei, were provided by the NBR and, to a limited extent, by demand deposits with the RBFT. The IB financed investment in all sectors of the economy, except agriculture and the food processing industry, and supervised the design and construction of the investment projects it financed. NBR funds were the major source of financing, but the IB also held some deposits from special funds at enterprises earmarked for investment. The BAFI served the agriculture and forestry sector and the food processing industry. It provided short-term credit for productive activities, as well as financing for investment along the same lines as the IB, mostly with credit from the NBR. Finally, the SLB extended only a very small amount of domestic credit in the form of housing loans to the population, and deposited the remainder of its funds with the NBR. The SLB, with a substantial network of branches across the country, held almost the entirety of household savings deposits, as well as a smaller amount of deposits of the supplementary social insurance fund.

In addition to these five banks, certain other institutions could be considered part of the financial system. One was the state insurance company (ADAS), which held its relatively small deposits with the NBR. Four foreign off-shore banks also conducted limited amounts of business in foreign currency and held deposits with the RBFT. Finally, there existed about 800 credit cooperatives with deposit accounts at BAFI, and some 6,000 credit unions with accounts at the SLB, which were entirely self-financing. Loans granted by these institutions to individual members were fully collateralized by the member's savings account with the institution.

The first step toward reforming the financial sector in Romania was the abolition of the financial plan in early 1990. In order to maintain some monetary control in an uncertain environment, quarterly credit plans were prepared by the Ministry of Finance with the help of ministries and banks. The banks, together with the economic units they served, determined the level of credit needs based on expected production and investment, while the NBR supervised this process. The resulting credit plans were approved by the Government, and available credit was subsequently divided up by banks. Credit requirements to clear domestic payments arrears and to cover losses from previous years were fully accommodated, as discussed earlier, as was financing of existing stocks. Later in the year, the credit plan mechanism was relaxed, and banks were formally given the freedom to negotiate financing contracts with economic units for the implementation of investment projects. The sectoral specialization of banks was abandoned, and all banks were allowed to open deposit accounts for enterprises and individuals.

In addition to these changes, under decree-law 54 on private initiative issued in early 1990 to encourage development of small private firms in general, private banks were also allowed to be established. Two such banks were granted permission in 1990 and began operations in late 1990 and early 1991, respectively. To further reduce the reliance of banks on central bank credit and budgetary resources for lending, a process of recapitalization was also begun with the abolition of the effective 100 percent rate of remittances from profits to the budget that previously applied to banks. Finally, the monopoly on foreign exchange transactions previously held by the RBFT was eliminated.

In late 1990, the commercial and central banking functions of the NBR were separated; the NBR kept only the central banking functions, and a new bank (the Romanian Commercial Bank--RCB) was created and took over NBR's commercial operations. From that point on, the Romanian financial sector had the two-tier structure common in market economies, albeit with a much higher degree of concentration.

At the same time, the Government started drafting a new banking law and the new central bank statutes. These laws, which were promulgated by Parliament in April 1991, were designed to create a modern banking environment in Romania. The banking law makes banks financially responsible for their lending operations, and revokes all restrictions on the creation of liabilities. It provides for the recapitalization of the banks, and the NBR is made responsible for issuing prudential regulations. The law also provides for the introduction of reserve requirements and deposit insurance, but leaves the timing and details of implementation of these measures to the NBR.

The central bank statutes confer to the NBR full authority for the conduct of monetary policy, including interest rates, and state that the

NBR's only goal is the stability of the national currency. In addition, the NBR is made solely responsible for the conduct of exchange rate policy, including the issuance and implementation of foreign exchange regulations and the management of official foreign exchange reserves and gold. The NBR is given authority to license and supervise commercial banks. The law also places limits on the amount of credit the NBR can extend to the state budget.

Most importantly, perhaps, the central banking law makes the NBR independent in the performance of its duties. The Governor and the Board of Directors are appointed by the Parliament on the recommendation of the Prime Minister for renewable eight-year terms, and can be removed only by Parliament at the request of the Prime Minister. They are not allowed to be members of the legislature or the judiciary, or hold positions in business.

In order to promote competition among banks, the Government authorized foreign banks to operate in Romania. As a first step in this direction, after the promulgation of the banking laws the NBR allowed the foreign off-shore banks in Bucharest to begin transactions in lei, subject to the same reporting requirements as domestic banks.

These fundamental reforms have opened the Romanian financial sector to the forces of competition and have laid the foundation for a modern market-oriented banking system. The pace of change in the structure of the financial sector, however, is severely limited by the absence of experience with a modern market-based financial system, the lack of expertise and trained staff, the material constraints (e.g., commercial banks, with the exception of the SLB, start off with only a handful of branch offices around the country), and the slow change in attitudes and mentality of the banking and business communities.

V. Conclusions

The Romanian reform program is designed to bring the country out of a strict centrally planned economic system into a world where individual choice and markets play the central role. In the short space of a little over a year considerable progress has been made. The status of the reform effort in the main policy areas is summarized in Table 3. The achievements to date become all the more striking if one considers where the country was at the end of 1989. The economic and institutional crisis gripping the country at the time of the launching of the reform was the outcome of four decades of central planning, compounded in the late 1980s by an almost religious fervor to repay all external debt. The economic legacy of Ceauşescu was an economy with an inefficient industrial structure and an almost totally obsolete capital stock, a completely disorganized system of production and distribution, a collectivized agricultural sector, a decaying infrastructure, and a population whose living standards had been forced steadily down to a level where even basic necessities--food, heating, electricity, medical attention--were hard to come by. There is little doubt

Table 3. Romania: The Status of Reforms

Policy Areas	Measures
Prices	Prices liberalized in three rounds--November 1990, April 1991, and July 1991. About 80 percent of prices are now determined freely in the market. Controlled prices of imported goods (notably energy) set at world price levels.
Labor market	-- Controls on labor mobility abolished in 1990. Free collective bargaining introduced in 1991, although a tax-based incomes policy is in place for stabilization purposes. -- Unemployment compensation scheme introduced in 1991.
Interest rates	All bank interest rates liberalized in April 1991. Controls on spread between deposit and lending rates in place.
Foreign trade	-- State monopoly on foreign trade abolished in early 1990. All citizens can engage in foreign trade transactions. -- All quantitative import restrictions abolished in January 1991. -- Tariff code rationalized and maximum rate reduced to 40 percent in January 1991. A new tariff code is under preparation.
Exchange system	-- Exporters allowed to retain 50 percent of their export earnings in foreign currency in January 1991. -- Interbank foreign exchange auctions started in February 1991, while the official rate applies to a limited number of foreign trade transactions. -- The Government announced in July 1991 its intention to unify the exchange system. -- The operation of foreign exchange houses allowed in August 1991.
Private sector activity and privatization	-- Private sector activity, including joint ventures, allowed in February 1990. -- First privatization law enacted September 1990. State enterprises converted to commercial companies or "régies autonomes". -- Sales of state housing and leasing of state stores started in 1991. -- Land reform law enacted in May 1991. -- New privatization law enacted July 1991. Thirty percent of shares of commercial companies to be distributed to private ownership funds for free distribution to population; remaining shares to be sold.
Financial sector	-- Central and commercial banking activities of the National Bank of Romania separated in December 1990. -- Private banks allowed to operate in Romania in 1990; two private banks commenced operations in 1991. -- New banking and central banking laws enacted in April 1991. -- Off-shore banks allowed to conduct transactions in domestic currency in early 1991.
Tax system	-- Profit remittance system replaced by a profit tax in July 1990. -- Turnover tax simplified and revised in 1990. -- Tax on the wage fund of enterprises replaced by a wage tax in 1991. -- Preparation for the introduction of VAT and a general income tax started in 1991.

that the initial conditions in Romania for the reform were far worse than those faced by the other reforming Eastern European countries.

The reformers who came to power in 1990 knew that the solution to the crisis lay in the undoing of the existing system and replacing it with a market-based system in as short a time as possible. The task, however, was made even more difficult by the worsening external environment. The Middle East crisis, which pushed up energy costs, sharply reduced exports to the region, and led to a freezing of a sizable amount of Romanian assets in Iraq, was a major shock. In 1991, the collapse of CMEA trade, particularly exports to the U.S.S.R.--a major market for Romanian manufactures--only added to the difficulties. Nevertheless, the reformers remained committed to their ultimate objectives and persisted with the measures considered to bring about the desired outcome.

The Government believed that the first priority was to establish a legal framework that would be conducive to the development and protection of private property and ownership rights, and the promotion of private entrepreneurship and economic decision making. As such, considerable effort was devoted by the Government in rescinding previous laws and promulgating new ones. During 1990 and 1991, laws dealing with banking and other financial operations, land ownership, privatization of state enterprises, foreign investment, and free wage determination, among others, have been passed or are in the final stages of preparation.

The Government has also taken a series of steps to reduce its role in the functioning of the economy. Most prices have been liberalized; controls apply only to a small list of products that are considered essential in the consumption basket of the population. All quantitative restrictions on imports have been removed, and only relatively low tariffs are employed to protect domestic industries. This change is an important step, along with the convertibility of the leu, in the integration of Romania into the world economy. Enterprises and labor are free to determine wages through collective bargaining, although for stabilization purposes the Government has retained the right to restrict wage increases above a certain norm. Banks and their customers are able to negotiate interest rates without reference to the National Bank of Romania, and foreign banks are allowed free entry into the domestic market. Finally, all citizens have been given the right to establish businesses and to compete freely in the market.

The return of state assets to private individuals, either through sales or giveaway schemes, has been proceeding at a rapid pace. The breaking up of collective farms and redistribution of agricultural land is expected to be nearly completed by end-1991, with over 80 percent of farmland in private hands. About 50 percent of state housing has already been sold to the public, and the remainder will be sold by 1992. The privatization of state enterprises is to be achieved under the law recently passed by Parliament, while small-scale privatization has already begun. The transfer of state-owned assets is considered critical to the reform for three main reasons. First, it allows private agents to exercise control over the bulk of the economic resources of the country. Second, it makes the reform process more irreversible: undoing the reform would require confiscation of property, of which the likelihood is small. Third, it helps eliminate the monetary overhang and thus create conditions of macroeconomic stability, which are conducive to the success of the general reform effort.

While in many respects Romania of 1991 is vastly different from Romania of 1989, this is not to suggest that the transformation has been completed and the reform program successful. Indeed, one can still point to a number of areas where change is scarcely visible. State monopolies still dominate the economy, particularly in industry, and will probably continue to do so for some time. Competitive markets have yet to emerge, even though the legal basis has been established and the Government has declared its intention not to interfere with their functioning. Except perhaps in agriculture, a system in which prices reflect the forces of demand and supply is still not evident. Private enterprise, though growing rapidly, still represents a very small share of the economy. The Romanian reformers, as others in the region, are discovering that introducing and changing laws is one thing, but establishing institutions, developing markets, and particularly altering the behavior of individual agents--conditioned by decades of centralized and tight government control--is a far more difficult and lengthy process. For this reason, and because the reforms are evolving over time, judgment on the Romanian reform program should be reserved for the time being. At this stage one can say that the process in underway and considerable progress has been made.

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