The Romanian Economic Reform Program

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The following symbols have been used throughout this paper:

... to indicate that data are not available;
— to indicate that the figure is zero or less than half the final digit shown, or that the item
does not exist;
- between years or months (e.g., 1990-91 or January-June) to indicate the years or
months covered, including the beginning and ending years or months;
/ between years (e.g., 1990/91) to indicate a crop or fiscal (financial) year.

“Billion” means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.
The term “country,” as used in this paper, does not in all cases refer to a territorial entity
that is a state as understood by international law and practice; the term also covers some
territorial entities that are not states, but for which statistical data are maintained and
provided internationally on a separate and independent basis.
Preface

Embarking on the process of transforming its economy to a market-based system in early 1990, Romania joined the ranks of other reforming Eastern European Countries. At the start of its reform program, however, Romania was in a deep economic and institutional crisis and, unlike the other countries, had previously made not even a modest attempt 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 initial achievements.

The information discussed in this paper was collected during several IMF staff visits to Romania during 1990 and 1991. The authors would like to thank the Romanian authorities for their cooperation. They are also grateful to Julian Berengaut, Eric Clifton, Patrick de Fontenay, Joshua Greene, Frank Lakwijk, Erik Offerdal, and Massimo Russo for many helpful comments and discussions. The paper was edited by Margaret Casey and Elisa Diehl of the External Relations Department. The views expressed here, as well as any errors, are the sole responsibility of the authors and do not reflect the opinions of the IMF Executive Board or IMF staff.
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I Introduction

In December 1989, with the fall of Nicolae Ceaușescu, 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 political and economic. With respect to the latter, Romania was to abandon the central planning model under which it had operated since the late 1940s, and was to move as rapidly as possible to establish 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 resource allocation.

The provisional Government designed and implemented a comprehensive reform program aimed at achieving the desired economic transformation. While political leaders 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 would be a daunting one, they nevertheless agreed that there was no alternative. Thus, in 1990, the provisional Government launched a major reform program to restructure the economy, of which two features are particularly noteworthy. First, the program was wide-ranging, touching on all the important aspects of the economy. This is not to suggest that the Romanian reformers possessed a well-defined blueprint for reform; on the contrary, 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. Thus, in 1990, the provisional Government launched a major reform program to restructure the economy, of which two features are particularly noteworthy. First, the program was wide-ranging, touching on all the important aspects of the economy. This is not to suggest that the Romanian reformers possessed a well-defined blueprint for reform; on the contrary, 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 "homemade," in that it was developed almost entirely by the Romanian reformers themselves, who put together the overall strategy and the main elements of the program without the assistance of foreign advisers and multilateral institutions. Only after the basic groundwork had been laid did they solicit and obtain external support and advice.

With the start of the reform program in 1990, Romania joined the ranks of the other reforming Eastern European countries. Broadly speaking, its goals and many of its policies were similar to those of other countries in the region, but with important differences in detail. However, while there is an abundance of literature documenting the experiences of the other countries in the region—notably, Poland, and, to a somewhat lesser extent, Czechoslovakia and Hungary—very little is available that describes the Romanian reform program. This paper, in outlining the program's main elements against the background of the system that has been operating over the past forty years, aims to furnish the historical perspective from which it will be possible to appreciate the scale and magnitude of the efforts that Romania has made and must continue to make if it is to realize its fundamental goals. Although the Romanian reformers have moved decisively to transform the economy and have achieved much over the past year or so, the reform process is still in a fragile state, and the transition to a fully market-based system is fraught with risks. This paper highlights the strengths and weaknesses of the Romanian economic reform effort at both the conceptual and operational levels, but does not arrive at an overall judgment on the program precisely because its final outcome is not yet clear.

The reformers recognize that their efforts can succeed only in an environment of macroeconomic stability. Accordingly, in January 1991, they launched, with IMF support, a strong and comprehensive macroeconomic adjustment program to complement their reform effort and to put the economy on a sound noninflationary 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. Because this paper focuses primarily on Romania's structural reform policies, it does not examine in any detail the macroeconomic adjustment program, which is still under way. It covers elements of the authorities' macroeconomic strategy 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 economic system before the
start of the reform program. Section III discusses the overall design of the program, focusing on the economic, legislative, and institutional initiatives that were taken. Section IV describes the implementation of the main objectives of the reform program—that is, 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. 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.
The Economic System Before the Beginning of Reform

To clarify what the reform program is trying to achieve and the obstacles it faces, this section describes the main aspects of the centrally planned system in Romania and its development in the 1970s and 1980s. It covers first the developments in the economy from the early days through the 1970s, and then focuses on the 1980s.

Origins of the Centrally Planned Economic System

During the postwar years, the Romanian economic system developed in ways similar to those of other centrally planned economies. The state owned virtually all means of production, except for a small proportion of the land cultivated by private farmers. The State Planning Committee (SPC), which prepared the plan targets based on Communist party directives, was responsible for the detailed planning of all economic activity. Once the plan was approved, the Government monitored its implementation as well as managed economic activity directly through the branch ministries. The branch ministries, each covering a different sector of the economy, also allocated inputs and decided on product use (that is, consumption or investment) and distribution, using a three-tiered planning process with five-year, annual, and special sectoral plans.

Prices, which were strictly regulated and did not play an allocative role, were determined in the context of the plan on a markup 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 adjusted occasionally to reflect changes in costs. The only prices that were market-determined—although at times 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 criteria. “Base wages” (that is, remuneration per unit of time) were established centrally for all categories of employees. In addition, “norms” (that is, output per unit of time) were 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 white- and blue-collar employees. The management of the enterprise could not raise wages to attract more labor, and its authority to fire workers was severely limited. Labor was directed to desired industries and regions through direct controls on mobility.

The distribution of raw materials, capital goods, and intermediate products was determined on the basis of the material balance, a planning tool for ensuring that the total sources and uses of a certain product were in balance. It prescribed the distribution of a product according to 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.

State-owned and -controlled foreign trade organizations (FTOs) supervised by the various branch ministries managed foreign trade exclusively. All transactions in foreign currencies were conducted through the Romanian Bank for Foreign Trade. Import decisions were made 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

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

2In this paper, “the plan” means the overall central plan covering all sectors of the economy. Subsidiary plans, like the financial plan, foreign trade plan, and so on, are referred to explicitly.
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, which covered the differences between the international and domestic prices of traded goods through a system of taxes and subsidies on exports and imports. This system resulted 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 arrangements with the countries of the Council for 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, for which it essentially served as a balance sheet, consolidating the relevant financial information and checking the consistency of the physical plan. The prices used were those prevailing at the time the plan was prepared. 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 served as 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 the allocation of funds, 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 financial plans were meant to be fully consistent, so that the value of the sales of consumer goods at plan prices was equal to the money income of the population (that is, the aggregate of wages, pensions, and so on). 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, insofar as they reflected the failure of the system to provide the desired consumer goods.

**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, Romania also took several measures to improve economic management within the centrally planned framework. These measures, however, did not go as far as did those in other countries and left the way in which the system operated essentially unchanged. It is interesting to note that while the West considered Ceaușescu 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 his rule. To him, the need for state control of the economy was unquestionable and the planning mechanism sacrosanct. A good example of Ceaușescu’s thinking on this subject is found in a speech he delivered in July 1974, in which he said:

> To give everyone the freedom of spending society’s money on whatever, and however it might strike one’s mind—that 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, while it increased the SPC’s responsibilities in overseeing plan fulfillment and making adjustments to the targets if necessary, attempted at the same time 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, with the SPC combining the proposals in the final draft. Moreover, with the establishment of the Department of Technical-Material Supply within the SPC in 1969, the SPC was given a central role in allocating inputs. Before this, allocation of inputs had been primarily the responsibility of the Council of Ministers, which, in 1967, for example, allocated centrally over 200 raw materials and intermediate products. The same year, the branch ministries allocated an additional 1,300 inputs (Spigler (1973)).

A further reform was the addition in 1969 of a new administrative layer between the branch ministry and the enterprise: the centrala (plural: centrala).
centrale), 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 centrale employed a total of about 8,000 in its enterprises, although a few employed as many as 100,000 (Granick (1975)).

The centrale played 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 subsequently took place between the centrale and the enterprises. The centrale had wide discretion for specifying different types and qualities of products to be produced by its enterprises, for nominalizing targets additional to those set by the branch ministries, and for revising 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 markup rule remained in place, the law stipulated a more comprehensive accounting of costs in the formation of prices. Most producer and consumer prices, which had remained unchanged since 1963, were reevaluated 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. However, enforcement of these guidelines was weak, especially in the countryside.

Since wages could not be used to influence 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, common among enterprises, of refusing to hire any applicant whose employment card had not been 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 postpone his departure, by delaying the certification of his employment card. For the same reason, there was virtually no mobility between small private farms and the state sector. Even in the case of agricultural cooperatives, a worker needed the permission of the manager to leave and move out.

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 some predetermined “necessary skills,” could obtain permanent residence permits for these cities. By the late 1970s, virtually all cities with a population of more than 100,000 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 the possibility of renewal. In this way, labor could be directed to those enterprises and cities that would otherwise suffer from labor shortage.

To improve the management of foreign trade transactions, in 1973 the Government established a commercial exchange rate (also known as the internal conversion coefficient) of lei 20 per U.S. dollar, to be used for comparing the prices of foreign and domestic goods. 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 with 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 enterprise investment and, at the same time, to 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 made 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 through the introduction of the centrale failed
to enhance enterprise autonomy, because as the centrale 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 enhanced neither their allocative role nor their flexibility. The single commercial exchange rate introduced in 1973 had merely an indicative value, because the policy of keeping domestic prices stable and the operation of the price equalization fund prevented 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 restrictiveness of the legislation and the economic difficulties facing Romania in the late 1970s and early 1980s deterred new investment (Granick (1975)).

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), whose objectives 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 provided a general framework for reform, in the context of which additional systemic measures were taken throughout the 1980s. In support of these measures, a three-year stand-by arrangement was negotiated with the IMF in 1981, which lasted until 1984.

Important changes in planning and enterprise management 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, with the state retaining firm control over economic activity. The SPC, as well as determining plan targets, continued to monitor plan implementation closely 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 annual 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 of an additional 2,000 products. Further 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 prevent enterprises from exaggerating production by overstating stockbuilding of finished products, the NEFM introduced 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 when producing for export. However, distortions in the planning system soon rendered the forward contracting system ineffective. Underlying the latter was the assumption that enterprises would fulfill their plan targets, but because these targets were increasingly unrealistic, the system could not function properly. Moreover, it provided an incentive for overstating the stockbuilding of exportable goods, since this had become the only way for enterprises to overstate production.

In an effort to make enterprises less reliant on the budget for investment financing, the NEFM placed much greater emphasis on enterprise self-financing, with the result that the budgetary outlays for investment were reduced during 1980-83. In addition, interest rates on investment credit to enterprises were substantially raised in 1983, in an attempt to make enterprises more cost-conscious and to increase the efficiency of resource use. 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 required to finance a larger part of their investment, they possessed limited resources owing to the overstatement of their profits and the excessive tax burden on enterprises during the 1980s. Moreover, they were not able to invest their own funds as they wished, because their investment projects had to be approved by the SPC. Consequently, it is doubtful whether their funds were more efficiently allocated. 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 during 1980-83, started growing rapidly again. Finally, in

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4A summary of the operation of the NEFM is presented in Sectia Propaganda si Presa al Partidului Comunist Roman (1987).
1984, after the program with the IMF lapsed, the authorities lowered interest rates, restoring them to their earlier levels.

The policy in the late 1970s of maintaining price stability in the face of changing world prices 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 the resulting distortions, they introduced a number of measures 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 during 1981-83; major domestic price adjustments took place in the same period; and the price equalization mechanism was modified.

Whereas, in the past, the price equalization fund had completely insulated both exporters and importers from world price movements, starting in 1981, the modified mechanism exposed exporters 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 realized but fell below the domestic price when converted to lei at the commercial exchange rate, the price equalization fund paid the exporter a subsidy. 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 higher-than-targeted realized export price, and, otherwise, to the price equalization fund. The system of price equalization applying to imports, however, remained essentially unchanged.

These measures were intended to increase the incentives provided to exporters to improve export prices as well as to correct the large misalignments between domestic and world prices. Not only did they fail to achieve even these limited objectives, but they also failed to change the role played by prices in the Romanian economy—the plan continued to determine the allocation of resources. 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—"global contracts"—was put in place, specifying the performance targets and the corresponding salary levels of each work unit within the firm. In the event of plan over- or underfulfillment 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 to maximize profit. 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 failed to match plan targets, payments to the budget and to the enterprise development fund took priority, in that order. If actual profits exceeded plan targets, workers and managers received higher payments.

The enhanced incentives created by the system of global contracts and profit distribution were plagued by severe problems. First, the incentives were directed more toward penalties than rewards. 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 carried 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 predating the NEFM, notably, the practice of the employment card and the system of closed cities, remained in place during the 1980s. In addition, in the late 1980s, the Ceaușescu 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. However, because implementation started relatively late in the decade, the program did not significantly affect the allocation of labor.5

Despite the changes introduced with the NEFM, and the brief association with the IMF in the context of a stand-by arrangement, the planning process and the economic management system in the 1980s not only remained essentially unchanged, but

5 However, it is estimated that some one thousand villages were destroyed as part of this policy.
II  THE ECONOMIC SYSTEM BEFORE THE BEGINNING OF REFORM

the state tightened its control over economic activity and the strict central planning framework. 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, failed to 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 detailed character of the foreign trade plan and its unrealistic 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 Ceausescu 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 further distorted 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. 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.

Economic Developments in the 1980s and the Situation at the End of 1989

During the 1980s, the evolution of the Romanian economic system, as well as the policies followed, 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 capital equipment became obsolete, energy intensity increased, and the standard of living of the population deteriorated substantially.

Under the Ceausescu 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 being made, 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 1 percent a year, owing 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. It reflected not only an unwillingness to pay high interest rates and place the country in what Ceausescu perceived to be an economically dependent relationship with foreign creditors but also the difficulties encountered in rescheduling Romania’s debt. Its implementation required the accumulation of large current account surpluses, achieved mainly through severe import compression and a policy of promoting convertible currency exports at all costs (see Chart 1). The debt repayment closely followed a rescheduling of commercial bank loans that had been agreed upon 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 $0.5 billion in 1987, $2.9 billion in 1988, and $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 had almost stopped using credits from bilateral sources by 1989. A decree promulgated in 1989 actually made it illegal for Romanian entities to contract external debt. Only short-term capital movements continued, mainly reflecting developments in short-term export credits granted by Romania.

In 1988, real GDP fell by 0.5 percent, mostly owing 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 gener-

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6The causes and symptoms of the increasing disorganization of the economic system in the 1980s are discussed in Ronnas (1991).
ate a large current account surplus to continue the repayment of external debt. To that effect, it imposed draconian restrictions on the household use of energy to ensure that industry would have an adequate supply.

By March 1989, nearly all of the external debt had been repaid, with less than $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 because of 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.

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 could not be attributed 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. Rather, the deterioration in economic performance was due 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 because of the increasing use of lower-quality inputs, and inefficient machinery that was either domestically produced or imported from CMEA countries in place of imports from the convertible currency area, as the latter were compressed during the decade.

The domestic counterpart of the current account surpluses needed to repay the debt was a large domestic savings surplus, which the Government generated partly through heavy taxation of enterprises and tight control of social spending. The tax burden on enterprises became excessive toward the end of the decade, largely because of unrealistic plan targets—on which the tax liability of each enterprise was based—resulting in large enterprise losses that were financed by bank credit and inter-enterprise arrears. At the end of 1989, these arrears had reached an estimated lei 300 billion (almost 40 percent of GDP in 1989).7

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

Finally, during the 1980s, standards of living declined substantially (Table 2). Consumption per

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7This amount of arrears had accumulated despite earlier debt write-off operations for agricultural cooperatives under Ceaușescu.
capita stagnated throughout the decade but, perhaps more important, the shortages of basic consumer goods in the latter part of the decade meant that welfare probably fell by more than the consumption-per-capita statistics revealed. The authorities imposed particularly harsh restrictions on household consumption of energy, allowing, in most parts of the country, only a few hours a day of electricity and heating, 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 people’s access to doctors and hospital beds declined during 1980–89, as did the life expectancy for men.\(^8\)

\(^8\)Anuarul Statistic, 1990. An account of the deterioration of the standards of living in Romania during the 1980s is also offered in Teodorescu (1991).
Against a background of economic, institutional, and social crisis in Romania, a coherent reform strategy gradually emerged. This section examines the overall design of the reform program, and, in particular, how the reform strategy evolved.

Conditions at the Beginning of 1990

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

The provisional Government was also faced with social turmoil following the December events that led to the overthrow of Ceaușescu. The turmoil was manifested, particularly, in worker absenteeism and lack of discipline and a breakdown of law and order, which aggravated the disorganization of the economy. Moreover, in many enterprises, workers decided to eject their managers, whom they associated with the old regime, and to hold new elections to replace them. These elections were often disorganized and had to be repeated.

The economic and institutional crisis combined with the sociopolitical circumstances prevailing in the country at the beginning of the transition period had three major implications for the Romanian reform process. First, the resulting economic collapse required an immediate policy response from the authorities with no time for a "pre-reform" period—in the sense used by Calvo and Frenkel (1991) and as 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. Instead, the authorities introduced several measures to unblock the productive structures before they had formulated a coherent reform program. As a result, many of these measures had to be subsequently modified or replaced, making the reform effort—at least in its early stages—a process of trial and error.

Second, the release of the population's pent-up desire for consumer goods and the dramatic decline in living standards in the 1980s influenced considerably the early decisions of the provisional Government. One result was to make the adequate provision of basic consumer goods—especially food, heating, and electricity—a necessary condition for the population's consent to policy changes and the improvement in living standards in the 1980s influenced considerably the early decisions of the provisional Government.

One result was to make the adequate provision of basic consumer goods—especially food, heating, and electricity—a necessary condition for the population's consent to policy changes and the improvement in living standards in the 1980s influenced considerably the early decisions of the provisional Government. Another result was to focus 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. Third, the collapse in output combined with the policy of boosting real incomes to improve living conditions caused a rapid deterioration of the macroeconomic situation in 1990 and forced the
III MAPPING THE TRANSITION: DESIGN OF THE REFORM PROGRAM

authorities to change somewhat the priorities of their reform program in midstream.

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 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 less for the year as a whole. In 1990, GDP is estimated to have fallen by almost 8 percent in real terms 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 aimed at containing the downward trend in economic activity. However, many of these structural measures were introduced in haste before a coherent reform program had been devised. The most important of these measures were (1) the complete liberalization of peasant markets in January in order to increase the supply of food; (2) the abolition of the State Planning Committee in January, and its replacement by the Ministry of the National Economy, with mainly coordinating functions; (3) the abolition of certain provisions of the turnover tax that were particularly burdensome on enterprises; (4) the introduction in February of Decree-Law 42, which allowed agricultural cooperatives to distribute land to their members and to other peasants for “long-term use,” and Decree-Law 54, which allowed small-scale private enterprises with up to twenty employees; (5) the introduction in March of Decree-Law 96, which liberalized the regime governing foreign direct investment in Romania; and (6) the abolition of the state monopoly on foreign trade and the partial liberalization of foreign exchange regulations. These early structural measures—although they were pointed in the right direction—turned out to be inadequate and incomplete, and, with the exception of the liberalization of peasant markets and the modification of the turnover tax, 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 assumed 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.

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

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12 These provisions, introduced in 1988 to boost tax revenues, had come to be known as the “Ceausescu tax” (see Section IV for more details).

13 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.

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collapse, aggravated the domestic imbalances and caused a sharp deterioration in the balance of payments. The deterioration was further exacerbated by the reversal of the previous regime's policy of import compression; the introduction in January 1990 of a ban on food exports to improve the availability of food domestically; and the deterioration of the external environment in the second part of 1990 owing to the Middle East crisis.

On the fiscal side, revenues declined owing to the simplification of the turnover tax in January 1990 and to the replacement of the system of remittances from profits—the other major cause of the excessive tax burden on enterprises in the 1980s—by a profit tax later in the year. Expenditures also declined somewhat, owing largely to the sharp reduction in investment outlays, which reflected the cancellation of several of Ceaușescu's showcase projects. Current expenditures, however, increased dramatically, mainly because outlays for subsidies, pensions, and transfers doubled. These increases were, to some degree, inevitable: under the previous regime, some benefits to which civil servants were entitled had simply not been paid, and promotions had been 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. The provisional Government considered these increases to be necessary to ensure social peace by improving living standards, especially those 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.

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. Consequently, broad money increased by over 22 percent in 1990. Moreover, wage increases granted during the early months of the year (before the Government and trade unions agreed upon a wage moratorium 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 had been fully liberalized. As a result, it added to the stock of forced savings, or monetary overhang, created by the planning system, thus exacerbating inflationary pressures in the economy. Although it is extremely difficult to estimate even roughly the monetary overhang resulting from the fundamental changes in the demand for money taking place in a situation of systemic upheaval and great uncertainty like the one that occurred in Romania in 1990, the pattern of income velocity of money can be indicative. Income velocity of broad money at the end of 1990 in Romania was about half its level during the late 1970s and early 1980s, suggesting that perhaps up to 50 percent of the money stock was involuntarily held.

On the external side, in another attempt to improve the domestic supply of food and energy (the latter, unlike in most other Eastern European countries, was imported mostly from the Middle East), the provisional Government decided to discontinue the previous regime's policy of import compression 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 $2.9 billion in 1989 to an estimated deficit of $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. Because external financing—other than trade financing—was not available, mainly as a result of Romania's self-imposed alienation from the international financial markets in the late 1980s, the convertible currency current account deficit in 1990 was financed almost entirely from the country's foreign exchange reserves, which were all but exhausted by the end of the 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 Romania's macroeconomic situation during 1990, besides being a...
Evolution of the Reform Strategy

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

In February 1990, the provisional Government established a twenty-member Commission to prepare a proposal for a program of transition to a market economy. This Commission produced a preliminary draft report on March 1 (Government Commission (1990a)), outlining the program and specifying areas for further study, and submitted its final draft to the provisional Government in April (Government Commission (1990b and 1990c)). Although the Commission consisted mostly of administration officials, 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.

This report was unique in Eastern Europe in being an official public statement of a government’s reform plans. Moreover, despite the remarkably short time in which it was produced and the relative isolation of the country, it was entirely “homemade.” The objective of the economic reform process, as well as its urgency, was clearly stated in the earliest 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 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 for its sense of perspective and its comprehensive approach to the issue at hand. Perhaps more important, the transition to a modern market economy was placed in the context of a wholesale transformation of the country toward political pluralism and multiparty democracy (Government Commission (1990a), pp. 6-8). At the same time, transition was envisaged as a process that would embrace all facets of economic activity. Indeed, the
report encompassed all aspects of economic reform: 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 social and environmental dimensions.

The report presented the transition to a modern market economy in two stages: first, reform of the existing economic and institutional structures to those of a market economy; and, second, 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 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."\(^{20}\) 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).

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 during 1990–92 (Government Commission (1990c)). In terms of sequencing, the report gave priority to ownership reform, reduction of the state's role in resource allocation, and social protection. The liberalization of prices, trade, and capital flows, although already under way 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 breakup of the monobank system. Interest rates were to be increased but would 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 directed special measures at disadvantaged groups (for example, mothers with many children, orphans, and the disabled), it did not focus on any particular section of the population but included measures affecting all citizens. These measures included reductions in the work 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 context of 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 to be taken simultaneously in all areas, and offered specific policy proposals in each area that would build 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, the Commission drew up this blueprint for reform 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 distortion and 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 of developing private economic activity, including privatization of state
enterprises and foreign direct investment; the report failed to recognize not only that these targets would not be achieved before price distortions were removed, but also 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 the sociopolitical conditions prevailing in Romania at the time, ran counter 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 provisional Government's reform effort. 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. The Government that was formed under Prime Minister Petre Roman in late June retained many members of the provisional Government's economic policymaking team. The new Government was to serve until a draft new constitution was adopted by Parliament, at which point—originally scheduled for the end of 1991 or early 1992—new elections would be held.

The new Government endorsed the general strategy outlined in the Commission's report and started to implement it. From the beginning, the Government understood the importance of building the appropriate legal framework for a market economy, especially in view of Romania's recent emergence from an excessively centralized central planning system. To this end, the Government appointed a Minister of State (of Deputy Prime Minister rank) on Relations with Parliament who would be solely responsible for elaborating and coordinating a detailed legislative plan. In addition, a Council for Reform was appointed, consisting, inter alia, of legal specialists and economists to assist the Government in drafting, interpreting, and implementing 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.²²

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 breakup of monopolies, the abolition of the centrale, and foreign capital inflows. The law brought the issue of ownership reform to the forefront, and clearly signaled the Government's intentions vis-à-vis the state enterprises. Apart from its many positive points, this major piece of legislation shared to some extent the defects of some of the provisional Government's earlier acts. Because it had been hastily prepared, and many provisions were unclear or difficult to implement, it subsequently had to be clarified by, and supplemented with, an additional privatization law and a land reform law.

During the spring and summer of 1990, the size of the output collapse became increasingly evident, as did the growing domestic imbalances and the mounting pressures on the balance of payments. These events 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, most of which 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 in the success of virtually every other reform initiative, and accordingly reordered its priorities and modified the sequencing of structural measures. It also realized that price liberalization would inevitably cause a jump in the price level, because of the existence of a monetary overhang. Finally, the Government recognized the need for consistency between its social and macroeconomic policies and started rethinking its social objectives.

The Government's awareness of and concern with these issues were evident in the Prime Minister's report to Parliament on October 18, 1990, on the status of implementation of economic reform (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). At his request, Parliament granted the Government

²¹Council for Reform, Public Relations, and Information, henceforth referred to simply as Council for Reform.

²²Information 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 in Council for Reform (1991) and Ministry of Trade and Tourism (1991).
exceptional powers in the area of economic reform, including the power to introduce new 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 approach adopted in the Commission's report. Price liberalization was given a central role, the pace of reform was accelerated, and social policy became better targeted. In addition, the Government recognized the urgency 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, the Government seemed unaware of the weaknesses of important pieces of legislation that had been quickly prepared and enacted; nor did it yet fully realize that changes in the legal framework, although necessary, were not sufficient to instill market discipline into existing state enterprises.

The 1990-91 winter months saw three major developments in the authorities' reform strategy. First, as the Government's persistent legislative effort gained momentum, the authorities realized the defects of earlier structural reform laws and amended or complemented 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 also 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—with maintaining controls—raised others substantially, notably those of many basic consumer goods.

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 were drafted and submitted to Parliament, of which 46 were promulgated. Many of them pertained to the functioning of the economic system and covered 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 that complemented 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 12 months and then discussed in detail the 1991 program—the Program for Reform, Adjustment, and Stabilization. The report acknowledged that the provisional Government had made mistakes during the first year of transition, notably in drawing up early reform plans that were too optimistic and in not taking sufficient steps at the outset to inform the population of the objectives and costs of transition. According to the report, the optimism of the early reform plans reflected the provisional Government's failure to recognize the magnitude of economic imbalances, as well as its inability to fully resist populist pressures on the eve of the May 20 elections. Moreover, the Government had assumed that changes in the institutional framework alone would be enough to set the economy on the right track. In the words of the report,

The economic reform was primarily achieved on an institutional plane, while managerial structures both at the macro level 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, supported by the IMF, that reflected the primary importance accorded to stabilization and served 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 with, 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.

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

An open trading system was created in early 1991 through the abolition of all quantitative import restrictions and the rationalization of the existing tariff system. Its goal was to minimize price distortions and contribute to opening the Romanian economy to the rest of the world—from the beginning, one of the major objectives of reform. At the same time, with a view to moving 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 on the financial discipline and restructuring of enterprises. 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 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, the Government planned to impose financial discipline on enterprises with the means it had at 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 began in early 1990, when these were written off against government deposits accumulated in the banking system as a result of past fiscal surpluses. In 1990, a total of lei 265 billion (about one third of 1990 GDP) in unserviceable enterprise debts was written off this way, exhausting the stock of government deposits, and a further lei 125 billion (equivalent to about 15 percent of 1990 GDP) was refinanced by the National Bank of Romania. The authorities decided in 1991 to replace the outstanding stock of NBR refinancing with nonnegotiable government instruments, thus eliminating these bad assets once and for all from the books of the entire banking system.

To avoid the re-emergence of losses and bad debts once the existing ones had been eliminated and prices had been largely liberalized, the Government made financial discipline of enterprises an essential ingredient of its reform program, to be enforced through a combination of measures: the restructuring of the tax system in early 1991 to guarantee enterprises adequate retained earnings to finance investment; strict bank supervision to prevent credit being extended to unprofitable activities; and enforcement of existing bankruptcy procedures while a new bankruptcy law was being prepared. However, the Government promised temporary budgetary support to enterprises undertaking sound restructuring programs.

Finally, the Government's 1991 budget incorporated a social safety net that was substantially different from the one envisaged in the early reform documents. It 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 would 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 and changed during the first year. Both the experience of introducing structural measures and the developments in the Romanian economy influenced the pace and sequencing of reform envisaged by the authorities: it quickly became clear that an accelerated pace would shorten the period of uncertainty and enhance the credibility of the reform program. As for sequencing, price liberalization and enterprise financial discipline came to be regarded as preconditions for, rather than simply components of, a successful transition. This evolution, although it occasionally caused the Romanian reform program to appear erratic and lacking 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 important, the fact that policymakers were themselves learning about transition as it was occurring.
IV Principal Objectives of the Romanian Reform Program

The main objectives of the Romanian reform program fall into three broad categories: introducing market forces into the economy, notably by liberalizing prices, trade and the exchange system, and interest rates, and allowing these forces to guide economic decision making; transferring ownership to the private sector; and reducing the Government's role in the economy. This section presents the specific policies and measures the authorities took to achieve each of these objectives.

Introduction of Market Forces in Economic Decision Making

Price Liberalization

Price liberalization is central to economic transformation. Under central planning, prices did not play an allocative role but instead were used mainly to control income distribution (Hinds (1990)), resulting in several distortions. In many cases, there was a gap between production costs and sales prices, which distorted resource allocation. For goods deemed to be "essential," production costs were higher than prices, so that producers had to rely on subsidies to continue operating. These subsidies, as well as the large need for funds to finance investment from the budget, resulted in an excessive tax burden on enterprises and in 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 the price equalization fund, which taxed profitable exporters and importers to subsidize unprofitable ones. Finally, the use of prices as a tool for income distribution and the channeling 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. Because production was guided by planning rather than by the price system, and resources were channeled to the capital goods sector, the insufficient quantity and poor variety of available goods created excess demand conditions in many consumer goods markets. And, because consumer prices were not allowed to adjust, these goods were effectively rationed through queuing—a familiar sight in centrally planned economies. The counterpart to this, however, was the accumulation by households of large excess money balances.

Correcting relative prices and eliminating the monetary overhang in an orderly way are prerequisites for achieving 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 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 provisional Government took some important measures to liberalize prices in certain markets even before it had finalized its overall reform program. Prices of agricultural products that producers sold directly in peasant markets were liberalized, and newly created private firms and firms with foreign equity participation were allowed to determine the prices of their products freely.

Aside from these initial measures, the provisional Government's general approach to price liberalization evolved over time. From the outset, the authorities' general objective was to create a system whereby prices are determined by supply and demand. However, they intended liberalization to be careful and gradual, because the economy was marred by grave distortions, reflected in serious disequilibria in some markets and large differences.

23 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.
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 these goods and services 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 remaining 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, in the following order: (1) 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 (2) 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, among other things, world market prices as a reference. Prices in the second group—consumer goods and services—would be determined during the transition period as follows: (1) 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; (2) prices of certain other products, such as fabrics, garments, footwear, furniture, durable consumer goods, cars, and hotel and tourist services, would be subject to government-imposed ceilings; (3) prices of a few “special imports” (luxury goods, cosmetics, cigarettes, and beverages) would be set administratively, with a view to controlling the total amount imported; and (4) 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 were to be completely liberalized in 1992.

This complicated schedule for price liberalization was never implemented. The Government realized that it needed to take more decisive steps in this direction, 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, prices of all goods and services produced by three or more producers were freed, except for those of (1) 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 (2) 40 basic consumer goods and services, whose prices were left 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 far fewer 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 in part for the price increases.

The second round of price liberalization was postponed until April 1, 1991, and 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 of 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 former 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 fewer 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. Because of continuous price adjustments throughout the economy, the prices of these products, set jointly by the Ministry of Finance and the producers, became irrelevant only weeks after the negotiations were concluded. Further, domestic producers considered the system to be unfair because it did not apply to joint ventures. Most important, the system put pressure on the Government to offer subsidies, as loss-making enterprises blamed their financial difficulties on the price controls. In light of these developments, the authorities quietly abandoned this system of controls. The effect of this action, combined with the second round of price liberalization, was that by mid-1991 about 80 percent of prices in Romania were free. 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 (that is, 5 basic food items and 9 other categories, including home heating fuels, local transportation, and rents). It is noteworthy that in only eight months, Romania went from a system of complete price controls to one that compares favorably with many market economies.

**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. Generally speaking, trade liberalization has been advocated for two main reasons. First, it helps to raise economic growth and generate employment by improving resource allocation and economy-wide efficiency. This argument 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 competitiveness of the external sector and by 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 promotes inefficient import substitution.

Overall, the evidence available 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.

Crucial in the process of trade liberalization is the issue of sequencing, that is, which measures should be adopted first. It is generally accepted that nontariff barriers, such as quotas and import licenses, 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 that provide 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—and provides revenue to the Government.

Once nontariff measures have been sharply reduced, priority should be given to bringing about more uniformity in the tariff structure. In addition to minimizing production distortions for a given protection level for importable goods, a more uniform tariff structure is less vulnerable 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 Romanian Government moved decisively to liberalize the foreign trade sector, first by abolishing the state monopoly in foreign trade. Starting in...
February 1990 under Decree-Law 54, private enterprises were 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 (FTOs). Following the abolition of the state monopoly in 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, coexist with about fifty large former FTOs. The FTOs are state owned, but they are expected to be opened up to private participants, 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 Government intended to introduce three categories of import licensing, based on balance of payments considerations and sectoral priorities. The first category would apply to raw materials and inputs, for which licensing would be automatic and would be required only for data-gathering purposes. The second category of licenses would apply to about 100 to 200 products, such as tools, machinery, and agricultural products, that were produced domestically. Quotas for such products would be established in consultation with the respective producers and consumers. The third category of licenses would apply to goods for which the Government did not have clear information as to the import needs or domestic production capability. For these products, the Ministry of Trade and Tourism would consult with the relevant ministries before approving the license applications.

The Government also intended to introduce three types of export licenses. The first category would cover products in excess supply domestically. 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 remaining exports, licenses would be issued automatically.

This licensing system was regarded as a temporary solution to managing trade during the radical transformation of the economy, which was hampered by 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 its 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 that received subsidies from the Government or were subject to domestic price controls.

The domestic economy was now to be protected solely through tariffs and exchange rate policy, and, starting in January 1991, the Government modified the existing tariff code to make it more compatible with the overall objectives of the reform program. First, it revoked the generalized exemptions from tariffs granted to inputs used by the public sector; only energy products were exempt from duties. Second, it abolished the distinction made for tariff purposes between imports of inputs and final products or among different uses of the same product. Third, it cut the highest tariff rates 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 has been harmonized with those of other Western European countries. Second, the rates have been determined on the grounds of efficiency considerations alone, implying that the fiscal consequences of any particular structure are not regarded as important. Third, the tariff code is to be used to create incentives in the economy for improving efficiency—products for which Romania is clearly not internationally competitive will not be protected. Thus, protection will be limited to those products that are viewed as needing 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 based on several considerations, including the domestic and international prices of the product, domestic production and consumption, import requirements, and sectoral development strategies. The new tariff system was submitted to Parliament in mid-1991 and is awaiting enactment.

The liberalization of trade was accompanied by a policy of allowing agents greater access to foreign exchange. Before January 1990, although residents...
and nonresidents could legally hold foreign currency accounts, their ability to open or effect transactions through these 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. Residents could legally hold foreign exchange outside the banking system, although the requirement to effect all foreign exchange transactions only through authorized agents remained in force until August 1991.

From September 1990, exporters were no longer compelled to surrender all foreign exchange earnings to the Government. Instead, they became eligible for a minimum uniform retention of 50 percent of their gross export earnings. They could use retained foreign exchange without restrictions on payments and transfers for current account transactions, and could import 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.

In February 1991, the Government instituted an interbank exchange market open to all enterprises through participating banks acting as brokers. The supply of foreign exchange to this market comes primarily from the 50 percent retained earnings of exporters and from the Government. Foreign exchange is made freely available for all bona fide current account transactions, with the exception of limits on profit remittances by nonresidents. Starting in August 1991, individuals were permitted to conduct small-scale transactions in foreign exchange through exchange houses. 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.

**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.

The experience of several Latin American countries in financial sector reform, however, has indicated 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 signaling 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 in a short time. If 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 complicated. Household deposit rates at the Savings and Loan Bank (SLB) averaged 2.5 percent in 1989, whereas the SLB received 3.0 percent on its deposits at the National Bank of Romania (NBR). Other banks paid between 1.5 percent and 1.8 percent for credit they obtained from the NBR in 1989. Enterprise deposits were remunerated at 1.5–1.8 percent in 1989.

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 that had been created 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

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

27 For a survey of interest rate policies in the context of financial sector reforms, see Villanueva and Mirakhor (1990).
IV PRINCIPAL OBJECTIVES OF THE ROMANIAN REFORM PROGRAM

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 setting rates, over time they 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 excessively, 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.

Transfer of Ownership to the Private Sector

Basic to the transformation of the formerly centrally planned economies in Eastern Europe is the transfer of state-owned enterprises to private ownership. Privatization is generally viewed as essential if producers are to respond to market signals in making production and investment decisions, because private ownership provides incentives for producers to minimize costs (by maximizing profits) and to allow output to respond to market indicators rather than to the dictates of the central plan. Private ownership also facilitates the monitoring and evaluation of, and control over, the performance of those managing and operating enterprises, thereby 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 important, privatization is believed to render the 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 of state enterprises to private ownership. Most programs have also included measures to privatize state-owned housing and agricultural landholdings.

Although the need for privatization has been recognized, issues have arisen regarding the content of privatization programs, and despite broad agreement as to 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 transition period, may result in substantial undervaluation of the disposed properties, providing windfall gains to the purchasers. Questions have also arisen as to 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 nomenklatura. 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 equal number of shares. 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 effectively. To remedy this problem, several economists have proposed creating several large holding companies in each country, each of which would hold shares in a number of enterprises. 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. Furthermore, to encourage direct investment from abroad to finance modernization and improve the competitiveness of domestic enterprises, reforming 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

29For 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), Hinds (1990), Lipton and Sachs (1990a, 1990b), and Tirole (1991).

28See Borensztein and Kumar (1991) for a discussion of the pros and cons of the “giveaway” element embodied in the voucher scheme.

30Lipton and Sachs (1990a) and Blanchard et al. (1991) are among the proponents of such an approach.
traded. However, how soon citizens should be allowed to sell or trade their initial allocations of enterprise or holding company shares is an open question. On the one hand, it can be argued that these shares should be nonnegotiable for a limited time, to prevent well-financed traders from acquiring large blocks of shares at low prices early in the adjustment period, 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 has taken significant steps to facilitate privatization. Since November 1990, many small enterprises have been sold to domestic owners and to joint ventures between domestic and foreign partners. In addition, the Government has vigorously promoted leasing of state-owned assets, including 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 would then 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 to be retained by the Government for eventual sale to private parties, either domestic or foreign.

Law 15 had several shortcomings, which the authorities quickly realized. 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—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 Parliament. The actual certificates in the POFs will be distributed to Romanian citizens in bearer form and will be tradable between Romanian citizens after 12 months. These certificates cannot be transferred to foreigners for 5 years. They will initially carry no voting rights, but, within 5 years, the board of each POF 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), whose board of directors will be appointed by 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. It can deposit the income and other proceeds it receives into interest-bearing accounts, or use them 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 to employees and managers of up to 10 percent of a commercial company's shares. In general, these shares 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, which 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 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 passed to private administration. Leases are given for up to two years, after which the new owners of the property take control. Together with newly created private firms, 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; it 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 choose the management of the enterprises they own according to their respective share holdings.
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 unserviceable enterprise bank loans, which were used to cover past enterprise losses. The remaining loans are scheduled to be replaced by the end of 1991 with nonnegotiable 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 these government instruments or, in some cases, eliminate outstanding unserviceable loans directly. To provide further incentive 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, it is considering new bankruptcy legislation.

Besides commercial companies, Romania’s privatization program covers 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, it has sold some 50 percent of state housing to the public. In addition, it has approved a land reform program under which citizens 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 reflects 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.

Reduction of the Role of the Government in the Economy

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

Fiscal Reform

In the context of the financial planning 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 extrabudgetary 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. To this end, they have initiated large-scale tax reforms while reducing the burden of taxation 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 to fund 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. Moreover, these countries are also constrained by the lack of experienced staff in the administration to design and implement their ambitious tax reform measures and must often rely on external technical assistance in this effort.

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 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 large after-tax losses for enterprises, while the budget was in surplus. These losses were covered by automatic extension of bank credit, which left banks with unserviceable loans on 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, effective January 1, 1990, the provisional Government abolished the turnover tax levied at the producer level—known as the “Ceaușescu tax”—and the system of remittances from profits, and replaced them with a new remittance mechanism, through which any profits in excess of 10.5 percent of total costs were transferred to the Treasury.

On the expenditure side, the provisional Government decided to cancel many of the investment projects started by the previous regime, as well as to slow the rate of implementation of other investment projects, owing 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 to the population were...
increased, partly to compensate for previous deprivations and partly to cushion vulnerable groups from the costs of transition and adjustment.

During 1990 and early 1991, the Government undertook a comprehensive tax reform, revising the turnover tax fundamentally with effect from November 1, 1990. First, it substantially expanded the base from domestically produced final goods intended for domestic consumption to cover all goods and services, whether domestically produced or imported, except those intended for export. Second, it simplified the rate structure, transformed the rates from specific to ad valorem, and reduced the number of rates to twenty, ranging from 1 percent to 90 percent. Finally, to reduce the negative impact of cascading, the Government set rates on intermediate goods substantially below those on final goods. It also overhauled the system of direct taxes, introducing a genuine profit tax in July 1990 to replace the profit remittance scheme and replacing the tax on the wage fund of state enterprises with 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. For example, 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 profit 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 systems 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 the 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.

Financial Sector Reform

In a typical centrally planned economy, one bank—the National Bank—has a 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 but does not engage in credit operations. This monobanking system not only ensures that the central authority has direct and complete control over the quantity of money but it also 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 interenterprise 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)).

If there is to be a successful 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-tiered banking system, made up of a central bank and commercial banks, developed. Second, the commercial banks need to be autonomous and must start operating on a profit-making basis, which involves, primarily, competing for deposits and assessing client credit risk. This, in turn, implies that interest rates must be liberalized and used as a tool 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 the development of skills and institutions, but also profound changes in attitudes. An added complication is that these reforms often have to be initiated in an unstable macroeconomic environment, which, in turn, requires tight monetary policies. The development and introduction of indirect means of monetary policy may then need to be delayed 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 according to the financial plan and were controlled centrally, as discussed in Section II. In addition to providing credit and accepting deposits, the banking system was responsible for monitoring the implementation of various aspects
of the physical plan at the enterprise level. Although the clear division of responsibilities between the state-owned specialized banks was designed to make these tasks easier to fulfill, it also had the effect of eliminating competition between banks. 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 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 in that it issued 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 sectors 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 most household savings deposits, as well as a smaller number 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 offshore banks also conducted limited amounts of business in foreign currency and held deposits with the RBFT. Finally, there were about eight hundred credit cooperatives with deposit accounts at BAFI, and some six thousand 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, the Ministry of Finance, with the help of ministries and banks, prepared quarterly credit plans. The banks, together with the economic units they served, determined credit needs based on expected production and investment, while the NBR supervised this process. The Government approved the resulting credit plans, and banks subsequently divided up the available credit. 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 permitted to negotiate financing contracts with economic units to implement 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, Decree-Law 54 on private initiative, issued in early 1990 to encourage development of small private firms in general, allowed private banks 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 its central banking functions, and a new bank (the Romanian Commercial Bank (RCB)) was created and took over the NBR’s commercial operations. From that point on, the Romanian financial sector had the two-tiered 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, 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 on 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. The NBR is made solely responsible for conducting exchange rate policy, including issuing and implementing foreign exchange regulations and managing official foreign exchange reserves and gold. It is given authority to license and supervise commercial banks. The law also limits the amount of credit the NBR can extend to the state budget.

Most important, perhaps, the central banking law makes the NBR independent in the performance of its duties. The Governor and the Board of Directors are appointed for renewable eight-year terms by Parliament on the recommendation of the Prime Minister 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 to hold positions in business.

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 offshore 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 restructuring the financial sector, however, is slowed by lack of experience of a modern market-based financial system, lack of expertise and trained staff, material constraints—for example, 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 just 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 that when the centrally planned system collapsed at the end of 1989, it left the country in the grip of an economic and institutional crisis, the outcome of four decades of central planning, compounded in the late 1980s by an almost religious fervor to repay all external debt. Ceaușescu’s legacy was an economy plagued by 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, and medical attention—were hard to come by. There is little doubt that the initial obstacles to reform in Romania 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 dismantling the existing system and replacing it with a market-based system in as short a time as possible, a task made even more difficult, however, by the worsening external environment. The Middle East crisis, which pushed up energy costs, sharply reduced exports to the region, and led to the 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 designed to achieve them.

The Government believed that its 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. To this end, it devoted considerable effort to 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 to only 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 Romania’s integration 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 can 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, through either sales or giveaway schemes, has been proceeding rapidly. The breaking up of collective farms and redistribution of agricultural land is expected to be nearly completed by the end of 1991, placing over 80 percent of farmland into 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
Table 3. 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. |
| Interest rates          | All bank interest rates liberalized in April 1991. Controls on spread between deposit and lending rates in place. |
| Exchange system         | - Exporters allowed to retain 50 percent of their export earnings in foreign currency as of September 1990. - 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 | - Private sector activity, including joint ventures, allowed in February 1990. - First privatization law enacted August 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. |
| and privatization       |                                                                                   |
| Tax system              | - Profit remittance system replaced by a profit tax in July 1990. - Turnover tax simplified and revised in November 1990. - Tax on the wage fund of enterprises replaced by a wage tax in 1990. - Preparation for the introduction of VAT and a general income tax started in 1991. |

exercise control over the bulk of the country's economic resources. Second, it makes the reform process more binding: undoing the reform would require confiscation of property, which is most unlikely. 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 in 1991 is vastly different from Romania in 1989, the transformation is still far from complete. 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 mining, 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 has yet to emerge. Private enterprise, although growing rapidly, still represents a very small share of the economy. The Romanian reformers, like 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 still evolving, judgment on the Romanian reform program should be reserved for the time being. Nevertheless, a number of fundamental steps in transforming the economy have been taken, and the reform process is under way. If the momentum can be sustained, there is good reason to believe that the objectives of the Romanian economic reform program will be realized.
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