Romania: Macro-economic stabilisation and structural reform
Maitland MacFarlan;Joaquim Oliveira Martins
Organisation for Economic Cooperation and Development. The OECD Observer; Apr/May 1998; 211;
ProQuest
pg. 39

Spotlight

Romania
Macro-economic Stabilisation and Structural Reform

Maitland MacFarlan and Joaquim Oliveira Martins

The complementarity between macro-economic and structural policies is widely recognised. Yet it is often neglected when macro-economic indicators head in the right direction. With high growth rates of GDP, it is not always easy to focus on structural weaknesses and question whether the policies intended to sustain macro-economic stabilisation are well judged. Coherent design, both of macro- and micro-economic policy, is particularly relevant for countries making the transition from central planning to a market economy in view of the large economic dead weight inherited from the previous structures. The tortuous story of Romania between 1989 and 1997 illustrates the importance of these links in a particularly striking way.[1]

At the outset of transition Romania was, in many respects, in a more difficult position than most of the other countries in central and eastern Europe. In the early 1990s, the room for manœuvre for structural reforms seemed limited, particularly given the difficult social conditions of the previous decade. Indeed, during the 1980s, the population had had to pay for the quick re-imbursement of a sizable foreign debt and some public-construction projects on a pharaonic scale. The 'People's Palace' in Bucharest is a notable example. The pressure on already low disposable incomes meant a contraction of household consumption. The emphasis of the Ceaucescu regime on economic self-dependence led to the accumulation of a technological lag and put excessive focus on heavy industry. This led to the depletion of domestic energy sources, inducing shortages and subsequently costly dependence on imports of energy and raw materials.

This difficult legacy argued in favour of a gradualist approach, seeking to minimise the social costs associated with the transformation to a market economy. Although these social concerns were understandable, the strategy was ill-conceived and failed to produce sustainable gains in either economic or social conditions. The experience of the first seven years of transition suggests that the costs of a gradual strategy have probably been higher than if a bolder approach to structural transformation had been adopted. In 1993, the OECD pointed out clearly the risks that arised from delaying structural reforms.[2] In particular, if loss-making industrial and agricultural enterprises were artificially maintained through state subsidies and easy access to credits, both fiscal and monetary policy would be undermined.

The importance of the links between macro-economic and structural policy was disguised for a while by the boost in exports and resumption of growth in 1993, and the apparent success in reducing inflation under the stabilisation policy of 1994. But the export performance of 1993–94 was to a large extent based on unrestructured heavy industry and could not be sustained without massive imports of energy and raw materials that led to a progressive deterioration in the external position. In 1995 the growth rate of GDP peaked at 7.1%, but the sizable increase in the current-account deficit (Figure, p. 42) resulted in a fall in confidence in the currency. In November of that year, the authorities were forced to accept a sharp depreciation in the official exchange rate.

In 1996, output continued to grow at around 4%, apparently suggesting that the exchange crisis had had only a moderate impact. But during the year macro-economic conditions progressively deteriorated. The official budget deficit almost doubled over the 1995 figure, at a substantial 5.8% of GDP. In fact, when 'quasi-fiscal' items are included, such as the National Bank refinancing of credits to the agricultural sector and other indirect subsidies, the overall deficit exceeded 10% of GDP. This serious slippage was mainly the result of pervasive lack of financial discipline in large state-owned companies, aggravated by the populist policies adopted during the election campaign that boosted incomes and expenditures. The public deficits were financed mostly by printing money, with the predictable result that at end-1996 inflation accelerated to 57%. The overall approach to economic policy was clearly unsustainable. As international financial institutions withdrew their financial support, policies in Romania were at an impasse.

A New Approach

In 1997, the new coalition government elected in November of the previous year decided to abandon the gradualist approach and implement

Maitland MacFarlan and Joaquim Oliveira Martins work in the Non-Member Countries Division of the OECD Economics Department.
E-mail: eco.contact@oecd.org

1. ***OECD Economic Surveys: Romania***, *OECD Publications, Paris, 1998.*
2. ***OECD Economic Assessment of Romania***, *OECD Publications, Paris, 1993.*

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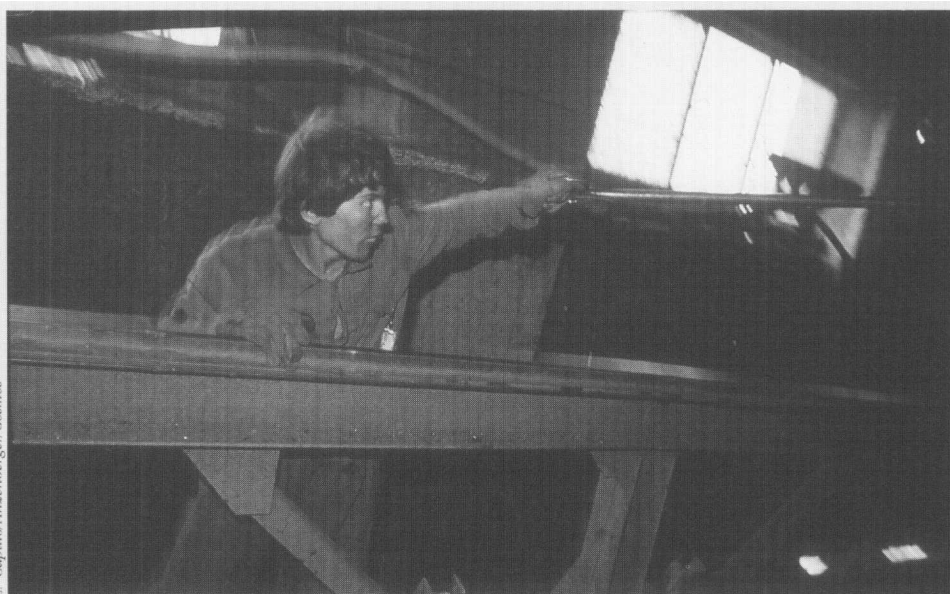
a shock therapy. The main novelty in the government programme was a firm intention to accelerate structural reforms towards privatisation, the liquidation of loss-making firms, the liberalisation of prices, the reduction of trade barriers and the promotion of foreign investment. Most indirect subsidies were stopped, and direct subsidies and easy refinancing from the central bank were phased out. The previous system of an official exchange rate was abandoned and the currency was allowed to float according to market forces. On the basis of this programme, the IMF and the World Bank accepted to re-negotiate a stand-by credit line and a package of structural loans of roughly $1 billion.

The programme implemented in 1997 represents an additional, but largely unavoidable, transition shock for Romania. Social and economic conditions have deteriorated in a country where poverty was already widespread. By mid-1997 real wages had fallen by 30% from their position a year earlier. Both large and small enterprises have been hard hit by the contraction in demand, soaring interest rates and – especially large industries and state farms – the phasing-out of state subsidies. For 1997 as a whole, GDP probably fell by 6% or more. Unemployment has remained surprisingly low, at around 7%, in part because the private agricultural sector has played the role of buffer, but its ability to do so is unlikely to last as restructuring progresses and the capacity of rural areas to absorb the unemployed reaches its limits. Prices of energy and other public utilities have doubled or more, causing prices to rise by over 30% in March 1997 alone. Since then, tight monetary conditions have brought inflation down, but it persisted at 3–4% per month at the end of the year. Inflation for 1997 as a whole was over 150%.

There are nevertheless some encouraging signs. Exports have picked up and the current-account deficit has declined. Improved trade performance could re-ignite economic growth – as in 1993, but this time on a sounder basis. The target of 4.5% of GDP for the government deficit in 1997 was reached despite difficult fiscal conditions. And capital inflows have increased, helping to stabilise the exchange rate and increasing the reserves of the central bank.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Industrial restructuring by the new government has laid off 70,000 workers, though severance payments were generous.

Against this background, the question of adequate macro-structural links again becomes the core issue. If structural reforms do not move ahead rapidly enough, the short-term costs of the austerity programme imposed by the shock therapy of 1997 will not be balanced by the longer-term gains of a more efficient economy. Indeed, if the population does not see some result from the difficulties they have been through, the political consensus formed after the elections of end-1996 may come under threat.

How Rapid and Deep are Structural Reforms?

Time is one of the most precious resources for transition and much time has been lost in Romania. In its initial programme, the government set out an ambitious list of structural reforms, and parliament has since been legislating actively to pass around 100 new laws. The implementation of reforms has nonetheless lagged behind initial expectations.

For example, a bolder approach to privatisation has been instituted, but only half of the initial target of roughly 2,700 companies to be privatised in 1997 was achieved. As part of the new approach, the State Ownership Fund announced that there would no longer be a minimum price on the sales of state property and that enterprises that could not be sold would be liquidated. In parallel, the government attempted to impose tough financial conditions on state-owned enterprises: subsidies were considerably reduced, imposing a *de facto* budget constraint on cash flows, and stocks of unpaid tax-arrears to the state budget incurred heavy penalties.

But practical difficulties meant that this bold strategy could not be fully implemented. Assessment of financial viability of companies is often problematic because accumulated losses arose in part under the distorted price system of the administered economy. Many enterprises, particularly large ones with sometimes a heavy burden of financial arrears, did not find a buyer. The liquidation of non-viable enterprises also faced strong resistance, both on political and social grounds. Indeed, large firms such as oil refineries and steel plants are often viewed as valuable assets both by the authorities and the public opinion. Selling them off cheaply is politically

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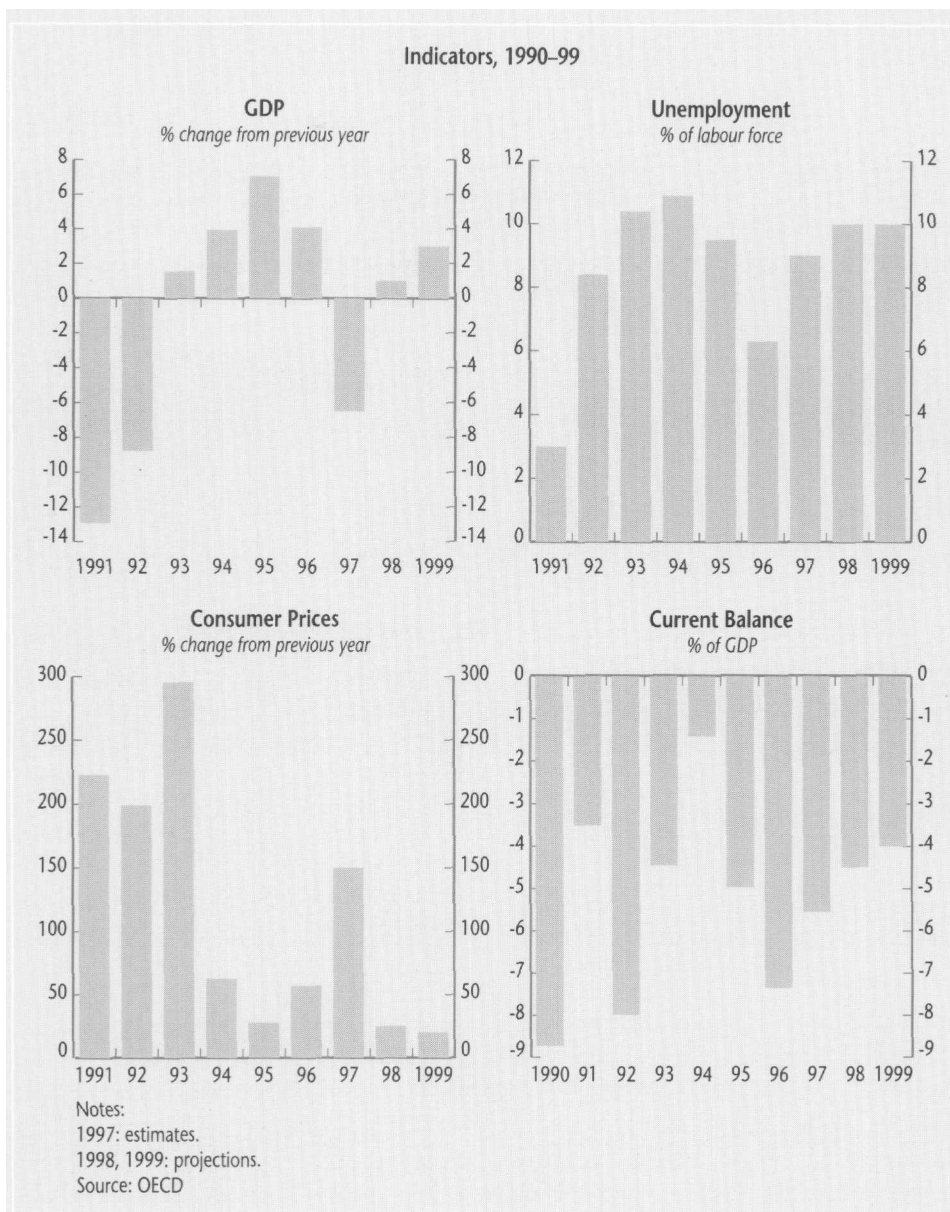

sensitive, especially when the potential buyers are foreign investors.

If they are not rapidly solved, these policy dilemmas will threaten the coherence of the reform package. For example, the amount of arrears in the economy, which reached 36% of GDP at end-1996, is rising again. Most, indeed, are still concentrated in large state-owned firms, notably in the large public utilities (*regies autonomes*). As a result, the amount of non-performing loans in the banking sector has also increased and, by mid-1997, over 50% of total bank credits were either unlikely to be repaid or were already obviously losses.

The reform of the banking sector is another key macro-structural link in the economy. Experiences in other transition economies show that a fragile banking sector is the weakest link in the chain of economic adjustment.[3] This sector is dominated by four major state-owned banks, two of which are severely burdened by non-performing loans – mainly a legacy of the pre-1997 policy when the banks were required to provide low-interest (and largely unrecoverable) credits to the agricultural and energy sectors.

The government has nevertheless made firm and sometimes difficult choices that should foster structural change. A number of loss-making agricultural farms have been closed down. The mining sector has been largely restructured, inducing massive lay-offs of around 70,000 workers; to minimise distress and social tensions, lay-offs were accompanied by substantial severance payments. In addition, the official stance towards foreign investment is now open and liberal, although a 1.5% transaction tax is applied to foreign portfolio investment. This openness should stimulate private capital inflows and help improve corporate governance. The start-up of an over-the-counter market (based on the US NASDAQ model) and the use of the stock market for privatisation purposes have invigorated capital markets. The government also intends to begin privatising the state-owned banks in 1998, and has announced major restructuring packages for the two most problematic ones. These moves will be supported by recent improvements in the supervisory regime of the National Bank.

Romania has embarked on a long overdue programme of difficult economic reforms, but the scope for development is nonetheless widely recognised. Romania has the second biggest population in central and eastern Europe, a large pool of skilled labour and generous agricultural land. With better management of its endowment of natural and human resources, it has the potential to be a well-performing emerging market economy. ■

*3. John Litwack, 'The Russian Federation – Commercial Banking', **The OECD Observer**, No. 210, February/March 1998.*

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