The Structural Responses of Romanian Industries to Transition From a Planned to Market Economy

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The Structural Responses of Romanian Industries to Transition from a Planned to Market Economy

The aim of the thesis is to critically examine the transition process from a planned economy towards a market economy that has taken place in Romania. Based on a political economy approach, this current research takes a new direction by departing away from the dominant view in the transition literature that underpins the IMF and the World Bank policies (neo-liberalism), that postulates a spontaneous adjustment without a past. We adopt a political economy approach to investigate the institutional and structural rigidities hindering restructuring and transformation of the Romanian economy. In this thesis, the impact of real wages on industrial performance is examined using a panel dataset of Romanian industries from 1990 to 1996. A reduction in real wages has become a standard prescription for economies undergoing industrial restructuring due to its perceived beneficial impact on both employment and exports. Using both static and dynamic panel estimation, real wages are found not to be negatively associated with either output and employment, a result that provides little support for the orthodox neo-classical viewpoint. The theoretical and empirical inputs reveal the limitation of neo-classical economics and demonstrate the need for an evolutionary approach that recognises the role of history and path dependency. It is suggested that an institutionalist approach that put more stress on improving productivity may be more likely to achieve the long-term objective of successful industrial restructuring. The key to the transition from a planned economy to a market economy is the institutions that are established to enable the market to operate. While this is acknowledged, after ten years of transition in Romania what has not been fully addressed is the appropriateness of the forms of

institutions that have been suggested for adoption and whether they constitute the right mix. We consider the appropriateness of the evolutionary approach proposed by the old institutionalist view on institutional change as a contrast to a new institutional view.

Chapter 1

Introduction

1.1 Overview

The collapse of the command economies in Eastern Europe has confronted conventional notions of developmental theories with a set of new challenges. One of the major challenges is how a market economy can be embedded where it ceased to exist for decades. The Bretton Woods Institutions (the World Bank and the International Monetary Fund) have been influential in establishing the framework for structural changes in these countries. In many ways the policy recommendations for Eastern European countries have followed the policy prescriptions of the structural adjustment programmes that have been applied to the Third World since the early 1980s.

The dominant paradigm that underpins much of the World Banks and International Monetary Funds (IMF) policy prescriptions is neo-classical economics with its emphasis on liberalisation of prices and reduced role for governmental intervention in the operation of markets. In this thesis the present manifestation of neo-classical theory, which incorporates developments such as transaction costs and public choice arguments, is shown to form the basis of many of the recommendations for the transformation of Eastern European countries such as Romania. The limitations of the dominant neo liberal or neo-classical paradigm are analysed by confronting it with an alternative political economy approach that incorporates a variety of other schools of thought, notably, the industrial strategy school of thought (Shapiro and Taylor, 1990; Amsden et al, 1994; Chang and

Nolan, 1995) and 'old' institutionalism (Veblen, 1898; Commons, 1934). Despite the differences in policy recommendations that emerge from these other schools of thought they all stress the limitations of neo-classical economics which, in many of its guises, assumes an institution-free world characterised by perfect knowledge and markets that always tend to settle towards equilibrium. Arising out of this critique of neo-classical economics a more explicit institutional framework is developed to examine the current economic transformation of Romania. Romania, perhaps more than many of the other Eastern European countries, has found the adjustment from central planning to a market economy particularly problematic.

The choice of Romania as a basis for this thesis is partly motivated by the lack of existing work on this country. While undertaking this research it has become apparent that Romania has attracted little attention from academics in the West reflecting, probably, the lack of mainstream interest among global institutions. Their literature on transition in this country has not exceeded two country reports by the IMF (1996) and OECD (1998). This thesis attempts to fill this gap by using economic theory to analyse the transition process in this country. In addition, the choice of Romania was determined by the access to data sources that has arisen through the academic and governmental connections established through Tempus programmes with economists in both government and universities in Romania.

Romania represented a classical example of central planning where no attempts at reforming the system were carried out before the transition. The structural changes such as the development of financial systems, changes in property rights,

restructuring of industries and ability to attract foreign direct investment have been modest.

This lack of reforms prior to 1989/1990 had, and still has, implications for the nature and speed of the transition process in Romania. One of the main contentions of this thesis is that the previous socialist regime in Romania had specific policies which meant that the Romanian economy was already accustomed to austerity policies, had no foreign debt, and existed in a state of imbalance, where there were shortages and repressed inflation. While some of these features may have occurred in other East European countries, they were even more apparent in Romania (Daianu, 1996; Montias, 1991; Avner and Montias, 1993).

The argument we set out in this thesis is that transition is dependent on particular features of a country's past and that in this sense transformation is path dependent. In developing this path dependent approach we draw on institutionalist and evolutionary political economy arguments. The application of these approaches to Central and Eastern European countries could offer a fresh perspective for, and a better understanding of, the transition process. Furthermore, the examination of the Romanian experience could fill a gap in the literature. Although concentrating on Romania this thesis contributes to the understanding of the economic transition not only in Romania but also in other countries. The rest of this chapter establishes the aims and objectives of the study (section 1.2), outlines the

methodological approach adopted (section 1.3), and details the structure of the thesis (section 1.4).

1.2 Aims and objectives of the study

We critically examine the transition process taking place in Romania from a planned to a market economy. The aim of the thesis is to reveal the inadequacy of the neo-liberal agenda, underpinned by neo-classical economics, that has driven the policy recommendations of the World Bank and IMF, and to argue that there are benefits to be gained from adopting an alternative political economy framework when analysing the transition process. More specifically, the aim is to establish an alternative analysis of institutions as compared to the prevailing new institutionalist view, which is largely based on a transaction cost interpretation of institutions. This alternative analysis draws on the evolutionary approach that characterises the 'old institutionalist' approach of the American institutional economists, such as Veblen and Commons (Veblen, 1898; Commons, 1934).

Given these aims the objectives of the thesis are:

- To examine the augmented neo-classical view of the transition process and to assess the extent that it informs policy instruments, especially those recommended by the World Bank and the IMF.
- To test the (neo-classical) hypothesis, and the consequent policy stances that arise from it, that a reduction in real wages leads to the restructuring of industry.

- To compare the augmented neo-classical approach with alternative theoretical explanations of transition concentrating specifically on the development of the 'old' institutionalist view, thereby postulating the importance of incorporating path dependency into an explanation of the transition process.

The thesis thus explores the institutional changes that have taken place in Romania since 1990, as it progressed from a planned to market economy. It adopts, essentially, a microeconomic focus, concentrating on industrial response to transition, recognising, however, that such microeconomic analysis takes place within the context of the wider macro economic changes affecting Romania.

A World Bank study of seven East European countries defines industrial restructuring as a complex process whereby "firms in all countries must continuously restructure to maintain profitability in the face of a changing economic environment, technological progress, and competition from other firms. This continual restructuring leads to higher productivity and economic growth" (Pohl et al, 1997, p.1). The need for such restructuring is paramount as the industrial sector represents the main source of output and employment in the transitional economies of Eastern Europe (Amsden et al, 1994). The issue we confront in this thesis is whether orthodox theory and policy provides the appropriate conditions for change and sustainable growth, or whether greater attention needs to be paid to the conditions and constraints that operate on a

particular country's economy, thus requiring a more detailed understanding of that country and, hence, more specific policy responses.

This research contributes to our understanding of the transition process in Eastern Europe in two key ways. First, surprisingly, the debate surrounding transition has largely disregarded the question of how a market economy could be embedded where it ceased to exist for decades and how markets could be established within the ruins of state-Socialist structures. Instead the academic debate has concentrated on the pace of transforming economies from central planning to ones based on market systems, accepting the de-linking from the past as the only step forward for the countries in transition. Two approaches have emerged: that of shock therapy which is backed by the IMF and the World Bank (IMF, 1996; Donnorummo, 1998; Blanchard, 1997; Daianu, 1996; Sachs, 1990, 1992, 1993; Sachs and Woo, 1994; Lipton and Sachs, 1990; Woo, 1994; Woo, Parker and Sachs, 1997; Borensztein, 1993; Pohl et al, 1996) and the gradual path to a market economy emerge (Dewatripont and Ronald, 1992, 1995; Murrell, 1991, 1992a, 1992b).

This current research takes a new direction by departing away from the dominant view in the transition literature, that postulates a spontaneous adjustment without a past, to investigate the institutional and structural rigidities hindering industrial transformation and consequently successful transition to a fledging market economy. Central to this is the legacy of the past. Each country has its own

history, culture and institutions that makes its transition pathway unique. As indicated earlier, Romania offers an ideal case study for such investigation.

Second, very little empirical work has yet been undertaken on Romania. This is the first study of its kind that has created and has been able to use a unique data set. The analysis is comprehensive in that the data are drawn from all branches of industry. In this context we focus on the industrial and organisational response to the changing macroeconomic environment. This is a vital issue for countries in transition. Though most countries have realised macroeconomic changes, progress at the micro level has not developed at the same pace (The World Bank, 1996,; Pohl, 1996; Hunya, 1998).

1.3 Methodology

The methodology adopted in this thesis is that of political economy. In defining the term political economy, we closely follow Rothschild (1989, p 3) who defines the usage of political economy as characterised by a "conscious opposition to the ruling neo-classical paradigm and various attempts to develop alternative approaches, methods and theories". This broader political economy methodology is essentially an institutional approach that is used to analyse institutional changes underpinning the current economic and industrial restructuring in Romania. Particular emphasis is attached to the institutional and economic structures of the Romanian economy. The research provides an alternative approach to the dominant paradigm in Eastern Europe (neo-classical economics), which down-plays the important need for institutional building.

Realism, history and institutions, in addition to the organic analysis to economic processes, are integral premises within the political economic approach (Arestis and Sawyer, 1994). These features underline such a mode of inquiry, and the approach is better able to understand reality by surpassing positivist and ahistorical analysis, which largely underpin the neo-classical paradigm, that sees individuals as atomistic rather than social beings. So, by taking an institutional perspective, transition is not seen as an instantaneous adjustment without a past. Instead transition is understood by how market institutions have been created and how they are linked to the collapse of the central planning institutions in a search for a more stabilized political economy model. Central to this is the examination of how the collapse of central planning and traditional markets affect the current transition. This emphasis gets beyond how more efficient institutions have outperformed less efficient institutions, to analyse how the vacuum created by the collapse of old institutions has been filled.

The analysis incorporates both formal and informal institutions which, together, constitute the legal, administrative and customary arrangements for repeated human interactions and enhance the predictability of human behaviour (Pejovich, 1995). Formal institutions define the political system (the hierarchical structure, decision making powers, the individual rights), the economic systems (property rights in scarce resources, contracts), and the protection system (judiciary system, police, military). Informal rules have their origins in the experience, traditional values, ethos, religious beliefs, ethnicity and other factors that influence the subjective perceptions individuals form to interpret reality (Pejovich, 1995; Boyd

and Richerson, 1985). As the stability of formal institutions has become eroded by the abrupt collapse of the command economy, people have fallen back on their informal norms of behaviour (Pejovich, 1995) such as ethnicity, extended family and shared values. Romania presents a classical case since nationalism is one of the main signs of continuity in the country's politics.

Arestis and Sawyer (1993, p.4), in the context of a political economy methodology, argue that " there are a range of criteria relevant for evaluating the adequacy of a theory. The techniques would include formal (including mathematical) modelling, historical and institutional analyses, along with empirical investigation". So, in addition to adopting a historical and institutional approach this thesis uses a number of different empirical techniques to test the neo-liberal policy prescriptions. The context for these tests is the industry or sectoral level concentrating on the industrial response to transition. The reasons for concentrating on sector level performance rather than firm performance are as follows:

- The vast majority of work on transition has concentrated either on the macroeconomic or microeconomic (small number of firms, single industry or a single aspect of reform such as privatisation) aspects. Detailed sector-level data (the mesoeconomic effect of reform) are rarely examined (Bara, 1998). Macroeconomic data might suffer from the problem of aggregation, while on the other extreme microeconomic data might lead to conclusions of limited scope (Kennedy, 1997).

- On a more practical level the data on sectoral level activity are published by Romanian statistical agencies.
- There are well known difficulties in getting data at the firm level. Reliable financial data are not available and there are inherent difficulties in undertaking surveys.

The research employs analytical and quantitative analyses to capture the impact of macroeconomic policies on industrial output and employment. To examine these changes a unique set of data, that covers the period 1989-1997, has been established. The following represent the main sources that have been used:

The Romanian National Commission for Statistics

Romanian National Bank

United Nations Economic Commission for Europe.

European Bank for Reconstruction and Development (EBRD)

The Organization for Economic Co-operation and Development (OECD)

The data include statistics on industrial activity, both aggregated and disaggregated, by branch, size and ownership, output, employment and prices. It also incorporates data on the labour market, trade, foreign direct investment and the financial system. The data is used to examine whether industrial performance has been influenced by the reforms that have taken place in Romania.

Using the data collected an econometric analysis has been undertaken. The STATA and DPD computer packages are used to analyse panel data from 1990 to 1996 (Plewis,1985; Finkel, 1995, Baltagi, 1998) to test a set of hypotheses relating to the performance of different sectors of Romanian industry. The main hypothesis that has been tested using this panel data is whether output and employment in Romania have increased as a result of a decline in real wages. This econometric analysis follows Amsden and Van der Hoeven (1996) who use an econometric model to explore whether structural adjustment programmes encouraged industrial restructuring via a decline in real wages as suggested by neo-classical economics. The importance of this test can be gauged by the consensus among global market institutions that the reduction in real wages has a beneficiary impact on industrial output and employment in Eastern Europe (IMF, 1992; OECD, 1992). We have also been able to decompose unit labour costs into their component parts (real wages, productivity and the wedge between consumer and producer prices) to examine which of these components impacts most on reducing unit labour costs and hence increasing profitability.

Data measurement is a prevailing problem in the transitional economies of Eastern Europe (Bartholdy, 1995). Having started this research, we became aware of the difficulty of collecting data. However, the link established through the Tempus project has been useful for compiling a unique set of data which cover all sectors of the Romanian industry. Concerning the econometric model, we rely mainly on the data published by the National Commission of Statistics. The use of their data by the OECD (1998) and the IMF (1996) consolidates their trustworthiness.

Subjecting the data to different model specifications and robustness checks improves the validity of the model.

1.4 The structure of the thesis

The rest of the thesis is organised into seven chapters. Chapter 2 outlines the development of the Romanian economy from independence in 1919 to 1989. The aim of the chapter is to set the economic and political transition in Romania in its historical context. A central point of the argument presented in this chapter is that the Romanian economy after transition retained some elements that characterised the previous socialist period which in turn retained aspects of the preceding inter-war periods, when the economy was guided by nationalistic protectionist policies.

Chapter 3 sets out a theoretical framework for the premises underlying structural adjustment programmes (new-liberal policies) advocated by the World Bank and the IMF, particularly reviewing the main concepts, objectives, effects and theories relating to these policies and their application to Eastern Europe. This largely concentrates on the development of neo-classical microeconomics and its revision through public choice theory, transaction cost theory and property rights analysis, often refered to as new-institutionalism. It also establishes the macroeconomic framework and theory that have guided much of the structural adjustment programme recommendations. The chapter shows that, despite various revision of the model, it remains ahistorical and aspatial.

Chapter 4 looks at the alternative theoretical approaches to transformation in transition economies. Up until this point the thesis largely concentrates on the underpinning theoretical basis of the IMF and World Bank policies representing, as they do, an augmented neo-classical view of microeconomics and a new classical theory of macroeconomics. Chapter Four examines how this commitment to these theoretical strands has largely reduced the debate on economic transformation in Eastern Europe to one concerned with the optimal pace of transformation. Therefore the chapter presents some of the alternative theoretical approaches to the transformation process looking specifically at the Austrian view, the Industrial Strategy approach and the old-institutionalist view. The relevance of the industrial strategy and institutionalist approaches, which represent the core theoretical edifice of the thesis present a more complex view of reality. Being integral parts of a broader political economy framework, these approaches facilitate the analysis of structural changes but with respect to institutions, history and evolution.

Chapter 5 presents an empirical analysis testing one of the fundamental relationships advocated by the IMF and World Bank, namely that a reduction in real wages acts as a stimulant to industrial restructuring. The chapter reviews a theoretical basis for this focus on real wage reduction and then uses data on Romanian industry to test the hypothesis. A panel data approach is used to undertake the econometric analysis. The rejection of the null hypothesis that real wage reduction stimulate industrial restructuring questions the theoretical edifice of neo-classical transition economics and shows the superiority of the

institutionalist view that highlights the role of rigidities behind the poor industrial response to real wage reductions.

Chapter 6 analyses the transitional policies that have been implemented in Romania. It begins by looking at the fiscal and monetary reforms and then concentrates on the policies that have been applied to various industrial sectors to bring about industrial restructuring. A feature of the reform process is the confusion over policy initiatives and the difficulty of implementing the policy initiatives. Such difficulties, we argue, result from ignoring the constraints that arise from the peculiar nature of the Romanian economy and the conditions in which the reforms were to operate, which derive from the past performance of the Romanian economy.

Chapter 7 provides an examination and assessment of the outcomes from the policy changes (discussed in Chapter 6) that have taken place in Romania from 1990 to 1996. This chapter deals with internal and external macro-economic policy outcomes as well as industrial and social (mainly employment) outcomes. The nature of the policies implemented, often because of IMF conditionality, follow orthodox thinking regarding institutional change. The outcomes for the Romanian economy are disappointing although, as the thesis will show, this is what could have been predicted since the policies by ignoring path dependency continually come up against constraints that, at best, reduce the effectiveness of the policy changes and, at worst, signal the inappropriateness of the nature of the policy reforms and the way they have been implemented. The performance of the

Romanian economy is contrasted with that of other East European countries highlighting that, in many respects, the economies of these countries differ and that general policy reforms which assume a common past are unlikely to be successful in all cases.

Chapter 8 consolidates the arguments presented in the previous chapter, extending the critique of the neo-liberalism viewpoint based on relative prices further to show the institutional rigidities behind the weak response of Romanian industry to transition. It shows that the concentration of neo-classical economics and neo-institutionalism on exchange relations is misleading. The new institutional approach is compared to that of the 'old' institutionalists who emphasis how the social economic fabric of society, path dependency and evolution need to be incorporated into an analysis of institutions if appropriate institutions are to be adopted.

Chapter 2

Historical Background and Overview of Transition in Romania: 1919-1990

2.1 Introduction

This chapter outlines the development of the Romanian economy in the period 1919 to 1990. The aim of the chapter is to set the economic, political and social transition in Romania in its historical context. A central point of the argument presented in this chapter is that the Romanian economy after transition retained some elements that characterising the previous socialist period which in turn retained aspects of the preceding inter-war periods when the economy was guided by nationalistic protectionist policies. This discussion of the historical development of the Romanian Economy provides the background information for the path dependency argument to economic transition in Eastern Europe.

Section 2.2 outlines the geo-politics of Romania. Section 2.3 examines the inter-war period between 1919 and 1939. Section 2.4 covers the post War 2 period between 1945 and 1989. Section 2.5 reviews the transition in Romania and covers the policy reforms. Section 2.6 draws some conclusions.

2.2 The geo-politics of Romania

Romania is situated in the Balkan area together with Bulgaria, Albania and former

Yugoslavia. Historically, the Balkan countries have been the poorest part of Central and Eastern Europe. The Central European Region consisting of Poland, Hungary and the Czech Republic has been the main attention for Bretton Woods institutions (the World Bank) in the current transformation from a command to a market economy within Central and East Europe. According to Sujan (1994), Poland, Hungary and the Czech Republic are distinguished from other pre-communist regimes in the region according to the following criteria:

- A common historical background as an integral part of Western Civilization and Roman Catholic or Protestant culture.
- Geographic proximity to Western Europe.
- Development of free market and democratic traditions alongside Western Europe, accelerating with the formation of independent states after the First World War.
- Higher level of economic and technological development than almost all the other transition countries.

In contrast, the Balkan countries have been overwhelmingly agrarian and shared the following characteristics before the Second World War (Gallagher, 1995):

- An industrial proletariat and bourgeoisie hardly existed.
- There was a lack of social democratic traditions and strong collectivist and despotic values.
- The orthodox church was traditionally submissive to the ruling power.

Thus, while the Central European region states and Balkan countries were regarded as socialist states from 1947 to 1990, with some degree of commonality in politics and economics policy, their heritage, structures, culture, religion and economies suggest they were very different entities.

2.3 Romania between the two World Wars (1919-1938)

The Romanian state was recognised by the 1919 peace treaty, signed in Paris, that concluded the First World War. Under this treaty the three Romanian provinces of Wallachia, Moldavia and Transylvania were consolidated into one nation state, having formerly been under different spheres of influence notably that of the Austro-Hungarian Empire. The emergent state was faced with a major debt problem which arose from post-war agreements with other Austro-Hungarian states that meant there was a shortage of capital for development. This shortage was compounded by the marginalisation of Romania in international markets.

In the early 1920s world market prices for Romanian primary products, which formed the bulk of exports, were extremely low. Under the nationalist policy, known as "our own policy" (Turnock, 1974, p 123), adopted by the National Liberal Party, the ruling party of the time, the first priority was to promote industrial development. As a result, as is shown in Table 2.1, after the First World War, Romania's industrial output increased substantially compared to the pre-war period, with the major share held by heavy industry. The national industrial development policy demanded highly

selective investment priorities and the mobilisation of internal capital resources. This industrial policy was implemented via the use of subsidies and monopolisation of industry. A number of obligatory cartels were established manufacturing everyday necessities such as paper and sugar (Turnock, 1986). A domestic oil cartel was created in 1924, followed two years later by the establishment of the Socomet Cartel, which embraced virtually all of Romania's iron and steel manufacturers.

By 1937 when registration of cartels was required by law, a total of 94 cartels were recognised by the state, doubling to 183 by 1939. The cartels, which were most prominent in building materials, food processing and paper, controlled between a third and a half of total production (Turnock, 1986). Tariffs were imposed on imported manufactured goods, and foreign investment was discriminated against in favour of Romanian capital (Avner and Montias, 1993).

For much of the period from 1919 to 1939 Romania was dominated by monopolies and undertook essentially nationalistic protectionist policies. As the next section shows these features have influenced the path that the Romanian socialist state adopted.

Table 2.1 Average Annual Growth Rates for Industrial Output (%)

Sector	1913	1919-1929	1929-1938	1938-1943
Metallurgy/ Engineering	4.2	19.8	6.6 (1)	3.6
Oil refining	6.1	20.5	3.2	
Cement	3.3	12.5	5.9	2.5 (2)
Wood processing		2.2		
Paper	2.5	17.6	4.3	
Textile	2.5		4.3	
Leather		9.9	4.4	
Food processing				2.6
Total	1.7			3.4

Source: Turnock (1986, p87).

(1) Iron and steel only.
(2) All building materials.

2.4 Post World War Two Romania: Stalinist-cum-nationalist policies

The Stalinist model which first began in the former Soviet Union in the 1920s was imposed on the rest of Eastern Europe at the end of the Second World War. The main objective of the model was to build Communism. This objective would be achieved through a transition period (Socialism) which required the development of productive forces, eliminating the difference between mental and physical labour and between town and country (Nove, 1986).

The rationale of the model, as described by Stalin, was to catch up as quickly as possibly with the West. As he put it in the middle of the first five year plan "the tempo must not be reduced! We are fifty or a hundred years behind the advanced

countries. We must make good this distance in ten years. Either we do it or we shall go under" (cited in Ellman, 1989, p 13). This development would be achieved through rapid growth and structural change (namely industrialisation) and collectivisation through centralised control of economic activity based on public ownership of the means of production.

By 1945 Romania was one of poorest countries in the region. The economy was mainly agrarian. When the communists took power, Romania was one of the least developed countries in the region and the whole continent of Europe. In 1930, only 7.9 percent of the population was engaged in industry.(Gilberg, 1975). The industry in the period prior to the Second World developed slowly both sectorally and regionally. The only large scale modern industry was the oil industry which was dominated by foreign firms (Tsantis and Pepper, 1979). Activity in manufacturing industry was low and concentrated in a few sectors, mainly in light and consumer goods industries, mostly based on agricultural raw materials and oil. Machine building, steel production, and the extraction of minerals and fuels were still underdeveloped. Industry was also geographically concentrated with most of the industries located in or around Bucharest, the semi-industrial region of Transylvania, around Craiova, and in the Ploiesti region with its rich oil wells (Tsantis and Pepper, 1979). Even the futile efforts by the government to develop an industrial base were weakened by the destruction inflicted by the Second World War that destroyed much of the industrial capacity.

In 1944, the pre-war regime was removed by a popular uprising, which was a broadly based progressive movement, leading the way for the formation of the Romanian Communist Party in 1947. The main aim of the development programme adopted was once again, to transform an agrarian society into a modern industrial economy. The efforts of the government concentrated in the early years on combating the damage inflicted by the war. National Income did not reach its 1938 level until 1950 and it was not until 1953 that the pre-war level of agricultural production was realised (Tsantis and Pepper, 1979).

Romania adopted a classical model of the Soviet planning model. The state owned the means of production as well as controlling distribution and exchange. In 1947 central planning as an instrument of state management of economic activities was launched in Romania. It started with two one-year plans. It was followed by a series of five year plans, the first of which was 1951-1955. The relationship of economic management to political control duplicated the Soviet system (Spigler, 1973; Avner and Montias, 1991; Demekas and Khan, 1991; Tsantis and Pepper, 1979). The economic system was headed by a council of ministers whose number and selection were the Communist Party's responsibility. The State Planning Committee (SPC), headed by Communist party members, prepared the plan targets and was responsible for its implementation through branch ministries. Branch ministries allocated inputs and decided on product use and distribution (Demekas and Khan, 1991).

Furthermore, the planning system in Romania was characterised by the following principles (Tsantis and Pepper, 1979):

- Comprehensiveness of the plan. The plan was the only tool used to administer economic activities. It covered the majority of sectors. Even the limited resources devoted to sectors outside the direct reach of central planners (private farming and housing) were included in the material balances of each plan.
- Continuity of planning. Short and medium term plans were continuously adjusted to coincide with longer term plans. It was left to enterprises to reconcile monthly, quarterly and annual plans to five year plans.
- Complementarity of economic activity. The objectives of a plan were set by the Romanian Communist Party (RCP) to ensure that economic activities were established on a complementary basis. In formulating the plan, there was an emphasis on the reconciliation of competing demands through either vertical aggregation (aggregation of sector/ sub sector plans) or horizontal aggregation (Judeţ[1] plans).
- Democratic centralism. The notion requires popular participation at the micro level (enterprise) and a degree of participation in drafting a plan. Differences were to be reconciled through dialogues carried out between central planning authorities and ministers. However deliberation of plans usually took a top-down approach as resource allocation in the economy at large was organised

[1] Regional units.

politically.

Gilberg (1975) shows that the gradual destruction of private banking and private manufacturing went hand in hand with the RCP's increasing power in the political realm. By 1947-48 the last remains of major private enterprise in industry were removed. The private sector only existed in small craftsmen, artisans, and small farm business (Turnock, 1974).

The system was based on central planning as a tool to organise economic activity while maintaining political concentration of power in the hands of a one party system. Via central planning and forced intensive industrialisation communist parties tried to transform agrarian societies into industrial countries in as short a time as possible to get out of an underdevelopment trap (Ellman, 1989; Smith, 1981). As a consequence, a large proportion of GDP was accounted for by industry, especially heavy industry, with high market concentrations. This was at the expense of other sectors such as agriculture and services.

There was a lack of formal market institutions and market infrastructure. There was no role for the price mechanism as an allocative tool. In Romania, prices were strictly regulated. Prices were determined by the plan on the basis of mark-up, with the exception of agricultural products sold by private farmers in the so called peasant markets, which were limited in size. Wages and allocation of labour were tightly

regulated, as the plan was dominated by the output target raising wages to attract more labour and the ability to fire workers were limited. The calculation of costs only included labour and intermediate goods, as no charge for capital, land and natural resources was considered. Such accounting procedures have impacted on the switch to market based activities since no real provision for depreciation or maintenance was built into the system and, hence, the Romanian economy has been left with a legacy of poor infrastructure that has implications for the likely outcome that can be expected from market reforms. Performance was determined by quantitative measures. Despite raising the importance of product quality, performance remained largely judged on the basis of achieving volumetric targets (Tsantis and Pepper, 1979).

Romania started from a lower level of development than many of the other Eastern European countries but as was the case prior to 1939 adopted forced industrialisation, as did other East European countries, as a development policy. Two phases of development strategy were adopted by the RCP:

- Extensive development path 1950-1965. The emphasis was put on creating new industries, especially producer goods, with the aim of combating the uneven development in the country. Therefore the strategy followed mainly the process of unbalanced growth.
- Intensive growth from the mid-sixties. The development strategy was changed by the RCP towards intensive industrial growth through capital deepening and broadening, targeting specialised secondary industries,

achieving greater efficiency from existing inputs as well as new endowments of capital and labour. In addition, there was a special emphasis on agriculture in terms of increasing funds to mechanised agriculture. This strategy laid the foundation for the succeeding two plans, 1976-1980 and 1981-1990 (Tsantis and Pepper, 1979).

Forced savings, in the sense that little was available to consume, and extensive investment at the expense of consumption continued to be the tool of industrialisation throughout the Communist period of rule in Romania. Both labour and capital inputs increased substantially in the industrial sector. The surge in industrial output was fuelled by a massive shift of labour out of agriculture. Industrial growth was impressive by world standards. In the period 1951-1976, the rate of industrial growth was comparable to that of Japan, Greece and Spain and only South Korea, Singapore and Iran registered a higher rate (Tsantis and Pepper, 1979).

Table 2.2 shows the growth rates of Romanian industry and agriculture from 1951 to 1970, the early years of socialism in Romania. While industrial growth rates show a continuing positive change, agriculture production declines substantially over the same period.

Table 2.2 Rates of growth of Romanian industrial and agricultural production (%)

Years	Industry	Agriculture
1951-55	+22	+5
1956-60	+18	-5
1961-65	+29	-12
1966-70	+23	-11

Source: Granick (1975), p 34.

The emphasis on industry and the production of producer goods as opposed to consumer goods is exemplified by the information for 1949 to 1955 shown in table 2.3 where a comparison is drawn between planned output and actual output. The concentration on producer goods was even more apparent for actual output than planned output.

Table 2.3 Actual and planned output by different sectors

	1949 (plan)	1950 (actual)	1951-55 (plan)	1951-55 (actual)
Industry	47.2	48.3	51.4	57.5
Producer goods	36.8	41.9	42.1	50.2
Consumer goods	10.4	6.4	9.3	7.3
Transportation and communi-Cations.	21.2	17.3	16.2	11.1
Agriculture and forestry	9.4	11.3	10.0	10.4
Housing, education, culture, Science and public health	11.0	14.2	.	11.0
Other branches	11.2	8.9		10.0
Total	100.0	100.0		100.0

Source: Montias (1967), p 25.

Another way of looking at industrial growth rates between 1950 and 1970 is via the use of growth indices. Table 2.4 compares the official Romanian Government's indices with those based on external independent calculations, the Lee-Montias Index and the Alton Index (see Granick, 1975 for more details). Although registering slightly lower growth rates than the official rates the external indices indicate that during the 1950s and early 1960s Romania experienced significantly high rates of industrial growth.

Table 2.4 Annual rate of growth of industrial output (percentage)

Years	Official index	Lee-Montias index	Alton index
1951-55	15.1	10.6	7.7
1956-60	10.9		9.2
1961-65	13.8		10.8
1966-70	11.8		
1956-58	9.7	9.5	
1959-60	13.1	15.4	
1961-63	14.0	12.2	
1964-65	13.6		
1966-68	12.1		
1969-70	11.4		
1971-75			
Directives	8.5-9.5		
Draft plan	8.8-9.8		
Final plan	II.0-12.2		

Source: Granick (1975), table 2, p 36.

One should be cautious in taking these data at face value. In the central planning system, industrial output was measured in terms of gross value rather than value

added. The output of each enterprise was measured at constant prices against a fixed base year defined by the central planners. The gross industrial output was the sum of gross output of enterprises in socialist industries (state industries plus co-operatives) plus craftsmen outside co-operatives plus small scale private industry. The use of the gross value measure rather than the value added measure adopted in market economies introduced an upward bias in the growth rates of industrial production. Such overestimation in official indices has been well documented for other East European countries (see Hodgman, 1954; Nove, 1986; Seton, 1957; Kaplan and Morsteen, 1960; Nutter, 1957; Ernest, 1960 for Poland; Staller, 1962 for Czechoslovakia; Stopler, 1960 for East Germany; Granick, 1959, 1975; Montias 1967; Smith, 1981 for Romania).

The level of investment in Romania was high, even compared to other East European countries. Granick's (1975) comparative study of Romania, Yugoslavia, Hungary and East Germany reveals that in 1966-1970, the ratio of net investment (net fixed investment plus increase in inventories as a ratio of national income) was 30.3%. This compares with 21% for East Germany. Although Romania had this high level of investment and relatively high growth rates, its economy suffered from a structural industrial imbalance. Consumer and light industries were not integrated into the modernisation programme. Eurostat's (1995) study of pre-transition Romanian industry shows that, even in the early 1950s, nine tenths of the industrial investment was assigned to heavy industry such as metal working and chemical industries.

Romania was a rich country in terms of natural and energy resources, such as oil, gas, and coal. However, as energy production targets were usually not met, industrial plant was only able to operate at less than half of its capacity. Large amounts of energy were produced with an emphasis on the supply of fuel and electricity rather than its efficient use (Patterson, 1994). Romania was self-sufficient in terms of oil and natural gas till the early 1970s when the country started importing oil and natural gas. The former was mainly imported from the Arab Middle Eastern countries while the latter was imported from the Soviet Union. In 1990, Romania imported two-thirds of its oil supply and two-thirds of its gas supply (Patterson, 1994).

Although Romania adopted a Stalinist model of development (forced industrialisation and monopoly of the communist party over the state apparatus), this was mixed with a nationalistic policy which seemed to represent the major political force determining the overall level of the country's model of development since the formation of the Romanian nation state. From the late 1960s, Romania began to adopt an independent path from the Soviet Union influence. During Ceausescu's period the leaders of the Communist Party employed nationalism as way to provide a legitimacy for the state. This was used to postpone the attempts to reform the system as well as distancing its self from the domain of Moscow (Tismaneanu, 1991; Tismaneanu and Pavel, 1994).

This independence was not only reflected in its economic policies but in other aspects of life: e.g. in schools Russian was replaced by English, French and German.

Romanian cultural activities took on fresh vitality. Romania refused to send troops to quell the 1968 uprising in Czechoslovakia. It did not take part in Warsaw Pact manoeuvres or allow them in Romanian territories. There were differences between Romania and the more advanced countries (Czechoslovakia and East Germany) over the heavy industrialisation drive in Romania in the CMEA (Montias 1967). The dissent with the other CMEA countries and the anti-Moscow polices turned Romanian authorities towards the West to fund future industrial investment.

Attempts to reform the economic system started in 1967 with the establishment of the "Directives" appointed by the central committee of the Romanian Communist Party. The responsibilities of the Directives were confined to improving the management of state-owned enterprises. These changes in economic organisation, as stated by Spigler (1973, p 4) were never described as reforms but instead as "improving the management and planning of the national economy (Perfectionarea conucerii si planificarii economici nationale)". The reforms were very limited, the enterprises still possessed very little autonomy and the system remained very centralised (Smith 1981). Investment was largely centrally determined, enterprises received detailed plan instructions, industry remained highly concentrated and monopolistic and the long term contracts were constrained by satisfying the plan targets not by introduction of economic factors (Demekas and Khan, 1991, p 4-5). Nationalistic policies, which put self-dependence as a prime target for Romania, were adopted.

By the late seventies it was apparent that the Romanian economy was running into a crisis and the extensive development model came to a halt. There were imbalances in the economy that resulted from the emphasis on the development of heavy industries. There were far too many branch plants producing intermediate goods with low levels of productivity rather than factories producing final goods. Industry was directed towards energy intensive and raw material consuming factories.

2.5 The Romanian economy prior to transition in 1989

Avoiding market-socialism and other reforms prior to the transition put the Romanian economy in a unique position in the context of East-European transition. Neither the partial market reforms such as those followed by Hungary and Poland nor the Yugoslav experience of workers self-management were adopted prior to 1989. Therefore Romania started the transition to a market system with a typical Stalinist model of development.

In each country the political decision by the post-socialist governments over the structural reform rested on the existing politico-economic situation. In Romania, the gradual approach adopted by the first post-socialist government was largely determined by what had happened under Ceausescu's regime and the policies followed in the 1980s. The deterioration in living standards, resulting from the self-sufficiency policies operating in the 1980s restricted the ability of the new government to implement shock-therapy treatment.

The state sector was totally dominant, with high levels of market concentration, and a relatively large proportion of GDP being produced by heavy industry, operating under rigid quantity targets. The employment structure also heavily favoured manufacturing (Daianu, 1991). Despite the same economic problems encountered by Poland or Hungary such as low productivity, shortages of consumer goods and freight, the Romanian state refused to reform the system. Cuts in both consumption and imports aggravated the problem. The country was forced to reschedule its foreign debt in hard currency "During the 1980s the quick reimbursement of a US$ 11 Billion foreign debt (20-30 percent of GDP) imposed severe constraints on the population. As there was no growth in exports (in dollar terms), in order to repay the debt, imports from the West were cut by one half over the decade" (OECD, 1998, p1). The Romanian Government at this time also ignored the role that modern technology could play in its drive to catch-up with the West (Jackson, 1990). These economic imbalances in the Romanian economy culminated in the crisis of the late 1980s that foreshadowed the revolution in 1989 (Opritescu and Korka, 1995).

By 1989 the Romanian economy was in a deep crisis. It suffered from several imbalances: first between consumer goods production and the means of production, second between raw materials and energy production and those consuming and/or employing such resources, third between industry and agriculture; fourth between services and infrastructure (Zaman and Bratu, 1997).

The Romanian economy thus suffered from structural industrial imbalance. Consumer and light industries were not integrated into the modernization programme. The Romanians also ignored the role modern technology could play in the catching-up process. It was not the concentration on heavy industry per se that distorted the Romanian economy but the lack of an effective industrial policy. Romania remained a classical example of the Stalinist model. No major reforms had been envisaged to allow for any decentralization of firms. Industrial enterprises in Romania were organizations oriented primarily toward production with limited autonomy and decision-making responsibilities outside production (World Bank, 1979; cited in Smith, 1981).

In December 1989, Romania started the transition from a state socialist, centrally planned economy towards a fledgling market economy. On the 22nd of December 1989, a bloody, popular uprising overthrew Ceausescu's regime. Within that week of popular disturbance, the President Nicolae Ceausescu and his wife Elina were executed following a military trial. On the 1st January 1990 the National Salvation Front (a new organisation that included members of the former regime), with the support of the army, assumed power.

2.6 Conclusion

This chapter has examined the development of the Romanian economy from the birth of its nation state in 1919 until the early transition period 1989-1990. Essentially, this period before transition was divided into two phases. The first phase includes the

period from 1919 to the pre Second World War. The second phase mostly includes the Socialist period which followed the war and lasted until early 1990. Economic activity throughout these periods has been concentrated either in cartels or private monopolies, supported and encouraged by the state, or in state owned and managed organisations. There was little in the way of active competition throughout this period which has had implications for the establishment of efficient markets in the transition period. There were also imbalances in the economy throughout the period 1919-1990 with emphasis on heavy industrial output, a shift away from agriculture and little emphasis given to consumer products. These imbalances were reinforced by a nationalistic output that looked towards self sufficiency and protectionism that again have implications for the path that transition could take in Romania.

Chapter 3

Neo-classical Theory and the World Bank and International Monetary Fund Policies towards Transition Economies

3.1 Introduction

The theoretical perspective central to this thesis is that history matters and that the transitional process in Eastern European countries is path dependent. The importance of tradition, habit and the past are features that tend to be downplayed or are even absent from the neo-classical orthodoxy. However, the neo-classical economics has retained its dominance in areas such as development economics and latterly in the economics of transition. In this chapter prior to the discussion of the path dependency approach, we discuss neo-classical theory and its policy implications. This is used as a basis for comparison with our alternative institutionalist approach, which recognises the need for an evolutionary analysis and recognises the role of path-dependent development. This approach which is developed in the following chapters offers a critique of the neo-classical orthodoxy and in doing so, offers a critique of the International Monetary Fund (IMF) and the World Bank policies.

The policy prescriptions of the World Bank (WB) and the International Monetary Fund (IMF) are driven by an adherence at the micro level to augmented neo-classical analysis and at the macro level by a new classical emphasis on the ineffectiveness of demand management policies. The emphasis has been on trade liberalisation, privatisation and structural change to establish efficient markets that then can, given a

stable macro economic environment, perform effectively. In this chapter the theoretical underpinnings of the IMF and World Bank policy strategies, "neo-liberalism" (Taylor, 1999; Gowan, 1995) or "Washington consensus" (Williamson, 1990, 1997), will be analysed, which can then be compared, later in the thesis, with the alternative interventionist approach, that we might label as the industrial strategy school of thought.

Section 3.2 focuses on the major developments incorporated into the standard neo-classical microeconomic model. Supply side new classical macro economic theories and policies are examined in section 3.3. Section 3.4 traces the application of neo-liberalism, which combines neo-classical and new classical economics, to the transition process under way in Eastern Europe. Section 3.5 draws some concluding remarks.

3.2 Neo-classical Microeconomics

Although there have been considerable refinements of the neo-classical paradigm the basic framework remains intact. The neo-classical model rests on three main assumptions: maximising behaviour, stable preferences and market equilibrium (Becker, 1976, p5). The market is seen as a collection of separate optimising individuals interacting with each other at prices exogenously determined by impersonal markets. These markets (given some assumptions regarding the

preferences of consumers and the technology of the firms[1] and other properties which makes the market perfect), lead to Pareto-optimal outcomes as the individuals maximise their utility or profit. Efficient markets work through ensuring the establishment of accurate price and incentive structures. Prices are assumed to transmit accurate information through the interaction of supply and demand. In the context of most economies, including those in Eastern Europe, it is believed that the deregulation of the economy, with the freeing up of market forces should bring about automatic removal of distortions in the economy. The model is mainly concerned with the problem of allocative efficiency where marginal cost equals the price. In equilibrium, rational people, independent of each other, allocate resources efficiently. As shown by Brada producers will economise in the utilisation of inputs, while consumers are expected to experience welfare gains, because they will not be forced to substitute initially unwanted for eventually unavailable commodities (Brada, 1993; cited in Hoen, 1998, p9).

The question of whether the neo-classical model of perfect information and Pareto-optimality coincides with reality has been raised even by neo-classical economists. However, despite the acceptance by neo-classical economists that our world is filled with imperfections, misconceptions and costly transactions, they insist that the model is

[1] In the standard neo-classical model, a rational assumption about the behaviour of firms is made. The model assumes a well behaved production function (Solow, 1956): market clearing in both output and inputs, one homogenous output, large number of identical perfectly competitive firms and consumers. Firms are competitive and maximize profits. There are two homogenous factors of production, labour and capital which are substitutable and can be aggregated to the sectoral and macro levels. Output is linear homogenous in the two factors of production.

useful (Boettke, 1996). Neo-classical economics follows a positivist methodology, where the usefulness of the model is put down to its ability to predict (Rogers, 1989; Arestis and Sawyer, 1993; Blaug, 1980). Extensions to the neo-classical model have incorporated information asymmetry problems and uncertainty, usually expressed in expected utility terms, to account for the complexity of market transactions.[2]

A major problem in neo-classical economics is the playing down of the role of institutions in market transactions which acts as 'constraints on behaviour in the form of rules and regulations' (North, 1981). As Hoen (1998) shows, standard neo-classical economics does not take institutions into account. They are assumed to exist, but do not restrict the behaviour of economic agents. The transparency of the market is perfect, while property rights are well defined, completely decentralised, and transferable at any time. In fact, within the neo-classical framework utility maximising consumers and profit maximising firms are restricted only by budgetary and technical constraints. It implies that transaction costs can be assumed to be zero. Attempts to incorporate institutions into the neo-classical world have largely concentrated on three approaches, public choice theories, transaction cost theories and property right (principal agent) theories which are largely described as new-institutionalist economics (Dietrich, 1994).

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[2] For example, within neo-classical circles there is a question of how much variation in output could be explained by the changes in labour and capital. The role of the residual has increased as the neo-classical economists try to include more factors of production, such as educated labour, to increase the robustness of the model. However as (Myant, 1999, p19) points out referring to Denison (1967) "there

3.2.1 Public choice theories

The revival of neo-classical ideas in the late seventies and early eighties rested mainly on the idea of state failure to steer economic development brought about, in part, by those involved having vested interests or adopting rent seeking behaviour. Up until then the main area of debate was why the state should interfere in the economy. Little emphasis was put on the effectiveness of this intervention. As Hoen (1998, p 8) shows "public-choice-like approaches focus on rent seeking and bargaining power of interest groups vis-à-vis governments, which represents the legal body that can reshuffle decision-making power over economic resources. In actual fact, receiving a larger share of the pie just implies (re-) allocation of property rights."

In this approach, the state can distort the market by providing subsidies or make provision in kind which divert resources away from productive activity (Bhagwati, 1982). According to the rent-seeking approach (Krueger, 1974) state protection in the form of import quotas, for example, would allow private agents to expand resources and increase their rents.

The state is also seen as a regulator which acts in its own self-interest, identified as the self-seeking enrichment of public officials. Public officials transfer income and other resources for the sake of political support by interest groups (World Bank, 1995b, 1996, 1997, 2000). Not only does this result in economic inefficiency, but it

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is always a gap between growth in measurable outputs which, in the classic empirical study, was attributed to vague notions of advances in knowledge or reduction in the lag in their application."

also worsens the income distribution when public sector leaders are the owners of wealth. In short the public choice argument rests on the premises that direct government policies distort the economy. Under directed credit, all production decisions are made taking into account signals that do not convey the scarcity prices of different inputs. (Seck and El-Nil, 1993). The conclusion that can be drawn from the public choice approach is that the continuation of excessive government intervention in the transition economies will distort rather than improve the allocation of resources.

3.2.2 Transaction costs approach

The existence of transaction costs is central to the new institutional economics. Transaction cost analysis is mainly driven by the attempt to revise the neo-classical assumption of perfect information (Ibrahim, 1998b). North, who received a Nobel Prize for his work on transaction costs explains his analytical methodology as "a modification of the neo-classical economics. What it retains is the fundamental assumption of scarcity and hence competition and the analytical tools of microeconomic theory, what modifies it is the rationality assumption. What it adds is the dimension of time"[3] (North, 1994, p 359).

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[3] A quote from the lecture Douglas North delivered in Stockholm, Sweden, December 9, 1993, when he received the Alfred Nobel Memorial Prize in Economic Sciences. Reprinted in the American Economic Review (1994).

Transaction costs may be classified under three headings: search and information costs; bargaining and decision costs; and policing and enforcement costs (Dahlman, 1979). Such costs arise in a world of uncertainty and are brought about by the participants in the market having bounded rationality and adopting opportunistic behaviour especially when dealing with specific assets or contracts that are susceptible to hold up (ransom) (Williamson, 1975, 1985).[4] The more generic the resource, product or contract the more likely that these can be exchanged and as such there are no 'sunk elements' associated with the transaction that makes transacting difficult.

The response to such transaction costs is the call for the development of institutional relationships that reduce the size of such costs. Thus, money facilitates beneficial exchange, while barter may flounder because of search, negotiation and enforcement costs. Hierarchies or firms develop because rather than using specific contracts to undertake market exchange less specific contracts can be used within the firm that minimise the number and complexity of contracts required in market exchange. Markets are seen to be effective in those cases where transaction costs are minimal but are less effective because of transaction costs that might arise in other circumstances. But adopting suitable institutional arrangements can re-establish the functioning of effective market behaviour.

[4] See Dunn (1996) for a critical review of bounded rationality and opportunism.

For Kamath (1992), transaction costs analysis is a powerful tool to analyse the political economy of suppressed markets. Building on Barzel (1974, 1976) and Cheung (1974, 1975, 1979), Kamath advocates that state regulation would only distort the proper functioning of the market and the contracting behaviour of economic agents. As he puts it "since commodities and services are complex, regulations cannot cover all margins subject to optimisation" (Kamath, 1992, p3). The role of the state is seen as being limited to establishing and enforcing the institutional arrangements and not being directly involved with the production or exchange process. So, in the context of transition economies this means that as long as some necessary institutional framework is established, for example the establishment of private property rights, then one can expect a more efficient allocation of resources via markets (contracts) or via quasi market relationships (firms).

However there remains a problem with the transaction cost approach. While it is possible to classify types of transaction costs, it is still not possible to give a precise definition or, indeed, submit them to empirical testing (Hodgson, 1993). Indeed, Coase (1937), the founder of transaction costs analysis, did not indicate the nature of these transaction costs. Nevertheless some researchers have used the approach to analyse institutions in transition economies. For example, Davis (1998) examines the commodity and financial markets in Russia in the period 1990-1996 using transaction costs analysis. The way the commodity exchanges are structured triggered high

transaction costs because of the manner in which property rights involved in trading were established.

3.2.3 Property rights approach

The issue of policing and enforcement that arises in the transaction cost approach is further emphasised by another neo-classical revisionist branch: the property rights approach. This approach has more direct implications in terms of policy proposals for Structural Adjustment Policies (SAPs) in both Third World countries and Eastern Europe. Coase's (1960) pioneering work on property rights emphasised the lack of institutions in the standard neo-classical model. He stressed that in the real world, where transaction costs are positive, exchange and trade are not costless, institutions are needed. If property rights were fully defined and allocated then transaction costs would not limit exchange relationships. Barzel (1989, p2) points out that property rights over assets consist of "the right or power to consume, obtain income from and alienate those assets. Obtaining income from and alienating assets require exchange; exchange is the mutual ceding of rights".

Davis and North's (1970) pioneering work asserts that institutions in terms of property rights, rules, laws and regulations require continuous adjustment in order to promote efficiency. These institutions are defined and enforced by the state. They examine the case of the US in the late 19th century and early 20th century to show that the institutional change which led to efficiency improvement, was initiated via

technological changes and market integration. They based their analysis on a public choice framework as such institutional change resulted from organised interest groups faced by transaction costs of bargaining and enforcement. North and Thomas (1973) took this argument further to explain the fall of feudalism and the rise of capitalism in Europe in terms of technological and demographic changes. Though the authors attempted to use historicity to explain institutional change and development, their reductionist methodology, which views institutions as mainly outcomes of maximising individual behaviours, only constrained by technology and natural endowments, simplify their work (see also, North 1987, 1990, 1973, 1994).

It is important to emphasise that despite the recognition that legal rights enhance economic rights they are neither sufficient nor necessary for their existence. Demsetz (1967) stressed this point as he argued that the creation of new property rights resulted from economic value, not legal explication, as people normally delineate rights according to the increase or decrease in the value of these rights.

For private ownership to exist, three elements should be satisfied: exclusivity of ownership, transferability of ownership, and constitutional guarantees of ownership (Pejovich, 1995, p,66-68). The exclusivity of ownership indicates that the owner of an asset has the right to choose what to do with that asset. However her rights are not absolute as they are restricted by law. The implication of this element is that it would create better incentives and greater value of assets as ownership internalises the costs

of resources (Pejovich, 1995, p 67). The second element (transferability of ownership) means that is possible to transfer assets to others at agreed terms. In a capitalist system the constitution guarantees the protection of private property rights as it separates economic wealth from political power (ibid.). Therefore clear and defined property rights are required to reduce the cost of transacting and overcome the problem of enforcement of terms of exchange (Becker, 1965; Cheung, 1981; Barzel, 1982; North, 1981, 1987; Littlechild, 1986). To property rights theorists, this set of clear private property rights leads to the efficient allocation of economic resources.

The implication of this line of reasoning is that countries undertaking transition to a market economy should privatise their state property.[5] Following Stiglitz (1994, p 12) "Coase's perspective has a clear prescription: market socialism, like any other form of socialism, is doomed, simply because ownership rights are not well defined. When property is owned by every one, it is in fact owned by no one; no one has the appropriate incentives. In this perspective, then, the first task in the transition to the market economy is privatisation of state property". In an economy based on collective ownership by the state the incentive structures that emerge from private ownership are absent and it is therefore difficult to exert control over management. Control of

[5] Bretton Woods institutions (the IMF and the World Bank) claim that private enterprises outperform public enterprises. According to World Bank (1987, p-6-7): "the performance of SOEs (state-owned enterprises) varies between countries, but their record has frequently been poor, particularly in developing countries. They have clearly failed to play the strategic role in industrialization that government had hoped for".

management in state owned enterprises is constrained by lack of information, co-ordination and incentives (Daviddi, 1995).

3.2.4 The separation of ownership and control (principal agent theories)

Although principal agent relationships are apparent across various aspects of market transactions it is the owner (principal) manager (agent) relationship that has been the centre of much of the revisionist neo-classical literature. The main problem tackled by the principal agent theorists is how to reconcile the different interests of the individuals engaged within a firm's activities. The principal, who is the owner of the assets, induces the agent (manager) to act in the principal's interest. In both the public and private sectors there are principal agent relationships characterised by asymmetric information leading to adverse selection (as a result of hidden information) and moral hazard (hidden action) problems (Martin and Parker, 1997, p12).

The separation of ownership and control and hence the question of corporate control of enterprises (Kay and Silberston, 1995) is not properly addressed in the standard neo-classical model. While the theory identifies the role of competition, it is silent on the ownership issue (Killick and Commander, 1988). There is no separation between ownership and control as the theory assumes that the owners of firms hold perfect information about the processes of production and distribution, and are also responsible for monitoring the firm. As Stiglitz (1991, p15) argues "many economists argued that there was no need to look carefully into the black box called the firm:

firms maximise profits (stock market value); if managers didn't, they would be replaced; and firms that didn't maximise value wouldn't survive. Accordingly, what went on inside the firm was mere detail. The behaviour of the firm could be described completely without knowledge of those details". The opening of the 'black box' recognises the role of equity markets as monitoring and control devices for suitably incentivised management. The faith placed in this mechanism gives rise to the belief that dispersed private ownership provides the only route to an efficient allocation of resources. Such a belief led to the switch from state to private ownership of companies in Eastern Europe without due consideration being given to the financial infrastructure needed by private firms.

Owners are residual claimants in the production process who, by maximising this residual, exert beneficial pressures on other groups that constitute the firm e.g. managers. Proponents of this claimant theory claim that the problem of dispersed owners not being aware of day-to-day issues is not an issue since, via the stock market, such owners can still act to discipline management by selling shares and opening up the prospect of take-over. To Grosfeld (1990), shareholders have stronger incentives to exercise adequate pressure on non-value maximising managers. If control fails and shareholders cannot design a compensation contract to provide incentives for value maximising, take-over helps to reassert the interests of share holders. This analysis exemplifies the Anglo-Saxon model of corporate governance. This model of aggressive competition and take-over does not require outside investors

to participate in corporate control, as control is operated through the capital markets and the value of shares (Corbett and Mayer, 1991). Consequently outside investors have little commitment to the long-term strategies of firms preferring, instead, to look for short-term profits. This outside control model stands in stark contrast to the inside control model, such as the German and Japanese models where commercial banks and mutual funds play an active role in enterprise restructuring, through cross shareholding and substantial enterprise equity holding (Corbett and Mayer, 1991).

The adoption of the Anglo-Saxon model by Bretton Woods organisations and subsequently transition economies has led to the development of stock markets in these countries and to the belief that privatisation is the only tool to create an effective enterprise governance structure (Kay and Silberton, 1995). Where the state maintains ownership and acts as the principal this is considered to be counterproductive to efficiency since it protects the enterprises from domestic and international competition. Whereas in a private enterprise the objective is profit, in the state-owned enterprise a multiple of objectives prevails. Private enterprises are assumed to perform better, as the monitoring of agent behaviour is more effective as the rights to profits are clear. To Grosfeld (1990, p141) shareholders have stronger incentives to exercise adequate pressure on non-value- maximising management in public firms.

However this argument in favour of privatisation as a means to achieve corporate control and efficiency has not gone without challenge even from within the Anglo-

Saxon model. For example, Bishop and Kay (1990) compared the UK privatised enterprises with those which were kept under public ownership and concluded that privatisation was neither a necessary nor a sufficient stipulation for improving enterprise efficiency. Their study demonstrates that, regardless of the form of ownership, most of the enterprises improved their performance, while total factor productivity increased at a slower pace in privatised firms than in their counterparts in the public sector. Vickers and Yarrow (1988) have also argued that privatisation in Britain in the 1980s showed that change in ownership was not the only determinant of economic efficiency, other factors such as the role of competition and regulation in the product and factor markets also influenced efficiency. In a case study of 20 developing and East European countries, Van der Hoeven and Sziraczki (1997, p 3) also argue that "a change in ownership in the absence of changes in regulations to allow for competition will not result in increased efficiency but in rents being transferred from public sector entrepreneurs (or bureaucrats in the public sector cashing in on these rents) to private sector entrepreneurs, who would be more than willing to pay a high price for a protected enterprise allowing them to cash in on rents".

Along with the establishment of private property rights, privatisation has been one of the key features in transition economies drawing on the theoretical arguments outlined above. This extended neo-classical framework, outlined above, recognises that the state plays a limited role in solving the problems of markets that prevent them from

being perfect, such as externalities, increasing returns to scale, monopoly power and public goods (Baumol, 1965; Bator, 1995). This view is compatible with the World Bank approach to market failure (Ibrahim, 1997). Here the role of government is largely confined to macroeconomic stabilisation necessary for the structural changes to happen with market failure being associated with imperfect knowledge or imperfections in the capital and labour markets. The conclusion drawn is that an active government industrial policy is irrelevant and that neo-classical policy prescriptions for transition should be adopted. Thus, for small countries that lack market power, the government's role is to facilitate the flow of information, to promote improvements in the operations of capital markets and to ensure adequate investments in human capital formation.

The IMF and World Bank deny that their bias against active public sector involvement at the micro level is based on ideological reasons. De la Rosière, a former managing director of the IMF (1986), claims that "advocacy of these policies is not a matter of theology. It is instead grounded in the lessons of actual country experience" (Singh, 1992, p 125.) However the validity of this statement has not gone without challenge. The empirical base of better performance of the private sector over the public sector in Less Developed Countries (LDCs) has been questioned (Chang and Singh, 1992; Kirkpatrick, 1986). Kirkpatrick's study of a sample of 23 countries in Asia, Africa and Latin America shows a very small and statistically insignificant relation between the size of the publicly owned sector and per capita

GDP and the rate of growth of GDP. Chang and Singh's extensive literature review of empirical studies in LDCs reveals that when controlling for variables such as size, age, industry, country, product mix, technology and quality and employing more appropriate (multiple) criteria which affect efficiency than merely ownership, there is little evidence to support large scale privatisation. A more updated literature review also reached the conclusion that in both developed and less developed countries there are mixed results regarding the relationship between privatisation and economic performance both at firm and industry levels (Martin and Parker, 1997). Van der Hoeven (1997), Rock (1997) and Kühl (1997) show that there is no causal relation between privatisation and economic efficiency. The experience of many transition economies, such as Romania, and the similarity of their economies to many LDCs elsewhere in the world, tends to confirm these results.

Much of above discussion has been concerned with the establishment of property rights and the recognition that there are transaction costs that might be overcome by appropriate institutional frameworks. While there has been some recognition of the role of institutions in this augmented neo-classical approach, there is still an issue as to what is fully meant by an appropriate institutional framework for transition. Though these theorists transcend the limited neo-classical analysis of allocative efficiency to take institutions into account, the individualistic approach to institutions restricts their analysis (Ibrahim. 1998a, 1998b).

"New" institutionalists adopt the neo-classical concept of rational man that then sees the development of institutions as the outcome (often unintended) of individuals' behaviour. The example of road behaviour and on which side of the road people drive is often taken as indicating how an institutional arrangement emerges from initially voluntary, rational economic behaviour (Schotter, 1981). The direction of causation is from individuals to institutions.

Adopting neo-classical methodology where competitive markets create new opportunities, in terms of scarcities and relative prices for individuals pursing their self interests, the "new" institutionalists investigate the economic system in terms of contracts or exchange relationships. The organisational institutions that arise result from the transaction costs of using the market and are seen as minimising transaction costs. The policy implications of this for the transition process are to transform the structure of the economy by the creation of firms that adopt the role of the market rather than combating the structural rigidities that might exist within the economy (Ibrahim and Galt, forthcoming). This outcome results from the continued adherence of the "new" institutionalist economists to the notion of supply and demand, and competitive equilibrium. Williamson for example believes that in the beginning there were markets and only as the market-mediated contracts collapse, are the transactions in question removed from the market and organised internally (Williamson, 1985, p87). This implies a passive or "adaptive organisation", in Lazonick's (1991) terms, as firms try just to cut down their costs. Questions related to the structure of

production somehow seem auxiliary. As Amsden (1997, p470) puts it, in the "new" institutionalism growth is retarded by high transaction costs, but why not by high production costs?

This has a direct impact in understanding the issue of institutional change in countries in transition. Murrell (1991), adopting the public choice approach, viewed the state in the command economy as a collection of individuals trying to pursue their own personal agendas. On the other hand, the property right and transaction costs approaches, while offering an insight into the problem of organizational behaviour, stop short of analysing the socio-economic context constraining such organizational behaviour. The self-interested behaviour and harmonious contractual relations adopted by the property rights school and transaction cost theorists does not put much emphasis on the historical and institutional nature of organisational forms, such as authority and employment relations (Dietrich, 1994). They downplay the state-society relationship in state socialism and consequently the multiple ways this relationship in the transitional period can play itself out. The diversity of transition experience is reduced to a linear process from an inefficient system to a more efficient. So the institutional building follows an ideal implementation of a generalized set of policy prescriptions, stabilisation and replacement of property rights. The pragmatic-constructivism (Hoen, 1998) of neo-institutionalism assumes a generalised concept of transition. It is seen as instantaneous adjustment without a past

(Ibrahim, 1998b). Although they appreciate the need for market institutions, they see them as emerging in a rational manner.

3.3 New classical macroeconomics

By the early 1980s, the world wide consensus over state-led development had broken down. The state was seen as the problem, not the solution. The Keynesian golden age of full employment, spectacular growth, low inflation proved to be no longer sustainable (Marglin and Schor, 1990). Supply-side approaches rooted in neo-classical economics began to come to the fore, notably monetarism (Friedman, 1968, 1977) and the new-classical economics (Lucas, 1977).[6] This neo-liberal paradigm (Gowan, 1995) became the main paradigm which dominated governments, the IMF and World Bank, and other financial institutions. Privatisation and liberalisation were seen as the only routes to development. The vast majority of Third World countries adopted structural adjustment programmes with more or less the same package of proposals based on the establishment of accurate price and incentive structures. It was believed that the deregulation of the economy, with the freeing of market forces would bring about automatic removal of distortions in these economies and enable effective prices to allocate resources (IMF, 1983).

The new classical theorists argue that the economy is always operating on the vertical aggregate supply function. Demand management has no systematic effect on output

[6] Hahn (1980) classified the two schools under one heading (monetarism).

as the economy only randomly deviates from its natural rate of unemployment.[7] Any systematic government management of aggregate demand will produce movements in the aggregate demand function which are anticipated. Rational agents will not entertain expectations which they know will lead to errors that could be avoided. By revising their expectations, they only generate random errors, since only these sorts of errors cannot be anticipated. The supply-side of these packages tries to improve the efficiency of the resources used and create appropriate incentives. This is usually performed through supply side policies that include liberalisation of prices and trade, cutting down wages and government spending.

To facilitate microeconomic adjustment, macroeconomic policies were advocated that on the demand side were intended to stabilise an economy by controlling inflation and correcting temporary disequilibrium in the balance of payments. IMF's Polak Model (1957) assumes that macroeconomic disequilibrium is a monetary phenomena resulting from excess domestic credit expansion (Dell, 1991; Kirkpatrick and Nixson, 1987; Bird, 1984, 1987; Killick, 1984; Shaw, 1973). However, it was increasingly recognised that any systematic attempt by the government to manage aggregate demand had no determinate effect on output. The main attack on Keynesian demand management came from the policy ineffectiveness thesis. This suggests that changes in aggregate demand brought about by fiscal and monetary policies have no effect on

[7] The new-classical concept of rational expectations (Lucas, 1977) is introduced into Friedman's natural rate of employment hypothesis to form the "policy ineffectiveness premise".

output and employment which are constrained from the supply side (Glyn, 1995). Based on this conclusion structural adjustment programmes, rather than aiming for demand expansion, aim at restraining demand and correcting price distortions, through the following policies: expenditure reduction through restraining demand, expenditure switching through directing resources from non-tradable production to tradable production and institutional reforms aiming at reducing the role of the state through fiscal reforms, trade liberalisation and privatisation (Cornia, 1987). In addition these policies emphasise the role of declining real wages in generating and correcting fluctuations in employment (World Bank, 1995a; IMF, 1992; OECD, 1992; Agénor, 1996).

According to Friedman (1968, 1977), the labour market is co-ordinated by movements in real wages and the natural rate of unemployment is the rate "which has the property that it is consistent with equilibrium in the structure of real wage rates" (Friedman, 1968, p8). In the standard neo-classical model of labour markets, an increase in wages above the equilibrium level reduces employment (Stigler 1946, 1947). The labour market is regarded in the same way as any market for commodities. In this scenario of homogenous workers, employment and wages are determined by supply and demand. If the supply of labour exceeds its demand, the level of wages paid will decrease so as to be equal to the last unit of labour employed, and the excess supply of labour will be absorbed by the firm (Porket, 1995, p 3) There is an inverse relationship between wages and employment as the demand for labour

slopes downwards as a result of diminishing marginal productivity. In a world of full information and frictionless markets, workers are paid according to their marginal productivity. At the prevailing market price, employers can employ as many workers as they wish and employees are well informed about the market, so they can always move from less paid jobs to higher paid jobs. If workers do not accept wages determined by the market or if institutional factors such as trade union power or minimum wage legislation hold the real wage above the market clearing level, the excess supply would not be absorbed by firms (Agénor 1996; Porket, 1995).

In this model higher wages have no effect on labour productivity, as the only impact of increasing wages is a reduction in employment (Rothschild, 1965; Eichner, 1986; Card and Krueger, 1995). Alternatively a cut in real wages (as, for example, outlined by Estrin, Schaffer and Singh, 1993) would result in a decrease in unit labour costs. In turn this would boost both output and employment leading to a productivity gain as the former rises more than the latter. A further impact of the lower costs that are implied by declining real wages is an increase in exports. Because of its importance to the policy recommendations relating to transition we test this low wage hypothesis for Romania in Chapter 5.

3.3.1 Trade theory and labour market

In addition to the neo-classical emphasis on micro adjustments in transition, such as privatisation, and the new classical emphasis on supply side policies, rather than

demand management policies, attention has also been given to the interpretation of international trade policies within a neo-liberal context (Nashashibi, 1980; Balassa, 1982; World Bank, 1990, 1991, 1993, 1996, 2000). Proponents of trade liberalisation argue that there is a strong and consistent correlation between trade openness and economic growth. They rest their premises on Ricardo's theory of comparative advantage where all countries involved in international trade would benefit from the process. The main objective is to put prices of goods in the domestic market in line with their counterparts in World markets. Imposition of tariffs, subsidies, export taxes and import quotas by governments, inhibits "getting prices right" as it deviates domestic prices from world prices (World Bank, 1990, 1996). Very restrictive assumptions underlie these premises, implying that all markets, including labour markets, should be free of imperfections and that there should be constant returns to scale and substitutability between labour and capital.

The pro-trade liberalisation argument is based on the need to liberalize the economy from the grip of rent-seeking politicians and bureaucrats. Since it estimated that there was a general statistical association between less intervention and lower price distortions, on the one hand, and higher productivity growth on the other, the World Bank (1991) emphasised the need for trade neutrality. The implication of this finding was that there was a positive relationship between openness and free trade, however measured, and growth (World Bank, 1991, 1993, 2000). Therefore the World Bank recommended trade liberalisation, which effectively meant reducing the extent of

government control of foreign trade.

It was argued that import substitution strategies should be replaced by export promotion strategies by directing countries into tradable sectors i.e. diverting the resources from the domestic to the export sector (Balassa, 1992). By exploiting their comparative advantage in low wage labour, newly developing countries, via free trade, would stimulate enterprises to improve their product-mix. In this approach supply is assumed to be relatively elastic and thus the drop in wages would stimulate exports and hence output, as supply creates its own demand (Ocampo and Taylor, 1998). Here, devaluation has an expansionary effect on economic activity. It is assumed that real depreciation would increase exports and lead to substitution from imports to domestically produced goods that would lead to an expansion in aggregate demand. (See Dornbusch and Werner, 1994 for the case of LDCs; Érdős, 1996 and Wunner, 1998 for Eastern Europe).

The analytical framework often adopted divides the economy into two sectors, tradable and non-tradable. Goods in the non-tradable sector are determined by supply and demand in the economy which are located in the sectors such as transport, electricity, finance and other services. Goods in the tradable sector, determined such as manufacturing and agriculture, are determined by world markets i.e. exogenously (IMF, 1996). An assumption is made that in an open economy a small economy can not affect world prices (Ghani, 1988; Demery and Addison, 1989). In a world of

perfect competition and flexible wages, trade can be further facilitated by devaluation of the currencies of newly transformed economies (the ratio of local currency/foreign currency exchange rate) which acts as a relative price change between tradable and non-tradable goods (Dornbusch, 1974).

Devaluation would have a positive effect on both supply and demand (Faini and Jaimi, 1990; Fontaine, 1992; Maizels, 1988). On the demand side devaluation increases the quantity demanded of the traded goods and decreases the quantity demanded of the non-traded goods. On the supply side, the devaluation tends to raise the domestically produced output of traded goods. The combined effect is an increase in the production of exports and import substitutes with resources transferred from the non-traded sector (Ocampo and Taylor, 1998). This results in expenditure switching, higher exports and improvement in the external position of the country concerned. Assuming full employment, production shifts from the production of non-tradable goods to the production of tradable goods. Ceteris paribus, such expansion in the production of tradable goods exerts a rise in the demand for labour, following the derived nature for factors of production. Employment is also expected to increase. Assuming a full substitutability between labour and capital, the rise in costs of imported capital following the real depreciation of the exchange rate works in favour of labour and leads to employment growth (Pack, 1976, 1982).

However, this argument is open to serious problems if the restrictive assumptions of perfect competition, and perfect substitutability do not hold. The hypothesis and the implications for growth in the demand for labour lose their validity if one rejects the Cobb-Douglas constant return to scale argument (the pillar of free trade theory) by assuming imperfect competition and increasing returns to scale (Helleiner, 1989; Kaldor, 1981; Helpman, 1990) which better explains the complexity of the real world especially in developing countries.

The expansionary free trade effect has also been subjected to the criticism that there is no perfect mobility of goods or factors of production. Mobility is restricted because of the imperfections in the world economy. The benefits of free trade may not occur as international trading operations are hindered through trading blocs, protection of agricultural trade and other methods of managed trade by Western governments and international organisations such as the World Trade Organisation (Singh, 1995; Krugman, 1993; Taylor, 1988).

This approach to devaluation has been attacked by the structuralists who argue that devaluation has a negative effect on output and leads to a higher level of inflation (Taylor, 1986; Krugman and Taylor, 1978; Taylor, 1989; Eshag, 1992). These arguments will be discussed in more detail in chapter seven. Structuralists show that nominal devaluation increases the costs of imported goods which consequently leads to an increase in the cost per unit of output and overall domestic price. However,

many commentators, including neo-liberal theorists, confirm the structural theorists. In an IMF working paper, Calvo, Reinhart and Vegh (1994) argue that real exchange rate devaluation is not a sustainable mechanism as a vicious circle is created through subsequent waves of devaluation, inflation and further devaluation. Kamin (1996) and Flood and Marion (1997) show similar conclusions. A panel data estimate for less developed countries experiencing stabilisation programmes by Morley (1992) found a negative relationship between devaluation and output. This conclusion was also ratified by an IMF staff paper (Lizondo and Montiel, 1989).

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Shafadeen (1995) shows that despite the difference in pace, sequencing and modalities from one country to another, the Bretton Woods institutions recommend neutralising incentives for exports and imports at low tariff levels through the removal of import quotas and other quantitative restrictions or their conversion into tariffs; subsequent reductions of the level and the dispersion of import tariff rates; compensatory devaluation of the national currency, and removal or reduction of export taxes.

The conclusion we draw is that microeconomic, macroeconomic and international trade theories associated with neo-classical economics have had a distinctive influence on the analysis and prediction of change for those countries moving from a socialist to a capitalist economy. These theories have also influenced the policy recommendations of the IMF and World Bank for privatisation, price liberalisation

and restricted government intervention in markets, as will be outlined in the rest of this chapter.

3.3.2 The 1980s: a lost decade for developing countries

Having set out the broad orthodox theoretical background to some of the transition issues, in the following section of the chapter we assess the effectiveness of the application of some of these theories to developing countries, thereby drawing some implications of the likely impact their similar policies might have on transition economies. The World Bank World Development Report (1996) has set the policy prescriptions for the post-socialist countries towards growth oriented, poverty alleviating programmes. The analysis in this report draws on two earlier reports (World Bank, 1991, 1993) where the term 'market-friendly' approach was introduced. The adoption of the 'market friendly' approach signified a potential change in direction for the World Bank compared to the policy stance adopted in the 1970s and 1980s. This section aims to compare this 'market-friendly' approach to that applied in the 1980s and the reasons that led to its adoption.

The 1980s was a lost decade in terms of economic development for many countries, although during this decade the transition economies were only in the early stages of changing from planned to market-based economies. Much of the economic development facilitated by the IMF and World Bank, through their structural adjustment programmes with their emphasis on macro-stabilisation policies and

micro-economic adjustment, failed to bring about the hoped-for change in economic performance from less developed countries (Singh, 1992b, 1992c). The Bretton Woods institutions' wishes of a lasting improvement in output, living standards and boosting the less developed economies have not been achieved. According to the Food and Agriculture Organisation's (FAO) statistics for Africa, the per capita GDP in that continent fell from $854 in 1978 to $423 in 1988, while external debt rose from $48 billion to $423 billion (FAO, 1991). GNP per capita in Latin America fell by 10% over the period 1980-1990 (World Development Report, 1990). Its foreign debt grew by 10.7% per annum from $287.8 to $409.8 billion, despite the fact that net payments of profits and interest amounted to $231.8 billion in the same period (Bernal, 1989, p. 113). By the end of the decade the severe decline in the standard of living in both continents was substantial.[8]

The orthodox interpretation of the Third World crisis in the 1980s blamed domestic policies as the main factor behind the crisis. But reducing the crisis to its national level underestimates the shock that hit the international capitalist system during this period. The oil price shocks in the 1970s which involved a large increase in financial accumulation by OPEC producers affected non-oil LDCs as recognised by Allsop and Joshi (1986). The recession in the industrial countries, brought about initially by the

[8] The United Nations Commission for Latin America concluded that: "a tremendous step backwards in the material standard of living of Latin American population in the 1980s. In 1990 44% of Latin America's population were living below the poverty line" (ECLA in Petras and Morley, 1992). The FAO report revealed that more than 55% of the rural population in Africa lived in absolute poverty (FAO, 1991).

oil price rise, reduced OPEC surpluses and tended to pass the deficit to the Third World and Eastern Europe through reductions in the demand for their exports. The non-oil LDC's continued importing and financing their increased deficits by running down reserves, which had been substantial due to previous high commodity prices and borrowing on international markets (Allsop and Joshi, 1986).

In addition, the terms of trade adversely affected primary producers. The world financial environment changed for the worst; real interest rates rose: the US dollar in which most of the debts of the LDCs were denominated, rose in value. [9] Rather than being the result of domestic mis-management, an alternative argument can be forwarded that the LDCs were not the main cause of the problems experienced but were rather the recipients of adverse factors affecting the world economy which were beyond their control (Singh, 1992b; Chakravarty and Singh, 1988).

However, the neo-classical school interpreted the debt crises of the LDCs as a temporary state of disequilibrium interrupting the financial system, which they regard as inherently stable with economies tending to a dynamic equilibrium. As Michael Beenstock argued: "there is no fundamental threat to the world monetary stability - there is nothing to fear but fear itself." The liquidity crisis was regarded as temporary in nature, and it would disappear as suddenly as it rose (Beenstock, 1984, pp 224-225). Thus, the debt crisis was understood as a temporary liquidity problem for each

[9] It came to a crunch when Mexico, one of the major debtors, declared in 1982 its inability to pay its debts, followed by other major debtors, and the debt crisis spread across the Third World.

country that should be treated on a case by case basis. The partial forgiveness and the write-down of debt should only be given to countries that follow radical adjustment programmes. If this has an adverse effect on the lives of the people, it is because of unfortunate but unavoidable circumstances. What matters in this approach is the ability of the debtors to service their debts. The reasons for their indebtedness are not of much concern.

Given the viewpoint outlined above and the continuation of structural adjustment programmes imposed by international agencies to install what were perceived as sound market practices in LDCs, it is not surprising that development through this period was stifled. The direct consequences of the SAPs, such as reduction in aggregate demand and cutting wages and social services, could have led to disturbances that threatened economic instability. Such an environment stifles private investment, which hesitates to invest in such a situation of uncertainty. It also, most probably, leads to capital flight from those countries affected.

At the end of the 1980s and beginning of the 1990s 'safety net' programmes, targeted at low income groups who were highly affected by the imposition of the structural adjustment programmes, were included within the revised SAP packages. This led to the adoption of terms such as "structural adjustment with a human face" and "market friendly approach" into the World Bank literature. The common link between the

two terms is the 'soft' defence of the market base of the structural adjustment programmes compared to earlier stages of their implementation. The 'SAPs with human face' refers to the UNICEF work in the late eighties which was then adopted by the World Bank as a response to the increasing social cost of the SAPs. These programmes include social safety nets to protect the poor by targeting the most vulnerable groups, targeting scarce state support on the poor and vulnerable (e.g. by moving from general food subsidies to targeted subsidies or feeding programs to the very poor) (Messkoub, 1992).

Many questions arose out of these programmes, which are still not answered: what criteria are used to define 'the poor'? What are the causes of poverty and are they linked to the SAPs? Is it possible to implement such social safety nets with minimum state action, which remains a pillar of the SAPs? Is it plausible to implement these changes on separate programmes without being a part of a holistic, integrated social programme? Such handouts to the poor are neither a new phenomenon in World Bank history nor an attempt to change its policy. This approach tries to avert the eyes from the contradiction between its structural adjustment programmes and social welfare, and diverts attention away from questioning who loses and who gains from such programmes.[10]

[10] Tracing World Bank history, the same scenario occurred at the end of the 1970s when McNamara, the ex-President of the World Bank called for a credit scheme to help 100 million of the poor in the Third World following the World Bank green revolution and modernization programs which had a damaging effect on the Third World countries.

3.3.4 The World Bank market friendly approach : a new direction?

A comparison between the World Bank Report in 1981 and the 1991 Report referring to the market friendly approach reveals how mildly the latter criticises the role of the state in relation to the market compared to the former report. This does not deny the new classical basis of both reports. Yet, the former concentrates on the state as an obstacle to development and the latter stresses how the state can furnish the way to the market to allocate resources efficiently. The World Bank report (1991) defines its market friendly approach in the following terms: a central issue in development and the principal theme of the report, is the interaction between governments and market. This is not a question of intervention versus laissez-faire. The 1991 report supports the view that competitive markets are the best way yet found for efficiently organising the production and distribution of goods and services. Domestic and external competition provides the incentives that unleash entrepreneurship and technological progress. But markets cannot operate in a vacuum - they require a legal and a regulatory framework that only governments can provide. And, at many other tasks, markets sometimes prove inadequate or fail altogether. This is why governments, must, for example, invest in infrastructure and provide essential services to the poor. It is not a question of state or market: each has a large and irreplaceable role (World Bank, 1991, p 6).

The report draws on the example of South Korea interpreting it as a successful application of this approach which ensures the establishment of accurate price and incentive structures. It is believed that the deregulation of the economy, with free market forces, could bring about an automatic removal of distortions in these economies. The East Asian miracle is attributed mainly to their sound macroeconomic policies: high saving and investment rates; export-driven growth; and investment in education. The report also emphasised the importance of providing social services, and fostering a productive climate for enterprises at the macro level via stabilisation cum liberalisation policies that would correct price distortion. However at the micro level, the role of industrial policy has been rejected. There are a number of commentators (Amsden, 1989; Wade, 1990) who have suggested that the success of South Korea has been due in large part to a more active government industrial policy, a view that fits the industrial strategy discussed later in the thesis.

3.3.5 Industrial Policy: the World Bank View

The World Bank Report (1993) questioned whether active industrial policy by governments had improved productivity. The report assessed productivity with reference to the concept of total factor productivity, which is evaluated by utilising the neo-classical Cobb-Douglas functional form assuming competitive and substitutable factors of production and constant returns to scale. In the case of Korea, the report notes that "although the Korean government selectively promoted chemicals and iron and steel, the large growth in the share of iron and steel was accompanied by quite low Total

Factor Productivity (TFP) performance between 1966 and 1985" (World Bank, 1993, p.316). The report goes on to deny the role of East Asian governments in promoting industrial growth: "we find little evidence that industrial policies have affected either the sectoral structure of industry or rates of productivity change" (p.21). Industrial policies were largely ineffective (p 321). The World Bank's econometric results are compatible with the neo-classical literature where an active industrial strategy has strong implications in terms of unproductive rent seeking.

The World Bank Report (1996) on government failure, argues that "government interventions may be guided by political objectives, be poorly implemented, create vested interests, or give rise to rents and corruption" (p.111). Therefore the report's recommendation for Eastern Europe was a " slimmer government" using the Bank's terminology. The need for such a slimmer government in neo-classical economics is based on three further arguments, to those presented earlier in the chapter, as shown by Wade (1995):

- The information available to public officials is inherently more limited or inaccurate than for decentralised private agents. This questions the ability of government to carry out its intentions, whatever they may be.
- Government interventions create 'rents' for those captured private agents who use resources 'wastefully' or 'unproductively', in growth-inhibiting ways. This likewise questions the ability of government to implement its policies with the intended net effects (because the costs, once broadened to include the

unproductive use of resources to capture government created rents, are likely to exceed the benefits).

- Government officials tend to seek objectives only distantly related to the ostensible public purposes of their agencies, especially because their behaviour is less constrained by anything analogous to the profit imperative for business people. This argument questions the extent to which the real, as distinct from publicly stated- objectives of government actions are to correct market failure and promote the public interest.

The above analysis shows an acceptance of the role of the state in development which is confined to the case of market failure. One can see that the shift from the case of the state as an obstacle to development to the one correcting market failure could be related to both theoretical development within the neo-classical development and the social consequences of the application of structural adjustment programmes in the 1980s. However the policy recommendations have not changed. Neo-liberal theorists argue that state intervention has conformed to free market principles, or using Amsden's (1990) terms, has got the relative prices right as the state enhances the forces of supply and demand to push prices of key resources, such as foreign exchange and capital, to their equilibrium or scarcity levels. So, the successful growth of the 'tiger' economies is explained by the adoption of macroeconomic stabilisation policies, investment and high levels of education.

Placing the role of government at merely the macroeconomic level deprives it from influencing any institutional changes. As Myant (1999, p17-18) puts it, "the government's contribution need not only be in providing measurable inputs. It may have a crucial role in ensuring a balance between them and in creating the basis for their interaction." The World Bank's Report (1996) calls for a case by case judgement on whether the state should intervene to correct market failure. In the Bank's words "well-intentioned government intervention to correct market failures may prove even worse than sub-optimal private provision" (World Bank, 1996, p.111)

3.4 Neo-liberalism in Eastern Europe

East European countries are classified within the middle income counties (World Bank, 1996; Bruno, 1992). SAPs were recommended by the IMF and the World Bank as the solution for the same problems faced by the middle income counties such as Brazil, Chile, Argentina and Mexico in the 1970s and 1980s. As pointed out by a member of the IMF staff, Michael Bruno (1992, p 742), both the objectives of the reforms and the tools used to attain them are similar to those adopted by middle income countries. To Bruno, the similarity between the aims of reforms in Eastern Europe and other middle-income countries could be summarised as an attempt to integrate these countries into the world economy by opening up their economies and moving from controlled and distorted domestic relative prices to relative world prices for tradable goods. This suggests the use of macroeconomic stabilisation policies to control prices, and internal and external balances, thereby controlling inflation (which

was generally repressed by open budget deficits, monetary overhang and soft budget constraints), and stimulating economic growth (Bruno, 1992).

The analysis above follows a typical monetarist analysis that assumes that aggregate output is exogenously determined from the supply side (Lipton and Sachs, 1990). IMF stabilisation policies take a monetarist approach that prioritises control via aggregate demand. The main task of IMF macroeconomic policies in Eastern Europe has been to ensure that price increases from price liberalisation (and any inherited inflation) are under control through cuts in government spending, balanced budgets and income policies to induce acceptance by workers of the current real wage level (Glyn, 1995, p 127). The consequences of adopting this approach is a general acceptance that aggregate output is expected to decline at the early stages of transition followed by recovery in what is known as a J-curve (Blanchard, 1997).

The downward part of the J-curve or the initial decline of output was put down to a variety of reasons which were mainly supply side constraints on the reallocation process. Kornai (1994) views the output decline as an inevitable symptom of a transformational recession which directly resulted from the system shift from central planning to a market economy. This view is shared by Blanchard (1997). To Blanchard the emphasis is on getting prices right. The downward slope of the J-curve in the early years of transition arose from price and trade liberalisation and the alleviation of subsidies. Atkinson and Kehoe (1996) emphasise the presence of

labour market frictions. Some theorists relate the downward part of the J-curve to external shocks such as the dismantling of the Council for Mutual Economic Assistance (CMEA), or the sanctions against Iraq following the Gulf war (Korka, 1995). To others the recession was due to tight macroeconomic policies or 'credit crunches' (Calvo and Corricelli, 1992).

The IMF has attempted to impose policies largely influenced by neo-classical and new classical ideas on Eastern European countries in a similar manner as those imposed on third world countries. The expected outcome from such stabilisation and liberalization policies is the same, i.e. the re-establishment of efficient market prices and a reduction in price distortions. Not only is the theoretical basis of these policies questionable, but it is also dubious why the IMF and the World Bank should seek to impose policies previously applied to LDCs onto Eastern European countries. Such an approach is limited as it ignores the distinctiveness of the centrally planned economies. The Eastern European economies lacked market institutions for decades which implies a completely different conceptualisation of how markets work whether smoothly as in the Western markets economies or constrained by structural problems as in the third world countries. This issue is developed in chapter 3 where it is shown that the planned economies of Eastern Europe lacked market institutions for decades. Prices did not reflect scarcity and economic activities were chiefly directed and co-ordinated by command.

As Svejnar (1991, p124) argues the initial conditions in the reforming Socialist counties at the start of transition were characterised by the following: "limited extent of domestic markets and the isolation from the world markets; centrally fixed absolute prices; incentives that were unrelated to economic efficiency; policy imperatives like the maintenance of full employment; a lack of well defined property rights; an absence of institutions for accounting, antitrust, audits or taxation and the relative absence of market transactions". These conditions led to similar outcomes which could be summarised as following: "misallocation of resources, obsolete infrastructure and capital equipment, low productivity and income levels, insolvency and slow adjustment of many state-owned enterprises, and severe ecological problems."

Also, unlike the LDCs, the tradable sector (industry) in Eastern European countries was large (see Table 3.1). For example, in Romania the size of the industrial sector accounted for 50 per cent of the output of the economy, whereas the service sector accounted for 36 per cent. If we compare Romania with a similar sized LDC then the expected size of the industrial sector would be 36.8 per cent of the national output and services would be 49.6 per cent. Therefore, in the Eastern European countries industry was very large compared to the countries at the same level of development, while agriculture was over sized in both Eastern Europe and LDCs. Therefore the tradable sector was very large compared to the non-tradable sector, especially services.

An empirical study carried out by Dohrn and Heilemann (1996) sought to measure the extent of structural changes in the transition countries of Eastern Europe. They employed the Chenery Hypothesis (CH) that relates the sectoral structure of an economy to its level of development, size and natural resource endowments. The paper first applies this hypothesis to a sample of 31 developed and developing countries. The results attained are used to measure the distortion in the existing economic structure of East European countries and form a forecast of future structural change. The conclusion of the authors is that these countries will face a high downsizing in industry while the service sector remains small.

This structural difference between Eastern European countries and LDCs makes the attempt to apply the neo-classical thesis of "getting prices right" difficult. In socialist Eastern European countries, prices of non-tradables (public transport, electricity heating) were drastically lower than those of tradable (Winieki, 1993). In addition, price distortions inflate the share of the already oversized industrial sector even more and, conversely, deflate the shares of agricultural and service sectors. Therefore, in practice, industry shares are not as inflated as they might seem.

Table 3.1: Relative size of industrial sectors in Eastern Europe (actual and expected) around 1980 (in per cent)

Country		Actual	Expected
Bulgaria	Agriculture	19.0	10.4
	Industry	63.0	36.0
	Services	18.0	53.3
Czechoslovakia	Agriculture	8.0	7.8
	Industry	71.0	37.5
	Services	18.0	55.0
East Germany	Agriculture	10.0	6.0
	Industry	69.0	37.5
	Services	21.0	56.3
Hungary	Agriculture	15.0	10.0
	Industry	59.0	36.8
	Services	26.0	53.2
Poland	Agriculture	16.0	9.2
	Industry	64.0	38.4
	Services	20.0	52.4
Romania	Agriculture	14.0	13.6
	Industry	50.0	36.8
	Services	36.0	49.6
USSR	Agriculture	16.0	7.5
	Industry	62.0	38.0
	Services	22.0	54.5

Source: Winiecki (1993, p10), table 3.

3.5 Conclusion

This chapter has covered a wide range of issues. The theme of the chapter has been that at both a theoretical level and a policy level the emphasis has been on the efficiency of markets as a means of allocating resources and at most governments are required to facilitate the institutional change towards markets, to monitor these changes and at the macro level to adopt stabilisation policies to control inflationary tendencies. The augmented neo-classical view has moved from a simplistic,

frictionless world it once inhabited but has not moved that far. There is still the over arching belief that government intervention should be restricted to 'oiling the works' to reduce frictions in market exchanges rather than the need to adopt a different force to create the momentum required for sustainable growth in Eastern European countries.

We have sought to examine the neo-classical and new classical theoretical underpinnings of the IMF and World Bank policies on transition and development concentrating on the influences such theories have had on the policies recommended for less developed countries and latterly for Eastern European countries. Although there has been a shift towards a more market friendly approach there is still a strong commitment to privatisation, development of markets and a limited involvement of the state. This arises because of a lack of a robust historical and institutional basis for theorising. Even with the developments within neo-classical economics, it is still fully based on based on ahistorical and aspatial economic relationships that take place in a vacuum.

Chapter 4

Alternative Approaches to Transformation in Transition Economies

4.1 Introduction

In chapter 3 we argued that the underpinning theoretical basis of the IMF and World Bank policies has been essentially an augmented neo-classical view of micro-economics and a new classical view of macro-economics. In this chapter we first examine how commitment to these theoretical strands has largely reduced the debate on economic transformation in Eastern Europe to one concerned with the optimal pace of transformation. Two main approaches have emerged from this theoretical basis, that of 'shock therapy' or 'big bang', favoured by the IMF and World Bank, and that favouring a more gradual path towards a market economy as shown in section 4.2. While both approaches tend to favour markets over governments as the basis for resource allocation they differ over the time period in which the process should be implemented.

Besides the alternative neo-classical views on transition there are a number of other different views on the transition process. The second part of the chapter presents some of the alternative theoretical approaches to the transformation process looking specifically at the Austrian view, the Industrial Strategy approach and institutional approaches. Section 4.3 discusses the Austrian view and industrial strategy approaches. Section 4.4 show how different views of transition lead to different recommendations for institutional change by confronting the new-

institutionalists and augmented neo-classical interpretations of institutions with those derived from old-institutionalism. Section 4.5 draws some conclusions.

4.2 Shock Therapy and Gradual Path

The shock therapy approach advocates that the precondition for any successful reforms should include early and rapid transformation of property rights, restrictive monetary and fiscal policies, and flexible exchange rates (Donnorummo, 1998; Daianu, 1996; Sachs, 1990, 1992, 1993; Sachs and Woo, 1994; Woo, 1994; Woo, Parker and Sachs, 1997; Borensztein, 1993). The belief being that countries which carried out radical reforms (shock therapy) perform better than those adopting a more gradual approach to reforms. Donnorummo (1998, p.1) argues that "those countries which swallowed their bad tasting medicine early and in large doses have been more successful than those which have attempted to implement a more gradual approach".

Woo (1994, p 277) defines the shock therapy (big bang) treatment as a simultaneous implementation of the following measures:

- Almost complete price liberalisation.
- Liberalisation of the trade sector by the devaluation of the currency and removal of trade barriers.
- Adoption of non-inflationary macroeconomic policy through tight fiscal and monetary policies. It includes the reduction of any budget deficit, primarily by cutting subsidies to the state owned enterprises (SOEs).

Monetary policy aims at producing positive interest rates and eliminating preferential credit to SOEs.

- Legalisation of private economic activities, decentralisation of production and investment decisions, and announcement of impending privatisation of SOEs.

According to this view it is essential to undertake a radical, irreducible minimum set of changes that are crucial to moving to a market economy. All the programmes adopted should entail a set of liberalisation, stabilisation and privatisation policies that should all become operative at once. Any output collapse that results from the change can be blamed on the previous inefficiencies of the old regime rather than on the shock therapy itself. Were shock therapy reforms not taken, the output decline would be prolonged unnecessarily (Sachs and Woo, 1994). New-institutionalist views of rent seeking have underpinned much of the argument proposed by supporters of shock therapy. Those who argue for shock therapy claim that governments in Eastern Europe can only ensure their credibility and commitment to transition if rapid change is adopted.[1]

Sachs (1992)[2] gives four major risks that East European countries could face if they do not privatise quickly. First, workers and managers in state enterprises

[1] According to Sachs " the need to accelerate privatization is the paramount economic policy issue facing Eastern Europe. If there is no breakthrough in the privatization of large enterprises in the near future the entire process could be stalled for years to come." (Sachs 1992, p.15).

[2] As Sachs, an active advocate of the Bretton Woods institution policies, applies the popular neo-classical term of interest groups (the state is considered as a collective of individuals trying to capture personal gains through the state apparatus) in his first two points, he reveals the current prejudice of the World Bank and IMF to Eastern Europe transition.

constitute a coalition to maximise their short run incomes which would lead to a renewal of wage-price spiral and large budget deficits. Macro-economic instability would follow and this could drain the reform process. Second, political parties will find an active base of support in the bureaucracy and among public sector workers and managers all of whom have a stake in the enterprise, and will resist privatisation unless it includes compensation. Third, privatisation will become associated with unemployment and the government will slow down the reform process for employment objectives. Fourth, former owners will demand a restitution of their property, and thus will discourage investment especially from abroad. A state by its own nature creates interest groups that oppose economic reconstruction whatever political and economic circumstances dominate. Although the Communist Party bureaucrats may have been disbanded, the new state creates its own groups which can only be challenged by quick privatisation.

This view is also held by Kornai (1992), who considers that the size of governments in Eastern Europe is still too large, and should be reduced. He suggests the following recommendations to bring these states to a desirable level:

- Combating state administrative expenditure.
- Getting rid of both assistance to loss making firms (by hardening the current soft budget constraints) and unemployment benefit.
- Reducing the taxation on the private sector.
- Cutting down the welfare expenditure.

In this approach one should not worry about the consequences of these recommendations, as it is inevitable to destroy the old institutions in order to create a healthy development of markets, i.e. these policies act as mechanisms for creative destruction (Woo, Parker and Sachs, 1997).

The gradual approach opposes the shock therapy treatment. Structural adjustment programmes should be applied gradually especially trade reforms and price liberalisation as market forces take time to emerge (Dewatripont and Roland, 1992; Dewatripont and Roland, 1995; Murrell, 1991; 1992a; Murrell, 1992b).

Dewatripont and Roland (1995) present a model of transition which has uncertain outcomes. The government is faced with the choice of adopting shock therapy or gradual reform. To Dewatripont and Roland (1995, p 1208), the superiority of gradualism over a shock therapy reform is based on two factors: "(i) gradualist reform packages have generally higher ex ante feasibility and can thus start earlier, and (ii) sequences of reforms may create constituencies for continuing reforms and increase irreversibility of enacted reforms". Therefore they suggest that in the case of a negative aggregate outcome, the shock therapy approach is politically unfeasible due to high reversal costs.

To Dewatripont and Roland (1992), the major cost of reform is the compensation payment to laid-off workers. Based on the neo-classical concept of allocative efficiency, transition necessitates labour reallocation and massive layoffs to achieve a Pareto-optimal situation. This induces costs to the state budget whatever

the pace of reform. The merit of gradualism is that that allocative efficiency is reached sequentially with lower costs. Their preferred tool is compensation payments in terms of exit bonuses, which should target workers with the highest relative outside opportunities. When these workers leave, the following plan should target those with the highest relative outside opportunities among the remaining workers. This method is adopted till allocative efficiency is realised.

Although the gradualists finely address how the structural adjustment policies could both hinder a conducive environment for growth and trigger social instability, alternative policies have not been addressed. They stop short of questioning whether the gradual polices could either result from consistent policies trying to sustain economic growth or arise because of hindrances affected by political factors. This is largely due to their adherence to neo-classical economics. Murrell (1991) acknowledged that the standard neo-classical model is simplistic. However, to him, it is still valid at a high level of abstraction and should underpin the policy reform. " The debate on reform is driven by the metaphor and the simple model rather than by the details of modern theory and knowledge of western economic institutions" (Murrell, 1991, p 73). He goes on to claim that " in the battle of competing visions in economic reform, the invisible hand paradigm commands a powerful position. It is the only theoretical perspective that affords the possibility of declaring the superiority of one set of arrangement - unrestrained free markets" (Murrell, 1991, p 73).

One can see that both approaches adhere to the neo-classical J-curve where output collapses first, then recovery follows according to a supply response (Blanchard, 1997). The downward part of the J-curve or the initial decline of output, can be explained by a variety of reasons, as was indicated in chapter 3. These reasons were mainly due to supply side distortions (Kornai, 1994; Blanchard; 1997; Atkeson and Kehoe, 1996; Korka, 1995; Calvo and Corricelli, 1992).

The main disagreement is on the upward part of the J-curve. Both accept the package of reforms which includes stabilisation and liberalisation that lead to the same objective, i.e. Western capitalism, notably the Anglo-Saxon variety. What seems to distinguish the two approaches is the cost of reform. Both approaches agree that there is a cost incurred in transforming centrally planned economies into market economies. The gradualists argue that shock therapy treatment entails social costs therefore governments should apply these reforms step-by-step. On the other hand, the shock therapists accept that there are costs of reforms, but argue that shock therapy is the only option open for the countries of Eastern Europe.

The IMF and World Bank structural adjustment programmes were mainly established to deal with the problems of less developed countries and to give an impetus to economic growth. However, much of Eastern Europe, during the socialist era, had achieved a relatively stable path of economic development, albeit recognising the constraints of trying to maintain an egalitarian system. In such circumstances any shock therapy was likely to have negative as well as positive

impacts since rapid change tends to destroy many of the institutional arrangements already set in place before alternative arrangements become operational.

Thus, for example, in most Eastern European countries, workers enjoyed full employment with complete employment security. However, full employment policies did not mean a guarantee of a specific job, rather it meant assurance of a job in a specific firm. Therefore rather than the ability to lay off workers, managers were only able to induce significant intra-firm mobility (Porket, 1995). Labour hoarding was prevalent in the socialist systems. Only disciplinary layoffs were allowed and there were implicit incentives for managers to maintain excess capacity in order to meet production targets (Svejnar, 1991). Trade unions, which were part of the state apparatus, were not involved in collective bargaining and strikes were banned by law. Their main tasks were to ensure that plans were properly executed (Ruble, 1981).

Critics of the shock therapy approach argued that the sharp decline of output in the period 1989-1992 could have been avoided if a gradual approach, similar to that adopted by China and Vietnam, had been adopted. However, Eduardo Borensztein, Deputy Chief of the Commodities and Special Issues Division in the IMF's Research Department, rejected this argument, instead arguing that shock therapy was unavoidable in Eastern Europe (Borensztein, 1993). In contrast to countries such as China and Vietnam, economic and political circumstances at the start of transition precluded any choice of a gradual approach. Those countries were in a state of limbo, facing collapse of central planning without a trace of a

market system to organise production. They faced large shortages of products and macroeconomic disequilibrium. In these countries the financial system was also underdeveloped with a banking system based on mono-banks and a non-existent capital market. Decision-making concerning investment and subsidies was taken at senior governmental levels following strictly defined plans. The bond market did not exist and public sector deficits were merely translated into the creation of credit (money). Interest rates on deposits were historically maintained at such low nominal levels that the real interest rate charged to firms was zero or often negative (Svejnar, 1991).

Therefore, shock therapy advocates claim that for all the East European countries, the abrupt collapse of communism in 1989 negated any possibility that prices and trade could be liberalised gradually, because the political authority to steer such a plan had disintegrated.

Despite the differences in the pace of reforms in Central and Eastern Europe, the commitment to the market-friendly approach has remained salient, a process which reflects a vision to transition as a once and for all step, whether through a shock treatment or taken gradually. The move from a statist to a market economy was one which was seen as being mutually exclusive. Microeconomic restructuring has abandoned the option of industrial restructuring of the existing enterprises through industrial policies. This method is replaced by privatisation, liberalisation, through wage reductions and ensuring hard budget constraints on enterprises are maintained. As Pohl (1996, p 1) explains "It is fruitless for governments to pick winners and

try to restructure them; instead governments should allow markets to foster competition and eliminate inefficient firms".

The option of restructuring the manufacturing industries, which represent the lion's share in terms of output and employment, as well as representing the main source for the budget for decades, through improving the product signals runs against the World Bank conditionality which restricts subsidies to the targeted industries. The decline in public investment in infrastructure, research and development, and the lack of developmental banks implies that Eastern European industries have to enter international markets without institutions able to combat structural rigidities. Instead of creating comparative advantage in high value added products through overcoming technological and product quality bottlenecks, they have to specialise in what is offered by international division of labour. The faith in the neo-liberal agenda left the countries with only exports through devaluation to restore effective demand. The reforms give the priority to macroeconomic stabilisation. If the market is functioning well, savings created by individual entrepreneurs will automatically generate investment.

In the view of new-liberals, a quick installation of private property rights is the central element in institutional transition (Estrin, et al, 1993). Privatisation and industrial restructuring became synonymous concepts. A World Bank study on industrial firms in Poland, Hungary and the Czech and Slovak Republics showed a direct relationship between privatisation and industrial restructuring (Estrin et al, 1995). The sample of thirty-six case studies used in the study categorised the short

run adjustments to market shocks into three categories: 'passive', 'quite active' and 'very active'. The passive response was related to accumulation of inventory and financial reserves as well as a minimal adjustment to the status quo, subject to the constraint that the firm is not threatened. Very active responses meant reorientation of sales to Western markets, organisational changes towards marketing, finance and personnel decisions, refinancing, focusing product lines and commercial product differentiation. Quite active responses included these changes being undertaken by the very active firms, but perhaps without a clear strategy (Estrin et al, 1995). Long-run adjustment included the formulation of a long run strategy.

The findings of this study suggest that a strong positive correlation exists between industrial restructuring and privatisation, or progress towards privatisation. Estrin et al (1995) claim that privatisation prevents the stripping of firms' assets by insiders. In the absence of effective property rights, managers and/or workers are encouraged not to restructure nor to maintain the status quo but to exploit the firm's assets. They also suggested that there was no simple correlation between restructuring and hardness of budget constraints. They went on to claim that in many cases hardening of budget constraint, especially if a clear privatisation strategy is lacking, may hinder the process of restructuring. This relates to the consumption of assets by insiders, as managers and workers would consume assets before strong property rights emerge to protect the residual owners' interests.

Other contributions to the shock therapy versus gradualism debate include those by Gomulka (1998), Brenton, Gros and Guy (1997) and Horne (1996). Gomulka's (1998) comparative study of Poland, Hungary and the Czech Republic shows the merit of adopting a shock therapy approach in Poland. The success of this shock therapy was due to the ability of Poland to avoid the macroeconomic instability and stagflation experienced by Hungary in 1995/1996 and the Czech Republic in 1997/1998. Brenton, Gros and Guy (1997) analysed the relationship between the level of output, macroeconomic stabilisation and the speed of transition in Central and Eastern Europe and the former USSR countries. They reached two conclusions. First, that those countries which managed to reduce inflation experienced the lowest level of output decline in the early years following transition and achieved recovery faster. Second, countries which were boldest in adopting economic reforms were also able to manage their output decline and were subsequently able to achieve growth.

Horne (1996) advocated that the significance of studying those economies in transition should transcend the specific issue of the reform strategy adopted and be viewed as a test for the neo-classical economics which underpins such reform policies. This view is shared by Dehejia (1996) who argues that policy makers should take into consideration political factors when adopting the standard neo-classical model of structural adjustment. Therefore, policy formulation as to whether to adopt a shock therapy approach or a gradual approach should be mainly driven by recognising the political implications of such policy formation. For example, the shock therapy approach might not be feasible and will not gain

majority support if the adjustment costs are high (as was believed would be the case in Romania). Because workers are the bulk of voters, the gradual approach is likely to be more feasible, especially if these workers are working in declining sectors, since then they will perceive that there could be an increase in net earnings compared to the status quo.

In essence the difference between a shock therapy approach and a gradual approach is the speed of transition rather than the form the transition should take. Both emphasise a similar form of transition underpinned by the recommendations emerging from neo-classical theory. In the rest of the chapter we concentrate on the contribution to the transition debate from alternative approaches to that of neo-classical economies.

4.3 Alternative Approaches to Transition

The collapse of central planning institutions in Eastern Europe raises a wide range of questions challenging the conventional notions of development. One of the main questions is the one we raise at the beginning of this thesis, how can the market economy be embedded where it had ceased to exist for decades? Surprisingly, as shown above, this question has not been prominent in the literature. Instead the academic debate concentrated on the pace of transforming economies from central planning to ones based on market systems. With regard to the conceptualisation of how markets work, two broad approaches challenge the neo-classical paradigm: the Austrian view and the industrial strategy school of thought. What links the two approaches is their belief in the irrelevance of the neo-

classical paradigm in understanding the complexity of the market system. In the following sections we review both paradigms to see whether different policy recommendations have emerged. In addition, we also develop a more institutional approach to an understanding of market processes, comparing explicitly the new and old institutional views. We have not considered other schools of thought, such as Marxist schools of thought, since we wish to concentrate on the shift from planning to markets rather than a critique of markets themselves.

4.3.1 The Austrian Approach

It can be argued that, historically, the Austrian School can be located within the broader tradition of neo-classical economics. As Boettke (1996, p 2) points out "Austrian Economics, unlike Institutionalism or Marxism or Post-Keynesianism, is not heterodox in certain fundamental aspects. The mainstream of Austrian economics supports laissez-faire, non-interventionist policies" (Mises, 1929, 1979; Hayek, 1935, 1945, 1949, 1978; Menger, 1963; Kirzner, 1973, 1997). Free markets are seen as a necessary and sufficient conditions for the efficient allocation of resources. On macro-stabilization issues there are hardly any lessons to be drawn from Austrian economics as this school of thought tends to rely on subjective behaviour of individual economic agents rather than aggregation of (macro) economic behaviour (Hoen 1998). At the micro level, the Austrians depart from a neo-classical model of allocative efficiency working in a static manner, i.e. a model of instantaneous adjustment without a past. They concentrate

on the problems of incomplete information and uncertainty where the market is seen as a dynamic process[3] (Hayek, 1945).

Within the Austrian system, stress is placed on the role of the entrepreneur in the dynamic process (Kirzner, 1973, 1997; Hayek, 1949, 1978). This is in contrast to the neo-classical model where the transformation of inputs into outputs is seen merely as a technical exercise within the black box called the firm. Although not strictly classified as an Austrian economist the role of entrepreneurs has been discussed at length by Schumpeter (1947). For Schumpeter entrepreneurship is characterised by the following: First, it can always be understood ex post, but it can never be understood ex ante; that is to say, it can not be predicted by applying the ordinary rules of inference from the pre-existing facts. Second, it shapes the whole course of subsequent events and their long run outcome as it changes social and economic situations for good, it creates situations from which there is no bridge to those situations that might have emerged in its absence. Third, the frequency of its occurrence has something to do with the quality of the personnel available in the society, and with individual decisions, actions and patterns of behaviour (Schumpeter, 1947).

For the Austrians, an entrepreneur learns from his/her experience. As time goes by, he/she makes rational decisions. Equilibrium is not seen as a static point to which rational agents converge. Through learning, individuals discover that there are

[3] The problem of incomplete information has influenced what is called the new institutional economics (Williamson, 1985, North, 1993) to modify the standard neo-classical assumption of rationality, by regarding market contracts as outcome of optimization by individuals under sets of

always unobserved parts of the future (Hayek, 1978; Kirzner, 1997). Any type of government interference, whether through ownership or regulation would block this learning process. In the process of social learning, the market is considered as an effective way of making an individual take part in a process more complex and extended than he could comprehend (Hayek, 1949).

This indicates that Hayek was influenced by Adam Smith's view of the market (false consciousness and the invisible hand). This is why the exchange of information is the key to the theoretical edifice of Hayek. It also explains how he conceives the role of institutions. Institutions work in an adaptive way, i.e. by responding to the natural signals conveyed by the market. Quoting Hayek again "Since we do not know the facts we hope to discover by means of competition, we can never ascertain how effective it has been in discovering those facts that might be discovered."(Hayek, 1978, p180).

Economic development is seen as a continual adjustment process. The Darwinian concept of the survival of the fittest seems to explain the dynamic of economic activity. Responding to the external environment (market signals), a selection of firms may by entry and exit accomplish growth and change.

By regarding competition as a historical process evolving through time, the Austrians link the issues of markets and social institutions, a major theme of this thesis. The market and social institutions are seen as unintended results of

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constraints, including those that give rise to transaction costs.

individuals' maximising behaviour. As Menger (1963, p 158) put it "a large number of the phenomena of the economy which cannot be viewed as organically created social structures, e.g. market prices, wages, interest rates etc, have come into existence in exactly the same way as those social institutions, for they, too, as a tool, are not the result of socially teleological causes, but the unintended result of innumerable efforts of economic subjects pursing individual interest". Austrians view institutions as working in an adaptive way, responding to the natural signals conveyed by the market. Market institutions are expected to emerge spontaneously, though dynamically, in an evolutionary path.

Unlike neo-classical economics, Austrian economics brings institutional evolution to the forefront of analysis. However, their individualistic methodology limits a full understanding of the complexity of institutional building (Ibrahim. 1998a). The designers of the reforms in Eastern Europe expected a behavioural change following the liberalization of economic activities. In neo-classical terms, firms would follow the right informational signals provided by the market, or in Austrian terms would search for new available information to make decisions. The continual problems of adjusting to markets experienced by Eastern European countries suggest that the neo-classical and Austrian explanations of change in post communist countries are left wanting.

4.3.2 The industrial strategy approach

The industrial strategy approach offers a critique of the 'hands off' neo-classical and Austrian views of market reforms. This approach is based on an institutional perspective of the state-market relationship. Different terminology has been used to label this approach: industrial strategy (Sawyer, 1991; Shapiro and Taylor, 1990); industrial policy (Singh, 1992); sectoral policy (Chang, 1994). Although this approach lacks a coherent identity, one can trace it to the Post-Keynesian work on growth and distribution (Kalecki, 1976; Kaldor, 1972), the work on institutional embededness (Polanyi, 1957; Veblen 1889), and economic structuralists (Gerschenkron, 1962; Eshag, 1983; Taylor, 1992).

The origins of the structuralist approach can be seen in the work of the United Nations Economic Commission for Latin America (ECLA) which explained the poor performance of developing countries by reference to their structural rigidities in terms of production and trade. This viewpoint tended to run counter to the neo-classical view of perfect competition and well functioning market operations (see Eshag, 1983; Tarp, 1993; Colclough, 1991; Shapiro and Taylor, 1990) and was more in tune with the interventionist approach adopted by Keynesians.

A strand of thought rooted in the structuralist tradition emerged under different headings during the 1980s, labelled either neo-structuralism (Tarp, 1993) or industrial strategy (Shapiro and Taylor. 1990). The basis of this approach to adjustment and stabilisation lies in the underlying economic, social and political structures of the society concerned. In this model it is vital to trace back the causal

factors in the economy that lead towards disequilibrium. Income distribution is at the heart of the model. In addition, prices are set with direct relationship to production through a mark up instead of being determined by demand side factors. On the basis of these prerequisites, Kalecki (1971), Taylor (1993) and Amsden (1994) analyse how regressive income policies would lead to a decline in output rather than, as suggested by neo-classical economics, a rise in output. Thus, cutting wages leads to a fall in real income which consequently leads to income disparity and a fall in demand as already indicated. This hypothesis is tested later in the thesis.

These theorists also argue that devaluation generates redistribution of income from groups who have a high propensity to consume to groups who have a low propensity to consume. As shown earlier curbing aggregate demand offsets the expenditure switching effect. Devaluation leads to higher inflation and as money loses its value so people have less to spend in real terms and thus aggregate demand declines as a result of this negative real balance effect. So, as a main cost reduction policy instrument, exchange-rate devaluation has been considered to be a catalyst for inflationary pressures and is thought, therefore, to be a less effective tool for reducing imports (Taylor, 1993; Solimano, 1993; Shafadeen, 1995).

An important point raised by the structuralist approach is that the minimal state approach of neo-classical economics represents only one type of capitalism, that of the Anglo-Saxon model (e.g. United States and Britain). Different models that are still mainly market economy orientated have challenged the notion of laissez faire capitalism (Albert, 1994). The success stories of continental Europe and Japan

after the Second World War, and more recently, the success (if somewhat erratic) of East Asian countries has been largely implemented under an active industrial policy (Amsden, 1994; Chang, 1994). The emphasis in this approach is on the role of institutions in promoting industrial change. In other words, the emphasis is on state intervention as an active ingredient in the process of economic development. The state is regarded, to some extent, as being entrepreneurial as it has the ability to provide a vision for society and create the necessary institutions required to achieve this vision (Chang and Rowthorn, 1995). They argue that contrary to the Austrian claim, spontaneous order in the market is only a part of economic order, and constructed order, associated with consciously designed or deliberately modified organisations, networks, and state intervention, plays an equally important role (Ibrahim, 1997).

The structuralist approach goes beyond the framework of mainstream economics (see World Bank, 1991, 1993, 1996, 1997, 2000) where there is an acceptance of a limited role for government intervention in the case of market failure, information problems and externalities. But even in Western market economies some argue for a more active role of the state and the need for industrial policy to correct market failure (Dyson and Wilks, 1983; Jacquemin, 1984; Hudson, 1985).

For neo-classical economists to argue for minimal state intervention shows little regard for the problems of moving from a predominantly planned economy to a predominantly market-led economy. Reducing the need for policy in the current transition to that of simple market failure is limited as the market did not exist for

decades. There appears to be a gap in much of the argument about transition that has come about because of the dominance of the neo-liberal agenda. The debate has largely concentrated on the details of the structural adjustment programmes and not on the long term objective of these programmes and who is going to co-ordinate them (Chang, 1995; Amsden et al, 1994; Landesman and Abel, 1995; Brabant, 1993). To these theorists the experience of Japan and East Asian countries, especially South Korea and Taiwan, where the state played a central role in the development process, offers fruitful lessons for East European countries.

The ability of the state to pursue a developmental role depends on whether it can enjoy autonomy from the different social groups, such as labour and the owners of capital, and on its technical capacity to formulate these policies (Amsden 1989; Wade 1990; Evans, 1985, 1995). It is argued that export-led growth in East Asia has been implemented under a symbiotic relationship between the state and local capital. The state has enjoyed relative autonomy by creating a business class through which it intervened in the economic sphere. The government has directed these conglomerates through access to internal and external credit. The government has shaped the industrial structure mainly through the control of the banking system. The key domestic financial institution has been the banking system, not the unregulated financial institutions (Singh, 1995; Amsden 1989; Wade 1990). Here the state plays a more clandestine role (Chang and Rowthorn, 1995), by having highly selective extensions of credits that favour certain groups in society.

The developmental state theorists stress the importance of a complementary relationship between state and market (Ibrahim, 1997). Unlike the Anglo-American and Austrian economists, they regard the state as a decisive tool to sharpen the competitiveness of economies. State intervention is seen as market sustaining rather than market distorting. Here, plan and market are alternative means of economic co-ordination (Best, 1990; Kozul-Wright and Rayment, 1996). The purpose is not to substitute the plan for the market as in the central planning model which Johnson (1982) called the 'plan ideology' but to shape and use the market. The state has to intervene both on the demand side, through restrictions on foreign competition or captive procurement policies, and on the supply side through the manipulation of factor prices: labour, capital, intermediate inputs and technology (Singh, 1995).

For example, in Japan and South Korea there has been a close co-operation between the state and market sectors under the control of state planning authorities such as the MITI in Japan and South Korea's Economic Planning Board. In these countries the development strategy is nurtured through institutional frameworks organised by a systematic state industrial policy, using government investment to develop infrastructure, provide cheap finance and facilitate tariff protection when needed.

State assistance to industry is closely linked to competition policy as both are often seen as integral parts of developmental plans. Instead of choosing favoured industries according to the effective lobbying undertaken by certain interest groups, the state selects those industries which it believes are able to compete in

international competition. Here the view of competition departs from the neo-classical concept of allocative efficiency as it is more dynamic in approach being associated with the problem of growth and structural change and innovation. Amsden and Singh (1994) show that competition policy in Japan and South Korea was orientated towards creating a dynamic efficiency defined as achieving the highest possible long term productivity growth. This view was also forwarded by Chang (1995, p.394) who argued that the reformers in Eastern Europe should recognise that "as in the case of trade policy, competition policy in East Asia is designed on a clear recognition that different industries at different stages of development need different treatments. Rather than treating market power or collusive behaviour as categorically bad, they were allowed, when their impacts on productivity growth were regarded as positive, (especially, but not always, at infant and senile stages) and discouraged when the opposite effects were likely to dominate (usually at the mature stage)".

Gains in productivity come about not from neo-classical comparative advantage and the static concept of economies of scale, but from the adoption of technology and channelling of investment towards higher wage activities (Amsden et al, 1994, 1997). As argued earlier, the neo-classical view emphasised the role of cheap labour in creating international competitiveness of developing countries. This argument has been challenged by those who support the industrial-strategy approach. Amsden (1989) shows that, although real wages were low at the early stages of development, they increased considerably in order to increase productivity. She shows that while it took English workers seventy years (from

1781 to 1851) to raise their earnings by 150%, it took the Korean manufacturing workers only twenty years (1955-1976) to increase their earnings by the same percent (Amsden, 1989).

Through active investment policies the developmental state establishes national goals which foster private capital accumulation (Laski, 1996). The 'catch up nature' of industrialisation in the newly industrialised countries is the driving force behind the need for massive state intervention in their economies. The complex nature of the market economy, the incapability of the local national bourgeoisie to provide rapid accumulation of capital for new industries and infrastructure makes state intervention an unquestionable commitment (Gershenkron, 1962). The government has to build capital institutions and restrain private capital from engaging in short term activities. The experience of East Asian countries shows public investment actually crowded in private investment rather than crowding it out.

What seems to be a major factor in East Asian growth is that public investment in exports led to labour productivity growing faster than the real wages and consequently reducing unit labour costs (Amsden et al, 1994). If wage reduction had not been accompanied by an increase in effective demand, this would have resulted in a reduction in production and income. Following Glyn (1995, p 118) "the additional potential profits created by the wage reduction would accrue as unsold stocks rather than being realised in money form. Enterprises would cut production and employment, incomes and demand would decline, and the surplus, over and

above workers' take-home pay, would fall back until it was no larger than workers' consumption".

Competing in international markets needs trained, qualified labour as well as producing products of high standards. Indigenous technological capabilities seems vital for industrialisation, a process which is carried out through learning by doing (the development of competitive capabilities may be costly and prolonged, depending on the complexity and scale of technology). It involves interactions with other firms and institutions, and apart from physical inputs, it calls for various new skills from the education system (Nelson, 1993). An active policy requires a state capable of fostering technological capability, picking up the promising industries and breaking them into the market. This fits in with Kaldor's model (1981) of endogenous growth where the accumulation in human capital and technology creates externalities within the economic system through increasing returns to scale and the social or industry wide returns of R&D. Kaldor recognised the complementarities that exist in the real world between the demand for products, the demand for factors of production and activities in general, in contrast to equilibrium theory in which goods and factors of production are competitive and price is the prime signal for allocation of resources (Kaldor, 1972). Producer behaviour seems to be affected mainly by quantity signals rather than mere price signals.

The industrial strategy approach reveals the limitations of the simple market failure approaches to transition. Decomposing institutions to their constituent parts, as recommended by the Austrian economists is also misleading. Rejecting

the notion of the market as an abstract form of exchange allows the study of transition in Eastern Europe to be more fully understood as a complex process (Ibrahim, 1998; Ibrahim and Galt, forthcoming). Much of the argument that we have labelled the industrial strategy approach is not aimed at substituting planning for the market, but to provide policies that sustain the market but with the recognition that such sustainability requires direct governmental intervention.

4.4 Old Institutional Economics

A similar theme stressing the socio economic context of markets can be seen in the work of Hodgson (1988, 1993, 1997, 1998a, 1998b); Mayhew (1987, 1989) and Lange-von-Kulessa (1997), who revive the research tradition of American institutionalism (Veblen, 1989; Mitchell 1936, Commons, 1934) which emphasises the role of evolution and path-dependence. These theorists deny the false separation of economics from other social sciences such as sociology. In fact they view economic phenomena as deeply rooted in the socio-cultural networks and history of the society studied. Economic sociologists stress that economic agents are locked into institutional and social networks of interpersonal relations (Granovetter, 1985). Further, sociologists such as Misztal (1996) show how mutual interdependencies through trust act as intermediaries for social cohesion (Amin and Hausner, 1997).

One of the distinctive features of the old-institutionalists is their emphasis on the role of habits. As Veblen (1919, p 241) argues, "institutions are an outgrowth of habit. The growth of culture is a cumulative sequence of habituation, and the ways

and means of it are the habitual response of human nature to exigencies". In this Veblenian approach, habits and institutions provide stability and inert quality where the skill and know-how are transmitted through time. Therefore it provides a degree of continuity and stability of social life. This notion of the social embeddedness of information and knowledge provides a much more complex notion of the real world than the neo-classical sole-valued utility function. Nelson and Winter (1982) adopted an evolutionary approach as an alternative theoretical framework to the optimisation procedures of neo-classical economics. Nelson and Winter followed Veblen in their argument that routines and habits act as the organisational memory through which skills and knowledge are appropriated and passed on (Nelson, 1993, 1998). He developed the argument further in his enquiry to study the different national systems of innovation.

The old institutionalists provide a holistic approach as a contrast to the reductionist individualism advocated by neo-classical and new-institutionalist theories of rational agents. In this holistic approach as Blaug (1992, p 44) shows "social wholes are postulated to have purposes or functions that can not be reduced to the beliefs, attitudes and actions of the individuals that make them up". Here social entities where individuals interact are neither objectively given nor neutral. In fact, traditions, organisations and other formal and informal institutions moulding individuals are in a permanent process of variation that changes institutions themselves and, therefore, the conditions under which individuals act.

Veblen recognised that evolutionary economics should be "addressing the origin, growth, persistence, and variation of institutions" (Veblen, 1919, p 265; cited in Hodgson 1998, p.426). Here evolution is not a unilinear path from the less to the more efficient mode of organisation. The selection of the organisation under study can only be understood in its articulation with a particular socio-economic system (Ibrahim and Galt, forthcoming). The analysis is directed towards the different tensions inside the socio-economic system that either develop or constrain the development of institutions. Therefore, instead of viewing institutions as shaping Robinson-Crusoe-style individuals, the old institutionalists view the configurations between institutions within which individuals form social relationships both shaped by and shaping those institutions. To clarify this point, we follow Hodgson (1993) in his taxonomy, which is borrowed from biology, to distinguish between the two main forms of economic evolution: phylogeny and ontogeny. The phylogenetic meaning of economic evolution implied by Veblen, according to Hodgson, is "the complete and ongoing evolution of a population, including changes in its composition and that of the gene pool" (Hodgson, 1993, p 40). On the other hand, ontogeny "involves the development of a particular organism from a set of given and unchanging genes. Its environment will also affect this development, but nevertheless growth of the organism is the result of genetic instructions. Hence the genes represent a given set of (environmentally dependent) developmental possibilities" (Hodgson, 1993, p.40). New-institutional economics, because of its limited account of evolution restricted by the given set of constraints derived from neo-classical economics, assumes that evolution runs in ontogeny.

Path-dependency shows not only that the past is affecting the present, which is accepted by the orthodoxy, but that it takes multiple paths (Ibrahim and Galt, forthcoming). This contrasts sharply with the neo-classical economics notion of historical efficiency (Hodgson, 1993), as free markets may lock-in a development path that does not settle to equilibrium. Therefore the variety of experiences shown by different transition economies become a sign of evolution. This rejection of a crude Darwinian unilinear evolutionary path underlying the new-institutionalists analysis is also rejected by contemporary biologists who see evolution proceeding by multiple paths that do not all lead to optimal paths. (Gould and Lewontin, 1984; Smith, 1984; cited in Grabher and Stark, 1997, p 4).

The similar theme that runs through industrial strategy and old-institutionalists approaches is the recognition of the simplicity of neo-classical economics that views the market as a creation of equilibrating mechanisms. Being integral parts of a broad political economy approach, they emphasise the role of socio-economic context seeing markets as social constructions. As Polanyi (1957, p.140) forcibly described when analysing the history of market economies, "the road to the free market was opened and kept open by an enormous increase in continuous, centrally organised and controlled interventionism. To make Adam Smith's simple and natural liberty compatible with the needs of human society was the most complicated affair. Witness the complexity of the provisions in the innumerable enclosure laws; the amount of bureaucratic control involved in the administration of the New Poor Laws which for the first time since Queen Elizabeth's reign were

effectively supervised by central authority; or the increase in governmental administration entailed in the meritorious task of municipal reform... Administrators had to be constantly on the watch to ensure the free working of the system. Thus even those who wished most ardently to free the state from all unnecessary duties, and whose whole philosophy demanded the restriction of state activity , could not entrust the self-same state with the new powers, and instruments required for the establishment of laissez-faire".

The development of a market economy is therefore linked to the institutions formulated and enforced by the state. Both market and the state are social institutions that interact in a complex manner. Some elements of this complexity are drawn out by the structuralist and old-institutionalist views. What we emphasise in this thesis is the strength in understanding the complexity of combining the structuralist and old institutionalist views.

Another prime link that differentiates these approaches from the neo-classical approach, and Austrian economics is the recognition that markets involve more than the exchange of existing resources. There is a prime emphasis on creating incentives for production and investment. This links the study of economic organisations to the institutions surrounding them, such as government agencies, financial institutions and universities supporting R&D in industry. Underlying the effective role of institutions in development across different national states lies conscious decision making by the state (Nelson, 1998). This leads us to see how the evolutionary notion proposed by old institutionalists and industrial strategy

theorists is developmental (i.e. dynamic) as it includes efficiency and growth (Abramovitz, 1999; Metcalfe, 1989; Nelson, 1998). This surpasses the abstract notion of the market as solely a form of exchange to concentrate on the complex set of national institutions that sustain or constrain development and technical change (Abramovitz, 1952).

Building on the above, one could see the fallacy of the forced separation between the state and the market. In the current transition in Eastern Europe, as Landesmann and Abel (1995, p.137) argue " the vital question is not whether the state should or should not intervene but rather, what are the types of state intervention which can increase the response rate of agents (firms, households, workers) to a newly market environment and equip them with 'capabilities' allowing them to respond more flexibly to market signals". Therefore an important distinction is made by Landesmann and Abel (1995) between reactive policies and active policies. The reactive policy is one set in response to social and political pressures that have emerged from the burdens of structural adjustment programmes. This inefficient industrial policy stands in contrast with the active industrial policy proposed by industrial strategy theorists that target the institutional framework conducive for medium and long run development.

Economic transition describes a social process in which a complex set of normative and operating principles are embedded in historical structures (Clark

and Soulsby, 1999).[4] Post-communist transition provides a setting that is very different from the well-established market economies where institutions provide continuity and constraint change. Discontinuities are more fundamental, and changes less constrained by the socio-economic framework which is itself under a process of transformation (Grabher and Stark, 1997; Whitley, 1995; Clark and Soulsby, 1999).

The emphasis should be on an institutional framework that recognises the role of historical influence on present day economic activity. East European countries emerged from a central planning system that had its own logic, that had existed for decades, a socio-economic system with a complex set of institutions in which agents were embedded. Central planning's institutions collapsed while new institutions of the market economy have not yet been set in place. So, the political economy of transition is conceptualised as evolutionary and path-dependent (Ibrahim, 1998b; Ibrahim and Galt, forthcoming). The development path taken in the transition depends on the trajectory taken in the past (Stark, 1996; Grabher and Stark, 1998). This analysis transcends seeing transition as a movement between two well defined points. Therefore instead of analysing the Romanian transition through an abstract notion of quick/slow economic reforms (privatisation,

[4] Alexander Gerschenkron (1962) shows the limitations of the historical approach adopted by neo-liberals to Eastern Europe by tracing down the process of state building in Central and Eastern Europe. This work had a major influence on the industrial strategy theorists (see Amsden 1989, 1990, Wade 1990, Chang and Rowthorn, 1995). Gerschenkron also showed the important role universal banking[4] played in the development of East and Central Europe from the end of 19 century to the first World War. He pointed to the salient role of a close link between banks and industry in the development process of these countries. To him, the dominance of banks over industry and the subsequent industrial concentration is a feature of late industrialisation. The reliance of industrial enterprises on the banking system was primarily due to scarcity of capital.

liberalisation and marketisation) and government failure, these economic reforms are situated in a concrete socio economic context. The interaction of the residues of state socialism with the emerging market institutions articulates the old institutionalists' approach in examining the role of ideologies in a specific context.

However one should recognise that transition provides a challenging case for institutionalists where the institutional transition includes two processes of institutional change, namely, deinstitutionalization and reinstitutionalization (Clark and Soulsby, 1999). Deinstitutionalization refers to " the processes whereby an institution's elements lose credibility and the contingent nature of cultural accounts and rules are revealed, interrogated, contested, opposed, effectively challenged and, ultimately, overturned". (Clark and Soulsby, 1999, p 39-40). Reinstitutionalization refers to " the process of redefining and relegitimizing patterns and activities using a framework different from that previously taken for granted. The construction of new formal institutions (laws, structures, procedures) may be effected very quickly, but their realization in new social practices occurs only very slowly, as the values and their underlying logic take time to be reproduced unquestioningly in routinised conduct". (Clark and Soulsby, 1999, p 39-40).

Instead of a clear distinction between the private and public sectors, an interdependent network that incorporated formal and informal ties, that worked as a buffer to reduce the uncertainty accompanying the transformation, characterized the transformation of ownership in Eastern Europe (Stark, 1996; Grabher and

Stark, 1998, McDermott, 1997). In the Czech Republic, instead of breaking the old ties the voucher programme rearranged them, i.e. became re-institutionalised as "the outcome is a web of connections through which a multiplicity of actors are renegotiating not simply contractual ties but their mutual claims on interdependent assets. Through that web, firms, banks and state bureaucracy identify firms that should be saved, devise strategies for restructuring assets, bargain about the allocation of resources, and renegotiate the very rules and governance institutions for resolving disputes among them". (Grabher and Stark, 1998, p 65).

The merit of following the old institutionalist framework is that historical legacies are at the forefront. The current transition is essentially path-dependent. Top down-decision making in economic affairs had been the norm since the formation of the nation-states in Eastern Europe, particularly in Romania and the other Balkan states (Good, 1994; Lampe, 1989). History matters in the sense that economic development does not operate in a vacuum. History evolves in a path-dependent trajectory. The transition from the planned to the market economy involves both continuities and discontinuities. Choices made in the past reflect on the current choices opened up for the country concerned. While the formal institutions of the state socialism had collapsed, the post-socialist state cultural values and other informal institutions remained intact and are likely to continue to shape the behaviour for years to come (Ibrahim and Galt, forthcoming)

4.5 Summary and Conclusion

In this chapter and Chapter 3 we have set out a number of different theoretical approaches and policy responses that relate to the transition of previously planned economies to market economies. Much of the advice, often with conditions imposed, given to Eastern European countries, including Romania, has been based on a neo-classical micro-economic framework and new classical macro-economics. The stress in these approaches has been on adopting those institutional arrangements, such as private property rights, that it is believed provide the basis for establishing market structures and market behaviour that replicates those found in advanced market economies. This has been backed up by ensuring tight macro-economic policies that restrict inflationary pressures and achieve a stable platform for economic growth.

Among the alternative approaches that have been put forward we have identified two main theoretical strands, old institutionalism and industrial structuralism that together offer an alternative theoretical stance on transition and a different set of policy recommendations that sees a more active role for the state. The basis of these alternative approaches is that there is no unique market solution to transition but that each country's transitional path is dependent on that country's past and on the formal and informal institutions that have been in place and which, because of the lags or memory in the system, will influence current, and future, economic activity.

In the case of Romania, for example, there is a strong sense of nationalism and protectionism that has influenced the allocation of resources. At the more micro level the habits, traditions and relationships among the Romanian population suggest that imposing western attitudes, management, firms, structures, etc, that have a strong competitive edge may not be that successful. What is implied by the view we have formulated in Chapter 4 is that transition is country-specific and to be successful needs to recognise explicitly the constraints imposed by the past and that change will evolve from this basis and cannot be imposed in some abstract format.

Our other main contention is that in the transition process there is a need for a close relationship between the public (state) and private sectors. Industrial development is best not left to those inexperienced in the operation of markets, especially when those markets are often interpreted in a laissez-faire manner. The state has the function not only of correcting for market failure, which even many neo-classical economists support, but of providing a structure in which active support is given to industrial development. The state has to provide, and maintain, many of the formal institutions such as the provision of credit that the emerging market, because of its volatility expressed in the collapse of numerous banks in Romania, cannot provide. An active state operating in the transition process can mitigate against extremes of volatility that might be set transitionally, although this state intervention needs to be based on a coherent strategy than merely a reaction, rather than a knee-jerk reaction to economic events.

Our main argument, therefore, is that the process of transition from planned to market economies would have been achieved with less negative outcomes and less volatility if greater attention had been given to the evolutionary nature of institutional change and more support given to an active state involvement in the process of change.

The next three chapters provide an empirical response to this argument. Firstly, by testing a central neo-classical hypothesis that reducing wages would increase employment and output, and secondly, by analysing specific reforms undertaken in Romania and the outcomes of those reforms.

Chapter 5

Have Lower Real Wages Helped Industrial Restructuring in Romania?

5.1 Introduction

As shown in chapter Three, since the late 1970s, real wage reduction has become the favoured tool of the IMF and the World Bank for restoring profitability and for the encouragement of more productive, trade-oriented manufacturing activity in low–income and middle income countries such as Brazil, Chile, Argentina and Mexico (Bruno, 1992; Amsden and Van der Hoeven, 1996). During the last decade, structural adjustment programmes (SAPs), underpinned by real wage reductions, have been proposed by a number of commentators as a means of increasing the competitiveness of Eastern European firms (Bruno, 1992; Feldstein, 1998; Gowan, 1995). The other main cost reduction policy instrument, exchange rate devaluation, has been considered to be a catalyst for inflationary pressures and is thought, therefore, to be a less effective tool for reducing imports (Taylor, 1986; Dornbusch and Renoso, 1989; Solimano, 1993; Van Wijnbergen 1983).

In this chapter we examine the basis for a policy of real wage reduction in the context of Romanian transition during the 1990's. The next section of the chapter reviews the theoretical basis background for the current focus on real wages. Issues pertaining to the data set are described below in Section 5.3, together with an overview of the trends in output, employment and wages in Romania between 1990-96. Section 5.4 sets out the approach used in the empirical tests and reports the estimated results. Section 5.5 utilises component analysis of unit labour costs to examine the relationship between declining real wages and profitability of

Romanian industry. Section 5.6 discusses the implications of the results for economic policy whilst some concluding remarks are made in Section 5.7.

5.2 Background

The theoretical basis for the reliance on real wage reductions in restructuring programmes lies in the standard monetarist model of the economy. A change in the capital-labour ratio, which results in the economy utilising its workforce at a level which is below full employment (for example due to errors in expectations (Friedman, 1968) or discrepancies in the length of the contract period (Fischer, 1977), can be redressed by a fall in money wages. This will prompt a decrease in real wages, leading to more labour being hired and ultimately, a return to full employment. In this scenario relative prices are considered as the only equilibrating mechanisms. Thus, real wage cuts are seen as a means of boosting output and employment in post communist economies of Eastern Europe (IMF, 1992; OECD, 1992). IMF stabilisation policies both within Eastern Europe and elsewhere have tended to adopt such a neo-classical approach in which the main focus has been to ensure that price increases arising from price liberalisation (and any inherited inflation) are controlled through cuts in government spending, balanced budgets and income policies to induce acceptance by workers of current real wage levels (Glyn, 1995, p127).

The beneficial effects of real wage reductions have been the subject of criticism from economists from outside the neo-classical mainstream such as Amsden et al (1994) and Taylor (1987, 1993). These heterodox (or structuralist) economists

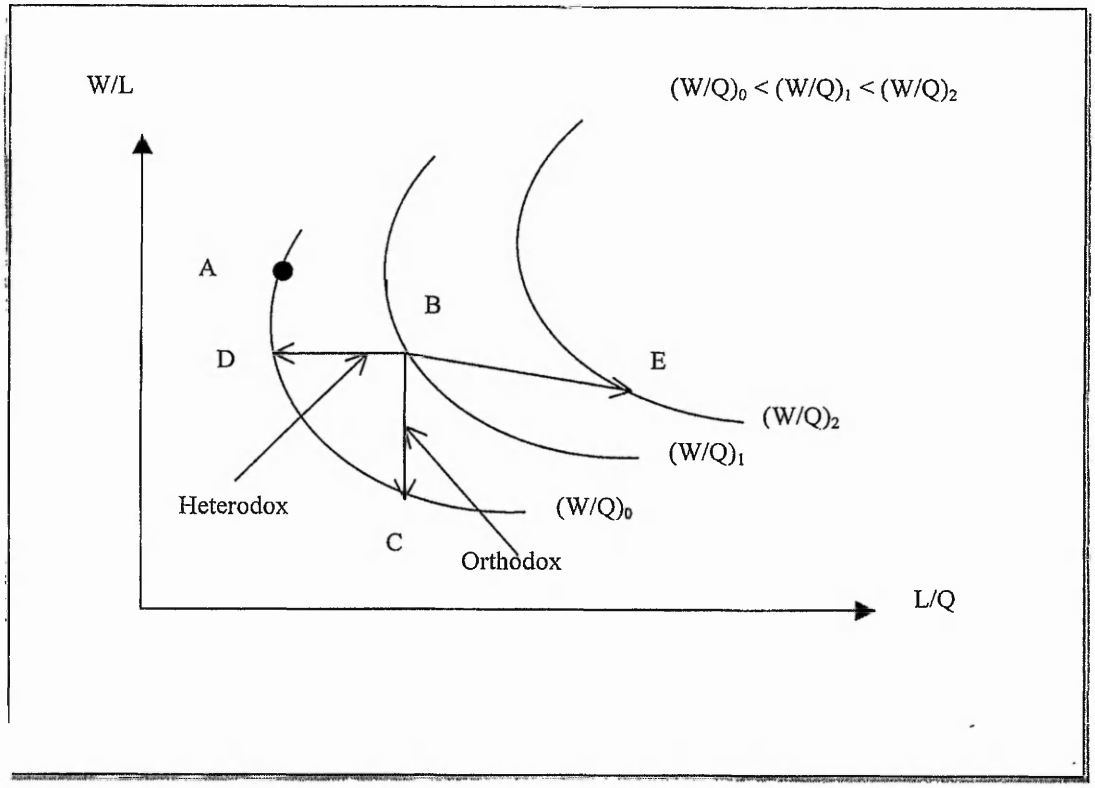
argue that reductions in real wages, without an accompanying increase in productivity, will not increase output and employment. Although 'structuralism' is more correctly viewed as a research programme than a clear and defined paradigm (Taylor, 1990; Tarp, 1992), such commentators tend to share the view that macroeconomic disequilibria are rooted in the underlying economic, political and social characteristics of society. Thus, structuralists have focused on the institutional rigidities that deny the sustainability of the neo-classical assumptions of well-functioning markets, perfect competition and mobility of factors of production (Tarp, 1992). The implication is that policy should concentrate directly on raising productivity which requires "short-term government support and administrative guidance while the productivity and quality enhancing investments of business are under way" (ibid, p 88). [1] This stands in contrast to the neo-classical scenario where the emphasis is on reducing costs through real wage reductions.

Following Amsden et al (1994), figure 5.1 illustrates the application of these alternative scenarios to post socialist countries of Eastern Europe. The diagram identifies two initial positions – point A represents the initial unit labour costs for a capitalist firm and point B represents the unit labour costs for a socialist firm. Although wage costs for the socialist firm may be lower than those for the capitalist firm, B is higher than A because lower productivity in the socialist firm leads to higher unit labour costs. In the neo-classical (orthodox) scenario, a decrease in real wage per worker (W/L) lowers the unit labour costs and

[1] As improvements in productivity and quality of product take time, government support in terms

consequently leads to a proportionate increase in employment and output i.e. a move from point B to point C. However the structuralist (heterodox) economists aim to reduce unit labour costs via increasing productivity, i.e. a move from point B to point D where labour per unit of output is lower than at point B but both employment and output are higher than at point B. Unfortunately an alternative scenario can and has occurred in Eastern Europe where a simultaneous decline in productivity and real wages leads to lower levels of output and employment. This is shown in the diagram by a shift from B to E.

Figure 5.1: Orthodox and heterodox scenarios for the effect of real wage reductions on industrial restructuring



Source: Amsden et al (1994, p 88).

of protection of imports and subsidised credits is needed (Amsden et al, 1994, p 87).

These two alternative approaches lead to directly opposing predictions about the impact of real wage decline on output and employment, one approach implies a positive impact of declining real wages, while the other approach casts doubt on this conclusion. The importance of resolving this debate is clear in the context of countries in Eastern Europe, many of which have embarked on structural-adjustment-type programmes during the process of transition to a market economy. Amsden and Van der Hoeven (1996) suggest simple empirical tests of the neo-classical hypothesis. They estimate regression equations of output on real wages and employment on real wages and, in both cases, argue that a significant negative coefficient on real wages implies support for the neo-classical hypothesis. Amsden and Van den Hoeven carry out these tests on data covering a range of developing countries over the period 1978 to 1989. Contrary to the neo-classical predictions, they find a positive correlation between real wages and both output and employment. In the empirical section of this chapter, panel data techniques are used to replicate Amsden and Van der Hoeven's tests on Romanian data during the 1990s. Romania provides a particularly good case study with which to evaluate the effect of real wage reductions since wages have declined substantially since 1990, including a 40 per cent decrease in average real wages between 1990 and 1994 (OECD, 1998).

5.3 Data and trends in output, employment and wages

5.3.1 Data availability

Data measurement is a prevalent problem in the transitional economies of Eastern Europe (Bartholdy, 1995). One of the main tasks in the development of market institutions has been to develop a reliable accounting system, which had been underdeveloped in the pre-transition period. Romania represents one of the worst cases in the region. A specialist of the former Statistical Office (now the National Commission for Statistics) claimed that before transition "figures on average wages, industrial and agricultural production and national income were not those calculated by their office, but simply invention by the old regime" (Jackson, 1990, p 2). Also, there was a sharp cut back in the availability of published information after 1985. This added to the chronic lack of published data which was distorted by biased concepts, methods of aggregation and systems of reporting (Jackson, 1990). Although the quality of data collection improved somewhat after 1990, public disclosure of information remains a particular problem in Romania. On the last visit by the author to the Romanian National Commission for Statistics (July 1998), a complete set of data on industrial output, employment and wages before 1996 was not available to the public and the author had to rely on personal connections (established through a Tempus project to develop economics in Romanian universities) to complete the data set. In a conversation with an official at the National Commission for Statistics (NCS), it was admitted to the author of this study that there were problems with data aggregation and reporting, the methods adopted having been changed twice between 1992-1996. In addition data collection was problematic due to the unavailability of qualified staff due initially

to low wages. Despite these difficulties, a unique set of data, that covers the period 1990-1996, has been compiled using a variety of sources, full details of which are given in Appendix 1. The data set includes statistics on industrial activity both aggregated and disaggregated by sector, covering output, employment, wages and prices.

5.3.2 Data Description

Most of the statistical data used in the model are drawn from the National Commission for Statistics (for full details of the specification of the data see Appendix 1). In testing the real wage hypothesis for the period 1990-96, we use annual panel data on value added, employment, wages, consumer prices and producer prices for the 27 Romanian industrial branches[2] which have been extracted from the National Commission for Statistics sources. The data cover the main sectors of Romanian industry: manufacturing, mining and electric, thermal energy, gas and water.

Output:

Gross value added[3] is used as our measure of output. It is calculated for the 27 branches of Romanian industry, deflated by the producer price index (with 1990 as the base year), net of subsidies, product taxes and value added tax. Value added represents the newly created value of output, in other words the surplus value of the produced goods and services over that consumed during the production

[2] The branch consists of a group of units with homogenous production and inputs.
[3] The value added data for 1994 are semi-final and those for 1995 and 1996 are preliminary.

process. This measure is preferred to gross output as it allows a direct comparison across industries at different stages of production (see data appendix).

Employment:

Employment includes all persons who carry out socio-economic profitable work in a particular year. This excludes military staff and similar personnel.

Wages:

Data on wages are extracted from the National Commission of Statistics' Integrated Household Survey. This is a yearly statistical survey on salary, its earnings and labour force costs. The net real wage is calculated as the net nominal wage over the consumer price index (CPI), again using 1990 as the base year.

5.3.3 Trends in Wages, Employment and Value Added

One of the main features of transition in Romania has been its very low level of wages compared to other East European countries. For example, Table 5.1 shows that gross monthly wages in Romania during 1995 and 1996 were nearly one third of those in Hungary, Poland and the Czech Republic. Further, as Tables 5.2a and 5.2b indicate, real wages in Romania declined dramatically between 1990 and 1994. Although wages started to pick up in 1995, by 1996, the average real monthly wage was still only 80 per cent of its value at the start of transition.

Table 5.1: Index of average gross monthly wages in selected transition Countries

	1994	1995	1996
Romania	100	100	100
Czech Republic	280	296	322
Slovakia	224	231	257
Poland	280	288	317
Hungary	369	298	294
Bulgaria	100	107	66
Russia	128	112	157

Source: OECD (1998, p.125 Table 24)

Table 5.2a: Real wages by main sectors of Romanian industry: 1990 Romanian Lei

	1990	1991	1992	1993	1994	1995	1996
Industry	33330	27753.5	24449.2	20886.5	20786.4	24319.4	26964.7
Manufacturing	32240	26232.4	22441.6	18909.9	18658.4	22231.7	2490.6
Mining and quarrying	44290	40277.6	37762.3	33110.1	33023.0	35913.9	37537.2
Electric and thermal energy gas and water	39690	37083.6	36894.4	32512.6	32348.5	33945.1	36330.9

Source: compiled by author.

Table 5.2b: Index of real wages by main sectors of Romanian industry

	1990	1991	1992	1993	1994	1995	1996
Industry	100	83.27	73.29	62.67	62.37	72.99	80.90
Manufacturing	100	81.37	69.61	58.65	57.87	68.96	70.73
Mining and quarrying	100	90.94	85.26	74.26	74.65	81.09	84.75
Electric and thermal energy gas and water	100	93.43	93.58	81.89	81.66	85.25	93.34

Source: compiled by author.

As Tables 5.3a and 5.3b show, industrial employment has witnessed a sharp decline during the transition period. In 1996, industrial employment was about two thirds of its level in 1990. The only exceptional case was in Electricity, Gas and Water, where employment registered an increase of almost 45 per cent. The manufacturing sector saw the sharpest decline of 38 per cent.

Table 5.3a: Employment by main sectors of Romanian industry: no of employees (thousands)

	1990	1991	1992	1993	1994	1995	1996
Industry	3846	3643	3254	3017	2856	2615	2586
Manufacturing	3452	3213	2811	2590	2426	2192	2148
Mining and quarrying	267	278	271	263	260	253	251
Electric and thermal energy gas and water	127	152	163	164	170	170	187

Source: compiled by author

Table 5.3b: Index of employment by main sectors of Romanian industry

	1990	1991	1999	1993	1994	1995	1996
Industry	100	94.72	84.61	78.45	74.26	67.99	67.24
Manufacturing	100	93.08	81.43	75.03	70.28	63.50	62.22
Mining and quarrying	100	104.12	101.45	98.50	97.38	94.76	94.01
Electric and thermal energy gas and water	100	125.00	137.50	140.63	142.70	142.71	144.79

Source: compiled by author

The index of real value added by the main sectors of Romanian industry is presented in Table 5.4. Following the severe recession from 1990 to 1992/3, all sectors witnessed something of a recovery up to 1996. For example, industrial output bottomed to 60 per cent of its 1990 level in 1992. Despite the subsequent years of recovery, industrial output in 1996 still represented just 75 per cent of the 1990 level.

Table 5.4: Index of real output by main sectors of Romanian industry

	1990	1991	1992	1993	1994	1995	1996
Industry	100	77.2	60.3	61.1	63.1	69.1	75.8
Manufacturing	100	76.2	57.9	58.3	60.5	67.8	76.3
Mining and quarrying	100	81.7	81	79.9	81.3	80.2	56.2
Electric and thermal energy gas and water	100	90.6	84.1	89.9	89.8	92.8	94.4

Source: compiled by author

5.4 Empirical Approach and Results

5.4.1 Empirical Approach

Amsden and Van der Hoeven (1996) estimate the response to the fall in real wages by two separate equations for output and employment. Unfortunately, their econometric approach is unclear. They appear to pool their data across countries and to use simple OLS estimation. In this case, the estimates produced by OLS are likely to be inconsistent. However, they also report standard Durbin-Watson statistics implying that estimation was undertaken on individual time series. In any case there is a clear advantage in pooling the data in this study. As Baltagi (1995, pp.3-7) points out, pooled (or panel) data estimation improves the efficiency of the estimates over those obtained from either cross-section or time-series data by giving the researcher a large number of data points, increasing the degrees of freedom and decreasing the collinearity among explanatory variables. In addition, panel data allows the researcher to control for unobserved effects which are specific either to the cross-sectional unit or to the time series unit.

Hsio (1986 p1-2) suggests that the major advantage of panel data sets over the time-series and cross-series is that it helps the researcher in resolving or reducing

the possibility of correlation between omitted variables and explanatory variables. As one utilises information on both the intertemporal dynamics and the individuality of the entities investigated, she/he is better able to control for the effect of unobserved or missing variables.

In the case of large cross-sectional units and only a few periods, time series methods may be somewhat problematic (Greene, 1993, p465). This set of data covers all 27 sectors of Romanian industry across a relatively short time series (1990-1996). In such a case, sophisticated time series modelling is impossible. Rather time effects are commonly used as 'transitions' or discrete changes of state. They are typically modelled as specific to the period in which they occur and are not carried across periods within a cross-sectional unit. Heterogeneity across units is an integral part, indeed, often the central focus, of the analysis (Greene, 1993).

Following Baltagi (1995, p 9) a general model for panel data is the two-way error component regression model :

$$y_{it} = \alpha + X_{it}\beta + u_{it} \qquad i = 1, \ldots, N; \quad t = 1, \ldots, T \tag{5.1}$$

where:

i denotes the cross-section dimension and t denotes the time-series dimension;

α is a scalar, β is a K*1 vector whereas X_{it} is the ith observation on K^4 explanatory variables;

$$u_{it} = u_i + w_{it} \tag{5.2}$$

u_{it} represents the unobservable effects specific to the cross-sectional units and which are time invariant;

u_i represents the time effects which are invariant across the cross-sectional units;

w_{it} is the remainder disturbance which represents the usual disturbance that varies with individuals and time.

We estimate output and employment equations on data pooled across the 27 industrial branches over the period 1990 to 1996. Our estimating equations are as follows:

$$\text{value added}_{it} = a_o + a_1 \text{ real wages}_{it} + \lambda_i + \mu_t + u_{it} \qquad (5.3)$$

$$\text{employment}_{it} = b_o + b_1 \text{ real wages}_{it} + \tau_i + \omega_t + v_{it} \qquad (5.4)$$

where i indicates industries, t years, λ and τ are individual effects, μ and ω are time effects and u and v are residual errors.

All variables are measured in natural logs. This is somewhat less restrictive than the linear specification employed by Amsden and Van der Hoeven and allows the coefficients to be interpreted as elasticities. Nonetheless, for completeness we also report estimates using a linear specification. Estimates are obtained using Stata version 6.0. As was noted in Section 1, a significant negative coefficient on the

[4] There are K regressors in X_{it}, not including the constant term.

real wage variable in either of the equations would provide support for the neo-classical hypothesis that a decline in real wages helps industrial restructuring.

This approach allows a close comparison with the work of Amsden and Van der Hoeven (1996). However, the simplicity of the specification carries with it significant drawbacks. In the first place, real wages are almost certainly endogenously determined within the model. Fortunately, the panel structure of the data allows us to use lagged values of wages as instruments. Secondly, there is likely to be a good deal of persistence over time in both value added and employment. A common approach in panel data models is to allow for dynamic effects by the inclusion of a lagged dependent variable as follows:

$$\text{value added}_{it} = a_o + c_0\text{value added}_{it-1} + a_1 \text{ real wages}_{it} + \lambda_i + \mu_t + u_{it} \quad (5.5)$$

$$\text{employment}_{it} = b_o + d_0\text{employment}_{it-1} + b_1 \text{ real wages}_{it} + \tau_i + \omega_t + v_{it} \quad (5.6)$$

The introduction of the lagged endogenous variable will generally mean that standard estimators are inconsistent. Consistent estimators can be found using the GMM approach described, for example, by Arellano and Bond (1991) and which involves transforming the equation into first differences and then using lagged values of the endogenous variables as instruments, the number of instruments being different in each time period. We use this procedure to obtain estimates for the dynamic model, using DPD version 2.0 (see Doornik, Arellano, and Bond, 1999). The GMM estimates will be consistent in the absence of serial correlation. Evidence of this problem would be demonstrated by evidence of *second* order

serial correlation in the first differenced model. We report a diagnostic test for this as well as the Sargan test of instrumental validity.

The appropriate treatment of the error terms is an important issue in panel estimation. In the first place, the presence of unobserved effects which are specific either to particular industries or to particular years will render OLS estimators inconsistent (see, for example, Greene, 1993, p 560). We test for both time and industry individual effects using Breusch-Pagan Lagrange Multiplier tests (see Baltagi 1995, p.62). In the event of individual effects being present, the second issue is whether they should be treated as fixed or random. The specific effects can be treated in one of two ways. The first one is the fixed effects model or least square dummy variable approach. The fixed effects approach treats the individual effects as being fixed and estimable. In this case, the estimation procedure is to employ dummy variables for each industry and/or year. Alternatively, the random effects specification assumes the individual effects to be randomly distributed and independent of the remaining stochastic disturbance term. The fixed effects approach can lead to a large loss in degrees of freedom. On the other hand the random effects estimates will be inconsistent when the cross-section effects are correlated with the independent variables. Greene (1993) suggests that the fixed effects model should be preferred in the case of an exhaustive sample as in this study. Here we use the Hausman test (see Baltagi, pp 68-73) to determine which specification is most appropriate for our data.

5.4.2 Estimation results

Output Equation

Table 5.5 summarises the estimates of the output equation. The static estimates are reported in column 1 and the dynamic GMM estimates in column 2. For the static model, the Lagrange Multiplier suggests the presence of individual but not time effects (see Baltagi, 1995). The Breusch-Pagan test rejects the null hypothesis of no individual industry effects, whereas the null of no time effects cannot be rejected. Further a Hausman test for fixed (over random) effects is strongly significant suggesting that the random effects estimator may be inconsistent and the fixed effects estimates are to be preferred. In any case, the fixed effects estimate of the coefficient is very close both in absolute value and in significance. Consequently we report one-way error component fixed effects estimates. The wage coefficient is approximately 0.21 under the fixed effects estimation, implying an elasticity of output to real wages of 21 per cent. Thus, there is no support for the neo-classical hypothesis that a reduction in real wages will boost output.

The GMM estimates of the dynamic model are reported in column 2 of table 5.5. There is some statistical confirmation that the GMM estimates are preferable in that diagnostic tests suggests the presence of serial correlation in the static model whereas, in the dynamic model, both the test for second order serial correlation (in first differences) and the Sargan test for instrumental validity are insignificant. Further, the coefficient on the lagged dependent variable is strongly significant. The GMM estimate of the coefficient on wages is roughly half the size of the

static estimate. However, it is still positive and strongly significant. In other words, neither the simple static estimates nor more sophisticated GMM IV estimates provide any support for the neo-classical hypothesis that a reduction in real wages will boost output. In fact, there is some evidence that output in Romanian industry has responded negatively to the decline in real wages during the 1990s.

Table 5.5: Real Wages and Value Added in Romania: 1990-1996.

	1 **Fixed Effects**	2 **GMM IV**
Value added (-1)	-	0.18*** (0.06)
Real wages	0.21** (0.09)	0.11** (0.04)
Constant	3.5*** (0.41)	-0.05*** (0.02)
Wald χ^2	5929.4***	25.28***
Industry effects	Yes	-
Year effects	No	No
NxT	189	135
LM test for industry effects	313.8***	-
LM test for year effects	1.50	-
Hausman test	6.01	-
Serial correlation	3.86***	-1.06
Sargan test	-	26.58

Notes:

1. Dependent variable is the index of value added (1990=100)
2. Figures in brackets are robust standard errors.
3. *** shows significance at 1% level, ** at 5%, * at 10%.
4. In column 2, both the lagged dependent variables and real wages are treated as endogenous and instrumented as described in the text.
5. The Wald χ^2 test is of the joint significance of the dependent variables and is distributed as χ^2 (k) where k is the number of regressors. The LM tests are the Breusch-Pagan for group and time effects. Both tests are distributed as χ^2 (1) and are described more fully in Baltagi (1995, pp.162-3). The Hausman test is for random effects and is described in Baltagi (1995, pp 68-70). The statistic is distributed as χ^2 (2). The serial correlation test in column 1 that described in Baltagi (1995, p. 93). That in column 2 is that described in Arellano and Bond

(1991) for second order and is performed on the first differences. Both statistics are normally distributed. The Sargan test is for instrumental validity and is follows a χ^2 (j) distribution where j is the number of instruments.

Employment Equation

Estimates of the employment equation are reported in Table 5.6. In this case, the Breusch-Pagan tests (LM tests) suggest the presence of both industry and year specific effects. Consequently we report random and fixed effects estimates of the static model (in column 1) using a two-way error component. The static estimate of the coefficient on wages is 0.07 (equivalent to an elasticity of 7 per cent), much lower than for the value-added equation and positive only at the 10% level. The GMM IV estimate of the wage elasticity is marginally negative (-0.032) but insignificantly different to zero at any conventional level. Although the evidence for positive feedback from wages to employment is weaker than for value added, there is again little evidence to support the neo-classical hypothesis of a negative association between real wages and industrial performance.

Table 5.6: Real Wages and Employment in Romania 1990-1996

	1 Fixed Effects	2 GMM IV
Employment (-1)	-	0.90*** (0.11)
Real wages	0.07* (0.04)	-0.03 (0.04)
Constant	4.3*** (0.18)	0.03 (0.02)
Industry effects	Yes	Yes
Year effects	Yes	Yes
Wald χ^2	2553.3***	76.75***
NxT	189	135
LM test for industry effects	111.6***	-
LM test for year effects	30.70***	-
Hausman test	33.4***	-
Serial correlation	6.32***	-1.04
Sargan test	-	14.67

Notes:
1. The dependent variable is the index of employment (1990 = 100)
2. For other notes see Table 5 notes 2-5.

Naturally, there are drawbacks with the simple specification employed here. For example, it is quite possible that the direction of causality in the employment equation is reversed and that declining employment is a factor in causing real wages to be depressed. However, the complete absence of negative association between real wages and either value added or employment suggests that there should be a high degree of scepticism about the value of using declining real wages as a policy tool for restoring output and employment in economic transition.

As shown earlier, all variables are measured in natural logs. This is somewhat less restrictive than the linear specification employed by Amsden and Van der Hoeven and allows the coefficients to be interpreted as elasticities. To enable a direct comparison with Amsden and Van der Hoeven, we report estimates using the values (as opposed to the logarithms) of the variables in Table 5.7. Quadratic and cubic forms are included to allow for non-linearity. Results are reported in Table 5.7. For the output equation, none of the coefficients on the wage variables are significantly different from zero. More parsimonious models omitting the insignificant quadratic and cubic terms are reported in columns 2 and 3. The wage variables remain significantly different from zero. For the employment equation, the linear wage term is positive and strongly significant, whereas the quadratic and cubic terms are insignificant (column 4). When the cubic term is omitted (column 5) both the linear and quadratic terms are positive and strongly significant. However, when both quadratic and cubic terms are omitted, the linear term becomes insignificant. In summary, once again there is no sign of a negative relationship between real wages and either output or employment.

Table 5. 7 : Generalized linear model

	Output			employment		
	1	2	3	4	5	6
rw1	-5.44e+09 (5.49e+09)	-4.92e+09 (3.53e+09)	-5.38e+08 (8.73e+08)	9.917009*** (2.992262)	7.972715*** (1.884696)	.8771302 (.486584)
$(rw1)^2$	8097130 (2.02e+07)	5885469 (4592258)		-.0185375 (.011002)	-.0095194*** (.0024502)	
$(rw1)^3$	-2101.126 (19373.81)			8.84e-06 (.0000105)		
constant	8.37e+11** (3.37e+11)	8.11e+11** (2.63e+11)	5.11e+11*** (1.24e+11)	720.0396 (280.6147)**	817.3735*** (263.128)	1302.236*** (228.0105) 1302.236*** (228.0105)

Notes:
1. Figures in brackets are robust standard errors.
2. *** shows significance at 1% level, ** at 5%, * at 10%.
3. n.s: insignificant at all levels.
4. Dependent variable in 1-3 is output and in 4-6 is employment as defined in the text.

5.5 Determinants of profitability

In the previous section we looked at the impact of real wages on output and employment. In this section, we investigate the contribution that real wage reductions have had on reducing unit labour costs in Romania, following a methodology used by Estrin et al (1993) for the cases of Hungary, Poland and Czechoslovakia.

Unfortunately profitability in East European countries is difficult to measure. Hughes and Hare (1991, 1992, 1994) attempted to overcome this problem by using domestic resource costs (DRC). World market prices act as a bench mark for revaluing inputs and outputs in different branches to asses total factor productivity (Nashashipy, 1980). The reliability of this method is questionable especially in the context of Eastern Europe. In these countries with their long

tradition of irrational prices, different returns to capital and labour are expected across different industries. Therefore it is difficult to assess the amount of intermediate inputs absorbed that determine the ranking of profitable industries (Glyn, 1994).

The profound unreliability of profits data in the most developed countries in the region (the former Czechoslovakia, Hungary and Poland) especially at times of inflation, has led Estrin, Schaffer and Singh (1993) to use the decline in unit labour cost as a measure of profitability. Following Estrin, Schaffer and Singh (1993), unit labour cost is defined as wage costs per unit of output:

$$ULC = wL/pY \qquad (5.6)$$

Where

w = nominal wage; p = producer prices; pc = consumer prices: Y = output.

L = employment.

Rearranging (5.6)

$$ULC = (w/p)/ (Y/L) \qquad (5.7)$$

Where (w/p) = real product wage; (Y/L)= Labour Productivity.

Denote pc/p = the "wedge" between consumer and producer prices

Then

$$ULC = (w/pc) * (pc/p) / (Y/L) \qquad (5.8)$$

Taking logs

$$\ln(ULC) = \ln(w/pc) + \ln(pc/p) - [\ln(Y) - \ln(L)] \quad (5.9)$$

Thus, in terms of logarithms, unit labour costs are equal to the consumption wage + the wedge minus labour productivity. As in the work of Estrin et al (1993) this allows us to see the relative importance of a change in the consumption wage (w/pc) and a change in productivity (Y/L) on changes in unit labour costs.

Table (5.8) shows the individual effects of each component of unit labour on the overall level of unit labour costs and hence profitability; MLUC traces the change in the mean value of unit labour costs in the years 1990-1996 across all industries. Unit labour costs decreased in 1991 followed by an increase in 1992 and a decrease in the subsequent two years. This was followed by another increase in 1995 and finally a decrease in 1996.

Columns 2, 3 and 4 aim to isolate the effects of the components of unit labour costs to determine which component has most affected the decrease in unit labour costs. This may be accounted for by either an increase in productivity or a decrease in real wages or/and the wedge. This is achieved by using equation 5.7: ULC= ULC = (w/pc) * (pc/p) / (Y/L) where, w/pc is real wage, pc/p is the price wedge and Y/L is productivity. Holding productivity at its 1990 level and allowing the other variables to take the values in relevant years produces MLCUP i.e unit labour cost at fixed productivity. Likewise, by fixing w/cp the real wage at 1990 levels we can calculate MLCR for each year where the other variables are allowed to change. A similar procedure is used for the price wedge pc/p. Thus we are able

to isolate the impact of changes in different variables and their effect on unit labour costs.

Column 2 (MLUCP) shows the mean of unit labour costs if productivity had stayed at the level of 1990. In other words it enables us to isolate the effect of productivity. The difference between column 1 (MLUC) and 2 reflects the effect of productivity on unit labour costs (ULC). For example, in 1991 the mean of unit labour costs was 321 as column 1 shows. The difference between 321 and 265.48, as shown by column 5, suggest that productivity has declined thus increasing the unit cost of labour. For all years the net difference between column 1 and 2 is positive which indicates a decline in productivity and as productivity declined unit labour costs increased. What we can not say as yet is whether the actual change in unit labour costs was mainly affected by the decline in productivity. To do this, we have to trace the other factors affecting ULC, namely inflation (the wedge) and real wages. Adopting a similar procedure as for productivity column 3 fixes real wages at 1990 levels and then column 4 fixes inflation (the wedge) at 1990.

Throughout the period studied the net difference between column 1 and column 3 (column 6) remained negative which suggests that the decline in real wages resulted in a decrease in unit labour costs.

For the first two years the net difference between column 1 and 4 was negative. This indicates that if the wedge remained fixed at the 1990 level, unit labour cost could have been more than if the wedge was to be included in the measurement of

unit labour cost. This means that inflation (the wedge) decreased and hence ulc. This was reversed in the years 1993-1996 whereas in each year the net difference between column 1 and column 4 is positive. This shows that the increase in unit labour cost was driven by an increase in inflationary pressure.

As column 1 shows unit labour cost witnessed a decrease in 1991, 1994 and 1996. In 1991, the decrease in unit labour cost resulted from a decrease in real wages and inflation (the wedge) which counteracted the decrease in productivity. In both 1994 and 1996 both an increase in inflation and a decrease in productivity had an increasing effect on unit labour costs. However the decrease in real wages offset their impact and led to an overall decline in unit labour costs.

The above analysis shows that the general decrease in unit labour costs was mainly due to a decrease in real wages and was not accompanied by an increase in productivity. This confirms the earlier econometric results. Productivity fell especially in the first years where a sharp decline occurred. This indicates that output decline was more than the decline in employment. The decline in employment was not enough to counter the decline in productivity ratifying the structuralists' view that sticky employment is a symptomatic phenomena in Third World countries and Eastern European countries due to the low elasticity of wages and employment (Amsden et al, 1994, pp 81-6) .

Table 5. 8: the dynamic of unit labour costs and its components

Year	MLUC 1	MLUCP 2	MLUCR 3	MLUCWD 4	MLUC-MLUCP 5	MLUC-MLCR 6	MLUC-MLUCWD 7
1990	364.64	364.64	364.64	364.64	0	0	0
1991	321.37	265.48	377.45	376.16	+ 55.89	- 56.08	- 54.79
1992	433.91	307.30	480.77	462.56	+ 126.61	- 46.86	- 28.65
1993	361.52	273.15	599.70	290.74	+ 88.37	- 238.18	+ 70.78
1994	344.14	287.91	533.98	279.62	+ 56.23	- 189.85	+ 65.52
1995	399.35	359.04	489.06	318.26	+ 40.31	- 89.71	+ 81.09
1996	340.64	329.99	424.89	296.56	+ 10.65	- 84.25	+ 44.08

Note:
MLUC = the mean of ulc
MLUCP= the mean of ulcp had productivity stayed at the level of 1990
MLUCR= the mean of ulcp had real wages stayed at the level of 1990
MLUCR= the mean of ulcwd had the wedge between consumer and producer prices had the wedge stayed at the level of 1990

5.6 Discussion

The results in previous sections provide little support for the neo-classical hypothesis that real wage reductions have a positive impact on output and employment. The structuralist school provides a powerful explanation for this finding based on the fact that that in both less developed countries and Eastern Europe, the share of labour in production costs tends to be very low (Amsden, et al, 1994). Following Amsden et al (1994) and Amsden and Van der Hoeven (1996), we estimate the share of labour in gross value added across the whole Romanian economy. As Table (5.9) shows, money wages in Romania between 1990 and 1996 did not exceed 13.6%. Comparable estimates from other East

European countries include 10% in Bulgaria to as high as 20% in Czechoslovakia (MIT, 1991; Pinto, Belka and Krajoewski, 1992, cited in Amsden et al, 1994, P 86).

Table 5.9: Share of money wages in Romanian Value Added 1990-96

Year	(wages/gross value added)* 100
1990	11.51
1991	10.78
1992	10.65
1993	11.04
1994	9.95
1995	11.51
1996	13.64

Source: compiled by author

The main thrust of the neo-classical argument that relative prices operate as the only equilibrating mechanisms, is misleading in an environment dominated by structural rigidities. The weak output response may be related to a variety of institutional factors that impact upon either the supply side, or the demand side of the economy. On the supply side, output may be constrained via a combination of forced savings, the lack of capital and imported inputs, fiscal limitations or weak supply elasticity (Taylor, 1987, 1988; Tarp, 1992). However, although there have been several devaluations of the lei, in order to make Romanian exports more competitive in world markets, the overall supply side impact of the policy has been to raise the cost of imported goods (and hence prices). The relationship between Romanian inflation and the value of the lei (relative to the US dollar) is set out in Table 5.10. In the light of the fact that Romanian inflation has continued to outpace devaluations of the lei, there is little surprise that Romania has been

experiencing an ongoing trade deficit (National Commission for Statistics, 1995, 1996, 1997) as higher import costs continue to outweigh the additional income generated through higher exports.

Table 5.10: Inflation and Exchange Rate Depreciation in Romania: 1990-96

Year	Inflation (CPI)	Exchange rate (lei/$)
1990	100	49.9
1991	270.2	270.4
1992	838.8	632.5
1993	2987	1757.66
1994	7071.9	2579.56
1995	9353.4	3832.16
1996	12983.4	5802.17

Source: Data are compiled by the author from NCS and Romanian National Bank's annual reports.

On the demand side, cutting wages leads to a fall in real income, which consequently leads to income disparity and a fall in demand. In Romania, real wages declined by 42 per cent in the public sector and 29 per cent in the economy as a whole between 1990 and 1996 (OECD, 1998). Such a decline restricts the internal market and the sales of the domestic enterprises. As argued by Kalecki (1971) and subsequently by Amsden (1994), a fall in real wages will decrease the total demand in the economy, unless it is offset by a surge in government spending, investment or net exports. None of these have happened in Romania: government spending has been restricted by IMF imposed conditions, net exports have been in deficit (National Commission for Statistics, 1995, 1996, 1997) and disinvestment has been the norm in the midst of a deep industrial recession. According to OECD estimates, between 1990 and 1994 one third of jobs in industry were lost; real wages declined

by 40 % and the real income of households fell by more than 20 % (OECD, 1998, p.116).

The decline in public investment in infrastructure and R&D has meant that Romanian industries have had to enter the international market without institutions able to combat structural rigidities. Instead of creating comparative advantage in high value added products through overcoming technological and product quality bottlenecks, they have had to specialise in what is offered by international division of labour. For details on the commodity comparison of exports see the discussion on p.186 and table 7.6 on page 187.

5.7 Conclusion

A standard feature of IMF restructuring programmes in transition countries has been reductions in real wages. Earlier we argued that the theoretical basis for such a policy is at best open to question. Further, empirical tests on panel data from Romania for the period 1990 to 1996 confirm previous findings that there appears to be no positive association between real wages and either output or employment. Declining real wages in Eastern Europe seem to have failed to play the promised role of an effective instrument of industrial policy during economic transition.

The standard neo-classical predictions rest on the assumption that workers are mobile and will tend to move from lower to higher paid industries. The results in this chapter and elsewhere provide little support for this assumption. A more appropriate response to the poor performance of Romanian industry over the

1990s may be to take a structuralist approach in which imperfections in the neo-classical model are seen as a direct result of institutional rigidities. This type of approach in contrast to the simple policy prescriptions of IMF-type structural adjustment programmes, may better serve the long term objective of successful industrial restructuring in Romania, a matter which will be developed in the next chapter.

Chapter 6

Transition Policy and Industrial Change in Romania Since 1989

6.1 Introduction

Chapter 6 and Chapter 7 provide a detailed analysis of the transition process in Romania relating these changes to the theoretical perspective discussed in earlier chapters of the thesis. The aim of Chapter 6 is to provide a detailed explanation of the policies adopted in Romania post 1989 indicating that the procedures and policy stance adopted were a confused amalgam of neo-classical recommendations and institutional inertia that, while to some extent path dependent, did not adopt this as an explicit strategy.

The post-Communist Romanian Government initially adopted essentially a gradualist approach to transition arguing that there might need to be a trade off between faster economic change and social harmony. An alternative view is that the Romanian Government, after 1989, was essentially made up of those who held power before 1989 and were reluctant to introduce change. Nevertheless, over time, they instituted the kinds of reform package largely advocated by the World Bank and International Monetary Fund (IMF), which were based on essentially neo-classical theoretical propositions as discussed in Chapter 3. Adherence to such policies was in part necessary because of the need to have the financial support of the international agencies. The early reforms therefore saw the adoption of tight fiscal and monetary controls and the liberalisation of prices and trade, at least in some markets. Industrial

reform was largely based on privatisation although the state still maintained a strong managerial influence on operations.

During the period since 1989 several changes have taken place within Romania as regards transition policy. In 1997 a more active set of policies were implemented which might, under some circumstances, be regarded as a shock therapy approach. But, after ten years of transition the distinction between shock therapy and gradual policies is somewhat blurred and the distinction somewhat meaningless.[1] It might be more appropriate to argue that in Romania what has essentially occurred is a 'stop and go' stabilisation policy (Daianu, 1992; Hunya, 1998), where, for example, after an initial period of gradual reforms a tight monetary and fiscal policy regime was introduced in 1991 which was then relaxed in 1992. Such on and off policy has been a particular feature of the Romania economy.

One interpretation of the early 'gradual' transitional policies in Romania is that those in power recognised the need to build onto past economic relationships and strengths, i.e. were aware of the need for transition to follow a path dependent approach. Unfortunately this would be claiming far too much of those, who for the most part were merely wishing to maintain their own power base by producing policy reforms that, rather than leading to institutional change and development, led to institutional

[1] Hungary has often been presented as the model of gradualism yet in March 1995 this country adopted an austerity policy which, if anything, was a shock intended to halt the growth of fiscal and foreign deficits. Poland and Russia were often regarded as shock therapy countries yet, in Poland, the government relaxed wage regulations as early as 1992 and since 1994 economic policy has been a mix of Keynesian expansion policy and a stabilisation policy aimed at curbing inflation.

inertia. Doing very little slowly was not the sign of a well thought through path dependency approach, but rather a confused reaction to events and an attempt to minimise any change. The types of reforms and the process by which they were introduced are dealt with in the rest of this chapter, with particular emphasis on industrial reforms, while the impact of the reforms is discussed in the following chapter. The next section examines the difficulties of introducing markets into a hypercentralised Romanian economy. Section 6.3 discusses stabilisation policies. Section 6.4 analyses policies used to stimulate private sector activities. Section 6.5 concentrates on Foreign Direct Investment. Section 6.6 looks at industrial structure.

6.2 Transition in Romania: introducing markets into a hypercentralised economy

At the start of its transition Romania had a highly centralised economy with 100% administered prices, including food. Suppressed inflation, which can be approximated by the ratio of money supply to the Gross Domestic Product (M2/GDP), was approaching 60% high but somewhat lower than other East European countries. Also, compared to other East European countries, Romania had favourable macroeconomic conditions with an almost negligible external debt ratio. Table 6.1 provides a comparison of the performance of the Romanian economy at the beginning of transition with the performance of four other East European countries, Hungary, Poland, Czechoslovakia and Bulgaria. Romania's economic performance in many respects was superior to some of the other countries.

Table 6.1 Macroeconomic indicators for selected east European countries at the start of transition

	Hungary	Poland	Czechos-lovakia	Bulgaria	Romania
GNP per capita (US$)	2590	1790	3450	2320	2290
GNP Growth(1) 1970s 1980s	 4.5 0.5	 5.5 -0.7	 4.6 1.4	 7.0 2.0	 9.3 1.8
Administered Prices(percent)	15	100 (2)	100	100	100
State ownership	90%	70%	economy wide	Economy wide Except 15% of Agriculture	economy wide
Money(M2) /GDP (1990)	0.4	0.9	0.7	1.3	0.6
Ext debt/ GDP	65	80	19	50	3
Ext debt service ratio (1990)	57	56	23	116	-

(1): Net Material Product.
(2) Excluding food prices.

Source: World Development Report, 1991.
The Vienna Institute for Comparative Economic Studies: COMECON data, 1990.

Avoiding market-socialism and other reforms prior to the transition put the Romanian economy in a unique position in the context of East-European transition. Neither the partial market reforms such as those followed by Hungary and Poland nor the Yugoslav experience of workers self-management were adopted prior to 1989. Therefore Romania started the transition to a market system with a typical Stalinist model of development.

In each country the political decision by the post-socialist governments over the

structural reform rested on the existing politico-economic situation. In Romania, the gradual approach adopted by the first post-socialist government was largely determined by what had happened under Ceausescu's regime and the policies followed in the 1980s. The deterioration in living standards, resulting from the self-sufficiency policies operating in the 1980s, restricted the ability of the new government to implement shock-therapy treatment.

The state sector was totally dominant, with high levels of market concentration, and a relatively large proportion of GDP being produced by heavy industry, operating under rigid quantity targets. The employment structure also heavily favoured manufacturing (Daianu, 1991). As indicated in chapter 2 the nationalistic policies which put self-dependence as a prime target for Romania led to an economic crisis in the 1980s and severe imbalances in 1989.

Between the first election in May 1990 and October1992, a new constitution replaced that of the communist era. This period witnessed the birth of a multi-party system, independent newspapers and independent organisations such as human right organizations. Despite such developments in the political sphere there were some signs threatening the process towards political openness. The attack on a peaceful University Square demonstration by the miners, where the violence spread to include some buildings belonging to opposition and independent newspapers, overshadowed the government move towards a more pluralistic society.

In the early months of transition, the government's attempt to increase consumer food and energy supplies strained existing reserves and production capacities, and was only made possible by cutting back industrial energy consumption and increasing imports. Although most individuals at the level of minister had been removed from power, the government apparatus was taken over, in terms of both personnel and organisation, by communists of the early 1970s and technocrats. This group rejected market reforms, because of 'social risks and costs' and what it considered was the proven need for national planning and privatisation on ideological grounds (Jackson 1990).

For four decades, the Romanian economy had been based on socialist ownership of the means of production (state and co-operative ownership). The private sector was practically non existent and the economy was characterised by excessive centralisation and rigid planning. The post-transitional government decided to restructure this over-centralised economy via gradual reforms, which favoured macro economic policies as a tool of restructuring. In addition, in the first few months after the revolution, parliament passed a number of laws concerning market reforms which saw the abandonment of central planning and monopolisation of economic activity and a reduction in the role of the government ministers. These changes in the law were expected to facilitate the creation of Romanian entrepreneurs, encourage foreign direct investment and complement the process of converting the state-owned companies into commercial enterprises, to be privatised, or "regies autonomes". This was accompanied by setting up a legal framework for commercial companies that

pledged a non-discriminatory policy towards enterprises as well as replacing the mono-bank system by a two- tier system (Anton, 1996; EBRD, 1995; OECD, 1993; OECD, 1998). It was not until 1992 that a further set of laws was introduced regarding the creation and functions of commercial companies.

Between 1992 and 1996, despite the introduction of some reforms such as judicial and public administration reforms, the overall reform programme was slow. This period was characterised by elements of stagnation and even back sliding. The state bureaucracy was heavily politicised in a re-consolidation of party control over the State. The parliament was unproductive and publicly rather inept, which aggravated the already strong tendency among many Romanians to view politicians with serious distrust. Corruption among government officials and politicians became a problem in these years, and was a further cause of public dissatisfaction (Carothers, 1996)

However in this period the Romanian Government established good relations with the West especially the United States of America in an attempt to persuade the international organisations and countries of Western Europe not only of its commitment to creating a market economy but also of a genuine move away from the previous isolationist nationalistic policies. Romania joined the Council of Europe and signed a partnership for peace. Romania also applied to enter the European Union and NATO, although neither has yet been achieved.

Even with the political uncertainties, the period between 1992 and 1996 is considered as a period of successful macroeconomic policies as it witnessed growth and low inflation, especially in 1994 and 1995, a year in which growth exceeded six percent (Daianu, 1996). The major policy reforms that occurred in this period cover enterprise reform and privatisation; creation of a favourable foreign investment environment; fiscal and monetary reforms, financial sector reform; price, wage and social protection reform and trade policy reform.

6.3 Stabilisation reforms

The underpinning aim of fiscal and monetary policy in Romania has been to control inflation and reduce government budget deficits, objectives backed by the IMF. Thus, the fiscal reforms adopted by the Romanian Government initially sought to apply strict financial discipline to control budget deficits. The fiscal policy adopted included abolishing subsidies and reforming the tax regime. Subsidies on production and consumption were lifted except for the production of mining and agriculture and the consumption of energy. The tax system reforms were aimed at raising state revenue and stimulating foreign and domestic investments.

Four laws formed the framework for the tax reform (Romanian Development Agency, 1995; Popa, 1995):

- A profit tax (corporate income tax) was introduced in January 1991 to replace the old system where state enterprises made remittances from their profits to the state budget.

- A salary tax was introduced in January 1991 to replace the previous tax on the wage fund of state enterprises.
- The turnover tax was revised in November 1990.
- The foreign investment law, introduced in March 1991, allowed generous tax incentives including profit tax holidays.

As well as changes to corporate and personal taxation, expenditure taxes were introduced in order to support the budget and to consolidate the previous tax reforms. Value Added Tax was introduced in 1993 and taxes on spirits and luxury goods were introduced in 1995. As well as changes to central government taxation a new set of local taxes were introduced in 1994. Notwithstanding these reforms, the fiscal situation showed an increase in the budget deficits especially between 1993-1996. In this period the budget deficit as a percentage of GDP grew by around one percent per year as a result of declining revenues rather than expenditure growth (OECD, 1998).

Romanian monetary policy mainly concentrated on the first phase of monetary stability, notably curbing inflation.[2] Price liberalisation had been delayed until November 1990 but even then important wholesale prices for all basic raw materials remained under administrative control, as well as retail prices of electric power, fuel used in home heating and urban transport services. Prices were not high enough to

[2] In contrast the experience of the more advanced countries (Czech Republic, Poland and Hungary) reveals that their main concern has been over the effect of foreign direct investment on monetary aggregates. The major question in these countries is the reliability of a tight monetary policy via the simultaneous use of high interest rates and stable exchange rates, and whether sterilisation of the capital inflows is the solution (UN Commission for Europe, 1996).

cover the domestic costs of extracting raw materials and producers continued to obtain subsidies from the state (Montias, 1991). Suppressed inflation, inherited from the former regime, did not disappear, while those retail prices that had been raised through liberalisation met opposition and discontent. Inflation was fuelled, in addition, by wage concessions granted by the government, who came under pressure from the new independent trade unions. Inflation kept on being fuelled by the new system of wage regulation introduced in 1991and by indexation of global wages to prices to maintain 80 per cent of the value of real wages in the previous year. This regulation was relaxed for some enterprises in 1992. Budget deficits and credit expansion together caused a significant increase in the monetary overhang. Interest rates were liberalised in April 1991 (Demekas & Khan, 1991). This episode of changing policies reflects the inability of the government to devise a coherent strategy for transition.

In April 1991 the Romanian government effectively discontinued the gradualist approach and introduced a strong and comprehensive macro economic adjustment programme supported by the IMF. This comprised of devaluation of the currency and tighter fiscal monetary and income policies (Labaronne, 1992) which were again tightened by the 1992 programme under IMF conditionality. In spite of the second stabilisation programme confirmed by the IMF, the implementation of many economic measures was postponed in 1992 due to political elections putting a brake on so-called unpopular decisions. Nevertheless, a main consequence of restricted economic policies was a dramatic output fall and increased unemployment.

Expansionary policies were again reintroduced during 1993. This on and off nature of strict and relaxed monetary and fiscal policy continued to be a feature of the Romanian economy during the 1990s.

In 1994, once again Romania adopted a tight monetary policy, following a period of hyperinflation between 1990 and 1993. The new policy package consisted of three main measures: an increase in interest rates; devaluation of the exchange rate; and strict control on the money base. Although interest rates had been liberalised in 1991 it was only in 1994 that real interest rates became positive. The hyperinflation and trade imbalances in the period between 1990 and 1993 had persuaded the Romanian National Bank to raise the average refinancing interest rate from 59.1% to 136.3 %. The main aim of this interest rate increase was to stem the flight from the Leu (the Romanian national currency) and to form an active market for foreign exchange (OECD, 1998). This increase in real interest rates had a binary effect. On one hand, it contributed to the slow down of inflation and developed some confidence in the Leu. But, on the other hand, it made access to credits more difficult and hampered production and investment. In 1995, as the inflation slowed down, the reference interest rate decided by the Romanian National Bank also declined to 35%.

Internal convertibility of the national currency was introduced at the end of 1991. However, the exchange rate was not allowed to float freely on the currency market until 1994 when both Romanians and foreign companies had free access to all official commercial transactions (including oil imports). In August 1994 the inter-bank

foreign exchange market was launched. Starting from July 1995, foreign banks with local branches were permitted to work as dealers in this market. Dealers were restricted to 1 million US dollars or equivalent in Lei, converted at the official rate, while the exposure for brokers was restricted to 100,000 US dollars (EBRD, 1996). At the beginning of 1996 the authorities applied tight restrictions on firms' access to conversion of local currency into foreign currency, and on foreign currency operations by commercial banks. The main aim was to manipulate the tendency of the Leu to fall. Only four firms were able to participate in the inter-bank market for foreign exchange, only one of them was private and none was foreign (EBRD, 1996).

Part of the changes to the operation of monetary policy was the restructuring of the banking sector. In 1990 a two-tier banking system replaced the mono-banking system common to central planning. Accordingly, an independent central bank was created as well as commercial banks. Prior to transition, the banking sector consisted of the Romanian National Bank and four specialised banks which were, the Investment Bank, the Bank for Agriculture and Food Industries, the Romanian Bank for Foreign Trade and the Savings and Loans Bank. The latter playing the usual role of mono-banking under the central planning system. The Romanian national bank performed the role of a central bank in issuing currency and administering the state budget. It also performed the operations of a commercial bank as it used to take deposits as well as providing loans to enterprises.

Banking has been the dominant institutional form of the financial system in Romania. The role played by the capital market has been much more modest. Romania's first stock exchange was established in mid-1995 when the first investment funds were set up, in addition to the issuing of shares for take-over bids. There have been issues over credibility of these new financial institutions given the number of bank failures and the methods adopted to stimulate privatisation of capital. The lack of an effective credit, lending and borrowing system has had serious complications for consumption and investment behaviour with preference for short termism.

In addition to liberalisation of prices the Romanian government moved towards trade liberalisation. However, it was not until May 1992 that export and import licences were eliminated and then qualitative import restrictions were only applied to products related to public health and security. The country adopted a liberal tariff policy[3] and export duties were removed. Romania joined the World Trade Organisation (WTO) in December 1994, when a new agreement was put in place which superseded the old quantitative restrictions. Under the WTO agreement, Romania was allowed in some cases to apply high individual tariffs, notably in agriculture. Romania signed a 'Europe Agreement' with the European Union (EU) in 1993 (EC, 1993), the full version of which came into force on 1st February 1995. The agreement allows for free trade in industrial goods between Romania and members of the EU. Under this agreement Romania eliminated custom duties for over 90% of its industrial products.

[3] The tariff treatment of most of the Romanian agricultural products remained high, on average about 110% according to the EBRD (1996) estimates.

The elimination of custom duties for Romanian imports was gradual, 20% of them were eliminated in 1996, while the rest were expected to be eliminated by the year 2000.

6.4 Stimulating private sector activities

A major reform in the first stage of transition was the introduction of a set of laws that provided a legal framework for the development of private property rights and the development of a private industrial sector. It is widely argued by neo-liberal economists that a deep economic restructuring in post-socialist countries can only be achieved by the creation of a new private sector (Pohl, 1997; World Bank, 1996; Estrin, 1994; Frydman and Rapaczynski, 1994). This entails the privatisation of state organisations and the encouragement of new enterprises. Both initiatives have been tried in Romania but with little success.

Various laws were passed in the belief that they would stimulate private sector activities. Little regard was given to more fundamental institutional change that might be necessary to stimulate economic activity in the move to a market economy, for example, establishing a credible credit system and investing in infrastructure. The legal framework for creating a private sector consisted of the following laws:

- Law No. 15/1990 (the Law on the Restructuring of the State Owned Companies) reorganises the state enterprises into commercial corporations and public companies (regies autonomes)

- Law No 31/1990 laid down the rules for the operation of commercial companies
- Law No 18/1991 clarified land property rights
- Law No 58/1991 established the Romanian Development Agency 1991 in order to undertake the privatisation of public sector organisations to become commercial companies
- Law No 133/1996 transformed Private Ownership Funds into Financial Investment Companies.

The privatisation strategy was carried out in two stages. The Law No 15/1990 laid the foundation for the first stage of privatisation. It stated that state owned enterprises should be transformed into commercial (joint-stock or limited liability) companies to be either privatised or remain under state direction. The transformation of part of state-owned companies into firms with state capital was regarded as a premise for privatisation (Calin and Korka, 1995). According to Law No 15/1990, all Romanians age 18 and above would receive nominal vouchers, free of charge, which represent 30% of the capital of the commercial companies. The disposal of these shares was organised by the National Agency for Privatisation. The rest of the nominal shares (70%) were owned by a public financial institution called the State Ownership Fund (SOF) which was responsible for directing the whole process of privatisation. The initial plan was that SOF in each year would draw up a plan for the forthcoming year that included dispossessing of at least 10% of the shares each year. Approximately 6,300 commercial companies were prepared for privatisation and

regies autonomes under the law 15/1990. The first stage of direct disposal of assets and shares operated between 1991-93 but proved unsuccessful. The second stage adopted a strategy of mass privatisation in 1993 which targeted all enterprises with state capital for which the previous procedures had not been finalised.

An important element of the next stage of the privatisation strategy in Romania was the identification of certain critical industries which were likely to have important impacts on the development of other activities. Five Private Ownership Funds (PPFs) were set up to share the risks involved in these critical industries and to improve the restructuring process (Calin and Korka, 1995). The five PPFs were:

- PPF(1): wood crafting, non-ferrous metallurgy
- PPF (2): textile and ready-made clothes
- PPF (3): naval transport, fishing, tourism and entertainment
- PPF (4): glass and ceramics, building materials, cosmetics, pharmaceutical products
- PPF (5): electronic and electro-technical products, leather products and footwear

The companies that were to be privatised in this stage of the privatisation process were classified according to their size (Calin and Korka, 1995):

- Small enterprises, included approximately 2,000 firms which each had control of capital less than 50 million Lei. The preferred method of privatisation in this case was to use management/employee buy-outs (MEBO). If this method

failed, then auctions would be organised. These companies were to be privatised under co-ordination of the regional commissions of the State Ownership Fund (SOF), the Private Ownership Funds (PPF) and the Privatisation National Agency (PNA).

- Medium-sized industries, which included those with capital between 50-500 million Lei. There were approximately 3,200 companies of this size which had state connections. The privatisation of these companies came under the remit of the Private Ownership Funds.
- Large enterprises, that numbered approximately 480 companies, each of which had more than 500 million Lei were to see 100% of their assets sold off. The POF took the responsibility for the disposal of these firms under the authorisation of the SOF. However, the approval of PNA was also required.

Romania had always been an agrarian society and this remained an important sector in the economy. The legal framework for privatising those sectors of the agricultural industry which had been collectivised was set up under the Land Law (18/1991). Under this law 75% of the agricultural land was available for privatisation. The agricultural companies were allocated according to regional criteria. Accordingly, 80% of arable land was in private ownership by 1992

In Romania by mid 1995 only 40 per cent of the state owned enterprises had been privatised, within which only 19 enterprises had emerged from asset sales and public tenders. According to Labaronne (1997) by the end of 1995 1,329 out of the former

6,244 state owned enterprises had been privatised. This represents only 8 per cent of total capital and just over 500,000 employees. Public enterprises at that time still dominated industrial production. Facing a failure in the implementation of the 1991 privatisation laws the Romania authorities passed a new law for accelerating mass privatisation in June 1995, which has been in force since 1996. The transfer of 30 per cent of the capital of all state owned enterprises to the five privatisation funds did not provide a solution to the issue of corporate governance. This was especially the case since the State Ownership Fund also kept control of large parts of capital. The 1995 law established the possibility for the direct exchange of newly distributed privatisation vouchers for shares in approximately 3,000 'profitable' enterprises.[4] These firms had to sell between 30 per cent and 60 per cent of their capital and the remaining shares were supposed to be sold at auction. Old privatisation certificates co-existed with new privatisation vouchers which led to a degree of confusion in the privatisation process. The five PPFs were abolished by the 1995 law. The complexity of the Romanian privatisation system is not likely to achieve a quick resolution to the privatisation issue or to stimulate foreign investors. This confusion is compounded by the attempts by state enterprise managers to maintain control of their organisation (Laboronne, 1995).

A considerable bureaucracy was established to undertake the privatisation process which, in part, accounted for slow progress in this area. By the end of 1997,

[4] If the firms were indeed profitable one could question whether this method of privatisation was necessary and why, even with the fledging Bucharest Stock Exchange, privatisation could not have taken place through asset sales or public tenders.

privatisation was governed by a whole set of laws, for example, Law No 58/1991, subsequently modified, Law No 77/1994, subsequently modified, and Law No 55/1995. Because of the slow progress of privatisation a number of emergency ordinances were also introduced in 1997 to stimulate the process of privatisation. However, applying these different decrees was difficult due to the increased number of regulations and contradictory criteria adopted (SOF, 1998b). The process of privatisation was also governed by the Ministry of Privatisation established in 1997, which prepared the privatisation policy, approved its annual programme and controls. The Ministry of Privatisation was also entitled to carry out programmes for technical assistance for privatisation as well as promoting foreign investment (SOF, 1998a). The Council for Reform and the Romania Development Agency, two other decision making centres, were also involved in the process of privatisation. The development of all these institutions merely created a conflicting set of organisations that restricted the move towards effective privatised industries. The underlying financial and ownership criteria required for successful privatisation had not been clearly articulated in Romania.

One of the main problems with the privatisation process in the early years of transition is that the main method of privatisation used was mass privatisation that while giving ownership rights, via tokens, to most of the population, did not involve the sale of assets nor the raising of new funds. In such circumstances, the new owners have little knowledge of the acquired firms and even less idea of how to restructure them, because they have not risked any of their assets to implement any

control mechanisms (Amsden et al, 1994). Such was the mistrust of the public in the programme and the government's credibility that many Romanians sold their coupons on the "black" market, though theoretically they could not be traded (Swan, 1997).

In other central European countries a whole set of proxies for privatisation, such as the distribution of vouchers (mass privatisation), state owned privatisation funds or investment funds, management or employee leases or buy-outs, liquidation and sale of physical assets were all substituted for asset sales.[5] In those Eastern European countries that use such proxy techniques privatisation came up with enterprises which were not really private firms. Their private owners cannot be identified because they do not exist. Governance has fallen into the hands of former leaders, managers, employees, state banks, investment funds under state control, rather than into the hands of new private owners. In many of these privatised enterprises the strategy of managers is aimed at maintaining their control and decision making. The behaviour of managers and employees as new shareholders of the newly privatised enterprises tend to replicate their behaviour as former stakeholders in the former state owned enterprises. They do not behave either as managers operating in a capitalist market or as profit maximising owners. They essentially look for the survival of their enterprise and, thus, the survival of their own position, job and income (Andreff, 1996; Ickes

[5] Only two countries, Hungary and Estonia, have used privatisation techniques based on asset sales, direct sales, tenders, auctions or public offerings, ie, privatisation methods similar to those used in western market economies (Heinrich, 1997). Privatisation strategies adopted in other Eastern European countries reveal the absence of the pre-conditions needed for privatisation in a 'capitalist manner', one that is attractive to new private entrepreneurs, foreign investors and financial markets. In Hungary a capital market had emerged sooner than elsewhere in Eastern Europe and a private sector had been legalised as early as 1982. Such features provided pre-conditions for privatisation through asset sales.

and Ryterman, 1994; Carlin, van-Reenen and Wolfe, 1995). Instead of maximising the value of their assets, insiders within the privatised enterprises tend to maintain social benefits and social consensus against any lay-off of workers. In other words, privatised enterprises in Eastern Europe are reluctant to embark on any major restructuring of the organisation.

The process of privatisation has been slow partly because of the confusion created by often contradictory laws and because of the lack of interest in investing in loss making industries that were still heavily subsidised and controlled by the state (Stan, 1997). Romania, like many other countries, had no laws that brought about the bankruptcy of firms, so that inefficient organisations carried on in business without any fear of exiting the market. Restructuring was largely interpreted by the State Ownership Fund (SOF) as financial support to heavy industry, base chemicals and agriculture but this financial support was in fact used to pay wages (OECD, 1998, p99). The withdrawal of this support under the 1997 policies will undoubtedly lead to the closure of firms with the resultant increase in unemployment whether recognised or hidden. An accusation made against the SOF is that it is full of bureaucrats intent on discouraging reforms through favouritism and using privatisation for their own benefit (Pasti, 1997). Thus, while formal institutional change has been attempted little attention has been paid to encourage new habits and procedures.

6.5 Foreign Direct Investment

Foreign direct investment plays a fundamental role in the integration of Romania into world markets. At the macro level it reduces the deficit in the balance of payments. At the micro level it was expected to play a positive role in modernising the structure of production and increasing productive output (Estrin et al, 1997). It was also expected to augment domestic capital and introduce effective western management practices. Romania had the potential to attract foreign investors since it had a large domestic market (23 million consumers), the second largest market in Eastern Europe after Poland, an excellent position on traditional commercial routes allowing access to more than 200 million consumers, cheap labour and a high level of training in engineering and technology (Romanian Development Agency, 1997).

Although there was some pre-1989 registration of joint ventures, the bulk of the legal framework for foreign direct investment was established in 1990-1991 under the following laws: Commercial Register Law No. 26/1990; Partnership and Company Law No. 31/1990; Foreign Investment Law No. 35/1991; Profit Tax Law. One of the main concerns of the Romanian government at the start of the transition period was to ensure the move away from the nationalistic policies that had been adopted under Ceausescu. Therefore under the laws mentioned above, Romania sought to adopt a much more liberal investment policy to attract foreign companies. This permitted 100% full ownership of companies by foreign companies, if necessary, and joint ventures with Romanian companies. Foreign investors were not subjected to discriminatory policies in access to the local markets except in those cases where

Romanian national interests needed to be protected (Romanian Development Agency, 1991).

Foreign direct investors are unlikely to maintain unrestructured organisations in Eastern European countries if they are experiencing low economic efficiency, low productivity, over manning and the maintenance of obsolete machinery and equipment. Therefore, we could expect a greater degree of economic restructuring in those Eastern European countries where foreign direct investment is more prevalent. Given the nature of much of Romanian industry it was not surprising that Romania tended to lag behind virtually every Eastern European country except Albania and Bulgaria in terms of foreign direct investment. If the stimulus for economic restructuring has been restricted by the state and is not open to foreign decision making then this is likely to restrain the degree of economic development as was the case in Romania.

Foreign direct investment is not attracted to a country merely because of comparative advantage, such as lower unit costs of labour, a large domestic market or richer endowments of natural resources and raw materials. What is important for many investors is a stable investment climate (economic growth, low inflation, some degree of unemployment to call on a pool of labour and keep wage costs down). Romania did not provide the kind of investment climate which foreign firms viewed as being without risk. The disadvantage for foreign direct investment have reduced but initially they faced complicated institutional mechanisms and horrendous bureaucracy

that made investment difficult. Until 1994 Romania had attracted only $551m of foreign direct investment although by the end of 1995 42,464 joint ventures had been established, far outweighing that in Hungary (23,000), Poland (16,000) and Russia (8,000) (Romanian Development Agency, 1995). While seemingly a benefit to Romania what these joint ventures signal is, in fact, a lack of confidence of foreign investors, who rather than invest significant amounts of capital are merely exploring the possibility of further investment.

6.6 Industrial Structure

The legal framework established to privatise state owned industries and to attract foreign direct investment was intended to change the industrial structure of Romania to enable it to compete in open world markets. However, in attempting to do this, the government was faced with industrial sectors whose character had been determined by years of central planning. The industrialisation drive in Romania following the Second World War was mainly based around large-sized enterprises. This was not just confined to heavy industry but also included consumer goods industries (Tsantis and Pepper, 1979). Socialist planners put a great deal of emphasis on large industries to achieve economies of scale, especially at plant level. In addition, it was also easier to monitor such large firms than many smaller enterprises. The disadvantages of such a strategy were that the economies of scale did not relate to the size of the market which remained relatively small. In addition, the managerial talent was not available to run such large organisations. These disadvantages were considered as only

temporary and were outweighed by the benefits arising from the economies of scale (Tsantis and Pepper, 1979).

Table 6.2 shows the average number of employed persons for each industrial enterprise in selected countries for the year 1973. The number of employed persons per enterprise was high in Romania compared to other Eastern European countries, other industrialised countries and late industrialised countries. As the table shows, in 1973, Romania registered the highest number of employees per enterprise compared to other countries.

Table 6.2: Average Number of Employed Persons for Each Industrial Enterprise, in Selected Countries, 1973

Socialist Countries		**Industrial Market Economies**		**Developing Countries**	
Romania	1480	Federal Republic of Germany	149	Columbia	71
Hungary	1070	Austria	96	Brazil	54
U.S.S.R.	712	United Kingdom (1972)	87	Korea	49
Yugoslavia	531	Sweden	68	Greece	41
Bulgaria	520	Canada	58	Israel	25
German Democratic Republic	297				
Poland	114				

Source: Tsantis and Pepper (1979, p.200).

A World Bank study of Romanian Industry (Tsantis and Pepper, 1979) showed that the concentrated industrial production in enterprises had the following characteristics:

- Nearly 82% of the industrial labour force were concentrated in enterprises employing more than 1,000 employees.
- Large enterprises remained labour intensive despite the modernisation efforts and the emphasis on building heavy industries and capital intensive production processes. Large enterprises employing more than 2,000 people were the main source of employment.
- Disaggregating Romanian industry showed that labour productivity was low except for very large enterprises (more than 5,000 workers) and small enterprises (up to 500). Enterprises in the range of 500 to 5,000 showed low levels of productivity.
- The dominance of large enterprises contributed to the broad product mix but had limited specialisation. This was particularly the case in the more intensive engineering plants and light industries. The large number of simultaneous production lines frequently taxed the capabilities of production managers and made it difficult to increase productivity.

The public sector remained important in many Eastern European countries. It was always likely to be a premature assumption that there was no future and no role for the public sector in the transformation process (Andreff, 1995). State intervention for the purpose of implementing an industrial policy has been used by a number of countries even though, for many, it resembles the legacies of industrial planning which operated in the Communist period. Countries such as Hungary and Poland have provided support to ailing industries when necessary (Hare, 1995). In Romania

the Agency for Restructuring has operated since January 1994 covering 230 enterprises of strategic importance to the economy, but performing poorly in financial terms. Although it could have developed a sensible industrial policy this agency, along with the Fund for State Ownership, has tended to stick to a bureaucratic system that does not impose hard budget constraints on enterprises, shows no urgency over restructuring and tends to favour the survival of industrial lame ducks in heavy industry (Lhomel, 1996). Since 1997 the Fund for State Ownership has supposedly changed its behaviour and has announced the privatisation of 455 enterprises. The state no longer looks to restructure before privatisation, as it previously attempted to do, but now leaves the restructuring to the new private owners where restructuring often implies laying off workers which can be shown sends out negative signals to potential foreign investors.

In Romania the privatisation process and industrial policy remained in the grip of the state authorities. For example, the Romanian Development Agency, which is in charge of small and medium sized enterprises concentrated activities on the legal supervision of start-ups and partly on representing the interests of the private sector at government level (Hunya, 1996). But what was not apparent in Romania was a coherent industrial strategy of the form advocated by the industrial structuralists. Romanian policy was piecemeal, inefficiently represented and rather than using the strengths of the past adopted many of the weaknesses of an over bureaucratic state.

6.7 Competition policy

Considerable effort in the early years of transition was given to privatisation, macroeconomic stabilisation and the opening up of the Romanian economy to worldwide competition. Paradoxically little attention was paid to internal competition policy and the need to control any restrictive practices or monopolies. This may have been appropriate when trying to stimulate market activity and the desire for profits (monopoly rents) but by 1997 the Romanian Government recognised the need for some degree of competition policy to reduce the negative impact of excessive monopolistic practices.

There is a theoretical justification for competition policy to operate in transition economies. For example Pittman (1996) has argued that the guidelines offered by both neo-classical economics and Western European experience towards competition policies are pertinent for industrial state-owned firms in transition. Specifically he argues that for countries such as Hungary and Poland targeting barriers to entry in connection with vertical integration or exclusive vertical contracts by dominant enterprises is required. Neo-classical economists such as Pittman view a direct relation between the introduction of competition policy in terms of anti-monopoly legislation, releasing market forces and economic efficiency. To them these policies force state-owned enterprises in Eastern Europe to privatise the profitable sub-parts of monopolistic, vertically integrated units. This leads to lower prices and the creation of efficient small private firms. But, as Amsden et al (1994) show, competition policy is somewhat redundant given the external control on firms provided by firm failures and

exit from the market. Excessive competition policies in this context may merely serve to reduce the number of active firms and destroy the incentive of switching to a market based system of allocating resources. There is an element of needing those firms, monopolist or not, that can survive the transition period since they are likely to represent the most efficient units in a more open economy.

Amsden et al (1994) argue that competition policy as proposed by neo-classical economists is ill-conceived. These theorists confuse economic concentration, measured as either the percentage of output in each industry accounted for by small firms or industry level concentration or the percentage of aggregate output or employment accounted for by the top hundred firms, with inappropriate firm size as an indicator of monopoly power. While such an emphasis may point to the need for downsizing and vertical disintegration of big monopolistic firms in certain industries, it does not recognise those industries that suffer from fragmentation and which operate below world standard minimum efficient scale (Amsden et al, 1994). Thus, a case can be made for Romania to maintain that which it had been familiar with since the 1920's, i.e. monopolies and cartels that are able to face the rigours of international competition. Rather than adopting a simple Structure-Conduct-Performance view of monopoly that sees industrial concentration as the main issue, the control of monopolies and the instigation of competition needs to recognise the strengths and weaknesses of firms in different markets and judge the benefits or costs of monopoly on behaviour and performance measures.

6.8 Conclusions

The Romanian government has instituted a range of policy reforms to create the structures necessary for the operation of a market economy. However, these macro, industrial and organizational policies have often been introduced in an unstructured, piecemeal manner without recognising the need for a coherent holistic approach, even when setting up market systems. Often policy reforms have not been allowed to run their course, often changing or being reversed because of internal and/or external pressures. Many of the reforms, such as those relating to privatisation, were inappropriate and were mere gestures towards the market rather than instituting the necessary processes to confirm the benefits (and costs) of private ownership. Giving away vouchers does not lead to effective ownership of corporate governance. Likewise, ignoring the downside of industrial change, such as bankruptcy, will lead to the maintenance of inefficient units. That is not to say that government should step aside and let the market determine events, but that, as suggested by the industrial structuralists, an active industrial policy would confer benefits on the transition process.

Rather than recognising the specific nature of the Romanian economy and building on the informal and formal institutions that were likely to be able to strengthen the move towards markets, the Romanian economy has been faced with institutional inertia, ill-conceived institutional change, and attempts to implement less than appropriate institutional developments. The impact on the Romanian economy of the manner in

which the transformation reforms have been developed and implemented are the subject of Chapter 7.

Chapter 7

The Performance of the Romanian Economy Since 1989

7.1 Introduction

In the previous chapter we considered the nature of the reforms that were implemented in Romania since 1990 noting the stop-go nature of the policy changes and the adherence to the implementation of IMF/World Bank inspired reforms. In this chapter we analyse the performance of the Romanian economy in the light of these policy reforms. The material in this chapter is mainly based on data obtained from the Romanian National Commission for Statistics and must therefore be subject to the usual caveats as to its reliability. To provide some check as to the reliability of the data comparisons are drawn with the performance of other East European countries. Much of the detailed information is set out in a set of tables in Appendix 2. The comparison with other countries also serves to highlight the differences between countries and thus the limitations of implementing general rather than specific policy reforms.

In the next section an assessment of the macroeconomic performance of the Romanian Economy is undertaken. This is followed in section 7.3 with an analysis of the performance of the Romanian Economy in external trade and capital markets. Section 7.4 concentrates in more depth on foreign direct investment in Romania since this provides some test of the extent to which structural and organisational change has taken place in Romanian industry. Section 7.5 continues an assessment of industrial change by analysing the effects

of privatisation policies. Section 7.6 looks at the impact of policy reforms on the labour market. Section 7.7 looks at whether there were forces at work in Romania resistant to change and Section 7.8 discusses the later reforms undertaken in 1997.

7.2 Macroeconomic performance of the Romanian Economy

As in other East European countries, the transition of the Romanian economy has been a difficult process. The first years showed a sharp drop in economic activity: GDP declined by almost 35% between 1989 and 1992. Both industrial and agricultural output declined, continuing the decline that had set in prior to 1989. External shocks to demand such as the collapse of the CMEA, the war in Yugoslavia and the Gulf War contributed to the fall in the Romanian level of economic activity. It was not until 1993 that the Romanian economy began to register positive economic growth, starting from a real growth rate in GDP of 1.5% in 1993 rising to 7.1% in 1995. By 1997, however economic decline had once again set in with the economy registering a fall in real GDP of 6.6%. Table 7.1 shows, that at 1989 prices, GDP in 1996 had only recovered to the same levels achieved in 1989. Between 1993 and 1996, Romania was one of the countries with the highest growth rates in the region (see Appendix 2 for comparative data). Although starting from a relatively low base the rate of growth in GDP terms was only outpaced by Poland. However, in 1997 the decline in Romanian real GDP was the highest of the sample of countries used for comparison. Table 7.1 also shows that, gradually through the transition period, the private sector increased its share of GDP from 24 percent in 1991 to 52 percent in 1996.

Table 7.1 Level of GDP in Romania 1989 to 1996 (1989 prices)

	1989	1990	1991	1992	1993	1994	1995	1996
GDP(billion lei)	800	817	889	684	639	670	738	803
%private sector			24	26	35	39	45	52

Source: National Commission for Statistics 1996/97

The differences in the growth rates between Eastern European countries, and the different economic cycles followed by these countries, raises questions about the appropriateness of applying the same set of policies. It suggests that the structure of the economies, their past performance and their past conduct and behaviour constrain the manner in which these economies are likely to respond to the application of the kind of stabilisation policies recommended by international agencies. The fluctuation in growth rates raises doubts about the nature of the stabilisation policy followed by Romania and once again reflects the stop/go approach adopted for macro-economic issues.

As indicated in chapter 6 the Romanian economy experienced a severe period of inflation following 1990. Both money supply and consumer price inflation in Romania (the indices used to measure inflation) increased sharply between 1991 and 1993, even by the standards of other East European countries. However, it declined considerably in 1994-1995 (see Table 7.2). The increase in consumption and imports in mid-1995 led to a build up of inflationary pressures which consequently led to tightening of monetary policy and import restrictions (UN

Economic Commission for Europe, 1996). Also money supply growth accelerated further during the autumn due to increased credits to farmers to finance the harvest.

Table 7.2 Inflation in Romania 1989-1996

	1989	1990	1991	1992	1993	1994	1995	1996
Consumer price index (% as Against 1989)	100	105.1	248	881.6	3139.3	7432.6	9830.4	13644.6
Producer price Index(% as against 1989)	100	126.9	406.2	1156.9	3065.8	7373.2	9961.2	14930.1
Broad money (Lei b)	547.8	612.3	1024.7	1856.1	4514.9	10648.7	18278.1	30335

Source: National Commission for Statistics, 1996, 1997

In Romania, both changes in the money supply and the consumer price index (CPI) in the period 1991-1994 have been one of the highest among the countries selected for comparison. Both indicators of inflation (money supply and consumer price index) started to decelerate in 1994 to reach two digit numbers in 1995 and 1996. But in 1997 both showed a massive increase, with money supply increasing by 104.9 per cent and the CPI increasing by 154.8 per cent. Although the CPI shows fluctuations which characterises the stop-go nature of the Romanian economy, the Producer Price Index (PPI) showed a continual increase throughout the whole period.

Decomposing the consumer price index (CPI) into its components shows a similar trend to the total CPI with food prices showing an increase above that for

the total, whilst non-food and services both showed an increase less than that of the total (see Table 7.3).

Table 7.3: Consumer Price Index (CPI) and its components for Romania 1991-1996

	1991	1992	1993	1994	1995	1996
Total	270	838.8	2987	7071.9	9353.4	12983
Food goods	286.2	963.4	3361.2	7940.3	10469.3	14276.5
Non-food goods	267.8	787.9	2907.4	6769.8	8775.5	12205.9
Services	235.7	661.0	2249.5	5641.8	8051.2	11830.8

Source (National Commission for Statistics, 1996, 1997)

The sustainability of a consistent macro policy in Romania remains an open question. Despite the commitment by the National Bank of Romania (NBR) to restrictive monetary and fiscal policies as agreed with the IMF in 1996, the price surge in the winters questions the credibility of the declaration. Price increases in the winter season have became the norm in Romania following supply side constraints since 1991 (Invest Romania, 1997; Eurostat, 1997), and policies to tackle inflation by concentrating on monetary phenomena ignore the impact of supply side constraints which might be taken into consideration if an industrial structuralist approach had been implemented in Romania.

In terms of fiscal changes, despite the reduction in subsidies, one of the main reform objectives, a reduction in the budget deficit, was not achieved. The 1990-1993 recession deprived the government of its main source of taxes. The deterioration in the budget deficit in the period 1993-1996 had been underestimated by the government. Quasi-fiscal support such as financing state-

owned enterprises, especially in the agricultural sector, at below market interest rates, were not recorded in the consolidated accounts (OECD, 1998, Daianu, 1996). The OECD report (1998) also shows that large public expenditure items such as payments to farmers and public sector employees salaries were carried forward to the subsequent accounting years. There was also a problem of collecting taxes in the early transition period. The internal macro economic performance of the Romanian economy, from the evidence presented above, has been characterised by its unevenness and the inability of the policy reforms to produce a stable macro economic environment and raises questions as to the appropriateness of some of the policy instruments recommended by the IMF and World Bank.

7.3 External macroeconomic performance

In this section we look at the external macro-economic changes that took place in Romania between 1989 and 1996 encapsulating both capital and trade flows. In 1990 Romania was the least indebted country among those in Eastern Europe. Its overall external debt was 230 million US dollars compared to 4400 million US dollars for the Czech Republic, 10890 million US dollars for Bulgaria, 21270 million US dollars for Hungary, 48900 million US dollars for Poland and 61100 million US dollars for Russia (National Bank of Romania, 1996). In most countries, but especially in Romania and the Czech Republic the amount of debt increased due to increased borrowing on the international financial markets (UN Economic Commission for Europe, 1997).

Table 7.4 Gross debt/GDP in Eastern Europe, 1990, 1994, 1995, 1996 (%)

	1990	1994	1995	1996
Bulgaria	55	118	81	103
Czech Republic	14	34	36	36
Poland	82	46	37	31
Romania	3	18	18	23
Russia	44	34	37	41
Hungary	60	69	72	62
Eastern Europe	38	43	39	36

Source: UN Commission for Europe (1997), table, 3.7, p 157.

Table 7.4 shows that the Gross Debt/GDP ratio in Romania increased from 3% in 1990 to 23% in 1996. This represented the lowest ratio in the region. Poland, which had the highest ratio in 1990 (80%), managed to decrease the share of debt/GDP (31% in 1996). However, the ratio in Hungary remained high, 60% in 1990 and 62% in 1996. In the Czech Republic, the ratio of Gross Debt/ GDP increased from 14% to 36%. The debts of all countries in Eastern Europe fell in 1995 and 1996, following a systematic increase in previous years (see Appendix 2, table A.6). However, the reduction in the dollar value of total debts mainly resulted from the valuation effect of dollar appreciation (Economic Survey of Europe, 1997). As shown in Appendix 2, table A.8, the ratio of Gross Debt/exports for Eastern Europe as a whole decreased from 184% to 96%. The ratio of net debt (gross debt less foreign exchange reserves) to exports also declined substantially from 171% to 56%. Romania registered the lowest level in Eastern Europe at the start of transition for both ratios: 28% for Gross Debt/exports and 15% for Net Debt/exports. During the transition period both ratios increased. The former reached 92% and the latter approached 70% in 1996. All other countries in Eastern Europe except Russia showed a trend that operated

in the other direction (See Appendix 2, table A.8). Thus, the changes taking place in Romania did not produce the required industrial change and hoped for activity in international markets. The country moved from one of relative financial stability, in terms of its external relationships, to one of debt.

Table 7.5: External Money and Trade Indicators

	1989	1990	1991	1992	1993	1994	1995	1996
Exchange rate (lei/$, end period)	14.4	34.7	189	460	1276	1767	2578	4035
Exports, fob ($ mil.)	10487	5775.4	4265.7	4363.4	4892.2	6151.3	7910	8084.5
Imports, fob ($ mil.)	8438	9202.5	5372	5784.1	6020.1	6562.4	9486.7	10555
Trade balance ($ mil)	2049	-3427	-1106.3	-1420.7	-1127.9	-411.1	-1576.7	-2470.5

Source: National Commission for Statistics, 1996, 1997

An examination of international trading patterns in Eastern Europe shows that most of these countries witnessed deterioration in the aggregate current accounts of the balance of payments. Eastern Europe ran a structural trade deficit with Western Europe. This deficit increased either as a result of sluggish western import demand, as in 1993, or from higher domestic demand of East European countries, as in 1995 (UN Economic Commission for Europe, 1996). The nominal value of imports and exports and hence the trade balance for Romania between 1989 and 1996 are shown in Table 7.5.

As in many other East European countries, the Romanian current account in the balance of payments statements deteriorated. Both exports and imports fell with the decline in exports outpacing that of imports. This was mainly due to the slow

structural changes and the lack of market reforms that took place in Romania. The level of exports deteriorated in the first five years of transition. They started to recover in 1994 but the overall level of trade in that year only achieved that of 1988/1989 (IMF, 1996).

Dividing exports into commodity groups, as shown in Table 7.6, reveals that all commodity groups witnessed a sharp decline in the period 1989-1991 ranging from 47.2% to 75.3%. The sharpest declines were in machinery and transport equipment, petroleum related products and textiles. Most commodity groups showed signs of recovery in the post 1991 period, except machinery and transport equipment, where the recovery took place in 1995, and agricultural products which, having shown a positive increase of nearly 53%, went into another phase of decline in 1995. Despite the surge in exports, by 1995 only exports of textile and garment products and metals and steels exceeded their 1989 level. This large export surplus is mainly based on subcontracting to a dense network of small enterprises[1] where textile materials are imported, processed and then re-exported (OECD, 1998).

[1] More than 30% of the trade over in Romania is done by sub-contracting to small enterprises (OECD, 1998, p 107).

Table 7.6 Romania: Commodity group export development and changes (%), 1989-95

	1989	1991	1994	1995[2] Jan-Jun		1989-91	1992-94	1995[1]
Agricultural products	5	6.i	6.5	8.3		-50.6	52.8	-2.4
Petroleum and products	17.8	12.4	9.7	10.9		-71.8	13.5	11.6
Textiles, garments, etc.	10.4	9.5	18.8	23.1		-63	186.1	28.6
Metals and steel products	14.7	14.5	17.1	19.7		-59.7	69.7	32.8
Machinery and transport equipment	17.2	21.2	11.6	14.4		-49.7	-21.4	26.1
Chemical products	13.1	8	10.2	13.3		-75.3	85.7	88.1
Other	21.8	28.4	26.1	10.3		-47.2	32.7	6.7
Total Exports ($m)	10,487	4266	6151	3426		-59.3	44.2	26.2
By Geographical area								
European Union	30.6	33.7	46	52		-55.2	96.6	43.1
United States	5.4	2.9	3.1			-78.1	54.4	39.1
Eastern Europe	17.4	14.2	7.2	5.3		-66.7	-27.5	8
Former USSR	22.6	23.3	6.7	5.2		-58.1	-58.5	-18.8
Other	23.9	25.8	37	34.9		-56.2	107.1	-29.5

Source: IMF (1996), table 16, p 111.

Romanian foreign trade inherited a dual structure that is characterised by both specialisation in low skilled labour intensive industries and capital intensive industries (OECD, 1998). The dual structure has continued in the transition period. This is shown by the high concentration of exports in certain industries

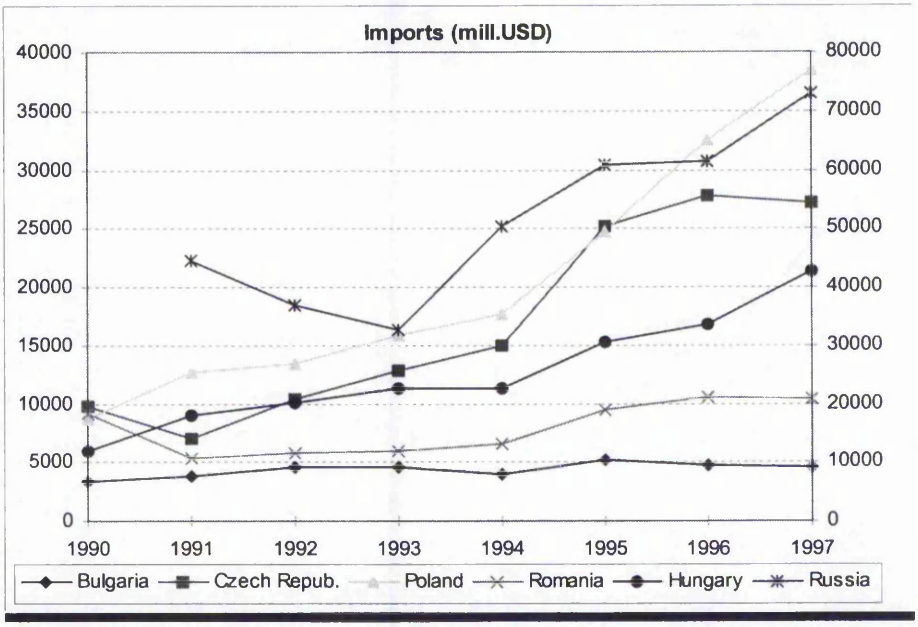
[2] Relative to first half of 1994.

such as iron and steel (capital intensive) which accounted for 10% of exports, apparel and clothing (labour intensive) which accounted for 19%.

There has been a change in the geographic distribution of exports. As Table 7.6 shows, exports to the European Union increased sharply while exports to the traditional markets of the formally centrally planned economies of Eastern Europe and the former Soviet Union contracted. The proportion of exports to European Union countries increased from 30% of total exports in 1990 to 52% in 1995. While the proportion of exports to other East European countries and former USSR shrank from 17% and 22% in 1990 to 5.3 and 5.2 in 1995 respectively. Despite the increase in Western import demand, there was uncertainty regarding the ability of Romanian firms to respond to producing higher exports because of supply constraints which arose from low investment during the initial transition period.

Figure 7.1 shows the level of imports for Romania and the comparative countries used in this thesis in the period 1990-96. In all countries shown, imports have grown. Romanian imports declined dramatically in 1991, followed by a systematic increase in the years 1992-96. These soaring imports generated a trade deficit equivalent to 7% of GDP in 1996 (OECD, 1998). Unlike exports, the geographical distribution of imports has remained fairly stable with European Union countries accounting for around 60% of the overall total. The export recovery led by essentially labour intensive firms following the early years of export decline has been highly dependent on imports of materials.

Figure 7.1: Import ($m) for Selected East European Countries and Russia



Running a substantial current account deficit for several years raises the question of sustainability of development and the extent of the constraints on economic growth. Without an increase in exports and a recovery in industrial production, and with low levels of foreign capital assistance, financing the current account deficit persisted leading to a depletion of foreign exchange reserves. This has been a characteristic of the Romanian transitional period. Romania had a persistent balance of payments problem and its external financial position was weakened by its failure to attract a considerable amount of foreign private finance. This compounded the delays in agreements with the IMF and the World Bank that restricted the amount of official funds received (UN Commission for Europe, 1996). This, along with the budget deficit, constrained economic growth in Romania. An agreement on a stand-by arrangement for financial support was

reached with the IMF in December 1995 and Romania finally received a credit rating in March 1996, but, even then, the balance of payments problems still remained.

7.4 Foreign Direct Investment

A central aim of transition in Eastern Europe is integration into world markets. Under central planning, these countries were isolated from international capital flows. The Marshall Plan, which had a significant impact on Europe's re-construction following the Second World War, was expected to be replicated in the context of Eastern Europe (Eichengreen and Uzan, 1992). However official funds towards such reconstruction have registered disappointing figures. Assistance by Western governments was mainly seen as temporary and to be replaced quickly by private sources. Borrowing from the IMF as well as the use of Guaranteed Export Credits[3] were modest (UN Economic Commission for Europe, 1996, p 141). The level of borrowing from the IMF exceeded both the disbursements from the World Bank and the European Bank for Reconstruction and Development (IMF, 1996, p 76).

The influx of foreign direct investment was expected to play a substantial role that goes beyond fostering industrial restructuring to help, for example, in boosting foreign currency reserves, relaxing constraints on current accounts and improving favourable international credit ratings (Estrin et al, 1997; Hunya, 1992; Donges and Wieners, 1994; UN Economic Commission for Europe, 1997).

[3] Guaranteed Export Credits, another source of official funds, were used modestly due to its high

The most comprehensive sources detailing the stock of FDI in Eastern Europe are the United Nations Economic Commission for Europe annual series: Economic Survey of Europe, Economic Bulletin for Europe and the quarterly series, East-West Investment News. For the first two sources the stock of FDI is based on the balance of payment statistics reported by the central bank in each country. However, the stock of FDI produced by the East-West Investment News, in addition to balance of payment FDI inflows, consists of the foreign component of FDI enterprises' statutory capital[4], foreign components of the equity capital of an FDI enterprise, retained earnings and indebtedness due to the foreign parent, including dividends declared but not yet paid to the direct investor.

The analysis in this thesis relies on statistics provided by the Romanian Central Bank and the Economic Survey of Europe, which are calculated using balance of payment data. The advantage of using this method is that, while possibly less comprehensive, it is more reliable than some of the other information that is used, which can both understate and overstate foreign direct investment. But it is also recognised that the balance of payments data have their limitations. Even for the balance of payments data, comparability across countries is often limited, given definitional problems such as the threshold for the equity stock that distinguishes direct investment from portfolio placement and the failure to record reinvested earnings. Also, the balance of payments data does not differentiate between the

costs and low level of domestic investment.

[4] Statutory capital comprises monetary and in-kind contributions of foreign and local partners in a foreign investment enterprise at the time of registration.

potential and real flow of FDI committed by the foreign firms. So the recognisable increase in the foreign direct investment to Eastern Europe should be viewed with caution.

The influx of FDI to Romania has been one of the lowest in the region compared to, for example, Hungary, Poland and the Czech Republic. Table 7.7 below shows that in 1993 FDI into Eastern Europe was only 10% of the total FDI into developing countries. In 1992 Argentina and Malaysia received comparable amounts to that of Eastern Europe and the former Soviet Union as a whole, and both China and Mexico received substantially higher amounts.

Table7.7: Foreign Direct Investment Flow for selected EAST European Countries (million US$)

Country	1989	1990	1991	1992	1993
Bulgaria	-	4	56	42	NA
Czech Republic	171	120	51	983	480
Hungary	215	354	1	1479	2238
Poland	11	89	1462	678	NA
Romania	-	112	291	77	NA
Solvakia	86	53	40	72	120
Solvenia	-	-	82	111	NA
			41		
Total CEE	397	679	2401	3370	NA
Total FSU	-	-	200	1135	NA
China	3393	3487	21366	11156	NA
Malaysia	1668	2548	4073	4118	NA
Mexico	2648	2548	4742	5366	NA
Total LDCs	25804	31445	39624	50388	NA

Source: Meyer (1994, table A.1).

A sectoral breakdown of the FDI shows that FDI has concentrated first on manufacturing, with a trend more recently towards services, and on selling in local

markets rather than export (Radice, 1995; Meyer, 1994,). There are two diametrically opposed forces which determine the inflow of FDI to the region:

- Attracting factors: access to new markets, low wages and favourable conditions created by privatisation and the laws passed by East European governments in favour of FDI with the aim of gaining technology skills, hard currency etc.
- Repelling factors: the ambivalence of East European governments between attracting FDI on the one hand and national priorities on the other. Foreign direct investment is welcomed but it often has to seek the approval of different levels of bureaucracy. In addition, the local courts are not set up to deal with FDI issues.

It is widely argued by Bretton Woods institutions and neo-liberal economists that privatisation is a major determinant in attracting FDI (see Economic Commission for Europe, 1996; Hunya, 1992; Estrin, 1997). However as seen in the case of the leading countries in terms of receipt of FDI, Poland, Hungary and the Czech Republic, there is little support for this argument (Table 7.8). The sharp decline in the proceeds from privatisation in 1996, indicates that the flow of FDI relied on other factors than privatisation and was mainly driven by green field investment and an increase in existing capital assets.

The Romanian transition has been characterised by slow privatisation of large companies in the period of study, 1990-1996 (IMF, 1996; OECD, 1998). There was an acceleration of privatisation at the beginning of 1997 that caused an

increased interest among foreign investors in larger companies, e.g. Lafarge (France) bought 51% of Romicim's Shares (Romania's major cement producer) for an estimated price of $200 million (Invest Romania, 1997). Thus, although not the only factor influencing FDI, privatisation of state enterprises in Romania had some impact on the rate of FDI into that country and more latterly has been greatly helped by the opening up of this asset market to foreign purchases.

Despite the continuous legal changes encouraging FDI, the legislation did not include appropriate guidelines for carrying out the process. This was one of the main reasons which deterred the influx of FDI. For some, Romania might have appeared an attractive FDI location since it had some comparative advantages, such as lower unit costs of labour, a relatively large domestic demand and a rich endowment in natural resources and raw materials. However, what seems to attract FDI is a stable investment climate, an acceptable country risk as assessed by international bankers and capital markets and a fair and transparent legal and fiscal treatment of FDI. In this respect Romania still does not provide a very encouraging investment prospect for foreign firms since it still has legacies of high inflation, fiscal deficit and relatively low unemployment. Paradoxically, a low unemployment rate acts as a deterrent to potential foreign direct investment because it does not put downward pressure on wage rates, and low unemployment also means there is a problem of getting rid of redundant labour. The foreign investor is left to carry out the restructuring of industry.

Table 7.8 Foreign direct investment and proceeds from privatisation, 1993-1997(million US$)

	1993	1994	1995	1996	1997
Czech Republic					
FDI	568	862	2562	1428	
Privatization proceeds		1077	1205	944	700
Hungary					
FDI	2339	1146	4453	1983	
Privatization proceeds	1842	1017	3813	660	800
Poland					
FDI	580	542	1134	2741	
Privatization proceeds	734	642	1516	495	3500

Source: Economic Commission for Europe (1997), table 3.6.17, p 171.

In terms of FDI per capita, Romania by the end of 1995 had only received US$ 80 per capita, mainly for investment in SMEs. (Anton, 1996). The main investors in rank order in 1996 were the Italians, Germans, South Koreans, French and Dutch (SOF, Romanian Development Agency). Much of the foreign direct investment in Romania during 1995 was aimed at the food and the service sector. 23% of the foreign direct investment went to the food industry, 6.5% going to banking. Much smaller percentages were then distributed over a whole range of industries. Agriculture received only 1.8% of foreign direct investment and tourism only 3.2%. Romania had attracted less foreign direct investment than Hungary, Poland or Russia yet had seen the development of over 40,000 joint ventures. The establishment of joint ventures in itself may seem a move in the right direction but can also be considered as a lack of confidence by foreign investors who, in the framework of international oligopoly, are merely sampling economic performance in Romania and averting any risk by investing only small amounts of capital. This leads to the problem, in many cases, of the under-capitalisation of joint ventures.

7.5 Industrial structure

One of the main challenges facing Romania was the reform of its large industrial sector which had the main share of output and employment. According to the National Commission for Statistics the main sector in the economy, measured by value added and employment, was the industrial sector (National Commission for Statistics, 1996). The weight of industrial value added in total value added ranged from 35.6% in 1993 and 1994 to 34.6% in 1995 (National Commission for statistics, 1995, 1996, 1997).

A study carried out by the Ministry of Industries (cited in Lefter, 1995) showed that the industrial structure in Romania during the early transition period which were large consumers of energy, was directed towards productive sectors, fuel and raw materials, ferrous and non-ferrous metallurgy, building materials, chemicals, cellulose and paper. The study also showed that the existing industrial structure was characterised by the following:

- A large number of large and medium sized firms, especially in metallurgy, chemicals and machine building.
- Although the size of industrial branches is comparable with those in the rest of Europe they tended to be heavy users of energy and raw materials.
- The regional distribution of industry was relatively evenly spread across Romania, as a result of the distributional policies implemented during the 1970's and 1980's.
- Domestic resources of energy and raw materials are relatively scarce and

entailed high extraction costs.

- The prevalence of volume production, characterised by high consumption of energy, fuel and raw materials, but which had a relatively low degree of capitalisation.
- The prevalence of out of date technologies, where many installations had become obsolescent, in part due to inadequate maintenance, and operated below full capacity, which meant that they were not replaced as frequently as was needed.
- The switch to world markets and the opening up of domestic markets meant that some markets were lost, some of which had been the traditional mainstay of economic activity.
- There was a high level of pollution in some sectors, such as the metallurgical industry, chemicals, petrochemicals, cement industry.

A main characteristic of Romanian industry at the start of transition was the high level of industrial concentration, as shown in Section 6.6. Table 7.9 below traces the number of enterprises and the average number of employees by size of enterprise in the years 1990, 1993, 1994 and 1995. The table shows that over this period there was a change towards the development of Small and Medium Sized Enterprises (SMEs). In 1990, the proportion of enterprises with less than 200 employees was 7.6% which increased to 91% by 1993 and 94% by 1995. However, the percentage of employees in this sector only increased from 0.7% in 1990 to 10.6% in 1995. Many of these small enterprises emerged from informal trading relationships that might have existed before 1989.

Table 7.9: Proportion of Enterprises in Each Industrial Size Category in Romania 1990-1995

	% of enterprises				% of employees			
	1990	**1993**	**1994**	**1995**	**1990**	**1993**	**1994**	**1995**
Total	100	100	100	100	100	100	100	100
Up to 200 employees	7.6	91.2	93.5	94	0.7	9	10.5	10.6
201-500 employees	20.3	2.9	2.6	2.2	4.4	8.1	9.9	9.9
501-1000 employees	24	2.4	1.6	1.7	10.6	14.2	16.5	15.5
1001-2000 employees	23	1.9	1.2	1.2	19.5	21.4	21.7	23
2001-3000 employees	10.9	0.9	0.6	0.5	16	16.8	13.6	14.2
3001-5000 employees	8.8	0.5	0.3	0.3	20.8	14.6	12.3	13
Over 5000 employees	5.4	0.2	0.2	0.1	28	15.9	15.5	14

Source: National Commission for Statistics, 1994, 1995, 1996.

The contribution made by small and medium sized enterprises is also shown by looking at the development of private enterprises in the industrialised sectors by ownership structures (see Table 7.10). The number of private industrial enterprises increased substantially from 7,100 in 1990 to 32,323 in 1995. These accounted for 96% of the 33,824 registered enterprises in Romania. However, the number of employees in the private sector increased from 48,000 in 1990 only to 433,000 in 1995 out of the total number of employees 2,615,000, i.e. 16.6%.

Table 7.10: Number of Industrial Enterprises and Employees by Type of Ownership

Number of Enterprises						
	1990	**1991**	**1992**	**1993**	**1994**	**1995**
Total	2241	9909	17085	23858	33824	33824
Public ownership	1683	2069	2116	2514	2182	2064
National Industry	1612	2011	2058	2117	1808	1642
Local industry	71	58	58	397	374	422
Mixed ownership	....	....	35	107	244	256
Private ownership	....	7100	14207	20599	30844	32323
Co-operative ownership	558	740	727	554	427	
Average no of employees (thousands)						
Total	3702	3409	3093	2900	2717	2615
Public ownership	3365	3084	2783	2549	2290	1959
National industry	3297	3053	2762	2478	2214	1895
Local industry	68	31	21	71	76	64
Mixed ownership	....	....	31	32	65	145
Private ownership	....	48	105	186	271	433
Co-operative ownership	337	277	174	133	91	78

Source: National Commission for Statistics, 1996.

Table 7.11: Employment Indicators in Romania 1989-1996

	1989	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**
Employment (ths Of persons)	10805.4	10945.7	10839.5	10785.8	10458	10062	10012	9493
Industrial employment	4064.6	4169	4015.1	3817.4	3300.9	3030	2882	2714
Employment in Construction	771.8	766.7	653.1	462.7	579.2	574	563	479
Employment in Trade, hotels and Restaurants	635.4	648.9	724	912	929.2	716	722	988
Employment in Agriculture and Forestry	3066.9	3056.3	3144	3205	3443	3614	3647	3265

Source: National Commission for Statistics, 1996, 1997

Table 7.11 indicates that total employment decreased during transition. The sectoral analysis shows a decrease in industry and construction and an increase in trade, hotels, restaurants and agriculture. However, the increase in the expanding sector was not enough to absorb those from the declining sector. It is difficult to argue that the slight increase in agricultural employment was a sign of recovery. First, agriculture has been continuously subjected to artificial subsidies from the government (OECD, 1998). Also at the start of transition, there were signs of over employment in agriculture. In the late 1980s, there were twenty persons employed for every 100 hectares of utilised agricultural area compared to eight persons in Western Europe (Eurostat, 1997, p61) which reflects low productivity of agriculture in Romania. Furthermore there was excessive specialisation and inadequate planning, as many collective farms and state-owned enterprises engaged in both primary agriculture as well as other activities.

In addition to the privatisation programme stress was also placed on the development of indigenous new firms which, because of capital constraints, knowledge of markets and phasing over the life cycle of firms, were of necessity small and medium sized firms (SMEs) (Anton, 1996; Gibb, 1993; Fülp, 1994; Kotrba and Svejnar, 1994). The development of SMEs has been recognised as being necessary by most of the post communist countries but, as in Romania, many have found it difficult to overcome the financial constraints, corruption and power relationships that restrict the implementation of these policies

Between 1990 and 1997, 645000 new private firms were officially established in

Romania although many of these were merely formalising their previous existence. Given the nature of many of these firms they had short life cycles and were in areas where entry (and exit) was easy such as trade and services, where there is little sunk fixed and human capital (Chamber of Commerce and Industry, 'Centre for Small and Medium-sized Enterprises', 1997). Many of these firms undertook exchange rather than production processes and as such have not built up the quality productive base for the production of manufactured goods.

The entrepreneurs that have emerged have been concentrated mainly in the area of small businesses, shops, and restaurants. The emerging entrepreneur class comes from two sources, (OECD, 1998); those with a past experience in the state sector before the collapse of socialism that benefited from personal connections with banks and are currently engaged in foreign trade, manufacturing and services; secondly educated young businessmen with limited access to capital who engaged in areas with low entry costs, mainly micro small business, shops and restaurants.

Many factors have hindered the successful development of entrepreneurs in Romania. It can be argued that those factors are a combination of the legacy of the past together with tight macro economic stabilisation policies. One of the main problems that faced private businesses, whether national or foreign investors in Romania, is the complicated legal system: "Laws have to cover each matter of detail and also need complicated methodological norms providing guidelines regarding their implementation" (OECD, 1998, p 23). What also aggravates the problem is the multiplicity of institutions responsible for structural change. As

noted in Chapter 6 above, several institutions have been involved in the process of restructuring where the responsibility of these institutions usually overlaps. Another major problem is the deficiency of finance. In contrast to large state enterprises SMEs have mainly relied on self financing through savings and profits. As far as external finance is concerned this is usually carried out on a cash basis. People refrain from credit-based financing from banks due to the complexity of procedures, lack of experience and the high cost of credit (IMF, 1996).

In the current situation characterised by fundamental uncertainty the ability of firms to survive does not depend merely on competitive advantage but on how they engage through markets and non-market relations in a complex set of institutions. For Romanian entrepreneurs what seems to be of importance is their origin, access to finance and their ability to mobilise support from other different sources (Ibrahim and Galt, forthcoming). It should not be surprising, given the background of Romanian entrepreneurs, that the attempted introduction of different institutional arrangements has been difficult and, in some cases, inappropriate. The emphasis of the 'old' institutionalists and the role of habit would suggest that any change in institutional arrangements that did not recognise the long term relationships people have with existing institutions was unlikely to be successful except over a long period.

To understand how entrepreneurs can be encouraged to establish long run, viable firms requires a deeper analysis as to how production is organised, co-ordinated and distributed. Production should be linked to technical innovation by enhancing

organisational capability. As Simon put it "the attempts of new institutional economics to explain organisational behaviour in terms of agency, asymmetric information, transaction costs, opportunism and other concepts drawn from neo-classical economics, ignore key organisational mechanisms like authority, identification and co-ordination, and hence are seriously incomplete (Simon, 1991, p 42).

7.6 Costs of transition - Unemployment

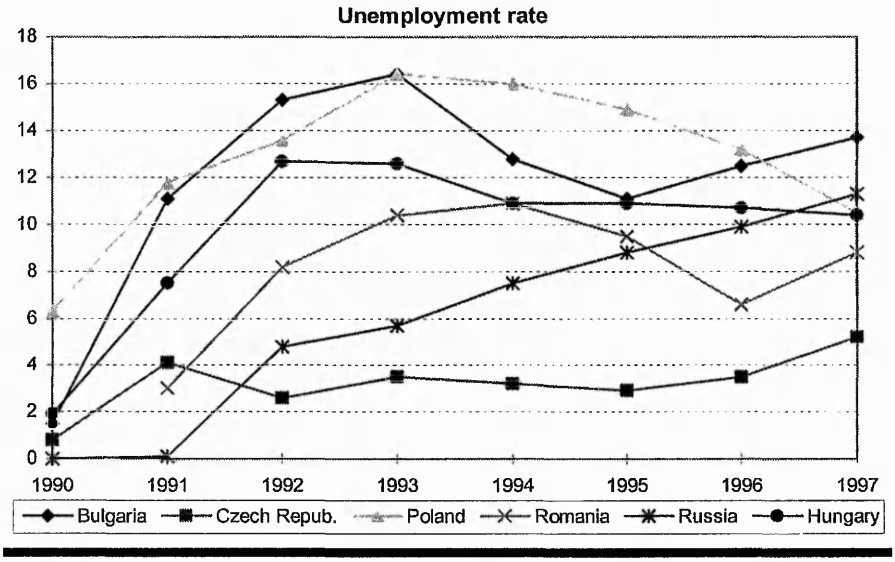
In centrally planned economies, the phenomena of open unemployment did not exist. Therefore tackling the burden of soaring unemployment and the social consequences it causes is one of the challenges facing transition economies. As Figure 7.2 shows, Romania followed the general trend in the region (except in the Czech Republic), where the level of unemployment increased relatively quickly till 1993, then the rate of increase slowed down in 1994 and 1995. Romania and Bulgaria saw the largest fall in 1996. As this was not accompanied by recovery in industry, the decrease reflected an increase in hidden unemployment rather than a sign of economic recovery (UN Commission for Europe, 1996).

Table 7.12: Unemployment in Romania

	1989	1990	1991	1992	1993	1994	1995	1996
Unemployment (ths. pers)	.....	.....	337.4	929	1164.7	1223.9	998.4	657.6
Unemployment rate(%)	.....	.....	3.0	8.0	10.4	10.9	9.5	6.3

Source: National Commission for Statistics

Figure 7.2: Unemployment for a selected East European Countries



Source: Romanian National Bank (1998)

By 1995 the unemployment rate in Romania was around 10% (see Table 7.12). In part this was to be expected as it is well known that stabilisation programmes, such as those backed by the IMF, are likely to lead to wage restrictions and demand cuts and, thus, trigger an output fall and an increase in unemployment. This contrasts with the IMF and World Bank belief, as was argued in Chapter 3 and later tested in Chapter 5, that reduced wages would lead to increase in demand for low cost goods and would then lead to an increase in output and, hence, employment. The drop of real wages that occurred in Romania restricted household consumption except for a few and impoverished large groups of the population. The continued level of unemployment is partly explained by the limited outflow of those who are unemployed into new employment, since new

private enterprises tend not to hire the unemployed, preferring to use the skills of those still employed in public enterprises. The reduction in real wages and the increase in unemployment has led to a situation where there are still large areas of poverty in Romania with all its consequences for living standards and health. Whatever Romania's situation the benefits of the markets for a few have been counteracted by the problems that exist for many in that country. The changes for those who have succeeded in the free market have not trickled down to the majority of the population. Such inequality requires a set of institutions that are not simply those related to establishment of property rights and the encouragement of price liberalisation. As Amsden et al forcibly argue "members of the society must have the feeling that they share in the benefits of growth, if there is growth and that the burdens of recession are distributed in a fair way" (Amsden et al, 1994, p 204).

7.7 Resistance to Change?

The changes that swept across Eastern Europe in 1989 were much more revolutionary for Romania than most other countries in the region. Most of the other Eastern European countries had experienced some forms of market reforms prior to 1989 which enabled the more dramatic changes after 1989 to evolve from the institutional framework that had been established and to which people had gradually become accustomed. In Romania this pre-transition adjustment period had not occurred and it had no time to evolve from a planned economy. Thus the more gradual approach to transition, whether by design or not, which saw limited institutional reform between 1990-1996 can be viewed as a necessary period in

which to establish the habits necessary for the more substantial implementation of market institutions. However one suspects that, rather than this period being one reflecting a deliberate strategic choice to implement such a policy, it was more likely the result of blocking tactics from influential sections of Romanian society, which were resistant to any change (Stan, 1997). But even taking this interpretation suggests the merit of the old institutional view that an evolutionary process based on institutional legacies will produce a path dependent development. If people find it difficult to adjust to new circumstances then this must have implications for the institutional frameworks that can be successfully introduced.

Romania presents a classical case that nationalism is one of the main signs of continuity in the country's political economy. The response of the government to the poor economic performance discussed in the previous sections, rather than to be developmental and target pro-growth measures, returned to the favourite tool of nationalism. The reactive state lacking a long run developmental policy used the nationalistic slogans against ethnic minorities and the threat of foreign intervention.

Politically organized Hungarian minorities were harassed in order to appeal to nationalist lobbies. Such appeal was an effective tool for government where the support of the ultranationalist party kept President Iliescu in power till 1996 (Gallagher, 1998, p 52-53). Though Romania did not face the situation in former Yugoslavia and managed to comply to liberal democracy in addition to the

relatively low level of ethnic conflicts, the post-socialist period witnessed the rise of an Ultranationalist party called the Greater Romania Party. Ultra-nationalist images of the continuing presence of " the enemy within has revived memories of the Hungarian occupation of north-west Transylvania between 1940 and 1944 (p30). Instead of criticizing the ultranationalists for the riots in Tîrgu Mureş riots against the ethnic Hungarians, they were offered important national and local public offices in the 1992-1996 period (Gallahar, 1995; Pop-Eleches, 1999).

7.8 1997 Reforms

By the end of 1996, after much consternation about the lack of development of the economy, Romania saw the emergence of a new government, which hopefully was going to counteract economic crisis and management of the economy. In 1996 presidential and parliamentary elections, the ex-communists were defeated by a centre-right coalition, with Iliescu losing the presidency to a reformist, Constantinescu.

Constantinescu's party (the Democratic Convention of Romania) joined in a governing coalition with another group of opposition parties - the Social Democratic Union and the Hungarian Democratic Federation of Romania (which represents the country's Hungarian minority). The former ruling party, the party of Social Democracy of Romania, formed the opposition along with two nationalist parties, the Greater Romania and the Party of Romanian National Unity.

1997 saw a shift in emphasis in the transition process with the introduction of "100 laws" (OECD, 1998). These provided the legal framework for the creation of the institutions and environment needed for speedier privatisation, labour market change, reform of product markets, changes to the tax system and social security, restructuring of public administration and proposals for greater financial discipline. Along with these suggested micro-economic structural changes there were changes at the macro level, such as the tightening of monetary policy to control inflation and stabilise the currency, and a commitment to a reduction in the government's deficits. The overall impact of the monetary and fiscal policies was a reduction in available credit and funds leading to a downturn in economic activity, a rise in unemployment and the closure of previously supported debt ridden state enterprises. The structural adjustments were meant to support the direction pursued by the macro-economic policies, although the restrictive macro-economic policies have worked to limit the ability of institutional change to take place and restructure the economy (Ibrahim and Galt, forthcoming).

Structural change in Romania has, up until the production of this thesis, been rather limited. For much of the transition period it has still been dominated by industry and agriculture and a lack of development of services and new advanced industries. Although the recent changes in Romania have not as yet "borne fruit", one view is that these changes should have been made earlier in the transition process, for example the OECD adopted a critical standpoint regarding the period of slow adjustment between 1990 and 1996. Their preferred option would have been a rapid period of change that, although having economic and more

particularly social costs, would have established the structural changes that could underpin macro-economic policy. However, there must be some doubt as to the validity of this argument. Independent of policy recommendations institutional and historical legacies shape the transition path and do so not on policy preferences but according to how powerful actors enact those (new and old) institutions. It is this that, in part, creates institutional inertia and path dependency and why, for example, politicians and managers were able to delay change. Those in power in Romania during the early 1990s used the argument that the transition process should be gradual to mitigate social deprivation. However, Pop-Eleches' (1999) comparative study of Romania and Hungary shows little to support this argument.

7.9 Conclusion

The empirical evidence presented in this chapter shows that the Romanian economy has not, as yet, been able to adjust to market forces either outside the country or within. The restructuring of the economy has been hindered by the stop/go macro-economic stabilisation policies that have created uncertainty and instability for the economy. Even though there has been an increase in SME activity this has largely been concentrated on micro firms, often under capitalised, due to the credit problems of the banks. Industrial change has been slow. There have been attempts at privatisation which initially got off to a very slow start and was introduced using inappropriate methods which concentrated on ownership rather than on efficiency or effectiveness. There has been little success in attracting foreign direct investment, except through joint ventures which, as we

have argued, in a sense expose the riskiness of the Romanian economy at its current stage of development.

The policies adopted for industrial restructuring have often been half-hearted and reactive. What has been lacking is a coherent industrial policy that plays to the strength of the Romanian economy and which recognises, for example, that in some cases there is a need for a more direct public sector input and recognises the traditional strengths and weaknesses of the economy. The reason why much of the restructuring has not been successful is due not only to institutional inertia but to the inappropriate adoption of some institutional arrangements rather than developing institutions that are derived from the culture, traditions and habits of the Romanians. Rather than seeing these as a constraint over which are imposed specific institutional changes such as the establishment of private property rights, these features should be incorporated into the objectives of the institutions established. As in any economy, the present operation of the Romanian economy is derived from the past conditions in that economy and the adoption of various structures and policies in the past exhibit themselves in the current economy. In a sense, there is a memory built into the performance of current economies derived from past activity.

As the evidence presented in this chapter shows institutional inertia has been evident in many Eastern European countries but has been particularly apparent in Romania. In Romania, despite abandoning communist ideology, the label neo-communist has been applied constantly to those who held power after 1989 and

who used nationalism as a way of maintaining legitimacy (Marga, 1993; Verdery and Kligman, 1992). Putting historicity at the forefront of the discussion of transition moves the analysis of institutional change far beyond the restrictive conceptions of new institutional economics. The emphasis gets beyond how more efficient institutions have outperformed less efficient institutions to analyse how the vacuum created by the collapse of old institutions has been filled.

Chapter 8

Summary and Conclusion

8.1 Introduction and Themes of the Thesis

This chapter draws together the main arguments presented in the thesis. In this first section the main themes of the thesis are elaborated. In section 8.2 the alternative theories of transition are considered. In section 8.3 a comparison of instantaneous adjustment arguments and path dependency are discussed. In section 8.4 a review of the empirical analysis is undertaken. 8.5 presents some of the limitations of the work and 8.6 provides some concluding remarks.

The mixed response to transition in different Eastern European countries and former USSR states suggests that the nature of change from a planned economy to a market economy has not been fully understood or predicted. State hierarchy in many cases has not been effectively replaced by markets or private organisations. The failure of transition in some countries during the earlier years was often explained by suggesting that the institutions required for an effective set of markets had not been put in place. It quickly became apparent that there was a need for the establishment of an institutional framework. However while accepting the need for the introduction of new institutions there still remains an issue as to the appropriateness of any suggested institutional framework.

The types of institutional changes suggested were either replications of those institutions that operated in western market economies, or were limited changes

that stressed the establishment of private property rights, liberalisation of markets and the voluntary reaction of individuals and organisational structures to establish appropriate exchange systems that would minimise transaction costs. This was a typical "new" institutional economics approach guided by underlying Anglo Saxon, neo-classical economics. There was little emphasis in the reforms on the socio-economic and historical setting within which the transition process has been attempted.

In this thesis we have examined the extent to which "new" institutionalism (Coase, 1937; Williamson, 1975, 1979, 1985; North, 1987, 1994), with its emphasis on transaction costs, property rights and contractual behaviour, consciously or unconsciously provided the theoretical underpinnings that have been adopted to guide economic transition in Romania. The new institutional approach was then compared to that of the "old" institutionalists (Veblen, 1898; Commons, 1934) who emphasise how the socio-economic fabric of society, path dependency and evolution need to be incorporated into an analysis of institutions if appropriate institutions are to be adopted. We argue that "new" institutional economics overemphasises an examination of exchange relationships in the transition process and, unlike the "old" institutional school, downgrades issues relating to production technologies, lack of innovation, the historical legacy of planning and the availability of resources, notably finance and skilled (as opposed to educated) labour.

While there is a recognition of the role of institutions such as property rights and

contracts, as well as organisational structures such as firms, the restrictive conception of these institutions as adaptive tools to the power of the market diverts the study of Romanian transition away from an analysis of the institutions in which agents are embedded and which guide or constrain both micro economic co-ordination and change. It is not just a case of establishing some key institutional changes but appreciating that the set of institutional changes established is appropriate and recognisable by those who have to adjust to new circumstances. Further it takes time for such adjustments to occur and guidance rather than reliance on voluntary or spontaneous adjustment will be needed.

At the start of the transition period to a market economy Romanian industry had faced many long standing problems. Up until 1990 the Communist Government had adopted a set of restrictive policies that dramatically reduced imports and domestic consumption in order to repay debts to Western countries. Such policies had been a reaction to the earlier collapse of the Stalinist model of industrial growth. Instead of looking to reform the system during the 1970s and 1980s the basic model was maintained and policies to bolster self-sufficiency were introduced. The consequences of such policies were to adversely affect living standards and the performance of industry. In 1990 industrial output and employment were far below their potential having fallen from levels achieved during the 1950s and 1960s.

These issues were covered in chapter 2 of the thesis concluding that the Romanian economy after transition retained some elements from the previous socialist period

and the preceding inter war period when the economy was guided by nationalistic protectionist policies. The political economy of post-socialist Romania retains many elements which characterised not only the socialist era but also the period proceeding it, notably the inter war period. For example even before the establishment of a communist state there was "an exaltation of the nationally homogenous community and exploitation of völkisch themes: a hostility to (or distrust of) market relations and intense cultivation of collective identities and attachments." (Tismaneanu, 1993, p 310).

8.2 Alternative Theories of Transition

As in other Eastern European countries many of the policies adopted for transition to a market economy were driven by the neo-liberal formula adopted for Structural Adjustment Programmes by the IMF and the World Bank. This thesis has critically analysed the theory and practice of such policies and examined in detail alternative approaches that might have been adopted. While concentrating on the meso economic aspects of transition the analysis has been set in the context of the macro economic changes influencing the performance of the Romanian economy.

In chapter 3 an analysis was undertaken of the main theoretical arguments that currently underpin many of the policies adopted for transition economies. We have argued that much of the policy debate has been guided by an 'augmented' neoclassical microeconomic model that is based on a new institutionalist analysis of transaction costs and property rights supported by the ideas of public choice theory, producing arguments for minimal state intervention and for privatisation

and price liberalisation. This neo-classical stance has been supported by a new classical macroeconomic framework that rejects the supremacy of demand management and advocates supply side policies to liberalise commodity and labour markets.

The limitations of the dominant neoclassical paradigm, supported by the World Bank and the IMF, are demonstrated in chapter 4 by confronting it with criticisms by Austrian economics, the industrial strategy school of thought and old institutionalism. This provides the basis for the development of a more institutionalist framework to investigate current industrial transformation in Romania. Thus, Chapter 4 offered alternative explanations of transformation in transition economies by introducing a broader political economy view that questions the logic of the neo liberal approach to transition. The emphasis in the chapter is on alternative models of transition and the subsequent policy responses that arise from such models. The chapter establishes the case against a minimal state strategy to transition and sets out the argument for an institutionalist approach to transition based on 'old' American institutionalism rather than 'new' institutionalism based on for example a transaction approach to institutional development.

The 'old' American institutionalism pays greater attention to problems of production and related problems such as technology and the legacy of central planning. 'Old' institutionalists (Veblen, 1898: Commons, 1934) emphasise how the socio-economic fabric of society, path dependency and evolution need to be

incorporated into an analysis of institutions if appropriate institutions are to be adopted. It has become apparent, especially since the collapse of the Russian economy in particular, that, when markets are being studied in countries with less favourable institutional arrangements, a legacy of central planning and a lack of relevant technological know how, a more fundamental understanding of the transition process is required.

In order to incorporate the complexity of the transition process in Eastern Europe the research has departed from conceiving the central planning system as a deviation from equilibrium, whether static, in the case of the neo-classical economics, or dynamic as envisaged by the Austrian economists. The emphasis has been on an institutional framework that recognises the role of historical influence on present day economic activity. Romania emerged from a central planning system that had its own logic that had existed for decades, a socio-economic system with a complex set of institutions in which agents were embedded. Central planning's institutions collapsed while new institutions of the market economy have not yet been put in place. Structural changes such as privatisation and restructuring of the financial sector have been slow. So in the current situation characterized by fundamental uncertainty, the ability of firms to survive does not depend merely on competition but on how they engage through market and non-market relations in a complex set of institutions.

8.3 An instantaneous adjustment or a path dependent trajectory

Transition in Eastern Europe raises the question of how a system changes from one method of allocating resources to another method of allocating resources can be perceived. Neo-liberal economists' (including "new" institutionalists) conception of transition sees markets and privatisation as the only guarantee that efficient organisations can replace less efficient ones. It is argued that a unilinear, homogenous route should be taken by East European countries to achieve a proven efficient outcome (Sachs, 1993). Market forces are able to carry out the dual process of de-institutionalisation of state-socialism, which had provided social legitimacy and stability for decades, and re-institutionalisation, where the re-legitimisation of patterns and activities is undertaken in a different institutional framework (Clark and Soulsby, 1999, p 39-40). Market forces induce an instantaneous adjustment without reference to the past.

To represent the transition as a simple automatic adjustment, which can be characterised as a comparative static adjustment, ignores the dynamics of the process (Landesmann and Abel, 1995).The "old" institutionalists' emphasis on path dependency requires that this dynamic is recognised. Path dependency does not imply that a market outcome of a certain type is predestined as "new" institutionalists argue. It implies that past constraints on individuals and firms, their previous information and knowledge, restricts what is achievable now and in the future. Not all paths are open to the transition economies because they are not able to incorporate the necessary changes to achieve those paths. This does not mean a single unique route needs to be followed. It simply means that a limited

set of paths can be followed in the future and that these depend fundamentally on where the existing path has already reached. Further down whichever route is followed other changes can be taken on board. But such changes require the prerequisites to be in place and to be accepted. That history matters and can give rise to alternative paths for development has been recognised by North (1990), who, despite his general adherence to transaction costs analysis, asserts that "...if the process by which we arrive at today's institutions is relevant and constrains future choices, then not only does history matter but persistent and poor performance and long run divergent patterns of development stem from a common source" (North, 1990, p93).

In analysing the nature of change in a transitional period a distinction needs to be drawn between formal institutional change, the construction of new organisational types such as private firms, and social institutional change, whereby those experiencing the transition accept and conform to the imposition of new structures. While the former, if it indeed does take place, may be observed as representing a fundamental system shift, it is less likely, given the prevailing constraints on knowledge and information, that the inhabitants of a country experiencing transition will shift their behavioural patterns in such a fundamental way. Formal institutional change, in the shape of new laws and organisations, may have taken place but if there is no change in the social institutions i.e. the way people actually operate then it is difficult to argue that a significant system change has indeed taken place. The whole process of de- institutionalising and re-

institutionalising takes time and the process will be beset by institutional inertia (Clark and Soulsby, 1999).

8.4 Empirical Analysis

Having set out the various theories and policy responses that have been advocated for transition economies and the argument for a more evolutionary approach the rest of the thesis sought to provide empirical evidence and tests of the impact of transition on Romania. The econometric analysis of one of the main neoclassical hypothesis regarding development and transition, namely that a decline in real wages will lead to an increase in output and employment, was presented in chapter 5. A reduction in real wages has become a standard prescription for economies undergoing industrial restructuring due to its perceived beneficial impact on both employment and exports. This combination of essentially neoclassical and new classical theories underpinned the policies recommended by the IMF and World Bank. The belief of these organisations and their supporters was that the poor performance of the industrial sector could be corrected through liberalization policies which set 'prices right'. A positive supply response is expected following their monetarist approach as the poor performance is mainly due to economic mismanagement.

Given the adherence to essentially augmented neo-classical and new classical principles that underpin much of the policies that operated post 1990, it was only possible to analyse that which had happened and to provide commentaries to what might have been achieved if Romania had followed alternative prescriptions that

adhere more to an old institutional combined with an industrial strategy approach. We could never know the counter factual for the past 10 years but the argument still has relevance for the rest of the period of the, as yet, unfinished transition process.

The impact of real wages on industrial performance was examined using a panel dataset of Romanian industries from 1990 to 1996. To examine these controversial views this study reproduced Amsden and Van Hoeven's (1996) empirical study that investigated the impact of real wages on output and employment across a sample of developed and less developed countries. The advantage of this study over that of Amsden and Van der Hoeven is the use of panel data that allows the examination of both time and cross-section analysis (panel data technique). Real wages were found to be positively associated with both output and employment, a result that provides no support for the orthodox neo-classical viewpoint. It is suggested that an institutionalist approach aimed at improving productivity may be more likely to achieve the long term objective of successful industrial restructuring.

In addition to the econometric analysis presented we have also undertaken in Chapter 5 an analysis of the components of unit labour costs, looking at the role of real wage changes and productivity changes on these costs. The outcome of this analysis provides support for the econometric analysis, by confirming the industrial structuralist/strategy view that decline in productivity is a major factor

influencing the weak response of Romanian industry during the early transition period.

Even though there are renowned problems with accessing data from Eastern European countries we have been able to collect a unique data set on the Romanian economy and more specifically its industrial sectors. In addition to using some of this dataset in the econometric analysis undertaken in chapter 5 we have used it in chapters 6 and 7 to provide a detailed analysis of the new liberal policies adopted in Romania and how this transition process compares to that of other countries in Eastern Europe. An analysis of the reforms and the reform process that took place in Romania is made in chapter 6, while chapter 7 analysed the impact of the reforms on the macro economy and on industrial restructuring.

8.5 Limitations of the Present Study and Future Work

This thesis has adopted a political economy approach to transition and undertaken empirical analysis of the Romanian economy. In undertaking this research data availability was one of the main problems facing the author. However personal contacts established through a Tempus project to develop economics in Romanian universities helped in overcoming the problem of public disclosure of information. As data are affected by what happened previously, comparing transition data with data prior to 1990 could have offered a better insight. It would have been more useful to have data prior to 1989 to compare with the existing results or extending the period of the study. The before and after approach is used widely (Killick, 1984; Cook and Kirckpatrick, 1995). It is considered objective and it is easy to

use. However this method has some problems. In the two periods, pre and post 1989, the Romanian economy was under two different politico-economic systems. Also, the model assumes other variables remain constant. Further, the before and after approach ignores the correlation between policy and non-policy variables.

Data availability in Romania was restricted by the cut back in the availability of public information in the period 1985-1989 in addition to data distortion arising from biased concepts, methods of aggregation, reporting and underdevelopment of the accounting system.

Another area for debate is the focus on the sectoral level (the level of industry). More work is needed to explore industrial restructuring at the micro level, ie the firm level, which generally requires detailed data which are often not readily available. A case study of a certain industry could have provided more depth to the study. Future work may provide a more in-depth analysis by such an examination of industrial restructuring at the firm level. This would require undertaking interviews with owners and managers of firms.

Also, future work may be needed on whether the macro policies had a differential impact on different social groups. This requires data on consumption patterns, asset ownerships and accessibility to public services.

8.6 Concluding Remarks

The thesis developed the critique of the neo-liberalism based on relative prices further to show the institutional rigidities behind the weak response of Romanian industry. Policy prescriptions recommended for Romania and other East European countries were guided by the "new" institutional economics approach and its underlying Anglo Saxon, neo-classical economics. There was little emphasis in the reforms on the socio-economic setting within which the transition process has been attempted.

The thesis showed that the mere concentration of neo-classical economics and neo-institutionalism on exchange relations is rather misleading. The types of institutional changes suggested for the countries of Eastern Europe were either replications of those institutions that operated in western market economies, or were limited changes that stressed the establishment of private property rights, liberalisation of markets and the voluntary reaction of individuals and organisational structures to establish appropriate exchange systems that would minimise transaction costs. The research drew a distinction between the different institutional approaches classified as "old" and "new", although this is not merely a time delineation but more a way of distinguishing between the emphasis the different approaches put on the nature and type of institutional analysis that should be undertaken.

Building on the industrial strategy paradigm, the research has taken an institutional perspective to investigate transition in Romania. The rejection of the notion of the

market as an abstract form of exchange permits a fuller understanding of the complexity of transition. The economic activities in a specific country are embedded in their national institutions. Studying these activities incorporates the cultural, historical and political environment surrounding them. The legacy of the past, in addition to the fall in investment and output, and the sharp social divisions shapes current and future economic decisions.

The "new" institutionalists criticise the standard neo-classical theory for underestimating the role of institutions in shaping human behaviour, though the mere focus on market exchange and contracts put the "new" institutionalists in the camp of market failure resulting from transaction costs. Their restrictive conception of firms as adaptive tools to the power of the market seems to divert the study of Romanian transition away from analysing the institutions with which agents are familiar and from which, via an evolutionary process, they can develop a more appropriate mix of institutions for the changing circumstances in which they find themselves.

There is no recognition in the new institutional approach that markets may not only fail because of transaction costs. As Nelson and Winter (1982), Murrell (1992) and Swan (1996) argue, firms, instead of responding to market signals, may continue on their past behaviour at a low level of activity or might disappear completely. Therefore, rather than merely concentrating on transaction cost issues, a more detailed focus is needed on how emerging institutions respond to issues like the legacy of the central planning, the collapse of the traditional markets,

rigidities associated with production and lack of technology.

Although much of the transition process has been influenced by new institutionalism there are some instances where an evolutionary approach has been adopted. Clark and Soulsby (1999) offer examples of continuity at the level of the enterprise that involve informal networks which operated throughout the socialist era and which have helped post socialist industrial restructuring in the Czech Republic. Stark (1996) points to a similar phenomenon in Hungary where there was a continuation of clandestine organisations and social ties that filled the vacuum following the collapse of state socialism. What has occurred in these countries is a recognition of the need to work with some of the legacies of state socialism rather than just superimposing new institutional arrangements.

There is a clear role for the state in the old institutional framework that sees it encouraging, supporting and working with the private sector rather than merely establishing market institutions and adopting macro-economic stabilisation policies. Rather than simply appealing to private property rights the policy recommendations advocated by old institutionalists might involve, for example, the development of private proprietors by providing public support that lowers the barriers to entry for small and medium firms and legitimises the activities of those in the 'second' (informal) market. The objective of such policies would be to build on the networks, habits and relationships that were active in the second market, even throughout the period of state socialism. The problem with such policies is that legitimising such enterprises is not easy (Kornai, 1992). The

tendency towards corruption and unregistered work will remain unless the government recognises that such activities are a stage in the evolutionary process that can be built upon to produce legitimate enterprises. Given time and appropriate policies, which see the state providing support for industry in the form of capital allowances, tax breaks and training, thus providing benefits as well as imposing fiscal costs, then organisations operating in the second market will adapt their behaviour and see the benefits of becoming legitimate.

A vital factor that determines the ability of the state in East European countries to play a developmental role is an efficient bureaucracy that does not fall into the grip of interest groups. Amsden et al (1994) points out that good bureaucracy is an institutional safeguard for the post-socialist countries which should be prompted through the following: "the bureaucracy should be relatively well paid, entry should be on a competitive basis, the prestige kept high, and the lines of promotion based on performance and merits. Bureaucrats should be prevented from entering business or politics while still in service. Retirement should be relatively early to provide the chance to join the private sector" (Amsden et al, 1994, pp 204).

High on the agenda is the priority of adopting a pro-growth socially acceptable policy. This seems to be lacking from both phases in the Romanian transition. In the period 1990-1996, Romanian government used gradualism as a tool to block changes, while the later shock therapy approach was based on imposition of formal institutions without accepting the role of social organizations and path

dependency. This is also confirmed by the high decline in real wages which fail to induce growth in both output and employment as shown in chapter 5.

Behind this need to restructure the state in order to initiate pro growth, socially acceptable policies lies a legitimate state that recognizes that transition is a path dependent process. What we see in practice in several of the ex centrally planned countries, including Romania, is that the institutional reforms that have been introduced have not proven to be successful in establishing an efficient or equitable market economy. Romanian economic development remains influenced by the location of plant, the skills and location of workers and the contacts and power structures that those who held power in the past are loath to give up. In Romania the network between ministries, central departments and managers of large enterprises has been continually reproducing itself in post socialist Romania. The laws relating to commercial companies which aimed to undo these ties have been constantly opposed by ministries and enterprise managers who still hanker for the safe bureaucratic dictat that reduced the need for managers to make any decisions or take any initiatives (Pasti, 1997). If these social institutional ties are not recognised and incorporated into a more gradual evolution of institutions then the system change looked for will not only be a short run failure but will take longer to achieve because they need more monitoring, adjustment and redevelopment.

Nothing was done to create the necessary changes in production or technology or the financial framework to allow more than the simplest of market exchanges to

occur. Forward contracts that required credit facilities in which people had confidence were extremely rare. Indeed there may have been a more fundamental problem in the way that Romanians view contracts not as obligations but merely statements of intent (Pasti, 1997). Transacting under these conditions is extremely complex and exaltations by new institutional economists to remove the impediments to lower transaction costs merely ignore the socio-economic setting that dictates behaviour in a country like Romania.

Although the gradual approach to transition may be described as having limited success, it is still questionable whether the shock therapy introduced in 1997, which introduced sweeping institutional reforms, will prove successful. The more restrictive monetary and fiscal policies and the greater acceptance of the failure of firms has obvious structural and social implications. The issue is whether these changes produce just short run dislocation of the economy or whether they will lead to longer term economic problems if the economy cannot adjust to the changes being introduced. This re-establishment of a new institutionalist emphasis on institutional change once again ignores the nature of the economy in which these changes are expected to take place. It takes time to learn new habits and attempts to speed up that process unduly will not produce the long term benefits desired. Superimposing market institutions, that are often sophisticated in their operation, onto Romanian economic structures ignores not only the old institutionalists recommendations of building on the existing institutions in an adaptive way but also ignores the Austrian view of markets that sees them, often in a similar manner to the "old" institutional view, as evolving through time.

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APPENDIX 1

Data Appendix

Data are drawn from National Commission for Statistics (Romanian Statistical Yearbooks 1990-1997).

Since 1989, the national accounts for Romania have been drawn up according to the European System of Integrated Economic Accounts (E.S.A). This replaced the system of material production which had been subjected to adjustments concerning the content and scope in order to fulfil the national accounting concepts of the planning system.

Romanian industry has 3 branches: mining and quarrying; manufacturing; and electric and thermal energy, gas and water. Those branches are broken down into 27 sub-branches[1] as follows:

1. Industrial Data

a) Manufacturing:

Food and beverages

Tobacco industry

Textile and textile products

Textile, fur and leather wearing apparel

[1] A branch composed of grouping units with homogenous production. What characterises these units is a unique activity namely inputs, process of production and homogenous output.

Leather goods and footwear

Wood processing

Pulp, paper and cardboard

Publishing houses, polygraphy and recording on supports

Crude oil processing, coal coking and nuclear fuel treatment

Chemical and synthetic and artificial fibres

Rubber and plastics processing

Other nonmetallic mineral products

Metallurgy

Metallic constructions and metal products

Machinery and equipment

Computers and informatics

Electric machines and appliances

Radio, TV and communication, equipment and apparatus

Medical, precision, optical, watchmaking instruments and apparatus

Means of road transport

Other means of transport

b) Electric and thermal energy, gas and water:

Electric and thermal energy, gas and water

Electric and thermal energy, gas and hot water production, transport and distribution

Water collection, treatment and distribution

c) Mining and quarrying:

Coal mining and preparation

Petroleum and natural gas extraction

Extraction of nonenergetic products

2. *Gross value-added (GVA)*

The gross value added for the 27 branches of Romanian industry is calculated based on basic current prices (million, lei current prices) including the subsidies on products and netting out the taxes on product and value added tax[2].

Gross value added is the balancing of the production account, which shows the surplus of the produced goods and services value over the goods and services consumed in the process of production.

Adopting the production approach, the Gross Value added (GVA) is calculated as follows (National Commission for Statistics, 1996):

GVA = GDP- (TP + D - SP) where:

GDP = Gross Domestic Product (market prices)

GVA = Gross value added (basic prices)

TP = Taxes on products including value tax

D = Custom duties

SP = Subsidies on product and for imports.

3. Employment

According to the labour force balance, worked out by the National Commission for Statistics, employment includes all persons who in a certain year carry out socio-economic profitable work. This excludes military staff and similar personnel (Ministry of Defense and Ministry of Domestic Affairs employees, Service of Romanian intelligence staff).

The term employment includes, according to the methodology adopted by the quarterly Household Labour Force Survey (National Commission for Statistics), all persons aged 15 years and over, who carry out an economic activity producing goods and services to get income as wage or payment in kind during at least one hour before registration.

The term employee is defined as a person who carries out her/his activity by a labour contract into an economic or social unit, regardless of its ownership type, or to private persons to get wages in cash or in kind. This excludes both a person who carries out his/her occupation in his/ her own unit and who employs one or more employees (employer) and who carries out an activity without employing any employee (own account worker).

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[2] The value added data for 1994 are semi-final and those for 1995 and 1996 are preliminary.

4. Wages

The data on wages are extracted from the National Commission of Statistics' Household Integrated Survey. This is a yearly statistical survey on salary earnings and labour force costs.

The net nominal salary earning is calculated by subtracting the tax, the contribution for the supplementary pension and the unemployment fund[3], from the gross nominal salary.

We calculated the net real wage as the net nominal wage over the consumer price index (CPI). We follow the National Commission for statistics which reports real earning index as the nominal average earnings index to the consumer price index determined by the Laspeyres formula for the families of employees.

5. Consumer price index (CPI)

The data on CP1 are extracted from the National Commission annual reports: Romanian Statistical Yearbooks (1990-1997).

CPI is the estimate of the evolution of prices/tariffs for the bought goods and services in a specific year (current year) against a reference year. We use 1990 as the reference year. The index is calculated as a weighted mean of prices.

[3] Until 1990, the contribution of childless employees was also extracted.

Until 1993, the weighting system used by the National Commission for Statistics (NCS) to calculate the CPI was based on the structure of consumption expenditures from 1990. This was replaced by the structure of 1993 expenditures in 1994.

In the calculation of the CPI, the following expenditures are excluded:

1. self consumption of goods and services from own production of family house hold;
2. expenditures such as taxes, fees, fines, gambling, interests paid to credits, insurance rates, savings and interests to savings banks;
3. house hold expenditures on payment for agricultural work (ploughing, harvesting, etc).

6. Producer prices or industrial production prices

Since 1990, the National Commission for Statistics has used a statistical sampling survey of prices, on a representative sample of industrial activity. Prices for the year 1994 were based on a sample consisting of about 1030 industrial units. Since 1995, the sample has been including 1078 industrial units.

Producer price index (PPI) records the evolution of prices/tariffs marketed by economic agents producing industrial goods and services during a certain year (current year) against another year (the basic year). In this study 1990 is taken as the base year.

Industrial output price includes both the output delivered to the internal market and to exports excluding the following:

1. output of weapons and ammunition, quarrying and preparation of radioactive ores.

2. industrial output of long-cycle fabrication.

3. single piece output from engineering branches.

4. output consumed within the same enterprise (domestic consumption)

APPENDIX 2

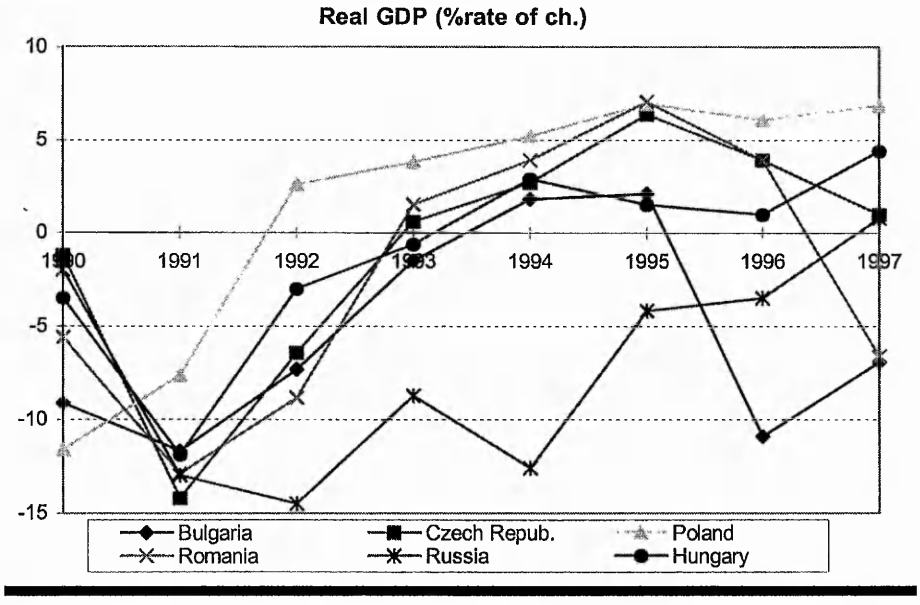
Comparison of Economic Activity in Romania with Selected Eastern European Countries

Table (A.1) Real GDP (% change from previous year)

	Bulgaria	Czech Repub.	Poland	Romania	Russia	Hungary
1990	-9.1	-1.2	-11.6	-5.6	-2	-3.5
1991	-11.7	-14.2	-7.6	-12.9	-13	-11.9
1992	-7.3	-6.4	2.6	-8.8	-14.5	-3
1993	-1.5	0.6	3.8	1.5	-8.7	-0.6
1994	1.8	2.7	5.2	3.9	-12.6	2.9
1995	2.1	6.4	7	7.1	-4.2	1.5
1996	-10.9	3.9	6.1	3.9	-3.5	1
1997	-6.9	1	6.9	-6.6	0.8	4.4

Source: (National Bank of Romania, 1998)

Figure (A.1) Growth of output (rate of change)



Source: (National Bank of Romania, 1998)

Table (A.2) Money Supply (M2) % rate of change to last year

	Bulgaria	Czech Repub.	Poland	Romania	Russia	Hungary
1990		0.5	160.1	22		29.2
1991	125.6	26.7	47.4	101.2		29.4
1992	50.2	20.7	57.5	79.6	568.1	27.3
1993	39.1	19.8	36	141	109.4	17.2
1994	78.6	19.9	38.2	138.1	200	13.4
1995	39.6	19.8	34.9	71.6	125.8	18.4
1996	124.5	9.2	29.3	66	30.6	21.2
1997	359.3	10.1	29.1	104.9	28.4	23.2

Source: (National Bank of Romania, 1998)

Table (A.3) Prices (annual % change in CPI)

	Bulgaria	Czech Repub.	Poland	Romania	Russia	Hungary
1990	23.8	9.7	585.8	5.1	5.6	28.9
1991	338.6	56.7	70.3	170.2	160.4	35
1992	91.3	11.1	43	210.4	1534.7	23
1993	69.4	20.8	35.3	256.1	874.5	22.5
1994	96	10	32.2	136.7	307.3	18.8
1995	62.1	9.1	27.8	32.3	197.5	28.2
1996	123	8.8	19.9	38.8	47.8	23.6
1997	1082.9	8.5	14.9	154.8	14.8	18.3

Source: (National Bank of Romania, 1998)

Table (A.4) CPI and its components (weighted mean of prices, 1990=100)

	1991	1992	1993	1994	1995	1996
Total	270	838.8	2987	7071.9	9353.4	12983
Food goods	286.2	963.4	3361.2	7940.3	10469.3	14276.5
Non-food goods	267.8	787.9	2907.4	6769.8	8775.5	12205.9
Services	235.7	661.0	2249.5	5641.8	8051.2	11830.8

Source: (National Commission for Statistics, 1996, 1997)

Table (A.5) Budget Deficit/GDP (%)

	Bulgaria	Czech Repub.	Poland	Romania	Russia	Hungary
1990	-8.5	-0.2	3.1	-0.4		0.4
1991	-3.8	-2.1	-3.8	-1.9	-13.9	-4.9
1992	-5.8	-0.2	-6	-4.4	-5.5	-6.7
1993	-11	0.1	-2.8	-2.6	-9.9	-5.6
1994	-6.5	0.9	-2.7	-4.2	-11.4	-7.4
1995	-6.6	0.6	-2.6	-4.1	-5.2	-2.4
1996	-10.9	-0.1	-2.5	-4.9	-7.9	-2
1997	-3.7	-1	-1.3	-3.6	-7	-4.1

Source: (National Bank of Romania, 1998)

Table (A.6) Gross external debt (million US$)

	Bulgaria	Czech Repub.	Poland	Romania	Russia	Hungary
1990	10890	4400	48900	230	61100	21270
1991	12301.1		48300	1143	67000	22658
1992	13857.7	7100	48200	2479	78200	21438
1993	13889.4	8500	48700	3357	83700	24560
1994	11411.4	10700	42174	4596.8	93600	28521
1995	10229.2	16500	43886	5482.1	103800	31655
1996	9595.6	20800	40661	7208.9	108000	27646
1997	9763.3	21400	38100	8391.8	132700	23747

Source: (National Bank of Romania, 1998)

Table (A.7) Gross debt/GDP in Eastern Europe, 1990, 1994, 1995, 1996 (%)

	1990	1994	1995	1996
Bulgaria	55	118	81	103
Czech Republic	14	34	36	36
Poland	82	46	37	31
Romania	3	18	18	23
Russia	44	34	37	41
Hungary	60	69	72	62
Eastern Europe	38	43	39	36

Source: Economic Survey of Europe (1997), table, 3.7, p 157.

Table (A.8) Measures of the debt burden of Eastern Europe, 1990-1996 (%)

Gross debt/exports									Net debt/exports						
	1990	1991	1992	1993	1994	1995	1996		1990	1991	1992	1993	1994	1995	1996
Bulgaria	328	283	235	250	196	149	165		328	275	218	236	177	131	157
Czech-Republic	63	93	68	53	62	68	60		57	86	62	32	31	9	20
Poland	398	338	292	298	216	162	139		361	312	267	273	186	108	79
Romania	28	51	65	74	75	73	92		15	35	49	57	48	55	69
Russia	72	125	197	191	189	161	-		70	123	194	181	181	138	125
Hungary	243	190	156	216	254	178	133		231	157	124	157	194	116	86
Eastern Europe	184	168	144	136	123	108	96		171	152	125	113	108	60	56

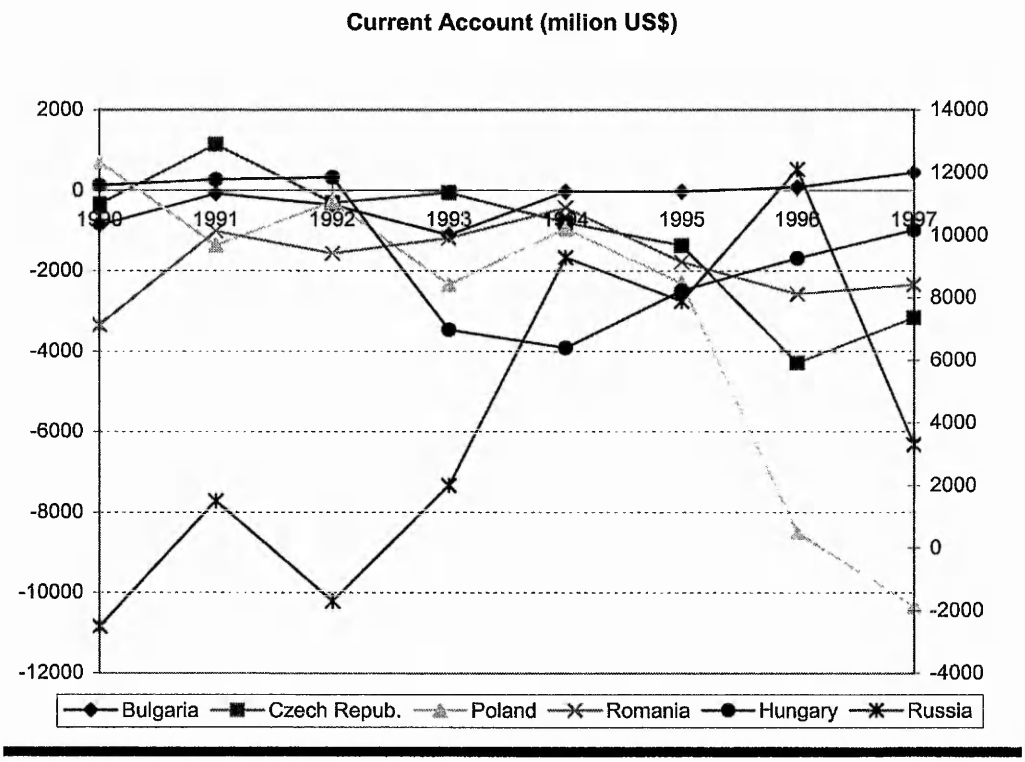
Source: Economic Survey of Europe (1996) table 3.6.5, p 136; Economic Survey of Europe (1997), table 3.6.6, p 157.

Table (A.9) Current Account (million US$)

	Bulgaria	Czech Repub.	Poland	Romania	Russia	Hungary	
1990	-860	-338	716	-3337	-2500	127	
1991	-77	1143	-1359	-1012	1500	267	
1992	-361	-305	-269	-1564	-1700	324	
1993	-1098	-53.5	-2329	-1174	2000	-3455	
1994	-24.8	-786.8	-944	-428	9300	-3911	
1995	-25.6	-1362.3	-2299	-1774	7900	-2480	
1996	81.8	-4292.2	-8505	-2571	12100	-1678	
1997	445.7	-3155.8	-10329	-2338	3300	-981	

Source: (National Bank of Romania, 1998)

Figure (A.2) Current Account



Source: (National Bank of Romania, 1998)

Table (A.10) Exports (million US$)

	Bulgaria	Czech Repub.	Poland	Romania	Russia	Hungary
1990	2615	9052	10863	5775		6346
1991	3737	7921	12760	4266	50900	9258
1992	5093	8448.4	13997	4364	42400	10028
1993	3726	13206	13585	4892	44300	8094
1994	3935	14255	16950	6151	68100	7613
1995	5345	21647	22878	7910	81300	12810
1996	4890	21907	24420	8085	88400	14183
1997	4913.9	22776	27229	8431	93100	19637

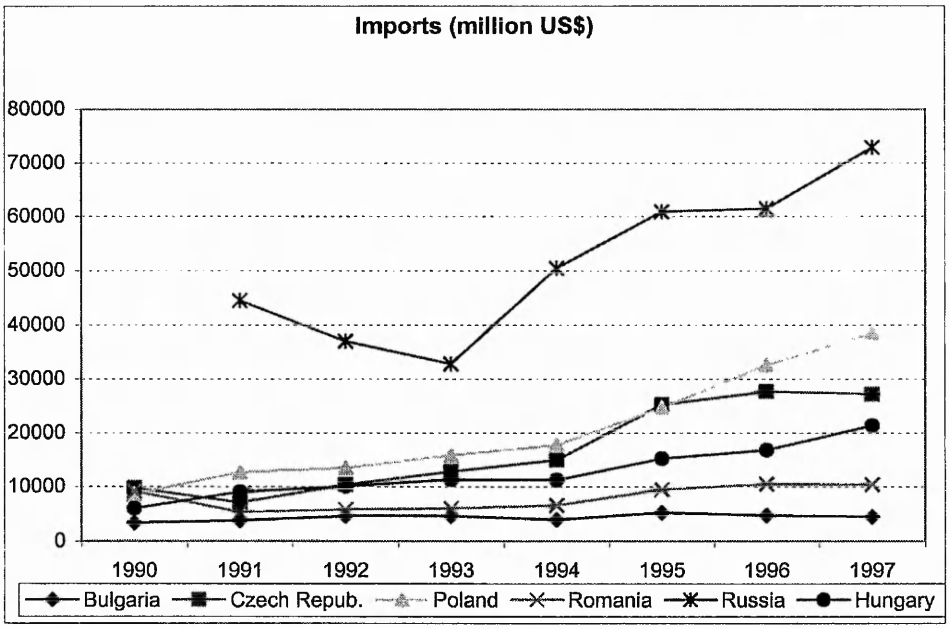
Source: (National Bank of Romania, 1998)

Table (A.11) Imports (million US$)

	Bulgaria	Czech Repub.	Poland	Romania	Russia	Hungary
1990	3372	9815	8649	9202		5998
1991	3769	7080	12709	5372	44500	9069
1992	4609	10350	13485	5784	37000	10076
1993	4612	12860	15878	6020	32800	11340
1994	3952	14971	17786	6562	50500	11248
1995	5224	25252	24705	9487	60900	15252
1996	4702.6	27716	32574	10555	61500	16828
1997	4518	27179	38498	10411	72900	21371

Source: (National Bank of Romania, 1998)

Figure (A.3): Imports



Source: (National Bank of Romania, 1998)

Table (A.12): FDI

	Net Direct Foreign Investment (million US $)					
	Bulgaria	Czech Repub.	Poland	Romania	Russia	Hungary
1990			89	-18		311
1991	55.9		298	37		1459
1992	41.5	982.9	665	73		1471
1993	55.4	563.3	1697	87		2328
1994	105.4	748.9	1846	341	537	1097
1995	98.4	2525.6	3617	417	1711	4410
1996	134.4	1387.9	4445	263	1708	1987

Source: National Bank of Romania (1997)

Table (A.13) Net capital flows into Eastern Europe[a], by type of capital, 1990-1995 (billion US$)

	1990	1991	1992	1993	1994	1995
Capital account[b]	-2.3	3.5	2.7	12.9	10.8	28.9
Capital account	-2.1	4.1	2.1	13.5	10.6	31.2
Of which						
FDI	0.4	2.3	3.1	4.5	3.2	9.1
Portfolio	0.9	0.9	1.2	1.0	3.6	4.7
Medium, long term funds	-0.1	-0.8	-0.1	2.1	4.3	6.1
IMF loans	0.4	3.7	0.7	-	-	-2.8
Short term funds	-4.1	-2.8	-1.9	1.2	0.2	2.7
Other short term capital[c]	-	-	-	-	2.4	9.4
Errors and Omissions	0.1	0.6	-0.6	0.7	-0.4	2.3

Source: Economic Survey of Europe, table 3.6.6, p 142.

a. Albania, Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia.
b. Including errors and omissions.
c. As reported in Poland's balance of payments, comprising chiefly net receipts from cross-border trade.