

**NEW PRIVATE FIRM CONTRIBUTIONS
TO STRUCTURAL CHANGE IN THE ROMANIAN
ECONOMY**

AURELIAN DOCHIA

Corporate Finance Department, Societ  Generale Romania

- Abstract -

Ten years ago, when practical questions were raised on how best to proceed in order to transform centrally planned economies into market economies, economists realized that they did not have a guiding “theory of transition” and consequently had little to offer as policy recommendations. A loose consensus emerged however, based on neoclassical economic theory, on two practical measures to be taken in order to initiate the change--*forcing a structural ownership change* through the privatization of state assets, and the *liberalization of prices*. Different “models of transition” were derived from that basic scheme, distinguishing themselves on the details of practical solutions and the sequencing of events. But a growing mass of evidence is accumulating after the first ten years of the transition showing that the results achieved by different countries depart in many cases from the prescriptions and predictions conventional reform models proclaimed. Some failures are too serious to be simply dismissed as due to “good policies being poorly implemented” and a growing number of economists are taking a critical position.

One of the areas being now re-examined concerns the paths and methods used to achieve the structural shift in ownership. Most governments and their advisors were focusing on privatization as the main route to achieving structural change. But the results were frequently disappointing: it turns out privatization is a slow process, complicated by political interference. In addition, it became evident that privatization in itself is not sufficient for markets to function and, without a proper institutional setting to foster competition, the expected gains in efficiency do not materialize.

At the same time, countries like Poland or even China, which were never acclaimed as champions in divesting state assets, achieved the highest growth rates. Part of the secret to their performance is most likely related to the vibrant sector of new private firms. New private firm contributions to creating a genuine proper market environment should probably be reconsidered and this is the perspective from which the present paper is examining the Romanian case.

The first part of the paper is aimed at tracing a comprehensive and consistent portrait of the private sector in Romania. Based mainly on statistical data, the development and the main characteristics of the private sector are identified, compared and commented. Two factors determine, in the author’s opinion, the performance and the significance of the private sector for the economy of the country: the quality of the entrepreneurial class and the quality of the business environment. Each of these factors is examined in the paper within the Romanian context.

Finally, conclusions are drawn on the development perspectives of the private sector in Romania and some general policy recommendations are derived.

Introduction

While the gains in political democracy over the ten years after the fall of the Berlin Wall are significant, the progress in reforming the economies of former socialist countries is less obvious. For many people living in Eastern Europe and the CIS, the transition was an experience similar only to the 1929-1933 Great Depression, a “human crisis of monumental proportions”, as a recent UNDP report calls it (UNDP, 1999). Even now, a decade later, many countries in the region cannot get back to 1989 levels of production. According to the same report, the number of people living on an income of USD 4 a day in the region has risen from 4 percent in 1988 to 32 percent in 1994.

Is hardship inevitable in the transition process, or was there something wrong with the way in which policy-makers tackled the issues of economic reform and transition? Perhaps the basic principles of the “transition” were themselves inadequate. Ten years ago, when practical questions were raised on how to best proceed in order to transform centrally planned economies into market economies, economists realized that they did not have a guiding “theory of transition” and consequently had little to offer as policy recommendations. A loose consensus emerged however, based on neoclassical economic theory¹, on two practical measures to be taken in order to initiate the change: *forcing a structural ownership change* through the privatization of state assets, and the *liberalization of prices*. Different “models of transition” were derived from that basic scheme, distinguishing themselves on the details of practical solutions and the sequencing of events.

A growing mass of evidence is accumulating after the first ten years of the transition, showing that the results achieved by different countries depart in many cases from the prescriptions and predictions conventional reform models proclaimed. Some failures are too serious to be simply dismissed as due to “good policies being poorly implemented²” and a growing number of economists are taking a critical position. Joseph Stiglitz, Senior Vice President and Chief Economist at the World Bank, is one of the most prominent critics of the “Washington consensus” set of policy recommendations, observing that there are both examples of countries with an impressive record in achieving development through non-conventional policies (China and other Asian countries) as well as countries which failed in spite of their more or less orthodox policies (Russia and other former Soviet Union countries). The reasons are not simple to explain, but in general, they are connected to

“reform models based on conventional neoclassical economics” that are “likely to underestimate the importance of informational problems, including those arising from the problems of corporate governance;

¹ In essence, neoclassical theory asserts that the existence of a large number of independent competing firms and prices resulting from individual decisions of buyers and sellers, acting freely based on their interests and the information available to them, are the necessary and sufficient conditions for competitive markets to work and to function to achieve an optimal allocation of resources.

² Talking about Russia’s failure, Stanley Ficher, Vice-president of the IMF, recently stressed that “the main problem was not the omission of any important element in the reforms package proposed to the Government in Moscow . The inadequate implementation of fund policies, corruption and the lack of interest by Russian politicians for a real recovery in the economy were the causes of the crises the former Soviet state has been facing in the last years.” – quoted by Paul Welfens in *The Financial Times*, October 5 1999.

of social and organizational capital; and of the institutional and legal infrastructure required to make an effective market economy.” (Stiglitz, 1999, Abstract)

Privatization versus Greenfield Choice

The role of the privatization process in nurturing the development of the private sector and prompting the crucial structural transformation of transition is now being re-examined [Nellis 1999; Havrylyshyn / McGettigan, 1999; Earle, 1999]. Conventional wisdom maintains that a rapid transfer of state assets into private hands is the single most important measure to be taken in order to create a proper market-driven functioning of the economy. But experience tends to demonstrate that economic performance is not directly related to the speed of the privatization process, but depends heavily on its “quality”. Russia is the most blatant example, but even the Czech republic is not praised anymore for its innovative privatization schemes that produced the most rapid and radical change of ownership. On the other hand, Poland is the most successful transition economy (considering it is the only one having achieved a 17 percent GDP growth in 1998 over 1989) - without distinguishing itself as a privatization champion (over 400 “hard core” key industrial enterprises are still state-owned (Blaszczyk, 1999)). China is an even more striking example: in spite of its ideological restrictions on the sale of state assets, China has a vibrant private sector and the world's longest record of years with two digits growth rates in the last two decades.

For many years, the merits of different privatization methods and schemes were debated, with authors pondering factors like speed, social and political feasibility, or the impact of alternative privatization methods on corporate governance and on the economic viability of firms. I myself contended that the issue was overstated and I tried to demonstrate, based on an application of the Coase theorem (Dochia, 1996), that the privatization method is not so important, eventually even irrelevant. Indeed, if transaction costs are low, an optimal ownership structure (that is one using assets in the most efficient way) will ultimately result through transfers on the capital markets, irrespective of the initial distribution determined by the application of a particular privatization method.

Experience proves that, however, because of the imperfect nature of emerging markets, transaction costs are high. The initial distribution resulting from a particular privatization method will not be changed for a long period of time and assets get locked into less than optimal utilization.

Empirical evidence from a large number of countries³ suggests there is a correlation between the efficiency of economic organizations and their ownership structure: state-owned firms tend to be less efficient than privately owned firms, and closely controlled private firms are more efficient than dispersed ownership structures. Also, companies controlled by foreign investors tend to be more efficient than domestic ones. These findings strongly support the allegation that the privatization method matters and that mass privatization is not conducive to the most efficient corporate governance⁴.

³ Comprehensive references and comments on these studies are in Nellis, 1999 and Havrylyshyn, McGettigan, 1999.

⁴ It should be noted, however, that mass privatization programs were very popular, even with international financial institutions. “The international financial institutions must bear some of the responsibility for the poor outcomes, since they so often insisted on the primacy of economic policy. That is, they requested and required transition governments to privatize rapidly and extensively, assuming that private ownership by itself would provide sufficient incentive to shareholders to monitor managerial

But the same empirical studies found that country institutional background is of paramount importance for the performance of economic organizations. Some authors even conclude that

...there are many cases where privatization has not led to efficiency improvement; these are generally associated with situations where the degree of competition has remained unchanged before and after the privatization...(Tandon, 1995, p. 329-330)

and that

...the further east one travels, the less likely is one to see rapid or dramatic returns to privatization. (Nellis, 1999)

with numbers of examples from Russia, Georgia, Armenia or Mongolia to exemplify the assertion⁵.

Why is that happening? Basically, economists are brought to admit that

...capitalism is revealed to require much more than private property; it functions because of the widespread acceptance and enforcement in an economy of fundamental rules and safeguards that make the outcomes of exchange secure, predictable, and of reasonable widespread benefit. Where such rules and safeguards, such institutions, are absent, what suffers is not just fairness and equity, but firm performance as well. That is, in an institutional vacuum the chances are high that no one in a privatized firm is interested in maintaining the long-run health of the assets.

(Nellis, 1999, p.17)

Finally, new light is shed on the “building from scratch” path for creating the private sector through start-ups, or greenfield firms. In many countries, while efforts and resources were devoted to privatize the “dinosaurs” inherited from socialism, a silent revolution took place through the contribution of millions of entrepreneurs that ceased waiting for the state to perform the reforms and did their own transition. The outcome is so impressive that many authors now believe that the fundamentals of the reform process should be re-examined: **instead of a top-down, government driven reform centered around privatization, a bottom-up approach should be encouraged, based on genuine entrepreneurship and resulting in a substantial and dynamic small and medium-sized enterprise sector.**

This alternative path to transition has already worked remarkably well in many instances. It is widely recognized that

In Poland, for example, small and medium-sized enterprises played a far more important role in the move toward a market economy than the privatization program, which lagged behind other economic reforms.

and

One study of Russia concludes that governments should concentrate more on the development of small and medium size enterprises than on privatization itself.

(Havrylyshyn, McGettigan, 1999 p.5)

behavior and push firms to good performance. (...) The prima facie assumption was that to build capitalism, one needed capitalists; lots of them, and fast.” (Nellis, 1999, p.17)

⁵ In spite of the many shortcomings or even failures that may be related to privatization in different countries, I’m strongly sympathetic with John Nellis’s argument that “states that botch privatization botch public ownership of enterprises as well” (Nellis, 1999, p.4) and therefore perpetuation of public ownership is just an illusory alternative to poor privatization.

The same may be concluded in China, but start-ups have played a role in practically all transition countries, from Estonia to Vietnam. Analysts recognize new firms have a wider impact than originally anticipated.

- ◆ New firms have substantially contributed to expanding the size of the private sector, their impact being usually more rapid and more considerable than the privatization programs.
- ◆ Start-ups have contributed to efficiency gains in the economy – all studies indicate that the efficiency of the new firms is higher than that of ancient ones, state-owned or privatized.
- ◆ New firms had a decisive contribution to fostering the competitive environment in the economy; start-ups have put an effective pressure on existing firms to achieve efficiency gains and contributed to price stabilization.
- ◆ By giving consumers a wider range of choices, new firms have also directly improved welfare.
- ◆ New firms are a main source of economic growth; entrepreneurs have the ability to identify market niches and to adjust production to the specific needs of these markets. Unlike old firms, whose resources cannot be easily redirected to other uses, greenfields are adapted to contemporaneous technologies and markets structures.
- ◆ It is hard to minimize the importance of the new firms in restructuring transition economies in multiple dimensions (sectoral, dimensional, products range, organizational, financial etc.). The creation of new firms, most of them small and medium-sized, is part of the restructuring process, and at the same time facilitates the restructuring of large state-owned firms by providing alternative uses for resources (assets and personnel).
- ◆ Last but not least, new firms bring some fresh “entrepreneurial spirit” into economic and social settings where initiative was deterred for decades by the central-planning approach. Managers of state-owned enterprises are unlikely to turn into good entrepreneurs even after their companies are privatized.

Many authors have also emphasized the social and political importance of the new private firms in the stabilization of democratic political structures or in spreading more open and less bureaucratic cultural models.

Romania is not among the most successful transition countries. Unlike other countries in the CEE region, Romania is not firmly established on an economic stability and growth trajectory -- 1999 is the third consecutive year of contraction in GDP and the per capita income is still inferior to the 1989 level. The private sector's share of GDP (currently around 60 percent) is lower than in other CEE countries. But more important is the fact that the current share of the private sector is not the outcome of the privatization process (only 20 percent of the state assets have been divested as of the beginning of 1998), but the result of the activity of hundreds of thousands of new firms, most of them small and medium-sized.

This is a remarkable achievement, considering that Romanian authorities have focused on privatization – as already noticed by early authors:

In Romania, as in other Central and East European Countries, when dealing with transition strategy until now the governmental bodies have placed a major emphasis on the problems related to the privatization (or “de-étatisation”) of the state-owned sector, while those connected to the development of the small and medium enterprises have been considered of secondary importance in the economic policy agenda. In other words, the dominant attitude is that the development of SMEs should come as a secondary consequence of the policy of privatization: in fact the two types of objectives have been almost identified, and even unified under the heading of the National Agency for Privatization (NAP). (Frateschi, 1993, p.33)

- and that the starting conditions were not very favorable.

In Romania, the entrepreneurial tradition is very weak and general public awareness of the economic importance of SMEs very low: worse, small business – especially in retail trade and still more in wholesale trade – is often associated with fraud, speculation and profiteering.

(Idem, p.34)

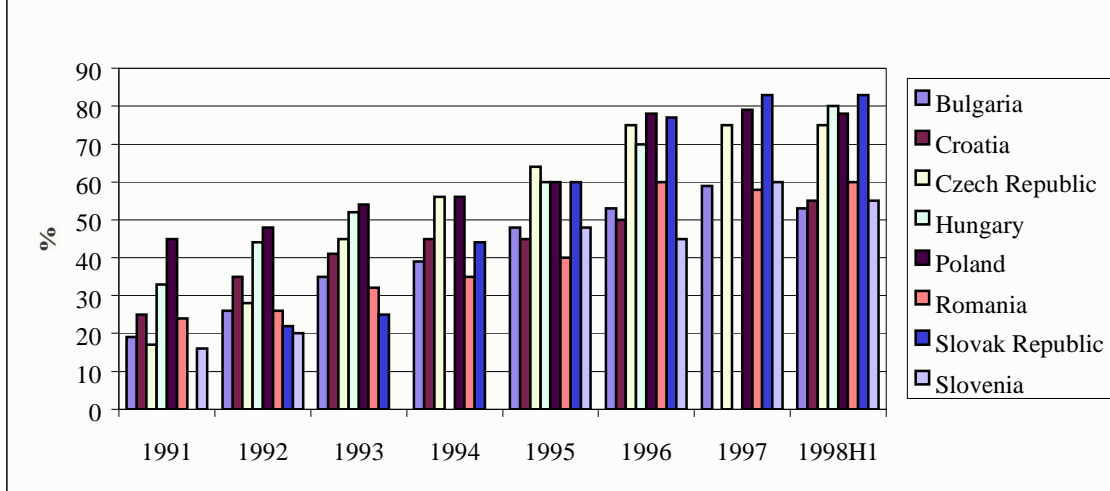
But unlike their Polish siblings, the new Romanian firms did not succeed to produce a positive impact powerful enough to overturn the downward trend of the economy. What happened?

Some Basic Facts about the Creation and Expansion of Private Firms

In 1998, the private sector was producing between 70 and 80 percent of the GDP in countries like the Slovak Republic, Hungary, Poland and the Czech Republic, while in the other CEE countries (Romania, Croatia, Slovenia and Bulgaria) the share was between 50 and 60 percent (see Chart I and Appendix 1). The difference between the two groups of countries is due to different starting levels and to the effectiveness of their national privatization programs. Poland and Hungary, who had an important private sector before 1990, achieved a doubling of their shares of GDP (1.7 and respectively 2.4 times more). The Czech and Slovak Republics were notoriously operative in switching ownership status for the bulk of their state assets⁶ and succeeded in quadrupling the share of their private sectors over the period. Romania (with an increase of 2.5 times the share of the private sector in GDP) performed better than Croatia (2.2 times) but less well than Bulgaria (2.8 times) or Slovenia (3.4 times). It should be noted that Romania started in 1990 with a private sector larger than countries like Slovenia, the Czech Republic or Bulgaria.

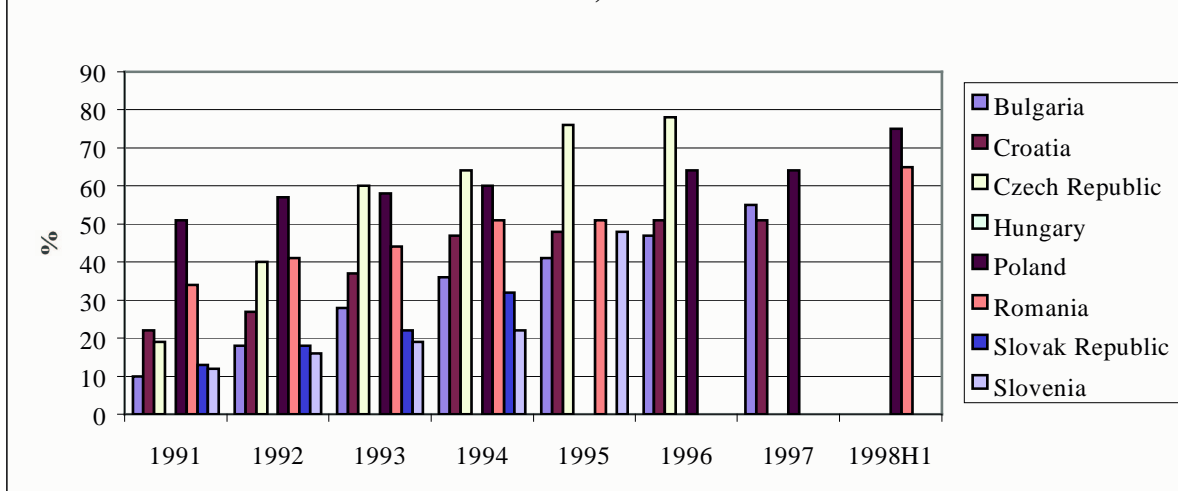
⁶ Statistics in all countries, including Romania, do not distinguish between the private sector increases resulting from the sale of state companies/assets and the increases resulting from start-ups. Therefore, statistics do not accurately account for new firm contributions to GDP – with inter-country comparisons being particularly affected. In Romania, as privatization was slow (it is only in 1998 that the share of capital transferred to private investors attained 20 percent of the initial State Ownership Fund holdings), it may be considered that the “private sector” reported by statistics is quite accurately describing the new private firms’ situation. This statistical approximation will be used throughout the present paper.

Chart I: Private Sector Share in GDP, Selected Transition Economies 1991-1997



The same general picture is offered when comparing the employment in the private sector (Chart II and Appendix 1). It is worthwhile mentioning that in Romania the private sector employment was consistently and substantially higher than the GDP produced by the private sector – reflecting a lower labor productivity, due to a large extent to the high proportion of agriculture in the Romanian private sector’s output.

Chart II: Private Sector Share in Employment, Selected Transition Economies, 1991-1997



Box 1 The Missing Private Sector

In many parts of Romania, especially in and around the large cities, relative prosperity is discernible from the large number of expensive cars and new houses (“villas”) – an image in stark contrast with the bleak statistics indicating a permanent deterioration of the level of living. This is clear evidence, for most analysts, that an important share of the revenues of the population comes from the un-official, un-accounted for “black” economy. As by definition this is a “private” endeavor, it results that the official statistics are understating the size and impact of the private sector – but there is wide disagreement on the “by how much”.

Apart from pure guesses (more or less educated), few reliable estimates are available. The Romanian Intelligence Agency has published estimates periodically on the size of the “underground economy”, going from around 30 to over 40 percent of the GDP – but their methodological basis is not revealed.

A recent report by the US Treasury (Cercescu, 1999) makes a thorough analysis (based on monetary aggregates) of the “hidden” economy and comes out with surprising results. In the period between 1993 and 1996, the underground economy was less than 20 percent of the official GDP; it amounted to 25 percent in 1997 and to an astonishing 49 percent in 1998! While the official economy declined in real terms by 3.6 percent between 1993 and 1998, the underground sector was booming with over 400 percent growth. If the 83 percent growth of the underground economy was accounted for, the decline in GDP recorded by statistics for 1998 would turn into a healthy 3.2 percent growth. The largest part of the underground economy is related to illegal imports that have increased by 640 percent since 1993; in 1998, the volume of illegal imports was 12 percent higher than the official imports.

There is a sharp contrast, evidenced by the findings of the study between the constantly declining official sector and the flourishing underground economy. Considering its underground component, the size of the private sector in Romania is around 73 percent - substantially higher than the official figures. The significance of its existence is contradictory. The underground sector produces many disturbances in the allocation of resources; at the same time, it illustrates the huge growth potential existing in Romania. While officials take a hostile position regarding the underground economy, it is evident that for many families it offers a living, maybe the only one they can afford – as much as 5 million persons in Romania probably obtain some revenues from employment in the underground sector.

Other authors (Johnson, Kaufmann, McMillan, Woodruff, 1999) try to understand what the causes are that favor the expansion of the underground sector in certain countries and identify four groups of factors:

- ◆ excessive fiscal burden – prompting entrepreneurs to avoid reporting part of their operations;
- ◆ bureaucracy and corruption in the public administration – in order to avoid them, private companies tend to go underground for some of their activities;
- ◆ power of the criminal organizations - firms tend to hide their real revenues in order to avoid becoming targets for racketeering and extorsions;
- ◆ weak legal systems that do not properly guarantee contract enforcement, discredit contracts and encourage firms to use other instruments and methods for conducting business.

Based on investigations of firms in Poland, Romania, Russia, the Slovak Republic and Ukraine, the same authors conclude that corruption is higher in countries like Russia and Ukraine (90 percent of the managers declared they bribe officials) and lower in Romania and Poland (20 percent of the managers have to bribe officials).

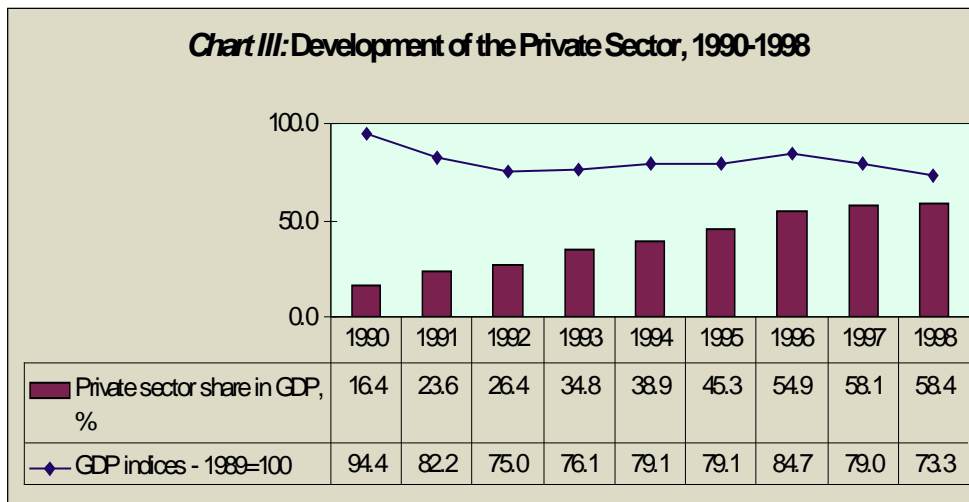
Data suggests the private sector was an effective buffer against the decline in production that accompanied the initial phases of the reform in all transition countries. Countries having a more vigorous private sector seem to be better prepared to overcome economic slump, having shorter and less deep recessions (*Table 1*).

Table 1. Cumulative Changes in GDP in Selected Transition Economies, 1989-1997			
(In percent)			
		1989-97	Peak Decline 1/
Albania		-20.3	-40
Bulgaria		-36.8	-37
Czech Republic		-8	-21
Hungary		-9.6	-18
Poland		11.8	-18
Romania		-19.3	-26
Average (unweighted)		-13.7	-27

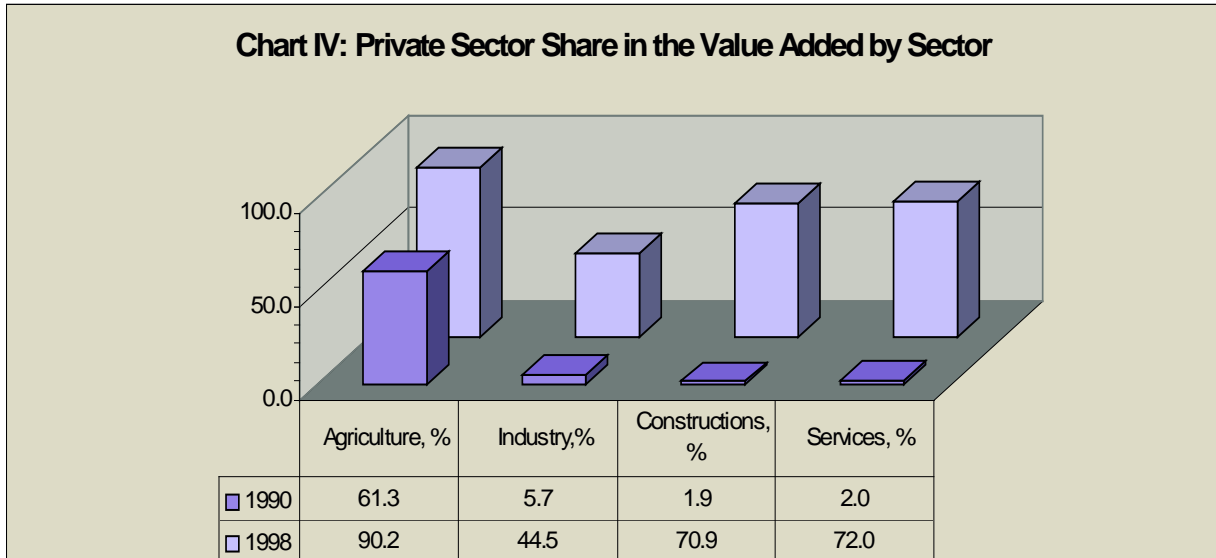
Source: IMF Staff Country Report No.99/26, *Bulgaria. Recent Economic Developments and Statistical Appendix*, Table 18

1/ Indicates the Lowest Level of GDP Since the Beginning of Transition

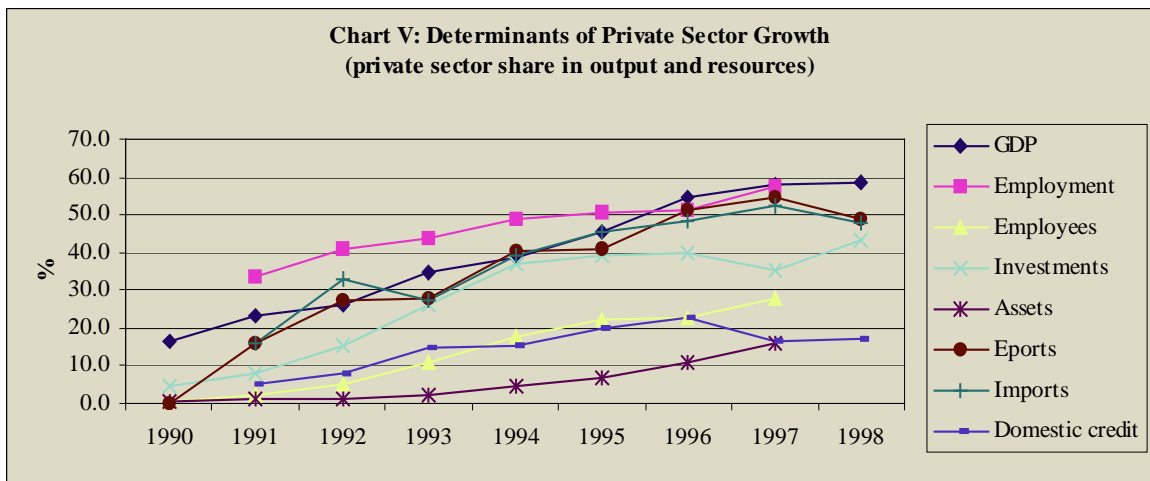
The private sector is more resilient than the economy in general – it continued to improve its position in the GDP even during downturns (see Chart III).



At the same time, there are wide disparities in the participation of private firms to the economic activity in different sectors: agricultural production dominates at over 90 percent of the private sector since 1990 (and for certain products even before), followed by services and construction. Industry remains behind, with only a 44.5 percent contribution to the value added by the sector.



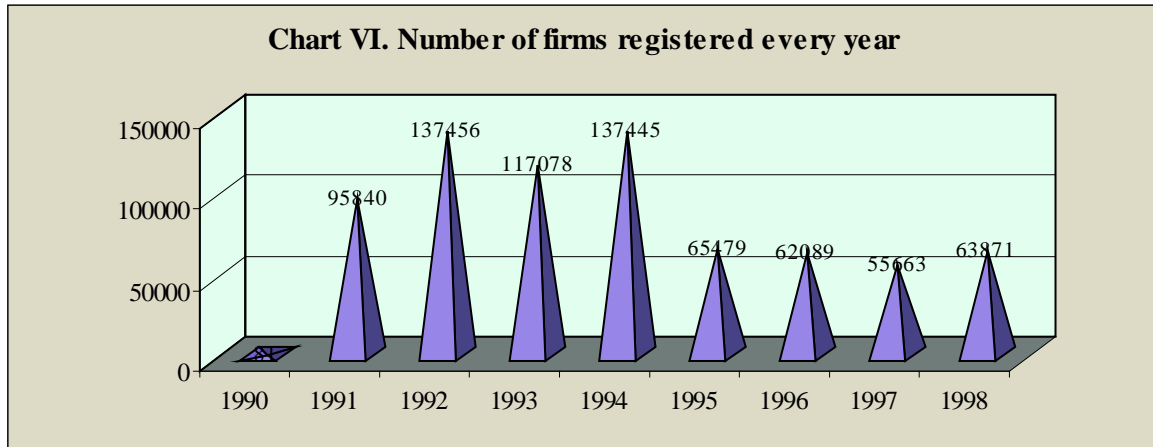
Private sector development (as reflected by its growing share of GDP – see Chart V) is strongly correlated with the rise of employment in the private sector and with the private sector’s participation in foreign trade (both imports and exports). The growth of the private sector is also related to its investments. However, the private sector is still utilizing a very small proportion of the resources in the economy - less than 20 percent of the fixed assets and of the domestic credit. Employees in the private sector represent only 27 percent of the total number of employees, as most of the agricultural production is obtained using family labor.



The private sector is clearly dominating by number - an overwhelming majority of 98.4 percent of the total of 761,842 economic agents registered with the National Trade Register between 1990 and May 1999 are private⁷. Most of these private entities (641,163) are organized as commercial companies, but there are also over 100,000 self-employed entrepreneurs and 5,000 cooperative organizations. The majority of these firms were set up in the period between 1991 and 1994 (see Chart VI).

⁷ Source: *The Chamber of Commerce and Industry of Romania and of the Bucharest Municipality – The National Trade Register Office: Monthly Statistics Bulletin no. 90*

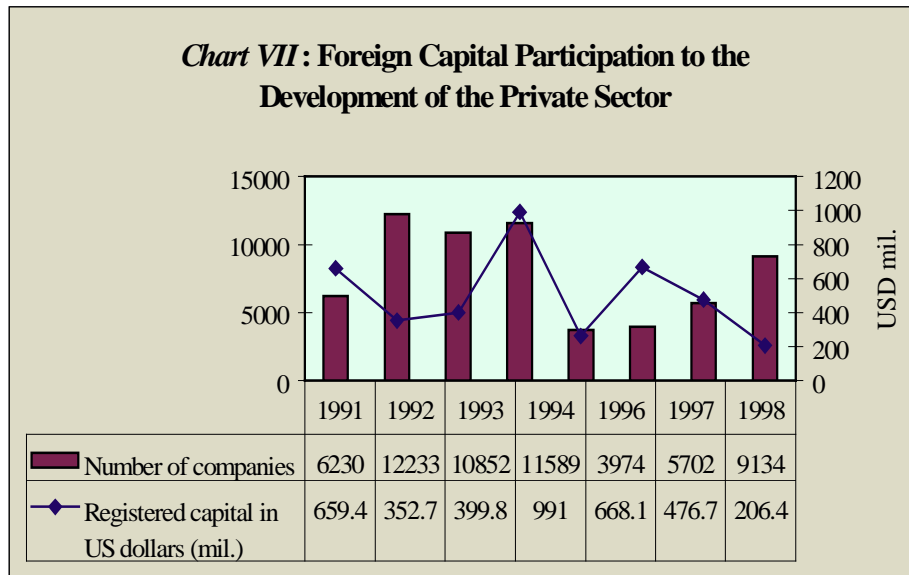
It should be noted, however, that the total number of registered private economic agents is to be considered cautiously. It is a well-known fact that many of the registered companies are in reality economically



inactive – only half of the registered firms regularly submit their financial statements as required by the law and, on many of them, the basic identification data is missing or inaccurate. More than 230,000 limited liability companies failed to increase their capital to the minimum level imposed by a 1997 amendment to the Company’s Law – an indication that these firms are in fact defunct.

The number of economic agents is not an accurate measure for the “entrepreneurial spirit” either. Many private entrepreneurs were prompted to create a series of firms in order to extend the fiscal facilities granted to new firms until 1995. Sometimes, new “clean” firms were created in order to obtain credit from banks. And there is no doubt that firms were set up as a mere shell for underground activities.

There are over 66,000 foreign owned companies that invested over USD 4 billion since 1991 (Chart VII).



Source: The Chamber of Commerce and Industry of Romania, Foreign Investment in Romania. Statistic Synthesis no.16

Most firms, both domestic and foreign, are dedicated to wholesale and retail sales activities, but the largest proportion of capital is invested in industry.

Typically, private firms are small (Table 2); micro-enterprises (less than 10 employees) account for more than 92 percent of the total number of private companies. However, the activity is concentrated in the medium and large companies, which make up for 36 percent of the total turnover of the private sector, although it represents only 1.3 percent of the number of firms.

	1994		1995		1996		1997	
	Number	Turnover	Number	Turnover	Number	Turnover	Number	Turnover
Total , of which:	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
- Micro (0-9 employees)	95.1	54.5	94.7	49.0	93.1	40.9	92.2	37.2
- Small (10-49 empl)	4.0	19.7	4.3	21.1	5.7	24.8	6.5	27.2
- Medium (50-249 empl)	0.7	13.7	0.8	14.0	1.0	15.6	1.1	17.9
- Large (over 250 empl)	0.2	12.1	0.2	15.9	0.2	18.7	0.2	17.7

Source: Comisia Nationala pentru Statistica, *Evolutia Sectorului Privat in Economia Romaneasca (1990-1997)*, Editia 1998

While small firms' share in total turnover declined between 1994 and 1997, large firms increased their share in the total turnover. As a result, a major structural shift took place in 1998 when privately owned companies outnumbered the state owned ones in the **Romania Top 500** companies classification (CEMATT, 1999). But with very few exceptions, all private firms in the Top 500 are either former state companies recently privatized or owned by foreign capital: **domestic new firms remain typically small and very small.**

In general, small firms tend to achieve better economic performance (Table 3), especially in labor-productivity related indicators. This is related to the fact that the private firms are more profitable than the state-owned ones: in 1997, 60 percent of the private firms concluded the year with a profit and 29 percent with losses, while among the state-owned firms a similar proportion (57 percent) of firms ended the year with a profit, but a substantially higher proportion (41 percent) registered losses.

Classification By Size of Firms	Turnover/Employee		Gross profit/Employee		Turnover/Investment	
	1996	1997	1996	1997	1996	1997
National average	1.00	1.00	1.00	1.00	1.00	1.00
- Micro (0-9 Employees)	2.46	1.41	2.61	1.33	1.51	1.18
- Small (10 – 49)	0.63	1.51	2.17	1.96	0.35	0.68
- Medium (50 – 200)	0.90	0.86	1.14	1.28	0.82	0.68
- Large (over 200)	0.68	0.83	0.54	0.67	0.89	1.28

Source: [ZAMAN, VILCEANU. 1999a]

The discrepancy between the private and the state firms is even more evident when the volume of profits and losses is considered (Table 4). State firms produce only 7.4 percent of the profit in

the Romanian economy and 21 percent of the losses, while private firms contribute 80 percent of the profits and 43 percent of the losses. If the balance for the total economy ended positively, this is due exclusively to the private sector which compensated for the negative balance of the state and mixed sectors.

Table 4: Distribution of the Profits and Losses among Private and State firms in 1997					
	Gross Profit		Gross Losses		Difference
	ROL bln.	%	ROL bln.	%	ROL bln.
Total Companies, of which:	29221.3	100.0	23165.6	100.0	+6055.7
Private	23429.3	80.2	10081.2	43.5	+13349.1
State	2169.8	7.4	4786.4	20.7	-2616.6
Mixed	3622.2	12.4	8298.0	35.8	-4675.8

Source: [Zaman, Vilceanu, 1999b]

The better financial performance in private firms is related to generally lower wages (Table 5).

Table 5: Wage Differentiation Between the Private and Public Sector	
Mean Private Sector wages, as a Percent of the Corresponding Mean Values in the Public Sector, 1996	
	<u>Public Sector Wages = 100</u>
Industries	
Agriculture	96
Extractive Industries	52
Manufacturing	84
Power, Gas, Water	66
Construction	99
Trade and Tourism	78
Transport, Communication	87
Finance	82
Real Estate	132
Education	77
Health Care	80
Social Services	88
Main Occupational Groups in the Manufacturing Sector	
Managers, Intellectual Occupations	102
Technicians, Clerical Staff	
Manual Jobs:	89
- Machine Tool Operators, etc.	83
- Other Specialized Workers	87
- Unskilled Workers	

Source: *OECD Economic Surveys Romania*, February 1998, p.129

A much more comprehensive and nuanced portrait of the private sector firm may be drawn from the statistical survey performed by the National Commission for Statistics (see Appendix 5). Private firms are not only smaller in terms of employment (the average number of employees is four times lower in private industrial firms, as compared to state firms), but also in

terms of capital (the registered capital in industrial state firms are, on average, 18 times higher than the share capital in a private company). On average, turnover of state firms is five times higher than that of private firms – but the turnover per employee is only 33 percent higher. State firms outperform the private ones in exports and in the value added. They do also spend more per employee – wages in private firms tend to be lower than in state ones. In exchange, private firms are more profitable (their operating surplus is 13 percent higher than state-owned firms) and invest more out of their own resources. The same findings do apply (with some adjustments) to other sectors – construction, trade, services and even agriculture.

The Ingredients of Economic Success: Entrepreneurs...

Whatever progress Romania has achieved until now in transition, it is due to a large extent to the struggle, initiative and risk-taking attitude of hundreds of thousands of individuals who chose the adventurous path of building a new, different future for themselves and their families. The entrepreneurs are largely recognized today as the driving force of economic progress and, in transition countries, they are also supposed to be on the frontline of reform.

But along with the merits, the Romanian entrepreneurial class is also sharing the responsibility for the failures of economic reform and an accurate view of their role should account for both the merits and failures.

But who exactly are the entrepreneurs we are talking about? Throughout the present section, we will focus on a sub-division of the entrepreneurial class, loosely defined as “those who count” in shaping the functioning of the economic system and who influence its evolution. A large number of the “entrepreneurs” as defined by statistics– like the agricultural family-farmers, some small economic organizations and a good part of the self-employed - are not directly our subject here.

The entrepreneurs’ position and role in the development of the private sector in Romania is the result of specific circumstances that presided their emergence as a socially distinct group and the particular features of their subsequent evolution. Early studies (Costariol, 1993, p.23) noticed two basic differences between Romanian entrepreneurs and typical West European entrepreneurs: a) different social origins of the entrepreneurs, and; b) the different approach, attitude and expectations they have towards business⁸.

Because the chain of familiar handicraft tradition was broken during the communist regime in Romania and the number of entrepreneurs who had been trained in the field as workers or junior technicians in large-scale enterprises is very limited, the two main categories that form the backbone of Western European entrepreneurs (sons of traditionally entrepreneurial families and former blue-collar workers employed in the large scale industry) are almost completely missing. Instead,

the typical private entrepreneur in Romania is a first-generation person, middle aged, mainly with previous experience in a managerial position with large scale state-owned companies or, if he is young, usually with a University education. (Costariol, 1993, p.24)

⁸ The study mentioned is focusing on the Small and Medium Enterprise Sector, but its conclusions are valid for the entire private sector in Romania which is dominated by SME’s.

This is due to the fact that workers and technicians in large state companies were given little personal responsibilities as to the performance achieved by their units and therefore they now possess little of the know-how, organizational skills and decision capabilities needed when undertaking entrepreneurial ventures. At the same time, white-collar personnel had better access to the key business knowledge within the company:

Information concerning strategic factors like the market, clients, suppliers of raw materials, financial tools, and asset availability, accompanied by low salaries in their declining companies, give former managers a better chance to start their own private and often profitable business. This is especially true in a rapidly changing and very troubled system, where a good rapport with a client is of greater use than any technical ability. (Idem, p.24)

There are several important consequences deriving from that structural feature of the entrepreneurial class in Romania:

- a) On the whole, the entrepreneurial class in Romania benefits from a higher educational level when compared to other European countries. But at the same time, it is rather short on practical experience in real industrial work and is therefore lacking in manual and technical abilities. This implies that the average Romanian entrepreneur does not look forward to embarking upon a manufacturing venture, whereas he usually feels a stronger vocation towards commercial and sometimes also speculative activities (this is one of the reasons manufacturing companies are a minority among the newly established enterprises).
- b) Because of their higher social class origins, Romanian entrepreneurs are somewhat insensitive to the issue of mutual solidarity and reluctant to associate with one another. Private entrepreneurs lack an associative spirit in general and are scarcely inclined to group themselves into strong, well-organized associations. There is a profusion of competing business and professional associations, each claiming it is the “authentic” representative of the business community.
- c) Most private businessmen perceive the business environment as being absolute competition and act as though every other enterprise was a dangerous adversary, rather than a potential partner. This attitude is frequently prevailing within the enterprises themselves, where personal ambitions and mistrust between partners generate conflicts and leads to splits and break-ups. Vertical and horizontal integration and consolidation in general is hindered, contributing to the weakness of the Romanian private sector.

But by far the most significant consequence of the white-collar, managerial origins of the Romanian private entrepreneur is its special relation with the state and state companies:

- a) Many private ventures were from the start conceived to gravitate around a state company. Although some of them are legitimate and respectable businesses, in a very large number of cases they are simply devices aimed at siphoning profits and assets from state companies into private hands. The simplest and best known mechanism is the “tick firm”:

Two SRL (limited liability companies), usually having deep roots in the political environment, were placed on the “inputs” and the “outputs” circuits of a state enterprise. The first one is selling the raw materials at

higher prices. The second one is buying the production cheaply. The “tick firms” are prospering, and the guest company becomes, in a few years, a true “black hole”. (Cercescu, 1999)

Some authors go even further and consider that:

after 1989 the capitalist class was formed mainly on the account of the state by rape of real estate, fixed assets and even social capital of state enterprises and organizations. ...From state plants’ directors that tacitly transferred to their wives’ tick-firm equipment, raw materials, contracts and bank loans guaranteed with state property, to managers of import-export organizations privatized overnight to continue the operations and cash the dollars into their own accounts, to the relatives of former CPEx (Communist Party Political Executive Committee) members and directors in the old financial institutions promoted as heads of the new banks, they all demonstrated an extraordinary business ingenuity that procured them billions. (Brucan, 1999, p.37)⁹

b) The “special relation” is not limited to state companies but is spilling over to all state institutions

the only form of survival (for the private entrepreneur) was, during the last ten years, the alliance with the political-administrative apparatus. The entrepreneurs that resisted in time did comply with that unwritten rule. (Margarit, 1999)¹⁰

prompting some analysts to declare that

Romanian capitalists are a product of the Romanian State and, as such, they are an annex of the state. (Boari, 1999)

c) When the political dimension is added to the list of “special relations” between the private sector and the state, the resulting picture is what is usually called “crony capitalism”. In fact, “crony capitalism” is the continuation of the old “kinship socialism”:

The practice of the old *nomenklatura* of promoting its interests through the politization of economic activities takes, in post-communism, the form of the so-called “crony capitalism” – deeply related to the kinship socialist economy that generated it. The old economic order is therefore shaping the power relations that define the new “order”. (Palade, 1999)

Other authors see the private sector more like a victim of a battle between the “industrial elite” and the “financial elite” for controlling political power.

The private sector was too dependent on the (public) administration, whose approvals and decisions were indispensable for any successful business, to be in a position to assume a political conflict with it. (Instead, the private sector) preferred to accommodate, trading the uniformity of economic rules and mechanisms for the singularity of the decision bought through bribery. This allowed them to continue their business and maintain their profits even without getting a first ring position in the power system. So they finally turned out as an unreliable and duplicity ally. A similar position adopted the foreign capital, capable of accepting any rules, including the one of breaking any rule if this can secure the success. (Pasti, 1995, p.309)

An extremely severe diagnostic is derived from this analysis.

⁹ The same author observes that the same process occurred in all post-communist countries and concludes that it must be “a historically objective and necessary process”.

¹⁰ The author utilizes a case where a good business project did not take off until local officials (one director in the bank, the head of the agricultural directorate, others from the city-hall, police, and financial administration) were co-opted as partners.

Today, in Romania, we are dealing with a **closed economy** that relies in its functioning on the collusion of interests between the state apparatus and an exclusive category of “entrepreneurs”. **This alliance sets the structural conditions for the functioning of the economy in Romania.**

(Boari, 1999)

Understanding the basic, structural relation established between the state and the entrepreneurial class helps explain some otherwise surprising facts. The ambiguous attitude of Romanian entrepreneurs towards the state is one example: the state is to blame for almost all bad things that happen to the business, but it is the state they turn to when looking for solutions. And the solutions demanded are not of a liberal type as one might expect from private entrepreneurs (the “minimal state” perspective), but are strongly interventionist (the state should actively protect specific interests – bakeries, poultry farms, furniture producers etc. - by extending subsidies, increasing import tariffs, allocating funds and other resources to specific groups etc.). Every meeting organized by the different entrepreneurial associations is concluded by a document proposing solutions for a turnaround of the national economy; but these “solutions” are nothing more than “wish lists”.

...almost all schemes that, at least in intention, aim at stimulating the economic growth, are based on facilities, exemptions, discrimination, subsidies, protection against competition etc., that is on all elements needed for rent-seeking to remain a *modus vivendi* in the economy. (Croitoru, 1999)

In general,

Against a background of absence of an anti-state spirit, we do find an activism dedicated to promoting and concluding “deals” with the state to reap privileges, favors, protectionism and rents. (Munteanu, 1999)

The collusion between the state and the private sector also accounts, at least partially, for the aggravation of the crisis during the downturn after 1997. Because of its dependency on the state, the private sector was not capable of taking over and playing a locomotive role in restructuring. Instead, the private sector was itself severely hit and contributed to the economic contraction.

The affinity of the private sector to state firms makes the two almost indistinguishable in their manners; many state companies take the liberty of behaving like private firms and some private entities enjoy the privileges of state protection and support. *Credit Bank*, a “private” financial institution having state companies as the main shareholders, was such a strange combination whose private character was related mainly to the interests it served (see the Dossier in the Appendix). *Banca Dacia Felix*, another private endeavor in the very lucrative financial sector, succeeded to get around 2000 billion lei from the National Bank before going bust.

But maybe the most harmful consequence of the “state capitalism” system that dominates economic life is that it makes it very hard for many other entrepreneurs who are not “part of the system” to survive and prosper and for free markets to function properly. The media has recorded hundreds of examples of Romanian or foreign entrepreneurs who give up or are defeated in the battle with the “state capitalism” system. Genuine success stories are rare, but very precious because they give reason for hope (see Europharm Dossier in the Appendix).

... and Business Environment

A minister of the Romanian Government recently remarked that:

The business environment in Romania is extremely hostile to investors. It is rendered hostile by corruption and by the bureaucratic system of approvals for any action an investor takes. I have no doubts now that Romania is offering today such a hostile environment.

(Minister Traian Basescu, quoted by Oanta, 1999)

Romanian and foreign entrepreneurs have long complained about it. Up to a point, these complaints are not unusual – businessmen everywhere tend to grumble about taxes or cumbersome regulations. Transition economies, confronted with the huge task of re-building the whole institutional system in a very short period of time, have explicable difficulties in harmonizing all the different aspects of the business environment and in making it work. Therefore, the situation in Romania should be treated with a certain tolerance.

But what is really disturbing in Romania's case is that over the last few years, instead of an improvement, the business environment seems to have deteriorated. The latest *Economist Intelligence Unit* survey on the issue is placing Romania among the most "toxic" environments to business, after Russia, Indonesia and Pakistan (*The Economist*, 1999 p.138). A similar conclusion was reached by a study prepared for the Romanian government: out of 130 countries analyzed, Romania is among the 20 most constraining fiscal and administrative regimes.

Practically all elements that compose the business environment are inadequate. We will not insist here on more general aspects like macroeconomic stability, competitive markets, hard budget constraints, property rights, etc. that have been examined in various instances and by different authors. My aim here is to present the business environment as it is perceived by private entrepreneurs, focusing on the problems most frequently invoked by them.

A clumsy and extremely volatile **legislative framework** is, according to many businessmen, a main source of uncertainty in business. There is a profusion of laws, government decisions, instructions for application and regulations that create confusion because of their ambiguity, contradictory provisions and frequent revisions. Legal norms that are crucial for business are modified again and again: a title like "Law no.148 for approving Government's Emergency Ordinance no. 50/1998 for the modification and supplementing of the Government Emergency Ordinance no. 82/1997 regarding the level of the excise duties and other indirect taxes" is a common reading in the *Romanian Official Gazette*. The excessive use of government ordinances as legislative instruments is itself a major source of uncertainty – such an ordinance is abruptly passed, without due review and reaction from interested parties, and is almost certainly changed later on by the Parliament. To add to the confusion, three legal systems (the pre-war, the socialist and the transition one) coexist, with many laws that were never explicitly abrogated invoked by bureaucrats when an initiative is to be obstructed.¹¹ The approximation to EU legislation – an obligation Romania assumed as a candidate to integration – was never addressed in a systematic manner. A well-known journalist was summarizing the situation:

One of the reasons foreign investors bypass Romania is the legislative instability. We do not have laws, the ones we have are not adequate for the times Romania is traversing, the ones we make are wrong. When they are not wrong from the outset, when they do not conflict with old, non-abrogated ones, even though they are conceived with best intentions among others for harmonizing the Romanian legislation with the European one, they do leave too many doors open and tricks (that can be used) in order to defy them, the instructions for application are poor and we do nothing in order to implement them. (Munteanu, 1999)

The cluttered legislative framework is putting a lot of pressure on the **judicial system**, which is itself not up to the task. Lack of instances, judges and lawyers specialized and

¹¹ The Legislative Council started to clean up the system but the task is immense.

experienced in business matters is part of the problem. Long, complicated and therefore costly procedures push interested parties to devise side arrangements, creating a favorable environment for corruption. Private firms, especially the small ones, do not have the resources to fight long legal battles, while large state firms are practically immune to the execution of sentences.

But the situation in the legislative and judicial area is only creating conditions for the **public administration bureaucracy** to develop the most elaborate anti-business practice. A combination of incompetence, apprehension of public servants to assume responsibility, widespread mistrust in their loyalty and correctness, and political interference in decision-making—reinforced by strong residues of the old communist hyper-centralized attitude in the individuals' and institutions' memories and conduct—confront entrepreneurs with the most absurd, nightmarish situations.

To set up a firm, an entrepreneur has to obtain 95 signatures of approbation from 15 different institutions; for each of these, 5-6 sets of documents have to be presented and, as usually something is missing or has an inadequate form, certain steps are repeated several times (Pais, 1999). Local authorities have a heavy hand in running the procedures and are frequently accused of inhibiting private initiative. A private entrepreneur who endeavored to build a USD 1.2 million hotel in the Danube Delta declares:

The Tulcea district is still communist. The local authorities would do anything to block private initiative. Why? Because public money can be plundered more easily. I do note down every outlay when there is a matter of protocol, as well as when the (officers) from the (Financial) Guard come to have a meal. They even asked me what I do, why do I note it down and I told them that everything is to be registered in the papers, because I do not want to pay from my own pocket for their meal. The building permit took one and a half years to obtain, while the construction itself was done in just one year and two months. The reason is Tulcea authorities' mentality, they want to block any private initiative. I had to pay bribes in order to obtain perfectly legal documents. They were asking me all kind of absurd things. For example, in order to get the license for using the water from the Danube (to supply the hotel), I had to submit the written consent of the owner of the dam that I used. Well, the dam was built by myself. They wanted me to write down a paper mentioning that Mr. Gaina is consenting to use the dam made by himself for water supply.

(Marinescu, 1999)

The onerous and inefficient bureaucracy is accompanying the private firm throughout its life; any change in the firm's legal status or activities entails repeating the same procedures, with another set of documents (the old ones are rarely found in the inadequately organized and poorly housed archives of different institutions). Even closing down a company becomes a complicated matter.

Cosmos Development SRL was a small firm set up in 1992 in Bucharest, dedicated to consulting, editing and publishing different economic periodicals. Its single partner, a foreign natural person, decided to close the firm because its business interests moved to different horizons. He started the required procedures in May 1998, pretty confident that for a single partnership, without any third-party liabilities, it should be a simple matter. 18 months later he was still jammed in the process. The stumbling stone was the fiscal certificate that is to be delivered by the fiscal authorities. After many meetings between the accountant of the firm and the tax officer, where some questionable but minor critical remarks resulting in around USD 50 due payments were solved, the delivery of the certificate was still delayed. The tax officer proposed a "private meeting" to finalize the operation, but the owner of the firm refused. Meanwhile, the tax office was re-organized and moved to a different location – all previous files became impossible to trace. The firm is now one of the several hundreds of thousands of "dead-alive" private firms that are cluttering the trade register records.

Taxation and the fiscal system are among the main causes of discontent for private entrepreneurs. The high level of taxation is suffocating business – that is a recurrent complaint (and of course not an original one) on which all entrepreneurs, small or large, domestic or foreigners, share a common judgment. Entrepreneurs claim taxes take up more than 50 percent of their revenues. Ministry of Finance experts counterattack by showing that, compared to other European countries, the level of taxation (around 30 per cent of GDP) is moderate. Although it seems paradoxical, both figures are correct. The average taxation is around 30 percent of GDP, but the average involves a lot of exemptions and non-payments (due mainly to large state enterprises); therefore, a private company may well be paying more than 50-60 percent of its net income or of its value added as taxes. The heaviest taxation is applied to the most efficient, highly value added activities, where wages are taxed at the marginal rate of 45 per cent.

The dispute over the tax level is lately confused by an innovative approach to taxation adopted by the authorities – the “special funds”. “Special funds contributions” are *ad-hoc*, special-purpose taxes levied directly by ministries or other public institutions. They are approved by law or (usually) by government ordinances and have a disruptive character – they come unexpectedly and can derail the most cautiously prepared business plan. One of the first such special funds was the “agricultural workers pension fund,” a contribution aimed at providing former cooperative workers with a pension after cooperative farms were dismantled. As the contribution is paid for by the agricultural, food producer and distributor chain, an estimated 10 percent increase in food prices results from this tax.

During the last two years as the constraints on the state budget deficit increased because of strict conditionalities imposed by the IMF agreements, different Ministries set up their own, independent budgets fed by newly devised taxes and contributions. The Economic Reform Fund, the National Cultural Fund, the Social Solidarity Fund for Handicapped Persons, the Fund for Development and Modernization of Customs, the Fund for Film Production, etc. – according to some estimates, over 20 such funds exist now but nobody, including the Ministry of Finance, knows exactly how many such funds exist.

The special fund is one of the greatest tricks ever invented in the domain of fiscal legislation. Not sufficient resources in the budget for education? We create a special fund. Now, all employers have to pay a wage-related contribution for education. The Romanian tourism is agonizing? A special fund, to which all those having the slightest relation with tourism should contribute, is the rescue solution.... The special fund is a direct consequence of the restructuring in the public administration. Instead of cutting down the number of bureaucrats, the ministries create a special fund. As the fund has to be administered by someone, a special direction, a department, an agency or any other institution is set up, with a resonant name. In many cases, half of the money collected in the special fund is spent on paying salaries for the administrators, on offices, cars, materials and pens. In other cases, the special funds indicate a poor management of the state budget revenues. Professor remuneration is an example. It is the State’s obligation to pay professors in the state schools out of the taxes it collects. Because the state is not capable to do so, it institutes a special fund for education. In other words, we pay twice for the same worthless result: schools with no water, professors living on miserable remuneration and classrooms with no desks. (Rosca, 1999)

In addition to frequently being a double taxation, the noxious character of special funds is related to the fact that they are escaping the usual political and even administrative controls.

The fiscal environment is also made difficult by frequent changes in regulations. A law is passed granting certain fiscal facilities to investors and, only months later, it is repealed through the state budget law. Excise duties and value added regulations have been changed several times in one year.

Accounting rules and changes in accounting norms also have a dramatic impact on taxation. Romanian firms pay “taxes on inflation” as the accounting norms (prepared by the Ministry of Finance) are not in line with the provisions of the IAS 29 standards (International Accounting Standards for hyperinflationary economies). Therefore, many firms get decapitalized by paying taxes on apparent revenues.

Besides the level of taxation and the ever-changing and inadequate fiscal regulations, the fiscal regime is aggressive to business in its practical, daily application by the bureaucrats in the fiscal administration. Tax officers have a deeply rooted attitude of suspicion, especially in relation to private firms that are presumed, by default, to have fraudulent intentions and practices. Internal regulations in the Ministry of Finance and within the Financial Guard prompt inspectors into having a biased approach when investigating a firm. If they conclude an investigation with sanctions and penalties, 15 percent of these penalties are contributed to a fund used to supplement the compensations received by the Ministry of Finance personnel. Recently, the Minister of Finance issued an order which imposed minimal targets on revenues resulting from sanctions and penalties applied to economic agents for every regional fiscal administration. Failure to realize the minimal target prompts pecuniary penalization for the personnel in the fiscal administration and even layoffs. In these circumstances, entrepreneurs do frequently hear from tax inspectors coming to investigate their firm with the statement: “I will not leave until I find something”.

Abuses are frequently reported – but they are quite difficult to prove. The most common is excess investigation. According to a survey made by the Confederation of Private Entrepreneurs in the Timis county, several private firms complained they had been investigated several times successively within a short period (30-45 days), on the same issues, and every time fines were applied. There are reports of firms being investigated 250 days in one year by the many different, independent and uncorrelated institutions. As again Minister Basescu states:

Public institutions may kill a business if they want to. It only takes to be a disagreeable businessman and you have 15 inspections that will destroy your business. (Mediafax)

The ambiguities in the norms and regulations leave plenty of room for fiscal officers to place sanctions and fines. When several interpretations are possible on a specific norm, the one less favorable to the firm is applied.

Few entrepreneurs attempt to fight fiscal administration decisions. Procedures are long, complicated and costly. Before going to Court, several settlements are provided for in the fiscal administration system itself. During the first six month of 1999, the General Directorate for Complaints Resolution in the Ministry of Finance received 2,390 petitions. Until September, only 1,523 have been solved (and only 583 companies received a favorable resolution). (Preoteasa, 1999). Many claims get lost in the bureaucratic system before a resolution is reached – time is playing in favor of the administration.

Societe Generale Corporate Finance Advisory is the Romanian subsidiary dedicated to investment banking of the multinational bank Societe Generale. After one year of activity, the firm asked for the restitution of the value-added tax it had paid during the year on goods and services acquired. Two inspectors spent two weeks checking all company books that were kept by the accounting and auditing firm KPMG. In their final report, the tax officers contested almost half of the VAT claimed. SG-CFA and the KPMG accountants prepared and submitted their “objections” to the report conclusions as provided by the law. Although the law provides an answer should be given within 30 days, the financial administration never

replied. At the insistence of the claimant, the tax officers said that the answer had been sent by mail – but they could not produce any evidence. As the next steps of the procedure cannot be initiated prior to having a solution to the first “objections”, the firm was practically blocked from pursuing his rights. In the meantime, the value of the sum involved is reduced to half by devaluation.

No wonder many private firms prefer “shortcuts” – if not straight bribery, then at least more sophisticated arrangements, by which tax officers are paid as “accountants” or “tax consultants” by the firms they are supposed to investigate.

Restricted access to institutional financial services is another obstacle to private firms. Because of the high and variable inflation rates, interest rates on lending are prohibitive for many businesses. To cover risks, banks tend to have very large spreads. As long as the treasury is hungry for money to finance the fiscal deficit, banks have no appetite to lend to the companies. Many companies lack collateral and so are frequently denied access to necessary financing. While financial intermediaries are often reluctant to lend to small private enterprises for sound financial reasons (such as the high transaction cost of monitoring), badly functioning financial systems, ineffective laws on collateral and poor enforcement of financial contracts also limit access to credit. Once again, the most effective method to obtain credit is not a good business plan, but a good introduction to the bank. Several banks have now failed because of their crony lending practices.

The lack of **adequate governmental policies** for the private sector, and particularly for the small and medium enterprises, is also mentioned by private entrepreneurs and their organizations as one of the major impediments to growth and expansion. Special laws and provisions were passed at different moments (Government Ordinance 25/1993 and, recently, Law 133/1999) aimed to support private firms through subsidies, fiscal incentives and other preferential treatments. But their effect was almost null – the legal provisions were much too general to have a practical impact and, when more specific, they were not supported by adequate resources.

The governmental policies based on preferential treatment for certain sectors or groups of companies have rarely produced positive results. Instead, they contributed to the creation of a distorted system of incentives, encouraging SMEs to become dependent on subsidies and inhibiting their growth. But very few entrepreneurs, not to mention politicians, in Romania do realize that. By asking for special treatment and favors, they open the back door for bureaucrats to get back in business.

Conclusion: From State Socialism to State Capitalism

The conditions of the new private firms in transition are a good illustration of what has been achieved in Romania after ten years of economic reform. The collapse of the old socialist central planning mechanism and the emergence of new privately owned firms were not sufficient to put in motion a fully market-driven economic system. Instead, a hybrid system seems to form in which bureaucrats in state institutions have an important role in allocating economic resources and distorting competition in favor of their protégés. Entrepreneurs whose main capital was made through relations now dominate the business. All the others are struggling to survive by adjusting to the conditions.

Instead of creating a truly independent and self-reliant private sector, the Romanian transition has produced a state-compliant and state-dependent private sector. But this may be an inevitable stage of the transition. What is really worrying in Romania's case is that the process seems to have stopped here:

Romania got stuck in the first stage of the transition. A certain sector, formed either by people from the old *nomenklatura*, or by individuals who oriented themselves very rapidly in the interstices, created and knew how to take advantage of the opportunities of the initial period, produced a zone of economic and social supremacy, acquired sufficient economic strength and has no interest in generating a second phase where competition may lead to losing its monopoly. (Tismaneanu, 1999).

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Estimated Private Sector Share in GDP and Employment in Selected Transition Economies, 1991-1998

	1991	1992	1993	1994	1995	1996	1997	1998H 1	1991	1992	1993	1994	1995	1996	1997	1998H 1
	% in GDP								% in employment							
Bulgaria/1	19	26	35	39	48	53	59	53	10	18	28	36	41	47	55	...
Croatia/2	25	35	41	45	45	50	...	55	22	27	37	47	48	51	51	...
Czech Republic/3	17	28	45	56	64	75	75	75	19	40	60	64	76	78	...	...
Hungary	33	44	52	...	60	70	...	80	...	...	...	...	...	...	...	...
Poland	45	48	54	56	60	78	79	78	51	57	58	60	...	64	64	75
Romania	24	26	32	35	40	60	58	60	34	41	44	51	51	...	...	65
Slovak Republic/4	...	22	25	44	60	77	83	83	13	18	22	32	...	...	...	...
Slovenia/5	16	20	...	...	48	45	60	55	12	16	19	22	48	...	...	...

Source: IMF Staff Country Report No.99/26, *Bulgaria. Recent Economic Developments and Statistical Appendix*, Table 33

1/ According to the Revised National Classification of Economic Activities from 1996. The change in definition resulted in a step increase of 3.5 percentage points in the share of GDP in that year

2/ End-of-year data; employment data for the period before 1993 includes only 100 percent privately owned firms; from 1993-1994 mixed firms with more than 50 percent private ownership and transformed firms are also included. Data for 1996-1997 is according to the revised definition of the labor force. Tentative estimates.

3/ Shares of GDP estimates are for the "non-state sector"; private sector employment includes mixed ownership.

4/ Before 1994, firms with mixed ownership were excluded from the definition of the private sector. Since 1994, such firms were included in the definition of the private sector.

5/ Excluding socially managed enterprises.

Appendix 2
The Private Sector in the Romanian Macroeconomic Context

	1990	1991	1992	1993	1994	1995	1996	1997	1998
GDP, bln. ROL	857.9	2203.9	6029.2	20035.7	49773.2	72135.5	108916.6	250480.2	338670
Private Sector Share of GDP, %	16.4	23.6	26.4	34.8	38.9	45.3	54.9	58.1	58.4
GDP Indices - 1989=100	94.4	82.2	75.0	76.1	79.1	79.1	84.7	79.0	73.3
Private Sector Share of the Value Added in:									
Agriculture, %	61.3	73.9	81.7	83.5	89.3	89.0	90.1	92.2	90.2
Industry, %	5.7	9.2	11.8	17.4	23.3	29.0	38.5	43.4	44.5
Constructions, %	1.9	16.1	21.0	26.8	51.6	57.8	69.2	71.9	70.9
Services, %	2.0	16.8	18.8	29.3	39.1	58.1	66.7	70.8	72.0
Employment, Thousands of Persons	10840	10786	10458	10062	10011	9493	9379	9023	
Employment in the Private Sector, Thousands of Persons		3621	4284	4402	4923	4815	4828	5186	
Employees, thousands of. Persons	8155.6	7573.8	6887.5	6671.7	6438.4	6160.4	5938.7	5597.0	
Employees in private sector, thousands of Persons				727.0	1129.0	1361.0	1366.0	1559.0	
%	0.7	2.4	5.3	10.9	17.5	22.1	23.0	27.9	
Investments, bln ROL.	168.0	314.0	889.0	2822.0	8005.0	12995.0	20945.0	44135.0	45343
of Which, Private Investments, %	4.3	8.1	15.6	26.0	36.8	39.3	39.7	35.4	43
Fixed Assets, bln. ROL	3498.0	4505.0	23217.0	26583.0	33811.0	169866.0	188934.0	242714.0	
Private Ownership, bln.ROL	22.0	49.0	282.0	597.0	1523.0	11230.0	20380.0	36939.0	
Foreign-owned, bln.ROL				1.0	16.0	118.0	523.0	1751.0	
Exports FOB, USD mil.	5775.4	4265.7	4363.4	4892.2	6151.3	7910.0	8084.5	8431.1	8302
of Which, Private Sector, %	0.2	15.9	27.5	27.9	40.3	41.2	51.4	54.8	49
Imports CIF, USD mil.	...	5793.4	6259.6	6521.7	7109.0	10277.9	11435.3	11279.7	11838
of Which, Private Sector, %	...	16.1	32.8	27.2	39.2	45.4	48.3	52.4	48
Trade Balance, USD mil.	...	-1527.7	-1896.2	-1629.5	-957.7	-2367.9	-3350.8	-2848.6	3536
of Which, Private Sector, %	...	16.8	45.1	25.0	31.9	59.4	40.7	45.2	47

Domestic Credit, mil ROL, End of Year	610208	1321288	1778368	4263611	9183376	17399015	31450022	47431996	81288969
Non-government Credit, mil ROL, End of Year	683955	1375159	1912770	4901977	9484528	16435380	26841440	35900662	59086517
Credit to Private Sector	...	64379	141702	641919	1403754	3513833	7225435	7808985	13901667
- Short-term	...	45028	104972	529515	1176675	2801363	5648703	6169448	11463601
- Medium and Long term	...	19351	36730	112404	227079	712470	1576732	1639537	2438066
Exchange Rate ROL/USD (Year Avg.)	22.4	76.4	308.0	760.1	1655.1	2033.3	4035.0	8023.0	10951

Source: Various publications of the National Commission for Statistics and the National Bank

The Private Sector Position in the Romanian Economy

Share in:	1990	1991	1992	1993	1994	1995	1996	1997
Gross Domestic Product	16.4	23.6	26.4	34.8	38.9	45.3	54.9	58.1
Industrial Production	...	1.3	3.2	6.2	12.9	20.7	24	26
Agricultural Land	12.6	69.8	70.3	69.9	70.1	72.3	72.3	70.5
Under Crop land	28.4	78.9	80	78.5	79.5	81.4	80.9	81.6
Agricultural Production	56.1	79.3	80.8	84.5	86.4	86.1	86.3	89.5
- Vegetable	56	81.6	80.9	86.8	87.4	88.1	87.6	90.2
- Animal	56.3	74.8	80.5	80.6	84.9	83.2	84.4	88.2
No. of Tractors	4.8	16.5	26.5	35.2	47.1	55.2	59	69
Fertilizers Used	9.2	49.6	49.8	56.3	60.8	65.1	65.1	70.8
Cattle	44.4	80.4	81.7	84.8	87.8	89.6	90.3	92.6
Swains	28.9	49.8	54.6	53	56.9	57.9	57.9	65.8
Sheep	62	86.1	87.1	89.2	90.1	91.2	92.5	94.7
Poultry	35.5	49.9	52.7	57.5	66.1	63.2	69.2	81.4
Investments	4.3	8.1	15.6	26	36.8	39.3	39.7	35.4
Construction Works	3.1	4.5	13	30.2	55.5	70.8	75.5	70.5
Dwellings Stock	67.3	78.7	88.3	90.4	91.8	92.3	93	94
New Dwellings	11.9	23	50.2	63.9	70.5	74.7	85.5	87.4
Goods Hauling	...	0.7	1.4	2.6	1.2	16.5	23.5	37
Passenger Transport	...	0.3	0.4	1	2.2	2	3	3
Retail Trade	0.8	21.7	45.8	65	71.1	74.3	76.7	81.9
Consumer Services	3.9	20.1	35.4	42.6	54	58.4	59.8	62.9
Hotel Capacity	...	...	...	18.2	24.9	26	24.9	25.1
Number of Hotel Guests	...	...	...	18.5	27.2	30.6	30.3	32.8
Exports FOB	0.2	15.9	27.5	27.9	40.3	41.2	51.4	54.8
Imports FOB	0.4	16.1	32.8	27.2	39.2	45.4	48.3	52.4
Trade Deficit FO/FOB	0.7	16.7	49.1	24.1	22.2	66.4	38	42.1
Trade Deficit FOB/CIF	...	16.8	45.1	25	31.9	59.4	40.7	45.2
Employees	0.7	2.4	5.3	10.9	17.5	22.1	23	27.9
Students in Private Univ.	...	...	26.5	30.7	31	25.4	26.4	30.7
Radio Stations				3	33.2	44.1	52.1	53.3
TV Stations				3.7	31.1	40.4	47.7	53.2
<i>Source: CNS, Evolutia Sectorului Privat in Economia Romaneasca (1990-1997)</i>								

**Number of Active Enterprises in Industry, Construction, Trade and Other Services,
by Activities and Ownership**

	1996			
	Total	Private	Mixed, >50% Private	Co-operative
Total	312067	304713	1453	1621
Mining	169	94	8	0
Manufacturing	32084	29683	376	537
Electric and Thermal Energy, Gas and Water	276	46	8	0
Construction	7046	6512	94	60
Trade, Repair	226038	223583	684	864
Hotels and Restaurants	10886	10547	110	41
Transport and Storage	10215	9614	67	0
Post and Communications	374	365	4	0
Real Estate, Rental, Companies Services	11202	10685	80	46
Education	515	476	1	1
Health and Social Assistance	2684	2683		1
Other Collective, Social Aid and Personal Services	10578	10422	21	71
	1997			
	Total	Private	Mixed, >50% Private	Co-operative
Total	316751	309038	2189	2094
Mining	201	128	19	0
Manufacturing	35962	33445	688	671
Electric and Thermal Energy, Gas and Water	267	45	14	0
Construction	9470	8914	220	70
Trade, Repair	226101	223542	763	1169
Hotels and Restaurants	10122	9800	128	39
Transport and Storage	11305	10685	127	0
Post and Communications	474	464	5	0
Real Estate, Rental, Companies Services	12229	11598	177	58
Education	546	511	20	1
Health and Social Assistance	3536	3531	0	2
Other Collective, Social Aid and Personal Services	6538	6375	28	84

Source: The National Commission for Statistics, *The Romanian Statistical Yearbook 1998*

Appendix 5

Private Company Performance in 1997

(Companies with More than 50 Employees)

		Industry			Construction			Trade		
		Total	Private	Relative	Total	Private	Relative	Total	Private	Relative
Number of Companies		4027	2779	0.69	1363	1135	0.83	1495	1160	0.78
Social Capital	ROL bln.	113095	12471	0.11	4313.0	2549	0.59	6877.0	3542	0.52
- per Company	ROL mil.	28084	4488	0.16	3164.0	2246	0.71	4600.0	3053	0.66
Number of Employees (Year Average)	Persons	2433445	907951	0.37	362888.0	264828	0.73	242049.0	169432	0.70
- per Company	Persons	604	327	0.54	266.2	233	0.88	161.9	146	0.90
Turnover - Total	ROL bln.	194993	60267	0.31	21992.0	17268	0.79	53142.0	31384	0.59
- per Company	ROL mil.	48421	21687	0.45	16135.0	15214	0.94	35546.0	27055	0.76
- per Employee	ROL thou.	80131	66377	0.83	60604	65206	1.08	219551	185231	0.84
Direct Exports	ROL bln.	45304	13854	0.31	1021	888	0.87	1946	1693	0.87
- per 1000 ROL Turnover	ROL	232	230	0.99	46	51	1.11	37	54	1.46
- per Employee	ROL thou.	18617	15259	0.82	2814	3352	1.19	8040	9992	1.24
Gross Value Added at Factor Costs	ROL bln.	74035	21525	0.29	8008	6226	0.78	6601	4649	0.70
- per 1000 ROL Turnover	ROL	380	357	0.94	364	361	0.99	124	148	1.19
- per Employee	ROL thou.	30424	23707	0.78	22068	23511	1.07	27271	27439	1.01
Personnel Expenses	ROL bln.	36417	10819	0.30	4705	3423	0.73	2765	1871	0.68
- per Employee	ROL thou.	14965	11916	0.80	12966	12924	1.00	11423	11043	0.97
Gross Operating Surplus	ROL bln.	28057	8882	0.32	3086	2711	0.88	3213	2516	0.78
- per 1000 ROL Added Value	ROL	379	413	1.09	385	435	1.13	487	541	1.11
Investments	ROL bln.	19700	8107	0.41	2097	566	0.27	1527	1300	0.85
- per 1000 ROL Added Value	ROL	266	376	1.41	262	91	0.35	231	280	1.21
- per Employee	ROL thou.	8095	8929	1.10	5779	2139	0.37	6309	7673	1.22

Source: Comisia Nationala pentru Statistica, *Rezultate si performante ale intreprinderilor din industrie si Rezultate si performante ale intreprinderilor din constructii, comert si servicii*, Editia 1999

The File Of The Lost Money**The Credit Bank Dossier**

By Tiberiu Vilcu

Published in the magazine “Banii Nostri”, June 1999

The story of the bank “Renasterea Creditului Romanesc - Credit Bank” is a typical Romanian soap opera of the post December ‘89 period, starring spruce billionaires and directors acquainted with all sorts of bribes to many elements - somnolent authorities, a bewildered system of justice and countless deponents. In September ‘98, following a heart attack which occurred in circumstances that are not elucidated, the president of the bank, Emil Cioflan, was found dead in the office of the university he was teaching at... A soap opera with a lot of figures and with no moral, with the exception of the financial one.

The Eye of the State Fattens the Bank of the Private

Credit Bank was known as a private bank (one of the first founded after 1989), but the actual situation was different. The bank “Renasterea Creditului Romanesc - Credit Bank” was founded in December 1991 and started to operate in February 1992, with a registered capital of 3.4 billion lei, later increased to 5 billion. In the beginning, three-quarters of the registered capital was owned by autonomous bodies and state companies - from SNCFR (with 18.6%) to Fulger Bragadiru (with 8.6%) or Vulcan S.A. (with 2.7%) - which were state companies, investing state money - our money. It is interesting how these companies were able to invest in the Renaissance¹² bank, even though their own economic situation was precarious. Actually, many of them later came close to bankruptcy. Meanwhile, the management of the bank was “very private” and knew how to use the resources, financial or not, brought by the generous shareholders. SNCFR offered spaces in the train stations for Credit Bank agencies and did all their operations through the bank, the circulated sums being enormous, with likewise gains.

The activity of Credit Bank started off in force, with a rapid growth of business volume and a rapid expansion in territory. The profits from the operations were only gathering in the accounts of the bank, a situation probably considered unsatisfactory by the bank’s management who tried - and succeeded - to pocket substantial gains. Paradoxically, the gains were larger as business became worse for the bank - massive credits given to “cardboard billionaires” who had no real collateral and no intention of returning the money.

The Accused Bench and the Armchairs of the Management

The bubble burst in January 1995 through the arrest of Marcel Ivan, the president of Credit Bank, accused of fraudulent bankruptcy, forgery and the taking of bribes. He had asked Gheorghe Vasile (“Gigi Kent”) and Gheorghe Bica for 10 percent of the loans they had gotten from the bank. Also, he had transferred a few tens of thousands of dollars from the bank’s accounts to his own account in Germany. The investigations showed that Marcel Ivan drained the bank of over 130 billion lei. His arrest led to a lack of confidence in Credit Bank, one of the largest banks of the moment. To avoid the crisis the National Bank intervened to support Credit Bank - NBR’s (National Bank of Romania) first attempt to help a commercial bank in distress. But the problems of the bank worsened. Other leaders of the bank were arrested on similar charges: the economic director of the bank, the chief of the credits

¹² “Renasterea Creditului Romanesc”, the name of the bank is in translation “The Renaissance of Romanian Credit”

department, a number of heads of local agencies from all over the country. At the same time it became apparent that the bank's financial situation was not solid, as a result of non-performing credits given preferentially. To cover the vulnerable position Credit Bank had in the banking system, the NBR decided in the summer of 1995 to give it a credit of 600 billion lei, supplemented in the autumn by another 600 billion to cover the massive withdrawals of deposits by the population.

Another battle was waged on the corridors of the bank in a bid to take control. Presidents and members in the administrative councils were investigated and then revoked, by means including the justice system. An important character in these struggles was Steriu Popescu, founding member of the bank and honorific vice-president, pushed aside however by Marcel Ivan when he was president. Steriu Popescu is himself under investigation in six penal dossiers (some of them in connection to Marcel Ivan!) for giving illegal credits worth 60 billion lei. After a short comeback as vice-president, Steriu Popescu was placed under guard, but he lived in the United States until he died in February 1998.

During this time, the holes from the Credit Bank's accounts grew continuously, and the attempts to cover them by attracting new shareholders failed. The capital of Credit Bank remained at 11 billion lei, and the bank's financial situation worsened in the unstable climate created, among others, by the justice system. This emitted contradictory decisions in which it recognized Emil Cioflan as president of the bank sometimes, and other times Marcel Ivan. The same uncertainty surrounded the administrative councils, and even the shareholders. In 1997, the National Bank decided to dismiss a number of people from the head of Credit Bank, including Marcel Ivan, Steriu Popescu, Peter Blum, Ilie Alexandru and even Emil Cioflan.

NBR Steps In

Under these circumstances, the National Bank announced in June 1996 that it was withdrawing its support to Credit Bank - basically withdrawing the credits it had given the previous years. Interminable lines formed at the agencies, the bank being unable to give the depositors more than a few hundred million every day. In April 1997 the National Bank decided to revoke the banking licenses of the two banks in major difficulty: Dacia Felix and Credit Bank.

On paper, Credit Bank was not doing too badly: it had debts of 600 billion lei, but it had credits to recover worth 1300 billion lei. The big problem, however, was that most of the money was forever "buried" in all sorts of businesses and companies run by more or less famous characters, from Gigi Kent (the "Cota 1400" Hotel) and Alexandru Raducanu (owner of the Sanca company and of the "Odobesti" Restaurant) to Ilie Alexandru (the owner of the Slobozia "Dallas" with its pocket size "Eiffel Tower"). Not to mention the debts to the bank of the companies owned by Marcel Ivan and Steriu Popescu—over 100 billion lei!

Even though it had started in June 1996, the procedure to declare the bank in a cease of payments situation had not been finalized until the summer of 1998. It was necessary for the Extraordinary General Assembly of shareholders to meet in October 1998 to accept the procedure of reorganizing the bank in compliance with the law of bankruptcy. This recognition of the de facto state of things meant that only from that time were the deponents able to recover their money, and not entirely, only to the limit of 10 million, in turn affected by inflation. What the Credit Bank crisis meant only those affected can say. And they are not few, since the deposits of the population summed up to 150 billion lei. Their numbers got

larger with victims from other, equally famous bank crashes (the last saved one being Bancorex, and the last one to get over it being Albina).

EUROPHARM DELIVERS DRUGS AND RECIPES FOR SUCCESS

by Mariana Ionescu

Published in the "Invest Romania" magazine no. 12, Spring/Summer 1999

Europharm is one of the well-established names on the pharmaceutical market, both as a medical drugs producer and a distributor. The 1998 sales amounted to USD 52.3 million on the domestic market and exceeded USD 1.2 million on the foreign markets. It is a success story, with a strong will as the main character.

Looking for a Market

The company was established after 1990 in Brasov and competed successfully with the state-owned companies that had a much longer business history. Europharm Trading SA, the first venture, was established in 1992 with a launching investment of 2 million lei, and is active in trading and producing various medical drugs. In 1993, because it wanted to extend its production and distribution, Europharm Trading SA found a partner in the US – Largo Import Export Florida Inc. – and together they established the Romanian-American joint venture Europharm-Largo SA Brasov. In 1994, Europharm Holding SA and Europharm SA were established, both with headquarters in Brasov. The former focused exclusively on distribution, while the latter was involved mostly in production. In 1995, a new association with Farmaco Kishinev from the Republic of Moldova took place, the result being the establishment of the Europharmaco Kishinev joint venture. Its purpose is to produce medical drugs and pharmaceutical goods and to distribute them in the Republic of Moldova and in the other members of the Community of Independent States.

Network and Diversify!

Production began with two antibiotics, but over time the Europharm range of products has amplified and diversified. Currently it encompasses 78 products in 9 therapeutic classes: antibiotics and anti-virus; analgesics, antipyretics and anti-inflammation drugs; medication for the respiratory apparatus; dermatological medication; medication for the digestive apparatus; medication for the cardiovascular apparatus; medication for the central nervous system; medication for the uro-genital apparatus; and multivitamins. Irrelevant in addition, it produces herbal teas, medical instruments, and cosmetic goods. The distribution network ensures the wholesale and retail sale for Europharm goods, together with other domestic and foreign similar products, through its 17 warehouses and 28 pharmacies located in the most important Romanian cities and in Kishinev, Moldova. "Europharm warehouses offer a large range of products, including the cosmetics ointments commonly associated with drugstores. At the same time, we deliver drugs for hospitals and more than 200 private pharmacies. For the future, we want to provide special-order deliveries for any kind of pharmaceutical good," says Rodica Ionita, Vice-President of Europharm Group.

Since its establishment, Europharm has had a very dynamic evolution and the workforce has increased to 1,300. The production is mainly located in Brasov, where it employs about 300 people. Currently, there are 5 production halls in Brasov: antibiotics, non-antibiotics, suppositories, cosmetics, ointments and medical herbal teas. The pill production is located in Ploiesti, especially the analgesics and antipyretics (like aspirin and paracetamol); the production of medical goods like bandages and sterilised tissues is located in Hemeiusi (Bacau County); the production of capsules, compressed tablets, syrups, powders for injection solutions and perfusion solutions is located in Kishinev (Moldova). In 1998, the amount of Europharm goods produced for the domestic market had a total value of USD 24

million, while the foreign market (including Europharmaco-Moldova) absorbed over USD 1.2 million.

Beating the Bureaucrats

Since its establishment, Europharm has faced many difficulties. Among these were the blocking of significant money amounts because the payment transfers for the free-of-charge prescriptions and the compensated ones were not made in due time by the Health Ministry.

There were also groundless delays in the release of production authorizations, sanitary endorsements or the registration certificates for the new products. Despite these obstacles, Europharm had continuous development out of its own resources and by reinvesting the profit. Because the investment loan legislation was fuzzy, the long-term credits, which bear low interest rates, were used only as working capital.

“All equipment had to be brought from abroad because Romania is not producing this kind of stuff. But then, there is no fiscal facility yet for importing new equipment, even if lower custom duties or a custom duty exemption could be very efficient incentives for the domestic medical drug production. We had to import second-hand equipment and, only when we could afford it, new equipment with GMP certification.” Most of the raw materials are from abroad too, the main source being the European Union. The amounts to finance the production for this year were projected at about USD 10 million. “More than 90 percent of the raw materials are imported because we could not find them domestically. The few domestic materials available do not offer a convenient quality/price ratio. The only materials produced in Romania which we use on a large scale are alcohol and amidin.”

SmithKline Beecham Jumps in

In 1998, the American partner sold the shares it had owned, but on September 25, the same year, Europharm and British giant SmithKline Beecham concluded a strategic partnership for Romania. “This partnership offers both financial and technical benefits. We would like to invest ourselves, but with our scarce resources it is more feasible to get sound financial support from a company with a real expertise in the field.” The new investments will be made in production: a new plant for medical drugs and a warehouse for raw materials and finished goods (final term – June 1, 1999), both of them located in Brasov. “Another new plant will be started this year. It will probably take about 2 years to make it operational because it is a large unit. The investment will exceed USD 10 million because the new plant must comply with the GMP international standards.”

The question about how a young company became successful in a crowded marketplace comes naturally. “We had to work in tough competition with the high quality imported medical drugs that have a good package and efficient marketing. I think Europharm’s success relied mainly on our will to be leaders in the field of medical drugs; the company was actually established by three pharmacists and that helped a lot. We wanted to prove that the medical drug sector belongs to us. In order to turn opportunities into a nice account, we have a good recipe – hard work, strong will and the ambition to do something,” believes Ionita.