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CAN THE VICIOUS CIRCLE BE BROKEN ?

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INTRODUCTION

A funny story that used to be very popular in Romania goes like this: “A Romanian, an American and a Serbian were taken prisoners, somewhere, no matter where, by an unknown tribe, and the price of their freedom was either paying $10,000, or being flogged with 100 whips, or the shame of swallowing a bucket of domestic slops. The American quickly won his freedom by paying the amount of money demanded, while the Serbian was released, a bit later, after stoically enduring the 100 whips. The Romanian initially choose the bucket of domestic slops, and being unable to go on, he asked to be whipped, but not bearing even this punishment, he is still paying his captors in the amount of those $10,000.”

This anecdote, smiling in the face of adversity, describes very well the case of Romanian reform. It has been tried since 1989 to avoid paying both the economic cost and the social cost of making the economy competitive through reform. The reform has not been achieved. Therefore, the economic and social costs are even now being severely paid and - what is more serious - the possibility of escaping the increasing constraints/captivity is diminishing .

1. Constraints : sizes and perspectives

The vicious circle in which the Romanian economy contends comprises at least these following aspects:

The Romanian economy must reclaim the problems in which it is mired, but it no longer possesses the money, not even for this. It lacks the funds to build or to replace what it is likely to be decaying.

Privatization is prevented from being the solution it actually represents, because of the fact that due to the negative accumulations, every unit of privatized asset is encumbered by two units of debts. And the process of depreciation is still carrying on, so that within one year there will be three units of debts to each unit of asset.

The government budget has now come to the point of spending, directly and indirectly, more on the tasks that do not usually fall within its responsibilities (such as supporting bankrupt activities, restructuring the banking system, ensuring the survival of the pension system), rather than on those it is charged with. This produces a situation in which the fulfillment of the latter becomes more threatened, and eventually impossible.

A massive and unsustainable commercial deficit of approximately 40 percent of the returns from export even in 1998 bridles, financially speaking, the Romanian economy. Moreover, there is no chance of lowering the pressure in the years to come, as the economy itself has a severe competitiveness deficit.

In their present structure, Romanian products — in terms of real, qualitative and competitive supply — can not meet the requirements of foreign markets and not even those of the domestic one. Each of the main liberalizations in foreign trade during the post-December period, such as abandoning the government monopoly on the foreign trade in 1990, concluding the agreement of associating with the European Union (EU) in 1995 and entering the Central-European free trade zone in 1997, have had important and quite obvious contributions to the commercial deficit. Evidently, not the liberalization itself is to blame, but the lack of training and adjustment, through restructuring, to the conditions of direct competition that liberalization would inevitably produce. Nothing else could have been expected from an unstructured economy that remained practically the same. The economy being structurally conditioned further on, the trend is that of an increasing commercial deficit. Given the present structure of the economy, an increase in exports is unlikely to occur, as this seems to be the most that Romanian economy can offer now. The limitation will be only a financial one, as Romania is bound to encounter increased difficulties in attracting foreign funds to finance imports, which are likely to exceed exports even if their size remains constant. Therefore, for at least a decade from now, Romania will remain under the threat of default, due to the difficulties in financing the trade deficit, especially if there will be nothing completely heroic done to restrict imports.

2. The heritage of the most Orthodox communism

How is it that we came to this situation? The reason is very simple. Nothing has been done to adjust an economy conceived, created and developed for, and in, an almost total economic and political isolation to an era of internal and external liberalization of all kinds (monetary, commercial or foreign exchange). The Romanian economy in general, and the industry in particular, are the product of the most orthodox communism of Eastern Europe, in which resources were allocated almost exclusively based on political criteria, through commands and party orders, through arbitrary and voluntary actions, totally disregarding the market. From this point of view the legacy made the path to a market economy extremely difficult, perhaps the most difficult within the area.

The systemic crisis of communism had already occurred by 1989, within the one sector communism itself considered to be fundamental: production. A small decrease in production, including industrial production, had already taken place by the end of the 80's, yet a more significant one seemed unavoidable in the following years. The pattern of Romanian industry, built on obsolete industries, could have had no other trajectory. Scarcities of all kind were already quite common, marking the surfacing of the crisis, while the government was smothering the two main valves (inflation and unemployment). And so Romania was entering the last decade of the 20th century with an enormous gap between demand and supply, also noticeable by the fact that only 14 *bani* of 1 *leu* currency had corresponding goods and services on the market. Therefore, there was a ruining inflationary potential.

If to this legacy - which is not an excuse, but a reality - we add the surrogate reform characterizing Romanian economic policy after December 1989, which basically consisted of half-measures in macro-economic reform and practically no micro-economic reform, not to mention the total lack of institutional reform, we can easy understand why Romanian economy finds itself to be caught in a vicious circle.

3. “The pathological gradualism” – an expensive improvisation

It has been a politically embarrassing and economically lamentable performance seeing an entire country worshipping a single idol - the current model of the Romanian industry. The most amazing homage paid to this idol as early as in 1990 was the exaggerated populism in favor of the industrial working class, meaning direct conversion of the former investment allocations in wage increases, which almost doubled the profound disequilibrium that the Romanian economy was facing. A year after the events of December, 1989, when finally the first and insignificant steps towards a market economy were taken, not even 9 *bani* of 1 *leu* could find corresponding goods on the market, thus making the reform more difficult. The directing of the reform towards saving the industrial model at any cost, bankrupt as it was, and also the ideological and political hesitations on the way to a market economy, transformed the Romanian transition into an extremely expensive improvisation, both economically and socially.

Many researchers and analysts have tried to define, one way or another, the post-December economic improvisation of Romania, which, obviously, can be classified neither as “shock therapy”, nor as “gradualism”. The most appropriate description seems to be that of a “pathological gradualism,” as it eloquently suggests the unhealthy meanings of half-measures, which lead but to a dead end where no perspectives can be discerned any more.

4. Half-measures in the field of macro-stabilization

Of the half-measures the reform started with and that have persisted for years, the irresolute and indefinite approaches of the main liberalizations in the economy have had the most severe consequences at economic and social levels.

Partial and gradual price liberalization, instead of a general and simultaneous one, has shown to increase the long-term costs of this action essential for shifting to a market economy, and the only solution able to induce truth and order in the economic environment. Gradual price liberalization, based on subsidizing the prices of some goods and services fundamental for household consumption, has actually triggered a reverse subsidizing of the sooner liberalized products to the detriment of those later liberalized ones. Thus, precisely those products that were not socially very important were allowed to absorb at an amazing rate the substance from the economy and from the population income, while the production base of those goods of social importance was severely and suddenly affected. The consequences of this were endured by the population, which thought itself to be protected by the governmental subsidies for the latter goods while it was in fact financing to its own prejudice the decrease in the production of those socially important goods.

Price liberalization in the absence of interest rate liberalization caused de-capitalization of the banking system, and caused the credit to stop functioning as a lever for economic restructuring. Interest ceilings in the background of the price “explosion” seemed to be a great gift offered to industry, which could keep on borrowing money, money that was already getting cheaper as inflation worsened. But failure was inevitable for the banking system, which had to pay the bill. A substantial flow of funds from the budget was required, that is still from the population, so as to re-capitalize the banking system.

Price liberalization in the absence of exchange rate liberalization was a naive approach. Stubbornly opposing the liberalization of the exchange rate — so that the bankrupt industries and activities founded on “people sweat” could not be depicted — the first post December governments introduced the so-called “multiple exchange rate”: an “official” one and a market one. But as it was to be expected, all the “industrial citadels” pretended to have forgotten that they were still surviving on “people sweat”, and tried hard to obtain the funds needed for importing at the “official” exchange rate, while they asked for their returns from exports to be accounted for at the market exchange rate. The latter was impelled by the market to a level approximately three times more advantageous for a currency owner. Obviously, someone had to pay the difference. It was not long before the consequences occurred. The currency reserves were soon used up. By the time the first post-December Romanian government was replaced, there were only several million dollars left in the entire banking system!

Only in 1994 was a relative macro-stabilization established, after introducing for the first time, at the insistence of the International Monetary Fund (IMF), real-positive interests. Unfortunately, a deplorable policy of stimulating industry prior to its restructuring was promoted shortly after, in the name of maintaining the current counterproductive industrial model. The result was harmful industrial growth, at the expense of unbalancing the internal state accounts and of a dangerous growth of deficits for the external accounts.

5. Maintaining the industrial model : lack of structural adjustments

All of the former macro-stabilization attempts failed, as the restructuring of the real economy did not support them. The Iliescu regime - which has governed the country in different forms for 7 years after December 1989 - could have changed the situation as it possessed the industrial framework, but it did not. The failure resulted from an inability to realize that Romania would never have the financial resources to restructure by itself, through re-industrialization and re-technologization, the entire industrial system and that the only solution was to focus only on a part of this system and to eliminate the others. As a result, the Iliescu regime endangered the entire industrial structure through its attempt to maintain the industrial structure while disposing only of insignificant resource flows that only seemed to complicate things by cultivating ungrounded dreams. If in 1989 Romania probably still enjoyed competitive advantages internationally in some activities and departments, it is clear that it lost even those in the meantime; without the funds required to introduce modern technology over the ten years that have passed by Romanian industries are found today to be obsolete.

It is no wonder that the last years' macro-stabilization attempts — actually aiming at adjusting the previously exaggerated resource expenditures to the existing funds — have brought about important drops in GDP, unusual during peacetime; and this was even without a restructuring of the non-performing sectors taking place, not even by ceasing activity.

There were discussions about a contradiction between macroeconomic and microeconomic policies in Romania. But such a remark seems inappropriate. As the latter is essential, the former will finally subordinate to the latter — even if initially, or for a short period of time, it might be opposing it by means and purposes. Essentially, microeconomic and macroeconomic policies have complied with each other for most of the period. The contradiction can be observed only when reform requirements are involved.

Still fundamentally unchanged, the Romanian economy is confronted now, as before 1989, with a similar lack of efficiency and competitiveness. The only change is that one of the valves that helped inefficiency and uncompetitiveness emerge — inflation — has been revealed. The other valve, unemployment, as a main expression and consequence of restructuring, has remained closed for almost the whole post-December period. Not having allowed unemployment to act as a corrective lever in the economy, all the competitiveness deficiencies have been expressed through prices, thus unable to moderate their increasing trend. In fact, given these circumstances, the Romanian economy is year by year shifting, unchanged, to a different and higher price level. Accepting unemployment as a corrective lever in the economy is thus the only method for restraining and controlling inflation.

6. Overwhelming atypical problems

Establishing a balance between inflation and unemployment is an important problem for Romania. International clichés in this field do not prove to be helpful. Therefore, in establishing a ratio between inflation and unemployment that would be both economically acceptable and socially bearable we should ponder the multiple atypical problems the economy is confronted with, none of which are mentioned in any of the international solutions.

6.1 A DEMOGRAPHY OF THE DEVELOPED COUNTRY TYPE IN AN UNDER-DEVELOPED ECONOMY

Economically speaking, Romania is generally confronted with the problems of the under-developed countries, while demographically it must face the problems of the industrial developed countries. The almost irreconcilable typology of these problems, and the opposite nature of the measures needed to fight against them, can lead to major economic or social schisms, for which there are almost no preventative strategies. Objectively, due to its being an underdeveloped economy, Romania does not have the financial resources to simultaneously ensure the stimulation of the birth rate, the economic protection of mother and child and the protection of the elderly population, which is increasing both relatively and absolutely. Demographically inevitable and economically compelling, the "aging" of the population has not resulted in dramatic problems until now, as it was reported only in developed countries that possessed the economic resources to overcome it.

Due to its objective economic deficiencies, Romania might soon become the first ever example of human surrender in front of the "aging" of population. In terms of the share of pensioners in the total population (17 percentage points higher than the average for developing countries) the Romanian pension system, with more beneficiaries than contributors, is bound to yield. It already relies exclusively on the contributions from the budget, which should not concern itself with the pensions system, as it has its own, more constrained problems. Unless a new pension system is brought into operation, one that increases the retirement age by a faster scheme, the present pensioners will have no more funds to enjoy. The electoral and political reasons for which this pension system was delayed will soon exact a heavy cost.

6.2. AGRICULTURE AND INDUSTRY IN A HISTORICAL PHASE-DIFFERENCE WITH A DE-STABILIZING EFFECT

Another atypical problem confronting Romania, (now and even decades from now) is that the economy, turned back in the 50's as far as the size and structure of the landed property are concerned, should resume the historical inevitable process of concentrating land and capital in agriculture, at the same time as it frees labor from this sector. It does this during a period not of industrial construction but of industrial restructuring, implying for some years to come lay-offs rather than absorption of labor force. Major social tensions are bound to occur, with poor opportunities for responding to them economically.

For now a series of factors prevents the initiation of this process. The more the starting is delayed, the more dramatic the consequences will be. After more than 8 years since the law on landed property was adopted, there is still no land market to foster the concentrating of land and capital in agriculture. The 1991 law on landed property brought only a re-individualization of the property on the lands that had never belonged to the state, but that were forcibly joined together by the ex-owners as part of the agricultural production cooperatives. The process of granting property titles that resulted from the respective re-individualization has not ended yet. More than one half million trials are burdening the fulfillment of the process. Last year the law for juridical circulation of the land was endorsed, allowing for a land market to develop; however, by delaying a law of retrocession to the former owners of the land that was nationalized or confiscated by the state, the effective establishment of a land price is obstructed.

Obviously, Romania can not maintain its present divided configuration of land property, as its average arable surface for each farm is only of 1.7 hectares, a situation that can no where in the world ensure the survival of the farm-owner, while an increase in competitiveness is obviously out of the question. And there is no better way to increase competitiveness than by extending the average arable area of a farm on grounds of increasing the level of output efficiency on the surface and the level of labor productivity, thus freeing the labor force.

For the moment the process is also delayed by the fact that the landowners — even if they are producers — do not pay taxes yet, and in general agricultural producers and landowners have no obligation towards society for them.

The price for not starting this process is, therefore, doubled. On the one hand a major part of Romanian agriculture and of Romanian countryside is turning back to the Middle Ages' barter economy instead of turning into a market economy. On the other hand the Romanian products, less and less competitive, are losing ground on external markets and even on some segments of the domestic market. The re-orientation of the labor force towards agriculture, and in general the shift from urban to rural — a phenomenon which is not only taking place which is indeed thought to be the solution by some Romanian economists and sociologists — is obviously only a temporary palliative. In the long term it will prove to be economic and social nonsense, worsening the relations between industry and agriculture.

Relations between industry and agriculture tend to become more and more atypical. Romanian industry was built and extended on account of agriculture. The Romanian case is one of deprivation and sustained domination of agriculture. However, industry has absorbed the objective labor releases from agriculture. But, having been developed by force, meaning political orders and voluntary actions, practically without having taken into consideration the market signs, the Romanian industry, structurally dominated by energy-intensive and by obsolete branches, is not able, in spite of its size, to rely on its own resources. And yet it is waiting for support from agriculture when the time has come for it to return the services received from the latter. Agricultural subsidies, as net transfers of resources between economic sectors, are an illusion in Romania, as there is no other sector, especially not the industry, that could release such an amount of net resources. The reality should be faced and the demagogy of Romanian parties regarding assistance for agriculture should disappear — whatever political areas they belong to. There will be no net resources to subsidize agriculture. This subsidizing is a luxury only the developed countries can afford, because their industries are capable of providing the required resources.

Romanian agriculture will not be able to develop based on the resources it creates, until the industry is reorganized such that the latter is independent and does not impede on agriculture. The rest is just words and politics.

However, industrial restructuring does not only imply construction. Perhaps even more so, it implies increasing efficiency, re-technologizing, and even removals and reclamations, stimulating lay-offs rather than absorption of the labor force. For at least a decade from now, no matter how positive the restructuring will be, industry will not be able to absorb labor force. Thus not only agriculture but also industry will release labor force, and by doing so raise major social problems.

Romania will not have the means to avoid the atypical, severe and overwhelming problems thus created. The only solution is that of restructuring the industry as soon as possible, in order to allow the agriculture to rely, at least, on its own resources.

Moreover, beyond industrial reclaiming which is necessary in either cases, the problems will be substantially different should Romania act as if a member-to-be of EU or the contrary. In Romania this problem is not well enough understood and not at all discussed. We should not act as if the problem does not exist, and we should not express adherence to EU without a serious documentation that should refer to the future of agriculture — one of the few sectors in which Romania still has opportunities to develop.

The problems will be no less difficult in any case; but if joining the EU is seriously pondered, it must be taken into account that the EU is already facing agricultural self sufficiency and is, by this time, exporting agricultural products from the temperate areas, therefore not needing another producer that would only increase its surpluses and the pressures for export. Unsparingly talking, the EU is not at all interested in Romania to capitalize its agricultural potential, as it will only complicate the situation, already difficult, that EU is confronting with in this sector.

It must be said without reservation that the potential in agriculture is practically the only one that Romania still holds. Therefore, Romania must decide whether the advantages likely to be gained in case of joining the EU, indirectly and in long term, in industry and in other economic sectors, make up for the positive loss that would, in this case, occur due to the unavoidable inhibition of capitalizing on agricultural potential. The most complex problem originates in the fact that this inhibition will be induced beginning with the preliminary phases of negotiations with the EU, while the final adherence remains a totally uncertain prospect for Romania, judging from the high standards EU has compared to those of Romania.

6.3 SOCIAL PROTECTION FOR A DIFFERENT STAGE OF DEVELOPMENT

Among Romania's atypical problems we can also include its budget constraints, caught in a vicious cycle of low income and high expectations. The Government enjoys only the resources that the gross output of an underdeveloped country can offer, yet Romanian political actors wish to practice the social protection of a developed country. The incontestable effect is that practically no resources are left for the budget to allocate for development, thereby tightening the vicious cycle. Regardless of political desires, it will be necessary to renounce some of the tenets the social protection model practiced by developed countries. Romania must modify its social protection to meet its real capabilities, by focusing exclusively on the most affected members of society.

7. Politics and reform – a severe incongruity

Unfortunately, Romania seems to be less and less prepared to confront these overwhelming problems, not only because of the delaying of reform at the microeconomic level — and to a great extent at the macroeconomic level — but also because of the political and institutional impasse.

7.1 VAGUENESS AND AMBIGUITY IN THE FIELD OF PROPERTY

For ten years Romania has not put an end to the issue of property - either in real estate, or in land, or in industry. The retrocession has not been brought under regulation for ten years; yet, even worse, there have been adopted regulations that defy or disregard private property.

An awkward contradiction is revealed by the fact that so many supposed social-democratic political forces (foremost among whom are PD and PDSR) suggest interest in accession to Euro-Atlantic structures, while their actual views oppose solving the property issue in a manner consistent with the economic area towards which they claim to direct Romania.

A case peculiar to the vagueness in the field of property — dramatic due to its consequences — is that of the privatizable state industrial property. The privatizable capital, ever since it was defined as such in the decree promulgated in 1990, remains without an owner. This decree granted autonomy to those state enterprises, renamed "commercial companies", that were thought fit to be privatized. Yet the state, as their owner, had practically no one to represent them, and thus no one held responsibility of the enterprises during the time until their eventual privatization.

Though this seemed to be a positive thing at first, in the end it became a disaster. The state's so-called withdrawal from its administrative function — its compliance with which had proved quite deplorable — was taken for an abandonment of owner's authority and unleashed a severe process of dissolution and degradation, one which always takes place wherever and whenever there lacks authority . The SOF is legally defined not as a representative of the state — as owner of the non-privatized capital — but only as a stockholder. And so, screened by this ambiguity, SOF serves as an owner whenever it suits it: only when it is privatizing something. Putting it another way, when talking about the current financial administration of its own industrial capital, SOF asserts itself to be only a stockholder and it declines any responsibilities concerning not only the economic results but also any decision that might arise from these results. SOF is a fortunate stockholder, the most fortunate in the world! It is not at least affected by the losses of the enterprises to which it is a stockholder. And no creditor — either a supplier, or a bank, or the budget itself — is legally entitled to hold SOF responsible for the fact that the respective enterprises do not comply with their financial obligations.

Should we wonder that the enterprises without an owner register losses and arrears?! If there is no one to control them, then it might seem foolish not to have losses and to pay your debts.

Unfortunately, so many specific cases, more or less made public, proved that the ruining of state enterprises favored the interests of some parties or political groups. And it is a fact that the 1999 law on "accelerating the reform" did not clarify the problem of ownerless state enterprises, even if it was said to have finally brought the modifications needed to urge reform. And, after all, this was what allowed the government to assume responsibility for it in front of Parliament. The explanation must be that even then the political forces within the coalition were not interested in solving the problem, perhaps assuming that exactly these ambiguities would benefit them the most.

7.2 THE CONTRADICTION BETWEEN REALLOCATING AND SHARING THE RESOURCES

Maybe the most important of the political problems affecting reform could be phrased this way: the contradiction between reallocating resources, inherent to reform, and sharing resources, as the political forces now practice (for their own benefit). So many events from before 1996, and even after, clearly reveal that the parties expect from the act of governing an economic consolidation of their present and future political position. Therefore, they are subject to a double tension. On one hand there is a tension induced by the Party members who seek economic, not to mention material, benefit from their membership. And on the other hand there is a tension caused by the "sponsors", who do not support the party only for the greater good or out of pure and unselfish fellow feeling. The absence, probably deliberate, of some definite legal regulations regarding financing the political parties worsens the situation.

Shifting from an economic system based on common property, which actually belonged to no one, to one based on private property ultimately requires a process of sharing national assets. The parties, regardless of their political stripe, consider their highest priority to be the distribution of agricultural and industrial assets, and control over national resources, at the lowest cost or even, if possible, by political gift. The problem is that this high priority process must take place when the reform is supposed to be the utmost priority for the economy. The reform ultimately involves changing the present structures and methods of counterproductive resource allocation, having proven themselves to be highly inefficient and can generate nothing but domestic poverty and destroy external competitiveness. From an economy like the Romanian one there is nothing else to be expected, given the fact that it allots energy, resources, and wages to products that are unprofitable or don't sell at all; and whose budget requires constantly raising the taxes for those who actually pay them, to compensate for so many who do not. There is an obvious contradiction between the re-allocation of resources aiming to increase their efficiency, which is inherent to reform, and the process of sharing the resources or of gaining control over them, as envisioned by the parties. The adverse effect is that, while the efficient re-allocation of resources is delayed, the resources shared among political forces or distributed, to their supporters are unable to acquire a social function through investment. Consequently, various forms of immediate consumption (villas, expensive cars, trips abroad, funds for the party, politically based sponsorships) compound the losses.

Moreover, in order to conceal these misallocations of resources from their social functions, a false and expensive social protection program is being put into practice. Those who are profiting from the resources can not openly ask sacrifices from the population, so they impose them indirectly. This also explains the hypocritical agglomeration of the Romanian political spectrum within the social-democratic area, frequently used as a demagogic curtain for the most contemptuous activities disguised in vested interests and wild capitalism. Under these circumstances resources diminish, and so does whatever is left to be distributed, while the process of creating new resources is visibly and severely slowed down, so that reform has fewer and fewer opportunities for breaking the vicious cycle it has entered.

7.3 THE INSTITUTIONAL DEFICIT

Another political problem, linked in many aspects to the previous one, is institutional in nature. In Romania there is an institutional deficit. Almost no initiative sees fruition, as institutions are not entitled to or capable of applying the decisions taken. In many cases actors within the institutions obstruct progress deliberately, to advance their own interests.

Public administration, starting with the Romanian Government, is poorly conceived and organized, extremely bureaucratic, and based on vested interests — and thus inefficient. Generally, the present structure is an imitation of the communist one, having nothing to do with the administrative requirements for promoting the reform. The most poignant example of this is the fact that, due to their structure, ministries within the Romanian government focus on the administration of the economic segment for which they are responsible, rather than formulating, developing and supervising policies for the private or public sectors in their field. Except for the Ministry of Finance, which by its nature must approve almost any normative act, no other government entity (ministry or agency) with a synthesizing role is taken into consideration by the other ministries. This is the case of the Council for Reform, of the Department for European Integration and of all governmental agencies that, by statute, deal with problems and not with particular sectors of the economy, having by no means neither the mandate nor the required resources for achieving their objectives. As a result, by their own structure, such institutions just waste funds and perpetuate their futile existence.

Nevertheless, the number of governmental agencies is increasing, instead of decreasing. The number of public administration employees increases as well, reaching a wearisome point. The explanation resides strictly in the phenomenon of vested interests, which has been extending since a coalition of parties gained power. The algorithm, meaning the sharing of public administration positions between members of the coalition parties, caused an outgrowth of this sector in order to meet the different and contradictory pressures of the political forces which have supported the government in the Parliament. New governmental agencies are being established, so as to find a job for a member of one of the political forces or, even worse, so as to counter-balance or even to endanger (by diluting the decision-making process) another structure which, according to the algorithm, belongs to some other political force from the coalition.

Without absolutely no effort, but obviously with a healthy effect on the budget, the number of governmental agencies could be reduced to less than one third and that of public administration employees by more than half. No economic reform will be achieved if it is not accompanied, or actually preceded, by an institutional reform, starting with the Romanian Government itself.

8. The controversial problem of sectoral industrial policies

In Romania a contradiction exists between the scarcity of resources, severely exacerbated by the unusual drop in GDP, and the waste of resources, given the absence of the signals that would direct them towards those sectors and activities with real opportunities on the market.

Setting priorities is not, generally, easy; but for Romania it seems to be something very complicated. After almost ten years of groping and attempting to recover all of its industry, now it is hard to say for sure in what sectors and activities Romania stills hold any competitive advantage, and thus to which of them it is more worthy to direct resources. Moreover, Romania's must not overlook the risk that forming sectoral priorities for resource allocation may result in wasting resources through vested, legal, interests. Thus, it is possible for the distribution of resources to be done not in accordance with potential offered by each sector or activity, but rather with the political interests of each party.

But market-based allocation of resources is something we read about in books and never encounter in real life. Regardless, under these circumstances an efficient re-allocation of resources might occur after a long time; but, until then, the legacy of disastrous resource allocation practices continues, the produce of habit and vested interests.

The international financial institutions oppose the idea of industrial policies based on sectoral priorities. They recommend the neutrality of public finances. Yet it seems that the World

Bank — being in the position to grant money for development and therefore having to face problems of sectoral choices — has already become more flexible than the IMF, who finds market-driven resource allocation to be in the best interests of macro-stabilization. Anyhow, both the IMF and the World Bank overlook two issues.

The first is that all developed countries owe their success in part to sectoral industrial policies, at least when referring to the incipient phase of construction, during which resources were pumped into the sectors considered to have opportunities, by the means of fiscal, custom and credit facilities. The international financial institutions argue that this situation, if indeed it was the case, occurred in the 1950's based on other development concepts. Today we find ourselves in the 21st century, in an era of globalization and liberalization, when economic success is conditioned on compliance with the market. The most telling evidence is that the developed countries themselves gave up the industrial sectoral policies for public-finance neutrality. But this argument, put forth by international bodies, ignores the fact that countries such as Romania still find themselves somewhere in the 1950's. And its only hope for relief comes from directing resources towards specific sectors, as the transposition of the policies and of the options of a mature market economy country into one emerging market economy is unlikely to succeed.

The second issue that the international financial institutions fail to consider is that allowing the market alone to decide on the sectors and activities is the best option of industrial policy only if we refer to building something from scratch. But it is uncertain whether the option is even operative, not to mention efficient, if the industries already exist. When dealing with inherited industries, resource allocation involves major political decisions which do account for the market, but which are essentially administrative in nature.

From this point of view the situation of Romania is relevant. In the context of sectoral neutrality for public finance, prescribed to Romania by the international financial institutions, the market failed to produce any competitive activity, domestically or internationally. On the contrary, the Romanian economy seems to get more inefficient and resigned to free fall. The invisible hand of the market neither stopped the inertial and inefficient allocations nor prevented the expensive ones driven by vested interests. The situation is worse than in the case of re-allocations based on sectoral priorities, even considering the experiences of the latter. And it seems that for an eventual takeoff to be possible Romania has no alternative to a strategy based on sectoral priorities, which would at least discourage the present waste of resources due to allocation to everything, and therefore to nothing!

Adding complications to the debate, the positions of the IMF and World Bank are diverging, though they are reciprocally conditioned. And neither complement those of the EU, which promote a regulated market economy with indirect sectoral requirements as priorities for the accession.

Coordination between the IMF, the World Bank and the EU is imperative. And so, as with the child that can not be delivered with too many midwives, the confusion of signals sent to

Romania, combined with the absence of an allocation based on sectoral priorities, causes the worst: a continuous and disastrous improvisation.

9. An atypical approach : inflation with zero budget deficit

Macroeconomic policy must adjust to accommodate these overwhelming atypical problems. Fighting inflation using the classical tactics might at some point prove to be ineffective, and perhaps even counterproductive in the long term. Romania will not have the resources — neither with external support not by its own devices — to face, without major imbalances, its problems. The economic tensions must somehow be released, and inflation probably represents the lowest cost method. The alternative is increased unemployment (almost 30 percent of the labor force) and/or a sudden social protection cutoff (decrease by half) — a situation that seems to be socially unbearable and economically impossible. The decrease in real terms of the standard of living — necessary to confront the respective problems — must be left to inflation.

But higher inflation must be combined, in an atypical way, with a zero-budget deficit, despite the heroic efforts this requires. The state must temporarily abandon its position as lender, leaving the existing savings at the disposal of the real economy. This may permit the real economy to move at least incrementally forward, creating a more generous tax base for a budget that might gradually recover instead of getting poorer and poorer as before.

Otherwise it is absolutely obvious that the economy will keep regressing because of the high interest rates induced by the budget deficit combined with the dramatically small amount of savings (less than 10 percent of GDP, compared to 20-30 percent of GDP for a standard country). The small amount of money available on the market is fiercely sought after, and therefore it can be obtained only at extremely high interest. The worst instigator is the budget which, being under continued pressure, accepts to borrow at any cost.

From this point of view the situation of the latest years is fully representative. There is no use in fighting against inflation by reducing the budget deficit, if the remaining deficit (even if it is smaller) impels interest rates to outrageous levels with savings being more restricted on account of the decrease in GDP. Therefore, by now Romania has interest rates double the rate of inflation. That the rate of interest be marginally above the rate of inflation is a fundamental requirement. But if the margin itself is greater than the rate of inflation, the real economy is without doubt buried.

The inflation induced by a deliberate policy of increasing the money supply must be allowed to absorb the tensions within the system, including here those within the budget, while a temporarily moratorium on state debt might allow the economy to start developing by decreasing the real interest rates. Otherwise the present situation will go on, making things even more difficult: we will confront both inflation and a major recession of the economy. And only a higher inflation will be able to get the economy out of this vicious cycle.

10. Foreign direct investment : a factor of change only at a critical mass

Of course the situation may change — not in essence but in size — with a substantial flow of foreign direct investment. Only direct investment offers benefit to Romania, for unlike portfolio investment it involves proper involvement in business, and transfer of technology and management techniques, both in the form of acquisition or entrepreneurship (greenfields). Portfolio investments serve little benefit to countries like Romania, which lack mechanisms for managing external financing, especially for the highly liquid funds engaged in speculative profits. In a initial phase portfolio funds can even complicate the situation, by intensifying the vulnerability of an emerging market economy, overwhelmed by atypical structural problems.

In order to induce structural changes in Romania, foreign direct investments need to exceed a critical mass of, probably, 9-10 billion dollars, that is at least 5 billion dollars higher than their present level. This must by necessity include certain major investors. At such critical mass foreign direct investments would become a kind of a locomotive that would push or drag, willingly or not, the rest of the economy into changing, with or without the cooperation of politicians and institutions.

Judging from the structural problems in Romania, the foreign direct investment at levels above the critical mass would give resolve several issues: identifying the sectoral competitive options; overcoming the institutional ineffectiveness; stopping the waste of resources within unprofitable sectors; overcoming the indirect obstacles posed by vested interests; and finally, promoting the construction component within reform.

For the time being, foreign direct investments in Romania face the risk of being impeded, unless they see Romania as a cheap base of production for other markets, thus relying on the Romanian market alone. And this because they must cope with the tyranny of small figures that dominates Romanian economy. They must take into account the average Romanian wage of less than $90, and the diminished purchasing power. Also, at a significant size of foreign direct investment the repatriation of profits might face the restraints of the foreign exchange market, caused by the fact that returns from exports are limited at only 8 billion dollars, and despite of the fact that in the end the exports must finance both imports and external debt service.

Increasing foreign direct investment focused on exports would gradually but quickly relax these constraints. By increasing the returns from exports, Romania would manage to extend its paying capacity for imports, for external debt service and for repatriation of profits from investments, at the same time as it enlarges its domestic market.

But of course all of these are only hypotheses, as Romania will not attract foreign direct investment unless the Balkans find stabilization — which may never happen. Until the Romanian business environment becomes more friendly, less corrupted and less bureaucratic; until the problem of real estate, land, and industrial property is clarified; until the legislative framework is stable and stimulant; until the unions accept the inevitability of restructuring, even the personnel restructuring meant to increase efficiency; until taxation is enforced consistently, a prerequisite of an attractive business environment; until these criteria are met it is possible that Romania may never find stability.

Without a critical mass of foreign investment, Romania can not overcome the present state of economic decay. It is possible that while facing dramatic restraints Romania will be forced to react, as never before, and to escape this economic decay without the support of foreign investment. But this situation will not occur today, nor tomorrow, not even during this generation; maybe sometime in the future!