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Market Economy and Economic Reform in Romania: Macroeconomic and Microeconomic Perspectives

YVES G. VAN FRAUSUM, ULRICH GEHMANN & JÜRGEN GROSS

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ALTHOUGH ROMANIA ABANDONED THE PLANNED ECONOMY MODEL IN 1989, the country and its government continue nevertheless to suffer criticism and bad press reports, mainly for an alleged lack of progress in democratic reform and the slow pace of transition towards a market economy. This article elaborates on economic reform, summarising strong and weak points, achievements and areas of continued concern, looking at both the macroeconomic and microeconomic perspectives, and illustrating how the quality of management is what ultimately determines the progress of reform and restructuring. The first part of the article takes the macroeconomic perspective, summarising recent economic trends and the strengths and weaknesses of the Reform Programme; the second part takes the microeconomic perspective, summarising enterprise performance, diagnosing corporate management style, showing how short-comings on the macro level are reinforcing the shortcomings on the enterprise level, and how enterprises choose the major break-out routes. The microeconomic perspective, far from complete, is developed from an enterprise survey and experience gained in the field.

The macroeconomic perspective

Recent economic trends

In the planned economy of socialist Romania the share of gross fixed capital formation (GFCF) in national income (NI) was high and remarkably stable, averaging 30.4% in the 1980s. However, since annual GDP growth in the 1980s averaged only 1.52%, this yielded an investment productivity of about 0.05, a dismal performance, confirming the growth-reducing effect of the large distortions endemic in socialist economies.

The industrialisation drive in the 1970s had been partly financed with foreign capital inflows, resulting in cumulative current account deficits (from 1971 to 1981 inclusive) amounting to US$ 7186 million. Concerned by the prospect of increasing foreign debt and falling creditworthiness, the socialist regime decided to pay back the country's foreign debt. Debt repayment could only be accomplished by reducing domestic absorption in relation to income and diverting a larger proportion of income

to exports, which in a market economy is likely to require a real exchange rate depreciation.

However, Romania being a command economy, the planning authorities were able to engineer (a) a drop in private consumption (as a share of national income) by at least 2%, (b) a drop in gross fixed capital formation (as a share of national income) by 4%, (c) a government budgetary surplus. Although exports fell in 1981–82 and stagnated thereafter, imports fell by even more, resulting, from 1982 on, in a current account surplus which went towards repaying foreign debt, a goal achieved in 1989 (World Bank, December 1991; IMF, 1992).

Debt repayment has come at a tremendous but statistically not well documented cost to the population. Analysis of official data on income and wages shows that:

(a) GDP per capita virtually stagnated after 1984;
(b) more significantly, the real wage rate stopped progressing in the 1980s;

Other series suggest that the living standards of the population fell considerably:

(c) whereas the budget share of food in household consumption had fallen from 53% to less than 46% between 1960 and 1980, this trend was reversed in the 1980s; by 1989 food expenditure made up 51% of household consumption;
(d) daily per capita calorie intake fell from 3259 in 1980 to 2930 in 1988 (National Commission for Statistics, 1991);
(e) in spite of stagnating real incomes, savings deposits in real terms increased at an average rate of 5.3% per annum during the 1980s (illustrating the extent of forced saving).

In the aftermath of the December 1989 'revolution', Romania abandoned the command economy model. Although the second half of the 1980s were harsh, the years of reform or transition to a market economy model have been no less difficult for large segments of the population. Real income fell in all years since 1989 (except 1993), with recorded negative GDP growth rates of − 13% in 1991 and an estimated − 15% in 1992. By mid-1993 unemployment had soared from virtually zero in 1989 to over one million, a figure which would have been significantly higher were it not for the 400 000 Romanians who had emigrated during that period.

Whereas in 1989 the government budgetary surplus still amounted to 8.2% of GDP, in 1991 and 1992 the government experienced relatively modest deficits (− 2.6% and − 1.9% of GDP respectively). Meanwhile the current account turned into the red. Equally dramatic was price inflation and currency devaluation. End-of-period consumer price inflation exceeded 200% in 1991 and 1992. Finally, whereas the (official) exchange rate at the end of 1989 stood at 14.5 Lei = $1, by February 1994 one dollar bought 1480 Lei.

The Reform Programme: design

The government's Reform Programme is being implemented against a background of economic decline; whereas in 1989 GDP per capita was estimated at $1563, in 1992, through the combined effect of a 46.6% drop in real output and a real exchange rate (RER) devaluation, GDP per capita stood at $680 (though one could claim that the

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Lei is undervalued by the purchasing power parity criterion). In other words, Romania had almost overnight dropped into the lower league of middle-income countries. This is a real paradox considering that Romania possesses natural resources, human resources (e.g. engineers) and physical infrastructure. The paradox underlines again the endemic productivity problem so often ignored by corporate managers and policy makers.

The Reform Programme consists of macroeconomic stabilisation, price and market reform, institutional reform, social dimensions and environmental dimensions (Van Frausum, 1993). These components are linked; indeed, unless the economy is stabilised there will be insufficient domestic resources freed to respond to the price signals; unless there is price and market reform (i.e. the removal of distortions), any resources that exist will not be channeled efficiently; unless there is institutional reform, supply response to changed relative prices will be blocked or delayed. Unless there is a social dimension to the Reform Programme, the vulnerable groups of the population may not accept the stabilisation component of the programme and the reform risks collapse.

A priori the Reform Programme may seem well designed. In the area of macroeconomic stabilisation the government is sticking to a fiscal target (i.e. a budgetary deficit of 2% of GDP in 1992), a policy of high interest rates has been adopted as an indirect method of monetary control, and partial wage indexation (compensating for inflation by 50% to 65%) was introduced as a heterodox inflation control measure.

In the area of price and market reform, the operation of the foreign exchange market was modified (limited convertibility of the Lei, liberalisation for current account transactions, establishment of a daily exchange rate with participation of the National Bank, establishment of exchange offices) and external trade largely liberalised, with a new customs tariff introduced in January 1992, based on the harmonised system. Price controls have gradually been eliminated, as have consumer price subsidies (in November 1990, May 1992, September 1992 and in May 1993, when the subsidies for bread, milk, butter, sugar and cooking oil were phased out). The interest rate structure was simplified and credit allocation by administrative fiat was abolished. Law 54/1990 forms the basis for fiscal reform: a value added tax was introduced on 1 July 1993.

In the area of institutional reform and sectoral policies, apparently impressive achievements have been made: laws on economic activity, foreign investment/joint ventures, the Trade Register, unfair competition, patents, consumer protection and trade union activity have been enacted. These laws establish the new 'rules of the game'. State enterprises have been corporatised. Privatisation legislation regulates the sale of assets, mass privatisation and case-by-case privatisation; until they are privatised, six holding companies (State Ownership Fund and five Private Ownership Funds, in short SOF and POFs) are the *de iure* owners of over 6000 commercial companies. Under a PHARE-funded programme ownership certificates worth 30% of the social capital of the SOEs were distributed to the public; these certificates represent in effect shares in the five POFs. Agricultural co-operatives were liquidated and land was distributed to the peasants up to a limit of 10 ha for each entitled family (data supplied by the Ministry of Agriculture show that 4.11 million people received land). Dwellings built and owned by the state were sold.

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Restructuring of SOEs has, unfortunately, not gone further than the occasional netting-out of inter-company arrears. A few business advisory services have been opened to promote small and medium enterprises (SMEs) and some work—donor-funded—is being done in the area of export financing, term financing and SME credit guarantee schemes.

Law 33/1991 and Law 34/1991 regulate the activity of commercial banks and the National Bank (NBR) respectively. According to Law 34/1991 the NBR establishes and controls monetary and credit policy, issues rules of prudential banking policy and sets exposure limits.

In civil service reform, the number of ministries was dramatically reduced, as were staff levels; some progress was made towards decentralisation.

The Social Dimensions of Adjustment (SDA) component of the programme set up a social safety network for vulnerable social classes, mainly the unemployed. A system of unemployment allowances, not very generous—and therefore also not distortive—is financed by a 4% tax on the wages fund and 1% tax on workers' salaries.

The Reform Programme: the downside

The Reform Programme still has serious flaws, both in design and in its implementation. Not unlike in African developing countries, supply response to the programme has been disappointing; in reality, where programmes are generally blamed for people's misfortunes, the slow supply response can rather be attributed to delays in implementation, lack of commitment, lack of complementary inputs (e.g. foreign exchange) and shortage of entrepreneurial talent which is technically, managerially and financially prepared to enter into production of tradeables. Lack of commitment is explained by the fact that the policy makers committing the nation to reform are among the most hesitant, the least dynamic or most conservative forces of society, the ones under pressure from friends, peers and family, the ones least suitable to manage in a crisis situation.

Moreover, people are moved around in institutions, and those committing the institution or nation to reform are succeeded by others who have a less than comprehensive vision of reform and who, unless pressed, tend to 'forget' previous commitments. The attitude of many so-called decision makers constitutes a bottleneck, being characterised by buck-passing and risk aversion: unless they are put under pressure—a strategy which the IMF seemed to have adopted to get a stand-by agreement signed by the government in December 1993—any decision of theirs is most likely to be negative or to take no action.

The Romanian economy is said to be in transition from a planned to a market economy. Some label the transition economy a hybrid; in reality it shows striking resemblances, both in its basic features and symptoms, to the market socialism model (World Bank, 1987).

(a) Several (four) types of ownership co-exist: state, co-operative, mixed and private. There are a large number of privately owned, essentially non-manufacturing enterprises (at the end of 1992 around 200 000 were registered on the basis of Law 54/1990); they account for half of all retail trade. Over 7000 SOEs, either commercial

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companies or *Régies Autonomes*, operate in mining, manufacturing, construction, utilities, distribution and other services. Some 98% of industrial output still comes from SOEs. In early August 1992 registered foreign capital amounted to $704.3 million in 26 849 companies—of which close to 200 joint ventures are mixed private–public enterprises—i.e. an average investment of $26 232 per joint venture. Four out of 125 investor countries (Turkey, Syria, Lebanon and Jordan) account for 8358 joint ventures but just 7% of the amount invested.

(b) Privatisation advances at a slow pace, which is intrinsic to the design of the privatisation model (case-by-case privatisation favoured over mass privatisation), because of political and bureaucratic resistance, the small amount of capital possessed by the population (at the end of 1991 savings deposits amounted to 184.23 billion Lei whereas the total share capital of 6280 commercial companies was estimated at about 1500 billion Lei in mid-1991) and limited interest from abroad.

(c) Although the general manager of a SOE is appointed by the board of administration made up of shareholder (i.e. state) representatives (mostly officials from branch ministries, now confirmed or selected by the SOF), commercial companies enjoy a lot of autonomy, not least since the shareholder representatives have insufficient clout and management experience. There is virtual divorce of ownership of capital from decision making about its use: nobody takes responsibility for the care of public capital; on the contrary, anecdotal evidence suggests that managers often let the situation worsen in order to achieve short-term gains (selling cheap, below true cost, to related trading companies which in turn sell at the higher market price). This practice lowers the economic value of the company, which would reduce the cost of a MEBO-operation—MEBOs have become the preferred privatisation technique in 1993—were it not that the SOF insists on selling companies at the unrealistically high 'book value'. In defence of the general manager, it must be said that he lives under severe pressure from the workforce and subordinate managers.

(d) SOEs are largely self-managed; they are not responsive to calls from the shareholder to develop strategic planning, they resist turnaround management techniques and resist redundancies for economic reasons (the manager prefers to reduce the workforce by gradual attrition or for reasons of indiscipline). Workers and managers lack motivation to improve performance; on the contrary, overmanning seems to affect product quality. Management gets around high interest rates and monetary restrictions by extending inter-company arrears. In this way they avoid the hard budget constraint and delay the necessary sectoral and corporate restructuring. In spite of the collapse in industrial output—a cumulative 54% fall in the three years 1990–92—few enterprises have actually closed down (one implication being that prospective investors complain about lack of factory and office space). Any restructuring that has taken place has happened by default (scrapping entirely useless production lines or as a result of the decline in external and internal demand), not as part of some strategy.

(e) In spite of an unemployment rate of 9% (mid-1993), certain segments of the labour force (e.g. coal mining) seek to obtain wages in excess of the market clearing price for labour. The government has countered this trend by imposing high marginal taxes (if negotiated wages exceed reference wages) and negotiating (partial) wage indexation with the trade unions.

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(f) The share of state investment has been drastically reduced and central allocation of resources has been abolished. Capital mobility, however, has not been achieved; investment choices in commercial companies are made in isolation.

(g) Although Romania has adopted a two-tier banking system, the few commercial banks operating behave like oligopolists. Small investors seeking term finance for viable investment projects are turned down while banks channel the scarce resources to their biggest borrowers on an *ad hoc* basis. There is as yet no basis for allocating credit according to market criteria (credit risk evaluation).

(h) A draft bankruptcy law has not yet got through Parliament, whereas the old law is inappropriate (it applies only to merchants) and not operational. *De facto* collusive behaviour exists among firms and banks: neither banks nor creditor firms initiate bankruptcy procedures.

(i) Production indicators have been abolished, enterprises enter into contracts with each other and subsidies were gradually cut (except in the mining industry and those enterprises which have privileged access to foreign exchange through the NBR auctions). Enterprises apply cost plus profit margin pricing rules even though their cost-accounting system is seriously flawed and does not allow them—at least not in market-driven sectors—to identify which products are really profitable and on which losses are incurred.

(j) In theory, exchange rates are set through daily auctions at the National Bank; also, starting in August 1991, exchange offices are authorised to sell and buy foreign currency within a 2% deviation from the auction rate (in reality, this rule is flouted; the exchange offices offer premia and charge commissions in their transactions, in order to withstand competition from the black market). In practice, the exchange rate was fixed (until early 1994) by the top echelons of the establishment (Serbanescu, 1993), eager to delay the painful alignment with the black market rate. However, by segmenting the foreign currency market and controlling access to it, the culprits are fueling the very devaluation of the Lei they wish to halt.

The above-mentioned weaknesses of the Reform Programme are related to the ownership issue, enterprise management, credit allocation, banking reform, bankruptcy legislation, wage rate determination, pricing and exchange rate setting. The programme is also flawed for the following reasons:

- foremost, inflation was not brought under control;
- newcomers to domestic trade and foreign investors are still facing numerous hurdles;
- the real interest rate remains negative;
- the corporate income tax rate (45% for profits exceeding 1 million Lei) is too high;
- cost recovery has yet to be implemented, for instance in the health sector;
- although a vast legislative framework has been adopted, the record on enforcement of laws and financial contracts is less impressive; this is because the legal professions are underdeveloped and because civil servants—out of ignorance or passive resistance—interpret the regulations in ways not intended by the legislator; furthermore, civil servants tend to reason that anything which is not explicitly authorised (by law) is therefore necessarily forbidden;
- in an effort to promote private agriculture, land of agricultural co-operatives—

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though not that of state farms—was returned to the former owners or distributed to peasants; in doing so, land is distributed in very small, uneconomic plots. This distribution process also entails high administration costs. Furthermore, the dismantling of co-operatives has left a certain vacuum; the appropriate agricultural extension services and smallholder credit institutions are not being developed as fast as privatisation proceeds.

- reform of the state-owned banking sector is extremely slow in many areas, such as the diversification of financial assets, supply of term lending, modernisation of the payment system—inter-bank, inter-district cheque clearing takes two weeks—computerisation, staff training;
- there remains a lot of room for improvement in (a) government decision making in such areas as project/investment planning, budgeting and monitoring, decentralisation and delegation, as well as in (b) civil service reform with the objective of motivating staff, giving civil servants a mission and making them perform better;
- the social safety network has not prevented large segments of the population (e.g. pensioners, single wage earner households, single parent households) from falling below the poverty threshold; nor has the quality of health services improved.

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Macroeconomic stabilisation: delayed

Ideally, all components of reform are implemented simultaneously, like a 'big bang'. The deflationary impact of stabilisation is thus partly offset by growth-inducing measures. However, because of limits in administrative capacity, simultaneity is not feasible. This gave rise to the debate about the sequencing of reform. Following the structural adjustment experience in Africa and Latin America, virtual consensus existed that stabilisation is the first priority, followed by liberalisation of the real sectors, followed by liberalisation of domestic financial sectors and, finally, opening of the capital account.

Consensus about the sequencing of reform started to break down in the light of Central and East European experience; Romania is no exception. The legacy of the planned economy and the flaws of the (quasi)-market socialism model are at the root of the persistent macroeconomic imbalances (World Bank, 1991). The government faces a conundrum:

(a) the distortions which the current regime inherited from the socialist past were responsible for the slow-down in economic growth observed during the 1980s; the systemic distortions explained the inefficient allocation of resources between factors and between sectors, and had caused a secular decline in investment productivity;

(b) the flaws of the (quasi)-market socialism model are largely responsible for the macroeconomic imbalances (foremost inflation), imbalances which are costly in terms of economic growth foregone; this cost can be anywhere between 1.5% and 5% in terms of GDP growth (Van Frausum, 1991), depending on the size of the imbalances and distortions;

(c) because of (b) the government is urged by multilateral institutions to design a

> macroeconomic stabilisation package; yet stabilisation policy packages cause more pain in the short term, and, unless the large market and policy-induced distortions are tackled, the short term will not really be so short (two or three years, or longer if the ownership and enterprise management issues are not addressed in depth). The IMF memorandum signed in December 1993 (approved by Parliament in early 1994) does, for once, tackle the causes of macro imbalances and sets the stage for restructuring 'by market forces', rather than by the hitherto unsuccessful government-led sectoral strategies.

The Romanian government has managed to limit the budgetary deficit to −2.6% of GDP in 1991 and −1.9% in 1992. This result came about thanks to a downward adjustment in expenditure, from 42.7% of GDP in 1989 to 35% in 1991, and in spite of a sharp reduction in revenue, from 51.1% of GDP in 1989 to 32.4% in 1991. The current account has registered substantial deficits since 1990 (−$1.7 billion in 1990, −$1.4 billion in 1991 and −$1.5 billion in 1992), essentially financed by ODA. More dramatically, the government lost control over inflation; annual inflation (July 1992 to July 1993) was recorded at 261.7% and average monthly inflation in the first seven months of 1993 hit 12.3%.

In spite of a declared restrictive monetary policy applied by the central bank, the inflation spiral has been fueled by the monetary overhang and excessive wage claims (immediately after the 1989 Revolution), by gradual cuts in price subsidies, by the introduction of a value added tax in 1993, and by waves of currency devaluation (resulting from the segmentation of the foreign currency market). The inflation spiral is further kept going by such mechanisms as wage indexation and oligopolistic price setting by domestic producers.

Concentration of production in large SOEs and an accommodating soft budget constraint explain oligopolistic price setting; although monetary policy is restrictive the mechanism of inter-company arrears and overdraft facilities keeps the most inefficient enterprises alive. The soft budget constraint—and financial indiscipline—are intimately related with the ownership issue. The state, though the shareholder, is not exercising its ownership rights beyond claiming dividends; consequently, enterprise management enjoys large autonomy but shows little responsibility. Neither the shareholder nor the banks have effective watchdogs monitoring enterprise managers who have had little exposure to Western management techniques.

The soft budget constraint means that large loss-making enterprises (defined as enterprises making losses on a cash basis) have no incentive for restructuring; and, since price signals are blurred by high inflation, the allocation of resources between factors and between sectors remains inefficient. Considering furthermore the negative effect of inflation on domestic saving—and thus investment—the combined result is lower income growth.

Government decision making

Several authors have emphasised and quantified the importance of political culture as a determinant of economic development (Singh, 1985; Londregan & Poole, 1989;

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Kormendi & McGuire, 1985). Ever since the December Revolution, presidential majorities have been composed of:

(a) middle-aged modernisers who, although vocal pro-reformers, are unable to present a past record of liberalism and opposition to the former regime; some exhibit the arrogance characterising intellectuals and show a tendency to get entangled in strategic thinking and battles over the new legal framework, without bothering much about implementation (i.e. paralysis by analysis);
(b) turncoats, soft on reform, emphasising in their speech and political agenda the need to limit the social costs of adjustment, using a vocabulary occasionally stuffed with nationalism.

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The opposition, largely made up of (often unenlightened) pro-reformers, has so far been ineffective in presenting to the population a viable, alternative agenda and team of doers, while enjoying few degrees of freedom (or financial resources) to improve the quality of life in the urban areas which it has controlled since the local elections.

The speed of economic reform and the commitment to lift the blockages have followed the pendulum of political power between the pro-reformers and populists making up the presidential majority. As a result, the government is sending out mixed signals which confuse investors and the donor community. On the positive side we record the strongly reformist government strategy paper which the presidential majority in Parliament—united in their desire to hold on to power even though dominated by the populist centre-left—adopted in March 1993 and which the reformist opposition, paradoxically, felt compelled to vote against. Also encouraging was the outcome of the negotiations (July 1993) between the (hard coal) miners claiming unrealistically high wages and the government more concerned with the inflationary impact of such wage claims. However, the government's victory appeared incomplete since the miners could not be convinced to swap lower wages in return for credits to finance modernisation investment, without which the entire sector faces collapse in the future.

The reformists inside the government lack effective power, and the result is a slow pace in implementation of reform. There is passive resistance by populists and a largely conservative bureaucracy (exhibiting an anti-business bias), a lack of political will to recognise and admit policy mistakes and take corrective steps, a belief that creating/multiplying new institutions will automatically resolve decision-making bottlenecks (in reality the bottlenecks are simply transferred), softness in fighting emerging corruption, and the occasional nationalist reflexes, illustrated by the vote in Parliament in June 1993 banning land sales to foreigners (though the government later clarified that this vote was void since it was in contradiction with an earlier promulgated law).

The microeconomic perspective

Recent trends in corporate performance

Beyond anecdotal evidence, insider information and data collected in the course of sectoral restructuring studies, little is known about management style in Romanian

TABLE 1

FINANCIAL PERFORMANCE

	Sub-sample light industry	*Sub-sample medium-heavy industry*
Liquidity ratios		
1. Current ratio	4.37	4.89
2. Acid test	1.81	2.11
Leverage ratios		
3. Debt/net worth	0.18	0.49
4. Receivables/net worth	0.16	0.19
Activity ratios		
5. Sales/total assets	0.89	0.77
6. Sales/inventories	6.42	2.31
7. Sales/receivables	6–8	4
8. Working capital/sales (in days)	144	255
Profitability ratios		
9. Profits/sales	0.13	0.049
10. Profits/total assets	0.076	0.027
11. Profits/net worth	0.090	0.039

Notes: Profits stand here for profits before income tax (45% in Romania);
Current ratio = Current assets/current liabilities.
Acid test = (liquid assets + receivables)/current liabilities.

SOEs during the transition period, or about the determinants of corporate survival and recovery. This lack of knowledge complicates efforts to (a) understand the micro- and macroeconomic factors that have contributed to economic decline, (b) design industrial policy and enterprise-level assistance programmes. To overcome the information gap, an enterprise survey (sample size = 100) was organised. The questionnaire, distributed in April–May 1993, consisted of two parts, a section on financial and operational data and a section of 47 questions on enterprise strategy.

Enterprises surveyed belong to the textile, shoes, furniture, pulp and paper, glass, fabricated metals, electrical consumer goods and engineering branches and exclude heavy industries such as metallurgy and chemicals/petrochemicals. The sample is therefore biased towards the light and medium-heavy industries where Romania enjoys a revealed comparative advantage.

Financial performance. The financial data provided by the companies allow their financial health to be assessed (see Table 1).

Liquidity ratios in Table 1 tell us that enterprises are marked by excessive (overall) liquidity. *A priori*, such excess liquidity (over 4.00) is inconsistent with shareholder wealth maximisation because current assets yield a relatively low average rate of return compared with the cost of financing them (although one can argue that negative real (deposit) interest rates constitute an incentive to keep excessive stocks of raw materials). On the other hand, Romanian SOEs are desperately short of cash, which

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is the ultimate liquid asset. The absolute liquidity ratio (liquid assets/current liabilities) is generally below 10%, which is well below the norm and below the figures observed in 1991(in that year absolute liquidity ranged from 11% in the construction materials sector to 33% in the electrotechnical & electrical sector).

Working capital needs are excessive (144 days and 255 days in the two sub-samples), well above a normal figure of 100 days (observed in France). Similarly, the sales/inventory ratio is particularly low in medium-heavy industry; a figure of 8.00 would have been more commendable. Analysis therefore hints that enterprises experience low to negative cash flows resulting from increased inventories and/or increased inter-company arrears, combined with low (but non-negative) returns on net worth, typically less than half the normal figure for similarly low-geared companies.

Low return on net worth, in particular in the heavier industries, results in part from liquidity being locked up in receivables and inventories and points also to low productivity of assets. The sales/total assets ratio in our sample is well below unity, indicating a low degree of asset utilisation.

Contrary to the usual scenarios in market economies, reduction of cash in Romanian SOEs did *not* happen because of uncontrolled growth, nor because of excessive investment (which dropped significantly since the Revolution), nor because of accumulation of financial losses. Also, contrary to common belief, Romanian SOEs are *not* primarily burdened by a serious debt problem, in terms of absolute magnitude (though, from the banks' point of view, many loans are non-performing). Indeed, the debt/net worth ratio is usually healthy, although consultants are not infrequently arguing that the true economic value of enterprise assets would average only 15% to 30% of the book value (in which case the financial leverage indicators would look far less healthy). Not even in the metallurgy, chemicals/petrochemicals and machine-building sectors does short-term and long-term debt amount to more than 17.4% (metallurgy), 20.4% (chemicals/petrochemicals) and 28.6% (machine building) of total liabilities (in 1991). This conclusion is confirmed by the quite acceptable interest paid/gross profits ratios observed, respectively 28.6%, 23.1% and 39.8% in metallurgy, chemicals/petrochemicals and machine building, compared with 28–34% for French enterprises not in a critical situation.

Corporate management style. Answers on a series of qualitative questions allowed us to describe corporate management style.

1. Homogeneity. A degree of homogeneity in the survey results could immediately be observed across all sectors. Enterprises surveyed:

- recorded a low investment rate; on average, cumulative investment over the past three years amounted to 15.5% of sales in the light industries and 11% in the medium-heavy industries; two-thirds of enterprises complain that financial depreciation is insufficient to cover physical depreciation (in our view this may be partly due to inappropriate inflation accounting);
- invested insufficiently in R&D (when measured as a percentage of sales, they spend on average between 1.5% and 1.7%); this insufficiency is particularly observed in

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heavier industries; part of the explanation lies in the fact that R&D used to be carried out by specialised research and design institutes.
- self-financed their investment almost 100%;
- re-trained few workers and allocated few man-days to management training;
- adjusted wages according to government-decreed indexation guidelines; around 20% of enterprises also took trends in productivity into consideration;
- allocated almost insignificant amounts to marketing and have generally an under-staffed marketing/sales department;
- paid little attention to packaging materials (packaging materials cost accounts for slightly over 2% of sales);
- in their approach to quality assurance, tend to control almost 100% of output; still, product quality is not entirely satisfactory because of sub-standard basic materials and other inputs; more that half of light industries complain that inputs are of variable quality, to which they respond—foreign exchange and bargaining power permitting—by switching to imported inputs, imposing standards on their suppliers and/or refusing defective supplies, providing assistance to suppliers and collaborating with them in testing inputs, and changing domestic suppliers;
- claim to apply cost accounting, although ongoing restructuring studies for market-driven sectors tend to show that this accounting system is imperfect (e.g. the allocation of the often high indirect costs); as a result the management team has an incomplete picture of where the profits are made and where the losses are incurred. This said, cost accounting is used to set output prices (cost plus a profit margin); few enterprises (around 20% and mostly light industries) are taking competition into consideration when setting or adjusting prices.

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2. Strategy.

(1) Turnaround management. The survey points out that senior corporate managers generally have an idea of:

- where the company's strengths and weaknesses lie (although about 20% claim not to have any weaknesses at all);
- what the growth products are or what the products facing declining demand are.

However, considering that enterprises are cash-constrained, that they allocate few funds to marketing efforts, and that cost accounting is incomplete, this vision cannot but be imperfect.

More disturbing is that although (a) managers identify products ready for exit, (b) enterprises are cash-constrained, only a minority of enterprises (no more than 30%) are willing to consider closure of production lines, have sold or leased assets, or have merged production lines with other enterprises (typically less than 10% of the enterprises surveyed), in an effort to reduce losses and achieve a positive cash flow.

Less than a quarter of enterprises explicitly recognise the existence of an internal productivity problem. No wonder then that seemingly few enterprises have adopted productivity improvement (or cost-reduction) measures beyond the laying-off of

workers (compared with 1989, employment dropped by 20% in light industries and by one-third in medium-heavy industries surveyed).

On the other hand, two-thirds of enterprises mention that equipment and technology are obsolete; interestingly, these are also the enterprises which, being obviously constrained in cash and long-term finance, are most active in seeking foreign finance, ideally through a joint venture arrangement.

More than 80% of the enterprises surveyed mention having sent missions abroad with the purpose of identifying partners. Unfortunately, although all but two enterprises admit having had contacts with foreign investors, most investors, quite predictably, did not commit themselves to a joint venture arrangement but would rather co-operate by placing commercial contracts, providing technical assistance or a licence and engaging in collaborative R&D. When asked about the reasons why contacts with potential foreign investors do not achieve results, Romanian managers cite lack of knowledge or interest on the side of foreign investors, political instability, the legal framework and the size of their firm, which apparently constitutes a disincentive. Western managers (DTT, 1992) are critical about local partners' lack of understanding of Western ways of managing businesses; management skills problems, understanding the profit motive, work ethic and language skills also present staffing difficulties for Western managers.

Romanian managers do not always make the association between their own enterprise's weaknesses and reluctance on the side of the foreign investors: among these perceived weaknesses are worker (in)discipline and motivation, the corporate organisational structure and productivity. Though not a finding of our survey, anecdotal evidence tends to point to a serious problem facing executive management in gaining control over the organisation and indeed in imposing authority over the work force.

The straightforward conclusion appears to be that corporate management is not sufficiently focusing its efforts on turnaround management—with the exception of measures to alleviate the liquidity (cash) problem—and strategic management.

(2) Privatisation. Privatisation is believed to affect management practice positively by enhancing a change in mentality, improving decision making, speeding up restructuring and attracting foreign investment.

Encouragingly, all the responding corporate managers look on privatisation favourably, although it is not clear whether these answers are sincere. On the other hand, less than half of them believe that their company can actually be privatised easily. This enthusiasm for privatisation seems to be developing at a time of growing frustration with the SOF's and government's lack of progress in restructuring and privatising the SOEs. The primary obstacles to privatisation are lack of financial resources, the high value or large size of the company, and obsolete technology.

More than half the managers would be interested in privatisation through the mechanism of a management buy-out (MBO), irrespective of the degree of ease with which the company could be privatised. On the question why managers have not yet taken the initiative for a MBO so far, the first answer is lack of finance (probably the cash down-payment which the SOF requires), followed by a perceived gap in legislation.

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Furthermore, senior managers look favourably on (a) the workforce holding a portion of the company's equity, and (b) having the company listed on a Stock Exchange (a two-thirds majority of managers think that way)—which does not yet exist in Romania.

(3) Liquidity problem. To address the liquidity (cash) problem, enterprises resort (in relations with customers) to:

A. what are essentially financial measures, such as

- payments in advance;
- cash payments (cash & carry);
- channelling payments through the CEC network (i.e. the savings bank);
- targeting sales and refusal to sell to bad clients/payers; or

B. what are essentially marketing strategies, such as

- re-orientation of production towards quick sales;
- building up their own retail network;
- reducing selling prices;
- increasing export orientation (i.e. export for import).

Systems analysis of corporate management in Romanian SOEs

Existing overall organisation vs. evolutionary pressures. The general, overall organisation mode of enterprises is not adapted to the needs of a free market economy, neither in structure nor in process. The existing economy is not at all 'free', but resembles a hybrid. In order to survive, the individual enterprise on the one hand has to adapt its overall organisation to the newly emerging mechanisms of a free market economy. On the other hand, it retains organisational elements adapted to the conditions of the former system, in order to maintain essential operations crucial for daily survival.

Features of existing, overall organisation.

1. Manufacturing. In the centrally planned economy, the most important criterion an enterprise had to satisfy was physical output, initially regardless of quality or cost. Therefore, the whole organisation centred around manufacturing, and all other activities of the enterprise were devoted to this process, being subordinated to this 'primacy of manufacturing'. This feature remains important. Even after the downfall of central planning and the abolition of targets dictated by the responsible ministry, delivery of physical output continues to be viewed as a kind of guarantee of survival. Trade unions—but also some managers—still believe that volume keeps jobs. In addition, the management of Romanian enterprises is often very reluctant to lay off employees, owing to aspects of 'social value' (described later on). Looking at the management structure and mentality, the implications are twofold. First, the main concern of the general manager (the CEO) is ensuring manufacturing, not matters of

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competitive products, pricing or cost management. Literally, he knows every screw in his manufacturing plant, even if he has no idea about the markets and the competitors he is facing. Second, the most important person after the general manager is the chief of manufacturing; he decides—together with the general manager—the course of the enterprise.

Under the previous system, managers—primarily engineers—were geared towards production and operations management. From a macroeconomic point of view, finance was not a constraint—although hard currency was—since the system managed to achieve a high national savings rate and capital costs were not significant (on the contrary, absorption of investment funds was reportedly problematic). Managers are, therefore, less familiar with developing and implementing a business strategy, developing the marketing function, negotiating, securing external finance, generating cash internally (under conditions of price and demand uncertainty), tackling productivity problems (e.g. energy saving), ensuring total quality, managing human resources.

A 'strategy' in the Western sense of the word does not exist; the strategy consists in ensuring a certain level of physical output, along with the concomitant adjustments of physical inputs (raw materials, spare parts, etc.).

In the transition period, management is confronted with a dilemma: on the one hand, all processes of planning and control within the manufacturing process have to concentrate on minimising major bottlenecks in the supply of materials (a feature of the command economy); on the other hand, this planning and control has to take into account the 'new' requirement of manufacturing goods according to customer needs, which become more prevalent in the transition period. Satisfying customer needs is only possible, *inter alia*, if one is able to ensure a constant level of quality of the finished good, and this in turn is only possible if a certain quality level of inputs is ensured, which is still not possible at this stage in the Romanian economy.

2. Closed entities vs. efficiency. Interlinked with the 'primacy of manufacturing' is another legacy from the command-economy era, namely the design of enterprises as virtually self-contained, autonomous closed entities.

In the absence of the degree of division of labour between industries reached in Western countries and in order to obey the 'primacy', every enterprise had to achieve a maximum of autonomy, i.e. to allocate nearly all the resources needed to produce physical output in one place, that is inside its own boundaries. Therefore, many of the organisational units of Romanian enterprises do not exist in their Western counterparts—for instance, special units producing tools for manufacturing, housing facilities, units concerned with the breeding of livestock, gardens, kindergarten and so on. In terms of costs, this means inefficiency. In the transition period, it still means surviving, when one considers the frequent breakdowns or absence of supply of essential goods and services.

Another aspect to be considered in the context of closed entities is the prevailing mentality in managing people. In contrast to Western enterprises, which adopt a primacy of cost efficiency, the Romanian enterprise has to ensure not only the delivery of physical output, but also a social function of employing people, no matter whether this is efficient (in the Western sense) or not. In addition, in former times an

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enterprise—and therefore its general manager—was more 'important' the more people it employed; important in economic and social terms. The more 'valuable' an enterprise, the better its position to obtain crucial resources in the process of centrally planned resource allocation, therefore the more likely it was to survive. Social value, and not only economic performance, was thus a key for survival and still is important in the transition period, in the original sense and in an additional one, for avoidance of social friction.

Faced with an outdated manufacturing technology, products with poor performance, restrictions on the amount as well as quality of input materials, inefficiencies, and the absence of Western-oriented cost management, the vast majority of Romanian enterprises are not profitable. This situation is aggravated by an increasing influx of goods of Western origin, against which the Romanian goods are not competitive, often in quality and quite often not even on price (depending on the nominal exchange rate).

Confronted with such a situation—and from a Western economic point of view—Romanian enterprises are simply employing too many people. However, increasing unemployment would not only enhance the social vulnerability of the socioeconomic system as a whole, but also threaten the security of the individual managers, in terms of both personal security and career prospects. Therefore, both management and government institutions involved are reluctant to reduce the number of employees, despite all the evident signs of economic decline of the enterprise.

3. Management system. By 'management system' we mean (a) the way in which information needed for conducting and controlling the overall performance of the enterprise is processed, and (b) the mentality underlying how decisions are made.

A prominent feature in the management system of Romanian enterprises is the absence of feedbacks: owing to the principle inherent in a command economy, giving an order is viewed as being identical with the execution of that order; there are no regular feedbacks on whether orders are properly executed, nor indeed on whether they have been executed at all.

The phenomenon encompasses all domains of information processing and leads to the result that, in general, no coherent, valid information regarding the overall performance of the enterprise is available. In the absence of proper cost accounting, no proper decisions can be made with regard to the overall increase of efficiency in daily operations. The structure of the existing cost accounting system in enterprises does not allow calculation of the costs per unit of finished good produced. Therefore management has no hint how to reduce the costs of running operations and how thus to become more profitable.

Since there are no feedbacks on market needs, (emerging) competition or customer satisfaction, a reasonable fraction of the assortment comprises products never or seldom sold; but all of them implying costs. Management faces the dilemma between cutting the product range—resulting in increased unemployment—and not cutting the range, which may mean bankruptcy and threaten employment.

Looking at the way decisions of a strategic nature are made, a regular planning process in the Western sense is absent, not to speak about a bottom-up planning or a management-by-objectives approach. All important decisions are made by the

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general manager himself (sometimes assisted by the chief of manufacturing), irrespective of whether he has the relevant information—i.e. feedbacks as a basis for the decision—or not. Since the people in possession of the relevant information do not participate in the decision-making process, the quality of the decisions made remains doubtful. This is a prominent feature inherited from the days of central planning: the responsible ministry set the business goals to be achieved for the general manager, who passed these commands down to his subordinates. Neither he nor the ministry was interested in the real results of the actions commanded, because any deviation from the official plan was punished, either directly or indirectly by various forms of sanction aimed at decreasing the 'social value'.

4. Mentality of work. Interlinked with the previous point is the general mentality in which the day-to-day work is performed, at least at the hierarchical levels below the general manager. The employee obeys certain informal 'rules' in his daily work:

(1) minimise work effort;
(2) always say 'yes' to every command given, even if it is clear that the command cannot be carried out;
(3) avoid looking at the quality of the work performed, in order not to be responsible for it (the only person responsible is the general manager);
(4) when asked (seldom enough) if the command has been carried out, always answer 'yes', no matter if this is really the case or not.

This work mentality is reflected in management behaviour, which can best be described as 'bottleneck mastering': since the managers cannot rely on the information given to them from their subordinates, they adopt the habit of doing everything themselves, with the consequence that they do not concentrate on their primary tasks, but get deeply involved in the operational day-to-day business.

5. Material shortages. There is another reason for involvement in the daily business, namely frequent material shortages (in quantity and quality) and shortages of foreign currency needed to buy materials of sufficient quantity and quality. In turn, foreign currency can chiefly be gained through increasing exports, which again is only possible with sufficient availability of input materials, both in quantity and quality. This vicious circle enhances the 'bottleneck mastering'.

Break-out routes chosen by enterprises (based on field experience)

Route 1: Value change/exports/co-operation. This is the escape route enterprises seek first: trying to increase exports, mostly in combination with a search for a foreign co-operation partner. Most of the SOEs believe that virtually all their problems are settled if they succeed in increasing exports via a Western investor who wants to establish a joint venture with them.

Some enterprises succeeded in doing exactly this, without first realising the preconditions which have normally to be satisfied prior to such activity. But for the majority of enterprises, the essential obstacle to this approach is the general lack of competitive products which can be exported, owing to quality and technology weaknesses. Therefore, along with establishing a clear-cut market strategy—deciding

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which of the existing business fields to concentrate on, which ones have to be abandoned—and the introduction of marketing activities, a value change in the product range offered has first to be achieved, aiming at products with a competitive edge, be it in quality or price, or both. This in turn is only possible if the enterprise in question is willing to sacrifice 'sacred cows' like the primacy of manufacturing or tackle the problem of chronic overmanning.

In other words, a significant change in value can be achieved only after the preconditions for such a change have been satisfied, i.e. only after a thorough reorganisation of the enterprise, with concomitant establishment of a comprehensive business strategy and marketing functions, in the Western sense of these words.

Route 2: Restructuring of the portfolio. This leads to route 2, the complete restructuring of the enterprise, starting with the break-up of the whole 'organism' into viable and non-viable parts, covering all domains of enterprise activity. In the course of restructuring, new functions also have to be established, first of all marketing and cost accounting comparable to Western standards. Since a complete restructuring is more painful than 'just' looking for foreign partners, route 2 is far more rarely envisaged as feasible by management than the first route.

Route 3: Process changes. A reorganisation remains incomplete when only restructuring takes place, i.e. only structures are changed, without concomitant changes in the accompanying work processes. However, introducing a change not only in structures but also in processes meets with reluctance, even resistance. This might partly be due to a misconception regarding the nature of a 'free market economy enterprise'; Romanian management tends to think: 'We have regrouped all our activities according to the functions essential for a Western enterprise, now we are ready for a free market'. This kind of thinking might otherwise be due to a cultural barrier common to many Romanian managers, namely the view of an enterprise as a closed, autonomous entity, with not only economic but also social functions.

Employees and management are realising too late in the stage of implementing process changes that increasing overall efficiency and keeping social functions alive are contradictory goals for the majority of SOEs. The question has to be settled very quickly: 'What shall be the compromise to be achieved (pragmatically) between an increase in overall effectiveness/efficiency, on the one hand, and keeping social functions, on the other?'

The same pragmatic compromise has to be made when two other cultural barriers to the introduction of Western-style management are considered, namely the general work mentality and the decision-making process.

Since one cannot change a work mentality generated in decades of socialism in only a few months, the solution adopted by the enterprises is the introduction of new instruments of planning as well as controlling of the work processes which are crucial for the company's survival (e.g. manufacturing planning & control, work with main suppliers). The introduction of these instruments has three effects:

(a) first, despite the existing work mentality, essential feedback loops are created which allow the management to have at least a general overview over the

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performance of the business, and in addition enable management to evolve a planning process based on facts, not on fiction;

(b) second, expressed in terms of organisational development, a change will take place in the minds of the participants, that is, they will become accustomed to the procedure of regular feedback of results and to direction of daily activities not according to mere improvisation needs, but to a plan;

(c) third, the way decisions are made will be changed; through the feedback loops, management decisions are evaluated on the basis of results achieved, are therefore correctable and consequently can no longer be made by the top manager alone.

In addition, through the introduction of these instruments, the implementation of a bottom-up planning process and delegation of competence cum responsibility could be achieved, at least for the major domains of business activity. In the former system of central planning there was responsibility without competence, i.e. without the manoeuvring space necessary to fulfil the assumed responsibility, leading to a kind of 'chimney effect' in that all responsibility was passed upward until it reached the general manager, who was then responsible for everything.

Route 4: Cost management/MEBO. Enterprises pursuing route 3 (general process changes) at some time introduce methods for controlling and planning costs. Together with the introduction of cost management, an overall reporting system has to be developed, encompassing all important fields of activity of the enterprise in question. Through this reporting system the relation between efforts and results per activity becomes visible to the managers, thus enabling them to define proper goals and control the results for each of these fields of activity. Again, delegation of competence cum responsibility is facilitated through the creation of cost (and profit) centres, the latter accompanying the introduction of an enterprise-wide cost management and reporting system.

Considering that privatisation through sale to investors is proceeding only slowly, management buy-out and/or employee buy-out (MEBO) is regarded as a preferred option, one believed to resolve the problems with the existing work mentality. Top management has the perception that a MEBO will increase entrepreneurial spirit and therefore will lead to increased motivation of and for work. MEBO as a road to privatisation is often combined with the first route, namely increasing exports with the help of a foreign investor.

Using MEBO as a 'route of escape' is only possible after its preconditions have been satisfied: the creation of a new awareness regarding the nature of management and work in the minds of managers/employees through the processes of enterprise reorganisation, alongside introduction of instruments of planning and control. Organising a MEBO with 'old-minded' people is equivalent to giving existing problems inside the enterprise—which have to be solved via reorganisation—a new name.

Conclusions

At a moment when certain early or fast reformers (Poland and Russia) have doubts about the speed of their reform process and the implied social costs, the question can

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be asked whether Romania has not correctly opted for a slower but steady transition. Considering its record on output decline, unemployment, currency devaluation and inflation the answer is clearly negative. In Romania and elsewhere, more reform is needed, not less, to reverse output decline and halt inflation. Though stabilisation policies carry short-term adjustment costs, the costs of 'not doing' are far larger. This is particularly true in the heavy industries (steel, petrochemicals etc.) where rationalisation (closing the least efficient plants and transferring production to the more efficient ones) would generate savings sufficiently large to compensate and to re-train workers dismissed, to increase spending on maintenance and small modernisation investments. This is to say that, for the sectors which account for most of the large loss-making enterprises, the decision makers' fear of the social costs of restructuring is not justified.

In 1990 Romania embarked on a Reform Programme which is comprehensive in design. Some elements of this reform have come virtually painlessly (putting in place a new legislative framework), some were courageous, such as price liberalisation and eliminating consumer subsidies. Although having suffered a significant drop in real incomes, Romanians have proved to be patient, preferring incremental change and 'muddling-through'. However, 'muddling-through' is just not good enough to restructure the ailing agricultural and industrial sectors. Considering the obsolete nature of most of the country's capital infrastructure (short-term growth is therefore less likely to come from a mere increased utilisation of existing, obsolete capacity), the limited domestic savings, and the country's low international creditworthiness rating, government and corporate management will have to

- be more selective in allocating investment resources (an internal rate of return on investment of just 8% in what is now a developing country is no longer acceptable);
- decide where the core activities lie.

Diversifying without rationalising is not feasible.

Implementation of the Reform Programme is now the major issue, not its design. Successfully managing the programme requires breaking down the legacy of the socialist past, changes in work mentality, a more pragmatic approach, speeding up decision making and general recognition that real job security can be achieved only by building up a competitive economy, enterprises and products. Strategic management has to be forced down to corporate management.

Time and opportunities have been lost through wavering macroeconomic and corporate management. No amount of external credits and conditionalities will overcome indigenous hesitation and reluctance, though the IMF's stringent Stand-by Agreement (December 1993) seems to indicate that the donors are banking on the external constraint forcing the government to accelerate the restructuring process. Demand for faster reform has in essence to come from the dynamic forces of the society encouraged by their increasing exposure to consultants, foreign investors and managers and competitors. Romania's risk-averse and increasingly irrelevant political elite, by and large, cannot be counted among these dynamic forces. Though having been for decades adapters rather than innovators, the country's engineers are the

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single largest pool of potential entrepreneurial talent. Donor assistance will have to be increasingly targeted to this talent.

Finally, the donor and foreign investor community have to understand that the macroeconomic and corporate management models which will be 'taught' and implanted in the former socialist countries will be only as good as Western management itself. The more the 'market economy' model is rigged with distortions and burdened with high unemployment rates, budgetary deficits and 'new' poverty, the more confused, sceptical and disenchanted Central and East European policy makers will be. Such frustration will not make them more eager to speed up the reform process.

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List of abbreviations

CEO	Chief Executive Officer
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
IMF	International Monetary Fund
MEBO	Management and Employee Buy-Out
MBO	Management Buy-Out
NBR	National Bank of Romania
NI	National Income
ODA	Official Development Assistance

PHARE	EC-funded assistance programme for East European countries (excluding CIS)
POF	Private Ownership Fund
RER	Real Exchange Rate (= nominal exchange rate adjusted for inter-country inflation differentials)
R&D	research and development
SME(s)	Small and Medium-sized Enterprise(s)
SOE	State-Owned Enterprise
SOF	State Ownership Fund

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