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Virrey del Pino 3210

1426 Capital Federal

Te. 552-3291/9313/7771

MACROECONOMIC DEVELOPMENTS IN ROMANIA

Carlos Alfredo Rodríguez

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MACROECONOMIC DEVELOPMENTS IN ROMANIA

Carlos Alfredo Rodriguez

Since December 1989, when the communist regime in Romania was overthrown, impressive efforts have been made towards transforming the economy into a market oriented, capitalist economy. The new Constitution voted in November 1991 guarantees property rights and declares Romania as a "market economy". Reforms were made in the areas of privatization, land ownership, restoration of competitive pricing, trade regime, fiscal management, and exchange rate system and monetary policy.

The transition, however, has not been easy, and the future does not look as bright as one might wish. Rumanian industry, energy intensive, technically inefficient and oriented mostly to the Comecon area, collapsed together with this regional market. In the last three years, industrial output has fallen at annual rates of nearly 20%. Efforts to restructure industry or to bring any subsector of industry to a normal level of operation are hampered by declining aggregate demand, difficulties in the foreign exchange allocation process that impede a normal input supply, high inflation and tight credit, not to mention that most of industry still remains under the directives of the state under the new figure of Stock Companies that eventually will be privatized.

Macroeconomic instability--inflation, sharply falling output and raising unemployment--is a severe obstacle to the implementation of the required serious steps of structural adjustment: trade creation and diversification, development of an industrial policy, privatization and the creation of a capital market. Authorities have reacted to the ongoing macroeconomic instability by fiscal and monetary tightness that is apparently being bypassed by defacto action of market participants under the assumption that they eventually will be bailed out by the government. Credibility of policy actions is therefore an essential requirement in the process.

Several institutions that supported the macroeconomic balance of the previous centrally planned economy still remain in place. Among these are a wide system of price controls that sets prices well below world levels, a system of fiscal subsidies that financially supports the price controls, export quotas and prohibitions on the subsidized products and other raw materials and, lastly, foreign exchange prohibitions for capital account operations and rationing for current account operations.

As in other previously centrally planned economies (CPE) which have undergone the transformation into a market economy, Romania has had high inflation rates and sharp reductions in economic activity. GDP fell by 5.8% in 1989, 7.3% in 1990, 13.7% in 1991 and is expected to fall by 15% in 1992. The fall in GDP has been accompanied by a sharp raise in unemployment, a previously unknown problem in the CPE. A social unemployment insurance mechanism has been implemented and financed through a payroll tax. So far the system has proven effective and financially viable. The fall in output is partly due to the virtual destruction of the Comecon market for which Romania oriented most of its industrial production. Agricultural output also experienced a sharp fall, in this case due to the short run effects of the much needed land privatization. Other factors, such as delays in the privatization process, price controls and shortages and rationing of foreign exchange also contribute to reducing the level of economic activity and should be quickly addressed by authorities.

In this Chapter we address in detail some of the problems behind the most significant macroeconomic disequilibria. Foreign exchange control seems to be at the heart of all other disequilibria. Purchases of foreign exchange by exporters for retention purposes are financed by interenterprise arrears. These arrears are an endogenous source of credit that circumvents the tight credit conditions that the monetary authorities try to implement in order to fight inflation. The lack of foreign exchange is in turn used as a justification for energy rationing, as well as for maintaining a wide system of price controls and subsidized prices that distorts resource allocation at a high fiscal cost.

The interaction between inflation, credit and interest rate policy are presented in Section II. Section III shows how interenterprise arrears nullifies the attempts at credit control through the frequent use of "global credit compensations" financed by the NBR. Section IV deals in detail with the several foreign exchange allocation mechanisms that have been in use since 1989 and concludes that a permanent solution to the problem of FOREX shortages requires the implementation of full convertibility for the Leu. Price controls are discussed in Section V. The counterpart of the price controls are the subsidies that government transfers to most of the activities subject to them. The implementation of the subsidies seriously distorts resource allocation, to the extent of requiring extensive export controls, and it has a high fiscal cost that reached an estimated 17% of GDP in 1992 for the Central Government subsidies alone. The paper concludes in Section VI with a global assesment and some policy recommendations. The most significant of those recommendations are the need to eliminate price controls and foreign exchange

rationing though the implementation of full convertibility. Authorities should not resort to any new global compensation scheme, but rather provide mechanisms to "securitize" the existing stocks of arrears.

II-INFLATION AND MONETARY AND CREDIT POLICY

Following the fall of the CPE, inflation has been very high in Romania. Initial currency overhang, price liberalization, output fall and, lastly, monetary financing of fiscal expenses are among the main reasons.

Money was issued to finance fiscal deficits of around 2% of GDP, and to finance a whole range of quasifiscal expenses including a global compensation of the debt of enterprises and the capitalization of state owned banks. Other factors that significantly determined inflation were the much needed price liberalization and the partial elimination of producer and consumer subsidies, and the several reversals in exchange rate policy that contributed to currency speculation, large devaluations, shortages of foreign exchange and helped generate uncertainties about future exchange rate developments.

It is fair to say that by any standards, credit to the private sector has been intended to be very tight. However, the tightness of official credit supplies has been bypassed by the generation of extremely large inter-enterprise arrears that were pardoned (through "global compensation") in late 1991 in an action that basically was an ex-post validation of the ongoing inflationary process. The lack of a capital market, and of well defined property rights imply that the arrears may supply the needed fuel for the inflationary process to continue on its own in what would be an economy with endogenous money supply, as was the case in several of the late Latin American hyperinflations.

In both 1991 and 1992, the Treasury appropriated proceeds from the revaluation of Gold Reserves to finance regular fiscal expenditures. This procedure is inflationary and the fiscal uses for the Gold Revaluation Account should be discontinued. The proceeds should be used for the unique purpose of capitalizing the National Bank of Romania (NBR) as it is done in most other Central Banks in the world.

To partly compensate for the expansionary effects of the global compensation in late 1991, a 10% reserve requirement was applied to all Lei denominated deposits of enterprises. The reserve requirement was extended to all household Lei deposits in late 1992 in order to compensate for the expansionary effects of using the Gold Revaluation Account to capitalize state

banks. These instances represent the first use of reserve requirements as instruments of monetary control in Romania. Unfortunately, they were both imposed, not to create a new monetary policy instrument, but rather as a way to obtain quasifiscal resources to fill the gap created by other quasifiscal expenses. Further increases in reserve requirements should not be used for financial, fiscal or quasifiscal gaps as this will quickly result in high bank spreads and further demonetization of the economy. Authorities should also consider that the actual system favors foreign exchange deposits against Leu deposits as the former are not subject to any reserve requirement.

Within the general framework of tight credit, some exemptions were made by the NBR's granting of subsidized credit lines. During 1992, these subsidized credits included a 100 billion Lei line for agriculture at 15% annual rate, a 10 billion Lei loan at 20-40% interest for export financing and, finally, a 73 billion Lei loan at 15% for the energy sector. These subsidized credit lines have two bad side effects: first, since they imply that central bank credit is expanding, the money supply grows and this is inflationary; second, since the interest rate is subsidized, the quasifiscal balance is negatively affected and the NBR's net wealth deteriorated.

Inflation accelerated sharply in the later part of 1992 (Table 1) as consumer subsidies were significantly reduced in September and the nominal exchange rate was adjusted upwards by 100% following the May liberalization. Inflation was around 10% during September and October and is expected to have exceeded that level in November. A new boost on inflation is expected in May 1993, when the government has promised to completely eliminate all remaining consumer subsidies on a wide range of goods that in 1992 amounted to 7 percent of GDP.

TABLE 1
MONETARY DATA

	TOTAL M2	LOCAL CURRENCY	FOREIGN CURRENCY	DOLLAR EQUIV.	EXCHANGE RATE	PRICE LEVEL	MONTHLY INFLATION
Dec-89	420914	416936	3978	275	14.44	100.0	0
Dec-90	514457	499347	15110	435	34.71	137.7	11.6
Jan-91	518702	502961	15741	453	34.74	158.1	14.8
Feb-91	516081	498917	17164	500	34.30	169.2	7.0
Mar-91	516755	497911	18844	510	36.97	180.4	6.6
Apr-91	524644	494709	29935	493	60.67	228.2	26.5
May-91	568415	535174	33241	551	60.35	239.8	5.1
Jun-91	567449	531714	35735	576	62.05	244.5	2.0
Jul-91	594903	557152	37751	621	60.77	267.7	9.5
Aug-91	599866	562734	37132	605	61.38	297.6	11.2
Sep-91	601712	560010	41702	699	59.77	319.4	7.3
Oct-91	671708	631855	39853	660	60.36	352.6	10.4
Nov-91	814708	768327	46381	252	184.0	391.1	10.9
Dec-91	1033266	992856	40410	214	189.0	444.5	13.7
Jan-92	1065679	1022903	42776	216	198.0	531.2	19.5
Feb-92	1048017	999107	48910	247	198.0	597.4	12.5
Mar-92	1082517	1036593	45924	232	198.0	657.3	10.0
Apr-92	1072641	1029026	43615	212	206.0	688.0	4.7
May-92	1098723	1038006	60717	269	226.0	771.3	12.1
Jun-92	1123307	1030699	92608	305	304.0	804.1	4.3
Jul-92	1197687	1058853	138834	380	365.0	829.6	3.2
Aug-92	1322167	1140772	181395	474	383.0	857.6	3.4
Sep-92	1425303	1239814	185489	435	426.0	944.5	10.1
Oct-92	1446423	1204887	241536	562	430.0	1035.2	9.6

Source: National Bank of Romania

During the 12-month period October 1992/91, the local supply of money increased in nominal terms by 91% while the CPI increased by 193% during the same period. The real value of the local currency holdings, therefore, fell by 35%. The fall could be explained partly by the 15% fall in real GDP expected during 1992. In addition, inflation has increased significantly since September and real cash holdings may be required to fall by even more as the public adjusts inflationary expectations upwards. Dollarization may also be taking a bite in the demand for local currency, as dollar deposits are much more attractive insofar as offering a higher real rate of return to their holders. While Lei deposits at the Savings Bank are remunerated at annual rates of 25% for sight deposits and 50% for one year time deposits, dollar deposits get around 9% plus whatever devaluation is expected to take place. Since during October 92/91 the devaluation rate in the interbank dollar market was 66%, dollar deposits were clearly more attractive than Lei deposits.

Early in 1992, NBR authorities, worried about the inflationary effects of negative real interest rates, increased the rediscount rate from 28% to 80% annual. The move was not completely successful in raising interest rates in the market as the Savings Bank (traditionally the largest retail bank, still belonging to the state) did not follow by raising its borrowing rate.

Presently, real interest rates offered to depositors by the Savings Bank (that behaves as a dominant monopolist as it has the largest share of the market) are 25% for sight deposits and 50% for time deposits of one year maturity. This policy has kept interest rates negative in real terms and has probably contributed to the observed fall in demand for real cash balances and the increased dollarization rate.

The growing path of dollarization and demonetization can be clearly seen from the data in Table 2. As the data shows, real cash balances in local currency have fallen by about 50% during 1992 alone, while the ratio of foreign currency deposits in total M2 has about quadrupled from only 4% in December 1991 to 16.7% in October 1992.

TABLE 2
MONETIZATION AND DOLLARIZATION

	REAL VALUE OF LOCAL CURR. HOLDINGS	SHARE OF FOREIGN CURR. DEPOSITS IN M2
Dec-89	100.0	0.9%
Dec-90	87.0	2.9%
Jan-91	76.3	3.0%
Feb-91	70.7	3.3%
Mar-91	66.2	3.6%
Apr-91	52.0	5.7%
May-91	53.5	5.8%
Jun-91	52.2	6.3%
Jul-91	49.9	6.3%
Aug-91	45.4	6.2%
Sep-91	42.1	6.9%
Oct-91	43.0	5.9%
Nov-91	47.1	5.7%
Dec-91	53.6	3.9%
Jan-92	46.2	4.0%
Feb-92	40.1	4.7%
Mar-92	37.8	4.2%
Apr-92	35.9	4.1%
May-92	32.3	5.5%
Jun-92	30.7	8.2%
Jul-92	30.6	11.6%
Aug-92	31.9	13.7%
Sep-92	31.5	13.0%
Oct-92	27.9	16.7%

The rate of dollarization has increased sharply since the liberalization of the foreign exchange market in May 1992 which allowed enterprises to retain their foreign exchange earnings if deposited at a local bank. The deposits were partly financed by the growing amount of inter-enterprise arrears that increased in gross terms by 600 billion Lei between April and October 1992 (net arrears are believed to be about a third of the gross amount, about 200 billion Lei). The problem of the credit arrears is at the center stage of the picture of macroeconomic disequilibria together with the virtual rationing of foreign exchange.

III-INTER-ENTERPRISE ARREARS

Under the previous centrally planned economy, enterprises had to meet strict quantitative targets and it was customary that any financial disequilibria be compensated by fiscal authorities once or twice a year. Enterprises would get their supplies from other enterprises and significant amounts of inter-enterprise credits were created during the period until a "global compensation" was arranged. Under the compensation, such as that in December 1991, cross debts were written off and the resulting net debts were financed by new credit lines granted by the NBR. In December 1991, gross arrears reached 1.8 trillion Lei, about 80 of nominal GDP. The cost to the NBR of the global compensation scheme in 1991 was about 250 billion Lei in the form of increased credit granted to debtors at a subsidized rate of 28% annual (during the next 10 months inflation reached 133% implying that the real interest rate was -47% for the 10 months between Dec.91-Oct.92). The amount of gross arrears cleared in the December compensation scheme is not available, but by April 1992, inter-enterprise arrears already showed a level close to a trillion Lei and grew to over 1.6 Trillion by the end of October.

Current net inter-enterprise arrears (assuming they are about one third of gross arrears) are about 38% of M2 and cannot be monetized without running the risk of a substantial increase of the inflation rate that already is at a two digit monthly level.

As mentioned, a major cause for the generation of inter-enterprise arrears is the lack of bankruptcy legislation. A bankruptcy law is being considered by Congress. Although necessary, the sanctioning of the Bankruptcy Law likely will not provide a short term solution to this pressing financial problem. It is obvious that Courts will not be able to deal fast enough with very large stock of arrears inherited.

It is fundamental that authorities continue giving the clear message that the arrears will no longer be refinanced by the monetary authorities. Monetary authorities have been forceful on this issue and if arrears can be at least stabilized, a piecemeal approach to solving them can be tried with a battery of instruments, among them: use of bankruptcy procedures, implementing measures like the Government Resolution 701 of October 1992, mandating State enterprise to cancel the arrears with their liquid assets and by other means such as documenting whatever is feasible in negotiable corporate bonds.

Authorities should consider the possibility of securitizing the arrears, or part of them. This could be done by issuing a corporate bond with some preferred claim to dividends or privatization rights. The bonds should be negotiable and be issued at a competitive interest rate, possibly fixed in real terms at a low level (perhaps 1-2% real positive a year), and with long term maturity (10 years or more). Bonds of bad creditors will trade at a discount versus bonds of those seen as good prospects by the market. In this way enterprises will get the message that global compensation will not be used again and that lending to good customers does pay off. These bonds could be used by commercial banks as collateral for loans and thereby fulfill a pressing need of the market, as currently there are no assets which can be used for such purposes.

TABLE 3
Gross Inter-enterprise Arrears in 1992
(Billion Lei)

	April	May	June	July	August	Sept.	Oct.
TOTAL	969	1121	1198	1321	1234	1236	1607
Industry	598	635	664	794	688	688	747
Dom.Trade	97	124	128	127	130	132	379
Fgn.Trade	68	149	167	155	173	81	185
Other	206	213	239	245	243	335	296

In addition to the inter-enterprise arrears addressed above, the backlog of performing debts of enterprises to banks is estimated to have reached about 120 billion Lei in September 1992. Tax arrears to the Treasury were also common practice until 1992 when the Treasury started charging the NBR 80% annual rate on rediscounts by the NBR. The rate was seen by the market as very high in real terms and tax arrears quickly diminished. In addition, the Ministry of Finance has authorized that electricity be cut to enterprises that do not pay their bills and in the case of large debtors a procedure of liquidating the enterprise may be started by a commission at the Ministry.

IV-THE FOREIGN EXCHANGE MARKET

The Current Situation

Perhaps the most significant obstacle for resource allocation in Romania is the inefficient market for foreign exchange. Everywhere one asks, problems are blamed on foreign exchange shortages to the point that they are probably the main production bottleneck found.

Inflation perspectives also are not helped by suppliers' attempts to cover against uncertainties about the future value of the exchange rate or the FOREX allocation mechanism to be used. Export enterprises tend to hold to their FOREX earnings and finance them with arrears to local suppliers in a clear indication that they expect the value of the foreign exchange to increase by more than whatever interest is charged on the arrears. The withholding of foreign exchange by exporters reduces supply and creates strains on other productive sectors that cannot obtain needed imported inputs.

While FOREX is officially auctioned in the interbank market by a program which automatically finds the price that maximizes the number of transactions, the fact is that less than 50% of the suppliers at the selected price get access to the FOREX. In spite of wide oscillations in the execution ratio (ratio of sales to demand at the selected price) and of inflation rates of 10% in September and October 1992, the exchange rate has remained completely fixed at 430 Lei per dollar during October-December 1992.

There is some evidence that the interbank market is significantly less than competitive, lacking price flexibility, transparency and sometimes requiring significant delays (even months) for the process of obtaining FOREX as reported by some importers. In its present form, the auctions in the interbank market are a significant obstacle to the development of international trade as they generate great uncertainties about access to required FOREX, insofar as the price, quantity and timing. Devaluation alone is not the solution to the problems of access to foreign exchange. The solution requires implementing a stable and transparent mechanism which the market believes will remain long enough for the economic policies to be effective.

The current exchange system does not satisfy either the requirements of an efficient market allocation mechanism or of a minimally efficient system of quantitative rationing. As it stands, the FOREX allocation mechanisms used in the last two years have helped generate wide oscillations

in the real exchange rate as seen in Figure 1. The real exchange rate (defined as the ratio of the interbank market exchange rate vs. the dollar and the Romanian CPI) fell from close to 250 in March 1991 to 88 estimated in November 1992 (Table 4).

The sharp nominal devaluation implemented during May-July 1992 was only able to temporarily reverse the falling trend in the real exchange rate. Since September 1992, authorities have apparently intervened in the auction market to keep the nominal exchange rate constant. Since inflation was around 10% in both September and October and expected to be 12% in November, the real exchange rate took a nose dive during these months. This is a very dangerous policy as the market anticipates a large devaluation and withholds foreign exchange from the auction. In addition, the higher expected devaluation increases the rate of return for holding foreign exchange versus Lei and therefore provides further incentives for the ongoing dollarization process.

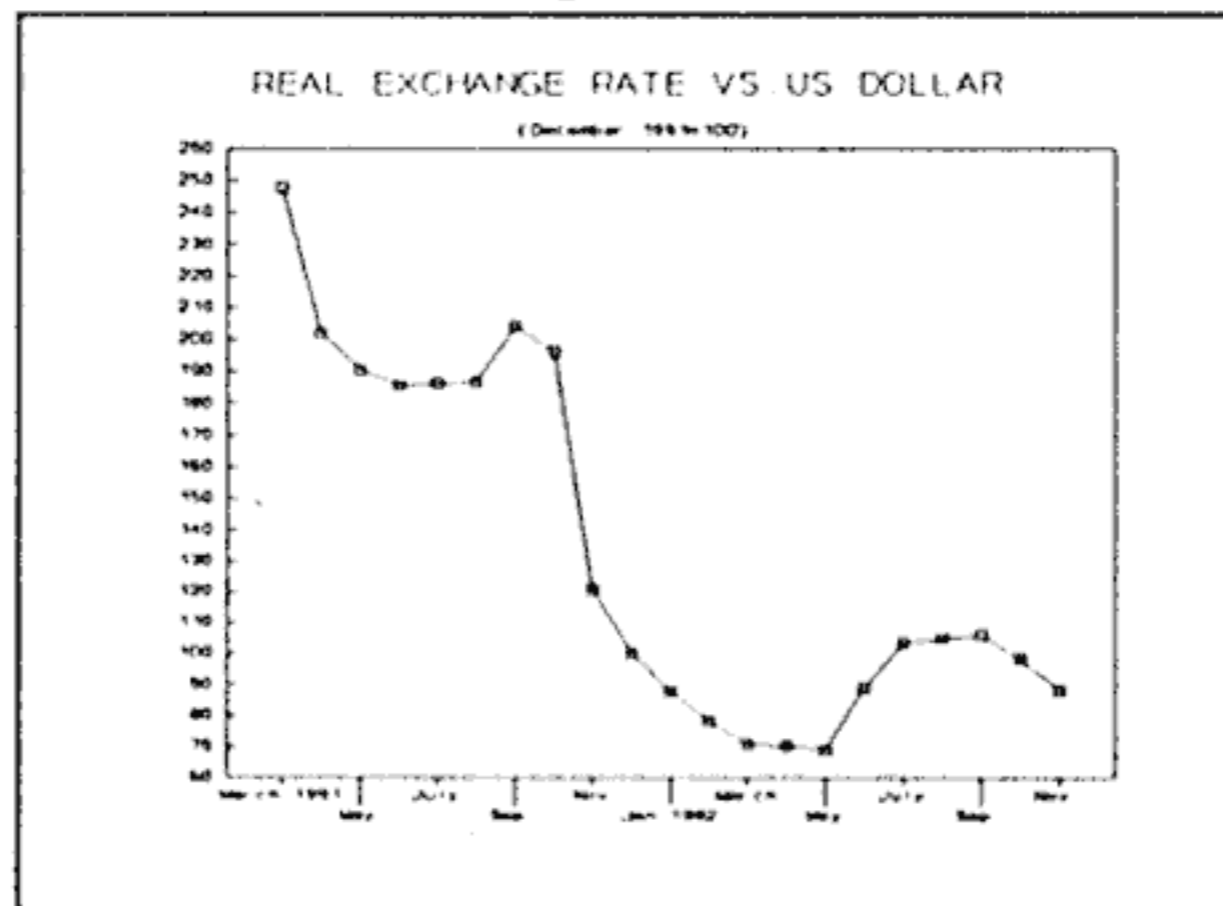
A significantly more transparent foreign exchange allocation mechanism could be instituted if authorities were to allow for the exchange rate flexibility that this would require. Conditions for the exchange rate not to increase to unsustainable levels should be sought via genuine channels such as fiscal restraint, monetary tightness, and a permanent solution to the problem of the inter-enterprise arrears that so far seems to be an unlimited source of cheap credit that is channeled to the purchase of foreign exchange.

Recent Developments

Contrary to other decisions in the transformation process, authorities do not seem to have had a clear objective regarding the organization of the foreign exchange market. The only aspect in which there has been consistency is in not allowing for any significant degree of capital account convertibility of the currency. Citizens are allowed to purchase a maximum of 100,000 Lei (about US\$180) a year. Foreigners can purchase foreign exchange only to the extent they can show proof of previous purchase of local currency for that amount. Exports of local currency are strictly forbidden and custom guards take care that this regulation is implemented even with tourists.

Special provisions apply to the repatriation of profits of foreign investors under the Foreign Investment Law. These profits are limited to the range of 8-15% of capital invested (according to the type of activity) and investors must compete in the foreign exchange market for the virtually rationed foreign currency in order to make the remittances.

Figure 1



Note to Figure 1: November CPI inflation is estimated at 12%.

TABLE 4
Real Exchange Rate vs. US Dollar
(Ratio of Interbank dollar rate to Romania CPI)
(December 1991 = 100)

March 1991	247.7
April	202.0
May	190.3
June	185.6
July	186.3
Aug.	186.5
Sep.	204.0
Oct.	196.1
Nov	120.9
Dec.	100.0
Jan. 1992	87.7
Feb.	78.0
March	70.8
April	70.4
May	68.9
June	88.9
July	103.5
Aug.	105.0
Sep.	106.1
Oct.	98.4
Nov.	87.9

*Nov. estimate assumes CPI inflation of 12%.

TABLE 5
Operations of the FOREX auction market
(Thousands of US\$)

	Exchange Rate	Amount Transacted	Percentage Executed		Exchange Rate	Amount Transacted	Percentage Executed
July 10	358	59206	100	Sept. 1	383	770	11.44
11	355	10052	100	2	383	N.A.	-
14	355	7155	100	3	383	1098	7.23
15	358	10144	100	4	391	2275	37.97
16	357	2744	100	7	391	3036	17.66
17	360	2724	100	8	391	2279	12.42
18	362	2959	100	9	399	5061	25.99
21	358	4409	100	10	396	6909	68.12
22	357	4879	100	11	396	5771	36.71
23	358	1452	19.47	14	396	1661	9.35
24	365	2817	31.13	15	405	1811	100
25	365	1100	43.28	16	405	2982	31.6
28	360	1064	10.37	17	405	2942	22.9
29	365	1329	18.09	18	407	2880	19.11
30	365	2565	23.97	21	408	4183	26.19
31	365	1017	16.35*	22	412	2355	54
August 1	365	1349	16.15	23	416	2380	53.31
4	372	1340	27.99	24	420	2026	10.79
5	366	1374	14.16	25	426	5748	N.A.
6	370	1344	10.3	28	426	1567	N.A.
7	373	1598	10.53	29	426	1527	N.A.
8	370	1664	13.18	30	426	2707	N.A.
11	370	2451	11.9	Oct. 1	430	2160	N.A.
12	365	1971	10.68	2	430	2074	N.A.
13	370	1523	10.23	3	430	2954	N.A.
14	373	930	4.88	6	430	870	N.A.
15	379	2093	7.97	7	430	4496	N.A.
18	376	459	3.53	8	430	5381	N.A.
19	379	1969	18.67	9	430	3935	N.A.
20	380	1233	11.79	10	430	2369	N.A.
21	380	746	6.51	13	430	2604	N.A.
22	380	2606	24.07	14	430	2866	N.A.
25	380	556	7.77	15	430	2916	N.A.
26	383	1846	26.32	16	430	1966	N.A.
27	383	1813	20.83	17	430	3313	N.A.
28	383	986	13.74	20	430	2227	N.A.
29	383	445	4.83	21	430	3533	N.A.
				22	430	3199	N.A.
				23	430	4725	N.A.
				24	430	4140	N.A.
				27	430	2143	N.A.
				28	430	3742	N.A.
				29	430	2976	N.A.
				30	430	2961	N.A.
				31	430	3369	N.A.

After the December 1989 revolution, the allocation of foreign exchange for current account purposes was done by a system of mandatory surrender of export proceedings at an officially established exchange rate that increased gradually from 15 lei to 35 Lei to the dollar in February 1991 when the system was changed. Households and enterprises were allowed to hold bank accounts denominated in foreign exchange.

On February 18, 1991 a slightly liberalized system was put in place. Exporters had to surrender only 50% of their earnings to the NBR at the official rate while the remaining 50% could be traded in the newly created interbank market at a free rate. In this market, a daily auction was conducted and transactions were settled through the use of a computer program designed to find the price that maximized the amounts transacted. With 50% of export proceeds surrendered, the NBR supplied cheap foreign exchange for priority imports of raw materials and energy. This allocative system lasted for nine months during which, on average, the interbank rate for the dollar was between three and four times the official rate. The increased attractiveness of holding foreign exchange was evidenced by the fact that dollar deposits in convertible currencies increased from US\$ 492 million in February 1991 to US\$660 million in October 1992, increasing their participation in M2 from 3.3% to 5.9%.

On November 11, 1992, authorities imposed the mandatory 100% surrender of all export proceeds at an official exchange rate, now unified at 189 Lei per dollar. All state enterprises were forced to surrender to the NBR their foreign currency deposits at the rate of Lei 189. This move was seen by the market as an expropriation (the average interbank rate for October was Lei 294, 55% higher than the rate used for the forced conversion) and may have damaged the credibility in the stability of local financial institutions as well as in the sustainability of any exchange rate arrangement. Dollar deposits in convertible currencies fell from the level of US\$660 million in October to only US\$213 by December 1991. It should be noted that since the official rate was only 60 Lei, the new unified export exchange rate increased from an average of 177 Lei in October to 189 Lei in November.

Following the restoration of the 100% surrender and unification of the rate, export proceedings increased in December 1991 only to fall to sharply for the next months. As a consequence of this policy, a well fledged black market started to operate, probably fed by under-invoicing of exports.

By May 1992 it was clear to authorities that the restoration of the 100% surrender at a fixed official rate had the effect of lowering exports and establishing a black market. A significant policy switch took place on May 4, 1992 when the 100% surrender was replaced by 100% retention provided the foreign exchange is deposited at a local bank. The auction market, run by the computer program, was reinstated and the restrictions on enterprises' holdings of foreign exchange accounts were lifted.

Even though the auction market, as run by the computer program seemed to be able to reproduce the functioning of a competitive market, some additional restrictions regarding the offers that could participate seriously undermined its allocative efficiency. Authorities had the power to accept offers (buy or sell) that were within a 5% band around the previous day fixing. If for the accepted set of offers the program could not find a market clearing price with 100% executions, authorities were allowed to set the rate. Of course, they could again set the previous day fixing in which case a situation of excess demand could perpetuate.

The auction market initially lacked the credibility of the market and started full fledged operations only in July 1992. As seen in Table 5, during the first nine days for which information is available, the auction actually worked competitively, with an execution ratio (ratio of demand orders to supply orders at the determined price) of 100%. Starting July 23, the market fell into a situation of chronic excess demand from which it rarely recovers. In some days the execution ratio did not reach 5%, meaning that only one dollar out of 20 demanded was obtained at the given price.

The most standard complaint of enterprises is that they cannot obtain foreign exchange to purchase the required imported inputs. Since industrial production has been falling at the rate of 20% annual for the last three years, this scarcity indeed may be having a high social cost. The auctioning process may not be functioning as transparently as authorities desire. Firms tell of the impossibility of gaining access to the auction process, even when paying the market price. In the context of excess demand, banks are interested in representing suppliers of foreign exchange (exporters) rather than demanders (importers). Importers must wait for several months during which both the price and the quantity available are uncertain. Obviously, with such uncertainties about price, quantity and time of delivery, it becomes all but impossible for enterprises to plan production whenever they need imported inputs.

As expected, a black market substituted the inefficiencies of the rationing. As of December 1992, the premium stood at about 30% over the official rate. Foreign exchange houses sell dollars to households (up to the Lei 100000 limit) at a rate equal to the auction rate plus a 30% commission. Significant proceeds from under-invoicing exports are believed to be held in foreign accounts. These funds may be used to finance imports which can not obtain foreign exchange through formal procedures.

Obviously the auction system did not work because authorities did not allow the price to settle at its competitive level. The 5% band regulation insured that participants did not dare make a significant offer at any other price than the previous day fixing, thus ensuring the persistency of the price. While the rate rose substantially from May to July (this could explain the success of the early July auctions), it barely changed during July and August. Finally, in September the rate was allowed to increase by 11.6% (while inflation was 10.6%) and it has remained at that level since. The time path of the real exchange rate in Figure 1 shows a consistent trend of real depreciation that is clearly inconsistent with a situation of excess demand unless rationing is taking place.

In October 1992, the foreign exchange allocation mechanism was changed for the fifth time since 1990. The NBR stopped providing the service of pooling all offers and clearing them by means of a unique execution ratio. Rather, this time it requires each bank to individually supply its demand for foreign exchange exclusively with the supply offers it presented to the auction. The NBR still provides the service of using the computer program to determine the daily price, after which each bank now has its own execution ratio as excess demands or supplies are not cleared across banks any more. This move is supposed to pass the burden of rationing on Banks which will now have the incentive of obtaining a high execution ratio to attract good customers. In practice, banks lure suppliers of foreign exchange by offering "services" such as credit at special rates. Demanders of foreign exchange that cannot promise a future supply of it are simply discouraged by the banks to apply through them by a variety of methods that include delays or difficulties in approving their import documentation (banks must clear the documents as a requisite for presentation at the auction). Given the well functioning black market, it is highly probable that at least in some cases the banks' offers of premium value on special services to exporters or the added costs to importers be close to the market clearing premium of 30%.

Since the new rules were in place in October, the exchange rate at the auction has been completely fixed at 430 lei per dollar, in spite of wide changes in the execution ratio for the market and across banks. Since then inflation has been 10.6% in September, 9.6% in October and is expected to be above 10% in November. In addition, the complete elimination of consumption subsidies for May 1993 adds to the expected inflation rate. Parallel to the de-facto pegging of the nominal exchange rate at a time of increasing inflation, demonetization has increased and deposits denominated in foreign exchange have significantly increased, both in real and in relative terms.

The Current Account balance has been negative throughout 1992, except in the third quarter when the effects of the short lived free market auction mechanism were experimented. For the whole of 1992, the Current Account is expected to reach a negative balance of 903 million dollars. As it stands, such negative current account balance is expected to be financed mostly through loans from multinational institutions and there is still a financing gap to be provided in the order of 180 million dollars.

Recommendations

The uncertainties and lack of clear definitions on exchange rate policy may have seriously affected resource allocation and proved to be an obstacle to the structural adjustment efforts made in other areas of the economy. A capital market is unlikely to develop in a framework of uncertainty about the level of the exchange rate as well as of the rationing mechanism to be in place. Since October 1992, the rationing of foreign exchange is basically decided by banks with no clear rules established. While the black market exists, it is illegal and not transparent enough to allow for normal supply decisions to be taken through it.

The rationing mechanism in place is a serious obstacle for developments in other areas of the economy and should be changed. The 30% black market premium sets a roof to the amount of devaluation that could take place if full convertibility of the currency (both internal and external) were to be allowed. The first priority should be the granting of full convertibility for the Leu. This step would provide incentives for holders of foreign exchange to supply it in the market with the full assurance that they will be able to get it back, if needed, at the market price. Under present rules, an exporter that sells the foreign exchange through the auction has no guarantee that he may be able to repurchase again.

Full convertibility will not imply a rush for foreign exchange purchases. Both households and enterprises presently purchase dollars at the black market price and deposit those dollars (with no questions asked) at any bank. Therefore, the main effect of convertibility will not be to encourage demand for dollars but rather to encourage the supply of them. A fully convertible Leu will not be weaker but rather it will become a stronger currency.

Of course, full convertibility will be viable only at the price that allows the market to clear. Currently, the price should not be much higher than the 30% black market premium. However, the equilibrium price will be affected by the supply of Lei liquidity in the market. Basically, two factors will determine the future availability of Lei in circulation (and therefore the exchange rate): the credit creation needed to finance the fiscal deficit and the endogenous credit creation through the inter-enterprise arrears. Fiscal tightness and a permanent solution to the inter-enterprise arrears are therefore basic conditions for a stable exchange rate after convertibility is restored.

Restoring only internal convertibility is not likely to work. If the rate is to be fixed, the monetary authorities would need a stock of international reserves that they simply lack. If the rate is to float, capital flows will be necessary to stabilize it in the face of the natural instability of the daily flows of international trade. As it stands, nobody would supply foreign exchange on a day in which exports supply is short of demand as he may not be legally able to demand the funds when the situation is reversed.

If full convertibility is restored, after the initial devaluation, the rate in the interbank market should be free floating, subject to operations of the NBR with its own reserves aiming to stabilize the real exchange rate around its medium term equilibrium path. Under no circumstances should the NBR intervene to stabilize the level of the nominal exchange rate with inflation at the 10% monthly level as it has been the case in the last three months (September-November 1992). The outcome of such an operation would be the depletion of the foreign exchange reserves and the restoration of rationing.

V-PRICE CONTROLS AND GOVERNMENT SUBSIDIES

Subsidies Under the centrally planned economy, a wide variety of producer and consumer goods were subject to subsidies that allowed them to be priced significantly below their market equilibrium level. The basic structure of subsidies still remains in operation, although their relative size has been somewhat reduced. Not only do subsidies have a high fiscal cost and distort resource allocation, but they became the justification for the imposition of export controls on the products they subsidized.

In part, the subsidy structure is the result of another widely used instrument in the CPE: price controls. In general, controlled prices are set at levels below equilibrium and the subsidies are needed to help the financial equilibrium of the enterprise (in any event, any financial disequilibrium remaining would be solved through the global compensation of arrears).

There are nowadays three basic sets of subsidies, all administered by the Ministry of Finance, at the expense of the Central Budget;

(i) Subsidies to cover the losses of the Autonomous Entities (Regie Autonomie). These subsidies cover the enterprises' losses and are not associated to their output or level of costs. Presently, only RAs in the areas of mining, water transport and train track construction and repair are subject of this subsidy.

(ii) Subsidies to the Population, applying to a wide range of products that are subject to price controls. The subsidy covers the difference between the unit cost and the controlled price (tariff).

(iii) Subsidies to cover the losses of Public Institutions. These are not very relevant from a financial point of view.

In addition to the subsidies of the Central Government, local budgets also grant subsidies, mainly to energy and to public transportation.

From a perspective of resource allocation and financial costs, the subsidies to the population are most significant. The most costly item is the subsidy for home consumption of electricity: while the KW is sold to enterprises at Lei 22.5 (this amount is close to production costs, although there are some differences that are analyzed in detail in Chapter xxx), it is sold to households at only 6 Lei. In 1991, the cost of the subsidy to electricity was 1.56% of GDP.

TABLE 6
FISCAL COST OF SUBSIDIES
(In Bn. of Lei, and in % of GDP)

CENTRAL GOVERNMENT	<u>1991</u>		<u>1992 (est.)</u>		<u>1993(proj.)</u>	
TOTAL	113.0	(5.37%)	493.0	(8.96%)	653.0	(5.26%)
Regie Autonomie	48.0	(2.28%)	104.0	(1.89%)	245.0	(1.97%)
S. to the Population	65.0	(3.09%)	389.0	(7.07%)	408.0	(3.29%)
LOCAL GOVERNMENTS						
Energy and Transport	23.8	(1.13%)	103.0*		n.a	
TOTAL SUBSIDIES	136.8	(6.51%)	33.0*		n.a.	

*/ Values from the 1992 budget. Revised actual numbers for 1991 are not available, but the projected subsidy of the local governments of Lei 136 billion was 39.8% of the initially projected amount of 341 billion Lei for the total subsidies of the Central Government.

Source: Ministry of Finance

The range of goods included in the consumer subsidies is wide and intends to cover those products that are high in the consumption basket of the poorest: electricity, burning gas, lignite, bread, school books, powdered milk, imported wheat, city transportation, oil, sugar, meat, salami, several types of orthopedic products, etc. The production of a wide range of agricultural fertilizer is also included under this heading.

For May 1 1993, authorities have announced the complete elimination of all subsidies to the population both for the Central and Local governments. The relevance of such move is highlighted by the fact that in 1992 those subsidies are expected to have a cost of 9.5% of GDP (assuming actual subsidies from the local governments stay at the projected 136 bn.Lei). This change is expected to have wide implications for resource allocation and income distribution. It is obvious that, as was the case in September 1992, the elimination of the subsidies will also have a toll on the inflation rate.

The complete elimination of the subsidies is a courageous decision that marks a most necessary step to implement a functioning market economy in Romania. As the situation stands, price controls give raise to the need of subsidies and rationing, including rationing of foreign exchange and export quotas.

It is assumed that the elimination of subsidies will be simultaneous with the elimination of price controls on those products. Otherwise, the fiscal cost of the price controls will have to be substituted by a probably more costly (socially) system of rationing.

Table 6 describes the fiscal costs of the system of subsidies for 1991, 1992 and the estimates for 1993. It is clear that subsidies are a most significant item of budgetary expense. They are designed to maintain the relative price structure of the old Centrally Planned economy and they stand against market reform, transformation of the economy and fiscal balance. Their elimination is a welcomed development. However, authorities should take care of the income distribution costs this may imply as well as the impact effect on inflation. In this last matter, fiscal and monetary restraint are essential in order not feed back the initial inflationary effect of lifting the subsidies.

Price Controls Widespread government intervention into the determination of prices is still in use. Prices of all products subject to subsidies are fixed by governmental decision every few months. In addition, prices of a wide range of consumer and producer goods made at state enterprises are also subject to control as well as the prices of all those products that are produced by less than three firms. Although there is no available estimate about the economic importance of the set of controlled prices, it seems that most products in the economy are in one way or the other subject to some control. There are three ways to exercise control:

(i) Direct determination of a maximum price (Gov. Decision 776 of 1991 establishes maximum prices for 35 products, mainly in the area of energy and fuels. This list has been modified several times since).

(ii) Approval by the Ministry of Finance, Industry or Agriculture of a price resulting from a negotiation between the suppliers and customers. Prices to be negotiated are set by Government Decision 776 and they encompass a wide range of products including raw materials, intermediate products, electrodomestics, metals, fuels, transport equipment, medicines services, food and agricultural products. Inflation has insured that the controls are not as strict as intended: at present negotiated prices can be adjusted every 30 days with approval of the relevant Ministry. All goods with less than three suppliers are also subject to the process of negotiation.

(iii) Commercial margins for all goods produced by state enterprises are to be approved by the Ministry of Finance. As approvals are easily granted, this regulation is not actually binding.

An example of the distortions introduced by the system of price controls is the case of electricity which is a regulated price under category (i) so that any adjustment has to be approved by Governmental Decision. In last September, by Gov. Decision, the electricity company RENEL was allowed to incorporate into its price the effects of the devaluation that took place between May and July, therefore adjusting the rate to an exchange rate of Lei.360. Since then, and up to December, the exchange rate has increased to Lei 430 but RENEL has not received any authorization to increase its tariff. Energy is periodically rationed to industrial users causing all the inconveniences that such uncertainties generate on the rate of production. Long queues for gasoline (each of about 500 meters) and the almost total lack of supply of fresh milk products are also examples of scarcities created by the price control mechanism.

VI-GLOBAL ASSESSMENT AND POLICY RECOMMENDATIONS

Trade expansion requires investments that cannot be evaluated without a framework of macroeconomic stability and clear market rules. In this respect an efficient FOREX allocation mechanism is a must, but not the only requirement these days in Romania. Privatization is far from complete and in consequence there is no local household capital with which to finance the required industrial restructuring. Securities against the capital of the state enterprises should be distributed to the public and these should be negotiated in a capital market. The inter-enterprise arrears were traditionally pardoned once or twice a year in Romania and this behavior is inconsistent with a market economy that aims to develop a capital market in the context of monetary stability. Authorities must implement a permanent solution to the arrears problem. A permanent solution means that the responsibility of the arrear must be shared exclusively by borrower and lender. Implementing the Bankruptcy Law is necessary to deal with the creation of new arrears but will doubtfully be able to deal with the large stock of inherited arrears. It is recommended that this stock be securitized through the issuance by the debtor of a preferred corporate bond, negotiable and yielding a positive real interest rate.

Export quotas, temporary import surcharges and selective price controls remain in place and add to the generally uncertain regulatory framework within which decisions have to be made. Allowance for freely determined interest rates and competition among banks as done early in the program is a welcomed event; however, several lines for subsidized credit remain within the National Bank and other state banks. Such subsidized credit may further distort resource allocation at a time when permanent and profitable investments are most needed.

There is a significant amount of confusion in the market about the high level of the nominal interest rates that, however, may end up being negative in real terms after allowance is made for expected inflation. However, while one can make relatively easy predictions of inflation at the aggregate level, each agent may not feel sure about his possibilities of increasing his price (or wage) in line with the general level of prices. In this respect the implementation of credit lines indexed to relevant indicators such as wages(for mortgages) or the export exchange rate (for export prefinancing) should be studied.

On the fiscal side, authorities have shown great restraint in spite of the enormous social costs that the transition is implying. Fiscal restraint is good to the extent that it helps prevent an even higher inflation that would compound the social costs and delay the adjustment. At this point we observe a tendency for inflation to accelerate due in part to non monetary factors such as price liberalizations and the expectation of devaluation. Under those circumstances, any further efforts to keep monetary discipline and especially fiscal restraint are more than welcomed. In this respect, in 1993 the nominal capital gains derived from the revaluation of gold should not be monetized and spent as in previous years but rather be used for non expansionary purposes, among which the most common use given elsewhere is the capitalization of the Central Bank.

The current system of allocation of foreign exchange does not help resource allocation nor does it facilitate the conduct of production decisions or international trade. As it stands, the system combines the worst aspects of a free market determined exchange rate with those of rationing, without receiving any of the benefits of either system. The possibility of flexibility at a time when authorities are interfering to keep the rate stable generates the expectation of a devaluation and this encourages exporters to retain foreign exchange. The scarcity of foreign exchange is very damaging for production at a time of severe slump.

Since October 1992, authorities have set the price of foreign exchange at a non equilibrium level and passed the problem of rationing on to the commercial banks and the illegal black market. This attitude does not solve any problem: the foreign exchange market is not free nor is the rationing efficient.

Authorities should study the possibility of restoring full convertibility to the Leu (both for capital and current account transactions) in the context of a managed float aimed at keeping the real exchange rate along its medium term equilibrium path. Full convertibility would restore confidence in the national currency, encourage capital inflows and provide exporters with incentives to sell their foreign exchange thus helping to reduce the shortages.