From Socialism to Capitalism - Transition Economies: Romania

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by

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ABSTRACT

FROM SOCIALSIM TO CAPITALISM – TRANSITION ECONOMIES: ROMANIA

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East-Central Europe has experienced dramatic changes as the early 1990s brought an end to the socialist regimes of the former Soviet Union satellites. In understanding the transition those countries have undergone from socialist to capitalist arrangements, it is necessary to appreciate the essential differences between the two systems. This thesis starts with a presentation of the basic characterizing features of socialism and capitalism as they have been manifested in practical application. The description of the fundamentals of the opposing ideologies is followed up by a discussion of the transition from one to the other, with a particular emphasis on the problem of soft budget constraints.

Although the transformation of the former socialist regimes of East-Central Europe was not pursued through identical approaches, it can be described by a number of common phenomena including instability, high inflation, and significant declines in output. Romania is observed as a case study of transition, having displayed a more reluctant commitment to change. The gradualist attitude of the first years of transition brought modest growth and restructuring. A switch to more radical reforms in the late 1990s and dedication to the goal of EU integration resulted in significant improvements and led to Romania’s acceptance as an EU member nation. This paper offers an overview of its transition and economic performance during the almost two decades since the country’s 1989 revolution.
From Socialism to Capitalism - Transition Economies: Romania

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INTRODUCTION: TWO SYSTEMS

Economic theory and empirical evidence, though they might prove divergent on various issues of differing degrees of importance, converge on the subject of systemic economic organization. Both the testament of history and the realm of disciplinary hypothesis point to the existence of, “fundamentally… only two ways of co-ordinating the economic activities of millions.”1 Specifically, “one is the central direction involving the use of coercion,” while “the other is voluntary co-operation of individuals.”2 The past century of economic reality has presented these systems under two principal forms.3 The former, implemented through some version of a “totalitarian state” has taken the shape of socialist regimes, while the latter, of “society organized through voluntary exchange,” as a “free enterprise exchange economy,” is “competitive capitalism.”4

The ideological parents of these opposite approaches both sought the same apparent result. Adam Smith saw capitalism as the path to “universal opulence which extends itself to the lowest ranks of the people,”5 while Karl Marx considered the competitive capitalist pursuit leading to “anarchy, crisis, and the dissolution of the private property-based system itself.”6 He instead supported an alternative method, “one based on the social or public ownership of property.”7

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2 Ibid.
7 Ibid.
The difference between the two systems is essentially based on the political link to the economic decision-making entity characteristic of each. One claims private enterprise while the other advocates public control. The anointment of the state as a substitute for the individual introduces the element of closer political involvement in economic certainty. Theoretically, it is “possible to have economic arrangements that are fundamentally capitalist and political arrangements that are not free.” Capitalism “can operate under dictatorial regimes as well, as long as the political powers are friendly to private property, free enterprise and freedom of contract between individuals.” However, “historical evidence speaks with a single voice on the relation between political freedom and a free market.” It is the realization of this interconnectedness that led Milton Friedman to recognize economic freedom as a “necessary condition for political freedom,” and Adam Smith to declare it, “a fundamental human right,” while labeling the deprivation of the “great people” of “employing their stock and industry in the way that they judge most advantageous” as “a manifest violation of the most sacred rights of mankind.”

The twentieth century experience of the Soviet Union and of those countries of East-Central Europe to which the Soviet influence spread serve to bring into painful relief the reality of the interdependence of democracy and competitive capitalism principles. Friedman’s belief that “communism would destroy all [of our] freedoms,” stands justified and further validated by the subsequent overthrow of the communist regimes in those

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11 Ibid.
nations and their transition to a free market, capitalist system. The transformation from a socialist to a capitalist framework requires an understanding of the principal characteristics of the two systems and the reasons rendering a transition from the former to the latter necessary.

SYSTEM CHARACTERISTICS

The ideological features of each system are extensive and a thorough presentation of the connotations of the respective terms would greatly exceed the point and scope of creating a practical understanding of the nature of real application as observed under so-called “existing” socialism and capitalism. A more useful characterization is based on the defining aspects of political power, distribution of property rights, coordination mechanisms, behavior of economic actors, and typical economic phenomena of each system. The first three of those categories under “existing socialism,” can be summed up by undivided power (of the governing party), dominant state position and ownership, and (preponderance of) bureaucratic coordination, respectively. The range of economic socialist behavior includes “soft budget constraints, weak responsiveness to prices, plan bargaining, [and] quantity drive,” while the resulting economic environment features chronic shortages, “sellers’ market, labor shortage, [and] unemployment on the job.” Conversely, under a capitalist system political power is friendly to private property and to the market, property rights give dominance to private property, and coordination belongs primarily to the market. Economic agents’ behavior is characterized by hard budget constraints and strong responsiveness to prices, while the environment created does not

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14 Ibid.
15 Ibid.
16 Ibid.
consist of chronic shortages and is typified by a buyers’ market, chronic unemployment and business cycle fluctuations.\textsuperscript{17} It is essential to recognize that the defining features of the two systems are founded on the preeminence of certain characteristics, not their sole existence. Thus, capitalism “calls for dominance of private property,” without requiring that it is the only form of ownership that may occur.\textsuperscript{18} Similarly, it is to be expected that any of the other elements normally characteristic of socialism may be observed in a capitalist environment, and vice versa, as long as they constitute a modest and non-defining aspect of economic (and political) reality.

The transition from socialism to capitalism inherently requires a complete reversal of the system, visible in the transformation of each of the stated characteristics. Before approaching the subject of transition, however, the natural question of the transition’s vitality arises. It is necessary to address the reasons that suggest that a transition is essential and that prove that the reality constructed by one system is desirable over that of the other. Therefore, it becomes imperative to posit the question, ‘why capitalism,’ and effectively, ‘why not socialism?’

**WHY CAPITALISM? WHY NOT SOCIALISM?**

To the latter question, the answer is simple: because socialism failed.\textsuperscript{19} Its failure became not only evident through its eventual dissolution in most nations in which the communist experiment was conducted, but also in the lack of success of the ideological predictions of socialism to materialize. As stated by Leszek Kolakowski, the former leader of the Polish Communist Party, “all of Marx’s important prophecies turned out to

\textsuperscript{17} Ibid.
\textsuperscript{18} Ibid.
\textsuperscript{19} It is necessary to mention that ‘socialism’ in this paper refers to ‘existing socialism,’ or socialism as it has been observed in application in the communist regimes of the Soviet Union and its satellites.
be false.” More specifically, capitalism did not lead to a decline in the rate of profit as more capital accumulated, neither did it cause the “immiserization of the working class,” but quite adversely, produced a growing middle class and rising standards of living. Furthermore, despite fluctuating business cycles, capitalism continues to prosper, while the opposite is true about socialist societies. In short, reality might give justification to the claim that “as a prophet Marx was colossally unlucky and his system colossally useless.”

Contrasting the fate of two opposing systems, it may be argued that the failure of one may not axiomatically legitimize the adoption of the other. In the context of the socialism-capitalism debate, it inevitably follows up socialism’s failure with, ‘why capitalism?’ The answer lies in the two principal results of capitalism, namely democracy and faster technological development. The merits of democracy can be viewed from the perspectives of instrumental and intrinsic value. The instrumental value of democracy rests on the argument of economic growth and material welfare, while the intrinsic value consists of guaranteed political freedom and the prevention of tyranny. Perhaps the greatest harm wrought by communist regimes was the ideological monopoly which they inherently dictated. “Under full-fledged, stabilized socialism there is no open competition between alternative ideologies for the hearts and minds of the population.

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22 It is necessary to note that in the case of socialist societies that seem to be flourishing (i.e. People’s Republic of China), economic prosperity has come with the introduction of capitalist measures, not under strict typically socialist policies.
25 Ibid.
The bureaucracy enjoys an almost full ideological monopoly." Ideological circulation and debate leads to civilization’s advancement and progress both theoretically and practically. The inhibitive socialist environment furthered the effects of the restrictive nature of a non-competitive system which stymied the drive for innovation. The second main advantage of capitalism is the greater technological development achieved through the encouragement of entrepreneurial initiative and innovation, making more effective the use of human and physical resources. Empirical evidence confirms the faster growth of capitalist economies when compared with that of socialist countries’ with similar levels of development. Considering Lenin’s claim that “socialism calls for greater productivity of labor – compared with capitalism and on the basis achieved by capitalism,” history serves as a natural reproof of communism and as an argument for capitalism.

THE TRANSITION IN THEORY

Analyzing the transition from socialism to capitalism, it becomes helpful to consider the reversal of the process of socialization. The emergence of socialism was not natural. “Socialism did not arise by organic development: the socialist system does not originate spontaneously from the intrinsic, internal forces of the economy. Instead, the socialist system is imposed on society by the communist party with brutal force, when it gains power. It liquidates its political opponents and breaks up any opposition.”

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28 Ibid.
effect the antithesis of communism, capitalism should be expected to be built under opposite conditions. In other words, “capitalism does not need to be imposed on society.” While debate exists over the naturalness of the market and its spontaneous or imposed nature, history shows that minimal measures toward a free-market (i.e. the removal of barriers to capitalism) have naturally stimulated development in the private sector. It is evident that a system which implements “ideological monopoly,” and “liquidates its political opponents...and [breaks up] any opposition,” does more than to install itself as the sole mode of operation. It not only rids society of alternatives themselves, but also of any means of achieving alternative ends. It depletes society of the tools through which other systems could be pursued, both materially and ideologically. The unaided transition to capitalism is therefore one lacking all instruments through which capitalism can be achieved other than the idea and desire for change. Thus, while inherently society may gravitate towards a free market, “capitalism speeds up significantly if the state is an active assistant.” Fundamentally, the socialist process of free enterprise elimination must be reversed through “a legal infrastructure that protects private property and enforces private contracts and financial discipline.”

The transition may assume one of three main political characters, specifically, the replacement of the communist dictatorship by another dictatorship of anti-communist orientation (e.g. the White terror in Hungary, or Pinochet’s dictatorship in Chile), the emergence of a democratic system as a result of a ‘velvet revolution’ (as it happened in the early 1990’s in Eastern Europe), or an internal transformation of the communist party

31 Ibid.
32 Ibid.
33 Ibid.
34 Ibid.
35 Ibid.
towards a pro-capitalistic system (as is the case with the People’s Republic of China).\textsuperscript{36} Whether the existence of a traditionally socialist system politically with a capitalist system economically is possible remains to be seen. Friedman denounced the view of “democratic socialism” as “a delusion,” claiming that “there is an intimate connection between economics and politics, that only certain combinations of political and economic arrangements are possible, and that in particular, a society which is socialist cannot also be democratic, in the sense of guaranteeing individual freedom.”\textsuperscript{37} The point of interest of this paper is not the possibility of such a duality, but the second type of transformation, that of the substitution of a democratic system in the place of the preceding socialist regime. The history of the former Soviet Union and its satellites is such a case, and it is the transformation of Eastern Europe which constitutes the subject of this thesis.

**TRANSITION PROBLEMS**

The transition from the constraints of communism to democratic freedom, both economic and political, represents a process of full rotational change that can justly be expected to be accompanied by varied transformational difficulties. Some problems are due to the low level of development resulting from the inefficiency of the socialist system.\textsuperscript{38} Others arise simply because the nation is found in transition and the institutions ensuring the effective operation of the new system have not yet been developed. While the amelioration of the first category of difficulties is contingent on time and lasting growth, problems of the latter set may be reduced through appropriate


\textsuperscript{38} Ibid.
government measures.\(^{39}\) Other reasons for discontent, and thus impediment in the process of transition, occur because of certain inherent disadvantages of the capitalist system, such as chronic unemployment and varied wage levels and income inequality.\(^{40}\) Those aspects of capitalism, though their classification as disadvantages may be argued, are phenomena to which citizens of post-socialist countries are not yet accustomed, and thus may create resistance to change, as the long-term benefits of the transition are obstructed by the human tendency to cling to the familiar. Additionally, even after the implementation of a democratic capitalist system, the consequences of the policies of the old regime are likely to be experienced. The actions that must be taken to combat the legacy of the prior system could be harsh and disillusioning to the population.\(^{41}\)

**SOME SOLUTIONS**

The obstacles of the transition may be alleviated through the attitude and prioritization given to the various measures of the transformation. “The most important strategic decision is the sequencing and speed of transition.”\(^{42}\) “Shock treatment,” in the pursuit of stabilization should be adopted for countries which “face an unusually large macroeconomic disequilibrium.”\(^{43}\) Infrastructural reforms that help to support stabilization policies must be introduced and followed immediately.\(^{44}\) Agreements with international and regional organizations can help to increase the credibility of the government both in its commitment to change and in its ability to effect that change.\(^{45}\)

The credibility problem of transitional governments, both domestically and

\(^{39}\) Ibid.
\(^{40}\) Ibid.
\(^{42}\) Ibid.
\(^{43}\) Ibid.
\(^{44}\) Ibid.
\(^{45}\) Ibid.
internationally, rests partly with the setting of unrealistic expectations: “If government policies lack credibility, are hesitant, and full of unworkable compromises, then managers and individuals will refuse to change their behavior to fit the new policies.” Countries emerging from decades of oppressive and constrictive regimes tend to hold very high expectations for immediate improvements, which are reinforced by government promises. The failure of the near-future to deliver those hopes can result in disenchantment with the idea of change, lack of motivation in participation towards a seemingly intangible ideal, and perhaps an attitude of preference for the former system which at least offered familiarity and the surety of expectations, even be they less than enticing.

THE SOFT BUDGET CONSTRAINT

Before embarking on a description of the general conditions on the eve of transition in East-Central Europe, it is necessary to expand on one of the defining characteristics of a socialist system. Specifically, the concept and role of the soft budget constraint in the creation of an inefficient economic system must be explained. Once the soft budget is presented, the requirements for progress towards the capitalist environment of hardened budgets become obvious.

The designation of the soft budget constraint (SBC) emerged to reveal “economic behavior in socialist economies marked by shortage,” and to describe “a central policy issues in transition economies.” The so-called “SBC syndrome” has become a staple feature of socialist economies in the transitional process of implementing market

46 Ibid.
47 Ibid.
reforms. In effect, change is attempted while the economic legacy of the socialist system remains active. That legacy consists in the survival of firms despite their inefficiency and inessentiality. In centrally planned economies demand exceeds supply and firms do not produce “as much as is effectively possible,” but instead “as little as is allowed.”

This phenomenon was possible because the budget constraint, the provision that a firm “must cover its expenditures out of its initial endowment and revenue,” a condition which would lead to the optimizing behavior of the firm, was relaxed. Thus, in socialist systems, even firms that would normally (under a hardened budget constraint) be forced to reduce or cease activity in the case of persistent deficits which they cannot cover without the aid of an outside organization (a “supporting organization”), were allowed to continue operations. The supporting organization in the context of centrally planned economies was embodied by the state, which bailed out chronic loss-makers with various instruments including financial subsidies. In East-Central socialist economies, the “prevalent form of budget softness was accumulated tax, social security, and wage arrears,” but the range of rescue methods is considerably more expansive and extends to capitalist economies through institutions such as “state subsidies to agriculture and assistance to ‘rustbelt’ industries.” Additionally, budget softening can take the form of

49 Ibid.
52 Ibid.
53 Ibid.
credit or indirect means of support, such as restrictions on competitive imports or other barriers to foreign competition.\textsuperscript{56} Through such mediation, the expectation of survival even after inefficient production and losses shaped the behavior of socialist firms and characterized the attitude that they would carry into transition.\textsuperscript{57}

The uncertain nature of the transition offered additional incentives to support unsustainable firms. The high expectations of the population coupled with the inherent negative consequences of the instability of change carried on by agents lacking the necessary resources to effect it efficiently provided the basis of support for firms and constructions on which the perceived well-being of the population was somehow dependent. Particularly, “social insurance institutions covering large numbers of people have not been permitted to go bankrupt.”\textsuperscript{58}

Motivations for the support of failing companies are numerous. The natural termination of loss-making institutions would result in the unemployment of many workers, a situation which could result in unrest, especially in a system of political volatility.\textsuperscript{59} Additional reasons include feelings of paternalism, political strategies for garnering support and influence, and the fear of “spillover effects” resulting from firms of economic weight, or which are “too big to fail.”\textsuperscript{60}

The fact that bailouts, or rescue efforts, are observable even in capitalist environments both at the national and the international level seems to confer soft budgets a validity that is not extended to their typically socialist application. The question of the justifiability of such measures, or of the degree to which they should be tolerated and

\textsuperscript{56} Ibid.
\textsuperscript{57} Ibid.
\textsuperscript{58} Ibid.
\textsuperscript{59} Ibid.
\textsuperscript{60} Ibid.
pursued, has gained a somewhat increased importance today. Yet, whether the phenomenon is deemed defensible or not, the certainty of real conditions for its existence is undeniable.

The reality of at least a handful of preconditions for soft budgets cannot be negated. Firstly, the simple implementation of bailout policies in the past suggests the continuation of them in the future. The precedent of rescue generates the expectation of mutually understood involvement in the case of recurring problems. Secondly, the lack of credibility of ex ante promises not to extend rescue help has little effect in motivating the reduction of the chance of failure. Lastly, though the costs of bailouts may be high, especially in long-term interventions, social and economic disruptions caused by allowing certain institutions to fail may be even higher, and the “preservation of national stability,” will take precedence over considerations of bailout repercussions.61

The practice of perpetuating soft budgets leads to recognizable patterns of economic behavioral aberrations. Among these distortions in economic comportment is “the attenuation of the managerial effort to maximize profits, or when there is no profit motive, to reduce costs.”62 Additionally, the drive to innovate and develop new technologies and products is diminished, and firms change their focus from the customer to potential support organizations through rent seeking.63 Soft budgets reduce the vitality of the relationship between expenditure and revenue and may result in the assumption of undue risk, by transferring the burden of risk away from the investor.64 “Runaway demand and overinvestment in risky ventures may lead to economic expansion,” a

61 Ibid.  
62 Ibid.  
63 Ibid.  
64 Ibid.
phenomenon that constitutes “one of the fundamental explanations for why socialist economies were characterized by generalized shortages.”

As previously mentioned, the failure to innovate, which can be “directly related to the SBC syndrome,” was a principal cause of the lagged development of the socialist systems, and the reason for their ultimate termination. Both the lack of incentive to optimize products and services resulting from the inexistence of the competitive market and the nurtured incapacitation to detect and choose appropriate ventures for investment produced a system of insufficient quantities of poor quality outputs. Whether the limited access to sub par products was an unintended benefit to be desired to the alternative of an abundance of potentially utility diminishing goods (or disutility creating), is not a question which can in this case be objectively evaluated.

In the successful transition to a capitalist system the preponderance of soft-budget institutions must be eliminated. Theory suggests that hardening budgets have the effect to “promote restructuring, raise total factor productivity, and encourage the shedding of surplus labor,” while historical experience shows that hardened budgets have indeed “had a beneficial effect on enterprise restructuring in Eastern Europe.” The efficient reversal to hard budget constraints rests on “the ability to enforce tax obligations and private contracts.” In other words, firms must be trained to achieve financial and investing responsibility. Payments and other financial obligations must be severely pursued, an attitude which undoubtedly adds additional stress in periods of instability, reason for which it has been avoided through the perpetuation of rescue policies.

65 Ibid.
66 Ibid.
67 Ibid.
68 Ibid.
Hardened budgets alone, however, do not constitute a comprehensive problem solving formula. Hardened budgets have the beneficial effect of enhancing passive restructuring, or the reduction of excess labor, by fostering rationalization of costs.\textsuperscript{69} Active restructuring – new fixed investments – is only achieved through the availability of external financing.\textsuperscript{70} “Tightening of bank credit may raise enterprise efficiency in the short run but at the cost of curtailing investment. This impasse can be solved only with the development of an efficient financial sector that is capable of ensuring financial discipline and channeling resources toward good investment opportunities.”\textsuperscript{71}

The pursuit of executing integrated restructuring thus implies both the installation of a factually responsible financial infrastructure as well as its success in inspiring credibility in its ability to practice disciplinary and regulatory enforcement. The actual functioning of the financial sector following budget hardening ensures the achievement of passive restructuring. The credibility of the system forms the requirement for attracting and capturing external financing for investment.

TRANSITION IN EAST-CENTRAL EUROPE

At the onset of transition, the inefficiencies of soft budgets were not the only characteristics of the former socialist states in East-Central Europe. Normal market institutions had been destroyed through decades of communist rule to such extent that “the most basic of categories of economic life in a market economy,” including “corporations, bankruptcy law, securities trading, [and] collective bargaining” needed to

\textsuperscript{70} Ibid.
\textsuperscript{71} Ibid.
be reinstated.\textsuperscript{72} The legacy of the socialist system was inefficient heavy industry, neglect for consumer needs, inappropriate industrial structure, and ecological degradation.\textsuperscript{73} The initial period of transition was thus characterized by instability, high inflation, factory closings, and sharp declines in real GDP.\textsuperscript{74}

The most striking feature of the transition is perhaps the much greater than expected fall in output. The phenomenon has multiple potential explanations. One possibility is the overly restrictive stabilization policies implemented immediately in unstable political and economic environments. The institutional framework left by the centrally planned economy that preceded the transition, which at best was inadequate though it might rather be deemed inexistent, offered no structural support for the execution of such strict programs. Some stabilization policies may thus have been too ambitious for the existing economic conditions.\textsuperscript{75} A second explanation is that the disbanding of the CMEA (Council for Mutual Economic Assistance), which accounted for a large portion of trade in transactions conducted with the Soviet Union, resulted in the considerable reduction of trade with its former members.\textsuperscript{76} The collapse of the CMEA may have contributed to a so-called “trade implosion,” or “trade destruction,” due to the inexistence of market institutions, and which became significant in the context of underdeveloped credit markets.\textsuperscript{77} Its dissolution could be interpreted as the natural fate

\textsuperscript{72} Ibid.
\textsuperscript{73} Ibid.
\textsuperscript{75} Ibid.
\textsuperscript{76} Ibid.
of an organization whose activities were no longer relevant, since the parameters of its competitiveness were removed.\textsuperscript{78}

One aspect of the output collapse was that it started before any reforms were implemented, suggesting that another one of its causes was a state of economic limbo, of virtually no direction either centrally or market oriented.\textsuperscript{79} Additionally, the process of resource allocation to newly profitable activities inherently imposed a period of adjustment and consequent productivity decline.\textsuperscript{80} Other macroeconomic factors influencing the downward trajectory of output may include the combination of the process of price liberalization and the policies implemented to control inflation which led to declines in real wages, money, and credit, as well as an increase in domestic energy prices due to reductions in energy subsidies, and binding credit limits which could have reduced available capital.\textsuperscript{81}

While transition efforts were characterized by a quick fall of output and the setting of inflationary persistence, they were accompanied by slow structural adjustment and privatization.\textsuperscript{82} Although small-scale privatization in trade and services experienced initial success, the privatization of large-scale enterprise especially in manufacturing remained at a “virtual standstill.”\textsuperscript{83} The reasons for lagged large-scale privatization rang from legal and political reservations to the practical lack of investors.\textsuperscript{84}

\begin{footnotes}
\item[79] Ibid.
\item[80] Ibid.
\item[81] Ibid.
\item[83] Ibid.
\item[84] Ibid.
\end{footnotes}
Considering the inefficiency of the socialist system of production based on heavy industry, the reticence of economic agents to participate into the privatization efforts of unfit facilities and operations could simply be declared as common sense. However, it is very likely that even had domestic investors the desire to venture into the realm of large-scale privatization, in the initial period of transition they lacked the means to achieve it. In fact, the predominance of small-scale enterprise that sprung up following the institution of the market can serve as an indicator of the investing possibilities of the economy. The extent of liberalization may thus represent the maximum level of practical investment which economic actors could undertake at the respective time.

There are at least two additional realities of transitional economies which must be addressed. One is the legacy of bad loan portfolios and enterprise arrears. The “existence of a large bad loan portfolio,” is “one of the causes of the persistence of large gaps between the deposit and lending interest rates,” and it “may distort the relative creditworthiness of enterprises,” even if it my not reflect their potential profitability. Continued borrowing poses the problem of survival versus adjustment. While ideally this issue should be resolved by restructured banks, the poor qualifications of the financial institutions themselves, their relative continued dependence on the central bank, and conflicting interests attendant in the process presented a vicious circle of insolvency.

The last aspect of transition which will be discussed is the attempt to achieve fiscal balance, or to advance towards hardened budgets. “A key feature of the initial

85 Ibid.
86 Ibid.
87 Ibid.
88 Ibid.
stabilization phase in all cases has been the balancing of the budget, primarily through a substantial permanent cut in government expenditure on good and services subsidies.”

As previously mentioned, soft budget constraints have been a characteristic of transition economies, implying that the cut in government subsidies, though they might even have been considerable, were not exclusive or were replaced by other instruments of support to unsustainable institutions. Although state support remained an actuality of transition, the shift from the “relatively egalitarian and well-provided social welfare network into a market system in which all the income and wealth distribution problems, risks of unemployment, and other objectionable social side effects of free capitalism,” generated significant social pressure to continue similar services.

While the validity of the concept of a “well-provided social welfare network” may be debated, its perceived relative desirability to an environment of instability, inflation, and declining output is a certainty. The exigency with which the tendency of transition societies to maintain a grip onto some aspects of socialist mentality is judged should be conducted with an awareness of the ideological and physical resources with which they embarked onto the transitional process. The stability of a concrete system, be it less than optimal, is generally preferred to the tumultuous uncertainty of prolonged revolution. It was not only the drawn out instability accompanying the change that generated apprehension towards volatile alterations, but the failure of the transition to swiftly deliver the expectations that a capitalist system promised. The fact that the society demanded some assurance of future certainty through programs of social welfare was not only natural, but excusable considering that popular mentality, while still holding on to

89 Ibid.
90 Ibid.
the ultimate ideal of effected change, did not possess the answers regarding the specific ways in which to achieve it. The dampened enthusiasm of the populace was not only justified by the inability of the new governments to achieve the changes they promised, but through the nature of those political formations themselves, which, although bearing the name of change, featured the too familiar faces of ex-communist party members.

This having been said, it is necessary to mention that the process of transition, although sharing the same predominant characteristics, varied in each country in which it was pursued. The individual path assumed by the various nations depended on their history and interaction with capitalist ideas, their perceived understanding of the nature of the ultimate result, their endowment of human and physical capital, as well as more practical traits such as the beginning debt position which dictated the specific type of stabilization policies that were to be implemented. The difference between the transition experiences of the countries of Eastern/Central Europe thus consisted not only in the particular measures they adopted but also in the overall approach to change, that of either ‘big bang,’ or of ‘gradualism.’

ROMANIA IN TRANSITION

Before attempting to address the issue of change in Romania, it is necessary to establish the point from which the transition was launched. For this purpose the socialist system prior to the period of transition must be presented. The industrial environment of Romanian in 1989 could be described through three defining characteristics. Specifically, it featured an even territorial distribution of industrial capacities in a socialist attempt to

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pursue the principle of equality. Thus, the 1970s and 1980s sought the extraction of fixed volumes of output from each county regardless of the intrinsic differences in their productive potential.\textsuperscript{92} The second characteristic consisted in the idea of economic self-sufficiency of each country, enacted through an industrialization programme which preferred diversified industrialization to regional specialization and was centered on heavy industry and the transfer of labor from agriculture to industrialization.\textsuperscript{93} The third feature of the system was the increased importance of large-scale industrial enterprises and the subsequent increase of the industrial unit with accompanying urban growth.\textsuperscript{94} The inevitable failure of such a system in which resources are not allocated to their most productive uses and economies of scale are irrelevant seems obvious and indeed eventually led to the system’s destruction.

1989 marked the forty-first and last year of communist rule in Romania. At the time, Romania’s economic system “was perhaps the most centralized and distorted among the countries in the region.”\textsuperscript{95} The December Revolution of 1989 overthrowing the Romanian dictator, Nicolae Ceausescu, marked the bloodiest transition towards a market society of those occurring in East-Central Europe at the time.\textsuperscript{96} The first year of transition, 1990, brought major economic reforms that ended the system of central planning through the elimination of state firm ownership in most areas, liberalization of prices (approximately half of the regulated prices and adjustment of the majority of the

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\textsuperscript{93} Ibid.
\textsuperscript{94} Ibid.
rest to international levels), initialization of liberalization efforts, weakening of wage controls, and relative decentralization of the government. In May 1990, the election of a president and parliament and the drafting of a constitution began the process of redefining the country’s political and legal structure.\textsuperscript{97}

The transitional process in Romania shared the same main characteristics as those of other transforming economies of Eastern Europe: declining output, rising inflation, economic stagnation, growing macroeconomic imbalances, confusion, and instability.\textsuperscript{98} Although a stabilization program was introduced in late 1990, the dysfunctional industrial infrastructure of obsolete technology, energy inefficiency, and ecological disregard, coupled with previously stifled and thus underdeveloped managerial and entrepreneurial expertise formed a less than ideal platform for change.\textsuperscript{99}

At the outset of transition, the attitude of the Romanian population towards the type of binding controls of ‘shock therapy’ that were adopted in other post-socialist nations could be described as apprehensive.\textsuperscript{100} Following the level of centralization from which it had just emerged and the reality of too-near past experiences of communist sacrifice, the Romanian people showed hesitation in accepting the challenge of present compromise for the intangible future, and opted for a slower path to reform.\textsuperscript{101}

In retrospective, the transitional approach of virtually the first decade following the revolution, though it produced results, did not demonstrate the type of catalytic nature that could bear the expected fruits of drastic change. The relatively limited results of the

\textsuperscript{98} Ibid.
\textsuperscript{99} Ibid.
\textsuperscript{101} Ibid.
first part of the transition period cannot be attributed to one single factor, and although
the gradualist manner of transformation undoubtedly played a role, other elements of
transition most likely trumped its influence in determining the speed of change. The
mentality of high expectations for swift significant transformations may seem to
contradict the unwillingness to pursue the process of transition speedily. Yet just as
illogical may seem the hurried pursuit of ideals while lacking the knowledge of the steps
through which to achieve them, the equivalent of making very good time towards a
destination without being quite sure which road leads to it.

Considering the concentrated efforts of the socialist regime on heavy industry, it
should come as no surprise that the most difficult and taxing process of transition should
be industrial restructuring.\textsuperscript{102} Once the market established the inefficiency of the socialist
industrial institutions, their decline was inevitable and resulted in significant labor force
losses especially in those areas where industry had played a considerable role.\textsuperscript{103} As the
uncompetitive products of the inefficiently large iron and steel, and chemical and
engineering industries proved inept to engage Western markets, those sectors suffered
dramatic reductions.\textsuperscript{104} Output and fixed investment fell considerably, further affected by
the disturbance of the revolution.\textsuperscript{105} Real consumption rose, leading to a substantial trade
deficit, as imports of preferred foreign consumer goods rose and exports fell. The trade
deficit was financed by the effective depletion of foreign exchange reserves.\textsuperscript{106}

\textsuperscript{103} Ibid.
\textsuperscript{104} Ibid.
\textsuperscript{106} Ibid.
The labor cutbacks ensuing from decreased output production had to be followed by some sort of solution. A temporary answer consisted in “technical unemployment,” with workers kept on the books but working on a rotational basis. Industry reforms were carried out in the same cautious manner characteristic of the gradual transition of the system as a whole. Thus the restructuring of industry and the removal of subsidies was a tempered process.

Similarly, privatization proved a slow development, both because the skeletons of socialist enterprises required considerable makeovers to be considered worthwhile investments and because of the limited supply of money that was available through the banking system. Privatization in agriculture formed an exception, as lands that had belonged to co-operative farms were privatized and previously peasant-owned plots were restituted to the families to which they belonged before their seizure by the state for the great collective good of the proletariat.

Perhaps the agricultural privatization was more successful because it was an idea which the people embraced with enthusiasm. The opportunity to reclaim ‘mosia stramoseasca,’ or the ancestral estate, was one step which not only did not present the threat of the unknown, but hinted the promise of rehabilitation to a time that perhaps survived in the social consciousness as one of stability and content. It was thus a measure and on which people could embark full-heartedly and without reserve.

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109 Ibid.
110 Ibid.
In 1986, following the rescheduling of bank debt, the communist regime had pursued the elimination of all foreign debt.\textsuperscript{111} In 1989 Romania could boast the best debt-to-GDP ration in Eastern Europe and foreign reserves in excess of 1.7 billion US dollars.\textsuperscript{112} That end was achieved, however, through severe measures, trade surpluses, and the compression of imports.\textsuperscript{113} As a result, at the beginning of its transition Romania had no external debt and was thus less dependent on export trade with the CMEA, although its dependence on CMEA imports was significant.\textsuperscript{114} The effort of paying the external debt produced a decline in real gross investment and consequentially an ever more inadequate capital stock, which together with a growing shortage of inputs and their substitution for imported ones led to the fall of the rate of growth of value added by the domestic industry.\textsuperscript{115} At the beginning of 1991 a program of substantial price liberalization and elimination of price subsidies was implemented. Because by that time Romania lacked foreign reserves, exchange rate reform let the floating rate be determined by the interbank market, leading to an exchange rate that tripled the previous official rate.\textsuperscript{116}

In the context of reform in the social sector, the market was saturated with numerous deficiencies including information asymmetries and financing, insurance, and

\textsuperscript{114} Ibid.
\textsuperscript{115} Ibid.
\textsuperscript{116} Ibid.
underconsumption problems. The reform of the social sector was not only stymied by these inefficiencies themselves, but they were exacerbated by the unique policies enacted under Ceausescu’s regime during the 1980’s. The social sector during that period was severely underfunded, centralized, politicized, and isolated from international developments. The physical infrastructure deteriorated, equipment and supplies dwindled or became obsolete, and the quality of human capital diminished. While theoretically Romanian professionals were well-trained, the country lacked the knowledge and technology necessary to successfully rebuild infrastructure.

ROMANIA AND THE EU

If the ideological ending of the socialist system can be traced to a specific day, the conclusion of the transitional process to capitalism is more elusive. Supposing that accession to the European Union (EU) may be considered as the practical confirmation of Romania’s “return to Europe,” then its 2007 membership should symbolize the definite end of the period of transition. The process of gaining EU membership might reflect to some extend the process of completing the internal transformation of the ex-socialist system.

The gradualist nature of the economic transition of Romania from socialism to capitalism has rendered the country the “persistent laggard” of the EU. Expressed in other terms, it provided the “poorest ‘goodness of fit’ with the letter and with the spirit of

118 Ibid.
In virtually every area of assessment of transition observed by the EBRD (European Bank for Reconstruction and Development), during the first years after revolution Romania is comparatively the slowest (Fig. 1 – Fig. 8). Although after the government’s professed dedication to more radical reforms in 1996 the gap between Romania and the other East-Central European countries in similar transformation narrowed, before that time not only was transition lagging, it consistently received the lowest score indicative of transition. Far from the high end representative of industrialized market economies (on a scale from 1 to 4), it consistently received the lowest indicator score, specifically in the areas of competition policy, banking reform/interest rate liberalization, and overall infrastructure reform (Fig. 1 – Fig. 3).

Figure 1. Comparative Competition Policy

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121 Ibid.
While in price liberalization (Fig. 4) and trade/foreign exchange system reforms (Fig. 5) Romania succeeded in achieving industrialized standards as early as the mid 1990’s and others, namely privatization (Fig 6, Fig 7) and infrastructure reform (Fig.3) picked up as a result of the EU ascension efforts of 2000-2004, enterprise restructuring
(Fig. 8) and competition policy (Fig. 1), although clearly improving, continue to receive modest scores.

**Figure 4. Comparative Price Liberalization**

**Figure 5. Comparative Trade and Foreign Exchange System**
Figure 6. Comparative Large Scale Privatization

Figure 7. Comparative Small Scale Privatization
Figure 8. Comparative Enterprise Restructuring

In terms of growth rates, Romania followed the pattern of falling output visible in the other transition countries at the beginning, although Romania reached the deepest recession and continued to have the slowest growth until 1992 (Fig. 9). While other countries (with the exception of Bulgaria) achieved relatively stable growth rates afterwards, the political and economic instability of transition in Romania plunged it into another recession in 1997-1998. Output picked up significantly after 2000, and although still fluctuating, it remained strongly in the range achieved by the leading transitional nations.

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122 Data available from the International Monetary Fund. <http://www.imf.org>
Figure 9. Comparative Growth Rates

Romania’s reluctance to fully abandon aspects of the socialist system embodied especially in a large state-owned industrial sector, the persistence of corruption and the inability of the government to gain credibility domestically or internationally in its commitment to reform, served to position Romania at the far end of all ten East European candidates. Furthermore, its responses to EU conditions failed to inspire a dedication to reform, rather suggesting so-called “gate-keeping strategy,” in qualifying for the sake of ‘making the cut,’ without commitment to change. As a result, even after being recognized as a “functioning market economy”, eleven additional measures were added to the list of conditions on which membership in the EU was

123 Ibid.
124 Ibid.
The key to being accepted was its ability to maintain economic stability and to prove fiscal discipline.\textsuperscript{126}

The history of Romania’s transition could be described through instability. The policies of the first dominant political force after the revolution, the National Salvation Front (FSN) encouraged the concept of “economic gradualism,” and trumpeted the slogan of “therapy, not shock.”\textsuperscript{127} While spouting rhetoric, few positive results were achieved as the state maintained control over prices and large portions of firms, and the credibility of the party and of its leader did not leave the sphere of suspicion.\textsuperscript{128} As Iliescu, formerly associated with the communist party, was elected president and the questioning of the elections’ legitimacy was silenced in a less than democratic fashion, the conviction that those in power have sought it for personal gain and not for the interest of the people installed itself in the minds of the population.\textsuperscript{129} Such a mentality, which continues to disseminate an attitude of distrust towards the government, is justified at least in part by a history of blatant corruption and abuses of power. The people’s aversion to practical change, though the idea may still remain enticing, was visible not only in economic behavior, but also in political choice. Iliescu served as president for effectively two terms and a half. Of the four full presidential terms since the revolution, he’s held half of them, the first six years after the revolution, and a normal four year term following the interlude of the Democratic Convention of Romania (CDR).

\textsuperscript{125} Ibid.
\textsuperscript{126} Ibid.
\textsuperscript{127} Ibid.
\textsuperscript{129} Ibid.
The CDR won the 1996 election on a campaign of radical economic reform, and of abandonment of the gradual approach which had produced little results until then. Not only did it win the election but its apparent commitment to hard reforms regained the support of the EU, the G-24, and the IMF. Reception of attempted reforms by the people varied as they were received with enthusiasm that later diminished in the face of failure. Although some positive results were achieved, inflation soared and the economy was hurled into recession (1997-1998), for the second time since the revolution.\textsuperscript{130} The economic climate was characterized by fiscal indiscipline which undermined monetary and exchange-rate policies, persistent inflation, government interference in the operation of the National Bank of Romania, scarce/inexistent foreign currency reserves, and high current account deficits.\textsuperscript{131}

Under these conditions Iliescu was elected again as president in 2000, at the head of FSN’s successor, the Romanian Social Democratic Party (PDSR, soon to be PDS).\textsuperscript{132} The attitude of the party greatly differed from the one of gradualist change it had displayed in 1990. The new Prime Minister, Adrian Nastase, embraced a radical reform attitude, and the party declared its intention to conclude accession negotiations with the EU by the end of 2004.\textsuperscript{133} The ambitious timeframe imposed by such a commitment set the pace for reform. During the next four years average GDP growth, driven mainly by investment and exports, was approximately five per cent, accompanied by reductions in poverty and the fall of unemployment by five per cent.\textsuperscript{134} Furthermore, inflation had

\begin{thebibliography}{9}
\bibitem{130} Ibid.
\bibitem{133} Ibid.
\end{thebibliography}
declined steadily, the level of foreign reserves exceeded national records, and Romania was able to conclude arrangements with the IMF for the first time in five years.\textsuperscript{135} Although the PDS was the largest party in the parliament, and it had successfully overseen the stimulation of the economy, it lost the 2004 elections to the Justice and Truth (DA) alliance as a result of continued popular lack of confidence and the conviction of widespread corruption due to failure to provide higher transparency and accountable policymaking.\textsuperscript{136}

The economic growth of last years has led to Romania’s admission into the European Union. The stimulating role that the objective of EU ascension played is undeniable, as it required the decisive commitment to reform. The next step in Romania’s economic development and European integration is membership in the Economic and Monetary Union (EMU), a goal which has been set for 2014 by the president of the National Bank of Romania, Mugur Isarescu. Isarescu has been the president of the National Bank of Romania since 1990, the longest-serving public official in Romania (and by 2005 the third longest-serving central banker in the world) and has succeeded in maintaining the reputation of the bank as “an island of economic stability and expertise,” in “sharp contrast to the prevailing pattern of post-communist Romanian politics.”\textsuperscript{137} The statue of the bank has been further strengthened through a 2004 amended granting it full independence as a public institution.\textsuperscript{138} Its success in accession depends on the development of its ability to “anticipate and forecast economic developments,” to maintain low inflation, and to execute its responsibilities with the level

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\textsuperscript{135} Ibid.
\textsuperscript{137} Ibid.
\textsuperscript{138} Ibid.
of independence required by the EMU.\textsuperscript{139} The achievement of those goals will be closely scrutinized as fluctuations in world economic conditions are affecting the relative new success of the capitalist experiment in Romania.

\textsuperscript{139} Ibid.
References


*International Monetary Fund.* [http://www.imf.org](http://www.imf.org)


## APPENDIX

### Romania: Structural and institutional change indicators

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<tr>
<th>Year</th>
<th>Enterprises</th>
<th>Privatisation revenues (cumulative, in per cent of GDP)</th>
<th>Private sector share in GDP (in per cent)</th>
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