

Lecture:

Among other things, your textbook includes a discussion of the role of international financial institutions such as the [IMF](#) (the International Monetary Fund) and the World Bank in maintaining currency stability and promoting economic development. Both of these institutions are part of the Bretton Woods system that was devised in 1944, and since then have greatly expanded their activities through the extension of loans based on conditionality to mostly developing countries and former communist states undergoing the transition from centrally planned economies to market economies.

Chapter 9 of the text also discusses the difficulties which some of the former communist states have been experiencing over the last eleven years in attempting to undergo the transition to a market economy. The purpose of this lecture is to link these two issues together by engaging in a case study of the relationship between the International Monetary Fund, and [Romania](#), a former communist state in the Balkans which has experienced a great deal of difficulty in trying to make the transition from a centrally planned economy to a market economy.

The case study focuses on Romanian efforts to undergo the transition since 1996, when a more democratic regime had replaced the ex-communists who had ruled the country since the Revolution of 1989. This case study looks at the domestic factors which have inhibited Romanian economic reform as well as the role of the IMF.

Domestic Obstacles to Reform

What has blocked economic reform efforts in [Romania](#) since 1996? Part of the answer lies in the intersection of the requirements of the international financial institutions and the nature of Romanian domestic politics. The ruling coalition in Romania has been partially captured by vested interests that oppose the full-scale economic reforms needed to create a market economy. The interaction between national and international forces blocked economic reform because it spawned a difficult, two-level negotiating process that required agreement between the IMF and the Romanian government on the one hand, and among the various coalition partners in the government, on the other.

The IMF has been criticized for the rather harsh prescriptions that usually condition the loans it negotiates with recipient governments world-wide. Its overall emphasis seems to be on austerity measures rather than policies promoting economic growth. The IMF has also been criticized for pursuing policies that effectively erode the sovereignty of the recipient states. While some IMF loans contain provisions for unemployment compensation and other social safety nets, the austere conditions generally associated with IMF loans may actually destabilize fragile emerging democracies like post-communist Romania.

The vested interests of the members of the post-1996 ruling coalition have made it difficult for the government to maintain a unified position on economic restructuring. Leaders who have benefited from the partial economic reforms implemented to date have no desire to risk losing their gains by going ahead with a program of full-scale economic reform, as recommended by the IMF.



According to Joel Hellman of the [World Bank](#), "actors who enjoy extraordinary gains from the distortions of a partially reformed economy have fought to preserve their gains by maintaining the imbalance of partial reforms over time." This phenomenon has been observed in other post-communist states undergoing an economic transition. The post-communist electoral winners of 1996 did not oppose the initiation of economic reforms, nor have they sought a full-scale reversal of the reforms. Instead, they have frequently sought to block specific advances in the reform process that threaten to eliminate the special advantages and market distortions that benefit themselves personally.

Romania's Political Algorithm

On the domestic level, the implementation of IMF conditions has also been complicated by the exigencies of maintaining what has been dubbed the Romanian "political algorithm." The government's inability to move ahead with reform can also be explained by the complex political formula for distributing ministerial portfolios among coalition parties.

Economic reform has also been stalled by Romania's political structure. Under the country's semi-presidential system, a relatively weak Prime Minister must deal with cabinet ministers who are not members of Parliament, but representatives of political parties that view the allocation of cabinet portfolios—not policy-making—as the ultimate political goal. The situation is worsened when four or five parties compete for a limited number of high profile posts, such as Finance, which seems to have been staked out by the dominant National Liberals. In addition to designing the cabinet, the political formula is also used to appoint secretary of state positions, even the boards of directors of national companies and banks. This system creates further vested interests that spawn more domestic constraints on economic reform and inhibit the government's ability to fully implement the conditions associated with IMF loans.

Finally, economic reform in Romania has also been slowed because of social turmoil. For example, in June 2000, as the government sought to implement a salary cap at unprofitable state enterprises, to comply with conditions attached to the extension of an IMF standby loan, a new round of labor protests took place in Bucharest.

Romanian Disagreements with the IMF

Romania never received full disbursement (of five stand-by loans negotiated between Romania and the IMF since 1989, none have ever been completely implemented) of a 1997 stand-by agreement because it did not comply with the IMF's requirements. IMF loans are critically needed by a transitional economy like Romania's because they hold the key to other loans and foreign investments essential to propping up the country's declining economy. Romania's international credit rating was dependent upon such international rating agencies as Standard and Poor's, Moody's, Thomsen Bank Watch, and Fitch IBC.

The IMF "endorsement" was especially important to Romania in 1998, when international credit began to dry up in the wake of the Asian economic crisis and the Russian default that year. In addition to its low credit rating, the scarcity of foreign investment in Romania was also due to a lack of transparency in Romania's privatization process. (**Privatization** usually means the selling off of a public enterprise to the private sector), inconsistent and confusing foreign investment laws, and its large, corrupt, and inefficient bureaucracy.



Reform of Banking Systems

The IMF also considered reform of banking systems of transitional and developing countries(plagued by "crony capitalism")to be central to correcting the entire economic system .In the case of Romania, the government had issued high interest treasury bonds to keep corrupt and foundering banks afloat.The IMF and the World Bank successfully pressed the merger of the corruption plagued Bancorex(the Foreign Trade bank) with the Romanian Commercial Bank,but the Romanian government still had to assume \$1.7 billion in bad debts from Bancorex and the Agricultural Bank.At the urging of the international financial institutions,Romania also created the Banking Assets Resolution Agency(AVAB) to recover bad debts owed to banks like Bancorex, by selling off the assets of companies indebted to it at public auctions.

Tax Breaks

The Romanian government and the IMF have also disagreed about tax breaks for foreign firms that want to invest in privatized state enterprises.For instance, against IMF advice, the Romanian government offered tax incentives to Renault,the French auto company, to encourage it to buy into the Romanian automobile firm,Dacia.The IMF has constantly pressed for tax increases to reduce the public debt, but when the government complies , it has problems collecting them.

Moreover, unprofitable state enterprises not only owe taxes to the government, but huge arrears to each other.The IMF has singled out Conel, the state electricity company,Romgaz, the state gas company,and SA Petrom, the national oil company,as particularly flagrant offenders.But some of the large state enterprises cannot easily be privatized.For example, Prime Minister Vasile's efforts to deal with Romanian miners by just closing some unprofitable coal pits(the mining sector in Romania is public and has lost billions of dollars in the 1990s) resulted in a wave of protests and strikes which almost brought down the government in 1999.

Raising Private Capital

As part of a new policy, the IMF did not want Romania to use any new loans to pay off previous debts to the country's creditors.After some rather difficult negotiations during the summer of 1999,the IMF finally agreed in August, to extend a standby loan of \$547 million to Romania, based on the condition that Bucharest would raise \$350 million in the private-capital market.The IMF loan was designed to help Romania deal with its adverse balance of payments problem and to stabilize its hard currency reserves.The World Bank followed the IMF's lead,and on August 25,1999,released \$150 million as the first tranche of a \$300 million private sector adjustment loan aimed at restructuring and privatizing state enterprises.

The Romanians received the first tranche of about \$73 million of the IMF loan in August 1999 and hoped that private lenders would follow.However, Bucharest was not able to raise the specified \$350 million in private funds.The Romanian government sent a letter of intent to the IMF, explaining its difficulties in raising the necessary capital and asking for more time.Nonetheless, the IMF froze the standby loan after the release of the first tranche, as Romania was unable to reach an agreement with Credit Suisse First Boston to float a loan in the commercial financial markets.Differences arose over the interest rate:Romania wanted to pay about 12%, while the bank wanted to charge 17%, stressing that there was no support for Romania in the market.



Romania had contacted other investment banks to serve as lead agencies for the placement of the loan. The IMF's decision to freeze its 1999 loan was based on other factors as well, particularly the lack of financial discipline displayed by the Romanian government.

Unintended Negative Consequences

IMF conditionality has proved to be a negative influence on Romanian state behavior. Instead of promoting cooperation, Bucharest has behaved somewhat deviantly in its efforts to meet the conditions and economic targets established by the IMF. For example, by September 1999, it was clear that Romania would exceed the IMF target for an acceptable public deficit, although the levels of public deficits were always subject to negotiations.

Supplemental Spending

Part of the problem in 1999, as in other years, could be traced to the supplemental spending requests submitted by various ministries after the government and the IMF had already agreed on a budget. The Romanian government would routinely allocate supplemental funds to meet some of these requests. For example, in 1998, the Foreign Ministry requested additional funding in order to pay Romania's dues to the United Nations and the Council of Europe, arguing that the country's international image would be hurt if it defaulted on its dues.

Romania's external debt

Romania's negotiations with the IMF were also affected by the growth in its external debt since 1989. There was even some concern that paying off the external debt at the expense of the domestic sector could replicate the "Ceausescu model", which had left the country debt free but severely impoverished and had significantly contributed to the Revolution of 1989. Romania's external debt had grown from virtually nothing in 1989, to more than \$ 8 billion by the end of September 1999.

A major portion of Romania's external debt was owed to the IMF, the World Bank, the European Bank for Reconstruction and Development, and the European Investment Bank. Romania was also indebted to private commercial banks, including Credit Suisse First Boston and Citibank of London. In 1999, as Romania was in the process of negotiating a fifth standby loan with the IMF, approximately \$2.6 billion of its external debt came due.

Romania's economic difficulties in 1999, were compounded by the precipitous devaluation of the leu (Romanian unit of currency). The leu lost nearly 40% of its value in just a few months. The Romanian Central Bank thus found itself in the quandary of having to decide whether or not to use its scarce hard-currency reserves to pay off its external debt or back the leu. Romania chose to pay off its external debt and avoided default.

Conclusion

Nonetheless, even after elections in November 2000, had swept a new political party into power in Romania, the country still found it difficult to convince the IMF that it was making sufficient progress in economic reform to meet the conditions for a new standby loan. An IMF team visited Romania after the elections and decided to wait and see. However, the IMF was encouraged by the fact that the new government in Romania had made progress in privatizing the Agricultural



Bank, keeping in mind that reform of banking systems is one of the basic conditions which the IMF usually attaches to all of its loans. In 2001, the prospects of the completion of the IMF loan for Romania looked more hopeful. Indeed, by the year 2003, the last tranche of the IMF loan was disbursed, and for the first time since 1989, there had been a full payout of an IMF loan to Romania.

However, by 2003, Romania's success in finally receiving a full IMF loan may not have been due to the domestic political and economic conditions in the country in making progress towards fulfilling the prescriptions for economic reform that had been mandated by the IMF. It may have been due more to the effects of 9/11 on the relationship between the United States and Romania, where Romania assumed more strategic geopolitical importance in the US war against terror, and the US used its influence in the IMF to ensure that Romania was rewarded for supporting Washington.