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Which Way Goes Romanian Capitalism?

Making a Case for Reforms, Inclusive Institutions and a Better Functioning European Union

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- This paper examines the Romanian economy and its version of capitalism from a long-term perspective and in a broad context. It focuses on economic prospects in the face of a legacy of backwardness and the endurance of domestic weaknesses, in the context of the Great Recession and the eurozone crisis.

- Romania has a pressing need to mobilise its internal resources and absorb EU funds on a much greater scale so that it can enhance economic growth and mitigate external shocks. To this end, Romania needs to undertake thorough reforms in the public sector, combat rent-seeking and waste, foster domestic savings. The functioning of institutions and of taxation should convey a sense of fairness to citizens.

- Romania needs to rethink its growth model. Romania must improve its education system by increasing the level of resources assigned to education and creating coherent policies to strengthen institutional capacities and to improve quality standards.

- The Romanian economy would benefit significantly from EU policies that are more responsive to the economic and social fractures revealed by the current crisis.

- Not least, financial markets have to be tamed in Europe and elsewhere if they are to serve economies.

Content

Introduction: Romania in a crisis-ridden environment

How many people, in the wake of the fall of the Berlin Wall, would have been able to imagine the hard times that Europe is facing today? The essay, »The End of History«[1], expressed a *Zeitgeist* that many people believed would be permanent. It is only fair to point out that not a few post-communist countries have since crossed key thresholds, allowing them to join the EU and NATO. But capitalism has its ups and downs, and the current down is a very steep one. Some causes include, inter alia, »irrational exuberance«[2], which pops up cyclically in market economies; a financial system gone astray following waves of deregulation; and a simplistic philosophy on the functioning of markets, also known as »market fundamentalism«. To compound the picture, the EU has been in relative global decline for years now. The Third Way[3] approach once aimed at making Western economies more flexible in order to gain competitiveness. But, although it decried the fickleness and destabilising features of financial markets, it did not comprehend the perils of an oversized financial sector in mature economies, the consequences of a derailed financial system, or the loss of a moral compass. And, to make matters worse, the eurozone is in profound trouble because of a flawed design and inadequate policy arrangements. This manifold crisis has hit the new member states (NMSs) hard because not a few of these countries also have to cope with the less beneficial effects of a growth model that relied on massive capital imports and underestimated tradable sectors. This model is rooted in the logic of the single market (e.g. the opening of the capital account) and contrasts with the evolution seen in emerging Asian economies after the crisis of 1997-1998.

There is talk of sluggish economic growth, and even stagnation, in Europe for years to come. Such circumstances call for a re-examination of the prospects of catching up. It is true that there are major differences among EU economies. Germany is a powerhouse of world trade and industry and the Scandinavian countries are excelling in combining flexible markets with a high volume of public goods. There are also significant economic performance differences among NMSs. Nevertheless, the general feeling in the EU is of disaffection and concern for the future. Although Romania has substantial economic potential and some catching up did take place there, the country has been caught in the aforementioned vortex and remains one of the poorest countries in the EU. It has major institutional and structural weaknesses that have made its post-communist transition difficult and that raise significant questions about what lies ahead – not least in view of a very complicated international environment. This paper explores post-communist Romania and its market-based economy from a long-term perspective and in a broad context. It focuses on economic development prospects in the face of a legacy of backwardness and enduring domestic weaknesses in the context of the Great Recession[4] and the eurozone crisis.

1. Where does Romania come from?

History leaves its marks on a country's present and future. Sometimes, what social scientists call »path-dependency«, is quite strong. Romania's status in the EU as a less-developed economy is rooted in its pre-communist and communist history.[5] Its quest to catch up with the West has been a secular aspiration that links the past with the present.

Pre-communist Romania[6]

Modern-day Romania emerged as a nation-state in the 19th century as part of the peripheral incorporation of south-eastern Europe into the Western-dominated world economy[7]. After World War I, it also encompassed other territories, such as Bessarabia, Bukovina and Transylvania, which were inhabited mostly by Romanians. Both before 1914 and during the interwar period, Roma-

1. Fukuyama (1990)

2. An expression coined by Alan Greenspan, the former head of the Federal Reserve System, and the title of one of Shiller's books, which tries to explain the volatility of financial markets (2000).

3. Tony Blair, Gerhard Schroder and Bill Clinton are among the top politicians and heads of government who promoted this vision in the 1990s. An *eminence grise* behind this train of thought was Anthony Giddens (1998).

4. Many people refer to the current financial and economic crisis as the Great Recession to distinguish it from the Great Depression of 1929-1933. One salient difference is the smaller decline in output and employment during the current downturn, although what has been happening in Spain, Greece, and Ireland would invalidate this distinction.

5. See also Daianu (1992)

6. This part is based mainly on Roberts (1951) and Murgescu (2010).

7. Chirot (1976). For the theoretical framework, see also Wallerstein (1974-2011)

nia was a predominantly rural society, with more than three-quarters of its population living in the countryside and working in agriculture. The state was weak and largely preyed on by predatory interest groups. Public goods were scarce and unevenly distributed. Most of the rural population lived in poverty and had very limited access to the benefits of modernisation (literacy, health care, technological progress, etc). The impact of the reforms made after World War I – enfranchisement for all adult males, land reform, recognition of minorities rights thanks to the ratification of the Minorities Treaty of 1919 – was limited by the agrarian depression and by the Bucharest-based elite, who were backed by King Ferdinand I (1914-1927) and the military and who wanted to ensure that the political system of »Greater Romania«[8] continued to corrupt practices of the »Old Kingdom«. Ultimately, the system succeeded in integrating most of the parties and the state apparatus into a patrimonial oligarchic system, which eroded parliamentary democracy. Until 1937, newly appointed governments regularly won parliamentary elections, centralising political control over the distribution of resources at all levels. When this system failed to work in the elections of December 1937, King Charles II (1930-1940) established a royal dictatorship (1938-1940).

Economically speaking, Romania faced serious difficulties during the interwar period. World War I had caused severe casualties and massive material destruction. Moreover, the global agrarian depression of the late 1920s and early 1930s shrunk revenues and, together with the fragmentation of land ownership, hindered attempts to invest in technological improvements. Overblown economic nationalism[9] and poorly timed economic policies prevented Romania from reaping the benefits of its potential, especially in the case of its oil wealth[10]. The reactions to the Great Depression were also slow and clumsy. When faced with the falling international prices of its most important export staples (grains and oil), bankruptcies and foreign capital repatriations, the government and the National Bank at first tried to maintain free trade and the level of the national currency, while severely cutting the wages of state employees to balance the budget. These policies failed, and eventually Romania had to change its economic policy again, introducing strict state controls over the foreign exchange and relying more on internal demand than on exports.

This new economic context and policy shift favoured industry. Industrial output increased and substituted for a significant part of consumer goods imports. Yet, the high income inequality and the peasants' poverty made the domestic market too limited to allow a major breakthrough in industrial production. In addition, various industries needed to import their capital goods and some raw materials, limiting Romania's degree of self-reliance. At the same time, the political and economic expansion of Nazi Germany, which considered Romania and other countries to be complementary to its own industry-based economy[11] (i.e. part of the *Ergänzungsraum*), undermined the import-substitution industrialisation model[12]. Similar to most of the other south-eastern European countries, Romania was trapped in under-development at the end of the interwar period. Developmental prospects were hindered by rural overpopulation, desolate agricultural productivity, limited development opportunities for industry and dismal geopolitical perspectives, combined with increasing social tensions, the collapse of the constitutional political system and corrupt institutions. As some foreign experts argued, Romania, like the rest of south-eastern Europe, needed a »big push« in order to achieve modernisation[13].

Communist Romania

At the end of World War II, Romania came under Soviet occupation and was »remade« according to the Stalinist model of society. Large war reparations and joint enterprises in major industries drained huge economic resources towards the Soviet Union. King Michael I was forced to step down, »bourgeois« parties were abolished, Romania became a one-party state, and people who had previously belonged to the elite and all poten-

8. In the context of prevailing nationalism, and because it had more than doubled its territory and population after 1918, interwar Romania was called »Greater Romania« (compared to the pre-1914 term, »Old Kingdom«).

9. For a more general context of interwar economic nationalism, see David (2009)

10. Murgescu (2006).

11. For the German interest groups that advocated economic expansion in south-eastern Europe, see also Freytag (2012)

12. The main Romanian theorist of a development model sheltered from the pressures of the world-market was Manoilescu (1929, 1937); on the intellectual context of his work, see Love (1996). A leading proponent of liberalisation policies was Madgearu (1930).

13. Rosenstein Rodan (1943).

tial opponents were subjected to massive repression. Industrial enterprises and most of the service sector became state property, agriculture was collectivised, and the economy was made subject to centralised planning. Social and economic engineering was aimed at consolidating communist rule with a big developmental push based on massive investments, industrialisation and a large transfer of the workforce from agriculture to industry (and also, to a lesser extent, to the service sector).

From the late 1940s to the late 1950s, Romania followed the Soviet leadership obediently. Yet, in the mid-1950s, driven by events like the Hungarian revolution of 1956 and Khrushchev's de-Stalinization, and by what were most likely nationalist impulses, Romanian communist leaders started designing a strategy to acquire more independence. In a first phase, they saw to the withdrawal of Soviet occupation troops in 1958. Then they began to diversify their links to the West and to dissident communist states (i.e. Yugoslavia, China). They also opposed Soviet attempts to push forward the economic integration of all the communist states in Comecon[14], stating in 1964 that each communist party should independently decide its own path of socialist development.

The political turn towards national communism[15] was accompanied by taking measures to accelerate economic growth. In the 1960s, a group of technocrats backed by prime minister Ion Gheorghe Maurer advocated some limited reforms in the management of enterprises[16]. The expansion of heavy industry remained at the core of socialist economic development. The option for swift industrialisation had been one of the major reasons for Romania's divergence with the Soviet Union in the early 1960s; the Romanian communist leaders had disagreed with the economic integration policies pushed by the Soviets within Comecon, which would have had Romania specialise in agriculture and related industries.

Although its strategic choice prevented Romania from obtaining the economies of scale potentially brought about by the international division of labour, investments in heavy industry paid off initially and the deepening of relations with the technologically advanced West enabled some impressive output growth. Likewise, plans made in the 1960s provided for the development of consumer goods industries. Aided by the rise in imports, this allowed for increasing consumption and improved living standards of the population.

Romania achieved high economic growth rates in the 1960s and 1970s. Per capita GDP more than doubled[17] and, for the first time in its history, Romania managed to achieve a limited convergence towards the European average[18]. Industry became the dominant economic sector, both in terms of its share in the GDP and employment. There was significant migration from villages to cities and, in the 1980s, the urban population exceeded 50 per cent of the total population for the first time in recorded history. Growth rates were higher in the least-developed parts of the country, which reduced regional imbalances. Significant progress was also achieved in health care, education and standards of living.

But there were obvious limits to this economic development paradigm, some of which were determined by the basic features of the command system, and others by global constraints and Ceaușescu's management style. Basically, the communist model focused on output quantities, shunned market forces and disregarded efficiency criteria. Ceaușescu's tightened grip on power in the early 1970s favoured political activists over technocrats, put an end to the reform attempts of the late 1960s, and increasingly shifted resources towards developing the heavy and chemical industries[19] and prestigious projects with limited economic value. For a certain period of time, the consequences of these policies were obscured by the increased availability of Western cred-

14. The Moscow-led international economic organisation that brought together most of the communist states; it was the economic counterpart to the political and military Warsaw Treaty.

15. National communism was one variety of communist regime developed in the 1960s, which combined the communist command economy with a personalised political leadership and the ideological instrumentalisation of nationalism. Inside the communist system, it was an alternative to liberalising experiments, utopian communisms and the conservative communism symbolised by the Brezhnev stagnation; for an overview, see Soulet (1996)

16. Arguably, the attempted economic reforms of the late 1960s collided with the logic of national communism. The latter was in tune with the late Stalinism of the 1980s.

17. According to Angus Maddison's calculations using 1990 international Geary-Khamis dollars, it was 1,844 in 1960, 2,853 in 1970 and 4,135 in 1980 (2003: 101)

18. See Murgescu (2010: 331)

19. There are divergent assessments of the industrial growth of the communist period. Some analysts insist on output growth and on the gains of complexity, while others insist on the fact that a too broad diversification prevented the concentration of resources and economies of scale needed for maintaining international competitiveness. In addition, quality changes are hard to measure when the price mechanism is as flawed as it is in a command system.

its[20], which made it possible to maintain growth rates and see a continued increase in internal consumption[21]. Nevertheless, the waste of resources by inefficient industries and the decline of internal oil extraction due to the exhaustion of available reserves ended up turning Romania from an oil exporter into a net oil importer. This evolution became particularly harmful in the context of the second oil crisis from 1979 to 1982. The communist leadership was unable to change the prevailing growth model and Ceaușescu preferred to drastically curb imports and force exports in order to acquire the foreign exchange necessary for paying back foreign debt and putting an end to Romania's dependence on external finance in that way.

The reduction of imports was implemented in a crude and often indiscriminate manner, generating disproportionate disruptions to the economy. Forced exports also caused perverse side effects. For example, in the 1980s, Romania exported more than half of its production of fertilisers, and the growth of agricultural output was hampered by a scarcity of fertiliser. Random interruptions of basic utilities (electricity, heating, etc) and shortages of consumer goods, including some basic foodstuffs, led to a severe decline in the standard of living. The slowdown of growth was followed by years of economic contraction, which differentiated Romania even from its peers in the East.[22]

2. Post-communist transition in Romania

National communism, in its Romanian incarnation, created a major handicap once the transition to a new political and economic regime was initiated in December 1989. Romania proved to be particularly ill-prepared for the challenges of post-communism. Romania's only alleged advantage was that it had, thanks to the tremendous efforts made in the 1980s, paid off its foreign debt. But this had happened at the price of suppressing consumption, curbing technological imports and keeping large parts of the economy separate from the outside world. Therefore, the Romanian economy was marred by structural imbalances and dysfunctions, especially because the heavy industry had been overweighted and the service sector underweighted. During the 1980s, technological progress was almost completely stalled, work habits worsened, and productivity either stagnated or went down. It became increasingly difficult for most enterprises to compete on foreign markets and to defend their positions on the domestic market – if the latter were to be opened for competition. The quality of management was poor, and Ceaușescu's style of leadership enhanced false reporting and arbitrary decision-making. The regime had prevented the coagulation of civil society and the debate of possible reforms. At the same time, the polarisation of the public's anger toward Nicolae and Elena Ceaușescu had created unrealistically high expectations that their removal would solve all the country's problems, and most of the population demanded swift improvements in standards of consumption and living. Political and social turmoil contributed to the disruption of the economic command system, and encouraged former political cadres and various people holding middle management positions to start accumulating their own capital at the expense of their enterprises or of public institutions.

Industrial downsizing and two big recessions in the 1990s[23]

After an initial upsurge of consumption in the first part of 1990, the Romanian economy went into a tailspin that was caused by the collapse of the socialist command economy's structures both domestically and abroad[24]. The chronological evolution of the Romanian economy during the 1990s can be divided into several phases:

- 1990-1992 – collapse of production and partial disintegration of the structures of the command economy; first elements of transformation (foreign trade and price liberalisation, dissolution of agricultural cooperatives) upset by a severe fall of GDP (1992 = 71 per cent of

20. In 1972 Romania joined the IMF and the World Bank as the only socialist member state of these organisations besides Yugoslavia. The latter, while making use of market mechanisms in steering of its economy, maintained the state and social property under the form of so called labour-managed enterprises.

21. Nevertheless, one should notice that the use of Western credits was moderate throughout most of the 1970s and increased massively only after 1979, in the context of the second oil crisis.

22. The continued preference for resource-swallowing industries and the payback of the external debt in the 1980s illustrates a case of immiserising growth in a command system (Daianu (1985); for the concept of »immiserising growth«, see Bhagwati (1958); see also Ban (2012b)

23. cf. Daianu (1998), Cernat (2006), Pop (2006)

24. The so-called »transformational recession«.

1989), inflation (210 per cent in 1992) and unemployment (8.4 per cent in 1992)

- 1993-1996 – partial recovery in the framework of a mix of cautious, gradual reforms with some revival of centralised economic structures; taxation reform (introduction of VAT); limited foreign investments; privatisation that favoured locals (voucher privatisation, MEBO [management employee buyouts], etc.) and avoided major restructuring; subsidies to various enterprises through credits from state-owned banks

- 1997-1999 – a second big recession in the context of political decisions to further liberalise the economy, restructure large parts of it, and close down deficit-creating enterprises[25]; a severe fall of output (industrial output declined by more than 20 per cent), which, combined with unfavourable influences of the Asian and Russian financial crisis of 1997-1998, aggravated this recession; privatisation of several large enterprises with strategic FDIs.

A decade of growth, albeit with a fragile growth model: 2000-2008

In 1999, the EU decided to start accession negotiations with the post-communist states that had not been in the first round of candidate countries. This decision, accompanied by closely monitoring the adjustments made by the candidate states, fostered institutional progress and stimulated FDIs and economic convergence[26]. Romania had a period of high economic growth rates between 2000 and 2008. As a matter of fact, it joined the rest of emerging Europe in a process of accelerated growth and overall transformation, which culminated in its accession to the EU in 2007. From 2002 to 2008, Romania's GDP expanded at more than six per cent per year in real terms, which was made possible by the massive amounts of capital that poured into Central and Eastern Europe during those years.

But Romania only had its first taste of receiving such high levels of capital inflows. Other post-communist economies had been forerunners in this regard during the first decade of transition. Economic growth went above its potential in most years of that period, and was buoyed by heavy capital inflows. The introduction of a 16 per cent flat tax in 2005 fuelled a consumer spending binge and propelled borrowing by both households and companies. The upsurge in borrowing and remittances from abroad obscured income inequality and fuelled unrealistic expectations of growing incomes[27]. Likewise, big rises in public sector wages stimulated consumption-led economic growth, and these rises were replicated in the private sector. As a result, in 2007 and 2008, external deficits went up rapidly and moved into the double-digit range. The current account deficit was ca. than ten per cent in 2006, 13.4 per cent in 2007 and 11.6 per cent in 2008[28]. Much of the funding of the current account deficit was provided by private borrowing. This is mirrored by the size of private external debt compared to external public debt at the end of 2008. A hard landing of the economy against the backdrop of the financial crisis was inevitable, and a steep fall of output (the GDP dropped 6.7 per cent) occurred in 2009; a smaller fall of the GDP (-1.6 per cent) occurred in 2010.

The GDP per capita almost doubled from 2000 to 2008, which would validate the convergence theory based on capital flowing downhill. But it did not change the fact that Romania remains one of the poorest members of the EU. This is not surprising in view of the enormous development gaps separating Romania from most of EU member states. Temporary labour migration rose greatly, especially after the partial opening of Romanians' access to the Schengen area (as of January 1, 2002); more than 2.5 million people left the country because of high wage differentials[29]. Their remittances, which amounted to several billions of euros before the eruption of the current crisis, temporarily helped to finance external deficits and alleviate social problems at home.

25. This policy stance was favoured by a large coalition formed by the Democratic Convention of Romania (DCR), the Social-Democratic Union (SDU), and the Democratic Union of the Hungarians in Romania at the advent of its power. The DCR was itself a conglomerate that included the Christian-Democratic National-Peasant Party, the National Liberal Party and several smaller parties while the SDU was a coalition of the Democratic Party and the Social Democratic Party.

26.

27. Romania had a Gini coefficient of 30.6 in 2009, above the average for the EU27 countries. This compares with a coefficient of 23.4 for Slovenia and 23.7 for Slovakia, as two other NMSs (according to the SILC, which is an EU-wide survey conducted in Ireland by the Central Statistics Office).

28. National Bank of Romania statistics.

29. The EU27 average net wage is about 1,400 euro while in Romania it is just a bit below 400 euro.

The implosion of the economy and falling budget revenues revealed a large structural budget deficit (of over 8 per cent of the GDP in 2008). Structural deficits were hidden for years due to high, yet unsustainable, economic growth rates. But once these were exposed after the crisis hit, corrective measures were inevitable in view of the foreign exchange constraint and the state of international financial markets. Sudden stops of external finance and collapsing trade markets in the EU compelled Romania and other NMSs to seek external financial assistance.

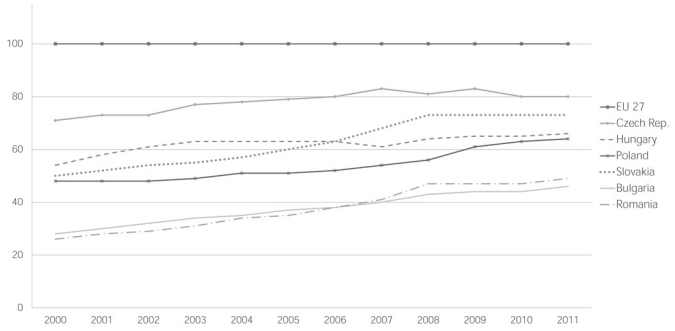
The eruption of the financial crisis in Europe and a growth model called into question

In the years preceding the Great Recession, Romania, the Baltic countries and Bulgaria epitomized a fragile growth model: with very high external deficits (in the double digits), inadequate resource allocation (biased toward non-tradable sectors) and high external private indebtedness. The rules of the EU, especially those governing its »single« financial market, have favoured massive cross-border capital flows, most of which were in the pursuit of high yields. Foreign banks played a huge role in this regard, given that parent banks considered existing and prospective new member states as their new territory for expansion. Italian, Austrian and Greek banks were the most aggressive in this process. An ebullient expansion of credit to businesses and households, as well as intense euroisation, did occur (with real growth rates being above 30 per cent yearly). One consequence thereof is that systemic risks grew while the National Bank of Romania had a very hard time reconciling the need to reduce inflation with discouraging excessive capital inflows[30].

An analogy can be made to other member countries (Ireland, Portugal, Spain, etc) where housing bubbles and private indebtedness have played key roles in the ensuing crisis. In some of these countries, labour costs outpaced productivity gains, investment poured into non-tradable sectors, and double-digit external deficits signalled insufficient competitiveness. In Romania, the situation was aggravated by pro-cyclical policies after 2004, which overheated the economy and fuelled external deficits.

30. See also Gabor (2010)

Figure 1: Catching-up of EU NMSs



(per capita GDP at PPP, EU27=100)
Source: Eurostat (30.01.2013)

Economic catching up took place in Romania between 2000 and 2008 (as indicated by the income per capita in Figure 1). Yet, this convergence hit a wall because of mounting external deficits. Moreover, the crisis years brought about a major setback. The EU's »rules of the game« and the one-size-fits-all monetary policy in the eurozone have stimulated resource allocation into non-tradable sectors in less developed areas. The insertion of NMSs into industrial networks is varied and reveals clusters with different performances[31]. It is worth noting that the Visegrad Group seems to fit better into the industrial core of the EU than do the southern members of the Eurozone. Interestingly, Romania, although economically inferior to the Visegrad Group, is, according to MIT's Observatory of Economic Complexity, superior to Spain and Portugal with respect to the level of complexity of its exports[32]. Still, one has to qualify this finding since quite a lot of exports have a large import content. This means that the actual Romanian component in the value added chain is often relatively small.

In early 2009, Romania, like Hungary and the Baltic countries, asked the IMF, the EU and the World Bank for financial assistance, and a financial package of 20 billion euros was granted by these organizations. There was also the so-called Vienna Initiative, which prodded foreign banks to not retrench their operations in the NMSs. These external interventions entailed the front-loading of a major fiscal adjustment. Yet, this programme was fraught with pitfalls. One of its major weaknesses was to neglect the significance of EU funds absorption as a countercyclical

31. Becker et al. Chapter 4 (2010), Indermit and Raiser (2012), Drahokoupil and Myant (2010), etc

32. MIT, The Observatory of Economic Complexity, http://atlas.media.mit.edu/rankings/

weapon in the economy during a period of major fiscal adjustment. It was only in the second half of 2010 that policymakers in Bucharest and experts in Brussels and elsewhere properly understood this significance, albeit to no concrete avail, since the absorption levels continued to stay low. Also, measures of the assistance programme could have been arranged better, though a macroeconomic correction was inevitable. Cutting public sector wages by 25 per cent and substantially reducing social benefits (with the intention of reducing pensions) were radical measures. This showed that the Romanian government, like its Bulgarian and Baltic counterparts, shied away from implementing more targeted adjustment policies because these would have required a carefully designed strategy and sophisticated administrative skills[33]. The governments were also operating under enormous time pressure. The drastic measures may have been justified by the steady rise in wages in pre-crisis years (as in other NMSs) and by the smaller leeway in using exchange rate devaluation to mitigate the fall of economic activity. Euroisation is high in Romania (more then 50 per cent of transactions are euro-denominated), which introduces a bias in the management of the exchange rate. Some claim that the exchange rate policy in Romania resembles that of a currency board regime. Like in other NMSs, high euroisation and the fear of impairing bank balance sheets are again the culprits. The drastic wage cuts made the adjustment look more like an internal devaluation, just as in the Baltic countries. Yet, as against southern countries in the eurozone, Romania had a major ace up the sleeve during the period of big turmoil in Europe. Even if they were dented by euroisation, the exchange rate and autonomous monetary policy still constitute »policy space«.

The harshness of the corrective measures took its toll: two centre-right governments were swept from power in 2012, and the parties that had supported these governments were severely punished by voters at local and parliamentary elections. It is worth noting that the new government backed by an alliance between the Social Democratic Party[34] and the National Liberal Party did, nevertheless, maintain the precautionary agreement with the IMF, the World Bank and the European Union (the European Commission); the course of the fiscal policy was not reversed. The budget deficit went below three per cent (in ESA terms) in 2012 and a smaller deficit is programmed for 2013; the current deficit is estimated to have dropped below 3.7 per cent of the GDP in 2012.

Romania has signed the Fiscal Compact and must therefore comply with the demands set by the European Semester. But fiscal probity alone cannot sufficiently enhance economic growth: more energy must be directed towards a higher absorption of EU funds, the reduction of waste in the public sector, the modernisation of public administration in general, and the reform of state companies. The mobilisation of internal reserves, a big rise in EU funds absorption, and the recovery of public and private investment, could, arguably, raise the economic growth potential by about 1.5 percent of the GDP annually. It should be mentioned that the financial and economic crisis has diminished the growth potential from about five per cent to about two per cent annually (according to many analysts' estimates). Unfortunately, the international environment is quite unfriendly and the eurozone is menaced by years of quasi-stagnation. This would also keep the growth prospects for the Romanian economy down, and could worsen its growth potential. There is talk of regaining the lustre of the European economic model, but the crisis legacy is so overwhelming that such hopes are clearly unrealistic. Moreover, it is hard to believe that an overhaul of national policies could suffice, as some studies advocate[35]. A new design of the eurozone, in terms of its institutions and policies, and a new pattern of the functioning of finance – in addition to improved national policies and a stronger focus on R&D activities to upgrade production – are needed in order to heal the EU[36].

3. Romanian capitalism in its post-communist phase

The economic and political opening of Romania was inevitable after 1989. The dominating clamor during the first decade was to »return to the West« and the popular pressure for opening was enormous. Romanians did not substantially question or debate the nature or the variations of the Western model. There was a widespread consensus that it should include a multi-party democracy and a market economy. The term »capitalism« was

33. See also Bohle and Greskovits (2012: 252ff)

34. The Social Democratic Party is the former Party of Social Democracy of Romania, which merged with the Social Democratic Party and adopted the latter's name in 2001.

35. One wide-reaching World Bank study attempts to present good practises in the EU and around the world as a means of reinvigorating EU economies: see Indermit and Raiser (2012)

36. See also Daianu (2012)

seldom used, and the variations of capitalism even less debated. Later, during the transition period, more emphasis was laid on conforming to EU standards (the *acquis communautaire*) and obtaining the credentials of a functional market economy. In spite of some domestic opposition to convergence with EU standards and protracted reforms during the first half of the 1990s, the *Zeitgeist* in Europe and the dynamics of globalisation made opening and liberalisation the main venues for change. Additionally, the desire to join NATO and the EU was a rallying cry for major political parties. But the reality on the ground was more complicated due to the pre-1989 legacy (relative backwardness and late Stalinism[37]) and the configuration of vested interests.

Initial conditions

The countries which had been economically more developed than Romania and had experimented with market-oriented reforms prior to 1989 (e.g. Hungary; Poland, even under martial law) were better prepared for making the transition. Their stock of physical and human capital, their historical links to the West, and their large contingents of expats willing to return to their native countries to get involved in post-communist reforms all made a noticeable difference during the first decade of transition. This was demonstrated in the functioning of both the private and the public spheres of the economy. Romania had the apparent advantage of no external debt, but the legacy of late Stalinism and the dramatic suppression of private consumption negated that advantage. In addition, there were social and political forces reluctant to accept basic features of the Western model such as the rule of law, transparency, respect for civil rights, and the accountability of public institutions and public servants. The contrast to the better-placed Visegrad countries paired with the turmoil in the western Balkans in the wake of Yugoslavia's dissolution generated uncertainties about the ultimate fate of Romania (and Bulgaria), and thus discouraged inward foreign direct investments and made the post-communist transition more difficult. Economic reforms proceeded at a slower pace and were less consistent, while Romania was perceived as being less suitable to join the EU. Its admission to NATO also occurred in a second wave of enlargement – five years after the admission of other former communist countries (Poland, the Czech Republic, Hungary and Slovenia). These delays confirmed that catching up is not an easy process and that convergence is time-consuming. But it also reflected an unfavourable path dependency during transition.

At the onset of its post-communist transition, one of Romania's biggest handicaps was its lack of a class of private entrepreneurs. In countries where partial reforms were initiated under communism (e.g. Hungary, Poland), transition took off more easily. In academic circles, there was much talk about bringing about »capitalism without capitalists«[38], but the fact is that significant differences existed among countries in this regard. Romania's brand of communism, especially in the late 1970s and the 1980s, had been extremely hostile towards private economic entrepreneurship. However, pervasive shortages had provided incentives for people who circumvented official regulations. On the one hand, the skills and networking developed in illegal market transactions proved to be valuable assets in the post-communist transition. On the other, however, it is highly questionable that those skills were suitable for well organized and sophisticated business operations in open markets. In addition, those who worked in state companies that carried out foreign trade operations accumulated contacts and learned the workings of market economy and its institutions by doing. A former top communist official turned dissident highlighted six social groups which formed the new capitalist class of post-communist Romania: former directors of socialist enterprises; descendents and relatives of former high-ranking communist apparatchiks; people who worked in foreign trade before 1989; former emigrants returning to Romania with capital, know-how and connections; a small group of self-made men; and bank managers[39]. Many of these new capitalists had accumulated their starting capital by draining state enterprises, either through private contracts at distorted prices or through privatisation. But this classification of »new capitalists« is not dissimilar to what was reported and examined in other post-communist countries. As a matter of fact, we are dealing with the same phenomenon. However, differences exist due to local specificities under communism and to cultural and social legacies[40].

37. This notion refers to the very rigid system of political and economic control in Romania (reminiscent of Stalin's grip on power) and the surreal personality cult during the 1980s, as against attempts of reforms in Hungary and Poland (even under martial law).

38. Eyal, Szelenyi and Townsley (1998)

39. Brucan (1996: 103ff)

40. See also Stoica (2004)

During the 1970s and 1980s, Ceaușescu tolerated hardly any public debate in the political and administrative leadership, so the people who succeeded in obtaining and maintaining leading positions were almost exclusively yes-men, with the habitus of paying lip service to any ideas coming from above. As in other countries, communism favoured foul play and people got used to saying things in public that were different from what they may have thought. This increasing distance between words and reality discredited institutions and legality[41]. Cynicism regarding the role of ideas and the rule of law hampered the functioning of institutions and favoured corruption. Consequently, when these people managed to consolidate their leading positions in post-communist Romania, interest in developing and implementing coherent public policies was rare, and the state was more often captive to vested interests. The habitus of an elite with origins in communism was combined with pre-communist traditions that considered the state an embezzlement source for predatory interest groups. This undermined attempts to professionalise administrative and political management. One finds here an explanation for Romania's continuing »low state capacity«.

Structural and institutional change

Many local businesspeople were eager to avoid competition from foreign capitalists and tried to shape privatisation to suit their own interest. Nevertheless, the opening of the Romanian economy brought in multinational companies (MNCs). While foreign investments were rather modest during most of the 1990s, this situation began to change in 1997-1998, when the Romanian government decided to privatise some of its most important public companies and encourage inward foreign direct investments. The perspective of Romania becoming a member of the EU encouraged major multinational companies to invest in Romania, and the accession negotiations established that the government would need to sell some of the most important state enterprises[42]. Additional reasons for privatisation was the crass mismanagement of state companies, their milking by varous groups, and the heavy political involvement in these businesses. Notorious are the cases of Sidex (steel industry), which was bought by Mittal, and Petrom (oil industry), which was acquired by OMV. Basically, in the decade from 1998 to 2008, multinational companies gained control over several major industries and the service sector, not to mention control over banking where the foreign presence is overwhelming (more than 80 per cent of existing assets at the end of 2012). The massive inflow of FDIs brought not only additional financial resources, but also organizational know-how and access to international markets. It favoured modernisation, but, at the same time, it dislodged large parts of the domestic economy and made any further development dependent on the interests of the international (parent) companies. Arguably, this process was inexorable under the circumstances of those times. Nonetheless, not a few privatisation deals could have been better designed in order to benefit the Romanian economy.

Some analysts distinguish between countries that managed to attract FDIs to relatively complex industries (Slovenia and the Visegrad Four) and other countries that had to be satisfied with »impatient« foreign capital, which flowed more into housing and the financial sector than into manufacturing (Romania, Bulgaria, the Baltic states)[43]. This distinction tends to oversimplify the reality: Romania also has its fair share of FDIs in complex industries (e.g. the Renault-owned car manufacturer Dacia). But is also true that much capital that came in during the pre-crisis years did go into non-tradable sectors, and some FDIs proved quite volatile[44]. Some problematic aspects have been transfer pricing practices, abuse of market domination and, not least, the non-combat of corrupt practices (like the de facto indulgence in local habits, or what foreign capital encounters in other emerging economies[45]). There has also been a disregard for the bigger picture regarding economic development, which is partly due to a simplistic prevailing mantra: that development is an inexorable outcome of privatisation,

41. Boia (2012: 68)

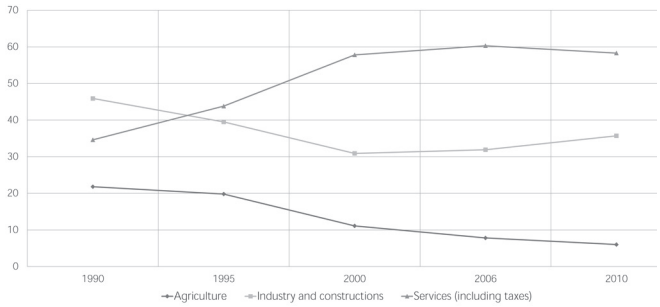
42. Not a few enterprises that had been privatised for very little money were broken into pieces and sold later by the new owners for big profits. These enterprises may not have had a future in any case, but some of them could have survived and, more significantly, jobs and skills could have been saved. The problem was that, at that time, Romania's financial constraints were quite high and state companies were very poorly managed.

43. Bohle and Greskovits (2012: 206), Indermit and Raiser (2012)

44. See, for example, Nokia's investment in a telephone factory near Cluj in 2007, which was relocated again only three years later.

45. Ban commented to us that MNCs' use of corruption in emerging economies is widely documented. Indulgence in local practices may even benefit international companies when corrupted local officials help them skew the terms of privatisations in the disfavour of the local economy. Constrained by the legislation of their mother countries, some MNCs have introduced internal regulations which prevent outright bribing of local officials, but this do not exclude more sophisticated corruption practices.

Figure 2: Main economic sectors according to their contribution to the Romanian GDP (%)



Sources: Murgescu 2010: 470, 475; INS 2012: 322.

opening and liberalisation. *Nota bene*: only in the late 1990s did the World Bank start to emphasise the role of institutions in post-communist transition. Later, the European Bank for Reconstruction and Development (EBRD) did the same and, after the current crisis erupted, it alluded to the importance of domestic capital in local banking sectors. Ironically, the IMF, which used to be the main driver of financial liberalisation in the first decade of transition, has much nuanced its position on the issue of unrestrained flows of capital (in view of its potentially destabilising effects).

The economic structure of post-communist Romania changed considerably (see Figure 2), but persistent features still catch the eye. This type of resilience may be a proof that *natura non facit saltus*, that economic convergence is time consuming, and that income per capita, as an aggregate indicator, needs to be sustained by a pervasive change in the level of productivity. An obvious example in this respect is Romania's »rural question«, which is of very long standing[46] and still unsolved. Low-value-added industrial sectors have a lot of weight in the overall economic performance, and massive migration (which got more intense once EU western countries opened their borders to labour from the East) has impaired the stock of human capital, which is not good for future economic growth unless education is able to make up for it (there has been intensive brain drain during this period of time). One could argue that large wage differentials (as against wealthy Western countries) have made migration inevitable, as it has happened around the world in modern history. But it may also be true that smarter domestic policies could have downsized this phenomenon by scaling down job destruction as a driver of migration[47].

The short-sightedness of public policies is obvious if one considers education. Theoretically, the transition to democracy, the open access to information and the development of the Internet should have fostered massive progress in this field. Yet, financial constraints and a lack of interest in long-term investments caused the Romanian governments to cut the education budget. Chronic underpay has gradually undermined morale, quality has suffered, and many attempts to ameliorate the system and adjust it to the challenges of the contemporary society were doomed to failure. As human capital is a crucial resource for economic development, Romania needs to improve its education system. This means both an increase in the level of resources assigned to education – currently, Romania spends only three to four per cent of its GDP (including private sources) on education, which is significantly less than in most post-communist NMSs – and the establishment of coherent policies to strengthen institutional capacities and improve quality standards. Only in this way can Romania get a fair chance for its population to be well educated, not least because it underpins its future as a civilised society.

The economy looks highly imbalanced when considering the proportion of pensioners to the active population: in 2012 the former were 5.3 million while the latter were 4.3 million (out of which public sector employees made up 1.2 million). The substantial migration of job seekers, which took place after travel- and job-related restrictions were lifted in the EU for Romanians, has also contributed to this imbalance. But the scale of the underground economy changes the actual balance because it provides jobs (legal and illegal) to between 3 and 4 million individuals. There is thus a high degree of non-transparency, which impacts social and economic relations, on the relevance of official statistics. For instance, the minimum wage does not provide a basis for judging people's incomes when they get paid via unofficial venues so their employers can reduce their costs in terms of social security contributions (SSCs). The considerable underground economy (25 to 30 per cent of the GDP) mirrors institutional weaknesses, citizens' poverty, insufficient marketisation of agriculture, and widespread

46. See also the chapters on agriculture in Georgescu-Roegen (1971)

47. For the economics of Romanian migration during transition, see Ban (2012a).

rent-seeking. It should be said, however, that this is not a peculiar local feature. As a matter of fact, it includes Romania in a larger European geographic distribution of economic, social and cultural propensities, with the Nordic fringe scoring much better than the southern one. Is this state of affairs a curse? It is when one realizes that changes for the better, i.e. towards modernisation, cannot be fast and will demand strenuous efforts for at least one to two decades or longer. It is not a predicament if one believes that no community (country) is destined to be a laggard, and that reforms can produce change in the right direction and sometimes even surprisingly fast – as with Ireland before it went broke during the current financial crisis owing to the follies of its financial industry.

Romanian capitalism judged within a European framework

Romania has weak institutions, rent-seeking is endemic, and its economy is under the spell of »extractive institutions«[48]. One could argue that rent-seeking, which is widespread in numerous emerging economies (e.g. in Asia), does not necessarily impede rapid economic growth. This is an issue worthy of investigation. We venture to submit that, while corruption may be inevitable in less-developed societies with weak institutions, its deleterious effects are stronger wherever the magnitude of rent-extraction is very high and the empowerment of most citizens is precluded by vested interests. It is also likely that, where vested interests are very strong, strategising for the common good is less likely and may be quite ineffective. This happens in EU member states, too. The waste in Romania's public expenditures mirrors widespread rent-seeking and incompetence. According to EU data, Romania was at the top among member states when it came to the share of public expenditure for capital goods in GDP (above four per cent from 2000 to 2008). And the outcome in terms of actual capital goods causes disbelief; it is as though Romania spent much less annually. Likewise, Romania has one of the lowest fiscal revenues in the EU: with less than 28 per cent of the GDP over the past decade, as against an average of 34 per cent for the NMSs and an average of 40 per cent for the EU27). This is a reflection of poor institutions. It is also a reason for the state's inability to provide its citizens with public goods that condition economic development and equal opportunities (education, health care, infrastructure, etc).

Those who say that too much of the public budget is devoted to social expenditures are, arguably, wrong. It may look excessive in view of the very low size of budget (fiscal) revenues. This is because of pervasive tax evasion and mismanagement of the public sector (a euphemism for rent-seeking). As already mentioned, Romania spends very little on education. Not least is the issue of EU funds absorption. Its low coefficient is closely linked with the overall functioning of public administration, a poorly designed mechanism for EU funds absorption and lacking skills. This state of affairs is mirrored by a low capacity to implement projects.

In order to judge Romania's post-communist capitalism, one needs to put it into a wider framework and compare it to other NMSs and to the dynamics of capitalism in Europe. Clusters of countries are visible among the NMSs; this topic deserves more scrutiny. One might think that having both a stronger legacy of economic backwardness and weaker institutions would handicap policy-making capable of fostering robust growth and higher value-added production in several countries. These features may also explain why some people lump several NMSs in a sort of »Baltic-Balkan« capitalism, which is markedly defined by state weakness and precarious dialogue among social partners[49]. But one could also argue that the neo-liberal bent of the logic of Europe's single market has played a major role in this regard. If this is the case, it could help to redesign policies at national and EU levels to enhance economic convergence. However, it would also suggest different path dynamics for member states if EU policies stay unchanged. One lesson can be extracted from this: unless policies are designed in such a way as to foster convergence, or at least to help enable countries absorb asymmetric shocks (e.g. via EU-level policies[50]), centrifugal forces will get the upper-hand in the Union.

Romanian capitalism is heavily influenced by what happens in the European Union, and by how EU member states deal with phenomena rooted in the financial cri-

48. See Acemoglu and Robinson (2012), Rodrik (2012)

49. Bohle and Greskovits (2012), who use Polanyi's matrix on diversity of capitalism.

50. An unemployment insurance scheme, as advocated by Dullien and Schwarzer (2009), would be such a tool.

sis, the crisis of the eurozone and the spreading social crisis. The latter has been going on longer and is also linked with the pains of welfare schemes in ageing societies and the power of insider groups. Many countries in Europe are bound to revisit the social contract and will have to regain the trust of their citizens. This trust was damaged greatly by the current financial crisis. There is a widespread sentiment that finance has been playing too large a role in shaping policy choices, that fairness has been fading away in designing public policies, and that a moral compass has been lost in politics and the corporate world.[51] The rise of extremist political forces and xenophobia and the rejection of mainstream parties in a mounting number of European countries are disquieting. It is true that the situation is substantially better in the northern area of the EU, and that the German economic and social model has proved its resilience and capacity to perform economically. However, it is hard to imagine that this model will be able to provide an easily replicable template for reforms in other member states. Not least since the troubles in the eurozone are also caused by its inadequate design and policy arrangements. Moreover, it is hard to fathom that internal devaluation, as it is being experimented with in several countries, will be able to solve the problem of rebalancing economies in the eurozone on a recurrent basis.

4. Romania, the EU and catching up

The EU as »attractor«

The EU has been and still can be a powerful force of positive change in a weak institutional setting. This influence was felt even before Romania's accession to the EU in 2007. The *acquis communautaire* embodied a roadmap that helped summon domestic resources and find a direction, a strategic purpose. There is frequent talk among top local politicians and business leaders of the necessity of a new anchor (e.g. euro adoption) once accession to NATO and the EU has taken place. On the one hand, this seems to be a rather sensible stance for a country that still has weak institutions and lacks benchmarks and guidelines for collective action. On the other, the economic progress achieved by various other countries around the world shows that it is not warranted to consider EU membership to be the *sine qua non* ticket for modernisation. EU benchmarks do help, but they cannot automatically put a country on the path towards modernisation. In addition, as the current crisis has amply indicated, the EU (i.e. eurozone) is susceptible to its own deep troubles and to a diminished capacity for enforcing institutional change when national elites oppose it.

There has been undeniable progress during the past decade and Romanians have found out about how Western societies function; millions of Romanian citizens travel abroad, and live and work in other EU member states; the flow of information and a first-hand taste of the lifestyle and working habits in the developed parts of the EU send powerful messages home. The modernisation of organisational patterns and a know-how transfer have taken place in Romania, much of it done by foreign companies. There were also considerable productivity gains, especially during the past decade, after accession prospects became clearer and inward FDI sped up. But there have not been enough of these to make a steady advance – apart from the fracas produced by the financial crisis. The liberalisation of financial flows and the huge disproportions between Romanian prices (and wages) and those in the more developed parts of the EU have favoured bubbles and volatility, as well as increased social polarisation. Pro-cyclical policies have played their role in this regard, too. There has also been a dismemberment of industrial production chains, with a subsequent erosion of human capital.

The EU, through the *acquis communautaire* and the fact of Romania's membership, has enhanced institutional improvements in the field of justice and rule of law[52]. EU prodding and reform-minded domestic constituencies have succeeded, in ameliorating the justice system and making some progress in the establishment of the rule of law, albeit not without encountering stiff resistance. Yet this progress is fragile and vulnerable to backsliding, especially considering that the economic crisis has diminished the effectiveness of EU institutions' supervision[53]. Moreover, the actual functioning of the rule of law requires a certain collective ethos that imbues citizens' behaviour, as individuals, with respect for rules and procedures. And this collective ethos also needs

51. See also Daianu (2011)

52. The rule of law for elites is crucial for the transition from a natural state to an open access order, based on impersonal social and economic relations, see North, Wallis and Weinberg (2009: 21ff, 148ff).

53. Gabanyi (2012)

to pervade the higher echelons of power. This leads to the issue of the functioning of selection mechanisms in economic and political life: whether they promote meritorious or unsuitable people, the latter being liable to pursue narrow-minded goals and work against the interest of fellow citizens[54]. There is also the related issue of figuring out how to increase the propensity of good professionals to pursue careers in public service – in view of the low pay and the unappealing overall climate in public administration.

The EU is economically vital for Romania. Most – about three-quarters – of Romania's exports go to EU markets and Romania's banking sector is heavily controlled by European groups. The persistent malaise of the European economies, especially those in the eurozone, is a major handicap for Romanian economic growth. Thus, Romania has a deep interest in the economic recovery of the EU as a whole. One of the purported recipes for reforming EU governance is the establishment of tighter financial rules, regarding both state finances (public debt and deficit) and the banking sector. In 2011-2012, Romania agreed to these new rules. Yet it is questionable whether the very tight rules of the eurozone are suitable for all EU economies, as they disregard huge differences in performance and structure. Even within the eurozone, unless there is an overhaul of policy arrangements (including the possibility of fiscal transfers as a means of dealing with asymmetric shocks), one-sided fiscal discipline is likely to backfire[55]. Fiscal rules for economic recovery have more bearing now. While structural fiscal adjustment is a must in view of the big rise in public debts in the eurozone, it is less clear whether all member states should have to achieve budget deficits below three per cent by 2013-14.

Romania's euro adoption (which is enshrined in the Treaty of Accession) hinges on two fundamental preconditions. One is a sufficient amount of real economic convergence as a means of withstanding pressures within the eurozone. This is one of the major lessons of the eurozone crisis. It is wishful thinking to believe that this precondition could be tackled in a few years time. The second precondition is to have the eurozone repaired institutionally and policy-wise by the time a candidate country applies for membership. Membership in the European banking union would make sense given the heavy presence of foreign groups on the local banking market, but it is not clear to what extent this would be feasible for a non-eurozone EU member state.

The EU's policy dilemmas and trade-offs bring the European social model to the fore. Based on the high taxes in most member states and on generous supply of public services, the European social model has been crucial for the post-war economic growth, for the high living standards achieved by the European citizens, and for the success of the European political project[56]. This social model has been challenged by the excesses of neo-liberalism and is endangered by the changing demographics of Europe (i.e. its ageing society) and the EU's relative loss of economic competitiveness at a global level. At the same time, some of the NMSs have developed less inclusive models of capitalism, which exerts some pressure on the social model developed in most of Western Europe. It goes without saying that most of the pressure comes from emerging economies outside of Europe. And if the economic and political integration inside the EU is to advance, this will also involve measures of fiscal and social harmonisation. But the EU should not turn into a lose-lose union in a race to the bottom regarding the supply of public goods. The idea is to promote individual and corporate responsibility via a sense of solidarity and loyalty to the European project. Otherwise, fragmentation forces will gain more force and cleavages in the EU will deepen. Currently, most European states are reluctant to make compromises on these issues, and harmonisation will probably be a lengthy and difficult process.

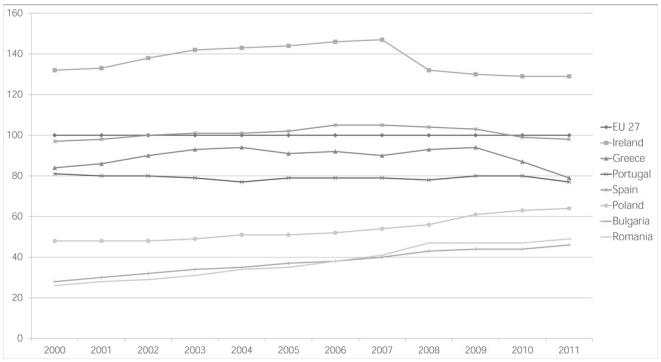
We have now arrived at the key issue of economic convergence/divergence within the EU. The EU's track record in catching-up economies has been mixed. The Union has incorporated several states with significantly lower development levels than its core members: Ireland in 1973, Greece in 1981, and Spain and Portugal in 1986, and the Eastern and Central European NMSs in 2004 and 2007. Before 2008, most of these countries seemed to illustrate the reasonable success of European convergence (see Figure 3 on next page). Ireland was showcased as the prime example: it not only succeeded in catching up, but in becoming the second EU economy

54. Alina Mungiu Pippidi (2012) has thoughtful insights in this regard.

55. A key message of the Monti Report, which was made public by the European Commission in 2010 links the completion of the single market with the possibility of fiscal transfers among member states.

56. Sapir distinguishes four sub-models of the European Social Model (2006); see also Albert (1993)

Figure 3: Catching-up of EU NMSs



(per capita GDP at PPP, EU27=100)
Source: Eurostat (30.01.2013)

in terms of GDP per capita. The Great Recession revealed that some of the progress achieved by these countries was fragile and reversible[57]. The collapse of external, finance-led economic growth forced the economies of these countries to contract dramatically, and the severity of the crisis endangers the whole eurozone. Adjustment measures have been harsh and socially costly and their economic effectiveness has varied greatly. Some countries appear to be embarking on the path of recovery, while others are engulfed in persistent decline. It remains to be seen whether the overhaul of the eurozone design and of EU policy arrangements (governance) will resuscitate convergence.

Mobilizing domestic resources

The significant variance of the EU's impact on the convergence/divergence of the NMSs reveals the paramount importance of internal responses to the opportunities opened by the European framework. Some countries have succeeded better in mobilising their internal resources and in tapping into the benefits of EU membership. This will become increasingly important in light of the more restricted facilities that the EU is offering to its less developed NMSs and of the more severe conditions than those that were available to Ireland, Greece, Portugal and Spain in the 1990s. Does Romania possess internal resources which it could mobilise in order to achieve economic convergence?

Efficiency reserves exist in all societies. In a system in which micro and macro inefficiency are high, robustness and resilience can be strengthened without additional costs. The same output can be obtained with a lower intake of resources and, although it may sound strange, buffers can be increased simultaneously. Theoretically, a higher potential to mobilise resources should present an opportunity for highly inefficient systems. Nevertheless, moving towards the production possibilities frontier in a highly inefficient system is not easy because of the vested interests that oppose change. It is only when the pressure to change is high enough, whether through internal or external incentives and pressure, and when interest coalitions that favour reforms are stronger than the ones betting on the status-quo (i.e. are willing to continue to extract rents), that breakthroughs occur.

Mobilising internal resources (efficiency reserves) implies, in most cases, the overhaul and upgrade of the public sector administration. In Romania, the functioning of the public administration is also crucial for the absorption of European funds. Public policies should prioritise the development of tradable sectors. To this end, fiscal incentives – those which EU rules allow – should combine with an exchange rate policy that encourages better resource allocation (i.e. the production of tradables). The bottom line is that all these endeavours call for better-functioning domestic institutions and structural reforms, including better management of state companies. Considering the complex texture of the institutions that make up the state sector, as well as the entrenched resistance of rent-seeking groups, the upgrade of the Romanian public administration will inevitably be gradual and will entail concerted public policies. To ensure that such policies remain consistent for more than one political cycle, the efforts of the political decision-makers and of the concerned public servants will need to be supported by the internal public opinion, modernised public institutions, and EU and international institutions. Support and co-operation on the part of Romania's most important international partners in NATO and the EU can also be significant, as can the support of all corporations that consider themselves as bona fide stakeholders in Romania's future and act as such.

57. Krugman anticipated a »mezzogiornification« of southern EU member states after the introduction of a common currency (1991: 8). But he put it in relatively benign terms. The fact is that the current crisis has shown that the eurozone is more constraining as a single currency regime than the gold standard of the interwar period. For the functioning of the gold standard regime, see Eichengreen (1992). Whether the banking union will help remedy this remains to be seen.

In this process, Romania's institutions would have to go from being »‹extractive«› into being »‹inclusive«,›, to use the words of Acemoglu and Robinson. This would involve a taxation system that provides essential resources to the state, improves public services for the whole population, and keeps social polarisation in check. Taxation policy has to convey a message of fairness to citizens, most of whom have been severely battered by the current crisis. Fairness implies better tax collection and, arguably, a differentiated income taxation scheme. A return to a more simple differentiated taxation should not be seen as an ideological choice. Instead, it should be viewed as a tool for protecting social cohesionand promoting inclusive economic growth. Which taxes to differentiate, how much, and when to do it, though, are open questions, which should consider also the constraints posed by the current crisis. At the same time, it is essential to develop civic values throughout the social body. In this respect, education can and should make a positive difference, but the education system itself needs serious institutional reforms. Equally important is the influence of the media, which must support the principle that nobody is above the law, however powerful a person may be at one point in time.

Efficiency reserves are huge in agriculture, energy production and consumption, and the service sector, which includes, but is not limited to, the public administration. Romanian agriculture is a sector with a dual structure. It combines a relatively small number of large farms working for the market with modern technology and with a huge number of small, subsistence-oriented agricultural households. It produces 6 to 7 per cent of Romania's GDP, while employing almost 30 per cent of the economically active population. The average productivity is several times smaller than in the EU27. A smart public policy would encourage land consolidation and the assistance of farmers who lack the financial resources necessary for using modern implements and logistics. Small farmers should be encouraged to form associations, like in the EU's advanced economies. EU funds could be used to recreate irrigation systems and to provide essential support services that would easily foster productivity and output. The essential issue here will be embedding agricultural progress into a comprehensive model of rural development that can absorb the labour force that has been freed from agriculture and can raise the general living standards in the countryside[58].

58. Lanner (2009)

Energy production and consumption also display enormous efficiency reserves. Although Romania possesses some internal resources of oil and gas, it also depends on the import of substantial energy resources. The Cernavodănuclear plant provides about one-sixth of the electric energy of the country and is one of the safest in the region. Renewable energies represent a dynamic, but still underdeveloped and expensive sector. Nevertheless, the potential is high when we consider both the renewable energies and the gas reserves under exploration. Even more important is the potential of saving energy in industry and private households. EU funds and EU-based MNCs can make a positive difference in the development of renewable energies and in the implementation of energy saving schemes. Huge reserves are also in the labour-intensive service sectors such as trade, education, health care, tourism and public administration. These sectors benefit from a relatively cheap, skilled labour force, but are marred by chronic mismanagement. Consistent policies to improve quality standards and to connect these services to international consumers can make a positive difference and compensate for the inevitable erosion of the comparative advantage of low average wages.

Industrial rejuvenation should also be in the cards, as is the case in many European countries. In spite of the industrial downsizing mentioned above, Romania has a wide range of industrial sectors and segments of them can make progress, not least because of available skills and the excellence of some Romanian IT companies. Europe 2020 can provide a framework for aiding knowledge based industrial sectors, while the public budget has to make its own contribution in fostering R&D expenditures – the current rate, less than 0.5 per cent of the GDP, is among the lowest in the EU.

Both industrial rejuvenation and the modernisation of agriculture depend on the development of infrastructure (highways, irrigation systems, upgrading the railroad network, the drinkable water system, the sewage system, etc.), where Romania is much lagging behind other EU countries. Poor infrastructure offsets Romania's labour cost advantage significantly.

Regionalisation – or the setting up of regions – is a major project to be carried out in Romania. It can bring about substantial benefits, but it entails pitfalls, too: bear in

mind that the debt crisis in Spain and Italy was intensified by the budget profligacy of provincial and regional governments. A balanced budget rule should be established and introduced in the Romanian constitution regarding the functioning of regions. Regionalisation should strive to strengthen institutions, not to weaken them; it should help public administration capacity to devise policies and implement projects, including EU funds absorption.

The need to rethink the growth model

Romania needs to grow in order to catch up economically. Even if ecological concerns (as resource constraints) are taken into account for the sake of making development sustainable, economic growth remains a rational societal purpose. But growth has to rely more on renewable resources: it has to be inclusive – as numerous recent IMF and OECD studies have shown – and it has to be better undergirded by knowledge and innovation. These are lofty goals that will not be easy to achieve unless public policies are better designed and aided by an enabling international environment. A more entrepreneurial, Schumpeterian, sort of capitalism is not easy to achieve when technology and know-how transfer from abroad is the overwhelming channel for upgrading domestic production. Importing technology and knowledge is more than welcome when an economy is much behind advanced economies. But there is a threshold after which growth and overall development need stronger domestic drivers, including the ability to innovate and export products with a higher R&D content.

For a less developed EU member state, the rules of the Union are essential in order to reduce development gaps. The current crisis speaks volumes about the pitfalls of betting excessively on foreign savings, as occurred in the pre-crisis years; of having a non-significant presence of domestic capital in the local financial sector and in other key sectors; and of not focusing on tradable sectors by using a strategic approach. Due to insufficient local capital, attracting inward foreign direct investment, especially in priority sectors, is a must. Subsequently, raising domestic savings, using these better for industrial development, and reducing the mismanagement of public resources are also a must. The end of development banks in NMSs was arguably premature. For example, Germany, the economic powerhouse of Europe, has its Reconstruction Credit Institute (or, the KFW). One could argue that the EBRD and the European Investment Bank could supplant national institutions, especially in a Union. But this is, we believe, an unconvincing argument. Can the aforementioned weaknesses be addressed? Can a more robust development model be built up? We believe they can, and that the dynamics in the eurozone matter enormously for the Romanian economy.

The current crisis is one that requires models to be revisited. Policy fundamentalism and the simplistic economic philosophy that markets failures are negligible are called into question. There is a necessity for open-minded and pragmatic policies at national, EU and global levels. One paradox is that governments' policies are scrutinised, and punished, by nervous financial markets while the latter have to be bridled in order to serve economies. To this end, a new regulatory and supervision framework for finance has to be introduced. In the EU, this is inextricably linked with the setting up of a banking union.

In previous sections a plea was made in favour of thoroughly reforming state companies and the public sector, and strengthening the rule of law in Romania – the underlying thesis of which being that institutions are of utmost importance in economic development. But while better institutions enable more effective public policies the very set-up of development policies is a fundamental variable which is in the hands of policy-makers. A sketch of a development-oriented policy mix, which sums up basic points made in our paper, is outlined below:

- a strategy for making institutions function properly, including setting priorities, allocating resources, and taking measures to insulate these institutions from undue pressures and predatory vested interests; human resources policies; the fostering of institutional values and professional standards; monitoring;

- mobilising internal resources and encouraging domestic savings;

- efforts to reform education in conjunction with a significant rise in R&D expenditures, which should enhance the domestic production of higher value-added goods and services; public expenditure for education should rise above five per cent of GDP;

- a strong push to develop infrastructure, a point at which Romania is at a major comparative disadvantage;

- financial institutions that focus on funding strategic sectors, which can be done within the framework of the Europe 2020 strategy and can rely on EU funds as financial resources for development; Eximbank should turn into an export and industrial development bank and expand its operations. CEC Bank should be better capitalised;

- industrial policy measures that enhance higher value-added production (these measures can have a fiscal component, which is allowed in the EU);

- policies that target the exploitation of natural resources in a way that benefits Romania (energy is a prime example); maintaining public control of major energy companies such as Transgaz and Romgaz;

- tapping into the huge potential in agriculture against the backdrop of climate change and the rise in the world relative prices of basic commodities; public policy is badly needed because of the small plots of land and the poverty of most farmers; the decay of irrigation infrastructure;

- a monetary policy and an exchange rate policy that maintain strong buffers (hard currency reserves) and bolster the production of tradables (the Asian experience is pretty informative in this regard);

- an aggressive trade policy based on the reality that the main drivers of growth are outside Europe and will be, arguably, for a substantial period of time;

- a substantial rise in tax revenues by broadening the tax base and combating tax evasion (a tax intake target of 32 per cent of the GDP by 2016, while budget revenues should reach over 35 per cent of the GDP), should permit an adequate quantity of public goods without endangering the health of public finances (this provision should consider the ageing of the population, demographic dynamics);

- a reduction of social security contributions to enhance competition, transparency (diminish the informal labour markets), and job creation;

- a determined effort to diminish market abuse by various companies, both local and international; this should be pursued within a EU framework, together with other NMSs that face similar problems.

The guidelines mentioned above would be part of a »policy space«, which means more than just a »fiscal space« – the latter needed in a world that strains public and private budgets. Policy space refers to both a wider range of policies, as validated by economic achievements around the world, and their use in a clever combination[59]. Policy space also includes the way social partners – such as the state, employee representatives, and corporate world representatives – work together towards the common good and avoid increasing social fractures. To this end, the experience of several EU member countries can inspire reforms. Some may claim that too much social expenditure is the cause of the current crisis in Romania and elsewhere. In our view, this is a biased and misleading claim. It is true that the financial and economic crisis blends with and deepens the crisis of the welfare state. The latter crisis precedes the former, and was caused by a hypertrophy of the public sector in some countries (the case of Greece is a glaring example), and by populism, political cronyism and demographics. But to claim that the way out of the current crisis is a demolition of the European model is misguided. This model has to be redesigned since public resources were eroded while claims on public assistance were mounting in many countries. It is good for citizens to be incentivised, even assisted, to become more self-reliant.

However, the satisfactory solution cannot be achieved by resorting to social Darwinism. Governments must find a way to reconcile the need to re-dimension (i.e. adjust according to possibilities) public goods offered by the state so that the principle of »equal chances« is preserved, with people relying more on their own efforts and with measures that keep fairness alive. It should be stressed that fairness is not taken care of well if losses are socialised recurrently while some economic sectors – especially finance – are protected, and even subsidised, because they would otherwise pose systemic risks. While the socialisation of losses in the financial industry may be comprehensible under certain conditions, it is morally and politically unacceptable if it turns into a policy habit

59. One of the leading proponents of policy space is Rodrik (1998, 2007), who was an early skeptical voice on international financial institutions' one-sided policies that were advocated for emerging economies.

– apart from the moral hazard issue. As a matter of fact, it perverts the very functioning of markets and corrodes democracy.

It would be better for Romania if the EU learned from its policy failures and overhauled its governance structures. The reform of finance is an essential part of it, not least because the functioning of a banking union requires it urgently[60]. However, the overhaul of governance in the EU and the setting-up of a banking union meet enormous hurdles. Many EU member countries are turning increasingly inward at a time when deeper integration seems to be the more rational choice given the depth of the eurozone crisis. This trend would better be reversed. Yet, as in a democratic framework, deeper integration can hardly occur against the wishes of its constituencies, so it is crucial that European citizens value the achievements and opportunities of the European Union more. But for this to happen, the political elites who support the European project need to make its case much better, in a convincing manner.

In a best-case scenario, mobilising internal resources, tackling institutional domestic weaknesses effectively, absorbing EU funds on a large scale, and setting a proper range of development priorities (which should also be pursued by industrial policies) would allow Romania to restart its convergence path and avoid falling into a »middle-income trap«[61]. But this outcome depends heavily on the dynamics within the eurozone and in the EU in general[62]. The question about the direction of Romanian capitalism has, therefore, to be examined in the wider scope of the direction of capitalism in Europe. Economic convergence is crucial for the political and economic sustainability of pro-European policies. Improved domestic institutions and enabling EU policies will allow Romania to gradually shift from a development model based on the comparative advantage of a relatively cheap labour force towards a model based on interconnected clusters of higher value-added economic activities.

End remarks: Seeking a cure in an uncertain Europe

Romania is at a critical juncture in its post-communist history. It has the building blocks of a market economy and has joined the EU and NATO. In spite of having achieved important economic progress during the past decade, it still is one of the poorest members of the Union. It is also afflicted by structural institutional weaknesses and less effective public policies. Its growth model has been quite fragile, not least owing to the »rules of the game« in the EU and the vagaries of international finance. The current financial crisis has caused an economic setback and dented Romania's growth potential.

One may argue that the downhill capital flows in the NMSs fit the textbook example and are therefore to be resumed in Central and Eastern Europe, where capital is relatively scarce. But the real history of EU enlargement must be read in a more nuanced way. It must consider the consequences of oversized finance sectors in advanced economies and the ensuing financial crisis, and the inadequate design of policy arrangements in the eurozone and the EU. All this complicates the mission of Romanian political and intellectual elites to achieve catching up in the years to come. One must also add the inadequacies of domestic institutions to the impact of external shocks.

The prospects of economic stagnation over wide stretches of Europe are looming while shifting economic power in the world hardens the global environment for Europe's emerging economies. In such a context, Romania needs to mobilise its internal reserves, absorb EU funds on a much larger scale, and undertake extensive reforms in the public sector as a means of raising its economic growth potential and offsetting adverse shocks. Domestic savings should be enhanced to underpin eco-

60. »Light-touch« regulation has wreaked havoc in the financial industry and the economy at large. Business models have failed as a result of their emphasis on trading and speculation, and the neglect of risks and complexity. »Too big to fail« (and »too big to save«) institutions present a formidable challenge to governments and central banks, but complexity and size themselves are challenges to management. Having simpler and smaller organisations – which can be achieved by using anti-trust legislation to split large organisations and by ring-fencing retail from trading operations – would be a step in the right direction. More own capital and less reliance on debt, lower leveraging, and rules that prohibit the use of depositors' money for the banks' own trading would also contribute to making systems more robust. The demarche to align incentives and limit pay, and linking it with performance and the interests of shareholders, is part of these reforms.

61. Overcoming this trap demands productivity gains that rely more on domestic drivers, including innovation. To this end, it is essential to upgrade the education system as the basis for R&D activity and the overall infrastructure. For some NMSs, this mission is increasingly tough as low-wage emerging economies, in Asia in particular, are moving quickly to the frontiers of knowledge and are successfully applying it in production.

62. On the causes of the current financial and economic crisis in Europe and the economic and social fallout resulting from it, see also Daianu (2009)

nomic development (i.e. domestic investment) and a more robust growth model. These are key policy issues that need to be addressed by Romania's policymakers and elites: the less public policies are captured by vested interests, the more effective policy-making will be. At the same time, EU policies need to be more responsive to the economic and social fractures revealed by the current financial crisis. Financial markets have to be reined in if they are to serve economies, and a moral compass has to guide both politics and the corporate world.

It is quite obvious that national policies are capable of making a difference in the European Union. But at the heart of the eurozone crisis is more than just that, since its design and policy arrangements are defective. In spite of domestic stabilisers, the way the eurozone operates today is more onerous than the regime of the gold standard during the interwar period last century. The formation of a banking union is a commendable undertaking and could provide an exit out of the eurozone crisis. But its implementation essentially boils down to fiscal arrangements that are meant to deal with asymmetric shocks – what Herman van Rompuy calls »fiscal capacity« – and to break the vicious link between sovereign debt and bank balance sheets. And this, unfortunately, is still an open question. Unless EU policies change for the better it is likely that fragmentation forces will get the upper hand and fatally cripple the European project. Such a dénouement would be a historical setback for Europe – and for those who wish to keep the demons of the past in the dustbin of history.

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