

THE DECLINE OF ROMANIAN OIL INDUSTRY BEFORE AND AFTER THE COLLAPSE OF COMMUNISM

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Abstract

We will show how in the absence of substantive reforms the problems of oil industry degenerated in the decade after the 1989 revolution. There are several reasons for this unhappy outcome: some of them are exogenous or refer to the economy at large (the collapse of foreign markets, hyperinflation), while others are endogenous, resulting from the very bad management of the companies themselves. From a larger perspective all these problems are institutional: the lack of private property, collectivist policies and the capture of the state – put it shortly, bad institutions – have deepened the inefficiencies and aggravated the waste of capital.

The overall fall of the economy and the changing demand for refined products that occurred during this period meant that at the end of 1990 a profound restructuring was necessary. The refineries were simply unfit to cope with the requirements of economic realities and considerable capacities needed to be closed.

Keywords: oil industry, inflation, communism, reform.

JEL Classification: N14, N54.

1. Why fast privatization was important

After the revolution in 1989, although the country was moving towards capitalism, the oil sector remained under the influence of the government for a relatively long period of time. The Romanian institutions were unfit for the market economy and the politicians were unwilling to commit to such a goal. The result was a long and tumultuous transition process, during which state management was extremely common throughout the economy.

From an economic perspective, the state of Romanian industry at the beginning of 1990 was very difficult: it was conceived in the tubes of central planning, directed by military-style orders (in fact energy companies were coordinated by military personnel), according to the directives of Ceaușescu and with no concern for the preferences of the consumers. Instead of focusing on satisfying the most urgent needs of the public, the whole structure of production had a completely different mission – that of observing the dictator's "precious indications" as to how much steel per capita should be produced or how many tractors should be manufactured. The rejection of profit as the single most important criterion for assessing the efficiency of production has led central planners to project a highly energy-intensive industry: the energy intensity was

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four times higher than in the US and four times above the European standards (Cossé, 2003). Therefore, the collapse of communism sent the factories in dire straits: they discovered suddenly how inefficient they were. Economic restructuring became inevitable.

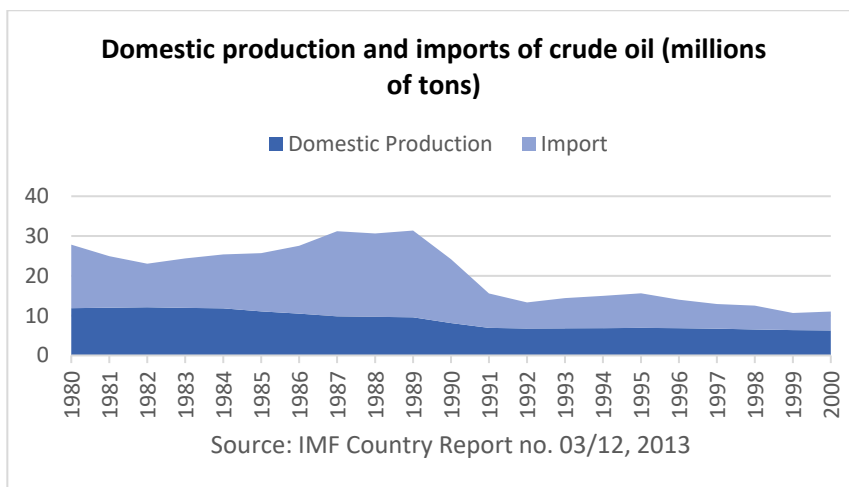
To alleviate the painful process of transition, policymakers should have insisted on fast privatization and deregulation, so that capital goods (the means of production) could be transferred as soon as possible in the hands of private individuals/firms. Not only theoretical reasons but also the experience of neighbouring countries confirms that the economic cost of readjusting the structure of production is smaller when a “shock therapy” is pursued. However, they were reluctant to admit this, and the democratic governments preferred to continue to engineer and manoeuvre the economy according to a “gradual reform” paradigm. But gradualism did not work as expected. Public decision-makers lacked the appropriate incentives to conserve or enhance the value of oil industry. Very soon, as the theory predicts, the state “has been captured” and the lobby of different interest groups opposed any reforms.

The effects of the interventionist paradigm have exacerbated the bad results of socialism and eventually, a decade later, left a disastrous legacy: heavily indebted companies, huge piles of useless capital, rampant corruption.

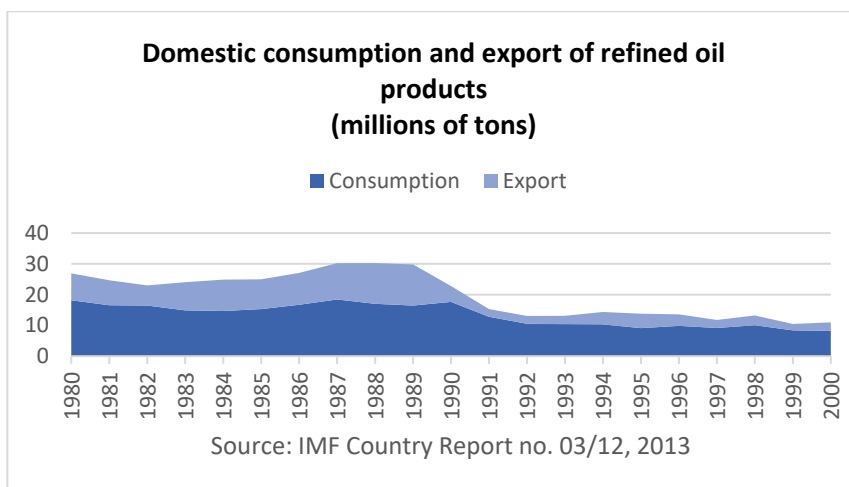
2. The great contraction

Given its “strategic importance”, the oil sector was at the centre of government policy. The general goal was to provide cheap petroleum products for the population and industry, using the existing facilities built by Ceausescu’s socialist regime for processing raw materials.

Because of numerous factors (Antonescu, 2012) such as the *natural* decrease of the national oil reserves, the reduction in new exploration works and the lack of new investments (especially in technology) due to bad state management policies, the national oil production decreased drastically after 1989. If the oil production was around 9 million tonnes in 1989, it collapsed in 1990-1991 and continued to decrease throughout the 90s, reaching 6 million tonnes in 2000 and only 4 million tonnes in 2013.



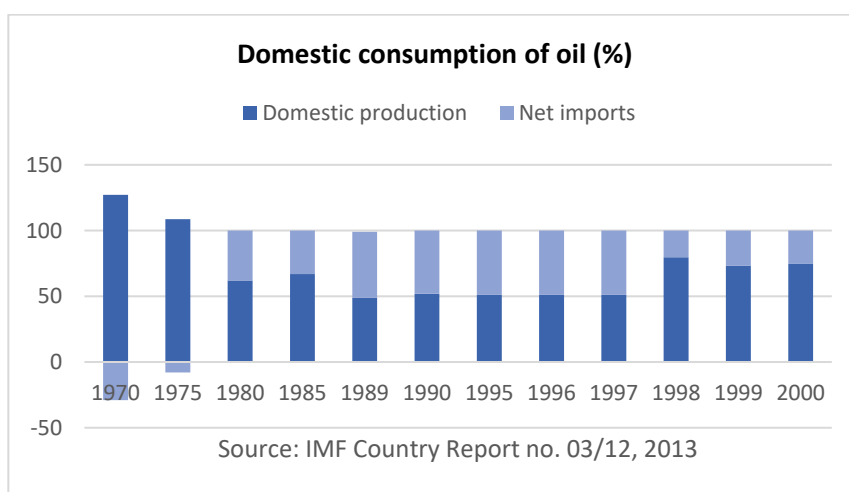
The reason for this collapse is twofold. On the one hand, the aggregate energy demand declined to half. “The drop in consumption took place primarily in industry, while household’s consumption has remained roughly flat” (Cosée 2003, p. 5). Many factories reduced or stopped their production because they lost their former foreign customers in CMEA, the economic organization that included the countries of the Eastern communist bloc along with a number of other communist states, or because they were unable to produce quality goods for the local population.



On the other hand, and more fundamentally, production declined because in the new institutional environment nobody was really responsible for state-owned companies. Aggregate investment declined to half, from 30% of GDP in 1990 to 16% of GDP in 1999. State-owned enterprises became a sort of no-man’s land, their managers who often refused to produce unless they were

bribed carried no responsibility, their workers' absenteeism jumped and their overall productivity dropped (Alessandrini, 1998). In the new atmosphere of "happy anarchy" strategic thinking was missing and SOE managers captured the state, lobbying for ever more subsidies and objecting to financial discipline (Negoita, 2011). In the oil industry corruption probably peaked during the war in former Yugoslavia, in 1994-1995, when despite the embargo over 1100 train wagons shipped oil products over the border, in a single operation which eventually determined a major judiciary and political issue in 2000.

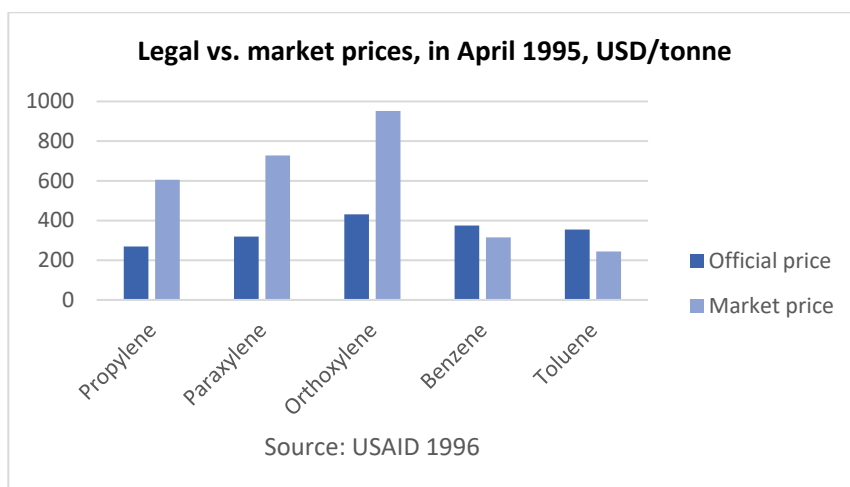
Although oil consumption decreased after the revolution, it continued to remain higher than supply. The only solution left for the authorities in order to solve this problem was to import crude oil. Thus, until 1997 half of domestic consumption of fuel was covered by oil imports.



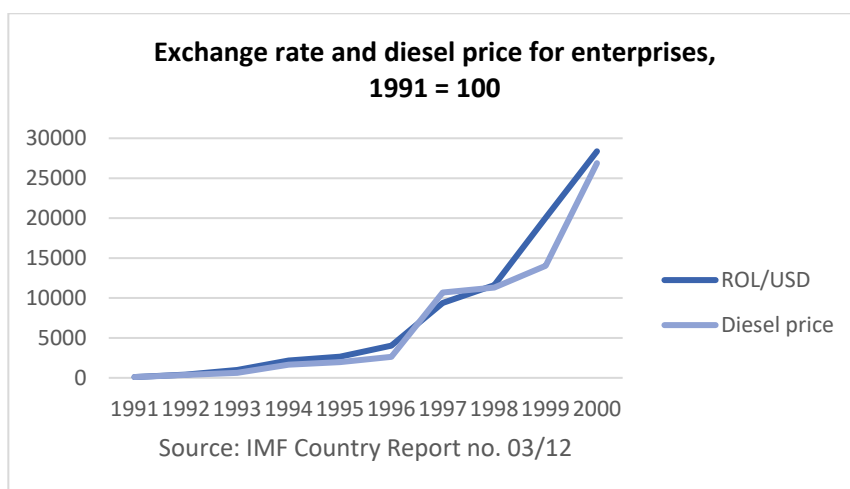
3. Inflation, price ceilings and decapitalization of state companies

Between 1992 and 1997, Romania imported around 800-1000 thousand tons of oil per month, which were paid in hard currency (mostly dollars). The oil was processed in the large refinery sector, which we have previously discussed, and the output was sold on the Romanian market at below the cost prices¹. The reason for this is that in early 90's the price for processed petroleum products was fixed at national level and no producer could sell below or above that price.

¹ The interesting aspect is that the prices for petroleum processed products were actually below *import prices*, without adding here processing and transport fees.

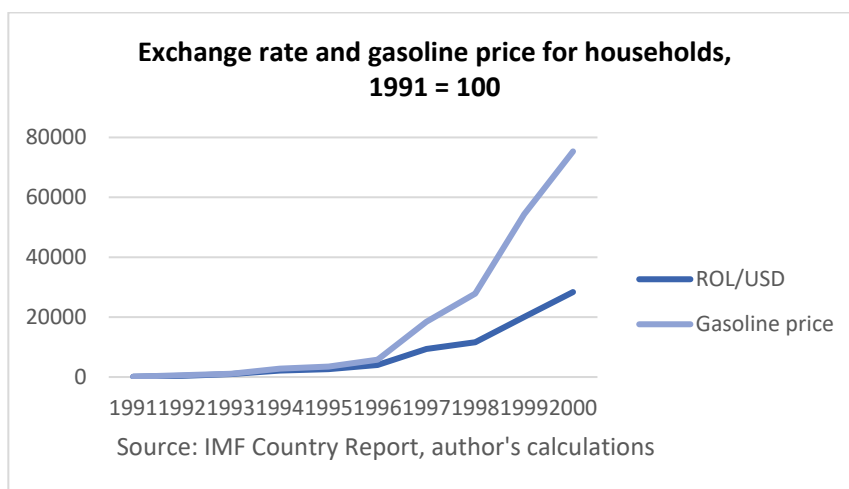


The official goals of this policy were (1) to provide social protection for the population and (2) to fight what mainstream economists refer to as “cost push inflation”. The government was afraid that the decision of liberalizing the price of oil products meant higher transport prices, which would subsequently spill over into the prices of the transported commodities, pushing them up even further. This is the main reason for literally dumping petroleum products on the market at a managed national price that was below the import price of the main input that went into their production.



These two goals were actually the symptoms of another policy that the Romanian government was engaged in during those years: money creation in order to cover the massive deficits that the inefficient and overgrown industrial sector was accumulating. This type of policy is extremely costly from an economic point of view, and would normally lead to high prices for final

products. Therefore, in order to achieve what they considered to be the best of both worlds, i.e. continuing the easy money policy while also hiding its consequences and avoid social unrest, the authorities decided to maintain and continually fine-tune the interventionist scheme of maximum prices. Thus, they basically indexed the gasoline and diesel prices to the rate of currency devaluation. Only in 1997, during the global financial crisis and the incoming recession, within the framework of an IMF stand-by loan agreement, the Ciorbea government decided to sharply increase the price of gasoline



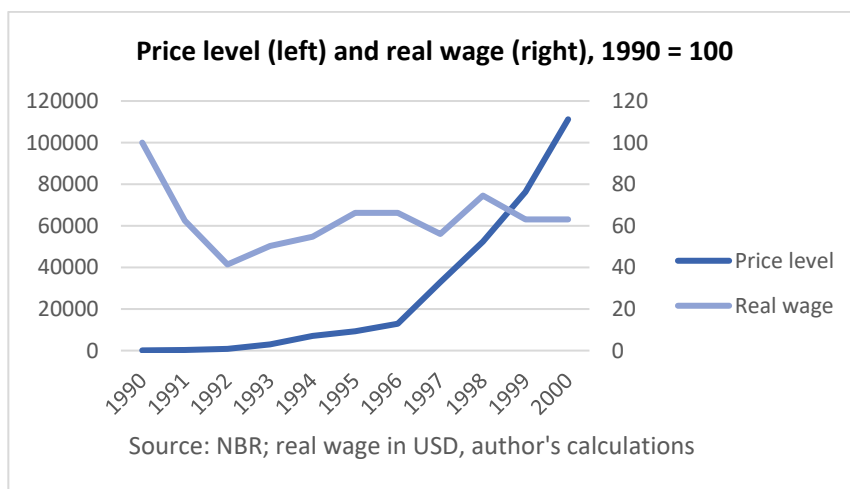
The result of artificially low prices was the huge accumulation of debt in the refining sector, the import-export banks and the international trade wholesalers of petroleum products. The oil sector revealed itself to be inefficient and overdeveloped under the management of the state, a large refining capacity becoming useless. When the state was eventually forced to privatize the sector, first, due to increasing debt and secondly, due to the pressure of international organizations like the IMF, the WB and finally the EU, the companies were already basically bankrupt.

Inflation itself was another factor that aggravated the financial situation of SOEs. Because in early '90s the leu lost its purchasing power very fast and companies were unable to set their selling prices to reflect the anticipated inflation, they were decapitalized. They purchased crude oil at initial prices, then they supplied refined products and sold them at prices that were essentially indexed to this initial cost of production, actual cash inflows being received later on; afterward, when they would buy again crude oil from the international market, they could only discover that, because of the leu's devaluation, their cash income was much smaller than their new supply cost. To put it differently, refineries discovered the unpleasant truth that in times of hyperinflation there is a major difference between *nominal* and *real* incomes and profits. Therefore, to

continue their activity, they permanently needed new injections of liquidity and more and more loans from Bancorex – the state-owned bank that financed international trade.

“Inflation is always and everywhere a monetary phenomenon” – is one of the most important dictums in economics. The only reason for which *all* prices rise substantially over a period of time is an increase in the money supply by the central bank. In the 90’s Romania had huge inflation problems, with Consumer Price Indexes of over 250 percent per year. 1991 and 1993 were two of the worse years from this point of view, following a relative decrease in 1994 and 1995 only to generate another inflation crises (although relative smaller) in 1997.

Romania has pursued an inflationary policy precisely because decision-makers attempted to hide the real economic situation. Given that they were reluctant to admit that, in the absence of market demand factories should reduce, stop or change their business, which would have implied significant layoffs, policymakers decided to print money in order to reduce real wages and keep afloat as many state enterprises as possible.



It is easy to see that from an economic point of view, such a policy was unsustainable. Importing raw materials and selling processed products below the import price does not make economic sense, while printing money cannot help. Although the exact dimension of losses in the oil industry was difficult to estimate – and quite impossible in the absence of private property and free markets – especially given the cross-subsidies among SOE’s companies, estimates place the refining sector’s loss at 1 million dollars per day. The outcome for the Romanian policy was rather predictable. Because the state chose to postpone the privatization of the oil sector and to continue the cheap price policy, the refineries began to accumulate huge debt for the import bill.

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