ECONOMY

REFORMS – DEFINITELY TOO LITTLE. ALSO TOO LATE?

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OVERVIEW

TRENDS

Moldova started the transition process from scratch: there were no foreign exchange reserves, no central bank, no market mechanisms – but also no liabilities. After one decade of irregular economic reforms, Moldova is now the poorest country in Europe, and its economy features a large array of vulnerabilities. Net average wages do not exceed 40 USD/month, one third of the labor force left to search for work abroad, the shadow economy accounts for more than half of GDP, and the country is heavily indebted.

Since independence, the economy has plunged by about 60%, while the recent economic growth is yet unconvincing, as this paper argues below in more detail. Moldova also faced a severe financial crisis in 1998, as the contagion effect of the Russian crisis contaminated the local economy that has more links with Russia than with any other trading partner.

Moldova is still muddling through the first-generation stage of reforms

International literature (CASE, 2000)[9] agrees on the main elements undermining successful economic recovery in Moldova: lack of teritorial integrity, strong incentives for rent-seeking behavior, inefficiency of the legal system, widespread corruption. Lack of ownership of the reform programs is also recognized as a cause for reforms' failure, as these programs appeared to be usually in response to the conditionality linked to financing from international financial organizations. It is acknowledged (following World Bank terminology) that there are two reform stages in a transition economy: first generation reforms, that set the new rules of the game; and second generation reforms, that teach market players to act in the framework set by the new market rules. Moldova finds itself, in most cases, still in the first stage of reforms. The implementation of the new rules of the game has either been prevented by a highly inertial system (e.g., trade structures have not made significant progress) or occurred by default (e.g., T-bills acquisitions by foreigners was permitted before the capital market being regulated, or main privatization deals were actually a debt-equity swap).

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[9] Larisa Lubarova, Oleg Petrushin, Artur Radziwill (2000), *Is Moldova ready to grow? Assessment of post-crisis policies*, CASE Studies and Analysis 220, Warsaw.

In the *Country Strategy Paper 2002-2006*, the European Commission considers that „since Moldova is located directly on the border of an enlarged EU, instability and poverty in this country are a matter of concern for the EU". Taking note of this concern, we intend to warn on the risks the economy of Moldova is likely to face in the short and medium run.

MACROECONOMIC POLICIES AND EXTERNAL IMBALANCES

Inflation has recorded low levels in Moldova over the last years. However, inflationary pressures accumulate, as the anchors for price stability are put at risk by the current monetary and exchange rate policy.

Fig. 1. Key macroeconomic indicators

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
GDP, % real growth	-1.2	-31.2	-1.4	-7.8	1.3	-6.5	-4.4	2.1	6.1	4.8*
Current account, % GDP	-11.9	-7.0	-5.8	-10.5	-12.6	-17.3	-3.6	-8.4	-7.4	-7.2*
Trade balance, mil.USD	-148	-53	-70	-260	-347	-388	-128	-306.6	-313	-181**
Inflation, %, Dec/Dec	2706	104.6	23.8	15.1	11.2	18.3	43.8	18.5	6.4	8.0*
Nominal depreciation, %,Leu/USD Dec/Dec	***	19	5	4	0	77	40	7	6	n.a.
M3, % GDP	19.2	15.9	16.5	16.2	19.0	17.0	18.3	20.3	n.a.	n.a.
Gross official reserves in months of imports	1.7	2.8	3.0	3.0	3.1	1.4	2.9	2.6	2.5	2.5*

Source: IMF, EBRD, CASE *programmed **as of end of June 2002 ***the Moldovan Leu was created and enforced in November 1993, at

The increase in money supply is due to the faster rise in net domestic assets (NDA) than in net foreign assets (NFA). The NDA/NFA ratio was 2.3 in 2000, 3.17 in 2001, and it is programmed for 3.49 by the end of 2002[10]. This evolution should be associated with the sharp expansion in bank credit (+18% in 2000 and +27% in 2001 in real terms), which might entail a perverse misallocation effect in the absence of decisive structural reforms. Furthermore, stimulating aggregate demand does not make economic recovery possible in Moldova (CASE, 1999)[11] because rapid growth in final consumption fuels exclusively an increasing trade deficit.

The exchange rate has been appreciating in real terms since 1999 onwards, which seems to repeat the experience prior to 1998. The real appreciation

[10] Calculations based on data from IMF (2002), *Republic of Moldova – Staff Report for the 2002 Article IV Consultation.*

[11] Artru Radziwill, Octavian Scerbatchi, Constantin Zaman (1999), *Financial Crisis in Moldova – Causes and Consequences*, CASE Studies and Analysis 192, Warsaw

of the Leu is likely to prove detrimental in the context of rigid wages in the public sector and widening foreign trade imbalances.

The current monetary policy (NDA going up faster than NFA) and exchange rate policy (real appreciation of the leu) create long-term inflationary pressures

Indeed, the trade disequilibria is the main negative input in the composition of the current account. Showing huge deficits (-21% of GDP in 2000, -16% in 2001 and an estimated -21.3% in 2002), foreign trade is still oriented towards Russia (40.1% of exports and 11.7% of imports) and the other CIS economies (20% of exports and 24.2% of imports), while EU and Romania account for significantly smaller shares (22.9% of exports and 28.9% of imports, respectively 7.8% of exports and 13% of imports – all data as of end of June, 2002). The bad news regarding foreign trade refers to its composition. Almost two thirds of Moldova's exports are natural resource-intensive; the volatility of international prices for this type of goods extends to the volatility of incomes from exports. Moreover, Moldova's exports are overconcentrated, as the calculation of the Hirschmann index indicates (table 2), furtehr aggravating the negative consequences of a potential adverse shock on foreign markets. The recent accession to WTO is unlikely to improve the situation in the short run, given the presumed lower exports' elasticity to tariff cuts (as compared to the imports' elasticity).

Fig. 2. Foreign trade composition, end of first semester 2002

	Exports	Imports
Structure, by products groups, Kraus classification, % of total		
Natural resource intensive	62.8	33.6
Low skilled labor intensive	21.4	31.3
Technology intensive	10.8	19.8
Human capital intensive	5.0	15.3
Concentration, %		
Hirschmann index	23.0	9.73

Note: a.) According to Kraus classification, „natural resource intensive" class includes groups I-V and VIII, „low skilled labor intensive" class includes groups XI, XII, XV, XX, „technology intensive" class includes groups VI, XVI, XVII, XVIII, „human capital intensive" class includes groups VIII, IX, X, XIII.

b.) Hirschmann concentration index is calculated as: $HIx=\sum(xi/X)^2$, respectively $HIm=\sum(mi/M)^2$, where i is the number of product groups (groups I-XX of the Combined Nomenclature), xi and mi stand for exports, respectively imports of i, while X and M represent total exports, respectively total imports. This index varies between 0 and 1 (or 0% and 100%). Hirschmann index for total exports, shows following values (Davenport, 2001): Latvia 16.0, Romania 13.0, Croatia 12.0, Slovakia 11.0, Slovenia 11.0, Hungary 10.0, Bulgaria 9.0, Poland 7.0, Czech Republic 6.0, transition countries average 16.0, Spain 12.0, Portugal 12.0, Greece 10.0, Italy 5.0, developed countries average 17.0.

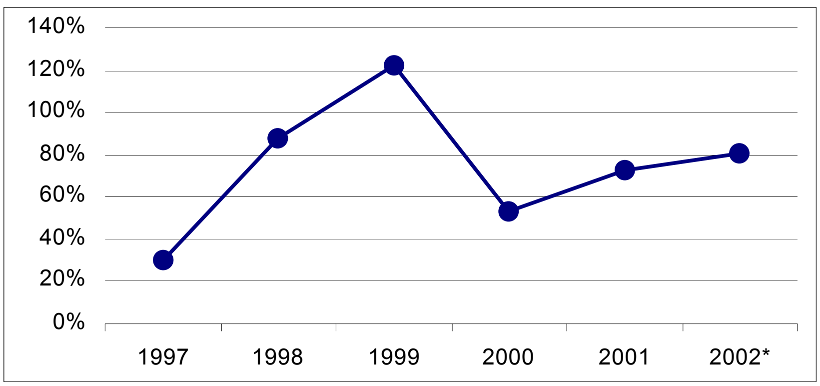
Source: own calculations based on DSS data

In view of the big difference between export and import concentration, it is also probably safe to submit, but it should be qualified by more in-depth research, that intra-industry trade is low and that import dependency of exports is limited. In terms of policy recommendations, this means that a competitive devaluation of the local currency might not have an indirect effect of limiting exports because iported inputs become more expensive.

The large trade deficits are partially balanced by the large inflows of foreign remittances. As Fig. 3 indicates, foreign remittances represents the main flow of foreign capital in Moldova's economy. It represents the "Polichinelle secret" by which Europe's poorest country (87% of population lives below the "minimum subsistence level") keeps going on. Of course, since they make up for elementary consumption needs, a large part of foreign remittances stimulates the imports of current consumption goods.

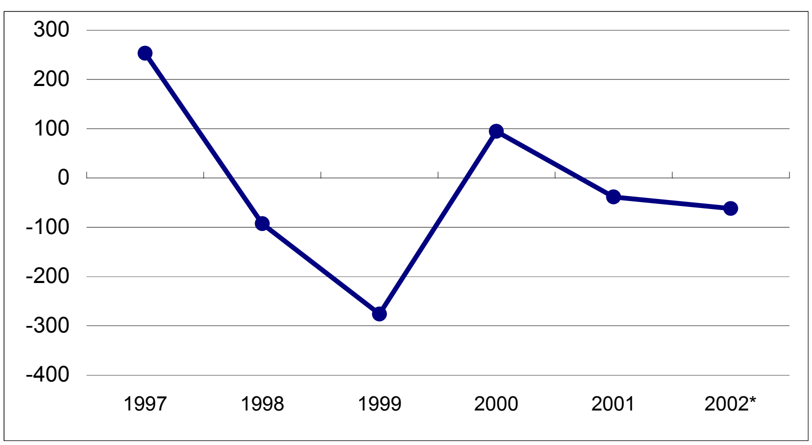
If we leave foreign remittances aside, the other autonomous capital flows are either net negative (see Fig.4) – the case of portfolio investments, or are largely the results of debt equity swaps – the case of foreign direct investments. Hence, the main genuine financing source of the current account deficit remains foreign borrowing.

Fig. 3. Share of total remittances in total net capital flows



Note: foreign remittances = compensation from employees + current transfers; Source: based on NBM data

Fig. 4. Short term private capital, net flows,



Note: a) figures represent mil. USD b) short term private capital flows = portfolio investments + short term private loans + other flows + errors and ommissions
Source: based on NBM data

As a result, Moldova is heavily indebted, its total external debt matching more or less its GDP. Public debt (including publicly guaranteed debt) takes the lion's share, but private debt rose six times from its 1997 level. The energy arrears, at about 20% of GDP, show the scale of the distortions in

Moldova's economy; they also speak about Moldova's incapacity to generate non-debt creating flows of foreign exchange for paying off its debts.

Fig. 5. External debt composition, % GDP

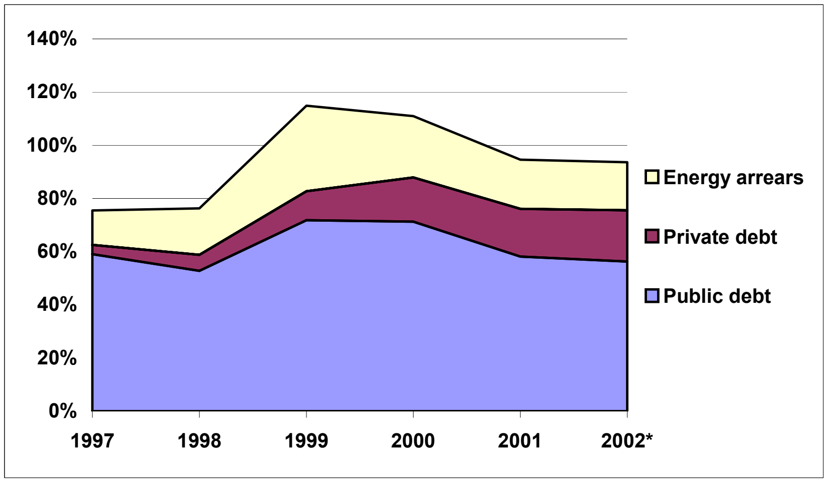


Fig. 3. Indicators of external debt

	2001	2002 prog.
Total external debt, public and private, excluding energy arrears, % GDP	76.1	75.6
Debt service on total external debt, mil. USD	221.9	248.1
Official foreign exchange reserves / Public external debt, %	24.4	22.8
Debt service on public external debt / Official foreign exchange reserves, %	57.7	76.1
Debt service on total external debt / Exports	70.9	67.8

Source: calculated based on IMF and NBM data

The scale of the debt problem is huge, and Moldova faces a constant risk of credit, combined with an increasing market risk and devaluation pressures. When official reserves are merely a quarter of the stock of public debt alone, and meeting the debt service is a challenging task each year, the combination between credit risk and market risk puts a constant threat towards the default risk. Foreign borrowing is therefore not a valid option for a healthy financing of the current account deficit in the medium and long run.

STRUCTURAL ASPECTS AND THE FINANCIAL SYSTEM

We mentioned already the fact that foreign direct investment in Moldova is in many cases undertaken by default, in the form of debt-equity swaps. Some relevant examples are:

- Gazprom took over the majority stake in Moldovagaz in exchange for a cut in energy arrears (the deal was evaluated at 50 mil. USD; no tender took place);
- the German company Mabanaft took over the majority stake in Tirex-Petrol (largest oil company) in exchange for overdue energy debts (no tender took place);
- EBRD accepted to transform a 8 mil. Euro investment in Glass Container Company (part of the Wine Export Promotion Project) into equity.

These are fake, or quasi, foreign direct invetsments (this is why the FDI's stock of 40% of GDP is misleading). They do not reflect any location advantages on behalf of Moldova; instead, they represent a second best solution for the so-called investor, do not inject capital in the troubled local companies, and are unlikely to have positive spillovers (quite the opposite, they create market entry barriers by blocking other potential investors; there is also no guarantee of improved management practices).

The combination between the credit risk and the market risk puts a constant threat towards the default risk

On the other hand, the promotion of cash-based privatizations is hindered by the gloomy investment climate. The lack of strategic resources, the small size of the domestic economy, the wide-spread bureaucracy and coruption (EBRD, 2001)[12] deter FDI. Hence, there is no surprise that 40% of all FDI in Moldova come from Russian investors; they are more accustomed with the local environment, and can better integrate their investments in regional networks of distribution, since Russia also accounts for a large share of Moldova's foreign trade. Claims were also raised that the Eastern-way orientation is politically directed, taking advantage of institutional fragility and lack of functioning market mechanisms. As a remark, according to Russian statistics (quoted in CSSR, 2002)[13], Russian direct investments in CIS economies added up to 120 mil.USD in 2001, 93 mil. USD of which being directed to Moldova.

The financial system remains weak. There is low monetization in the economy, stock market capitalization is only 0.1% of GDP, and the banking sector is very concentrated, first four banks owning 69% of total assets. High real interest rate stays high, as credit is constrained by two factors: availability and cost. High borrowing requirements from Government and, as a consequence, the attractivity of t-bills, low supply of domestic savings, high operational costs, high systemic risk deem bank intermediation rather inneficient; in this context, the surge in bank crediting over the last period will likely prove to be of an inflationist nature in the end, as the problems mentioned above can not be solved over night.

[12] EBRD (2001) *Strategy for Moldova.*

[13] Center for Strategic Studies and Reforms (2002), *Moldova in transition. Economic Survey*, no.9/2002

FDI as debt-equity swaps represents a poor strategy – no fresh capital, no location advantages, no positive spillovers

The best indicator of the structural strain in Moldova is probably given by the very low performance in tax collection. Tax revenues represented 22.3% of GDP in 2000, 22.4% in 2001 and an estimated level of 23.2% in 2002; one third of these revenues come from VAT collection. At the same time, expenditures have constantly exceeded 30% of GDP; interest payments represent one fifth of budget expenditures (payments for domestic debt are slightly higher than those for external debt).

Fiscal improvement through expenditure rationalization, focused on the reduction of education and health contributions, contradicts one of the pillars of the Poverty Reduction Strategy, namely the promotion of human development policies. Another controversial measure in the fiscal area is (according to IMF) the proposal to increase the land tax based on area and quality of land owned, that would replace the income tax on farmers, VAT on agricultural products, the current land tax, and social contribution of farmers (with repercussions on the integrity of the collection system).

SUMMING UP: MAJOR VULNERABILITIES

- *Incapacity to assume ownership of reforms.* Reforms are induced and designed by programs associated to financing of international financial institutions. This explains the shaky evolutions of reforms, their inconsistencies within a country-wide strategy, and their delayed and/or fragmented implementation.
- As a logical consequence of the lack of reforms' ownership, *Moldova follows sharply contradicting objectives in terms of its long-term development perspective.* On the one hand, Moldova is *de facto* integrated, from the perspective of commercial and investment flows, in CIS, and, on occasions, is playing with the idea of the joining a hypothetical Russia-Belarus federation. On the other hand, Moldova states its objective of EU integration. The conflict between these two objectives is observed also by the European Commission (in its mentioned *Country Strategy Paper*) and suffocates the development of the Moldova's economy in a straight direction.
- *The likely accumulation of inflationary pressures*, in the absence of decisive structural reforms (the structural component of inflation does not seem to be dealt with).
- The *persistence of huge trade deficits*, together with the predominance of natural resource intensive class of exports (with volatile international prices) and excessive concentration of exports.
- The *excessive recourse to debt equity swaps*, that represent a second best solution for the so-called investor, do not inject capital in the troubled local companies, and are unlikely to have positive spillovers. Moreover, trade reorientation is not stimulated under the circumstances of very low Western driven FDI outside the debt equity swap mechanism. Political interference allegedly plays an important role in choosing this method of privatization.
- The *incapacity to generate autonomous* (non-debt creating) *flows of foreign exchange*; portfolio inflows were in most years net negative and

foreign remittances (not generated by domestic policies) are dominant in the composition of foreign capital flows.
- The heavy external indebtedness of an economy that is practically dependent of official financing. Consequently, there are constant credit and market risks, the combination of which leads to a quasi-permanent risk of default.
- The *lack of proper market mechanisms* and the absence of a friendly investment climate. Moldova is, in most cases, locked in first generation type of reforms.

A WAY OUT: POLICY RECOMMENDATIONS

European Union's objective regarding Moldova is to help it "overcome crisis by improving its position in foreign trade and diversification" of its products and markets. EBRD considers that key challenges for Moldova are: to demonstrate capacity to implement the structural and institutional reforms needed for building the market economy; to secure international financial institutions' financing in order to avoid default; to successfully privatize telecommunication, wine, and tobacco industries; to implement an effective regulatory framework; to improve the investment climate.

In addition to all these, we issue the following policy recommendations:

- **do not favor the accumulation of inflationary pressures** (price control is one of the targets in the Government's program). Inflation rate should not represent a policy objective in itself as long as structural reforms are not undertaken (as long as structural component of inflation is not dealt with resolutely).
- **consider the opportunity of a competitive devaluation** of the local currency, which could help reduce the trade deficit in the short run. This should nevertheless be done in a way that would not fuel inflationary expectations.
- **improve, or impose, controls on specific capital outflows** (don't let money leave the country if you can't compensate them through capital inflows).
- **tax speculative and debt-creating inflows**, in order to limit the scale of foreign indebtedness and to diminish the incentives for a rent-seeking behavior (use the practice of unremunerated reserve requirements for one year). Limit as much as possible foreign borrowing, as it can not be a valid option for a healthy financing of the current account deficit in the long run.
- **promote foreign direct investments** in the forms of greenfield investments and **privatization for cash** (diminish the recourse to debt equity swaps).
- **assume political role in promoting investments from EU members and EU candidate economies, as the main policy tool for trade reorientation towards EU, and for changing trade structure (through intra-firm trade).** Start with a specific large privatization, since the smaller the size of the economy, the higher the impact of a demonstration effect.