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Moldova's European Transformation: Building Consensus for Democratic and Economic Reform

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Article at a glance

- Political and economic reforms in Moldova over the last decade have been more difficult than expected and often remain incomplete.
- Although Moldova has made progress in its transition process, the legacy of government mismanagement of the economy presents a challenge to reform.
- The new reformist government has a historic opportunity to advance long-neglected reforms and help realize Moldova's goal of membership in the European Union.

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Introduction

After gaining independence in 1991, Moldova made a strategic choice to implement democratic, economic, social, and political reforms in order to achieve a European future. Even the country's former communist government, in power from 2001 until 2009, adopted pro-European rhetoric; however, they paired it with steps taken in the opposite direction. In July 2009, Moldova made the transition to democracy official when a majority voted in favor of pro-European parties, bringing an end to Europe's last Communist government.

The Moldovan path to Europe proved to be hard, maybe harder than anyone expected. As U.S. Vice President Joe Biden stressed in his recent statement to the Moldovan people in Opera House Square in Chisinau: "[P]olitical change is hard. Economic reforms can be even harder, especially when unemployment is high and prices are rising."[1] However, with the new determination to pursue political and economic reforms, Moldova can achieve these goals.

Lessons from Moldova's Transition

Mikhail Gorbachev's *perestroika* and *glasnost* in the late 1980s inspired Moldovan reformers and received overwhelming support from the people. At the start of Moldova's transition from communism and central planning in the early 1990s, the most important questions were not about whether or not to implement reforms. With the exception of communist hardliners, almost everyone agreed that radical reforms were necessary. The most debated issues were how to promote them, what models to choose, and how to accelerate transition to a socially-oriented market economy.

The process of mass privatization serves as an example of one early economic reform in Moldova. During this process, 95 percent of the population received patrimonial bonds, or vouchers, and 90 percent used them to gain formal private ownership of their homes, land, or other assets owned by the government and offered for privatization. By the end of the 1990s, however, most Moldovans gradually lost confidence in reforms due to a number of factors.

First, reforms required strong political will, unity, and responsibility from the ruling elites. Politicians, however, were locked in internal fights for their own personal or class interests and did not focus on radical transformations in the national interest. Second, reforms were not synchronized and did not adjust to real situations and the needs of the people. Their social costs were too high and especially painful for the elderly and retired who had been forgotten in transition. Additionally, the younger generations were ingnored; young Moldovans were not offered better education or career opportunities in their own country during the transition period. Third, international assistance, although valuable, did not focus on what could be called the "arithmetic" of transition – the basic needs of populations, social protections, education and healthcare programs. Instead, the focus of foreign donors was on the "high mathematics," like structural adjustments and restructuring assistance.

It was an important period when the seeds of democracy and future prosperity were planted, but sagging support for reforms enabled communists to return to the government through democratic elections. They came to power in 2001 on the wave of popular discontent and populist promises as well as criticisms of the International Monetary Fund (IMF), World Bank, and other international organizations. Following through on their promises, they renamed one of the most important reform programs, land privatization, in the Romanian/ Moldovan languages from "Pamintul" (land), to "Mormintul" (grave). In reality, this program had been one of the most successful and comprehensive reforms that destroyed the kolkhoze, fortresses of communism in rural areas that were the basis for collective farms. Land privatization established and protected private ownership rights, which led to increased productivity in agriculture, and set an example for other countries in the region.

The benefits of these reforms are clearly visible today: last year's World Bank *Doing Business* report

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credited Moldova with an impressive ranking of 17 among 183 countries for registering property due to land titling and private ownership of land with an efficient and low cost land registration process. Property registration, however, is the only area in which Moldova excels in the *Doing Business* ranking compared to its neighbors.[2]

A forgotten lesson of the 1990s is that once reforms have started, they should be promoted firmly and consistently with minimum government interference, though the government must still supervise. In Moldova, however, the process of reforms was never straightforward; in many cases took one step forward and two steps back.

For example, when mass privatization started in 1994, the government was very worried about an imbalance between the value of bonds distributed to the population and the value of property submitted to privatization for these bonds. To address this issue, the government arbitrarily and artificially increased the value of state property while also banning the privatization of hundreds of strategically important state-owned enterprises (SOEs). Among them were Moldovan telecom operator Moldtelecom, electrical distribution networks, tobacco factories, public utility companies, and wineries. By the end of this process in 1998, more than 20 percent of state-owned property designed for privatization through patrimonial bonds was never privatized. Some of these "strategic" SOEs are still under poor government management; some others have been privatized into the hands of those connected to the communist leadership; and most have just been destroyed with their assets squandered. As a result, the majority of ordinary citizens never received the dividends they had expected.

"Economies need a balance between the role of markets and the role of government – with important contributions by non-market and nongovernmental institutions," writes Joseph Stiglitz, Nobel Prize winner for economics, in his recent book *Freefall*.[3] In Moldova, there always was and still is an imbalance in favor of the government and its bureaucracy. That is the explanation for why among 183 nations surveyed in the 2011 *Index of Economic Freedom*, Moldova continued to be classified as "partially free," ranking 120th in the company of Tonga, Malawi, Senegal, and Cote d'Ivoire, with lower than average scores on fighting corruption (33 percent), protecting property rights (40 percent), and labor freedom (39 percent).[4]

Challenges to Economic Growth in Moldova

There is a notion in economic development that refers to the least understood aspect of population growth – its tendency to continue after birth rates have declined substantially. This built-in tendency, called "hidden momentum of population growth," might be compared to a speeding automobile: when the brakes are applied, it keeps going for some time before it stops.[5]

This concept of "hidden momentum" could be used to explain why Moldova's economic model is still skidding and sliding. Some Moldovan experts characterize Moldovan economic growth as fragile growth without development, despite impressive inflows of foreign assistance which have played an important role in macro-economic and financial stabilization.[6]

A group of experts headed by Valeriu Prohnitchi authored the comprehensive *Moldova's Economic Growth Analysis* and pointed out a few constraints that the Alliance for European Integration (AIE-2), the ruling government coalition in Moldova, had to confront from the very beginning. These constraints are financial, economic, and institutional in character. For example, one constraint is an economy in free fall with a 16 percent budget deficit due to unfunded pre-electoral promises from the communists in the Cabinet to increase salaries in the public sector. Other constraints include Moldova's 6.5 percent decline in growth in 2009, a substantial reduction in remittances from Moldovan workers abroad, and an administration inherited from the previous government that is unsustainably inflated in numbers, professionally incompetent and resistant to reform.[7]

The "hidden momentum" is the inertia of previously taken decisions, adopted laws, established patterns, anti-competitive cartel practices, and the monopolization and re-privatization of the most profitable businesses by the former Moldovan President Vladimir Voronin and his clan. These patterns are at the core of Moldova's inefficient economic model.

During the communists' post-2001 rule, no single reform was brought to meaningful completion. This has had corresponding negative results: firms in the energy sector are laden with debt, the country has outdated infrastructure, the public sector is inefficient, the education system is overly expensive, social assistance is fragmented, there is very high health spending, and pension systems are fiscally unsustainable. Overall, indicators of Moldova's development are still far below European Union (EU) averages.

Adding to this gloomy picture is the significantly increasing emigration of the most educated and skilled Moldovan workers. These workers then send remittances that account for almost a third of Moldova's Gross Domestic Product (GDP), placing Moldova among the top five countries in terms of received remittances. Outflows of Moldovan professionals and young talented specialists – also known as "brain drain" – can be attributed to discrimination in the selection of public servants according to personal connections rather than employees' professional and moral qualities. It will take more than one or two years to overcome these patterns and change the mentality of people still indoctrinated by communism.

> To improve growth, Moldova must increase the efficiency of existing and potential sources of economic growth.

Priorities for the Reform Program

In 2010, Moldova's economy registered vigorous post-crisis recovery with real GDP growth of 7 percent. That not only exceeded the expectations of international and local experts (IMF predicted 3.2 percent, European Bank for Reconstruction and Development expected 4.5 percent, and the National Bank of Moldova forecasted 5 percent), but substantially outperformed other countries in the region that experienced decreasing rates of growth and even stagnation.[8] Nonetheless, Moldova's growth still follows a "jobless growth" model based on traditional Moldovan consumption pattern with a high unemployment rate (6.5 percent) and low productivity growth, especially for SOEs.

According to experts, a reversal of the mechanisms through which the global economic crisis affected Moldova supported the revival of the economy. Exports exceeded 20 percent, remittances increased by 5 percent, and foreign direct investments (FDI) strengthened by 50 percent.[9] Interestingly, about a quarter of GDP formation represents the contribution of what the National Statistics Bureau called "the elements of the unnoticed economy," or the informal sector.

Moldova's robust economic growth and the projections that it will remain high during the next few years (4 to 5 percent annually) is an inspiring result of the Economic Stabilization and Recovery

Plan (ESRP) for 2009-2011. It was supplemented by "Rethink Moldova," a 2010 document that established strategic directions for economic development backed by unprecedented financial support – $2.6 billion – from international donors. Half of this support is in the form of grants and the other half is in concessional credits.[10]

An important step in the negotiation of an Association Agreement between the EU and Moldova is the adoption of the action plan for the Deep and Comprehensive Free Trade Agreement, which is expected to be signed on May 5, 2011 at the next meeting of Moldova – EU Cooperation Committee in Brussels. The biggest challenges to its implementation will be further liberalization of the market and growing openness to competition, especially in the service sector; building efficient social protection policies; and eliminating anti-competitive and monopoly practices.

In January 2011, the Moldovan government approved a program for 2011-2014 named "European Integration: Freedom, Democracy, Welfare" with seven clearly defined priorities: 1) integration with Europe; 2) reunification with the breakaway province of Transnistria; 3) efficient and balanced foreign policy; 4) rule of law; 5) poverty reduction and the provision of high quality public services; 6) sustainable economic growth; and 7) decentralization of power. By launching this program, the government is setting a goal of changing the development paradigm within the next few years from a consumption-based economy to a knowledge economy based on investments, innovations, and competitiveness. That, in turn, will lead to balanced and sustainable economic growth and the creation of new jobs.[11] Only in this way can Moldova overcome its existing limits on growth from traditional sources – estimated by experts to be a maximum of 5 percent annually – while it needs growth rates to increase two-fold to catch up with the development progress in Romania, Bulgaria, and other peer-countries in southeastern Europe.[12]

The Way Forward

To improve growth, Moldova must first increase the efficiency of existing and potential sources of economic growth. For instance, Moldova could take better advantage of remittances by creating conditions for their redirection from consumption to investment. Necessary for that is also the improvement of remitters' confidence in Moldova's banking sector, a public awareness campaign, protection of property and consumers' rights, formalization of Moldova's shadow economy, and an introduction of modern banking instruments such as online payments, savings, and encouragement of small and medium-sized enterprise creation. During last 10 years, cumulative remittances via banks amounted to about $8 billion, though only 6 percent of them were invested, 20 percent saved, and two thirds used for consumption.[13]

At the same time, an assessment by Global Financial Integrity (GFI) showed that illicit currency outflows from Moldova during last decade amounted to $1.9 billion, or about $182 million annually. Among the main sources of Moldova's illicit financial flows are bribery, corruption, theft, and fiscal evasion. The most widespread source, however, is the distortion of goods' value at customs points.[14]

Second, Moldova needs to improve its business climate by continuing deregulation, liberalizing markets, and encouraging fair competition that will boost privatization processes, attract more FDI, and create necessary conditions for knowledge- and innovation-based economic growth. Movement in this direction began when the government reduced the number of business activities subject to licensing requirements by nearly a third, eliminated about 120 products from the list of those requiring government approval certifications. This and other important reforms placed Moldova at the top of the 2011 *Index of Economic Freedom*, ahead of other countries in the region in terms of fiscal and monetary freedom as well as freedom of commerce.[15]

Third, liberalization of trade must be a priority. Reforms in the transportation and customs regimes, such as the removal of export restrictions or adjustments to national legislation such that they conform to European norms, are particularly necessary. Infrastructure improvements, including those in banking services to facilitate the export of goods and services where Moldova has a comparative advantage in the region, are also important to increasing exports of high value-added agricultural products such as tobacco. Significantly increased exports in 2010, with a forecasted 12 percent annual growth rate during the next three years, is considered to be the first sign of a new paradigm for the national economy's development.[16]

Fourth, Moldova must accomplish public sector administrative reform. That includes increasing efficiency and performance, including that of SOEs by resuming the process of their privatization, as well as decentralizing power and budget resources. This process started by downsizing the public administration by a few thousand employees, but the government apparatus is still very slow and inefficient.

Sustaining Moldova's current momentum towards integration with the rest of Europe depends not only on the government, but also on encouragement and support from the United States and European Union.[17] Moldova is ready to realize its dream of becoming an EU member from the Commonwealth of Independent States. In order to accomplish that goal, Moldova must stay the course of reform and overcome the legacy of the past under the leadership of a new reformist government.

Endnotes

[1] Remarks by U.S. Vice President Joe Biden in Chisinau, Moldova. March 11, 2011.

[2] "Moldova: Economic Growth Assessment," USAID Moldova, January 2010, p.7; and O.Nesterova, "Doing Business-2011: Moldova ne uspela s reformami," Logos Press, November 5, 2010.

[3] Joseph E. Stiglitz, *Freefall: America, Free Markets, and the Sinking of the World Economy*, W.W.Norton & Company, 2010. p.xii.

[4] 2011 Index of Economic Freedom, Heritage Foundation.

[5] Michael Todaro and Stephen Smith, *Economic Development*, 10th ed. Pearson Addison-Wesley, 2009, p. 281.

[6] Irina Kovalenko, *Miraji moldavscogo rosta*, Logos Press, February 25, 2011, Nr. 7 (887).

[7] "Moldova Economic Growth Analysis (MEGA)" No. 3, December 2010, p.4 http://www.expert-grup.org/library_upld/d287.pdf.

[8] Ana Pop, Centrul Analitic Independent Expert-Grup, Express-analiza, nr. 31, December 17, 2010.

[9] Realitatea Economica nr 16 – Radiografia Anului 2010, January 13, 2011.

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[11] AIE-2 isi asuma schimbarea paradigmei economice. Journal de Chisinau, January 18, 2011.

[12] Dorin Dragutanu, "Republica Moldova pierde in competitsia economica cu tarile din regiune.," *Economist*, Business-Expert, September 17, 2010.

[13] *Moldpress*, January 6, 2011

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[15] "Moldova intre Malawi si Senegal, in topul libertatii economice," *Moldpress*, January 13, 2011.

[16] "Economists see exports' revival as first signal of economic growth," *Moldpress*, January 13, 2011; "Prognoz ekonomicheskoy nadezhdy", Logos-Press, March 4, 2011, nr. 8 (888).

[17] Mathew Rojansky and Lyndon Allin, "Moldova's Moment," *The Moscow Times*, March 11, 2011.

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