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**Is Moldova ready to grow?  
Assessment of post-crisis policies  
(1999-2000)**

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## ***Is Moldova ready to grow? Assessment of post-crisis policies (1999-2000)***

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### ***Abstract***

The efforts to stabilize the Moldovan economy after the crisis of 1998 have been largely successful. The country avoided international default as current account position radically improved, cooperation with international financial institutions was re-established and a significant primary fiscal surplus was achieved. As a result, the exchange rate was stabilised and inflation substantially reduced. Moreover, several important structural reforms were implemented and privatisation of key-industries pursued with much more determination than previously. However, only economic growth would bring real solutions to the persistent problems of external and internal imbalances of the Moldovan economy and would allow the country to face its heavy debt burden in the future. Unfortunately, prospects for sustainable growth remain weak, as the most important issues that constrain private entrepreneurship and investments have not been effectively tackled. These issues include: lack of territorial integrity, ineffective legal system, widespread corruption and rent seeking. It is unlikely that these problems can be solved until the Moldovan parliament assumes full ownership of reform process.

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# Introduction: Economic crisis in Moldova

Moldova underwent a major financial crisis that followed promptly after the outbreak of the Russian Crisis in August 1998<sup>1</sup>. Capital flight brought the country to the verge of default, as collapse of the exchange rate put an end of the fragile monetary stabilisation and increased abruptly the debt burden, while the real sector was severely affected by the rapid loss of CIS export markets. However, the financial crisis should be seen in the perspective of the proceeding period of a 8-year-long decline in GDP and it cannot be truly overcome without changing fundamental characteristics of the economy.

**Table 1. Moldova – basic economic indicators**

|  | 1993    | 1994   | 1995  | 1996  | 1997  | 1998  | 1999  |
|--|---------|--------|-------|-------|-------|-------|-------|
| Real GDP growth rate                     | -1.2%   | -30.9% | -1.4% | -5.9% | 1.6%  | -6.5% | -4.4% |
| Annual inflation rate<br>(end of period) | 2707.2% | 104.6% | 23.8% | 15.1% | 11.1% | 18.2% | 43.8% |
| Exchange rate,<br>lei/1USD (end of year) | 3.64    | 4.27   | 4.50  | 4.65  | 4.66  | 8.32  | 11.59 |

Source: Moldovan Economic Trends

Although the determinants of growth and the causes of financial crises belong to the most hotly discussed and controversial issues in the economic literature, economic developments in Moldova are relatively simple to explain<sup>2</sup>. While the initial decline of GDP was related mainly to disintegration of Soviet economic system, very negative changes in the terms of trade (mainly increase of energy prices) and civil war, the prolonged decline was clearly a result of bad policies. The stop-and-go approach to reforms, the development of powerful vested interest groups and political instability prevented the creation of the functioning market economy conducive to growth of private entrepreneurship and investments. Wrong microeconomic incentives, resulting from neglecting structural reforms, proliferation of non-payment culture and corruption, contributed to the slow pace of enterprise restructuring, lack of market orientation, scarcity of new market entries, low level of investments and waste of resources in non-productive or even value-detracting activities. In this situation, sustainable growth simply could not take place<sup>3</sup>.

Microeconomic distortions also had an impact on the macroeconomic policies that clearly were on an unsustainable path. Tight monetary policy was in striking contrast with unsustainable fiscal policy that was driven by the inertia of spending commitments on the expenditure side and by the inability to raise tax revenues on the income side. High deficits led to excessive absorption in the economy that was not met by the supply side response due to the impeded restructuring process. It fuelled imports and the trade balance steadily deteriorated. Particularly, inefficiencies in the energy sector led to the wastage of imported energy resources. At the same time, capital inflows necessary to finance the budget deficit, combined with domestic restrictive monetary policy, prevented the depreciation of the currency. The ultimate result of the policy mix was the rapid accumulation of

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<sup>1</sup> The authors want to thank Christopher Mallmann, Apostolos Papaphilippou and Constantin Zaman for comments. All remaining errors are ours.

<sup>2</sup> See Radziwill et al. (1999) for detailed discussion of fundamental causes of 1998 financial crises in Moldova.

<sup>3</sup> See: Castanhera and Popov (2000), Guriev and Ickes (2000), Filer et al. (2000), Campos and Coricelli (2000) for discussion of determinants of growth in transition economies.

external debt and expenditure arrears. The unsustainability of both internal and external position of the state led to the inevitable financial crisis. The turmoil in financial markets that followed the Russian crisis in 1988 was therefore only a trigger that brought the inevitable collapse of the fragile monetary stabilisation.

This paper analyses the quality of post-crisis adjustments with respect to these developments, and discusses whether they may warrant sustainable growth and therefore overcome fundamental causes of the crisis. The remainder of this paper is organised in the following way. Chapter 1 describes the frantic efforts to stabilise the economic situation immediately after the crisis. It concludes that while these efforts were largely successful, much more fundamental reforms are necessary in order to truly overcome the economic crisis. Accordingly, Chapter 2 gives recommendations for such reforms and chapter 3 evaluates actual post-crisis structural policies. Chapter 4 discusses chances for sustainable growth in the medium perspective and concludes.

## 1. Struggle for short-term stability 1999-2000

Although the economic crisis had fundamental and structural causes, the most immediate post-crisis actions involved a struggle to achieve short-term macroeconomic stability. The situation was especially fragile in 1999 while some breathing space for policies was already achieved in 2000.

### 1.1. Achieving external sustainability

The immediate cause for the financial crisis in Moldova was the rapid deterioration in the balance of payment after the outbreak of Russian crisis in August 1998. While the current account imbalances between 1995 and 1997 were coupled with surging capital inflow, both current account and capital account were negatively affected in the second half of 1998. As a consequence of the Russian crisis, Moldova experienced a deep plunge in exports and as other countries in the region – a dramatic outflow of private financing. Moldova did not have a program with the IMF since beginning of 1998, so the situation was further aggravated due to the negative financing from international financial institutions in this year. This dramatic situation and the unsuccessful attempts to maintain the exchange rate led to the substantial loss of international reserves and the increase in external arrears. These tendencies could not be continued in 1999. Accordingly, improvements in the balance of payment were the most important and visible signs of adjustments in the year following the crisis. While adjustments in the current account was spontaneous and did not require the active role of the government – apart from the delayed decision of NBM to float the exchange rate in November 1998 - the government attempts to prevent the collapse of capital account deserve some credit.

#### **Improvement of current account balance**

The main result of the initial real depreciation of the domestic currency was a sharp reduction of imports leading to a very substantial improvement of the current account. This effect was further

strengthened by an increase in transfers (mainly humanitarian aid). As a result current account was reduced to the sustainable level of 2% of GDP<sup>4</sup>.

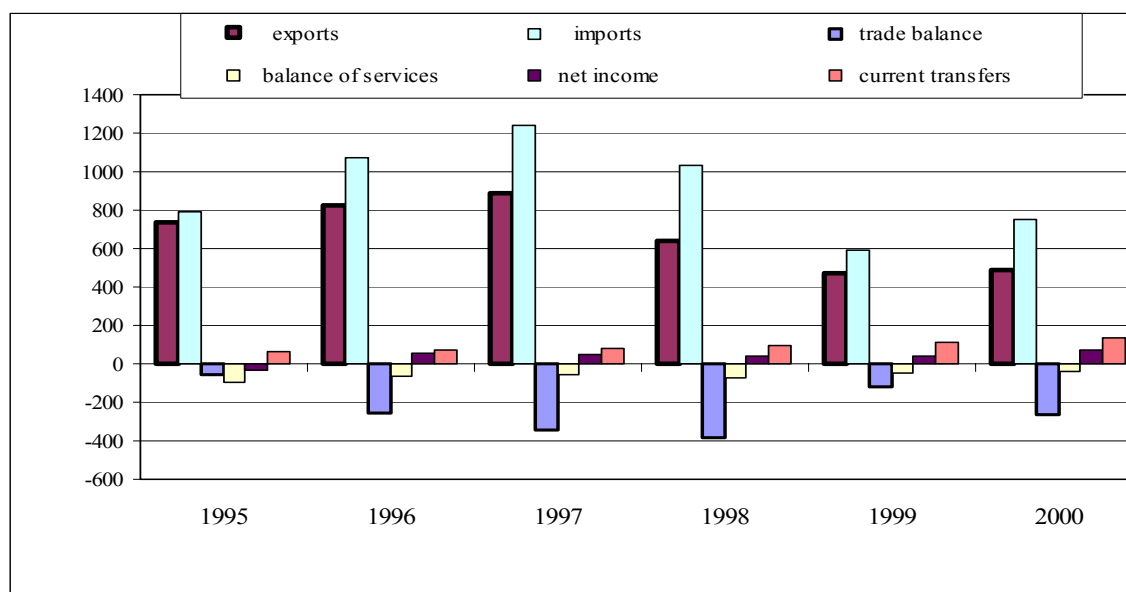
**Table 2. Current account as % of GDP**

| 1995 | 1996  | 1997  | 1998  | 1999 | 2000 |
|------|-------|-------|-------|------|------|
| -8.0 | -11.1 | -14.2 | -19.0 | -2.0 | -7.3 |

Source: IMF, own calculations, 2000 forecast from GTZ macroeconomic model<sup>5</sup>.

In the year 2000, this adjustment has been somehow reversed as imports surged again due to a moderate nominal and significant real appreciation of the domestic currency. However remittances from Moldovans working abroad and transfers noted unusual highs in 2000, so the impact on the current account was less substantial.

**Figure 1. Elements of current account, USD mln**



Source: IMF, own calculations, 2000 forecast from GTZ macroeconomic model.

### Fragile capital account

While the situation in the current account improved substantially in 1999, the capital account was subject to further deterioration, as capital continued to flow out of the country. This tendency, however, has been partly offset by two achievements of the government. First, the agreement with the IMF allowed for non-negative net financing from this organisation in 1999 and even more importantly paved the way to significant disbursements from other official creditors. Secondly the Moldovan authorities arranged successfully the buy-back operation of 130 mln USD debt to Russia, that allowed to reduce the debt and debt service significantly<sup>6</sup>. In 2000, the government generated

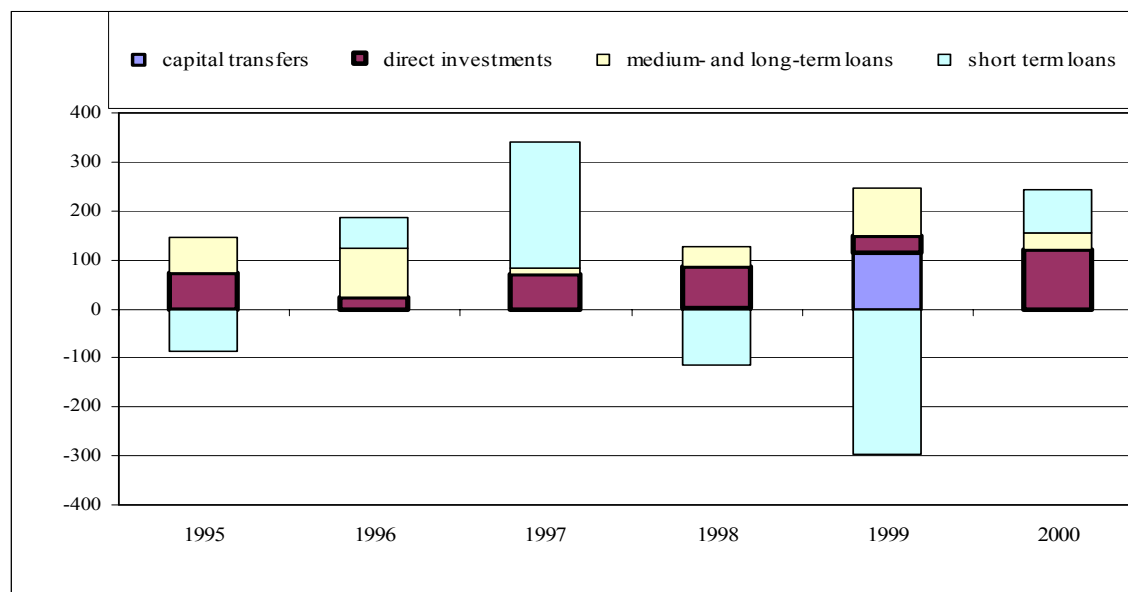
<sup>4</sup> See: Jarociński (2000) for detailed analysis of current account adjustments in 1999.

<sup>5</sup> The macroeconomic model has been developed in the framework of GTZ project "Medium Term Financial Planning" with the participation of subcontracted CASE experts.

<sup>6</sup> In the balance of payment this operation has been shown as capital transfers of USD 115 mln and debt repayment of 130 mln USD.

significant capital account surplus, in spite of lack of a program with the IMF through the ambitious program of privatisation that together with raising capital standards for the banking system contributed to the rise in the FDIs. Last but not least, due to a general macroeconomic stabilisation, capital flight has been stopped.

**Figure 2. Elements of capital account, net USD mln<sup>7</sup>**



Source: IMF, own calculations, 2000 forecast from GTZ macroeconomic model.

### Reserves and arrears

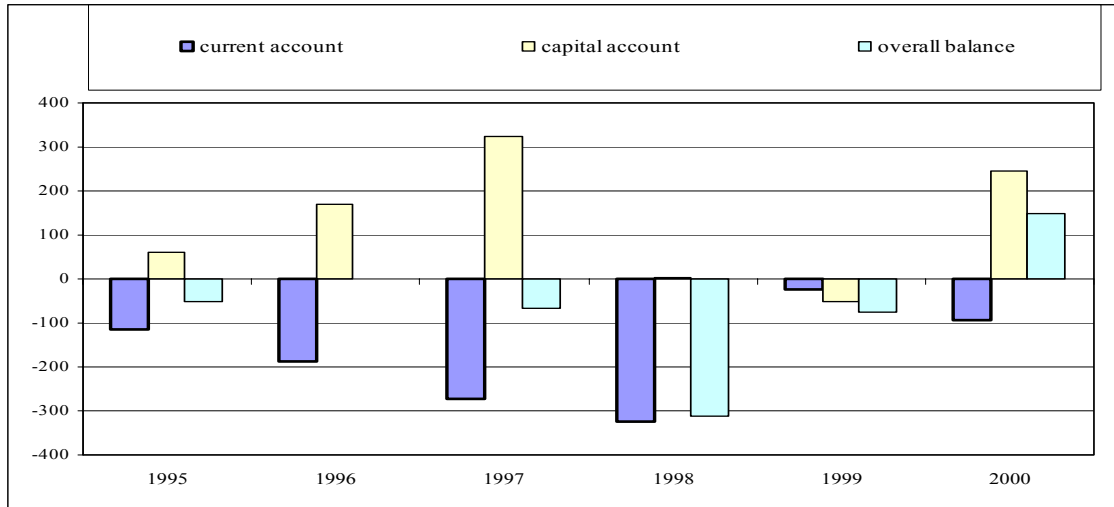
As a result of these actions the overall balance of payment<sup>8</sup> improved significantly in 1999 and further on in 2000. In 1998, the substantial overall deficit aggravated by payments to IMF forced the sale of a substantial part of foreign reserves (220 mln) and the accumulation of new arrears (140 mln). In 1999 reserves actually increased by 40 mln USD, although arrears increased further (by more than 120 mln USD). Although the Russian energy suppliers implicitly accepted the increase in arrears, it posed an extreme risk to Moldovan economy, as the country was experiencing temporary cut-offs in energy supplies. In 2000 the overall balance was actually positive, which forced NBM to buy dollars (40 mln USD) in order to avoid excessive appreciation of domestic currency and allowed for some reduction of external arrears.

**Figure 3. Overall balance of payment, USD mln<sup>9</sup>**

<sup>7</sup> Some 90 mln USD shown in the diagram, as short-term investment in 2000 is just a result of converting arrears towards Gazprom into government bonds – reported as negative exceptional financing below the line.

<sup>8</sup> Overall balance of payment, as defined here, excludes adjustments in international reserves of national bank, changes in net position against IMF and exceptional financing through restructuring and changes in arrears (items shown “below the line” in the analytical form of balance of payment).

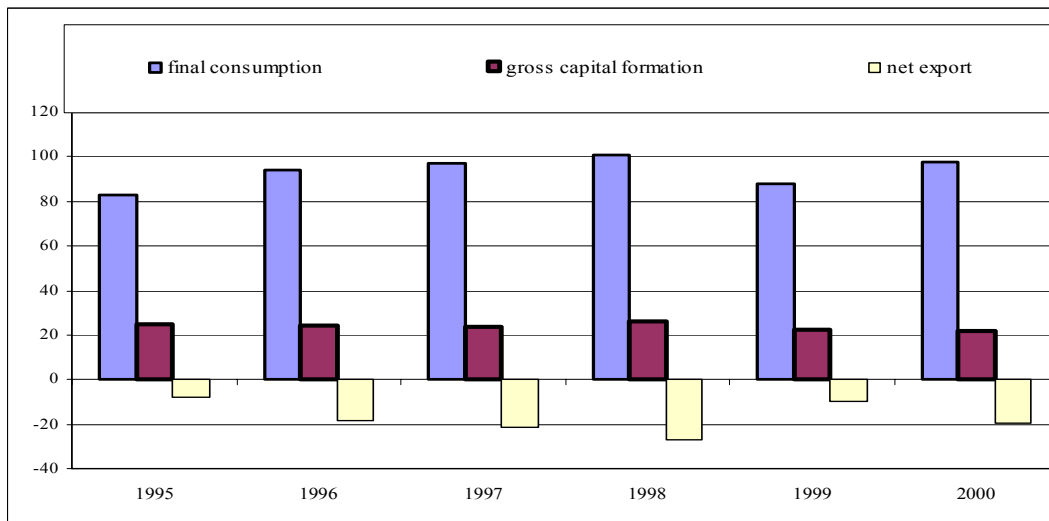
<sup>9</sup> See the footnote no. 5 and no. 6. If energy debt conversion of 90 mln USD is excluded, overall balance of payment is ca. 50 mln USD in 2000.



Source: IMF, own calculations, 2000 forecast from GTZ macroeconomic model.

In general, while government policies should be praised for preventing further capital account deterioration in the years 1999 and 2000, the re-emergence of a large trade balance deficit in 2000 calls for attention, as it might contribute to the repetition of the crisis in the future. This consideration is especially important as imports fuel mainly private consumption and therefore do not build up export potential of the Moldovan economy, while FDIs may be much lower if the privatisation slows down in the future.

**Figure 4. Structure of GDP, %**



Source: Department of Statistics, own calculations, 2000 forecast from GTZ macroeconomic model.

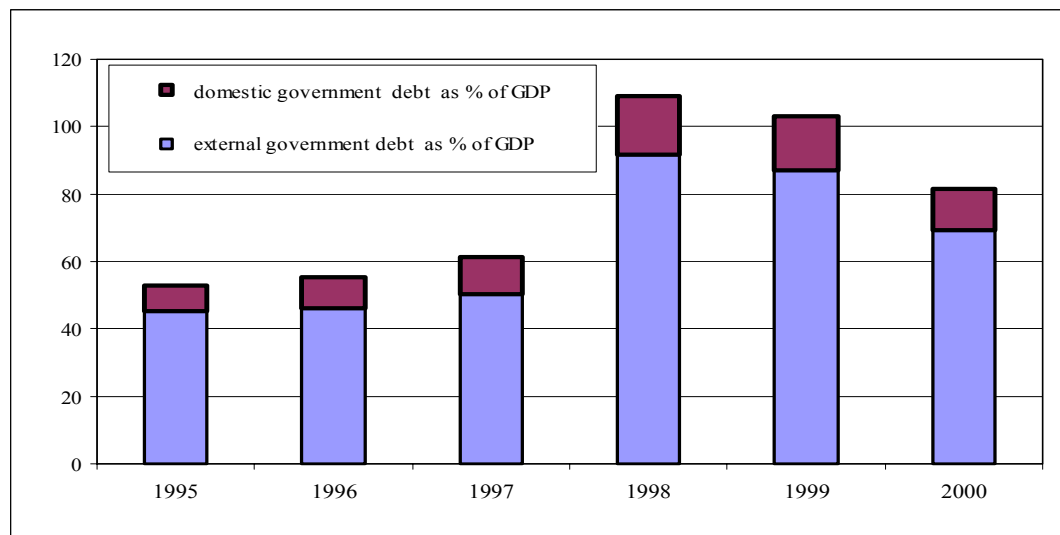
## 1.2. Debt trap and fiscal consolidation

Capital flight in 1998 had major consequences for fiscal policy. The unfavourable situation in international financial markets, which preceded the Russian crisis, made external debt financing of the deficit impossible. Also domestic commercial banks were not willing to provide liquidity to the state budget. As the revenue side of the budget was below expectations, the government had no



choice but to introduce a series of ad- hoc expenditure cuts throughout 1998. However, the problem of servicing the internal debt could not be solved this way. In this situation, NBM was forced to extend direct credits to the Ministry of Finance. Such a policy could not be continued, however, as it would lead directly to hyperinflation. Instead, the government had to undertake a dramatic adjustment of its fiscal policy. This adjustment had to be even harsher, as the external indebtedness of GDP almost doubled between 1997 and 1998, due to the depreciation of the domestic currency.

**Figure 5. Direct government debt<sup>10</sup>**



Source: Ministry of Finance, own calculations, 2000 forecast from GTZ macroeconomic model.

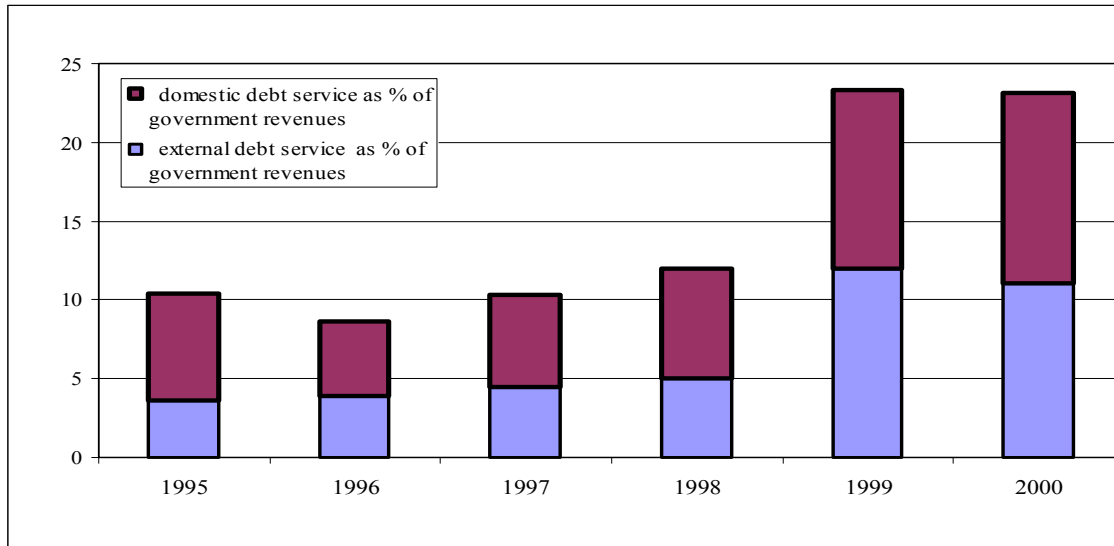
Accordingly, all external interest and amortisation payments that the government needed to make required more domestic resources and other expenditures had to be squeezed substantially (or revenues increased) in order to achieve a substantial primary surplus.

However, tax revenues remained very weak in 1999, partly because of crisis, partly because of changing structure of GDP (less consumption and imports implying less revenues from VAT, excise and duties) and partly because of a reduction of non-cash payments. Therefore, almost all the adjustment had to be achieved through the reduction of expenditures. Expenditures cuts initially were of an ad-hoc nature and therefore of rather low efficiency. Only later on, some more planned expenditure rationalisation started to be introduced and more systematic attempts were made to increase tax collections<sup>11</sup>. One of marked achievements of these policies was the constraint in the accumulation of arrears.

**Figure 6. Government interest payments**

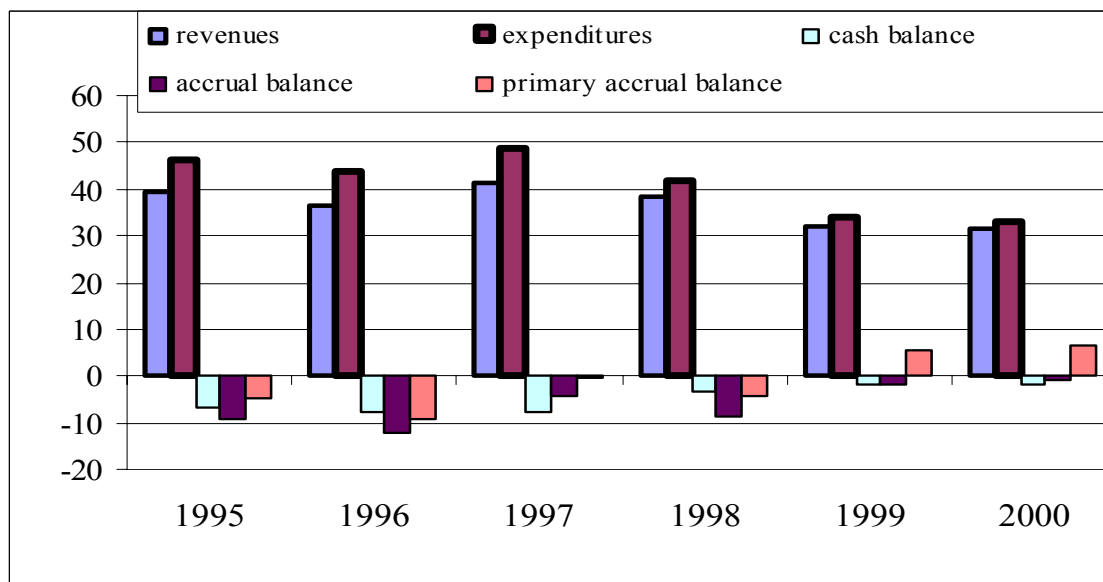
<sup>10</sup> Additionally, private external loans guaranteed by the government and debts of energy enterprises (implicit liability of state of Moldova, at times being partly converted into explicit government debt) constitute some 7% and 26% of GD, respectively, at the end of 2000. If these items are added the total government debt increases to 135% of GDP.

<sup>11</sup> The structural reforms in fiscal sphere are discussed in the chapter 3.



Source: Ministry of Finance, own calculations, 2000 forecast from GTZ macroeconomic model.

**Figure 7. Elements of budget deficit, % of GDP**

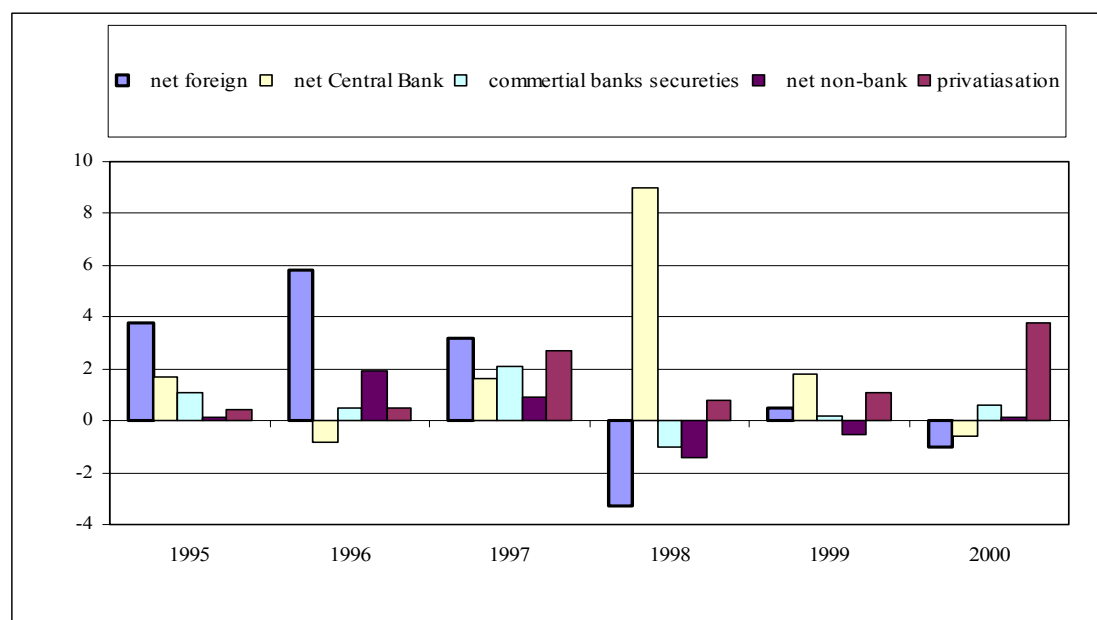


Source: Ministry of Finance, own calculations, 2000 forecast from GTZ macroeconomic model.

Although a primary (accrual) surplus has been achieved, the acute problem of cash deficit financing remained, as a further increase in external debt was not possible, financial capacities of commercial banks were very weak and the constraint on direct credit from National Bank of Moldova was necessary for containing inflation. There was only one option available and

accordingly, the government with unprecedented determination launched a cash privatisation process<sup>12</sup>.

**Figure 8. Financing of budget deficit, % of GDP**



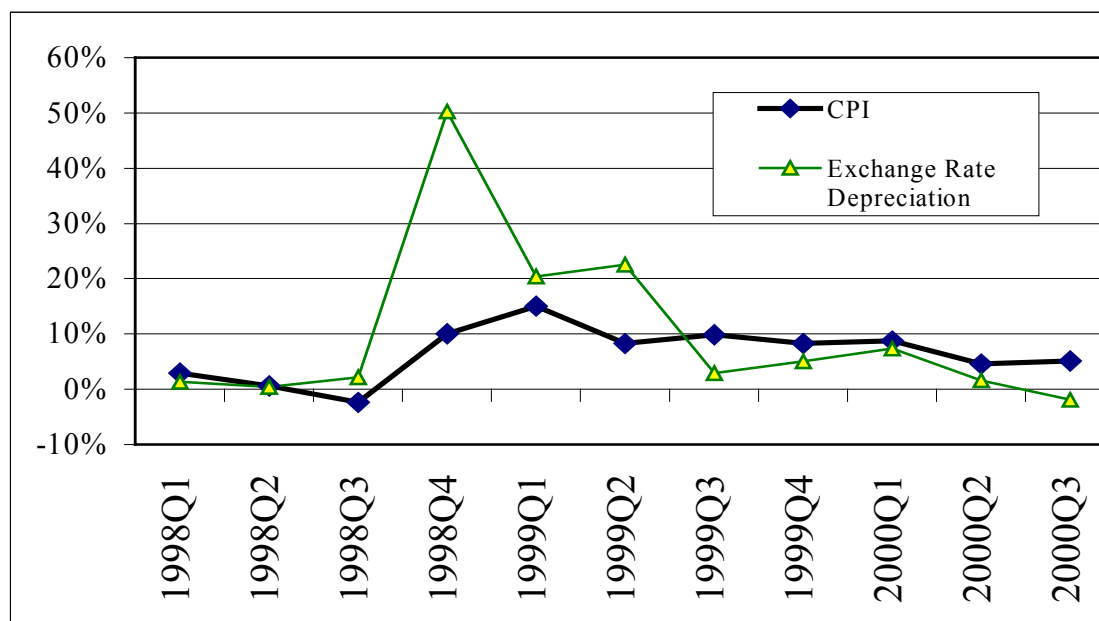
Source: Ministry of Finance, own calculations, 2000 forecast from GTZ macroeconomic model.

### 1.3. Disinflation and exchange rate stabilisation

The balance of payment crisis exerted a strong pressure on the national currency. Initially, NBM tried to maintain the exchange rate through substantial interventions on the foreign exchange market. In a few months between August and November, NBM reserves were depleted to their 1994 level, while depreciation pressures did not subside. Finally, in November 1998 NBM stopped interventions and allowed commercial banks to freely determine the exchange rate. Since that moment, the official exchange rate has been set as a weighted average of rates in interbank transactions. Depreciation of the currency put strong pressure on prices through the increase in import prices, restrained only by higher domestic supply to domestic markets due to abrupt loss in export possibilities to CIS markets. As NBM extended a direct credit to the government, the growth of money supply brought a surge in inflation in the fourth quarter of 1998 and at the beginning of 1999. Finally, the declining demand for real money balances was the obvious result of a loss of confidence in the national currency and accordingly increasing velocity of money added another cause for increasing inflation. While the exchange rate depreciated from 4,7 in the middle of 1998 to 8.3 in the end of 1998 and 11.6 in the end of 1999 NBM managed to constrain inflation to 40% annual average, and to 43% end of period in this year. That allowed for real depreciation of the currency that contributed in turn to the adjustments in trade balance.

**Figure 9. Inflation and depreciation: QoQ**

<sup>12</sup> Note that the high revenues from privatisation in 1997 were a result of sales of military equipment (21 air fighters).



Source: National Bank of Moldova, own calculations.

In 2000 the situation has been reversed. The increase of capital inflows led to a stable exchange rate (even in nominal terms), while a relatively large increase in the monetary stock, delayed effects of depreciation and the increase in prices of energy and food (results of drought) maintained relatively high inflation (ca. 30% on average and just below 20% end of period). This led to another real appreciation and the deterioration in the trade balance. The rapid increase in monetization in year 2000 and gradual fall in interest demanded on treasury bills shows however, that financial institutions appreciated the stabilisation policy of the Moldovan authorities.

## 1.4. Summary

The currency crisis in Moldova that of the second half of 1998 forced rapid macroeconomic adjustments that took place in 1999. Lack of foreign financing reduced the current account deficit substantially, similarly the budget deficit had to be decreased, as nobody was willing to finance unviable budgetary expenses. After a sharp depreciation the exchange rate is stable and inflation, although still high, is subsiding. Macroeconomic stability is however still fragile and prospects for growth weak. Accordingly, the following chapter presents some main directions for economic policies that should establish the basis for long lasting stability and growth.

## 2. Strategy for growth and long run stability

Internal and external imbalances in the Moldovan economy that led directly to the crisis will not be removed unless there are development dynamics in production that may satisfy expectations of Moldovan consumers. Unless sustainable economic growth is achieved, the aggregated demand is reflected either in current account deficit or inflationary pressures. Real economic growth is also essential for human development and reduction of poverty. Accordingly this chapter provides the general strategy for generating economic growth in Moldova.

## 2.1. Major impediments to growth

Various answers are offered to the question of causes for depths and length of economic decline in Moldova. Sometimes it is argued that promoting more domestic demand for Moldovan products is necessary for stimulating the growth of production, either through the increase in incomes (more government transfers?) or through import substitution (protection of domestic producers?). Sometimes the lack of profitability of Moldovan firms and an excessive tax burden are underlined (more subsidies? less taxes?). Finally, market allocations are described as inefficient and not allowing for investments in the most productive sectors (more state intervention?). The analysis of the economic developments in Moldova before the 1998 crisis gives allows an assessment of some of these claims. Relatively high domestic demand before 1998 resulted in a growing trade deficit rather than the increase in production, subsidies and lax fiscal policy contributed to the lack of restructuring while attempts to encourage investments through state credit guarantees inevitably led to failures of the supported projects and accumulation of bad debts. Finally, a very significant depreciation of the currency after the Russian crisis did not lead to any significant export growth or major import substitution.

It is argued here that the fundamental weakness of the economic reforms in Moldova was the failure to create a economic situation in which the supply side responds to market demand. This is essential as there is a substantial potential demand for Moldovan products. Most importantly there are very large export possibilities and the country could and should have developed rapidly its export sector, while building on its well-known comparative advantage (cheap and well qualified labour, fertile soils, climate). Because of the small size of the Moldovan economy in comparison to international (and also national) markets, such expansion would not even require the acquisition of large market shares. Yet, there are barely any signs of such an expansion. Although export orientation is far more promising, Moldovan producers should also serve domestic markets more effectively. Still, at the present moment domestic markets are highly penetrated by foreign products even in sectors in which Moldovan producers should specialize (labour intensive agriculture, food and beverages, light industry). This is not only caused by the liberal external trade regime, but by the lack of quality domestic substitutes of foreign goods.

What is therefore absolutely necessary for seizing demand opportunities and bringing economic growth, both in respect to exports and domestic sales, are changes in production patterns and quality adjustments. Producers should simply respond to consumer demand and not be driven by inertia or government influences.

## 2.2. Stimulation of supply response to market demand

Creating a situation in which producers are willing and able to respond to the market demand through relevant changes in production patterns is the most important task for the government. There are few key directions in this effort. Firstly, it is essential to promote profit orientation of enterprises. This means that economic agents should be reacting to price changes both in internal and international markets. Price changes should in turn signal changing market demand, including changes in preferences towards quality and increasing importance of marketing and advertisements. Secondly, distortion-induced attractiveness of non-productive and value detracting activities should be diminished. Instead, as a result of the search for business opportunities under a proper legal framework, resources should be channelled to the most productive uses. Thirdly, adjustments in

production patterns would not be possible without growth of factors of production. This requires an increase in investments in physical and human capital and the development of infrastructure. However, the most crucial factor that affects all others is the creation of a stable and credible system that allows confidence of domestic citizens and foreign investors.

### **Promoting profit orientation**

The basic requirement for promoting profit orientation is the improvement in corporate governance. This in turn should be achieved foremost through increasing the share of private sector and less state involvement in current economic life. Cash privatisation of state enterprises should be accordingly pushed forward in order to create real owners and to reduce the power of insiders. Such privatisation is especially important for the development of “strategic” industries. Enterprises that still remain in state hands should face a hard-budget constraint, which is necessary for profit orientation and restructuring. Loss-making ones, that fail to restructure, should be accordingly bankrupted. Correction of failures of voucher privatisation are necessary, the key issue is to provide for better control by shareholders and creditors over management. The latter is currently too often profiting from asset stripping and transfer pricing rather than from achieving good economic results. As small and medium enterprises (and individual farms) tend to be the most responsive to market demand, the most suitable in potentially high-growth sectors (services, food and light industry, specialized labour intensive agriculture) and able to create the largest number of new jobs without large investments, their growth should be a priority. It should be supported through the more favourable regulation (especially simplification of registering procedures and elimination of excessive licensing), better and more stable legal protection and administration services focusing less on controlling economic activity and more on providing a stable framework, which will facilitate the growth and development of the private sector.

The second requirement for effective profit orientation is the strengthening of the price signal and is strongly linked to a better organization of markets. The most important solutions here include the promotion of wholesale trade, commodity exchanges and struggle against barter, in-kind operations and arrears that diminish price transparency. Another issue involves elimination of internal and external barriers to trade and especially elimination of regional market segmentation. The role of the state in providing the proper market and transport infrastructure is especially important here.

### **Reviving agriculture**

The situation in agriculture requires special attention regarding the issues highlighted above, as in this sector ability to adjust towards market demands are currently especially low. Therefore, the development of market-oriented farms is the highest priority and accordingly land privatisation must be completed, even if private parcels might be initially of suboptimal size from a technical point of view. The importance of the real owner who considers various possibilities of land use and chooses the most profitable is far more important than theoretical efficiency considerations. Only fully defined ownership rights must then allow for free trade of land and therefore for the voluntary creation of more efficient larger farms. Similarly, the process of land consolidation through associations should be strictly voluntary and be encouraged only through the development of legislation protecting rights of their members. Moreover, better access to banking and credit also is

determined by the final settlement of ownership issues and functioning land market - with land titles serving as the collateral readily available to farmers.

The second crucial issue for the development of market-oriented agriculture is the transparency of prices in the sector. Farmers should know price structures for agriculture regarding inputs and outputs, so that they can assess expected profitability of production. Only such assessment allows for good production planning (formulation of business plans), and therefore crediting from commercial banks and eventually should lead to financially viable growth of output. The importance of agricultural commodities cannot be overestimated. Commodities set the price based on demand and supply. The advantage of well-functioning exchanges is transparency in market prices of agricultural products, non-constrained access to information published in newspapers, and the establishment of standards in quality of commodities, deliveries, payments, etc. Commodity exchanges also give a basis for the development of financial instruments, like future contracts (that guarantee a farmer a fixed price at which his product will be purchased in the future) that may further strengthen the willingness of banks to lend to the sector. Although the usual practice is the spontaneous establishment of agricultural commodities by buyers and sellers, in many transition economies the state and local authorities participated in establishment of fully independent commodity exchanges<sup>13</sup>, which might also be recommended for Moldova.

### **Restructuring of the energy sector**

On the intersection of the general effort to restructure and the development of infrastructure is the issue of the energy sector. Until now it is a source of waste and many distortions that have both microeconomic and macroeconomic consequences. From the microeconomic perspective, the most important is the soft budget constraint that results from low effectiveness of payment collections. It allowed many practically bankrupt enterprises to waste energy resources almost freely. This situation is giving the first and principal impulse for the development of barter and a system of inter-enterprise arrears and arrears towards the government. These in turn led to the proliferation of netting-out operations and the widespread use of non-payments that has proved to be one of the key obstacles to the efficient functioning of markets. On the other hand, the incoherent policy of energy supply cuts became one of key uncertainty factors in production planning. This affects the credibility of Moldovan suppliers towards their trading partners, as general cut-offs are often paralysing production in financially viable firms. From a macroeconomic perspective, the uncontrolled consumption of energy was contributing significantly to the growing current account deficit and external debt accumulation. It is especially dangerous as it implies excessive dependence on one trading and crediting partner, Russia. Last but not least, the energy sector became the focal point for vested interest, corruption and fraud. For all these reasons the restructuring of the energy sector is on top of the structural reform agenda. The most immediate tasks require the introduction of payment discipline and individualized responsibility for non-compliance. This will most likely lead to the rationalization of energy consumption and gradual elimination of non-cash operations from the economic life in Moldova. In order to introduce these necessary changes, privatisation of the energy sector needs to be completed under a well-defined state energy regulatory agency. In a longer term perspective the diversification of energy sources and connection to European power networks will be the priority. The energy sector is the blood system for the real economy and its reliability and efficiency is essential. Restructuring the energy sector is therefore a condition sine qua non for the rebound of production and the growth of the economy.

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<sup>13</sup> See: Antczak (1999) for discussion.

## **Discouraging value-detracting activities**

Currently much resources and especially entrepreneurial energy is wasted in non-productive activities. Most of them are linked to various forms of rent seeking (search for profits artificially created by state induced distortions). The most common distortions include hampering competition through extensive licensing and barriers to entry - which encourages monopolistic practice - and inducing dependence of economic results on government decisions on unequal treatment of enterprises through subsidies or tax exemptions. These distortions need to be removed through “the hands-off approach” of the government towards current economic life and more actions towards deregulation and demonopolization of markets. Even more dangerous than the attractiveness of rent seeking is a good climate for activities that are on the verge of criminal offence. Weak state structures, corruption and lack of effective law enforcement give rise to actions ranging from smuggling and tax evasion to asset stripping to fraud and racketing. These activities not only divert economic resources from productive activities, but also discourage the development of honest businesses. A “prisoners’ dilemma” situation is observed. The prevailing rent seeking and racketing make honest businesses in Moldova unprofitable and insecure – therefore new business entries do not take place and only dishonest operations are attractive - and the situation is only aggravating in time. This vicious circle can be stopped by the state’s decisive effort to improve law enforcement, the struggle against corruption and the state withdrawal from current economic life.

Channelling human resources from rent seeking and value-reducing activities towards value producing ones is an essential condition for growth, both in economic and human development terms. In the simplest terms, the real success of transition is therefore a creation of conditions in which relative well-being or even richness can be achieved through high level of education, experience and hard work rather than through “political contacts” or readiness to engage in morally doubtful operations.

## **Generating productive investment**

The search for business opportunities based on improvements in the production and sales’ efficiency requires adjustments and necessary investments. There are two crucial issues that determine the level of actual investments. The most fundamental issue of confidence, stability and protection of investments are discussed in the next section. Closely related is the issue of financing. For a small open economy like Moldova, foreign direct investments are crucial for the development, as they bring not only capital but also modern technologies, managerial and marketing oriented know-how. Equally important is the effectiveness of the banking system in converting savings into productive investments. It would require a further strictly supervised development of capacities of commercial banks (including building know-how and experience in crediting real sector) and also the reduction of attractiveness of portfolio investments in T-bills. This can be achieved only through the consequent tightening of fiscal policy, which is more conducive to growth of productive investments than direct lending from the budget. Direct efforts of the government to support investments should be undertaken with much caution and be focused on projects with the highest social return, which is not fully internalised by private markets: transport infrastructure and human capital development. However, it should be strongly underlined, that in most of successful transition countries own resources and retained earnings were the major fuel of initial growth. Firms and individuals invested



these resources only because an appropriate level of confidence was secured by the state structures. In case of Moldova, these resources either remain idle or are transferred abroad.

## **2.3. Building general confidence**

Creating confidence among economic agents, both domestic and foreign, is probably the most crucial task for the government. Confidence not only generates foreign direct investments and interest in trade with Moldova, but also more profoundly reduces the attractiveness of permanent emigration of the most skilled individuals and diminishes capital flight. It also reduces the overall level of uncertainty, necessary for investment decisions and business start-ups. It also discourages fraud as chances of getting away unpunished are reduced and the importance of good reputation is higher in the longer time perspective.

### **Political and legal structures**

Key conditions for building confidence include political stability and most importantly the resolution of the Transnistrian conflict. This is absolutely essential as the lack of territorial integrity and even the slightest possibility of an armed conflict puts under the question mark any serious economic decisions. Other crucial component of building confidence in Moldova is a well-defined strategy towards EU accession with fast progress in implementation of the Partnership and Cooperation Agreement and the accession to the South-East European Stability Pact. Establishing and sticking to the general pro-European development strategy would make all reform efforts irreversible and therefore much more credible. Confidence depends equally fundamentally on the creation of an effective legal system that really protects citizens, entrepreneurs and contractual obligations. Focus on increased law enforcement and the fight against corruption should be the part of a wider effort to improve state structures and to rebuild the authority of the state as the guardian of legal order. Unless significant progress in this respect is made, the chances for sustainable growth are weak.

### **Macroeconomic stability**

Consequently, the implemented strategy of development backed by international institutions should increase credibility and consistency of reform policies and bring widely defined economic stability. From a macroeconomic perspective, the tightness of fiscal policy is essential, as the conservative monetary policy cannot make up for the mistakes in fiscal field and the excessive budget deficit brings inflation, accumulation of foreign debt, crowding-out of private investments or accumulation of budgetary arrears. All of these are detrimental to long lasting economic stability and were at the core of financial crisis in 1998. Economic stability requires therefore a carefully planned and consequent effort to generate more tax revenues, mainly through broadening of tax base, that is through reducing tax evasion, legalizing the shadow economy and reducing tax exemptions. On the expenditure side, more prioritisation is necessary, including introduction of targeted social assistance programs, elimination of subsidies and general privileges and focus on development of functioning legal institutions and primary health and education services. The establishment of a pension system that would both stimulate growth and higher compliance through the link between contributions and benefits will be also increasingly important.

### 3. Real sector reforms in 1999-2000

The crisis forced the Moldovan authorities to undertake real reforms that were broadly consistent with the development strategy sketched in the previous chapter. The critical situation also made the public more likely to accept painful measures necessary to revert the negative tendencies accumulated in recent years. Moreover, the large external debt left the country fully dependent on the co-operation with international organizations, especially the IMF, and therefore more likely to accept their policy advice. Indeed, the new cabinet of young and liberal reformers voted in March 1999 initiated a more energetic program of reforms and arguably, it was the first government in the office that was truly determined to introduce real reforms. Although this government was forced to resign in the end of 1999 due to the political backfire to the program of privatisation of wine and tobacco industries<sup>14</sup>, the new government (to some surprise of local observers) continued consequently the reform efforts. The most focus has been put on the areas, where progress is relatively easiest to achieve, provided that there is a political will or enough external pressure from international organisations. Accordingly, privatisation was accelerated and fiscal policies adjusted. Much slower progress has been noted in the institutional and legal basis of the economic life and real restructuring.

#### 3.1. Land reform

The largest achievement of structural reforms in Moldova since 1998 is undoubtedly the acceleration in the land reform. During 1998-2000, significant progress was made in the break-up of large-scale collective farm and privatisation of agricultural land. The nationwide phase of the National Program “Land” was launched in March 1998 and it was completed by the end of 2000. As a result, 989 large-scale collective farms (96% of total number and 75% of the agricultural land) were broken-up and agricultural land titles for more than one million hectares were distributed to 800 thousand farmers. For the first time since the II World War, farmers can themselves make decisions about the most optimal usage of land, capital and labour. A fast process of land concentration followed. It is very important, that farmers choose leaders on a voluntary and democratic basis with the sole purpose of increase of agricultural production efficiency. So far, farms greater than 100 hectares have been formed on over 69 % of all land distributed in the national land program and farms having more than 500 hectares – 23% of land. Consolidation is proceeding mainly through lease agreements concluded on total land area of 700 thousand hectares. The land market in Moldova is practically still no-existent due to lack of implementation of the regulation, especially the still non-operational national cadastre system (although the work on it is very advanced now). Also the development of market institutions in agriculture, including commodities and wholesale centres, the insurance system and access to the banking system has hardly begun. However, a three-year post-privatisation program will be launched on January 1, 2001 with the aim to support and develop mortgage crediting, offer juridical consultations, create about 72 agricultural shops and centres to serve farmers. Success of the development of market-oriented farms will be the most important stimulation to the growth of Moldovan economy, the result is however still difficult to predict as vested interest groups still oppose the free trade of land as well as transparent and liberalised trade in agriculture products.

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<sup>14</sup> See the section on privatisation.

### 3.2. Privatisation

The second key development in the post-crisis period is the acceleration of privatisation. Since the beginning of the 90s, three privatisation programs were adopted and implemented, the first one - for patrimonial bonds - in 1994, the second - mixed privatisation for bonds and cash - in 1995-1996, and, finally, privatisation for cash exclusively in 1997-1998. All programs were heavily delayed, implemented fragmentally and highly politicised. While state management proved to be very inefficient, the most important weakness in the privatisation process largely conducted on non-cash basis was the lack of improvement in corporate governance in the privatised companies. Two thirds of all property for privatisation against patrimonial bonds is controlled by investment funds<sup>15</sup>. On one hand, due to shortcomings of the legislative base, the funds could not control managers. On the other hand, the funds themselves gave in to the temptation of gaining unjustified profits through transfer pricing and asset stripping. In order to stimulate corporate governance more oriented towards shareholder value, the National Security Commission strengthened significantly in 1999 the standards of disclosing information as well as regulation of purchases of the control package. These improvements are however unlikely to change the situation considerably. More important changes after 1998 have entailed the full endorsement of cash privatisation strategy in case of enterprises remaining in state hands<sup>16</sup>. Accordingly, cash privatisations accelerated significantly, especially in the case of enterprises in key-industries. These enterprises were initially excluded from the privatisation process, as the government tried to keep control of them (especially in energy sector), because of strategic considerations. This choice had very negative consequences, as after the rapid accumulation of arrears in recent years, suppliers gained eventually the ownership in Moldovan enterprises through non-transparent debt for equity swaps. It meant that by restraining the privatisation in the first place, the government achieved the most dreadful outcome. Moreover, even recent privatisations of natural monopolies do not generate expected revenues as delay caused the gradual decapitation and deterioration of financial condition of enterprises and made them unattractive to foreign investors.

#### **Energy sector**

In mid-1999, the long-awaited privatisation of the public gas company Moldovagaz took place. Without the announcement of a tender the Russian gas supplier Gazprom took a majority stake in “Moldovagaz” in exchange for reduction of energy arrears. “Moldovagaz” was registered in 1999 with following distribution of shares: the government of Moldova -36 percent of shares, Gazprom - 50 percent plus one share, and the administration of Tiraspol - 14 percent. The Moldovan government also had to accept the responsibility towards the Russian partner for all debt of the enterprise. This transaction is highly non-transparent and until now is not fully finalized. It is also uncertain and rather unlikely whether it can improve the functioning and efficiency of the energy sector. Uncontrolled borrowing policy and lack of political decisions of the government in 1992-1998 have resulted therefore in indebtedness and even higher dependence on the Russian trade partners.

Similarly, the privatisation of the state fuel company “Tirex-Petrol”, former monopoly, was not proceeding till 1999, as the influential political forces lobbied for crediting of agriculture through

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<sup>15</sup> See: Ellerman (1998) for discussion of the role of investment funds in voucher privatization in transition economies.

<sup>16</sup> See: Mihalyi (1999) for analysis.

the company in the form of fuel. During these years the enterprise has been practically lead to bankruptcy. When in July 1999 the parliament adopted the law about the privatisation of Tirex-Petrol", 51 percents of the state shares in the company were offered to the Romanian party on account of arrears for deliveries. However at the last stage of negotiations it was unexpectedly found out, that "Tirex-Petrol" had accounts payable before German firm "Mabanaft" unknown at the previous stages of negotiation. Finally, "Mabanaft" took over ownership through direct negotiation with the government. This example illustrates not only the quality of the management of privatisation process and the uncertainty that foreign investors face while considering investments in Moldova, but also the weak control that the government has over state enterprises.

More encouraging has been the progress achieved in the restructuring of electric energy distribution in years 1999-2000. This is probably the only example of a prepared and consequently implemented (although delayed) privatisation project in Moldova. In December 1998 the Law On the Individual Project of Privatisation of Energy Sector Enterprises was adopted by the parliament. The former state monopoly "Moldenergo" electric utility was broken into nine separate firms specialized in generation, distribution and transmission activities. The first stage of the project involves privatisation of electricity distribution companies, while the second stage involves a simultaneous privatisation of the heat and power production plants. In summer 1999, the government of Moldova announced an open international tender for the privatisation of the electricity distribution companies. Of the nine companies, which applied for the preliminary selection stage, eight firms were admitted to the main tender stage, but after a resignation of the reformist government in the end of 1999, six firms have withdrawn their applications. In the end only two firms; "Union Fenosa" and "LuganskOblEnergo" participated in tender. At the beginning of 2000 "Union Fenosa" has won the tender on a privatisation of three (from five) distributive networks. "Union Fenosa" was also the only company that responded to the tender of remained two distributive networks in the end of 2000, as the trust of investors has not been recovered. The crucial factor of the political instability in undertaking privatisation projects is also reflected in the privatisation of thermal power stations (CETs). Not a single application has been submitted to the tender commission by the November 2000 deadline. Chances of a privatisation of CETs are very uncertain as prospects of new elections make foreign investors very reluctant to commit to the long-term presence in the country. It is also under question mark, whether privatisation of the Chisinau heating supplier S.A. "Termocom" might be completed successfully soon, although the government agreed to forgive the enterprise debts in a move to attract more investors.

The experience is therefore mixed. What is the most important achievement is that new owner of electricity networks increased payment discipline, what allowed for the elimination of single largest distortion from economic life in Moldova. On the other hand this success was achieved by the privatisation of the natural monopolist at very favourable conditions. However, this is a price that Moldova has to pay for waiting so long with launching privatisation projects. In any case, the bad situation of enterprises and financing needs of the budget leave the government no option, but to privatise.

## **Wine and tobacco**

Wine making and tobacco are two the most prospective branches of Moldovan industry. The lack of real ownership and restructuring put a barrier to their development and this situation has not been changed in 1999 and 2000 due to political controversies and powerful vested interest. In the end of 1999, the reformist government actually has been removed from office and the cooperation with

international organisations broken, exactly because of failure to privatise these enterprises<sup>17</sup>. The decision on privatisation accepted finally by the parliament in October 2000 does not bring any guarantee that this time the privatisation really will take place, as important political groups continue to profit from the current situation. Without privatisation, the financial situation of the enterprises, especially wineries, will continue to deteriorate and chances for fast production and export growth that could stimulate other sectors of economy would be wasted. However neither the parliament nor general public in Moldova has developed this understanding, so if privatisation finally takes place, it will be the sole result of IMF and World Bank pressures.

## **Telecommunications**

Privatisation of state enterprise “Moldtelecom” is an extreme example of inefficient management of the privatisation process in Moldova. On the one hand, during the last 5 years the governments declared necessity of “Moldtelecom” privatisation according to the requirements of the international financial organizations, on the other hand, process of privatisation was delayed by all accessible means. Especially since July 1999, after adoption of the law “On individual project of reorganization and privatisation of state enterprise Moldtelecom”, practically there were no obstacles to the privatisation. Delay of the process led to reduction in the market price, as in last two years Moldtelecom practically lost monopoly for long distance calls to internet-phone companies and is not able to respond properly to rapid development of mobile telephone services.

## **Privatisation: Summary**

Although the process of privatisation has been significantly accelerated in the period following the crisis, much of work has to be done in the future. At the end of 2000 the privatisation neither of leading winemaking and tobacco enterprises, nor “Moldtelecom”, nor heating and electricity enterprises, nor heating distribution was carried out. Out of the 1,155 companies included in the privatisation program for 1997-1998, only 661 companies have been privatised so far. As a consequence of years of neglect and consequent reduction of market value of enterprises combined with high political instability, it is very difficult to attract investors, even to participation in the privatisation of natural monopolies. The key issue during a privatisation is the resistance of directors of the privatised enterprises, which are not wishing to lose the control over assets<sup>18</sup>. This is because high level of corruption and incompetence of state ownership allows managers to draw unjustified personal profits at the expense of enterprises. The government therefore has no options: cash privatisation is the only realistic solution for improvements in corporate governance and reduction of fraud in state owned enterprises. Moreover, only privatisation proceeds might allow for timely service of debt and financing from international organisations is conditional on progress of privatisation.

### **3.3. Bankruptcy and restructuring**

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<sup>17</sup> At the 1999-2000 the fulfillment of privatization program for tobacco and leading winemaking companies becomes one of the main conditions of renewal of the financing of Moldova from the IMF and WB.

<sup>18</sup> See: Djankov, S. (1998) for detailed analysis.

The hard budget constraint and the control of creditors may contribute to better corporate governance and elimination of the non-payment culture. Especially the consequent and efficient implementation of the bankruptcy law mechanisms can ensure financial discipline and development of viable strategies in enterprises. Only recently however there is a political will to actually bankrupt loss-making companies, whose exclusive result of operations is the accumulation of debts. Accordingly, in early 1999 the government has adopted the decision that committed Ministry of Finance not only to speed up a development of new national standards of book keeping, but also to initiate promptly bankruptcy of the loss making enterprises, whose overdue debts before the state budget exceeded 5 million lei. The same recommendation was given to the Social Fund while power enterprises were committed to initiate bankruptcy of enterprises, having energy debts exceeding 1 million lei. Although over the last three years the economic court declared as insolvent 213 companies (practically none before the end of 1997), the number of actual bankruptcy procedures is much lower than their potential number. Even as the understanding of the necessity to bankrupt enterprises is rising, there are important obstacles to efficient proceedings, including foremost low quality of law and lack of functioning judiciary.

### **Bankruptcy Law**

The first variant of the bankruptcy law was adopted by the parliament at the beginning of 1992. Poor quality of preparation of this law and absence of legal institutions for its implementation has caused practical non-appearance of bankruptcy procedures until the end of 1997. Improvement of the legislation and mechanisms of bankruptcy procedure became therefore a priority for the government and the parliament in 1999 and 2000. The goal was to provide a more efficient and credible legal environment in order to optimise company liquidation procedures and therefore establish the shortest possible legal process, without loss in fairness. Accordingly, the parliament adopted in March 1999 amendments to the bankruptcy law, allowing for the simplification and acceleration of procedures. The adopted amendments have appeared insufficient. At present, a new variant of the law on bankruptcy is being developed, again with the purpose of establishing firm and simple bankruptcy procedures and extending the powers of state creditors. However, even the prompt approval of the new law will allow streamlining bankruptcies and therefore increasing the financial discipline in the economy, only if the effective judiciary is created.

### **Judiciary**

The efficiency of any bankruptcy procedures implementation depends on the quality of the judiciary institutions. However there are only two economic courts in Moldova (Chisinau district economic court and economic court of Republic of Moldova). In spite of their key role and substantial income they generate to the budget, there is also a problem of insufficient financing of these structures. There are only 12 judges within district court and each of them considers annually more than thousand legal cases, which means that it takes years to complete a particular case. The legislation provides also for own law enforcement of economic court decisions, but because of lack of financing this provision is not respected. Only recently has the economic court of Republic of Moldova prepared the draft of the law providing for the creation of two new economic courts (at the north and at the south of Moldova) and the increase of the number of the judges for Chisinau district court up to 16 persons. However the budget for 2001 is not providing funds for these purposes. Unless expenditures on judiciary are strictly prioritised in the budget, the prospects for more effective

economic law enforcement are marginal.

### **Financial restructuring**

As an alternative to the bankruptcy procedures some potentially viable enterprises are undergoing restructuring process. The reorganization plans are elaborated and implemented by these companies with the support of the Council of Creditors and ARIA (Agency for Enterprise Restructuring and Assistance). Restructuring and reorganization activities with ARIA technical assistance have achieved some success between 1997 and 2000. However, experts insisted on creation of the new legal rules for the acceleration of restructuring processes. Accordingly, in early 1999 the government has approved the decision “On urgent measures on restructuring and financial improvement of the industrial enterprises”. Although many rules of this decision are not executed up to now some improvements in restructuring process with the benefit of participating companies have been reported. This achievement is particularly important as currently over 33 percent of the industrial enterprises currently do not operate or operate in much below capacities, generating losses.

### **3.4. Development of short and medium enterprises**

The creation of a competitive private sector is a necessary precondition for development of the real sector of economy<sup>19</sup>. While the privatisation of large industries is very important, the majority of Moldova’s enterprises began operations only after 1995 and newly created enterprises (excluding agricultural farms) amount to 81.8% of today’s firms. These firms are usually of small and medium size as such firms require the least investments, are efficient in the underdeveloped sector of services and can quickly react to changes in demand. Still, the largest part of small and medium enterprises (about 166,000 or 84.8%) operate in the field of unorganised business as self-employed individuals. Until the end of 1998, there was no suitable regulation of such businesses. As a result smallest firms were pushed into the shadow economy and had huge problems of obtaining bank credit. Only in the end of 1998, the law “On entrepreneurial patent” was adopted by the parliament. This law allowed for the legalization of the smallest firms, however its low quality allowed for much ambiguity and various interpretations and for that reason it has been changed already two times (April and November 1999). It obviously contributed to the poor effectiveness and low popularity of the new legislation. Accordingly, only about 26 thousand persons hold entrepreneurial patents at the end of 2000, i.e. only 20-25 % of the potential number. Moreover approximately 90 % of all patents are given out to firms involved in trade, with not much development of small production enterprises.

What has been hardly changed in Moldova in recent two years is the high degree of state interference in enterprises activity. In this respect, the single most important obstacle for entrepreneurial activity is in the large number of licences. So far only some work has been undertaken towards better organisation of licensing and eliminating the excessive freedom of the government to set up new licences. Until 1999 licensing was realized on the basis of government decisions. Such decisions were approved in 1990, 1995, 1997 and 1998. At the beginning of 1999 the Constitutional Court of Moldova has recognized these decisions as unconstitutional. According to the new Law “On licensing of activities” adopted in June 1999, there are 13 ministries, the National Bank, 3 departments and 10 other state bodies issuing licenses for 106 types of activities. Although

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<sup>19</sup> The private sector constitutes 62 % of value of enterprises assets, 86 % of net sales, 76 % of employment and 66 % of GDP in Moldova.

the new law put an end to the “spontaneous” licensing, the number of licences itself should be considerably reduced in order to streamline the registration, licensing, and administrative procedures that hamper the establishment of new enterprises and pushes others towards operations in the shadow economy. Licensing procedures and the frequent controls by tax officers are also the most common opportunities for “taxing” small and medium enterprises in the most devastating way; i.e. through predatory corruption. For some time there existed the belief that moderate corruption may “oil” the bureaucratic machinery. In Moldova the opposite effect was however taking place – regulation was complicated precisely in purpose of generating opportunities for rent seeking and bribes. Uncertainty about the size and frequency of forced payments of this kind makes the opening of a new business a very risky decision. Yet, the problem of corruption has not been seriously addressed in any way so far, there was not a single high-ranked official convicted for corruption so far.

At the same time small and medium enterprises face acute problems of financing. The high interest rates of crediting (32-35% in 1999) limit access of enterprises to financial resources. The majority of representatives of small business have no knowledge and experience for work with credits, also banks are reluctant to lend to the sector. Accordingly, during 1999 only 11.2% of businesses invested in the purchase or rent of fixed assets. The last two years have brought some improvements in this respect. The most importantly, with a reduction of the budget deficit commercial banks lost the most important source of income – interest earned on T-bonds, the share of credit to the government in the total stock of money increased to estimated 51% in 2000 from 87% at the end of 1998<sup>20</sup>. There is some indication that banks indeed try to make credit products more accessible to smaller enterprises. It is believed that this process will be further accelerated in 2001. The National Bank of Moldova supports this process through the constant strengthening of the banking system and the attraction of foreign investors. Alongside with commercial banks realizing micro crediting still rather reluctantly, specialized enterprises for micro crediting are operating at the wider scale. Simplified procedures of crediting allows issuing credits usually within 10 days from the date of the first appointment, and up to \$ 2000 - during 4 days; that is very attractive for small business. The state also started to act more actively in the interest of the sector. In mid-of-1999 the State Program for support of small entrepreneurship for 1999-2002 was adopted. Within the framework of this program the Ministry of Finance approved the rules of granting tax credits to small and micro-enterprises. The program envisages three-year long vacations in paying the value-added tax for 2 groups of firms - small enterprises employing 6 to 19 people and having an annual turnover of 3 million lei, and for micro-enterprises having up to 5 workers and a turnover of one million lei. The mechanism of tax credits allocation is imperfect, with plenty of bureaucratic procedures. Therefore, to take advantage of these privileges is possible only to a few representatives of small business. Presumptive tax law for small enterprises is also considered as the stimulation for the growth of this dynamic sector of the economy.

Tax exemptions (which in Moldova always can be possibly revoked anyway) are however not crucial for the development of the sector, rather stability of law and regulation is essential. Therefore it needs to be concluded that in spite of some improvements, a favourable climate for development of small and medium business in Moldova is not created yet. As bureaucratic impediments persist and the corruption remains high, the shadow economy prospers and entries to the legal business life are scarce. Legalization of activities would be more profitable only if legal activity would guarantee legal protection, reduce predatory treatment, and allow for the access to banking sector. Such

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<sup>20</sup> Note however, that very high ratio in 1998 was partly a result of the direct credit extended by central bank to the government during the peak of the crisis in the last months of the year.



improvements of the environment for SME development, conducive to investments are still moderate or non-existent.

### 3.5. Rule of law and business environment

An effective legal system that protects contracts and property in an enforceable manner is the first condition for development of private entrepreneurship. The Civil Code adopted originally in 1964 does not correspond to the current legal and economic reality, as the law was heavily influenced by communist ideology. By opinion of experts, the Civil Code in present shape lacks roughly one third of necessary norms and concepts in regulating life in the market economy. Parallel functioning of Civil Code stipulations and provisions of recently adopted laws that bring different solutions to the regulations of similar legal relations, creates conflicts and ambiguities in the process of application of the law. Accordingly, the work on creation of new Civil Code began in 1997. In October 2000 under pressure of IMF the parliament passed in the first reading one of the three drafts of the Civil Code, worked out by a group of university scholars under guidance of a German TA project. This project will be the basis for further debates in the second reading. It might be combined with elements of the other two drafts – one worked out by the Moldovan presidency and one by the U.S. Agency for International Development. There is some moderate optimism, as the adoption of Civil Code in June 2001 is strictly required by international financial organisations. The further delay could become the large impediment for market development. However, even if the code is adapted it remains an open question, how effectively will it be enforced, as the juridical system remains very weak and undercapitalised and law enforcement is impeded by corruption.

Among the main impediments to business developments are often changes of the legislation, including retroactive modifications. During 1998, for example, there were at least four rounds of changes on the rules governing incentives for foreign investors. Investors are also concerned about the policy for removing the incentives that have already been approved. Also at the end of 2000 the parliament has adopted a set of modifications to some laws, according to which the state has the right to demand the cancellation of court decisions on sequestrations of property of public utilities issued since January 1, 1999.

In summary, some progress in building up legislation in line with requirements of the market economy has been achieved. However, frequent changes in laws are introduced in an unsystematic and contradictory way sending the wrong signals to existing and potential investors, for whom stability, consistency and transparency of legal base are very important.<sup>21</sup> At the same time law enforcement institutions remain very weak.

### 3.6. Fiscal consolidation

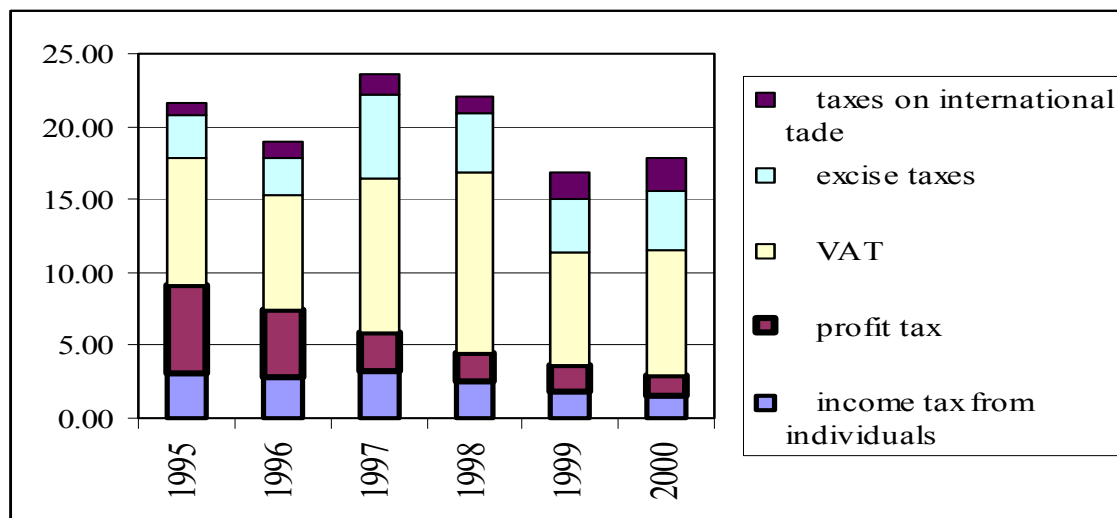
A fiscal consolidation was the crucial component of post-crisis policy adjustment. While it was mainly forced by lack of financing and involved radical cuts in the expenditures, structural reforms in the budget sphere have been necessary to make the program more sustainable. Changes were introduced in more consistent framework of medium term planning introduced with the help of German technical assistance, while more realistic revenue forecasting through the same project allowed for better budgeting and reductions in expenditure commitments.

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<sup>21</sup> Moldova. A diagnostic review of the environment for foreign investment. – MIGA, May 1999.

### 3.6.1. Tax revenues

Figure 10. Selected tax revenues as % of GDP



Source: Ministry of Finance, own calculations, 2000 forecast from GTZ macroeconomic model.

Overall, the figures do not show improvements in tax collection in recent two years, on the contrary, the year 1999 exhibited a marked decrease of tax (mainly VAT) revenues as a share of GDP. This might be partly explained by the adjustment in composition of GDP in 1999, i.e. reduction of consumption and imports<sup>22</sup>. The picture would be more favourable, only if cash revenues were taken into account and, more importantly, while the figures might not be very encouraging the undergoing process of institutional reform should be generally appreciated.

#### Tax administration

Work is pending on the new tax code. The chapter on tax administration is planned to be approved in March 2001 and was passed by parliament in the first reading. This law foresees large empowerment of the financial guard, the most effective arm of tax enforcement. It will be invested with special rights to carry out operative and sudden control over the tax compliance, to penetrate into public and private premises, to arrest property, to stop vehicles, to carry out investigations, to use physical force and weapons, to 'implant' agents into any company or enterprise, to carry out independent investigations and to send findings directly to court, not to the police or prosecutor's office<sup>23</sup>. Ministry of Finance managed also to pass through the parliament in the first reading the legislation empowering tax authorities to get from the banks any demanded information on their clients (even classified as trade secrecy), to suspend the flow of payments from banking accounts, to penalize enterprises, high-ranking executives and individuals. Unless an economic entity has fully discharged their tax liabilities, tax offices will have the right to refuse a certificate allowing opening and maintaining two or more accounts with unrelated banks. Nor will be such entity allowed to close available accounts<sup>24</sup>. These changes, if introduced might increase the efficiency of the tax collections.

<sup>22</sup> Similarly, expected good VAT collections in 2000 are mainly due to the very rapid growth of imports and consumption this year.

<sup>23</sup> Source: Infotag Financial

<sup>24</sup> Ibid

On the other hand however, they may have negative impact on the development of private companies and a functioning banking system, virtually defenceless against widely corrupted tax officers.

There have been other efforts to introduce a modern tax administration system already taking place in last two years. Important, but only potentially, is the establishment of the Large Taxpayer Unit at the end of 1998, a separate body for monitoring and tracking the major tax-payers - 626 enterprises, whose annual turnover exceeds 10 million lei. The list includes companies (especially engaged in import and export activities) obliged to pay the largest VAT, excises, duties and income tax. The Large Taxpayer Unit is however not operationally effective due to lack of resources and technical assistance, or, as might be argued, because of strong vested interested constraining its operations. Since 1999 tax officers are also more determined to seize the property of tax defaulters. This experience has to be given a mixed assessment: while it increased fiscal discipline, such seizures are highly non-transparent and especially the value of arrested property is determined in an arbitrary way. Moreover, similarly as in case of in-kind payments, Ministry of Finance has a major problem in selling the property. At the same time there is no control over it and it is widely believed to be subject to fraud. Only direct seizures of banking accounts can be seen as radical, but effective way of tax liability collections.

As a result of all these measures and proposals, tax collections in years 1999 and 2000 are believed to be significantly stricter. Available statistics however do not confirm the anecdotal evidence, number of audits, discovered violations and number of imposed payments are all in the decreasing trend – while tax evasion was most likely on the rise in examined years.

**Table 3. Struggle against tax evasion**

|                               | 1997   | 1998   | 1999   |
|-------------------------------|--------|--------|--------|
| Number of audits              | 17,541 | 15,345 | 12,103 |
| Number of detected violations | 9,233  | 9003   | 7,167  |
| Imposed payments (MDL mln)    | 290    | 375    | 168    |
| Actual payments (MDL mln)     | 39     | 50     | 50     |

Source: State Tax Inspectorate.

Only one element of the program of improving tax administration has been undoubtedly successful, that is the elimination of non-cash payments to the budget, that used to contribute heavily to the development of non-payment culture and related distortions in Moldovan economy. As a result of tough conditions, imposed mainly by IMF programs, these transactions have been sharply reduced, especially between budgetary institutions and the energy sector. It should be noted that while revenues to the state budget are recently almost exclusively executed in cash, revenues to local budgets contain a higher share of netting-out. There are also encouraging attempts to reduce in-kind payment to the Social Fund. In this respect, important improvement was that the State Tax Inspectorate took over functions of revenue collections of Social Fund, which increased the efficiency of collection of contributions.

**Table 4. Netting-out operations – revenues of consolidated budget**

|  | 1998 | 1999 | 2000Q3 | 2000E | 2001E |
|--|------|------|--------|-------|-------|
|  |      |      |        |       |       |

|                   |       |     |       |     |       |
|-------------------|-------|-----|-------|-----|-------|
| MDL mln           | 975.5 | 350 | 148.5 | 187 | 148.5 |
| Share of revenues | 36%   | 11% | 5%    | 5%  | 3%    |

Source: Ministry of Finance

This gradual elimination of netting-out operations will affect positively tax collections and also efficiency of budgetary expenditures in medium period. More profoundly, elimination of netting-out operations attacks the roots of non-payment culture in Moldova and therefore contributes to a more transparent economic life with diminished opportunities for fraud, tax evasion and rent seeking.

## Tax law

The new tax code strives to put together VAT measures that are in force and stop the practice of annual VAT legislation changes through the budget bills. It also aims at the full change towards the destination principle. This issue is complex, as in reality it requires the cooperation with major trade partners. Indeed Moldova and Russia are discussing the draft of a bilateral agreement on collecting indirect taxes on the destination principle. As for now, Russian authorities keep on levying taxes by the origin principle. The situation is particularly troublesome for Moldova in the field of oil-product and gas imports as related revenues are directed exclusively to the Russian budget. The improvement achieved so far in 1999 and 2000 were related to the reduction of VAT exemptions, while granting of new exemptions has been much more rare than in previous years<sup>25</sup>, which contributed to a more equitable and transparent system. Introduction of VAT in agriculture for 5% (20% basic rate) in 1999 is the key achievement. While in 1999 almost all kinds of agricultural produce were still exempted, in the year 2000 the list of exemptions has been substantially shortened. Also producers of bread, milk and dairy have to pay a 8 percent VAT since 1999 and 5% VAT on the imports of gas were also introduced in 2000. Some efforts are however contradictory: for example in late 1999, the Moldovan parliament cancelled the three-year VAT exemption for foreign investors<sup>26</sup>. This decision, though positive for the budget has further deteriorated the image of Moldovan authorities, which illustrates the negative consequences of an incoherent reform strategy.

The Moldovan parliament has passed in the first reading a chapter of the tax code on excise duties. The bill envisages the introduction of the so-called 'excise duty certificate', that should result in more effective taxation of manufacturers of goods subject to excise. A complete switch to the destination principle is also foreseen. Ministry of Finance attempts also to rationalize excise taxes, as it is planned to eliminate excise tax on all goods except tobacco products, alcohol and alcoholic beverages, imported cars and petroleum products. This work is however lagging and the list of excised goods remains long and contains items that are difficult to tax, and that not bring substantial revenues. This reduces the overall efficiency of the tax collection system. Interesting solutions were applied in case of excise on cigarettes. For legalizing cigarette imports Ministry of Finance proposed to decrease tax burden on importers. The experiment gave positive results, at 1 November 2000 budget revenues from cigarettes excise was 107 million lei, therefore twice higher than in the previous year. Before 1999 revenues from this source were marginal as illegal imports practically monopolized the market. By reducing excise rates in the budget for 2001, the government hopes to

<sup>25</sup> Temporary tax holiday for oil importers in 2000 is one of main exceptions.

<sup>26</sup> See the section on legal reform

resolve also the problem of smuggling of oil products. So far the volume of illegal imports is at least as large as official. However the real crack on smuggling and related tax evasion cannot be achieved until Moldova has well-defined, supervised borders with a functioning customs system.

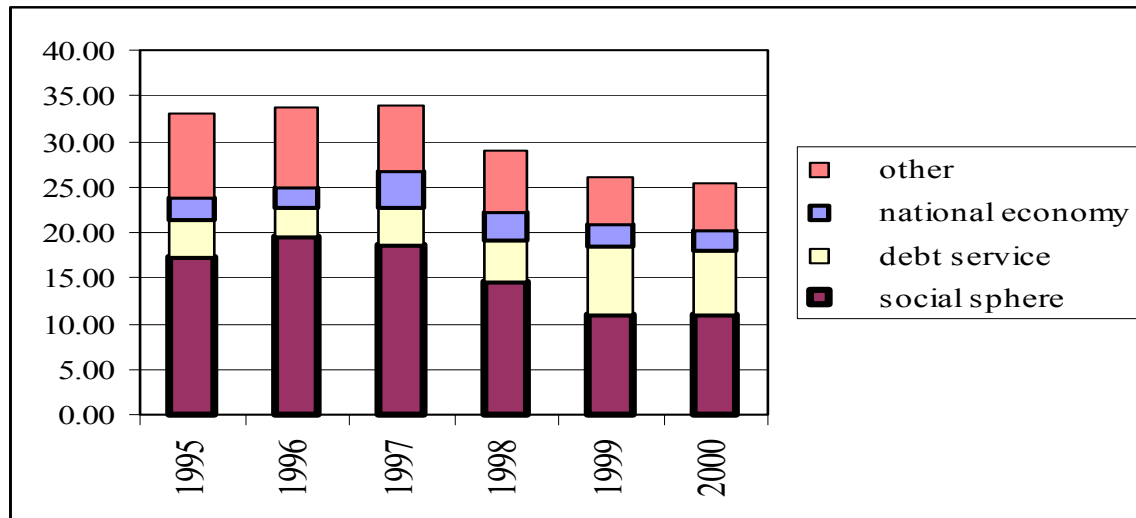
### **Customs reform**

The new Customs Code, based on EU standards, was passed to the parliament in July 2000. Introduction of export and import monitoring in correspondence with international nomenclature should provide the basis for improved revenue collections. There also have been investments in fiscal posts in years 1999 and 2000. Further on, a tender to hire an import pre-inspection service has been completed. Although some points of the agreement signed in early 2000 with a selected firm may indeed be seen as problematic (as it is not absolutely clear how activities of pre-inspection should be coordinated with those of regular customs), the new service will undoubtedly increase the efficiency of the system and lead to a decrease in corruption and smuggling. However in the end of 2000 the implementation phase has been halted by the parliament and the basic reasoning would suggest that it was a result of vested interest pressures.

Notwithstanding some improvements in customs administration, the most important issue of practically transparent external border with Ukraine, especially via Transnistria, remains unresolved. To address the problem, the government established 30 mobile and 17 fixed fiscal posts as a substitute to fully-fledged custom system in April 1999. However, in spite of first encouraging results, the collected revenues remained weak, main reasons being poorly defined responsibilities and insufficient financing of the posts. These imperfections derive from an essential political problem that is a lack of resolution of Transnistrian conflict. Although Transnistria is in practice conducting independent tax and custom policy, Moldovan authorities are reluctant to establish and finance the real border as it could be seen as acknowledgement of Transnistrian independence. As the settlement of territorial dispute is distant, prospects for effective tariff and fiscal policy remain weak..

### **3.6.2. Elimination of expenditure commitments**

**Figure 11. Government expenditures as % of GDP**



Source:

Ministry of Finance, own calculations, 2000 forecast from GTZ macroeconomic model.

For many years the government could not reduce expenditure commitments. Instead, the accumulation of arrears and direct sequestration was taking place, which had a negative impact on the efficiency of expenditures. The squeeze of available financing after the crisis could not however be compensated by unsustainable ad hoc expenditure reductions. Under additional pressure from donor organizations, expenditure commitments started to be cut back in years 1999-2000. While some savings were made through the reduction of subsidies, the large part of reduction of non-interest payments had to be made in the social sphere.

### Reduction of privileges and subsidies

Definitely the most important reform in this field was the elimination of large number of non-targeted privileges to the population and the rationalization of the energy subsidization. In 1999 measures were taken to reduce compensations for heating and energy. More fundamental reform was introduced in the year 2000, when a new law annulled various privileges envisaged in 16 different laws, such as privileges for communal services, energy and transport that cost a budget about 600 million lei annually (that is about 20% of budget revenues in 1999). Instead of these generous privileges for all (and in practice the most privileged population of big cities, especially Chisinau), the parliament passed a separate law on targeted cash compensations available to only few the most vulnerable groups: invalids, disabled children, World War II veterans, pensioners the victims of Soviet-era political repressions and families of victims of Chernobyl disaster. The aggregate figure of such compensations represents just one fifth of costs of the previous privileges and will be available to some 225 thousand people (while the number of pensioners living in this republic exceeds 700 thousand). Cash compensations will be paid directly to beneficiaries and there will be no direct subsidies to energy companies (that were taking place through complex netting-out operations previously). The reform would therefore support the strategy of tackling the poverty through targeted social assistance and at the same time reduce the extent of non-payment culture.

In 1999 subsidies to vineyards, diary and milk production were also eliminated. However, partly as a consequence of draught, partly as a stimulus of land privatisation and partly as a result of populism, subsidies to agriculture remain at roughly the same level since 1999, although a reduction

with respect to earlier years has been achieved. Elimination of subsidies is important not only for the state budget, but also as a condition for real restructuring of enterprises and elimination of rent seeking.

### **Administration reform and public sector employment**

The Law on Administrative and Territorial Reform is effective since January 1999, with the number of local administrations cut from 38 to 11. Further on, the Law on Local Public Finances was submitted to parliament in June 1999 and will be effective since January 2000. The law not only codifies the relations between the central budget and local governments' budgets, set norms for local budget preparation and execution, but also streams towards more financial independence and decentralization, essential for better expenditure targeting. Accordingly, 100% from enterprise income tax and value added tax on goods and services will be retained by local authorities (50% percent recently)<sup>27</sup>. This will allow for more discretion of local authorities in deciding on expenditures, while restrictions on borrowings should prevent debt accumulation. As a result of the reform, the local administration employment was reduced by roughly 10 thousand.

There were also other large cuts in public sector employment in the period following the crisis. It fell from 332 thousand in early 1998 to 309 thousand in 1999 and to 285 thousand in 2000. Some efficiency gains were also achieved. However in order to strengthen state structures and to increase the quality of public sector services, more systematic changes are required. More specifically, it is necessary to recruit employees only on the base of contracts with precise responsibilities and performance targets allowing for better evaluation and more performance-oriented remuneration.

### **Social Sphere**

A significant part of the public sector employment reductions took place in education and health care. As a result, expenditures in these sectors have fallen strongly between 1998 and 2000 (with especially deep decline in 1999). Large savings were achieved in education due to the rationalization of number of schools and reduction of weekly teaching days down to 5. The average number of students for one teacher was also increased. While these changes cannot be seen as positive developments per se, it is much better to reduce expenditures through systematic and monitored changes rather than through ad hoc cuts and developments of wage arrears, as it was taking place before 1999. Still the education policy lacks prioritisation, necessary at period of financial distress. The higher school reform needs also more attention, as the state continues to support institutions, which train specialists in non-demanded qualifications, while there is virtually no support for private, market oriented education incentives.

Similarly, deep cuts in employment and expenditures have taken place in the health care system. In 1999 alone, the real-value of the health care budget was reduced by around 40% in comparison to 1998. Savings involved closing of some hospitals, switching from hospital to ambulatory services and reducing non-medical staff. Increasing focus has been put on primary services. Most importantly, the very restrictive list of free of charge services has been established.

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<sup>27</sup> For Chisinau these shares are increased to 50% and 10% for income and value added tax, respectively (40% and 10% before the reform).

Since 1999 only the most essential services like emergency, natal care, vaccinations and diabetics are rendered free of charge, all other health services require now some patient co-payments. While these decisions are extremely tough and would not be accepted in any other European country, it seems a better strategy to introduce reductions openly rather than cut expenditures through arrears and sequestration.

Finally, some progress has been achieved in introducing of pension system more supportive to the market economy development and with stronger correlation between contributions and pension benefits. This reform could improve compliance and reduce the shadow economy. Accordingly, the parliament adopted the strategy of pension insurance system in the end of 1998 and laws on state social insurance, non-state pensions funds, calculation and payments of pensions, minimum pension etc. in the period 1998 – 2000. Although these developments are undoubtedly positive, experience proved that the path from the legislation to implementation of law in Moldova is very long. Therefore, it is still uncertain what the future of the reform would be.

### **3.6.3. Fiscal stabilisation: summary**

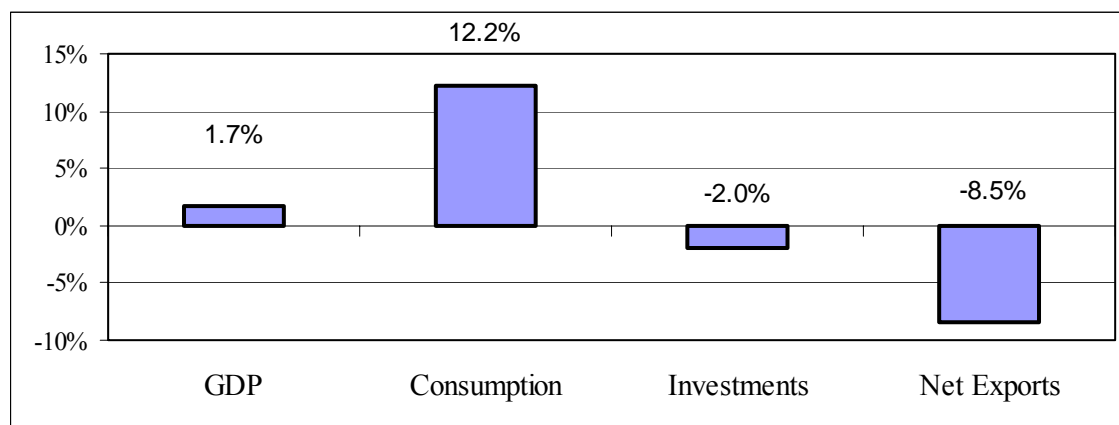
Significant efforts have been made in order to increase the quality of tax system and especially the effectiveness of tax collections. While it was possible to almost eliminate non-cash payments, there has not been an important success in the reduction of tax evasion and in solving related problems of corruption and transparent borders. Similarly, while some reforms on the expenditure side of the budget, especially elimination of privileges, increased the efficiency of expenditures and diminished arrears, lack of the right prioritisation remains the major weakness in utilisation of limited budgetary resources. Expenditures have to be increasingly focused on growth stimulating expenditures, i.e. on strengthening of juridical system and public order as well as on providing better quality primary health care and education services. It remains to be seen if the new territorial administration system will be conducive to this goal.

## **4. Conclusions**

Some developments in the year 2000 have been seen as a breakthrough and a sign of the end of the economic crisis in Moldova. These developments included foremost the stabilisation of macroeconomic situation and the growth in the first half of 2000. Such optimism, however, is only partly justified. The macroeconomic stability is fragile and might be only temporary as heavy debt payments in next years would require even more disciplined financial policies and stronger export orientation of the economy. On the contrary, the growth in first half of 2000 has been driven exclusively by consumption with the subsequent surge in the non-energy and non-investment imports.

**Figure 12. Contributions to growth: H1 2000.**





Source: Department of Statistics

Exports did not exhibit any significant dynamics while exports to the non-CIS markets were actually diminishing. Dependence on non-reliable Russian markets is therefore increasing again. If the current level of privatisation proceeds is not maintained and used for investments rather than consumption, Moldova may face another balance of payment crisis soon.

Our conclusion is therefore of only moderate optimism. Although real reforms undertaken in last two years by the Moldovan governments are conducive to growth, the critical mass has not been reached yet. The most important problems of lack of territorial integrity, ineffective legal system, widespread corruption and rent seeking have not been effectively tackled so far. Yet exactly these fundamental issues will determine the growth prospects of Moldova in the medium perspective. While virtually all structural reforms undertaken in years 1999 and 2000 were driven by pressures of IMF and World Bank<sup>28</sup>, the most fundamental problems can be solved only if the Moldovan parliament assumes the ownership and full responsibility for reforms and building up functioning market economy.

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<sup>28</sup> Most of described structural changes have been stipulated as structural conditions for disbursement of funds to Moldova.

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