Initiative for Policy Dialogue

Moldova Country Dialogue

July 15th – July 23rd, 2002

The Initiative for Policy Dialogue held a series of policy forums in Moldova from July 15th to July 23rd 2002, in partnership with the Swedish International Development Agency (SIDA).

The IPD team included Nobel Prize winner *Joseph Stiglitz*, Professor of Economics at Columbia University and Executive Director of IPD; *Shari Spiegel*, Director of IPD and former head of FI Emerging Markets at Lazard Asset Management; *Gerard Roland*, Professor of Economics at the University of California, Berkeley and an expert on transition economies; *David Ellerman*, Economic Advisor to the World Bank's Chief Economist; *Nadia Roumani*, Assistant Director of IPD; and *Manuel Montes* of the Ford Foundation.

IPD Country Dialogues promote discussion between governments and their citizens on economic policy alternatives in an open and inclusive manner. The aim is to stimulate discussion of new ideas and widen the policy dialogue to include voices from stakeholders who have not fully participated in the country's debate.

The Moldova dialogue consisted of five days of meetings and roundtable discussions with various stakeholders, including President Voronin and other senior government officials, members of parliament, leaders of opposition parties, provincial mayors, academics, civil society groups, business community representatives, journalists, and members of the donor community. Anya Schiffrin, Director of the IPD Journalism Program, conducted a training session for journalists. Shari Spiegel and Nadia Roumani from IPD and Rebecka Kitzing and Nina Orlova from SIDA held two days of preliminary meetings with various civil society groups. (See attached schedule.)

Economists had predicted that countries with an industrial base would suffer more during transition than countries with an agricultural base. Yet Moldova, a rural economy, experienced the worst transition of all CIS countries. Over the past decade GDP in Moldova fell by more than 70%. In the mid-1990s Moldova implemented a series of reforms that led to temporary economic stability, but did nothing to reduce poverty or lead to growth. Policy makers – both those in government and those in the opposition –

have now begun to search for alternative solutions. The aim of the Dialogue was to discuss economic policy options, focusing on alternative strategies for Moldova's long-term development.

2001 provided a year of contrast for Moldova. It was the first year the government did not receive any credits from international financial organizations, foreign investment was minimal, and privatization income dropped. At the same time, GDP grew for only the second year since 1991, increasing by 6.1%.

The first topic addressed in most meetings was how to replicate 2001 growth to achieve long-term sustainable development. Despite the fact that the country grew in a year characterized by minimal foreign investment, many participants in the Dialogue believed that foreign investment was still critical for future growth. The reality, however, is that Moldova sends money abroad and is unlikely to attract significant investment in the near future. Foreign debt is estimated to be approximately 150% of GDP (see details below), and debt servicing in 2002 is estimated to be nearly 75% of fiscal revenue. Without a significant debt write-off, Moldova will continue to export capital in the form of debt repayment. Everyone agreed that foreign direct investment, and even foreign aid, can be important and play a catalytic role in building expertise and new institutions. But one point that came out in the discussions is that Moldova will most likely need to concentrate on ways to mobilize its own internal resources to achieve growth.

To answer the question of how to replicate the 2001 growth, it was useful to first understand the actual sources of the growth. Not surprisingly, there were different views as to why growth had turned around so dramatically.

One view, held by the opposition, was that the current growth is the delayed effect of policies implemented by past governments. An example given was electricity reform, which ended frequent breaks in electricity supply in Chisinau, and led to increased productivity. Others said that the high growth rate was tied to growth in Russia, and had little to do with policies in Moldova. Another argument was that the data was wrong, and the statistics were unrealistic. However, evidence such as credit expansion and export growth indicates that there is at least some basis in the growth data.

The government claimed that recent growth was due to recent policies. In particular, President Voronin said that 75% of the growth was attributable to an increase in small enterprises, which could be the key to future economic growth.

The IPD team pointed out that a noticeable surge in workers' remittances from abroad might be one of the causes of the increased growth. As we discuss below, given the lack of opportunity in Moldova, approximately 15% of the population over 15 years old now works abroad.

Throughout the dialogue, three topics generated the most significant controversy and debate. Small Enterprise Development was one such topic. The two other topics of primary interest were Rural Development and Debt Restructuring. In addition, there was some discussion of proposals to try to develop domestic human capital and respond to the flight of workers out of Moldova. The main points of the discussions are summarized below.

1) Small Enterprise Development

Despite the President's emphasis on small business development as an explanation of growth, the importance of small enterprises is a hotly debated topic in Moldova. Some of the questions addressed in the discussions were: What should be the role of larger firms? Should larger firms receive subsidies? Are these firms already receiving indirect subsidies or protection? And should the government try to encourage small enterprise growth?

Some participants believed that small enterprises are the key to future economic growth. Others, especially those from within the ruling communist party, expressed the view that the government should continue to support large firms. They argued that Moldova would only be able to interact and compete with international firms in the global economy through large firms of its own. This opinion was strongly articulated in the meeting with Parliament.

However, most participants agreed that one size is not appropriate for all institutions and markets. It is important to distinguish the role of the firm in understanding the appropriate structure. In agriculture, for example, marketing and production firms are often different sizes. Production is done on small farms, while larger firms market the product.

The IPD team was able to incorporate economic theories and other countries' experiences into the discussion. Small enterprises have been a main source of growth in many developing and transition countries. Small firms are often able to compete more efficiently because they tend to be more flexible. Even in the United States many large firms – such as Federal Express, which started with a US government small business loan – started as small and flexible enterprises.

A second set of questions arose over the types of policies that could be used to encourage investment and new enterprise development. One suggestion was to streamline bureaucratic impediments to investment and simplify regulations. The IPD team brought up the Vietnamese New Enterprise Law as an example of such legislation. By streamlining bureaucracy, small enterprise registration in Vietnam increased 2-3 times in the space of a year. The government in Moldova said they're already in the process of doing this, though there was clearly opposition to it within the communist party.

IPD raised the idea of targeted tax incentives for small enterprises, as another way to encourage enterprise development. This idea is somewhat controversial, even in developed countries. For example, the Clinton administration used targeted tax policies to encourage small enterprise development when Joseph Stiglitz was Chairman of the U.S. Council of Economic Advisers. However, the IMF is against targeted measures because they can be subject to abuse due to problems in administration. The government will have to weigh the positive effect of promoting new enterprises vs. the risk of a poorly administered program, given the lack of institutional capacity.

The discussions also addressed the danger of policies that might discourage investment. For example, the business community is nervous about the new Moldovan law against economic crimes. Although the law has not yet been abused, it has the potential for abuse. Thus it increases the risk premium on new businesses and can deter investment.

Corruption

One of the greatest impediments to investment in Moldova is the high level of corruption. Moldova has been ranked as one of the most corrupt countries in the world.

In every meeting, everyone agreed that corruption presents an enormous cost for Moldova. The question addressed in the Dialogue was how to go beyond the rhetoric, and devise strategies and policies to effectively reduce the scope for corruption. Discussions centered on policies that minimize administrative discretion, because it is through this discretion that corruption is made feasible.

Corruption efficient tax structures provide one such set of policies. Some tax structures allow more discretion to judge income. Other structures are more corruption resistant. VAT, for example, is *not* a corruption resistant tax. In countries that are predominantly cash economies without good accounting records, a VAT tax can lead to evasion because it allows room for judgment. On the other hand, a tax on easily measurable and quantifiable items like large cars or luxury homes is less corruption prone. VAT works well in Europe, but it is not necessarily well suited for Moldova.

Some participants suggested that the answer to corruption could be stricter legal enforcement. Stricter enforcement at times can certainly be effective. The IPD team also emphasized that increasing the power of the tax police does not necessarily translate into higher revenues for the government. In many countries tougher enforcement has resulted in higher incomes for the tax police, without any increase in collection for the government.

Privatization

Many of the largest firms in Moldova have already been privatized, and there was more interest in discussing a 'post-privatization' strategy than discussing current privatization policies. However, the IMF has included privatization of the remaining government owned firms, such as telecommunications, electricity, and the wineries as a condition in its new program.

The widespread disappointment in earlier privatization policies has made the process of privatization very unpopular in Moldova. The privatization strategy that was pushed during the 1990s, i.e. voucher privatization, was subject to corruption and failed in Moldova as it did in several other transition economies.

More recently, the IMF has emphasized privatization of the electricity and telecommunication industries in Moldova. There is no question that large inefficiencies exist in both sectors and that more efficient infrastructure is necessary for long-term growth. However, there are questions of whether this is the optimal time to privatize telecommunications, given the current market conditions. The discussion centered on alternatives. For example, can these industries gain expertise in other ways? A short-term focus could be on creating strategic alliances with international firms, with the goal of privatizing when market conditions change.

Human Capital
David Ellerman from the IPD team also suggested another proposal to promote enterprise development, based on the use of education and innovation. This proposal tries to take advantage of the flight in human capital referred to earlier.

Moldova is endowed with a strong, well-educated, human capital base. However, this base lacks necessary training on new business techniques. Furthermore, due to insufficient work opportunities in Moldova, human capital has been moving overseas in search of work. Of the estimated 4.3 million people, approximately 15% of the population over 15 years old now works abroad. One initiative, aimed at increasing the capacity of the Moldavian labor force, tries to take advantage of this flight by sending workers abroad to receive training and then reintegrating them in small enterprises inside Moldova. The IPD team suggested that this type of initiative could be an example for other programs.

Overall, domestic enterprise development was regarded as central for growth, especially given the lack of foreign investment. Although there was some debate on the optimal size of firms, the discussions tended to emphasize the benefits of small enterprise development. Policies to encourage enterprise development and reduce corruption were stressed across meetings.

2) Rural Development

The second area of discussion focused on Rural Development. Moldova is predominantly an agricultural country. Three-quarters of land is used for agricultural cultivation. Demand for Moldovan goods fell substantially after the Russian crises in 1998. The Land Reform Program, initiated in 1996 but not fully implemented until after the Russian crisis, privatized land and broke up the 961 large collective farms into more than a million private holdings, each approximately 1.5 hectares in size. Since privatization, agricultural production has fallen even further.

The land privatization was based on the assumption that private firms to support marketing, inputs, and credit would appear. For example, when Moldova was part of the

Soviet Union farms were given output targets for production, and farmers didn't have to market their goods. After privatization, the expectation was that firms would develop to market goods, but in fact they did not. Firms for distributing credit and other inputs did not develop either. As in other countries, imperfections in the land markets obstructed their development.

Land privatization in Moldova led to segmentation, and the question of reconsolidation is now being addressed. The main questions that arose during the discussions were: Is there a need for land consolidation? What is the best way to engage in the process? Can institutions help market forces function better?

One idea raised to improve efficiency of the rural sector is to develop cooperatives for marketing, credit, and inputs. In the US, for example, many key agricultural products, such as butter, raisins, and oranges are sold by cooperatives. This is perhaps an area where foreign assistance can help play a catalytic role, by providing expertise based on other countries' experiences.

Credit cooperatives exist in Moldova, but it is not clear how far they go or how effective they are. Similarly, it is difficult for small farmers to gain access to inputs, such as tractors. The government has been setting up tractor stations to help farmers share access to inputs. Proponents of the policy say it should help markets better function. However others fear that the tractor stations are being used to coerce farmers to return to Soviet-style cooperative farms, with lack of incentive structures and huge inefficiencies.

Concerns were raised that consolidation should proceed equitably, and in a voluntary fashion. The IPD team stressed that many other countries were able to solve similar problems through policies and institutions aimed at creating more efficient land markets, rather than returning to cooperative farms.

A second set of questions centered on the effects of land consolidation on poverty and inequality. If land consolidation does occur, those who sell their land will lose their sources of income, potentially worsening migration out of the country and increasing poverty. The discussions continually emphasized the need to implement policies that provide access to credit and encourage the development of agro-industries to provide employment opportunities in rural areas.

3) Debt Management

The third area of discussion focused on debt management, and on the immediate debt crisis facing the country.

In the 1990s Moldova borrowed heavily in US dollars. When the Leu devalued following the Russian crises, the amount of outstanding debt in Leu terms nearly doubled. Moldova now faces an unsustainable debt situation, currently equal to \$1.91

billion, or 154% of GDP (including an estimated 374 million dollars in the Transdeistr's debts.) In 2002, Moldova must repay 250 million dollars, 75% of its public revenue.

The heavy debt burden is clearly unsustainable. Everyone agreed that Moldova needs some form of debt relief: there is no way a country can grow if more than 50% of budget is going abroad. In fact, without a debt write-down, Moldova will be a net exporter of capital for the next several years. At the time of the IPD Country Dialogue in July 2002, Moldova had just missed its Eurobond payment. Moldova is also exploring various options to restructure its debt through the Paris Club.

While there was complete agreement on the cost that the current debt burden imposes, there was less agreement on the costs associated with different debt reduction strategies. Much of the discussion focused on how to evaluate the risks associated with default (i.e. when a restructuring agreement can't be reached) versus the risks to the economy from a poor agreement.

When a country defaults on its debt there are risks of market panic, currency devaluation, a run on the banking sector, and the cut-off of credit or investment. However, if a poor agreement is reached without a large enough debt write-down, economic growth is at risk. A worst-case scenario of a high-cost default was recently experienced in Argentina. On the other hand, Russia was only able to begin to grow after it defaulted, and within a couple of years it was again able to borrow on international markets.

IPD stressed that it is always better to reach a negotiated agreement, but any outcome depends on what happens in the bargaining process. The risk and costs depend on the circumstances in a given country. In Moldova the cost will depend largely on the extent of foreign money in the system, debt in the banking system, and the risk of capital flight. It is unlikely that Moldova will receive much foreign investment in either scenario. Finally, there was a discussion on how to measure debt sustainability and how to value and manage the risk in future debt re-payments.

Conclusion

Without a debt write-down funds will continue to flow out of Moldova, and Moldova will be forced to be self-reliant. However, globalization still can be an asset for Moldova. Moldova is in a unique position of being able to access learning models and technology from the West, sell its products to the East, and benefit from its position as a country situated between two markets. Moldova also has the advantage of being able to look to the world for examples of successful development strategies. Many of these issues and country examples were discussed in the Dialogues.

There was significant coverage of the event in the local press, and a true dialogue on the issues developed between various groups of stakeholders over the week of policy forums. IPD has discussed the possibility of continuing work and discussion with the Moldovan government, local research institutes, and SIDA.

IPD Country Dialogue

Official visit to the Republic of Moldova
July 18 - 23, 2002

IPD Team

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