

# **Center For Strategic Studies and Reforms**

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UNDP / WB Project “*Strategy for Development*”

## **Republic of Moldova: Key Problems and Strategic Priorities for National Economic Development**

- Macrostabilization and economic growth, tactics and strategy
- Concept of economic strategy in Moldova's transition
- Key problems of the national economy
- Strategic priorities for development
- Annexes.

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**FOREWORD**

In the nineties, the Republic of Moldova has found itself facing serious challenges: the necessity to establish the young state, to contribute to democratization of the society, and, at the same time, to build the market economy. From time to time, the following questions arise: **what state, society, economy are we striving to build?** In the most general terms the answer to these questions can be found in the new Constitution of Republic of Moldova adopted in July 1994. The details are being elaborated in laws passed by the Parliament, and in the governments' programs.

The economy holds the first place in everyone's attention. In general, we can state that the initial stage of reform was completed in key elements: (i) macroeconomic/financial stabilization; (ii) liberalization of prices, trade and enterprises activity; (iii) institutional change. From this beachhead Moldova moved in 1995 into the stage of restructuring of the national economy which was forecasted to result in 3-4% annual growth of GDP. But this didn't happen. The unexpected failure of 1996 (GDP dropped by 8%, the budget deficit increased to 10,3%, and the trading balance accounted for 17.4% of GDP) was a serious warning of danger of a delay in conducting reforms which is resulting from conflicting economical and political interests.

The problem that occurred was that of interrelationship between tactics - immediate actions, and strategy (**how to move from the tactics of survival to the strategy of development?**), the need for a consensus in society and for political will to ensure the consistency and continuity of the reform. As opposed to the macroeconomic/financial stabilization that was achieved after 1993, mainly as result of the efforts made by the National Bank of Moldova and Ministry of Finance, the process of restructuring the national economy is lengthy and more profound, as it encompasses both the real economy and social sectors. It will entail a period of at least 10-15 years, which will be necessary for restructuring the branches of the economy and enterprises (production, technologies, human resources), updating infrastructure, and for required action in the social sphere to take place. With all these taken into account, there was a need to develop an orientation for a Strategy for Moldova for the immediate future that would secure national interests and collaboration of the Presidency, Parliament and Government.

The present report was prepared as a development of the analysis provided in "**Overview of the Current Macroeconomic Situation (at the beginning of 1997)**", CISR, March, 1997. Its objective is to reveal the most important, key problems encountered by the national economy, and identify on this basis the strategic priorities for the sustainable development of the country, a necessary step in the preparation of the "**Strategy for Development**", a mid-term strategy of Republic of Moldova for the period through 2005.

The report was prepared by CISR experts: *Andrei Cantemir, Anatol Gudym, Alexandru Munteanu, Oleg Petrushin, Octavian "cerbapchi, Octavian "ofransky, Vadim Bulan*, with participation of national consultants (*Pavel Cojuhari, Victor Moroz, Zahar Olărescu, Nadejda "i"can, Victor Zubarev*), and UNDP consultants *Brian Van Arkadie and Gabriele Muzio*. We also appreciate valuable assistance from *Jože Mencinger* (Economic Institute, Slovenia). In the drafting of the report there were utilized materials from Ministry of Economy and Reforms, National Bank of Moldova, Ministry of Finance, Ministry of Privatization and Administration of State Property, Ministry of Labor, Social Protection and Family, Department of Statistics.

This report is designated for a discussion, and represent the ideas of the "Strategy for development" project team. It does not reflect an official standpoint of the Moldovan government, UNDP-Moldova or the World Bank.

## **SECTION 1. MACROSTABILIZATION AND ECONOMIC GROWTH. TACTICS**

## AND STRATEGY – EXPERIENCE OF SIX YEARS OF REFORM

The process of transition from the centrally planned to market orientated economies has encompassed about 30 European and Asian countries. Moldova is one of them. Year 1989 is usually being considered as the point of departure for transition (beginning with Poland), though the attempts to reform the socialist economies were undertaken since the 60-ties.

In Moldova, after the well-known procedures of the *perestroika* period in the former USSR (with the most radical one being “The law on state enterprise” from 1988), were elaborated and adopted by the Parliament (the Supreme Soviet of MSSR), first, “The concept of transition towards a regulated (!) market economy” (1990), and, later, “The program for transition towards market economy in SSR of Moldova” (1991), in which was expressed the hope that “the pretty difficult path of transition towards the market economy is foreseen to be surmounted within approximately 1.5-2 years”.

The prognosis proved to be far from reality. Since then, after six years, with participation of two Presidents, two Parliaments, and six governments, certain experience in reform was accumulated: first, at the stage of search for the ways and methods for *liberalization of economy*, then, beginning with 1993 (in cooperation with IMF and WB), – oriented by the primary target of *macroeconomic stabilization* and *ownership reform*.

Difficult initial conditions for promoting reform in the first half of the 90-ties have resulted in an abrupt cut-off of Moldovan economy from the deteriorating production complex of the former Union, raise of prices on imported energy resources and raw materials, higher costs in transport, and loss of traditional markets. There were some subjective miscalculations, wrong assessment of perspectives. Overestimation of the national resources and of the overall potential, the newly obtained statute of a sovereign state gave birth to the illusion of rapid integration in Europe, and, on this basis, – of rapid economic growth.

Nevertheless, by mid-nineties, the main objective of the initial stage of reform was achieved: Moldovan *economy became predominantly market oriented, its transformation has accrued an irreversible character*. With various results reform was undertaken in six major blocks:

- financial stabilization (stable national currency, controlled inflation, reduced budget deficit);
- divestiture of the state-owned enterprises, creation of joint-stock companies and mass privatization (mostly against the National Patrimonial Bonds);
- prices and internal trade liberalization, and abolition of the system of centralized resources distribution;
- foreign trade liberalization;
- social protection of the population;
- development of the fundamentals of the legal framework and institutional structure of the market economy.

While lacking any integral concept, nevertheless, the consistency and scope of the activities undertaken within the economic reform followed some logic, mainly based on the other countries experience, with some adjustment made to local conditions. With this regard, we didn't manage to avoid some mistakes, impediments, disagreements.

The following could be accounted for the *positive results* of the initial stage of reform:

- development of the legal framework (more than 400 laws and regulations);

- creation of the two-sector economy with the increasing share of private capital up to 45-50% of GDP;
- stable national currency and creation of a low-inflation environment (1.18% monthly inflation rate in 1996, and 1.15% – for the period of January-May, 1997);
- price liberalization and annihilation of commodity deficit;
- creation of the skeleton of the market-oriented institutional structures (commercial banks, Privatization and Investment Funds and trusts, audit, leasing and consulting companies, free-enterprise zones, etc.)

Market-oriented economy was also reflected by an increase of the services share in GDP from 17% in 1991 up to 30% in 1996.

Overall, all these processes have indicated a *state of macroeconomic stabilization achieved by Moldova, despite of the fact that decline in production continued and a sharp drop of social indicators*. Nevertheless, according to the overall estimations provided by IMF, WB and EBRD, Moldova ranked higher than the majority of the CIS countries and its immediate neighbors - Romania, Bulgaria and Ukraine. Further more, the "Economist" magazine (March, 1995) defined: "Moldova is the model of sound reforming, its compactness makes it a perfect laboratory of reform."

As it turned out, these appraisals were overestimated by a certain degree. The reason for it – the non-complexity of reform. Liberalization and openness of Moldovan economy, stabilization activities undertaken in financial sector, active exports policy were not fortified by production restructuring, investments promotion, social sectors reform. But the most important – at the enterprise level, and overall in the country, emerged a vacuum of a well defined owner. Plus exit of 40% of GDP into the "shadow" economy, its criminalization. As a result, instead of the forecasted economic growth renewal, the official statistics had shown: the GDP contracted by 8%, state budget deficit – 10.3%, trading balance deficit – 17.4%. Of course, this recess is partially due to "statistical illusion", as the turn-over in the "shadow economy" is estimated at 2.5 billion MDL, and there was an increase – in the foodstuffs production, construction materials, transport, household construction, services.

The public budget crisis, as result of uncollected taxes, aggravation of the problem with salary payments and pensions, payments for the energy resources, the general worsening of the life quality of the population have caused, beginning with January, 1997, a complex of urgent actions embraced by the President's P. Lucinschi Decree "On the urgent actions for improvements of the social-economic situation" (January 22, 1997), and in the I. Ciubuc government's Program. Certain results were achieved – improved tax collection, the arrears with salary and pensions payments were contracted, the customs control was tightened, etc. Still, the situation is improving rather slowly.

What are the reasons for that? *Obviously, the economy was "suspended"*. The macroeconomic, financial stabilization can not be sustained for long based only on tight control over the amount of broad money. The proof to it – collapse of Bulgarian economy in 1996, and Yugoslavian – one year earlier. Conclusion that can be drawn from this is the following – low inflation rate and stable currency are just the immediate objectives of the economic policy. With the prolonged recess in production, there can not be a viable financial sector – it is impossible neither to overcome the budget deficit, nor the investment famine; one can not achieve improvement of the financial situation at the enterprises, including the availability of necessary working capital and satisfactory level of profitability.

With the entire weight of evidence, the question of *interrelationship between strategy and tactics* has come forth. With all the acuity of the problems that require the “crisis management” (liquidation of the state arrears with salaries and pensions, new energy tariffs, etc.), at this point, at the beginning of the “second wave of reform”, *one can not afford any further delay in solution of the profound, key problems:*

- restructuring of the enterprises, branches and sectors of the national economy, including industry - within the frame of the new industrial policy, agriculture - activating the agrarian reform, the production infrastructure (energy sector, transport and telecommunications) - on the grounds of de-monopolization and privatization;
- attraction of direct foreign investments, generation of internal savings to be used for investment purposes;
- real state support to enterprise by means of preferential taxation and crediting policies, support to the private sector in general;
- social sectors reform.

Solving these problems will allow *for curing the disease, not symptoms*, to overcome the recess and conduct restructuring of real economy, improve the living conditions of the population.

*What are the lessons learned from the previous years of reform? Where the corrections should be made?* The main conclusion – in Republic of Moldova were demonstrated the political will of authorities, parties and public organizations, support of the largest share of the population to transformation of the country into the market-oriented one. But the social and economic results are quite troubling.

Proof to that: Moldova was moved into the category of “developing countries”; decrease of GDP per capita up to \$920.00 (Ukraine – \$1,630; Romania – \$1,450) (1995); simplification of the production structure and de-industrialization of the country (the industry share of 25% in the 1996 GDP), peripheral for Europe assortment of the exported goods (increased energy and raw materials consumption per production unit, negative trading balance; decrease in life expectancy till 62 years for men, and 70 years – for women, semi-legal economic migration of the employees to Russia, Germany, Greece, outflow of the qualified employees.

Now, after six years of reform *some omissions* can be seen:

- inconsistent, unsystematic legal and institutional changes. The Parliament has not updated the Civil Code (which is the Economic Constitution of the country!), were not identified the priority sectors and enterprises (preferential taxes and credits), absolutely no state support is given to the enterprise development;
- tax policy has a well resolute fiscal character (does not have a stimulating character) ;
- time lag with hooking up the micro level of the reform - enterprise restructuring began in 1995, but, up-to-date, despite the stable high level of the enterprise insolvency, the most radical method of restructuring remains unchanged - bankruptcy procedure with the following spin-off of the enterprises and sale of part of the assets (buildings, equipment, transport) to small businesses;
- importance of the antimonopoly policy and encouragement of competition were underestimated;
- no action directed towards strengthening of the economic basis of local self-administration (local budgets, municipal property);
- increasing distance between the banking sector and needs of real economy (non-existence of the specialized banks, their non-participation in the enterprise restructuring);

- absence of the state policy on employment, equalizing approach, inefficiency of the social protection system.

Under these circumstances, when the expected in Moldova, and in other countries as well, renewal of the economic growth didn't occur, despite of the well-known results of control over the financial flows, ***pressure exerted on the Government with demand to review the ideology of reform*** in the part of the fiscal policy, privatization, land relationships etc., is growing. This pressure has originated, first of all, from the economic agents, for whom the period of stabilization with no growth is, indeed, a very difficult one (absence of affordable credits for technological modernization of the enterprises and of the working capital pushes them towards barter). Second – from trade-unions and political parties, that are striving to consolidate their position by means of “uncompromising critics” of the executive’s activities undertaken in the period of post-stabilized depression and social adversities.

The political stability, consistency and predictability of reforms – requirement for the economic growth, and, vice versa, uncertainty in the perspectives of the economic strategy, that took place in the period prior to the President’s election in 1996, and again occurred now, on the eve of the Parliament elections (February, 1998), has a quite pitiful impact on internal (legal nihilism, anti-tax incentives) and external (relationships with IMF, WB, etc.) factors of the country’s development.

Currently, ***three main approaches for re-launching the growth*** have taken shape: the governmental, consolidated by the Memorandums with IMF and WB – transition towards restructuring based on liberalization and macro-stabilization; left-radical – inflationary, which, by virtue, is proposing “emission, but tight control over the financial flows for the benefit of enterprises and population”; and, finally, the third, – “of the postponed growth” – to slow down, to refrain from the set forth speed and direction of the reform, “wait till some better times”. The last two approaches have in common their non-acceptance of the “ultimatum” of the international financial agencies, and, still, are counting on assistance that is to come from outside, though from different sources.

Estimating advisability of cooperation between Moldova and IMF/WB, one should keep in mind that it is coming far out of the bounds of a just financial relationship – obtaining of the “live money” into the budget, and “long and inexpensive money” under loans for certain projects (restructuring, private sector development, etc.)

The quality of relationship with international financial organizations influences, to a large extent, not only general trust of UN and European Community towards Moldova, but just utilitarian credit rating of the country, prerequisite for acquiring new partners.

Not by chance, foreign banks, ventures, investment and other companies in their businesses rely on the argument “IMF-approved destinations” – approved, supported by IMF countries. It is revealing, that precisely after 1993, when Moldova was given access to the foreign financing and has started reform, its position in the political and economic risks rating have dramatically improved.

Thus, according to the “Euromoney” (March, 1997) assessment prepared by the analysts from 44 biggest banks of the world, Moldova, with regard to the quality of the economic development factors, ranked on the 100 place among 179 countries, ahead from the majority of the CIS countries, including Ukraine.

The early start of the pre-elections to the Parliament by mid-1997 has paralyzed the Parliament and the Government in promoting reform, that resulted in a dramatic address of the President P.

Lucinschi on June 27, 1997 to the Parliament to release the breaks set to the process of “the second wave of reform” legal framework development – on ***national economy restructuring*** (on sale-acquisition of land, on collateral and bankruptcy, on de-monopolization of the energy complex), in the ***social sphere*** (pension reform), on ***territorial and administration reform*** oriented towards the European standards in local self-administration (Strasbourg Chart from 1967). The price of the issue was also called - non-receiving of the foreign credits in the second half of 1997 at the total of \$143M, collapse of the supporting elements of macro-stability (Moldovan Leu devaluation, price growth, etc.), worsening of the social tension. And, as result, the Parliament and Governmental crisis, early Parliament elections.

While estimating the importance of the current situation, it is necessary to keep in mind the cyclical character of reform, which can be followed in Moldova beginning with the early 1990-ties: acceleration - deceleration - acceleration, etc. The best results in promoting reform were achieved during the beginning of this period, and then in April, 1994 - June, 1995, with concurrence of the President's, the Parliament's and the Government's action.

Next “***period of the political stability***” is expected in 1998-2000, when President, Parliament and the Government will work together in a constructive manner, with no election obstacles. But, for this purpose, already in 1997 the strategy of reforms should be supported by legal basis (the Civil Code, Tax Code, perfected Land Code, the package of laws on social system reform), and organizational-economic support.

Therefore, to protect the country's interest, and ***based on the Constitution, it is necessary to accelerate the role played by the state*** in such, referred to it by the legislation, sectors, as the budget policy, management of the state ownership (including in the privatized enterprises), industry enterprises restructuring and creation of new structures in the agricultural sector, attracting foreign investments on the tender basis, implementation of projects financed by EBRD, providing goods for public consumption, organizational restructuring of education and health, regulation of natural resources exploitation and environmental protection, suppression of economic crime, citizen's property and personal protection, upgrading of the state employees qualifications. In most of these directions, the technical assistance provided to Moldova (total of 89 projects implemented in 1996 at approximately \$42M) by European Community (TACIS projects), USA and German governments (USAID, GTZ), through the UN Development Programs, could be used more efficiently.

Thus, it is important not to lose the sight of perspectives in the period of the pre-elections paralysis of the Parliament. With an utilitarian approach, the relationship between tactics and the medium-term strategy should be seen already on the stage of elaboration of the structure and indicators of the budget '98 (current budget and developmental budget; the expenditures limits, minimum incomes, limits for the internal and external borrowings), thus identifying the boundaries of the country's economic security.

And the last, as the public's thought is becoming more active specifically in the pre-elections period (“what state, economy, society are we constructing?”), it is important to hold productive discussions with regard to the state development problems, building of a civil society and economy reform, set the intellectual head-start for the nearest future.

## **SECTION 2. THE CONCEPT OF ECONOMIC STRATEGY IN THE MOLDOVAN TRANSITION<sup>1</sup>**

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<sup>1</sup> Section written by Prof. Brian Van Arkadie (UNDP consultant)

The formulation of an economic strategy involves developing guidelines for future policies, in the context of a medium to long-term view of options open to the economy. In the current Moldovan context, this implies answering three sets of interrelated questions:

- what is the medium-term vision of the future of the Moldovan economy?
- how can the transition be extended and deepened in an orderly and coherent fashion to create the conditions for implementing the vision? and
- what are the appropriate set of public policies to promote the development of the emerging market economy (i.e., the management of the post-transition economy)?

## **2.1 Vision of the future**

In a society undertaking a profound process of change, many aspects of the future will be inherently uncertain, and it will make little sense to set out detailed targets for longer term development. Nevertheless, precisely because of the uncertainties and insecurities affecting all segments of society, it would be very useful to arrive at a degree of consensus about key goals for the future. Public acceptance of the burdens involved in change is more likely if there is a broad understanding and belief in the positive results expected from the current sacrifice.

An initial sketch of possible dimensions of a vision of Moldova's future might address the following questions:

### ***What will be the place of Moldova in the global economy?***

Possible answers:

- Moldova will take advantage of its geographical position to develop trading connections in traditional markets in the FSU, in Central and Western Europe and in the Middle East;
- as a relatively small economy, Moldova needs to trade and will have a high ratio of foreign trade to GDP;
- it will therefore seek a niche in the international economy by developing a capacity to adjust swiftly to opportunities in international markets.
- Moldova will continue to maintain its geographical links to the East but will also deepen its economic and social connections to the West.

### ***What will be the implications of the international position of Moldova for the national economy?***

- new patterns of export specialization will emerge from enterprise response to incentives;
- Moldova will need to concentrate on the development of high value agricultural exports (including wine) to markets in the region and further afield – if the right policies are put in place, a steady growth in agricultural exports

will be achieved, and with increasing sophistication the unit value of goods exported should increase, providing the base for an increase in farm incomes;

- Moldova will also develop light industrial exports, initially based on low labor costs, but increasingly based on investment in human capital – actors in the economy must become increasingly aware of the opportunities and challenges of international markets and public policy should aim to promote international competitiveness.

***What will be the role of government in the economy?***

- commodity production will be predominantly private;
- the government will be responsible for (i) maintaining the legal framework within which enterprises operate, including measures to promote competition; (ii) ensuring fiscal and monetary stability; (iii) managing the tax and foreign trade regime in such a way that incentives promote efficiency and export growth;
- government will also be responsible for investments in infrastructure (public goods) and for the provision of basic social services, for which purpose it will need to develop a medium term public expenditure and public investment program;
- the agricultural sector will be supported by a mix of competitive private services and public support;

***What will be the form of enterprise organization?***

- there will be a range of small, medium and large firms in industry, agriculture and services, including individual or family proprietorship at for the small firms and joint stock ownership for the bigger firms;
- there will be an evolution in the structure of ownership, with increasing inequality, as successful managers/entrepreneurs reap rewards of performing successfully and the unsuccessful fail (this inequality will be justified if it contributes to buoyant growth, which in turn can sustain growing wage levels);
- agriculture will develop a diverse pattern of farm enterprise size, as the sector adjusts to the market environment under private land ownership, including large and medium sized commercial farms and many small households plots

***What social structure will emerge?***

- growth of the market economy will generate significant gaps in income and wealth - extremes will be avoided by helping workers and farm households enhance their productivity and to promote equity by a degree of progressiveness in the tax structure;
- the social structure and the provision of social services will evolve towards the Western European model, with State guarantees of minimum provisions of social services and family income, alongside private social services, insurance and a

dispersion of income and wealth reflecting the dynamics of the developing market economy.

## **2.2 Extending and deepening the transition**

Although it may be useful to sketch a vision of the future, in the market economy the actual outcome results from the decentralized investment and production decisions of the manifold actors in the economy. However, the actors in the economy respond to market signals within a particular institutional setting. At the moment, the economy is held back either because appropriate institutions have not been put in place, or reforms which have been implemented failed to generate hoped-for benefits.

The strategy will need to identify those areas in which further reforms are needed to make the emerging market economy more effective – in particular, to provide the institutional basis to move swiftly beyond stabilization, with the associated contraction in most spheres of economic activity, into a period of vigorous economic growth. This is likely to include:

- (i) further steps to improve the instruments of macroeconomic policy (particularly fiscal reform, which would reduce the pressures on monetary policy, allowing a reduction in real interest rates, and reducing the need for external borrowing); and
- (ii) steps to consolidate ownership of enterprises, encourage a much faster pace of market based enterprise restructuring and to expose enterprise management more directly to market stimuli and sanctions (risks and rewards).

## **2.3 Policies to manage the market economy**

As reforms are successfully implemented, the focus of government thinking should shift increasingly to tasks of managing accelerated development in the new market economy.

A particular difficulty of transitional strategy of Moldova arises from the dual nature of the transition : Moldova is shifting from a centrally command economy to a decentralized market economy; and also, as a small economy which needs to trade, and was previously totally integrated into the economy of the Soviet Union, is seeking to define a new niche in the global economy.

*A central focus of the strategy should therefore be the identification of the policies and institutions required to promote export growth and efficient access to international know-how. This will remain an important policy task even after “transition” is completed.*

## **2.4 Conceptual framework: the government economic policy role in a market economy**

It might be useful to start consideration of the concept of “strategy” by addressing an apparent paradox: the strategy is intended to make Moldova a successful participant in the global market economy. The fundamental principle of the market economy is that economic decisions are made by decentralized economic actors (workers, consumers, firms) making decisions in

response to their own perceptions of market opportunities. The national economic outcome reflects the sum total of these decentralized decisions: the national “strategy” therefore becomes the sum total of the individual strategies. In what sense does the government have a “strategy”?

There is no simple answer to this question. A minimum list of components for government responsibility to promote development might contain three different components:

- (i) in a transitional economy, primary tasks of government include steps to create the institutional arrangements with which markets can operate, which in particular involves decontrolling ***labor and commodity markets*** (free movement of labor; non-subsidized, market determined prices in competitive markets) and creating the conditions for operating effective ***capital markets*** (defining property rights and the conditions in which control over property is transferred);
- (ii) systematic programming of the provision of those services which the state continues to provide (notably social services and infrastructure) ;
- (iii) government will manage its own finances so as to maintain orderly conditions in which markets can operate, with minimum distortions.

***In the context of this view of the role of the State, the strategy would define appropriate medium term policies/programs in these three area.***

However, even this list contains ambiguities and complex choices. Two crucial areas where there are strategic choices to be made under these three headings concern the definition of property rights and the provision of public services.

***Property rights and capital markets.*** Property rights are strategic because they condition all aspects of operation of the economy, because they define crucial economic power relationships and because, once allocated, they may affect certain aspects of the society for generations to come. When starting from scratch, the allocation of ownership involves complex considerations of equity, efficiency and political viability.

To emerge from its current economic stagnation a high degree of entrepreneurship will be required – in particularly, significant segments of the tradable sectors (industry, agriculture and commercial services) should come under the control of those able to swiftly adjust to the demands and opportunities of the new economic environment. But perhaps the most difficult issue is how to create ownership rights in a form which maximizes the supply of entrepreneurship.

Whereas there are a fairly unambiguous set of principles that can be used to derive policies in relation to commodity markets, there are many different ways of defining property rights and setting up capital markets; In the current Moldovan situation, the issue of property rights in agricultural land seems to pose particularly difficult challenges, not yet resolved either at the levels of principle or practice.

***Strategic decisions in the provision of public services.*** Even with minimal State intervention, the State will continue to supply public goods and judgments must be made about the likely demand; in turn the supply of public goods will influence the decisions of private economic actors (e.g. investments in roads will influence transport costs and private decisions about the location and composition of economic activity) – thus decision about public investment must

be informed by a view of both the likely evolution of the economy and how public investments will influence that evolution.

In practice, this means that the strategy should contain:

- (i) either an outline public investment program, or guidelines for the formulation of such a program (which would mainly relate to public investments in economic infrastructure), and
- (ii) a set of social policies to provide for the viable delivery of social services (health; education) and appropriate arrangements for social security).

**Macroeconomic policy.** In relation to macroeconomic policy, the main issues now relate not so much to maintaining a stable macroeconomic environment, but how to do this in ways which are more consistent with revival in the real economy.

The objective of a stable price level and reasonable monetary and fiscal balance should be explained and justified, but the discussion should be carried beyond that to explore whether within given fiscal and monetary constraints the pattern of public spending, taxation and monetary flows could be better geared to promoting expansion in the real economy.

**Government interventions to guide the market.** There are two general arguments for government intervention in sectors producing tradables (and therefore susceptible to market decision), which might justify an activist government “strategy”, even in the context of a commitment to the market:

- Markets may be distorted; particularly in a transitional economy, in which market institutions are incomplete – in welfare economics, theories of the second best suggest that when one market is distorted, countervailing distortions may be justified to arrive at optima;
- There may be instances of market failure in which market signals do not give a correct measure of costs and returns (e.g. in the case of public goods, where the State therefore takes over provision).

Particularly difficult issues may arise where there are reasons to suppose that current prices are a poor predictor of the future. For example, in conditions of economic crisis (depression), the governments of many market economies have seen fit to take measures to help firms which would have otherwise collapsed, under the expectation that they would be viable when general conditions improve. In the transitional economies of the FSU there is a condition of general depression, so that many firms may be faced with insolvency despite their potential longer term viability.<sup>2</sup>

Another category of market failure relates to “infant industry” arguments for industrial policy (protection or subsidy), based on the proposition that it may be necessary to support the costs of learning socially, otherwise the “infant” would not have the chance to reach adulthood. Likewise, the development of new industries may involve “externalities” - that is, the existence of a firm may generate benefits for other firms, so that a group of firms may be more viable

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<sup>2</sup> In the literature on transition the case against subsidies derives from the risks of failing to submit firms to a “hard budget constraint”. However, it should also be noted that in mature market economies with fully developed capital markets, firms will have access to credit if financial institutions judge that liquidity problems are temporary and that the longer term future of the firm is sound.

that any one would appear to be if considered in isolation – which might justify subsidy of the initial entrants.

The difficulty with all these arguments for State interventionism, which leads market economy purists to resist them, is that they provide a case of potentially sweeping interventions by State functionaries, which in turn leads to two questions: how far is the State likely to be able to make good judgments regarding possible interventions? And, will such arguments for intervention merely become the occasion for politically motivated subsidization and the cloak for rent-seeking activities? More particularly, in a transitional economy, could such arguments be used as a simple rationalization for the reversal of painful reforms (e.g. the use of infant industry arguments to protect the senile.) While in principle, a case can be made that State intervention is required to redress the distortions, skeptics would argue that as the State is the main source of distortions, it may be questionable whether it can be expected to rationally adjust for them.

In the debate among economists about the appropriate role of the State in development, many issues remain unresolved both at the level of theory and empirical interpretation – e.g. there is no consensus about the role of the State in East Asian development, views ranging from those who argue that an interventionist, developmental State was crucial for East Asian success, to those who argue that these countries were successful despite misguided experiments with State intervention.

The pragmatic conclusion may be that the case for active State intervention in the market economy cannot be rejected on the basis of *a priori* arguments, but that particular cases need to be made with some care, based on particular (narrowly defined) arguments, rather than general (broadly defined) propositions.

***In the context of the medium-term need to restore growth momentum, any government interventions to support the fast development of the new market oriented firms should probably concentrate on the promotion of exports.***

## **SECTION 3. KEY POLICY ISSUES**

The mid-term strategy for the social and economic development of Republic of Moldova for the years of 1998-2000/2001-2005 is geared towards the economic revival on a new structural basis and upgrading the living standards of the population. To achieve the objective, there is a number of key problems to be solved, which can be organized in the following triad:

- consolidation of the state and strengthening of its role in assuring of the economic security and conduction of reform;
- restructuring of the national economy, including enterprises, branches and sectors - industry, agriculture, manufacturing infrastructure (energy sector, construction, transport, and communications), social sphere;
- restoration of the territorial and production complex unity of the country, conduction of the administrative-territorial reform and development of the local self-administration, insuring of the civil consent and political stability in society.

### ***3.1 Legal framework, role of the state in conducting reform***

The economic system of Republic of Moldova, as of the every other country, is determined by the ***legal norms and structures***, that are being set up by the state. The process of state-building of a young European country, difficult transition of economy to the market, transformation of the social programs have predetermined the need for the fundamental renovations of the legal framework, legislative structures in the patterns of organization and control of the economy and social sphere. The President, the Parliament, and the Government have to make considerable efforts to bridge the legal and institutional gap that resulted from the collapse of the former USSR, to establish new legality, to create the structures that would regulate the interrelationship between different economic agents operating in the market.

Among the specific features of restructuring in Moldova is, first of all, its starting point – the economic system, which was established under the well-known circumstances of isolation from the world market, prone to deformations, low ability of the processing industry products to compete on the market, high degree of the industry and turnover monopoly.

Second, under these circumstances, the orientation on the “automatism” of the market gears can lead to creation of a defected economic structure, characterized by the predominant consumption pattern, and, therefore, low level of capital formation and investment, and, also, by predominance in production and exports of the “peripheral” goods with high energy and raw materials consumption, which would mean a definite shift of Moldova in the outsiders category. At this point, such trends can be quite clearly defined.

Third, restructuring is taking place on the background of a highly criminalized economy, including its crediting and financial sectors. This might hinder the process of economic revival, because initially are being criminalizing the branches, which were to lead Moldova out of the crisis.

The priority should be given to elaboration of the Civil Code (the present version was adopted in 1967 for a different political and economic system), and, related to it, the Tax Code, Civil Lawsuit Code, Labor Code, etc. Due to their incorporation and codification, the laws will become shorter, will be overpassed the “fragmentation” of the legal field, will vanish the necessity to adopt secondary legal acts, amendments and instructions.

Overall, there is a need to strengthen the role of the state as a ***corrector of reforms according to social criteria***, so it could deliver efficient support to the most vulnerable groups, thus mitigating the social costs imposed by market. This is proved by the experience of developed countries (Germany, Austria, Sweden, France, Israel and other) and is revealed in conditions of non-stability or cyclical fluctuations of the economic process, while complementing products offered by the private sector by public ones, establishing natural monopolies, delivering social transfers, intervening when the extreme phenomena in production and consumption occur, and during the natural disasters.

It is advisable, for example, to look into the issue of adopting a basic law ***“On Support of Stability and Economic Growth”*** (acting in Germany since 1967), which is embracing the requirements to the state economic policy and methods for its implementation by means of state interventions in case of an “overheated” situation – through the state budget, central bank, mid-term financial plan, investment programs, and other instruments. One of the main reserves for economy revival is to upgrade the efficiency of the Economic Court, and, in general, of the ***enforcement mechanism*** for the court decisions.

Weakness of the ***state apparatus*** is the today’s Achilles’ heel of Moldova. The decisions are being made on its contraction, but the main danger now lays in a different perspective – the governmental job is non-prestigious, there was a sharp drop in professional qualifications and skills of the state administration employees, and, finally, low (official) wages, which is pushing many of them towards bribery and illegal participation in businesses.

Administrations of many central and local authority institutions have lost, may be, the most important characteristic of the administrative machinery – ability to prepare and implement a decisions.

There is an impetus for a new corps of executives that would have certain social guarantees from the state, with incentives for growth and diligent work, with remuneration based on the level of responsibility.

All this doesn’t exclude the need to tighten the control over the discipline and quality of performance of the actual governing structures, tough measures to put stop to corruption, thus minimizing the misbalance of the state system.

While ***perfecting the organizational structure of the Government***, it is advisable to complete the transition from the branch administration to its corporatization according to the market structure and emerging problems in the economy, with prevailing programming, methodological and regulating functions, which are to be delivered applying, mainly, economic methods.

### **3.2 Moldovan geo-politics – advantages and constraints**

#### **Strategic considerations ...**

Republic of Moldova is situated at the confluence of three geo-political areas: the South-eastern, Eastern and Central European. Today the transition is under way to reintegrate the pan-European economy with Moldova as its part.

Moldova is a **small-to-medium size country** similar in territory and population with Slovakia, Switzerland, Croatia, Slovenia, Denmark or Lithuania and has a potential comparable to these countries. It has a manageable, comparing to big countries, territory. A dense population (127inh/km<sup>2</sup>) and a good infrastructure insure a high degree of integration within the country and exclude the income based regionalism.

Moldova has the **advantage of cooperative, non-confrontational neighborhood**. Both Ukraine and Romania do not exhibit potential threat to Moldovan security, proving their commitment to regional stability during the mediation of Transnistrian conflict. Moreover, the cultural affinity with Romania and deep-rooted multi-tier links with Ukraine, supplemented by large minorities of Ukrainians in Moldova and Moldo-Romanians in Ukraine lay ground for a special relationship between three countries. The trilateral dialogue established in Istanbul earlier this year will bring first fruit in Ismail, where the three presidents will sign the document establishing the Danube economic cooperation zone, first between these three states.

Moldova lies on the **cross-roads connecting Balkans central Europe and the Black See**. Country's geographical location and traditional links favor it as a transit base for Ukraine-Romania, Poland-Turkey, Central and Western Europe – Caucasus economical and political relations. Also its recent status of the Soviet Union south-western outpost can be used to connect Russia with the Balkans, Turkey, Cyprus and, why not, Israel. Air companies of Moldova already reap benefits of Moldovan geography. Today Ukrainians fly Central and Western Europe by Chișinău.

The rail network of the country has a design that does not meet the needs of independent Moldova<sup>3</sup>, but the road network is well developed and today takes more than 50% of traffic. Moldova lacks an access to sea but it plans to build a port on Danube at Giurgiulești and could in the light of increased cooperation with Ukraine build its own port on the Black Sea under a long-lease agreement. Such a project would not only represent a gate for Moldovan exports to Middle East, Mediterranean and overseas but also will constitute a factor of development for the Ukrainian Danube region.

Moldova's market, due to its small size (Moldova's GDP was \$2bn in 1996) will not attract important flows of goods for domestic consumption but when the favorable investment climate and friendly trade arrangements with neighbors are in place Moldova will be viewed as **a place for strategic investment targeting the Bulgarian, Romanian, Ukrainian and Russian markets**.

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<sup>3</sup> The Rail connection to the North and South of the country is twice as long as the road one, and has to transit several segments of Ukrainian territory.

The existence of an excessive<sup>4</sup> and inexpensive labor force, relatively well trained and disciplined can be an incentive for them to do so. The other advantage of having an surplus of cheap labour force would be its export. Moldovans working outside the country will be an important source of capital, especially for investment.

Moldovan population is not receptive to criminalization of the economy due to its traditional moral values. This fact, together with transparency of country's economy and strengthening of authority of law will, prevent the development of CIS almighty mafia. The ***polylingual labour*** of Moldova<sup>5</sup> offers the chance of easy access to regional markets.

The present ***constraints*** for Moldova's development are:

First, the presence of ***foreign troops on its territory***, that, together with political instability in Russia, deter many potential investors by setting the risk level too high. While Russia still manifest its 'big brother' approach, for Moldova is important to develop a new kind of relations with Russia but also with other emerging regional powers such as Ukraine, Turkey, Poland and Romania based on respect and equitable cooperation.

Second, the ***undercapitalization*** of the region oblige to look for the foreign investment as the main source for a long term development and create the best possible environment for foreign companies.

### ... and physical conditions

Stepping into the world economy Moldova try to benefit from its advantages and to ease the pressure of constraints.

The accumulated economical potential, diversified, non-militarized structure of economy, the fertility of its soil (80% of which is black earth, a record rate in Europe), the unique integrated structure of agriculture, the developed light industry and mechanical manufacturing are the main Moldovan advantages.

The limitations are imposed by the instability of the dynamics of reproduction of social product, conditioned by the fluctuations of the volume of output in agriculture, that encompasses for 53-54% of GDP; the high dependency on imported fuel and other raw materials (steel, wood, chemical products, cotton); the actual low competitiveness of many final goods on the Western market; the shortage of professionals in the field of foreign trade.

Reliance on agriculture is the main characteristic for the region. Not only Moldova produces over half of its GDP in agriculture, but also Ukraine - 39% and Romania - 20% (the figure is probably higher for Romanian province of Moldova).

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<sup>4</sup> Today 60% of 2mln Moldovan labor force works in agriculture. With restructuring and optimization in the next couple of decades approximately 1mln of Moldovan workers will pour into the labor market and can be absorbed by other sectors.

<sup>5</sup> Besides Romanian and Russian, English and French is commonly spoken by the elite while Ukrainian, Bulgarian and Turkish is used in the border areas.

**Two strategic roots traverse Moldova.** The Russia-Balkans rail and road connections as well as a gas pipeline supplying all the Balkans and Turkey. A prospective North-South new route, from Scandinavia to Balkans is envisaged in the EU project for reconnection of Central and Eastern Europe.

This is the **A9 rail and European route corridor**. The second important transit route, but the most important internal, is the Central Europe - Black Sea track that passes through Bălți - Chișinău - Tiraspol. This once unique ancient trade root presently is devised in three flaws: one through Romania to Constanța, second through Moldova and third through Ukraine to Odessa.

**The biggest economic centers in the region are Kiev and Bucharest approximately at the same distance from Chișinău.** Odessa as the closest port and industrial center has a traditional attraction to Moldovan businesses. Other industrial and commercial regional centers likely to foster links with Moldovan enterprises are Romanian commercial and industrial agglomerations of Iași, Bacău, Galați, Constanța and Ukrainian Chernivtsi and Vinnitsa. There is a number of river ports that are or can be used by Moldovan companies: Reni, Ismail, Galați, Brăila.

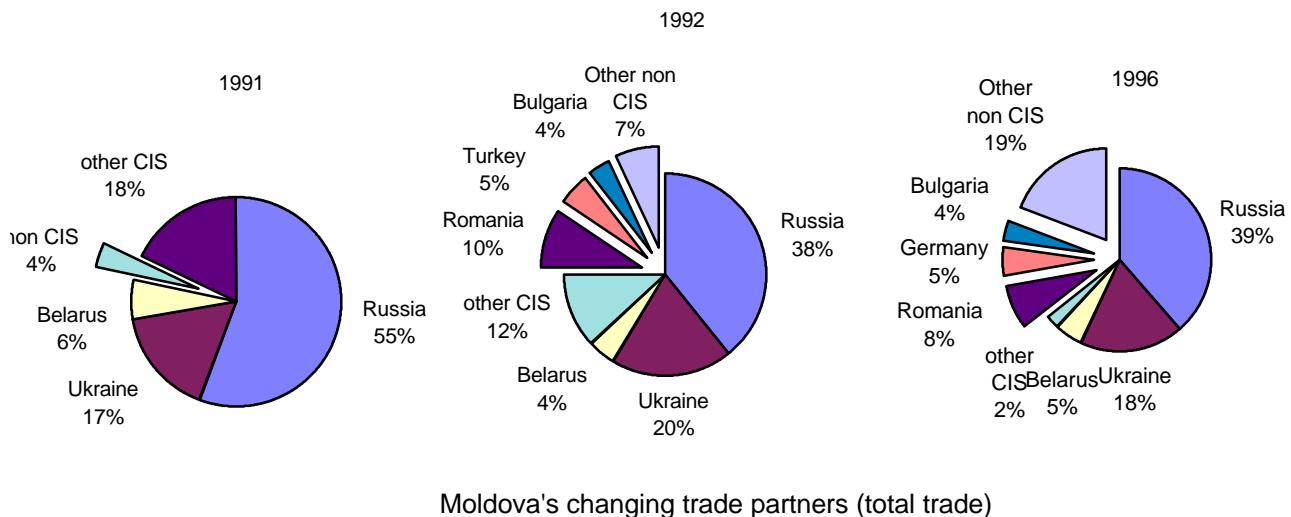
There are three main coal basins: Donetsk and Drogobych in Ukraine, Petroșani in Romania with more distant Silesia in Poland and Rostov, Kuzbass in Russia. The oil is produced in Romania, a little in Ukraine and is available for export in Russia and the Gulf countries. The Caspian sea region emerge as a potential large exporter of oil. The import can be done by rail or road. **The only oil terminal in the region is Năvodari in Romania.** Ukraine has started to build a \$40m terminal at Odessa but the works were stopped in '96 due to lack of funds. Moldova also intends to build on its Danube riverside at Giurgiulești an oil terminal, but so far the physical works hadn't started yet. The gas is extracted in the region: in Romania and Ukraine but supplies only a small part of the local consume. Thus the main supplier in the region is Russia (Yamalo-Nenets basin). The import from Uzbekistan or Turkmenistan have to transit Russian pipeline.

In summarizing, several statement can be made. Local sources of energy are very limited, with two hydroelectric stations (Dubăsari, Costești-Stâncă) covering only 0.5% of Moldova's needs and the explored reserves of gas and oil can not cover a significant part of country's energy needs. Giving the availability of fuel on the world market and in the neighboring countries – Romania for oil, Ukraine and Poland for coal – the present unilateral orientation on Moldovan fuel imports from Russia is dictated by the Moldovan export market. In 1996, 47% of it was found in Russia. The source of gas is however, for the foreseeable future, likely to remain Russia. A project is under way to build an oil terminal on the Danube (Giurgiulești) to be able to import oil directly from the Gulf. The reorientation, or better amplification of Moldovan exports to the new markets is the key out of this state of energy serfdom. The total import dependency of the energy sector shouldn't be viewed as a long term constraint as the access to the world market will bring a diversification of suppliers and the lowering of related risk.

## Moldova – an actor in the world market

Moldovan industry was organized to supply markets in the FSU, with production concentrated in consumer goods and defense related products. The country is attempting to reorient its trade more toward the West, but its principal markets remain in the FSU. Diversification of trading partners will be extremely important in the long run, and exports to the West will increase, consider the experts' estimations.

Trade is recovering fast after the collapse of Soviet market under Moldova's liberal regime. Since 1993, exports have risen by 90% to \$741m in 1995 and imports by 47% to \$773m. But 1996 saw a dramatic rise in imports that has widened the trade and current account deficits. Russia and Ukraine are until the main trading partners, but exports to the EU and to Central and Eastern Europe tripled in 1995.



In 1996 exports amounted to \$801.6M of which 32% was to countries outside the former Soviet Union. Products were foodstuffs, wine, tobacco, textiles, footwear, machinery and chemicals. Major export markets are Russia (53.6%), Ukraine (5.9%), Romania (9.3%) and Germany (3.7%) and Belarus (4.3%). Imports amounted to \$1079.2 million of which 38% was from outside the former Soviet Union. Over half the imports were oil, gas, and coal, steel. Major suppliers were Russia (27.4%), Ukraine (27.5%), Romania (6.7%), Germany (6%) and Belarus (5.7%). US exports to Moldova amounted to \$12M, consisting mainly of iron and steel, apparel, and juices. Imports were \$10.1M and consisted mainly of vegetable oils, animal foodstuff, milk products, and measuring and analysis instrumentation.

As to Moldovan exports, several aspects are to be mentioned. First, agricultural products are the largest item in the total exports, and its share increased since 1992 from 40% to 72% in 1996. At the same time chemical and mineral products, machinery, electrical equipment and transport machinery decreased from 42% to only 12% in the same period. Second, the lack of quality packaging together with marketing skills extended lately the practice of exporting raw agricultural products to third countries for processing and re-export. For example, Moldovan apple juice and ketch-up are dissolved and repackaged in Germany, one third of Moldovan wines are bottled and labelled as Bulgarians etc.

In trade with CIS recently a new problem arises. Russia insist of the application of VAT based on country of destination, while its CIS partners advocate the principle of country of origin. In the mean time Moldovan lorries pay double VAT passing through Ukraine and then Russia.

Moldovan industry has very little alternative but to seek sustainable growth through exports, given the very small domestic consumer base and nature of much of its heavy industry. In light of the proximity and size of the FSU markets and the traditional links with these territories it would be unrealistic and undesirable to ignore these customers. These links should be maintained and strengthened. At the same time, it will be important for industrialists to seek new markets in Eastern Europe, Africa and the Middle East, but primarily in the West, if substantial fall in sales of Moldovan products is to be avoided in the short term.

## Geography of trade: actual and potential patterns of trade

The end of the division in Europe brought on the economic map of Europe more than 100 million people live in Central and Eastern Europe, and more than 200 million are in Russia, the Ukraine, Moldova and Belarus. Although these 300 million consumers/workers/savers are currently poorer than the 370 million in Western Europe, some – and preps – many will catch up. During the catch-up phase, markets in the successful CEEC's are likely to grow two or three times faster than those in Western Europe. This rapid growth will fundamentally alter the economic map of Europe.

The gains that this opening provides for the Easterners are quite easy to understand. The sudden opening of a vast new market to the East constitutes a great opportunity for Western Europe as well. Trade between the Eastern and Western parts of the continent was suppressed due to CMEA policy of self-isolation. To get an idea about pan-European common market the potential trade was estimated using the gravity model based on per capita GDP, total GDP and geographical distance between partners.<sup>6</sup> It shows what would pan-European trade look like, if the East was as integrated (with the West and itself) as Western Europe is today?

### ***1st Scenario. Potential trade***

The study shows the trade diverting effect of CMEA before 1989. It found that there was too much trade East-East trade (specifically CEEC's-USSR) and too less East-West. For Moldova a following map resulted:

	CEEC's-12	EC+EFTA	FSU-4*
Actual trade	15%	15%	70%
Potential trade	20%	65%	15%
With partial income catch up	25%	50%	25%

\* Belarus, Ukraine, Moldova and Russia

The Central Europeans are projected to depend most heavily on the European Union market. Between 60% of trade in case of Belarus and 80% in that of Czech Republic's trade would be directed to European Union. Even Russia would have some 70% of trade with EU.

According to this scenario Moldova's potential trade partners are European Union-65%, FSU-4 - 20% and the CEEC's-15%. The major trade partners would be with similar shares the 6 large European nations: Germany, France, Italy, UK, Russia and Ukraine. The second group of partners by importance would be Romania, Poland, Austria, Switzerland, Spain, Italy, Belgium, Sweden, Netherlands and Bulgaria.

### ***2nd scenario. Trade potential with Partial Income Catch-up***

The income of the Easterners are increased to reflect the income catch-up that is hoped to occur during the coming decades. This scenario would increase the trade between CEEC's because of growing size of their economies comparing to the West European ones. But even then EU+EFTA would account 45% for Belarus, over 60% for Russia and 70% for Check Republic.

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<sup>6</sup>Richard E Baldwin, "Towards an integrated Europe", CEPR, 1994, pp. 80-114.

Moldova would trade two quarters of its goods with EC, one quarter with FSU and another quarter with CEEC's. In long run Ukraine would emerge as Moldova's most important partner, Romania will enter the group of its major partners. Poland will considerably increase its importance and Hungary and Czech republic will become also important partners.

### A new geography of Moldovan external relations

A synthetic map of Moldovan external relations shows an increasing openness to the world, unique guarantee of escaping from centuries old backwardness. Chișinău international airport connect Moldovan capital with more than 20 cities in Europe (See Map 1). The flights geography follows the development of economic and political co-operation. 14 countries set up embassies in Chișinău and Moldova opened embassies in 15 countries.

Moldova became part of a number of global and regional organization. In the political field the most important of them are UN, OSCE, Council of Europe. Since March 1993 Moldova is a member of CIS economic union. Regional cooperation, apart from CIS is exemplified by Black Sea Economic Cooperation Zone, Conference of Danube countries, Balkans Conference, rediscovering the centuries long legacies of geo-economic ensembles. On November 1994 Moldova signed the Agreement On Trade and Trade Related Issues with the European Union, also bilateral agreements on protection of investments with the Netherlands and Germany, 1995 in line with its European vocation.

Moldova has applied for accession to WTO and has submitted the initial documents. As of December 1996, these documents had been reviewed and questions had been submitted by WTO member countries to the WTO Secretariat and the Government of Moldova. United States granted Moldova Most-Favored-Nation Status on July 2, 1992 and also the General System of Preferences (GSP) in 1995. Bilateral Investment Treaty (BIT): was signed in Washington on April 21, 1993.

The traditional trade patterns are supplemented by new: Germany, Italy, Austria but also Romania and Bulgaria begin to influence the pulse of Moldovan economy. They bring expensive goods but also know-how and quality standards.

The traditional centers of decision-making that influence Moldovan politics and economy (Moscow, Minsk, Kiev) are supplemented by other ones: Brussels, Strasbourg, Washington, Bucharest, Istanbul, a fact that increases competition on this geo-political market. For the moment Moldova remain thorn between them.

*Will a peaceful expansion of EU to the East stop on its pre-war frontier along Baltic States, Poland and Romania creating a new division line in Europe? Will the West in Russia be able to work out a new kind of cooperative arrangement in Europe? Can the actual situation of uncertainty last? This remain an open question along with Moldova's future.*

### **3.3 Threats for economic safety**

From the first years of existence of the Republic of Moldova as an independent state there appears threats for its **economic safety (ES), insurance of which represents one of the most important national priorities and is the exclusive prerogative of the state.**

Referring to Moldova, there are **3 main elements** of ES here:

***economic independence***, which under conditions of current international division of labor though does not have an absolute character, presumes however state control on natural resources, and insurance of nation's competitiveness within the European and world economic system;

***stability and sustainability of national economy***, assuming property right protection, creating guarantees for entrepreneurs, restraining factors, which destabilize the situation (criminalization of economy, dangerous social disproportions in distribution of income, etc.);

***ability to selfdevelop*** on the basis of own scientific, technical and spiritual potential, favorable climate for investments and innovation, increase of professional, educational and cultural level of the country's population.

ES limits for some of its components in Moldova are different in mid 90s. So, they are low by pace of inflation, by registered level of unemployment, in the field of providing accommodation facilities. They approached mostly dangerous the critical value in decrease of production, collapsed scientific and technical potential, accumulated foreign debt, including due to the high energy capacity of the economy.

***External economic threats*** for Moldova are:

- dependence of the national economy (not less than by 90%) on import of energy resources (5.109 thousand of coal equivalent), lack of alternative variants of providing energy for the country;
- increase in dependence on import in receiving technical equipment, while local industry is destroyed, as well as research, experimental and project bases;
- fast growth of state debt level (1994 – 38.5% of GDP, 1996 – 49.9%);
- weakening of Moldova's positions on traditional for its production markets in CIS.

While external threats considerable influence the general image, rank of the country in the international community, then internal threats – can lead the country and society directly and spontaneously towards instability and social conflicts.

In the current critical for Moldova situation the following ones are ***internal threats*** for its ES:

- narrowing financial and political possibilities of the state, while defining the social and economic strategy and its practical realization;
- depression of production, destruction of scientific and technical potential, as well as primitivization of the structure of production sector, existence in the economy of a number of non-viable ideas;
- increase of instability of economic development (dynamics of GDP, of income, export etc.) in connection with reduction of share of industrial branches and a strong dependence of agrarian sector on weather conditions (with limited possibilities of irrigation, mechanization, fertilization etc.);

- low level of investments (7% of GDP), outflow of capital abroad, high degree of wear of production facilities of most enterprises;
- high share of shadow economy (more than 40%), its criminalization;
- social threats – sharp fall of level of living, worsening of aggregate health of population, weakening of motivation to work, high differentiation (1:11) of social groups of population by income level.

Social aspects of ES of Moldova in 1997, when the country already undergone an important part of the reform path, are manifested in the necessity to solve the following problems:

- unsustainable contribution basis will extend the gap between social benefits and funds due to tax avoidance and evasion and low viability of the enterprises (i.e. in the 1<sup>st</sup> semester 1997 accounts receivable of the Social Fund doubled compared with the same period of 1996);
- people annoyance caused by the painful nature of the reforming approaches should be manipulated by the opposition in their political interests, worsening meanwhile effects of the reform. We expect an intensification of the strikes with political colorist;
- development of private pension schemes, as well as privatization of the basic social services (education, health care) could be affected by the low operation of the capital market;
- implementation of the private mandatory social insurance systems (i.e. life insurance, unemployment, health) could be stopped by the poor personal savings (less than 2% from the total household income) and by the insignificant share of the wages in total household income (about 35%);
- worsening the dependency ratio will point out a significant financial burden on the active population in the short run.

A particular attention should be given to the internal ***threats of institutional character***, and the main one – weakness of state in performing its basic function in a market economy – putting in place the activity of economic agents by a legal, juridical protection and guaranteeing execution of concluded contracts. The way out is in creating a modern civil legislation (code) and strengthening the juridical system execution of courts' decisions.

Insurance of ES – is a strategic objective per see, because it is based on long term supreme national state interests. And this is a task not only for state government bodies.

A particular importance receives its perception by political parties and public organizations, as well as by all population. Perceiving the community of interests – personal, collective and of the country, elaboration of concept of common actions for liquidating internal and external threats – these are very complicated social and psychological processes, which will develop depending on historical traditions, level of political culture in the country and confidence of population in authorities.

The next 2-3 years will presumably be critical for Moldova. Either crisis processes will have to be irreversible and it will get the role of an underdeveloped country with a congested peripheral

life, or it will be possible to overcome the situation and in the nearest prospective, but already after year 2000, to find its own niche in the economic and spiritual area of Europe.

### **3.4 Privatization, enterprise reform and energy sector restructuring**

The central planning system has left an inheritance which in a number of respects has made it difficult for Moldova to develop an effective market economic system. Key weaknesses in the planned economy were:

- economic activity was located throughout the FSU according to a logic which did not reflect market principles. With the break-up of the Soviet Union, many enterprises were unlikely to be viable, with enterprises isolated from sources of supply and markets. This problem was particularly difficult for Moldova, one of the smaller FSU economies, which was left with enterprises which could not survive on the basis of the national market;
- one result was that the scale of industrial plants built was too large for economic operation;
- the system had an incentive structure and general orientation which was not geared to the pursuit of efficiency under market conditions ( an important example was the weak development of the marketing function in enterprises – production targets were emphasized with little concern for the availability of markets);
- energy use was not based on international fuel costs, and energy was used inefficiently;
- efforts were focused of raw material and capital goods production, with too little attention being given to consumer goods and expansion of services;
- a significant part of high-tech activity was in the military-industrial complex;
- profit received by the enterprise was not connected in any way to its efficiency and with the demand for its products - prices were established centrally, and chronic scarcities meant that even bad quality products could be sold;
- work incentives did not promote an interest in quality and product innovation.

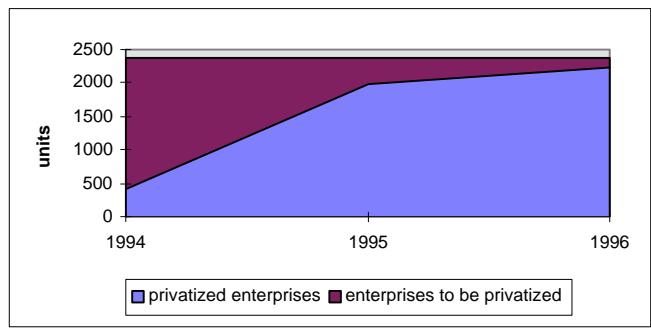
Effective incentives and accountability for the efficient use of enterprise assets is a key requirement for the effective operation of a market economy. The best way to achieve that is through a ***clear structure of decentralized ownership through unambiguous property rights*** that identifies who bears the costs of failure and reap the returns of success. This could be achieved in two ways: creation of new private enterprises and privatization.

From the beginning of economic reform, a fast growth in the number of private enterprises has occurred. As of 1.03.1997, there were about 25.8 thousand new enterprises (outside of the agrarian sector), including joint-stock companies, cooperative societies and joint ventures and, in addition more than 43 thousand individual enterprises. These newly created enterprises are mainly small businesses and for the time being play a minor, but growing, role in economy.

The second method used for the creation of decentralized property rights was privatization, the initial legal basis for which was the Law On Privatization(July, 1991).

Mass privatization actually begun following some delay in July, 1994, after three years of uncertainty. Mass privatization, mainly through national property vouchers, included about 40% of state ownership, was mainly implemented through two programs of privatization (1993-

1994 and 1995-1996), under which 2381 enterprises had to be privatized. As a result of implementation of the first stage of privatization, the property of state enterprises amounting to 2.6 billion lei (in the prices for 01.01.1994), or 85% of the property to be privatized, was allocated to the population.



One of the achievements of privatization program was the transfer housing to private ownership in a manner which was generally viewed to be fair. On 1.01.97 from 237 thousands apartments subject to a privatization, 205 thousands was privatized.

The end of mass privatization is only the first stage in a difficult and complex process. In fact, the first two programs of privatization appeared not to have been completely executed. A part of the shares exposed on republican auctions, was not claimed, because about 1/10 of vouchers were not invested at all, and some enterprises did not attract the interest of buyers. Thus, 101.6M shares remained unsold, with the nominal cost of 483.2M lei.

Also the cash sale of small uncompleted construction projects, of commercial real estate and the sale of packages of shares in 41 strategically important enterprises was not completed. The reasons for this were: the initial auction prices were considered by the market to be too high (shares were auctioned for bids starting from the reserve price, rather than through a “Dutch” auction), there was a lack of funds to inform potential investors and to mobilize experts on privatization who might have been able to attract foreign investors. Commercial real estate was not sold because of the delay in setting up of an appropriate ownership system (which was not done until June, 1996) and due to resistance by local self-management bodies.

The main result of mass privatization was the formal break-up of concentrated state ownership, and the transformation of the majority of large and average enterprises into joint-stock companies. The share of private sector in manufacturing of industrial production makes 60%, in retail trade and household service – 70%, in construction and transport – 44%. In the process of privatization a number of capital market institutions were created: privatization investment funds (PIFs), trust companies, authorized stock depositories, independent registrars, brokers and dealers and a stock exchange.

Because of the delay in the adoption of the new Civil Code, changes in Land Code, the introduction of a number of new laws (“On Joint-Stock Companies”, “On Normative Price of Land” etc.), the withdrawal of local administration from privatization from the spring of 1996, important legal and organizational gaps affected the implementation of privatization and control over it.

***A fundamental weakness of the mass privatization is that it failed to create a clear system of ownership control.***

The dispersion of ownership through the voucher system had two apparent virtues – it was equitably, as most of the population could participate in ownership, and it was swift and comprehensive – the difficulties encountered in the limited exercise of privatization by sale indicate that the general use of such a method might have delayed privatization for many years.

However, whatever its merits, the system implemented has left the majority of privatized (large and medium) enterprises without real owners interested in their further development. The dissipation of ownership among many small shareholders left the question of corporate management and control unsolved. In such a situation the control of enterprises remains with the administration, who are not answerable to the new “owners” but who do not, however, enjoy the security resulting from legal ownership and therefore have no strong incentive to pursue the longer term development of the enterprise. As a result, the benefits expected from privatization have not been realized – the privatized enterprises continue to stagnate and there is direct plunder of their property.

It was hoped that ownership control over management would be exercised by the PIFs acting on behalf of the many small shareholders (in the same ways that mutual funds and other financial institutions play a key role in exercising ownership rights over corporate management in sophisticated market economies, with highly developed financial markets, The PIFs have not yet proved able to play such a role. The majority do little more than sponge off the property transferred, damaging both the enterprises and the shareholders. On the other hand, the attempts of some PIFs to participate actively in corporate management encountered rigid resistance of the administration. There have been cases where PIFs have participated in restructuring of enterprises, but these have been few.

The system which has created could only have worked if there were meaningful markets for the shares of the enterprises and the PIFs (as exist in the more sophisticated market economies). The stock exchange of Moldova was created in June, 1995, and transactions have grown rapidly from a very small base. However, there is still not an active market for the large majority of enterprise shares or for holdings of PIF shares. In the absence of such markets, the ultimate “owners” of the privatized enterprises can neither enjoy real benefits from owning or influence the management of PIFs, and through them the management of enterprises.

The negative results of the mass privatization have included the creation of a system of enterprise ownership which is not very effective and also public disillusion resulting from the failure of share distribution to generate any benefits to the “owners”.

The dilemma facing Moldova is that, very clearly, the state is not capable of effectively control state property, nor does it have the financial resources to restructure enterprises. On the other hand, an effective system of decentralized property ownership has not been created to replace the old system.

*An important strategic issue facing the nation in the coming period is how to encourage the growth of a more effective system of ownership/management of the enterprises already privatized.*

The way forward lies with steps to encourage a fast process of evolution (organic growth) of enterprises, so that a significant segment can emerge as dynamic agents for economic growth. This could be done by a number of steps which would open up the possibility for the emergence a range of new structures of enterprise ownership and management, including:

- (i) The removal of legislative restrictions on the amount of shares of a single enterprise that a PIFs and commercial banks can acquire, to clarify enterprise ownership and to encourage more active participation of funds and banks in the revival of enterprises ;
- (ii) Promote the stock market quotation and sale of PIF shares, to increase pressure on fund managers to generate benefits from the fund portfolios;
- (iii) Encouraging management buy-out of enterprise shares , through joint venture deals, lending against the surety of the shares (“leveraged management buy-out” - if the managers did not succeed they would lose ownership);
- (iv) Improvement of corporate governance system (including use of the contracts for management);
- (v) Removing impediments to the break-up enterprises into units which could be purchased by managers or new owners.

The intended outcome would be both to generate benefits for the fund shareholders and to create a closer identity between ownership and management, to clarify the recipients of the benefits and costs from enterprise management.

There is also a need to take steps to complete the process of privatization of State assets. The delay in the adoption by the Parliament of the Law “On the Privatization Program for 1997-98” (the draft was submitted to the commission of Parliament in November, 1996), and also of a number of related laws has slowed down reform. The new program of privatization, mainly on a money basis, was adopted by the Parliament of Moldova in July, 1997. 446 items with a nominal value of about 1.75 bn. lei (in prices as of 01.01.1995) have been included in the program. The new program of privatization is directed towards finalizing the process of state property privatization . For acceleration and accomplishment of this program, a new mechanism of privatization for money was introduced – downward auctions (i.e. “Dutch” auctions). Rules of sale through the stock exchange of shares from state enterprises which remained after realization of the previous programs of privatization have also been formulated.

The new privatization program involves sale of state property not covered by the previous programs of privatization including:

- commercial real estate rented by small enterprises;
- small enterprises offered for sale earlier, but not sold;
- shares of the state in the earlier created joint-stock companies;
- the majority of small, medium and large enterprises, which were not subject to privatization within the framework of previous programs (including well-known wine-making factories);
- infrastructure enterprises (including the energy sector and telecommunications).

As a clearer system of ownership emerges, owners and managers should in turn be forced to respond to the market – their behavior will be influenced by the market environment. To promote market efficiency it is necessary both to promote competition, and to introduce the financial discipline necessary to bring managers face to face with market realities. Enterprises that cannot adapt to market conditions could face sale (change of ownership) or closure. But as closure will increase unemployment, the leadership of most transition economies seek ways to slow down the introduction of tight financial discipline, using various forms of subsidy, reducing pressure on enterprises to perform, generating substantial budget deficits and growth of internal and external debts. For more than half of the year the Economic Court stayed idle - because of

imperfection of the Law On Bankruptcy, the procedure of bankruptcy has been little used. For the last two years the decisions on administrative liquidation were taken in only 30 cases, but in only 5 cases were firms actually liquidated, 9 were privatized and 12 are still selling their assets.

Causes of failure in restructuring enterprises include instability of the legal basis, uncertainty with regard to property rights, insufficient financial assets, and high interest rates. A number of enterprises are far from repaying overdue debts; many cannot finance current payments.

Lack of financial discipline in Moldova generates economic irresponsibility of the administration of enterprises. As a result of easing financial discipline, the debts of enterprises are constantly growing. Observance of financial discipline also requires the use of appropriate accounting principles. It is intended to introduce Western accounting standards from 1998.

To improve the position of insolvent enterprises the law « On Restructuring of Enterprises » was adopted in 1996. Under this law, about 100 enterprises have concluded memorandums of agreement with the Council of State Creditors regarding bankruptcy protection, relating to a sum of overdue debt of about 500 million lei. Under this procedure, debts of enterprises are frozen, and a restructuring plan (including debt restructuring) is elaborated and implemented. At ten enterprises, assistance in restructuring was rendered by experts of the Agency for Restructuring Enterprises (ARIA) and foreign advisers, and two others by German technical cooperation experts. ARIA work consists of the development, jointly with enterprises, of a restructuring plan on the basis of the enterprise diagnosis. The management of the enterprise is trained in the fields of marketing, financial planning and management, new standards of book keeping, quality control system, computer skills, and English language. With the help of ARIA a new generation of managers is being created.

## Energy sector

The economic situation of Moldova now and in the near future will be decisively influenced by the situation in the energy sector. It is important therefore to remove inefficient state controls, reduce monopoly and develop competition in those sectors.

The power stations and the Heat and Energy Complexes are obsolescent: 60 % of the fixed assets are over 21 year old, 40 % – over 26 years. Technical losses and thefts of energy exceed 22% of total consumption. The “Moldenergo” State Company productivity is quite low – 80 clients are served by one employee, compared to a ratio of 1:145 typical of European experience.

The state monopoly has made no significant investments in the energy sector during the last 10-12 years. The populist approach to pricing adopted by the government results in tariffs set at levels which do not cover costs, leaving energy enterprises with no resources to fund modernization. As result, 450-480 grams of oil equivalent are being spent for manufacture of one kWh of energy, which is three times as much as in Western European enterprises. Given this state of decay, investment in the power industry as high as \$90-100M annually would be justified.

Inadequate prices and a system of cross subsidies resulted in losses estimated at 368 million lei in 1995 and 216 million lei in 1996. As a result, far from generating resources to fund investment, the energy industry is generating deficits, requiring budgetary support. As partial payment of “Moldenergo” State Company debts to RAO “Gazprom” (Russia), the Ministry of Finance has issued and transferred to the latter state securities worth an estimated US\$ 140M. Currently, despite tariff increases, debts continue to grow. At the moment, Moldova’s external debt to power suppliers is estimated at about \$ 600M (including \$ 300M Transnistrian debt).

The growth of debts was caused both by the limited capacity of households to pay their bills for energy supply, and lack of a financial discipline. Energy was supplied to insolvent industrial enterprises on the basis of instructions from government officials or through personal connections with power company officials. It is doubtful if many of these debts will ever be paid.

To conserve power, energy companies cut-off electricity a few times per day. As a result, those who regularly pay for the electricity consumed and try to produce competitively their goods, are subject to severe losses, for which the power companies do not accept any responsibility. In a power complex it is necessary to undertake the following steps:

- The energy system of Moldova requires immediate and radical re-structuring. A draft plan on de- monopolization and privatization of the power companies has been prepared by the ARIA agency.
- During recent years the state's inability to operate the power sector effectively has become evident. This is contributing to economic decline, and the financial collapse of the power companies. Privatization of the power companies may be necessary to insulate them from political pressures.
- Domestic investors lack the financial resources to acquire control and further modernize the energy complex; therefore, foreign investors should be involved in this process. As an alternative to privatization, the power companies could be transferred to private operators to be managed autonomously, on a long-term basis.
- As it might take some time to restructure the industry, there is an urgent need for the government to institute more realistic energy tariff policies and to insist on tight financial discipline in payments of bills; any subsidization of energy on social grounds should be transparent and carefully targeted to those in most need.

Nowadays the program of energy sector privatization is in a stage of development.

Additional issues related to enterprise development which must be confronted include:

- Steps to shift shadow economy towards operation in a legal environment;
- Creation of new financial institutions oriented towards satisfying investment needs of private sector and to facilitate availability of capital for the small enterprises;
- The further liberalization of foreign trade activities, with simplification and unification of licensing procedures ;
- Improvement of coordination, and increase in the productivity of financial and technical help to private sector from international donors;
- Radical improvement (practically to create anew) the statistics on the private sector;
- Improvement of professional skills of the staff for small business;
- Assurance of legal and administrative protection of the person and property for businessmen; and
- Promotion through the mass media of a more positive public opinion with regard to the private sector and to innovative entrepreneurial activity.

### **3.5 Banking system**

The system that prevails in Moldova today is one of traditional banking activities mostly limited to commercial lending and basic exchange and settlement transactions. This is appropriate for the time being, both because

- it is unlikely to be a significant demand for more sophisticated services in the country at this stage, and
- because it is prudent to let banks develop gradually, consolidating their expertise, operational structures and internal controls, before venturing into new areas.

In case of Moldovan banks a variety of services and clients would increase the competition and reduce specific risks. Of course, in providing loans commercial banks should not have a narrow specialization on branches of industry, on regions, or by terms of loans' reimbursement. On the other hand, if banks have the possibility to provide a wide range of financial services, that could generate problems. These banks are managed more laboriously and at the same time supervising them is a more difficult task. Because the skills of local banks' employees in respect with some aspects of banking activity are insufficient, it would be proper for them not to tangle with insurance operations and/or with securities.

Ideally, the banking system in Moldova should contain a limited number of strong and competitive commercial banks. These banks should not specialize by sectors or types of lending but neither should they diversify prematurely beyond the more conventional and adequately tested types of transactions. When the development of additional financial and investment services is required, in such areas as securities underwriting and trading, and insurance services, a possible strategy of diversification would be through specialized subsidiaries of the banks, that would need to be independently and adequately regulated.

At the same time, non-banking financial intermediaries should continue to develop in an adequately supervised and regulated environment to provide financial services complementary to those offered by the banks. A market for intermediation of securities, both debt and equity, could play an increasingly important role as corporate governance and ownership relationship are placed on a more transparent and financially viable footing. The securities market is still very small but it can, in the future, play an important role in the following areas:

- providing liquidity to owners of share in privatized joint stock companies, and a mechanism transferring stakes between different shareholders;
- providing a non-inflationary method of budget deficit financing through issuance of state securities;
- developing a competitive capital market for both domestic and foreign investors, which will accommodate the issue of new capital and act as a market check on the performance of existing firms.

Financial institutions and instruments could play a critical role in the accelerated growth of newly created private sector firms and in providing a mechanism for the privatization of large enterprises. Without access to adequate credit, investment capital and convertible currency, few entrepreneurs can start a sound and viable business.

A number of Moldovan banks inherited a considerable portfolio of bad loans from former state specialized banks, and have continued to offer their support to non-viable enterprises, hoping by doing that to eventually recover their bad loans. There is thus a danger that banks will persist in lending to inefficient enterprises with poor financial prospects. This is not only commercially risky for the banks, but given the very limited amount of financial resources available, this is particularly unfortunate from the national point of view, as strictly limited would be better

employed funding worthwhile new ventures, rather than being thrown at loss-making enterprises. Some help to discontinue these unsound banking practices should come from the introduction of a more decisive procedure for liquidation of bankrupt enterprises.

One of the main functions of banks is to mobilize savings. In this respect, confidence in the stability of the system is a key element and this could be improved by the introduction of deposits' insurance. Its main goal would be insurance of households deposits with commercial banks. Also, by establishing this corporation the National Bank would be absolved from continuous interventions for supporting banks – a task which in fact does not fit into main attributes of a central bank. The functions of the said corporation could not only paying off the depositors of bankrupt banks, but also intervention in the activity of banks which have problems. Corporation could decide whether a specific bank should be liquidated, or it is reasonable to inject supplemental capital to save it, eventually changing also bank's management etc. Such corporations (funds) of deposits' insurance exist in the USA, Switzerland, Poland, Hungary, Romania, Latvia and other countries.

In this regards it should be stressed out, that the model of deposits insurance system examined above is preferred to the one with implicit state guarantees. What could be the sources of financing a deposits insurance corporation? The first part will of course come from commercial banks, which will have to contribute with an initial payment as a percentage of their capital, plus monthly installments as percentage of their deposits amount. Another part could come from international finance institutions in the form of credits. There will be certainly some expenses to be bared, but they will certainly justify the final goal: maintenance of depositors' confidence in banking system, and this in its turn will induce growth of funds attracted from households to banks. Besides that, if a specific bank has problems, this will not generate the avalanche of immediate withdrawal of deposits, which is a very destructive factor even if in general the financial standing of the concrete bank is not so bad. Therefore, banking shocks will become, in conditions of good management, practically impossible.

### ***Should commercial banks become investment banks?***

One issue which has been under discussion concerns the merits of allowing banks to take direct control over investments in enterprises. On balance, it would be wise to restrict the role of banks at this stage; they should not be allowed to own or directly control non-financial companies. At this stage, when many enterprises carry such high financial risks, it would be particularly inappropriate for banks to acquire control of industrial or trading enterprises, which might undermine their own solvency.

In general, only banks which can rely on state support, for instance large, partially state-owned banks in Central Europe, have had a significant role in enterprise restructuring. While this involved the acquisition of stakes, often of control, of individual enterprises, they were later sold on. The main purpose of this exercise was that it represented for the bank the only way to recuperate loans that had been previously disbursed to the companies.

On the whole, analysis of economic restructuring needs in Moldova, and the experience of East European countries and Russia, suggests local banks are not the institutions that should play a prime role as industrial investors. A strategy of transformation of the financial and banking system into a competitive industry, initially concentrating into a limited, but properly selected, range of services based on international standards, would be a significant contribution to the strengthening of the national economy and attracting foreign investment.

Even in the longer run there are reasons for skepticism regarding an extension of the role of commercial banks:

- The expertise required for commercial banking differs from that required for investment banking; the development of the latter activity needs diversified knowledge, requiring the training of personnel in totally new areas;
- There is a lack of personnel to monitor enterprises closely. The costs of involvement in such activities is likely to be extremely high for a long time, compared to the core activities of commercial banks;
- Bankers should not confuse the role of creditor and owner, and be put under pressure to extend credit to companies they own;
- Ownership of the client company is not likely to add much useful information for the purpose of bank lending decisions.

Generally, Moldovan bankers accept their core functions as their top priority. In a transition economy, competence in ensuring swift and reliable processing of payments and settlements, together with the capacity to provide basic but appropriate financial products (including acting as the main source of short-term finance), is the crucial contribution banks can make to the reform processes.

The financial products and services that banks offer at the moment in Moldova are quite modest, and there is scope for improvement and diversification without over-stepping the conventional core functions of a bank. However, the key element for the development of a well-articulated, efficient and dependable banking system is the growth in the deposit base. Hence, bankers need to concentrate on building a solid long-term relationship with bankable clients, and this relationship can only be founded on trust, confidence and quality of the services offered. Thus the immediate objective of commercial banks should be to improve performance and quality in the core activities as building block for solid growth and, at a later stage, diversification. The involvement of banks in direct investment in enterprises should come as a further objective once they have consolidated satisfactorily their position in traditional activities.

### **3.6 Agrarian reform**

The agrarian sector is a key sector; together with the food-processing industry, it accounts for 60% of Moldova's production and three quarters of exports. More than half of the working population is engaged in this sector. Moldova's economic future depends on the effectiveness of reforms in this sector.

The centrally planned system within which agrarian enterprises operated in the past had the following features:

- centralized deliveries of equipment, energy, fertilizers and pesticides;
- considerable direct budgetary support, access to the cheap bank credit, and indirect subsidies from lowered prices for manufactured goods;
- centralized price setting for agricultural production; and
- protection from imported goods.

The distorted incentive structure for enterprises and workers did not encourage economically rational use of resources, while the absence of competitive stimulus to increase production efficiency.

Agrarian reform in Moldova has lagged behind other reforms in the transition period. The transformation of property relations in agriculture has yet to create the critical minimum mass to halt the agricultural recession. With the introduction of market reforms, protection from imports has disappeared, and the non competitiveness of goods produced with respect to both quality and prices has been demonstrated.

The agrarian sector remains chronically unprofitable and continues to receive budgetary support.. In 1995 the sector achieved a financial surplus of 231.7M lei despite receiving budgetary support of 306M lei as an indemnification for the negative impact of “acts of nature”. About 490 large enterprises, or 46% of the total in the sector, finished 1996 with losses, and the estimated overall profitability in agrarian sector was only 0.3% of turnover. In March, 1997 Parliament again approved indemnification of losses resulting from acts of nature to agricultural enterprises of 254.3M lei for 1996.

As of 01.01.97, accounts receivable and output stocks in the agrarian sector amounted 854.6M lei, while accounts payable were 1645.6M lei, indicating a low level of working capital. The debts of the majority of enterprises exceed the value of their property. In 1994-1995 agro-enterprises were granted commodity credits for chemicals and fertilizers (35M lei), for fuel (55M lei) and electric power (129M lei), but the major part has not been repaid.

The chronically difficult agrarian situation poses serious dangers for the national economy. Incomplete reforms extends the agony of the unprofitable enterprises, and in order to contain social discontent in the countryside, the Government is compelled to provide subsidies. However, subsidization is ineffective - it is unsystematic and is a heavy burden for the budget.

***Agrarian reform is needed to change the system of motivation, through a more precise definition of the property rights. Land reform seeks to transfer land belonging to the state into private hands. Agrarian reform should also help the new proprietors to create competitive, effective agricultural enterprises and to ensure efficiency of agrarian sector as a whole.***

## Land reform

Basic changes in the property rights in land began from January 1, 1992, when the Code on Land was enacted. Before that, all land belonged to the state. At the first stage of implementation of reform, individual farm plots which has existed under the previous regime were transferred as private property to the owners (without the right of sale) and garden lots were also privatized. At that stage, 13% of agricultural land was transferred. However, a more fundamental requirement of agrarian reform had to be the transformation of the ownership of land and other property which had been operated by the collective farms and state farms, along with the creation of a new system to supply services to agriculture.

With adoption of Land Code, workers in agricultural enterprises had an opportunity to transform their enterprises into joint-stock companies, with distribution of shares among the members of the collective and pensioners. To allow formation of new farm and processing entities, collective and state farm worker have received the right to leave the collectives with their land parcels and property shares, starting November, 1992, and then annually during November-March.

During the implementation of agrarian reform, legislation was amended and complemented by a number of general and specific laws:

*General laws include:*

Civil Code (enacted 1964, last amended October, 1996);  
On Ownership (enacted 1991, last amended March, 1996);  
On Privatization (enacted 1991, last amended July, 1996);  
On Entrepreneurship and Enterprises (enacted January 1992);  
On Joint-Stock Companies (enacted January 1992);  
On Bankruptcy (enacted January 1992);  
On Cooperation (enacted January 1992);  
On Leasing (enacted January 1992, last amended March, 1996);  
Constitution of the Republic of Moldova (enacted 1994);  
On Collateral (enacted May, 1996);

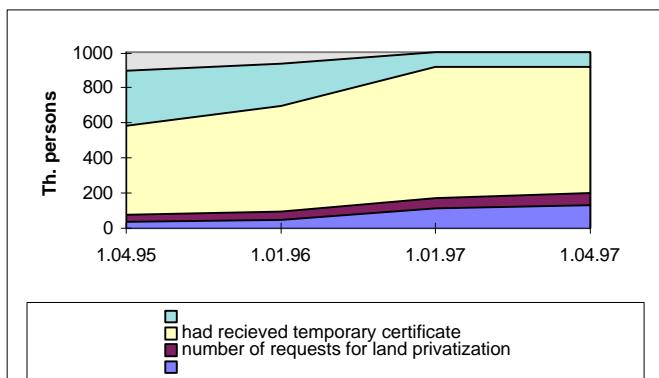
*Specific laws regulating relations in the agrarian sector include:*

On Peasant Farms (enacted January, 1992);  
On State Land Arrangement, State Land Cadastre and Land Monitoring (enacted December, 1992);  
On Land Taxation (enacted December, 1992);  
On Normative Price of Land (enacted December, 1994);

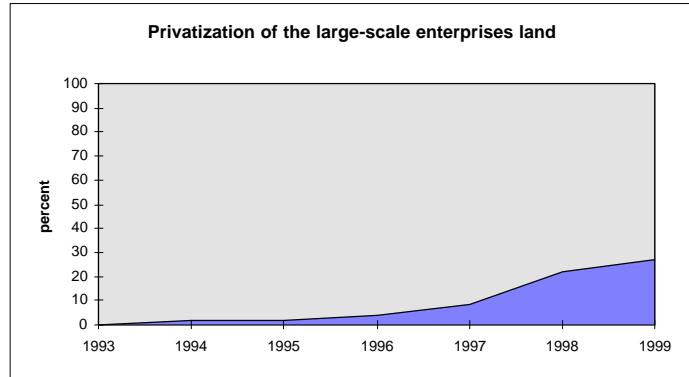
The process of transformation of collective farms, state farms and inter-farm enterprises into new structures has proceeded very slowly. Of 1074 agricultural enterprises in those categories existing in 1992, by 1996 some 665 have not changed their ownership, and many of 160 enterprises were transformed into joint-stock companies and production cooperatives retained the same management, and ordinary shareholders have few real rights, opening up wide opportunities for various sorts of abuse.

One route to increases in efficiency in the agrarian sectors would be through accelerated restructuring of enterprises, with allotment of land to peasants. While this might involve fragmentation into small units (the individual allocation being on average less than two hectares), subsequent consolidation of plots by those not interested in farming (e.g. pensioners) and the free association of the new proprietors might be expected to lead to the appearance of medium size units. Some farmers have united in farm associations. From 1994 to 1996 the number of these associations increased from 7 to 146 units.

While the approach adopted in Moldova involved a commitment to the transfer of most of land to the rural population, in practice the allotment of land has moved very slowly, and the impact of land transfer on agricultural practice has been very limited. In spring 1997 (as of 1 April) from 1005 thousand people having the right to receive land parcels, 915 thousand have received a temporary certificate and only 205 thousand had chosen to submit applications to receive the land. The process of receiving land parcels and permanent title confirming the right of ownership is time consuming and has faced various objective and subjective obstacles. A permanent certificate had been received by 132 thousand people or 13% from those having the right to receive it.



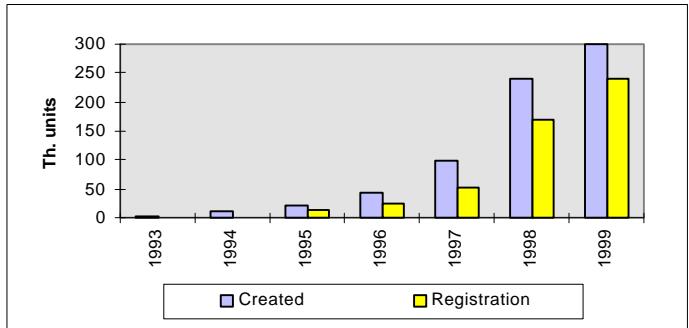
Dynamics of land transfer from collective farms, state farms and inter-farm enterprises into private property is shown in the figure, for April 1 of each year. Prospective land privatization up to 1999 reflects conditions agreed in the Memorandum between the Government of Moldova and the World Bank for the SAL-II credit signed in May 1997. As is visible from figure, on 1.04.97 only 8.6% of the total land area subject to privatization was transferred into



private property. Under the draft SAL-II the aim is that by 1.04.99 this ratio will reach 27.4%. It is hoped that this will represent a sufficient critical mass to ensure renewal of the agrarian sector.

In addition to land transfer, agrarian reform provides for the transfer of enterprise buildings and equipment to peasants. By the beginning of 1997, in 14.6% of agricultural enterprises, the calculation of property shares had not yet been made, and out of 1090 thousand persons having the right to share in the privatized property of enterprises, only 448 thousand (41%) have received certificates confirming their rights. Only 255 thousand (57% of those given certificates) were certified by the Ministry of Privatization and State Property Administration. Thus, only 23% of those having the right have received property and had the opportunity to use it in enterprise activity.

Low rates of allotment of land and property shares have resulted in a slow process of formation of new farms and their registration. (The projections until 1999 reflect the Memorandum between the Government of Moldova and the World Bank on granting the credit SAL-II). There is a significant delay in registration of new units and, caused by complexity of procedures, even for those with only 1-1.5 hectares of land.



In order to accelerate the process of agrarian reform, in February 1997 the Government agreed to simplify procedures for withdrawal of peasants from large-scale enterprises and registration of the newly created units. This decision stipulates a simplified procedure for registration of small farms. To partially cover the charges for title confirming land ownership, the Government allocated the sum of 2.5M lei for 1997, which cover the expenses for preparation and distribution of 16 thousand certificates.

The formation of larger farm units should receive a boost from removal of the moratorium on purchase-sale of land. Under the legislation, land could not be sold or purchased until 2001. In the second half of 1996 the Constitutional Court declared the moratorium inconsistent with the Constitution of Moldova. A draft of a new law on the sale and purchase of land is before Parliament and awaits approval.

A number of international organizations have helped with restructuring agricultural enterprises. In 1996, the Pilot TACIS project on privatization of land in the Orhei area started, 39 thousand

citizens have received shares of land; about 20.5 thousand parcels were registered, resulting 12,405 farms, 25 association of farms, 7 cooperatives. In addition to reorganizing 6 collective farms, the project seeks to create and strengthen the institutions that support privatized agriculture, including an extension service and an information center for farmers and businessmen. In the Orhei area, field advisers work in villages as well as in regional management of the agricultural processing complex.

An experimental project "Nisporeni", to reorganize the collective farm "Mayak" in the Nisporeni area was implemented in 1996 in cooperation with the Center for Private Business Reforms supported by the US Agency for International Development (USAID): 627 certificates confirming land property rights have been issued to individuals and have provided the basis for household enterprises; another 1355 people (mainly pensioners and workers) have also received certificates confirming the right of property on land and have transferred these rights to 9 leaders/businessmen, who have created associations ranging from 26 to 430 ha. Within the framework of the project, a manual ("Methodology of the Break-up of Collective Farms in Moldova") was prepared, adapted to Moldovan legislation and to local social and economic conditions, which includes recommendations for the transformation of collective farms and state farms into market-oriented farm units and associations.

On the basis of experience acquired, the project "Nisporeni", together with Ministry of Privatization, has trained more than 100 specialists in Chișinău and in 10 territorial agencies was carried out. Eight experts work in each territorial agency (lawyers, experts in public relations, economists and bookkeepers). In 1997 these experts are rendering technical assistance to 70 collective farms on their reorganization on the basis of methods developed in the project "Nisporeni". As a result of the above project it is intended that about 70 thousands peasants will receive certificates confirming land property rights and thousands of new farmer units will be created.

In the break-up of large agricultural enterprises special attention should be given to the problems of debt restructuring. One possible source to fund the liquidation of debts could be the shares of processing enterprises, which were transferred in the process of privatization to agricultural processing firms and to the suppliers of raw material. There are also other resources. To resolve the problem of debt restructuring, state bodies will need to show flexibility, so that farmers should not be expected to inherit the debts of the disbanded entities along with their plots.

The creation of uniform information Cadastre system of real estate would be a useful input into land reform. A pilot project for a National Legal Cadastre has started in July, 1996. Works was begun on: i) the development of legal basis for the regulation of the real estate market and ii) technical re-equipment need to create a computer based information system. In the absence of such a project, it would take not less than 35 years to supply certificates confirming the right of property on land to recipients of title.

In the new Cadastre system the coordinates of private land areas are linked to the state geodetic network, which should limit judicial disputes between proprietors. The new information system will be multifunctional, registration of property, collateral, mortgages, and covenants restricting property use. Through the project, 7 private concerns were created (in the geodesy, cartography and Cadastre fields) and licensed by the Cadastre Division. 125 people have been trained, but around an additional 1000 technicians will be required. The creation of regional Cadastre branches was suspended at the end of 1996, with the transfer of the Central Bureau of Technical Inventory from the Ministry of Privatization to the management of the National Agency of Geodesy, Cartography and Cadastre, a move which was challenged by the former president.

In the middle of 1996, with active international support, the Agency for Restructuring Agriculture (ARA) was created. Its tasks are: to render assistance in reforming collective farms and state farms, to centralize information about various international projects on land reform implementation, and in close cooperation with the Ministry of Agriculture and Foodstuffs to develop a strategy and tactics for implementation of land reform. The main tasks of the agency are to accelerate land reform implementation, and to promote de-monopolization of agriculture and the creation of market-oriented agrarian enterprises.

There is a role for state action in the transition period in promoting favorable financial conditions for the new private enterprises. The limited access of farmers to credit places a brake on land reform. As long as land is not a commodity, the farmer can not use it as collateral for receiving credit. The experience of transitional economies shows that even if when land is a commodity, banks are reluctant to accept it as collateral. In addition, high interest rates (35-40% annually) make it difficult for enterprises in agrarian sector to utilize credit. It may be necessary for the government to take action to reduce credit risk in the agrarian sector, and assist farmers faced with high interest rates (e.g. In Hungary the Fund to Guarantee Village Credit supports the finance of projects which have insufficient collateral and the Fund for Reorganization supports new farms in the transition period. Another option promoted by the American NGO "Volunteers in Overseas Cooperative Assistance" (VOCA), is the creation of credit unions. The laws related to such credit institutions need to be improved.

The main agricultural credit agency is the Moldova-Agroindbank. Since 1995 the portfolio of the bank has included loans to farmers. Most loans were repaid on time. Lack of collateral at agrarian enterprises stimulated the mechanism of provision of credit to the agrarian sector through processing enterprises.

## A reformed management system for large-scale agriculture

The land reform strategy discussed in the previous paragraphs concentrates on facilitating the exit of the new owners from the previously existing large scale enterprise, and also addresses the challenging tasks of creating an infrastructure to service the new small and medium scale sector. However, it is striking that even under the targets set out in the SAL-II agreement (see chart - above), ***by the end of the decade the major share of the agricultural sector will remain in large-scale units.*** The actual situation may remain to some degree unclear, because as the arguments above suggest, even where the organizational form changes in principle, in practice the former management structure has remained in place.

There are many reasons for the slow pace of change, including:

- the break-up of large units in some cases makes little economic sense (i.e. where there are clear economies of scale at critical points of the production process);
- the existing management are in a position to resist change because of the strength of their political position (e.g. as reflected in Parliament);
- management is also needed because in a transitional economy with weak development of markets, established networks of connections between enterprise managers remain important for the procurement of inputs and delivery of outputs.

In the longer term, under a regime in which agrarian organization is encouraged to adjust to market realities, it might be supposed that agricultural units would emerge of a wide range of sizes, from the small family plot (e.g. producing horticultural products for the local market) to the large commercial farming units on a scale in line with the previous agricultural enterprises. In the larger scale sector, professional management will be required, which is likely to be drawn from the cadre of existing managers.

The discussion of reform so far has not come to terms with this reality, as the proponents of reform (including the international agencies) have tended to concentrate on the goal of breaking up the large units, and by so doing tend to suggest that the remaining large-scale sector is a conservative residual which in the longer term should be liquidated. Moreover, it might be felt by the proponents of reform that any attempt to accommodate to the needs of the unreformed sector might compromise the drive to break-up the old system..

The danger with this approach is that in practice the major segment of agriculture is left in a twilight zone, in which it is neither “reformed”, nor does it work anymore according to the logic of the old system. In particular, managers are left in *de facto* control of enterprises, without being owners or being subject to accountability to a clearly defined ownership structure.

One route to clarifying this situation would be through the issue of title to plots, and for larger scale units to emerge from the voluntary sale or joint working of groups of plots; such developments are already happening (as under the Nisporeni project, see above). However, it should also be possible for existing large scale units to be transformed to joint *stock companies within which an effective system of corporate governance is developed, under which management would be held responsible to the owners for their management of the assets.*

*This suggests that a component of the next stage of agrarian reform should be the identification and promotion of new corporate ownership forms for larger scale agriculture, which would allow for continued large scale operation of segments of the agriculture system under clearer ownership, at the same time as allowing exit from the larger scale units of small proprietors.*

This would require the development of a system under which claims on land could be transferred into shares in agrarian joint stock companies, which could be marketed, allowing for the possibility of changes in control through share sales. At the same time, agrarian enterprises could be encouraged to buy and sell assets, allowing for an organic evolution of the size of enterprises, and to use their land as collateral for loans. A system of management contracts could be developed, under which managers could be given reasonable security of tenure (and compensation for dismissal), while subjecting them to a corporate governance system under which owners could, under prescribed rules, act to change the management.

Such innovations would only have a chance of success under two main conditions. The most important would be that a significant segment of the management cadre would have to see good prospects for their own economic futures in a more effective management system for large scale farming;. At the same time, the large enterprises, as much as the small farming sector, would need support from an effective set of market institutions. This will require policy initiatives in a number of areas.

## The institutional environment for more efficient agriculture

The development of more efficient agriculture involves both clarifying land ownership in both small and large farms, and creating an environment in which farmers are given the incentives to operate efficiently.

Perhaps most important, successful agrarian reform requires the development of competitive markets for farm inputs and agricultural outputs; farmers should not be dependent on local trading monopolies, nor forced to use one trader for the lack of credit facilities.

***An important component in the development of a strategy for agrarian development is the development of an effective policy for the promotion of competition in the agricultural marketing and processing system.***

The state has yet to create an institutional base for the provision credit and insurance for agriculture. Parliament has charged the Government to prepare drafts of laws “On Agricultural Production Credit” and “On Insurance of Agriculture in Cases of Acts of Nature”.

There is an urgent need to improve ***credit and insurance*** facilities for the agrarian sector. In particular, it is necessary to create a system of seasonal credit on the basis of collateral of land and crop insurance; to introduce leasing of agricultural machinery; to prepare conditions for the introduction of futures contracts. Credit for agricultural enterprises on the basis of futures contracts is provided for in the law “On Commodity Exchanges” (February 1997).

The shortage of financial resources leaves agrarian enterprises them dependent on firms willingness to deliver inputs against the security of the future crop. Such commodity credit allows keeps them alive, but does not give them the opportunity to purchase inputs on competitive markets. Such transactions depend on informal connections between the management of enterprises, as legal guarantees ensuring repayment of credit is ineffective.

The development of a system whereby farm assets can be used as collateral for loans requires that there should be an effective system of bankruptcy, which allows creditors to realize collateral in the event of default. Also, such a mechanism would allow the shift of land ownership from those who are not able to use if successfully.

Despite the fact, that the Parliament adopted the Law “On Bankruptcy”, the means for its implementation do not exist yet, so that enterprises are not forced to observe financial obligations. Currently enterprises of in all branches repay debts to the state on the basis of the Law “On the Procedure of Collecting Taxes and Other Obligatory Payments”, which provides for the confiscation of assets and stocks of finished products, which are then sold. Such an approach leaves the defaulting enterprise with little chance to survive, and the implementation of the Law is in practice quite difficult. By the beginning of 1997 there were more than 500 cases in courts involving claims on property; 400M lei of confiscated goods could not be realized because of high prices and poor quality. In February 1997 the Parliament adopted the first reading the draft of amendments to the law; adding provisions forbidding arrest, confiscation of perishable agricultural products, raw material, inputs and agricultural equipment. Thus, the further accumulation of debts by unprofitable agricultural enterprises was legalized, and a barrier placed in the way of developing a commercial system of agricultural credit.

### **3.7 Reform in the social sphere**

The description of the social impact of the reform process in chapter – set out many of the negative effects which must now be addressed. The economic shocks resulting from the breakup of the FSU, combined with the impact of policies which sought to achieve macroeconomic/financial stability resulted in a widespread decline in household incomes, a deterioration in the public delivery of social services and public goods, and an erosion in the real value of transfer payments (e.g. pensions). While some of these effects may be viewed as short-term in nature, resulting from the depression in economic activity, which will be reversed as the economy recovers, others demand fundamental restructuring of policies and institutions, to put them on a basis which will be effective and sustainable in the new economic environment.

**The labour market.** The number of persons officially registered as unemployed rose three fold over the period 1993-1996. Although the rate of official unemployment is only around 2 percent of the labour force, the number of persons on unpaid leaves has increased 7.4 times, currently reaching a level of 15 percent of total employment.

Along with unemployment, labour migration has increased. The low capacity of enterprises to absorb the redundant labour has encouraged people to leave for jobs abroad. During 1993-1996 almost 3 thousand. Moldovans worked in Israel, Germany, Greece and Russia on the basis of formal contracts, but this figure represents only a quarter of total migration, the biggest part of labour migrants leaving illegally for jobs abroad.

**Strategic opportunities.** Continuing structural adjustment and enterprise restructuring will inevitably intensify the process of laying off workers and will increase pressure on the labour market. Further employment decline can be expected in such non-profitable branches as engineering and electrical manufacturing. Growing sectors, such as services, food-processing, and residential construction, are unlikely to provide sufficient employment for all the redundant workers, so that further increases in unemployment can be expected, aggravating the decline in living standards.

Efforts to mitigate the burden of structural adjustment should focus on two possibilities:

- extending the opportunities of reemployment ;
- providing more effective protection for the unemployed..

Reemployment can be promoted by emphasizing the retraining of the unemployed, increasing labour mobility (both professionally and geographically), and improving access to information. At the same time, there is a need to promote more effective measures to help workers while unemployed. Unemployment benefits should be set to encourage workers to seek employment, by having the level of benefit decline with the duration of unemployment. The system for financing unemployment support should be kept as simple as possible, with the funding arrangements being separated from other social funds. The merits of placing the payment of benefits and the collection of contributions to unemployment funds under unified management should be examined (currently two different ministries are involved).

Government can also play a role in promoting labour market reforms through efforts to update the legal framework so as to increase the flexibility of the labour market infrastructure.

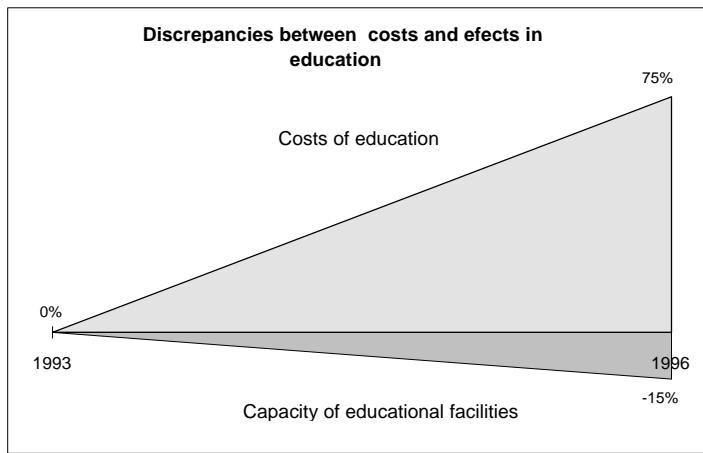
**Developing Human Capital.** A well educated and skilled person can contribute to economic growth and can more readily adjust to changes in the economy. Modern development depends on the knowledge and skills of the population, and therefore on the effectiveness of the education system..

The educational system in Moldova has both strengths and weaknesses. The inherited system had a number of virtues, including an equitable access to education, the comprehensive character of primary education, a high rate of literacy and an impressive level of technical and engineering skills. However, transition towards the market economy has revealed constraints that reduce the performance of the educational system, making it somewhat inefficient under the new circumstances, including a rigid and inefficient financial structure, fragmentary and inconsistent educational programs; a state monopoly in providing educational services; and the lack of staff incentives. As a result, school assets are not being properly managed, the unit cost of education has grown, and the qualifications of some specialists do not meet the requirements of the market economy. There are conspicuous gaps in the provisions of the skills required by the new market

economy. Therefore, reform of the education system is required to fill gaps and provide knowledge relevant to the market economy.

*Strategic opportunities.* Priorities for reform involve action in the following three areas: finance, scope of services, and service delivery. The need for financial reform is particularly urgent. The inadequacy of financial resources is undermining the quality and efficiency of education. Though the share of expenditures for education appears to be large (6,7% of GDP), it is not sufficient to maintain the public provision of educational services at previous levels. As a result, the number of kindergartens has decreased by 30%, and primary schools by 15%. At present, official estimates suggest that resources available to schools are sufficient to cover only 2/3 of minimum standards, and kindergartens' only 3/4. Only 6% of the total budget is allocated to material inputs (equipment procurement, educational materials, etc.). With inadequate finance and inefficient allocation, the problems accumulated in the educational sector are unlikely to be resolved.

The lack of budgetary resources suggests the need to diversify the sources of educational funding. Public funds could be allocated to basic education, such as child care in kindergartens and creches, mandatory primary education, and some fields of vocational training. In the short-term, while household burden of structural adjustments remains high, the government will have to cover the biggest part of educational finance. At the moment, the share of private finance does not exceed 5% of the total educational expenditures. In the medium and long-term, as the economy recovers, the share of non-state financing will increase, relieving budgetary burden of education. Private financing could also boost the efficiency of education, spurring accountability for quality. However, it is important that the government accepts the responsibility to provide guarantees for equitable access to high-quality educational services.



Adjustment of the curricula to market requirements will require both the introduction of new techniques and their application to a new set of problems. Curricula renewal should include courses important in the market economy, such as market economics, accounting, business studies, commercial law, marketing, etc. It is also

necessary to publish new manuals and books. Reform should encourage the development of educational materials by the publishing industry on a competitive basis. This would be furthered by a change in the selection process for educational material (a monopoly is still held by the state) towards a more pluralistic model (with choices being made by teachers, students and government representatives).

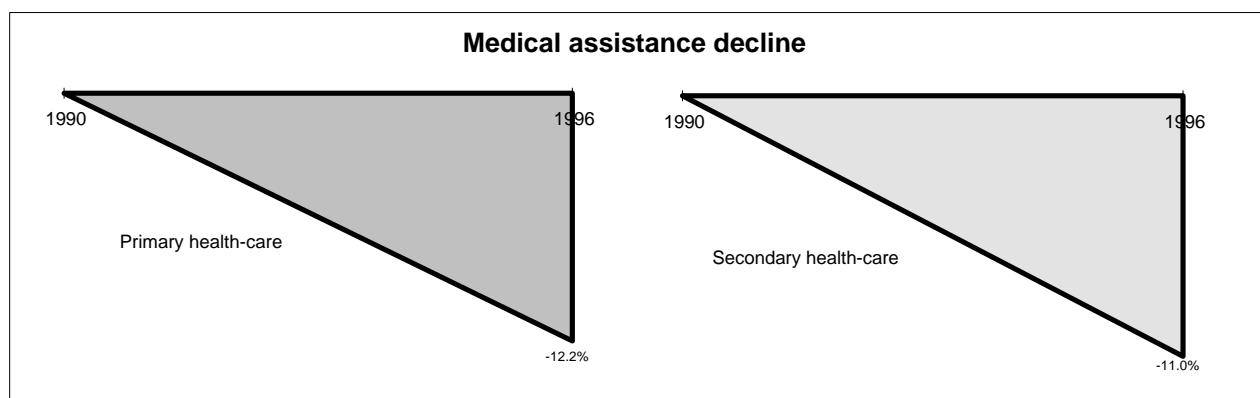
Creating a new educational service is a complex process, requiring decentralization to make education more receptive to local needs; introduction of new delivery models by attracting private resources to promote competition and efficiency; and diversification of educational practices to create more individual choice. These initiatives require an essential remodeling of the role played by government, to establish a new framework covering sources of financing, licensing of private institutions, and monitoring the quality of the educational services provided.

**Medical services.** Health is a crucial component of human resource development. It strongly influences physical and mental capacities, living standards and work productivity.

Four major factors have had a negative impact on human health during the period of transition: the decline in household income; changes in life style; job insecurity; and changes in the quality of medical services.

The drop in real income along with life style deterioration has had the worst impact on health, because of deterioration in nutrition, which is becoming a chronic phenomenon, assessed by specialists as resulting in the spread of actual malnutrition. The average daily calorific consumed has decreased by 30% during the last four years period, and is currently estimated as 2127 kcal. At the same time, the average alcohol consumption, smoking (especially among school children and girls) and obesity have substantially increased. Environmental pollution, specifically affecting drinking water quality and soil pollution, have also had a negative impact on health. The combination of these factors has led to an increase of one third in mortality rates due to cardiovascular, digestive and nervous systems diseases.

The quality of medical service provision has declined sharply as a result of budgetary constraints. The lack of modern medical equipment, rudimentary medical materials and medicines have substantially reduced efficiency of the services provided. For this reason, and because of the high price of medicines, it has been estimated that the volume of primary and secondary health-care provided has declined by 12%.



**Strategic opportunities.** The main objective of reform should be to improve health of the population under the likely tight budgetary constraints. This will require the more effective use of existing assets in the medical field, the adjustment of the medical services mix, and diversification of financing sources. During the transformation, it is important that government should assure equitable access to medical services, and promote cost-effective health protection measures (the promotion of healthy life styles, mass disease screening, etc.)

Reorganization of the medical services will have to be a major preoccupation.. There is a need to adjust the quantity, quality, and structure of the medical services delivered. Emphasis should be placed on strengthening primary medical care, including infectious diseases control and early diagnosis of disease. Especially important is the need to improve primary health care provided to women, particular to expectant mothers.. Strengthening the primary health care services represent an effective way both to improve general standards of health and to reduce the cost of curative service.

Improvements in the quality of the secondary health care services (outpatient and inpatient services) will require radical modifications of hospital finance and the system of medical

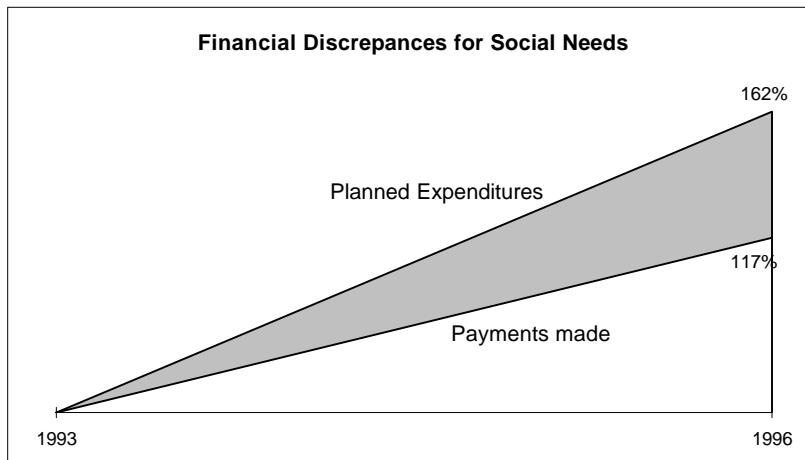
personnel remuneration. The rigid budgetary system neither gives managers freedom, nor incentives for using resources more efficiently. The basis for financing should be shifted from inputs (number of beds or patients) to output performance (performance of recovery, the number of treated patients, etc.).

Reorganization of financing of medical assistance is perhaps the most thorny and controversial issue to be addressed. How can requirements of financing and of equitable and efficient medical services delivery be reconciled? Several options exist, including various methods for the introduction of compulsory medical insurance and the privatization of health services. In case of Moldova no single solution alone will suffice. What is required is a combination of public finance; medical insurance, fees-for-service, and private delivery of some health services.

The government should set minimum standards for medical services and assure equitable access. Private health service delivery could provide services in excess of the minimum assured by the government. Public finance target levels for the proportion of GDP to be allocated to public health service should be set, geared to the achievement of minimum medical standards.

To simplify financial administration, it will make sense to separate the finance of primary and secondary health-care and shift resource allocation towards the primary health-care services. At present, 80% of finances are directed to hospitals, and only 20% to polyclinics. In the short-term, this proportion might be shifted to: 60% for hospitals, and 40% for polyclinics. Another priority is the need to improve expenditure allocation. At this point, only 15% of the budgetary allocations go to provide medical equipment, medicines, and procurement of other medical material; this proportion should be substantially increased.

***The social protection system and social transfers network reform.*** Through social protection, the government strives to reduce social risks and the burden of unemployment, disability, old age, death, etc. Success depends on a number of factors, particularly the economic situation; and the number of those needing social support. The current situation is complicated by the rudimentary approaches inherited from the former regime, which operated with a rigid centralized structure and inefficient management. Seeking to cover as many types of social need as possible, social protection has grown to enormous levels of commitment, while lacking the necessary financial means.



During recent years the discrepancy between commitments and available resources has grown and currently amounts to about one third of the commitment level. As a result, social benefits actually received have decreased dramatically, at the moment covering only 20% of the consumption budget "norm". At the same

time, burden of social costs (about 10% of GDP) leads enterprises to avoid paying social taxes, thus increasing the deficit in pension and other social payments funds. At the beginning of 1997,

Social Fund accounts payable (i.e. delayed payments) amounted to 404.1M, thus exceeding by 9.5 times figures for 1995.

Social transfers involve the most complex and controversial aspects of the social protection system, involving massive incoherence, perverse selection of those eligible, and large dispersion in sources of benefit.. The same person can simultaneously receive several types of social payments. "Ghost" recipients became a regular phenomenon. Studies have estimated that at least 20% of all social payments are not justified (in Russia this index is 35%). The transfers problem is also difficult because of the social assets that are still on the enterprises balance sheet (dormitories, resort centers, healthcare facilities, kindergartens, etc.). Their value is estimated as 2.5-3% of GDP (in Russia – 3.5%; Ukraine – 4.6%). Social benefits provided to enterprise employees constitute about 10% of their wage bill.. Administration of social assets by enterprises can reduce labor mobility and worsen the inconsistency of the pattern of social transfers.

*Strategic opportunities.* Social system reform should seek to strengthen the capacity to protect social benefits under serious financial constraints. Reorganization of the system of contributions and benefits, a key element in establishing of a new social protection system, will tend to be painful. Measures to be undertaken are likely to be severe and, therefore, unpopular, and will effect both the younger generation and beneficiaries. The government responsibility should be to spread costs of reform as equitably as possible among the economically active and non-active population, to maintain social peace and stability.

***Reform will affect all components of social protection network: pensions, social security, social assistance, and social transfers.*** The major purpose will be to reduce social expenditures through more efficient financial management and tightening eligibility conditions.

***Pensions:*** in the short-run, urgent actions could include the following measures:

- elimination of delays in payment by tightening finance discipline and partially paying pensions in kind;
- provision for regular current payments to pensioners and other social recipients;
- revision of the eligibility conditions for privileged pensions;
- reduction of overheads, including increasing the degree of decentralization in pension management;
- rationalizing the structure of social expenditures through ongoing monitoring.

Long-term actions could focus on:

- gradually raising the pension age;
- implementation of a pension system with three components: state pensions, or pay-as-you-go (which cover the minimum level); private pensions (under compulsory insurance), and complementary pensions (under optional insurance);
- putting into practice personal accounting of social contributions;
- investing accumulated pension funds.

***Social assistance*** reform should include actions directed toward reduction of the subsidies for public utilities. There are 27 categories of people (522 thousands) that benefit from several sorts of subsidies for energy, heat and gas consumption, with an annual cost of almost 110 mln.lei. Reforms should aim to reduce substantially both value of the subsidy provided and the number of recipients. For this purpose, an analysis of social transfers is needed to assess needs and to set requirements. In the future supplying the social transfers should be made on means-testing base and targeting approach.

In relation to the *social assets of enterprises*, the strategic option is to remove functions that are not intrinsic to the enterprise function. This could involve some combination of transferring enterprises social assets to local public administration; privatization of social assets ; leasing to specialized institutions; and corporate management of social assets (in concert with external partners).

***There have been high social costs of transition, and the burden will grow in the future with deepening structural adjustment and enterprises restructuring. The current capacity of the social protection network is not able to cover the risks faced by the population. Undoubtedly, comprehensive reform in the social sphere is required. An important component of social reform should be to help people to help themselves.***

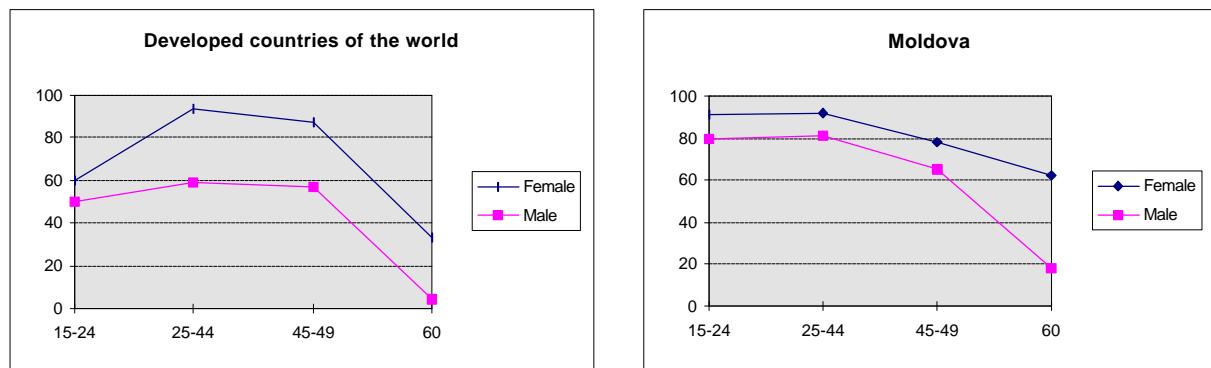
### **3.8 Gender in development<sup>7</sup>**

Gender in development is one of the most important social and economic problems of the country. Crisis in economy, collapse of the system of social protection of population had a negative impact on situation of women. New unsolved problems have added to the old ones.

***First of all, the problem of employment has deepened.***

In Moldova at the beginning of 90s the level of women' work activity has approached the work activity of men, and was higher than in developed countries of the world.

According to the 1989 population census women accounted for 52% of the total population, and the level of their work activity among employable women was 84.7% (level of work activity of men was 86.8%). Percentage of women in total employed in national economy was 51.1%, and



in 1995 – 45.5%.

Implication of women in remunerated work needed respective education level, which for women of Moldova became actually the same as for men, and was higher than the average world figure – about 8.5 years. Among workers with high and medium-specialized education percentage of women was 59%.

At the same time, because of underdeveloped sphere of services in the country, women along with remunerated work (40 hours per week) continued to perform a considerable amount of non-paid work at home. Thus, a double employment emerged, but larger than in countries with

<sup>7</sup> Chapter written by Prof. Nadejda <sup>a</sup>i<sup>o</sup>can

developed economy: Moldova – 72.2 hours per week, USA – 56.6, Canada – 46.4, France – 64.4, Germany – 57.5).

Negative aspects of employment: non-equal position of men and women in professional and qualification respect – average job evaluation of women is 1.5-2 categories less than of men, percentage of women among workers of 1<sup>st</sup>-2<sup>nd</sup> categories is 60-70%, but among 5<sup>th</sup>-6<sup>th</sup> categories is 10-15%; and ¾ out of non-having categories workers – are women. In agriculture percentage of women among workers having categories is 3 times less than of men. The salary of women is at an average of 70-80% out of salary of men.

Transition to the market, crisis of economy generated the **problem of unemployment**, which has affected mainly women: in 1992 total unemployment was 15.0 thousand, out of which – 60.6% women, and in 1996 it was 23.4 thousand, out of which – 68% women.

While hidden unemployment accounts for more than 250-300 thousand people (11.5% of employed), the number of unemployed women is more than 200 thousand. One of the features of women unemployment – is work as “shuttles” (i.e. people buying bulks of goods abroad and selling on domestic market and vice-versa), trading on streets, prostitutes. And as a consequence of worsening of material position and subsistence level, since 1990 the morbidity of women had a sharp increase, especially for syphilis illness (8 times).

**A new direction of employment – participation of women in entrepreneurial activities** is a chance to demonstrate their managerial capabilities, preserve social partnership with men, it is an alternative to the low-paid work in state sector. The possibility for women to take part in entrepreneurial activities is determined by a fairly high level of women education, but the starting positions for them are worse – men have gained more from voucher privatization (working standing); women have less savings. The number of women having deposit accounts opened with banks is 2 times smaller than of men. Among entrepreneurs which received loans, women are 20%. So far, the percentage of women among entrepreneurs is less than 10%.

Priority directions for entrepreneurial activities are: managers, accounting, auditing, economic education. Help is need from the state in preparing staff.

It looks like a paradox, but with the advent of democracy it was a decrease in participation of women in state decision-making, including the Parliament – from 35% in 1995, to 5% in 1996, while in a number of European countries this figure is up to 30%.

By contrary, in context of political instability the necessity of women to take part in all level decision-making is amplifying. Men introduce a spirit of competition in management, women – are a source of succession and stability in collective and in society.

The situation of women was also influenced by a sharp polarization of society by income, emergence of distress. Collapse of social protection system, system of medicine institutions and institutions for children, as well as of free and preferential sanatoriums, is amplifying the **problem of poverty** and misery, which is first of all developing mainly as a women and children problem. Poverty has aggravated the problems of maternity and childhood. In the period of 1990-1995 birthrate at 1000 people has decreased from 17.7 to 13 persons, natural accession of population – from 8.0 to 0.8. At the same time, it was a considerable increase in infantile mortality – from 19.0 to 21.2, below 5 years – from 25.2 to 27.4. Children’ health has worsened with regards to all main types of diseases. So, in Moldova during transition period there was a deepening of old problems of women’ situation, and new problems arose, which need to be solved.

Strategy of social and economic development of the country can not be conceived without the system of social protection of women. For its elaboration there is a need in:

- improvement of statistics – of remunerated and non-remunerated work; situation of health and education by gender and age; degree of participation of women in all level decision-making;
- modification of work organization taking into consideration different functions, performed by women, realization of educational and training programs, insurance of participation of women in reforming social system;
- establishment of a division for complex gender research (sociologists, economists, lawyers, specialists in demography, doctors of medicine).

Problems of transition period can be solved in a more constructive way with the participation of women as a active partner, insuring social equity of genders. It should be taken into account here that if work of women in production of material goods and services is regulated by market laws (demand, offer, competition), than their activity in the field of motherhood and education of children – is a function of family and society, which assumes maintenance and perfection of state system of social protection of maternity and childhood.

### **3.9 Environment<sup>8</sup>**

The strategy of sustainable development of the Republic of Moldova for the period 1998-2000/2001-2005 should contain, as one of main elements, a rational organization of natural resources utilization and environmental protection.

***Acuity of nature employment*** in Moldova is determined by: high density of economic activity and of population; key position of land and water resources within the ecological and economic complex of the country; lack of operated reserves of mineral energy resources; high degree of soil erosion and pollution of water resources; limited areas of recreation zones; dispersion (departmentalization) of the system of state governing bodies in the field of nature employment (land, water resources, mineral resources, environment).

***Land and soil resources*** (about 80% is black earth, i.e. high fertility soils) ensure a rich biological and economical potential of the agrarian and industrial complex, which gives about 70% of GDP.

Threat is in the following: agricultural exploitation of the territory exceeded 75%, and ploughing – 70%. Big inequality of relief and heavy fall of summer rains condition a high level of erosion danger for plantations – an average of 59% of the total area of plantations are situated on biases with different abruptness, and in some areas this indicator reaches 95%. About 840 thousand hectares of plantations (almost 33%), including 2/3 tilths, are at different degrees eroded. During last 20 years area of eroded land has grown by 246 thousand hectares, and wastage of humus increased by 25-40%. More than 350 thousand hectares of planted areas with a high and average degree of land erosion, which have decrease in productivity by 40-60% – need an enhanced protection from wash out, or alternatively – need to be taken out of intensive utilization.

Estimations show, that economic detriment from loss of productivity of soils is about 225-275 million lei each year, or more than 3% of GDP.

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<sup>8</sup> Chapter written by Victor Zubarev.

For a sustainable development of the country it is necessary to have the share of “ecological frame” not less than 30% of its territory. In Moldova level of land utilization in agriculture accounts for 75% of its territory, another 7% belongs to roads, streets, courtyards and constructions. Thus, “ecological frame” has utmost 18%. At recommended protection of ploughs with 4% forests stripes, in fact share of these stripes was 1.7% of ploughs. Soils are exposed also to other types of degradation: there is exacerbating dehumusation (0.5-1 t/ha per year), negative balance of NPK (nitrogen-phosphorus-potassium) is growing, biological components are degrading. Active landslides affect 26 thousand hectares or about 1% of total area of plantations, and in some areas (Călăraº, Nisporeni) degree of affection by active landslides reached 10-10.5%.

In general, regime of land utilization can be characterized as maximized, extensive by sense. Due to slow regenerative activity of soils and high erosion danger in agriculture, soil resources of Moldova can be classified today as unrecoverable.

**Water resources** of the 2 main rivers Nistru and Prut, which the country can actually use, taking into account their division between Romania and Ukraine, in an year with shortage of water account for 3.9 and 1.1 km<sup>3</sup> respectively, and in an year with a dramatic shortage of water – 2.7 and 0.9 km<sup>3</sup> respectively. Out of them, can be used for economic purposes 3.3 km<sup>3</sup> in an year with shortage of water, 1.8 km<sup>3</sup> in an year with dramatic shortage of water. Respectively within the territory of the country (local debit) only 0.65 km<sup>3</sup> and 0.31 km<sup>3</sup> of water is available. According to observations during 100 years, droughts in North and Central areas of the republic take place once in 3 years, and in South areas – once in 2 years,

In the territory of Moldova water supply is not uniform: from North to South the average ratio of surface channeling is decreasing 3 times. Water consumption is about 2.6-3 km<sup>3</sup>, including 1.5-2 km<sup>3</sup> used for cooling the aggregates of Moldovan GRES (hydroelectrical power station). From the total volume of water consumption (without Moldovan GRES) more than 60% is used for agricultural purposes (including irrigation), 10% – for industrial purposes, and about 30% – for households; needs.

A problem, having a social character, is providing population with potable water. At an average for the country level of water consumption equal to 163 liters per capita in 24h, in some districts this indicator is only 10-20 liters. Estimated stocks of subterranean potable water are 2.52M m<sup>3</sup> per day, and 30% out of them correspond to the “Potable Water” standard, while the basic volume of water has an increased mineralization, high composition of nitrates, and other adverse components. Therefore, in the field of water provisioning a double problem should be solved: utmost economy of water resources and efficient management of their reproduction and preservation.

**Forests** occupy an area of 317.6 thousand hectares, and they perform only soil protection, water protection and recreational functions. Forests’ coverage of the territory makes 9.4%, but it is very non-uniform: from 1.5-3% in some districts of the North and South area, up to 23-28% in Central area – so called Codrii. Forests represent 800 isolated plots and only an insignificant part are large massifs. Due to the ecological dependence, Moldovan forests can not be examined as a raw materials base for the development of related industries, as well as a component of country’s energetic balance.

**Minerals’ base** of the country represent non-ore mineral resources, which are sufficient for providing the country’s needs in construction materials. There were discovered and registered 377 fields of non-iron raw materials, out of which 122 fields are exploited. In prospective the export of cement and gyps production should be extended, fields of bentonites, diatomites,

limestones and others should be included in exploitation, and this would let to compensate import of materials, and extend export. Research and exploration works on hydrocarbon raw materials performed in 50s in the South area (Comrat-Vulcănești), were stopped in 1972 after discovering small fields of oil, gas and brown coal. Today they are re-launched – a considerable geophysical work should be done at a depth of 4-5 km, and this demands high expenditures. A concessional agreement with “Redeco” company (USA) is realized regarding exploration works and digging of hydrocarbon raw materials, based on dividing the final production.

***State of air pollution.*** Elimination of polluting substances from stationary sources in 1996 was 36.7 thousand tons (data without Transnistria) and has decreased by 46% comparing to 1991. At the same time, mobile sources in 1996 have eliminated more than 250 thousand tons, or by 20% more than 5 years ago. While before the share of mobile sources in total elimination of polluting substances was about 50%, today it reaches 90%. In cities, according to Ministry of Health data, exceeding of maximum concentrations of CO in air was more than 29% of cases, of dust – in 20% of cases, of nitrogen oxides – in 6.4% of cases, SO<sub>2</sub> – in 4.7% of cases.

A serious source of pollution is transit of contaminating substances by air. The republic is situated on the way of circulation of air masses from Atlantic Ocean, which are passing through the highly-industrialized Europe, and cause serious soil pollution (because of this, 20-50% of critical for our country pollution substances drop into the soil). Mostly this phenomena is observed in the North of our republic.

Consideration of ecological factor for the purpose of ensuring a sustainable development of the country in nearest prospective assume:

- strengthening the role of state in managing the natural resources potential by means of legal norms and ecologization of economic mechanism;
- decrease of energy and resource needs of production, enacting a system of mandatory certification of production according to ecological demands;
- transition to a more efficient utilization of natural resources, used in economic circle, further directing a part of funds towards recuperation and protection of natural resources.

Moldova should extend participation in international cooperation in the area of environment protection of the South-Eastern part of Europe, realization of joint ecological projects with Romania and Ukraine.

### ***3.10 Regional aspects of the country's development***

On joining the Council of Europe (July, 1995), Moldova has undertaken a number of new obligations, including ratification of the European Charter on Local Self-Administration, Charter of Regional Languages and Languages of Minorities. Under the aegis of Council of Europe operates a specialized structure – Congress of Local and Territorial Agencies. Only after two years, on July 16, 1997 Parliament of Moldova finally ratified with 66 votes pro, Charter of Local Self Administration. Now, according to the Charter's principles, the national legislation should be updated, including laws: “On Territorial-Administrative organization”, “On Local Public self Administration”, “On Elections for Local Public Administration Bodies”.

Today Europe operates in a new legal, political and social-economic reality – “***regionalism***”, which is expressed in increasing the rights and responsibility of regions within specific countries (Germany, Spain, Austria etc.), in amplification of interstate contacts on the principle “region-region”. In this context the main issues are: (i) how to distribute authorities between central and regional levels with maximum benefits both for the country and for the region; (ii) how to do this in such a way, so that the process of decentralization would not destroy the country.

In the Republic of Moldova historically due to peculiarities of nature and demography, economic structure, system of localities, from old times there appeared 4 integral economic sub-regions<sup>9</sup>: North, Central (Codrii), South-Eastern (Transnistria) and South. Two of them – Transnistria and South sub-region (making 1/3 of the territory and more than 40% of GDP of the country), from the beginning of 90s due to external non-economic, political reasons became ***problematic regions*** of the country.

Because of the armed conflict in Transnistria and emerged tension in the South (1991-1992) the unity of territorial and economic complex of Moldova was broken. The creation of the new administrative-territory formation Gagauz-Yeri (1995) partially waived out political tension in the South, however the problems of economic and financial inter-relations “center-territory” remained unsolved for this and other regions.

The only way to solve these problems – is ***local self-administration on a new economic basis***. Regretfully, acting legislation, including the Law “On Basis of Local Self-Administration” (1991) does not provide clear norms of organization efficient interaction of state government bodies in the direction “center-region”, mechanisms of creation a financial-economic basis for local self-administration, establishment of municipal property, budget federalization, creation of a stable income basis of local budgets. Moreover, instead of decentralization of the state budget, in 90s Moldova has gone backward, having put almost all cities and districts on grants and subventions.

Of course, this can be explained as a result of budget crisis, but objectively such a practice, on the one hand bereaves the local public administration bodies from being interested in a concrete work with economic agents, and on the other hand – pushes them into the shadow economy, barter, concealment of income and tax evasion.

Strategic importance of regionalism is in the fact, that the vital activity of any state in all its aspects takes place just in the territories – in districts, cities, where there are economic agents, households, production and social infrastructure, natural resources. And on how fast we could set up legal and economic conditions for a initiative and productive activity of local bodies, greatly depends the success of reforms and revival of economy in general.

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<sup>9</sup> See L. Berg “Basarabia. Country, people, economy”, St. Petersburg, 1918; “Enciclopedia României”, vol. 3, Bucharest 1939;  
A. Gudym and others, “Economic sub-regions of Moldova”, Chișinău, 1973.

***Priority tasks of the regional policy are:***

- finalizing establishment of a legal basis, ensuring augmentation of local self-administration, as well as ratification by Parliament of the European Charter on Local Self-Administration (Strasbourg, 1967);
- strengthening financial independence of regions on the basis of principles of budget federalism;
- utilization of advantages of free economic zones, technological parks, facilities of on-border trade for creating “growth points” in specific regions and cities;
- implementing measures of state support for areas of calamities, technological and ecological catastrophes.

Existing unjustified tiny administrative-territorial division of the Republic of Moldova (40 districts), their small demographic and economic potential are undoubtedly a barrier on the way to regional self-management. In 1989-90 there was done a scientific-methodical argumentation of the necessity to enlarge the administrative division of Moldova (State Institute of Planning – A. Gudym, V. Chișan, P. Averbuh and others) and taking into account all aspects there were proposed 4 variants: 18, 12, 9 or 7 districts.

Draft of ***administrative-territory reform*** submitted by the Government to the Parliament (June 1997) provides for dividing the country into 8 districts: Edineț, Bălți, Soroca, Ungheni, Orhei, Hîncești, Căușeni, Cahul, 2 autonomies – Gagauz-Yeri and Transnistria and Chișinău municipality. It is supposed, that on this very basis there will be ensured a combination of all types of stability – political, economic, inter-ethnic and national, and there will be created conditions for a sustainable development of the country, as the main conditions for integration in Europe.

## SECTION 4. STRATEGIC PRIORITIES FOR DEVELOPMENT

The transition of Moldova, hopefully, till year 2000, through the most piercing phase of the transformational crisis and step-by-step integration of the country into the European structures (Council of Europe, regional cooperation within the framework of Central and South-Eastern Europe, temporary agreement with the European Union) determine the necessity of extending forecast horizon and examination of several scenarios for the future.

Due to the fact, that social-economic processes in Moldova, as well as in other countries with economies in transition, are considerably determined by political processes, choosing one or another scenario should *implicitly* guarantee the preservation of sovereignty of the Republic of Moldova, democratic character and territorial integrity of the state, not to allow serious political shocks.

Analysis of pre-electoral positions of those parties and blocks, which really influence, and will have the chance further to influence on setting up the policy of Moldova, give the possibility to assess some “political corridor” of economic solutions, which limit the diversity of scenarios to only three:

- (i) pro-East – maintenance and strengthening of the current Moldova’s status within the ***CIS Economic Union***, on its legal basis, with delivery of the main part of Moldova’s production to the Eastern market, along with improvement of traditional links regarding energy resources and raw materials (metal, chemical products, wood, cotton), and development of new organizational forms of businesses – joint ventures, finance-industrial groups, clearing centers etc. acting as a kind of “gates” of CIS for countries of South-East Europe and Mediterranean countries (Italy, Spain, Malta);
- (ii) together with Romania – a more dynamic cooperation towards the level of ***economic integration of Moldova and Romania***, making use of advantages of territorial affinity, available production capacities (processing of oil, cotton, ports on Danube and Black Sea), frontier economic zones, joint economic actions in Balkan region;
- (iii) European – ***integration*** of the Republic of Moldova ***into the European Union*** (temporary agreement about cooperation was concluded in 1994) firstly during 5-7 years as an associated member, and afterwards – full member, complying with all conditions set in the “White Charter of European Union” (legislation, standards in the fields of finances, industrial and agrarian policy, trade, customs, statistics etc.)

Timing till the day “X”, when Moldova will have to take a responsible decision – CIS? European Union? Something between? – shall be determined not only by the orientation of political forces, but, mainly, by the results of social-economic reforms and capacity of the state. However, the probability, that such a decision will be adopted within the forecasted prospective till 2005 – is quite high.

## **4.1 Architecture of Europe of the XXIst century and Moldova**

In the new architecture of Europe, set up under the influence of centripetal forces of the geopolitics and economic integration of the “old continent”, the situation of the Republic of Moldova is determined on the one hand by a geographical factor – it is situated on the crossroads of Balkans, Central Europe and CIS, and on the other hand – by realities of the status of a small country. In Europe there are more than 20 small countries, and Moldova is one of them.

According to the new map of Europe’ regionalization there is a ***South-Eastern sub-region of the Central Europe***, with 9 countries: Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Yugoslavia, Macedonia, Moldova, Romania, Slovenia. Their common features include not only historical background, but also similar problems of state becoming and statehood, transition towards market economy, vital importance of agro-industrial complex restructuring as dominant factors in the structure of economy, development of production infrastructure – energy, roads, transportation and telecommunications. It should be noted that in 1997 the World Bank has set up a new group of countries (headquarters in Budapest) for coordinating its activity in Central Europe: Czech Republic, Hungary, Moldova, Slovakia, Slovenia, taking Moldova out of CIS countries group.

In entering Europe the above mentioned 9 countries in many respects are competitors – foodstuffs, textiles, tourism, cheap labor force. This also applies to regional association of countries of the Black Sea Basin.

Taking into account the general European geo-political situation of Moldova, as well because it is “sandwiched” between Ukraine and Romania, having big production capacity and roomy internal market, the ***most attractive for Moldova is realization of “small country model” – open to the world, politically stable, attracting foreign investors and residents with facilities in registration and operation, banking, customs, transit transportation and other servicing***. And it’s quite important here also the linguistic factor – Moldova as the most Eastern Romanic country in Europe, has old traditions among countries emerged after the broke-up of USSR. Efficiency of the “small country model” is shown by Ireland, Benelux countries, and from newly emerged countries – Slovenia.

Thus, the main task of the President, Parliament and Government should become permanent exercising of political and economic actions, for the purpose of showing their adherence towards transforming Moldova into an isle of political stability and economic wealth in the region, where interests of many international structures and countries converge.

## **4.2 Strategic goal and priorities**

Long-term strategy for development of the Republic of Moldova is determined by vitally important for the country ***interests***, which in concrete conditions of the end of 90s appear first of all as a necessity to overcome the multilateral crisis in the country, maintain sufficient indices of people’ wealth, stabilization of state governing bodies, guaranteeing supremacy of law, protection of property rights and liberties of citizen, reconstruction of territorial integrity of the country, preservation of national and cultural identity, development of creative potential, occupying a decent place among countries of Europe and of the whole world.

**General strategic goal** of the social and economic development of Moldova is to increase people's wealth on the basis of a social oriented market economy. This goal according to modern European standards can be attained by creating an efficient economic system, generating people's initiative and stimuli for highly-productive work, and being receptive to scientific and technical progress and ecological issues, while taking and implementing decisions.

Herewith are compulsory the ***principles of sustainable development***, recommended by UNO ("Agenda for the XXIst Century", Rio-de-Janeiro, 1992) to all countries as leading principles for elaborating national strategies: perception of limited natural resources potential for economic growth, as well as of upcoming danger of irreversible negative changes in environment; utilization of energy- and material-saving technologies; preservation of biological diversity and balance of natural systems for the purpose of satisfying the necessities of present and future generations.

Such a conceptual vision of the prospective should become a specific ideology, which would unite all layers of the society, parties and movements, with a civilized regulating performed by state. Its realization is a complex political, economic and social psychological task, oriented towards supporting the most important spheres of the households' living – production, education, health care, science and culture, – ensuring in complex preservation and multiplying of nation's genetic fund, without which the progress of our society and state is impossible.

Realization of the strategic goal of economic and social development of Moldova is a long-term, evolutionary process. In current non-stable situation, crisis in production and in society, unreliable long-term forecasting, the mostly advisable is a variant of ***middle-term strategy till 2005***, consisting of two stages.

***First stage***, for the period 1998-2000 coincides with remaining 3 years of activity of the acting President. His constructive cooperation with the Parliament and Government, established after elections (February 1998), should ensure the cut off of the decline in production on the basis of restructuring and its revival, stabilization of population level of living, finalizing the creation of the legal basis and economic mechanisms for the main directions of reform, including the financial sector, industry, agriculture, energy sector and social sphere.

Qualitative reference points of the ***second stage*** (2001-2005) – represent transition towards a sustainable development of production and social processes within an ideology of socially oriented market economy, set in the Constitution of the Republic of Moldova (1994).

It is important to see, that according to the experience of other European countries (Germany, Scandinavian etc.) the model of social market economy was based on market self-regulation, is also realized under an active role of state as a proof-reader of production and social order. Main instruments of governance – legal norms and institutions, created by state. In this case actions of state should be aimed at the same fields and indicators of the market, on which economic agents are orienting, while adopting decisions: monetary and credit policy, fiscal policy, foreign economic policy, rules of competition, investment policy, legal contracting basis etc. State also carries out the obligation to act in extreme situations (in production, consumption, in case of natural disasters). Social compensations presume management of income through the policy on pensions, social indemnities, family support, encouragement of savings.

***Short-term priorities***, for the nearest period derive from complicated realities of current social-economic situation in Moldova and according to commonly used practice are unified under the

term “urgent measures”. They are exposed in the decrees of the President P. Lucinschi (beginning with Decree No. 10-II as of 22 January 1997) and in the I. Ciubuc Government’s program of activity for the period till March 1998.

Primary objectives for diminishing tension in the society are: increasing financial discipline of enterprises aiming at a better tax collection – funds for social needs; effecting current payments and reducing pension arrears and arrears on salaries for budget sphere employees; fighting organized crime and corruption of state apparatus. Along with this, in ordinary “hot regime” current problems of country’s provisioning with foodstuffs (spring works, harvesting, provisioning for public needs) and energy resources are solved.

**Strategic priorities**, penetrating all period till year 2005 are oriented towards solving deep, key problems with a cumulative effect for the country’s social-economic development:

- (i) **maintenance of macrostability** as a necessary condition for economic growth (inflation rate not exceeding 5-8% per year, budget deficit at the end of period – 2%);
- (ii) **stimulation of growth** by methods of financial policy and organizational-economic actions of the state in the **sector of real economy** (enterprise and branches restructuring; new industrial policy; agrarian reform; reducing energy capacity of economy on the basis of demonopolization of energy sector and rationalization of energy consumption; state support of entrepreneurship);
- (iii) ensuring the level of savings in economy up to 20-25% of GDP and creation of conditions for **transformation** of households’ and private sector’s **savings into investments**; to bring the inflow of foreign investments to US\$ 700M in year 2000, with a further doubling of their amount at the end of period;
- (iv) stimulation of **export promotion** on the basis of increasing competition of the local production, search for own niches in foreign market;
- (v) **ecologization** of production and society;
- (vi) **social sphere reform**, with a specific stress on education and health care, support of low-income layers of population;
- (vii) **state governance reform** (of the organization structure and functions of central bodies, transition towards European standards of local self-administration).

External conditions, necessary for realization of the indicated priorities, should be created by an efficient cooperation of Moldova with European and regional structures (CEI, SECI, BSEC), interaction with international finance organizations, and within the country – by a social partnership of Government, trade-unions, patronat and political parties.

In the transition period an active role of state as an initiator and subject of reforms is strategically important, and also state is responsible for their orientation and implementation. Its key, initiative function – is legislation. Delay in adopting necessary laws, their adoption in the form of untoward compromises, or non-execution of laws is equal to destroying the state, lagging the process of production stagnation and deepening the social crisis.

### **4.3 Scenarios for the nearest prospective**

In short period of time – only in six-seven years – Moldova moved from monostructure (state-socialist) economy to a multistructure, mixed economy. This process is irreversible and one could predict with a quite high probability that the social-economic evolution of the country in the prospective till year 2005 will take place within a mixed economy having three main trends: increasing efficiency of functioning of each structure in its own niche, and without this it is impossible to overcome the crisis and to start the growth; liquidation of hypertrophy shadow economy (it accounts for almost 40% of GDP comparing to 5-10% in the EU countries and about 30% – in Latin America countries) and its “enforcement into legislation”; returning back, but now on a market basis, to guaranteeing the constitutional rights of the citizens in the areas of employment, education, health care, culture, social protection.

One could expect, that already by year 2000 private sector would become the leading, and by 2005 – the main one, accounting for more than 80% of employed. Share of state sector according to the 3<sup>rd</sup> privatization program will be decreasing further on, but with a slower pace comparing to 1994-1997. State will continue to keep a number of key positions in the economy in the form of monopoly or controlling package of shares – production of alcohol, tobacco products, railway transport, fundamental science institutions, medicine, education, culture. Under favorable for foreign investors conditions, share of joint ventures could grow up to 10-12% of GDP by year 2005.

Scenarios the forecasted period are already determined utmost by three parameters.

**Demographic situation** according to forecasts till year 2010 will be expressed in reducing the number of country's population. Natality has decreased dramatically from 10.9% in 1985 to 0.5% in 1996, inclusively in rural areas (54% of population) – to 0.4%. But this is just a part of the problem. The point is, that share of economically active population in the following 5-7 years will decrease too, accounting in 1989 – 54% and in 1996 – 46.7% of the total population. At the same time, the outflow of migrants going to work abroad (Russia, Germany, Greece etc.) is increasing (in 1996 – about 100 thousand people). Consequently, due to all these processes, social tension on one employee is increasing, and this generates not only the need in pension and health care reforms, but also radical changes in the production sphere, seeking a 3-5% GDP growth rate per year in order to avoid a catastrophic decline of level of living.

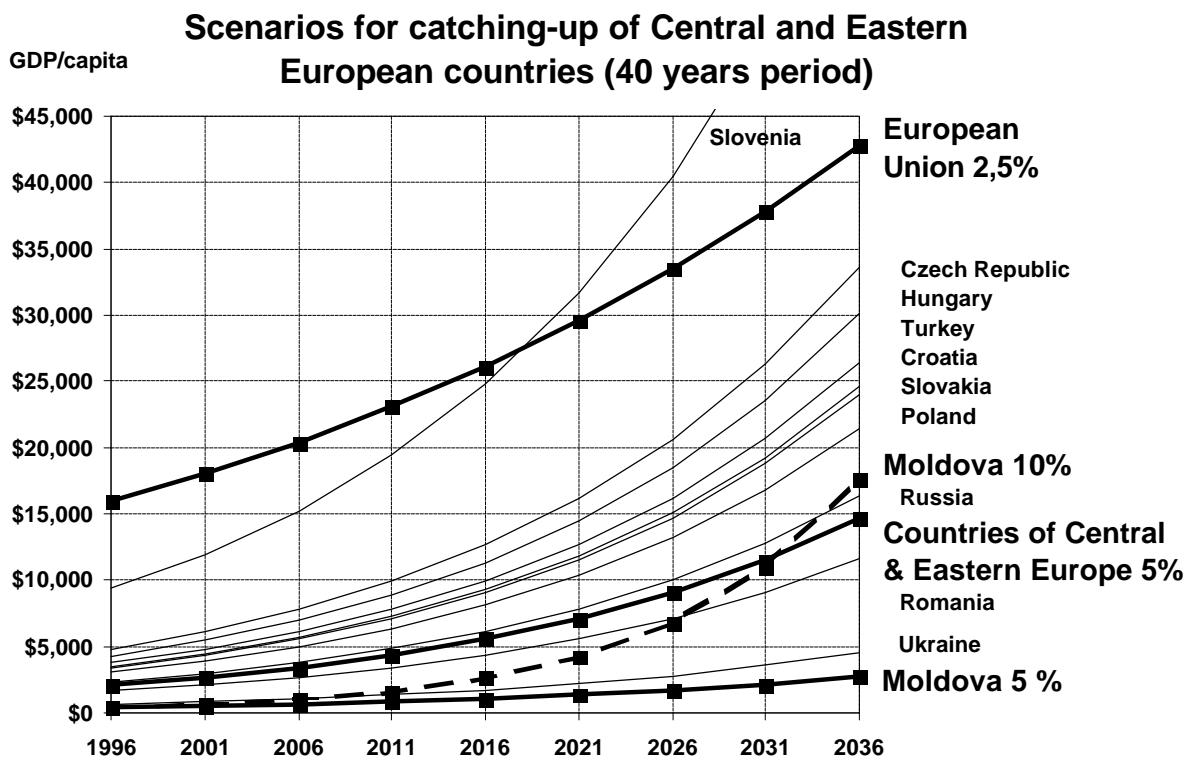
**Situation of the main funds**, main capital of the country – is the second dominant. In 90s, due to the decline in investment activity, these funds got out-of-date physically and morally, and at a number of enterprises – were destroyed. Volume of investments (1990=100%) in 1996 has decreased to 13% and was directed mainly towards infrastructure (gas pipelines, roads etc.), houses and sphere of services. In the structure of introduced main funds, the state' share decreased from 66% in 1990 to 34% in 1996, and share of private sector has grown from 25% to 54% in 1996, with mixed property – to 8%, and foreign participation – to 4%. In production, renewal of equipment has taken place mainly at export-oriented enterprises – wine-making, canning factories, light industry.

If the investment process will not be more active till year 2000 (“development budget”, inflow of foreign capital, attraction of private sector' and households' savings) then the structure of industry and economy in general will degrade, and in a number of directions (delivery of electricity, air and railway transport) there is a high probability of technogenic catastrophes. Moldova will turn into the most agrarian country of Europe with a very

limited internal investment base (science, technology, personnel) and low competitiveness of nation.

And finally, the third factor of cumulative action – *state debt*, including internal and especially external debt. Having overpassed in 1996 the level of US\$ 900M, or 57% of GDP, total external debt (including state guarantees, and excluding \$140M debt to Gazprom) will need in the upcoming years more and more resources for its repayment. After year 2000 a period of time will come, when external debt servicing (debt repayment and interest payments) will need more funds than foreign borrowings (for instance, according to the external debt amortization schedule, after year 2002 total amortization will need \$364M). The country will not be able to avoid difficult negotiations with international finance organizations, debt restructuring, or... new borrowings. And in this regards, the key for the way out – is in relaunching economic growth.

The said constraints determine for the country, its governing bodies and population (in any of the hypothetical variants, mentioned at the beginning of the chapter) in fact one direction – stop-and-go, i.e. to stop the decline and *to set in 1998-2000 a turning-point of the economic situation to a better situation*, to ensure at least a 5% GDP growth. However, as it seen in the respective chart in annex, Moldova even in this case, still will remain an outsider among countries of Central Europe.



Thus, for the choice “moving to Europe” it is necessary a bound towards 7-10% GDP growth rate per year, which would need strong political will and non-ordinary decisions in legal, economic and organizational reforming of national economy:

- to *add monetary methods* of ensuring macrostabilization *with actions for reviving investments, production and extending aggregate demand*;

- to start practical realization of the ***new industrial policy*** (the concept was adopted by the Government at 8 October 1996, decision No. 553), and to emphasize the priorities – advantaged development of branches, leaning upon local material and work resources (industries of foodstuffs, construction materials), as well as supporting economically efficient enterprises – “points of growth” in high-tech branches, having a high labor capacity (light industry, machinery construction) with their dominant orientation towards export;
- to ***reduce sharply energy consumption*** of the production sector, sphere of services and housing & utilities;
- to implement ***radical transformation of agrarian sector*** – land reform, enterprise restructuring, development of competition in the sphere of processing, trade and agroservice, setting up an efficient system of agricultural credit (credit cooperation, specialized funds, crediting zone of raw materials by large enterprises of foodstuffs industry);
- utilization of ***regional reserves for economic growth*** (local self-administration, free enterprise zones, frontier cooperation based on the principle “region-region”);
- ***re-orientation of social policy*** from the dominant of granting social assistance towards creation of conditions (mainly on the basis of small business) for each citizen, by its own work to ensure his wealth and wealth of his family. To amplify state’s addressed support of the least well-off layers of the populations;
- ***utilization of geo-economical advantages*** of Moldova on the crossroads of Balkans, Central Europe and CIS, realizing “small country model”, being a politically stable, economically facilitated and highly accessible – banking operations, registration of companies, transport, telecommunications.

Implementation of the ***optimistic scenario*** – Moldova overcoming the crisis till 2005 – is possible only under a high dynamism of reforms and social consent, under a general perception of the priority of national interests over corporate, clan or regional interests, with a decrease of pressure on the state coming from any social and political forces, because for neutralizing this pressure additional efforts, resources and time is needed, and this could reflect upon the trajectory of economic development.

***Pessimistic scenario*** assumes that Parliament would not ensure creation of a legal basis for “the second wave of reforms”, and the President and Government, alternating each other, will find themselves captured by circumstances, and assenting to the pressure of specific political and social forces, will be permanently engaged in realization of “urgent measures”.

Due to the fact, that attempts to partially return to administrate economy will show their dead-end, Government will be directed by a strategy of gradual, half-and-half implementation of inevitable structural reforms, assuming that it could in the long run alternate small pace of economy’ restructuring with a relatively low inflation and stability of the national currency. Keeping alive non-profitable large and middle enterprises, state in fact leaves the real sector under control of directors and privatization investment funds with their personal and group interests, coping with a collapse of economy’s technological base. At the same time, will drawn reserves of export-oriented enterprises and branches, which were mentioned before as “locomotives” for economic growth. The trade balance deficit will increase further on (in 1995 – US\$ 95.2M, in 1996 – US\$ 277.6M). Obsolescence of production potential will continue, because of lack of state funds for