Association for Participatory Democracy

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DILEMMAS OF THE ATTRACTIVENESS OF MOLDOVAN ECONOMY IN THE CONTEXT OF MOLDOVA'S EUROPEAN INTEGRATION

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Summary

This policy brief aims to detect major dilemmas faced by Moldovan economy in terms of approaching and eventually joining the European Union. In the current situation of economic crisis drafting clear and well-thought-out policies represents a premise for stabilizing and redressing the economic situation and ensuring a sustainable economic growth. The Government has to play a very difficult role, being pressed by the pessimistic economic reality on the one hand and necessity of negotiating with IMF in default of an anti-crisis program on the other hand. The last Government did not care much that starting the 4th quarter of 2008 the Moldovan economy was completely following regional recession trends and did not work out an anti-crisis program (to anticipate and prevent current difficult consequences of crisis). In these conditions, policy recommendations are required to consider the current constraints. Given these facts, the following issues will be analyzed:

- The current economic condition and economic policy framework promoted at national level;
- The economic attractiveness of the Republic of Moldova in the current crisis conditions;
- The policy recommendations aimed to enhance the attractiveness of economy from the perspective to join the EU.

The current economic conditions and economic policy framework

The aspirations of the Republic of Moldova to join the European Union are rather an optimistic vision, as many aspects of the country's economic life should be adjusted categorically or even require radical changes. These adjustments/reforms imply a political will and immediate political risks, but promise clear results at macro level and in terms of human development in the medium or long run.

The current economic condition of the Republic of Moldova is very precarious. The last Government did not propose and promote a program against economic crisis. Even more, it pretended not to observe the degrading economic reality, while the Moldovan economy was following all regional recession trends. An anti-crisis program is irrelevant for the current Government; it should focus on an economic stabilization and recovery program.

At present, the main economic indicators reveal a deplorable situation in all areas:

- While GDP was worth 28,842 million lei (nominal value, current prices) in January-June 2008 and increased by 5.4 percent compared with the similar period of 2007, it was worth 27.869 million lei in January-June 2009 and decreased by 7.8 percent, compared with the similar period of 2008. Paces of basic economic activity have slowed down constantly both in the 1st and 2nd quarter of 2009. The extractive industry, construction and transportation sectors suffered very much **[1]**. Following the decline in production volume and imports, taxes on products and imports have decreased by 12.8 percent, compared with the similar period of 2008 and thus hitting the budget.

- According to data for the 1st quarter of 2009, the final consumption has decreased by 9 percent compared with the similar period of 2008. The final household consumption has dropped by about 10.2 percent. This trend was maintained in the 2nd quarter as well, according to official statistics. The fall in consumption, particularly of foodstuffs and first-need products is a major challenge for the current Government. The population consumption is declining along with the 1/3 fall in remittances.
- The export and import of goods and services dropped by 14.7 percent and 28.2 percent in the 1st quarter of 2009, compared with the similar period of 2008. According to half-yearly data, Moldova's exports declined by 22.2 percent and imports by 33.5 percent in 2009 **[2]**. The decrease in foreign trade was the key cause of the fall in VAT collections to the budget.

- The decline in remittances was a major channel to spread the financial crisis in Moldova, as more than 40 percent of households depend on remittances at a large extent. According to the World Bank data, overall remittances ranked Moldova in the top countries with largest share of remittances in GDP (36.2 percent) in 2008. The cut in remittances may be also observed from the volume and structure of population's available incomes. If considering the data of the National Bureau for Statistics (BNS), one may observe that the share of remittances has stepped down from 19.7 percent in the 1st quarter to 16.6 percent in the 2nd quarter of 2009. The decline in remittances hits both the private and public consumption.
- The adverse national budget could account for 8.5 billion lei (about 800 million dollars) by the end of 2009 or even 14 percent of GDP, according to the Ministry of Finance. This budgetary deficit could be redressed through emergent measures aimed to reduce budgetary expenses, postpone salary rises planned for some categories of budgetary employees. This happens when a deficit of less than 5 percent expected in Romania in 2009 is tabulated as heavy for the neighbouring economy.

The current Government has worked out an economic stabilization programme and began negotiations with IMF. According to certain statements on negotiations, IMF does not have plans to give up the strict conditions, especially in terms of the leu depreciation and less popular conditions such as postponement of any budgetary salary rises. In addition to major political risks, the Moldovan Government has an extremely limited field of manoeuvre to negotiate with IMF and it will likely have to accept stricter IMF conditions, too. Painful reforms (i.e. reduction in the number of employees in public sector) are unavoidable and they should be started sooner or later. The governmental consumption in Moldova did not correspond at all to existing resources in the past years.

Attractiveness of the Moldovan economy during the current crisis

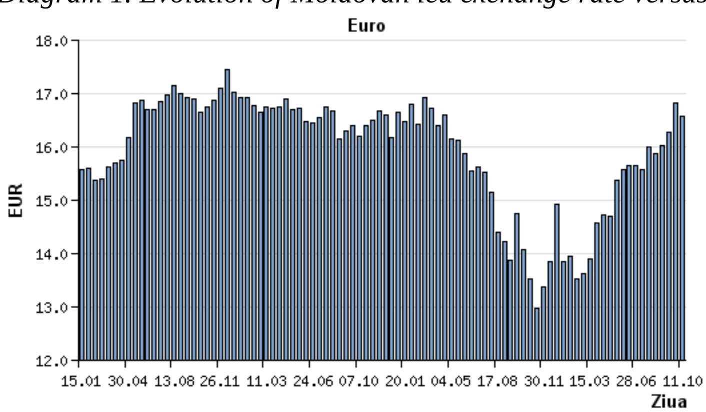
Attractiveness of Moldovan economy must and can be regarded in the light of *dilemmas* faced by big majority of economic sectors. At least four dilemmas are outlined in this context, and they are briefly analysed below.

Stability of leu

The stability of domestic currency, especially of prices is an important factor to define the attractiveness of domestic economy in general. Domestic currencies of neighbouring countries underwent divergent evolutions in 2009 in spite of permanent sustenance by central national banks. They constantly depreciated versus Euro, except for Romanian leu, which was sustained massively. According to World Bank data, Romania invested 4.5 billion Euros in stability of domestic currency in January-September 2009. The sudden depreciation of Romanian leu pressed the solvency of the banking system and inflation. Even more, the maintenance of an easily overrated Romanian leu exchange rate prevented the bankruptcy of companies and people who have debts in Euros.

The Moldovan leu has generally appreciated in the past three years and faced a constant depreciation versus US Dollar and Euro in 2009 (Diagram 1 and Diagram 2).

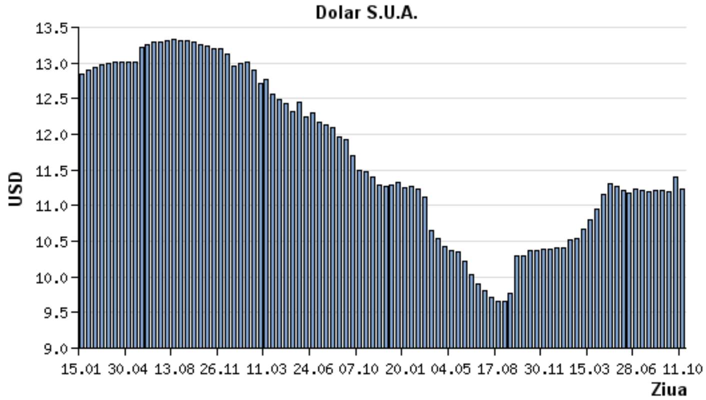
Diagram 1. Evolution of Moldovan leu exchange rate versus Euro, MDL/EUR



Source: NBM

In other terms, regional trends of depreciation of domestic currencies were observed in the Moldovan economy, too, but the leu depreciation was controlled by constant efforts of NBM to maintain the exchange rate. The basic dilemma in these conditions is to further maintain MDL or to allow its depreciation, as demanded by IMF. The sudden depreciation could raise grave problems to the already declining and mainly importing economy, as well as would have negative social repercussions. Maintaining MDL would require a consolidated input from outside since the current pressures are too heavy for existing capacities. NBR has spent more than 4.5 billion Euros to maintain the stability of RON, much of which with IMF contribution. The logic of an easily overrated exchange rate of RON is translated into lower inflation, avoidance of additional pressures on solvency of domestic banking system, as well as positive psychological effects on people, which cannot be underrated in the current crisis conditions.

Diagram 2. Evolution of Moldovan leu exchange rate versus US Dollar, MDL/USD



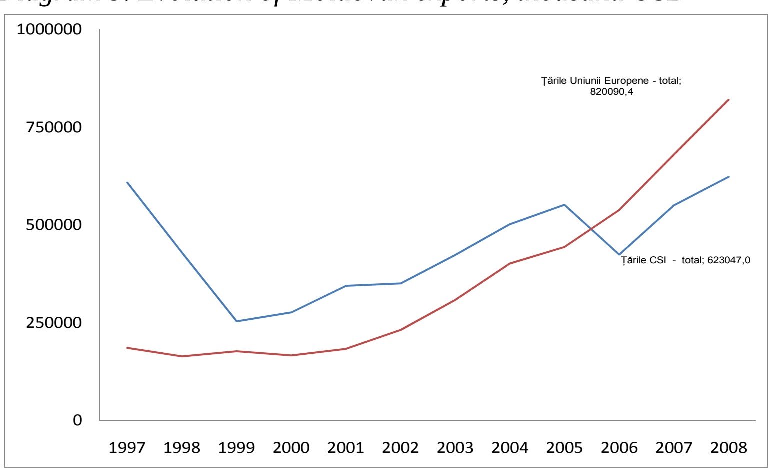
Source: NBM

But an overrated leu, as seems to be at present could deepen the crisis, affecting in particular the exporters and forcing urgent and painful adjustments in terms of budgetary salaries, which is an unpopular measure for the newly-elected Government. *The Government should find out the "golden middle" through a controlled and limited depreciation of MDL.* The experience of European neighbours such as Slovakia in terms of inflation control and monetary policy could be applicable, though the accession of this country to the Euro area marked a very important moment regarding the detachment of economy from old settings.

Moldova – importing country

The Republic of Moldova is a net importer of many products inclusively strategic. The trade balance deficit is serious, counting for 3,307.4 million dollars **[3]**, with imports exceeding more than three fold the value of exports in 2008. Neighbouring economies seem to be more equable in this respect. Slovak imports exceeded the exports by 1.4 percent only in 2008; those of Romania exceeded 1.7 fold the exports (in 2007), and exports balanced out imports in Hungary in 2008.

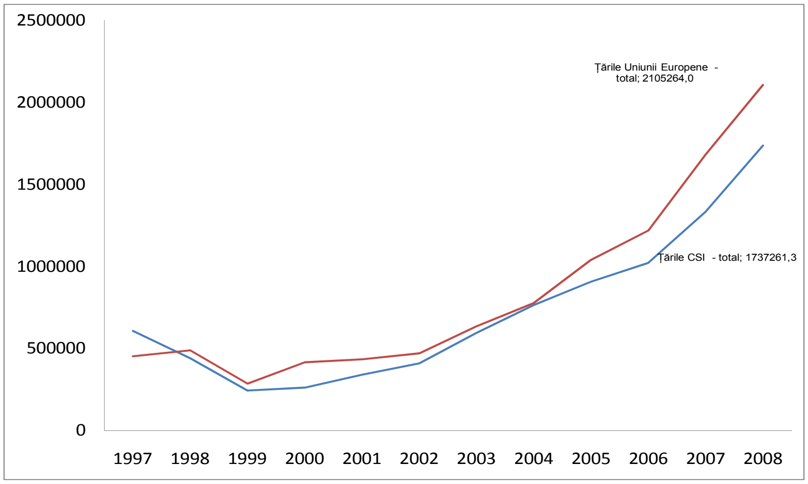
Diagram 3. Evolution of Moldovan exports, thousand USD



Source: NBS

Since both Moldovan imports and exports to EU member states have increased compared with those from/ to the CIS area. The EU market is clearly becoming more important for national exports, as well as a source of imports (Diagram 3 and Diagram 4). The controlled depreciation of MDL versus Euro could advantage national exporters which focus on EU market. From economic perspective based on statistics, the EU enlargement to the East has opened new export and investment opportunities and more jobs for citizens from old member states. However, the topic of Moldovan market's attractiveness for EU exporters, especially for investors capable to build production capacities remains open.

Diagram 4. Evolution of imports to the Republic of Moldova, thousand USD



Source: NBS

Budgetary deficit

The budgetary deficit of the Republic of Moldova could be higher than 14 percent by the end of 2009, which exceeds the 3-percent convergence criterion of GDP. This indicator is much higher than the regional average. In Bulgaria, for example, the budgetary deficit is estimated at 0.5 percent by late 2009. In Hungary the budgetary deficit could reach 3.4 percent of GDP in 2009, while in Romania - 4.4 percent of GDP **[4]**.

Political stability

The country's immunity to economic crisis, claimed by the previous Government, was actually illusory. The Moldovan economy has entered the full crisis completely unprepared because of the total discrepancy between statements and concrete actions. Even more, the period coincides with electoral race and the nomination of the new Cabinet of ministers. It's up to the acting Government to ensure political stability, which is a key precondition for economic stability and attractiveness of Moldova.

Policy recommendations to enhance the attractiveness of Moldovan economy from a perspective to join the EU

The above-mentioned dilemmas faced by the current Government are a visiting card though pessimistic of the Republic of Moldova in the context of ongoing negotiations with IMF. If negotiations with IMF are successfully accomplished by October 28, Moldova could begin negotiations with EU, so guaranteeing external support, especially financial, so necessary for stabilising the economy. It is worth noting that the EU conditions the start of talks with positive outcome of negotiations with IMF. In this respect, an important assessment of the IMF capacities to provide solutions to economic problems in special conditions, such as those faced currently by Moldova is required. IMF will not be able to guarantee the stabilisation of situation, as this institution does not usually recommend anti-crisis solutions, but just answers to economic issues in normal conditions.

The precarious economic situation has frozen out Moldova's perspective to join the EU. However, the crisis could be also regarded in the light of advantages that EU economic agents could enjoy. Under Article 140 of the Treaty of Maastricht, performances of EU member states are studied in view of *four criteria*, and namely ensuring the stability of prices, strong nature of public funds, respecting normal fluctuation limits foreseen by the exchange rate mechanism of the European Monetary System for at least two years, without devaluating the currency versus Euro, as well as the lasting convergence achieved by the member state which is the subject of a derogation, and its participation in the exchange rate mechanism reflected in long-term interest rates. Moldova has problems in all four areas, especially regarding the stability of prices that is difficult to ensure in crisis conditions and under IMF pressures and regarding the budgetary deficit that exceeds much those of neighbouring countries, including EU members.

Thus, concrete and urgent steps are required to stabilise the economic situation. Finalising the economic recovery plan before October 25 is welcome but cannot guarantee success of the Government in the three key areas and notably *stabilisation of public funds*, *recovery of economy activity* and *efficient social protection,* especially of vulnerable groups of people, particularly because external pressures are too heavy while internal capacities are too limited.

Two measures with potential immediate effects could be considered:

- *Giving up the policy of maintaining an overrated leu* (which would line up Moldova to regional trends of controlled depreciation of domestic currencies). This measure could encourage domestic exporters only if the economies from the Euro area would recover. On the other hand, if the depreciation will not be controlled, this could have grave repercussions on living standards of people. According to the data of Household Budget Survey for the 1st quarter of 2009, the internal consumption of food products, education and health has declined. The leu depreciation and eventual related inflation growth could hit the internal consumption more. One should not forget that the depreciation of leu versus main reference currencies could mark up all imported goods and services, or Moldova is a net importer in many sectors.
- *Stabilisation of public funds* – the budgetary deficit of about 14 percent of GDP is a too heavy burden in the current precarious economic conditions. The Government shall increase efforts to reduce public expenses, and less popular but necessary solutions may be adopted for this purpose, inclusively and especially reducing the share of salary-related expenses.

Although these two measures could have a relatively clear short run effect, ensuring and guaranteeing political stability in country, especially regarding the election of the chief of state, is the best tool so far. The political stability is part of minimum conditions for foreign investors despite limited investment resources.

Sources:
[1] Gross Domestic Product in January-March 2009, National Bureau for Statistics of Moldova, http://www.statistica.md/newsview.php?l=ro&idc=168&id=2636
[2] The balance of payments of the Republic of Moldova for the 2nd quarter, 2009, National Bank of Moldova, http://www.bnm.org/files/index_10099.pdf
[3] http://www.statistica.md/category.php?l=ro&idc=336&

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ADEPT is an independent centre of analysis and consultation on the decision-making, political, electoral and socio-economic processes in the Republic of Moldova and in the wider region.

ADEPT's mission is to promote the democratic values and support citizen active participation in public affairs.

Strategic Objectives

- Contribute to the efficient implementation of the governmental strategies aimed at the socio-economic development and democratization of Moldova;
- Promote and consolidate the democratic institutions and procedures;
- Encourage and facilitate citizen participation in the decision-making and governance processes.