POLICY NOTES

WHAT ARE THE IMMEDIATE CONSTRAINTS TO ECONOMIC GROWTH IN MOLDOVA? COMPARATIVE STUDY

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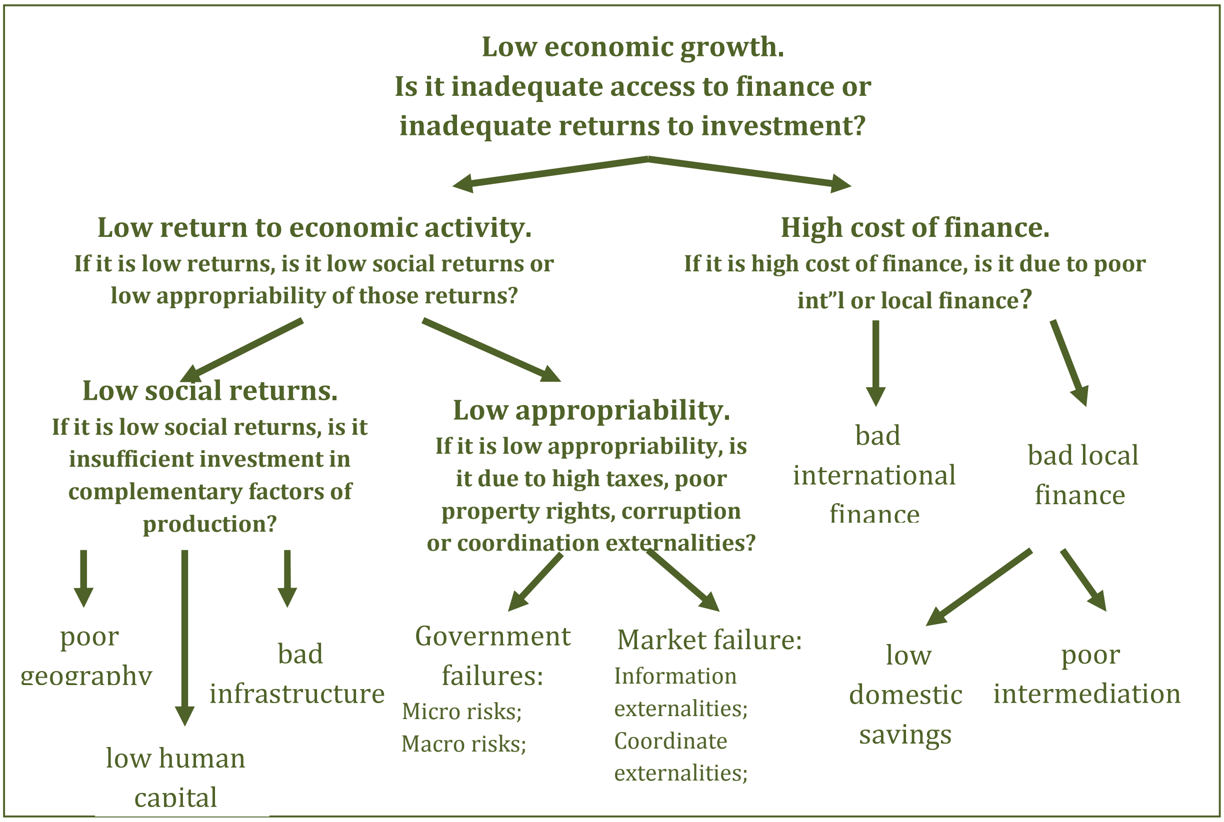
Twenty years after it gained its independence, the Republic of Moldova is still fighting for reforms and sustainable growth. In Moldova reforms have constantly been on the political agenda, but no success has been recorded in terms of changes. With some exceptions, the political class has not been able to assume the responsibility and costs of promoting fundamental changes. On the other hand, the absence of deep changes led to a situation where the national economy has accumulated structural and functional imbalances.

Currently we are in an interesting situation: Moldova has good growth rates, but the positive trend is not caused by internal factors and hasn't produced corresponding effects on employment. Consumption, financed by remittances, drives economic growth, and Moldova has limited internal capacity to generate an increase in the productivity and competitiveness of its economy. Any delay in achieving deep, liberalising reforms will trap the Republic of Moldova at its current development level, and impede its transformation in a fully-functioning market economy.

Scheme 1. Growth Diagnostics



The specialized literature is replete with analysis and models of economic growth and development. Some applicable to the Republic of Moldova, others irrelevant. In the past 10 years, a milestone in international practice in this area has been the work of Hausmann, Rodrik and Velasco, which describes a methodology for determining the most immediate constraints to growth and is based on "a basic, but significant classification." In short, this approach addresses the question of why growth is slow in a country's economy – whether this is due to low returns to economic activity or of limited access to finance – and makes it thus possible to identify some priorities for public policy.

This conceptual framework suggests the following areas of analysis (see the scheme above):

- Human capital constraints: Weaknesses in the public school system, social services or in the incentives for training services offered by the private sector.

- Infrastructure constraints: Deficiencies in public infrastructure, including road, rail, air, water networks, telecommunications and energy.

- Investment climate constraints: government policies, regulatory regime and its implementation, distorting incentives or weakening the stimulus to productive investment by private companies and individuals.

- Macroeconomic constraints: national policies that generate unstable or non-viable macroeconomic conditions and cause uncertainty for investors.

- Financial sector constraints: the financial system may be a constraint to economic growth if it imposes high interest rates to investors, if the interest rate spread is highly inefficient, or if the financial sector is unable (because of issues related to its structure, ownership, or capacity) to provide efficient financial services.

- Insufficient information or innovation: lack of information about prices and market conditions, poor dissemination of innovations, or insufficient stimuli for innovation.

- Natural capital: the geographical and environmental characteristics of the country may limit investment returns.

Summary of Conclusions

In this note we will focus on the constraints to growth in the Republic of Moldova. Our analysis is based on the following studies, all using the same methodology:

1. "Preliminary Report of Analysis of Constraints to Economic Growth", study for the "Compact" Program in 2007, Millennium Challenge Corporation. D. Caragia, V. Bozu, I. Gotisan.
2. "Report on Analysis of Constraints to Economic Growth," Expert-Group study commissioned by the State Chancellery in 2010, *particip.gov.md/files/Analiza_constrangerilor_final.pdf.*
3. "The Relationship between Constraints and Economic Growth" Program for young researchers, ASM, 2010.

In addition, this policy note takes into account also the last Country Economic Memorandum of the World Bank[14].

[14]„Moldova After The Global Crisis: Promoting Competitiveness And Shared Growth”, World Bank, 4 April, 2011.

Under the framework of constraints' analysis, the reason for low profitability of the economic activity is the deficiency or social benefits or the low rates of return on private capital.

Return on Social Capital

Those three studies do not have a uniform position in this regard. The geographical position and the natural resources of the Republic of Moldova are not a major constraint to economic growth, at least in the short term. According to the analysis conducted by Expert-Group, natural resources like land and water resources are currently sufficient for the country's economic development and the risks brought by climate change are by no means the most critical ones, also in the light of international comparisons[15].

Also the study prepared in 2008 for the "Compact" Program does not see natural factors as a critical constraint, although it admits that deficiencies exist. According to this research, access to markets will improve thanks to proximity to the EU, the availability of land and space for development is good and the effect of climate on the labor force is marginal. At the same time, climate and soil conditions lead to the rapid deterioration of the road infrastructure, and water resources may potentially become insufficient in the future[16].

The third study which we analyzed contains the findings which are similar to those of the first two studies, but places greater emphasis on the scarcity of irrigation and water resources. With the recovery of the economy and agriculture in particular, the deficit of water resources will increase, and in the long term water scarcity may become a major impediment to the growth. Other key issues in this sector include the low capacity of the institutions in collecting sufficient revenue to cover the operating, maintenance and investment costs of water supply.

Thus, the availability of land does not present a major constraint, because Moldova has excellent agricultural soils that cover about 77 per cent of the country. Natural capital is therefore conducive to the development of the Republic of Moldova. The geographic position of the country is a moderate constraint, however compensated by the openness of its economy to external trade.

Infrastructure

All three analyses highlight the inadequacy of infrastructure, particularly of road transport. Although the overall length and density of the road network appear sufficient, especially in a comparative perspective, its quality is unsatisfactory. This causes increased costs for doing business and reduces the attractiveness of the Republic of Moldova to private investment[17].

Besides road infrastructure, the study performed for the "Compact" program identifies three problems impeding the effective development of the **ICT** sector: the inefficiency of the telecommunications market; an underdeveloped ICT sector; the limited availability, and acceptance by citizens, companies and authorities, of electronic services[18]. Thus, although statistics show a satisfactory level of development, the sector is not delivering its full potential. This conclusion is found also in the Expert-Group study.

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[15]"Report on the Analysis of Constraints to Economic Growth", study by Expert-Group,*particip.gov.md/files/Analiza_constrangerilor_final.pdf,p. 7*
[16]"Preliminary Report on the Analysis of Constraints to Economic growth", D. Caragia, V. Bozu, I. Gotisan, p. 18
[17]"Report on the Analysis of Constraints to Economic Growth", study by Expert-Group,*particip.gov.md/files/Analiza_constrangerilor_final.pdf,p. 7*
[18]"Preliminary Report on the Analysis of Constraints to Economic growth", D. Caragia, V. Bozu, I. Gotisan, p. 36

According to the study commissioned to Expert Group by the State Chancellery, other types of infrastructure are at an appropriate level, for regional standards. This finding is based on regional comparative indicators (Indicators of transition, EBRD). However, its authors believe that the position of Moldova in these rankings shouldn't hide the deficiencies in terms of energy supply and energy efficiency, problems with water supply and sewerage systems in rural areas.

We consider it is important to note that efficiency and cost issues associated with the use of energy resources were not identified as significant constraints; however, they do represent impediments for large companies that need to achieve economies of scale in order to develop and compete at the regional level.

The same conclusions can be found in the other two studies. It should be noted that, poor infrastructure generally reduces the mobility of factors of production, and the mobility of production factors influences their cost. Thus, differences in the prices of production factors are implicitly an indicator of regional differences in the availability and quality of infrastructure. Therefore, we believe that road infrastructure is not the only constraint, and that it is necessary to cast a broader look, which would include other facilities such as air transport, telecommunications, energy, water and the rail network. In the "Global Competitiveness Report 2010-2011" Moldova is given a mark of 3.1 in terms of the quality of infrastructure, on a scale of 1 to 7, and ranks 119th among 139 countries, holding one of the lowest positions in Eastern Europe and Central Asia[19].

Human Capital

Shortcomings related to human capital are found by all three studies, although with different emphasis. The analysis conducted in the context of the "Compact" program, performed in 2008, finds that human capital is a major constraint. This is because the benefits yielded by having professional qualifications[20] are large and growing. Accordingly, the authors found that because a large number of emigrants holds tertiary education degree, Moldova has unused human capacities; yet, based on an observation of the relationships between years of study and wage levels, the authors exclude that human capital is currently a constraint. At the same time, however, the authors quote evidence showing that foreign employers offer higher remuneration for critical work skills, which, according to them, suggests that foreign companies have greater difficulty than domestic ones in finding on the labour market the set of skills and professional qualifications which they need.

The analysis performed by Expert-Group for the State Chancellery maintains that human capital is a constraint. The conclusion is based on the fact that there are major imbalances in the labor market: contrary to the findings of the study mentioned above, Expert-Group states that Moldova has a relatively skilled labor force, which, however, is not "used efficiently". According to empirical research carried out by international organizations, half of the employers think that the low level of labor skills is a major constraint to their work and, at the same time, that there is a low level of quality indicators in the education system in Moldova.

Concerning the shortcomings mentioned above, the third study, by ASM, notes these demographic trends in recent years: a reduction of population, plus a massive increase in the number of emigrants, and there has been a fall in the number of agro-industry specialists. The

[19] For most indicators included in the "Global Competitiveness Report 2010-2011" the analyzed indicators are qualified on a scale of values from 1 to 7 - expressing the worst condition of the analyzed indicator, and 7 is the opposite.
[20] The analysis was based on Mincer's relations.

quality and content of studies of the active population do not meet the labor demand in Moldova. Contrary to previous studies, ASM's analysis finds that the level of remuneration is low, while the remuneration of specialists with a high degree of skills is considered at levels comparable to those prevailing in the region.

These problems are confirmed by the Government's policy notes. The education system is inefficient, they maintain, showing a decline in the number of students unmatched by a corresponding decline in the already large number of teachers and non teaching staff, who are paid insufficiently. This is the result of the demographic decline, which continues because of low fertility rates and massive emigration, and obsolete rules, dating from Soviet times that allowed an unjustified increase in the number of teachers and non teaching staff[21].

Technological Innovation and Dissemination

The report conducted for the State Chancellery finds that the share of expenditure associated with research and development relative to GDP is comparable with that of other countries in the region, but the problem is the inefficiency of much spending on research and development, which is largely associated with the dominance of ASM.

While domestic companies have a low degree of innovation, innovation is not yet critical for economic growth. As noted in the study, this is also confirmed by the share of technologically advanced exports.

The study produced within the "Compact" Program finds no serious constraint to growth for the Republic of Moldova in the field of innovation or the dissemination of new technologies. Rather, the results of this study show a quite good situation in terms of innovation and dissemination. The main conclusion is that, compared to other countries, exporters successfully diversify their products; the researchers point to the large number of new patents and to companies reporting positive innovation results[22].

Also the third study focuses on the dissemination of new technologies, concluding that Moldova has shortcomings in this regard. Overall, Moldova's economy is based on the accumulation of production factors and not on innovation and the adoption of advanced technologies. It is for this reason that, with some exceptions, the economy fails to generate innovative and competitive products. Therefore, the conclusion is that deficiencies in technological innovation and dissemination are not presently a constraint, but could become one in the near future: inefficiencies do exist in the dissemination of technologies, and technology transfers currently yield poor results, and improvements of the situation require time.

Low Appropriatability

The fundamental question, in this perspective, is why one leu invested in Moldova yields so little.

The analysis of the causes can be grouped as follows:
- macro risks, affecting financial, monetary and fiscal stability;
- micro risks, chiefly affecting property rights, corruption, taxation;
- market failure:

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[21] Moldova. Policy notes. 2009, p. 15
[22]"Preliminary Report on the Analysis of Constraints to Economic Growth", p.52,*particip.gov.md / files / _constrangerilor_final.pdf* ***analysis.***

- informational externalities;
- coordination externalities.

Macroeconomic Risks

The three studies we reviewed reach basically the same results: inflation and the trade deficit are a major problem for economic growth in Moldova. The study conducted for the State Chancellery notes that NBM's inflation targeting measures are expected to bear fruit in the medium term, and the trade deficit is largely covered by remittances from emigrants. This reduces the vulnerability of the economy to pressure deriving from the trade deficit, but also has a rather high cost: more precisely, this flow of remittances, which mainly finances consumption, causes the appreciation of the REER and has negative effects on the competitiveness of local products.

Indeed, a fall in remittances would directly hit economic growth in the Republic of Moldova, and continued reliance on this external source of financing is not a viable option. In the medium term the failure to orientate the national economy towards investment and export may damage the level and quality of development[23] .

Microeconomic Risks

The three studies show deficiencies in this respect. The study by the Expert-Group notes that the most problematic areas are: employment/labor availability, import-export activities and the protection of investors' interests.

The study for the "Compact" Program finds that the investment and business climate is improving, compared to the reference countries that have been selected, but licensing conditions, permits requirements, rigid labor regulations and insufficient judicial objectivity, harm Moldova's attractiveness to investment and the business climate. Deficiencies are found in the taxation system: not so much due to the tax rates, but due to the costs associated with preparing and submitting reports to the various competent bodies, which are a major impediment.

The study by ASM draws a harsher picture of the existing microeconomic risks, considering them one of the most important constraints to growth in Moldova.

The business climate has to some extent improved during the most recent years. The Government became reform-oriented, which favors a business-enabling environment, and improvements have been observed, including in easing foreign trade and reducing tax-related burdens. But reforms are slow and have little consistency.

Equally importantly, persistent problems related to the weak protection of property rights, corruption, excessive and inefficient bureaucracy and overregulation greatly reduce the positive effects of other reforms aimed at improving the business and investment climate. The roots of this problem lay in divergent degree and depth of implementation of different reforms. Greater consistency and a more synchronic approach to reform implementation could magnify the positive economic effects of each reform.

[23]"The Relationship between Constraints and Economic Growth" Program for young researchers, ASM, 2010.

In fact, it is chiefly due to political instability, corruption and excessive bureaucracy that the business climate in Moldova remains more unfavorable than in the other countries of the region. Efforts are ongoing to increase the independence of the judiciary, but the current provisions do not protect the courts from political pressures. Indeed, the quality of the judiciary does not assist Moldova's aspiration to give itself sustainable economic growth.

ACCESS TO FINANCE

The studies conducted within the ASM program and by Expert-group conclude that access to finance is a major constraint to economic growth. The third study conducted in 2008 for the "Compact" program found that access to finance is not a constraint, but points out some problems in the financial system.

Overall, this study notes that the indicators of the banking sector are at an acceptable level, but also highlights structural problems related to:

- the legal framework,
- the absence of an office of credit history,
- opaque ownership relations.

This study finds that the financial system is not yet sufficiently developed, the local financial market is not mature and bank loans remain the primary source of funding for Moldovan companies. The main constraints of the banking system are: asymmetry in lending activity, limited supply of medium and long-term finance, as well as legal ambiguity in sector regulation.

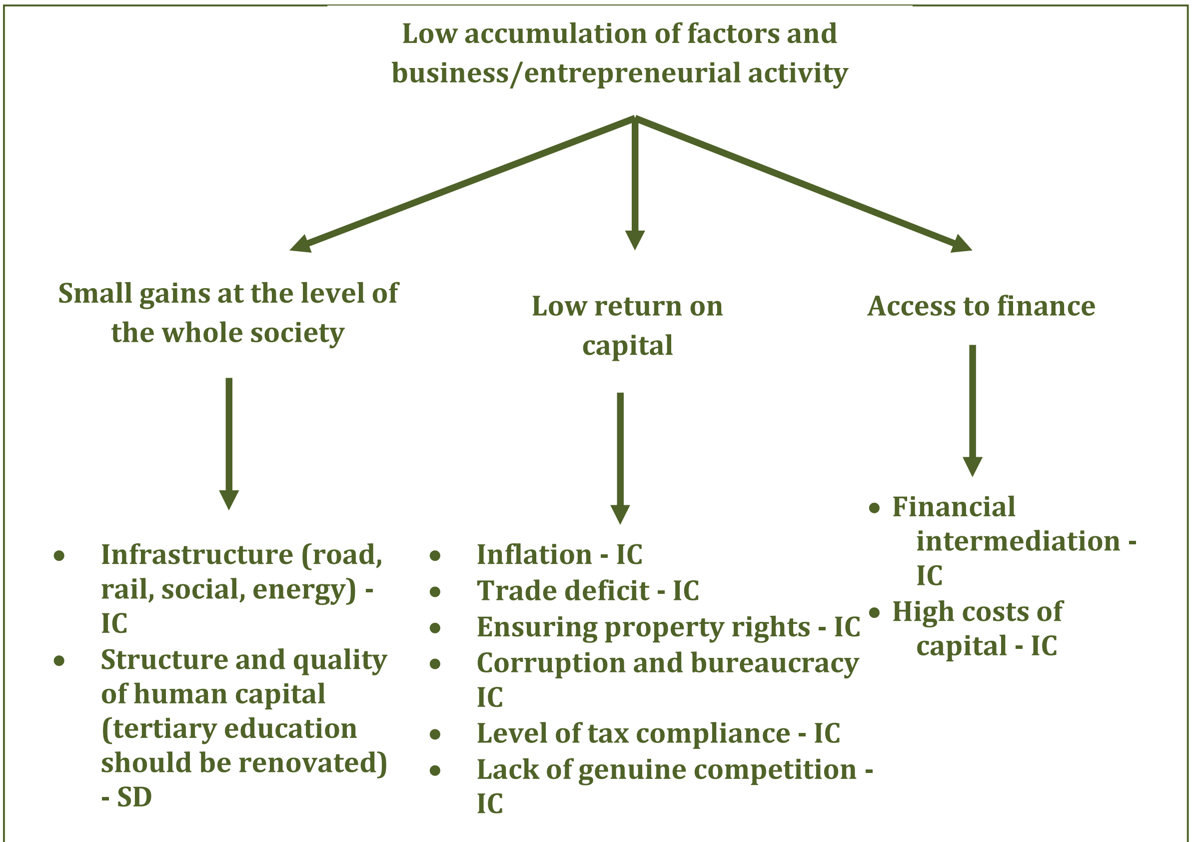
The other two studies reveal serious problems in this sector, because access to internal finance is inadequate and does not meet the needs of the economy (see also the third policy note of this issue). The main causes invoked by both studies are high interest rates (the highest rates in credits in the region), restrictive mortgage conditions, a high percentage of delinquent loans, lack of competition in the banking system, the limitation of available financial products, a poor legal and regulatory system, and limited access to international financial markets.

In other words, the causes of the problems observed in the financial sector of the Republic of Moldova are similar, if not even closely associated with, the microeconomic risks discussed above. We particularly refer to lack of competition and the weakness of the judiciary system, which provides insufficient support to the good functioning of the economy.

Conclusions

The analysis of constraints to growth focuses on the reasons underpinning the decision of holders of capital whether or not to invest (Cobb-Douglas production function). Growth constraints analysis looks at those factors that are outstanding impediments to economic growth. Following this conceptual framework, we will outline below the constraints to economic growth in the Republic of Moldova.

Scheme 2. Constraints Analysis for the Republic of Moldova



Note: CI- imminent constraint
SD - Structural Deficiency

The reviewed studies show a multitude of problems and deficiencies, and the most important question is to identify the most immediate binding constraints. We believe that at this stage of Moldova's development, the failure by the institutions to establish and enforce clear rules of the game for the whole society is the biggest obstacle to economic growth: constraints like corruption and bureaucracy, the weakness of property rights, and the lack of a proper competitive environment are those that chiefly prevent the emergence and development of an adequate and sustainable business environment.

To this primary constraint we add poor access to financial resources, because of high costs, lack of competition in the domestic financial market and limited access to international financial markets.

Theoretically, these two constraints should produce different symptoms: if the problem is access to finance, then interest rates should be high and with a chronic current account deficit; but if the problem is return on investment, we should see lower interest rates, and external resources that stimulate consumption but do not contribute to the productive capacity of the economy. We consider that both these constraints exist, and argue that they are the result of specificity in the structure of the national economy, which undermines the sectors/areas in which theoretically there should be or, in some cases, there is some improvement. Thus is the result of lack of essential and profound reforms in Moldova.

In other words, at the core of both constraints – microeconomic risks and inadequate access to finance – we observe very similar problems, all related to the weakness of the institutions

underpinning the economy. Thus, in a broader sense, we can see this as being practically one and the same constraint, with implications for both the financial sector and the business and investment climate.
An additional argument for choosing these constraints as the most binding ones is that a functioning market economy requires a number of basic conditions (liberalised prices and free trade, a functional legal system and guaranteed property rights; a well-developed financial sector; the absence of any significant barriers to entry and exit on the markets, and free competition, protected by the applicable legal framework; and a developed small enterprises sector) in respect of which Moldova still presents weaknesses, and which affect both appropriability of returns on capital and the availability of capital for investment. Accordingly, the next policy notes will focus on the business environment and access to finance in the Republic of Moldova.

The elimination of the broader constraint discussed above should provide impetus to the sustainable development of the national economy, and therefore presents itself as a high policy priority. In this respect, we note that both pro-active policies and structural ones are conceivable. Typically, pro-active policies involve higher direct financial costs than the structural ones, and do not seem to have always produced satisfactory results in the past (due to the well-known problems of imperfection of information and risk of capture). Thus, from an abstract perspective, it would seem that structural policies could generally tackle microeconomic risks both more effectively and at a lower direct cost than pro-active ones, and that pro-active policies aiming to stimulate the development of specific sectors should be used with caution. Well-targeted pro-active policies seem more adequate for tackling financing- related constraints. We believe, for instance, that pro-active measures stimulating financial diversification could be a valid option for consideration; the PARE+1 program is an example, but other measures could be considered whereby public capital is channeled to the real sector through private investment funds or venture capital.