

INTRODUCTION

This is the fourth annual economic radiography made by the Independent Think-Tank EXPERT-GRUP. Similar radiographies were developed so far for the years 2008, 2009, and 2010. Their purpose is to provide an overview of the major economic developments of the year and help the readers understand better their implications. Five essential aspects are covered by this issue:

- assessment of the risks which were anticipated in the previous issue for 2011;
- the most significant 5 economic trends of 2011;
- the most important 5 economic policy successes of 2011;
- the most remarkable 5 economic policy failures in 2011;
- the key 5 economic risks for 2012.

We would like to emphasize that these elements represent a consensual opinion of the EXPERT-GRUP team on the economic developments, but do not necessarily mean a strict rating by their importance. Giving up on rigorous rating or quantification, in the annual economic radiographies we rather try to identify the events, statements and mega-trends that, from our point of view, shaped the previous economic year and will determine the future economic developments of the country.

RETROSPECTIVE OF THE YEAR 2011

In the previous economic radiography, we anticipated the following major risks for 2011:

- **A sclerotic economic growth;**
- **An increase in the deficit of the State Social Insurance Budget;**
- **Uncertainties related to the creation of the Government Presidium;**
- **Price increase;**
- **Aggravation of the sovereign debt crisis in the USA and Europe.**

Having analyzed the statistics for 2011, we found out that most of our assessments were right.

In this issue:

- **Assessment of the risks anticipated for 2011;**
- **Top 5 economic trends;**
- **Top 5 economic policy successes;**
- **Top 5 economic failures;**
- **Top 5 economic risks for 2012.**

Real Economy is a monthly economic review tracking the most important policy and economic evolutions. Its readers are policymakers, CEOs of domestic and international companies and banks, representatives of the international institutions and foreign embassies, political parties and economic journalists.

Acronyms and abbreviations used:

y-o-y - year on year; q-o-q - quarter on quarter; m-o-m - month on month; Q4'07 - 4th quarter of 2007; Jan'09 - January 2009; NBS - National Bureau of Statistics; NEA - National Employment Agency; NBM - National Bank of Moldova; EG - Expert-Grup; MDL - Moldovan Leu (national currency); p.p. - percentage points;

EXPERT-GRUP is a Moldovan policy think-tank whose mission is to create a working environment in which free and non-trivial thinking thrives in order for the institution to be a leading source of unbiased economic analysis and to effectively advocate for innovative ideas and solutions to the economic problems that Moldova encounters along its path of economic transformation, societal development and European integration.

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The economic growth in 2011 was strong and improved structurally, but consumption continued to be the main growth factor ...

Sclerotic economic growth. The Moldovan economy continued to grow and it seems that the annual economic growth (according to our estimates, a little bit more than 6%) will be high in a regional comparison. Exports progressed dynamically (+52%); investment increased strongly as well (+11%). However, both exports and investment were largely determined by short-term factors, while consumption remained the main driver of the growth (121% of the GDP) and the discrepancies in economic growth among Moldovan regions widened.

Increase in the deficit of the State Social Insurance Budget.

Apparently, the situation was taken under control, as suggested by the Government planning lower transfers from the state budget to cover the SSIB deficit in 2011. But the data available for the first 10 months of 2011 reveal persisting pressures. The deficit planned for January-October (about MDL 300 million) was exceeded (MDL 337 million) and was funded on the account of a loan taken from the state budget. At the same time, by adopting a decision of increasing the number of sick-leave days paid by the employers and employees, the Government continued to transfer a larger burden onto the latter. What is then the reason of the compulsory insurance?

While the AEI-2 member parties spent time in mutual control and checks ...

Uncertainties related to the creation of the Government Presidium.

The Presidium worked, just as we have anticipated, as a mechanism of mutual political control, not as a coordination one. The establishment of this structure was even contested by the Liberal-Democrats in the Constitutional Court for the reason that it could block the activity of the Government. Although the Court decided that the establishment of the Presidium was perfectly constitutional, this does not weaken the argument that the Presidium is totally inefficient in terms of policy coordination.

... the prices kept rising ...

Price increase. In the last radiography we expected that in 2011 the price growth rate would accelerate because of unfavorable weather conditions. This actually happened; the prices in January-November 2011 increased by 7.6%, the seasonal price decreases were not that strong, while the increase of utilities cost had a record rate (+22%).

... and the external risks got even more acute.

Aggravation of the sovereign debt crisis in the US and Europe. In Europe the crisis of sovereign debts escalated to such a level, that even the existence of the European project in its current form has been questioned. The worsening of the crisis shed light on the main weakness of the European monetary union (absence of the fiscal union) and opened a confrontation of the adepts of an EU with lower competences (United Kingdom) with the advocates of a stronger EU (France, Germany). In the US, the increasing budget deficit almost brought the country on the brink of a technical bankruptcy. The global markets responded virulently to the developments in Europe and America, which suggests that the issue of the sovereign debts remains a time bomb under the global economy that has not been defused yet.

TOP 5 ECONOMIC TRENDS IN 2011

Economic growth of 6.1%. According to the EXPERT-GRUP estimates, in 2011 Moldova ranked the 3rd among the countries from Central and Eastern Europe (after Estonia and Lithuania) in terms of economic growth rate. We noticed the first structural signs of the new economic growth model that Government aspires to – a model based on investments, innovations, and exports and less oriented towards consumption. But let us remain sober. Though in 2011 the exports increased by 52%, if we control for the re-exports than we will find out that the "clean" exports increased by 23% only. This high share of re-exports calls for a reassessment of the trade policies, which should ultimately support growth of domestic production capacities and employment creation. The internal and external risks are high and the significant delays in reforms implementation hinder the economy functioning at full potential.

The annual inflation exceeding 8.0%. With one of the strongest economic growth rates in Europe in 2011, Moldova will probably also hold the less honorable record for inflation. According to the available data, in October the annual Consumer Price Index in Moldova reached 8.9%, far from the immediate neighbors (Romania - 3.5%, Ukraine - 5.5%) and almost 3 times higher than the 3% average for the Central and Eastern Europe countries. These price hikes were determined both by short-term factors (administrative adjustment of tariffs for public services, lower supply of agricultural products due to drought) and by institutional factors, particularly inefficiency of competition promotion policy and elimination of cartel agreements on the market.

Decrease of interest rates on loans to almost 14%. In October 2011 the average interest rate for banks' loans in Moldovan currency hit a historical low, 14.03% (after which it increased in November to 14.57%). The lower interest rates on loans supported the growth the loan volumes and improved the stability and return indicators of the banking system. Nevertheless, after the 2009 crisis the balance sheets of some commercial banks are still burdened by doubtful assets, with one of these banks taken under the direct administration of the National Bank of Moldova in November 2011.

Decrease of the budget deficit. The policy of the current Government is to reduce its presence in the economy - a policy that is also reflected by the decreasing share of budget expenditure in the GDP (38.4% for 2011 compared to 40.8% in 2010 and 45.3% in 2009) and by decreasing budget deficit. For 2011 we even expect a deficit under the level estimated by the Government (-1.9% of the GDP, compared to -2.5% in 2010 and -6.8% in 2009). Considering these indicators and the financial excesses of many European countries it would seem that the Republic of Moldova wants to become a model of macro-financial discipline. However, it is important to understand that this goal should not compromise the public infrastructure projects that are crucially necessary for the country to reach its economic potential in long-term.

The strong economic growth in 2011 ...

... was accompanied by a high inflation

... which did not hinder the growth of bank loans ...

... and the Government promoting the policy of a lower budget deficit.

But the macroeconomic successes were poisoned by the corporate scandals with major economic, social, and political impact.

Economic crimes and big corporate scandals. The year 2011 will be remembered for a series of noteworthy events: corporate raids on 4 commercial banks (Moldova-Agroindbank, Banca de Economii, Victoriabank, and Universalbank, the stability of the latter being significantly undermined) and on the Asito insurance company; the scandal with the Ukrainian company "Energoalyans" which demanded USD 60 million from the state-owned enterprise Moldelectrica; criminal conspiracy organized within the Chisinau-Gaz company, which resulted in a fraud amounting to MDL 24 million; arbitrary establishment of salaries and premiums for the managers of public enterprises and regulatory agencies; scandalous dismissal of the management of the Franzeluta factory; legal action taken by Le bridge International against Moldova; and many others that went unnoticed by mass media. All these emphasized 3 elements featuring the Moldovan political-economic model: 1) the strong interconnection of politics and economy; 2) the state-owned enterprises used as fiefdoms for recovering the "investments" made by those funding political parties; and 3) the defining role the corrupt exponents of the justice system play in the maintenance of the "system".

TOP 5 ECONOMIC POLICY SUCCESSES IN 2011

The Government managed to convince the EU to launch the DCFTA negotiations

Launch of negotiations on December 12 on a Deep and Comprehensive Free Trade Area between the Republic Moldova and the European Union. The EU decision to launch the negotiation with Moldova proved that in 2011 Moldova beat Ukraine in terms of approximation to the European Union (even if, from our point of view, the country is not fully ready, due to some critical constraints). The DCFTA will have a crucial importance for the future of Moldova and will manifest at two levels: 1) the negotiations themselves will require full mobilization of human resources and will strengthen the internal decision-making capacities; and 2) if implemented, the reforms required by the EU will support the economic integration of Moldova with the EU, an integration that will exceed the trade area only. Nevertheless, we do not expect DCFTA to become operational earlier than 2015.

The Court of Accounts became much more visible

Intensified activity of the Court of Accounts. Although the Parliament was late in appointing the Court of Accounts leadership, in 2011 the Court performed better than we were accustomed to. The undertaken audit reports revealed huge gaps Moldova needs to close in order to make better use of public resources and property; it should be noticed as well that the fierce debates taking place during the plenary meetings of the Court were not only for the record. However, it is important that the Court's work is followed by a greater interest from the part of the Parliament towards the Court's reports and that the identified systemic failures are eliminated. We also hope that in the future the Court will be able to maintain its political independence in defining and implementing its audit programs.

Moldova steps up 18 steps in the Doing Business 2012 rating.

Thanks to this improvement, Moldova entered the top-10 economies managing to progress in three or more business areas rated. More specifically, Moldova: streamlined the process of business registration; improved the insolvency regulatory acts; improved contracts enforcement and, the last but not the least, Moldova improved the information system on bank loans by creating the credits bureau - they have been speaking about the need to create it since 2001.

Decision on the privatization of public assets. In 2011 a political decision was made to start in 2012 the privatization of such big companies as Moldtelecom, Tutun CTC, Viorica Cosmetic, Banca de Economii and others. Besides the additional resources into the state budget, it is more important that the privatization is expected to improve the financial and economic indicators. However, unless the political crisis is overcome, there are no guarantees that there will exist attractive bids for the procurement of these companies. In 2011 the Government managed to obtain less than 1/3 of the money initially planned from privatization of public property.

Decision to apply indirect methods of revenue and property evaluation. Provided they are efficiently used, these methods will allow for a higher fiscal and social equity and will increase significantly the amount of public resources that could be used for funding development policies. Even though we are going to see the effect of these methods only in 2013, this decision is extremely important. In fact, we could see the early effects of this decision when watching the fierce political debates it generated among various exponents of the governing parties.

TOP 5 ECONOMIC POLICY GAFFES AND FAILURES IN 2011

Initiative to cut back the salaries of public enterprises' managers: pure populism. In January-February 2011 the Moldovan TV stations broadcasted the "salaries saga", from which the people learnt about the high salaries of the managers of some state-owned enterprises and regulatory agencies. Feeling the discontent of the population, the Government immediately called to order and a series of proposals to drastically limit and cut the salaries followed. Embarking on this populist path, the Government actually avoided solving the real problem; and the problem is that the Government lost control over many public enterprises, with some of the directors turning into a kind of "industrial lords" who do not care that the enterprises are inefficient and their assets are tunneled out. A cut in salaries cannot improve the performance of enterprises indeed. On the contrary, the managers will have even more incentives to embezzle public assets. Firing the inefficient directors coupled with industrial and managerial restructuring or privatization – these are the remedies to the inefficiency of state-owned enterprises, not the trivial salary cuts.

Moldova was among the leaders in the reform of the business regulatory framework ...

... and adopted difficult decisions, such as the continuation of "large scale privatization" ...

... and revealing the non-taxed revenues and assets

2011 started with a fully populist decision - a cut in the salaries of public enterprises' managers

Déjà vu: the state budget is again the victim of political discord

Violation of the financial-budgetary discipline at high level. The budgetary-fiscal policy and the budget laws (state budget, state social insurance budget, and the compulsory health insurance fund) became victims of political negotiations. In 2011 we saw this situation twice: when Parliament approved in April (i.e. very late) the budgetary-fiscal policy and budget laws for 2011 and when the Parliament passed on December 27 (late again) the budget package for 2012. The first time – an accident? The second one – a mistake? If it goes on for the third time, it will be – as a well-known American proverb says – a symptom of foolishness ...

Justice reform - victim of politics? ...

Justice reform failure. Despite the promises made by the Alliance for European Integration-1, in 2011 Moldova did not make any tangible progress with the justice reform. And as it turned out, some of the previous reforms such as the privatization of the bailiff service generated collateral effects, including the facilitation of instantaneous enforcement of some doubtful court decisions. Two opposite opinions on the justice reform priorities clashed within the AEI-2 and this blocked the situation further. The closure of Economic Justice Courts only eliminated one of the multiple corruption hotbeds, but so far without systemic effects. In May 2011, the EU even threatened that it would recall the promise to allocate EUR 50 million for the funding of the reform if Moldova does not develop a proper National Justice Reform Strategy. The Strategy was developed but still many questions hang over the priorities and implementation stages.

or ... vice versa?

Lack of a real political support for the strengthening of the antitrust institutional and legal framework. In the absence of this support, it should come at no surprise that the National Competition Protection Agency failed to prove the obvious cartel agreement on the fuels market. It is also no surprise that the governance as a whole failed to develop and pass the legislation on competition and state aid.

It is easier to prohibit the export than to make state reserves ...

The wheat exports interdiction. In early February, the Ministry of Agriculture and Food Industry proposed and the Government passed a decision prohibiting temporarily the export of wheat, in order to prevent the so-called "bread crisis". Once again, this decision proved how natural are the interventionist instincts for the Moldovan Governments regardless of their political color. The Government should have prevented a possible "bread crisis" taking form of shortage in wheat and flour through public procurements at the market prices and not by passing its responsibilities and the costs onto the private economic operators. This decision was criticized by exporters themselves and by the IMF and was canceled in a couple of months after approval.

TOP 5 ECONOMIC RISKS FOR 2012

A modest economic growth or even a recession. The global economic perspectives are still uncertain for 2012, especially in the Eurozone, where an economic recession is not excluded. This could worsen the situation on the Moldovan labor market and reduce the consumption expenditures – so far the main driver of the country's economic growth. The EU will need a lot of time to overcome its sovereign debts crisis and this will have economic and geo-political impacts for Moldova as well. European Union will use its resources mainly to solve its domestic issues. This has two major implications for Moldova: 1) the "success story" will need to be filled in with more content; and 2) the country needs development policies based on the expectation of a lower flow of external resources, generation of higher domestic revenues and more efficient use of the latter.

Intensified economic crimes. In 2011 several corporate scandals and raids served as test for the capacity of Moldovan institutions to ensure property protection. The test was failed by the absolute majority of these institutions, including by the judges themselves and by the justice administration bodies. The economic crime indicators increased by about a third in 2011 and all the preconditions are in place for this dynamics to continue in 2012. Besides the traditional economic offenses and crimes, committed by the "classical" criminal groups, the corporate raids designed by "white collars" will sprawl.

Fewer external resources for public investment. In 2011 we witnessed a very inefficient use of the public resources for capital investment, a significant part of them being funded by external sources. Out of the 200 km of national roads planned to be rehabilitated in 2011, only about 20 km were actually rehabilitated, in spite of the very generous funding offered by external partners. Having such "success" indicators, should Moldova complain that it does not have money for road repairs? It is possible not to have access to such generous funding any more, particularly given the perspectives of the financial crisis in the EU getting worse.

Worse relationships with the CIS partners. In 2011, even Belarus, a "reliable" trade partner of the Republic of Moldova, tried, after being pressured by the Russian Federation, to prohibit the import of alcoholic beverages from Moldova. In 2012, if the Ukraine is seduced/blackmailed by the Russian Federation into the Russian integration projects (such as the Eurasian Union), the pressures on Moldova to join these projects will get stronger as well.

A "forced" Government reshuffle. An unnatural change of the Government (i.e. not in the result of parliamentary elections) could contribute to essential changes in the economic policy and magnify the other aforementioned risks.

A minor economic growth or even a recession is the main risk for 2012 ...

... that could be emphasized by the actions of the "smart guys"

If we cannot capitalize the resources, we could remain without them ...

Cold winds could blow from the East ...

... which could be used for a potential change of the Government

Though compromised by the politicians' empty rhetorics, the institutional reforms are still the major priority for 2012

CONCLUSIONS

In 2011 we witnessed how the so-called "reforms" served as an excuse for the interminable political disputes and blockages. Despite the rhetorics, the actual progress of the country in 2011 was quite modest, especially with respect to the key reforms. The politicians spent a significant share of time and efforts for political revenges rather than for policy discussions. In fact, the politicians almost did not focus on any development policy. They have to understand that in order to minimize the impact of the risks looming ahead and to unleash the economic potential of the country, it is important to urgently target the needed reforms. These reforms include the following: justice reform; decentralization; reform of agricultural subsidies policy; strengthening the control over the public funds; reform of the central public authorities; reform of political parties funding; and the reform of the public property and state-owned enterprises policy.