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Moldova: Structural Change, Trade Specialization and International Integration

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Executive summary

After fifteen years of economic transformation, Moldova still remains a mostly agrarian country. The industrial sector is only successful in connection with agriculture (such as the production of food or beverages). The country's agrarian structure seems to be a legacy of Moldova's former role in the division of labour within the Soviet Union. Although the absence of the 'resource curse' facilitated Moldova's relative success in economic and political institutional reforms, there are still significant drawbacks in the quality of the economic order which prevent the institutional factor from compensating the 'geographical' deficits. An additional problem is the Transdniestrian conflict, which has resulted in the existence of a 'split state' and a 'split society'. High labour emigration in the wake of rising poverty, deficits of the labour market and the advantages of social integration within the post-Soviet space have a twofold effect on economic transformation: they reduce internal demand and workforce potential, but also create a permanent and significant inflow of migrants' transfers and establish opportunities for learning effects.

Moldova's geographical structure of trade is still dominated by the CIS. The European vector of its foreign trade remains underdeveloped, partly because of EU agricultural trade restrictions, but to a great extent because of internal trade barriers. Moldova's major comparative advantage (with respect to both the CIS and the EU, as well as globally) lies in agricultural production – food, beverages, tobacco, animal and vegetable oils – which is reflected in a very low diversification of exports. Imports are by far more diversified; the major imported goods are fuels, machinery and equipment. The energy intensity of the Moldovan economy makes the country extremely dependent on Russian gas and oil.

In order to achieve positive structural shifts and move away from agricultural specialization, Moldova needs to continue economic and political reforms and improve the quality of the investment climate in order to attract FDI. A peaceful resolution of the Transdniestrian conflict is of vital importance from the point of view of investment risks. Further consolidation of democracy could help to reduce rent-seeking and state capture (which is still very high in the republic). The evolution of the Communist administration since 2001 has been very promising in this respect. Moldova seems to be a natural benefactor of 'open regionalism' solutions in the Eurasian space, which could give it an opportunity to simultaneously improve its trade relations with the EU, the CIS and Southeast Europe. The EU Neighbourhood Policy could act as a trigger for internal reforms and as a factor of external re-orientation (if major problems such as Transdniestria could be resolved). On the other hand, Moldova could benefit from a redesigning of post-Soviet integration to make it compatible with the Western vector of integration, reduce political aspects of the 'protective integration' currently inherent in the CIS and similar groups, and focus on the opportunities of open regionalism solutions.

Keywords: *economic transition, restructuring, foreign trade, integration*

JEL classification: *F14, F5, J21, J61, L66, O11, P5*

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1 Introduction

Two major reasons for the underdevelopment and transformation failures discussed in the development and transition economies literature are the 'curse of geography' and the 'curse of institutions'. Some countries, despite or even because of their abundance of natural resources, fail to develop the necessary institutional framework, while others with poor resource endowment fail despite efficient economic reforms. This picture is over-simplified; nevertheless, it helps to focus attention on the most interesting and important features of economic development of these countries. In the post-Soviet world[1], examples of both problems are present: the 'resource curse' in Russia, Azerbaijan and Kazakhstan, and the deficit of resources in institutionally more advanced countries such as the Kyrgyz Republic or Armenia.

Moldova is a 'mixed' case: On the one hand, the absence of the resource curse has allowed the country to advance in institutional reforms; at the same time institutional progress has so far failed to reduce the agricultural specialization of the economy (already present in the Soviet Union), limiting potential development. On the other hand, Moldova – like Georgia, Azerbaijan and, to a certain extent, also Tajikistan, Armenia and the Caucasus – suffers from significant political risks associated with state-building failure (Transdniestrian conflict), which directly affect the economic structure and the country's institutions.

This paper discusses outcomes and trends in the economic development of Moldova, focusing primarily on three dimensions: structural shifts, trade specialization, and regional and global integration. It starts with a survey of selected macroeconomic and structural indicators of the republic, which allows a comparison with other counties in the post-Soviet space. The next section deals with Moldova's foreign trade and trade specialization. The aim of Section 4 is to place the Moldovan path of transformation in a general analytical framework, followed by an analysis of resources/geography and institutions/reforms as factors in structural change. The next two sections discuss specific problems – the Transdniestrian conflict and labour migration – and their relation to structural shifts. Section 7 presents a brief overview of Moldova's institutional integration into the world economy and regional structures (such as WTO, CIS, EU). The last section comprises the conclusion.

1 In this paper, the post-Soviet world is defined as the 12 CIS countries: Azerbaijan, Armenia, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Uzbekistan and Ukraine.

There is a unique statistical problem which needs clarification: the territorial divide with separate administration in the Transdniestrian Republic. For the most part, the data presented cover the central part of Moldova, for two reasons: inaccuracy or unavailability of Transdniestrian data, and the lack of central control there. However, because the two economies are linked and have very different characters, it is important to include a section focusing on Transdniestria.

2 Macroeconomic and structural dynamics and FDI

Industrial restructuring trends were typical of the whole post-Soviet space (see Table 1). However, the depression in the early 1990s had a much higher impact on Moldova and, even after recovery, growth rates were generally lower than the CIS average. The current improved growth dynamics are explained by 'growth export' from Russia, Ukraine and Romania, favourable weather conditions and correction of imbalances by the currency crisis in 1998, once again 'exported from Russia' (Dabrowski, 2003).

Table 1

Selected growth rates in Moldova and in the CIS

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
GDP growth rates, %															
Moldova	-17.50	-29.00	-1.20	-30.90	-1.40	-5.90	1.60	-6.50	-3.40	2.10	6.10	7.80	6.60	7.30	8.41
CIS average	-8.53	-20.26	-12.38	-14.74	-5.21	-0.52	4.51	2.27	3.12	6.35	7.51	6.96	8.93	8.99	8.82
Industrial growth rates, %															
Moldova	-11.10	-27.10	0.30	-27.70	-3.90	-6.50	0.00	-15.00	-11.60	7.60	13.70	10.80	15.60	8.20	6.30
CIS average	-5.22	-22.55	-11.46	-21.13	-9.40	-0.68	4.48	0.52	3.61	9.20	9.66	7.45	11.88	8.74	9.28
Total investments growth rates, %															
Moldova	-	-26.00	-44.00	-51.00	-16.00	-8.00	-8.00	10.00	-22.00	-15.00	11.00	11.00	7.00	8.00	1.00
CIS Average	-	-39.00	-30.63	-11.43	-1.63	5.50	12.13	17.25	-3.29	13.20	11.20	18.10	31.11	16.44	11.85
Growth rates of agricultural sector, %															
Moldova	-10.0	-16.0	-10.0	-24.0	3.0	-13.0	12.0	-12.0	-8.0	-3.3	6.4	3.0	-13.6	20.4	1.0
CIS average	-9.6	-7.2	-2.0	-11.0	-3.5	-2.7	3.1	-0.4	3.7	3.2	8.8	2.8	1.4	8.0	4.6

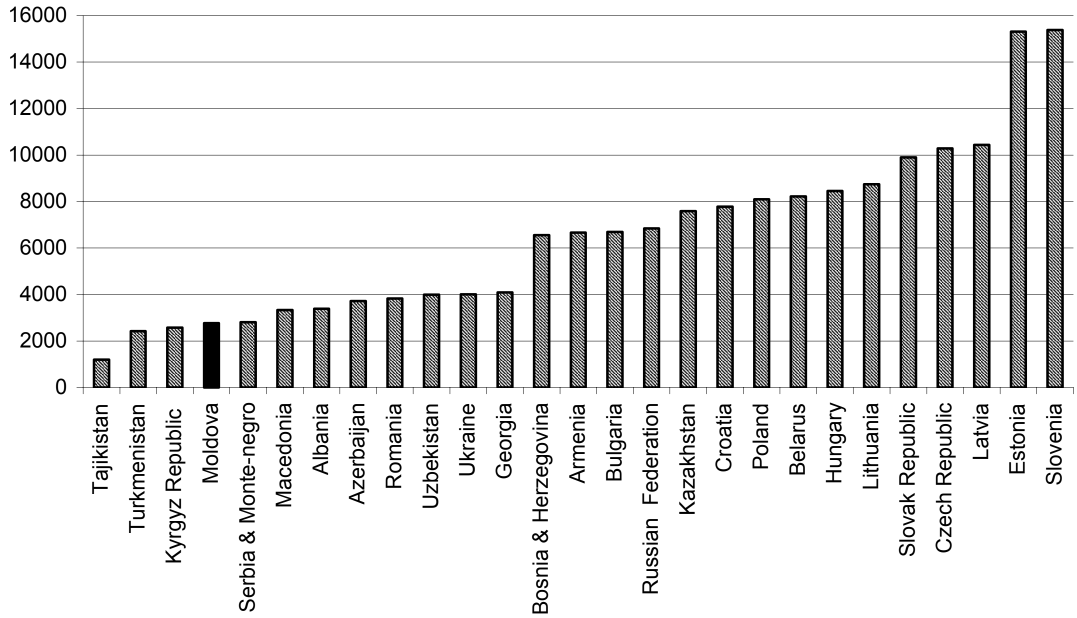
Note: CIS average = unweighted average of indicators for all countries for which reports were available in the respective year.
Source: CIS Interstate Statistical Committee, 2006

Moldova is among the poorest countries of the CIS; in 2004 GDP per capita, at half the average level of the Former Soviet Union, exceeded only that of Turkmenistan, the Kyrgyz Republic and Tajikistan. In terms of the absolute value of GDP, Moldova outranks only Turkmenistan and Tajikistan. Moreover, it is also the poorest country in Central and Eastern Europe (Figure 1).

An interesting feature is that the decline of industrial production exceeded that of total GDP in the early 1990s. In 2001-2003 the growth rates of industrial production were significantly higher than the CIS average. The only period when Moldova performed much worse than the CIS in general was in the crisis and post-crisis years of 1998 and 1999. On the other hand, Moldovan investment statistics are dismal: in all years but 1992, the country showed a worse performance than the CIS in general. The current investment growth is also significantly lower than that in the post-Soviet space. Moreover, the development of investments did not correspond to the simple macroeconomic model according to which a decline in interest rates is likely to cause an increase in investments. On the contrary, in the early 2000s the decline in interest rates was associated with a decline in investments as well – probably because of low confidence (see Hill, Mesropyan and West, 2005). It seems that the relatively good performance of industrial production is mainly based on the use of old assets and production facilities. This creates potential risks for further economic development, as Economou (2002) shows in his study of potential output. Since the economy has reached full productive capacity and there are no underutilized assets (as in Russia in the late 1990s), he concludes that the only way to achieve additional growth is through investment.

Figure 1

GDP per capita, 1990 USD (Geary Khamis purchasing power parity) of the CIS and CEE countries, 2004



Source: The Conference Board and Groningen Growth and Development Center, Total Economy Database, January 2006.

A high share of agricultural products characterizes the sectoral structure of Moldova's GDP, partly the result of the earlier Soviet development trends, but also due to the Transdniestrian conflict. The general problem of de-industrialization typical of post-Soviet countries was exacerbated in Moldova, as the separation took away much of the existing industry, the rest becoming, perforce, an agrarian country. On the other hand, the common post-Soviet trend of primitivization has been less evident (although there has been no improvement in the economic structure, either). Since 1997, the share of agriculture in gross value added has been higher than that of any other sector (excluding 'other activities'); nonetheless, it decreased from 30% in 1997 to 21% in 2004 (see Table 2). Industrial production in Moldova also depends heavily on agriculture. According to some estimates, agro-processing is responsible for about one half of industrial output (Hensel and Gudim, 2000). About 50% of Moldova's population lives in rural areas, and agriculture employs 40% to 50% of the workforce; the distribution of employment by economic activity has been relatively stable over years. The development of Moldovan agriculture does not follow the trend of the CIS, which may be explained by the predominant importance of weather factors (which are, naturally, very diversified in the huge Eurasian space) and significant differences within the composition of the agricultural sector.

Table 2

Main sectors of Moldova's economy: gross value added and employment

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Composition of gross value added													
Agriculture, hunting and forestry	-	-	-	-	-	30%	30%	28%	29%	25%	24%	22%	21%
Industry	-	-	-	-	-	24%	20%	19%	19%	21%	20%	21%	19%
Construction	-	-	-	-	-	6%	4%	4%	3%	3%	3%	3%	5%
Wholesale and retail trade	-	-	-	-	-	10%	12%	17%	14%	14%	13%	13%	12%
Transport and communications	-	-	-	-	-	8%	9%	9%	11%	12%	11%	13%	13%
Other activities	-	-	-	-	-	24%	25%	23%	24%	24%	29%	29%	29%
Distribution of employment by economic activity													
Industry	21%	15%	14%	12%	12%	12%	11%	11%	11%	11%	11%	12%	12%
Agriculture	37%	43%	46%	46%	43%	42%	46%	49%	51%	51%	50%	43%	41%
Rest	43%	42%	41%	42%	46%	47%	43%	40%	39%	38%	39%	45%	47%

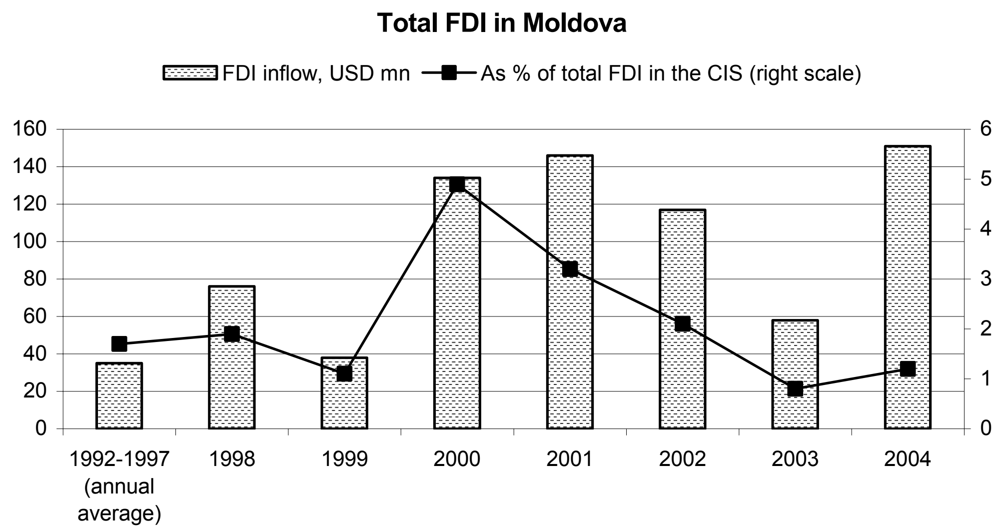
Source: Department of Statistics of Moldova, 2006.

Strong specialization in agriculture is probably the main problem for economic development. Regardless of the general diversification issues derived from the risks of agriculture (discussed under foreign trade), agriculture has a limited capacity to foster economic development. Agricultural markets are limited because of the very structure of people's preferences: increasing wealth is usually associated with a lower share of agricultural products in total consumption. Moreover, agriculture is probably the most regulated sector of the global market, with high trade barriers and subject to significant governmental interventions in the major industrial countries, particularly those of the EU; therefore institutional factors limit the potential increase in agricultural trade specialization.

From this point of view, agricultural specialization sets clear limits for the economic development of a country integrated in the world economy and makes a structural change inevitable.

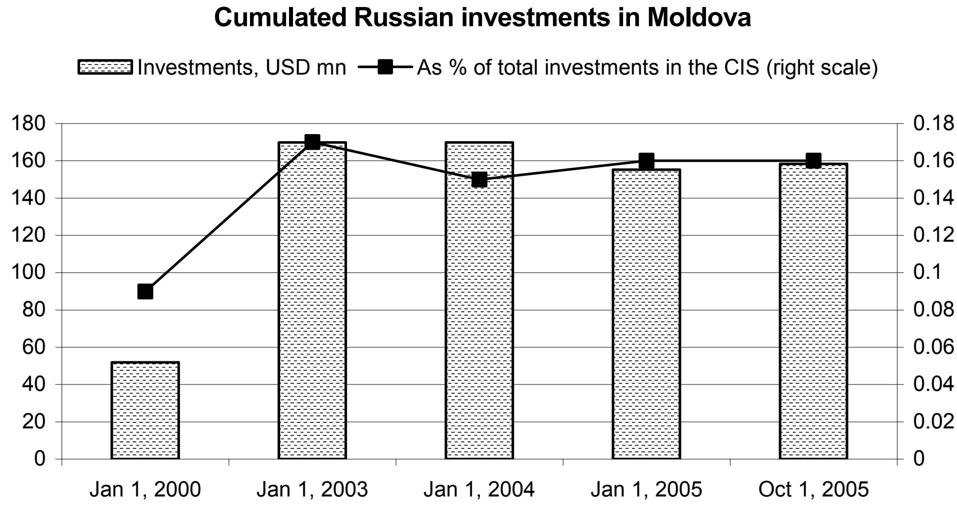
As the resource-rich countries in the CIS have been most successful in attracting FDI, and given the small absolute size of the Moldovan economy, it is not surprising that Moldova's share in the annual total FDI inflow in the CIS (even excluding Russia) since 1992 has not exceeded 2%; as of 1 January 2005, Moldova accounted for 1.7%, with accumulated FDI of USD 940 million (see Figure 2). From the point of view of FDI per capita, Moldova's position in the CIS seems to be better: it ranks fifth after Kazakhstan, Azerbaijan, Georgia and Armenia. About 31.5% of all FDI in 1994-2005 was located in the utilities sector (the *Moldovagaz* project), followed by manufacturing (21.9%), retail and wholesale trade (19.2%), financial services (9.9%) and transport (9.1%). Moldova has probably been one of the most attractive targets for Russian investments in the CIS (Figures 3 and 4). In mid-2004 it even outperformed all other countries according to the share of total Russian investments in the CIS. However, these outstanding results are probably due to statistical problems in accounting for Russian FDI in other CIS countries (for a detailed discussion see Vahtra, 2005; Crane, Peterson and Oliker, 2005; Libman, 2005, 2006, 2006a; Kheifets, 2005, 2006; Libman and Kheifets, 2006). Nevertheless, they give a certain indication of Moldova's importance for the current Russian investment expansion abroad. Moldova is among the few post-Soviet countries where Russia is – even officially – the largest investor in the national economy, accounting for 20.6% of the FDI inflow to the republic in 1994-2005, followed by Spain (11.3%), the USA (8.6%), the Netherlands (8.4%) and Germany (4.4%) (although the Netherlands and the USA could represent elements of offshore networks).

Figure 2



Source: UNCTAD World Investment Report 2004, World Investment Report 2005.

Figure 3



Source: CIS Interstate Statistical Committee, 2005.

Figure 4

Source: CIS Interstate Statistical Committee, 2005.

After the period of huge capital inflows in the early 2000s, due to large investment projects such as *Moldovagaz* (acquired in 1999), investment activity declined; however, in 2006 new large projects came under discussion as part of the gas price bargaining between Russia and Moldova. The most important assets are in the energy sector and include *Moldovagaz*, the gas distributing and exporting company co-owned by *Gazprom (*which increased its share in the company from 51% to 64% in 2006), and *Moldova GRES*, owned by the Russian power utilities monopoly *RAO UES.* The case of *Moldova GRES* is interesting insofar as the company is actually located in the Transdniestrian republic and therefore is not controlled by the government. Until recently, *Moldovagaz* was co-owned by Transdniestria, Moldova and *Gazprom,* but the latter acquired Transdniestria's share in 2006. Further assets in Moldova (including Transdniestria) are the following: *LUKoil* controls a network of filling stations in the country, and *Sevkabel* purchased *Moldavkabel* (cable production) in 2004 for USD 1.7 million. The Russian industrial holding *Traktornye Zavody* (Tractor Plants), currently merging with *Agromashkholding*, owns the Moldovan *Trakom.* Russian investors also control certain assets in other industries, including machine building (*Bedery Machine Building Plant)*, technology (*Saliut, Topaz*) and metals (*MMZ,* owned by *ITERA*) – but here again, many assets are located in Transdniestria. An especially attractive sector has been the food industry, including beverages and wine (e.g. Russian companies such as *W.J. Holding, Ochakovo* and *Moscow Wine Plant*); *Mikoian Moscow Meet Plant* intended to establish a joint venture with the Moldovan company *Bassarabia Nord;* however, the plans did not materialize, similarly to the attempt of the Moscow *MGTS* to purchase *Moldovtelekom.* Nevertheless, the list of Russian assets is impressive. Foreign investors (both Russian and especially non-Russian) dominate the Moldovan banking sector, in which the share of foreign ownership was about 60% in 2003. This is comparable to the situation in the new EU member states, however, as Vahtra discusses, the effects of Russian and European investors regarding the transfer of best practices and the quality of institutions could be significantly different.

3 Foreign trade and trade specialization

The dynamics of Moldova's foreign trade is summarized in Tables 3 and 4. The general trend is hardly surprising: a significant increase in the mid-1990s was followed by a decline in 1998-1999, when Moldova felt the impact of the Russian crisis and the general instability of the world economy; since 2000, after the restructuring, Moldovan exports and imports have been rising again. There is no clear pattern as to whether imports or exports grow faster. Growth of CIS trade was lower than growth of trade with third parties, reflecting the continuing process of re-orientation on the world market. The CIS share in exports has declined by 10 percentage points since 1995, and in imports by 20 pp., similarly to other post-Soviet states. The EU-15 is by far the largest external trading partner, its share in non-CIS exports having increased from 44% in 1997 to 61% in 2004, and in imports from 51% to 58%. By contrast, the share of the CEE declined from 1997 to 2004, from 26% to 22% in exports and from 29% to 20% in imports. Nevertheless, the CEE countries and the EU-15 combined comprise about 80% of Moldova's non-CIS exports and 70% of non-CIS imports. In 2004, Moldova's total exports amounted to USD 985 million: USD 502 million in goods and services were exported to the CIS countries, USD 296 million to the EU and USD 105.7 million to CEE countries. Out of the total imports of USD 1768.5 million, the CIS accounted for USD 765 million, the EU for USD 581 million and CEE countries for USD 199 million.

Table 3

Annual growth/decline of Moldovan foreign trade (in percent)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Export, CIS	15	16	12	-29	-41	9	25	1	21	19	10
Export, non-CIS	74	-10	6	-24	3	-7	14	32	25	32	12
Import, CIS	20	15	-7	-27	-45	7	31	20	45	29	19
Import, non-CIS	48	54	35	3	-41	50	7	14	29	24	38

Source: CIS Interstate Statistical Committee, 2006.

Table 4

Geographical structure of Moldovan foreign trade (in percent)

	1995	2000	2001	2002	2003	2004	2005
Export							
CIS	63	58.6	61	54.4	53.6	51	50.5
Non-CIS	37	41.4	39	45.6	46.4	49	49.5
Import							
CIS	68	33.5	38.1	39.4	42.3	43.2	39.6
Non-CIS	32	66.5	61.9	60.6	57.7	56.8	60.4

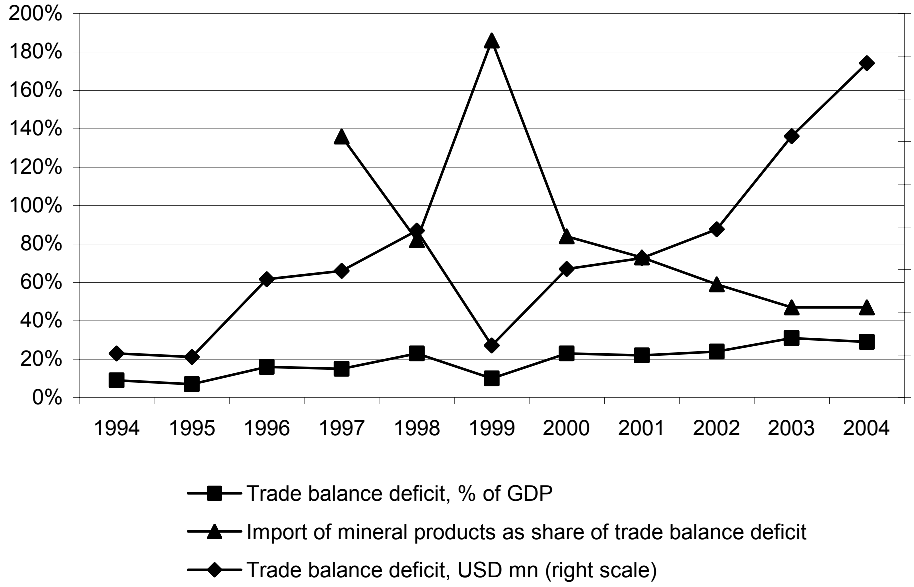
Source: CIS Interstate Statistical Committee, 2006.

A World Bank (2004) study based on the gravity approach demonstrates that Moldova's share in intra-CIS trade is significantly higher than could be expected relying on model predictions, and that the deviation for Moldova exceeds that of the majority of other post-Soviet states. On the other hand, Moldova's share in EU trade is about 20 pp. lower than theoretically predicted. Naturally, it is important not to overestimate the assessment: as the foreign trade directions are determined by a common Hayekian evolutionary 'trial and error' process in a complex economy, and the gravity theory is only one of the approaches to foreign trade, it would be wrong to argue that the theoretical predictions should ever match the market results exactly. However, these considerations still reflect potential inefficiencies in Moldovan foreign trade.

Ever since achieving its independence, Moldova has been characterized by a negative trade balance; the trade deficit increased from about 9% of GDP in 1994 to 29% of GDP in 2004 (see Figure 5). An important part of that deficit probably resulted from net imports of mineral products. The trade deficit occurred in trade with all major partners (CIS, EU-15, CEE) but its degree varied. In 2004, Moldovan coverage of CIS exports by CIS imports was 65.6%; for trade with the EU-15 that ratio was 51%, and for trade with CEE countries, 53%. However, starting in 1997 the export coverage in CIS trade had gone down by about 40 p.p., while in the case of EU and CEE trade it had increased by about 10 p.p. Therefore, imports in the CIS dropped more rapidly than exports from the region, creating a unilateral dependence (especially given the commodity structure, as discussed below). On the other hand, Moldovan goods seem to be gaining additional competitiveness on European markets. Surprisingly, Moldova recorded a surplus in trade with Russia for a long period, probably because of the pricing of gas and oil supplies (Gricenko, 2006).

Figure 5

Moldova: trade balance deficit



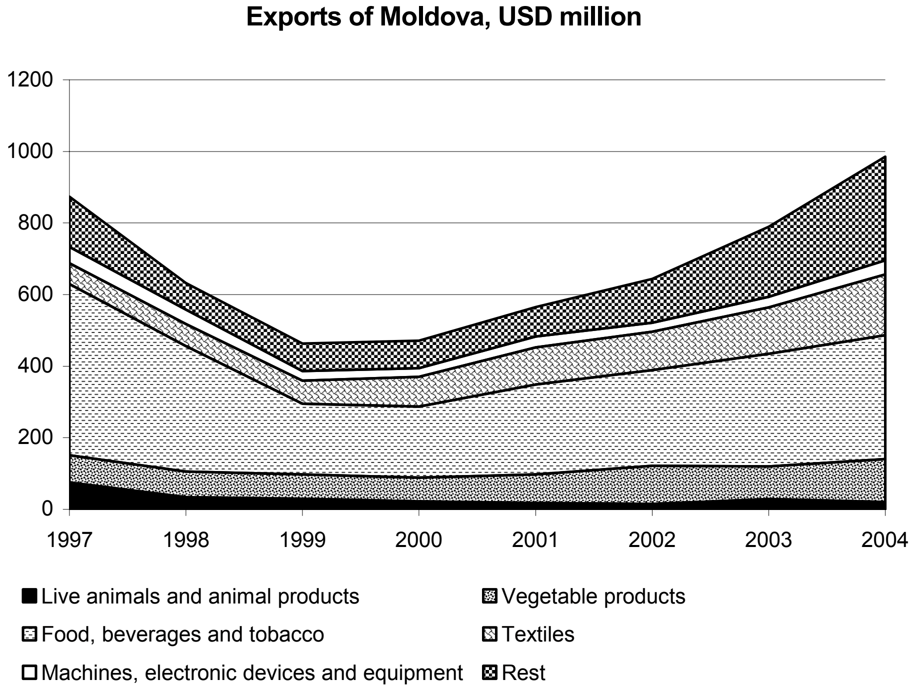
Source: Moldovan Economic Trends database, 2006; Department of Statistics of Moldova, 2006.

Agricultural products constitute a significant part of Moldova's exports, although their share went down in 2004 (see Figure 6). In the period 1998 to 2004, agriculture accounted for an average 60% of Moldovan export, with a maximum of 81% in April 1998 and a minimum of 39% in July 2004 (monthly data from Moldovan Economic Trends, 2006). From this point of view, Moldova is a monocultural economy with very low export diversification, rendering it vulnerable to global price fluctuations, weather conditions and protectionist measures of trading partners. On the other hand, Moldovan trade goods often enjoy a dominant position on the CIS markets, particularly in the field of wine production. For instance, Moldova's share in total Russian imports of wine was 62.5% in 1996 and 40.3% in 2003; in Ukraine it increased from 14.8% to more than 63% (World Bank, 2004).[2] As for Moldova's import structure, mineral products play the most important role, followed by machinery and equipment. However, imports are far less concentrated than exports. Mineral products account, on average, for less than 30% of total imports (see Figure 7). Intra-industry trade seems to be low, which is not unusual for emerging economies, especially with dominating agricultural monocultures (or export of natural resources) and low industrial potential.

[2] Nevertheless, in 2005 Moldova sold about 79% of its wine exports to Russia; Belarus ranked second with 7.7%, and Ukraine third with 5.4%. According to the specialized Internet source on Moldovan wine, vinmoldova.md, the share of Moldovan wine on the Russian wine market (including domestic production and imports) dropped from 66.53% in 2000 to 55.71% in 2005.

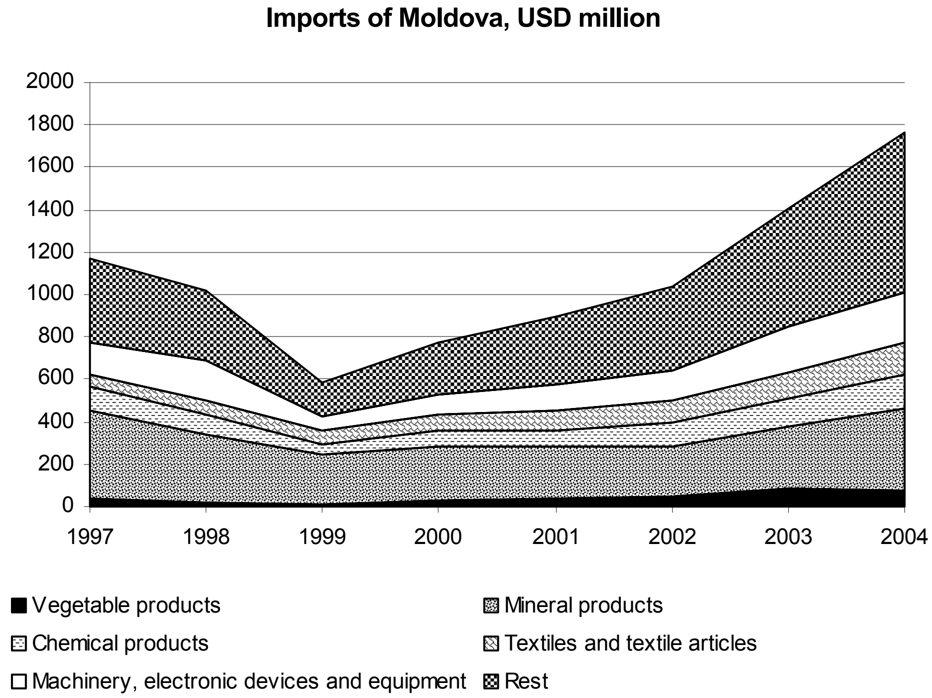
Moldovan imports in the 1990s were inelastic to the changes in income, reflecting inelastic demand for energy resources (with partial debt accumulation) (Papaphilipou, 2001).

Figure 6



Source: Department of Statistics of Moldova, 2006.

Figure 7



Source: Department of Statistics of Moldova, 2006.

Table 5

RCA for Moldova and selected regions of the world

	1994	1999	2004
EU			
Mineral fuels, lubricants and related materials	0.00	0.00	0.00
Chemical products	0.12	0.24	0.10
Animal and vegetable oils	4.18	0.63	0.18
Machinery and transport	0.02	0.16	0.20
Manufactured goods	0.25	0.41	0.67
Beverages and tobacco	4.92	1.01	1.75
Food and live animals	2.45	8.25	5.28
Miscellaneous manufactured articles	0.77	9.78	12.78
Crude materials, inedible, except fuels	4.47	18.37	26.83
Rest of the CIS			
Mineral fuels, lubricants and related materials	-	-	0.00
Chemical products	-	-	0.18
Manufactured goods	-	-	0.45
Machinery and transport	-	-	0.52
Miscellaneous manufactured articles	-	-	0.74
Crude materials, inedible, except fuels	-	-	1.07
Food and live animals	-	-	2.58
Animal and vegetable oils	-	-	21.67
Beverages and tobacco	-	-	53.50
Rest of the world			
Chemical products	0.11	0.32	0.19
Machinery and transport	0.16	0.17	0.28
Mineral fuels, lubricants and related materials	0.26	0.00	0.32
Manufactured goods	0.44	0.34	0.51
Miscellaneous manufactured articles	1.61	1.22	0.57
Crude materials, inedible, except fuels	3.08	2.71	1.02
Animal and vegetable oils	8.33	1.24	4.67
Food and live animals	2.41	4.77	7.54
Beverages and tobacco	23.90	29.61	26.52

Source: own calculation based on COMTRADE database

In order to analyse the trade specialization patterns of Moldova, we apply the traditional framework of the 'revealed comparative advantage' methodology, with the RCA indicator for product i being defined as: $RCA_i = (X_{iM} / X_M)(X_{iw} / X_w)$, where X_{iM} denotes Moldovan exports of product i, X_{iw} denotes world (regional) exports of this product, X_M denotes total exports of Moldova and X_w denotes total world (regional) exports. The RCA indicators are calculated on the basis of the one-digit SITC (Rev. 3) classification.[3] The results of the RCA for Moldova and the rest of the world are represented in Table 5.

Moldova's main comparative advantage is in beverages and tobacco; the RCA indicators for SITC 0 (food), 2 (crude materials), 3 (animal and vegetable oils) and 8 (miscellaneous manufactured goods) (for 1994 and 1999) also exceed one, indicating a relative comparative advantage. The changes over the decade appear to be insignificant or inconsistent: only for SITC 0 is it possible to argue that Moldova increased its comparative advantage over time, and for SITC 2 the comparative advantage went down. After 1999 Moldova lost its comparative advantage in SITC 8.

In a similar way we calculate Moldova's comparative advantages in intra-CIS trade and in trade of the potential region 'EU + Moldova'. We define 'world trade' in this case as the whole intra-regional trade excluding Moldova. Table 5 presents results of the calculation for 2004 (CIS) and 1994, 1999 and 2004 (EU). In the CIS, Moldova holds its major comparative advantages in beverages and tobacco, animal and vegetable oil, as well as food and crude materials excluding fuel – thus the RCA structure does not differ significantly from what could be observed for Moldova and the rest of the world. Regarding trade in the 'EU + Moldova' region, Moldova's major RCA are in SITC 2, followed by SITC 0 and 1; since 1994, Moldova's RCA indicators have exceeded unity for SITC 8. By contrast, Moldova lost its comparative advantages in SITC 3. From this point of view, both the European and post-Soviet orientation of Moldova's trade generally reflects the same structure of comparative advantages.

4 Natural resources and institutional development

Post-Communist transition studies in the social sciences combine three interconnected elements: state building, democratic transformation and market reforms (the 'triple transition', Offe, 1991). Moldova's results in these three dimensions are at least ambiguous. The variety of factors resulting in the current dismal economic performance could be grouped into three major elements: deficit of (natural) resources, conflict in Transdniestria, and low quality of institutions. Probably, this order also represents the importance of the problems; however, a clear statement is difficult because of numerous backward links. Indeed, poor resource endowment may even become a factor of economic progress, if it stimulates institutional reforms and productive entrepreneurship in Baumol's (1990) sense instead of rent seeking and rent distribution in 'resource curse' countries. Separatism risks and instability could be offset by natural resources attractive for international investors: Azerbaijan, with the Nagorny Karabakh problem, is the most evident example in the CIS. Finally, the debate over institutions vs. resources (or

[3] This approach is used e.g. in Addison-Smyth (2005).

institutions vs. geography) is neither empirically nor theoretically resolved: on the one hand, the deficit of resources of different kinds could probably be offset by high quality in the social order and vice versa; on the other hand, the formation of institutions and the geographical environment are not necessarily completely independent from each other (see e.g. Rodrick, Subramanian and Trebbi, 2002; Sachs, 2003; Ahlfeld, Hemmer and Lorenz, 2005, as well as a review paper of Olsson, 2003). Moldova has all three problems: however, it is possible to argue that the *relative* quality of institutions in Moldova is not as bad as in many other post-Soviet countries but worse than in Central and Eastern Europe, including Romania. From this point of view, the power dimension and the geographical dimension seem to be more important for negative structural shifts in the economy of Moldova than the institutional factor.

The first and the most evident factor affecting the economic development of Moldova is its extremely *poor resource endowment*. Actually, Moldova does not possess any significant mineral resources; neither is it able to use its geographical position for rent extraction from the transport of Eurasian oil and gas in Western Europe, as do Belarus and Ukraine. The natural resources of the country are mostly connected with opportunities for agriculture. From this point of view, an agricultural orientation of the state was unavoidable, yet inherited from the Soviet past, since Moldovan Soviet Republic had a similar agricultural function in the USSR (it provided about 20% of the grapes and wine in the Soviet Union, 30% of tobacco and 10%-15% of fruits and vegetables). Moldova ranked fourth among all transition countries (and third in the CIS) in 1990 according to the share of agriculture in the labour force (after Albania, Turkmenistan and Uzbekistan) (Gylfason, 2000). The country heavily depends upon weather conditions, which can significantly affect GDP and economic changes. The resource-rich post-Soviet countries were at least able to balance their insufficient institutional quality and high political risks against significant advantages from their oil and gas exports and even the possibility of attracting FDI in this sector.

Natural resources are not Moldova's only 'geographically given' problem. Unlike Russia, Kazakhstan or Ukraine, Moldova is a relatively small country with limited market potential and labour resources. Naturally, this factor makes its markets less attractive for FDI and limits the opportunities for economies of scale. However, Moldova's small size could also be considered both an advantage and a disadvantage. For example, the country does not need to solve various heterogeneity problems appearing in other larger transition countries, especially in Russia and in Ukraine; although it does have the Transdniestrian conflict, it also has better opportunities of international integration. Small, open countries have better opportunities to mobilize the diverse losers from the rent-seeking activities of privileged groups (World Bank, 2002). In the case of Moldova, however, the small size of domestic markets was one of the decisive factors for agricultural specialization in foreign trade.

The theoretical and empirical effects of agricultural specialization and the deficit of natural resources discussed in the literature are ambiguous. On the one hand, Gylfason (2000), in his empirical paper, extends the 'resource curse' argumentation on agriculture, demonstrating that a large percentage of agriculture in GDP is also associated with rent seeking, policy failures, underdevelopment of education and Dutch disease. This may not apply to Moldova, whose agriculture has remained uncompetitive in the absolute majority of markets except for the CIS. The latter can hardly account for any degree of competitiveness, due to the rigid structures of the market and biased economic competition. For example, Savin (1999) demonstrates that the prices for goods imported to Russia from the CIS systematically exceed prices for analogous goods imported from the rest of the world; intra-regional trade significantly exceeds the theoretical estimations according to the gravity model (Fidrmuc, Fidrmuc, 2001). This stability of trade relations is probably attributable to sustainable intergovernmental intrapersonal networks and to governmental interventions. Therefore, agriculture does not generate rents and 'windfall profits', as, for example, Russian oil and gas fields do, so the redistribution effects and gains can be expected to be lower.

Another, more sociological, problem is that agrarian societies are usually more conservative than industrial ones, and therefore less likely to actively participate in and support economic reforms (see e.g. Abylkhozhin, 2000). This statement is of a rather hypothetical nature, especially for Moldova, where a large share of the population participates in labour migration, mostly to the large cities of neighbouring countries. This argument is, therefore, probably unfounded, although it naturally requires empirical verification.

An absence of natural resources means not only an absence of opportunities to export, but also a high dependency on imports. In the early 1990s Moldova's economy was significantly less energy-intensive than that of Russia or Ukraine, but Moldova's energy consumption per unit of GDP was still twice as high as in the OECD countries. Moldova imports virtually all energy it requires from Russia over the Ukrainian territory. The increasing prices of energy at least contributed to the economic downturn in the early 1990s (Ronnas and Orlova, 2000); Moldova is still highly sensible to the potential 'gas wars' and price increases, which seem to be an important part of Russian foreign economic policy now, due to the general trends of world energy markets as well as to the changing Russian political attitude towards the CIS countries. Moreover, during the 1990s the role of gas in energy consumption increased dramatically (probably because petroleum products had already become expensive in the early 1990s) and therefore Moldova's dependence increased (see Caraganciu et al., 1997): gas supply is less mobile and more determined by the pipeline network.

On the other hand, as mentioned above, there is no ‘resource curse’ creating stimuli for rent seeking and preventing institutional reforms. From this point of view, nations with low resource dependency (like Moldova) are more likely to succeed in economic transformation than resource-abundant countries. The ‘systemic vulnerability approach’ (Doner, Ritchie, Slater, 2005) explains ‘good governance’ in developing economies by applying three major factors: (1) a broad, powerful coalition; (2) external threat and (3) absence of natural resources. In the CIS, Armenia meets all three requirements and is an absolute leader from the point of view of institutional transformation. For Moldova, the third and partly the second (Transdniestria) factors are valid; the current Communist government hardly seems to be a broad coalition, as in Armenia. Thus, there are some reasons to expect relative success with regard to *institutional economic and political transformation*.

Indeed, the quantitative indicators are surprisingly good, especially from the conventional point of view of the ‘poorest country of Europe’. According to the six dimensions of ‘public governance’, as estimated by the World Bank in 2004 (see Kaufmann, Kraay, Mastruzzi, 2005), Moldova ranks third in the CIS with regard to the control of corruption (after Armenia and Russia), has the best result from the point of view of the ‘political accountability’ of power, is fourth-best for political stability (after Armenia, Ukraine and Belarus, none of which experienced an internal conflict like the one between the Moldovan central government and Transdniestria) and second-best as regards the ‘rule of law’ (with better results only in Armenia). Pure economic indices (quality of regulation and efficiency of governance, i.e. the design of the economic policy itself and its implementation) are also relatively good: here Moldova ranks fourth (after Ukraine, Kazakhstan and Armenia) and fifth respectively (after Russia, Armenia, Ukraine and Kazakhstan). Moldova is third in the Heritage Foundation’s ranking of economic freedom for 2006 (after Armenia and Georgia). Friedrich Schneider’s assessment of shadow economies (2004) evaluates Moldova as the third-best country in the post-Soviet world (after Kazakhstan and Kyrgyz Republic).

Moldova is the only CIS country that has managed to establish a relatively stable parliamentary democracy and it has the highest Freedom House rating in the region. It is also unique in the CIS in that it has been able to pass one of the critical tests for democracy in the post-authoritarian states by undergoing two peaceful power transitions from one president to another (cf. Furman, 2004; Makarenko, 2005). The last elections, although highly contested, were also accepted by many international observers as having been democratic. Of course this does not mean that the current political regime in Moldova meets all the requirements of a developed democratic state; currently the Communist president Voronin (in office since 2001) has total control over the parliament and also dominates the media (see Piel, Schulze and Timmermann, 2005 for further discussion). Nevertheless, even the fact that it is possible for Moldova to have a Communist president and still maintain its democratic institutions shows that the country has made significant democratic progress. The Communist government demonstrated a remarkable evolution in the 1990s (Furman, 2006). According to a study by Smithey and Ishiyama (2000), Moldova has the second-best rating in the CIS from the point of view of independence of the judicial system (once again, after Armenia).

However, all these comparisons are relative; Moldova is far from achieving the standards of a democratic political system and a civilized market economy. It is still characterized by a high level of corruption, poor protection of property rights, bureaucratic interventions, and a partly hostile business environment, especially for small businesses. Although Moldova is the best of all post-Soviet countries according to the Transparency International Corruption Perception Index of 2005, it still ranks only 88 out of 158. And the relative success of Moldova according to the World Bank governance indices does not change the fact that the post-Soviet states (with the exception of Ukraine) do not earn more than 50 of 100 points on various scores of evaluation of their institutions. Moreover, although the share of shadow economy in Moldova is lower than in Russia or Georgia, it is still about 45%. The business environment in Moldova is still hostile to private businesses (Aculai, 2005). Radziwill and Petrushin (2004) demonstrate that the cultural factors, state capture and weak institutions in Moldova lead to what they describe as 'political Dutch disease', i.e. an inefficient institutional equilibrium even without natural resources. While the traditional mechanism is described as:

natural resources ⇒ high rents ⇒ struggle for control, corruption and barriers to competition,

Moldova is characterized by an alternative mechanism with similar outcomes:

vested interest and corruption ⇒ barriers to competition ⇒ high rents ⇒ struggle for control, corruption and barriers to competition

It is questionable whether the economic definition of 'Dutch disease' is appropriate in this situation, but there is an inefficient equilibrium and the same 'economic disease' suffered by all post-Soviet countries. What is more problematic is that Moldova has failed to achieve success in certain crucial economic reforms, e.g. in the agricultural sector and privatization, even as compared to some other post-Soviet transition economies.

Agricultural reform, which could be expected to be central, did not manage to replace the old institutional organization of agriculture by a new one adapted to the market. Originally, the government decided to transform old Soviet farms and collective farms (sovkhos and kolkhoz) into joint stock companies and granted the enterprises 50% of the shares of about 400 processing companies. However, the practical implementation of reform from below (self-constitution of joint stock companies) failed, and the majority of relatively rich collective farms failed to achieve any success in the market economy. In 1998 the parliament replaced the collective farms by individual farms (i.e. kolkhozes were split), but the farmers were not supported by the necessary equipment, and the shares of land were relatively small. As the profitability of farms was significantly below the bank-lending rate, refinancing also turned out to be an important problem for agriculture. Nevertheless, agricultural reform at least opened up an opportunity for market adaptation (Ceşuev, 2005; Liubareva et al., 2003). The agricultural sector has also been characterized by a significant decline in productivity: from 1990 to 2000, land productivity and labour productivity dropped by 70% and 75% respectively (Radziwill, Petrushin, 2004). Moreover, the area under high-value crops continues to decline. A significant institutional drawback is the slow development of the agricultural real estate market (Izman, 2003).

Moldova is an example of incomplete and late *privatization*. Although the first industrial privatization programmes were introduced in 1994 and 1996 and agricultural privatization was begun in 2001, the Communist government led by President Voronin curbed or delayed the privatization process and increasingly intervened in the economic processes. In the early 2000s the EU even stopped providing additional loans to the Moldovan economy because the government had not fulfilled its privatization obligations for wine and tobacco production, power utilities and telecommunications. Generally speaking, Moldovan privatization has comprised three stages: from 1993 to 1996 about 2 thousand enterprises were privatized by the 'patrimonial bonds' distributed throughout the Moldovan population; privatization was then carried out via auctions, IPO and tenders until 2001; and since 2001 the country has seen 'sporadic' privatization without any clear objectives and goals. The major advantages in the privatization process were achieved in the second stage, when the largest companies were privatized (see Liubarova et al., 2003). The 'sporadic' privatization is often carried out by the government, which has been able to slow down the privatization process. The Department of Privatization has focused its activities on post-privatization monitoring and control. In 2005, 93% of all companies were privately owned, but the private sector generated only 57% of GDP. These two failures of reforms in agriculture and privatization are probably one of the reasons for the extremely high level of state capture in Moldova (according to the BEEPS survey of 1999, Moldova ranked second in the post-Soviet world after Kazakhstan; see Hellman, Jones, Kaufmann, Schankerman, 2000) and the predominance of the interventionist 'rescue state' model in state-business relations (Iwasaki, 2004), even despite the small size of the country, parliamentary democracy, and advancements in other reforms.

An example of relatively successful institutional transformation is the Moldovan *energy sector*. In 1997 the government abandoned its monopoly and split the power utilities industry into 3 generating companies, 5 distribution networks and the state-owned transmission company. The distribution and generating companies were partly privatized (see Investment Guide for Southeast Europe 2004 for a detailed description). However, this transformation failed to reduce the energy intensity of the Moldovan economy, which still remains an important problem for its economic progress.

It is probably possible to summarize that the relative success in institutional development in Moldova is, in absolute figures, still too low to compensate the resource deficit. Moreover, it is weakened by state-building problems, which will be discussed in the next section.

5 State-building and the economy of Transdniestria

Moldova has been unable to regain control over its whole territory, but it is far from being a 'failing state': the governmental structure and political system are relatively stable, and other potential ethnic conflicts (like that in Gagauzia) were solved in a peaceful way. For this section, the Transdniestrian factor has two aspects of relevance: first, it is important to understand how it influenced Moldova's economic transformation, and second, economic trends in Transdniestria are part of general structural shifts in Moldova and must be analysed.

First of all, as mentioned above, the major industrial potential in the republic (especially such fields as machine building, light industry, metals and power utilities) is concentrated in Transdniestria. Actually, the existence or absence of old industrial assets in a transformation economy is not necessarily a negative factor. Developed industry is mostly characterized by influential political groups, which often resist political reforms. If they are successful, the major mechanism of the market economy – *Schumpeterian* creative destruction – is restricted or even 'switched off'. The experiences of Kazakhstan, where the influence of traditional lobbies was low, and of Ukraine, where industrial lobbies were able to capture politics starting in the early 1990s, illustrate this potential effect. Naturally, even the absence of powerful old lobbies cannot prevent the appearance of new influential groups or the predatory activity of the state, but at least a potential rigidity in institutional transformation is eliminated. On the other hand, old industries can provide a great variety of infrastructure factors (like qualified labour) for new economic development.

The very existence of a frozen conflict in a relatively small county like Moldova naturally increases the risk for international investors. There are the further problems of Russian weapons and ammunition in Transdniestria and the presence of Russian troops, even though the latter have recently been reduced. Republican authorities systematically block the transportation of weapons and ammunition to Russia. The transport of ammunition is also technically very difficult (if possible at all) and could create a huge ecological contingency factor (All Jazkova, personal communication). Besides potential conflict risks, other factors, such as the potential access of criminals or terrorists to the stores of weapons, or potential ecological problems, are also important. The Transdniestrian risk is often argued to be a factor preventing the development of more efficient institutions in Moldova itself (see Radziwill, Petrushin, 2004).

The paths of economic and political reforms in Transdniestria and in the rest of Moldova have been substantially different. Transdniestria is characterized by an immense concentration of economic and political power in the hands of the regional leadership (cf. International Crisis Group, 2004) and a lack of substantial economic reforms. The first privatization programme was introduced in 2001. At least 20% of industrial enterprises and at least 50% of agricultural companies do not earn profits, thus increasing the dependence on the small number of leading businesses. The majority of assets are still owned by the government, which was reluctant to implement any institutional changes until the late 1990s. At the same time, the Transdniestrian political regime is more comparable to other post-Soviet states than the Moldovan parliamentary democracy. Transdniestria is dominated by the authoritarian political elite, which has remained in office since Transdniestria declared its independence. The power–property ties between this elite and the largest Transdniestrian enterprises are significant.

The economy of Transdniestria is dominated by a small number of enterprises (12 to 15), which account for 70% of its GDP (as in Belarus or Tajikistan). For example, the aforementioned *MMZ* produced about 47% of the region's industrial output in 2000 and accounted for 40% to 56% of exports in 2000-2002 and two thirds of the tax revenues. Since the late 1990s these enterprises have been increasingly attractive for Russian FDI, but Russia's presence in the economy of the republic is generally very high and often invisible and not statistically recorded. Russia is also an important trade partner of Transdniestria (24.1% of exports and 24.2% of imports in 2004); about 12% of the Transdniestrian population also holds Russian citizenship.[4]

Despite the lack of reforms, GDP per capita in the Transdniestrian Republic is not significantly lower than in Moldova: in 2002 it accounted for 88% of the Moldovan GDP per capita, and in 2004 it was even slightly higher than in Moldova. Nevertheless, the GDP of the Transdniestrian Republic is highly volatile (Table 6) which may be explained by its export dependency and the influence of large enterprises. The problem of reliability of statistical data is also significant.

Not surprisingly, Transdniestria is heavily dependent upon foreign trade (which is typical for a relatively small country with insignificant internal demand but developed industry), see Table 6. Moreover, the Transdniestrian economy is energy-intensive and therefore

[4] According to Deutsche Welle, in 2003 about 600,000 Moldovans held Romanian passports, accounting for about 18% of the Moldovan population without Transdniestria; the Romanian citizenship law of 1991 favoured the 'restoration of citizenship' by Moldovans, see Iordachi (2004).

dependent upon the *Gazprom* gas supply. This explains why Transdniestria has accumulated a huge debt to *Gazprom,* amounting to the equivalent of three annual GDPs of the republic. Technically the Moldovan-Russian *Moldovagaz* is responsible for gas supplies to both Moldova and Transdniestria. As far as the food sector is concerned, during its quasi-independence period Transdniestria turned into a net food importer: in 2000-2004 food exports covered less than 20% of food imports.

Table 6

Selected economic indicators of Moldova and Transdniestria

	1996	1997	1998	1999	2000	2001	2002	2003	2004
GDP growth rates									
Moldova	-	1.6	-6.5	-3.4	2.1	6.1	7.8	6.6	7.3
Transdniestria	-	42.3	-34.6	-30.1	-20.9	11	-2.6	18.1	16.2
Foreign Trade as % of GDP									
Moldova	110.2	105.8	97.6	89.6	96.9	99.1	111.7	110.7	106.4
Transdniestria	161.1	153.8	279.4	240	409.7	359.4	276.9	324.5	309.7

Sources: CIS Interstate Statistical Committee, 2006, Gudim et al., 2003, Gudim, 2005

The general evolution of the Transdniestrian economy over the last fifteen years included a number of stages. The review of the Center for Strategic Studies and Reforms (Gudim et al., 2003) identifies five of them: 1990-1991 (search for a ‘free economic zone’ and ‘regional self-financing model’ within the general framework of the USSR), 1992 (military conflict with reciprocal attempts to block communication lines), 1993-1995 (resuscitation of economic ties with CIS countries, especially Russia and Ukraine), 1996-1997 (partial legalization of foreign trade by access to Moldovan custom stamps and numerous FDI and building projects), and the period since 2001 (deterioration of the foreign trade environment due to the new customs procedures introduced by Moldova). In 2006 Ukraine imposed new regulations on Transdniestrian trade which are practically tantamount to a kind of economic blockade of the republic.

The most important and generally addressed problem of Transdniestria – which spills over into Moldova – is the shadow economy. First of all, Transdniestria provides an excellent opportunity for smuggling and re-export deals, as well as other dubious schemes. Officially, Moldova’s share in the foreign economic transactions of Transdniestria does not exceed 10%, but there are good reasons to believe that this figure has been underestimated for several years. Besides this fact, the very nature of a ‘non-recognized’ republic makes any economic transactions contradicting Moldovan law illicit, including privatization deals, a field in which Russian enterprises have been very active. This factor naturally undermines any attempts at economic development and stabilization in the region – not only in Moldova, but also in Russia and especially in Ukraine. According to a study by the U.S.

Institute of Peace (2004), the major financial flows of Transdniestria are controlled by *Sheriff, a* company which is owned by the president of the breakaway republic, Igor Smirnov, and which has an annual turnover 5 times as large as the budget of Moldova and 25 times as large as that of Transdniestria (Ciobanu, 2004).

A report by the Center of Strategic Studies and Reforms (2001) suggests that the economy of Transdniestria is not self-sustainable, but at least as viable as the economy of Moldova. However, the very fact of the unsuccessful state building in the region is an important driving force towards worsening the economic environment and unfavourable structural shifts. From this point of view, a peaceful resolution of the Transdniestrian conflict becomes at least as important for the economic development of the country as success in institutional and structural reforms.

6 Labour migration

For Moldova, as for some other post-Soviet states (e.g. Kyrgyz Republic or Tajikistan), labour migration is currently one of the key factors of economic development. According to the Moldovan Department of Migration, in 1992-2003 labour emigration from Moldova accounted for 600,000 persons (including 105,000 in 1990-1996 and 50,000 in 1997-2003), or about 37% of the active population. In October 2002, according to the Ministry of Labour and Social Security, about 800,000 Moldovan citizens were employed abroad; the UNFPA fund estimates the current number of migrants at one million (about 25% of the Moldovan population). The migration flows are mostly directed to the Russian Federation, where the majority of migrants work illegally (in 2004 the Russian economy employed about 4 or 5 million migrants from the CIS, although the ministry of internal affairs granted only 460,000 work permits). Members of one third of all Moldovan households work in Russia; the total number of migrants accounts for 200,000 to 300,000. The CIS countries in general account for about 500 million labour migrants from Moldova. The rest go to European countries such as Italy, Greece, Estonia, Portugal and Romania, as well as to Israel[5].

The migration factor has twofold significance for the Moldovan economy. On the one hand, migration is naturally an important source of income for the national economy. The World Bank's assessment of migrant transfers to Moldova indicates a significant increase since the mid-1990s (see Figure 8), accounting for about 27.1% of GDP[6].This is the highest in the post-Soviet space, and the second highest in the world (after Tonga, with 31.3%). However, since the majority of migrants work illegally, there are good reasons to assume

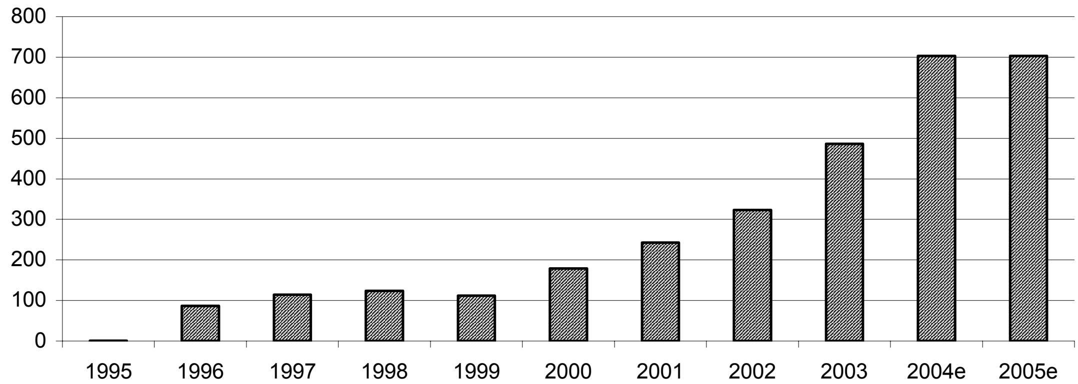
5 See: Labor Migration in Moldova. www.almamater.md/cgi/jump.cgi?DB=Document&view=File_ru&ID=622, accessed on 1 May 2006.

6 The share of transfers in total exports is estimated at 44% (*Gazeta.ru*, 4 May 2006).

that the official figures are significantly underestimated. According to Tiuriukanova (2005), an average migrant transfers about USD 110 to Moldova monthly; since the average stay is 20 months, the total transfers are USD 2200 per migrant and 1.5 years. Moreover, migration creates ethnic business networks, which are often crucial for transactions in an unstable and low-trust environment like the CIS. The existing informal ethnic business networks probably increase the competitiveness of Moldovan exports in the CIS significantly (although there is no empirical evidence available to the author of this paper). Moreover, migration is strongly linked with the learning process: migrants returning from Western countries to Moldova often establish new small and medium-sized enterprises and therefore transfer 'good practices' to the Moldovan economy (Pyshkina, 2003). It is, of course, questionable whether migration to CIS countries can also be considered a source of 'good practices'.

Figure 8

Workers' remittance, compensation of employees and migrant transfers to Moldova, USD million



Source: Global Economic Prospects 2006

On the other hand, migration is naturally associated with brain drain (see e.g. Perchinskaia, 2004) and a reduction of the available internal workforce, which could be used to rebuild the Moldovan economy. Generally speaking, Moldova (like many other post-Soviet countries) suffers under the problems of a population decrease (partly because of a transition to new population reproduction patterns and partly because of increasing mortality rates) and an increasing proportion of voluntary withdrawal from the labour market in the form of economically inactive population (e.g. students) as a result of social adaptation to dismal labour market conditions. Naturally, emigration in the extent practised by Moldovans makes these problems more severe. For a small economy like that of Moldova, emigration also means a significant decrease in internal demand, which consequently reduces the probability of attracting FDI. The migration also seems to reduce labour productivity, as the best workers leave the country (Pyshkina an Pyshkin, 2004). Finally, the predominance of illicit channels of migration also has a twofold negative effect:

it leads to adverse social and personal consequences for the migrants (see e.g. Burdel'nyi, 2003), and also supports the 'demand for bad institutions' and complicates learning processes.

7 Global and regional economic integration

For a relatively small country like Moldova, the problems of regional integration are, of course, of crucial importance. In fact, since 1991 Moldova has participated in a number of integration projects with a variety of outcomes.

In 2001 Moldova joined the *WTO* as the first post-Soviet country. This fact is, first of all, indicative of Moldova's relative success with regard to economic reforms, as well as its economic openness and orientation towards integration into the global economy. Currently the potential of the WTO is probably not being fully tapped by Moldova, as agricultural exports, even under current WTO rule, are subject to protectionist measures. However, further reforms of the world trade order, as well as internal changes in Moldova, could make its WTO membership a powerful instrument for the fostering of economic growth. Moldova could also use its WTO membership as an instrument of bargaining power, e.g. against other post-Soviet countries seeking WTO accession (like Russia or Ukraine). Moldovan-Russian negotiations over Russia's WTO accession were completed in March 2006; however, in the summer of 2006 Moldova insisted on reopening negotiations because of Russian restrictions on wine exports and because of problems related to the supply of gas, and in December 2005 Moldova declared its support for Ukraine's accession. Nevertheless, in April 2006 Moldova refused to sign the agreement with Russia because of the Russian restrictions on the import of Moldovan wine and the indirect taxation of the gas supply. On the other hand, membership in the WTO reduces Moldova's ability to participate in post-Soviet integration when it takes the form of customs unions (since large post-Soviet countries have still not entered the WTO, their unions cannot benefit from the WTO rules for regional economic integration, and Moldova cannot introduce restrictions or preferential treatment in line with other partners from the NIS).

Moldova is part of the *Commonwealth of Independent States* and therefore part of post-Soviet economic integration. However, its attitude to the Russian-led economic integration in the CIS has always been critical. Moldova does not participate in any subregional integration groups like the Eurasian Economic Community; on the contrary, it is an important member of the GUAM association (Georgia, Ukraine, Azerbaijan and Moldova), which has often been described as an opponent to Russia in the post-Soviet space. Originally, GUAM (until recently GUUAM; Uzbekistan left the organization in 2005) was established with a focus on joint transportation and pipelines projects. After the Ukrainian revolution of 2004, GUAM was revived to carry out closer economic integration; however, it has been less successful so far. Voronin's Communist government originally intended to increase its level of participation in the post-Soviet projects (and even to enter the Russian-Belarus Union State), but after 2004 it became increasingly opposed to the eastern vector of the integration policies and strongly oriented to the EU integration vector. Despite this low efficiency of top-down integration, Moldova is strongly interconnected with the CIS space via trade links, investments and labour migration. Formal participation in post-Soviet economic integration provided several advantages for Moldova. According to the Russian Customs Committee, in 1998-2002 Moldova received about 11% of all preferential treatment in trade from Russia, ranking second after Ukraine with 66% of all preferential treatment (Belarus is not included). The majority of privileges were granted for the wine trade. Until recently, membership in the CIS also provided access to cheap gas supplies from Russia through Ukraine. In this respect, the Moldovan policy was completely logical from the point of view of the exchange of market access rights (cf. Herrmann-Pillath, 2004). However, the CIS remains an inefficient integration group with numerous shortcomings, therefore restricting the expansion of Moldovan foreign trade: the World Bank (2004) identifies an intransparent web of multilateral and bilateral agreements (spaghetti-bowl approach to FTA), frequent unilateral exclusions, lack of permanency of agreements and the ad hoc application of safeguard and antidumping measures as major problems for Moldovan trade in the CIS. Moreover, the changes of Russian policy towards the CIS have affected the position of Moldova: Russia is planning to increase the price of gas supply to Moldova (or at least is ready to exchange privileged access to Russian gas for attractive assets in the republic. In 2006 Russia imposed restrictions on the export of Moldovan wine, which seems to have had a significant negative impact on the development of Moldova.

An important factor for Moldova's development is potentially the *European Union*. In November 1994, Moldova, as the first post-Soviet country, signed the Partnership and Cooperation Agreement with the EU, which became valid in 1998; Moldova was also the first to join the Council of Europe in 1995. In 2003 the Concept of Integration of the Republic of Moldova into the European Union was approved. Since 1991, EU has provided about EUR 253 million in financial support to Moldova in the form of different programmes (e.g. TACIS and CBC programmes, macroeconomic loans, EIDHR etc.). Within the framework of the TACIS programme (EUR 154.6 million in 1991-2005) Moldova ranked first among the post-Soviet countries (including Russia) in terms of total financial aid for the whole post-Soviet period per capita. Up to now, Moldova has failed to gain from its geographical position in the proximity of the European Union. The first and most straightforward explanation is that Moldova's agricultural exports could not access the protected European agricultural markets. The World Bank (2004) study suggests that, while important, these restrictions are only part of the problem. The second issue has to do with internal drawbacks of the foreign trade regime and of the general institutional framework, which seem to reduce Moldova's competitiveness on the European markets. There is also no sign that the geographical position of Moldova contributed to the more developed institutional isomorphism with the Union, excluding the democratization process (see e.g. Kyvelidis, 2000; Kopstein and Reilly, 2000; Emerson and Noutcheva, 2004, where this idea is discussed in greater detail[7]).

The *European Neighbourhood Policy* could provide new opportunities for Moldova. The Action Plan under discussion provides additional opportunities of access to the European markets and of possible asymmetric trade privileges. It may also act as a trigger for further economic reforms and as an instrument supporting governmental discipline and commitment to improving the quality of institutions (as the perspective of EU membership did in the CEE). Nevertheless, the Transdniestria problem remains an important factor preventing the further development of Moldova-EU relations (cf. Gabanyi, 2004; Gudim, 2005a, Shelari, 2005).

The European Union also supports Moldovan participation in the political and economic cooperation of *Southeast Europe (SEE)* (e.g. via free trade areas with the six countries of the *Stability Pact*), as well as plans to provide additional financial support to foster economic reforms in Moldova. Moldova's participation in SEE integration does not, however, appear to create a significant positive influence on its economic development, mostly because of the low level of development of the SEE countries themselves (a problem which will be mentioned in the discussion of the Moldovan-Romanian FTA below).

Finally, Moldova is part of less ambitious and advanced integration and cooperation structures such as the *Black Sea Economic Cooperation* (BSEC) zone established in 1992. Although their impact is significantly lower than that of the EU or the CIS, they are still worth mentioning. First of all, cooperation agreements like the BSEC establish an additional link between the EU and non-EU countries, thus supporting Moldova's integration into the European economy. On the other hand, there is empirical evidence that membership in these associations has a significant impact on foreign trade flows, even although they do not imply any large-scale changes in trade policy (Sayan, 1998).

An important potential partner of Moldova is *Romania*. Economic relations between Moldova and Romania are institutionalized in the form of regular inter-ministerial conferences, Romania is among Moldova's main trading partners, and a free trade agreement between these two countries exists. However, up to now, economic integration with this country has not been very successful, either. The reasons are twofold: On the one hand, Romania does not belong to the best-performing transition countries and therefore is probably unable to provide any impetus for Moldovan economic development. On the other hand, political problems of integration with Romania also remain significant. In the early 1990s, the Moldovan government and population actively discussed the possibility of re-

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7 It is worth mentioning that Kopstein and Reilly attribute Moldova to the countries with relatively bad geographical positions; however, as compared with other CIS countries, Moldova is quite close to the West.

joining the Romanian state. The official language of Moldova is called Romanian, and not Moldovan, and history lessons in the schools are devoted to the *history of the Romanian people,* and not to the *history of Moldova*; any attempts to change this highly sensitive area result in significant political confrontations (see Eimermacher and Bordiugov, 2003 for a detailed discussion). However, society remained split in this respect (the Transdniestrian secession is probably the best indicator for that), and therefore the plans for political integration with Romania were abandoned. The Romanian attitude to reunification was also ambivalent. The political problems between the two countries seemed to increase in the first period of the Communist administration. As the perspectives of Romania's accession to the EU are clear, it does not seem to be reasonable to discuss its relations to Moldova without the general context of the European vector of Moldova's external economic relations (for further discussion of this problem see e.g. Tomescu-Hatto, 2004). Moreover, the FTA with Romania will be scrapped after Romania joins the EU in 2007 (or 2008).

8 Conclusion

Despite its significant differences from the large, resource-rich post-Soviet states such as Russia, Kazakhstan and Ukraine, Moldova is also an example of 'transformation failure'. Agricultural specialization, inherited from Soviet times, still dominates both the structure of the Moldovan economy and its export specialization. Unlike other post-Soviet states, the trend to primitivization in Moldova has been rather weak, mostly because the primary sector already dominated its economy at the starting point of transformation. Therefore Moldova's growth remains volatile and dependent on its monocultural exports, supply of energy resources, and weather conditions, as well as the general limitations applicable to all agrarian societies.

Moldova has demonstrated relatively strong progress in institutional reforms and performs better than the rest of the CIS. Nevertheless, the results have not been sufficient to overcome the deficit of natural resources and agricultural specialization, or to avoid the general problems of post-Soviet societies, such as weak protection of property rights, corruption, state capture and low trust. Moldova has achieved the only relatively stable parliamentary democracy in the post-Soviet world, partly because of the 'democratization effect' of proximity to the European Union, though it falls short of Western democratic standards. This seems to have had an ambiguous effect on the Moldovan economy: on the one hand, it reduces the threats of inefficient equilibrium, 'institutional traps' and reform deadlock, but on the other hand, a high number of veto players have contributed to the slow and contradictory nature of several reforms, especially privatization and the reform of the agricultural sector. Moreover, from the point of view of the 'triple transformation' thesis, Moldova's great problem is the Transdniestrian region. The Transdniestrian conflict led to de-industrialization by the simple separation of territory, created additional risks, and reduced incentives for the establishment of more efficient institutions, as well as supporting the development of the shadow economy in the region. Finally, extremely high labour emigration has been a significant factor in Moldova's economic development.

Moldova remains highly integrated in the post-Soviet economic space, although the CIS does not provide an efficient institutional basis for regional trade. It is also one of the countries where Russian investors play an important role (although many of their assets are located in Transdniestria). Changes in Russian policy regarding gas prices and restrictions for Moldovan wines on Russian markets can therefore have a significant negative effect on its economy. On the other hand, integration with the European Union has not been very successful so far. The general structures of the comparative advantages of Moldova in EU and CIS trade are very similar. The reasons for the problematic development of EU trade are, on the one hand, EU restrictions on agricultural imports, and on the other hand, internal barriers for trade in Moldova and the low quality of its institutions. Moreover, trade cooperation with Southeast Europe (and especially with Romania) has not provided impetus for Moldovan economic development, partly because of the relatively poor economic performance of the SEE countries themselves, but partly also because of political restrictions.

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