

## **BRIEFING: Economic Reforms for Moldova**

*May 1, 2009*

### **Executive Summary:**

Young democracies pursuing economic growth and stability require effective and extensive reforms. Taking into account the unique situation of Moldova and the recent elections and subsequent unrest, this policy briefing recommends a system of shock therapy reforms be recommended for Moldova. Chief among the reasons for this recommendation are:

- The popularity and legitimacy of the new Moldovan government and the opportunity it has to issue extensive and fast moving reforms
- The critical need for reforms in Moldova that cannot be easily reversed

The reasons for this particular recommendation are as follows: first, it will ensure that free-market reforms in Moldova will occur. Second, the new government of Moldova was put in place through democratic process and voice with a clear directive and mandate of creating change. They are eager to bring about the process of real and immediate reforms to their country. Western aid to the country as they begin these reforms is paramount in importance to its success.

One potential flaw with this recommendation is the inability to test reforms before fully implementing them as the dissatisfaction with the government that may occur. The government currently has both the legitimacy and mandate necessary to implement these reforms, but may lose some of its public support as the reform process continues.

For these reasons, a system of Shock Therapy economic reforms is recommended for Moldova.

---

### **BACKGROUND INFORMATION**

On April 5, 2009 the Communist Party won a majority of the votes in the parliamentary elections. Mass demonstrations, organized over the twitter social networking tool, took place soon after; resulting in the Communist Party fleeing the country and the opposition, pro-democracy groups taking control of the government with enormous public support.

### **COSTS AND BENEFITS OF SHOCK THERAPY REFORM**

The economic philosophy of shock therapy is defined as a "...revolutionary strategy for the *complete reconstruction* of the economic arrangements of a country."<sup>1</sup> Shock Therapy proponents point to the fact that market economies have resulted in the most successful economies and are in fact the types of economies most suited to growth; hence the quickest path to economic growth would be to complete the transfer to a market economy as quickly as possible. There are several arguments and justifications for the implication of an immediate

---

<sup>1</sup> Murrell, 115. Emphasis added.

policy of shock therapy.

An advantage of the shock therapy process is that a quick, centralized set of reforms allows for better coordination in the implementation of these reforms. This argument is especially pertinent when examining linked reforms, such as and currency conversion rates and international/domestic trade. The effort in reforming one aspect of the economy while it continues to interact with a portion of the system still following old and obsolete patterns is a waste of time and energy. An “overriding strategic objective” of shock therapy is to “take decisive steps to ensure that...structures and interests [following old protocol] cannot derail reform”<sup>2</sup>

This improved coordination can lead to political benefits in both the short and long run. Balancing the government budget, strictly regulating the printing of currency, and political officials using their influence to improve confidence in the market can prevent the mass devaluation of currency. A stable currency and the preservation of pension funds can increase the support and legitimacy of the government.

Perhaps the strongest argument for radical reform is that it avoids problems of commitment.<sup>3</sup> Reforms are “expected to make things worse before they get better” with high unemployment, price increases, and production declines as the economy adjusts to the tremendous institutional and policy changes.”<sup>4</sup> As Joel Hellman points out, “[p]oliticians in democratic systems will be reluctant to introduce any reforms whose benefits will not be realized before the next elections...”<sup>5</sup> Short-term political games might easily outweigh the opportunity to continue reforms in the minds of a politician struggling to maintain power in a new and still

---

<sup>2</sup> Murrell, 113

<sup>3</sup> I will use the terms “radical reform” and “shock therapy” interchangeably

<sup>4</sup> Hellman, 1

<sup>5</sup> Hellman, 2

evolving democracy. Pressure can come from the “short-term losers” who call for a return to the older system with its set traditions.<sup>6</sup> Pressure of a different kind can come from the short-term “winners” who would try to stop specific reforms that would eliminate their specific advantages. Shock Therapy reforms instituted all at once, and put into effect quickly, are not easily overturned – preventing the subsequent government from reversing many of these reforms in a political move for short term gains while ignoring the long-term benefits.

This advantage to radical reform is also considered one of its largest faults. The problem of imposing (albeit) democratic reforms in an authoritarian nature can have serious repercussions both on the psychological status of the nation in question and, in the case of a negative results, lead to poor relations between the nation and the western powers seen to be advocating for these reforms. Radical reforms avoid “bargaining and negotiation among members of society...the traditional processes of market democracy.”<sup>7</sup> As Peter Murrell critically points out, “radical reformers are able to implement policies before existing interests become mobilized to act.”<sup>8</sup>

Additionally, radical reforms do not allow for much opportunity to adapt policies to fit the specific needs of a newly emerging democracy. Changes, both in the country and outside, might fail to be taken into account or faulty policies can be implemented without much opportunity to change or modify them.<sup>9</sup> Any policies implemented mistakenly as well as the short-term negative effects of almost all reforms can threaten the democratic system itself, as the “losers” become nostalgic for the old system and old party. This is especially dangerous in such a young Democracy as Moldova without established and entrenched political parties. Many Moldovans are unaware of what specific parties advocate for aside from the Communist Party,

---

<sup>6</sup> Hellman, 1

<sup>7</sup> Lipton and Sachs, quoted in Murrell, 115

<sup>8</sup> Murrell, 113

<sup>9</sup> Murrell, 120

and with the economic stress caused by reforms, may switch their loyalty back to the Communist Party. The lack of input that Moldovans would have into the economic reforms may contribute to feelings of increased loyalty towards the Communists.

Finally, radical reforms can also lead to a “Paradox of the strong executive.”<sup>10</sup> A powerful leader or leaders can lead to reforms being enacted more quickly and efficiently. But a strong leader can also use their power to privatize companies in favor of their own economic interests or goals. This “cronyism” can lead to a small group of powerful elites owning much of a country’s industry and valuable resources.<sup>11</sup>

### **COSTS AND BENEFITS OF A GRADUALIST APPROACH**

In contrast to Shock Therapy, a Gradualist approach to economic reform relies on slower changes rather than an immediate switch of institutions and markets to a capitalist system. Gradualism has several benefits as a system. Most obvious, is the ability for a gradualist reform to adapt to changes in trade, international relations, domestic concerns, and other factors.<sup>12</sup> Reforms can progress in one direction before economists realize that a different approach would be more suitable and beneficial.

For example, privatization, the most “difficult and complex” reform can occur in many different ways.<sup>13</sup> One method of privatization is simply to freely distribute large companies to citizens by the use of vouchers with which citizens could “buy” shares.<sup>14</sup> This is the more equitable solution when compared with selling the company to a foreigner or foreign management and can improve general support for the new system by allowing everyone to

---

<sup>10</sup> Class Lecture April 15, 2009

<sup>11</sup> Class Lecture April 20, 2009

<sup>12</sup> Murrell, 120

<sup>13</sup> Lipton and Sachs, quotes in Murrell, 114

<sup>14</sup> Class Lecture April 20, 2009

“own” some piece of capital.<sup>15</sup> However, the performance of the company can suffer greatly without concentrated ownership to ensure responsibility, or, as occurred in the USSR, speculators can buy vouchers from citizens who don’t understand their worth in the new system and have, many times justified, misgivings about their government.<sup>16</sup>

A nation could begin by using the voucher system, but realize that many businesses (like the electrical company, for instance) are being left in the control of citizens who don’t understand how to run them, with negative consequences. If the government was using a system of gradual reforms, it could begin switching privatization of large and important industries to foreign companies or wealthy individuals. Or the situations might be switched and the populace might be massively unsatisfied with the majority of their companies owned by foreign nationals and demand changes. Under radical reforms, both of these changes would be difficult to accomplish and could lead to massive inconveniences and distrust in the government. These inconveniences could lead to promote grave problems in the legitimacy of the government as they continue to try to create and implement reforms. According to Peter Murrell, “the institutional needs of the economy’s participants cannot be known a priori, but are a product of circumstance.”<sup>17</sup>

Another strength of the Gradualist approach is its democratic aspects. The habits and practices of true capitalism take time to emerge. Described as an “evolutionary” process by Peter Murrell, changes in law and markets will be difficult to enforce when working against the longstanding social systems. These reforms, according to Murrell, would be “most effective...[as] a product of the deeper informal structures of society. Law can be a powerful

---

<sup>15</sup> Class Lecture April 20, 2009

<sup>16</sup> Class Lecture April 20, 2009

<sup>17</sup> Murrell, 120

tool, but only if it is created by society rather than imposed upon it.”<sup>18</sup> This democratic aspect and the psychological effect it can have on the nations attitude towards its new systems and government are especially worth noting when remembering that as a Soviet Republic, the economic and governmental systems in the country “supported a theory-driven, top down, radical reconstruction of economy and society.”<sup>19</sup> Changes will be slow with the requirement of consent by the governed, especially when compared to the shock therapy school of thought; yet the stability that this influx of democracy can provide to the government and the governed may be well worth years of transition. Ironically, this slower transition would involve the “traditional processes of market democracy” far more than the faster transition using shock tactics would.<sup>20</sup>

A large cost of gradual reforms is the extended time that reforms will take to implement and enforce. Additionally, the largest drawback to the Gradualist approach is the possibility for derailment based on the extended time reforms will take to be implemented. The cessation of reforms can occur either at the direction of a politician trying to appeal to “short-term losers” and who is cognizant that any negative change, even if it results in greater long-term gains, can cost political points.<sup>21</sup> “Politicians in a democratic system will be reluctant to introduce any reforms [with] benefits...not realized before the next elections.”<sup>22</sup> Reforms that occur slowly can be stopped very quickly. Sachs writes “...economic strategy must take cognizance of the political context, which in our view argues overwhelmingly for a very rapid straightforward, and sharp program of economic reform.”<sup>23</sup> Reforms can also be stopped not by the “losers,” but also by

---

<sup>18</sup> Murrell, 120

<sup>19</sup> Murrell, 120

<sup>20</sup> Murrell, 115

<sup>21</sup> Hellman, 1

<sup>22</sup> Hellman, 3

<sup>23</sup> Sach, quoted in Murrell, 113

the short-term “winners.”<sup>24</sup> “Winners” often try to “stall the economy in a partial reform equilibrium that generates...[rewards] for themselves...imposing high costs on the rest of society.”<sup>25</sup> It is a very real possibility that due to political pressure, from both ends of the spectrum and especially if clever “winners” manage to combine their financial power with the unhappiness of the “losers,” reforms will end almost as quickly as they begin.

### **THE REALITY OF REFORM IN MOLDOVA**

The new Moldovan government was put in place through the direct intervention and at the express wishes of the people. The Communist Party was ousted from power almost certainly because of corruption and a platform that did not include any real opportunities for substantive economic reform.

The government now has the ability to institute real reform. The path towards true economic freedom will not be without its difficulties, but ends in great benefits for all Moldovans. A Western role is crucial in the transition by helping monetarily and symbolically with a clear support of reforms.<sup>26</sup> In tumultuous Moldova, a Gradualist approach has too much danger of being stalled or reversed and allowing the Communist government to sneak back into power. The danger of disillusionment with the reform parties in the imminent economic discomfort that will come with reforms is a risk, but the rewards of economic reform will be felt more quickly with radical reforms and will reinforce the system quicker than a Gradualist approach will. A Gradualist approach might have been possible to consider if the concept of democracy and the realization that reforms do require some destruction was a prevalent thought in Moldova. But in the specific case of Moldova, immediate and powerful reforms are necessary for the nation to survive, compete, and flourish in the global market.

---

<sup>24</sup> Hellman, 1

<sup>25</sup> Hellman, 2

<sup>26</sup> Sachs, xiii

Sources:

Joel S. Hellman, “Winner Take All: The Politics of Partial Reform in Postcommunist Transitions”

Jeffrey Sachs, *Poland's Jump to the Market Economy*

Peter Murrell, “What is Shock Therapy? What Did it Do in Poland and Russia?”

Class Lectures from Comparative Politics undergraduate course at NYU given by Professor Joshua Tucker, April 15 & 20, 2009