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Moldova: Major Economic Problems and Challenges

Background paper for the UNDP Roundtable on Social-Economic Issues organized at the request of the President of Moldova on April 12, 2003

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Introduction

The purpose of this paper is to provide background economic information to participants of the UNDP Roundtable on Social-Economic Issues organized at the request of the President of Moldova on April 12, 2003. The time horizon of this analysis is concentrated mainly on the period of 2000-2002 while some earlier historical background is provided when necessary.

Moldova is one of the smallest, poorest and heavily indebted transition countries suffering serious political and economic consequences of the conflict in Transnistria. The transition process in this country was extremely difficult and painful and its pace was uneven. The first stage of economic transformation was initiated in 1990. Liberalization of prices, of trade and enterprise operations were all introduced before 1992. An even more comprehensive program of transformation and stabilization was introduced in cooperation with the IMF and the World Bank in 1993.

The new Constitution (July, 1994) stated that Moldova was "a market economy". Moldova was the first of the post-Soviet countries to be admitted to the Council of Europe, and to sign a Partnership and Cooperation Agreement with the European Union in November 1994. A mass privatization program was implemented, and most industrial enterprises have been transformed into Joint Stock Companies. The National Bank of Moldova (NBM) introduced a new, stable, national currency and initiated credit auctions. As a result, the rate of inflation was reduced from 1184% in 1993 to 30% in 1995. In June 1995 the Stock Exchange started its operations. At this time Moldova was viewed as a star performer. With respect to implemented reforms, the country was ranked by the EBRD higher than most CIS countries and even higher than Romania and Bulgaria.

Moldova nevertheless failed to enter a period of economic growth following the course of economic events in Russia and Ukraine rather than that of Central European or Baltic countries. Reforms slowed down significantly after 1995. Many of earlier reform achievements started to look illusionary. The most important structural reforms, notably the privatization of land, were not implemented until the end of 1990s. This constrained for many years the growth prospects in the most promising sectors of the Moldovan economy: agriculture and agro-industry. The rapid accumulation of external debt softened the budget constraint and therefore helped to perpetuate the wrong policies. More generally, the government failed to create institutions conducive to growth of private entrepreneurship, to restructuring and to investments. Weak rule of law, low trust and perverse incentives were crucial in explaining the poor economic performance of Moldova [see Radziwill and Petrushin, 2002]

The situation of the economy after 1995 could be described as a "stable depression" that under the impact of external (currency crises in Russia and Ukraine) and internal (huge fiscal disequilibria) pressures developed into an open currency crisis at the end of 1998. Post-crisis recovery and adjustment involving a series of ambitious reforms in 1998-2000 brought an additional social pain. Finally year 2000 gave the beginning of economic recovery. Inflation came down again.

Following general elections in February 2001 country got for the first time a solid parliamentary majority and stable government (following years of short-living multi-party coalitions) but the pace of economic reforms evidently slowed down. During the last couple of years Moldova balanced several times of the verge of sovereign debt default and its current relations with the IMF and World Bank are very rocky. Country needs in the new long-term strategy of reforms, which will allow not only completing the transition process and avoiding danger of the next macroeconomic crisis but also will bring closer the perspective of European integration.

The paper is organized as follows. Section 1 presents general macroeconomic outlook of Moldova, analyzing GDP dynamics, employment and wages, inflation, monetary policy and exchange rate, foreign trade and balance of payment. Section 2 deals with fiscal situation, fiscal policy and fiscal management with special emphasis given to enormous debt burden. Section 3 reviews a broad spectrum of microeconomic and structural problems such as development of SME, FDI, agriculture reform, financial sector and barriers of market entry and business activity. Section 4 gives a general picture of privatization policies. Section 5 discusses the forthcoming policy challenges.

The paper was prepared by the team of economists representing the CASE – Center for Social and Economic Research, international Warsaw-based think tank working on problems of economic transition in Central and Eastern Europe, Transcaucasus and Central Asia. Because of the synthetic character of this review authors have to draw heavily from other existing policy analyses, surveys and publications of international financial organizations. However, authors accept the full responsibility for the content of this paper, its quality and formulated conclusions and recommendations.

1. Macroeconomic Outlook

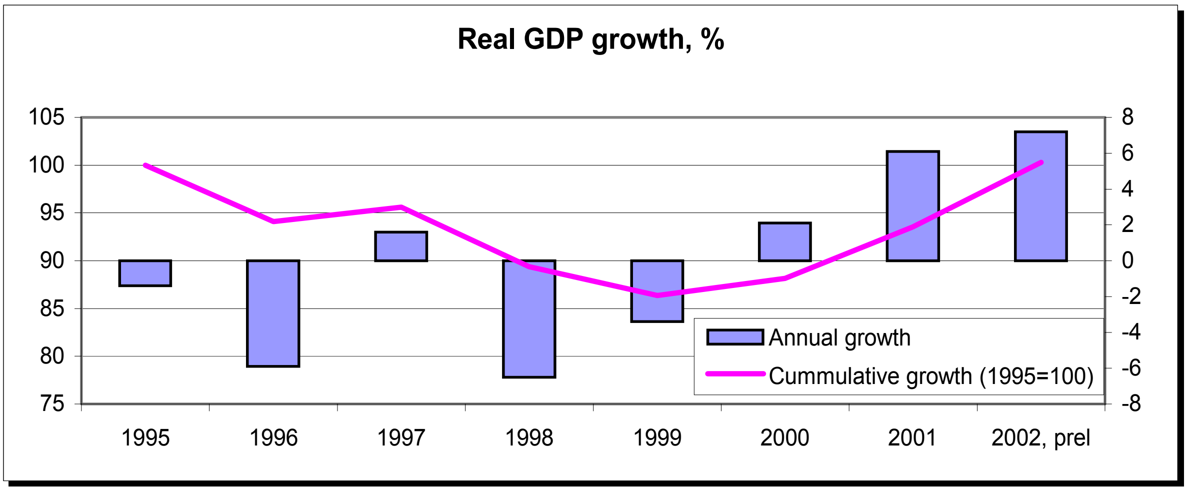
After a decade of economic decline, Moldova seems to be on the economic recovery path. This is the result of a series of comprehensive reforms implemented in Moldova in the decade of 1990s. Liberalization and privatization, agricultural reform and energy sector reform, fiscal adjustments and consolidation of the financial sector, as well as opening the country to the world economy – all together contribute to economic recovery and help to alleviate the high costs paid by the society during the 1990s. Increased salaries and pensions stimulate consumption, which (amplified by external demand) in turn generates higher demand for domestic production.

1.1. GDP dynamics and its decomposition by components of global demand and by sectors of the real economy

After a period of steady economic decline throughout the 1990s (with the exception of 1997) year 2000 marked the beginning of an upward trend (see **Figure 1**). The impressive growth rates of the last three years brought the level of real GDP back to that registered in 1995. The solid economic growth can be explained by a number of factors. First, the country is highly dependent on climate conditions because of the large agricultural and agro-processing sectors and these conditions were mostly favorable in last three years. Second, the rapid growth in three neighboring countries being major Moldova's trade partners (Russia, Ukraine and Romania) increased external demand for Moldovian goods. Third, the currency crisis at the end of 1998 helped to correct serious domestic and external imbalances [see Jarocinski, 2000] and create a more favorable macroeconomic environment for economic growth. Finally, a number of important systemic reforms carried out in 1990s such as successful disinflation, domestic and external liberalization, a far going privatization in industry, agriculture and services, land reform, financial sector consolidation and others started to bring fruits during last three years.

However, economic growth has bee recently accompanied by deepening of imbalance between aggregate demand and supply caused by a higher growth of domestic demand as compared to that of GDP, and negative or almost flat contribution of net export to GDP growth.

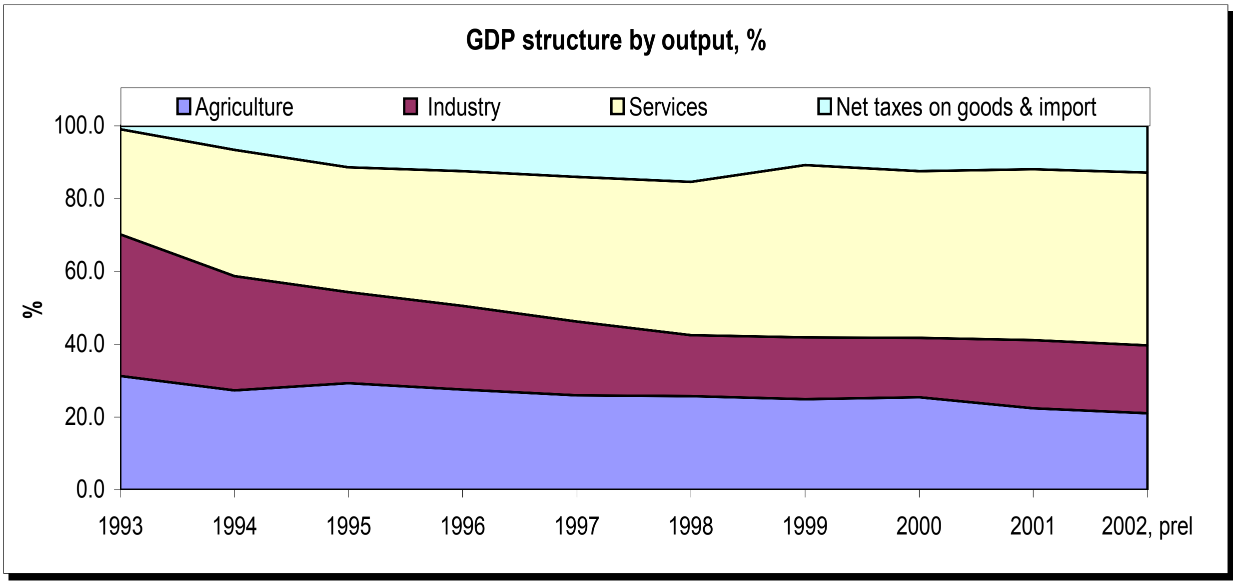
Figure 1: Real GDP Growth



Among the main categories of domestic demand, household consumption is the key factor supporting the growth. The increase in household income was fuelled by the rise in wages and pensions, and increased transfers from Moldavians working abroad, which accounted for some USD 275 million in 2002. The increase in fixed gross capital formation points toward an improvement of the financial standing of enterprises. Government spending has been tightened during the last several years, less so in the year 2002, as result of fiscal adjustment.

Relatively good external conditions (see above) supported the increase in exports. However, the contribution of net exports to GDP growth was negative for 2000 and 2002 (i.e. import grew faster than export in these years).

Figure 2: GDP structure by sector, in %



Growth in domestic and external demand impacted favorably on the supply side. Almost all sectors contributed positively to the real GDP increase (see **Figure 2**). The food industry made the biggest contribution to industrial output growth. For obvious reasons, the performance of this industry was closely related to the positive developments in agricultural production. The recovery in production of goods positively influenced the developments in many service sectors (transport, trade, and constructions).

While economic results for 2000-2002 were rather favorable for Moldova, the country's high dependence on external demand and climatic conditions points to the potential risks of adverse shocks. Without further restructuring and increase in investments, economic growth in Moldova is unlikely to prove sustainable.

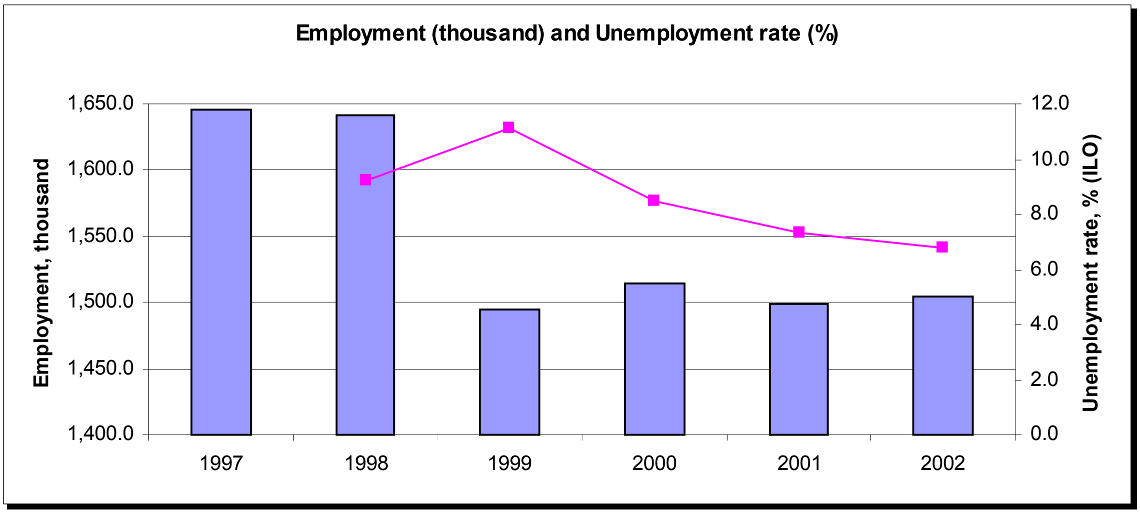
1.2. Employment and wages

Despite continued decline of output, employment data suggest that until 1998 labor reduction had been done on a small scale [Jarocinska, 2002]. Only 1999 brought a more rapid decline in employment of 8.5%. Apart from consequences of currency crises in Russia and Moldova (falling employment as a result of general economic slowdown), the main reason of decline was the progress in enterprise restructuring accompanied by sizeable job cuts, closure of many loss-making enterprises, and outflows of population seeking better job opportunities abroad.

Land privatization along with shrinking activities in the industrial, construction and other sectors moved labor force to agriculture, which has accounted for over half of the total employment in the national economy. Land cultivation and animal breeding have become the only sources of subsistence income for many persons laid off from other sectors.

The structure of employment over the last years has been relatively stable. Despite the economic recovery, employment increased only slightly in 2002. New jobs were concentrated in the manufacturing industry, the energy sector, trade, and constructions. This situation led to a reduction of unemployment in 2002. 110 thousands were out of work in 2002, which translated into an unemployment rate of 6.8%, lower than in the previous years (see **Figure 3**).

Figure 3: Employment and Unemployment

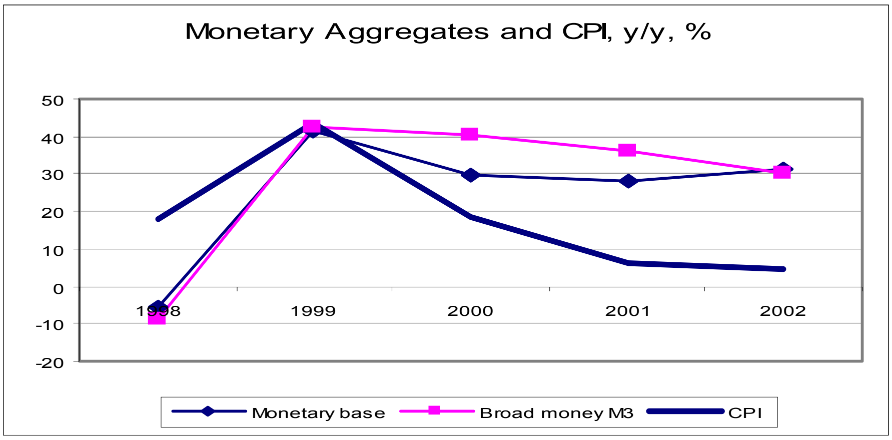


The average monthly wage in 2002 amounted to Moldovan Lei (MDL) 691.9 or USD 55.4. This amount covered only some 60% of the minimal consumption budget. Under these circumstances, the large shadow economy allows the poor to survive. Increase in self-employment indicates that people are encouraged to seek job on their own without any government assistance. According to the official estimates, some 230 thousand persons were declared in 2002 as working or looking for a job abroad, which accounts for almost one fifth of active population aged 15 and older.

1.3. Inflation, monetary policy and exchange rate

The main objective of monetary policy is to achieve and maintain the stability of the national currency and domestic price level. The NBM uses different indirect instruments, such as open market operations (including buying/selling Treasury bills and REPO operations), Lombard facility, reserve requirements, the NBM basic interest rate, etc.

Figure 4: Monetary Aggregates and CPI



The period after the 1998 currency crisis was marked with a substantial monetary expansion (**Figure 4**). During the last four years monetary aggregates grew by 20-40% yearly. The NBM conducted money emission in two major ways. First, the NBM purchased foreign currency in order to rebuild its international reserves. Second, it provided the Ministry of Finance with financial resources through buying T-bills for its own portfolio and offering direct credits to finance budget deficit.

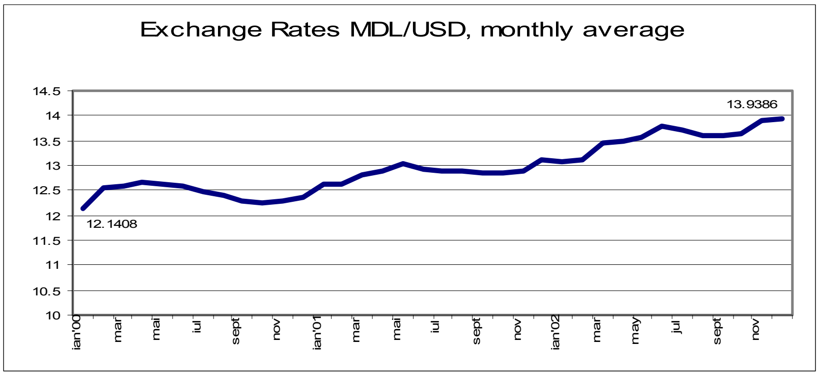
However, over the past five years, Moldova showed a remarkable lack of correlation between money supply growth and inflation. In 1998, the contraction of money supply occurred while inflation began to increase rapidly. In the period 2000-2002, money supply increases of 30-40% per annum matched rapidly falling inflation. The year 2002 continued to show very low inflation of only 4.4%. The very similar discrepancy has been observed in Russia and Ukraine in a post-crisis period.

The lack of correlation between money supply growth and inflation can be explained by a rapidly growing demand for the domestic currency determined both by growing GDP and decreasing money velocity. The latter can be seen as the effect of relative exchange-rate stability (after the initial post-crisis devaluation overshooting), gradual rebuilding of confidence to leu and domestic banking system, and remonetization on the microlevel (reducing role of arrears, barter and netting out operations). However, one must remember that remonetization will not continue indefinitely at least at the previous pace and rapidly growing money supply involves a new inflation threat at some point of time.

In addition, the favorable climate conditions helped to increase output and lower prices of agriculture products, which constitute a substantial share in the consumer basket of Moldovan households. This kind of supply-side price shock can be easily reversed in future contributing to higher headline inflation.

Considerable increases in real wages, salaries and pensions during 2001-2002 did not also pass fully to inflation because of an administrative price control. However, liberalization of some administrative prices scheduled for 2003-2004 may contribute to increasing inflationary expectations.

Figure 5: Exchange Rate MDL/USD, monthly average



In the years following the 1998 currency crisis the MDL/USD exchange rate was relatively stable (**Figure 5**). Substantial income remittances of Moldovan citizens working abroad (about USD 200 million in 2001 and USD 275 in 2002) can largely explain stability of the foreign exchange market. These transfers helped to prevent a significant depreciation of the leu in the absence of foreign financing from the international financial institutions (IFIs). For example, inflow of foreign exchange in 2001 amounted to USD 980 million and came mainly from exports of goods and services (69%), and workers' remittances (17%). Foreign exchange outflow amounted to USD 1,017 million for imports of goods and services (84%) and external debt servicing (16%).

Due to NBM net purchases of foreign exchange, international reserves increased despite external debt servicing. The NBM international reserves actually reached a level equivalent to 2.7 months of imports. Part of them was sold to the Government for external debt servicing. From 1997, the NBM implemented the bi-structural foreign exchange reserves (70% in USD and 30% in DEM, replaced by Euro in 1999).

Table 1: Interest rates, end of year, %

Interest Rate	*1998*	*1999*	*2000*	*2001*	*2002*
NBM basic rate	32.7	17	15	13.5	10.5
Interest rate on deposits	21	27.4	24.6	20.6	12.64
Interest rate on credits	28.2	35.5	32.3	28.5	19.29
Interest rate on T-bills	29.1	28.6	22.1	14.5	5.75

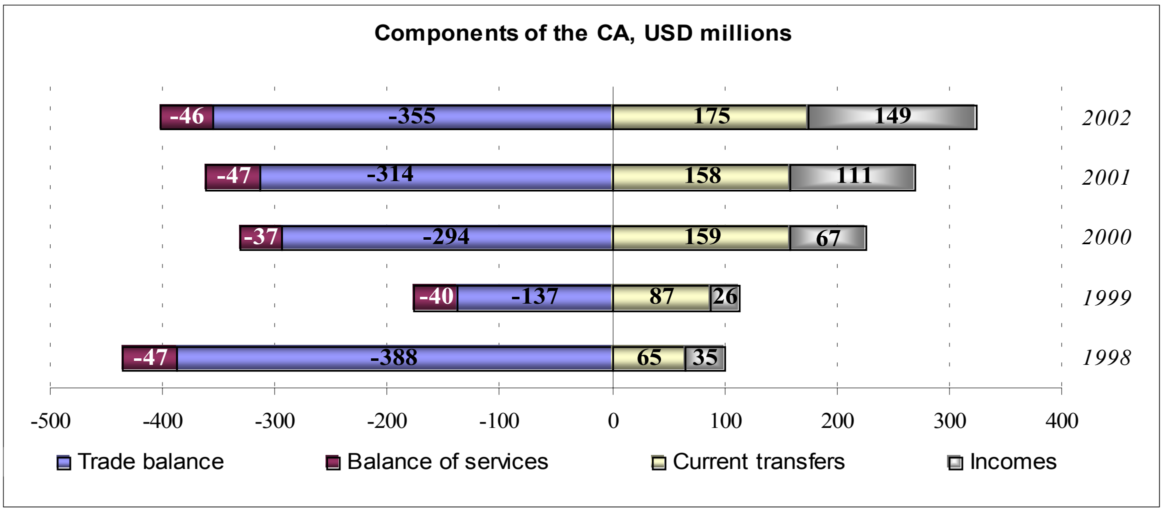
Recent years have shown a constant trend of lowering the interest rates on almost all financial instruments (**Table 1**). It can be explained by a favorable macroeconomic environment (decreasing inflation, relative stability in the foreign exchange market) and the growing excess of liquidity held by commercial banks caused among others, by massive net purchases of foreign exchange by the NBM, steady reduction in reserve requirement compulsory reserves and the consolidation of the banking system.

1.4 Export and import, trade balance, remittances and current income transfers, current account

The current account has continued to register a large deficit (see **Figure 6**). The large trade deficit has been offset by increased remittances of Moldavians working abroad. They have had a stabilizing influence on the exchange market and contributed to an increase in private consumption. The structure of current transfers has changed towards increasing foreign grants and technical assistance at expense of the humanitarian aid.

The year 1998 brought a turning point of Moldovan external trade with the external shock seriously affecting traditional export to Russia and CIS and imports becoming more expensive after the depreciation of the leu. Lack of diversification in terms of markets and products caused a contraction in export volumes. Only from 2000 did Moldova re-experience an upward trend in exports and imports. In 2002, the trade volumes of goods and services (both total and by components) exceeded for the first time, albeit insignificantly, the level of 1998.

Figure 6: Components of the Current Account, USD million



The Russian crisis affected particularly seriously the trade of goods. The service sector needed one year less to recover. Already in 2000 trade of services came back to the level of 1998.

One could expect that economic recovery and the increased population income would lead to faster growth of imports than exports. However, in 2001-2002 the opposite was true: the rate of growth of export of goods and services outpaced that of import. Although the absolute size of the trade deficit has grown, with a slightly lower value in 2002 compared to the year of the financial crisis (1998), its relative value (compared to trade volume and GDP) decreased over the period 2000-2002.

However, the trade structure has not changed. Agriculture, food-processing and textile products account for more than half of the total export. On the import side energy resources still constitute the highest share despite their continuous decline.

The biggest fluctuation in trade balance was generated by transportation services but they did not represent a large enough share in the total trade volume to affect significantly the overall trade balance. In the last two years, the tourism sector started to generate a substantial deficit as the increasing number of Moldavians traveled abroad (mainly to search employment) compared with the tiny flow of foreigners visiting Moldova.

Traditionally, due to bilateral free trade agreements, the CIS countries were the main importers of Moldovan products and Moldova has a trade surplus with them. However, in 2002 the trade balance with the CIS region became negative. This occurred on account of a sharp increase in import from Ukraine, which overshadowed the simultaneous increase in Moldovan export to Russia. As a result of the reduction of the share of energy resources in the total volume of imports, the position of leading import market passed from the Russian Federation to Ukraine. At the same time, Moldova had trade deficits (related to both goods and services) with the EU and with the rest of the world. The geographic concentration of external trade reveals the continuous economic dependence on Russia and Moldova's vulnerability to changes in Russian import demand.

In spite of better terms of trade with the EU (in comparison to those with the CIS), Moldova's export to this region is still modest. This may be due to the large agricultural and textile components of Moldova's exports, which come up against the EU's protectionism in these sectors. In other cases, access to this market is hampered by the poor quality of exported goods. Nevertheless, there have been some positive signs in the last three years. Both improved competitiveness of some industries and preferential schemes offered by the EU for a number of products have increased the share of Moldovan exports to this region.

Moldova's accession to the WTO and the Stability Pact Free Trade Area are expected to stimulate foreign trade in the long run. Initiation of bilateral talks with the EU on free trade is also a step forward in this direction. Combined with structural reforms, these actions are likely to improve market access for Moldovan goods.

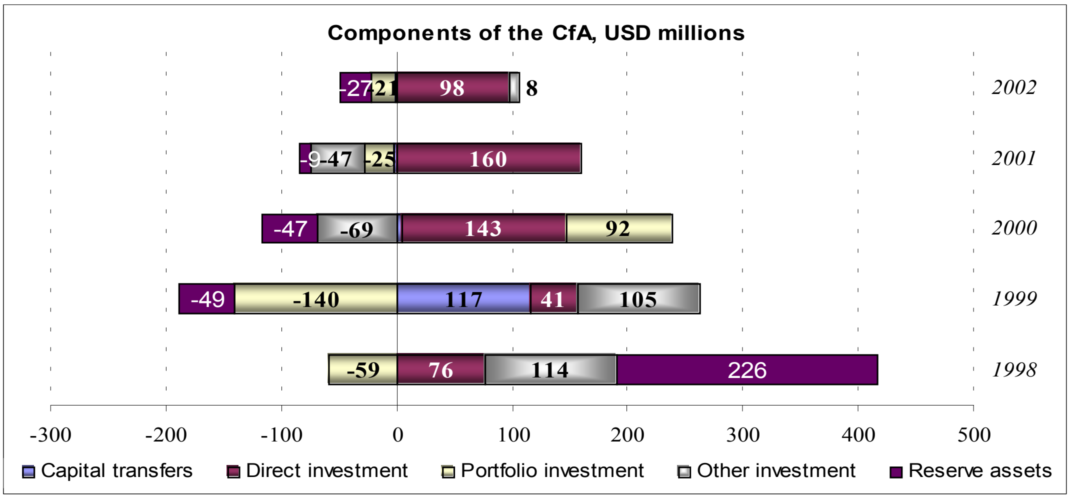
1.5 Capital and financial account developments

Although the capital and financial account of the balance of payments registered a surplus during the analyzed years its size was constantly decreasing and did not cover the deficit of the current account. The following factors had an effect on the financial and capital account developments: transfer of a portion of the state ownership in Moldovagaz to Russian Gazprom as repayment for the debt for natural gas imported over the last several years, repayment of loans previously extended to other sectors of the economy through debt-to-equity swaps, anticipated redemption of part of Eurobonds, rescheduling of government debt and government guaranteed loans, accrual of new arrears in external debt service, continuous non-payment for imported energy resources, unfreezing in the summer of 2002 IFIs financial assistance, which had been stopped in March 2001; rescheduling of Eurobonds, and privatization of important state enterprises with the participation of non-residents.

The trends of individual major items in capital and financial account established in 2000 continued in the following two years (see **Figure 7**). FDI were the major source of investment financing but their net size was gradually decreasing reflecting deteriorated country's investment rating (as recorded by some international rating agencies). This was a result of an increased perception of political risk, insecurity of property rights and overall worsening of country's business and investment climate (see below). Consequently, in the last two years, many potential investors refrained from equity investment in Moldova preferring rather short- and medium-term loans. The year 2002 was the first one when FDI in the form of loans exceeded the sums invested in equity capital.

In addition, a large part of statistically recorded FDI represented neither real “green field” investments, nor cash privatization transactions. They were related, for example, to conversion of Moldova's debt to Gazprom into latter’s ownership of the controlling package of shares in Moldovagaz.

Figure 7: Components of the Capital and Financial Account, USD million



Portfolio investments continued to represent a negative net balance caused by the rescheduling of Eurobonds and accrual of new debt arrears in relation to Gazprom. The main credit inflows came from the IMF, WB and EBRD loans. Also, the capital and financial account of the balance of payments responded to the changes in the position “other liabilities”, indicating an accrual of new arrears of external debt service and of current imports payments.

2. Fiscal Policy

Moldova managed to accomplish a dramatic fiscal adjustment reducing deficit of the consolidated budget from 9.7% of GDP in 1996 to 0.9% in 2002 (see **Figure 8**). This allowed for tightening of monetary policy, stabilizing leu and decreasing inflation. Reduction of expenditure from 36.3% of GDP in 1996 to 24% of GDP in 2002 was achieved mainly due to a massive reduction in net lending to enterprises through the budget and almost complete elimination of quasi-fiscal subsidies in the form of bank credits directed to specific sectors and borrowers. There was a slight decrease in revenues from 26.6% of GDP in 1996 to around 23% in 2002.

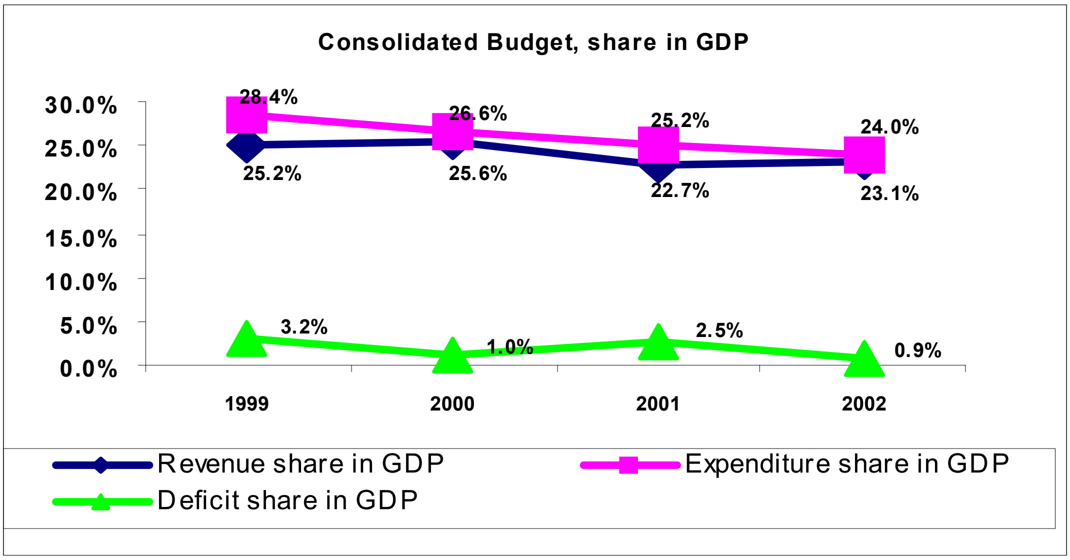
2.1. Revenue dynamics and its decomposition

Growth recovery and ongoing improvement in tax administration are principal factors that influenced revenue dynamics and collection levels of the consolidated budget. These factors contributed to a nominal average annual increase of 12.3% in tax collections over the last five years.

Tax revenues have the biggest share in the consolidated budget (86% of total revenues and 19% of GDP). Personal income tax and profit tax perform better in terms of budget execution than the others, despite the cut in the maximum personal income tax and profit tax rates (from 28 to 25 percent) at the beginning of 2002.

Value added tax (VAT) and excise tax, which are the most important revenue sources, accounted in 2002 for 40% and 13% of the consolidated budget revenues accordingly. Over 80% of these taxes receipts are collected by the customs administration (from import). However, over the last several years, revenues from these taxes have felt short of expectations because of numerous tax exemptions.

Figure 8: Consolidated Budget, share in GDP



The non-tax revenues make up only 12% of total consolidated budget revenues or 2.7% of GDP and, over the last three years, have presented a decreasing trend. This particularly relates to lower profit transfers from the NBM as result of a sharp reduction in interest rates.

Capital operations have also decreased and hold an insignificant share in total budget revenues due to the slowing down of a privatization process.

2.2. Expenditure dynamics and its functional decomposition; analysis of social expenditures

In the first years of Moldova's independence, as GDP fell, expenditures were not reduced at the same proportion. Consequently, in 1997, consolidated budget expenditures amounted to more than 40% of GDP. Since then, they were cut to only 24% of GDP in 2002. This reduction has not been easy. Expenditure rationalization involved, among others, elimination of almost all subsidies, reduced health services, better targeting of social assistance, and decreasing number of public employees. Government succeeded in bringing consolidated budget "expenditures on the national economy" down from 14% of GDP in 1997 to slightly over 2% of GDP in 2002. The slump in public investment continued, falling to under 5% in total expenditure in 2002 and under 1% of GDP.

However, the debt service rose sharply in nominal and real terms reaching 23.9% of the consolidated expenditures in 2000. In 2002 interest payments was reduced compared to the original budget plan because of a strong exchange rate of leu, low interest rates and rescheduling of the part of external debt. Other increase concerned public administration, where spending rose sharply from 4.7% of total expenditure in 1999 to 8.2% in 2002.

Meanwhile the share of social spending in total consolidated expenditures[1] increased from close to 34% in 1999 to 54% in 2002, i.e. from 11.7% of GDP in 1999 to 12.8% of GDP in 2002 (see **Figure 9** and **10**). During this period, education expenditure rose faster than other social expenditures. Generally, it means reallocation of budget resources from subsidies and quasi-subsidies to national economy towards social services.

Figure 9: Main Expenditure Groups

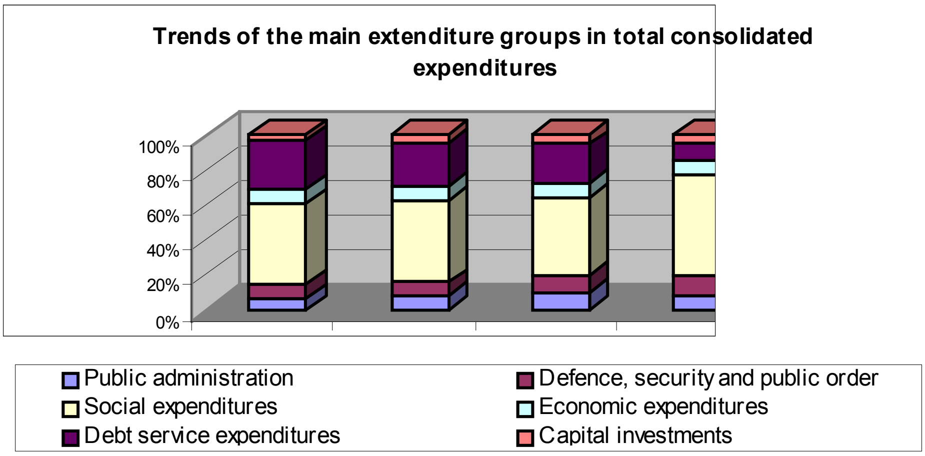
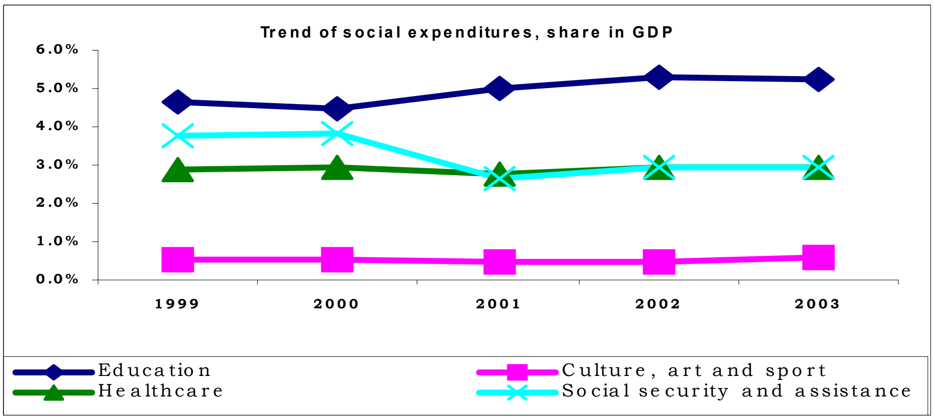


Figure 10: Trends of Social Expenditures, share in GDP



The Ministry of Finance has begun to implement a medium-term expenditure framework (MTEF), which gives a longer term fiscal perspective in the process of preparing annual budgets and creates a more disciplined spending environment for individual ministries.

The 2002 budget execution was adversely affected by unplanned wage increases, unsatisfactory tax collection and lower-than-expected external financing, leading to lower-than-targeted clearance of outstanding arrears.

2.3. Fiscal deficit and sources of its financing

The budget deficit was reduced from 7.5 percent of GDP in 1997 to 0.9 percent in 2002.

[1] Social expenditure comprises education, health, culture and art and media, physical culture, sport and youth, and social assistance. For the purpose of this paper, Social Fund expenditures are excluded.

The three main sources of deficit financing are money creation, domestic borrowing, and foreign borrowing. The structure of deficit financing has changed over years from external loans and NBM credit to a combination of Treasury bills and NBM credit, with much less reliance on external finance (due to decreasing sovereign rating and limited access to international financial markets).

In 2002 the lack of external financing caused that budget deficit was covered mainly from domestic sources. The net indebtedness to domestic creditors increased by 25% in comparison to 2001. The NBM credit increased by MDL 237 million and T-bills amounted over 43% of reported domestic borrowing. The proceeds from privatization constitute another hypothetical source of deficit financing. However, during the last years their execution was always much below the planned level.

2.4. Public debt stock and dynamics; forthcoming challenges

Moldova has found itself in a situation of a 'debt trap' that hampers prospects of its economic growth. Total external debt increased by 24% over the last three years on account of an increase in private debt (**Tables 2** and **3**). Public debt, which included liabilities of government and the NBM, had not changed since 1999. Debt rescheduling may bring a temporary relaxation of fiscal constraints and postpone the danger of country's default but will not solve the debt problem in the medium and long run. It can be done only by the prudent fiscal policy aimed in producing budget surpluses.

Table 2: External debt burden indicators

Item	Units	1999	2000	2001	2002 prel
External debt	US$ mln	1075.7	1230.1	1216.9	1337.9
Export of goods and services	US$ mln	608.8	642.2	740.9	878.1
External debt / GDP	%	91.9	95.5	82.2	82.2
External debt per capita	US$	299	342	338	372
New borrowing by public sector	US$ mln	198	63.1	43.4	49.2
Public external debt service	US$ mln	176.2	102.9	125.9	91
Public external debt service / export of goods and services	%	29	16	17	10.4

At the end of the year 2002, IFIs became the biggest group of creditors, holding 39% of the total debt. Official bilateral obligations accounted for around USD 200 million or 15% of the total external debt and can become the subject of rescheduling negotiations with the Paris Club (conditional on agreement with the IMF). It is also a possibility that rescheduling of Eurobonds in 2002 may complicate the negotiations. Some creditors may resort to the equal treatment clause in order to claim rescheduling conditions similar to those set for the Eurobonds, which are far from being favourable for Moldova. This concern is also expressed in the Country Report prepared by IBCA in February 2003[2]. The similar problems may be caused by the bills of exchange issued in favour of Gazprom. The issuance agreement provided that the holder might use them to pay taxes and purchase state property in the privatization process.

So far the year 2002 was the most difficult one in terms of meeting external debt obligations. Following Moldova's failure to redeem Eurobonds in July 2002 Fitch IBCA ranked the country as 'defaulted' but soon its rating improved as a result of a rescheduling agreement signed with the bond holders and ratified by the Parliament (see **Table 4**).

[2] Credit Analysis-Republic of Moldova, FitchRatings, www.fitchratings.com

Table 3: External debt, end of year (US$ million)

Item	*1999*	*2000*	*2001*	*2002*
Public debt	**934.9**	**997.6**	**930.3**	**968.9**
From IMF	175.4	154.1	145.9	151.4
Direct government debt	672.1	761.5	705	737.4
Loans	597.1	593.1	568.6	598.7
Bonds	75	168.4	136.4	138.7
Debt Guaranteed by governmental	87.4	82	79.4	80.1
Private debt	**140.8**	**232.5**	**286.6**	**369**
Total external debt	**1075.7**	**1230.1**	**1216.9**	**1337.9**
Arrears for energy resources	415.4	316.4	287.2	298.9

Table 4: Changes in Moldova's rating

Date	*Rating*
February 2003	B-
July 2002	DD
July 2001	CC
June 2001	CCC
November 1999	B-
July 1998	B

In the conditions of lower interest rates on government securities in the domestic primary market, the issuer (Ministry of Finance) gave in to the temptation of increasing the offer and drawing more financial resources to finance a fiscal deficit (**Table 5**). Also, over the last several years, the Government turned to the option of direct loans from the NBM leading to substantial increase of domestic public debt.

Table 5: Domestic public debt, end of year, MDL millions

Item	1997	1998	1999	2000	2001	2002 prel.
Internal state debt	984	1572	1910	2022	2401	2821
Government securities outstanding	459	563	595	707	894	1077
Direct NBM borrowing	512	1009	1315	1315	1507	1744

2.5. Fiscal management problems and challenges

The Government of Moldova has accomplished progress in improving and streamlining certain aspects of fiscal management. Most of the basic legal framework for the budget system and budget process is in place. A central treasury system has been established; work is well advanced on a new system of treasury management, including an improved budget classification methodology; efforts continue to strengthen revenue administration and tax collection, and attempts to launch a far-reaching fiscal decentralization reform were initiated. The Ministry of Finance is committed to securing further improvements in the quality of the budget process through the gradual adoption of the elements of a MTEF and building capacity in Program and Performance Budgeting (PPB) techniques.

However, the sustainability of the progress achieved in the area of fiscal discipline remains questionable. For example, the principles of tax law codification are not fully respected as many norms continue to be established in the annual budget laws. Fiscal provisions are included in some legislative acts regulating other social and economic areas. Tax law includes too many exemptions and is not stable. Some provisions regulating VAT refunds are complicated and bureaucratic. The principle of fairness is not respected as the taxes do not have a neutral character. Tax evasions are extremely large, and tax arrears are boosting.

The budget process remains particularly weak in allocating resources based on strategic priorities. As the consequence of currency crisis of 1998 and the large external debt burden, the Government adjusted the budget by reducing drastically expenditures on healthcare, education, and social protection. As a result, the quality of services deteriorated, while unequal access to services became the rule rather than the exception.

Three initiatives can improve budget information that will be available to decision-makers within the Ministry of Finance, Government, and Parliament. In future, the EGPRS, MTEF, and PPB should provide them with a more strategic vision of the budget priorities in the medium and long term perspective.

The Economic Growth and Poverty Reduction Strategy (EGPRS) can set clear objectives and priorities for the budget. The task for the Ministry of Finance will be to find a way to ensure that these objectives and priorities will be actually implemented in the budget. When the Ministry prepares the draft budget for consideration by both Government and Parliament, it will need to demonstrate the connections between the figures being proposed in the budget and the objectives of the EGPRS.

The MTEF and PPB are analytical tools that are now being adopted by the Government for the period 2003-2005. Program budgets present both the resources needed by each program and the objectives that each program aims to achieve. Similarly, the MTEF shows the future implications of current budget decisions. Thus, further development of the MTEF can help in tougher top-down prioritisation of expenditures across sectors. If these reforms are implemented well, it will be much easier for the Government and Parliament to evaluate budget proposals.

Further strengthening of public debt management and the development of an integrated public debt management strategy should help to minimize the cost of financing and ensure fiscal sustainability of debt servicing over the medium and long term.

Aggregate fiscal discipline needs to be strengthened through further consolidation of the state and local budgets and of extra-budgetary funds. Inclusion of capital investment financed from abroad and of other expenditures financed by donors is also necessary.

2.6. Changes in the tax system

The implementation of the Fiscal Reform Concept adopted by the Parliament started in 1997. Six Titles of the Tax Code have been drafted and approved: General Provisions, Income Tax, Value Added Tax, Excises, Tax Administration and Immovable Property Tax. As different from previous fiscal legislation, the present Tax Code was drafted based on the principles of fairness, taxpayers equal treatment on behalf of the State, degree of tax burden, fiscal autonomy, tax administration efficiency and other principles and criteria pertinent to a market economy.

The most important modifications applied to tax legislation over the past several years focused on:

- Increasing the VAT administration efficiency by raising the threshold for obligatory registration of VAT taxpayers from MDL 50,000 to 100,000, and then to MDL 200,000 of turnover made during the 12 consecutive months of the year;

- Decreasing the tax burden by reducing the maximum rate of individual income tax from 32% to 28%, and then to 25% , and of corporate income tax to 22%, while increasing annual personal income exemptions from MDL 2,100 to 2,520 , and then to MDL 3,600;

- Supporting small businesses by granting them income tax exemptions for three-year periods;

- Supporting farmers' households, regardless of their turnover and number of employees, by granting them income tax exemptions for three-year periods;

- Creating a more favourable conditions for business development by increasing the cap on expenses related to fixed assets repair, which allow for deductions of 5% to 10% of fixed assets value at the beginning of the year;

- Simplifying the documentation procedure for goods and services supplies by merging the transportation invoice and the VAT invoice into the single fiscal invoice.

A range of measures was implemented during the last years to improve tax administration efficiency and enhance fiscal management. In 2002, Title V on Tax Administration was adopted, which establishes the competencies of tax administration bodies and regulates the administration procedures of taxes and fees collection. The Large Taxpayers Unit has been operating at the State Tax Inspectorate since 1999. The structure of the State Tax Inspectorate was reviewed towards focusing on territorial inspectorates' management. Fiscal posts were created along the borders with Transnistria, as well as at the premises of alcohol beverages producers and oil products wholesale warehouses.

The Information Processing Department has been operating at the State Tax Inspectorate since April 1, 2002. This Department was assigned the task of centrally processing tax returns and other data necessary for the tax administration of the whole country.

To improve tax reform, it is necessary to finalize the tax law codification and to make tax administration more efficient. Codification means that each tax will be regulated by a separate Title of the Tax Code. To achieve this, it is important to draft and to adopt the following Titles: Local Fees; Customs Duties; Road Tax; Natural Resources Tax; and Other Fiscal Revenues and Regimes.

2.7. Fiscal decentralisation

Decentralization of fiscal, political and/or administrative responsibilities to the local governments started in Moldova from 1998. Approving the package of laws on local public administration laid the foundation for the creation of the legal and institutional framework of intergovernmental fiscal arrangements. The laws on Local Public Finance and Local Public Administration stated that the first level of local government (towns and villages) should be autonomous. However, at the same time *judets* (the second level of local government) got virtually unlimited discretion to determine how much money to allocate to municipalities and for what purpose. This conflict often reflects the perception that regional authorities are acting on behalf of central authorities or that they significantly control over the allocation of funds from the central government to local governments. Tensions exist around the conflicting and unclear powers of two parallel regional structures, local council and prefecture. Perhaps, these two major problems were at the base of a new territorial reform, which the current Government has recently adopted.

Moldova has already changed some laws to give local governments the additional autonomy but has not resolved yet many important questions regarding how local governments should be financed. Because the municipalities lack fiscal autonomy they do not really have any autonomy at all.

Particularly insufficient revenue autonomy is the weak point of a local government system. Local governments have no sufficient local tax base, independent authority over user charges, and administrative capacity to collect local revenues. To create a local tax base (commercial and residential property) the Government implemented Title VI "Property Tax" and is working on implementing Title VII "Local Tax". With regard to user charges, the main obstacles appear to be lack of administrative capacity and the persistence of central government regulations concerning pricing for locally provided services, such as transportation and utilities. Pricing regulations constrain local efforts to achieve greater cost recovery.

Current law on local public finance assigns a portion of some taxes (tax sharing) to "local governments" but in this case "local governments" means *judets*, not towns and villages. The law does not set the portion that goes to the *judets* and the portion that goes to towns and villages. *Judets* councils determine the share of each of these taxes that will go to each individual local government. Even within a single *judet* there are different sharing ratios for different towns. *Judets* decide how much of each tax to give to a town and village based on the *judets*' judgment of how much revenue the town needs to meet spending priorities using national norms adjusted by the *judet*. So the current form of tax sharing poses serious obstacles to effective intergovernmental fiscal relations such as:

- Tax sharing breaks a link between responsibility for raising revenues and accountability for service provision;
- Tax sharing creates a strong disincentive for mobilizing local revenues; and
- Current arrangement encourages informal mechanisms to finance local government, which are undesirable for their lack of transparency and adverse impact on business climate.

Perhaps, the transfer system is the most problematic part of revenue sharing mechanism. First, transfers should be transparently determined and go directly from the central government to the towns and villages avoiding the intermediate *judet* level. Second, the lack of transparency in political negotiations over central government estimates of expenditure needs and revenue forecasts creates a possibility for increasing the amount of transfers for some regions. It requests a new approach to formula of transfer calculation.

Autonomy must also be extended to expenditure decisions. Local authorities have increased their formal authority over spending decisions but central government often intervene with "recommendation" of spending more on education, health, wages, etc. (delegating unfunded expenditure responsibilities from central to local budgets). Additional spending obligations for local governments come from state-owned enterprises, which provide many public services, including local infrastructure (e.g., roads, heating, water and sewerage), housing, health clinics, and kindergartens. Financially constrained local governments are not in position to fully finance these services. To solve these problems local authorities should contract nongovernmental organizations as an appropriate option for local utilities, waste management, and other functions and/or to turn to their privatization.

Other issues of decentralization are accountability and transparency. A proper mechanism to ensure them is not fully developed yet. There is limited access to public statements of fiscal objectives, the budget is not transparent, and there is little public participation in fiscal decision-making (public hearings, consultations).

3. Microeconomic Prerequisites for Growth

3.1. Development of SME sector

SME development offers many possibilities for economic growth, while opening new job opportunities and raising living standards for the population. It also enhances competitiveness and regional development as well as promotes technological advancement.

The tendency over the last five years has been to support the development of SME in Moldova. To ascribe an enterprise to SME, the criterion of total employees (75 on average) was applied until November 2001. Since then a small enterprise has been broadly defined as an enterprise employing 10 to 50 workers on average during the year and grossing total annual sales of MDL 10 million; by contrast, a micro-enterprise employs no more than 9 workers and grosses total annual sales of MDL 3 million. In 2002, 21,000 SME were operating in all sectors of the economy, accounting for over 90% of all enterprises. The limited liability companies accounted for 74% of total number of SME followed by joint-stock companies, which form a mere 9%. Most SME operate in Chisinau Municipality, where 68% of all of them is concentrated, generating 75% of total turnover and employing 57% of the labor force.

In sectoral terms, SME are concentrated especially in the trade where they generate over 60% of total domestic sales, accounting for 90% of all commercial enterprises and employing over 45% of the labor force. However, the share of SME in the whole national economy is still small, accounting for 90% of all enterprises but employing only 25% of the labor force and generating only 28% or MDL 5.5 billion of total sales.

Cross-country statistical analyses show that SME sector is underdeveloped in Moldova comparing to the average both in the EU countries and in the Central and Eastern Europe. Judged by the number of enterprises operating, Moldova's indices are comparable to most countries. However, the criteria of total employees and turnover rank the country much lower [see World Bank, 2002]. For instance, in 2002 only 30% of all registered enterprises made profits, while 41% reported zero turnovers.

Government policies and measures aimed at supporting and developing SME are purely declarative. The several adopted programs have not improved essentially the conditions for SME growth. These programs were designed to improve the legal framework, establish a favorable business environment, support investment through advanced set of financial instruments, expand the infrastructure for SME development, and train employees for this sector. The Government lacks an efficient mechanism of monitoring programs implementation. According to the results of Transparency International Moldova survey carried out in 2001, 46% of entrepreneurs believe that "the Government hampers the development of the private sector". Entrepreneurs face many difficulties in the creation and development of small enterprises: imperfect legal framework, lack of financing, corruption, bureaucracy etc.

3.2. Foreign Direct Investments

Moldova is highly dependent on external capital flows, especially in the form of FDI. Because of lack of natural resources and low levels of personal and corporate income FDI is the only source of sustained economic growth, as described in the Government action plan.

The investment environment in Moldova differs negatively from that in other Southeast European countries. Generally, over the last several years, investors' perception of this region has improved, with eight countries given higher ratings. Moldova's situation, however, is deteriorating as shown by the FDI statistics (see **Table 6**).

Table 6: FDI: Moldova's position among Southeast European countries

Indicators	South-East Europe	Moldova	% of Moldova's FDI compared to the region
FDI, US$ million			
2000	22,700	143	0.63
2001	25,500	160	0.63
2002 (estimate)	33,700	98	0.29
% to previous year			
2001/2000	112.3	111.9	-
2002/2001	132.2	61.3	-

The major cash investors came from the US, UK, France, and Luxembourg. Although Russia remains Moldova's main strategic partner, Russian investments consisted mainly of the conversion of debts for gas into shares. There are, however, several Moldovan-Russian projects under way. Ratification by the Russian Duma of the Treaty for Partnership and Cooperation between the Russian Federation and Moldova in April 2002 and the results of the CIS Summit in October 2002 served as bases for state guarantees and lowering investments risks.

The energy, transport, communications, trade, and manufacturing sectors continue to attract the most investment. While the actual number of companies with foreign investment within these sectors is fairly small, they provide most of the FDI both in absolute and relative value.

New investments in the manufacturing, transport and communications sectors resulted in changing the distribution of equity capital among the sectors: reduction in the share of the energy sector, and increase in the shares of the processing, transport and communications sectors.

Recently, the investment climate deteriorated as result of the series of conflicts between Moldovan authorities and foreign investors as well as the decision of Moldovan authorities to review the list of foreign investors benefiting from income tax exemptions.

3.3. Agriculture reform

Agriculture has traditionally been and remains the backbone of Moldova's economy (see **Table 7**). This is the largest sector employing nearly half of the labor force, contributing to about one fourth of GDP and generating nearly 2/3 of total exports (together with the food & drinks industry). This contribution is amplified by multiplier and linkage effects as agro-processing accounts for a further 10% of GDP. Therefore increasing primary agricultural production that would give a boost to the agro-processing industry and enhance the country' export base would certainly lead to a sustainable broad-based economic growth.

Table 7: Agriculture: Main Indicators – 2002

Agricultural area 2.54 million ha *of which* Arable land 72% Pastures 15% Perennial 12% Orchards 5.6% Vineyards 6.0%	Share of agricultural sector in: GDP 21% Exports (agro-food) 60% Employment 46% Rural population 54%	GAP–2002: MDL 9408 million *Change in GAP*: 2002 vs. 2001: +3% 2002 vs. 1995: -16% 2002 vs. 1990: -52% *GAP structure*: crops 70% livestock 30%

Moldova disposes of above-average fertility of agricultural land that accounts for about 3/4 of country's territory. Over half of total population lives in rural areas where agriculture is the main source of employment and earnings. While during the transition period the share of agriculture in GDP was diminishing, its share in total employment was slightly growing. This means that during the economy-wide output decline of the last decade agriculture has served as a safety net to absorb some of the labor that has been released from other sectors.

Transition has been painful for the Moldovan agricultural sector that during socialism was used to operating in a centrally planned environment, which insulated the farms from market signals, imposed administrative targets as a substitute for consumer preferences, and allowed farms to function indefinitely under soft budget constraints without proper profit accountability. That was, of course, the basic cause of inefficiency of socialist agriculture. Therefore, the main target of the land reform initiated right after the country's independence in 1991 was to cure this chronic inefficiency of the sector by shifting from collective to individual agriculture and business-like corporate farms, as well as general downsizing of farms, all in line with the established experience of market economies.

Box 1: The summary of achievements of the National Land Program:

(i) 99% of agricultural land had been privatized,
(ii) 99% of beneficiaries had received land shares,
(iii) 1034 collective farms had finalized the privatization process,
(iv) 864 collective farms had been liquidated.

Debt Resolution Program – a unit of the NLP created in September 1999 – addressed the high levels of outstanding debt of the collective enterprises undergoing privatization and restructuring, thus allowing the newly created units to start essentially debt-free.

With the adoption of the new Land Code and the Law on Peasant Farms in January 1992, the land reform process started, essentially transferring land from state to private ownership with individual entitlement to physical plots of land. The initial progress, however, had been slow until the National Land Program[3] was launched in 1998. The result of this ambitious project was the transfer of land and assets from the collective to the individual sector and the development of a new group of hundreds of thousands of individual landowners, on one hand, and the corporate sector made of over 1000 debt-free large agricultural enterprises, on the other hand (see also **Box 1**). Today, over 70% of agricultural output is produced by the individual sector, composed of peasant farms and rural households.

[3] The National Land Program (NLP) was launched by the Government of Moldova and implemented by the United States Agency for International Development.

Mass privatization of land and restructuring of agricultural farms was actually the first stage of the land reform that was completed by the end of 2000. Transformation of the newly created enterprises in productive and efficient units set as objectives for the second stage of the land reform – the post-privatization program – was launched in early 2001 and still goes on. The program has been aimed at facilitating farmers' adjustment process to the new market environment and focused on the following major issues:

- Improvement of the legal basis that would regulate the activities of the new agricultural agents and the relationships among them in a new market environment;
- Market infrastructure development, primarily in the field of marketing, credit and input supply
- Access to information and advisory support.

Implementation of the post-privatization program in agriculture carried out by a range of state and non-governmental organizations as well as by projects of foreign donors[4], has certainly favored sector development by easing the existing constraints through a range of measures:

- Implementation of mechanisms for dispute resolution with regard to private land and assets;
- Development of the credit system for agricultural producers by means of: (i) improving capacities of existing financial institutions that serve private farmers; (ii) developing the Savings and Credit Associations; (iii) implementing the mortgage lending program;
- Development of market infrastructure for the rural agricultural businesses through: (i) creation of Western-type service cooperatives that ensure input supply and output marketing for the members; (ii) opening of a network of agro-stores; (iii) creation of machinery stations for provision of mechanized services;
- Development and extension of the network of information, training and consulting services for agricultural producers with regard to a wide range of issues, including legal, ecological, technological, marketing, etc.

The growth registered in agriculture the second year in a row (+3% in 2002 and +4% in 2001) is an important indicator of positive developments taking place within the sector. However, some negative trends persisting over the last decade, including 2002, do jeopardize the long-term sustainability of agricultural growth. These are:

- Reduction of areas under high-value crops and extension of areas under low-value crops.
- Slow development of land markets and consolidation of land plots, which delays the transfer of an essential production factor – land – from less efficient to more efficient agricultural producers.
- The low sector productivity – both land and labor productivities – persisting and even

[4] At the present moment the aggregated contribution of donor projects operating in agriculture sums up to USD 20.5 million. Financial support is being provided mainly by the World Bank, EU-TACIS, Government of USA, Great Britain, the Netherlands and Japan.

worsening over the years, particularly in the individual sector (among others, due to inflow of labor crowded out from other sectors of the economy).

3.4. Financial sector development

The banking sector in Moldova is small by international standards. At present there are 16 licensed banks, including one subsidiary of a foreign bank. One commercial bank is controlled by the state with 56% shares in its capital. The share of foreign ownership in the banking sector represents 60% of total. The consolidation carried out in the second half of 1990s (through increasing minimum capital requirements – see **Table 8**) created a competitive environment for commercial banks.

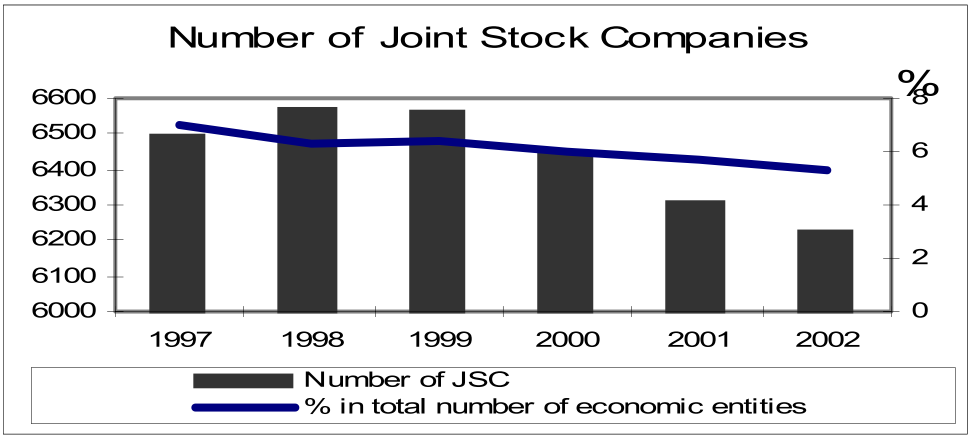
Table 8: Minimum capital requirements for commercial banks in Moldova

Bank category	Dec 31, 1999	July 1, 2000	January, 2001
A (basic banking services)	MDL16 million	MDL24 million	MDL32 million
B (A + foreign exchange trading)	MDL32 million	MDL48 million	MDL64 million
C (B + trust services and trading in equities)	MDL48 million	MDL72 million	MDL96 million

At the end of 2002, the banking system total assets amounted to MDL 8 billion, up by 33% compared to 2001. The upsurge was due to both an increase of MDL 1,108.7 million in the loan portfolio, or 35%, and an increase of MDL 198.5 million, or 33.7%, in the volume of operations carried out in the securities market. In 2002 deposits increased by 49%, registering a closing balance of MDL 5,118.1 million. The absolute growth in deposits of MDL 1,673 million recorded in 2002 was due to increases in deposits of physical persons by MDL 714.9 million, or 42.5%, and of legal persons by MDL 933.9 million, or 54.6%.

Both the qualitative and quantitative indicators of banking activity improved. The quality of credit portfolios increased as a result of growing compliance with the prudential norms and more effective credit policy. Doubtful and bad loans decreased their share from 10.42% to 7.61% of total portfolio. Overdue and interest-free loans were also reduced by 66% and 30% accordingly. Effective management in the banking sector contributed to raising long-term liquidity to the optimum level of 48% and current liquidity to 35.87%, as well as long-term capitalization to 36.4%. The prudential norms of the NBM set the highest liquidity level at 100%, the lowest at 20%, and the lowest long-term capitalization level at 12%.

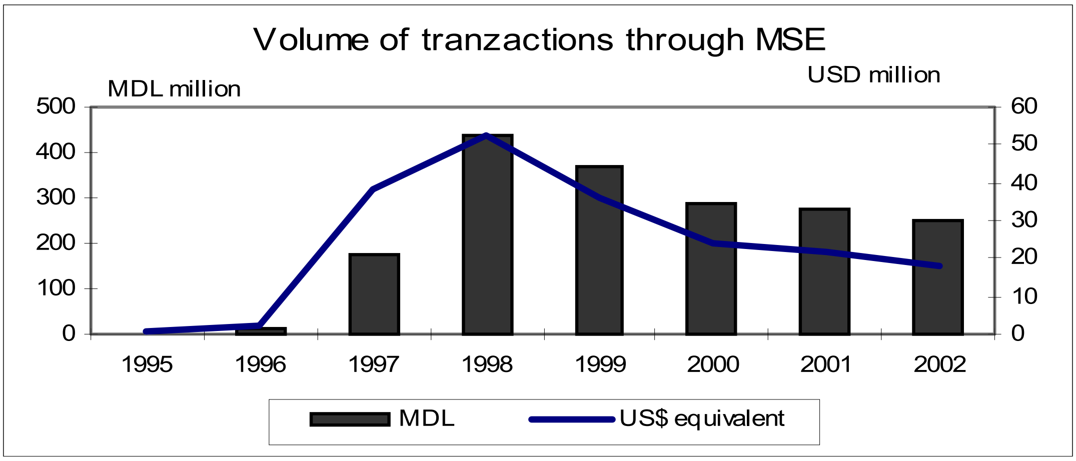
Figure 11: Number of Join Stock Companies



Capital market. Trading of equity securities in Moldova takes place through the Moldovan Stock Exchange (MSE), which is a private non-profit organization. MSE began its operation in 1995.

The capital market operates through emissions of and transactions with shares of joint-stock companies. As the number of joint-stock companies went down (**Figure 11**) the volume of transactions on the Moldova Stock Exchange has been decreasing too (**Figure 12**). Transactions carried out outside the MSE are greater than those carried out on the MSE. The alleged reasons for avoiding the MSE are imperfect legislation and high transaction costs.

Figure 12: Volume of Transactions through Moldova Stock Exchange



3.5. Barriers to market entry and regulatory environment of a business activity

Over the last 10 years, regulation of business activity has been bureaucratic and, therefore, unfavorable to the development of the private sector. The frequent changes in legislation affect negatively the work of enterprises. The procedures for obtaining licenses, permits, certificates, etc. are difficult and time-consuming. Entrepreneurs complain that it takes months to start a business and many are discouraged even before registering (they are required to obtain various permits and authorizations from local authorities prior to registration). The surveys held with entrepreneurs also confirm this reality. 23.7% or 1,257 of all BIZPO-Moldova hot line callers complained about the regulatory framework (obtaining permits and authorizations, licensing, and coordination of activity with the authorities, customs procedures). Entrepreneurs respond to these barriers by going underground. Transparency International Moldova estimates that the share of the underground economy is 60% of the official one.

3.5.1. Registration

Over the last several years, the Government has adopted various measures to simplify the procedures for regulating entrepreneurial activity. The efforts have been aimed specifically at simplifying registration and licensing procedures. Thus, in 2001 the Law on State Registration of Economic Agents was adopted and the Law on Licensing Certain Types of Activities modified. However, despite the Government efforts, registration and licensing procedures remain costly and time-consuming.

The Chamber for State Registration, which is subordinate to the Department of

Information Technology adopted a decision to set tariffs for enterprise registration. Registration expenses usually amount to MDL 250 (USD 18.5) for an individual enterprise and MDL 500 (USD 37) for a limited liability company. Registration of farmers and physical persons operating under the simplified rules (the so-called patent) is not a competence of the Chamber and is not provided by law either. Therefore, farmers are registered by local public authorities, while the holders of the patent of entrepreneurship by the State Tax Inspectorate.

According to official information, the procedure of registering an enterprise in Chisinau lasts on average 10 days from filing the registration request. The express procedure lasts three days at the double registration fee.

However, according to the 2002 World Bank Cost of Doing Business Survey, entrepreneurs that started a business during the last three years spent on average 22.7 days and USD 152 to register. One-third of respondents said that the registration and re-registration procedures were more complicated than three and five years ago. Over 60% said that the procedures had become more cumbersome during the last year.

3.5.2. Licensing.

The Chamber of Licensing issues licenses at the national level for 44 types of business activity, the other 13 types being licensed by other institutions. At the beginning of 2002, the Chamber substituted 23 ministries, departments and state agencies, which had exercised this competence prior to the modification of the law. Although the creation of the Chamber has simplified the licensing procedure, it has still to coordinate its decisions with the competent ministries and departments. In practice, it means the same procedures of the coordination and submission of documentation as those applied previously by the ministries.

The entrepreneur who wants to start a business being subject of licensing must submit a request to the Chamber of Licensing together with a set of additional documents (from 4 to 21 depending on the type of business). Some licensing fees are set in the Law on Licensing Certain Types of Activities, others - in the annual budget law. The procedures are costlier for enterprises that carry out concomitantly several activities, being subject of many licenses.

Most entrepreneurs believe that only the activities with a potential to jeopardize the state security, healthcare and the environment need to be licensed. The numerous authorizations and permits, which are issued by the same authority or institution that grants permission for registration, are sufficient for regulating the rest of the entrepreneurial activities carried out by the same entrepreneur.

3.5.3. Controlling mechanisms and inspections

Although the number of control bodies has been reduced (according to official information) and the Center for Combating Economic Fraud and Corruption has been created controls have not become more efficient and the situation of enterprises has not improved. 23% of hot-line callers point out problems arisen due to the big number of controls or the incompetence of the authorities performing them. Many entrepreneurs who are informed on the effective regulatory framework through assistance programs clash with the inspectors.

The law setting forth the functions of inspecting authorities fails to set a limit on a number of inspections that one body is authorized to carry out at one enterprise. Thus, each control body adopts its own instructions, regulations, and rules defining control procedures, execution terms, number and frequency, without coordinating them with the other inspection authorities to avoid inconsistencies. To comply with the procedures, the inspector makes his best to 'discover' a possible breach because he cannot end a control without imposing a penalty. Entrepreneurs avoid resorting to legal protection, knowing that in most cases court decisions favor the inspector. According to the 2002 World Bank Cost of Doing Business Survey, one enterprise had to deal with 16.6 inspections over a period of one year, with each of them lasting on average three months.

These issues had been under discussion for many years before the Government suspended on December 31, 2002 the Regulation on Inspection of Entrepreneurial Activity for no obvious reason, and without proposing an alternative mechanism. On February 18, 2003, a new Government decision was adopted that empowers the Ministry of Economy at the national level and the representatives of the Government at local level to perform general coordination and control of entrepreneurial activity. The same decision sets out to develop the integrated information system of supervision and control of entrepreneurial activity.

3.5.4. Tax and custom administration

In spite of the ongoing tax reform (see Section 2.6) the tax system is still considered by entrepreneurs as business unfriendly. The most frequently articulated complaints refer to:

- Unstable tax legislation affected by frequent modifications during the year;
- Advance tax payments;
- Overlapping of different taxes so that the rate of one tax depends on the rate of another; and
- Excessive penalties applied even for minor infringements of tax legislation, irrespective of their character.

Foreign trade activity needs in registration with the Customs Department. Generally, imports and exports are liberalized but certain groups of products need still import (14 groups) and export (10 groups) licenses. Certificates of origin and quality, a TIR certificate and the CMR documents issued by the Chamber of Trade and Industry of Moldova must accompany export goods. Both importers and exporters must comply with the requirements of pricing and declaration of prices at the customs. The Customs Department applies target prices for the import and export of goods.

The World Bank Cost of Doing Business Survey indicates that the costs for customs procedures of import/export are costly and time-consuming. The regulatory requirements and conditions of import/export operations have deteriorated over the last several years.

At the same time, IFI point out that many non-tariff barriers of administrative character (lacking any legal or normative ground) are still imposed on import/export operations.

3.5.5. Regulation of commodity markets

The regulatory framework for most commercial activities was established in the period 1991-1992 and has been changed many times since that time. Given that 68% of enterprises operate in the trade sector they are permanently affected by changes in legislation. 13 normative acts provide general regulation of commercial activity and numerous executive regulations and instructions are developed at ministerial and departmental level.

In 2002 the Government created Moldova's Commodity Exchange. It operates experimentally in accordance with its own regulations and the Law on the Commodity Market adopted in 1997. Although 60% of the labor force is employed in agriculture, domestic wholesale markets for agricultural products are underdeveloped.

The Law on Monopoly and Fair Competition was also adopted in 1997. However, it did not improve competition in Moldova. The Law on Consumer Protection grants consumers the right to associate. Consumer associations have the right to participate in the drafting of technical normative acts (standards), which set quality requirements for all products sold in the market.

3.5.6. Foreign exchange regime

In June 1995, the NBM accepted the obligations coming from Article VIII of the IMF Articles of Agreements what meant introducing current account convertibility of leu. Business entities carrying out foreign trade operations are allowed to open accounts in foreign currency since 1994. In 1998, the requirement to maintain deposits only in one banking account was abolished. According to Regulations on Foreign Exchange several other foreign exchange transactions are generally permitted to be carried out without the necessity of obtaining special permits from the NBM. Foreigners may freely convert and repatriate profits. Moldova maintains exchange controls on capital account transactions and the export of capital is required to be authorized by the NBM.

However, commercial banks and economic agents complain that some restrictions applied in the area of exchange regulation cause additional costs of doing business. These restrictions provide that: (i) foreign currency earned from export operations must be repatriated within a strictly defined period of time; (ii) it is prohibited to credit economic activity in foreign currency (this type of crediting is allowed only for imports or from external credit lines); (iii) paid-in capital of commercial banks must be held exclusively in national currency; (iv) banks obligatory reserves must be held in national currency irrespective of the currency in which the resources were attracted into the banking sector. The restrictions specified under (ii)–(iv) generate higher interest rates on loans extended in national currency and may expose the banking system to additional risks in case of currency crisis.

The Law on Regulation of Repatriation of Money, Goods, and Services Generated through Foreign Trade Transactions regulates the terms payments for export operations and repatriation of export earnings. The latter must be performed within 180 days after the date of delivery, 90 days after the day of payment, 60 days after closing of the technological cycle and at least once a year for the goods delivered according to leasing agreements. Severe penalties are applied for non-compliance with these provisions, which can paralyse the activity of the economic agent.

3.5.7. Labor market regulations and social costs of doing business

Labor relations are still regulated by the old Soviet Labor Code of May 25, 1973. In spite of changes adopted over the past 10 years it is an outdated normative act applied mostly in public organizations and state enterprises, and to a lesser degree in the private sector. Private companies do not sign labor contacts with their employees in order to not comply with its provisions. The Parliament is now discussing the need to adopt a new Labor Code.

Since 1994 many national and local employment and social protection programs have been proposed and adopted. An Unemployment Fund operating at the National House of Social Insurance was created as part of the social security budget to ensure the implementation of employment policies. This fund is made up of:

- Compulsory monthly contributions from the wage fund paid by physical and legal persons employing labor force (29%);
- Compulsory contributions from calculated monthly salaries paid by all employees of physical and legal persons;
- Budget resources allocated for social protection of the unemployed.

What concerns active labor market policies, in 2002 Government allocated MD 1.5 million to support financially the initiative of the unemployed to start up their own business activity (MDL 5,000 for each person). However, neither the Department for Employment nor the unemployed themselves have the ability to implement this program.

4. Results and Perspectives of the Privatization Process

4.1. The achieved progress in privatization

Historically, the privatization process in Moldova can be divided into four stages:

- Development of the legal and normative framework (1991-1992);
- Mass privatization using patrimonial bonds (vouchers) (1993-1996);
- Implementation of the Privatization Program for the years 1997-1998 (1997-2000);
- Sporadic privatization (starting in 2001).

The first stage included the development of the privatization concept, drafting and adoption the Law on Privatization of July 24, 1991, the compilation of the list of enterprises being subject to privatization, the distribution of patrimonial bonds (vouchers) to all citizens, and creation of the normative framework. Initially, the goal of privatization as envisaged in its concept was to redistribute state ownership among all citizens. It aimed at quick privatization for creation of the private sector.

The second stage included the implementation of the provisions regarding privatization. Until the end of 1996, 3.1 out of 3.5 million patrimonial bond owners participated in privatization, and 2,235 enterprises were privatized either partially or completely. The private enterprises started to dominate in all sectors of the economy, accounting for 60% in industry, 93% in agricultural raw material processing, and 95% in services and trade.

The third stage included privatization through investment tenders, the completion of the Program “Pamant”, the privatization of land owned by the privatized units, and massive trading of state shares on the Stock Exchange. In the period 1997-2000, 942 enterprises or ownership stakes were privatized, including 86 through investment tenders, 350 through auctions, and 506 on the Stock Exchange. Also, 2,267 land areas around privatized units were privatized. During this period, privatization proceeds totaled MDL 810 million, of which MDL 77 million was collected in 1997, MDL 121 million in 1998, MDL 186 million in 1999 and MDL 426 million in 2000.

The fourth stage, which started in 2001, is described as sporadic privatization. This stage has included the individual privatization of specific units without complying with privatization schedules, terms or quantitative requirements. The privatization program and the law regulating privatization for this period were not adopted in the first half of 2001. Although the new privatization program had been rejected or delayed countless times, in July 2001 the Parliament extended the term of the program developed in 1996 for the period 1997-1998, which had been extended previously through until December 31, 2000. At the end of 2000, the Ledger of Public Patrimony counted 3,171 enterprises, including 727 joint stock companies. More than half (482) of all joint stock companies are included in the Privatization Program while the others are either enterprises with minority state shares (113 companies with shares of around 30%) or enterprises of local public authorities (65), either liquidated or under reorganization (around 50).

Without clear commitment to privatization process, government moved several ownership prerogatives from the Department of Privatization to the line ministries and the latter significantly slowed down privatization process.

In spite of this unfavorable institutional environment several enterprises were sold such as Topaz JSC, Vismos JSC, Calarasi-Divin JSC, and Moldcarton JSC. Most buyers came from Russia and some of transaction was performed in exchange of Moldovan debt obligations.

The basic activity of the Department of Privatization became the so-called post-privatization, which is limited to the control of execution of investment commitments by buyers and taking legal proceedings. Over the last two years, the Department of Privatization participated in 170 legal proceedings yearly.

The tendency of slowing down privatization and supporting state enterprises has recently become prominent. Some types of activity are exclusively performed by state enterprises. These include the pharmaceutical sector, agricultural services, civil aviation, and mandatory medical insurance. Also, the third license for mobile telephony is to be issued to Moldtelecom at a price eight times lower than the prices offered for the previous two private operators.

4.2. The remaining privatization agenda

The objects that were not privatized previously will be subject of privatization in 2003-2004 because the Parliament once again (for the third consecutive time) extended the effective term of the Privatization Program adopted for the years 1997-1998. Wineries, tobacco companies, Moldtelecom JSC, two enterprises of electric energy distribution (RED Nord JSC and RED Nord-Vest JSC) remain a high priority on the privatization agenda. The other enterprises envisaged in the Privatization Program, with minor exceptions, are not attractive, having been scheduled for privatization many times (and without success) over the last several years.

Among the enterprises not included in the Privatization Program, particularly attractive are civil aviation companies, the Railways, water management enterprises as well as medical and educational institutions, which have long operated unofficially according to the private sector principles.

5. Forthcoming Policy Challenges

Moldova must deal with at least three strategic policy goals:

- How to sustain and accelerate its economic growth and allow all the society to benefit from its effects in more equitable way?
- How to complete the economic and institutional transition to a matured market economy?
- How enter the way of European integration following experience of its Central European, Baltic and Balkan neighbors?

All three goals are closely interrelated. Sustaining and accelerating economic growth will be impossible without further advancing structural and institutional reforms and closer integration with the European economy. Reducing poverty and more equal distribution of effects of economic growth will need in continuing economic growth and elimination of various systemic distortions and pathologies. Also continuation of economic and institutional reforms is absolutely necessary to be able to make the next steps on the way of European integration, i.e. conclude the Stabilization and Free Trade Agreement with the enlarged EU and after it approach possibility of starting EU membership negotiations. On this particular way Moldova is more advanced than other CIS countries. This relates to implementation of the Partnership and Cooperation Agreement (signed in 1994, becoming effective in 1998), entering the World Trade Organization (May 2001) and joining the Balkan Stability Pact (June 2001). We believe that European integration experience of Balkan countries can be of particular importance for Moldova (to greater extent than that of Central Europe and Baltic region).

Even very superficial look at growth experience of other transition countries shows that output recovery, which comes after the transformation output decline (in Moldova the latter lasted exceptionally long), will not last forever unless it will be supported by continuous structural and institutional reforms. Otherwise, simple growth reserves (mostly reallocation of existing resources, without major investment contribution) will be quickly exhausted, usually after three to five years period. The next growth push must come from large-scale investments and more sophisticated productivity gains. Both will be impossible without sustaining prudent monetary and fiscal policies as well as substantial improvement in business and investment climate. In the case of Moldova, which is very small and very open economy, external economic relations play also very important role. We have in mind liberal export and import policies, full convertibility of national currency, and national (i.e. equal) treatment of foreign investors.

Policy outlook presented at this study confirms unsatisfactory business and investment climate hampering both domestic and foreign entrepreneurial initiatives. Barriers of market entry and business activity originate from a wide spectrum of formal regulation as well as political and administrative practices: registration and licensing, labor market formal rigidity, high non-wage costs of labor, tax and custom administration, numerous regulations in the sphere of construction law, architecture and urban planning, sanitary inspection, fire protection, excessive inspections and controls in enterprises, interference of law enforcement agencies, other form of administrative harassment and corruption, weaknesses of justice system, unstable and non-transparent legislation. Even if formal regulations try to follow international standards (what is not always the case) law enforcement practice is very unfriendly in relation to business activity. Thousands of badly paid and often demoralized civil servants, tax and custom inspectors, policemen, judges and other representatives of state apparatus consider private business activity as the source of extraction of additional income. This kind of parasite activity can be observed not only in Moldova but also in other CIS and many developing countries. However, without complex and systematic curing this disease one cannot count on significant inflow of foreign investments (as well as preventing capital flight from the country).

Foreign investors, these who are already in Moldova and who consider coming in will closely observe the government privatization and regulatory policies. Any attempt of reversing past privatization transactions (in fact, re-nationalization) will issue the warning signal to all the business community. The same concerns any regulatory measures, which try to favor one market players at the cost of others.

Moldova also needs rebuilding its close cooperation with the IMF and World Bank damaged recently by failure to meet policy conditionality of both organization or attempt to go around some agreed steps. The support of IFI is necessary not only because of their direct financial support but also because their approval of government program (a kind of certificate of good practices) will open a door to debt restructuring negotiations with the Paris Club.

The accumulated debt overhang is another serious policy challenge faced by Moldova not only in the coming year or two but also in a much longer perspective. Relaxing constraints coming from the debt overhang and avoiding the danger of default will need the consequent long-term oriented and very prudent fiscal policy trying to deliver fiscal surpluses in the period of economic growth.

All the above mentioned policy challenges call for preparing the new long-term program of economic and institutional reforms, which would allow Moldova to continue economic growth and make progress on the way of European integration. The PRSP preparing process gives a good occasion for such a conceptual effort.

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