

Republic of Moldova: 2004 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Moldova

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with the Republic of Moldova, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 3, 2004, with the officials of the Republic of Moldova on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 18, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 7, 2005 discussion of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Republic of Moldova.

The documents listed below have been or will be separately released.

Selected Issues Paper
Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: <http://www.imf.org>

Price: \$15.00 a copy

**International Monetary Fund
Washington, D.C.**

INTERNATIONAL MONETARY FUND

REPUBLIC OF MOLDOVA

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation
with the Republic of Moldova

Approved by Alessandro Leipold and Tony Boote

January 18, 2005

Discussions for the 2004 Article IV consultation were held in Chisinau during October 20–November 3, 2004. The team comprised Ms. Castello-Branco (head), Mr. Cuc, Mr. Lundback, and Ms. Angelovska-Bezaska (all EUR), Mr. Bouton (World Bank), and Mr. Ruggiero (the Fund Resident Representative). The team met with Prime Minister Tarlev, National Bank of Moldova (NBM) Governor Talmaci, Minister of Economy Lupu, Finance Minister Grecianîi, and other senior officials. The team also met with representatives of parliament, business, civil society, and the diplomatic community.

In concluding the 2003 Article IV consultation on January 26, 2004, Executive Directors urged the authorities to accelerate structural reforms to improve prospects for growth and poverty reduction. In particular, Directors pressed the authorities to reduce administrative interventions and improve the business environment.

Both Fund- and Bank-supported structural programs went off track and expired in late 2003 (Appendices I and II), while the EBRD has stepped up its engagement under its Early Transition Countries Initiative (Appendix III). The authorities' first full Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) was discussed by Fund and Bank Boards in November 2004. Executive Directors supported the strategy but stressed the need to align current policies to those outlined in the EGPRSP and speed up implementation to build up a track record for future financial support from IFIs.

Moldova has accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Fund's Articles of Agreement. Its exchange system remains free of restrictions on payments and transfers for current international transactions. Although appropriate legislation is in place, improvements in the AML/CFT framework are needed to meet international standards. These include preventive measures against terrorist financing and adequate enforcement of the AML law.

Data quality has improved, but weaknesses remain, primarily with respect to price and national accounts statistics (Appendix IV).

Contents	Page
Executive Summary	5
I. Background	6
II. Report on the Discussions.....	17
A. Macroeconomic Outlook	19
B. Fiscal Policy and Reform.....	20
C. Monetary and Exchange Rate Policies	24
D. Financial Sector Issues.....	25
E. Structural Policies	25
F. External Sector Issues.....	26
G. Technical Assistance.....	26
III. Staff Appraisal	27
Text Boxes	
1. The Transnistria Issue at a Glance	6
2. Implementation of Past Fund Policy Recommendations	7
3. Impact of Higher Petroleum Prices.....	12
Figures	
1. Growth and Remittances, 1999–2004.....	8
2. Economic and Human Development	10
3. Average Monthly Wage Index.....	11
4. External Competitiveness, 1999–2004	13
5. Monetary Developments.....	15
6. Financial Sector Developments, 2000–04	16
7. Corruption Perception Index, 1998–2004.....	18
8. Fiscal Outlook, 2001–09	21
9. Government Size and GDP per Capita: Transition Economies, 2004.....	23
10. Leu/U.S. Dollar Exchange Rate and Foreign Exchange Purchases by the Central Bank, 2004	24
Text Tables	
1. External Arrears on Public and Publicly-Guaranteed Debt.....	8
2. General Government 2002–04.....	14
3. Fiscal Outlook for 2005–07	20
Tables	
1. Selected Indicators, 2000–05	29
2. Balance of Payments, 2000–05.....	30
3a. General Government Budget, 2000–05	31

	Contents	Page
3b.	General Government Budget, 2000–05	32
4.	Accounts of the National Bank of Moldova and Monetary Survey, 2002–05	33
5.	Financial Sector Indicators, 1998–2004	34
6.	Medium-Term Scenarios, 2003–09	35
7.	Localized Millennium Development Goals (EGPRSP).....	36
 Appendices		
I.	Fund Relations	37
II.	IMF-World Bank Relations	42
III.	Relations with the EBRD.....	47
IV.	Statistical Issues.....	48
V.	Debt Sustainability Analysis.....	51

Glossary

AML	Anti-Money Laundering
CAR	Capital adequacy ratio
CAS	Country Assistance Strategy
CCFF	Compensatory and Contingency Financing Facility
CEE	Central and Eastern Europe
CFT	Combating the financing of terrorism
CIS	Commonwealth of Independent States
CPI	Consumer price inflation
DIF	Deposit and Insurance Fund
DSS	Department of Statistics and Sociology
EBRD	European Bank for Reconstruction and Development
EGPRSP	Economic Growth and Poverty Reduction Strategy Paper
EU	European Union
FDI	Foreign direct investment
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
FY	Fiscal year
GDDS	General Data Dissemination System
GDP	Gross domestic product
IDA	International Development Association
IFC	International Finance Corporation
IFI	International financial institution
ILO	International Labor Organization
INS	Information Notice System
LTU	Large taxpayers' unit
MDG	Millennium Development Goal
MDL	Moldovan leu
MoF	Ministry of Finance
NBM	National Bank of Moldova
NDA	Net domestic assets
NPL	Nonperforming loans
NPV	Net present value
ODA	Official development assistance
OSCE	Organization for Security and Cooperation in Europe
PIN	Public Information Notice
PPI	Production price index
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
ROA	Return on assets
ROE	Return on equity
ROSC	Report on the Observance of Standards and Codes
SDR	Special drawing right
SME	Small- and medium-size enterprises
STF	Systemic Transformation Facility
TA	Technical assistance
TI	Transparency International
UN	United Nations
UNDP	United Nations Development Program
VAT	Value-added tax
WTO	World Trade Organization

EXECUTIVE SUMMARY

- Economic activity remains vigorous on the back of large and rising workers' remittances and buoyant regional growth. GDP grew by 6.3 percent in 2003 and is estimated to advance by another 7 percent in 2004, largely driven by domestic consumption. Although inflation has been on a downward trend since October 2003, inflationary risks are on the rise, fueled by an expansionary fiscal stance, fast credit growth, and strong foreign currency inflows.
- The economy is increasingly dependent on workers' remittances. These inflows have helped finance growing imports and fuel short-term growth, while providing a safety net to Moldovans, but they also contributed to strengthening the leu. Despite a large real exchange rate appreciation since mid-2003, external competitiveness appears favorable, with exports growing briskly and dollar wages well below those in neighboring countries.
- Policy discussions were dominated by four interrelated topics: the sustainability of the current expansion; the appropriate macroeconomic policy mix; the role of remittances; and policies to improve the business environment. The authorities view current growth as evidence of the effectiveness of their policies. In contrast, staff identified several risks to the medium-term outlook that call for policy adjustment, including rising inflationary pressures, emerging capacity constraints, a difficult business environment, and lingering vulnerability to external shocks.
- Fiscal policy should be tightened to help make room for current external debt service and support the central bank's efforts to control inflation. To ensure fiscal sustainability, fiscal policy would benefit from a more forward-looking perspective and greater reliance on a medium-term expenditure framework. The authorities felt that their fiscal plans were a realistic reflection of Moldova's needs and priorities.
- Monetary policy should place greater emphasis on the inflation objective, allowing the exchange rate to appreciate if foreign exchange inflows continue to grow rapidly. Going forward, a more flexible exchange rate policy would serve Moldova well in absorbing possible external shocks. The central bank seems to be under increasing political pressure to keep the leu stable. Financial soundness indicators are positive, but the financial sector vulnerabilities identified by the FSAP need to be addressed.
- Without an acceleration in structural reforms leading to a clear improvement in the business environment, economic recovery is likely to be short-lived. The reform agenda should include a decisive shift away from state intervention in economic activity and a more determined effort to open the country to foreign investment and to fight corruption, while maintaining a liberal trade regime.
- The authorities have reiterated their interest in a Fund program. A convincing track record of reform implementation in the context of the EGPRSP, coupled with tighter short-term financial policies, could pave the way for future Fund financial support.

I. BACKGROUND

1. The *political landscape* is shaped by upcoming parliamentary elections, prospects for EU integration, and the long-standing conflict in the breakaway region of Transnistria. No major change in economic policies is expected before the elections, slated for March 6, 2005. An Action Plan providing a framework for enhanced cooperation with the EU within the European Neighborhood Policy has been finalized; its endorsement is expected early in 2005. With OSCE-sponsored negotiations virtually deadlocked, prospects for resolving the Transnistria conflict are bleak (Box 1).

Box 1: The Transnistria Issue at a Glance

Following a civil war in 1992, the region on the left bank of the Nistru River (Transnistria) seceded. Before the breakup, this region accounted for about 40 percent of Soviet Moldova's GDP, 15 percent of its population, and 12.5 percent of its territory. It was also home to the bulk of Moldova's industrial base. Twelve years later, the conflict remains unresolved, largely because there are geopolitical and vested interests in preserving the *status quo*, which provides opportunities for tax evasion, smuggling, and other illegal activities. This situation aggravates Moldova's political risks and hampers growth prospects.

After Moldova rejected the final version of a federalization plan in late 2003, tensions increased, and escalated in mid-2004 over the closure of some Romanian-language schools in Transnistria. This incident was followed by the strict application by Moldova of regulations on registration and certificates of origin for enterprises operating in Transnistria, and retaliation from the latter, including a blockade of the Moldovan Railway line going through Transnistria. Prospects for resuming negotiations are slim, with both leaderships showing little appetite to compromise. Importantly, any solution to the conflict needs to address Transnistria's large external debt (mainly for energy supplies from Russia).



2. *Implementation of Fund advice* has been marred by weak ownership at the highest political levels, lack of political consensus for reforms, and capacity constraints. While stabilization efforts have been reasonably successful and growth has resumed, Moldova's track record on structural reforms has been generally disappointing (Box 2).

Box 2: Implementation of Past Fund Policy Recommendations

Fund advice on *monetary policy* and *financial sector reform* has been followed closely. Indeed, a common criticism of past Fund involvement is that it focused too much on institution-building in the financial sector, while other institutions remained underdeveloped. Although *fiscal policy* has often been driven by political pressure, important fiscal reforms have been implemented since the late 1990s, including the development of a treasury system, a medium-term expenditure framework, and a consolidated budget presentation. Together with appropriate monetary and fiscal adjustment to the 1998 regional crisis, these reforms paved the way for economic recovery.

While the monetary/fiscal policy mix has been broadly in line with Fund advice, implementation of *structural policies* advocated by the Fund and other IFIs has been uneven and incomplete. Slow progress often reflected strong resistance from vested interests and, arguably, insufficient attention from policy-makers and IFIs staff to political economy constraints.

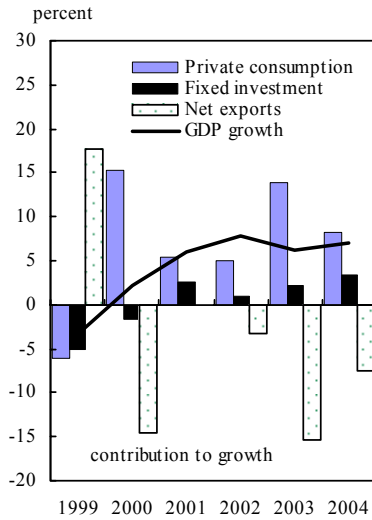
Views about the *usefulness of past Fund recommendations* diverge. This partly reflects differences of opinion within and outside the government and, within the government, between the top decision makers and other officials. Most technical counterparts and former government officials find discussions with Fund staff informative and helpful to push the reform agenda forward. They note, however, that weak capacity has hindered implementation. At the highest political levels, the dialogue has recently become more difficult. Pressure for reform has eased with the strong economic recovery, which the authorities consider as corroboration of the effectiveness of their own policies.

3. *Economic activity* benefited from a favorable external environment in 2003–04. Despite a poor harvest, GDP grew by 6.3 percent in 2003, advancing to 6.5 percent (y-o-y) in the first half of 2004. Large and rising workers' remittances underpinned consumption-led growth, helping consolidate Moldova's recovery from the 1998 regional crisis.¹ Consumption was also fueled by a marked increase in real wages and pensions. While strong economic performance in neighboring countries encouraged exports, the contribution of net trade to growth was negative (Figure 1). Fixed investment was boosted by a construction boom but, at around 18 percent of GDP, remains relatively low to support long-term growth (Table 1).

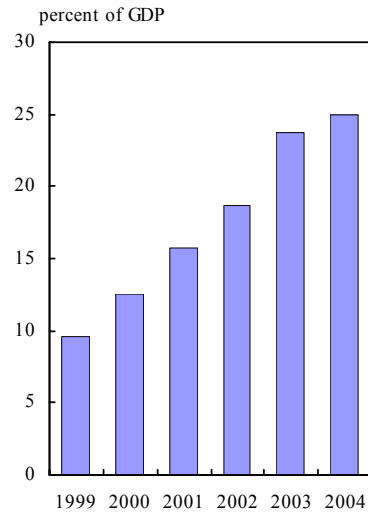
¹ See Selected Issues (SI) Chapter I on the macroeconomic impact of remittances.

Figure 1. Moldova: Growth and Remittances, 1999–2004 1/

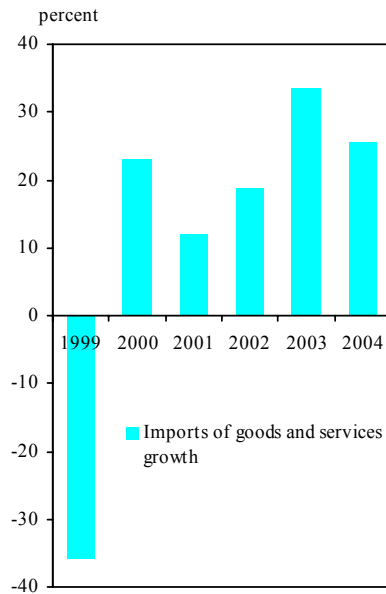
GDP growth has been driven by consumption....



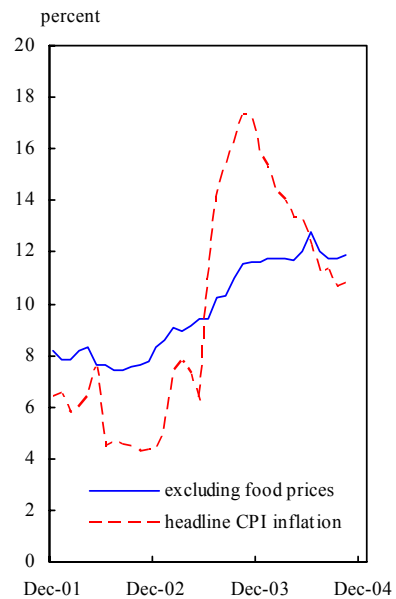
... fueled by workers' remittances....



.... boosting import growth....



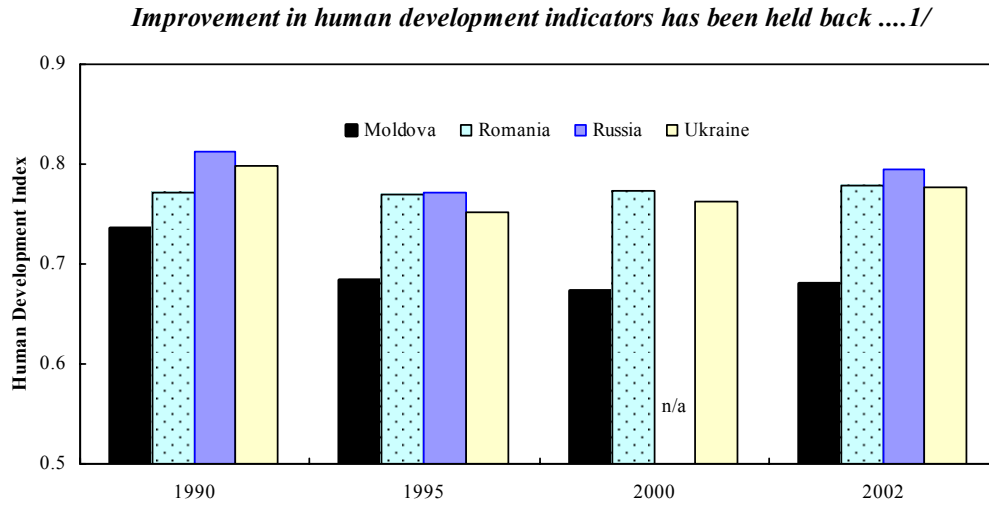
.... and rekindling inflationary pressures.



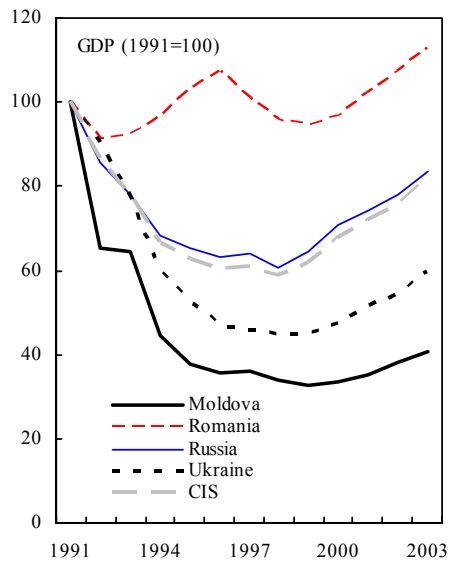
1/ 2004 data are estimates.

Sources: Moldovan authorities; and staff estimates.

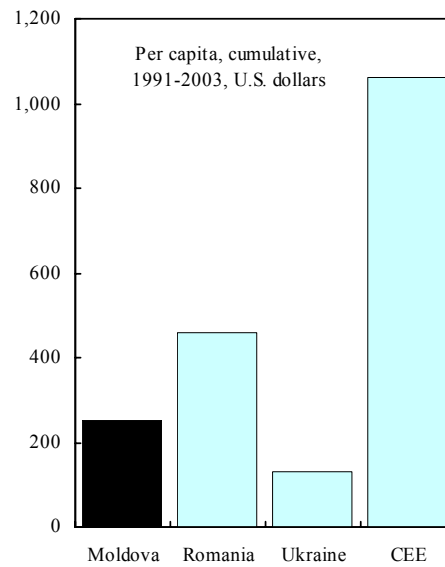
Figure 2. Moldova: Economic and Human Development



... by sluggish economic recovery....



... and low foreign direct investment.



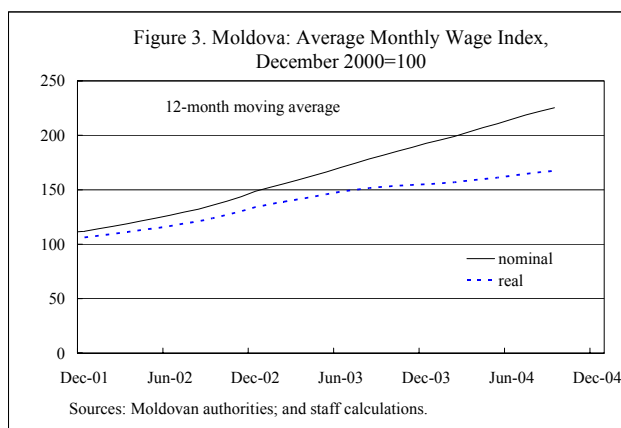
Sources: United Nations Development Program; World Economic Outlook; and Fund staff calculations.

1/ Index 0 to 1, higher development reflected in higher score.

4. Notwithstanding the present recovery, ***Moldova is lagging considerably behind its neighbors, partly as a result of the Transnistria conflict.*** It is Europe's poorest country, with per capita gross national disposable income of \$689 in 2003. Compared to its neighbors, Moldova's post-independence output collapse was deeper and its recovery more sluggish, while human development indicators and per capita foreign direct investment have lagged behind (Figure 2). Moreover, productive capacity has been sapped by the steady exodus of working-age Moldovans following the 1998 crisis (at least 25 percent of the labor force).²

5. The economy is increasingly dependent on ***workers' remittances***. Officially-recorded remittances reached almost 25 percent of GDP in 2003 and continued to grow rapidly in 2004, placing Moldova in a clear lead among European countries.³ Actual figures could be significantly higher. Remittances have fueled consumption and short-term growth and have contributed—through higher imports—to Moldova's widening trade deficit. In addition, they have put the leu under appreciation pressure, complicating the conduct of monetary policy.⁴ At the same time, by financing consumption and imports, remittances have boosted VAT collection (about two-thirds of VAT proceeds in 2004 came from imports), allowing higher government spending. By making up for the lack of other external financing sources, remittances have contributed to ease pressure for reforms. The impact of emigration and remittances is not limited to economic activity: while remittances provide an important safety net to the population, emigration has created considerable social disruption.

6. Headline ***CPI inflation*** has moderated to low double-digits, after peaking at 17 percent in October 2003 (Figure 1). The appreciating leu has helped attenuate the impact of higher oil prices (Box 3), but inflationary pressures have been fueled by a tighter labor market and robust domestic spending, accommodated by rapid money growth. Against the backdrop of a growing economy and massive emigration, labor shortages have emerged in some sectors (construction, transportation, and agriculture), pushing up wages (Figure 3). Public sector wages



² See SI Chapter II for a micro perspective on emigration and remittances.

³ In other remittances-driven economies, such as Albania, Bosnia, and Kosovo, recorded remittances ranged from 13 to 15 percent of GDP in 2003.

⁴ During the first three quarters of 2004, the leu rose by 9.3 percent in nominal effective terms.

have also been raised (notably in the social sector), in an attempt to bring them closer to the economy-wide average.

7. **External competitiveness** seems to be holding up, notwithstanding a marked real exchange rate appreciation (Figure 4).⁵ Export performance has been strong, dollar wages are well below those in neighboring countries, and the actual current account deficit is likely to be overestimated in view of unrecorded remittances and trade overinvoicing/underinvoicing (Table 2). Exports to the EU were particularly vibrant in 2003-04, reflecting the euro's strength, frontloading of export contracts ahead of the enlargement process, and a sharp increase in textile exports, mainly based on import-for-export arrangements with countries supplying raw materials for manufacturing in Moldova.

8. Recent **external debt** restructuring agreements helped improve the medium-term debt outlook. The most significant agreement (in May 2004) was with Gazprom, involving the buyback of promissory notes with a face value of \$114.5 million for a cash payment of about \$50 million, financed by the NBM. Together with the leu appreciation vis-à-vis the dollar, this resulted in a marked decline in the external debt/GDP ratio. The authorities also finalized a buyback with Hewlett Packard and agreed on reschedulings with the Export Credit Bank of Turkey and with Romania. Consequently, outstanding arrears were halved in 2004 (Text Table 1 and debt sustainability analysis in Appendix V).

Text Table 1. Moldova: External Arrears on Public and Publicly Guaranteed Debt		
	Millions of U.S. dollars	Percent of GDP 1/
Stock, end-2003	86	4.4
Clearance of arrears through buybacks and rescheduling, 2004	61	3.1
New arrears, net, 2004	16	0.8
Stock, end-2004 2/	41	2.1
1/ 2003 GDP.		
2/ Estimate.		
Sources: Moldovan authorities; and staff calculations.		

⁵ See SI Chapter III on external competitiveness.

Box 3: Impact of Higher Petroleum Prices

Moldova depends heavily on imports for its domestic primary energy needs—up to a 100 percent in the case of natural gas and petroleum products. Petroleum consumption has been growing rapidly (30 percent between 2000 and 2003), although in per-capita terms it remains the lowest in the region. In 2003, petroleum products accounted for 10 percent of Moldova’s total imports (7.3 percent of GDP).

In recent years, import prices of refined petroleum products have risen in line with international crude oil prices. Staff estimates that an oil price increase of \$10 per barrel would raise Moldova’s trade deficit by 2.5 percent of GDP and consumer prices by 2–2.5 percent.

These first-round effects on the balance of payments could be offset by expected higher spending and imports by Russia. Using an estimate of 6.7 million barrels per day for Russia’s petroleum exports, its incremental revenue from an oil price increase of \$10 per barrel would be \$24 billion annually. If about one-third of this were spent on additional imports—and Moldova succeeded in maintaining its export share—Moldova’s incremental exports would offset fully the higher energy import bill. Data for the first nine months of 2004 confirm this: exports to Russia grew by 18 percent relative to the same period in 2003, in excess of the 16 percent needed to finance higher petroleum import costs.

Sources: Moldovan authorities; and staff calculations.

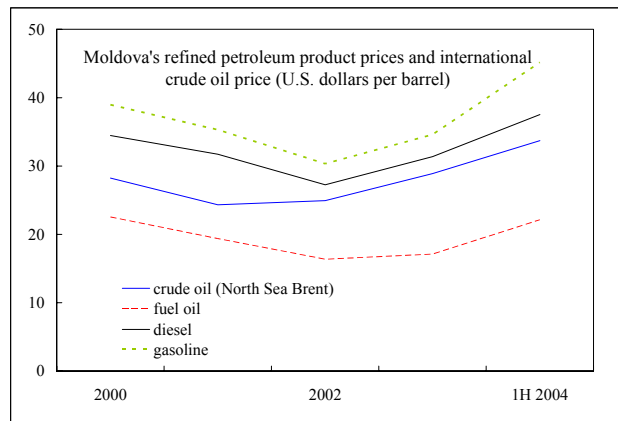
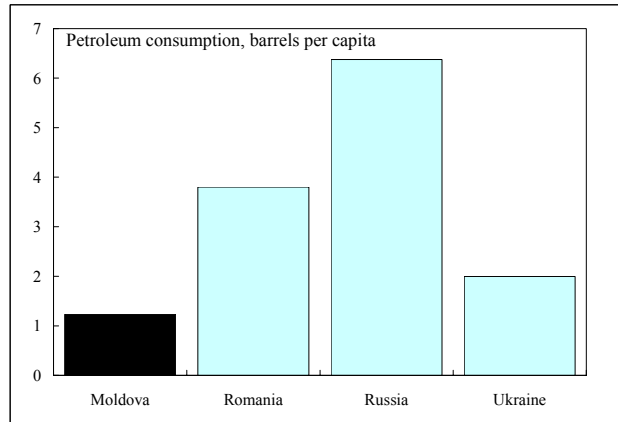
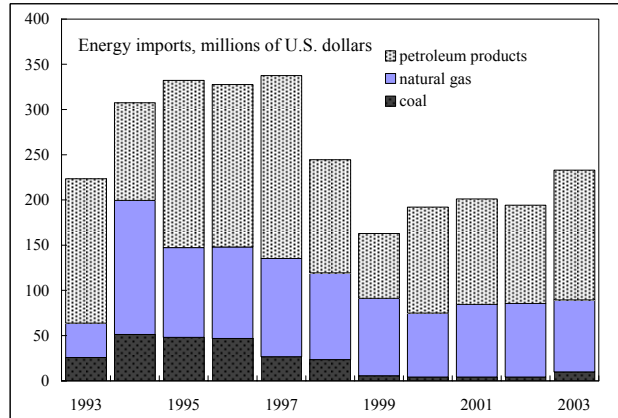
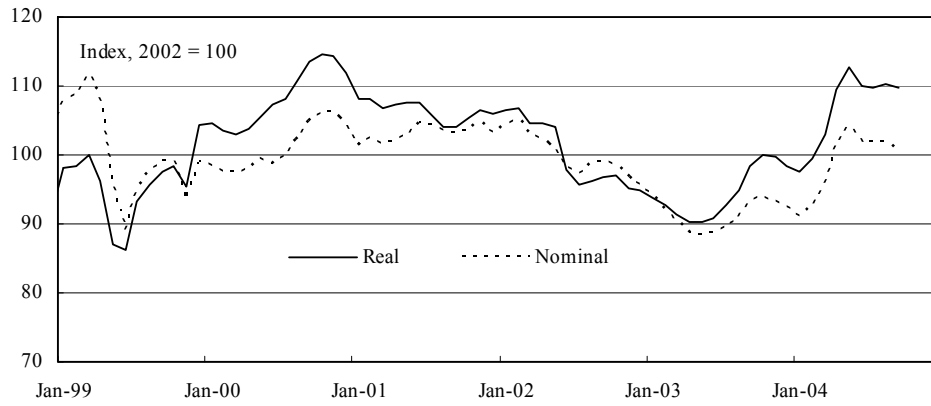
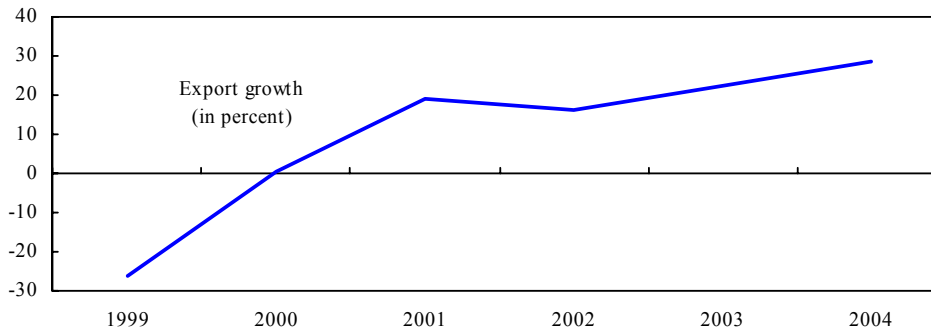


Figure 4. Moldova: External Competitiveness, 1999–2004

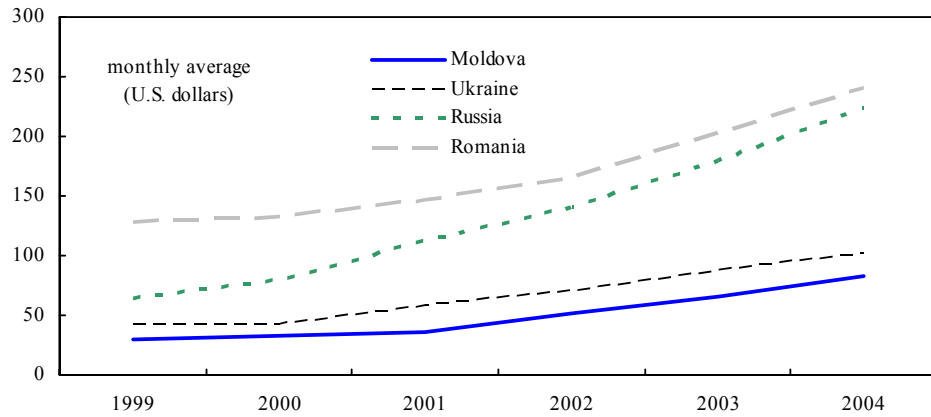
The real effective exchange rate appreciated in 2003 and 2004.....



.... but exports continue to grow...



.... and wages remain low in U.S. dollar terms.



Sources: Moldovan authorities; and Fund staff estimates and calculations.

9. The *fiscal stance* was loosened considerably in 2004 (Text Table 2; Tables 3a and 3b). The strong tax revenue performance in 2003 carried over into 2004, owing to more

aggressive tax collection efforts and higher-than-expected inflation, but nontax revenues and grants fell short of expectations. Meanwhile, primary expenditure is estimated to have exceeded original budget projections by 2.5 percent of GDP, largely on account of overruns at the local government level and higher spending by the Social Fund. Against that background, the budget was revised in October 2004; staff expects the general government

	2003	2004	
		Budget	Est.
Revenue and grants	34.4	33.4	34.8
Total expenditure	33.7	33.8	35.9
Primary expenditure	31.6	31.5	34.0
Overall balance	0.7	-0.4	-1.1
Primary balance	2.8	1.9	0.8

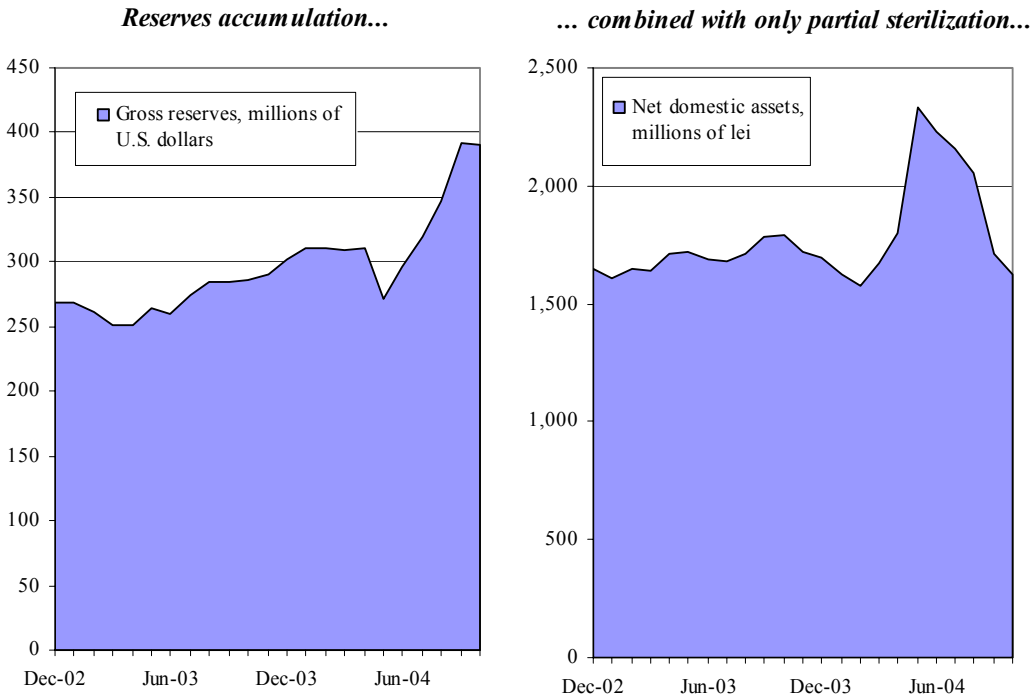
Sources: Moldovan authorities; and staff estimates.

deficit to have reached 1.1 percent of GDP in 2004 (versus a deficit of 0.4 percent of GDP in the original budget). With limited fresh external financing and lower-than-expected privatization receipts, the government increased recourse to bank financing and continued to run up arrears to some bilateral creditors but resumed interest payments to Paris Club creditors.

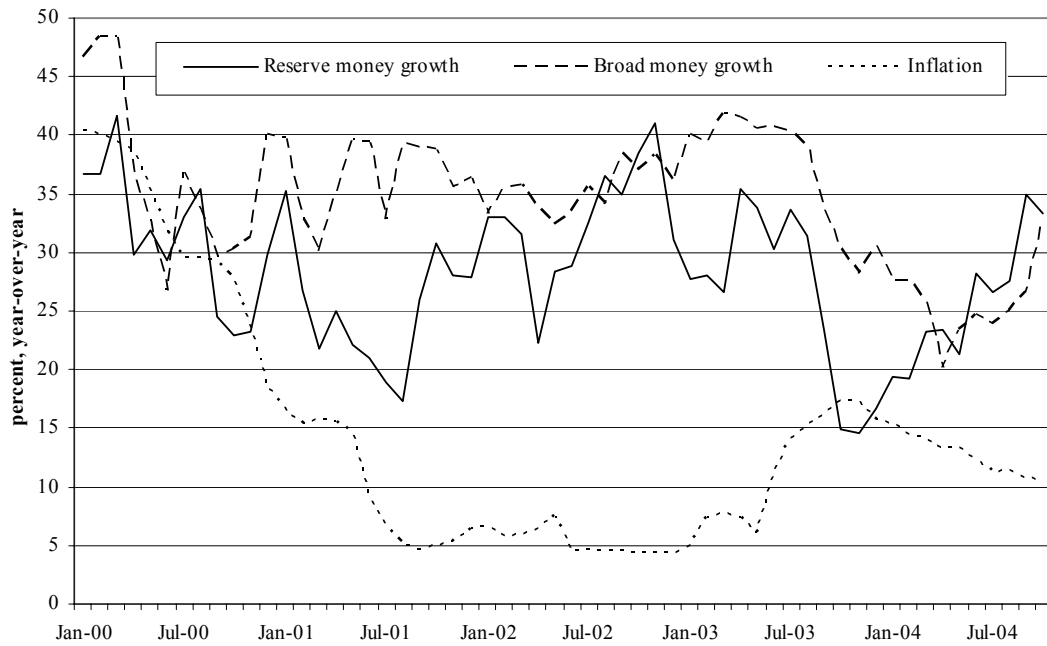
10. The large inflows of remittances in 2003-04 fuelled the tensions between the multiple objectives of *monetary policy*: bringing down inflation, containing leu appreciation, accumulating international reserves, and keeping interest rates low. With inflation moderating in 2004, the NBM intervened heavily in the foreign exchange market. As a result, *international reserves* hit a record high of \$392 million at end-September (Figure 5), finally reaching pre-1998 levels. Despite more intense sterilization efforts through use of repos, deposit auctions, and direct T-bill sales, by end-October both reserve and broad money were growing at over 30 percent (y-o-y) (Table 4). *Financial soundness indicators* are strong, but credit continues to grow rapidly and lending rates have remained high, signaling a substantial risk premium on private sector credit (Table 5 and Figure 6).⁶ Following Fund advice, since July 2004 the NBM has been gradually implementing a system where required reserves for foreign exchange deposits can be met with foreign exchange.

⁶ Credit to the private sector rose from 14 to 22 percent of GDP between 2000 and the third quarter of 2004. Nonetheless, the share of nonperforming loans dropped by two-thirds in the same period, although the share of loans under supervision—signaling potential future problems that may require attention by banks’ management—edged up.

Figure 5. Moldova: Monetary Developments



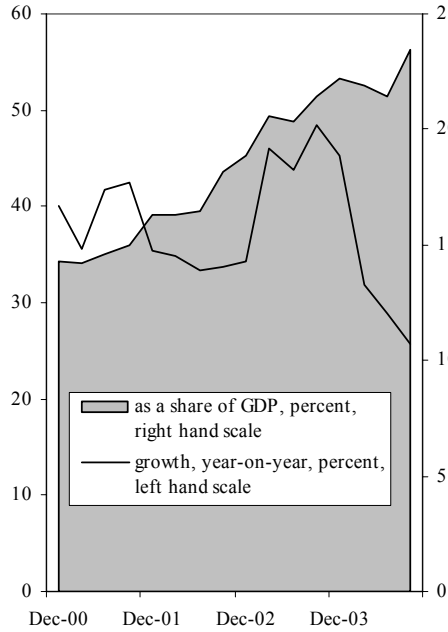
... have led to rapid money growth, increasing inflation risks.



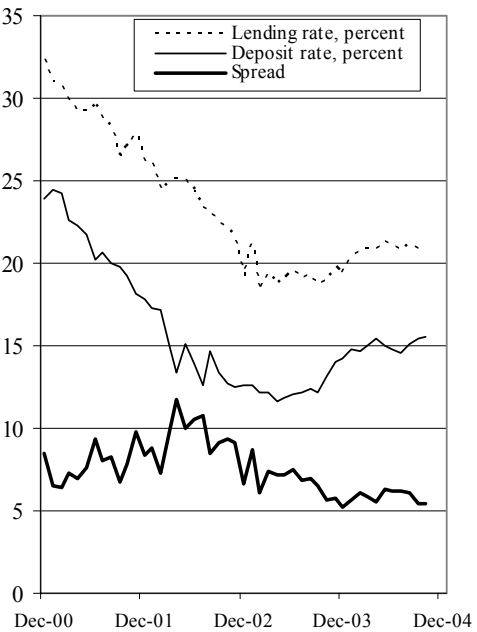
Sources: National Bank of Moldova; and staff calculations.

Figure 6. Moldova: Financial Sector Developments, 2000–04

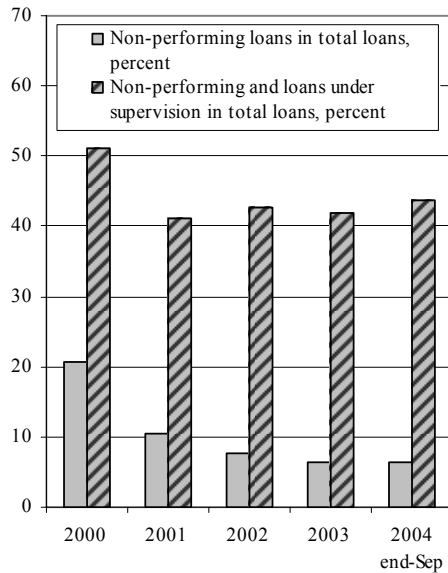
Credit growth has eased, but remains strong...



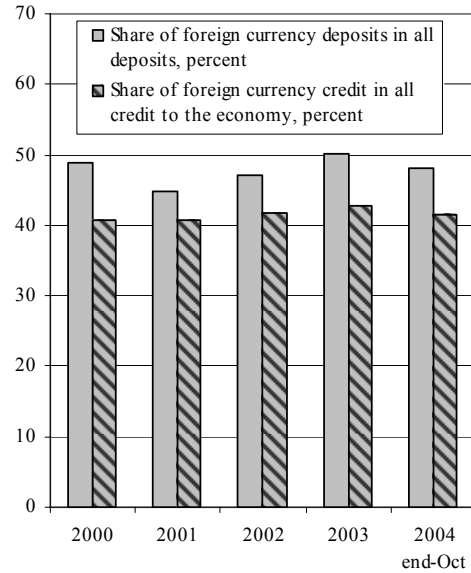
... while interest rates remain high.



The quality of banks' loan portfolio has improved...



... while dollarization remains relatively high and stable.



Sources: National Bank of Moldova; and staff estimates.

11. **Structural reforms** continue to move slowly. Government intervention remains widespread, political and corporate governance are weak, and corruption is pervasive (Figure 7). The EBRD transition indicators and a recent World Bank Investment Climate Assessment confirm that the business environment is among the most difficult in the region, with high transaction costs holding back private sector-led growth. The completion of the EGPRSP is an important step in the right direction, but progress in implementation has been slow and patchy. Attempts to make headway in the areas of deregulation, SME development, investment policy, and social assistance targeting have shown limited results so far. Nevertheless, the authorities have intensified their efforts to simplify licensing and business registration; new laws on microfinance and on investment (unifying treatment of foreign and domestic investors) have been adopted; laws on audit, accounting, and leasing are being reviewed; and a renewed attempt to curb corruption is in the works. Moreover, progress on fiscal reform has been achieved.⁷ By contrast, privatization has stalled, with several enterprises removed from the privatization program.⁸ Price controls and export restrictions continue to distort economic incentives, and higher rates of effective protection apply to selected sectors.

II. REPORT ON THE DISCUSSIONS

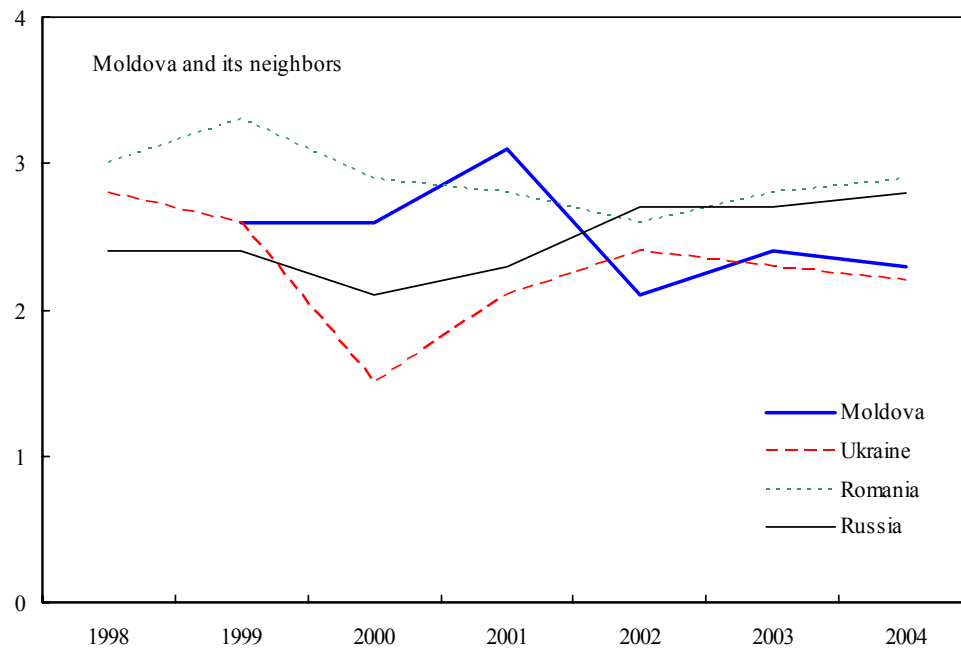
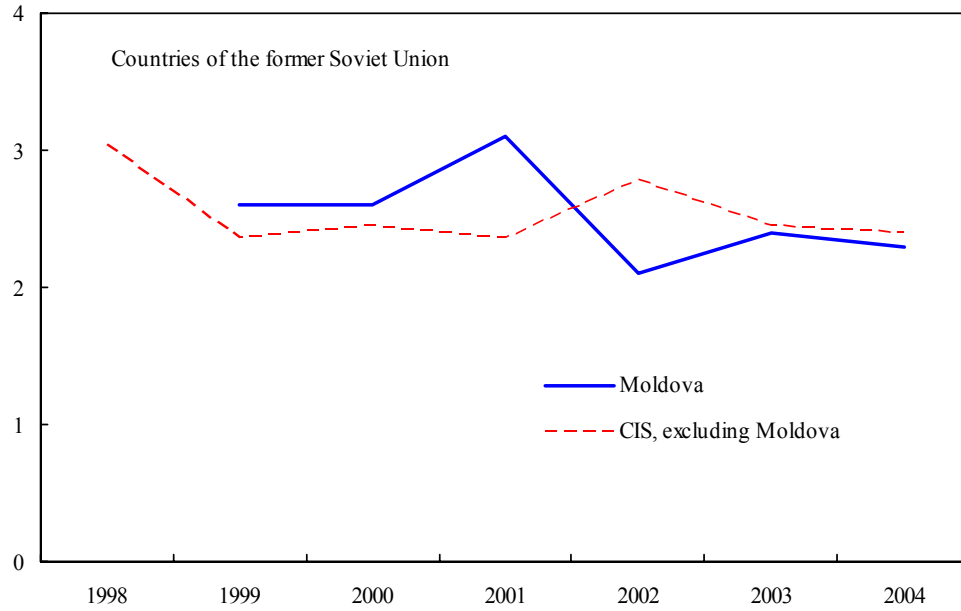
12. With no major departure from current policies envisaged in the run-up to the March 2005 elections, discussions focused on four interrelated topics:

- *The sustainability of the current expansion.* The key issue is whether the current growth momentum—consumption-driven and dependent on remittances—can be sustained in the medium term.
- *The macroeconomic policy mix.* The combination of an expansionary fiscal stance, fast money and credit growth, rising wages, and strong foreign currency inflows has intensified inflation risks, suggesting that adjustments in current macroeconomic policies should be considered.
- *The role of remittances.* For remittances to contribute positively to long-term growth, an environment supportive of private sector development is required. This would encourage greater use of these transfers for investment and stem the exodus of working-age population.

⁷ See Box 2 and SI Chapter IV on fiscal reforms.

⁸ See SI Chapter V on privatization.

Figure 7. Moldova: Corruption Perception Index, 1998–2004 1/



Source: Transparency International.

1/ Index 0 to 10. The higher the number, the more positive the perception.

- *Improving the business environment.* While the EGPRSP appropriately focuses on policies to improve the investment climate, the frequent departures from EGPRSP policies have dented investors' confidence in the government's commitment to market-based policies. The current favorable external conditions provide an ideal opportunity for a renewed effort to boost private investment and growth, but also carry the risk of easing pressure for reform.

A. Macroeconomic Outlook

13. The *short-term outlook* remains favorable, but inflation risks are on the upside. Regional growth should remain robust, and remittances are unlikely to dry up in the immediate future. GDP growth is projected to moderate to 5 percent in 2005, as consumption growth slows down. The disinflation under way since October 2003 appears to have stalled in late-2004, making the authorities' end-year inflation target (10 percent) hard to reach. Their inflation target for 2005 (8-10 percent) is relatively ambitious against the background of a tightening labor market, an expansionary fiscal stance, and continued foreign exchange inflows. On current trends, remittances should continue to boost imports and push up the leu and, as a result, the trade deficit is unlikely to improve. *Downside risks to the outlook* relate to Moldova's lingering vulnerability to adverse weather conditions and external shocks, including a slowdown in Russia and in the EU, which are the main destinations for Moldova's exports of goods and labor.

14. *Medium-term prospects* are subject to greater uncertainty. Staff argued that, without acceleration of structural reforms and an appropriate fiscal adjustment, the current economic expansion was likely to be short-lived. In particular, without a visible improvement in the business environment and a slowdown of emigration, a strong supply response was unlikely to materialize. The authorities, by contrast, maintained that Moldova's buoyant growth was broadly the result of their policies and their selective approach to Fund advice, and did not see merit in changing course. They acknowledged, however, that growth was below potential and that remittances should be channeled into business investment, but they also recalled that the current consumption and housing booms were to be expected under conditions of repressed demand.

15. To illustrate the medium-term options and their implications, staff prepared two scenarios: a *baseline scenario*, assuming unchanged policies and based on the authorities' fiscal and monetary plans, and an *alternative scenario*, consistent with bolder structural reforms and a tighter fiscal stance (Table 6). The scenarios were designed to contrast two alternative fiscal strategies, with monetary policy targeting the same inflation path—a task facilitated by supportive fiscal policy under the alternative scenario.

16. Under the *baseline scenario*, GDP growth would decelerate to 3 percent by 2007. On the demand side, the impulse to growth provided by the post-1998 surge in remittances is expected to taper off, as these inflows stabilize and consumer spending levels off. With private domestic demand expansion moderating, inflation and current account pressures should ease somewhat. Under current and projected fiscal trends, financing gaps of

0.9-2.4 percent of GDP would emerge during 2005-07, in all likelihood financed through further accumulation of external arrears. Beyond the exogenous risks noted earlier, the possibility that current expansionary policies will ignite inflation is one of the major *risks to the outlook*. Moreover, a continued real appreciation of the leu may stem the growth of manufacturing and agro-processing exports. Finally, the public treasury remains vulnerable to revenue shortfalls, raising the risk of disruptive fiscal adjustment or accumulation of arrears.

17. The *alternative scenario* envisages the implementation of a strong and credible structural reform program, underpinned by tighter financial policies. To close fiscal financing gaps, primary expenditure growth should be constrained to 14 percent, against the 16.3 percent increase in the baseline (Table 6 and Figure 8).⁹ This could be achieved through better targeting and expenditure rationalization—notably in social programs and education—and more gradual adjustments in wages and pensions. These measures would allow Moldova to fully service its current external debt obligations, but would still leave the arrears issue unresolved. The medium-term fiscal stance could be relaxed as the authorities succeed in mobilizing external financing; any additional resources could be used to reduce the government's debt to the NBM, partially clear external arrears, or boost spending in priority areas.

B. Fiscal Policy and Reform

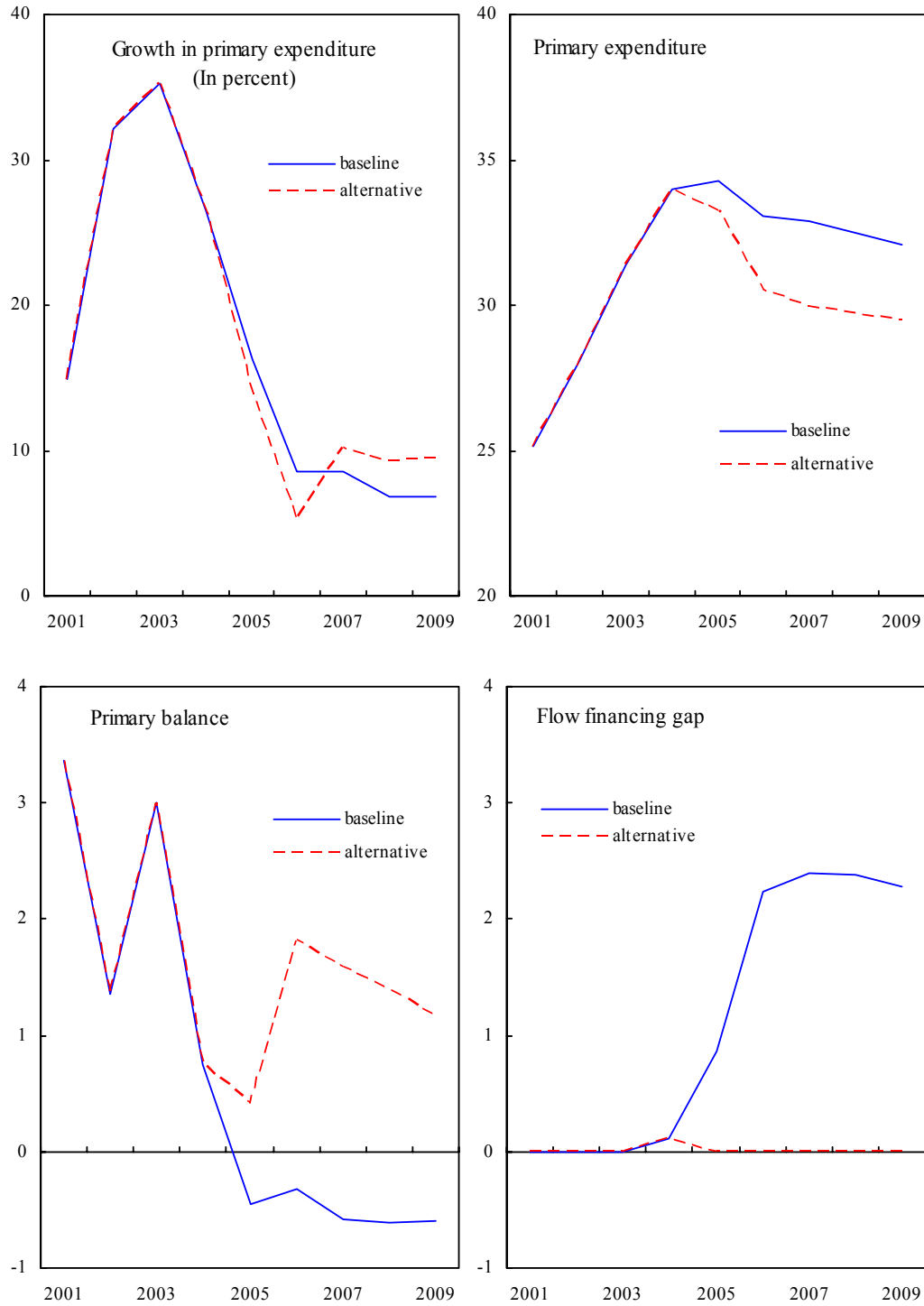
18. The fiscal stance is set to loosen in 2005. The 2005 state budget, approved by Parliament in November 2004, along with a decision to raise pensions by a minimum of 25 percent, point to a general government deficit of 2.5 percent of GDP (Text Table 3). Staff argued that fiscal policy should be tightened for several reasons. *First*, without fresh financing, the expansionary stance implies continuing buildup of debt payment arrears. *Second*, it complicates the NBM's efforts to control inflation. *Third*, while there is no indication of a debt sustainability problem, the emerging primary deficits signal potential risks in a scenario with low growth and higher interest rates. *Fourth*, there is a risk of lower-than-projected privatization receipts and budget grants from foreign donors. *Fifth*, a tighter fiscal stance would allow the government to resume debt payments to the NBM (see paragraph 27).

	2005	2006	2007
Revenue	33.8	32.7	32.3
Expenditure	36.3	34.8	34.4
Overall balance	-2.5	-2.0	-2.1

Sources: Moldovan authorities; and staff projections.

⁹ This would still make room for 4.2 percent real expenditure growth in 2005.

Figure 8. Moldova: Fiscal Outlook, 2001–09
(In percent of GDP, unless noted otherwise)



Sources: Moldovan authorities; and staff calculations.

19. The authorities argued that their fiscal plans realistically reflected Moldova's needs and priorities. They welcomed staff's analysis of the fiscal outlook under the alternative scenario, but saw little room for expenditure compression in the near term given their poverty-reduction and social objectives. Likewise, full servicing of external debts would become possible only with resumption of external financing. The authorities did not consider their fiscal policies inflationary and trusted monetary policy to keep inflation in check. While shortfalls in privatization receipts were possible, they would be accommodated through slower repayment of NBM debt. Staff pointed out that, as suggested in the alternative scenario, expenditure restraint would need to be only temporary and limited in size, still allowing for real spending growth in 2005. By deferring some spending, the authorities could close the 2005-07 financing gaps and, with the expected return of external financing, even make up lost ground.

20. Revenue performance will depend critically on the continuation of economic growth and the authorities' success in expanding the taxable base. While supporting the authorities' goal to reduce the overall tax burden, staff reiterated that a more gradual approach to tax cuts would allow time to review their revenue effects.¹⁰ Furthermore, tax rate cuts should be accompanied by measures to broaden the tax base, notably eliminating VAT exemptions and domestic zero-rating, and simplifying VAT administration. Against that background, the recently introduced exemptions for VAT and profit taxes for new domestic investment are a step in the wrong direction, although they establish a level-playing field with foreign investors. While the authorities feel that recent income tax performance confirms that previous cuts helped draw a sufficient number of firms into the tax net to offset revenue losses from lower rates, analysis of available data is inconclusive. Furthermore, gains from additional tax cuts are likely to become smaller, as the share of non-reporting firms declines.¹¹ Moreover, the projected revenue increases for the Social Fund (28 percent) and the Health Fund (24 percent) in 2005 might be optimistic given the projection of wage bill growth (18 percent). An additional risk to the revenue outlook is the heavy reliance on VAT (estimated at 37 percent of total tax revenue in 2004), implying high sensitivity to changes in consumer spending and imports.

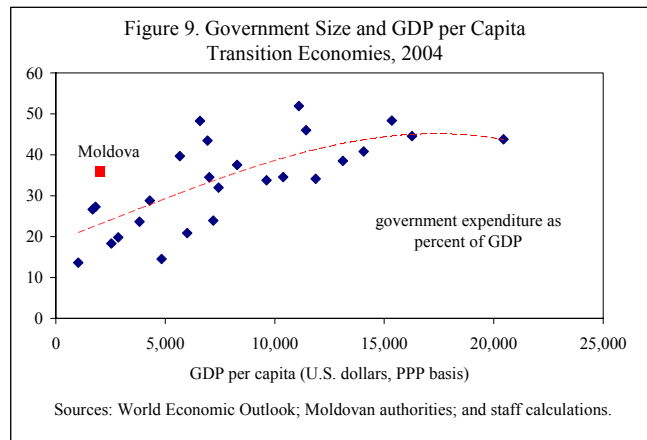
21. Expenditure plans for 2005 entail a significant increase in consolidated primary spending. This reflects the authorities' intention to direct more resources to the social sector, agriculture, transportation, and communications. The November 2004 pension hike will have a negative impact on Social Fund sustainability. While in 2004 the hike was financed by savings in other social benefit payments and a drawdown in bank balances, starting from 2005 the authorities may have to tap the reserve fund. The authorities recognize the need for Social Fund reform, including broadening the contribution base and lowering rates. Staff

¹⁰ Corporate and personal income tax rates were reduced in 2004; further cuts are envisaged for 2005-07.

¹¹ See SI Chapter VI on *Enterprise Profitability, Income Tax Rates, and Income Tax Revenue*.

cautioned that future changes in benefits should factor in the potential impact of emigration on the contribution base, and should go hand in hand with adjustments in contributions to ensure the Social Fund's long-term viability.

22. Working toward effective expenditure management, realistic revenue projections, and a more efficient tax administration are the key fiscal challenges over the medium term. The overall size and composition of public spending should become more closely aligned to the country's development needs, calling for better prioritization, and more effectiveness and efficiency in public services delivery. This could require a review of the role and optimal size of the government, with current government size relatively high for Moldova's level of income (Figure 9). The medium-term expenditure framework should avoid relying on continued fiscal revenue gains of the size experienced recently, while a comprehensive reform of tax administration should be a cornerstone of efforts to strengthen revenue performance.¹² Finally, the lack of contingency revenue and expenditure measures poses further risks to the fiscal outlook.



23. The authorities explained that their medium-term spending plans reflected the high social demand for government spending and unsustainably low wages in education and health care. The consolidated government wage bill is projected to increase by 44 percent in 2004–07, largely as a result of the alignment of wage scales within the government sector. Staff emphasized that it was essential to consider wage policy in conjunction with civil service reform. The authorities acknowledged that the public administration was not sufficiently adapted to the requirements of a market economy and confirmed their intention to implement a civil service reform, as envisaged in the EGPRSP.

24. There has been appreciable improvement in fiscal planning and budget elaboration. In line with ROSC recommendations, fiscal transparency was enhanced by integrating income from special funds and donor-financed projects into the budget. Equally important, the 2005 expenditure plans were based on the 2005–07 medium-term expenditure framework. The launch of the Health Fund in 2004 offers a basis for greater financial accountability in health care management, but its performance needs to be monitored closely, in particular given the high uncertainty about the amount of contributions from non-salaried subscribers.

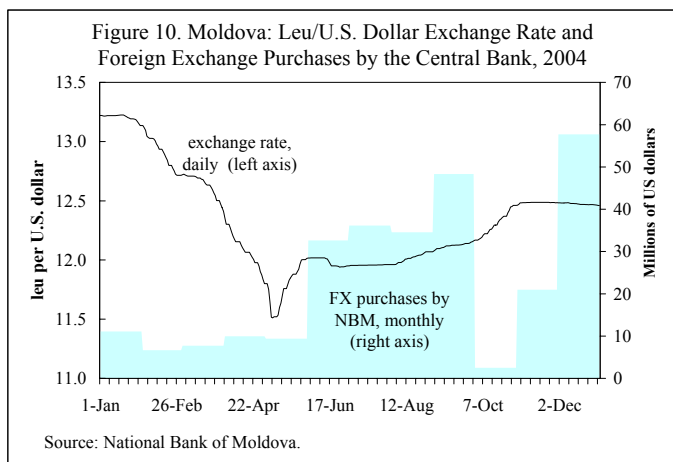
¹² See SI chapter IV on fiscal reforms.

C. Monetary and Exchange Rate Policies

25. While recognizing that the NBM has to balance different, sometimes conflicting, policy objectives, staff reiterated that monetary policy should assign priority to fighting inflation. Staff advised tightening monetary policy to stem inflationary pressures and bring inflation down to single digits in the medium term. The NBM acknowledged the risks of a pickup in inflation and stepped up its sterilization efforts in recent months. Moreover, NBM certificates will be used as a new liquidity management tool in 2005. Staff welcomed the more intense use of monetary policy instruments but argued that a more determined emphasis on low inflation would also require a willingness to allow the leu to appreciate further in the face of strong demand. At the same time, staff agreed with the NBM that, given Moldova's vulnerability to external shocks and its external debt obligations, some precautionary accumulation of reserves (from the current low levels of about 2 months of imports) would be appropriate, as long as it did not jeopardize the inflation objective.

26. While receptive to these arguments, the NBM appears to be under increasing political pressure to keep the leu stable. Indeed, following intensified government criticism of the NBM's exchange rate policy in early November, the leu/dollar exchange rate stabilized remarkably (Figure 10). These developments seem to question the NBM's *de facto*

independence and go against its efforts to keep inflation low. Although the NBM seems concerned about rising inflationary pressures, there are doubts—within and outside the government—about the merits of aiming at single-digit inflation at the current level of development and some concern about export competitiveness. Staff recalled that monetary policy could only influence competitiveness temporarily and urged the NBM to restrict its



interventions to smoothing short-term exchange rate fluctuations. Despite the recent appreciation, the exchange rate seems still somewhat undervalued, and external competitiveness appears adequate. Going forward, a more flexible exchange rate policy, capable of absorbing external shocks, appears appropriate for Moldova.

27. Staff stressed the importance of supportive government policies to underpin monetary and exchange rate policies. First and foremost, market-oriented structural policies would be instrumental to enhance long-run competitiveness and encourage an efficient allocation of workers' remittances. Importantly, a stronger fiscal effort during the next couple of years would allow the government to service its external debt (easing appreciation pressures on the exchange rate) and to resume debt payments to the NBM (strengthening NBM independence). Staff advised the authorities to work out a plan to gradually reduce the

government's debt to the NBM, currently about 8½ of GDP. While the 2005 budget envisages some repayments, these are contingent on (uncertain) privatization revenues.

D. Financial Sector Issues

28. A recent FSAP highlighted several weaknesses in the financial sector, including increasing government influence, opaque ownership structures, and governance issues arising from the lack of strategic investors.¹³ The FSAP was well received by the authorities, and many of its recommendations are likely to be implemented. However, they did not share staff's concerns about increasing signs of administrative interference in the financial sector, including the dominant state role in one of the largest banks, the preferential treatment of the state-owned insurance company, and the government's large debt to the NBM. Staff also noted that the opaque ownership structures of financial institutions and corporations created risks and complicated the task of banking supervision, while improving the business climate was crucial to attract foreign investors. The NBM agreed that there were important ownership issues in the sector but claimed that, in practice, bank supervisors had good knowledge of banks' activities. Staff also warned about the potential adverse impact of the recent credit boom, and encouraged the NBM to adhere to international practice and transfer profits to the government only once a year, following its annual audit.

E. Structural Policies

29. Staff argued that a fundamental policy shift was required to re-launch economic reform in Moldova. Notwithstanding the market-oriented line of the EGPRSP, the current policy strategy relies excessively on government intervention and regulation, which distort incentives for private sector development. Behind these policies is a strong belief that the government has an important role to play in the economy, and that non-market policies can be justified to meet important social and economic goals. Staff urged the authorities to align their strategy more closely to the EGPRSP and to speed up its implementation.

30. Improving the business environment is the key challenge ahead, while structural reforms need to be accelerated to complete the transition process and strengthen economic ties with the EU. Staff underscored the importance of simplifying government regulations, removing opportunities for administrative discretion, and eliminating restrictions to free trade. It urged the authorities to refrain from granting tax holidays and exemptions to priority sectors. The Ministry of Economy's efforts on regulatory reform have met, however, with strong resistance by some line ministries and agencies.

31. While the recently approved anti-corruption strategy is a step in the right direction, effective implementation is crucial to demonstrate ownership. The strategy is the latest in a series of plans to limit corruption, including those approved in December 2002 and

¹³ No first-tier banks have set up subsidiaries or branches in Moldova or have become part-owners of domestic banks (see the accompanying Financial System Stability Assessment).

November 2003. The authorities were encouraged to comply with the ambitious implementation schedule of the new action plan and set monitoring and reporting mechanisms to communicate progress in implementation. Staff also underscored the importance of establishing a clear functional and institutional separation between the objectives of fighting corruption and fighting “economic crime” (which includes matters such as tax evasion), both currently pursued by the Center for Fighting Economic Crime and Corruption. The authorities disagreed with this approach because they view corruption as intimately tied to economic crime.

F. External Sector Issues

32. External public debt service will remain a challenge in the near term. Staff stressed that, although recent agreements and the leu appreciation have reduced the external debt burden considerably, Moldova still needs to tackle the problem of outstanding arrears and their continued accumulation. The authorities remarked that they had put their best efforts into bilateral negotiations. They added that external financing was necessary to resume full debt service without jeopardizing poverty-reduction and social objectives, and reiterated their interest in a Fund-supported program to allow a possible Paris Club rescheduling and help unlock donor assistance. Staff urged the authorities to undertake the necessary fiscal adjustment to create sufficient room for servicing current debt obligations, while stepping up structural efforts to remove obstacles to private sector-led growth. Progress in these areas would help build a track record for possible future Fund financial assistance.

33. The debt sustainability analysis shows continuing improvement in debt indicators, although liquidity problems will likely arise in the short term (Appendix V). Nevertheless, the balance of payments is heavily dependent on the continued inflows of remittances. Should these dry up, the immediate impact on the exchange rate and the balance of payments could be significant.

34. Formally, Moldova’s trade regime is fairly liberal, with a low weighted average tariff (4.6 percent) and no quantitative restrictions, but *de facto* restrictions are widespread. Staff renewed its objection to selective restrictions on exports and imports, including a regulation requiring that certain agricultural products be exported only through the Commodity Exchange. It cautioned the authorities against protection of special interests and non-competitive industries, stressing the benefits of a stable, transparent, and uniform tariff regime. The authorities did not acknowledge the existence of informal trade restrictions, noting that their trade policies were consistent with WTO commitments.

G. Technical Assistance

35. During the past year Moldova benefited from intense IMF technical assistance. Fund advice has already been incorporated in several areas, including financial and monetary statistics, the payments system, fiscal transparency, and budget coverage. Several projects stemming from the FSAP are in the pipeline, including technical assistance on foreign exchange regulations and monitoring, and the sequencing of possible capital account

liberalization. More generally, there continues to be a strong interest from staff's technical counterparts in Fund expertise and advice.

III. STAFF APPRAISAL

36. On balance, Moldova's recent macroeconomic performance has been satisfactory and the short-run outlook remains positive. Buoyant regional growth has boosted export performance, economic recovery has taken hold, and inflation has moderated from the high levels observed in late-2003. However, the recovery rests on vulnerable foundations. Recent rapid economic growth owes much to large and rising workers' remittances. And, while structural reforms have stalled, a difficult business climate holds back investment. Looking ahead, the key post-electoral challenge will be to create an environment supportive of private sector development and foreign investment—both critical conditions for sustained growth, domestic job creation, and poverty reduction. This would require a radical shift away from interventionist policies, and a convincing effort to open the country to foreign investment, while maintaining a liberal trade regime.

37. Large-scale labor emigration has emerged as an important coping mechanism, with mixed blessing for Moldovans. On the one hand, emigration generates at least 25-30 percent of GDP in workers' remittances, providing a critical safety net to the population, and driving short-term growth. On the other hand, by depriving Moldova of a large part of its labor force, emigration will constrain long-term growth. Moreover, remittances may have helped ease pressure for market reforms. Finally, these inflows have put the leu under strong appreciation pressure, complicating the task of monetary and exchange rate policy and contributing to a widening trade deficit.

38. Pushing the structural reform agenda forward remains the main prerequisite for sustained economic revival. In particular, steadfast implementation of EGPRSP policies will serve as a test for the government's credibility. Without a pickup in the reform momentum leading to a clear improvement in the business climate, prospects for raising investment will remain limited, the country will continue to lose working-age population, and remittances will become an even more prominent source of external financing and social protection. A major stumbling block to structural reform is, however, corruption. Moldova continues to rate poorly in this area, and tackling the roots of corruption should be high on the reform agenda.

39. While acceleration of structural reforms should be the top priority, adjustments in the current macroeconomic policy mix are also called for to stem inflationary pressures and underpin long-term growth. The combination of effective implementation of a credible structural reform program with tighter short-term financial policies would build the track record essential to future external financing, including from the Fund.

40. Fiscal policy should, in the short run, buttress the NBM's efforts to control inflation, and, in the medium term, secure sustainable public finances. A tighter short-run fiscal stance would support monetary and exchange rate policies and help make room for current external

debt service. At the same time, additional external financing could allow for a more relaxed medium-term stance. Moreover, on the revenue side, continuing improvements in tax administration should go hand-in-hand with measures to broaden the tax base, including by removing exemptions. To ensure medium-term fiscal sustainability, budgetary planning should become more forward-looking, increasing the importance placed on medium-term expenditure plans, on detailed analysis of longer-term implications of spending decisions, and on realistic revenue projections.

41. Monetary policy should place greater emphasis on the inflation objective. Against the background of an expansionary fiscal stance, rapid credit growth, and strong foreign currency inflows, the NBM should tighten its stance to counteract rising inflationary pressures. While recent efforts to sterilize remittances inflows are encouraging and the buildup of reserves from low levels is desirable, the NBM should let the exchange rate appreciate if these inflows continue to grow rapidly. More generally, going forward, a more flexible exchange rate policy would serve Moldova well in absorbing possible external shocks, particularly from terms of trade and remittances.

42. Despite Moldova's relatively open statutory trade regime, the promise of export-led growth remains constrained by *de facto* trade restrictions and high business costs. Moreover, although trade with the EU has gathered pace, exports are still concentrated in a few commodities and markets. Improving and maintaining long-term competitiveness calls for removing impediments to trade and accelerating structural reforms.

43. While financial sector indicators are largely positive, existing vulnerabilities in the financial sector need to be addressed. Of particular importance are efforts to reduce the government's role and administrative interference in the sector, allowing for increased competition. Together with the recent credit boom, the opaque ownership structures of financial institutions and corporations creates risks to the sector, requiring intensive monitoring.

44. The authorities' recent external debt negotiations have met with significant success. Along with currency appreciation, the recent restructuring and reschedulings have alleviated the external debt service burden and improved the debt profile. The resumption of interest payments to Paris Club creditors is an important step toward normalizing the debt situation, but the outstanding arrears still need to be tackled. External creditors will be looking for a credible change in economic policies before committing to debt relief.

45. Moldova's official statistics are provided on a timely basis and are generally adequate for surveillance and program monitoring. Some shortcomings still remain, notably regarding price and national accounts statistics. The authorities have made good use of technical assistance from the Fund and are encouraged to build on the progress achieved to date.

46. Staff recommends that the next Article IV consultation be held within the regular 12-month cycle.

Table 1. Moldova: Selected Indicators, 2000–05 1/

	2000	2001	2002	2003	2004	2005
					Est.	Proj.
I. Real sector indicators						
(Percent change; unless otherwise indicated)						
Gross domestic product						
Real growth rate	2.1	6.1	7.8	6.3	7.0	5.0
Nominal GDP (MDL million)	16,020	19,052	22,556	27,297	31,836	36,779
Nominal GDP (\$ million)	1,289	1,480	1,662	1,957	2,582	2,861
CPI Inflation (average)	31.3	9.8	5.3	11.7	12.3	10.0
CPI Inflation (end of period, y-o-y)	18.5	6.4	4.4	15.7	11.0	9.5
Average monthly wage (Moldovan lei) 2/	408	519	704	912	1068	...
Average monthly wage (U.S. dollars) 2/	33	40	52	65	87	...
Saving-investment balance	(In percent of GDP)					
Foreign saving	8.2	2.5	4.4	6.8	6.7	6.3
National saving	7.2	14.2	11.9	10.3	11.3	11.1
Private	5.7	12.4	9.9	7.1	10.5	11.5
Public	1.5	1.9	2.0	3.2	0.8	-0.4
Gross investment	15.4	16.7	16.3	17.1	18.0	17.4
Private	12.5	14.6	13.4	14.5	15.6	15.3
Public	2.9	2.2	2.9	2.6	2.3	2.1
II. Fiscal Indicators (general government)						
Primary balance (cash)	2.9	4.1	0.4	2.8	0.8	-0.4
Overall balance (cash)	-3.5	-0.1	-1.8	0.7	-1.1	-2.5
Overall balance (commitments)	-1.8	-0.3	-0.9	0.2	-1.5	-2.5
III. Financial indicators						
(Percent change; unless otherwise indicated)						
Broad money (M3)	40.1	36.4	36.0	30.7	32.9	29.2
Velocity (GDP/end-period M3; ratio)	4.6	4.0	3.4	3.2	2.8	2.5
Reserve money	29.8	27.9	31.1	16.6	35.2	36.5
Credit to the economy	40.1	35.4	35.2	44.4	18.5	20.6
IV. External sector indicators						
Current account balance (millions of U.S. dollars)	-105.7	-37.4	-73.9	-132.4	-172.2	-180.6
Current account balance (percent of GDP)	-8.2	-2.5	-4.4	-6.8	-6.7	-6.3
Gross official reserves (millions of U.S. dollars)	226.0	228.5	268.8	302.3	421.3	504.7
Gross official reserves (months of imports)	2.5	2.1	1.9	1.7	2.0	2.3
Exchange rate (MDL/\$) period average	12.4	12.9	13.6	13.9	...	...
Exchange rate (MDL/\$) end of period	12.4	13.1	13.8	13.2	...	...
External debt/GDP (percent) 3/	123.6	105.6	101.2	89.5	63.3	58.4
Debt service/exports of goods and services (percent) 3/	25.0	25.1	28.3	21.3	21.3	17.2
Debt service/central govt. revenues (percent) 4/	31.6	49.9	43.9	28.1	17.0	14.8

Sources: Moldovan authorities; and Fund staff estimates.

1/ Data exclude Transnistria.

2/ Data for 2004 is the average for the first 10 months.

3/ Private and public, including IMF.

4/ Public and publicly-guaranteed debt, excluding IMF. Revenue excludes grants and includes extrabudgetary funds from 2003 onward.

Table 2. Moldova: Balance of Payments, 2000–05
(In millions of U.S. dollars; unless otherwise indicated)

	2000	2001	2002	2003	2004 Est.	2005 Proj.
Current account	-105.7	-37.4	-73.9	-132.4	-172.2	-180.6
Merchandise trade balance	-293.6	-312.8	-378.2	-622.5	-749.0	-847.5
Exports of goods	476.8	567.3	659.8	806.0	1,036.9	1,182.1
Imports of goods	-770.3	-880.1	-1,038.0	-1,428.5	-1,786.0	-2,029.6
Balance of services	-37.0	-37.9	-40.4	-45.5	-74.5	-81.1
Exports of services	164.6	170.9	216.7	254.2	312.7	356.5
Imports of services	-201.6	-208.8	-257.0	-299.8	-387.3	-437.6
Income (net)	24.3	93.2	108.4	231.4	298.7	336.6
Compensation of employees	96.0	123.0	189.0	294.0	365.2	419.0
Income on direct and portfolio investment	-33.6	14.9	-39.4	-28.4	-29.8	-33.0
Income on other investment	-38.1	-44.6	-41.2	-34.2	-36.7	-49.3
Current transfers (net)	200.6	220.1	236.2	304.2	352.6	411.4
Capital and financial account	112.8	-3.2	43.6	31.5	214.1	261.6
Capital account	-14.3	-20.7	-15.3	-12.8	-4.9	0.0
Financial account	127.1	17.4	58.9	44.3	219.0	261.6
Direct investment	126.7	53.0	130.4	68.3	80.0	90.0
Portfolio investment (net)	-4.0	-7.1	-28.4	-23.2	-6.2	-6.3
Other investments	4.3	-28.5	-43.1	-0.9	145.2	178.0
Loans	32.4	8.1	-12.2	-14.2	-1.9	6.7
Government	-11.1	-14.3	-12.6	-25.1	-17.5	-6.8
Disbursements	21.2	15.3	20.4	22.9	34.8	44.3
Amortization	-32.3	-29.6	-33.0	-48.0	-52.3	-51.0
Private net	43.4	22.4	0.5	10.9	15.6	13.5
Other capital flows 1/	-28.0	-36.6	-30.9	13.3	147.1	171.3
Errors and omissions	-9.8	13.6	-17.6	76.9	41.9	0.0
Overall balance	-2.7	-27.0	-47.9	-24.0	83.9	81.1
Financing	2.7	27.0	47.9	24.0	-83.9	-81.1
Use of Fund credit	-12.4	-2.4	-5.5	-22.3	-21.6	-21.9
Change of gross official reserves (increase -)	-47.4	-9.5	-27.0	-14.1	-120.1	-83.3
Exceptional financing	62.6	38.9	80.4	60.3	57.8	24.1
Financing gap	...	...	...	...	40.0	24.1
<i>Memorandum items :</i>						
Gross official reserves	226.0	228.5	268.8	302.3	421.3	504.7
in months of imports of goods and services	2.5	2.1	1.9	1.7	2.0	2.3
Nominal GDP	1,289	1,480	1,662	1,957	2,582	2,861
Current account balance, in percent of GDP	-8.2	-2.5	-4.4	-6.8	-6.7	-6.3
Trade balance, in percent of GDP	-22.8	-21.1	-22.8	-31.8	-29.0	-29.6
Exports, in percent of GDP	37.0	38.3	39.7	41.2	40.2	41.3
Imports, in percent of GDP	59.8	59.5	62.5	73.0	69.2	71.0
Remittances, net	96.3	202.0	288.6	445.2	556.5	...
Total debt service/exports of goods and services, in percent	25.0	25.1	28.3	21.3	21.3	17.2
External debt stock, in percent of GDP	123.6	105.6	101.2	89.5	63.3	58.4

Sources: National Bank of Moldova; and Fund staff estimates.

1/ Increase in other capital flows in 2004 and beyond reflects partly the unidentified inflows that are part of errors and omissions for the historical period.

Table 3a. Moldova: General Government Budget, 2000–05 1/
(Millions of lei; unless otherwise indicated)

	2000	2001	2002	2003	2004	2005
					Est.	Proj.
Revenues and grants	4,965	5,556	6,668	9,383	11,078	12,433
Revenues	4,815	5,394	6,537	8,328	9,843	11,291
Tax revenues	4,009	4,645	5,827	7,597	9,200	10,609
Profit tax	276	350	428	578	676	744
Personal income tax	265	348	468	623	703	787
VAT	1,343	1,498	2,034	2,792	3,410	3,789
Excises	659	681	658	888	908	954
Foreign trade taxes	231	234	333	477	515	588
Other taxes	228	231	263	259	289	304
Social Fund contributions	1,009	1,304	1,644	1,978	2,310	2,964
Health Fund contributions	...	...	...	2	388	480
Non-tax revenues	806	749	710	731	643	681
Grants	149	163	130	73	128	183
Revenues of special funds 1/	...	...	...	982	1,107	960
Expenditures and net lending (cash) 1/	5,530	5,605	7,114	9,201	11,435	13,338
National Economy	367	319	417	999	1,433	1,331
Social sphere	1,581	1,795	2,489	3,503	3,287	3,506
Education	719	923	1,240	1,841	2,093	2,236
Health care 2/	472	542	792	1,068	411	466
Other	390	329	457	594	784	804
Interest payments	1,021	797	486	580	607	740
Other expenditures	816	926	1,251	1,898	2,373	2,465
Social Fund expenditures	1,326	1,373	1,900	2,261	2,749	4,021
Health Fund expenditures	...	...	...	12	1,040	1,320
Net lending	-32	-17	-78	-52	-53	-45
Balance of special funds 1/	6	23	44	...	...	...
Overall surplus(+)/deficit(-) (cash)	-560	-25	-402	182	-357	-904
Primary balance (cash)	461	772	84	762	250	-164
(excl. project loan spending)	581	816	345	1,099	670	398
Change in arrears (+, increase)	-277	29	-202	122	123	0
Domestic expenditure	-336	-15	-294	-58	0	0
External interest	59	44	92	180	123	0
Overall surplus(+)/deficit(-) (commitments)	-282	-54	-200	60	-480	-904
Primary balance (commitments)	797	787	378	820	250	-164
(excl. project loan spending)	1,049	977	712	1,158	681	398
Financing	508	67	322	-66	357	904
Budget financing	257	-123	-12	-404	-74	342
Central government	257	-123	246	-313	-201	-217
Net domestic	-149	413	417	109	838	-43
Net foreign	-52	-621	-315	-473	-1,561	-663
Privatization	458	85	144	51	21	169
Financing gap	0	0	0	0	501	319
o/w flow gap	0	0	0	0	36	319
Local governments	...	...	-75	-24	170	25
Social fund	...	...	-184	-68	-43	535
Health fund	0	0	...	0	0	0
Project loans	252	190	334	338	432	562
Statistical discrepancy	-51	42	-80	116	0	0

Sources: Data provided by the authorities; and Fund staff estimates and projections.

1/ 2005 is the staff's projection based on the authorities' 2005 budget. Revenues and expenditures of special funds shown on a gross basis from 2003.

2/ From 2004, excludes expenditure of the Health Fund, which is shown as a separate item.

Table 3b. Moldova: General Government Budget, 2000–05 1/
(In percent of GDP; unless otherwise indicated)

	2000	2001	2002	2003	2004	2005
					Est.	Proj.
Revenues and grants	31.0	29.2	29.6	34.4	34.8	33.8
Revenues	30.1	28.3	29.0	30.5	30.9	30.7
Tax revenues	25.0	24.4	25.8	27.8	28.9	28.8
Profit tax	1.7	1.8	1.9	2.1	2.1	2.0
Personal income tax	1.7	1.8	2.1	2.3	2.2	2.1
VAT	8.4	7.9	9.0	10.2	10.7	10.3
Excises	4.1	3.6	2.9	3.3	2.9	2.6
Foreign trade taxes	1.4	1.2	1.5	1.7	1.6	1.6
Other taxes	1.4	1.2	1.2	0.9	0.9	0.8
Social Fund contributions	6.3	6.8	7.3	7.2	7.3	8.1
Health Fund contributions	...	...	...	...	1.2	1.3
Non-tax revenues	5.0	3.9	3.1	2.7	2.0	1.9
Grants	0.8	0.8	0.3	0.3	0.4	0.5
Revenues of special funds 1/	...	...	...	3.6	3.5	2.6
Expenditures and net lending (cash) 1/	34.5	29.4	31.5	33.7	35.9	36.3
National Economy	2.3	1.7	1.8	3.7	4.5	3.6
Social sphere	9.9	9.4	11.0	12.8	10.3	9.5
Education	4.5	4.8	5.5	6.7	6.6	6.1
Health care 2/	2.9	2.8	3.5	3.9	1.3	1.3
Other	2.4	1.7	2.0	2.2	2.5	2.2
Interest payments	6.4	4.2	2.2	2.1	1.9	2.0
Other expenditures	5.1	4.9	5.5	7.0	7.5	6.7
Social Fund expenditures	8.3	7.2	8.4	8.3	8.6	10.9
Health Fund expenditures	...	...	...	...	3.3	3.6
Net lending	-0.2	-0.1	-0.3	-0.2	-0.2	-0.1
Balance of special funds 1/	0.0	0.1	0.2	...	...	...
Overall surplus(+)/deficit(-) (cash)	-3.5	-0.1	-1.8	0.7	-1.1	-2.5
Primary balance (cash)	2.9	4.1	0.4	2.8	0.8	-0.4
(excl. project loan spending)	3.6	4.3	1.5	4.0	2.1	1.1
Change in arrears (+, increase)	-1.7	0.2	-0.9	0.4	0.4	0.0
Domestic expenditure	-2.1	-0.1	-1.3	-0.2	0.0	0.0
External interest	0.4	0.2	0.4	0.7	0.4	0.0
Overall surplus(+)/deficit(-) (commitments)	-1.8	-0.3	-0.9	0.2	-1.5	-2.5
Primary balance (commitments)	5.0	4.1	1.7	3.0	0.8	-0.4
(excl. project loan spending)	6.6	5.1	3.2	4.2	2.1	1.1
Financing	3.2	0.4	1.4	-0.2	1.1	2.5
Budget financing	1.6	-0.6	-0.1	-1.5	-0.2	0.9
Central government	1.6	-0.6	1.1	-1.1	-0.6	-0.6
Net domestic	-0.9	2.2	1.9	0.4	2.6	-0.1
Net foreign	-0.3	-3.3	-1.4	-1.7	-4.9	-1.8
Privatization	2.9	0.4	0.6	0.2	0.1	0.5
Financing gap	0.0	0.0	0.0	0.0	1.6	0.9
o/w flow gap	0.0	0.0	0.0	0.0	0.1	0.9
Local governments	...	...	-0.3	-0.1	0.5	0.1
Social fund	...	...	-0.8	-0.2	-0.1	1.5
Health fund	0.0	0.0	...	...	0.0	0.0
Project loans	1.6	1.0	1.5	1.2	1.4	1.5
Statistical discrepancy	-0.3	0.2	-0.4	0.4	0.0	0.0
Stock of general government debt	84.5	72.4	65.8	57.2	44.0	41.2
Domestic debt	10.5	12.6	12.5	10.7	11.7	10.0
Domestic expenditure arrears	4.8	3.5	1.7	1.2	1.0	0.9
External debt 3/	69.2	56.3	51.6	45.4	31.4	30.3
Memorandum item:						
GDP (in millions of lei)	16,020	19,052	22,556	27,297	31,836	36,779

Sources: Data provided by the authorities; and Fund staff estimates and projections.

1/ 2005 is the staff's projection based on the authorities' 2005 budget. Revenues and expenditures of special funds shown on a gross basis from 2003.

2/ From 2004, excludes expenditure of the Health Fund, which is shown as a separate item.

3/ Excluding IMF loans and publicly-guaranteed debt that is serviced by borrowers.

Table 4. Moldova: Accounts of the National Bank of Moldova and Monetary Survey, 2002–05
(Millions of lei; unless otherwise indicated)

	2002	2003	2004				2005	
			Q1	Q2	Q3	Q4 Est.	Proj.	
National Bank of Moldova								
Net foreign assets	1,616	2,112	2,197	1,973	3,285	3,725	5,371	
NFA (convertible)	1,616	2,113	2,197	1,975	3,287	3,727	5,372	
Gross reserves	3,716	3,996	3,842	3,535	4,762	5,229	6,678	
Reserve liabilities	-2,100	-1,883	-1,645	-1,560	-1,476	-1,503	-1,306	
Net domestic assets	1,647	1,692	1,670	2,229	1,713	1,420	1,653	
Net claims on general government	2,037	2,172	2,088	2,564	2,361	2,612	2,485	
Credit to banks	58	-21	-44	9	-185	-587	-133	
Other items (net)	-448	-459	-374	-345	-463	-605	-699	
Reserve money	3,263	3,804	3,866	4,202	4,998	5,145	7,024	
Currency in circulation	2,289	2,740	2,633	2,853	3,321	3,321	4,967	
Banks' reserves	974	1,064	1,234	1,350	1,676	1,824	2,056	
Required reserves	512	819	864	900	742	840	1,013	
Excess reserves	462	245	369	451	933	984	1,043	
Monetary Survey								
Net foreign assets	1,943	2,800	2,934	2,736	3,732	4,039	5,863	
NFA (convertible)	1,900	2,726	2,896	2,709	3,751	4,058	5,882	
<i>of which</i> Commercial banks	284	613	699	734	465	331	510	
NFA (non-convertible)	43	74	38	27	-19	-19	-19	
Net domestic assets	4,568	5,709	5,725	6,363	6,653	7,272	8,746	
Net claims on general government	2,094	1,823	1,844	2,511	2,330	2,739	3,107	
Credit to economy	4,166	6,055	6,168	6,290	6,847	7,175	8,655	
Other items (net)	-1,691	-2,169	-2,287	-2,438	-2,524	-2,642	-3,016	
Broad Money (M3)	6,512	8,509	8,659	9,099	10,385	11,311	14,609	
Broad Money (M2: excluding FCD)	4,518	5,622	5,801	6,130	7,115	7,316	9,595	
Currency in circulation	2,289	2,740	2,633	2,853	3,321	3,321	4,967	
Total deposits	4,223	5,769	6,026	6,245	7,064	7,990	9,642	
Domestic currency deposits	2,229	2,881	3,161	3,276	3,793	3,995	4,628	
Foreign currency deposits (FCD)	1,994	2,887	2,865	2,969	3,270	3,995	5,014	
Memorandum items:								
Reserve money growth (percent change; quarterly)	...	2.7	1.6	8.7	18.9	2.9	...	
Reserve money growth (percent change; annual)	31.1	16.6	23.2	28.2	34.9	35.2	36.5	
Broad money growth (percent change; quarterly)	...	3.8	1.8	5.1	14.1	8.9	...	
Broad money growth (percent change; annual)	36.0	30.7	25.8	24.6	26.7	32.9	29.2	
Credit to the economy (percent change, annual)	34.3	45.4	31.9	28.9	21.9	18.5	20.6	
Gross international reserves (in millions of U.S. dollars)	268.8	302.3	309.6	295.8	391.6	421.3	504.7	
Net international reserves (in millions of U.S. dollars)	116.9	159.8	177.0	165.3	270.3	300.3	406.0	
Velocity (M3; end of period)	3.4	3.2	3.3	3.2	3.0	2.8	2.5	
Broad money multiplier	2.0	2.2	2.2	2.2	2.1	2.2	2.1	
Share of foreign currency deposits in all deposits	47.2	50.1	47.4	47.5	46.3	50.0	52.0	

Sources: National Bank of Moldova; and Fund staff estimates.

Table 5. Moldova: Financial Sector Indicators, 1998–2004
(End-of-period and in percent; unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004 end-Sep
Size							
Number of banks	23	20	20	19	16	16	16
Total assets of the banking system (in percent of GDP)	29	26	29	31	36	38	39
Credit to nongovernment sector (percent of GDP)	19	13	14	16	19	22	22
Ownership							
Share in total assets of banks with foreign ownership exceeding 50 percent	22	34	40	35	37	35	35
Share in total assets of banks with state ownership exceeding 50 percent	-	8	9	10	13	15	16
Capital adequacy							
Capital adequacy ratio 1/	40	46	49	43	36	32	32
Liquidity							
Liquidity ratio 2/	67	79	67	60	56	48	51
Asset quality							
Nonperforming loans as a share of total loans	32	29	21	10	8	6	7
Non-performing loans, net of loan loss provisions / tier one capital	31	20	15	5	3	2	2
Loans under supervision as a share of total loans	38	32	30	31	35	35	37
Non-performing and loans under supervision as a share of total loans	70	61	51	41	43	42	44
Profitability							
Return on equity	15	18	25	14	17	20	18
Return on assets	4	4	7	4	4	4	4
Non-interest income / Total income	25	39	39	35	40	38	34
Interest rates 3/							
Domestic currency average lending rate	34	35	32	26	19	19	21
Domestic currency average deposit rate	30	28	24	18	13	14	16
Interest rate spread, domestic currency	4	8	9	8	7	5	5
Foreign currency average lending rate	20	19	15	12	12	11	11
Foreign currency average deposit rate	6	5	5	3	3	4	5
Interest rate spread, foreign currency	14	14	10	9	9	7	6
91 day T-bill (effective nominal yield)	48	38	25	8	11	18	9
Foreign currency deposits							
Share of foreign currency deposits in broad money	23	28	28	28	31	34	31
Share of foreign currency deposits in all deposits	44	50	49	45	47	50	46

Source: National Bank of Moldova

1/ Total regulatory capital over total risk-weighted assets.

2/ Liquid assets over total deposits.

3/ Latest observations are from October 2004.

Table 6. Moldova: Medium-Term Scenarios, 2003–09^{1/}

	2003	2004	2005	2006	2007	2008	2009
	Projections						
Baseline scenario	(Percent change; unless otherwise indicated)						
Gross domestic product							
Real growth rate	6.3	7.0	5.0	4.0	3.0	3.0	3.0
Inflation (average)	11.7	12.3	10.0	8.1	5.9	5.0	5.0
Nominal GDP (millions of lei)	27,297	31,836	36,779	41,358	45,115	48,792	52,769
	(In percent of GDP, unless otherwise noted)						
Government primary expenditure	31.6	34.0	34.3	33.1	32.9	32.5	32.1
Change, percent	30.1	25.6	16.3	8.5	8.6	6.8	6.8
Primary balance (cash)	2.8	0.8	-0.4	-0.3	-0.6	-0.6	-0.6
Overall balance (cash)	0.7	-1.1	-2.5	-2.0	-2.1	-2.0	-1.9
Overall balance (commitments)	0.2	-1.5	-2.5	-2.0	-2.1	-2.0	-1.9
Financing gap (flow)	0.0	0.1	0.9	2.2	2.4	2.4	2.3
Current account balance	-6.8	-6.7	-6.3	-6.1	-5.6	-4.7	-4.3
Total public debt stock/GDP, percent 2/	57.2	44.0	41.2	40.7	40.9	40.2	39.5
Total external debt service/exports of goods and services, percent	21.3	21.3	17.2	15.4	12.3	12.5	12.6
Alternative scenario	(Percent change; unless otherwise indicated)						
Gross domestic product							
Real growth rate	...	...	6.0	6.0	6.0	5.0	5.0
Inflation (average)	...	...	10.0	8.1	5.9	5.0	5.0
Nominal GDP, millions of lei	...	...	37,129	42,555	47,773	52,669	58,068
	(In percent of GDP, unless otherwise noted)						
Government primary expenditure	...	...	33.3	30.5	30.0	29.7	29.5
Change, percent	...	...	14.0	5.2	10.2	9.3	9.5
Primary balance (cash)	...	...	0.4	1.8	1.6	1.4	1.2
Overall balance (cash)	...	...	-1.6	0.2	0.3	0.4	0.3
Overall balance (commitments)	...	...	-1.6	0.2	0.3	0.4	0.3
Financing gap (flow)	...	...	0.0	0.0	0.0	0.0	0.0
Current account balance	...	...	-6.3	-6.2	-5.8	-5.5	-5.2
Total public debt stock/GDP, percent 2/	...	...	40.0	36.7	33.7	30.7	27.4
Total external debt service/exports of goods and services, percent	...	...	16.9	14.9	11.6	11.5	11.2

Sources: Moldovan authorities; and Fund staff estimates.

1/ Data exclude Transnistria.

2/ Excluding IMF loans and publicly-guaranteed debt that is serviced by borrowers.

Table 7: Moldova: Localized Millennium Development Goals (EGPRSP)

	2000	2002	Targets:	
			2010	2015
<u>Goal: Eradicate extreme poverty and hunger</u>				
Target: Reduce by half the proportion of persons with daily income below 2,15 USD (PPP) over the period 1997-2015				
▪ Population with income below \$2.15 (PPP) a day (%)	64.5	39.8	23	18
<u>Goal: Achieve universal access to gymnasium education</u>				
Target: Ensure equal opportunities for all children to study in gymnasiums				
▪ Net enrollment ratio in gymnasium education (%)	87.0	87.9	93.8	100.0
<u>Goal: Reduce child mortality</u>				
Target: Reduce by two-thirds the under-five mortality rate over the period 1990-2015				
▪ Under-five mortality rate (per 1,000)	23.3	18.3	11.9	8.4
▪ Infant mortality rate (per 1,000 live births)	18.3	14.7	9.6	6.3
▪ Immunization , measles (% of children under 2 years old)	98.6	99.2	100	100
<u>Goal: Improve maternal health</u>				
Target: Reduce the maternal mortality ratio by three-fourths over the period 1990-2015				
▪ Maternal mortality ratio (per 100,000 births)	27.1	28.0	21.0	13.3
▪ Births attended by skilled health personnel (%)	98	99	100	100
<u>Goal: Combat HIV/AIDS, tuberculosis and malaria</u>				
Target: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS				
▪ HIV/AIDS incidence (per 100,000 people)	4.06	4.66	3.50	3.20
▪ HIV incidence among 15-24 year-olds	11.9	6.0	4.2	4.0
Target: Have halted by 2015, and begun to reverse, the incidence of tuberculosis and malaria				
▪ Mortality rate associated with tuberculosis (deaths per 100,000 people)	16.9	15.8	12.0	7.0
<u>Goal: Ensure environmental sustainability</u>				
Target: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources				
▪ Proportion of land areas covered by forest (%)	9.6	10.3	12.1	13.2
▪ Ratio of area protected to maintain biological diversity (%)	1.96	1.96	2.22	2.37
Target: Halve, by 2015, the proportion of people without sustainable access to improved water sources				
▪ Population with sustainable access to an improved water source (%)	37.8	38.5	57.0	68.5
Target: Achieve a significant increase of the share of people with access to improved sanitation				
▪ Population with access to improved sanitation (%)	..	..	73.3	90.0

Sources: Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) 2004-06, Government of the Republic of Moldova, June 2004 for data commencing in 2002. Draft MDG Report by the Government of Moldova (December 2004) for data prior to 2002.

MOLDOVA—FUND RELATIONS

(As of November 30, 2004)

I. Membership Status: Joined August 12, 1992; Article VIII

II. General Resources Account:	SDR million	Percent of Quota
Quota	123.20	100.00
Fund holdings of currency	176.85	143.54
Reserve tranche position	0.01	0.00

III. SDR Department:	SDR million	Percent of Allocation
Holdings	0.12	N/A

IV. Outstanding Purchases and Loans:	SDR million	Percent of Quota
Extended arrangements	53.65	43.54
PRGF arrangements	27.72	22.50

V. Latest Financial Arrangements:

Type	Approval date	Expiration date	Amount approved (SDR million)	Amount drawn (SDR million)
PRGF	12/21/2000	12/20/2003	110.88	27.72
EFF	05/20/1996	05/19/2000	135.00	87.50
Stand-by	03/22/1995	03/21/1996	58.50	32.40

VI. Projected Obligations to Fund¹⁴: (SDR million; based on existing use of resources and present holdings of SDRs):

		Forthcoming				
		2004	2005	2006	2007	2008
Principal			14.58	16.42	14.53	13.88
Charges/Int		0.07	1.59	1.14	0.73	0.41
Total		0.07	16.18	17.56	15.26	14.29

¹⁴ Disbursements made after November 28, 2000—with the exception of disbursements of emergency assistance and loans from the Poverty Reduction and Growth Facility—are expected to be repaid on the expectations schedule. Countries may request the IMF Executive Board to make repayments according to the obligations schedule if their external payments position is not strong enough to meet the repayment expectations without undue hardship or risk. Please note: Repayments under the Supplemental Reserve Facility are scheduled to be repaid on the expectations schedule.

VII. Safeguards Assessments:

Under the Fund's safeguards assessment policy, the National Bank of Moldova (NBM) was subject to a full safeguards assessment with respect to the PRGF Arrangement that expired on December 20, 2003. The safeguards assessment was completed on June 12, 2002, and determined that the NBM's procedures and controls to manage resources, including IMF disbursements, were not adequate in all areas of the IMF's safeguards framework. Therefore, specific remedial actions to address identified vulnerabilities were recommended to the authorities and all priority measures identified have been implemented.

VIII. Exchange Arrangement:

Moldova's exchange rate regime was reclassified to *managed floating with no pre-announced path for the exchange rate* on June 30, 2002; previously it was classified as independently floating.

Prior to the introduction of the Moldovan leu on November 29, 1993, the Russian ruble (supplemented by NBM-issued ruble denominated coupons) was the legal tender in Moldova. The government introduced the leu at a conversion rate of one leu equal to 1,000 Moldovan rubles and an exchange rate of one dollar equal to lei 3.85. The leu remained broadly stable around MDL 4.75/\$ until mid-October 1998. It has since depreciated against the dollar and traded at MDL 12.46=\$1 on December 31, 2004.

Foreign exchange was initially traded on the Chişinău Interbank Foreign Currency Exchange (CIFCE). Operations of the CIFCE started at the beginning of 1993, and daily auctions commenced in early February 1995. An active foreign exchange cash market exists within authorized banks and foreign exchange bureaus. From November 16, 1993 through end-October 1998, the U.S. dollar exchange rate established in the CIFCE was the official exchange rate quoted by the NBM. Since November 2, 1998, the official rate as announced by the NBM is determined as the weighted average of all daily market transactions. The NBM quotes exchange rates of the leu for other currencies on the basis of the leu-U.S. dollar rate and the cross-rate relationships between the U.S. dollar and the currencies concerned in the international market.

IX. Article IV Consultation:

Moldova is on a 12-month consultation cycle. The last Article IV consultation was concluded on January 26, 2004 (Country Reports No. 04/39, and No. 04/40).

X. FSAP Participation:

Moldova received an FSAP mission in May 2004; the FSSA will be presented to the Board at the time of the 2004 Article IV discussions.

XI. Use of Fund Resources:

On February 4, 1993, Moldova purchased Fund resources totaling SDR 13.5 million, equivalent to 15 percent of quota under the Compensatory and Contingency Financing Facilities (CCFF). This was followed by a first drawing under the Systemic Transformation Facility (STF) of SDR 22.5 million, equivalent to 25 percent of quota, which was approved by the Board on September 16, 1993. On December 17, 1993, the Board approved a purchase of Fund resources under a stand-by arrangement (SBA) in the amount of SDR 51.75 million and the drawing of the second tranche of the STF totaling SDR 22.5 million. On December 19, 1994, Moldova made a second purchase under the CCFF totaling SDR 12.2 million, equivalent to 13.5 percent of quota, in conjunction with the second review of the SBA that expired at end-March 1995. The Board approved a successor SBA for Moldova in an amount totaling SDR 58.05 million (equivalent to 65 percent of quota) on March 22, 1995 (Press Release No. 95/15, 3/22/95). Three purchases, totaling SDR 32.4 million (equivalent to 36 percent of quota), were made under the arrangement. An Extended Arrangement amounting to SDR 135 million (equivalent to 150 percent of old quota) was approved by the Executive Board on May 20, 1996 (Press Release No. 96/25, 5/20/96). At the time of the third review, the program was extended by one year to May 19, 2000. While the fourth review was completed (www.imf.org), the program expired on May 19, 2000 without the completion of the scheduled last review because parliament rejected twice an important program condition. Five purchases totaling SDR 87.5 million (equivalent to 97 percent of old quota) were made under the EFF arrangement. A PRGF arrangement was approved on December 21, 2000 (News Brief No. 00/122, 12/21/00) in the amount of SDR 110.88 million (equivalent to 90 percent of quota). SDR 9.24 million was disbursed on December 29, 2000, followed by SDR 9.24 million on February 23, 2001, and SDR 9.24 million on July 26, 2002. The arrangement expired in December 2003 with only one review completed.

XII. Resident Representative:

Mr. Ruggiero has been the Resident Representative since mid-2002.

XIII. Resident Advisors:

An FAD resident advisor, Mr. Agarwal, completed a posting to support the development of the treasury in June 1998. Peripatetic return visits were conducted through 1999. During 1998, Mr. and Mrs. Faulk were assigned as resident advisors on banking supervision at the NBM. During 1999, they paid various follow-up visits as external experts. In July 1999, an FAD resident tax administration advisor, Mr. Vandenberghe, was extended for a third six month period to support the development of a large taxpayer unit. His contract ended in mid-2000.

XIV. Short-Term Assistance:

Mr. Antao conducted regular visits to assist the ministry of finance on macroeconomic analysis since mid-1997. From April 1996 to July 1998, Mr. Richards paid regular visits as a regional balance of payments statistics advisor to Moldova, Armenia, and Georgia.

Mr. Van Sluys and Dr. Peeraer visited Chişinău on several occasions in 1998/99 to assist in the area of supervision of commercial bank's foreign exchange activities. Mr. Thompson has been advising the NBM on accounting issues since 1999 and visited Moldova regularly during the past three and a half years, including for preparation of the NBM international audits. Mr. Ponomarenko visited Moldova several times in 2002–04 to assist the Department of Statistics and Sociology (DSS) in the area of national accounts. Mr. Astin has been visiting Moldova regularly to help the DSS reform the methodology for the CPI and PPI.

XV. Technical Assistance:

The following table summarizes the technical assistance missions provided by the Fund to Moldova since January 1999.¹⁵

Moldova: Technical Assistance Provided by the Fund, 1999–2004

Department	Subject/Identified Need	Timing	Counterpart
MAE	Monetary and foreign exchange operations; and banking, accounting, and auditing issues.	April/May 1999	NBM
STA	Government financial statistics	August 1999	MoF
FAD	Tax administration	May 2000	MoF
FAD	Customs administration	June 2000	MoF
MAE	Monetary policy management; payment system; foreign exchange operations; and banking supervision.	September 2000	NBM
LEG	Banking legislation	October 2000	NBM
LEG	Free economic zone legislation	Jan./Feb. 2001	MoE
FAD	Expenditure policy	May 2001	MoF
LEG	Bankruptcy law	June 2001	MoE
LEG	Banking legislation	June 2001	NBM
MAE	TA assessment/evaluation	October 2001	NBM
MAE	Payments system; liquidity projection and monetary policy framework; central bank accounting and internal audit; and bank supervision.	May 2002	NBM
MFD	Payments system	Missions 2003 and 2004	NBM
STA	National accounts	March 2002, Dec. 2002, March 2003, Apr. 2004	DSS
STA	Price statistics	Nov. 2003, Sept 2004	DSS
STA	Money and Banking Statistics	April, 2004	NBM
MFD	Anti Money Laundering	April, 2004	MDA Gov., NBM
FAD	Modernization of the LTU and VAT	May, 2004	MoF
MFD	Foreign Exchange Regulation and Banking Supervision	December 2004	NBM

Note: MoF: Ministry of Finance; NBM: National Bank of Moldova; MoE: Ministry of Economy.

¹⁵ For technical assistance before 1999, see previous reports.

MOLDOVA—IMF-WORLD BANK RELATIONS

(As of November 30, 2004)

Country Director: Mr. Paul Bermingham

Telephone: +380 44 490 06671

A. Partnership in Moldova's Development Strategy

1. The government and other major stakeholders consider poverty reduction to be the major development challenge facing Moldova. The government has welcomed the PRSP process as the primary mechanism for orienting and coordinating government and development partner activities. An Interim Poverty Reduction Strategy Paper (I-PRSP) was presented to the Boards of the IMF and IDA in December 2000. The change in government in March 2001, however, delayed progress towards the full PRSP. The new government submitted an updated I-PRSP and PRSP Preparation Status Report to the Boards of the IMF and IDA in April 2002. The Joint Staff Assessment at that time noted that the delay was understandable and concluded that progress on the development of the full PRSP was satisfactory and provided a sound basis for continued access to concessional assistance.
2. Since then, the government has completed a full PRSP, calling it - the Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) to emphasize the centrality of growth to poverty reduction. The EGPRSP, which was adopted by the government in May 2004, describes the participatory process underpinning the development of the strategy, provides a diagnostic of poverty, and presents sector programs and policy measures for sustainable economic growth and poverty reduction. The Joint Staff Advisory Note assessing the EGPRSP was discussed by the Boards of the World Bank and the IMF in November 2004.
3. The IMF has taken the lead in assisting Moldova in promoting and maintaining macroeconomic stability through prudent monetary and financial policies. In this regard the Fund has encouraged the Moldovan authorities to implement a policy reform agenda that would attract the needed level of concessional foreign financing from bilateral and multilateral creditors and encourage the international community to reschedule Moldova's external debt to enhance debt sustainability. The Fund has supported Moldova's economic reform program since 1993. A three-year program under the PRGF facility was approved in December 2000. The first PRGF review was not completed until Mid-2002 as a result of disruptions stemming from a change in government in early 2001. Several attempts to complete the second review have failed owing to the incomplete implementation of agreed actions. The program expired at the end of 2003, leaving $\frac{3}{4}$ of the available funds undisbursed.
4. The World Bank has taken the lead in the policy dialogue on a number of structural issues relevant to economic growth and poverty reduction, including private sector development, infrastructure, social protection, and agricultural sector reforms. A range of

instruments is used to conduct this dialogue. Since 1994, three structural adjustment operations have been carried out, which aimed at supporting structural reforms in the areas of financial discipline, cash privatization, de-monopolization and privatization of the energy sector and telecom, and urban and rural land markets. The First Structural Adjustment Loan (\$60 million) was approved in December 1994. The Second Structural Adjustment Loan and Credit (\$100 million, of which IDA credit of \$45 million) was approved in 1997. The third tranche was cancelled and replaced with a \$40 million Structural Adjustment Credit (approved on June 24, 1999). The second tranche of the SAC was accompanied by a \$10 million budget support grant from the Dutch Government. A supplement of \$5 million was disbursed in December 2001 to help the government fill a financial gap created by ice storm damages of November 2000. A Third Structural Adjustment Credit (\$30 million) was approved in June 2002. Lack of progress in structural reforms resulted in the credit expiring in September 2003 with 2/3 of the credit undisbursed. Adjustment operations have been combined with sector projects in rural finance, energy, agriculture, environment, health, education, social protection and private sector development. Recent analytical work of the Bank includes *A Public Expenditure Management Review*, an *Investment Climate Assessment*, a *Country Procurement Assessment Review*, a *Country Financial Accountability Assessment*, a *Trade Diagnostic Study* and the second *Poverty Assessment*.

5. The next section describes the Bank program and the division of responsibility between the two institutions. In a number of areas—social sectors, environment, infrastructure—the Bank takes the lead in the dialogue and there was no cross conditionality in the IMF-supported program. The Bank also is leading the dialogue on private sector development and agricultural sector reform and Bank analysis serves as input into the Fund program. In other areas—trade and customs reform, financial sector policies, public sector management—both institutions work together and share conditionality. Finally, in areas like fiscal, monetary, and exchange rate policies, and tax administration, the IMF takes the lead with little Bank involvement.

B. IMF-World Bank Collaboration in Specific Areas

Areas in which the World Bank leads

6. Areas in which the Bank leads the policy dialogue are social sectors, infrastructure, and environment. In the **social sphere**, the Bank has carried out *Poverty Assessments* to monitor and evaluate progress in alleviating poverty. A second poverty assessment has recently been completed. A *Social Protection Management Project* supports the implementation of comprehensive reform of the public pension system and the introduction of a regulatory framework for private pension funds. The project also supports the implementation of the new organizational structure for social insurance. The Bank has also supported a *Social Investment Fund Project* to assist in the building of local community and municipal capacity and skills through the rehabilitation of social infrastructure. The fund also focuses on improving the delivery of social services, creating short-term employment and opportunities in rural areas by financing small-scale public works and supporting micro-

business development. A second *Social Investment Fund Project* was approved by the Bank's board in June 2004.

7. In **health**, the Bank is focusing on improving the allocation of resources to ensure a more equitable and efficient orientation of healthcare resources to enable the government achieve a better utilization of finances and to appropriately meet the health needs of the population. The ongoing *Health Investment Fund Project* is focused on improving the health status of the Moldovan population and increasing the quality and efficiency of public health services by improving access to essential services by the poor. The *Moldova TB/AIDS Control Project* aims at improving Moldova's health status and assists in achieving the health-related Millennium Development Goals by reducing mortality, morbidity, and transmission of HIV/AIDS.

8. In **education**, the *General Education Project* supports the introduction of new general education standards. It develops, tests and implements: a new curricula; teaching materials; textbooks; teaching methodology; and teacher training. The technical assistance activity, *Reconciliation Through General Education in the Transnistria Region*, addresses the issue of access to mother tongue education through the rehabilitation of school infrastructure in schools affected by military conflict and promotes reconciliation and integration of communities separated by civil strife.

9. With regards to **infrastructure** development, the Bank is concentrating on upgrading basic utility services impacting the population at large and the poor in particular. The *Energy II Project* has two main components: (i) power system infrastructure—investments to upgrade and rehabilitate metering, dispatch and communications, selected priority rehabilitation of the electricity of the electricity transmission network, and institutional development and regulation of the electricity market; and (ii) heating supply and consumption—investments in improving heating supply and energy efficiency in selected public buildings. A *Pilot Water Supply and Sanitation Project* is aimed at enhancing the welfare of the population living in some of the poorest rural areas and medium-sized towns and cities by improving the quality, efficiency, and sustainability of water supply and sanitation services by rehabilitating and improving operations of selected water and sewage systems to increase service quality and efficiency, improving the financial viability and commercial practices of the participating utilities, and involving the private sector in the sector.

10. The Bank has supported a number of **environmental** projects. The *Agriculture Pollution Control Project* focuses on significantly increasing the use of environmentally friendly agricultural practices by farmers and agro-industry thereby reducing nutrient discharge from agricultural sources into the Danube River and Black Sea. A number of technical assistance activities are also under implementation. A *Biodiversity Strategy Development* is assisting the government in implementing Articles 6 and 8 of the Convention on Biological Diversity. The project also supports the formulation and adoption of strategies and actions for the protection and sustainable use of bio-diversity, through a participatory

process involving the public and private sectors and local NGOs. Similarly, the *Biodiversity Conservation Project* addresses existing national environmental priorities of improved water quality and habitat management on the Nistru River.

11. In the area of **rural and agricultural development**, the Bank's *First Cadastre Project* has initiated the first cadastre, implemented a rural land registration system, and helped develop the institutional framework to complete and manage the legal cadastre in urban areas. The project helped establish a system of clear and enforceable ownership rights so as to promote the privatization of land the development of real markets in Moldova. The *Rural Investment and Services Project* increases rural incomes and living standards by promoting rural entrepreneurship, agricultural production, economic diversification, and trade in the rural areas. The project provides public investment support to alleviate key institutional constraints in farmer's group formation, supporting development of marketing institutions and infrastructure for improved access to input and output markets, and developing a rural advisory service. The project also provides investment and working capital at commercial terms to support a broad range of agribusiness. A *Supplement to the Rural Investment and Services Project* was made effective in August 2004.

12. While the Bank has taken the lead in the areas described above, the IMF has a strong interest in these areas since many of these reforms are critical to achieving macroeconomic stabilization and enhancing growth prospects. Accordingly, there is a high degree of consultation and coordination between the two institutions on these matters.

Areas of shared responsibility

13. The Bank and Fund are working jointly in a number of areas:

14. **Private Sector Development.** While substantial progress in improving Moldova's business environment has been made, a challenging reform agenda remains. Both the Bank and the Fund have focused on this agenda in their assistance programs, including SAC III and PRGF and the surveillance exercise. The Bank has undertaken a number of studies, including the *Investment Climate Assessment*, the *Business Environment and Enterprise Performance Survey* (together with EBRD), a *Diagnostic Review of the Environment for Foreign Investment*, and a number of *Costs of Doing Business Surveys*, to gauge ongoing developments in this area and determine the most important impediments to private sector development. The Bank's *Private Sector Development II Project* strengthens the competitiveness of private and public enterprises in Moldova through the hands-on training of local managers abroad (human capital investment) and creation of a Competitiveness Center (market information and benchmarking). The IFC has promoted financial sector development by extending credit lines to a number of private banks for on-lending to private sector. The Fund has focused on policies needed to maintain a stable macroeconomic environment and remove obstacles to growth, thus encouraging private sector activities. The PRGF program included a number of structural benchmarks that focused on promoting a liberal trade regime and eliminating excessive state intervention in the economy. A number

of technical assistance missions have been undertaken to improve banking legislation and banking supervision, including the joint *Financial Sector Assessment Program*.

15. In the area of **Public Sector Management**, the Bank's *Public Economic Management Review*, *Country Procurement Assessment Review* and *Country Financial Accountability Assessment* examine fiscal adjustment and reform efforts in the social sectors and suggest policy measures to strengthen public expenditure management and actions needed to build capacity for increased government effectiveness. The Bank's project, *Trade and Transportation Facilitation in Southeast Europe* (part of the Stability Pact initiative), aims to strengthen and modernize the Customs Administration and other border control agencies with the objective reducing non-tariff costs to trade and transport and preventing smuggling and corruption at border crossings. The Fund has also provided technical assistance to improve custom and administration, government financial statistics, and public expenditure policies.

Areas in which the IMF leads

16. The Fund takes the lead in the formulation and execution of fiscal and monetary policies, external policies, and issues involving economic and financial statistics. In the budgetary area, the Fund leads the dialogue on fiscal matters, taking the lead on tax policy and reforms.

17. In these areas the Bank takes into account the policy recommendations of the IMF and ensures that its own policy advice is consistent.

C. The World Bank Group Strategy

18. The Bank's last full Country Assistance Strategy (CAS) for the period 1999 to 2001 was discussed by the Bank's Board in May 1999. The Bank had initially planned to prepare a full CAS for Board discussion in FY02 but decided to wait until Moldova's full PRSP was ready to ensure that the two documents were fully consistent. In the interim, the Bank presented a CAS Progress Report for the period 2002–2003 to its Board June 2002. The Bank has developed a full CAS for the period FY04-FY08. The main objective of the new CAS is to support the implementation of the government's EGPRSP and capitalize on the gains of previous assistance programs. Board presentation of the new CAS took place in December 2004.

MOLDOVA—RELATIONS WITH THE EBRD

(As of November 30, 2004)

The EBRD's strategy in Moldova is aimed primarily at supporting private sector development in the country, and increased policy dialogue with the authorities. The EBRD is providing support to (i) the financial sector through credit lines, the participation in the equity of local banks, expansion of its trade facilitation program, and the provision of new financial products, such as leasing and mortgage financing; (ii) private enterprises through credit lines and co-financing with local banks, offering privatization and post-privatization support, and the expansion of programs that provide advisory services; and (iii) public utilities with a special focus on improvement of the regulatory and operational environment. In the context of implementing Moldova's Economic Growth and Poverty Reduction Strategy, the Bank is working with other institutions in increasing its policy dialogue with the authorities on improving the business climate in the country. The EBRD's Early Transition Country (ETC) Initiative, announced in June 2004, is directed toward seven countries, including Moldova, where post-Soviet transition from command to market economies and democracies has been slowest.

To date the total value of projects supported in Moldova, in whole or in part, amounts to around €280 million.

Thirty two projects have been signed totaling €165 million of EBRD resources, including: (i) a wine export promotion project, which is targeting the main Moldovan wineries and glass producer, through restructuring of the sector (€23.6 million) and equity investment into a glass producer (€6.4 million); (ii) an energy efficiency project for upgrading the heating distribution networks in Chisinau (€7.5 million); (iii) several credit lines and equity investment for Moldova-Agroindbank for on-lending to small and medium enterprises (€28 million in total); (iv) several credit lines and equity investment for Victoria Bank (€9.9 million in total); (v) a project for linking Moldovan satellite earth stations to the Eurovision Network (€0.8 million); (vi) a road rehabilitation loan (€9 million); (vii) partial financing for construction of a new oil terminal at Giurgulesti (€9.1 million); (viii) credit facilities for micro enterprises through four local banks (€2.5 million); (ix) rehabilitating Chisinau's water services (€16.5 million); (x) Chisinau Airport Modernization (€7 million); (xi) trade facilitation program for Victoriabank, Moldova-Agroindbank, Moldindconbank, and Mobiasbanca (regional TFP - €8.3 million in total); (xii) equity participation in and a loan to the micro-lending company (€2 million); and (xiii) equity participation and loan financing for three privatized power distribution companies (€25.6 million).

In addition to banking projects, some 65 Technical Cooperation projects have been completed or approved (totaling €10.5 million).

MOLDOVA—STATISTICAL ISSUES

1. Although generally adequate for surveillance and program monitoring, Moldova's official statistics still have shortcomings, especially regarding the national accounts and price statistics. The lack of an updated census also hampers statistical analysis in several areas. Data for monitoring macroeconomic developments are provided by the Moldovan authorities in a timely manner (see attached matrix). Moldova is a participant in the GDDS. In December 2004 the Moldovan authorities requested a ROSC Data Module mission in 2005.
2. **National accounts statistics** are prepared in accordance with the *1993 SNA* methodology. Estimates do not include the Transnistria region for which data have not been collected since 1991. GDP is estimated from the production and the expenditure sides, on both an annual and quarterly basis. The data are prepared in current and constant (previous-year) prices, and annual data are revised—in two stages—as updated information becomes available. However, the quarterly data remain unadjusted, thus limiting their consistency with the revised annual data. Overall, the national accounts statistics need improvement in the following areas: (i) compiling annual and quarterly GDP in constant prices; (ii) benchmarking the annual and the quarterly data; and (iii) estimating the consumption of fixed capital in line with international standards.
3. **Price statistics** still have various shortcomings. Price collection for the CPI and PPI is limited geographically and missing data are not imputed following a standard procedure. The weights of the CPI basket, which currently are derived primarily from the Household Budget Survey, need to be improved to represent all segments of the population.
4. **Labor market statistics** remain inadequate for analyzing macroeconomic developments: (i) unemployment data following ILO methodology are not available; and (ii) wage data do not include fringe benefits, which form an important part of workers' compensation.
5. **Fiscal statistics.** A 1999 GFS statistical mission assisted the authorities in resolving data issues and provided technical assistance in the classification of accounts. Mission recommendations that still need to be implemented are: (i) improving the consolidation of general government data; (ii) reclassifying the financing data by type of debt holder and by type of debt instrument; and (iii) reporting by the MoF to STA for inclusion in *International Financial Statistics* of discrete monthly fiscal data, based on correspondent accounts at the National Bank of Moldova (NBM). In addition, World Bank technical assistance was provided to improve the budgetary reports of local authorities as well as the Social Fund. The authorities reported data in the *GFSM 2001* format for publication in the *2003 GFS Yearbook* which could not be published due to serious data issues. Data reported for publication in the *2004 GFS Yearbook* still have problems, but can be published.
6. **Balance of payments.** The compilation methodology follows the fifth edition of the *Balance of Payments Manual*. Data problems that remain relate to the: (i) under-reporting of imports and exports; (ii) collection of data on services; (iii) measurement of private capital

inflows, including direct investment data; and (iv) treatment of transactions with Transnistria. Moldova disseminates quarterly data on its international investment position.

7. **Money and banking statistics** have improved, following a series of technical assistance missions from the Fund. A new chart of accounts for the National Bank of Moldova (NBM) was introduced in 1996 and commercial banks adopted a new chart of accounts and moved to the International Accounting Standards (IAS) with effect from January 1, 1998. The monetary and financial statistics mission in April 2004 found that, while monetary data were broadly in line with international statistical standards and of a generally good quality, shortcomings remained in the compilation of some monetary aggregates. Therefore, in order to improve the analytical quality of monetary data compiled by the NBM, the mission made recommendations on several methodological issues, especially (1) the definition of money and monetary base; (2) the treatment of nonoperating banks; (3) foreign assets and foreign liabilities of the NBM; (4) the valuation of government securities; and (5) the classification of shares and other equity. The mission also advised that the balance sheets of other financial corporations should be periodically reviewed and, if necessary, the institutional coverage of monetary data should be expanded to include those financial institutions that may collect deposits or issue deposit substitutes.

MOLDOVA—SURVEY OF REPORTING OF MAIN STATISTICAL INDICATORS
(As of December 31, 2004)

	Exchange Rates	Inter-National Reserves	Reserve Money	Central Bank Balance Sheet	Broad money	Interest Rates	Consumer Price Index	Exports/Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt
Date of latest observation	12/31/04	11/30/04	11/30/04	11/30/04	11/30/04	11/30/04	11/04	Nov 04	Q3/04	11/04	Q3/04	9/30/04
Date received	12/31/04	12/10/04	12/10/04	12/10/04	12/10/04	12/15/04	12/10/04	Dec/04	12/04	12/15/04	12/15/04	10/20/04
Frequency of data	D, M	W	W	W	W	M	M	M	Q	Q	Q	Q
Frequency of reporting	M	M	M	M	M	M	M	M	Q	Q, V	Q	Q
Frequency of publication	D; M	M	M	M	M	M	M	M	Q	O	Q	Q
Source of update	A, N	A	A	A	A	N, A	N, A	A, C	A, C	A	A	A
Mode of reporting	E	E	E	E	E	E	E, M	E ¹	E, C ¹	E, V	C, V	E
Confidentiality	C	C	C	C	C	C	C	C	C	C	C	C

¹Received through the resident representative office.

Explanation of abbreviations:

Frequency of data:

Frequency of reporting:

Source of data:

Mode of reporting:

Confidentiality:

D=daily, W=weekly, M=monthly, Q=quarterly, A=annual, or O=other;
D=daily, W=weekly, M=monthly, Q=quarterly, A=annual, V=irregularly in conjunction with staff visits, or O=other;
A=direct reporting by central bank, ministry of finance, or other official agency, N=official publication or press release,
P=commercial publication, C=commercial electronic data provider, E=EIS, O=other;
E=electronic data transfer, C=cable or facsimile, T=telephone, M=mail, V=staff visits, or O=other;
A=for use by the staff only, B=for use by staff and the Executive Board, C=for unrestricted use, D=embargoed for a specified period and thereafter for unrestricted use, or E-Subject to other use restrictions.

MOLDOVA—DEBT SUSTAINABILITY ANALYSIS**D. Background**

47. Total external debt (public plus private, including energy arrears) declined in 2004, notably in terms of GDP. This decline is mainly a consequence of the sharp real appreciation of the leu. For end-2004, total external debt is estimated at about \$1,635 million, compared to \$1,752 million at end-2003, or 63 percent of GDP at end-2004, compared to 90 percent at end-2003 (Table 1a). External debt service indicators have also improved. As exports grew rapidly in 2004, the NPV of debt-to-export ratio is estimated to have fallen to 102 percent at end-2004, compared to 138 percent at end-2003.

48. Total public external debt stock was also reduced thanks to buybacks and rescheduling agreements. The most significant agreement (in May 2004) was with Gazprom, involving the buyback of promissory notes with a face value of \$114.5 million for a cash payment of about \$50 million, financed by the NBM. The authorities also finalized a buyback with Hewlett-Packard and agreed on a rescheduling with Romania and the Export Credit Bank of Turkey. As the leu appreciated significantly in real terms in 2004, the reduction of debt as a share of GDP was more dramatic. At end-2004 public and publicly-guaranteed (PPG) debt including the IMF was about \$930 million or 36½ percent of GDP (compared to about 50 percent at end-2003) (Table 2a).

49. Public domestic debt increased by 1 percentage point to about 11½ percent of GDP in 2004, mainly due to a large loan from the NBM to finance the Gazprom buyback operation. The government is planning to start paying back that loan in 2005 with only limited net-issuance of T-bills on the open market, which would lead to a gradual decline of public domestic debt in terms of GDP.

E. Outlook

50. Moldova seems to face more of a liquidity problem than a structural debt sustainability problem. Under the baseline scenario, as described in section IIA, debt indicators would continue to improve. By 2012, public debt service would have reached 4 percent of exports, down by 4½ percentage points from 2004. To gauge the robustness of the baseline scenario results, stress tests were conducted. These did not alter the general conclusion from the baseline scenario (Tables 1b and 2b, and Figures 1 and 2).

51. Nevertheless, the government faces a serious liquidity problem in the next few years. Renewed involvement by IFIs, leading to additional financing in the form of concessional loans and grants, and possibly further debt rescheduling would make it easier to close projected financing gaps. Although in the debt sustainability analysis financing gaps are assumed to be financed by external borrowing, the results suggest that debt indicators would still improve in the medium-term.

Appendix V. Table 1a. Moldova: External Debt Sustainability Framework, Baseline Scenario, 2001–12 1/
(In percent of GDP, unless otherwise indicated)

	Actual					Est.						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
External debt (nominal) 1/	105.6	101.2	89.5	63.3	58.4	56.8	57.1	55.9	54.4	52.2	50.3	48.5
o/w public and publicly guaranteed (PPG)	66.1	60.8	52.6	36.0	33.8	33.5	33.9	33.4	32.9	32.3	31.7	31.0
Change in external debt	...	-4.4	-11.7	-26.2	-4.9	-1.6	0.3	-1.1	-1.5	-2.2	-2.0	-1.8
Identified net debt-creating flows	...	-11.3	-11.2	-2.0	0.2	1.3	2.3	1.4	1.0	0.2	0.5	0.5
Non-interest current account deficit	-1.5	0.9	3.7	3.8	3.7	3.8	3.4	2.5	2.2	1.3	1.6	1.7
Deficit in balance of goods and services	23.7	25.2	34.1	31.9	32.5	32.4	32.2	31.0	30.1	29.0	28.7	28.0
Exports	49.9	52.7	54.2	52.3	53.8	53.7	54.3	54.6	54.6	54.1	53.5	52.9
Imports	73.6	77.9	88.3	84.2	86.2	86.1	86.5	85.6	84.7	83.0	82.1	80.9
Net current transfers (negative = inflow)	-14.9	-14.2	-15.5	-13.7	-14.4	-14.3	-14.4	-14.3	-14.0	-13.9	-13.6	-13.2
Other current account flows (negative = net inflow)	-10.4	-10.1	-14.9	-14.4	-14.4	-14.3	-14.4	-14.2	-13.9	-13.8	-13.5	-13.1
Net FDI (negative = inflow)	-7.9	-4.3	-2.7	-3.9	-3.2	-2.7	-1.8	-1.6	-1.7	-1.6	-1.5	-1.5
Endogenous debt dynamics 2/	...	-8.0	-12.2	-1.9	-0.3	0.1	0.6	0.5	0.5	0.4	0.4	0.3
Contribution from nominal interest rate	...	3.5	3.1	2.9	2.6	2.3	2.2	2.1	2.1	2.0	1.8	1.7
Contribution from real GDP growth	...	-7.3	-5.4	-4.8	-2.9	-2.2	-1.6	-1.6	-1.6	-1.5	-1.5	-1.4
Contribution from price and exchange rate changes	...	-4.2	-9.9	...	...	...	...	...	...	...	...	...
NPV of external debt 3/	...	...	74.8	53.1	47.0	44.4	43.6	41.9	39.6	36.6	33.8	31.2
In percent of exports	...	...	138.1	101.6	87.5	82.7	80.3	76.8	72.5	67.7	63.1	59.0
NPV of PPG external debt	...	...	38.0	25.8	22.4	21.2	20.4	19.4	18.1	16.6	15.1	13.7
In percent of exports	...	...	70.1	49.4	41.6	39.5	37.6	35.5	33.2	30.7	28.3	25.9
Debt service-to-exports ratio (in percent)	25.1	28.2	21.2	21.3	17.2	15.4	12.3	12.5	12.6	13.9	12.9	12.2
PPG debt service-to-exports ratio (in percent)	17.2	14.3	12.5	8.4	6.7	6.2	5.4	5.1	4.8	4.1	3.7	3.9
Total gross financing need (billions of U.S. dollars)	45.4	191.6	244.4	285.8	278.9	289.1	270.2	266.1	271.0	285.6	289.2	295.1
Key macroeconomic assumptions												
Real GDP growth (in percent)	6.1	7.8	6.3	7.0	5.0	4.0	3.0	3.0	3.0	3.0	3.0	3.0
GDP deflator in US dollar terms (change in percent)	...	4.1	10.8	23.3	5.5	3.3	3.0	3.0	3.0	3.0	3.0	3.0
Effective interest rate (percent) 4/	...	3.8	3.6	4.2	4.5	4.3	4.2	4.0	4.0	3.9	3.7	3.6
Growth of exports of G&S (US dollar terms, in percent)	...	18.7	21.0	27.3	14.0	7.3	7.3	6.6	6.2	5.0	5.0	5.0
Growth of imports of G&S (US dollar terms, in percent)	...	18.9	33.5	25.7	13.5	7.3	6.6	5.0	5.0	4.0	5.0	4.5
<i>Memorandum item:</i>												
Nominal GDP (billions of US dollars)	1480.3	1661.8	1957.5	2582.1	2860.6	3073.2	3261.2	3460.8	3672.6	3897.4	4136.0	4389.2

Source: Staff simulations.

1/ Includes both public and private sector external debt.

2/ Derived as $[r - g - r(1+g)] / (1+g+r+gr)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and r = growth rate of GDP deflator in U.S. dollar terms.

3/ Assumes that NPV of private sector debt is equivalent to its face value.

4/ Current-year interest payments divided by previous period debt stock.

Appendix V. Table 2a. Moldova: Public Sector Debt Sustainability Framework, Baseline Scenario, 2001–12
(In percent of GDP, unless otherwise indicated)

	Actual					Est.						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Public sector debt 1/	79.9	74.4	60.6	48.3	44.8	43.1	42.2	41.0	39.8	38.6	37.6	36.5
o/w foreign-currency denominated	67.3	61.9	49.9	36.6	34.7	34.3	34.3	33.9	33.4	32.7	32.1	31.5
Change in public sector debt	-11.4	-5.5	-13.8	-12.3	-3.5	-1.7	-0.8	-1.2	-1.3	-1.1	-1.1	-1.1
Identified debt-creating flows	-5.6	-8.0	-16.0	-9.9	-2.5	-1.7	-1.1	-0.7	-0.7	-0.5	-0.4	-0.4
Primary deficit	-4.5	-0.6	-2.9	-0.9	0.4	0.3	0.6	0.6	0.6	0.7	0.7	0.7
Revenue and grants	29.3	29.8	34.4	34.8	33.8	32.7	32.3	31.9	31.5	31.2	30.8	30.5
of which : grants	0.9	0.6	0.3	0.4	0.5	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Primary (noninterest) expenditure	24.8	29.2	31.4	33.9	34.3	33.1	32.9	32.5	32.1	31.8	31.5	31.2
Automatic debt dynamics	-0.7	-6.8	-12.9	-8.9	-2.4	-1.8	-1.4	-1.2	-1.2	-1.2	-1.1	-1.1
Contribution from interest rate/growth differential	2.2	-4.3	-5.3	-2.8	-2.0	-1.1	-0.8	-0.5	-0.5	-0.5	-0.4	-0.4
of which : contribution from average real interest rate	2.2	0.3	0.1	0.7	1.2	1.0	0.9	0.7	0.7	0.7	0.7	0.7
Contribution from real GDP growth	0.0	-4.6	-5.4	-3.6	-3.2	-2.1	-1.7	-1.2	-1.2	-1.2	-1.1	-1.1
Contribution from real exchange rate depreciation	-2.8	-2.5	-7.6	-6.1	-0.4	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Other identified debt-creating flows	-0.4	-0.6	-0.2	-0.1	-0.5	-0.3	-0.2	-0.2	-0.1	0.0	0.0	0.0
Privatization receipts (negative)	-0.4	-0.6	-0.2	-0.1	-0.5	-0.3	-0.2	-0.2	-0.1	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes	-5.8	2.5	2.3	-2.5	-1.0	0.1	0.2	-0.5	-0.6	-0.6	-0.6	-0.7
NPV of public sector debt	100.5	86.7	68.4	53.6	46.3	40.4	35.9	32.1	28.6	26.0	23.7	21.5
o/w foreign-currency denominated	87.9	74.2	57.7	41.9	36.3	31.6	28.0	24.9	22.2	20.1	18.3	16.5
o/w external	87.9	74.2	57.7	41.9	36.3	31.6	28.0	24.9	22.2	20.1	18.3	16.5
NPV of contingent liabilities (not included in public sector debt)	...	...	...	...	...	...	...	...	...	...	...	...
Gross financing need 2/	5.3	6.8	4.2	4.3	5.5	4.8	4.6	4.3	4.0	3.4	3.1	3.2
NPV of public sector debt-to-revenue ratio (in percent) 3/	343.0	291.4	199.0	153.9	136.9	123.6	111.2	100.6	90.9	83.5	77.0	70.6
o/w external	300.0	249.4	167.9	120.4	107.2	96.6	86.5	78.2	70.6	64.5	59.3	54.1
Debt service-to-revenue ratio (in percent) 3/ 4/	33.3	24.8	20.8	15.0	15.5	14.2	12.4	11.5	10.8	8.7	8.0	8.2
Key macroeconomic and fiscal assumptions												
Real GDP growth (in percent)	6.1	6.1	7.8	6.3	7.0	5.0	4.0	3.0	3.0	3.0	3.0	3.0
Average nominal interest rate on forex debt (in percent)	4.1	3.1	2.1	1.8	3.5	3.2	2.6	2.4	2.5	2.5	2.6	2.6
Average real interest rate on domestic currency debt (in percent)	7.6	-5.1	-0.7	3.6	2.8	2.7	3.9	2.7	2.7	2.7	2.7	2.7
Real exchange rate depreciation (in percent, + indicates depreciation)	-3.4	-3.8	-13.2	-12.8	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	12.1	11.6	12.3	9.7	7.9	7.1	4.9	5.0	5.0	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-4.4	24.7	16.2	14.6	7.5	1.4	4.0	1.9	1.7	2.1	1.9	2.0

Sources: Moldovan authorities; and Fund staff estimates and projections.

1/ Public and publicly-guaranteed debt, including IMF.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenue including grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

Appendix V. Table 1b. Moldova: Sensitivity Analysis for Key Indicators of Public and Publicly-Guaranteed External Debt, 2004–12
(In percent)

	2004	2005	2006	2007	2008	2009	2010	2011	2012
NPV of debt-to-GDP ratio									
Baseline	26	22	21	20	19	18	17	15	14
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2005-12 1/	26	17	10	4	-1	-6	-9	-12	-15
A2. New public sector loans on less favorable terms in 2005-12 2/	26	23	23	23	22	21	20	19	18
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2005-06	26	22	21	20	19	18	16	15	13
B2. Export value growth at historical average minus one standard deviation in 2005-06 3/	26	20	12	11	11	10	9	8	8
B3. US dollar GDP deflator at historical average minus one standard deviation in 2005-06	26	23	22	21	20	19	17	16	14
B4. Net non-debt creating flows at historical average minus one standard deviation in 2005-06 4/	26	23	23	22	21	19	18	16	15
B5. Combination of B1-B4 using one-half standard deviation shocks	26	20	9	9	8	8	7	7	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2005 5/	26	31	30	29	27	25	23	21	19
NPV of debt-to-exports ratio									
Baseline	49	42	39	38	35	33	31	28	26
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2005-24 1/	49	32	20	8	-2	-10	-17	-23	-29
A2. New public sector loans on less favorable terms in 2005-24 2/	49	43	42	42	41	39	37	36	34
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2005-06	49	42	39	38	35	33	31	28	26
B2. Export value growth at historical average minus one standard deviation in 2005-06 3/	49	37	20	18	17	16	15	14	13
B3. US dollar GDP deflator at historical average minus one standard deviation in 2005-06	49	42	39	38	35	33	31	28	26
B4. Net non-debt creating flows at historical average minus one standard deviation in 2005-06 4/	49	44	42	40	38	36	33	30	28
B5. Combination of B1-B4 using one-half standard deviation shocks	49	35	16	15	13	13	12	11	10
B6. One-time 30 percent nominal depreciation relative to the baseline in 2005 5/	49	42	39	38	35	33	31	28	26
Debt service ratio									
Baseline	8	7	6	5	5	5	4	4	4
A. Alternative Scenarios									
A1. Key variables at their historical averages in 2005-24 1/	8	7	5	5	4	3	1	0	0
A2. New public sector loans on less favorable terms in 2005-24 2/	8	7	6	6	5	5	5	5	5
B. Bound Tests									
B1. Real GDP growth at historical average minus one standard deviation in 2005-06	8	7	6	6	6	7	6	6	6
B2. Export value growth at historical average minus one standard deviation in 2005-06 3/	8	6	5	5	5	4	4	4	4
B3. US dollar GDP deflator at historical average minus one standard deviation in 2005-06	8	7	6	6	6	7	6	6	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2005-06 4/	8	7	6	6	7	7	6	6	6
B5. Combination of B1-B4 using one-half standard deviation shocks	8	6	5	5	5	4	3	3	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2005 5/	8	7	6	6	6	7	6	6	6
<i>Memorandum item:</i>									
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	5	5	5	5	5	5	5	5	5

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

Appendix V. Table 2b. Moldova: Sensitivity Analysis for Key Indicators of Public Sector Debt, 2004–12

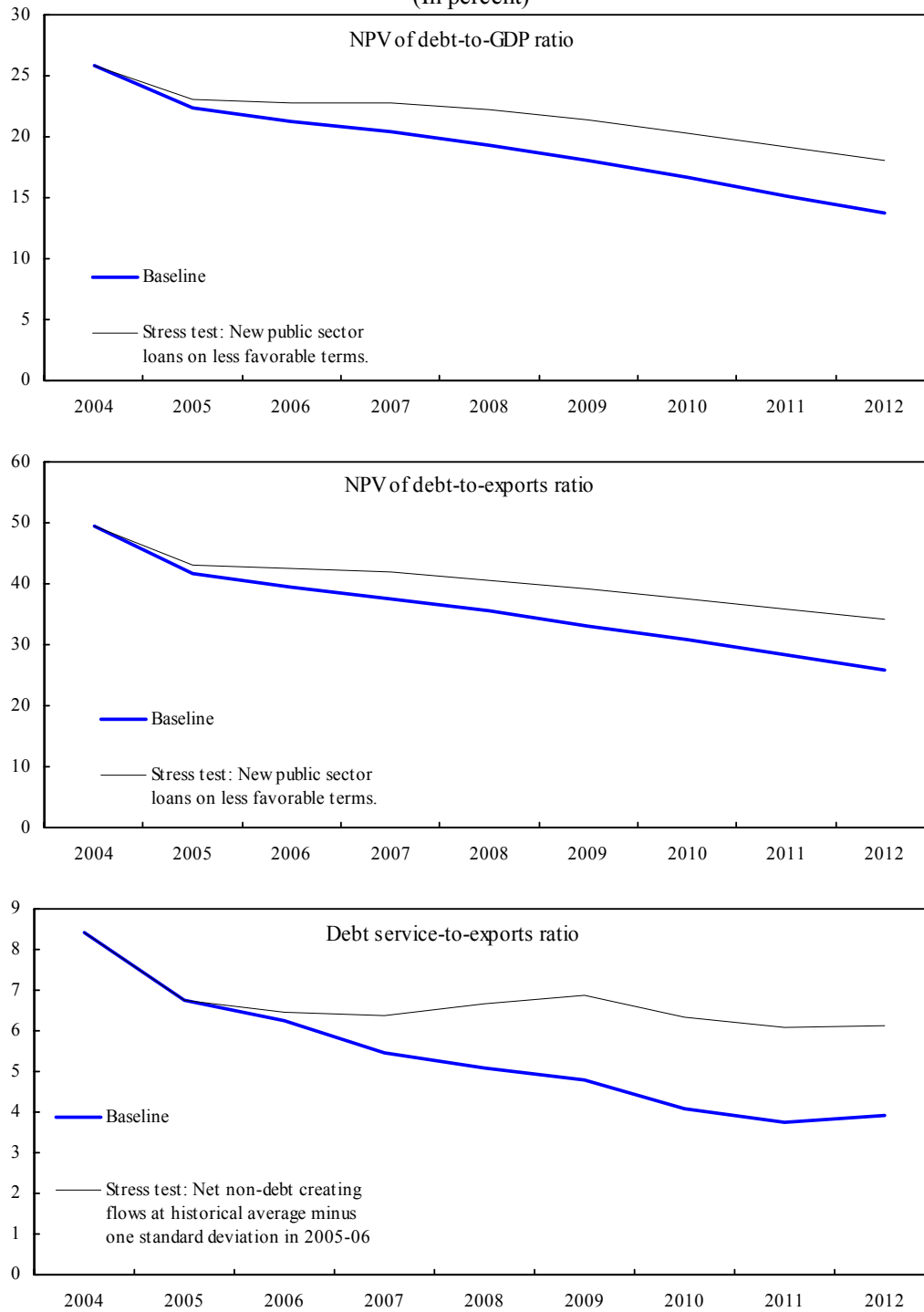
	Est.		Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012
NPV of Debt-to-GDP Ratio									
Baseline	54	46	40	36	32	29	26	24	22
A. Alternative scenarios									
A1. Real GDP growth and primary balance are at historical averages	54	44	35	27	19	13	7	2	-2
A2. Primary balance is unchanged from 2004	54	45	38	33	27	23	19	15	12
A3. Permanently lower GDP growth 1/	54	46	41	37	33	30	28	26	25
B. Bound tests									
B1. Real GDP growth is at historical average minus one standard deviations in 2005-2006	54	47	41	37	33	30	27	25	23
B2. Primary balance is at historical average minus one standard deviations in 2005-2006	54	45	39	34	30	27	24	22	20
B3. Combination of 2-3 using one half standard deviation shocks	54	45	37	32	29	25	23	20	18
B4. One time 30 percent real depreciation in 2005	54	63	55	48	42	38	34	31	28
B5. 10 percent of GDP increase in other debt-creating flows in 2005	54	56	49	45	41	37	34	32	30
NPV of Debt-to-Revenue Ratio 2/									
Baseline	154	137	124	111	101	91	83	77	71
A. Alternative scenarios									
A1. Real GDP growth and primary balance are at historical averages	154	129	106	82	60	40	23	7	-8
A2. Primary balance is unchanged from 2004	154	134	118	101	86	72	60	49	38
A3. Permanently lower GDP growth 1/	154	137	125	113	104	96	90	85	81
B. Bound tests									
B1. Real GDP growth is at historical average minus one standard deviations in 2005-2006	154	140	126	114	103	94	87	81	75
B2. Primary balance is at historical average minus one standard deviations in 2005-2006	154	134	119	106	96	86	79	72	66
B3. Combination of 2-3 using one half standard deviation shocks	154	132	112	100	90	80	73	66	60
B4. One time 30 percent real depreciation in 2005	154	188	168	149	133	119	109	100	91
B5. 10 percent of GDP increase in other debt-creating flows in 2005	154	164	151	138	127	118	110	104	97
Debt Service-to-Revenue Ratio 2/									
Baseline	15	16	14	12	11	11	9	8	8
A. Alternative scenarios									
A1. Real GDP growth and primary balance are at historical averages	15	16	11	8	6	4	1	0	-1
A2. Primary balance is unchanged from 2004	15	16	13	11	9	8	6	5	5
A3. Permanently lower GDP growth 1/	15	16	14	13	12	11	10	9	9
B. Bound tests									
B1. Real GDP growth is at historical average minus one standard deviations in 2005-2006	15	16	15	13	12	11	9	8	9
B2. Primary balance is at historical average minus one standard deviations in 2005-2006	15	16	13	11	11	10	8	8	8
B3. Combination of 2-3 using one half standard deviation shocks	15	16	12	10	10	10	8	7	8
B4. One time 30 percent real depreciation in 2005	15	16	16	14	13	13	11	10	10
B5. 10 percent of GDP increase in other debt-creating flows in 2005	15	16	24	16	14	13	10	10	10

Sources: Moldovan authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).

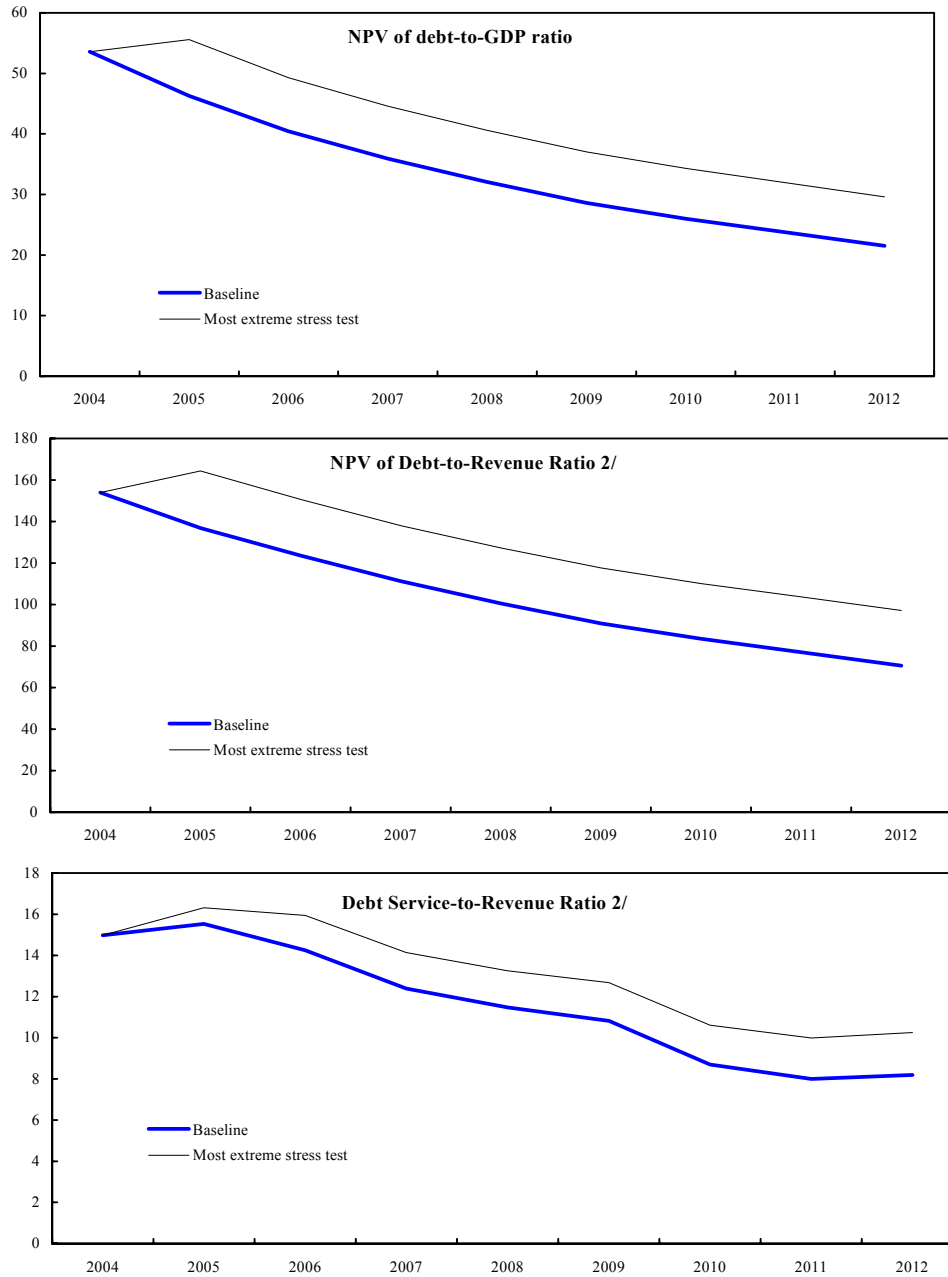
2/ Revenue is defined inclusive of grants.

Appendix V. Figure 1. Moldova: Indicators of Public and Publicly-Guaranteed External Debt, 2004–12 (In percent)



Source: Staff projections and simulations.

Appendix V. Figure 2. Moldova: Indicators of Public Debt Under Alternative Scenarios, 2004–12 1/
(In percent)



Source: Staff projections and simulations.

1/ Most extreme stress test is test that yields highest ratio in 2012.

2/ Revenue including grants.

**Statement by Jeroen Kremers, Executive Director for Republic of Moldova
February 7, 2005**

The Moldovan authorities appreciate the staff report and the accompanying Selected Issues paper, which reflect the open dialogue between staff and the government and give an accurate account of economic developments in the country and the challenges ahead. This Board discussion on the 2004 Article IV Consultation is important to shape views on the possible reengagement of a new PRGF arrangement. The authorities attach great value to a program relationship with the Fund, not only because it may pave the way to the Paris Club and unlock donor financing, but also because it is vital for enhancing domestic and international credibility and investor confidence. I would like to transmit the readiness and willingness expressed by the Moldovan authorities to enter into a new agreement with the IMF during the year 2005, that can contribute to bringing their economy to international standards, in line with market practices and also with their intention to move towards joining the European Union.

Medium- and long-term development goals, as well as the strategy to achieve them are set out in the Economic Growth and Poverty Reduction Strategy Paper (EGPRSP), which the Executive Board considered to be a comprehensive document containing crucial steps for attaining sustainable growth and reducing poverty. The authorities acknowledge that major changes in economic and social policies are critical for that purpose, and in the EGPRSP they express their commitment to prudent macro management and a sound reform agenda. The implementation of the strategy has been slow so far, but its pace is likely to pick up after the parliamentary and presidential elections, scheduled for early spring.

Growth

Macroeconomic developments in 2004 were favorable. Growth was robust at 7.3 percent. Inflation, although exceeding the projected rate of 10 percent, exhibited a downward trend. Export growth was strong, international reserves expanded considerably reaching USD 470 million compared to USD 302 million in 2003, and investments, both domestic and foreign, increased.

Moldova's growth strategy puts special emphasis on revitalizing agriculture - the sector that employs more than 40 percent of the workforce, accounts for about 20 percent of GDP and 60 percent of exports, but currently operates at only half of its capacity. In line with the commitments made in the EGPRSP to increase efficiency and expand agricultural output by creating a favorable environment for the sector and promoting reforms, the authorities have recently launched a new € 2.8 billion program "Moldovan Village". Its goal is to support development and improve the quality of life in rural areas over the next decade. The program calls for rehabilitation and upgrade of infrastructure, water and natural gas supply, development of small and medium-sized businesses, restoration of vineyards and the food processing industry, and environmental protection. This is an ambitious plan, and the authorities are likely to seek financial and technical assistance from the international community and investors.

The authorities recognize that the Moldovan economy continues to depend heavily on worker remittances. It is positive that these raise disposable income and thus provide at least minimal social protection to many Moldovans; they are also one of the major sources of foreign currency inflows helping to build up reserves and partially offset the large trade deficit. On the other hand, remittances fuel liquidity growth and put upward pressure on the exchange rate, posing difficulties to monetary policy implementation. They may raise the reservation wage lowering labor participation, and boost consumption and imports more than domestic capacity and income, and hence raise prices. As a consequence, over-dependence of the economy on remittances may increase external vulnerability. A useful chapter on remittances in the Selected Issues paper provides a detailed account of the scope and the complexity of the issue. The authorities share the staff analysis and recommendations and intend to address the issue in two ways. First, by enhancing the business climate and making domestic employment more attractive to so as to reduce incentives for emigration. This is critically important from the perspective of growth and capacity building since emigration tends to drain a qualified and skilled labor force. Second, by trying to in part redirect remittances from consumption to investment so that the large inflows are put also to more productive use.

Structural issues

A difficult business climate remains the main obstacle to private sector development and growth. The poverty reduction strategy of Moldova acknowledges that the problems to a large extent are of a structural nature related to weak governance, corruption and excessive government regulations. Institutional and structural measures in these areas coupled with the strengthening of the rule of law are the cornerstone of the authorities' reform agenda, which they intend to pursue aggressively throughout 2005 and beyond. Downsizing the government together with organizational adjustments followed by restructuring of the compensation and motivation system are considered important measures for attracting professional and highly qualified staff, increasing efficiency of the civil service, and curbing corruption. Possible ways of addressing these issues are being discussed. As a first step towards a compact and streamlined public sector, structural reorganization of the state chancellery has already been launched and reforms in other branches of the civil service are also planned following the upcoming elections. As noted in the staff report, a national anti-corruption strategy has been recently approved, which the authorities are committed to make an effective tool against power abuse and entrenched vested interests.

The authorities have indicated their intention to break with the past practices of excessive regulation and state intervention, and to implement market reforms. With the objective of making Moldova an attractive place for domestic and foreign investments, they plan to deregulate entrepreneurial activities, simplify business licensing and registration procedures, streamline the functions of supervisory bodies and promote fair competition. In this context, as a result of launching the Regulatory Reform in February 2004, the Law on implementation of the 'guillotine' principle was approved in December 2004. According to this law, during a 7-month period, all the relevant by-laws are to be revised according to a set of principles, after which the assessed acts will be included in a special Register. This

procedure implies an interaction between the public and private sector, as well as the participation of the society. As a result, the necessary prerequisites for the optimization of the core legislation and of the institutional system of the authorities in charge of regulating the entrepreneurial activity are being set up. The new mechanism and the principles of entrepreneurial activity's regulation will be incorporated in a new law. Additionally, the new Law on investments in entrepreneurial activity has been adopted, that envisages offering national treatment to foreign investors, the latter having equal rights with the local investors.

With regard to deregulating entrepreneurial activity, it should be mentioned that in accordance with the Law on modification and completion of some legislative acts (no. 432-XV, as of December 24, 2004) the Parliament of the Republic of Moldova approved the amendments to the "Law on regulation of repatriation of funds, goods and services obtained from external economic transactions". One of the goals according to these is to ensure a more simplified repatriation procedure for both legal entities and commercial banks. Commercial banks, the National Bank of Moldova and the Centre for Preventing of Economic Crimes and Corruption were exempted from the control on repatriation. The control function on repatriation will be transmitted from these institutions to the State Fiscal Authority, which will carry out verifications on repatriation within on-site inspections of the legal entities' economic activity, conducted in accordance with the legislation in force. At the same time, the mentioned Law stipulates extension of general repatriation periods of funds, goods and services up to one year and the reduction of the fine the legal entities have to pay in case of delay of repatriation. The exemption of commercial banks from the control on repatriation will increase the effectiveness of the banking system, as commercial banks are eased from additional burden and accordingly from extra costs.

The authorities also plan to revamp the privatization process. Actual progress in these directions in the near future will demonstrate the degree of ownership of the EGPRSP. It should also be mentioned that the Republic of Moldova became member of the European Charter for Small Enterprises. The first country report was submitted at the end of 2004, and has been placed on the European Commission's site.

Fiscal Policy

Revenue performance in Moldova has been on an upward trend for a number of years. In 2004, the tax revenue-to-GDP ratio is estimated to have further increased by about 1.1 percentage points reaching 29 percent, which is one of the highest in the region. In order to ease the tax burden and stimulate business activity, as part of a broader tax reform strategy, the authorities have made the decision to gradually lower corporate and personal income tax rates. With persistent efforts to strengthen the administration, they believe that losses from tax cuts will be more than fully compensated through the expanded tax base as lower rates are expected to reduce incentives for tax evasion. Moreover, once the new parliament is elected, the government intends to propose abolition of certain tax concessions that the legislative body did not approve last year.

Given widespread poverty in the country, the budget is geared towards the poor, and the expenditure priorities in the coming years will be guided by the poverty-reduction and

social objectives of the EGPRSP in line with the Medium-Term Expenditure Framework. In the absence of a social safety net, the increase in the minimum pensions is intended to provide at least minimal social protection to the most vulnerable. The authorities agree with staff, that profound social reforms will be needed to ensure sustainability of the country's social system. Similarly, the increase in wages of the public sector to attract and retain qualified staff will be considered in the context of the planned civil service reform.

Good progress was made to normalize relations with creditors and mitigate vulnerabilities stemming from the large external debt. Buyback operations with Gazprom and Hewlett Packard have been finalized, agreements on debt rescheduling with several bilateral creditors have been reached and arrears considerably reduced. The reduction in arrears was strongly favored by discount obtained on the debt buyback. However, arrears to Paris club creditors still remain and need to be addressed in the near future for bringing the overall debt burden to a sustainable level. At the same time, Moldova continued to remain current on all interest payments and its obligations to multilaterals. Consequently, the external debt and debt service indicators have notably improved.

The authorities realize that strong revenue performance and sound expenditure management will be essential to meet their social goals and to continue honoring other domestic and external liabilities. With the established track record in tax administration and additional efforts to curb the shadow economy, they feel confident that their fiscal objectives will be met in 2005.

Monetary policy

Large inflows of remittances have posed challenges to monetary policy implementation. With price stability as an overriding objective, the National Bank of Moldova (NBM) has been trying to strike a balance between reserve money growth and exchange rate appreciation. Interventions in the foreign exchange market have been instrumental in smoothing exchange rate fluctuations, building up international reserves and preserving competitiveness, which has contributed to export growth. The authorities share staff's view that monetary policy can only have short-term effect on competitiveness and that in the longer-term perspective this objective should be pursued through structural and policy measures aimed at strengthening productivity. However, they also believe that this could be a lengthy process, and meanwhile letting the exchange rate appreciate more rapidly could damage the fragile export sector and dampen growth. Mindful of mounting inflationary pressures due to an expanding money supply, the NBM sterilized part of its foreign exchange interventions through more active use of monetary policy tools including the outright sale of its holdings of discount treasury bills. In addition, to further improve the efficiency of its operations in the money market, the NBM has recently launched a new instrument - the NBM certificates with maturities of 14, 28 and 56 days. These securities were welcomed by the markets and are expected to play an important role in liquidity management.

In closing, I would like to note that the Moldovan authorities consent to publication of the staff report, the Selected Issues paper, the statistical appendix and the Financial System Stability Assessment.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 05/23
FOR IMMEDIATE RELEASE
February 17, 2005

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2004 Article IV Consultation with the Republic of Moldova

On February 7, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Moldova.¹

Background

Economic activity benefited from a favorable external environment in 2003-04. GDP grew by 6.3 percent in 2003, advancing to 6.5 percent (y-o-y) in the first half of 2004. Large and rising workers' remittances underpinned consumption-led growth, helping consolidate Moldova's recovery from the 1998 regional crisis. While strong economic performance in neighboring countries encouraged exports, the contribution of net trade to growth was negative. Notwithstanding the recovery, Moldova is lagging considerably behind its neighbors, partly as a result of the Transnistria conflict. Moreover, productive capacity has weakened with the steady exodus of working-age Moldovans following the 1998 crisis.

Twelve-month Consumer Price Index inflation peaked at 17 percent in October 2003, reflecting a transitory flare-up in food prices, but moderated to about 11 percent by October 2004. The appreciating leu has helped attenuate the impact from higher oil prices, but domestic spending pressures and a tighter labor market have kept non-food goods price inflation up, while rapid money and credit growth have rekindled inflationary expectations.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Despite a substantial real exchange rate appreciation, international competitiveness remains favorable. Dollar wages are well below those in neighboring countries, and exports have been growing briskly. Although the real effective exchange rate appreciated by 11½ percent (y-o-y) during the first three quarters of 2004, it remained below the end 2000 level. The official current account deficit widened markedly to 6.8 percent of GDP in 2003, but the actual deficit is likely to be smaller on account of unrecorded workers' remittances, underinvoicing of exports, and overinvoicing of imports.

Following a general government surplus in 2003, the fiscal stance loosened considerably in 2004. While tax revenues remained buoyant, owing to more aggressive tax collection efforts and higher-than-expected inflation, projected nontax revenues and grants fell short of expectations, and primary expenditure exceeded original budget projections. The budget was revised in October 2004, and now staff projects a general government deficit of 1.1 percent of GDP for 2004, compared to a deficit of 0.4 percent of GDP in the original budget. With limited fresh external financing and lower-than-expected privatization receipts, the government increased recourse to bank financing and continued to run up arrears to some bilateral creditors, but resumed interest payments to the Paris Club. Recent external debt restructuring agreements—notably a buyback of Gazprom promissory notes—together with the leu appreciation, resulted in a marked decline in the external debt/GDP ratio.

Monetary policy was also expansionary in 2004, on account of continued large inflows of remittances. With inflation moderating in 2004, the National Bank of Moldova (NBM) stepped up its foreign exchange purchases and, as a result, international reserves hit a record high of US\$392 million at end-September, finally reaching pre-1998 levels. Despite more intense sterilization efforts, by end-October both reserve and broad money were growing at over 30 percent (y-o-y).

Progress in structural reforms remains slow, while high transaction costs continue to hold back private sector-led growth. Some progress has been registered in fiscal reforms, and in revising the legal framework affecting investment, microfinance, audit, accounting, and leasing. Nevertheless, despite efforts to simplify licensing and business registration, there has been no significant improvement in the business climate. Moreover, the privatization program has stalled, while corruption remains widespread and governance weak. Government interference in the private sector—including formal and informal restrictions on exports of certain agriculture goods—casts doubt over the authorities' commitment to market-oriented reforms. The completion of the Economic Growth and Poverty Reduction Strategy (EGPRSP) is a step in the right direction, but implementation has been slow and uneven.

Executive Board Assessment

Directors welcomed the recent recovery of the Moldovan economy, the moderation of inflation, and the strengthened external position. At the same time, Directors expressed concern about the fragile basis of the recovery, and agreed that the key challenge ahead is to create an environment supportive of private sector development and foreign investment that will help promote sustained growth, domestic job creation, and poverty reduction. Accordingly, Directors

urged the authorities to assign top priority to revitalizing structural reforms and reducing government intervention in the economy, while ensuring that macroeconomic policies are geared to stem inflationary pressures and underpin long-term growth. Directors also highlighted the importance of efforts to resolve the conflict in Transnistria.

Directors observed that Moldova's recent rapid economic growth has benefited from a favorable external environment as well as from large and rising workers' remittances. While the short-run outlook remains positive, they pointed to the risks of excessive dependence on remittances, as well as to impediments to sustained growth in the medium term. These include: emerging labor shortages and increasing capacity constraints resulting from large-scale emigration; rising inflationary pressures from strong inflows of remittances and rapid wage growth; a difficult business environment; and vulnerability to external shocks.

Directors stressed that the acceleration of structural reforms will be crucial for sustaining the economic recovery and improving external competitiveness. They noted that structural reforms have stalled, and urged the authorities to speed up implementation of the structural policies envisaged in their Economic Growth and Poverty Reduction Strategy, with a view to encouraging investment, reversing the current emigration trend, and channeling remittances into productive use. This will need to involve decisive efforts to reduce government intervention in the economy, revamp the privatization process, phase out excessive regulation, and reform the public sector, with a view to improving service delivery. While the recently approved anti-corruption strategy is a step in the right direction, Directors stressed that strong implementation of this strategy will now be essential to demonstrate ownership and underpin the reform effort.

Directors recommended a tighter fiscal stance than that envisaged by the authorities. This would support the central bank's efforts to control inflation and make room for current external debt service, thereby preventing a further accumulation of arrears. To ensure sustainability, fiscal policy would benefit from a more forward-looking perspective and greater emphasis on a medium-term expenditure framework that provides for adequate resources for poverty-related purposes. Directors commended the authorities' efforts to strengthen the budgetary process and improve tax administration, and also emphasized the need for measures to broaden the tax base, including through the removal of tax exemptions. The importance of efforts to strengthen the long-term viability of the pension system was also highlighted.

Directors recommended that monetary policy place greater emphasis on the inflation objective. Given the recent rapid credit growth and strong foreign currency inflows, it will be important for the National Bank of Moldova to tighten its stance, including through greater sterilization efforts, if needed, to counteract rising inflationary pressures. Ensuring the independence of the National Bank of Moldova would help achieve the low-inflation objective. While the buildup of reserves from low levels was desirable, a number of Directors suggested that a nominal exchange rate appreciation would be appropriate if foreign exchange inflows continue to grow rapidly, and that going forward, a more flexible exchange rate policy would serve Moldova well in absorbing external shocks. However, some Directors expressed reservations about allowing the exchange rate to appreciate at this time, based on concerns about competitiveness and uncertain flows of

remittances. To improve competitiveness, Directors called for further efforts to remove remaining impediments to trade.

Directors were encouraged to note that Moldova's financial sector indicators are largely favorable, but urged the authorities to address remaining vulnerabilities in line with the FSAP's recommendations. In particular, they called for a reduction in the government's role and administrative interference in the sector, for more transparency in the ownership structure of financial institutions and corporations, and for efforts to address remaining weaknesses in the AML/CFT framework.

Directors commended the authorities for successfully restructuring some of Moldova's external debt and reducing the overall debt burden. They welcomed the resumption of interest payments to Paris Club creditors, but stressed that the outstanding arrears still need to be resolved, and looked forward to continued efforts to normalize relations with external creditors.

Directors noted that Moldova's official statistics are generally adequate for surveillance. They encouraged the authorities to address the remaining shortcomings—notably regarding price and national accounts statistics—with support of Fund technical assistance.

Directors looked forward to maintaining a close policy dialogue on the reform priorities with the Moldovan authorities in the period ahead. They emphasized that the effective implementation of a credible and well articulated reform program in line with the EGPRSP, together with restrained short-term policies, will be essential for building the track record necessary for securing possible new financing from the Fund.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2004 Article IV Consultation with Republic of Moldova is also available.

Republic of Moldova: Selected Economic Indicators

	2002	2003	2004 Est.	2005 Proj.
	(Percent change; unless otherwise indicated)			
Production and prices				
Nominal GDP (in MDL millions)	22,556	27,297	31,836	36,779
Real GDP growth	7.8	6.3	7.0	5.0
Consumer prices (end of period)	4.4	15.7	11.0	9.5
	(In percent of GDP)			
Public finance (general government)				
Overall balance (cash)	-1.8	0.7	-1.1	-2.5
Overall balance (commitments)	-0.9	0.2	-1.5	-2.5
	(Percent change; unless otherwise indicated)			
Money and credit				
Broad money (M3)	36.0	30.7	32.9	29.2
Credit to the economy	34.3	45.4	18.5	20.6
External sector				
Current account balance (in percent of GDP)	-4.4	-6.8	-6.7	-6.3
Total external debt (in percent of GDP)	101.2	89.5	63.3	58.4
Total debt service (in percent of exports of goods and services)	28.3	21.3	21.3	17.2
Gross official reserves (in millions of dollars)	268.8	302.3	421.3	504.7

Sources: Moldovan authorities; and IMF Staff estimates.