PART 3. MACROECONOMIC POLICIES

3.1 General transformation, focused on growth and competitiveness

Republic of Moldova, having passed the first and most difficult stage of former political and social-economic system disintegration, ***it is at the crossroads***: it will either choose the way to economic growth, on the basis of the deepening efficiency of its reforms, re-approaching the living standards of people to European standards, or will continue to be stagnant poor country, mainly agrarian, which risks to fail, whose existence could be put to doubt.

The Strategy for Development, suggested for the period of 1998-2005, is grounded, on the one hand on both positive and negative experience of the reforms, which has been accumulated in the country since the beginning of the 90's, and, on the other hand on the sharp need to overcome as soon as possible the procrastinated "stable depression"(of 1995-1997), which affects the state. The shadow economy generates the "cancer" of the overall economy, thus, creating a harder and more unbearable situation for the economic agents and population.

In these conditions, is more obvious the deregulation of the economic mechanism of the state – considerable budget deficit, insufficient collection of taxes, payment defaults, calmness in investing activities, arrears of wages, pensions and indemnities.

The question emerges: how long can macroeconomic instability be maintained in conditions of unbalanced budget, the "black-wholes" of the shadow economy, whose share accounts for 40%, the external debt of the state increased by one year, and inertial implementation of the structural reforms? In a certain sequence of events, a similar macro-stability, and at the same time economic depression, can lead to an agony and collapse.

The red line of the strategy until 2005 represents the way to growth and restructuring of the national economy.

An inalienable part of the latter, and a major condition of its realization, constitutes the further improvement of the financial sector:

The fiscal-budgetary system. The reform implementation needs to be oriented to improving the system, that will allow to reach the following objectives:

- transparency and simplicity of the fiscal system;
- fiscal system fairness; all tax payers need to observe the same fiscal rules in building up the national public budget;
- fiscal administration efficiency;
- attraction of local and foreign investments, both for stimulating the economic growth and resolving the problem of unemployment.

The fiscal system modifications need to be oriented towards ***diminution of the fiscal burden,*** by way of spreading it over the wealthy strata of the population.

Essential changes need to made in the system of contributions to ***Social Fund.*** For this purpose it is required to diminish the share of disbursements to Social Fund, which will contribute to a reduction of cost of the labor force and rising economy competitiveness.

The structure of the fiscal revenue will be subjected to an insignificant modification – there will increase the indirect revenues and diminish the share of direct revenues. Introduction of the principle of VAT calculation and collection based on destination (given that Moldova is an importing country), it will make possible to rise VAT collections. The list will be enlarged of goods subjected to excise-duties related to car commerce and will increase the share of excises on gasoline (the structure of gasoline sale price in Moldova will correspond to that in the developed European countries). In the future, the fiscal system of Moldova will be comparable with the fiscal systems of the highly developed countries and Moldovan economic objectives. An important share in the budget incomes will constitute the real estate (property) tax. The share of tax on individual entities' incomes will reduce, at the same time will diminish the fiscal facilities related to this type of tax. In this context, it is important, to implement successfully the national accounting standards. Once with Moldova's integration into the commercial economic relationships, the incomes deriving from foreign economic activity will be rising.

Some types of taxes and duties will have priority for the local public bodies. Developing budget independence at the level of the local administration will allow to promote some fiscal policies at this level.

The public expenses management relies on:

- ceasing the growth of public expenses volume and diminution of its ratio to GDP;
- financing the current budget costs without generating a budget deficit;
- efficient utilization of the budget funds.

The structure of the budget expenses will modify faster then the structure of budget incomes. There are needed some modifications in such fields as: state debt servicing, funding public administration bodies, direct/indirect subsidizing of the economic agents, social transfers.

Diminution of the pension expenses can be reached even during the near future by implementing the reformation concept of the pensioning system. The expenses for health care will be reduced by introducing private medical insurance.

Standardization of all public services and privatization (based on competition) will result in rationalization and optimization of public expenses.

The objective of the ***budget deficit and public debt*** field is to continuously diminish the ratio of the deficit level to GDP and to attract cheapest loans for its financing.

Monetary, credit and foreign exchange policy:

- further reduction of the inflation rate;
- ongoing reduction of refinancing rate, which contributes to reduction of interest rates in the banking system;
- not allowing NBM's crediting of the government;
- substitution of NBM's credit auctions by open market operations and Lombard facility;
- issuance of securities by NBM and limitation of issuance of state securities by the Ministry of Finance;
- implementation of a more flexible exchange rate policy – in order to increase the competitiveness of Moldovan exports it would be appropriate to have a <u>real effective</u> depreciation of Moldovan leu by 1% against the currencies of Moldova's main trading partners. Consequently, the real appreciation of Moldova leu against US dollar would be ceased.

Banking sector:

- encouraging foreign investors to participate in a more active modernization of the banking system, also by setting up foreign banks' branches in Moldova;
- foreign currency regulation: allowing legal entities to open multiple accounts with commercial banks (both for accounts in Moldovan lei and in foreign currency);
- setting up a deposits' insurance corporation, whose main purpose should be insurance of population deposits with commercial banks. The functions of the corporation could comprise – in addition to the repayment of failed banks' deposits – intervention in the activities of problematic banks;
- regarding the investment and development bank managed by the state – not to admit its involvement in financing enterprises that are going bankrupt. The bank needs to dispose limited funds and exercise its activity based on strictly commercial terms, its only target being profit;
- regarding the non-banking financial sector – to encourage setting up of certain specialized institutions in long-term lending and insurance, as well as institutions that would carry out operations at stock exchanges;
- implementing more rigid stipulations concerning commercial secret – limiting the number of bodies authorized to have access to information related to the commercial banks' clients and, at the same time, enhancing the responsibility of those entitled to that.

Correlating the macroeconomic stability with the structural reforms

For this purpose it is necessary to apply the factors of economic growth, which need to be reflected in the state programs (objectives, resources, mechanisms for implementation, control).

Horizontal programs, which need to comprise the whole public administration system, can be comprised with tin the following modules:

- progressive legal basis and implementation of laws;
- property reform, privatization;
- private sector development, supporting entrepreneurship and small business;
- attraction of direct investments;
- productivity and competitiveness, export promotion;
- regional development, local self-administration;
- action programs in the humanitarian fields – education, research & development, informatization, tourism ,etc.

Giving priority to the programs, which aggregately will realize the ideology "Moldova – open to the world».

A stringent importance has the finalizing of building the infrastructure for entrepreneurship (***business entrepreneurship***), inclusive: (1) legal basis, (ii) institutional infrastructure, (iii) technical infrastructure (telecommunications, post services, electronic communication means). On this basis, the humanitarian problems of the development of Moldova – education, researches, development of cultural institutions, public information means, – will quicken.

Given that the citizens of Moldova have obtained in property stocks of the enterprises, housing and land, it is necessary to create conditions for realizing their rights as owners and eliminate barriers to ***private sector*** development, which encompasses the middle strata of the population, that constitute the basis for a democratic society.

It is possible to ameliorate the legislation basis, taxation, banking, development of leasing, insurance and providing entrepreneurs with commercial information. But, the basic problems are linked to the "availability of starting capital». From these considerations it is necessary to pay a considerable attention to implementing the law on collateral, that would contribute to: (i) setting a centralized recording for determining the mortgaged commodity (if it is already mortgaged, etc.); (ii) clarifying the real estate titles; (iii) permitting creditors to provisionally lay lien on the mortgaged commodity, as well as to facilitate this process.

Investments promotion as a state horizontal program, needs to be oriented not only towards foreign investments (public investment programs), but also to active utilization of population and economic agents' savings and through supporting mechanisms of the investments practiced in a market economy. The Government must modify the legislation with à view to set clear, stable and transparent regulations on strategic, local and foreign investments, avoiding any discrimination between them. On long run, the foreign investments into purchased companies need to favor the modernization of their production means, develop new capacities and ameliorate competitiveness.

Export ***promotion policy*** needs to be based on the restructuring of national economy, enhancement of enterprise productivity and competitiveness – re-equipment, diminishing costs, improving the output quality in order to increase the exports of intensive-processing output. At the same time, the state support will be needed in research & development, of the respective structures (MOLDTRADE – Exports Development Agency, Chamber for Commerce and Industry), by utilizing the diplomatic missions of Moldova in quality of exports promoters.

Massive development of national currency in conditions specific to Moldovan economy might not be a solution for ameliorating the balance of payments. The real results can be obtained through liquidating the monopolies and protection of competition in import-export transactions, for which purpose is required to enhance the statutes of the Anti-monopoly Department under the Government, intensify the respective law and its observation.

Among the economic reforms, reformation of external trade is not simply most important, – it is one of the most difficult tasks and requires deep structural adjustments synchronized with a number of branches of the economy, pivoting on the provision for a maximal efficiency of integration of Moldova into the world economic net.

In the end, a particular attention should be paid to the ***regional development programs*** (Municipality Chiºinãu, Bãlþi, South of Moldova etc.), with the purpose to utilize more efficiently the resources of the territories, focusing mainly on the development of rural localities: agrarian entrepreneurship, employment outside agricultural enterprises, tourism, services, etc.).

Vertical programs can be oriented towards restructuring the vital sectors and branches of the national economy. First of all, they comprise:

- ***restructuring the industrial enterprises and branches***;
- ***agrarian reform, restructuring enterprises and branches of the agri-industrial complex;***
- ***de-monopolization, privatization and restructuring of the energy supply sector;***
- ***restructuring the constructions complex,*** by taking into account the new necessities of the production sector, infrastructure, services, constructions and housing.

Importance of these programs is determined by the fact, that without industry Moldova will face the destiny of a "peripheral economy", without any possibilities to provide for a stable economic growth and necessary technical-scientific environment; agri-industrial and constructions complexes (that generate more than 50% of the GDP) are based on the local raw materials, utilize the labor traditions of the population that are everywhere, including in the rural localities; in the end, the evident modifications of the energy supply system need to be considerably diminish the consumption of energy resources in the structure of the GDP, expenditures for import of energy resources and increase the production competitiveness of the domestic production on external markets.

The optimistic scenario

According to the optimistic scenario of development, the Republic of Moldova must simultaneously realize the horizontal and vertical programs, needs to enact the legal, institutional, economic and social factors. Their parameters and logic relies in the following:

GDP, consumption and investments. If we channel investments into the production sector and recovering production of the enterprises of real sector, we could achieve a GDP growth rate of 4-5% in 1999-2005 (without taking into account the shadow economy and excluding Transnistria), thus achieving, by the year of 2005, a nominal GDP of about 3 billion USD, *i.e.* 1.65-fold higher than that of 1997. Respectively, by this period, the GDP share per capita will exceed the amount of about 690 USD.

As regards to the GDP *structure,* it is forecast, that the share of agriculture will reduce (it being a source of “uncertainties” due to its seasonal nature). The industrial share in the GDP remains generally at the same level, a fact conditioned to a great extent of the relatively high level of investments in this sector. In these circumstances the share of services will increase, which is in fact recommended. In most of the developed countries the services share in the GDP accounts for about 60-70%.

As regards the ***consumption,*** to mention is that the growing rate of the private consumption needs to be less than the rate of GDP growth, in order to increase investments. On the other hand, the governmental (public) consumption must be reduced substantially. Taking into account the budget related constraints, as well as the external ones, it is obvious that in such situations are considerably effected the *domestic* investments. The country, due to lack of funds, does not succeed in holding up the continuous decline of the gross domestic investments, inclusive that of the production means. This is why, in this context, the only way out to recover the production and its competitiveness remains to be the inflow of foreign investments. Thus, it is necessary to remove the existent fiscal and legal constraints, etc., that impede foreign investments. Especially when the decline in domestic savings is one of the most negative tendencies of the transition period.

Monetary, credit and foreign exchange policy. Given that the NBM continues to promote a tough monetary policy, combined with a rigid fiscal policy implemented by the Ministry of Finance, during 2002-2005, the ***rate of inflation*** will diminish to 6% per annum.

The amount of ***lei in circulation*** will gradually increase in order to satisfy the needs of the economy in cash (under the growing GDP). At the same time, the broad money will increase, whereas growing money multiplier from 1.7 in 1997 to 2 in 2005 expresses the positive trend of increasing deposits with the banks, which by 2005 will grow about 4 times compared with 1997. This fact denotes the confidence of the population and economic agents in the banking sector of the country. The safety increases in the banking sector, the role of commercial banks as deposit institutions grows, and respectively grows the volume of credit investments into the economy of the country.

The exchange rate of the national currency will remain stable, i.e. without sharp fluctuations. For enhancing competitiveness of Moldovan exports; there should be a slight real depreciation (by about 1%) of the Moldovan leu, in comparison with the currencies of main commercial partners of Moldova. However, to mention is, that in real terms, the Moldovan lei will continue to appreciate, but at lower rates, of circa 1.7% per annum.

Balance of payments. The export is in a continuous growth, within the limits of 10-12% for the period of 1999-2005. To mention is, that for forecasting this growth, we rely on the success of reforms at the level of the real sector of the economy, which will foster the exports of the country. It is forecast also, that the exports taxation be canceled, and levy a VAT on imports.

During 1998-2002 the ***import*** grows in real terms, yet, at a lower pace compared with the export. The share of imports in GDP will decrease, a fact which will occur due to introduction of more saving technologies in the economy. It is envisioned a growth of the share of imported equipment destined to industry re-equipping, by simultaneous reduction of import of consumption goods, which alter the competitiveness of local manufacturers in the domestic market an does not contribute to economic growth.

According to the scenario, ***trade balance*** deficit will gradually decline to about $80m in 2002, *i.e.* by about 3.5 times compared with 1997. Respectively, the current account deficit will decrease to almost $50m in 2002, in comparison with the figure of $214m in 1996. This fact will have a favorable impact upon the overall balance, which already in 2000 may become positive.

Direct foreign ***investments*** will be continuously growing, given that the economic situation of the country in this scenario is stable, due to sustainable actions undertaken with a view to encourage such investments. Thus, already in 1998, in comparison with 1996, will be needed twice as much direct investments, and in the following years we shall need an annual flow of such investments of about $100m, which will speed up considerably after 2002 (these investments being predestined in a great extent for purchasing the technologic lines, etc.), in 2002 achieving the amount of almost $200m. Thus, according to estimates, by the year of 2002, the stock of direct foreign investments will exceed the amount of $660m, whereas in 2005 it will reach the volume of $1.2bn, *i.e.* $260 per capita – a figure compatible with the situation in Slovenia in 1995.

Budget-fiscal policy. As a result of the tough fiscal-budget policy, promoted by the Ministry of Finance, combined with the macroeconomic liabilities, there can be obtained the following results:

- diminution of the fiscal burden from 34% in 1997 to 29% in 2005. This is possible based on a fiscal policy, promoted by the Government, oriented to economic growth and attraction of both internal and external investments;
- diminution of budget expenses/GDP ratio, that in 1997 accounted for 46.7%, to 31.8% in 2005. Due to diminishing role of the state in the national economy, some public expenses will be replaced by private ones;
- diminution of budget deficit from 7.1% in 1997 to 1% in 2005. The rigid budget policy, oriented to modification of the structure, constraints the efficient utilization of the budget means, allows to subject to control the budget deficit.

Pessimist scenario

In case of passivity on behalf of Presidency, Parliament and Government in promoting the reforms, and continuation of inertial development (practice of 1995-1997), the pessimist scenario is foreseen. The main idea of this scenario is the inability of the country's supreme decision makers to continue and accelerate the implementation of economic reforms. Because of the government's indecision, inertia, and lack of structural adjustment, the collaboration with international financial institutions is not relaunched (blocked at the end 1997 because of the same reasons). Consequently, all macroeconomic indicators are worsening, and the country looses another valuable years of its development.

The ***real GDP*** will fall by 2% in 1998 and another 6% in 1999. According to this scenario, the nominal GDP by 2005 will reach only the figure of about $385m, *i.e.* $86 per capita (which is 8 times less than foreseen by the reformatory scenario during the same period).

The crisis will blow in 1999, when the first US$ 30m placement through Merrill Lynch, issued in 1996, will have to be fully repaid, and also there will be needed another US$ 185m for servicing (principal and interest) of state's foreign debt (including IMF loans). On the other hand: 1) the programs of financial assistance from IMF and World Bank will be ceased because of non-compliance of government with concluded arrangements, and 2) new borrowings from private capital markets abroad will not be possible to get, because of sharp worsening of country's credit rating, – Moldova will have to face a severe deficit of financial resources, accompanied by:

- a big rise of inflation up to 80% per annum in 1999, resulted after significant issuance of cash in circulation, aimed at crediting the government, imposed to NBM, – accompanied by massive dollarization of the economy, and loss of confidence of the population in the banking system, proved by a drastic fall of the bank deposits. At the same time, the NBM's refinancing rate will dramatically deteriorate also due to high inflationary pressures, and in 1999-2000 will become negative in real terms.
- massive depreciation of the ***national currency –*** by 6.2 times in nominal terms, which in conditions of lack of external financing, will lead to a sharp increase of the equivalent in lei for the amounts of Government's external debt service;
- deterioration of the ***state budget –*** in 2000, the budget deficit will reach 14.5% of GDP;
- substantial reduction of the NBM's ***foreign currency reserves***, which will need to "contribute", on the one hand, to financing the budget deficit, and on the other hand, to "cover" the BOP overall balance deficit and to service the IMF debt. As a result, the volume of gross foreign currency reserves in 1998-1999 will fall dramatically by more than $280m;
- the ***balance of payments:*** Due to the complicated situation on the macro and micro level, lack of foreign direct investments and of business confidence, it is clear that country's export potential will be lowered. In 1998 there is a small decline in exports, while in the following years, although export growth rates are positive, they will be too modest comparing to the evolution foreseen by the optimistic scenario. More drastic is the reduction of imports – by about 1% in 1998, and by 2-3% in 1999-2000. The cause is in lack of resources for imports financing. The country simply is not able to finance a bigger level of imports. The trade balance deficit will remain rather high, whereas in 2002, when the deficit will become minimal, it will anyway be of 1.7-fold higher than that of the same period of the optimistic scenario.

Due to the crisis in economy, foreign ***direct investments*** will initially reduce by 2 times, and afterwards, starting the year 2001 they will have a continuous growth, however in 2005 their share reaches only US$ 100m, comparing to those US$ 200m in the optimistic scenario.

Thus, in 1999 new borrowing from IMF, WB, EBRD and other creditors are practically blocked. At the same time Moldova has to service its state external debt, that (together with IMF loans) in 1998-1999 will demand over US$ 170m per year – money which at that moment would cost for the country very much. This is clearly shown in the scenario: in 1999 Moldova will have a negative balance of the capital and financial account, that is extremely dangerous for any country of the world.

Consequently, the year 1999 becomes the year of "big crisis", as well as the year of radical changes in the supreme economic and politic decision making structures of the country. Resignations follow, and then early elections, so that finally the path towards reforms will be restored. Negotiations will follow with international financial organizations, which will grant the needed assistance, but will certainly impose severe conditions for implementation of the undertaken reforms. After all, the country shrinks its capacity in order to face the expenditures, however at the same time, it did not manage to implement the structural reforms in time, it did not manage to technologically re-equip the enterprises and to re-direct them towards generation of export.

Further, the chapters 3 and 4 of the "Strategy for Development" comprise recommended actions to be undertaken in macroeconomic policy and structural reforms, oriented towards a sustainable economic growth and spiritual development of the country, towards the improvement of the living standards of the population and setting premises for a complex participation of the Republic of Moldova in European integration.

3.2 External constraints for Moldova

Conclusions on present situation and recommendations for the future

Present situation

- Moldova is a small open economy which has an economic growth directly related to external balance performance, in particular to export evolution. From this prospective, a worrying sign is that actually trade deficits are continuously increasing.
- There are disturbingly large and potentially detrimental unexplained inflows of foreign resources which create serious distortions in the balance of payments accounts.
- On the basis of recorded flows of external funds the country is facing a very large and growing external deficit. Practically all the borrowing at present and in the years to come is absorbed by external debt service. Thus, there is no net external financing. Since servicing of past debt heavily burden the state budget, the question of some debt rescheduling could be addressed.
- There is no indication of significant amounts of foreign resources finding their way into productive direct investment.
- Productive investment in the country continues to be sluggish thus reducing the prospects for revitalization of the economy and export growth.
- The stabilization of the economy started to bear fruit and already the government is reaping the benefits of a declining real cost of internal financing. However, public finances continue to highlight the inability to achieve the revenue targets. Hence, there seem to be little room for any increase in expenditure, either on investment or on external debt service. Moreover the public budget is in a pre-coma situation because of 1) more than optimistic revenues projections and thus, 2) bad actual revenues collections and 3) excessive spending.
- Slow pace of structural reforms, crowding out of productive investment by both private and public consumption and distortionary institutional and legal arrangements, uncertainty have all created unfavorable investment climate.

Overall, the recent evolution of Moldovan economy may be asserted as an expansionary fiscal policy combined with a tight monetary policy. An external borrowing has not unfortunately found its way into productive investment and did not lead to a real economic growth as it was expected.

Looking into the future

- The country cannot rely on the continuation of informal, speculative and highly unpredictable flows of external funds to cover the shortfall in resources. Nor can it rely on an unconditional goodwill on the part of external commercial lenders.
- Conception and implementation of medium-term strategy for the country demands urgent measures to address the external constraint and the careful management of external debt and generally of all flows of foreign resources. Therefore direct and indirect policy measures will need to be implemented in the short-term to avoid a situation of effective default on external obligations.
- ***If export promotion is adopted as a basic strategy to achieve economic growth***, then the reasonably good prospects for export growth are today hindered by a high exchange rate (chapter 3.3). However, export potential of the country will need some years to translate itself into an actual reversal of external funds flows. Hence, it is imperative to make sure that the overall external balance is sustainable in the immediate future and over the next two to three years. The export sector needs appropriate infrastructure and instruments, in addition to a determined and targeted policy action, including bilateral and multilateral negotiations, to be placed in conditions to face the foreign markets without disadvantages.
- A fiscal consolidation will be as more painful as longer it will be overlooked by policy makers.

External constraints and policy choices for Moldova

Balance of payments

Trade balance continues to deteriorate, with growing imports. After energy and fuel, consumer goods continue to figure prominently on the import side. Erosion in domestic price competitiveness has resulted in some substitution of domestically produced products with imported ones (e.g. from Turkey). The result is in a forecast deficit for 1997 of about US$ 280m-300m, which is clearly an element of concern. Any medium term strategy for the country must address this problem as a matter of priority.

The broad composition of imports and exports shows that the main positive contributor to trade continues to be the strong export performance of agriculture and the agri-processing sector, which together generated close to 600m USD in exports in 1996. The main negative item on the import side is represented by energy products with close to 400m USD. In addition, on the import side a large and rising contribution comes from all classes of consumer goods among which plastic products and electrical and electronic equipment which add up to about 250m USD. The interpretation of trends in the external position of the country is not made any easier by the fact that barter continues to form a very substantial part of international trade with CIS countries.

Besides that, data for the 3rd quarter of 1997 show that the trade deficit is comprised of about US$ 20m surplus with CIS countries and about US$ 100m deficit in trade with the rest of the world, largely EU countries. The problem is that no compensatory commercial or official lending, trade-related or otherwise, is forthcoming to the Moldovan government, unless it will comply with agreements concluded with international financial institutions. In any way continuous accumulation of such trade deficits and the increase of foreign debt will lead to a collapse.

On the other hand, the problem with reconciling the balance of payments data with actual cash flows is reflected in the very large errors and omissions entry appearing in the accounts, which was about US$ 120m. There are included here all sources of unidentified external flows of funds which have been in large surplus in 1996-1997. Attempts to find an explanation to this large cashflow, which is only accounted as a residual, have focused on the following elements:

- High degree of non repatriation of export earnings due to lack of registration of exports (e.g. through Transnistria) and through underinvoicing.
- Delays in repatriation due to the relatively long time-lag legally allowed to exporters (i.e. 180 days).
- Non-accounted repatriated earnings of Moldovan emigrant workers. This is potentially a very large item as it is estimated by the World Bank that the value of these unrealized remittances could be as high as US$ 100m p.a. Although they have also estimated that part of these earnings cover unregistered imports of goods done by private individuals to the extent of roughly US$ 15m per quarter this still leaves a residual of roughly US$ 40m p.a. which are potentially used to cover recorded import flows.
- Some private deals covering leasing of equipment, registered as import for the full value but in fact unpaid for. Often the cost of leasing may be part of informal partnership or subcontracting arrangements where the Moldovan partner pays in kind the supplier of equipment.
- Also, because of the actual non-transparency of cross-border trade, some of it is included here, however it should normally flow into the trade balance statistics.

It should be mentioned, however, that at the end of 1997 NBM presented a new version of balance of payments for 1996 in which, after the corrections made, the figure for errors and omissions is US$ 21m.

Simple cashflow projections of external resources

Keeping in mind the need to put some order and discipline in this area, we do however have to make use of the official reported figures. To clarify the prospects of the external position of the country we start by comparing the trade position with the external debt:

	New state debt incurred (incl. IMF)	Trade deficit
1995	100	53.4
1996	110	285
1997e	130	280

New borrowing in 1996 and 1997 is not sufficient to cover the trade shortfall, in fact it represents in 1997 only about half that amount. This is abstracting from other elements of the current account which make the deficit larger, and other external financial obligations of the country.

The accumulated stock of external debt reached at 1 January 1998 the amount of US$ 1192m, which is already above 60% of country's GDP. Here there are included US$ 709m of Government debt (including US$ 140m of restructured debt to Gazprom, and US$ 105m of placements through Merrill Lynch), plus US$ 230m debt of NBM to IMF, plus another US$ 253m of debt for energy resources to Russia and Ukraine. However, it should be mentioned, that in Balance of Payments the placements through Merrill Lynch and debt to Gazprom for which securities have been issued – are classified as portfolio investment, which is incorrect, because de facto they are state's debts.

If we add to the trade deficit the current and prospective debt service obligations we have the following picture:

	1996	1997e	1998e	1999e
Trade deficit	-285	-280	-265	-220
Debt service	-51	-150	-215	-230
New borrowing (net)	132	130	130	150
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Additional financing requirement	-204	-300	-350	-300

This is a crude and highly simplified picture but it is useful to represent the elements of unsustainability of the situation:

- the foreign resources required to balance the cumulative deficit in the capital and trade accounts would more than exhaust the total foreign exchange reserves of the central bank in just one year;
- after 1997, the totality of new borrowing would be absorbed by the debt service obligations and would not even cover their full extent. It is not clear where from could come inflows of foreign exchange needed for servicing the foreign debt in the future years, unless there is a radical deregulation and structural reforms completed by end 1998.

Thus, it is extremely important to keep normal relations with creditors, so that the country could benefit further from foreign financial assistance. Besides, it should not be tolerated worsening of the country's credit rating, because in this case Moldova could immediately loose the possibility to borrow on the private capital markets, and secondly, would be reduced dramatically the portfolio investments.

Potential for corrective action

Short-term corrective measures will need to be adopted rapidly if the country is to avoid to be in a position of non-compliance in its external payments in the next two years or so, with all the negative consequences that implies. In the short-term, exports are not likely to show rapid growth while there may be scope to reduce the deficit through a reduction in non-essential imports, a potential gross deficit reduction on this account that can be estimated at about USD 100-150m p.a. The net effect on the trade balance would not be of equal importance as some increase in the import of capital equipment would be desirable to indicate that productive investment is actually taking place and preparing the country for the future challenges ahead. However, it is not quite clear how the reduction in consumer goods imports could be brought about:

(a) it is not possible, within the framework of the country's present international economic relations to introduce mandatory import restrictions;

(b) it might be possible to use fiscal instruments to discourage acquisition of certain imported goods by Moldovan citizens (e.g. cars) – i.e. through excises, tariffs, control of borders, discriminatory credit facilities for importers etc.;

(c) a leu devaluation would, apart from exports fostering, reduce import penetration of some consumer goods while encouraging a switch to domestically produced goods. On the other hand it would increase the cost of imported capital goods and therefore increase the cost of internal capital formation. The import content of many domestically produced goods both for export and for internal consumption is quite high and therefore the gain in price competitiveness of domestic producers may not be equal to the extent of the leu devaluation.

It is by now quite widely accepted in the country that the policy of exchange rate stability of the leu against the US dollar has resulted in an undesirable real revaluation of the currency, and a particularly strong one when the leu is taken against the majority of European currencies. This amounts to a large income redistribution from the exporting to the importing sector of the economy. Serious consideration should be given to the consequences both in the short and medium-term that this policy can generate. Agricultural and food commodity exporters whose prices are fixed internationally (e.g. apple concentrate) have seen their earnings in lei eroded significantly in the last two years or so.

Another aspect are the large unexplained foreign exchange inflows which tend to compensate temporarily for a large chunk of trade deficits and thus prevent the real pressure on the exchange rate to be revealed. The argument that a lasting quasifixed exchange rate by itself can generate the so called "stability package" does not hold together. Perception that a currency is overvalued and that the exchange rate is unsustainable does more to undermine internal and external confidence and to stimulate speculation than any realistic policy stance.

Other significant improvements in the trade accounts will be obtained by a policy of energy conservation and efficiency improvement through the radical restructuring of the electricity generating and distributing companies (chapter 4.6). It is estimated that the gross energy consumption in the country could be reduced by 40% at current levels of activity. This could result in a reduction in the total import bill of another US$ 150m. Once again, in the short-term the observed saving would be less than the gross amount as any improvement in energy efficiency would be associated with new investment expenditure that would have an import component.

In both the options outlined above we have inter-temporal lags between implementation and results which may not be compatible with sustaining a situation of potential crisis. In the first case, although imports of capital goods may absorb foreign exchange resources released by a decline in consumer goods imports, it is conceivable that those imports can be arranged just through medium term supplier or purchaser credit financing. Therefore although the absolute values of imports may not vary substantially, on a flow of funds basis there would be a distinct advantage as payment would be deferred and spread over a number of years. In the case of energy saving measures, investments in this field are susceptible to attract some international financing.

And finally, another area where improvement in the trade position of the country could be brought about by policy action is in the negotiation of large external procurement and barter transactions. There is indication that the current system of energy purchase from Russia and the Ukraine against delivery of agricultural commodities and industrially processes food products involves a variety of mechanisms which result in an unfavorable terms of trade penalization for Moldova. An in-depth analysis of this situation is called for to establish whether readjustment of the relative prices is possible or whether cash trade in both directions would in fact be more beneficial to the country.

The problem of investment

The current poor trade performance shows that a considerable portion of imports is accounted for by consumer goods and that little indication exists of a trend to “re-equip” the productive apparatus of the country. Aggregate demand figures show that from 1994 onwards Gross Fixed Capital Formation has represented a declining share of a declining GDP. However, there was a decline in stock accumulation and hardly some new investment in fixed capital. Household and government consumption also went down significantly, and on the other hand, investments were declining even more. If little is happening by way of productive investment, the situation of disequilibrium in the trade (and current) balance is unlikely to be self-correcting as any expected future increase in exports would require evidence today of targeted capital investment in the productive sphere.

In this context the current policy of external borrowing used to sustain internal consumption rather than investment and cover trade shortfalls is unsustainable.

External borrowing is currently largely used to service existing debt and to cover current expenditure. If we look from state’s prospective there is an accumulation of external obligations for the country which is not accompanied by the creation of productive facilities able to generate the resources to cover those obligations in the future. As a simple rule-of-thumb the only safe way to use externally borrowed finance is to place it where it is more likely, in turn, to generate or save foreign currency in the future. This is obviously not the course which is being followed in Moldova at the moment (moreover, some of the granted loans, e.g. for development of private sector in agriculture, were deliberately directed to the support of old enterprises). And if this practice continues in the future, the country will face two simultaneous shortfalls. One is the simple shortage of foreign currency and the other is the lack of domestic resource accumulation needed to cover the liabilities.

From a larger prospective, substantial impediments for the investment are created by the slowness of structural reforms, unclear regulatory framework and uncertainty.

There are some worrying signals that big foreign investors are threatening to withdraw from Moldova due to excessive fiscal burden, unclear legal and regulatory framework, increasing rank-seeking an corruption (investment policy – chapter 3.5).

Revitalization of production and investment

For the country to reverse this negative spiral determined government action is needed on two main fronts: To promote capital investment and exports.

The promotion of capital investment requires that the maximum amount of foreign resources obtained from foreign borrowing be channeled to fixed investment rather than current expenditure. In some cases specialized medium-term financial intermediaries capable of arranging medium-term credit for the purchase of equipment or project-financing have been extremely valuable instruments to encourage enterprise formation and growth, particularly in the area of small and medium-size enterprises. Italy’s Mediocredito Centrale is a case in point of a successful state-owned bank dedicated to this type of activity. There are, however, also a large number of unsuccessful examples of “development banks” in many parts of the world and notably in South

America, which have not provided any contribution to viable enterprises and rather than engines of growth they became large absorbers of budgetary transfers.

Export promotion should, naturally, concentrate on the promotion of official and recorded exports. There are many types of instruments that can be used in this context among which:

(i) deregulation: creation of simple, clear and stable rules of the game for all exporters. The State should withdraw from direct control of exports: licensing should mean registration and not an additional control or outlay for rent-seeking.

(ii) tax concessions to exporters to favor the full reporting of transactions and the maximization of the effort to export – introduction of a zero VAT rate for exports;

(iii) creation of special agencies to offer services to exporters only, e.g. of an export insurance agency (non-profit, the Government initially allocates the necessary funds, then exporters would pay contributions for insurance service);

(iv) introduction of special tax and financial incentives for capital investment, such as accelerated depreciation of certain fixed assets, interest rates concessions and even capital grants.

Structural changes should continue to expand in all areas, facilitating investment into areas of evident competitive national advantages.

The prospects for export growth

Looking at the geographic profile of the trade performance of the country today, we find that most of the deficit is actually occurring in trade with the EU, while the much more sizable trade flows with Russia and the rest of CIS are almost balanced. Two considerations emerge from this. Firstly that trade with the eastern neighbors is an important asset for the country which depends from them for its energy procurement. Secondly that a determined, targeted effort must be made in the expansion of exports with EU countries that are today net exporters to Moldova.

Still, it should be noted, that orientation of export towards relatively facile Eastern markets is in the long term a wrong tactics, because lack of a tough competition in these markets from the West side is just a temporary phenomenon, which at this moment favors our country. In case when the situation changes, Moldova risks to loose Eastern markets as well. Thus, despite existing difficulties, an orientation of export towards West should represent a priority direction (foreign economic relations – chapter 3.7).

An additional consideration is that, in the short-term at least, the country is likely to continue to focus on the traditional export products, wine, tobacco and some other processed fruit and vegetable products. This will inevitably cause some difficulties given the strong position of agricultural producers in all those products in the EU, but it appears necessary to raise the issue in bilateral and multilateral discussions.

The prospect for Moldovan exports seem to be improving thanks to some limited but potentially important modifications being introduced in the wine-making, bottling and packaging. The standard 75 cl. bottle, is now in production in a new line opened in the Moldovan Glass Works as a result of EBRD financing and a joint venture with a Spanish glass manufacturer. This is a simple enough measure but it represents a necessary condition for Moldovan wine to penetrate western European markets. Effort is also being put in the enological upgrading of some of the wines and in new label design. The hardware for success is being put into place. One area where more would remain to be done is the transport sector and transit custom agreement where wine producers as well as most other exporters find a distinct comparative disadvantage. Now it is time for the software which consists in the proper understanding of the individual markets in Western Europe (and possibly the Far East) where clear opportunities exist for both wine and cognac.

Other areas where Moldova is already finding new niches is in light industry and particularly in the apparel sector. There are already a number of firms around the country that operate with Western European partners as subcontractors in garment production. Margins are likely to remain rather thin at present as Moldova is building its position mostly as a low wage producer in relatively labor intensive activities. However, cooperation in this type of production can generate a great deal of technical spill-over, learning-by-doing and quality improvements as controls to comply with more exacting standard of the end-markets are incorporated in the production routines. It is clear however that the path to gain autonomy in consumer goods (rather than commodity) markets is not an easy one, as distribution channels, image and labels have become the only real tools of competitiveness. However, exposure and familiarity with these markets will undoubtedly put Moldovan producers on a much stronger footing to increase sophistication and value added of their products.

The experience of direct cooperation between some donors (GTZ in particular) and Moldovan companies appear to be bearing fruit. The GTZ local outfit already has a core group of 41 companies with which it is cooperating on a systematic basis and many of these have found ways to establish different forms of external partnerships. In the future there are prospects for extending this cooperation.

Concluding remarks

On the whole, the prospects for export performance of the country in a 7-year time horizon are reasonably good. The real problem that one sees relates more with the sustainability of the macroeconomic environment, and external confidence, in the intervening period. It is for this reason that any sensible long-term strategy for the country should be concentrating without delay on the solution of the external debt and balance of payments constraint before that gets out of control.

Even if internal stabilization has produced significant benefits such as the sharp decline in inflation and lately in real interest rates, it is now time to consider that external financial resources cannot be taken as freely available one-way incoming flows. International lenders are not direct investors in the country and although they are taking some risk, in principle their assets, their stock has a fixed value and maturity. All the flows in one direction will be compensated by flows in the opposite at some stage, starting in the very near future. In this context, it appears a very serious misjudgment to incur in medium-term (5 years) commercial debt (from private capital markets) in order to service existing debt. The five-year time-span is really not sufficient to get the country to the other end of the tunnel. And new voluntary lending may not be so generously forthcoming to cover the repayment of such loans when they become due.

The financing of the deficit cannot be taken to be a matter of accounting. Obviously the arrears on the energy side increase the external debt of the country but they are often omitted from the consolidated figures of external debt and treated as a separate item. As a result, the new arrears end up being indistinguishable in the large pool of accumulated debt of the energy concerns which periodically become the object of renegotiation, rescheduling and intended debt-equity swaps.

The concern is that this creative way of treating the accumulation of trade debts, payment arrears and generally an unsatisfactory and undesirable structural imbalance in the external trade of the country can only be sustained for a limited period of time, although the exact duration of this cannot be readily defined.

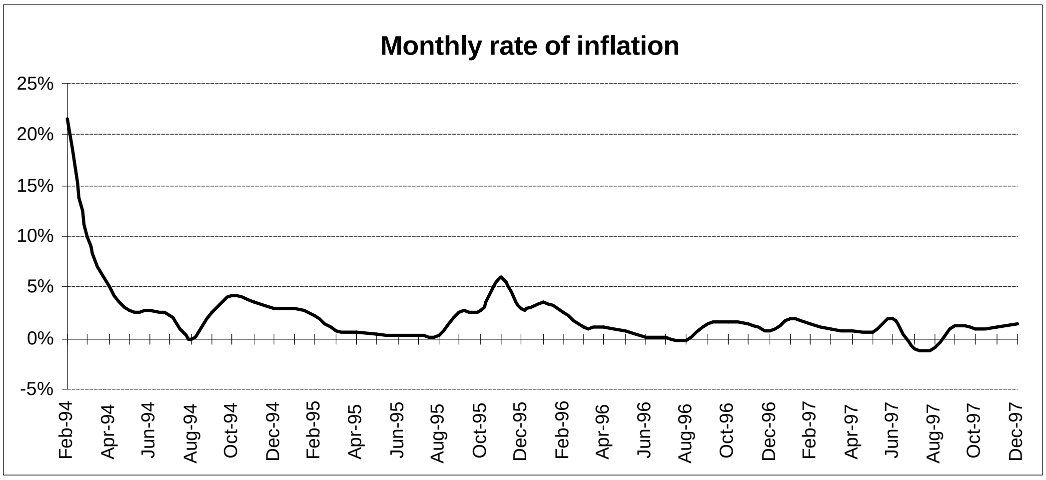
3.3 Monetary, credit and foreign exchange policy

National Bank of Moldova is responsible for drawing up and implementation of the monetary policy. Since 1991 the main goal of the monetary policy was to reduce the inflation rate, to achieve and maintain the stability of the national currency by means of regulating the money supply, avoiding sharp adjustments of the exchange rate. NBM is using reserve money or monetary base as the main target of its monetary policy. Presently NBM is employing credit auctions, where the refinancing rate is set up, which is a basic instrument for regulating monetary framework of the economy. In implementing its monetary policy NBM also sets the reserve requirement in addition to engaging in open market operations and effecting the control over the exchange rate.

Monetary and credit policy of the NBM

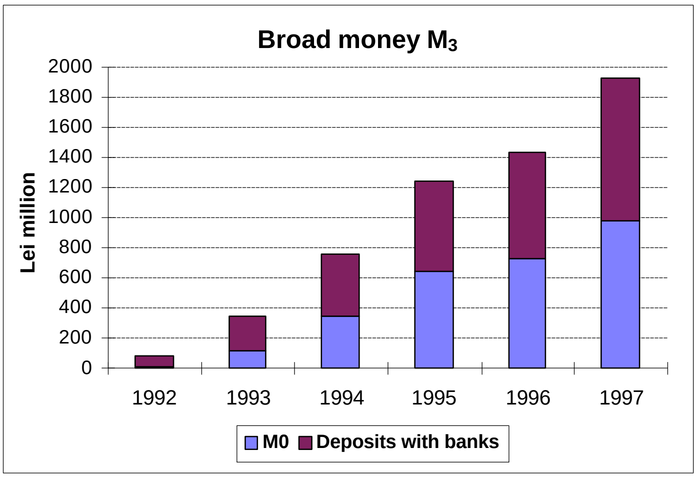
In June 1992 the NBM introduced the Moldovan cupon, a transitional currency after the Soviet ruble, and this allowed to a certain degree to keep domestic monetary indicators under control. Monetary policy has been constrained by the end of 1993, thus being created conditions which could contribute to a successful introduction of the new Moldovan currency, leu, launched into circulation in November 1993.

Since the introduction of the national currency, the National Bank of Moldova has adopted a number of measures directed towards limitation of expansion of lei in circulation and reduction of the rate of inflation, which in its turn is influenced not only by monetary factors, that can be controlled by NBM, but also by non-monetary factors, as for instance seasonalness of the national economy and increases in prices set by the Government (especially for services to households – transportation, communal services, energy tariffs and others). As a result of NBM actions the annual inflation has decreased considerably from over 2000% in 1993 to 11.2% in 1997. Annual rate was 15.1% in 1996, 23.8% in 1995, and 104.5% in 1994.



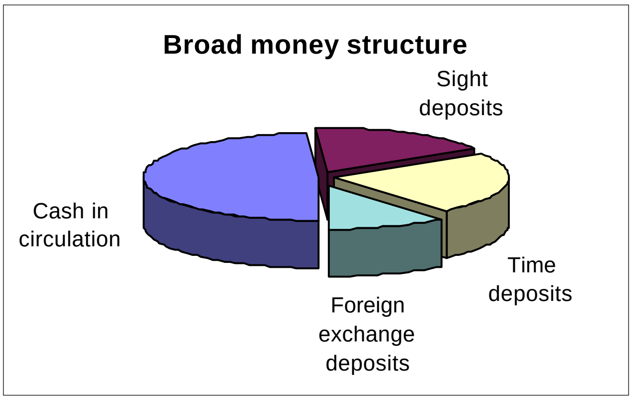
For ensuring the stability of Moldovan leu it is necessary to have a control over broad money M_3 (money supply), which is equal to cash in circulation (M_0) plus deposits in lei and foreign currency held by commercial banks. National Bank can not manage directly the broad money, however, by conducting its monetary-credit policy, it can influence directly the monetary base, which is composed of the amount of cash in circulation and banks’ reserves.

Broad money M_3 has grown by 15.3% in 1996 comparing to the growth by about 65% in 1995. In 1997 the growth of M_3 was 34%. It should be mentioned here, that growth rates of M_0 have been lower than growth rates of deposits (during 1995-1997 money multiplier rose from 1.59 to 1.71), and this is a positive sign, since increase of the amount of cash in circulation is an inflationary process. However, growth of the money multiplier was relatively modest, which is explained by the fact, that economic entities apply to the services of banking sector in a much lower extent, comparing to those from developed economies.



This is conditioned by high share of barter transactions, as well as of cash transactions. This situation is caused not particularly by some distrust in banking system, but especially by the tendency of fiscal evasion of economic entities. Another cause lies in a still high level of excess of banks' reserves – the NBM's mandatory reserve requirement is 8%, whereas the actual amount of total reserves is over 20%.

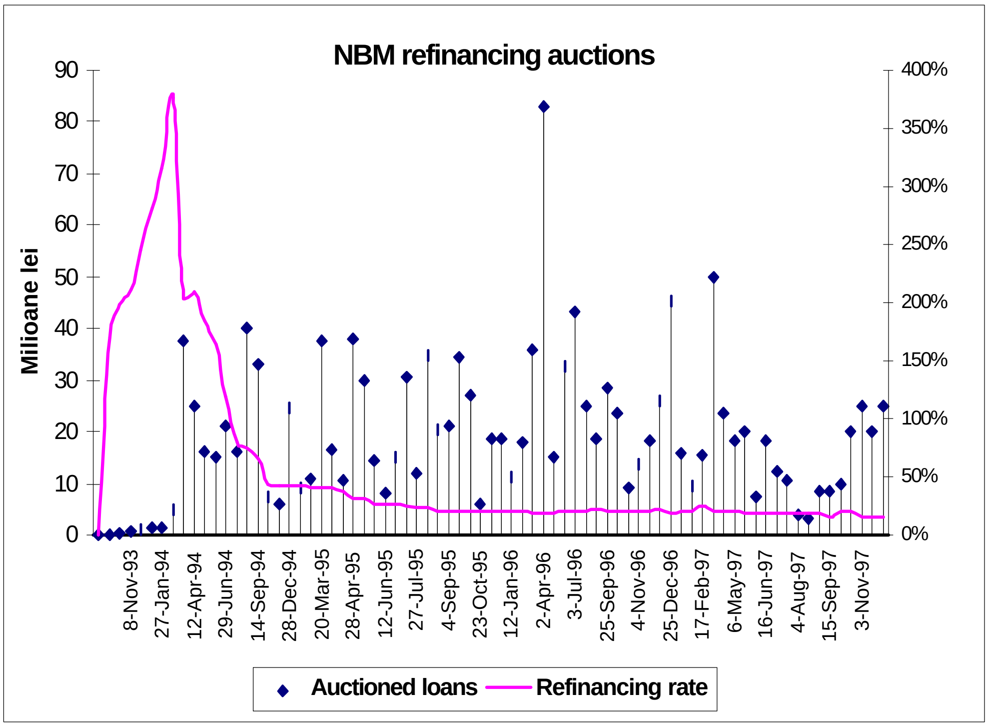
Monetary base increased by 9.3% in 1996 (by 41.6% in 1995), the increase for 1997 was by 31.5%. As in previous years, the share of cash in circulation in reserve money is growing, having reached 86.6% at the end-1997.



Monetary and credit policy of the NBM is implemented according to a special program (quarterly and monthly), under continuous monitoring of the IMF, which sets the ceilings that must not be broken: ceiling on lending to Government, Net Foreign Assets and Net Domestic Assets for the NBM. An important indicator is also base money. National Bank of Moldova has a direct influence on base money through the following instruments: internal lending (to commercial banks and to Government); buying-selling foreign exchange; operations with state securities.

Lending to commercial banks, as an instrument of monetary policy, allows influencing on reserve money (and on broad money respectively) through the volume of offered credits and interest rate for them (NBM refinancing rate). Till August 1993 loans offered by NBM were centrally distributed and their volume was determined depending on Government needs. This obviously annihilated the motivation of economic entities to work efficiently. At present loans are directed through credit auctions, and preferential credits were abolished. The first auction took place in August 1993.

The decrease of inflation rate has had a positive effect on NBM refinancing rate, which beginning with January 1994 became positive in real terms. At the end of 1997 NBM annual refinancing rate was 16%, while at the beginning of 1994 it was 281% (same period of 1995 – 42% and of 1996 – 21%).



The sources of insurance (collateral) for loans granted by NBM were: banks' own portfolio of state securities (68.5%), banks' reserves at NBM (11.4%), as well as funds at the correspondent accounts (20.1%).

The refinancing rate is the key reference rate of the NBM, although a more market-oriented rate, such as the Lombard rate, is available. It is determined at the level of interest rate on 28-day state securities plus a constant 5% margin. In 1997 there was an increase in the number of Lombard transactions that took place, amounting to 30 million lei (at interest rates of 20.17%-28.89%). Due to the growing volume of credits on interbank market, NBM will move in the future to the correlation of Lombard rate with average short-term interbank credits.

In 1997 NBM started open market operations, buying and selling state securities, and also performing REPO agreements, i.e. selling of state securities with their further repurchase at a specific date at an agreed price. As NBM's partners in these operations act commercial banks as primary dealers. Starting August 1997, open market operations take place at auctions held at NBM.

In 1997 there were sold state securities out of NBM's portfolio amounting to 38,6 million lei (amount of purchased securities – 5.1 million lei). Effective profit rates of state securities sold were at 20.25%-26.81% (of purchased securities – 17.48%-25%). Also, 7 REPO auctions took place, at which state securities amounting to 6 million lei were sold, at the rates of 19.5%-25.58%.

It should be stressed, that for the year 1998 it is foreseen to intensify the implementation of new financial instruments of monetary policy: open market operations and Lombard facility, which would substitute credit auctions by 1 January 1999.

Lending to Government is represented by credits offered by NBM to the Government (against Treasury Bills) for covering budget deficit. The volume of these loans is set according to budget deficit, stipulated in the Law on Budget for the future year. In 1996 NBM's lending to Government was equal to 100 million lei, and for 1997 the amount set in Budget Law (and coordinated with IMF) was 50 million lei. For the upcoming years it is predetermined that NBM will no longer grant credits to the Government, for covering budget deficit, because of their inflationary consequences.

Banks' reserves – represent the reserves that must be kept with NBM for each monetary unit deposited with commercial banks (mandatory reserves), as well as excess of reserves. Mandatory reserves initially had a prudential argumentation (covering demand for cash in case of banks' brokerage), but further on NBM started to apply them as one of instruments of control over broad money.

During 1994 National Bank of Moldova has modified several times the reserve requirement for regulating more efficiently broad money. Till 1 February 1994 the maximal reserve requirement was 20%, then it was increased up to 28%, that gave the possibility to reduce the expansion of broad money. From 1 June 1994 NBM set the reserve requirement back to 20% in order to increase financial resources of commercial banks and to satisfy the seasonal demand for credits. Afterwards this figure was reduced further: from 1 December 1994 – to 12%, and from November 1995 – to 8% for all types of deposits, both in lei and in hard currency.

Foreign exchange policy of the NBM

National Bank of Moldova is implementing a foreign exchange policy aimed at continuous and stable development of the foreign exchange market, ensuring the needs for functioning and development of national economy. With the introduction of national currency restrictions pertaining to forex transactions have been canceled.

Foreign exchange market. Exchange rate of the national currency is fixed daily at the auctions of Moldovan Interbank Currency Exchange (MICE), at which commercial banks' dealers participate. Economic agents (legal entities) can purchase and sell foreign currency only through banks that service them.

If initially the volume of foreign exchange operations was concentrated at MICE, presently a number of transactions are effected by commercial banks out of bourse, i.e. directly between them, or with NBM. Considerably increased the number of foreign exchange bureaus (over 400) and respectively rose the volume of operations of buying-selling foreign currency in cash. At the same time, the presence of "black" currency market (i.e. non-organized market) has been sharply reduced. Foreign exchange bureaus have indirect access to MICE, i.e. through commercial banks.

To conclude is that: in the last 3 years and a half the exchange rates quoted by commercial banks for non-cash transactions and rates at foreign exchange bureaus for cash do not differ much from the official exchange rate. This represents a sign that forex market is quite developed and liberalized, and foreign currency is freely accessible by individuals and legal entities (within the limits of current account operations).

Liberalization of currency regime. The National Bank if Moldova is continually implementing a step by step liberalization policy in the field of foreign exchange regulation. There have been eliminated almost all limitations on buying any foreign currency by individuals and legal entities operating in the forex market of Moldova.

In November 1994 the export surrender requirement for Moldovan economic agents was abolished, and this gave them the possibility to manage their accounts in foreign currency on their own. The rules of import and export of foreign currency into/from Moldova have been simplified, and there were set quite liberal regulations on keeping foreign currency in Moldovan banks. The undertaken measures led to a growing confidence of population and economic agents in national currency, that was proved by an increase of deposits in lei with the banking system.

At 30 June 1995 the Republic of Moldova has joined the obligations of Article VIII, Sections 2,3, and 4, of the IMF Articles of Agreement. This represented de facto a recognition of convertibility of the Moldovan leu for current account operations, i.e. operations linked with export and import of goods and services, as well as for some capital account operations (taking into account Balance of Payments problems and other factors, full convertibility of leu for capital account operations is currently considered inappropriate).

So, any economic agent is allowed to buy without limitation foreign currency on Moldovan forex market through commercial banks for effecting any operations related to import of goods and payment for services provided by non-residents.

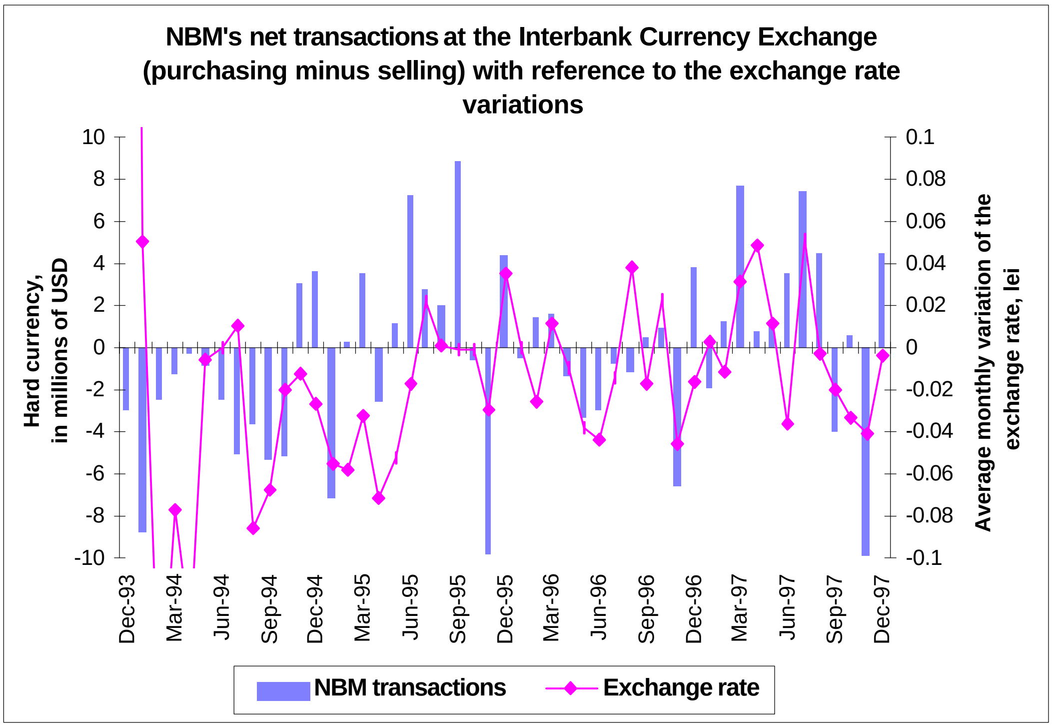
Also, any resident, that received loans from foreign creditors and registered them at the NBM, is allowed to buy foreign currency in the internal market for paying off the related principle and interest. Any foreign partner, who invested financial resources in Moldova's economy, is guaranteed the right to repatriate gained profit in any currency to his residence country.

In case of Moldova practically there is no ***dollarization*** of national economy. Generally, there are three main motivations to hold hard currency: for effecting transactions, for precaution reasons, and for accumulation of value. In the Republic of Moldova the conversion of Moldovan lei into US dollars is guaranteed, that is why there are no many people willing to keep dollars for the purpose of effecting transactions. On the other hand, the other two factors – increase of dollar demand as a result of precaution and as value accumulation – occur in a hyperinflation environment, however in Moldova the rate of inflation from the moment of introduction of leu is in a continuous decrease, reaching extremely reduced figures comparing to other countries with economies in transition. Taking into account, that, on the one hand share of population's income spent on purchasing foreign currency is low, and on the other hand share of households deposits in foreign currency with commercial banks has been constantly at a low level (about 20% in 1997) – all these prove that the process of dollarization of economy did not take place. The function of value accumulation of the national currency was not influenced by US dollar, and households preferred the leu for this purpose.

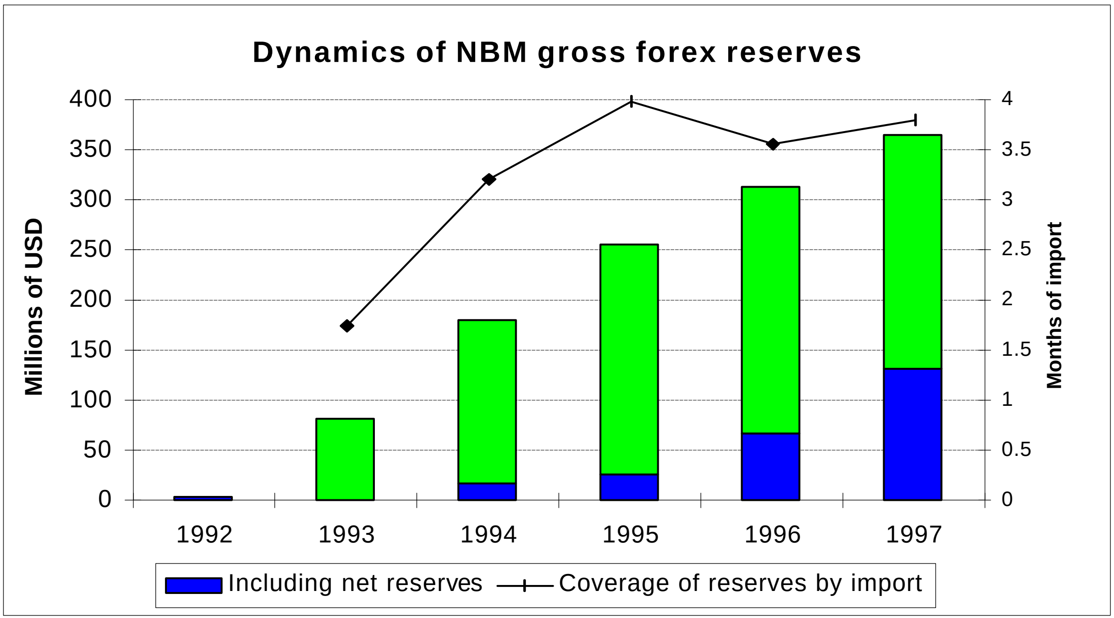
Also, there were no tendencies of forex speculations (arbitrage), quite characteristic for the period prior to introduction of national currency, when the exchange rate was continuously deteriorating, and financial institutions were getting considerable profits out of these activities.

Exchange rate policy

As it was already mentioned, official exchange rate of the Moldovan leu against US dollar is set at daily fixing auctions of the Moldovan Interbank Currency Exchange. Exchange rate of national currency upon main foreign currencies is calculated by cross-rate method. Auctioned exchange rate at MICE sessions are rates set as a result of an equilibrium between demand and offer. But it should not be considered that in Moldova the exchange rate is floating, because NBM is intervening in the forex market according to its monetary policy objectives, for diminishing major fluctuations of the exchange rate. In the chart below it is clearly seen that in the moments when NBM bought (or sold) hard currency, the exchange rate has promptly appreciated (or depreciated).

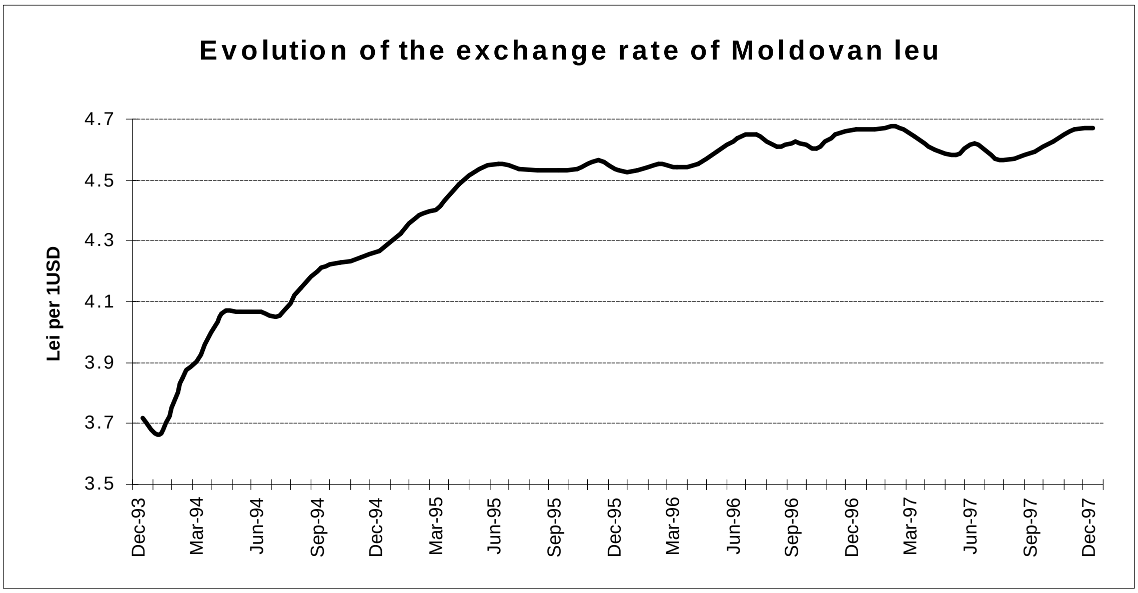


Although NBM's share in transactions on forex market is small, it should be stressed out, however, that the market reacts quite elastically on NBM's transactions at MICE. Commercial banks, economic agents take into account NBM's interventions, which at any moment in time, in case if it is necessary, can restore the level of exchange rate. This is explained by NBM's ability to cover any demand of hard currency that could emerge in the forex market, which is small by proportions. Republic of Moldova has an adequate volume of foreign exchange reserves in order to face the withstand the demands of national economy (volume of gross reserves at the end of 1997 was US$ 366m, covering about 3.7 months of import).

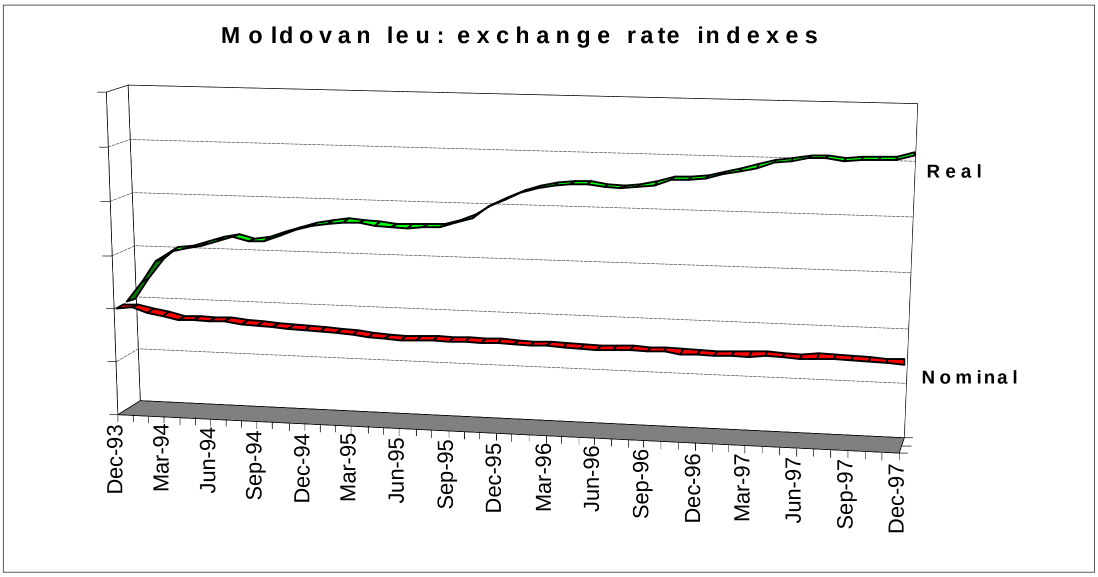


Thus, the exchange rate is supervised and could be put under the NBM's control at any moment. Therefore, in Moldova there is a combined method of setting up the exchange rate.

When analyzing the evolution of the exchange rate of Moldovan leu from the moment of its introduction till present time, it could be remarked that leu has depreciated slowly in ***nominal*** terms, from 3.85 lei per 1 US dollar, to an average of 4.6 lei per 1 USD in 1997, showing a remarkable stability in the period 1995-1997.



On the other hand, in ***real*** terms (taking into account inflation rate) during the same period Moldovan leu has appreciated continuously upon US dollar: in December 1994 – by 78% comparing to the same period of the previous year, in December 1995 – by 16.7% respectively, in December 1996 – by 13.8% and in December 1997 – by 11% comparing to December 1996.



It should be mentioned, that this evolution of the national currency has generated many objections lately from exporters, which claim that a too high value of leu makes our exported goods too expensive, thus deteriorating their competitiveness. Moreover, overvaluation of the leu, in the presence of huge and rising Balance of Payments disequilibrium (current account to GDP ratio in 1996 was 13.5%, while even a 7-8% figure is normally considered very dangerous for a country), encourages organized speculative drive against the leu.

On the other hand, analyzing the exchange rate policy in Moldova, the stable exchange rate is being used as a second anchor (apart from the tight monetary policy) for keeping the inflation in place. However, over a medium and long-term period, only one anchor, i.e. monetary policy, should be sufficient.

Another issue is that at MICE the exchange rate of leu upon US dollar is set directly, and the exchange rate against Deutschemark (and other currencies as well) is calculated, as already mentioned, through cross-rate, and this makes leu extremely sensible to the fluctuations of D-Mark towards the dollar. In 1997 there was a considerable depreciation of D-Mark against USD

– by about 20% as at 1 August 1997 comparing to the beginning of the year. Therefore, during 1997, when leu is maintained stable, our commodities exported to Germany are becoming more and more expensive, depending on the D-Mark depreciation. This obviously reduces the competitiveness and exporting potential of Moldova as with Germany. It should be stressed out, however, that among Western countries Germany has the greatest share of Moldovan export, of about 3.7%. If the exchange rate of leu was pegged to Deutschemark (as in case of Estonia, for example), then this kind of problems would have intervened. Since the main share of Moldovan export to Western countries goes not to the USA, but towards EU countries, then it could have been appropriate to peg the leu to a basket of EU currencies.

However, it is clear, that the above mentioned solution is not applicable in case of Moldova, because the majority of exports go not to West, but to CIS markets. Thus, exchange rate policy should take this fact into consideration. Although in the previous paragraph a conclusion has been drawn, that indeed the high exchange rate of leu affects considerably exports to Germany, the question remains active, weather this exchange rate affects country's exports as a whole, in which, as it is known, share of exports to CIS exceeds 70%.

The answer to this question is the following one: ***real effective*** exchange rate, i.e. exchange rate against currencies of the main trading partners of Moldova. In calculating this rate it is taken into account the fluctuation of the exchange rate of leu upon currencies of the country's main trading partners, as well as the inflation in these countries (among them: Russia, Ukraine, Belarus, Romania, Bulgaria, Germany and Italy). In 1995 leu has appreciated by 16.2% against currencies of the main trading partners of Moldova, in 1996 – by 5.5%, and in the first half of 1997 – by 6.9%.

In the table below it is shown a comparative evolution of different exchange rates of the national currency, minus sign indicating a depreciation of Moldovan leu, and plus sign – its appreciation:

Period (comparing to previous year)	Nominal	Real	Nominal effective	Real effective
Annual rate in 1995	-10,5%	+13,3%	+92,3%	**+16,2%**
Annual rate in 1996	-2,2%	+12,6%	+16,8%	**+5,5%**
Jan.-June 1997 comparing to July-Dec. 1996	-0,3%	+11,7%	+13,1%	**+6,9%**

If, for example, nominal depreciation of Moldovan leu at then end of 1996 was by 7.7%, i.e. 5.5% more than actual figure of 2.2%, then this would have contributed to a solution of the problem of competitiveness of Moldovan goods exported to the main trading partners and especially Russia, having in 1996 a share of 53.6% of Moldova's exports. Under these circumstances the real appreciation of national currency would have been maintained, but at 6.2%.

Therefore, suggested conclusion is the following: ***it is considered needed a nominal annual depreciation of Moldovan leu against US dollar at a degree that its real effective rate*** to be equal to 99%, or -1%, i.e. to show ***a small real depreciation of leu against currencies of country's main trading partners.*** It should be stressed out, that in this case still the real exchange rate of leu against dollar would remain positive, i.e. in real terms the leu would continue to appreciate against dollar, but at not so high values as now. This, in our opinion, is the optimal solution for the problem of exchange rate, that would improve the situation of Moldovan exports, which would become cheaper, and at the same time this will not have a negative impact on country's economic situation. Besides that, even a small currency devaluation would contribute to a reduction of imports' growth rate, especially of consumer goods, which is also a positive factor.

Suggested solution should not be by any means considered as an attack on the stability of national currency, because it will be initially devalued only by about 6% per year in nominal terms (and it will remain positive in real terms) and only on the basis of a well defined program and explained to the general public. People's faith in a stable currency will not be altered, because they will be able to anticipate correctly the slowly upward tendency of nominal expansion of leu, and NBM will continue, as it does now, to intervene at Moldovan Interbank Currency Exchange in order to alleviate sharp fluctuations of the exchange rate.

3.4 Budget-fiscal policy

Current situation

The process of transition to market economy requires that the budget and fiscal policies applied at present be reviewed.

First, it is meant the fiscal aspect, pertaining to collection of incomes to the budget. The experience of the last 5 years demonstrates, that the fiscal tension existing in the economy entails the fact, that the share of incomes collected to the budget accounts for 85% as compared to the approved budget. Although from year to year more and more revenues are collected to the budget, in real terms this growth is negative; more of that – it is lower than GDP growth (which is also negative).

The reasons of these trends:

- the enormous share of the shadow economy as compared to the GDP (about 60%), a fact which generates ***fiscal evasion***;
- due to the enormous fiscal evasion the ***fiscal burden*** lies basically on ***fair*** tax payers, who are few in number;
- lobby of some initiatives to “exempt” the sanctions related to, and debts to the budget, a fact which entails the behavior of “waiting” for new “exemptions” in the future;
- financial indiscipline of economic entities from both sectors of economy, public and private.

The ***second,*** regards the budget policy in public expenditures.

Although the Republic of Moldova succeeded to carry out some reforms during the recent years, by way of modifying the role of the state, played in the national economy, the bulk of the budget expenditures remain still unadjusted.

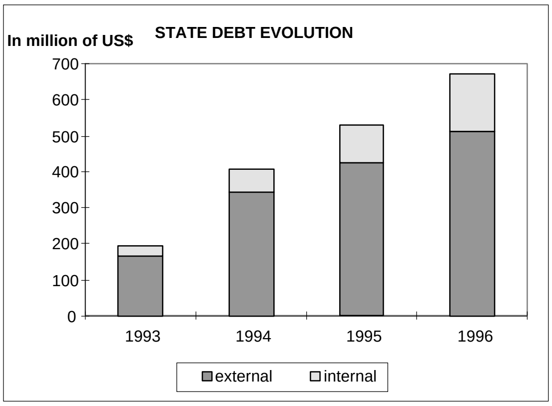
Thus, the budget expenditures designed for financing the state structures are not curtailed, although the role of the latter obviously decreased. On the account of public funds are funded some public institutions that overlap the functions of other public institutions. Moreover, these institutions’ activities is characterized by poor efficiency.

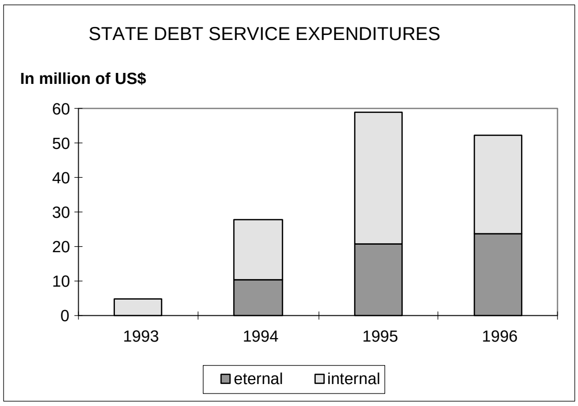
The approval of the Concept of social protection system reform is procrastinated, Medicare system, which could allow substitution of budget expenditures with private ones in this field.

Another issue represents the concept of reforming the state force bodies, designed for public order maintenance and state security, whose support also could be diminished in terms of public expenditures, provided the staff is reduced.

It is troublesome the situation of the budget expenditures pertaining to state debt servicing. The continuously growing trends of these costs demonstrate the difficult situation of the Government of Moldova regarding public debt. According to the trends established in the national economy during the last 5 years, we can state the fact, that Moldova is affected by so-called “***debt self-generation mechanism***” which can be described as follows: primary budget deficit grows→the volume of new loans increases →public debt increases→expenditures for public debt servicing rise→overall budget deficit grows→new loans are required→public debt increases again→ costs for public debt servicing grow, etc.

The way this "mechanism" works can be demonstrated as follows:





Note: 1996 expenditures for state debt servicing decreased because of diminishing of interest rate

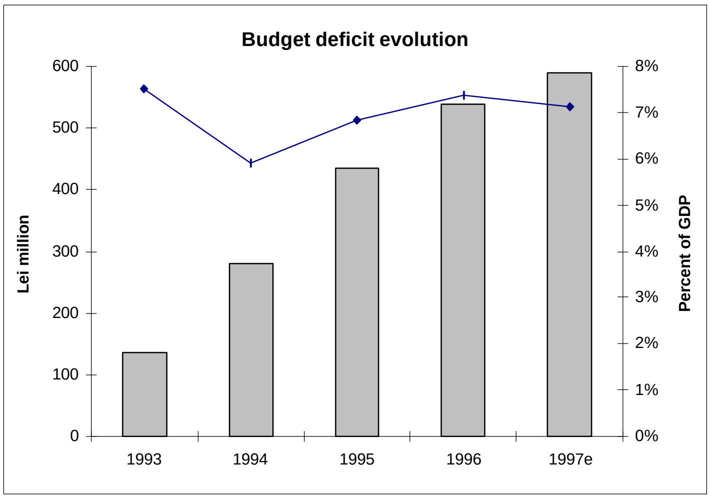
We point the attention to this mechanism, in order to prevent some macroeconomic decisions, which might aggravate even more the situation with the state debts and budget deficit. Certain priorities should be established in the budget-fiscal policy regarding the control and management of the state debt and budget deficit. More over, since the budget expenditures for servicing the huge state debt to a great extent ***substitutes the investment activity*** of the state**,** which during the recent years covers some current expenditures, without any available strategy or well determined policy on behalf of the state.

The budget expenditure can be reasonably utilized by way of applying the law on public purchases, which simultaneously could provide for generation of savings of budgetary resources in terms of energy resources, electrical power, food items, medicines, etc.

A particular discussion deserves the problem pertaining to the budget deficit. The positive trends of deficit diminishing, noticed in 1993-1995, and which unfortunately, have been entirely hauled and even started a reverse trend in 1996, as well as the estimates on 1997, allow us to ascertain the same negative trends.

The budget deficit can be the result of some policies or tools of improper policies, regarding the collection of revenue or/and incur of expenditure.

The revenues are collected with great difficulties and the situation can be corrected only in conditions of an economic growth or setting a transparent financial framework with some "stable regulations". It takes volition and time.



Much is discussed upon the fact, that a reorientation takes place of funds from the *real sector* of the economy (from industry, agriculture) to the *services sector* (banking, insurance, services). It is obvious, that the services sector is more attractive from the considerations, that the effect is gotten in a shorter period of time and at higher interest.

Typically, the state collects the budget incomes through taxes and duties levied on the industrial, agricultural enterprises, etc. In conditions of a budget deficit which is being funded via issuance of treasury bills, the budget (particularly the real sector of economy) incurs the costs required for servicing these securities, *i.e.*, the collected revenues to the real sector are redistributed to service, they flow out to the services sector. More of that, the revenues obtained by the services sector are not subject to taxation. Probably, due to these reasons we have a more or less stable banking system, whereas the real sector and budget encounter financial difficulties.

The budget-fiscal system reform premises

The analysis of the arguments "for" necessity to shift to market economy demonstrates that the fiscal system reform is not only a need for the sake of transition, but also component of the minimal complex of reforms required for assuring the realization of the transition itself.

The need of the fiscal reform is explained by at least three facts:
First, the incompatibility of the central planned tax system
with the market economy principles.

This argument can be proved by the example, that in all former socialist countries, as well as in Moldova, the fiscal laws were subordinated to some other laws, such as the law on payment of wages, law on pricing of production means, finished products, etc. Often in order to compensate the raise of salaries and production means costs, rather than raising the sale prices, they resort to diminishing the tax rates.

Or another example: often the authorities can announce the introduction of a new tax, and it gets a law nature (quasi-law), yet, they neither prepare the tax payer beforehand, nor ask his agreement.
And the last example: often the state knows which is the economic state of the tax payer and this fact also eases the tax collection.

Nothing similar could be characteristic to a market economy system. More over, the tax collection mechanism in a centralized economy essentially differs from that of a market economy.

Second, the need of fiscal reform derives from the interdependence of the economic system framework and from the fact, that in order to realize the transition period, certain reforms need to be serried out simultaneously. During 1996-1997 a generic understanding was profiled of the fact, that in conditions of the economic stabilization, at least 10 (!) reforms need to be implemented.

They include:
reform of the micro management system (new incentives, enterprises' autonomy, financial discipline);
pricing reform (price level, as well as the relative prices of goods);
creation of competitive markets;
fiscal reform;
financial system reform;
external sector reform;
macroeconomic regulation system reform;
setting some rights upon assets and liabilities in the economy;
creation of markets of production factors (labor, land, capital);
economic information system reform (statistics of the national accounts and enterprises' statements);

The fiscal reform, although it is a component of this minimal set of simultaneous reforms, needs to contribute to realization of other economic reforms;

Third, is difficult to reform national economy in conditions of macroeconomic instability. For achieving the stability it is necessary to subject to a strict control the budget deficit.

In the near future the budget related problems can aggravate, in the course of economic reforms implementation. This can be conditioned by the fact, that some economic reforms will require big amounts of additional short-term public funds, particularly, for economic infrastructure development, consolidation and reorganization of the industrial enterprises, funding bank losses and developing provisory programs aimed for social support of the unemployed and of socially-vulnerable.

Given that during the recent years it has been succeeded to partially fund the deficit by way of issuance of securities (Treasury Bonds), getting foreign loans and collections from privatization, it is quite probably, that the state will have to recourse to issuance of cash for funding the deficit, that is, to create premises for growing inflation.

The fiscal system reform is necessary not only for meeting the needs of the state in incomes for the transition period, but to enhance the budget incomes elasticity on the purpose to improve the budget situation for a medium term. In line with that, the fiscal reform needs to be carried out by taking into account the stimulation of private and entrepreneurial initiatives and contribution to privatization of state owned enterprises.

Taking into account the need to promote the budget-fiscal reform, as well as the Concept of Fiscal Reform in the Republic of Moldova, adopted by the Parliament in 1997, that establishes the concept and principal orientations of the reforms, the reform needs to be implement consistently. The fiscal reform is imminent to the transition period, for, it can be the only way of providing for budget deficit funding, without any hard consequences upon the fragile macroeconomic stability.

Reformation measures

Proceeding from the short-term objectives established in the Action Program of the Government for the period January 1997 – March 1998 the budget-fiscal policy should be oriented to consolidation of the financial system and particularly of the budget-fiscal sector.

The following should be done:

- elimination of the accumulated contradictions in the legislation in this area;
- diminution of the government role in the national economy due to create favorable environment for private sector development. It will permit a considerable reduction of state infrastructure financed from the budget, as well as the possibilities for diminution of fiscal burden will appear for stimulating of a next economic growth accompanied by accelerated investment activity;
- creation of the stimulants for consolidation of financial situation of real sector of economy especially through the redistribution of fiscal burden on those sectors of economy, which have capital inflow (banking sector, insurance), whose share in GDP structure is increasing but whose contribution to budget build-up is not significant. Elimination of the tax exemptions and implementation of *fair* taxation of all the economy sectors will permit a right reflection of financial flows to the production sector;
- definition of a clear list of taxes and duties admitted to be applied in the Republic of Moldova. Admissible tax rates have to be established for local authorities. It will permit to avoid expensive tax burden on economic entities and to offer opportunity of local governments to have their own fiscal policy;

- establishment of a principle, based on which amendments in fiscal legislation can be introduced not more than once a year – once with the adaptation of the annual budget. It will ensure fiscal rules stability and will avoid emergence of any unexpected tax circumstances;
- giving up of state guaranties. Special regulations should be established which will provide responsibilities and duties to public expenditures (e.g. monitoring of such credits, etc.);
- elimination of barter transactions between economic entities in internal and external economic relations;
- ensuring of a public acquisition transparency and, an efficient and reasonable usage of public financial resources. A severe control should be established on public expenditures at all stages of budgetary process and administrative responsibilities for non-destination expenditures of money;
- diminution of expenditures for central and local administrations taking into account that the role of the state in the economy is decreasing. The territorial-administrative reform as well as reorganization of central institutions aimed at their efficiency enhancement, should contribute to budget sources savings;
- reform of social infrastructure (Medicare, education, social protection, etc.);
- reform of military ministries and their structures.

3.5 Investment policy

Investment resources are an important factor for successful national economy restructuring, reviving the manufacturing sector and ensuring social prosperity. Insufficient levels of investment are particularly responsible for the lack of GDP growth in the 1995 – 1997 period, despite a sound financial policy by the National Bank of Moldova with regard to stability of national currency and reduction of inflation and interest rates.

In the 1990s, investment in the national economy has shrunk considerably (1990 = 100 %):

	1992	1993	1994	1995	1996	1997
Capital investment, total	67	32	16	14	13	12
including in:						
– manufacturing sector	48	22	12	11	12	11
– non- manufacturing sector	99.8	49	24	18	13	13

At the same time, composition of investment by source has changed: state investment has been reduced to 12.0 % of the total in 1997, while the share of private sector in total investment went up to 77.0 %. Investment of personal savings is still low (11.0 % of the total). Efforts to attract foreign investors have had relative success (5.5 %), but overall the process of mass privatization did not bring about a desired increase in investment.

The share of capital savings in the GDP structure is rather insignificant: around 16 – 17 % in 1991 – 1996 and 19,4 % in 1997. Budget crises, tax arrears and spending of about 50 % of the budget on social needs sharply reduced the level of budget investment: in 1995 – 132.8 million Lei, 1996 – 155 million Lei, 1997 – around 130 million Lei, or 4.2 % of total budget expenditure. The volume of investment from all sources amounted to no more than 12% of GDP in the 1991 – 1997 period.

Stimulation of investment activities at the current stage of transition will translate into increased capacity of the country in the future. In order to get over the crisis, the share of investment in GDP has to be raised to more than 25 – 27 % until 2005, which is the minimum level for the European countries in transition. Investment should be directed, in particular, to the