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ECONOMIC SURVEY

M o l d o v a i n T r a n s i t i o n

1

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CONTENTS

FOREWORD

The first issue of the Economic Survey: Moldova in Transition , submitted to your attention has been conceived by its authors as a research monitoring (analysis-forecast) publication of the national economy.

Economic Survey is aimed at filling in the almost empty niche - between the dispassionate materials of the Department of Statistical and Sociological Analysis and actively emotional publications in mass-media. The idea emerged within the UNDP/WB project Strategy for Development (Center for Strategic Studies and Reforms, NGO), with the support of other projects, under implementation in the country, including agencies ARIA, ARA, TACIS Moldovan Economic Trends, USAID Western NIS Enterprise Fund.

The timing of the publication is at critical points of the year - at the beginning (evaluation of the previous year, forecast for the next year); based on the results of the first semester, during the work on the economic forecasts, and budget for the next year; in the fall, when a good deal of the year is over and the trend and problems requiring adjustment are mostly evident. It is not less important the experience of other countries in transition, particularly the close neighboring ones.

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Any cooperation will be welcomed.

CHAPTER 1. SOCIAL ECONOMIC OVERVIEW: CURRENT SITUATION, SHORT-RUN OUTLOOK

The Republic of Moldova entered 1998 with a heavy burden of the social, economic and financial problems. Regardless to the discreet optimism concerning the results of the previous year (1.3% growth of GDP, 11.2% of annual rate of inflation, 0.3% devaluation of the national currency, 5% rise of real incomes of the population, diminishing arrears for wages and pensions), there are enough symptoms, that macrostabilization - the basic achievement of the initial stage of reform - is still vague, being caused by the delayed structural reforms in the real economic sector, incomplete restructure of the entire state administration system, as well as by the impact of the non-economic factors upon the situation in the country.

It is quite possible, that *1998/99 will be an even more critical period for the country in this decade*. The sharp decline of production output and social standards of the early '90-s were offset by "gobbling" previous accumulated national wealth, then, starting from 1996, the economy of Moldova got on the path of stable depression, of depleting resources, gradual cease of operations of the industrial production capacities, degrading raw material basis for foodstuffs production, stagnating R&D, population aging and health state worsening, destruction of social infrastructure as a system.

Moldova ranks among the last 1/3 of those 130 countries of the world in terms of GNP volume (US$ 2.3-2.5 billion, including Transnistria), below the 90th place, while in Europe it ranks together with Albania and Macedonia among countries with lowest incomes. Living standards indicators: men's average life (62 years) and women's (70), as well as the energy resources consumption per capita in Moldova is below the world average. The country's annual expenses for education and medicare is less than 3-5% of the GNP, as compared with expenses volume of the most European countries (1998 World Development Indicators. World Bank, March 1998). Nevertheless, *market transformation in the Republic of Moldova is irreversible*. Of 26 countries in transition, Moldova ranks in the middle in terms of liberalization of enterprise operations, prices and trade, privatization, inflation, legal basis and institutional structures of the market economy (Transition Report 1997. European Bank for Reconstruction and Development). In line with that, there is noticeable a lack of stability: the state budget deficit, constant tax arrears, chronic salary and pension arrears, non-payments and low profitability of most industrial enterprises, latent unemployment, state machinery corruption and, the state power is weak in providing for public order in the country. All these problems stem from the need to restructure the national economy, starting from enterprises up to its key sectors – agriculture, energy, industry and social sphere. For this purpose legal basis are required, investments, entrepreneurship and restructuring of privatized enterprises support, their profitability and competitiveness enhancement, export promotion.

Unfortunately, after the "big leap" towards market economy, undertaken by the Parliament and Government in 1993-1995, the pace of reforms was subsequently throttled back. If previously the "Economist" (March, 1995) wrote: "Moldova is the model of sound reforming, its compactness makes it a perfect laboratory of reform", afterwards, after a series of unsuccessful investment tenders ("Tutun", Cement Works from Rezina, "MoldTelecom"), repeated manifestation of "special interests" and fast extension of shadow economy, the image of the country faded away.

Already now the *shortfalls and mistakes of transition period* are evident: insufficient social compensation of reforms, procrastination of Civil Code adoption and incompleteness of legal base for reforms, non-respect of laws, low economic efficiency of state property privatization, delayed restructuring of industrial enterprises, including bankruptcy procedure, contradictory actions in agrarian sector (periodical cancellation of large farms' debts, slow land reform), energy complex monopoly, lack of state policy in employment, inadequate new conditions of the economic basis of the local-self administration.

The assumed predictions of immediate economic growth "in 1.5-2 years" after realization of macroeconomic stability did not become reality. The same failures occurred in other aspects: cutting down state expenditures, speeded up privatization, domestic market openness, etc. Year by year the state costs keep being "curtailed", whereas the difficulties of budget execution are growing. A good deal of state property has been already privatized, yet, the private sector output in terms of taxes and budget revenues is rather modest. The openness of the domestic market filled the country with low quality goods, including food items. The economy liberalization released from control the actions of the enterprises' senior management. Most functions of the sectoral ministries have died away, while the territories (municipalities, raions) have not been assigned due rights and resources. This is why the question arises of the role and responsibility of the state as initiator of reforms.

The Republic of Moldova is a new state of Europe, with unconsolidated laws, institutes and procedures of political economic and public life. And, unfortunately, amongst main reasons of stagnation delay is the permanent political and economic uncertainty, particularly manifested during pre- and post election periods, in conditions, when in the country the generally accepted strategy of the social-economic development and clear definition of procedure of working out its legal and management decisions are still missing. The interests of the country might be fully provided through a "cycle of political stability" in 1998-2000, when the long-run cooperation between the President, Parliament and the Government could considerably push Moldova towards reaching its strategic targets (Republic of Moldova: Key Problems and Strategic Priorities for National Economic Development. CISR, Chiºinãu, July 1997).

Proceeding from the real situation, *the majority right-centrist wing of the Parliament and their created Government, in May 1998, adopted a rather radical action program for 1998-2001*, including as priority measures on financial recovering, restructuring of production sector and social sphere.

Budget sphere recovering. For the purpose to overcome the crisis in the budget system, the Government will focus its efforts on:

- Enhancing efficiency of tax collection to the budget, first of all by diminishing and ceasing mutual settlements, providing primarily for cash inflows;
- Primary expenditures from the state budget are defined: payment of pensions, wages (including arrears) and compensations to the population; serving the state indebtedness; payment of expenditure arrears for energy resources; payment of medicines and foods for social sphere institutions (hospitals, ambulances, special schools, and others).

Energy sector restructuring. The Government will undertake measures to prevent financial bankruptcy of the given sector and to make it attractive for investors, through:

- Immediate adoption of legal and normative basis that regulates the activity of the energy sector in market economy conditions;
- Demonopolization, restructuring and privatization, creating adequate conditions in the manufacturing sector, transportation and distribution of energy resources;
- Improving the mechanisms of settlement of tariffs for electrical, thermal power and gas;
- Modification of privileges system;
- More ample collection of cash payments from companies and population for energy resources, by excluding mutual payments and settlements in kind.

With the purpose to develop the privatization program for 1997-1998, on June 25, 1998 the new Parliament adopted the concept of energy complex enterprises restructuring.

Agrarian reform. Considering the primary importance of the agri-industrial complex in the national economy and the need to enhance the effectiveness of reforms in this field, the Government will undertake measures in:

- Completion of land reform;
- Creation of land market, based on law;
- Suppression of "special interests" manifestations, that generate shadow economy, corruption and crime.

Privatization. The Government will undertake measures in removing the barriers, constraining the implementation of law “On privatization program on 1997-1998”, setting as cornerstone not only the budget interests, but also the emergence of the real proprietor, as well as attraction of investments. A particular attention will be paid to suppressing any illicit participation of state office holders in privatization process.

Social sphere reforms. Proceeding from the need to diminish the social cost of reforms and considering the financial possibilities of the state, the Government designs to:

- Determine the minimum set of social services, guaranteed by the state, and provide them to most needy layers of population;
- Carrying out the pensioning reform through introduction of respective amendments into legislation;
- Introduction of alternative forms of funding social services (medicare, education and others).

The anti-crisis measures adopted by the Government from the very first month of its activity (June 5, 1998), joined together the actions in the fiscal-budgetary system and in consolidating the financial basics of the social sphere.

The ground for this was a serious reason: *by the end of first half of 1998, the state budget in fact broke down*. Budget revenues have been collected only at 33% of the previously foreseen collections for the first half year (of that about 60% accounted for revenues from indirect taxes), the revenues of local budgets sharply declined, accounting for only 27% of the overall revenue of the consolidated budget. The greatest share of budget expenditures (over 50%) have been channeled unto three directions: current payments and paying-off salary arrears; purchase of energy resources and state debt servicing.

On June 29, 1998, the Government approved and submitted to the Parliament for consideration the amendments to the 1998 Budget Law, ensuring the foreseen level of revenues on the account of tax collections, increase of excisable goods’ list, sale of state property, etc., and this way to reduce, in line with that, its expenditures (by US$ 7.4 million) which triggered off a decline of budget deficit (by US$ 7.4 million). The amounts were diminished of state guaranties for foreign loans (from US$ 35 million to US$ 9 million), capital investments, expenses for agriculture, transport, communications and municipal economy. It was decided also to reduce the disbursements from state budget to Social Fund by 40%, which will entail costs reduction for compensation of electricity, heating, gas and pension transfers. As stated by the Prime-minister I. Ciubuc, “suggested measures are a serious surgery operation, but there is no way out.”

It is obvious that an implicit result of excises increase on gasoline and diesel, as well as elimination of TVA exemptions for diary products and bread, will generate a general increase in prices by about 10-15%, including by 20-25% for bread and diary products. This measure will certainly finalize the process of price liberalization for those products, but, on the other hand, extremely negative reactions from the population are inevitable.

Indeed, the Government has no more popular leverage, the variants of possible actions are less and less, because most of the anti-crisis measures have not been directed to activation of production, where from the economic growth should actually start from, but to averting the country’s insolvency.

The social-economic policy of the Government goes through a narrow corridor, along which most dangerous is the “debtor's prison”, built up by its predecessors. *The external debt* of the country as of January 1st, 1998, amounted to about US$ 1.3 billion (65% of GDP), and after the beginning of the year it continued to grow, basically on the account of energy resources. That critical level of debt was reached due to ineffective usage of foreign borrowings from abroad. Suffice it to say, that in 1994-1997 from 30 to 60% of the budget deficit was covered by means of foreign loans and credits. They were taken with the hope, that by the time when the state debt will reach a hazardous threshold, the economy will eventually activate, that the taxes inflow will rise, and, respectively funds for reimbursing the loans. However, by mid 1998 none of the mentioned above occurred. Meantime, if during 4 recent years the debt servicing took almost US$ 300 million, in 1998 will be required US$ 215 million, and in 1999 – US$ 235 million, under conditions of rather limited possibilities of getting assistance from abroad.

Regardless to the evident internal and external *threats of financial stability*, thanks to a highly professional approach of the National Bank (NBM), Moldova succeeded to up-keep in general, until very recently, a stable exchange rate of the leu, sufficient volume of forex reserves and a relatively low rate of bank credit (17% as of May 1998).

By mid 1998, however, the situation changed. Ministry of Finance borrowed “big money” on the domestic market, which entailed their shortage with the commercial banks. In June there was held, probably, the last credit means’ auction (refinancing rate rose to 22.5%) and the NBM stated its intention not to hold auctions in the future and shift to purchase-sale operations of short-run state liabilities.

Questions were also generated in relation with the securities auctions (Treasury Bills and Bonds), held by the Ministry of Finance. In order to settle them in the first half year of 1998 the Ministry of Finance paid incomes amounting to 57.5 million lei and, until the year end, in case the T-bills will keep being so profitable (32% per annum), their redemption will cost about 150 million lei There is a paradox: the state securities market altered from a fund supplier for budget deficit alleviation into an antipode – a negative balance emerged on T-bills’ payment and sale. High profitability of T-bills, on the one hand, and “firmness” of Moldovan leu, on the other (during January-May it devalued by less than 1%), generate uncertainties on: whether the forthcoming settlement of state securities will be delayed or, national currency will devaluate.

So far the NBM warns against that dramatic conclusion, yet, the entrepreneurs, investors and population require clearer guidelines concerning leu’s exchange rate position until the end of the year.

The situation created in the financial sector has a negative impact on the formation in Moldova of a domestic *investment system*, as well as on the inflow of capital from abroad. Creating conditions for investment inflow, first of all into the real economy, is the utmost importance long run task - it should also be taken into account in terms of its importance for renewing technologies and exports, generation of new jobs, increasing incomes of the state and population. The peak of direct foreign investments (US$ 64.0 million) occurred in 1995, then followed a two year decline. In the 1st quarter of 1998 investments amounted to US$ 15.9 million; subsequent expectations are linked to the sale of “MoldTelecom”, Cement Works from Rezina and other perspective enterprises and foreign companies’ involvement in infrastructure restructuring – energy sector, water supply system, hotels, tourism, etc. More than 1.3 thousand joint-ventures are registered in the country (with foreign capital worth US$ 146.0 million, or 58% of the overall), however their indicators are very modest in terms of employees (15 thousand) and export share (12%).

The situation can, and should be improved. Most important actions, that can have a positive impact upon the investment environment in the 2nd half year of 1998 are: demonstration of a political will by the Parliament and Government to move the problem from the deadlock, tender transparency and suppression of “special interests”, support of certain regions’ (Chiºinãu, Bãlþi, Gagauzia) and enterprises’ initiatives. Investment inflow can be opposed by some attempts to revise and cancel privatization results, state machine’s strive to “keep under control” profitable objects, discrepancies related to land market development, artificially maintained status of “missing real owner” at the enterprises in the post-privatization period.

Political will of the new Parliament towards reforms will be displayed already in July, since the President P. Lucinschi made an appeal suggesting to urgently adopt the amendments to the state Budget Law on 1998, the law on pensions and a packet of laws on administrative-territorial reform. Shouldn’t this occur, the Parliament and Government will hardly make the year of 1998 a turning point, in terms of putting the country on the way of sustainable development, although both right-centrist majority and opposition keep declaring their strive to do so.

Even if the opposition does not count on a long "longevity" the current Government, the Parliament cannot afford to lock itself in one year cycle governing of the country: elaboration of the annual program, budget law adjustment in the middle of the year, and eventually – promises to start economic growth from the next year, etc. In a series of countries, for instance, there is a practice of budget-fiscal planning on three year basis, in connection with a forecast of economic growth, inflation tempo, refinancing rates, and other indicators. They are adjusted on yearly basis, in compliance with changes in the economic conjuncture, government policy, etc.

It would be arguable to consider, that the social and financial problems of the Republic of Moldova aggravated in 1998 only because of unconditional fulfillment of IMF and WB recommendations. In part, this is justified as regards the pace and methods of "popular/mass privatization", rejection of protectionism, in weakening the role of the state in managing the transition period. One of the main reason of the created situation, is lack of long term action plan and succession in the governments' actions, prevalence of tactical decisions related to "burning questions". There were attempts to develop middle-term strategy of the social economic development of the country, however, they haven't been formally recognized (*Strategy of the National Economy of the Republic of Moldova Till Year 2000* (Draft). Ministry of Economy. Chiºinãu, 1996; *Strategy of Social and Economic Development of the Republic of Moldova During the Period Till Year 2000*; Center for Market Problems Research, Academy of Sciences of Moldova, and Ministry of Economy. Chiºinãu, 1996; *Republic of Moldova: Strategy for Development.* Center for Strategic Studies and Reforms. Chiºinãu, January 1998). A fundamental question is still unsettled, regarding the *coordination of market liberalism and regulatory role of the state.* Particularly it is meant, the state regulatory system of strategic development of the economy of the country. The state ownership of production means should be substituted by the right of the state to guide the strategic development of the country.

Taking into account all these circumstances, it is high time, when 1998/99 is a critical period for the fate of the of the country, that the Parliament and the Government undertake the complex of actions with cumulative, long-term effect in the main fields:

real budget, fiscal stabilization and control of arrears;

post-privatization restructuring of not less than 100-120 enterprises of the key industries (financial recovering, management improvement, attraction of investments, enhancement of competitiveness);

land reform and restructuring of agricultural enterprises - over 700 farms, land market development and of a system of lending to infrastructure and servicing new types of agri-businesses;

reorganization of *energy sector* – privatization and decentralization of manufacturing sector, transportation and distribution of energy (Moldenergo, Tirex Petrol, Termocom), revision of tariffs for consumers;

enhancement of economic and social results of *privatization*, sale of enterprises for cash and of land plots under privatized enterprises;

social sector – two priorities: revision and alteration of social protection system (in favor of needy social strata, with a view to eliminate the debts to the population from state budget); performance of pension reform.

Besides those issues, typically discussed by the Government with IMF and WB, there at least two more problems, requiring constructive efforts of the Presidency, Parliament and Government, are: (i) *reorganization* and enhancement of effectiveness of the *state machinery*; (ii) administrative territorial reform, federalization of budget and shifting to local *self-administration*. The argument favoring the urgent solution of those issues are evident: Moldova is a new state, the administration system is weak and ineffective, which is directly reflected in its corruption and involvement in informal economy. In new conditions, when the economic agents are independent and the methods of branch based management (basic in soviet economy) have died, the role of territories should be enhanced (municipalities, raions). Without a needed legal basis, sufficient incomes to local budgets and municipal ownership, the social and economic reserves of the territories won't be effectively used. And now they are also mostly involved in shadow economy. In addition to that, only based on economic grounds and European standards of local self-administration ultimately there can be resolved the problems of Transnistria and Gagauzia.

Thus, judging by the results of the first half year of 1998 of the social-economic development of Moldova, there are nor substantial positive trends. The CISR forecast (Dec. 1997) of a 3% GDP growth in the current year, according to the results of the first half-year, probably will be adjusted to lessening. The emerged some expectations at the beginning of the year, related to recovering from the stagnation and turning to a positive economic trend, was not justified. Moreover, threat emerged in the financial sector. The economy is still "hanging-on" on the edge of "fall or rise", and its further orientation depends on the coordination of the President, Parliament and Government, on the political situation in the country. Its stability will undoubtedly contribute to economic ice-braking. And conversely, continuation of political uncertainty, particularly its aggravation, will aggravate the economic situation and living standards of the population.

CHAPTER 2. MACROECONOMIC TENDENCIES

The year 1998 will be year of big endeavors, including tough acceptance of the simple truths of economic realities such as: that we can not consume without paying; nobody is willing to support or to credit someone else forever; it is impossible to continuously accumulate external debt without having the capacity to reimburse it; market mechanisms imply revenue distribution according to individual and group performance; unity and social solidarity are easier to realize in a society which is doing well; in open systems performances are estimated in relative terms (it is important not only what we are doing, but what our neighbors are doing).

2.1 Budget and fiscal policy

2.1.1 State budget and public finance

During the last 2 years budget and fiscal policy has been in the center of social and economic life of Moldova. Acute social and economic problems are the result of delays in structural reforms, inefficient public finance spending, which is used only for covering current state's expenditures (wages, pensions and their arrears, public debt servicing). But even these positions are under financed.

There are some internal constraints in the Republic Moldova which impede a stimulatory fiscal policy for the productive sector of economy. This sector should become a catalyst of economic development for the near future. These constraints are the following: ***political constraint*** (uncertainty linked with Transnistria region, or low viability of executive bodies); obsolete ***social infrastructure,*** having a low efficiency and high costs, which is actually waiting for budget allocations only; ***external and internal state liabilities*** related to public debt servicing; ***significant share of shadow economy*** which is tending to take under control the activity of economic entities, in both private and public sectors.

The insufficiency of public finance is caused by a number of factors, the main being:

- state's integrity problem, and non-existence of clear borders, with specific attributes (such as customs etc.). This results in imports of goods with no excises paid;
- significant and increasing share of shadow economy as share of GDP, as well as of tax evasion;

- limited transparency of the tax system in Moldova, having a large list of tax exemptions applied to the main budget revenue sources;
- corporate interest for tax forgiveness;
- big number of payments in kind, as well as of netting out in the transactions between economic entities and with the budget;
- inefficient and non transparent usage of financial sources, which are already insufficient (especially for energy resources, medicines, subventions).

In spite of achievements in 1997 regarding tax collection (the budget was realized at 110% comparing with the approved one), the problem of budget deficit still remains quite actual.

The budget deficit, which amounted to 692 million lei, or 8% of GDP (preliminary data), had a trend of increasing, comparing to 1996.

Dynamics of budget indicators (in million lei)

	1995	***1996***	***1997***	***I Q. 1998*****
Revenue, including Social Fund	2556	2835	3473	518.4
as % of GDP	39%	37%	40%	
Expenditure, includig Social Fund	2993	3418	4165	546
as % of GDP	46%	45%	48%	
Deficit, including Social Fund*	437	583	692	27.6
as % of GDP	7%	8%	8%	
GDP	**6480**	**7658**	**8655**	

* - according to Public Finance Statistics and new Budget Classification

** - excluding Social Fund

The increase in budget revenues in 1997 was achieved mainly due to:

- huge number of netting out transactions (about 37 percent);
- non fiscal revenues, such as military equipment, which were not initially included in the budget;
- increase of excise tax rates for petrol products;
- insignificant improvement of tax administration (due to enforcement of the Law No. 633, however the costs resulted from implementation of this Law are very high).

During the 1st quarter of 1998 comparing to the same period of 1997 tax collection to both state and local budgets is as follows:

	1997			**1998**		
1st quarter	state budget	local budgets	consolidated budget	state budget	local budgets	consolidated budget
TOTAL REVENUE	305596.5	160555	466151.5	394832.6	124112	518944.6
1. Current revenue	302588.8	157963	460551.8	380250	119159	499409
1.1 Fiscal revenue	222214.2	138125	360339.2	265985.2	98194	364179.2
1.2 Non fiscal revenue	80374.6	19838	100212.6	114264.8	20965	135229.8
2. Capital revenue	3007.7	2592	5599.7	14582.6	4953	19535.6

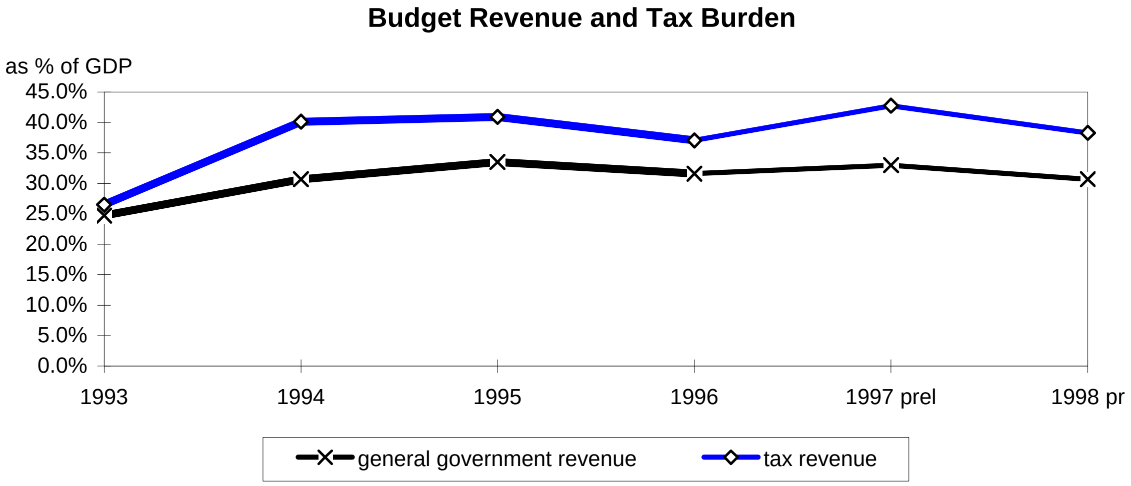
As it is presented above, a diminishing trend in tax collection is recorded at local budgets. These reductions are mainly coming from the income tax and property tax, which have decreased in absolute amount.

Tax burden. In spite of all achievements in tax collection in 1997, there still exists one negative aspect. And if the said achievements are for a short term period, then the negative aspect could have effects throughout a medium term period. The problem is the tax burden increase in the Republic of Moldova, and this increase is quite important if comparing to the evolution of this indicator during 1993-1996. But if we would take into account the grown number of tax exemptions, especially in 1996-1997, then we conclude that the tax burden is not distributed fairly through the sectors of economy. Moreover, even within some particular sectors the tax burden is not distributed equally between economic entities.

Budget Revenue and Tax Burden

	1993	*1994*	*1995*	*1996*	*1997 prel*
General Consolidated Budget Revenue, mln. lei	488	1847	2556	2835	3473
As % of GDP	27%	39%	39%	37%	40%
Tax Revenue, includig Social Fund, mln. lei	450	1454	2171	2418	2857
Tax Burden, %	24.7%	30.7%	33.5%	31.6%	33.0%
GDP in currebt prices, mln. lei	1821	4737	6480	7658	8655

Note: in 1993 the above indicators as a share of GDP are not relevant, because the volume of GDP in current prices is much more "sensible" towards the level of inflation, comparing to budget revenue.



Some conclusions should be made from the above said:

- in spite of statistical data, indicating that private sector share in goods production and services is increasing, the state had an expanding role in the GDP distribution in 1997. This could generate a new substitution of private sector by public sector;

- tax burden in 1997 increased by 2.4 percentage points comparing to 1996. WE refer here to the general tax burden in the economy, but some sectoral calculations (N. Culeabin, Institute of Economy of the Academy of Sciences) prove that in several sectors (such as the industry) tax burden reaches almost 60 percent. Inadequate sector distribution of tax burden was generated by a lot of tax exemptions given to some brunches or some economic entities, by "forgiving" of some liabilities, and by rescheduling the payables to the budget of certain economic entities etc. – all these under the conditions of growing needs of public sector;

- the growing tax burden and/or fast extension of corruption and protectionism generated in 1997 an increase of turnover in shadow economy, and respectively of the tax evasions. Thus, by increasing the excise taxes on gasoline (by 3 times) and diesel (by 2 times), a growth of income was expected at the same rate. But they were lower, because of inefficient control over the import of such products and lack of customs facilities at the borders with the Ukraine (or with Transnistria). The same is the situation with tobacco products imports: according to the Law on Budget for 1998 excise taxes on cigarettes have been reduced and unified. According to economic laws a drop in retail prices in the market was expected, but that did not happen. Consequently, the cigarettes' importers received huge profits, while the budget is still losing on that.

Analysis of the retail prices structure of the petrol products and tobacco products shows that in Moldova the excise rates for these items are amongst lowest, compared to several developed countries and neighboring countries.

Out of this consideration, we are supporting the increase (up to the level of 1997) of import excises for gasoline and diesel, as well for tobacco products, no matter which their country of origin is.

It is clear, that the need for ***reducing budget expenditures*** is imperative, and there is some room for maneuver here:

- reform of public administration, both central and local. It is impossible to maintain such over-staffed state apparatus, which can be characterized as inefficient, low paid and sometimes ***morally obsolete.*** Regretfully, the hopes that the structure of Government will be revised, and personnel – reduced, can not be realized after the new Government structure was approved already.

In the GDP structure public consumption is increasing, in spite of the decreasing role of state in the economy. This seems to be a paradox.

GDP structure by consumption
(as % of GDP)

	Final consumption				***GFCF***		***Exports***		***Imports***	
	Private		Public							
	1990	*1995*	*1990*	*1995*	*1990*	*1995*	*1990*	*1995*	*1990*	*1995*
Bulgaria	54.1	70.3	19	15.5	18.2	14.2	43.5	44.7	39.2	44.9
Czech R.	50.6	57.8	19.4	19.5	28.6	28	…	51.1	…	56.3
Cyprus	60.1	60.3	17.4	16.5	24.7	19.9	51.6	46.6	57.1	53.4
Estonia	64.4	58.1	13.2	23.8	30.2	25.6	…	75.8	…	84
Hungary	54.8	54	35.7	24	20.9	19.1	32.8	34.4	33.7	36.6
Latvia	52	59	8.8	20.3	23	16.6	47.9	47.3	49	49.4
Lithuania	54.9	69.5	11	19.8	28.8	21.4	54.2	53.6	63	65.4
Moldova	**40.4***	**69.9****	***15.5****	***25.9*****	**15.5***	**19.8****	**39.6***	**53.9****	**51.3***	**74.1****
Poland	48.5	63.1	18.7	17.6	21	16.9	28.6	25.9	21.5	24.6
Romania	65.9	68.6	13.3	12.2	19.8	21.9	16.7	27.8	26.2	33
Slovakia	53.9	49.3	21.9	20.3	31.3	29.4	…	63.5	…	61.7
Slovenia	53.2	57.9	17.4	20.2	18.8	21.2	90.8	54.2	78.5	55.5

* - for 1993
** - for1996
GFCF – gross fix capital formation

As it is presented above, countries which have reduced public consumption and promoted structural reforms became more efficient (for example Hungary, Poland, Slovakia).

- Reform of social protection system and social ***benefits***, which have not been restructured yet. What is meant here is the approval of the respective legal framework and its implementation;
- Military bodies reform;
- Implementation of a transparent mechanism of public procurements.

If these reforms continue to be delayed in 1998, then the period of 1999-2000 is coming, when budget expenditures for debt servicing will be at a critical point, and nobody would know how to “save” the country.

Wages and pensions arrears. The problem of arrears on wages and pensions remains to be the main problem of 1998, as it was in 1997. As of January 1, 1997 the arrears have been frozen and the payment schedule was approved. Thus, population served as a Government creditor during 1997, and the Government was a beneficiary of this “preferential” credit, without any interest and maturity, and real sources for repaying it.

Although by the end of 1997 the arrears were diminished down to 90 million lei, through other loans (especially from international financial organizations and borrowing on external markets), the arrears as of May 1, 1998 increased considerably, for pensions – up to 230 million lei, for budget wages – up to 150 million lei.

It is not clear where the funds for increasing wages by 30% for budget employees (according to government’s decision No. 231, March 1998) will be taken from. It is crucially needed to abrogate this decision, in order to avoid worsening of the situation of arrears.

At the same time, for the first quarter of 1998 the budget revenue is lower comparing to the forecast. External financing is quite limited, and internal borrowing is more expensive for the budget, also having a negative impact on banks’ interests rates.

One question arises: where will the government be getting the money from, or which expenditure account should be cut down?

It is vital to sequester budget expenditure.

Budget deficit and public debt. The level of public debt and state’s capacity to service it are very important issues in describing the financial situation of the state.

It is clear from the very beginning that the approved level of budget deficit of 350 million lei will be exceeded (under the conditions of revenue shortage and arrears at almost all expenditure items) just because the infrastructure of budgetary institutions as well as their functions remained unchanged. Anyway, in the end it is not that figure, but the ***primary budget balance*** which is most important for an adequate policy regarding deficit and public debt management. Primary balance shows if during the year new borrowing was or wasn’t used for financing current expenditures.

Based on budget indicators evolution during 1994-1997, we can see that although the tendency for approving a positive primary balance persists, at the end of fiscal year the situation goes vice-versa. And the authorities’ efforts to manage the public debt and to diminish total amount of public debt will not be successful, unless during the next 5-7 years a positive primary balance with an upward trend is not achieved.

The evolution of budget balance (million lei)

	1994		1995		1996		1997		1998	
	approved	*actual*	*approved*	*real*	*approved*	*actual*	*approved*	*actual*	*aprobat*	*est*
Overall balance	-241.5	-280.3	-300	-374	-350	-752	-330	-666.7	-350	-550
Debt service	109	118	180	265.2	250	242.8	379	377	450	430
Primary Balance	**-132.5**	**-162.3**	**-120**	**-109**	**-100**	**-509**	**49**	**-289.7**	**100**	**-120**

Note: “-” sign represents a deficit

* - in 1994-1996 according to the methodology of the Ministry of Finance

With all respect towards the sustained efforts of creating and strengthening, during 1995-1997, the internal financial market, mainly T-bills, still, it is necessary to limit the state's presence in the internal market. In case of Moldova the state should implement a policy of securities' issuance within the amount needed for repurchasing existing Treasury Bills and Bonds. As a result of this policy, the internal debt will not increase, which according to the Budget Law for 1998 could increase by another 320 million lei. In case when the state will not borrow that amount – it could be available for economic entities at lower interest rates. And this would stimulate an increase of economic activity.

It is well known that external financing is *cheaper* comparing to internal one, but access to external resources depends on the credibility and country rating of Moldova on international markets. And both of them, as well as the slow pace of reforms during the last 2 years, led to a halt of financial assistance from international financial organizations. And their decisions are obviously signals to other potential investors into the Moldova's economy. It is clear, that investment and credit risks for Moldova have increased during the beginning of 1998.

2.1.2 Transitional budget in 1993-1998: a critical review

The transition from a plan to a market economy calls for almost a wholesome reinvention of government, as its role in production and distribution requires considerable transformation and reduction. This has been done to various degrees, and under different conditions in various economies undergoing transition. Although most governments' machinery has shrunk during the recent transitional reforms, it is not always proportionately reflected in the size of the government budget, as discussed below.

GDP and Government Consumption as % share of GDP; 1993-1997

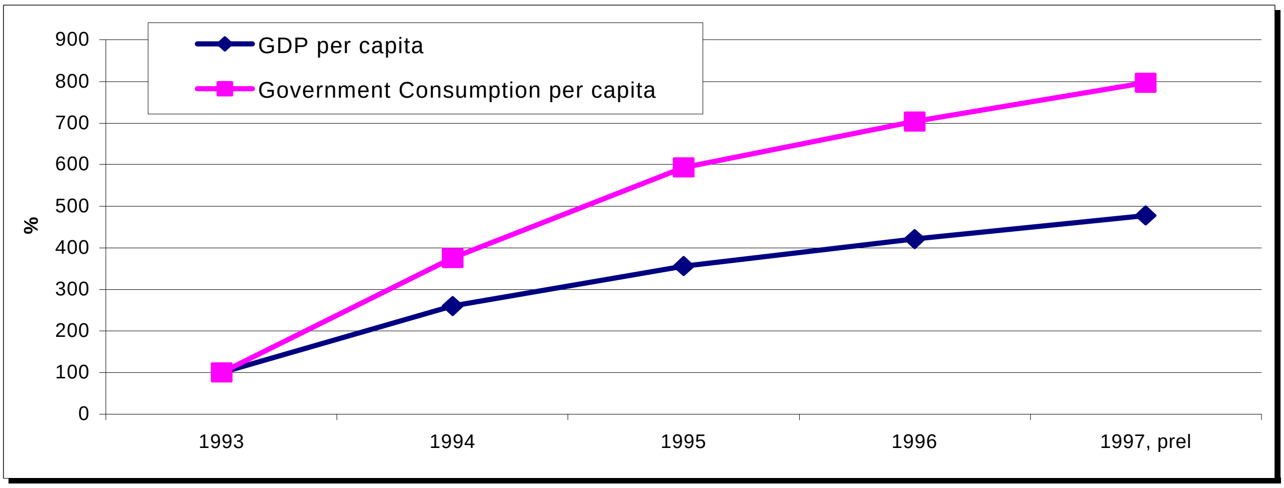
	1993	1994	1995	1996	1997, prel
GDP (lei million - current prices)	1821.0	4736.8	6479.7	7657.9	8655.0
Government Consumption (lei million - curent prices)	282.7	1065.3	1678.4	1987.1	2242.0
Share of Government Consumption in GDP, %	15.5	22.5	25.9	25.9	25.9
GDP (lei million - constant prices 1993)	1821.0	1258.3	1234.4	1135.7	1150.4
GDP per capita (lei - current prices)	504.7	1312.5	1797.9	2127.2	2408.0

Source: Based on the data from the Department of Statistical and Sociological Analysis

As observed from table above, the share of the government expenditure has increased between 1993 and 1995, and remained unchanged until 1997. This is despite the fact that in real terms, the total GDP has actually declined by 36 % over the period concerned. Further, a comparison between the per capita income and the per capita government consumption reveals a much faster growth in the latter over the same period, at an increasing differential rate.

Graph below illustrates the widening gap between the income and government consumption per head.

Graph 1. Nominal Annual Percentage Change in GDP and Government Consumption (1993 = 100); 1993 –1997



Source: Based on the data from the Department of Statistical and Sociological Analysis

In Moldova the total government spending is made up of State budget, Local budgets and Social Security budget. The combined State Budget and the Local Budgets comprise the Consolidated Budget.

A schematic review of the public sector's share in the GDP in the last years is presented in the following table:

Consolidated Budget as % share of GDP; 1996-1998

	1993	1994	1995	1996	1997, ap.	1997, prel	1998, ap.
GDP (lei million, excl Trans.)	1821.1	4736.8	6479.7	*7 317*	*9 100*	*8 655*	*10 100*
Revenues (%)	20.4	30.4	31.4	28. 35	28. 8	34.0	29. 2
Expenditures (%)	28.0	36.3	37.3	38. 64	32. 42	41. 7	32. 7
Budget Balance (%)	-7.5	-5.9	-5.9	- 10	-3.6	-7.7	-3. 50

Source: Ministry of Finance and Department of Statistical and Sociological Analysis

Here also it is noted that the share of total government expenditure has been on the increase compared to 1993, with a record high of 42% in 1997. However, the large gap between the government consumption and the government total expenditure poses a number of critical issues, including the pressure for subsidies, especially for energy and loss making enterprises, as well as bad debts and debt servicing.

Official data also show that the consolidated budget revenue share of the GDP increased each year from 1993 - 1995, with a slight fall in 1996. Figures for 1996 - 1998 indicate a rise in the revenue's share of the GDP in 1997, with an almost equally large fall in 1998 approved budget from 34 % to 29.2 %.

Finally, figures for budget deficit show a record high for 1996, and the actual deficit for 1997 to be double as anticipated in the 1997 approved budget.

The following table provides a general picture of the changes in the consolidated budget for 1996-1998 (excluding Transnistria).

Table 3. The composition of consolidated budget balance; current prices (lei million); 1996 1998

	1996	1997, ap.	1997, rect.	1997, prel	1998, ap.	01-04,1998
State Budget Revenue	1249.2	1916.5	1875.0	2119.0	2289.9	494.0
State Budget Expenditure including transfers	1697.1	2246.5	2475.0	2726.1	2639.9	573.5
State Budget Balance	-447.9	-330.0	-600.0	-607.1	-350.0	-79.5
Local Budgets Revenue & transfers	1050.6	984.5		1255.7	948.2	287.4
Local Budgets Expenditure	1355.4	984.5		1403.7	948.2	303.2
Local Budgets Balance	-304.9			148.0		
Consolidated Budget Balance	-752.7	-330.0	-600.0	-666.8	-350.0	-93.2

Source: Based on data from Ministry of Finance

At first glance, it becomes evident that the state budget revenue grew at a remarkably high rate of 70% in 1997 as compared to 1996. The figures for the 1998 budget suggest that there will be an increase of 8 % for 1998, fairly higher than the earlier estimates of 5.2 %. The local budgets' revenue has been reduced by some 25 % for 1998, with almost half of it already accruing in the first quarter. Again, the reduction is larger than the 16 % as originally predicted. On the expenditure side, the approved state budget is also anticipated to have a growth of 17.5 % over the approved budget of 1997. The figures for the first four months of 1998 show a less than proportionate deficit of 93.2 million lei, compared to the anticipated annual figure of 350 million lei.

Budget revenues in Moldova, in line with the international standards, comprise taxes, non-tax revenues and capital operations revenues.

The table below gives a picture of the structure by source, and its changes over 1996-1998.

Table 4. Structure of consolidated budget by source of revenue as % share; 1996-1998

	1996	1997, ap.	1997, prel	1998, ap.	1-03,1998
Revenues, total (million lei)	2074.16	2620.60	2942.40	2950.00	518.39
		% share in revenues			
1. Tax revenues	79.84	82.81	78.11	79.32	
Direct taxes	34.19	28.62	23.13	23.39	21.72
- profit tax	17.29	14.50	8.30	11.19	8.76
- income tax from indiv.	10.56	8.78	9.55	5.42	10.36
-land tax	5.58	4.39	4.26	5.08	1.81
-on real estate	0.75	0.95	1.02	1.69	0.79
Indirect taxes	43.64	52.47	50.24	55.93	45.38
- excise taxes	9.47	16.79	13.65	20.34	14.08
- VAT	29.60	30.53	32.26	30.51	25.35
- taxes for external operations	4.57	5.15	4.33	5.08	5.95
2. Non-tax revenues	20.16	17.19	13.62	19.08	
- revenues from property and entrepreneurship activity			10.19	6.78	
- other non-tax revenues	18.35	14.12	3.44	12.31	
3. Capital operations revenues	1.82	3.08	8.24	1.59	
Total	100.00	100.00	100.00	100.00	

Source: Based on data from Ministry of Finance

Revenues from direct taxes have been steadily decreasing their share from 34.2 % in 1996 to a predicted low of 23.4 % for 1998. In this category, only real estate tax shows slight increase (due to revaluation of fixed assets of economic agents and real persons), with the rest falling, especially income tax from individuals. This confirms the difficulties in identifying the income sources of individuals, as well as the discouraging impact of tax rates on the declaration of profits. By contrast, the relative share of indirect taxes in the revenue has been on the increase, especially with regards to excise taxes. The growth of tax revenue for 1997 is explained both by the increase in the taxable commercialized volume of products by 15-20 %, and by the increase in the average value added tax on the volume of sold products compared to the level of 1996. These are mainly linked to the recent structural changes in the manufacturing, raw material and consumer goods sectors. According to the 1997 State Budget Law, there were some concessions on VAT to certain types of producers amounting to lei 301.5m during 1997. This included tax benefits for bread production and sale (lei 73.1m), for milk and dairy products (lei 20.3m), for plant and animal production (lei 155.6m), for public utilities (lei 26.6m) and for natural and liquid gas (lei 9.3m).

The double increase of excise taxes was caused by increasing the rates on some domestic products (cognac, non fermented tobacco), undertaking some concrete measures over controlling the excise collection by State Tax Service, Department of Financial Control and Inspection as well as by customs authorities, and licensing the imports of gas and diesel.

In the non-tax category, incomes from privatization are likely to increase their share more than threefold. This is not surprising given the present phase of accelerated privatization.

However, as this should be only considered as a transitory source of revenue, a more far-sighted view of the future budgets should consider alternative sources in its place. On the same note, it is important to emphasize that the primary objective of privatization ought not to be raising revenue for meeting the budget expenditures, as is believed to have been the case in a number of CIS countries, including Moldova.

According to the information from the Ministry of Finance, in the first quarter of 1998 the collected revenues in the consolidated budget stood at lei 518.4m or 17.6 % of the annual planned figures. The state budget revenues constituted lei 394.3m; at a similar proportion of 17.2 % of the annual planned figures. The figures for the local budgets are lei 221.9m at 23.4 % of the annual planned figures. The first three months of the 1998 have observed a positive tendency in the collection of the income tax from individuals. The amount collected stood at lei 53.7m, which is about 33 % of the annual planned figures. The amount collected from the VAT, excise taxes, and profit tax stood at around 11-14 % of the annual planned figures. Moldova still has many unprofitable enterprises, where in a vast number of branches they are making considerable losses. This is likely to worsen further especially owing to the increase of the energy and other imported inputs share in the cost of production. This problem may largely explain some of the difficulties in collecting taxes.

Because of the seasonal character of activities of the main sectors, there is a tendency for the revenues to accrue more during the second half of the year. By way of example, in 1996 and 1997 respectively 32.0 % and 42.5% of the total revenues were collected only in the last quarter of the year.

Looking at the structure of expenditures as provided in the following table, we observe that the largest items of expenditure have been education and health throughout the period concerned, although at a falling rate. Comparing the figures for approved 1997 and preliminary (actual) figures, it is noticeable that the share of government expenditure on health care was smaller that predicted. Health care and education are both essential development concerns, and so far they have been rightfully held at the top of the government priorities in Moldova. The third largest item though is the public debt service, rising at an alarming rate from 8.6 % to 14.2% over the period. This is a rate of growth of 65 % over the period and of 30 % in 1998 over 1997. Capital investment, by contrast, has remained at a stagnant, low proportion of the public expenses.

Table 5. Structure of expenditure in the consolidated budget by % share; 1996-1998

	1996	1997, ap.	1997	1998, ap	01-03,1998
Expenditures, total (million lei)	2827.0	2950.6	3609.2	3300.0	546.0
% share in expenditures					
General State Services	3.85	2.99	3.85	2.58	4.93
Foreign Activity	1.03	1.50	1.03	1.06	0.47
National Defence	2.50	2.36	2.50	1.82	2.37
Juridical Authorities	0.73	0.87	0.73	0.62	0.86
Public Order & National Security	6.30	6.96	6.30	6.10	6.28
Education	28.42	24.19	28.42	21.79	23.80
Scientific Research	1.06	1.40	1.06	0.91	0.98
Culture, Arts, Religion, Sports	2.19	2.31	2.19	2.35	2.11
Health Care	18.46	17.39	18.46	15.31	16.22
Social Security and Support	5.91	14.21	5.91	16.69	17.81
Agriculture, Forestry, Fishery	3.74	2.52	3.74	20.06	1.69
Environment Protection	0.23	0.29	0.23	0.25	0.23
Industry and Constructions	0.11	0.59	0.11	0.08	0.07
Transport, Road Administration, Communication & Informatics	2.88	4.31	2.88	3.74	3.27
Public Utilities Administration & Use of Housing Stock	2.52	1.58	2.52	1.06	1.35
Complex for Fuel & Energy	0.04	0.01	0.04	0.01	0.01
Public Debt Service	8.60	12.84	8.6	13.64	13.21
internal		6.40			
external		6.44			
Completing State Reserves	0.32	0.29	0.3	0.28	0.09
Other Services Related to the Economic Activity	0.39	0.27	0.4	2.71	0.17
Other Expenditures, not included in main groups	5.05	2.23	5.0	0.78	19.98
Capital Investments	5.49	4.41	5.5	5.45	2.13
Total expenditure	100	100	100	100	100

Source: Based on data from Ministry of Finance

On the expenditure side there is a need to restructure the major items of expenditure, especially education and health, where capital and administrative structures are not necessarily appropriate for modern conditions. However, effective restructuring takes time to plan and then to implement. In Moldova, as elsewhere in the CIS countries such programs are mainly at the planning stage. Until implementation is possible, the squeeze on expenditures will affect standards in these critically important areas of human and social capital.

In the first quarter of 1998 the consolidated budget expenditure constituted lei 546.04m or 16.5 % of the planned annual figures. The share of the state budget expenditure was 79.4 % of the total consolidate budget expenditure, and 16.4% of the annual figures. The priorities receiving state financing were the education sector with lei 129.9m, or 23.8% of the total expenditure, social security and support with lei 97.3m or 17.8 %, health care with lei 88.5m or 16.2% and the public debt service with lei 72.1m lei or 13.2 % of the total state budget expenditure in the first quarter of 1998.

On the 1st January 1998, Moldova's external debt reached $ 1192 million, an alarming 64 % of the GDP. This is a critical level for any economy with serious limitations on export earnings and creditworthiness, such as Moldova. Equally critical is the fact that all the external finance is directed to the external debt service. In 1997 the external debt service was about $150 million, that is over 20 % of the total consolidated budget revenues. At the same time the new external loans for 1997 were in fact less than the debt service paid in the year by $20 million, standing at $130 million. Should the current trend continue over the next few years, it might surpass being critical, as it will become impossible to sustain. In 1998 Moldova will have to spend $215 million for the external debt service. This will make it difficult for Moldova to borrow externally by issuing new Eurobonds.

Financing of the budget deficit

The figures for the end of 1997 show that the budget deficit stood at 7.7 % of the GDP or 2.1 points less than in 1996.The preliminary figures for the first quarter of 1998 show that the budget deficit stood at lei 27.7m. The deficit was covered both by internal and external borrowing. Notably, 91% of the total deficit of the consolidated budget belongs to the State Budget.

Internal financing is carried out by raising loans from The National Bank of Moldova and commercial banks, and issuing state securities. The loans from the NBM represent 52 % of the internal state debt while those from commercial banks constitute a much smaller share of 1.3 %.

During 1997 some lei 1190.8m worth of State Securities were sold; showing an increase of 68 % percent as compared to 1996. Most profitable are the 91-day securities, the reasons being higher profitability and a more attractive maturity period compared with other securities. The highest interest rate here is a reflection of the adjustments to perceived risk attached to an emerging economy's debt following the problems in Asian markets. This can be explained by the abolition of taxes on State Securities operations. In 1997 the Ministry of Finance allocated lei 168.8m from the sale of governmental securities to covering of the state budget deficit.

According to the Law on the State Budget 1998, the tax on operations with State Securities on the secondary market and the tax on revenue received from operations with State Securities are abolished until 1999. This may considerably extend activities on the State Securities market, especially on the secondary one. Using this financial instrument, economic agents can more effectively use available resources. It should be emphasized that the tax on operations with State Securities on the secondary market mostly affected operations with securities having a 28 -day maturity period. The relatively small volume of transactions in these securities confirms this.

The extent of the T-bills market creates certain difficulties in other potential investment activities. The high interest rates required to finance the budget deficit diverts the flow of funds from real investment projects, where the interest rates are lower. The recent announcement on the 19th of May by the Ministry of Finance regarding the reduction of the nominal price of the T-bills from 1000 lei to only 100 lei will be another step in that direction. The recent changes aim at attracting the household resources to the T-bills market.

As of January 1st 1998, the external state debt, administrated by the Government, equaled $709.1m (lei 3304m}. The limit approved for the external state debt in 1997 the State Budget was set at $780m. The growth of the external debt of the state as compared to January 1st 1997 was about $60m or 9.3 %.

The biggest share in the structure of the external state debt is related to the loans received from the commercial creditors, including Gazprom with $ 306.6 million, followed by multilateral loans extended by international financial bodies (World Bank, European Bank for Reconstruction and Development etc.) with $ 255.5 million, and the loans extended by the Governments of other countries with $ 147 million.

During 1997, new credits worth $135.4 million were received. This included issuing of Eurobonds totaling $ 75 million , the first portion of the loan granted by the World Bank for structural adjustments under SAL-2 worth $ 35 million, investment credits by the World Bank and The European Bank for Reconstruction and Development of $ 8.6 million.

Following the objectives of creating an active financial market in the past three years, including a market in three-month government securities and Treasury Bill single-price auctions, the Ministry of Finance has issued a new type of Treasury Bills with a 14-day maturity. In

November 1997 there was a new programme launched, aiming at introducing bonds with a two-year maturity. Moreover, the Ministry of Economy and Reforms and the National Bank of Moldova plan to jointly examine the possibility of elaborating on a programme of medium-term Eurobonds for Moldova, which will give permanent access to external markets. However, this plan has witnessed a set back in November, when the Asian financial markets faced extensive turmoil. The concern has been that the risk might prove too high for Moldova to be exposed to external markets in the face of serious uncertainties. The Ministry of Finance has postponed negotiations on the possible issue of Eurobonds until the second half of 1998. Issuing in the first half of the year, it will possibly increase the expenses by 20 %. The Ministry of Finance affirms that Moldova is not satisfied with the actual interest rate on Eurobonds, which stands at 14-15 % per annum, and is considered too high. In the opinion of the Ministry of Finance the interest rate on Moldovan bonds should not exceed 10-11 % per annum. However, the possibilities for Moldova to issue the Eurobonds are very limited. This situation is caused mainly by two factors, first Moldova has already issued $ 75 million of Eurobonds, and second, the debts to Gazprom far from showing any signs of diminishing, have been accumulating further.

The primary goal of budget and fiscal policy for 1997 had been directed towards the maximum mobilization of public and private sector revenues to create favorable conditions for good governance objectives. These included in particular the implementation of a set of measures designed to minimize the possible tensions in society by supporting the current payments and reducing the arrears on pensions and salaries. In effect however, the priority budget actions during 1997 turned out to be the financing of most stringent budget expenses, especially the integral payment of the previous years debts and obligations.

In a broader context, and learning some lessons from 1997, the major areas of concern to be taken into account for rectifying and implementing the 1998 budget can be identified as the following:

Developing the capacity within the relevant institutions for a realistic forecast. This should not be solely confined to forecasting the budget, but rather for the whole economy. As stated earlier, the construction of a viable budget is closely dependent upon the ability of a given economy to generate sufficient revenue sources. In Moldova, as elsewhere, arriving at a balanced economy without undue, extensive cuts in the public sector's obligations towards development can only be possible, if and when, the whole economy improves in line with the set objectives. At the moment, the poor forecasting capacity, combined with political considerations, no matter how justified, result in unrealistic estimates of both revenues and expenditures. So far, it has created additional obstacles in obtaining the goals, as repeated rounds of revisions and negotiations have become a permanent feature.

Related to the above point, is the necessity to formulate the budget and its implementation in the context of priorities and possibilities. In other words, the usual main focus on meeting the financial requirements of the activities, which are already in place, should make room for a more strategic vision.

Last but not least, the growing concern about the shadow economy needs to be reflected in the outlining of an envisioned transformation of the economy, in more practical and focused way, than the mere expression of concern. Within the existing or emerging new institutions, there is ample capacity, know how and willingness to tackle this issue from different angles. It would be timely to mobilize and encourage systematic work on this issue to provide the necessary information and analysis into the cause and possible remedies. The ambiguity of a growing part of the economy can in no way be dismissed any longer, specially when arriving at realistic figures for policy making is concerned. One such immediate area is, evidently, the formulation and implementation of realistic budget for 1998 and beyond.

2.2 Monetary policy, country's external position, and banking system

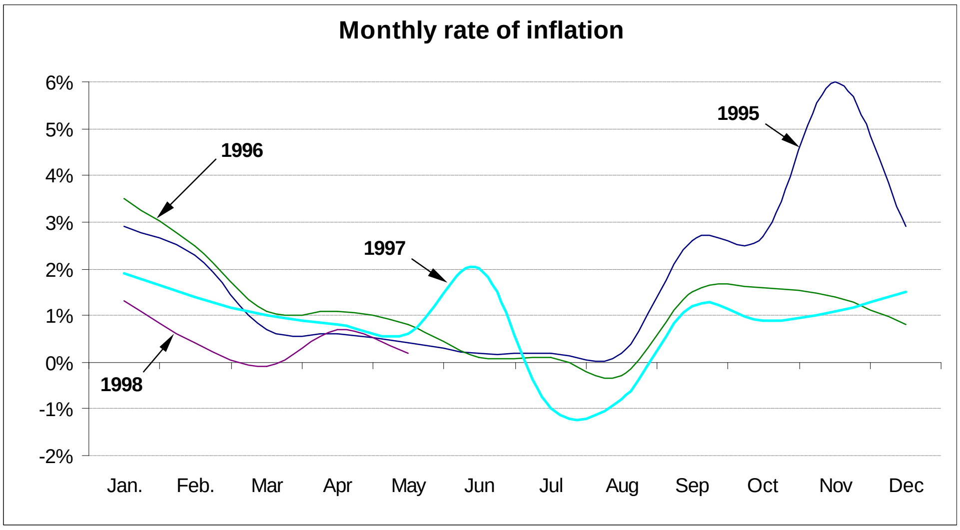
Monetary policy and its objectives are outlined, elaborated and implemented by the National Bank of Moldova. Its main directions of activity include: issuance and control over cash circulation, foreign exchange reserves management, compilation of state's Balance of Payments, auctioning of securities issued by the Ministry of Finance, observing banks' reserves and banks' credit servicing, supervision of commercial banks' activity and ensuring their safety.

The prime target of monetary policy is maintaining the stability of Moldovan leu – both external stability - vs. main hard currencies, and internal - stability of domestic prices and inflation rate. At present the main instruments of monetary policy are: open market operations, mandatory reserves requirement, buying-selling of foreign exchange.

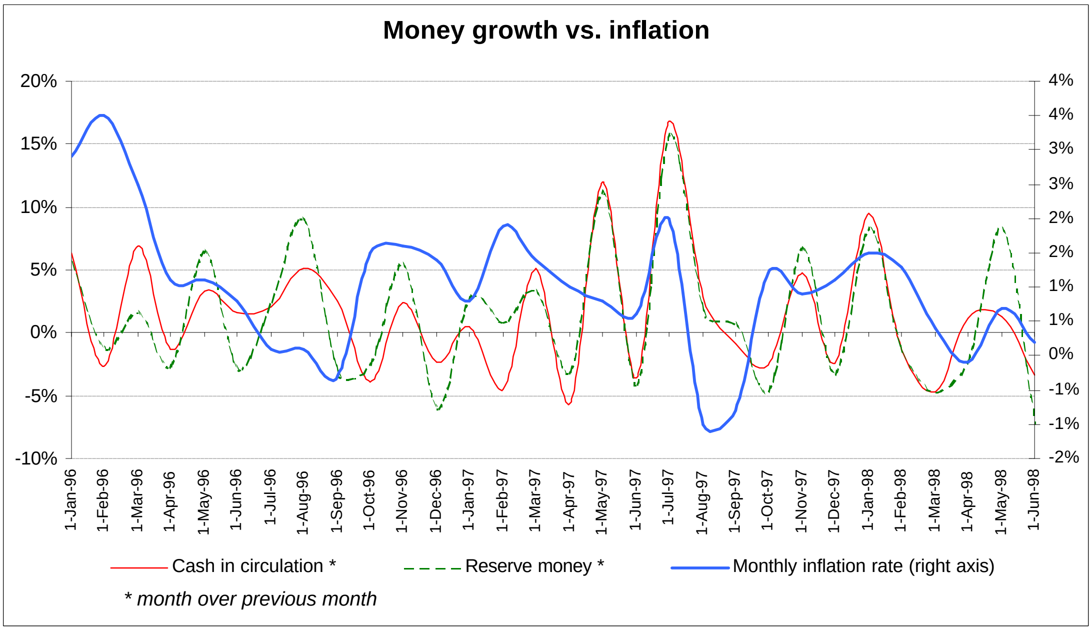
Monetary policy: main indicators

During 1998, in spite of external and internal constraints, the monetary policy continued to be oriented towards reducing of the inflation rate and maintenance of the exchange rate of national currency.

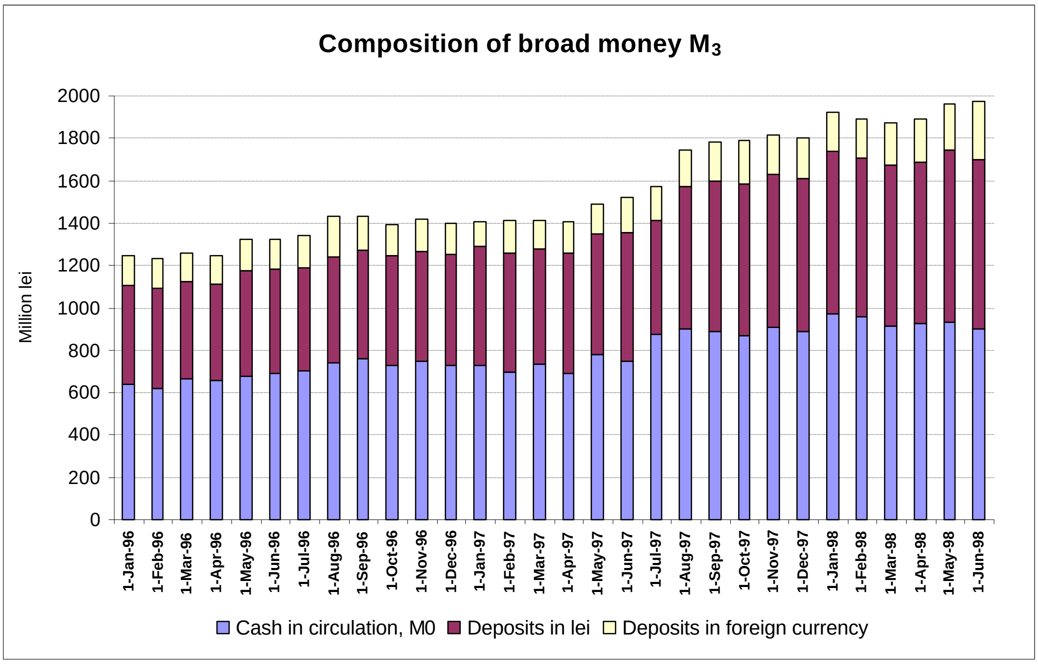
In 1998 inflation rate showed a significant shrink comparing to previous years. In March a deflation of 0.1% was observed. For the period January-May 1998 rate of inflation totaled 2.5% if compared to the level in December 1997, and the increase of prices in May 1998 over the same period of last year was 7.6%. This evolution shows that the annual inflation rate for 1998 could stand at 7.6-8.5%, comparing to the 11.2% registered at the end of 1997. Price seasonality shows the same tendencies as in previous years.



In the first quarter of 1998 the main monetary indicators showed a downward trend (which is in fact common for the last 3 years), resulting from the implementation of a non-expansionary monetary policy. Cash in circulation has curtailed by 4.9% at the end of first quarter 1998, if compared with the beginning of the year. During the same period base money has reduced with 7.4% (in the first quarter of 1997 cash shrank by 5.2% and base money – by 0.5%). By the end of May 1998 the volume of lei in circulation fell, comparing to the beginning of the year, by about lei 70m, i.e. by 7%, as a result of NBM's interventions in the foreign exchange market.

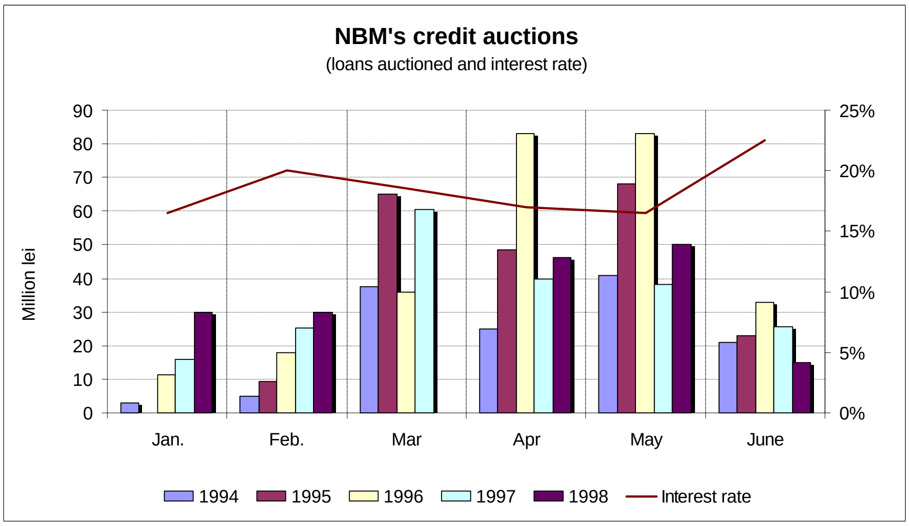


Broad money M_3 has shrunk during the first quarter of 1998 by 2.65%, while the level of deposits remained steady. Already in April 1998 broad money has increased by 3.6%, and deposits with banks – by 6.1%. And as of 1 June 1998 the growth of broad money was 2.6% over the beginning of the year, while deposits with banks grew 12.5%. Therefore, a positive evolution during the reported period of 1998 represents the continuous increase of the share of deposits in monetary aggregate M_3: from 49.4% at the end of last year, to 54.2% as at 1 June 1998.

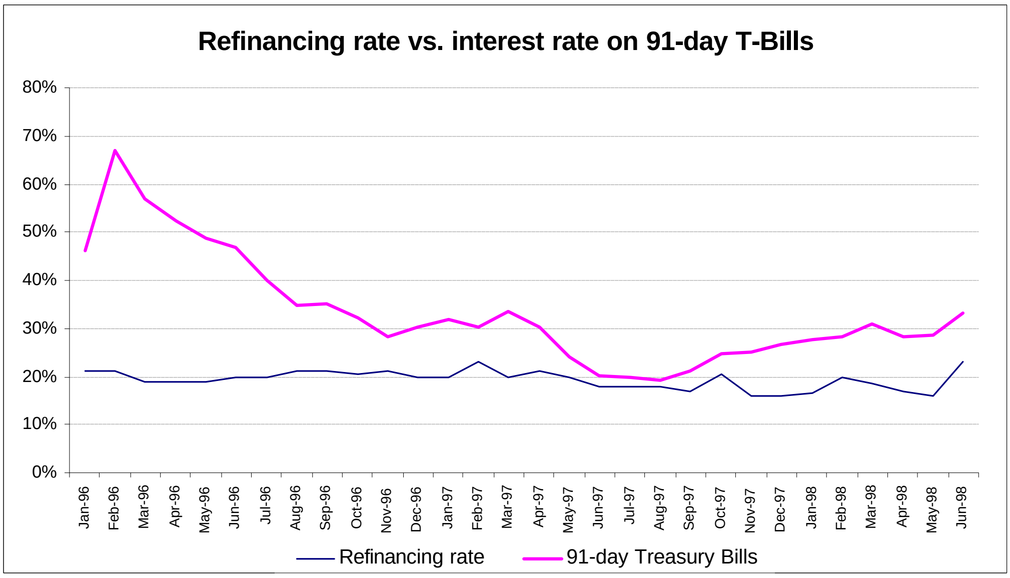


Monetary policy: main instruments

During the first half of 1998 were held 9 refinancing auctions at which there were sold lei 171m of credit resources, comparing to the lei 205m auctioned at the same period of last year, or lei 265m sold in January-June 1996.

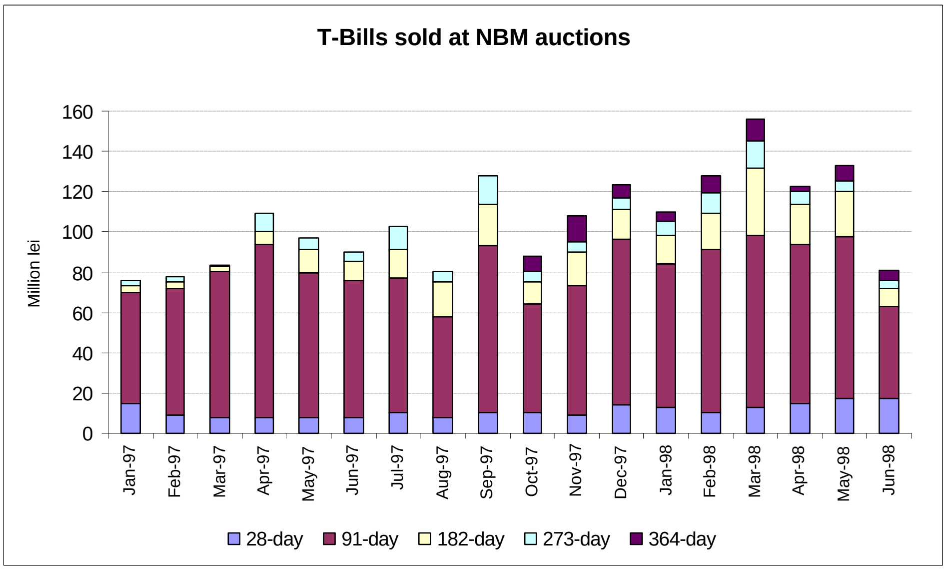


NBM's annual refinancing rate has declined slowly to 16% in May 1998, however at the auction held on June 15 it jumped to 22.5%. This was a normal response under the circumstance of continuous increases of interest rates on T-bills. In the chart below this evolution is clearly shown, being compared the refinancing rate with the interest rate on 91-day T-bills, which have the biggest transaction volume.



It should be mentioned, that this was the last refinancing auction, because afterwards they will be totally replaced by open market operations – Repo agreements and Lombard facilities. Consequently, large discrepancy between the refinancing rate and T-bills interest rates will be cleared. This discrepancy allowed banks to buy cheap credit resources and use them for financing state budget deficit, thus getting easy and guaranteed profits.

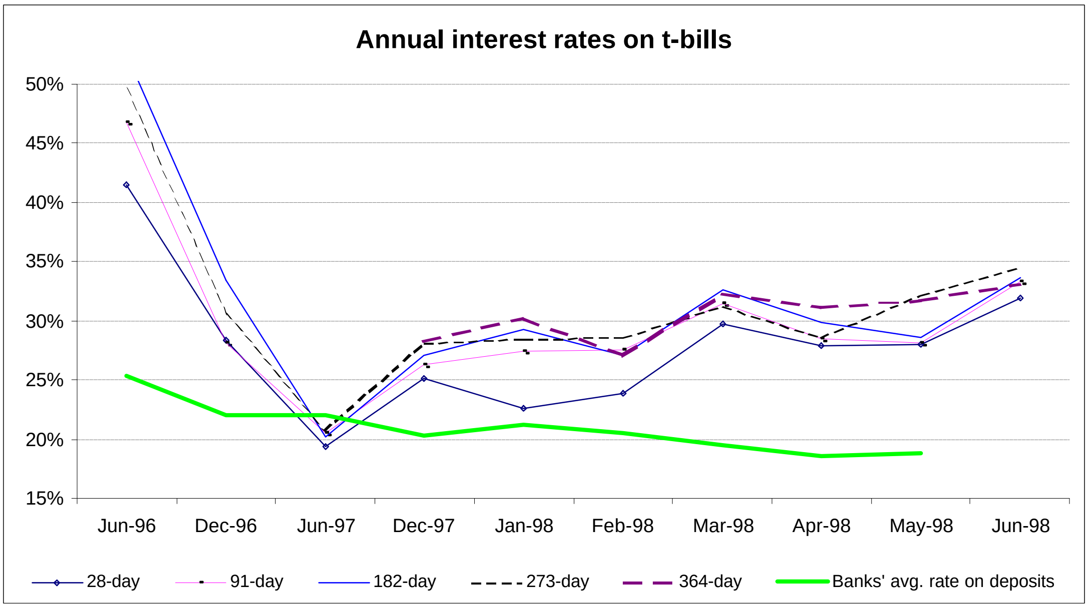
As the state's agent in selling state securities, during January-June 1998 National Bank of Moldova has sold to commercial banks at auctions T-bills amounting to lei 732m. Their structure was the following: 91-day – 60%, 182-day – 16%, 28-day – 12%, and about 12% – longer term securities. A positive aspect here is the continuous increase in the relatively long term securities: in January 1997 the share of 28-day and 91-day T-bills out the total sold was 92%, in June 1997 it was 84%, and in June 1998 – 72%.



During the reported period of 1998 interest rates on Treasury Bills and Bonds have been continuously growing. This is explained by state's acute lack of financial resources. Having a dangerous budget deficit and lack of funds for covering it, the only solution applicable by the Government in order to attract financial resources is issuance of securities, which gets bigger proportions with the time.

Under these circumstances, for making them attractive, the state is continuously increasing the interest rates on state securities, at the same time more funds are needed for servicing securities already issued. Already now the income from the new issuance of state securities can not even cover the amount needed for repurchasing the previously launched securities.

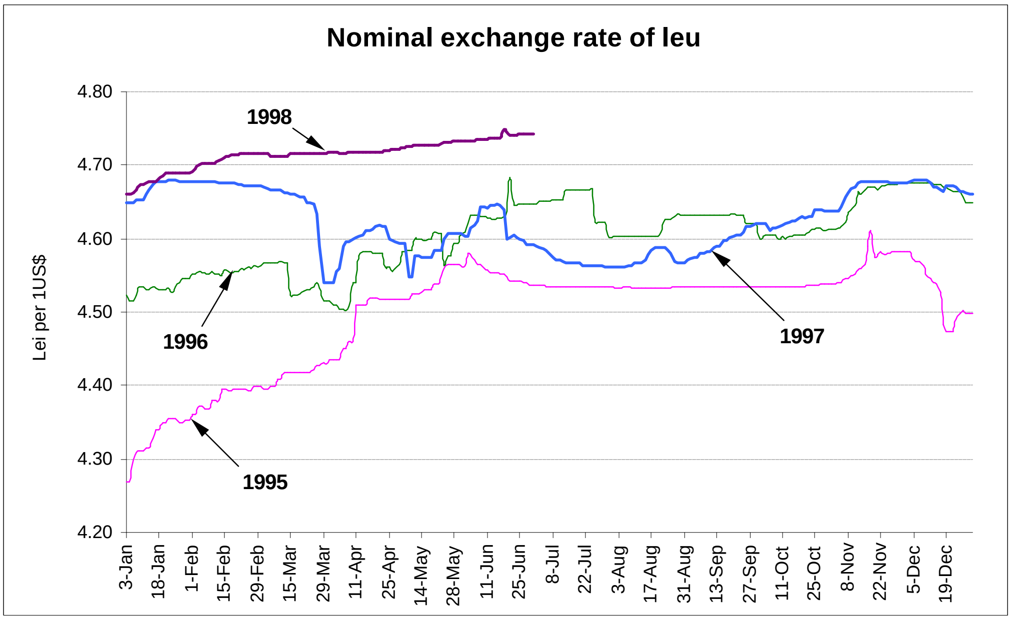
It must be stressed here, that during the second half of 1996 interest rates on T-bills were considerably higher than deposit rates in the banking system, consequently banks being massively involved in buying state securities instead of channeling crediting resources into the productive sector. Thus, the deposits of banks' clients were used for covering budget deficit. Due to the reduction of the interest rates on T-bills, this situation improved towards the end-1997, which is clearly shown in the chart below. However, already by the end of 1997 and during this year the interest rates on bank deposits, which have been gradually decreasing along with the central bank's refinancing rate, dropped far below the interest rates on state securities, which show a continuous upward trend.



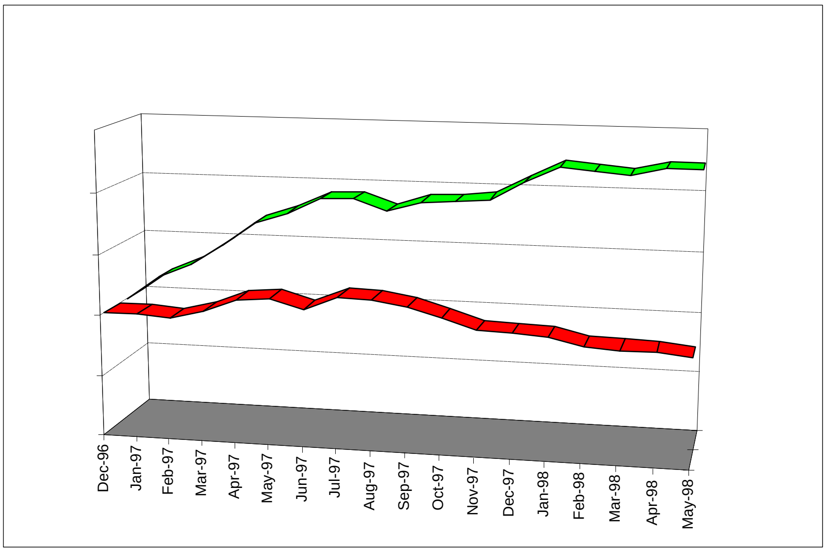
Exchange rate dynamics

During 1998 the exchange rate of the national currency against US dollar follows a more stable path comparing with previous years, undergoing a slow nominal depreciation – by 1.2% in May 1998 upon December 1997 (average monthly rate).

Current month May over December last	m'94/d'93	M'95/d'94	m'96/d'95	m'97/d'96	m'98/d'97
Nominal appreciation (+), depreciation (-)	-8.6%	-5.9%	-1.4%	+1.8%	-1.2%
Real appreciation (+), depreciation (-)	+56.7%	+0.7%	+7.8%	+7.8%	+1.3%



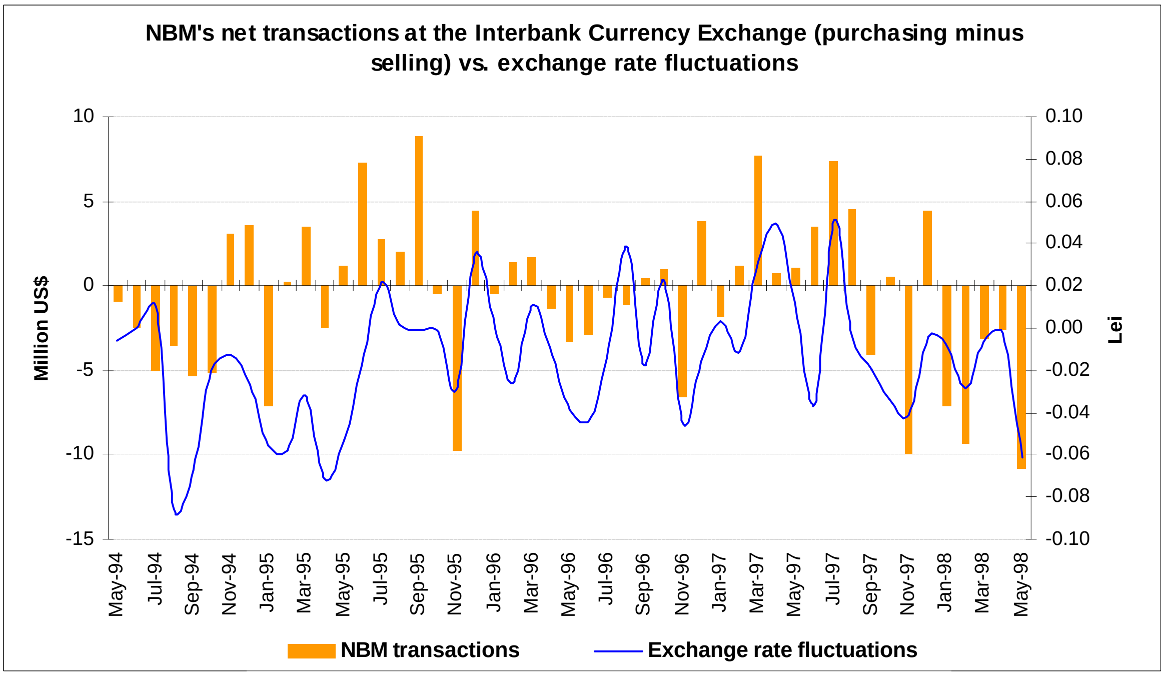
Due to the reduction in inflation rate, also has lowered the real appreciation of the national currency against US dollar (which was too high in previous years). In May 1998 real exchange rate index shows an appreciation of Moldovan leu against dollar: by 20.9% comparing to December 1995, by 12.4% comparing to December 1996, and by 1.3% comparing to December 1997.



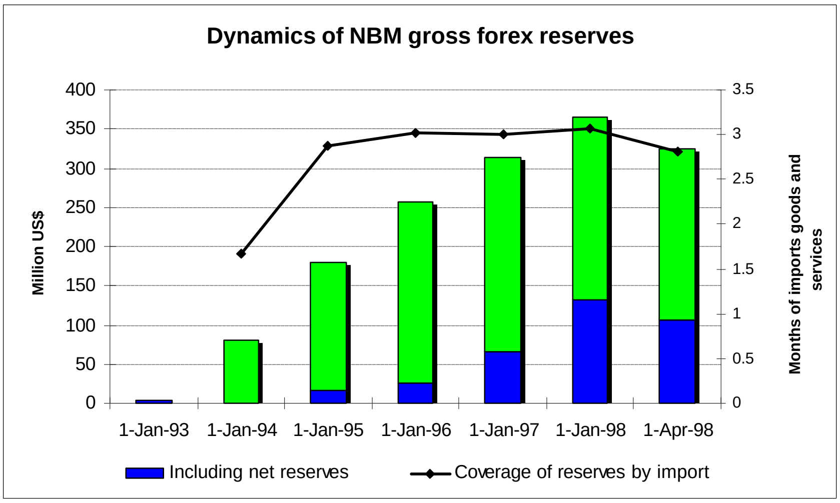
As regards to the real effective rate of Moldovan leu against currencies of the main trading partners of Moldova (Russia, Romania, Ukraine, Belarus, Germany, Italy), and adjusted to the inflation in these countries, the following is to be noted: according to CISR calculations in 1997 over 1996 the Moldovan leu has appreciated by 12.4% upon currencies of the main trading partners of Moldova, which to a certain extent affected the performance of Moldovan exports.

Evolution of NBM foreign exchange reserves

An alarming trend represent the massive sales of hard currency of the NBM at the Moldovan Interbank Foreign Currency Exchange in 1998. In previous years NBM's transactions at the Interbank Foreign Currency Exchange had a stable seasonality evolution, while during the period January-May 1998 the NBM bought zero foreign exchange, and at the same time sold considerable amounts of hard currency – almost $33m.



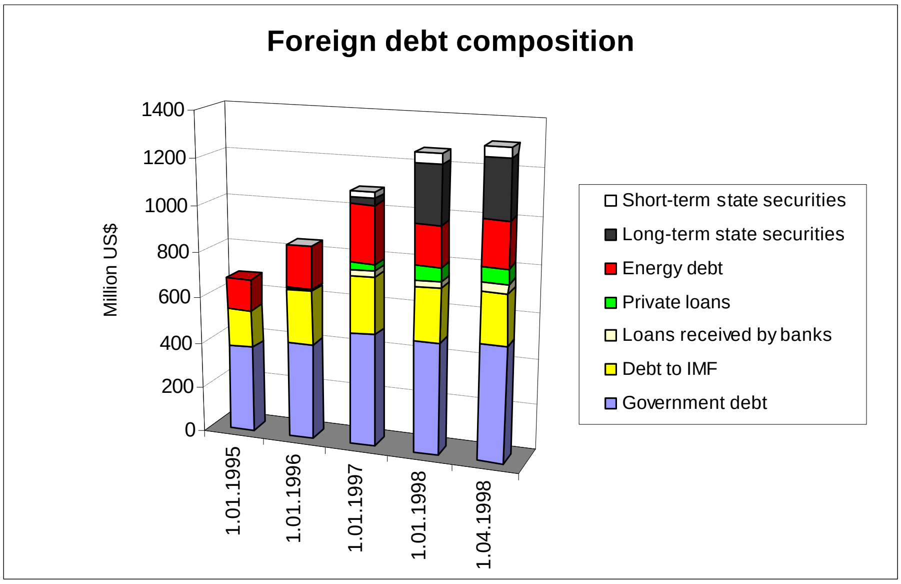
This obviously led to a reduction of NBM's foreign exchange reserves. During the same period of time gross reserves decreased by 9% (covering at the end of first quarter of 1998 2.8 months of imports), and net reserves – by a quarter. This reduction of NBM's reserves is accompanied by a slow devaluation of the national currency. For the moment the situation is under control, but it should be mentioned that if the demand for hard currency in the market will not decrease, then it could have a serious impact on the exchange rate, in the end causing a bigger devaluation of the Moldovan leu.



Another critical aspect within the context of the official forex reserves reduction is linked with the need to service external debt, which implies transfer of big amounts in hard currency for the repayment of principal and interest. Here is a simple calculation: during the 1st quarter of 1998 gross forex reserves reduced by $41m, while at the Interbank Foreign Currency Exchange there were sold $20m. Therefore, the difference was used for external debt servicing. For the following period of time the situation will aggravate even more, because already in 1998 the state has to repay more than $200m for foreign debt servicing (including almost $80m to be paid by NBM only, for the principal and interest to the IMF). And all this is happening under an aggravating factor such as the considerable current account deficit of the balance of payments.

Foreign debt of Moldova

The numbers regarding Moldova's foreign debt used here include the following: medium and long term loans received by the Government, IMF loans granted to NBM, state securities, loans received by commercial banks and private sector (including government guarantees), as well as debt for energy resources.

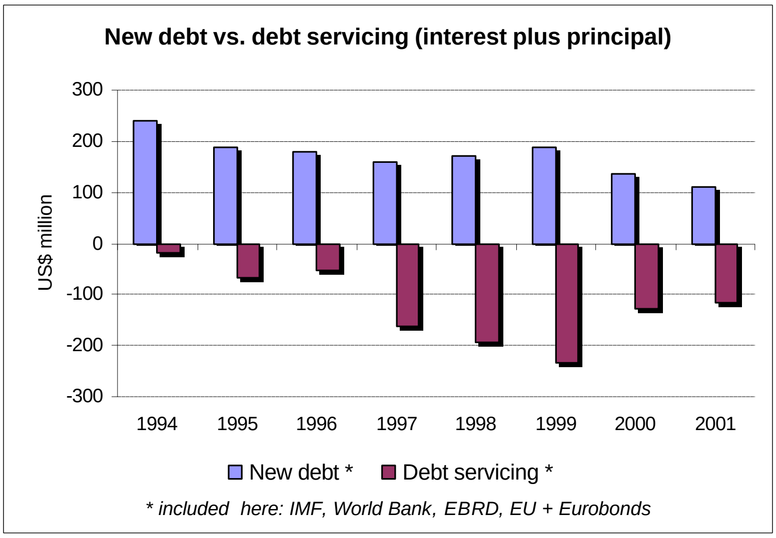


The stock of foreign debt at the end of the 1st quarter of 1998 has reached, according to BOP data, $1306m, which is 3.0% more than as at 1 January 1998 and 19.7% more than as at 1 January 1997. In fact, the significant growth of debt during 1997 is largely owed to the second private placement of Eurobonds through Merrill Lynch in the amount of $75m, as well as to the equivalent of $140m of state securities issued by the Ministry of Finance for covering the energy debt to Russia's Gazprom. As regards to the loans from international financial institutions, they were substantially reduced because Moldova did not follow the concluded memorandums. Consequently, in 1997 Moldova received only one tranche of $20m from the IMF within EFF, and a tranche of $35m out of SAL-2 from the World Bank.

In this circumstances prospects for 1998 seem to be quite modest. IMF June 1998 mission made reference to an eventual next tranche of $20m from the EFF loan, which could be granted in autumn 1998, only if Moldova will follow the obligations stipulated by the signed memorandum. World Bank June 1998 mission also promised relaunching of financial support by autumn, but it is clear that the next tranche of $35m from SAL-2 would not be granted before the IMF tranche. And of course, the main condition here is also the execution of the agreement concluded between the Government of Moldova and World Bank.

At the same time, during 1997 Moldova had to repay about $160m for its foreign debt servicing. It must be noted, that for the first time the outflows for debt servicing almost balanced the inflows of currency out of new borrowing from international financial institutions and private capital markets abroad. This is a very worrying sign, especially because at the end of 1997 the current account deficit of BOP reached about $300m.

During 1998-1999 the situation could be even more aggravated, because the external financing deficit, or deficit of hard currency inflows, will be even higher. It also obvious, that Moldova does not have enough gold or hard currency reserves in order to resist a crisis, in the event it happens. Only short term country's obligations reflected in the BOP External Position are already exceeding NBM's gross forex reserves (out of which two thirds belong to IMF).



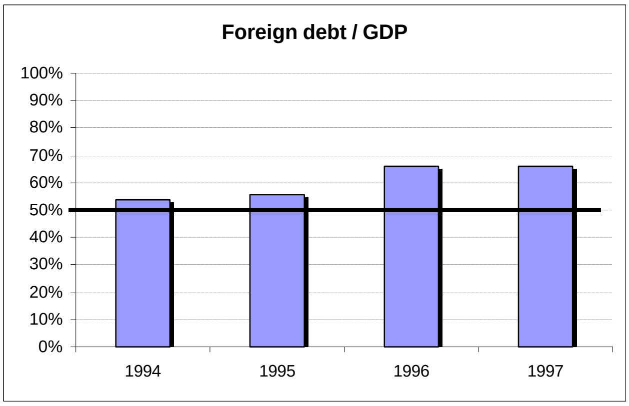
The only chance, here, to find a way out of the impasse and for avoiding a major crisis of country's payment capacity is obtaining new favorable loans from international financial institutions. There are no other sources of foreign currency. Moreover, the country's credit rating issued by Moody's and IBCA will be revised, and the new rating will certainly not be Ba2, but probably B1, i.e. 2 steps lower (or in the best case Ba3). This will limit considerably country's capacity to place new securities in the capital markets abroad, because as a result of altering of the country's image in the world the cost of servicing new Eurobonds will considerably increase.

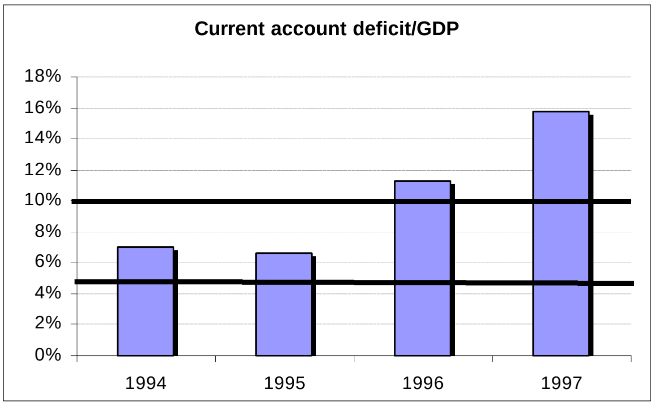
Thus, it is extremely important to continue the collaboration between Moldova and international financial institutions, especially IMF and World Bank, which are also our main creditors. However, the country could count on relaunching of the blocked tranches of EFF and SAL-2 only in case it fulfills the engagements regarding efficient implementation of structural reforms in the economy.

External position of the country: main indicators

According to BOP data external debt of the country (including debt to IMF) reached at 1.01.1998 about 66% of GDP.

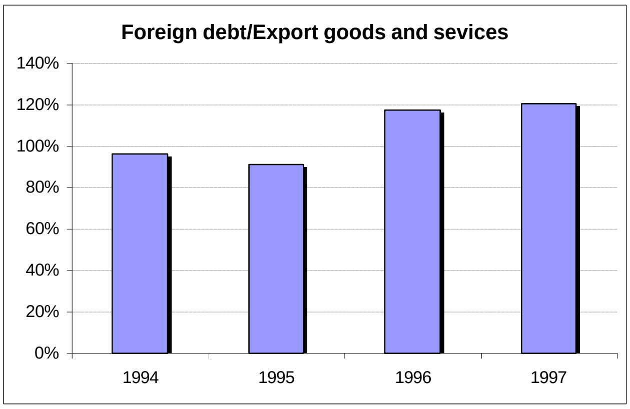
According to the World Bank methodology of calculating the indicators of country's indebtedness, the Republic of Moldova belongs to the category of countries with moderate level of foreign debt, the ceiling here being 80% of GDP. But it should be noted, that in case of Moldova the level of external debt of already 50% of GDP is quite dangerous, because of the considerable BOP current account deficit.

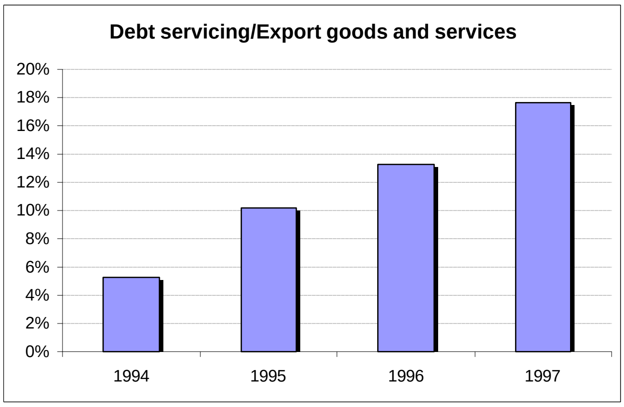




At the end of 1997 current account deficit reached $296m, which accounts for 15.8% of GDP. This is a very alarming tendency, because in terms stipulated by economic theory exceeding 4.5% must be a worrying sign, imposing the Government and Central Bank the objective to correct the disequilibrium in a short term period. However, exceeding the 10% mark must be considered as critical, proving the existence of serious malfunctions in the economy, when just fiscal or monetary measures are no longer sufficient. They must be accompanied by vigorous sectoral policies, which could correct the disequilibrium only after at least 2-3 years of rigid implementation.

Other indicators:

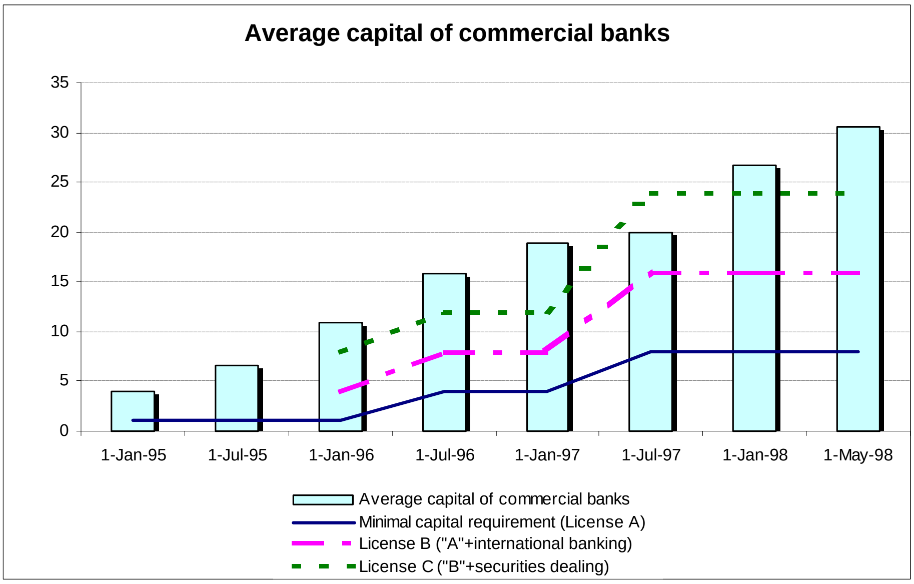




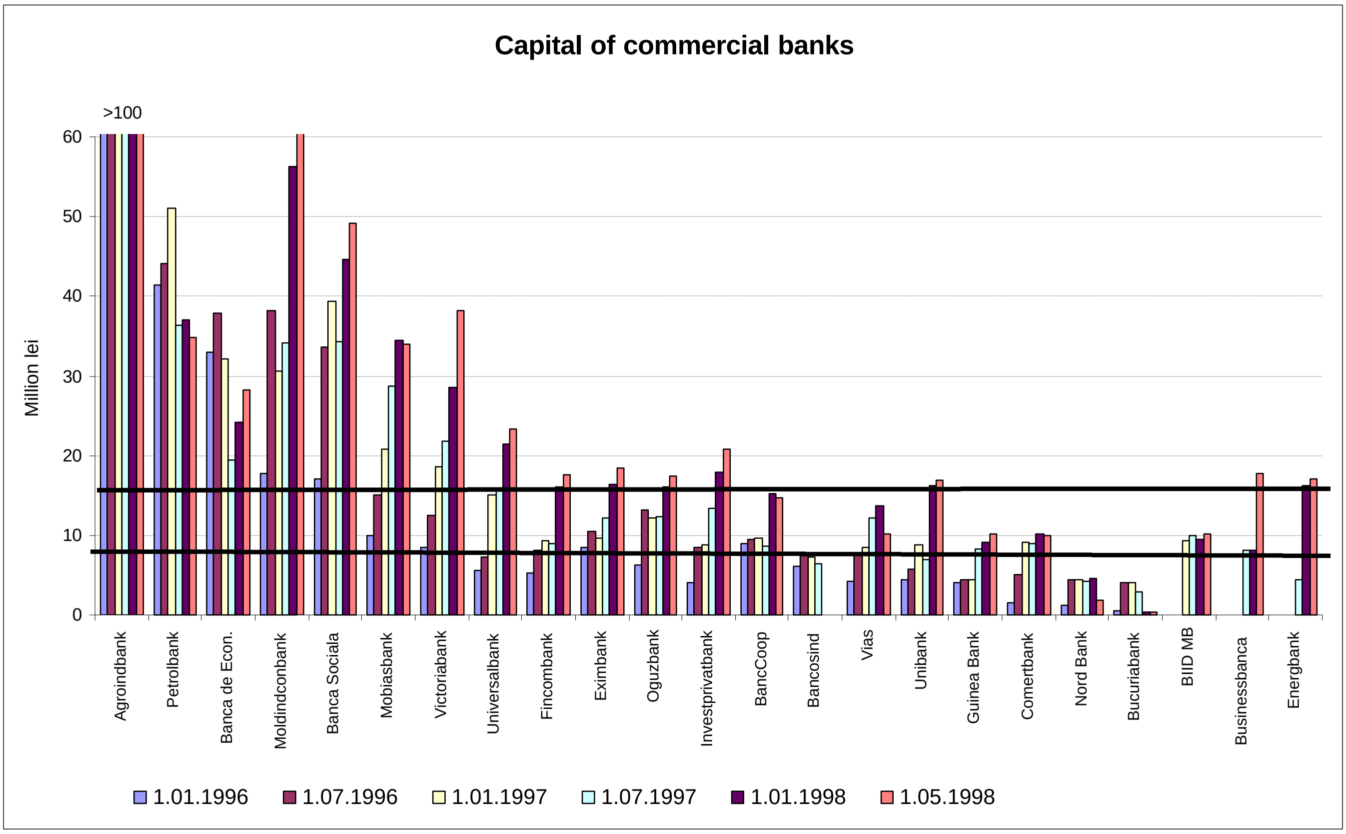
Evolutions in the banking system

The situation in the banking system of Moldova (22 commercial banks) can be generally assessed as positive. NBM continues to implement successfully prudential norms aligned to the Basle standards of banking supervision. Starting 1 January 1998 has been enacted a new minimal capital requirement for commercial banks – 8 million lei for receiving a type A license (basic license); also, the capital adequacy ratio (total regulatory capital/risk-weighted assets) was increased from 6 to 8 percent. Due to the fact, that in 1997 three out of four banks where performing international operations in foreign currency (types B and C licenses), they had to increase their total capital to the extend that it was needed according to the new requirements – i.e. to be bigger than 16 million lei. Therefore, the total capital in the banking system grew gradually, reaching at 1 January 1998 lei 588m, which is 35% more than at the beginning of last year. The same trend continued this year, total banks' capital reaching lei 643m at 1 May 1998, which is a 9.4% growth over the beginning of year.

For the reason of simplicity, on the chart below the evolution of average capital in the banking system is shown, calculated as a ratio between total capital in the system and number of commercial banks.



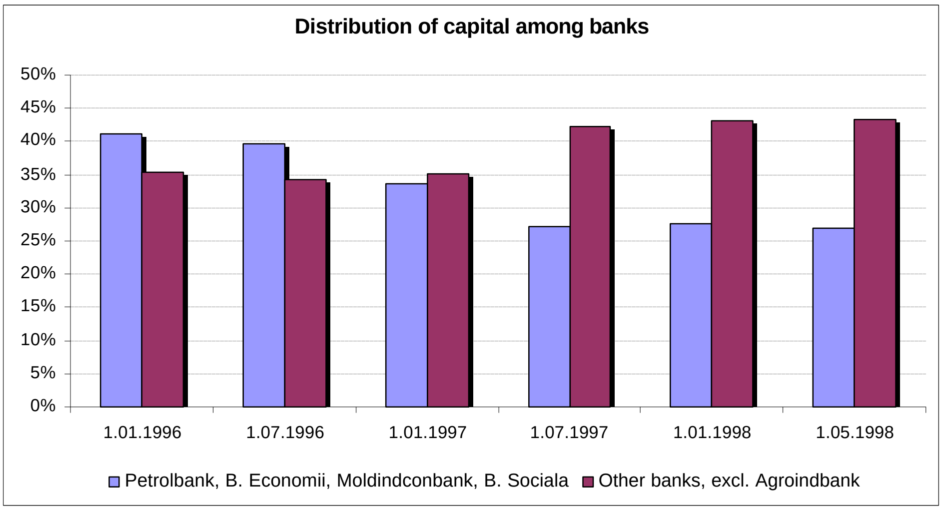
Additionally, a more exact evolution of the banks' capital and its distribution among banks is shown in the following chart. One could clearly notice the considerable jump of the banks' total capital starting 1 January 1998 due to the introduction of the minimal capital requirement of 8 million lei (the horizontal thick line at the bottom) and of the 16 million lei requirement for performing international banking operations (upper thick line):



Analyzing the evolution of the capital in the banking system, attention should be drawn to the positive aspect related to the distribution of capital among banks, or more exactly between groups of banks. In this context in the first group large commercial banks were included, which at 1.01.1996 had total capital bigger than the figure of 5% of total capital in banking system: Agroindbank, Petrolbank, Banca de Economii, Moldindconbank and Banca Socialã. But in order to avoid a possible interference in this model, the Agroindbank was excluded (since at

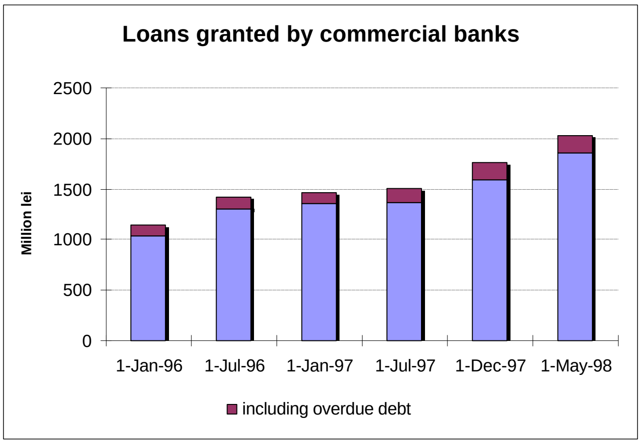
1.05.1998 the share of its capital in the total capital of the banking system was 30%). In the second group the remaining banks have been included.

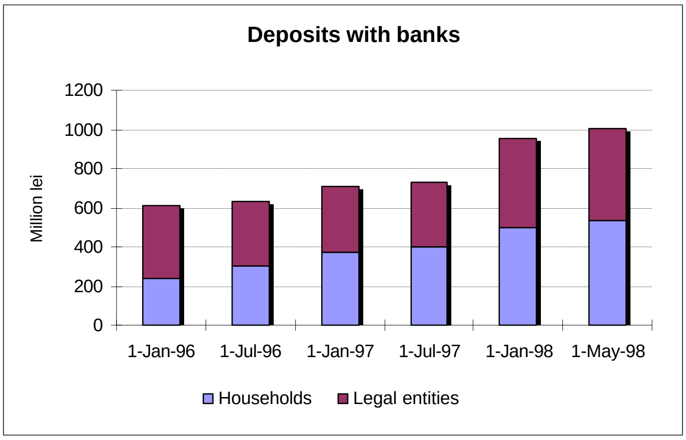
The conclusion is the following: middle sized banks managed to gradually increase their capital, thus by end of 1996 balancing the capital of large banks, and advancing it afterwards. If at 1.01.1996 the ratio 4 large banks/small and medium banks was 1.17:1, then at 1.05.1998 it was already 1:1.59 – and this proves a substantial consolidation of the majority of middle sized banks, which are new commercial banks.



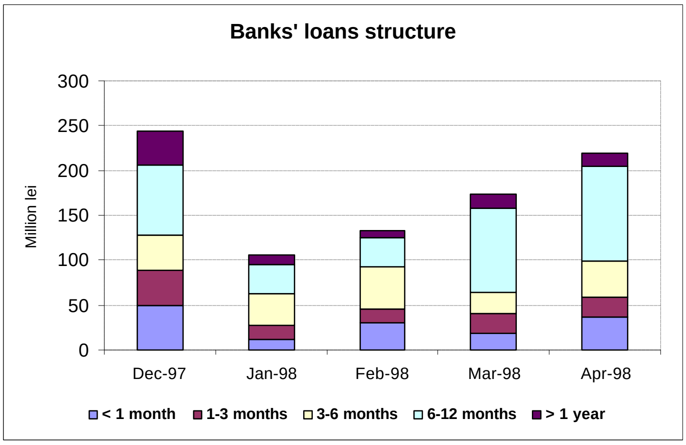
During the 1st quarter of 1998 loans granted by commercial banks have increased by 6%, reaching at 1.04.1998 lei 1.74 billion, out of which overdue debt accounts for 9.7%.

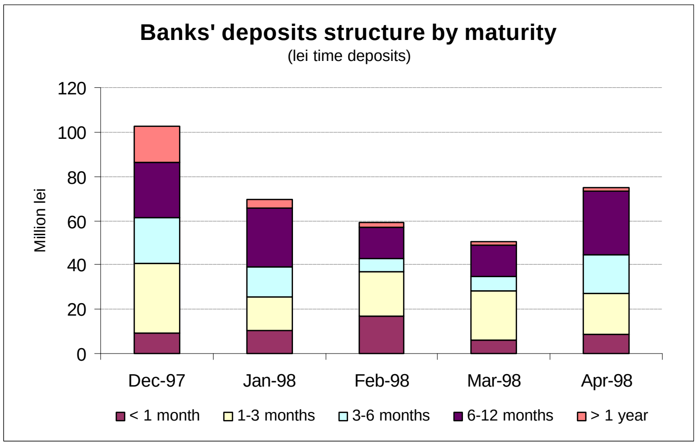
At the same time, the confidence of population in the banking system has increased, expressed by the continuous growth of deposits of individuals with banks. At 1 May 1998 they totaled lei 536m, which is 8.3% bigger than at the beginning of 1998 and 44.9% bigger than at 1 January 1997. During the same period (January-May 1998) deposits of legal entities have reduced slightly, influenced by the factor of seasonality, reaching at 1 May 1998 the same level as at the beginning of 1998.





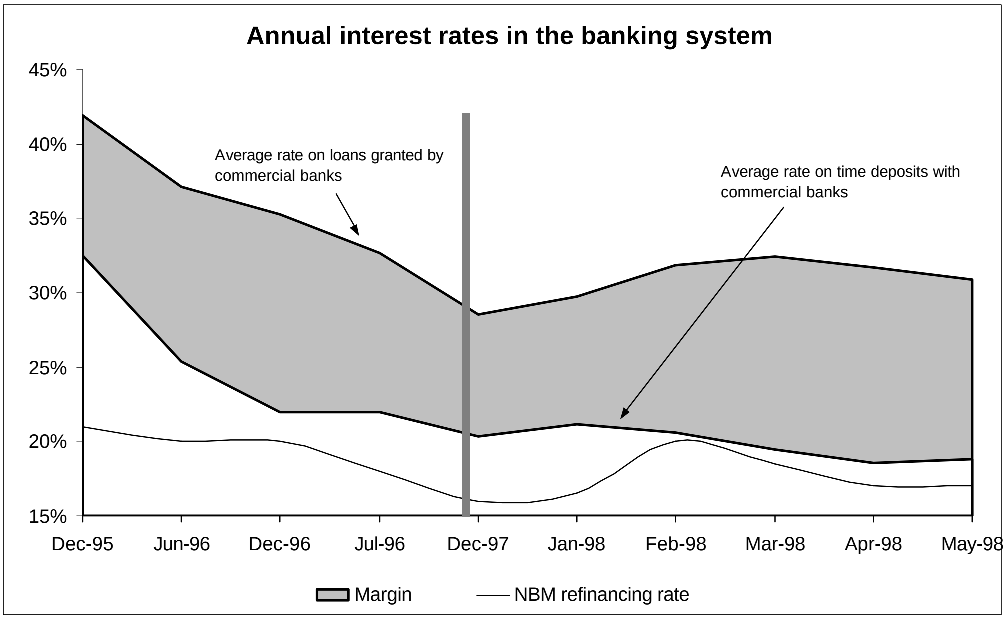
Analyzing the structure of commercial banks' loan portfolios and deposits in the 1st quarter of 1998 it should be pointed out that along with the growth of total volume of loans granted, driven by the seasonality factor, the share of loans granted for 6-12 months has increased: from 30% in January 1998 to 49% in April. Share of loans granted for more than 1 year did not vary essentially – it stood at 6-10%, but this is in its turn clearly explained by the structure of banks' deposits. If in December 1997 share of deposits with the term of more than 1 year accounted for 16%, then in April 1998 it diminished to 2%. Obviously, banks can not make long term credit investments when their clients' deposits are mainly short term. A very important role in this context have played the credit lines of the World Bank and EBRD for private sector support and directed to the economic agents through commercial banks of Moldova.





It should be noted, also, that during the 1st quarter of 1998 sight deposits in lei have grown significantly – by 2.5 times, which shows that economic agents act successfully in the market, gaining profits. Regarding the structure of deposits by currency, it is to be said that during the same period the share of new deposits in foreign currency has somewhat decreased, banks' clients preferring placing deposits in lei.

As regards to the interest rates in the banking system, the following negative tendency has occurred: during the period of January-May 1998, along with the reduction of the refinancing rate, the banks' interest rate on deposits also gradually decreased, but at the same time banks' rate for loans granted did not fall accordingly. Therefore the margin had actually expanded (phenomenon also observed during 1996) from 8.2% in December 1997 up to 12.1% in May 1998.



The explication of this phenomenon is linked to a number of factors, out of which are especially systemic risk and some inflation expectations by banks, and not so much the tendency of profit maximization or lack of competition in the banking system.

Concluding remarks of this chapter:

Positive aspects:

- inflation rate continued to drop – cumulative value for January-May 1998 was only 2.5%;

- broad money has increased by 2.6% at the end of May 1998 comparing to the end of 1997, while deposits with banks grew by 12.5%;
- NBM's refinancing auctions have been stopped starting the second half of 1998, being replaced by open market operations;
- the share of state securities with maturity of 182 days and higher, sold by the MoF and NBM, grew;
- exchange rate of national currency is maintained stable, showing a slow nominal depreciation against US dollar;
- excessive real appreciation of Moldovan leu upon US dollar has diminished;
- situation in the banking system is considered to be generally positive;
- starting 1 January 1998 banks' minimal capital requirement was raised from 8 to 16 million lei, and respectively grew the total capital in banking system;
- capital adequacy ratio (total regulatory capital/risk-weighted assets) was increased from 6 to 8 percent;
- medium sized banks, which form the majority, are gradually strengthening;
- confidence of population in the banking system is raising, showed by the increase of deposits with banks.

Negative aspects:

- continuous increase of interest rates on state securities, generated by state's acute lack of financial resources;
- inflows from sales of state securities already do not cover the amounts needed for repayment of the previously issued securities;
- real effective exchange rate of Moldovan leu, i.e. upon currencies of Moldova's main trading partners, continued to appreciate in 1997, affecting to a certain extent the performance of Moldovan exports;
- BOP current account deficit reached in 1997 an extremely dangerous level of 16% of GDP, and BOP data for the 1st quarter of 1998 do not show any sign of improvement;
- NBM's foreign exchange reserves are declining dramatically during first half of 1998;
- accumulation of external debt continues – it grew by 3.4% during 1st quarter of 1998;
- the situation on servicing and repayment of foreign loans is aggravating, and the outflows needed for debt payments are already bigger than state's new external borrowing;
- because of bad economic performance of the country the credit rating of Moldova, assigned by Moody's and IBCA is expected to be diminished;
- share of long term loans granted by banks is small, and this is an outcome of mostly short term deposits in the banking system;
- during the first half of 1998 interest rates on state securities are considerably higher than banks' deposits rates, thus banks' clients' deposits being used for budget deficit financing, instead of being channeled into the productive sector;
- the margin between average lending rate banks' deposit rate grew, because banks kept high the interest rate on loans granted.

Final conclusion:

The country can not rely endlessly on the good will of external creditors without reforming its economy and getting out of the crisis. Without a firm implementation of reforms in real sector of the economy and reduction of critical public finances' disbalance, the stability of the monetary policy – of inflation rate and exchange rate of national currency – is on the way to failure.

2.3 Investment

Foreign Direct Investment (FDI) in Moldova remains sluggish, lagging well behind successful economies in transition. This chapter describes one of the possible ways to clear up the ground for strategic investors, namely by creating opportunities for the venture capital business. This commentary is based on the Western NIS Enterprise Fund (WNISEF) four-year experience in the region.

Why Moldova needs FDI

None doubts that a small economy in transition needs substantial external financial infusions. For the government of a country like Moldova trying to survive in a difficult economic environment, it is vitally important to encourage FDI. FDI has several obvious advantages over the portfolio investments or lending under sovereign guarantees: 1) is less speculative. FDI financial flows would not get reversed as easy as short speculative investments in T-bills or commercial papers 2) FDI is usually associated with the new technologies, know-how, training of the local staff, etc.

FDI will ultimately benefit the Moldovan infrastructure development in general, introducing new, much higher than previously, competitive standards for Moldovan companies and for the whole economy. This said, Moldova does not need to preserve all industries which existed under the previous centralized economy, but only those which can be self-sustainable and competitive by regional standards at least.

Despite energetic and sometime desperate efforts of four Moldovan governments to foster FDI, the foreign investors are not rushing up to invest their money in Moldova. The Moody's rating of Moldova which is still higher than one of its bigger neighbors - Romania and Ukraine, is a weak consolation since Moldova is at a comparable level of foreign investment with other FSU countries and well behind Baltic States, Czech, Hungary and Slovenia.

Why investors are not coming to Moldova?

There is not a clear answer to this question. Fundamentals like fiscal deficit reflected also in the foreign debt which is piling up rapidly, the current account deficit are worrisome, and Moody's rating is looking rather downward than upward. Altogether these phenomena are building up negative expectations. However strategic investors are probably more interested in the general assessment of the investment opportunities: general framework - rules of the game, written and mostly implied or how predictable the environment is, and ultimately and most importantly, whether there are possibilities to make money all inherent risks taken into account. On the negative side is the rent seeking as expressed in the euphemistic World Bank language and red tape which have become omnipresent in Moldova. On the other, positive side, Moldova has got the best government in years. Obviously the size of the market has to do something with this reluctance of foreign investors to shift gears. Also, the rule of thumb is the proximity to advanced economies which would create positive spillovers and benefit bilateral trade. Moldova's neighbors - Romania and Ukraine are not in the best economic shape to take the lead. Shall Moldova wait until these economies improve? Just waiting would be a quite cynical recommendation.

When a strategic investor WILL invest?

A strategic investor wants guarantees that his wealth will be preserved and expanded. He comes to the country for a substantial period of time, especially when capital intensive businesses are concerned. Therefore his caution is explicable. He is led by his instincts which tell him that Moldova is not on the list of first priorities. If he decides to go for some risk, he would be perhaps more confident if the risk is shared with someone he trusts. If he decides to create a joint-venture in Moldova or invest in the existing company, he wants to make sure that the appropriate corporate management is enforced and the company is properly run, including financial control and monitoring. There are not many companies in Moldova which comply with these criteria.

What WILL a financial investor do?

Financial equity investors like European Bank for Reconstruction and Development or the Western NIS Enterprise Fund usually look at the much shorter time prospective than strategic investors. A financial investor would typically invest into a prospectively well-performing company, seek to achieve long-term appreciation of its market value and pass the stake into the company to a strategic investor.

WNISEF case study

The Western NIS Enterprise Fund is an investment fund capitalized at $150 million by the United States Congress via the United States Agency for International Development (USAID). $50 million have been committed to 19 companies through the Fund's early stage venture capital operations.

WNISEF invests in the share capital of privatized or new private companies or enterprises in Ukraine, Moldova and Belarus, and aiming at the strategic areas of the economic development of these countries. The investment is the first step of the collaboration between WNISEF and its local partner. The Fund does not require official guarantees from banks or insurance companies, although it may require personal guarantees from the management team and owners. In fact, the investment, although it is a time and efforts consuming procedure, is just the first step of the partnership. The WNISEF wants to have stable, devoted and professional partners, because after the investment is made, a tedious work starts requiring even more efforts. The WNISEF is providing different technical assistance programs at no cost for the company to help the management team to reach its targets. Our portfolio companies have found helpful especially programs in sales and marketing. We see our relationship with the management is the cornerstone of our success and want the management to be comfortable and constantly striving to improve because and due to the WNISEF’s participation into the company. One of essential parts of WNISEF's value-added to portfolio companies is the Management Information System (MIS) which is installed at no cost for companies and ensures financial control and monitoring. It creates the transparency over the company's financials and helps the management to learn the modern way to manage an enterprise. WNISEF is frequently organizing seminars and training for CEOs and other key managers. But the most important is the WNISEF's staff personal involvement in the company's activities and strategic decisions. WNISEF stands by the management of the company, trying to help, advise or criticize.

WNISEF's main goal is to help the company to become a leader in the region and/or in its field. We do not ask for the payment of dividends to the shareholders, and support dividends' recapitalization which bolsters company's development.

Example

Agriculture Distribution Center(ADC)

ADC's mission is to provide high quality agricultural equipment and services, including custom farming, to agricultural enterprises in Moldova thereby replacing the previous state structures of supply and improving the agricultural productivity in Moldova.

To achieve this mission, ADC has signed a dealership agreement with AGCO Massey Ferguson giving ADC rights to sell and service AGCO Massey Ferguson equipment in Moldova. The custom service, equipment sales, parts, and service departments have been established. Key members of ADC management have been attending seminars and training courses sponsored by WNISEF while personnel associated with the sales and service of AGCO equipment are scheduled to receive intensive training from AGCO in the UK and Denmark. As a first step in marketing AGCO equipment, ADC held demonstrations of AGCO combines and tractors at the international exhibition MoldAgro held in Chiºinãu. Currently, ADC is in the process of implementing a management information system which will allow the company to produce IAS financial statements in 1998.

The main competitor for Agriculture Distribution Center is a company that owns 5 MDW combines, but ADC has a competitive advantage due to the fact that MF combine productivity and quality of services provided are superior.

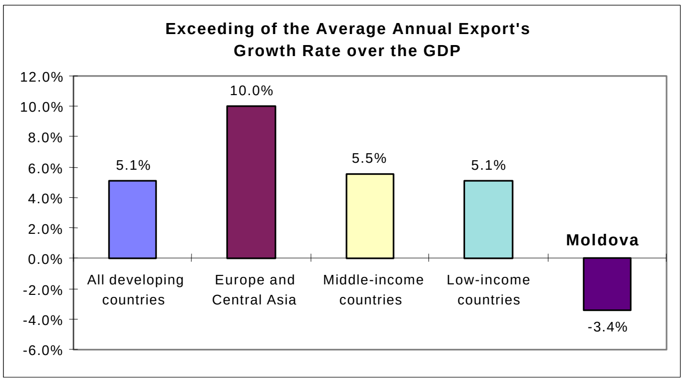
In addition, in 1997 twelve Case-combines were brought to Moldova under the governmental guarantee and were distributed between elevators that provide farms with harvesting services. View non-commercial status of these entities, they are not able to compete with Agriculture Distribution Center effectively.

2.4 External trade

Process of globalization and integration is the most important peculiarity of today’s economy. Most countries promote policies of economic openness consciously. Since the beginning of 90’s, Moldova, in certain circumstances, gradually oriented to the model of “small open economy”, being in the search of its niche in the world. The foreign economic relations have a strategic importance for shifting to a more open economy, create premises for its stabilization and structural restructuring. The state must provide for a political and regulatory environment, including creation of financial and institutional infrastructure, conditions for attracting foreign investments and supporting export-oriented businesses.

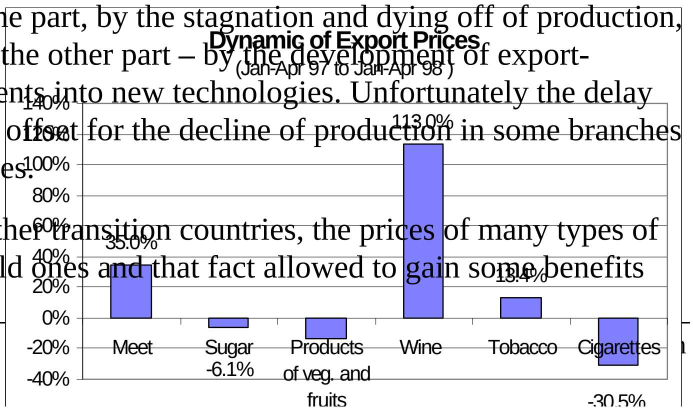
The sectoral structure of production, the composition and quality of Moldovan outputs gradually adapt to the market requirements – both internally and externally. However, during 1994-1997 the export index was constantly declining, whereas the average price of exports was growing faster (during those years more than twice). As a result, the export volume was growing from year to year, while the pace of its growth was gradually shrinking: from 32% in 1995 to 4.7% in 1997 (with the exception of the unique transaction of jets sale).

Along with the broadening economic openness of countries, many of them reached rates of exports growth prevailing upon the rates of GDP growth (see the graph). As shown in the picture, during the recent years Moldova’s ratio of export to GDP was unsatisfactory. The situation in the neighboring countries is as follows: in Romania the annual rate of export growth above GDP constituted 19% (during 1990-1997), whereas in the Ukraine, during 1992-1996, this indicator was tracked to be negative: - 18%.



Moldova’s development in the transition period is characterized, on the one part, by the stagnation and dying off of production, producing noncompetitive output, and, on the other part – by the development of export-oriented enterprises, that required investments into new technologies. Unfortunately the delay of enterprise restructuring did not allow to offset for the decline of production in some branches and by a growth in another, perspective ones.

Initially, in Moldova, as well as in other transition countries, the prices of many types of products were considerably below the world ones and that fact allowed to gain some benefits

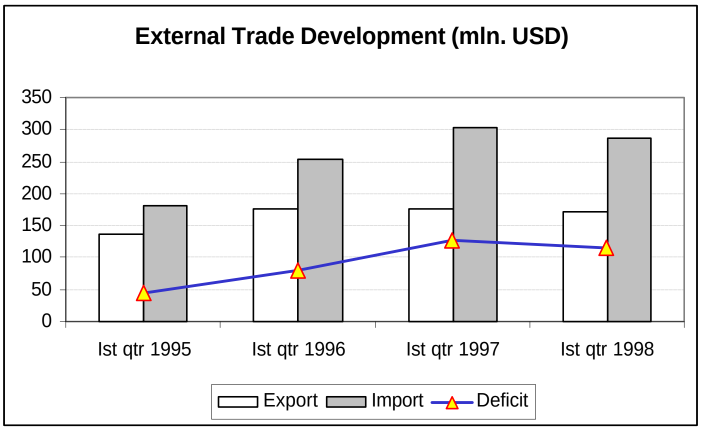


from the modification of trade conditions. During 1995-1997, owing to this factor, Moldova gained additionally US$ 308 million. Other countries' experience show, that possibility of favorable change of trade conditions is a temporary occurrence, which is followed by particular tension in the economy. As of the beginning of 1998 the Moldova's reserves for export growth through increasing prices practically exhausted.

The modification of average prices of basic types of exported products during the first 4 months of 1998, as compared with the same period of the past year, are presented in the picture. The index of the physical volume of exports continued to decline. As a result of a low level of grapes harvest, the demand of wine considerably grew, which conditioned the growth of its export price by 113%. This growth considerably caused the fall of overall volume of exports, for the red wine accounts for 37% of the exports of the country. The positive aspect in the export of wine is, that the share of bottled wine sharply increased – from 42% to 83%. In case there is a good harvest in the forthcoming year, the price of exported wine will most probably decline.

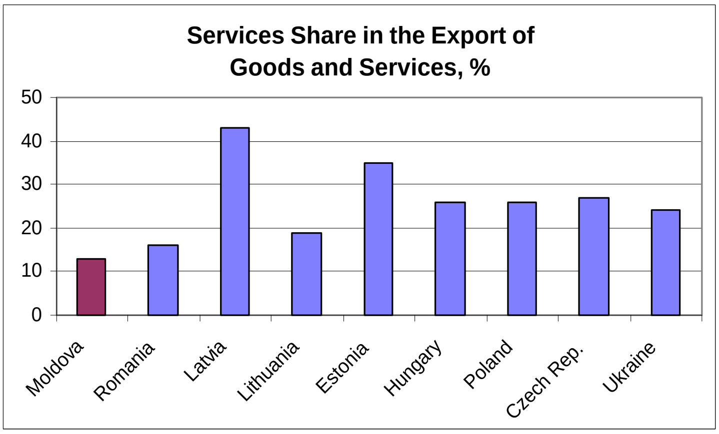
In the early 90's, due to well known events in the CIS, in Moldova, the share of re-export within total exports was big (some 20-25%), which once with the regulation of the identification of the country of commodities' origin and development of partner countries' custom systems, in 1997 declined to 4.8% (according to calculations of the Ministry of Economy).

During the 1st quarter of 1998 the export of goods, produced in Moldova (except for re-export), fell by 7.6% as compared with the respective period of the previous year, during 4 months the export volume stood below that of the previous year by 2.2%. The fall of export was also tracked in terms of all groups of products, with the exception of food products, alcoholic beverages, tobacco and outputs made of them", that grew by 12.2%. Thus, the export opportunities more and more focus on ready made products, made based of domestic raw materials (grapes, fruits, vegetables and sugar beet). The scarcity of hard currency resources at the economic agents and a limited demand implied a diminish of imports in the studies period. A stabilization of the trade balance deficit is manifested, although its absolute value still remains very big (see the picture).

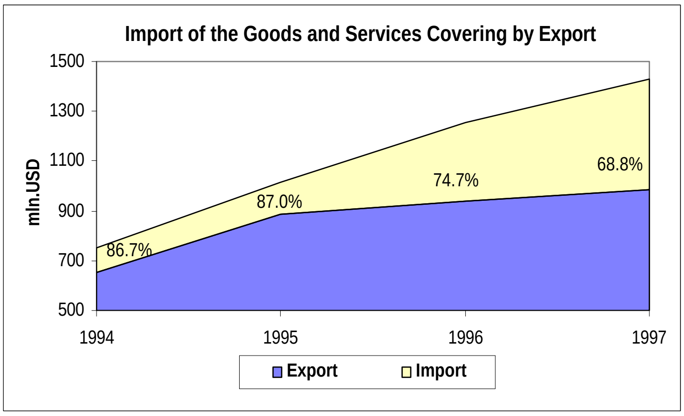


The diminish of exports could be explicated by the depletion of the row material base of the export oriented production (worsening of the state in viticulture, horticulture, tobacco – cultivation) and delaying of the restructuring the machine – building, light and furniture enterprises, which does not allow to escape from the colonial model of trade with energy and labor consuming goods. For the transition to trade with technologically more complicated goods the investing and producing growth of collaboration is needed. The restructuring of key enterprises, export promotion and the stimulation of import – substituting production are needed. As long as the amelioration of crises and restriction of the economy has a lengthy character, Moldova will have to work on the definition of its specialization in the international system of labor division.

In the modern world countries pay great attention to export of services, which in the international trade grow faster than export of goods: during the recent 15 years the average pace of service trade growth constituted 8% as compared with 6% of export of goods. In Moldova there haven't been created conditions for export of services, and thus, while export of goods grew by 15% in 1995, the export of services fell by 9%. In order to develop the export-oriented services, considerable investments are needed, including foreign ones, however, the inactive policy of the state in this field did not allow their attraction. Underdeveloped tourism, trade, poor quality and costly services in transports, communications and informatics engendered a deficit of trade balance of the country: in 1997 - US$ 43 million, and in the 1st quarter of 1998 - more than US$ 20 million. That is why, it is important to activate the policy of attracting investments into the service sector, oriented to export.



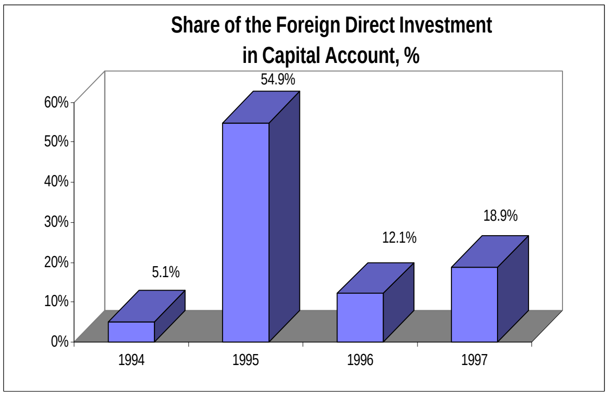
Comparing the share of exports of services within the overall Moldovan exports (13% in 1997) with those of a series of transition countries, one can notice the sharpness of the problem. During the last three years in Moldova comparatively faster have developed the export of services and informatics – by 2.2-fold, however, its absolute volumes are so far insignificant. When evaluating the export of services one should take into account, that the Moldovan balance of payments does not reflect the provided gas transit services, through high pressure pipeline, that should be adjusted by signing agreements with "Gasprom" on payment for transit of gas and on payment for gas by Moldovan consumers.

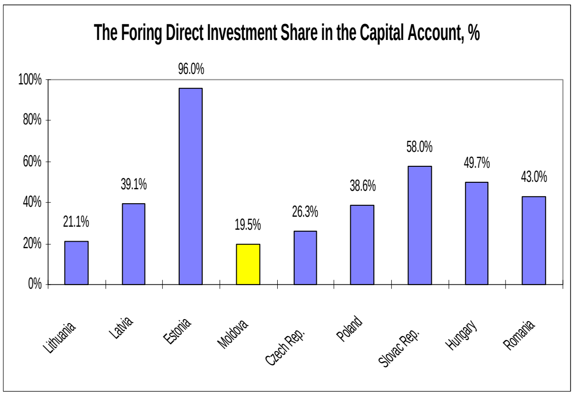


Starting since 1996 in Moldova the deficit of trade balance for goods and services sharply increased, which conditioned the growth of current account payment balance. International flows of capital for funding the economy of the country and international flows of goods and services are 2 sides of the matter. The deficit of trade balance of goods and services, *i.e.* positive balance of capital account points out the fact, that the country borrows financial resources from other countries.

The ratio of export and import of goods and services, as well as import coverage by exports are displayed in the picture. In 1997 the coverage level fell to 68.8%, which is less than the average indicator for low-income countries (72%). In fact all the countries at various periods of economic history use to either borrow capitals from abroad, or are lenders to other countries. And this is why, the deficit of current account not always reflects an unfavorable position of the country's economy. All the more, the transition countries are in objective need of inflow of capital for restructuring. Yet, the problem of Moldova does not consist in the growth of deficit of trade balance of goods and services as it is, but rather in the effectiveness of usage of foreign borrowings.

Given that the loans need to be remitted, by the time of loan maturity the country should have its niche within international trade, this is why the foreign assistance must be directed first of all to increasing the effectiveness of exports structural and reforms of economy, as well as to changing the import structure in order to increase the share of fund generating produce, designed for modernization of production sector and enhancement of Moldovan output competitiveness. As of Jan. 1, 1998 the foreign debt of Moldova amounted to US$ 1.2 billion, which accounted for 60% of GDP, and only an insignificant part of that was channeled to real economy sector.





Drawbacks in corporate management of privatized enterprises, lack of real owners with many of them, manifestation of “special interests” did not make possible so far to attract the required foreign direct investments (FDI) into the real sector of the economy. Their share within the overall finance inflow to Moldova is still very low. This indicator’s dynamics during the last years is displayed in the picture. Comparison of the share of direct foreign investments in the overall volume of loans in terms of various countries is displayed in the picture. For Moldova this indicator during 1994-1997 accounted for 19.5%, which is much less than with most countries in transition.

Given that during the years of macrostabilization in this country there was not created a basis for real sector growth, and consequently – of export potential, as well as limited the growth of export on the account of modification of the trade conditions, these factors can lead to a decline of exports already in 1998. Besides, there is a threat of worsening the import structure in terms of declining the share of fund generating products and increasing the consumer goods. That is why, urgent measures are required in order to create a favorable investment climate in the country. To mention is, that new Government Program for 1998-2001 the priority is mentioned of foreign economic relations development and export promotion.

Settlement of these tasks may contribute to:

- speeding up of Moldova’s joining in WTO and broadening relations with other international organizations;
- carrying out the policy of economic openness, removal of barriers hindering the flow of goods and capitals;
- concentration of capital with a view to activate its injection into restructuring the enterprises;
- stimulation of foreign capital attraction for setting up export oriented businesses;
- improvement of corporate management at the enterprises, improvement of legal basis aimed at protection of ownership rights;
- enhancement of human rights resources.

A series of measures designed for improving the foreign economic activity was included in the anti-crisis program, such as: setting up organizations for exports promotion, development of mechanisms for supporting exports, improvement of import structure and optimization of energy products consumption. Among them, the law “On anti-dumping, offsetting measures and protection of producers" and leverage to control prices of imported products for avoiding dumping.

CHAPTER 3. ENTERPRISES' SECTOR: STRUCTURAL REFORMS

3.1 Industrial policy and enterprise restructuring

The implementation of a new, market-oriented industrial policy and enterprise sector restructuring is the key for the sustainability of Moldova's economic growth, which has hitherto heavily depended on the development of a highly volatile agricultural sector, the main sector of the national economy. Only the reform of the enterprise sector can in the long term provide the necessary resources for the economic and social security. Delay of enterprise sector reforming is one of the main reasons for budget deficit, inflation and unemployment. This reform is at the heart of the country's transition on its way to Europe and it basically means enabling and fostering an accelerated restructuring of enterprise sector according to its competitive advantages in the market.

The purpose of the industrial policy is to reach a *growth of competitive industrial output in terms of quality and prices and to expand the markets.* Being a small open economy, Moldova should move towards enhancing its industrial products' competitiveness on foreign markets, otherwise the economy has no chances to survive, and subsequently, the country is doomed to vegetating next to more developed countries of the Central and Western Europe.

The industrial policy is part of economic policy of the state. Unfortunately, the Government's *Concept of Industrial Policy of the Republic Moldova for 1996-2000 (Oct. 1996)* has not received due support by the Parliament (in terms of its legal basis and economic mechanisms). Industrial development is therefore proceeding relatively in a relatively unplanned and undirected manner.

The *Program of the Government for 1998-2001* stipulates, that the "strategic target of the industrial policy is to form a multi-sectoral high-tech and competitive industrial complex, which will provide for a sustainable development and economic independence of the country, for sufficient incomes and integration of Moldova into the system of world economic relationships". The Government considers the *restructuring and further reform of the enterprises* as mostly important process of its period in the office.

Nevertheless by the middle of 1998 the situation in the industry is still serious. The enterprises are facing a lot of problems related to the following factors: high rate of barter transactions, low quality of products, high expenses per production unit, loss of traditional markets, high stocks of final goods, low level of production capacities use, enormous accounts receivable and payable, bank accounts blockage, high level of fixed assets depreciation after their reevaluation, decrease of working places. Currently 40 percent of the processing enterprises are non-profitable. The enterprise restructuring has become a necessary condition for developing Moldovan industry, because the foreign investors rate very high the risk of investing money in the enterprises that haven't been restructured yet.

The analysis has proved that the following additional conditions are necessary to speed-up and to promote successfully the restructuring process:

- to eliminate the barriers and obstacles related to the economic agents registration;
- to implement promptly the new accounting systems;
- to simplify the assets sales procedures;
- to launch new simple procedures of industrial land sales;