

Center for Strategic Studies and Reforms

Moldova in transition

ECONOMIC SURVEY

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Chişinău, April 1999

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MOLDOVA IN TRANSITION

economic survey

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PREFACE

The year 1999 will be for the Republic of Moldova at a crossroad. The I. Sturza Cabinet in its program took the way to a “new economic policy”, which more harmoniously combines the social components, structural reforms and actions in the financial sector. The program was backed by the Parliament, international financial organizations and it is more acceptable for the population.

The end of the first round of reforms (from the crisis of 1991-92 to the crisis of 1998) had a dramatic impact on the Republic of Moldova, through the events of the last year, both internally – in terms of economic decline resuming (after a positive break of 1997), salaries and pensions arrears accumulation, extremely low inflow of foreign investments, decline of exports (for the first time after 1990), as well as externally, due to financial crisis in Russia and extremely high level of foreign debt. Ultimately, a government crisis unleashed, which ended as late as in March 1999, granting, in the end, a chance to the Cabinet of the “young reformers”.

The contents of the present survey “Moldova in transition” takes into consideration the particularities of the moment and includes: evaluation of the lessons of 1998 and problems, that require first priority resolution; scenarios of the potential short-run social-economic development of the country; modeling of macro-economic indicators and processes, most important for enhancing the results of the reform.

This survey has been prepared in the framework of the UNDP/WB project “Strategy for Development”. The opinions and conclusions presented in this study entirely belong to their authors and do not necessarily express the viewpoint of the organizations which finance the research or of Moldovan state structures. In the drafting of the edition data from the Ministry of Economy and Reforms, Ministry of Finance, National Bank of Moldova, Department of Statistics and Sociological Analysis, TACIS project “Moldavian Economic Trends” was utilized.

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We invite you to collaboration.

1. LESSONS OF 1998. THE THIRD ATTEMPT AT STABILIZATION

In social-economic respect, the past year was for the Republic of Moldova any *year of disappointment*. The assumption that in the end premises for economic growth were created did not become true. Positive signal of 1997 (GDP +1.6%), growth of industrial and agricultural output, reduction of state arrears for salaries and pensions now have remained in the records of the transition economy just as a statistical episode. The President and the political elite of Moldova succeeded in achieving certain progress in terms of foreign policy, the Parliament was elected on multi-party basis (March 1998) and a new Government was formed, orienting its program towards reforms.

Regretfully, the break in reforms, undertaken by the Parliament in 1996-1997 and the following freezing of the relationships with IMF and WB led to enhanced structural disproportions, growth of internal and external debts, deepening of the budget crisis, reduction of cash inflows from exports, and a further aggravation of social situation. After August 1998 those problems were deepened by the Russian financial crisis, which became a catalyst of negative processes, such as reduction of foreign exchange reserves of the NBM, monetary and banking system disbalances, paralysis of production and exports, still heavily exposed to the Eastern market.

The *economic security* of the Republic of Moldova was at stake, and from the first time since the early '90s, this problem was examined (Dec. 1998) by the Security Council under the auspices of the President of Moldova.

Lessons of 1998. The events and results of 1998 show the *failure of the second attempt of stabilization* of the national economy. The first one (1993-1995) was rather successful (inflation suppression, national currency stabilization, mass privatization, commencing of industrial enterprises restructuring). The second attempt (1997) carried out by the Government, basically using administrative methods (pressures on tax collection, sale of jet-fighters, etc.), and having weak legal support from the Parliament, failed because of the accrued domestic structural disproportions, lack of structural changes at the micro-economic level, weakness of the state management system, and after autumn 1998 - because of the destructive impact of the Russian financial crisis. Neither the forecast of the Government, nor that of the international financial institutions became true.

The official statistics registered in 1998: minus 8.6% of real GDP and minus 11% of both industrial and agriculture output. Thus, the first round of reform – from the crisis of 1991/92 to the crisis of 1998 – was completed, however not in the best manner¹. After 7 years of reforms the Ranking List of the World Bank posted Moldova on the 94-th place amongst 133 countries, in terms of GDP per capita, including it to the group of 63 “Low income countries”². At the same time, all other countries of the South-Eastern Europe (Albania, Bulgaria, Macedonia, Romania, Turkey, Ukraine and Yugoslavia) were included in the group with higher incomes. In accordance with the UNDP evaluation (1998) about 80% of the population of Moldova have incomes worth less than US\$ 2 per day, whereas the income discrepancy between wealthiest 10% and poorest 10% reached 15.4-fold (in 1993 7.0-fold).

¹ For more details see “Moldova in Transition”, CISR Economic Survey No.2, Nov. 1998, pp. 4-9

² World Development Report 1998/1999, pp.189-191.

MAIN MACROECONOMIC INDICATORS

	1994	1995	1996	1997	1998	1999f
Real GDP growth rate	-30.9%	-1.4%	-7.8%	1.6%	-8.6%	-2.5%
Nominal GDP (excl. Transnistria), lei million	4737	6480	7658	8917	8804	10911
Nominal GDP, USD million	1164	1443	1665	1933	1630	1116
GDP per capita, USD	322	400	463	538	454	311
Export (fob), USD million	618	739	822	851	640	704
Export, yr/yr	156.5%	119.6%	111.2%	103.5%	75.2%	110.0%
Import (fob), USD million	672	794	1056	1235	1030	938
Import, yr/yr	126.8%	118.2%	133.0%	117.0%	83.4%	91.1%
Trade balance, USD million	-54.0	-55	-234	-384	-390.0	-234
Current account, USD million	-97	-115	-209	-309	-300	-129
as % of GDP	-8.3%	-8.0%	-12.6%	-16.0%	-18.4%	-11.6%
Foreign direct investments, USD million	18	73	53	79	70	150
as % of GDP	1.5%	5.1%	3.2%	4.1%	4.3%	13.4%
Stock of foreign debt, USD million	627	765	916	1005	922	957
as % of GDP	53.8%	53.0%	55.0%	52.0%	56.6%	85.7%
NBM gross forex reserves, USD million	180	257	314	366	144	200
NBM rez. In months of imports of GFS	2.85	3.03	3.00	3.07	1.42	2.15
Internal debt, million lei	270	477	737	940	1500	1700
Budget balance as % of GDP	-10.6%	-6.7%	-7.6%	-7.8%	-3.6%	-1.6%
Annual inflation rate (end period)	104.6%	23.8%	15.1%	11.2%	18.3%	19.1%
End-year exchange rate, lei/1USD	4.27	4.50	4.65	4.66	8.32	11.58
Average exchange rate, lei/1USD	4.07	4.5	4.6	4.6	5.4	9.8
Nominal end-year appreciation(+)/depreciation(-), MDL/USD	-17.3%	-5.4%	-3.4%	-0.2%	-78.6%	-39.2%
Nominal end-year appreciation(+)/depreciation(-), USD/MDL	-14.8%	-5.1%	-3.2%	-0.2%	-44.0%	-28.1%
Real end-year appreciation(+)/depreciation(-)	+74.4%	+17.5%	+11.4%	+10.9%	-33.8%	-14.4%

External trade data for 1998 is estimated

According to local and foreign experts, the main reason for poor economic performance was that during the past 2-3 years there was a vacuum of power in Moldova - a *political will towards reforms' continuation has weakened*, there was no unity of actions of the President, Parliament and Government, non-enforcement of laws, corruption of state structures and a considerable part of the economy shifted into the "shade".

It is significant, that the yearly research of the Heritage Foundation (USA) shows that the Index of Economic Freedom (IEF) for Moldova has improved significantly improved in the first half of the '90s (price and trade liberalization, quality of monetary policy, openness of the country to foreign investments, etc.) and the rating of the country rose from the 8th from the end, to the 96th place among 156 reviewed countries. However, during the recent three years, the IEF for Moldova stood unchanged – 3.35 (IEF'98: Singapore-1.30, Ireland-1.95, Estonia-2.15, Hungary-2.90, Romania-3.30 ... Cuba, North Korea-5.00).

The events of 1998 dissipated the illusions in the country. Both the Government and the population understood, that the monetary policy alone could not ensure a sound macroeconomic stability, while basic institutional and structural reforms were procrastinated, inconsistent, and sometimes even reversed.

So, what stabilizing factors have been applied in the economy of Moldova so far? Among main of them are: (i) non-payments, barter trade, clearing – which served as a mechanism of a non-monetary operating environment of the real sector enterprises, non-depending on cash flows and pricing signals; (ii) cash inflows from abroad, in the form of loans; (iii) rising import, due to a concentration of disposable funds at a "lion share" of economic agents, resulting a combination of the effects of first two factors.

To a lesser extent there were positive factors of the institutional and structural changes. This pertains first of all to the delay, up to the autumn of 1998, in adopting by the Parliament of the amendments to the Land Code, laws on energy complex reorganization, on bankruptcy, pension reform, administrative-territorial reform, etc. The work on Civil Code is going on already for the 5th (!) year. A serious demonopolization has not taken place in agro-business, energy delivery, transport and pharmacy sectors. The voucher privatization did not provide the enterprises with an effective system of corporate management and did not give them owners with stable motivation towards investment and development. In many cases this impeded restructuring of the industrial enterprises, which, as well known, started in 1995/96 after mass privatization, whereas in the agrarian sector, energy sector and other branches of the infrastructure it started even later. Bankruptcy procedures as mean of enterprises' financial recovery will be unleashed, apparently, only this year.

Inefficient legal regulation of various aspects of the economic life in conjunction with unreformed state machinery encouraged *emergence of corruption* and organized crime, hindering the private business sector. A considerable part of the business activities shifted to shadow economy, where the ownership right protection, contract execution, etc. are provided already based on different norms and methods.

Lack of a real control of state officials' activities, non-sanctioning of those not complying with the law, and on the other hand considerable arrears on salaries of state employees contributed essentially to extension of corruption in the Republic of Moldova. Any amendment to acting legislation does not have any positive expected effects due to the impact of corruption; the society does not develop according to market economy rules, there are no competition and progress in utilizing the disposable resources, state debt grows spontaneously, pauperization of the society deepens, there is a decrease of population's confidence in the state and conflict situations emerge.

It is hard to trust the information on the activity of the control organs, when the employees of those bodies did not receive salaries for 4-5 months. For them accepting bribes becomes the only source of surviving. That is why, starting from 1998 the data on criminal statistics, including that regarding the economic crimes becomes more "optimistic". Therefore, with the beginning of 1998, official data regarding the results of audits and inspections report a "diminution" of the average amount of fiscal evasion registered per tax payer. Also, in 1998 there were registered 2910 violations of economic and financial legislation, by 244 less than in 1997, losses being estimated at 103 million lei. Chişinău City Police marked a 13% decline in registered crimes, although 298 cases of criminal files concealing were discovered. By the beginning of 1999 statistical data of the Ministry of Internal Affairs shows an 11.4% increase in the total amount of crimes, after a decrease of 14% announced at the end of 1998.

A vicious circle is being created: corruption → economic decline → shortage of funds in the budget → arrears to state wage earner salaries → corruption growing.

Only corruption could be an explanation of the fact, that the Republic of Moldova imports natural gas at a price much higher than the world price, and at the same time it does not charge fees for gas transit through its territory (for information we would like to stress that the collected amount for gas transit through the Ukraine could be comparable with the GDP of Moldova). More strange seems to be the fact, that on the territory of Moldova (right bank of the river Nistru) there are no gas meters, therefore the volume of consumed

gas is estimated based on the data of the neighboring countries, connected to the same pipeline.

Financial sector problems. The situation in the financial sector during 1998 was quite troublesome. Here are the conclusions drawn with respect to the 3 main policy orientations – NBM's interventions in the foreign exchange market for supporting the national currency, foreign debt servicing, and internal debt.

NBM interventions in the FX market. Even before the Russian crisis began, an alarming sign represented massive sales of hard currency by the NBM at the Interbank Foreign Currency Exchange. For the first time since the introduction of the national currency NBM's net transactions at the Bourse were negative for many months in a row during January-July 1998. In total NBM sold \$41m more than bought during this time. Such a reduction of central bank's hard currency reserves could have had a serious impact on the exchange rate even if no Russian crisis was supposed to happen.

Then, right after the crisis started, NBM intervened massively at the Bourse defending the leu (in spite of warnings from IMF and others), and only during August-October 1998 it blew out another \$81m out of its reserves. Thus, total losses reached almost \$123m.

Starting November 2, 1998 the NBM decided to withdraw from selling hard currency at the Interbank Currency Exchange. At the same time it increased banks' reserve requirement to 15%. Official exchange rate is being set as a weighted average of rates of the banks' foreign exchange transactions.

It was a long way to this wise decision, which should have been done already somewhere in the first quarter of 1998. And it is advisable that this non-intervention policy remains such during 1999.

External debt servicing. Another aspect linked with the official foreign exchange reserves reduction is the need to service external debt, which implies transfer of big amounts in hard currency for the repayment of principal and interest.

In 1998 Moldova had to repay more than \$200m for foreign debt servicing – interest and principal. But the state external debt has not been entirely serviced – some of it, such as debt to Gazprom was not serviced at all. And since the Government and the central bank have not received any loans from IMF and World Bank for more than an year, the NBM was asked to finance out of its reserves a part of Government's external debt servicing. Moreover, at the very end of the year NBM fully redeemed the \$30m Government's private placement through Merrill Lynch, issued in 1996. Consequently the gross NBM's reserves dropped to \$144m at end-1998, comparing to \$366m at the beginning of the same year.

In 1999 the situation will not be easier at all – the country will have to repay about \$220m for foreign debt servicing. And the only way out, in the light of huge trade balance deficit, seems to be the new borrowing, mainly from the IMF and World Bank, which provide most attractive crediting.

Internal debt. At the same time, a big problem started to represent the country's internal debt. During 1998 interest rates on Treasury Bills have been continuously growing, reaching already the 40% limit right after the Russian crisis began. Having a rising deficit in funds to finance the current spending, the Government was more intensively trying to attract financial resources from local banking system and foreign investors in order to finance the budget deficit. Obviously, in order to place more securities the Government was pushing interest rates. However, this did not help much, on the contrary – there were dramatically increasing the needs to service this internal debt. Starting June 1998 the

proceeds received from sale of securities did not even cover servicing of T-Bills issued earlier.

In October 1998 sales of T-Bills dropped dramatically, while most foreign portfolio investors withdrew their investments (their share in total state securities issued being one third). In order to activate the securities market, NBM, which had to maintain the system alive since the Government did not have funds to do it, decided to introduce in November the mandatory requirement for commercial banks to hold 10% of their assets in the form of state T-Bills. This in the end helped to stabilize the situation, and the securities market slowly revived.

The lesson is, as it was pointed out in CISR previous reports as well, that the Government must sell state securities utmost in the amounts needed for servicing the ones issued before, finding other ways to reduce the budget deficit, for instance by cutting the spending and not by continuously borrowing (from the Central Bank, banking system or foreign investors).

With reference to the situation in the *banking system* it must be said that the commercial banks remain relatively undercapitalized, though in lei terms most of them well meet the NBM capital requirements. Starting 1 July 1999 minimal capital requirement will be increased from 8 million lei to 12 million lei, and from the next year it will be already 16 million lei. In order to improve the banking supervision, reduce risk and secure population deposits NBM is increasing requirement on capital adequacy subjected to risk (beginning with January 1, 1999 - minimum 10%). The issue of a deposits insurance corporation is unlikely to be developed further due to the inflexibility of NBM's position, as well as reluctance from international financial institutions which have doubts about the efficiency of such an institution and sources of its financing.

The issue of high systemic risk remains on the agenda, especially following the effects of the Russian crisis. Real interest rates remain high. Reserve requirement remains at 15%, though the Central Bank claims it will gradually reduce it during 1999, though depending upon the situation in the financial market.

Macroeconomic stability in the Republic of Moldova during the recent years needed one critically important component – *a balanced budget*. The overall deficit of the consolidated budget (state budget plus local budgets) during 1993-1998 varied between 5.8-9.1% of the GDP and imposed constant search of some internal and external sources for its covering. But these sources are very costly and virtually impede the flow of credit to the real sector. In this regard, the 1998 has been one of the mostly difficult years of the transition period, since there was a steep decline of the incomes to the budget.

As a consequence of the state weakness the fiscal evasions rose. To this fact contributed also the customs territorial "transparency" of the Republic of Moldova.

As a result, in the budget were collected incomes in the amount of about 2600 mil. lei, which in nominal terms show a reduction by about 250 mil. lei as compared to 1997, at the same time the amount of arrears to the budget increased. It should be mentioned, that cash amount of the overall budgetary incomes account for only 63-65% of the overall incomes. Barter transactions, netting out and payments in kind continue to be a considerable impediment in the development of financial-budgetary soundness.

Given that the access of the Republic of Moldova to the external financial markets has been virtually null, whereas the domestic market does not own sufficient capacities for lending to the budgetary system, a relatively low level of the budgetary deficit was registered (about 250 mil. lei). Starting May 1998 the net domestic funding of the budgetary deficit became negative, a fact that demonstrated, that the banking system and other Treasury bills and bonds (TB) investors did not want any longer to lend to the state even at

growing interest rates, given that the risks were also on the rise. External funding practically was not available.

Thus, the expenditures of the consolidated budget has been executed in volume of about 2.850 mil. lei, the cumulative expenditure arrears of the budget being at a level of more than 1 bn lei. Considerable arrears have been registered in terms of salaries, payments for goods and services, scholarships, etc.

The burden of 1998 problems passed to 1999. Amongst the main problems that will impede the budget execution in 1999 could be pointed out the following:

- Customs territory transparency. The formal bodies of the Republic of Moldova are controlling only 65-70% of the territory. The problem keeps aggravating also due to corruption of the customs bodies, as well as protection of some cargoes by state officials;
- The budgetary system, particularly during the first months of the year, will be deprived of incomes due to shifting to a new system of VAT calculation for trade relationships with Russia, Belarus and raions from the left bank of the river Nistru. This has been already confirmed in January 1999. It could be mentioned about the reduction of incomes pertaining to export oriented sector, particularly on the income tax and incomes from foreign economic activities;
- Barter transactions, netting and payments in kind will further contribute to deterioration of the public finance system. It is urging to decide on banning similar activities, more over because the given practice generates a rise of both mutual indebtedness among the economic agents and the latter and public sector;
- In similar conditions budget execution in terms of expenditures will be difficult. It is at stake the capacity of the state to fulfill its priority functions: in maintaining public order, education, health care, social assistance, referring to servicing both the external and internal liabilities. At the same time the state would no proceed officially to staff dismissal, thus maintaining a tensioned situation in the society. Most tariffs on electrical power, natural gas, thermal power (after Dec. 24, 1998) make the normal run of budget funded institutions impossible, because that increase has not been stipulated in the budget law on 1999;
- A continuous problem will be that of salary payment. According to the estimates, the state will not be in position to pay neither current salaries, let alone the historical debts in this regard. Political will is required and consistency in dismissing sharply the public sector employees, including public administration, as well as transmit to private sector some objects, whose maintenance are costly to the budget;
- Servicing the external state debt, in condition when the leu will fall in value even more, will cost the budget more than 25% of the overall expenditures, a fact which can reduce to zero any other state expenses. It is necessary to run a tough policy in monitoring and addressing the external state debt, because, unfortunately, the self-regenerating process of the debt has started.

Capital market. In conditions of transition to market economy the capital market becomes the main source of economic growth. The access to the financial resources is the primary condition for re-technologizing, access to know-how and overall scientific and technical research realizations.

The main condition for investment attraction is the stability in the country. In 1995 the Ministry of Finance decided that the only source of budget deficit funding would be

Treasury Bills and Bonds (TBs), placed both on domestic and foreign markets. This fact substantially contributed to reaching a stability of the national currency and diminishing bank interest rates. By issuing TBs the Ministry of Finance targeted two objectives: to obtain a non-inflationary source of funds, support the development of the capital markets and offer a practical instrument of running monetary policy. The NBM declared the TBs as mostly liquid securities. The incomes obtained from TBs are not taxable (according to the budget law on 1998-1999).

The pyramid of the securities market in Moldova has been existing for more than 3 years, and, almost collapsed in the second half of 1998. During August-September there were sold TBs in the amount of 176.56 mil. lei. At a supply rate of 330 mil. lei, the average rate of interest rose to 35.5%, and subsequently to 43%. In 1997 the average rate of interest for 28-91 days maturity TBs constituted 22%. This was an excessive interest rate in conditions of an 18.3% inflation rate. The declining volume of sales could be explained by market supersaturation – in conditions of general poverty few can afford to invest in securities; lack of trust in the new government, formed in May 1998, as well as loosening of confidence in these financial instruments' liquidity.

As a result, in August the accumulated funds were sufficient only for redeeming the securities issued previously, the threat of budget deficit deepening being still persistent. TBs with a 7-14 days maturity became mostly liquid and enjoyed most popularity. The steep fall in value of the leu in October undermined the trust in the national currency stability; the securities bearing a stable interest rate became far too risky. In December 1998-January 1999 the demand for TBs started to surpass the supply. Yet, this increase was caused at most not by the sure and big incomes supplied by these TBs, but by the NBM's regulation, according to which 10% of the commercial banks' assets had to be in the form of TBs. Later this ratio was lowered to 5%.

The first experience of Moldova with international loaning through Eurobonds was successful. Ministry of Finance issued through Merrill Lynch \$30m in 1996 and \$75m in 1997. The first Moldovan \$30m bond was issued in 1998. Yet, the financial crisis determined the investors not to prolong for an extra-year the repayment of the \$30m private placement issued in 1996 for 2+1 years. Moody's rating agency decreased the sovereign rating of Moldova from 2ab to 3.

In 1998 at the Stock Exchange of Moldova were sold 75 mil. shares worth 438.2 mil. lei, twice as much compared to 1997. The sales record was registered in December, when the operations volume amounted to 93.8 mil. lei. More than 30 brokers' companies are registered at the Bourse. Almost 900 companies are registered at the Stock Exchange of Moldova, but only 20 comply to the requirements in order to be included in one of the listing categories. The first incomes of the bourse – about 91 mil. lei and its shifting to self-funding occurred in 1997.

At present virtually there are no opportunities for portfolio investments in the securities market of Moldova. As long as the corporate securities do not generate incomes, most of the JSCs do not pay dividends, emergence of portfolio investments is not likely to occur. A good deal of purchasing operations are effected with a view to obtain the package of shares of one or another company. After the investor obtains the controlling package of shares, the other shares virtually loose their value. After the completion of privatization and ownership distribution there is a threat of stock exchange importance diminution.

Thus, the secondary securities market can be considered closed. The primary corporate securities market is closed too. Most of new share emissions are made on the condition that its old owners preserve the control upon the enterprises. In addition to that it is very complicated to obtain veritable data about the local enterprises. In 1997, for instance, only circa 300 companies published their yearly balance-sheets. A serious competition can be seen in the extra-bourse market. In 1997 those transactions amounted to about 60%, in 1998 having dropped to about 40%.

An important step towards creating a civilized securities market was the foundation of National Depository of the Securities Market. This structure is pre-targeted to facilitate the clearing operations, and recording the transactions carried out at the Bourse. Also, the Depository hinders from the performing illicit over the counter operations. The Depository encountered a serious resistance on behalf of the independent registrars. Another problem faced is the regulation on mutual payments. Only the NBM holds this exclusive right in Moldova, thus the activity of the Depository being burdened.

At present in the Republic of Moldova operate 43 companies that provide insurance services to population and legal entities, their income making up 104 mil. lei. The law of the Republic of Moldova on bills of exchange was adopted in 1993, yet, the bills of exchange are not used at large. The reasons are the difficulty of the legislation and mechanism of issuing and legal supervision in case of their non-payment, lack of population confidence towards the financial and banking system, lack of quotation mechanisms of shares at the bourse, the advanced risk of bills of exchange as compared with other securities in circulation on the territory of the Republic of Moldova. The issue of the bills of exchange is convenient both to the commercial banks, which get a source of funds attraction, as well as of the enterprises, that can perform faster mutual payments.

In September 1998 there was adopted the strategy of reforming the pension system, in October there was promulgated the Law regarding the state insurance pensions. The Law on private pension funds was adopted in March 1999. Yet, those mechanisms are not viable. Creation of personal pension accounts for the inhabitants of the republic is procrastinated.

The Republic of Moldova needs a well shaped and efficient securities market: it is necessary to reschedule the internal debt into an external one for a longer run and a lower interest rate than the domestic one – of about 30% as of today; it is necessary to create an agency for rating–indexation of securities in circulation on the Moldovan market (the creation of the Mobias Intelligent Finance independent company is a good initiative in this context); in condition of chronic non-payments, it would be desirable the permission of payments to the budget by way of bills of exchange; salary and pension arrears could be paid in shares or other types of securities, sold subsequently on the secondary securities market; in conditions of a functioning equity market enterprises could attract funds at lower rates than bank loans.

Real sector of economy. If one would divide the economy into the financial and real sectors, then everybody will agree, that it is the real sector that is the basis of the economic development of such a country like Moldova. It will be fully logically to ask the question: which are the results of this sector development?

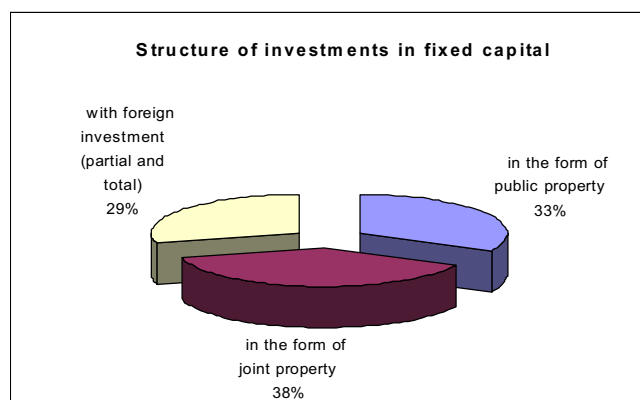
Macro-level:

- Drop of real GDP three times compared to 1990 – is almost an unique phenomenon in terms of dimensions amongst CIS countries, it also having beaten the record in its low level per capita amongst the CIS countries – below US\$ 500;
- The country consumes more and saves less, the GDP structure, calculated based on final usage method, shows an insignificant growth of the final consumption (from 57.5% in 1992 to about 97% in 1998); The state structure is more and more costly for the society (from 5.4% of the GDP five years ago to 27% in 1998).
- Dramatically declines the gross accumulation of fixed assets (from 59.8% of the GDP in 1992 to about 24% in 1998). According to the economic canons, this would cause an economic fall in the long run.

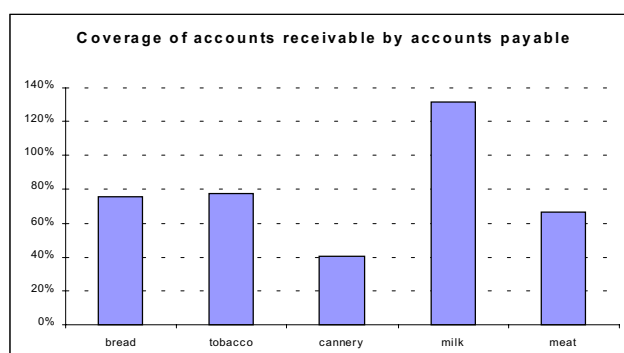
Diminishing investment into the public and private enterprises is partially compensated by the investment into foreign companies and joint-ventures. Regardless to the fact, that as a result of the enterprise privatization the number of private enterprises and joint-ventures increased, and the number of public enterprises decreased, investments into fixed assets in both of those two sectors have diminished as compared to 1994 by 40% and 55% respectively. The yearly volume of direct foreign investments during the recent years in Moldova amounted to \$50-70m or \$15 per capita per annum. The structure of investments into the fixed assets in 1998 is displayed on the graph.

A particular role in investing must have been played by investment funds, however they do not have enough funds, their activity is poorly controlled, the rights of small stock-holders of these funds are virtually unprotected by law. In 1998 the idea of creating technical parks and free entrepreneurship zones, oriented to export was not capitalized on, that might have broaden the inflow of investments.

Industry. In 1998 the industry accounted for about 58-60% of the early '90s level. A particularly deep drop was registered in light and furniture industries and machine-building complex. As a result in 1998 the production capacities of about 2/3 of enterprises were used at 10-20% of capacity, with all consequences deriving therefrom.



Industrial enterprises maintained a high level of dependence has been preserved of the from agriculture. The fall of overall agricultural output considerably impacted the level of the industrial output as a whole. Moreover, the pace of agrarian sector restructuring continued to be low, and that conditioned a catastrophically low level of investments in this sector.



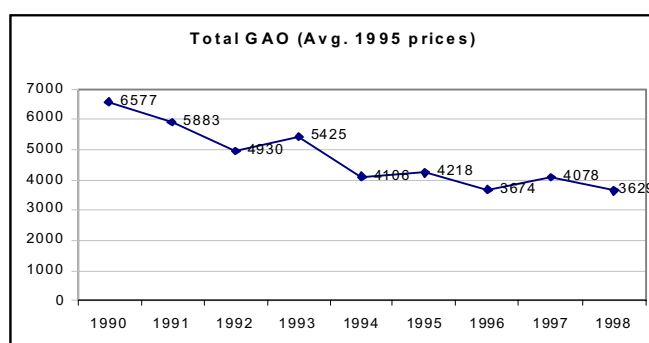
increased by 14%. The enterprises' liquidity considerably reduced, accounts payable cover the accounts receivable only at 68% (in 1997 this indicator for 74.5%). The level of this indicator for processing industry equaled 54%, its position in certain branches being displayed on the graph.

Delayed structural reforms in the energy sector led to its degradation. An increase in tariffs for energy sources was not backed by a clear and real system of compensations for the poor population, this is why on monthly basis only less than 5% of the natural gas consumers paid for it. State debts on gas soared to US\$ 90 mil. Besides, increase of tariffs for energy fuels and introduction of 5% duty on raw materials import diminished the competitiveness of the Moldovan products. The efficiency of energy sector enterprises' operation will depend on how qualified will be organized the process of attracting a strategic investor.

Agro-industrial sector. Moldovan agriculture remains hobbled by big insolvent agricultural enterprises and by small poorly equipped farms, both being unable to compete with Western producers. The situation of the agrarian sector is much worse compared to the first years of reforms. Now whatever might be the combination of measures, the situation is likely to deteriorate quite a bit further.

The gross agricultural output (GAO) during 1998 shows a decrease mainly due to the slump in horticultural products. Almost all crops except for vegetables, sunflower and potatoes showed a decrease in harvested volumes: cereals by 29%, corn – 47%, sugar beet – 16%, fruits and berries by 73%.

The reduction was caused mainly by reduction in yield rates per hectare (especially fruits - by 74%), surface of cultivated area, delay in harvest campaign, use of fertilizers (1-2 million tons compared to needed 8 million tons annually), phyto-protection of plants, etc.



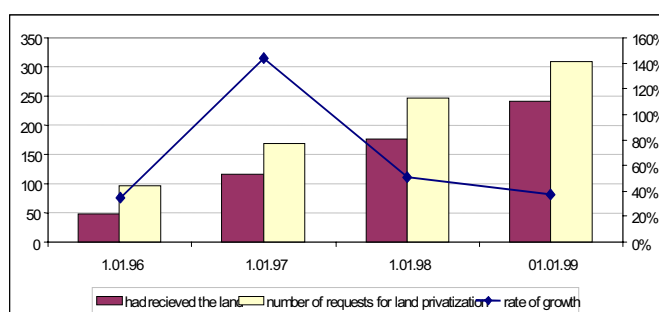
In 1998 most of processing enterprises used their assets at 30-35% of their capacity, and some of them are even stationing, their employees being sent on forced leaves. The volume of agricultural production constituted 85% of 1997 level. The sugar processing enterprises produced 25% less, canneries – by 23% less, wineries – by 28% compared to previous year. Production of meat processing factories is on continuous decline. Only two factories out of nine are functioning. On the same period, dairy enterprises showed an increase in production by 125% as compared to 1997. Worsening of the industrial processing sector during 1998 can be explained by lack of raw materials, lack of funds, impact of Russian financial crisis, outdated technologies and high product costs, that lead to non-competitiveness of domestic products,

insolvency of main sales markets (Russia, Ukraine and Romania) and lack of new solvent markets. According to estimates of the Ministry of Agriculture and Processing Industry the national economy incurred losses of 1.5bn lei, the state budget having missed to collect some 250 mil. lei.

In 1998, the share of individual sector in GAO increased by 10% and constituted 61% of the total. The private sector showed better results in both crop production sector (55% of total) and livestock production (61% of total). As of 1 January 1999, the total number of landowners constituted 241 thou. Thus, during 1998 their number increased by 66 thou (29%).

The chart on the right outlines the pace of ongoing land reform. Indicators show that 1996 is the most progressive year of land reform, then followed an acute decline in 1997 and a further decrease in 1998.

Land privatization



Very soon the land will be privatized and distributed to farmers. But the end of agriculture reform is still far, because it should continue with property consolidation, modernization of economic and production structures. New landowners need support, as they lack financial resources and relevant experience in the new circumstances. Recent adoption, in the first reading, of President's proposal regarding the legislation on land, which accepts depriving the land owners in case when they do not farm the land plots, is not a proper approach on behalf of the state to supporting new owners. This stipulation is contradictory to the stipulation of the Constitution of the Republic of Moldova on land owner rights. The land owners shouldn't be sanctioned in case when they decide not to use the land plots. Penalties should be imposed by the state in case when non-processing of land plot affects the surrounding land owners. In this situation elaboration of more efficient mechanisms of farmer support is required.

The slow pace of ongoing reforms is very expensive to the state budget. Historical debts of the agricultural enterprises constitute on average over 2bn lei. From a number of 1493 agricultural enterprises 65% have debts bigger than their sales, 28% have debts of 1.3-3 times bigger than sales and debts of 1.3% of enterprises surpass 10 times the volume of their sales. The financial situation of agro-industrial complex is even more deteriorated by the delay in making decision on restructuring the agricultural producers' debts and lack of efficient legal bankruptcy mechanisms. If this problem is not solved during the nearest future it will lead to a sharp increase in the share of shadow economy and theft of state and private properties.

In the difficulties with the budget deficit there is no hope anymore for granting subsidies or privileged loans to agriculture. The privatization process is not finished yet, and questions emerge on undertaking measures, which could stop the continuous demolition of the private and public property. The sector is continuously shrinking its working capital and barter transactions are increasing. The situation in which loans are not available, the expansion of barter transactions in the agrarian sector is inevitable. The major problem is not lack of food but the lack of financing for performing food procurement. The mechanism of payment for debts in kind is becoming a major impetus for trade destabilization: producers are offered lowered prices in order to increase the food coverage of their debts. This will lead to a decrease in agricultural prices and continuous deterioration of producers' financial position.

One may say in conclusion that there is a need in a funds inflow - banking capital into the credit market and foreign investments. Only for currents needs the sector needs on average \$180-200m (ARA's estimation). In other words, one can not expect a considerable improvement in the financial situation of agro-industrial sector this year.

Domestic trade, paid services. The economic crisis, falling purchasing power of the population and trade shifting to shadow economy caused the decrease, during 5 years, of the retail commodity turnover indicator by 40%. It is hard to believe, that the organized market accounts for almost half of the entire commodity turnover, if to calculate the volumes of commodity sales per capita, displayed by the statistics per annum (!): 2.5 kg. of meat, 600 gr. of fish, 200 gr. of butter, 700 gr. of oil, 1.9 kg. of potatoes, 3.4 kg of vegetables, 7.6 kg. of fruits, etc. The rural population (54% of the total) accounts for 26% of the commodity turnover, which proves again, that the rural localities pauperize faster. The private sector accounts for 74% of the overall commodity turnover. It is worth mentioning, that the commodity circulation of the public enterprises expressed in fixed prices of 1992 remained practically unchanged (about 8.7 thou lei), the same indicator in the private sector decreased almost 2.5-fold (from 10.3 thousand lei in 1992 to 4.2 thousand lei in 1997), which proves to a great extent a hiding of incomes in the private sector, rather than a lesser incomes of the latter.

The volume of paid services rendered to population has fallen since the early '90s in comparable prices by 75%. The structure of rendered services has changed: the share of social services decreased and increased the share of communal and communication services. This to a great extent could be explained by uneven rise of prices on this type of services. Most of all rose the prices for communal services, transport and communications. In the structure of ownership prevails the state sector (86%).

External trade. The indicator of economic "openness" of Moldova in 1998 reached 115% [(export+import)/GDP], this being the reason of exposure to external shocks and openness of domestic market to imports of poor quality goods. Problems which draw the attention here are:

- The peripheral nature of the economy has extended – in export structure grows the share of unfinished products (raw materials). The export structure became more agricultural-prone, and respectively more depending on climate conditions in an environment of non-irrigated farming (the share of agro-industrial complex in the export rose from 40% in 1992 to about 70% in 1998);
- The republic became monopsonistic, a considerable dependence of exports from one country-buyer (the share of Russia as main importer of Moldovan goods increased from 40% in 1992 to 61% in 1998). On the other hand, 80% of energy resources, such as coal, coke, gasoline, diesel fuel, and 100% of natural gas is imported from two countries – Russia and the Ukraine;
- By December 1, 1998 a decrease was noticed in net export from \$94.6m in 1994 to \$366.1m. In comparable prices of 1994 (millions of US dollars) exports changed slightly, whereas the import rose by 40%. The anticipating pace of growing prices on export as compared with import prices – is a positive phenomenon, yet, ephemeral, caused by the equalizing prices on domestic and external markets. Weak export flexibility to changing real exchange rate of leu and big share of energy resources in the import make the mechanism of export encouraging through changing the real exchange rate of the national currency almost impossible.

The consequences of the Russian crisis were dramatic for Moldova, due to its big dependence on the Eastern market. On the one hand, the trade share with CIS countries

decreased from 87% in 1991 to 35% in 1998, yet, from the other hand the export volume of Moldovan products to other countries also diminished and accounted for 74% of the 1995 level. The enterprises need investments in order to raise the quality of goods to international standards. However, enterprises chose the path of least resistance and sold production on the CIS markets, which do not have considerable requirements in terms of quality. Meanwhile, during late months of 1998 the export decline in the CIS countries was much deeper, than in other countries.

A particular role in the export to other countries plays the production of light industry, which reached 1/3 of the overall volume of export to those countries. Taking into account the preferential system provided by the EU countries to Moldova, the above mentioned production is a priority for promoting to the market of the other countries. While the export of food industry to those markets declined by 36%, the export of textile industry output and its articles increased by 22%.

Privatization and the private sector. One of the negative lessons of 1998 is that for the fate of the national economy is crucial to reach a mutual understanding between state structures and entrepreneurship. Meanwhile in Moldova the entrepreneurs became already a real power, which require a proper treatment. In a democratic society the Government should find a consensus with the businessmen at least for increasing the taxes inflow. As a result of administrative pressures on businessmen more and more economic agents shifted to the shadow economy, thus broadening the scale of smuggling and corruption and avoided tax payments to the budget.

During recent years three privatization programs took place in Moldova: for vouchers (1994), mixed (1995-1996), and for cash (1997-1999). As a result of the first two programs the formerly state property was “disaggregated”.

Proceeding from the need to complete the incomes to the budget, as well as urged by the international financial organizations in 1998 a certain progress was reached during the cash privatization (the energy sector, Moldtelecom, Moldova-Gaz, Rezina Cement Plant, “Floare-Carpet”, and others); it is not clear yet, how come, Moldova having submitted 50% of the share package of Moldova-Gaz, worth \$290m, decreases its debt to Russia only by \$47m, or, that in conditions of collapsing Russian ruble the Moldovan wineries on the territory of Russia are evaluated in rubles and not in US dollars? The sale of Moldtelecom does not contradict the Law on Monopoly.

It is still arguable the question of the share of private sector in GDP, because the private sector includes also such formations as collective-farms; a process is taking place of mass shifting of private economic agents to shadow economy. The private sector broadens, whereas the official statistics continues to provide distorted picture of its functioning by false conclusions. Thus, according to the latter, the productivity in the industrial sector is 3-4 times higher in the state sector as compared with the private one, or another conclusion - putting into operation of residential houses built up by private builders during the last 7 years diminished more than 3 times.

Shadow economy in 1998 reached dimensions, that were dangerous for the economic security of the country. The reality is, that the hard but “non-compulsory” tax burden (of about 50%), and the lesser, but obligatory informal burden (40% payment for the “political cover”, bribes to the bureaucratic machinery, payments for avoiding the artificial barriers for an economic activity, etc.) place the economic agents before the dilemma: bankruptcy or going to succumbing to shadow economy. Another circumstance – budget problem of the state and its capability to stimulate the work of the controlling bodies in due manner, non-payment of wages for some months corrupts and decreases the interest of the controlling bodies in tracing out the economic and financial violations.

As a result, shadow economy developed fast (its share as compared to formal economy grew from 25% in 1992 to 40% in 1994 and 55-60% in 1998). According to estimates, tax evasion increased from 3% of the consolidated budget income to 25%.

Financial and economic discipline violation frequency traced out by the employees of the Department of Revision and Control increased to 78%, whereas the frequency of economic legislation violations, revealed by the personnel of the Main State Financial Inspectorate – to 55%. In 51% of the performed controls by the Department of Standards, Metrology and Technical Supervision are unveiled violations from the norms; in terms of imported production this indicator accounts for 80%.

The transparency of the Moldovan borders, difference in customs and fiscal regimes on the territory of Moldova, Ukraine and Russia lead to many illegal export-import operations. Thus, comparison of import-export operations data traced out deviations of 92% of export transactions to Russia (1996) and 100% exports to the Ukraine.

Social implications. The phenomena, which occurred in the economy throughout 1998, have had significant adverse effects on living standards. With regard to this fact, statistical data reveal an *excessive decline in people's welfare*. The real monthly disposable income per person has dropped by 11% and reached its lowest level in the last four years – 118 lei (\$14). Consequently consumption of marketable goods and services has shrunk, giving more room to closed household consumption of homemade products. The share of expenditures for foodstuffs has extended by another 3% and captured almost 70% of the total household income. Disturbances in public finances and weak tax collection that prevailed throughout the period have *aggravated considerably salary/wages payments*, making paying off the arrears owed more difficult than ever before. If at the beginning of 1998 the overall stock of budgetary salary arrears accounted for 2 months, now we have entered the 1999 with a 4.5 months salary debt. The *financial viability of the social fund budget is very poor*. The chief reason is a low collection of social contributions. On average the ratio of tax collection did not exceeded 60% of the annual commitments. As a result, a great deal of both payable and receivable accounts has accumulated. In comparison with January 1998 the overall stock of pension arrears nearly doubled accounted at the moment for about 300 mil. lei. Due to lack of financial inputs into social fund budget, pension in-kind was practiced at a large scale; almost 50% of the total paid pensions comparable with 30% in 1997. The cumulative effect of financial disorderly adjustments has precipitated *income disparities and spreading of poverty*. The magnitude of income distribution is very large and constitutes 1:16. Changes occurred in income distribution were in detriment of the poor. The bottom 20% of the poorest population has shrunk their share from 5% to 4.3%, while the top richest 20% increased their welfare from 45% to 52%. Thus the rich become richer, and the poor become poorer. As a consequence, about 80% of the entire population live on daily incomes of less than \$2.

Main lessons. Outgoing 1998 year had proved one more time the rule: social costs get higher and people's credibility weakens once reforms are procrastinated. In the social sphere the *pace of reforms was too slow* and attempts to make some changes were done in a controversial and shallow manner. Exception could be only legal framework where several important laws have been approved. We can mention here the Law on Mandatory Health Care Insurance (27 Feb.); Law on State Pension Insurance (14 Oct.) and Law on Minimum Medical Services provided by State (1999 Feb. 3). Several more couple drafts of laws have passed the 1st and 2nd readings in the Parliament, waiting for the final stage (Law on Non-State Pension Funds, and Law on Social Insurance). Attempts to pay off pension/salary arrears have fallen due to lack of consistency in promoting social reform. Government institutions were *conceived mainly with current issues*, acting as a fire-fighter brigade. Time, money, and efforts were spent on taking ad-hock measures, which brought some insignificant and temporary results.

Institutional network for implementation the new laws is not settled yet. In reality a huge gap between the new legal framework and outdated social security institutions can be seen. Consequently, pension, health care and other sector reforms stopped. Public social arrangements are too costly and badly targeted. Keeping further the *implicit nature of the social expenditures*, as well as the *broad range of the social privileges* could undermine the fate of the social reform. Undertaken desperate actions to fit expenditures with the revenues did not have a positive effect. Three times during the 1998 the social fund budget was revised towards reducing either of its sides, but the result was insignificant. By the end of the year pension arrangements were paid at 60% of their initial rate. Family allowances and compensations for public utilities are too diffuse and provided in a manner closed to the universal coverage. *Cross-subsidization* of the electricity and thermal energy tariffs is the most vulnerable point in the social safety schemes. They captured near 20% of the public budget revenues, and are convenient only for the companies which produce/deliver energy resources. Phasing out the subsidies could meet strong institutional constraints, making this issue politically sensitive. The *administrative capacity of social institutions is too weak*, and this could be a serious impediment for the implementation of the reform proposals. Besides that, lack of publicity of the aims and scope of the social reform have strengthened opponent's positions and intensified rumors which impacted upon the success of the reform.

Policy options. Among broad range of social issues which face nowadays Moldova the following three groups will exert more pressure during the 1999.

Financial imbalances. The main challenge is how to meet social commitments, particularly pay off salary/pension arrears within tough fiscal and budgetary constraints. In line with that, policy instruments should be designed in a *targeted and cost-effective* fashion. This involves the necessity of rationalizing social expenditures in context with public finance restructuring. It is expected to be revised the level and duration of benefits. Eligibility criteria would need to be tightly designed. With regard to subsidies, it seems that it is premature to completely phase them out. Therefore, it is more likely to take the pragmatic approach of *limited transitory consumer subsidies*, keeping a trade-off between narrowness of targeting and the budgetary costs of subsidies.

Institutional issues. Efforts should be focused on making more simple the administrative procedures and reducing operational costs. Meanwhile improvement of institutional capability is getting more crucial and this requires development of a new organizational network for social security schemes. As a result, we can expect changes in a personnel structure and even some lay-offs.

Legal issues. They will deal at the same time with two kinds of activities: designing new legal framework and giving room for making operationally the new adopted laws. That is why, for 1999 year it is more likely that the latter job will prevail in order to unfreeze pension and health care reforms. Also, enactment of ministerial legal procedures is required for setting up the new social assistance infrastructure.

The chance for "young reformers". As we can see, under the impact of both external circumstances and internal factors, the Moldovan economy fully displays its dual nature. On the one hand are evident all the features of the liberal economy – openness of the country, needed laws and institutions are available. However, the laws are not enforced, the courts of law do not apply them, the latitude of the shadow economy is large. A mechanism has not been established on developing socially effective decisions and their implementation. Many institutions - High Economic Council under the President, the group of advisers to the Government, Fund of Entrepreneurship Support, Agency for Attracting Investments, Agency for Export Promotion, Stock Exchange, etc. – stood still on the incipient stage. On the other hand, there are strong mechanisms of group interests' realization.

Ever now and then the emerged discrepancies between the power branches, frequent changes of the Government, trade unions' conformism and frequent elections (each 4 years – 3 election campaigns!) constantly animate the hopes of the population to change.

Apparently a political and economic system emerged in the country, that not only reinforces stagnation, but for which economic depression and political instability is an invigorating environment for existence.

Finally, in Moldova starting the spring of 1999 the young reformers – liberals, who have to carry out an open and understandable program of reforms, by trying to make a U-turn in bettering the situation, got a chance. The need of a “new economic policy” for Moldova is determined by the main circumstance – a real threat emerged for the security of the country. Many of its indicators are close to the critical bottom level, both economic and social³.

In the created situation the main tasks of I. Sturza's Government, which was commissioned the mandate on March 12, 1999, are to overcome the acute phase of the crisis and to promote the reforms more actively based on the principles of economic soundness and social equity. The first block of problems, that have to be decided:

- determining the “*growth zones*” in the national economy, real sector and entrepreneurship development, by parallel reduction of shadow economy;
- *suppressing corruption*⁴;
- *revitalizing the state budget*, increasing the rate of tax collection and rationalization of the state expenses, limitation of budgetary liabilities;
- promoting a more economically efficient *privatization (for cash)* oriented towards attracting foreign investments;
- completing the “*Land*” National Program, restructuring the loss bearing agricultural enterprises by way of setting up new market infrastructure for farms and rural population;
- increasing and *promoting export*, its reorientation to new markets, restructuring and retechnologizing for these purposes of the industrial enterprises;
- reorganization and privatization of the *energy sector*;
- reformation of the *social sphere* – pension reform, reformation of the education and health care systems;
- *functional restructuring of the local administration*, reestablishing the unity and territorial-economic integrity of the country (Transnistria).

Biggest part of the problems must be resolved already in the next years⁵, through short term scenarios, some of them being long-term. It is fundamentally important, that while implementing both political and structural reforms, the Republic of Moldova enters the 21st century by activating its competitive advantages, otherwise it will become a niche to be filled by products and services of the other countries. Orientation to European Union, membership of WTO will play a vital role in this modernization process.

Ultimately, confidence is necessary. It is an important factor in economic performance: international political confidence with respect to Moldova and confidence in domestic politics. In many areas recent Governments have performed not so well, and we will hope that the new generation of political leaders will be more successful in their actions.

³ “Moldova in Transition”, CISR Economic Survey, No. 2, Nov. 1998, pp.6-7, 88.

⁴ See the Annexes: “Corruption as driving force of the shadow economy”.

⁵ “Law supremacy, economic revitalization, European integration”. Action program of the Government of the Republic of Moldova for 1999-2002. Chişinău, March, 1999.