

2. MACROECONOMIC SCENARIOS FOR 1999-2002

The authors would like to express their appreciation for critical comments and suggestions they have received on the earlier version of the scenarios to Mark Horton, Resident Representative of the IMF in Moldova

2.1. General description

Two scenarios were elaborated for the evolution of the national economy for the period 1999-2002. They were based upon previously elaborated scenarios within the Strategy for Development of the Republic of Moldova for 1998-2005 (CISR, January 1998), which have been updated to take into account the dramatic evolutions at the end of 1998.

Hence, there are presented here:

- base scenario, also defined as the optimistic, or recommended scenario, which assumes that the Government of Moldova will advance economic reforms, in compliance with agreements concluded with international financial institutions, and thus managing to avoid a default of the country in honoring its external obligations;
- negative, or pessimistic scenario, which broadly reflects the destructive effects of a major crisis in the country's economy followed by announcement of inability to honor the external obligations. This is in some way a simulation of the so-called "Bulgarian path", when the country in the end counts exclusively on Western assistance in restoring the economy, accompanied by very tough measures of monetary supervision.

Foreign debt

As in the scenarios drawn up for the Strategy for Development for 1998-2005, the current estimations are to a large extent influenced by external factors, i.e. the necessity to service the external debt, for which large volumes of hard currency are needed. The peaks of foreign debt servicing will be in 1999, when the amounts needed for repayment of interest and principal for foreign credits will exceed \$200m, and in 2002, when the \$75m Eurobond launched in 1997 must be fully redeemed. Another problem here is the significant debt to Russia for energy resources.



Very complicated in this context was the situation in 1998. Moldova had to repay about \$200m for foreign debt servicing (including one third of it paid by the NBM to the IMF). Moreover, the external debt has not been entirely serviced – some of it, such as bonds issued to Gazprom was not serviced at all, while another part was negotiated and rescheduled. And since during this period of time the state received no loans from the IMF or the World Bank, the NBM had to “contribute” out of its reserves to the repayment of principal and interest for the loans received from international financial institutions, foreign banks and others. At the very end of 1998 NBM fully redeemed the \$30m first private placement issued by the Government through Merrill Lynch in 1996.

In 1999, the situation will not be easier, because the country will have to repay about \$220m for foreign debt servicing. The only way out, along with the reduction of the trade balance deficit, is new borrowing, mainly from the IMF and the World Bank Group, which do provide most attractive crediting. Thus, a lot remains to be done in 1999 in order to regain the confidence of these international finance institutions and prove the compliance with performance criteria.

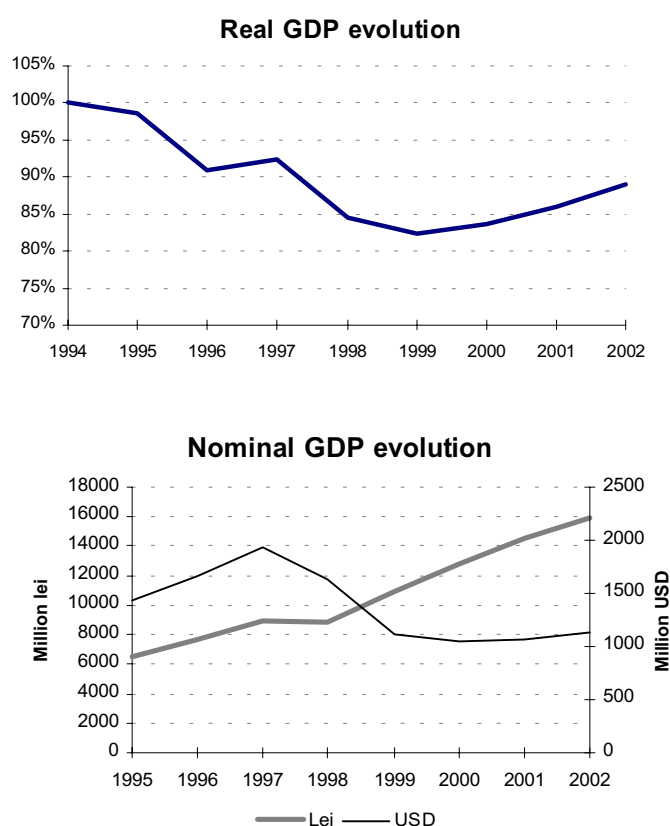
2.2. Base - positive scenario

Gross Domestic Product (in both scenarios GDP is forecasted without taking into account the shadow economy and excluding Transnistria)

Forecasting of evolution of economic growth in the Republic of Moldova is very difficult to be done because of a number of factors. The main is extremely high interdependence between state's economic policy and political events that take place in the country. In this scenario, where economic reforms' processes will have a strong support by the society, political parties, all executive bodies, some concrete results could be attained, which will serve as a basis for an eventual stable economic development.

The real GDP forecast of the Government, set in the Budget Law for 1999 and in the NBM's monetary policy guidelines for 1999, pointed to a 1% growth in 1999. However, most recent indications are more negative. Taking into account the evolutions in the economy (tendencies of last months of 1998 and first months of 1999 were taken into account), we forecast in this scenario a decrease of real GDP for 1999 by 2.5%, followed by positive GDP growth figures for the period of 2000-2002, counting on channeling of investment into the productive sphere and relaunching of real sector enterprises' production.

Nominal GDP will grow continuously, exceeding by end of 2002 the level of 15bn lei. At the same time, due to the depreciation of the national currency, the nominal GDP expressed in US dollars will be decreasing in 1999-2000, afterwards slowly growing up to about \$1130m in 2002. Respectively, GDP per capita could stay at \$314 by 2002.



	Share in GDP in 1998	Estimation of real growth in 1999	Contribution in GDP growth in 1999
Agriculture	24.4	-5	-1.2
Industry	22.4	-8	-1.8
Services	37.7	3	1.1
Net taxes on goods and imports	15.5	-4	-0.6
Total	100		-2.5

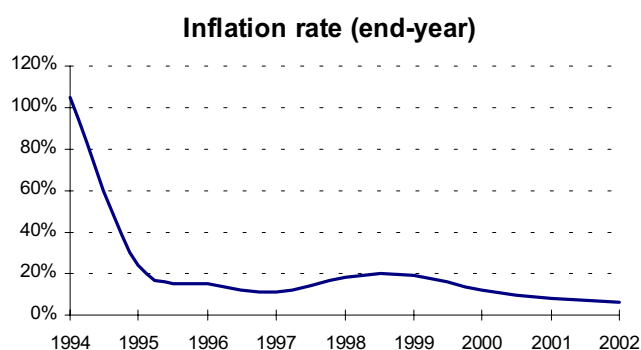
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With reference to the GDP structure by sectors it should be noted that agriculture will be in a decrease due to the process of reorganization and privatization that it is undergoing. Of course the results of the reforms will not be immediately seen. In industry, during 1998 and at the beginning of 1999, because of shrinkage of the domestic market, and especially of external markets, a continuous decline of production is observed. Services will have an upward trend due to the extending range of services, including in rural areas, retail trade, construction.

	Contribution in GDP growth in 2000	Contribution in GDP growth in 2001	Contribution in GDP growth in 2002
Agriculture	0.7	0.7	0.9
Industry	0.9	1.2	1.2
Services	0.4	0.8	1.2
Net taxes on goods and imports	-0.3	0.145	0
Total	1.7	2.8	3.3

Inflation

The annual rate of inflation for 1999 forecasted by NBM and set in its monetary policy



guidelines for 1999 is 13-15%. The evolution of the leu's exchange shows a continuous depreciation which, due to the openness of the national economy and high share of imports, which implicitly generates corresponding increase in prices, i.e. growth of inflation level. On the other hand, due to a more complicated export environment local producers are trying to sell more in the domestic market, lowering the prices (according to recent changes in fiscal legislation, producers selling goods at

prices lower than production costs are exempted from VAT). Thus, due to a saturation of goods in the domestic market, the prices are kept stable or are even falling, thus the CPI level is low.

Jan-99	Feb-99	Mar-99	Apr-99	May-99	Jun-99	Jul-99	Aug-99	Sep-99	Oct-99	Nov-99	Dec-99	Total
5.4%	1.5%	0.6%	1.2%	1.0%	0.5%	0%	0%	1.5%	1.5%	2.0%	2.5%	19.1%

Data for the 1st quarter of 1999 show a cumulative level of inflation of 7.6%. Taking into account the seasonality of prices we would expect an almost nil inflation level during the summer with an increase by end of the year. Therefore, we consider a more realistic forecast of 19.1% for the 1999 end-year inflation, with a gradual decrease in the next years down to 6% by end-2002.

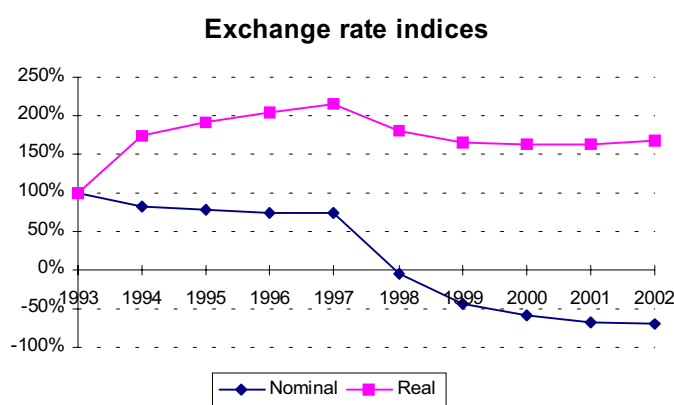
Exchange rate

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. Then, right after the crisis started, NBM intervened massively at the Bourse defending the leu, and only during August-October 1998 it blew out another \$81m out of its reserves. Thus, total losses reached almost \$123m. However, gross NBM's reserves decreased

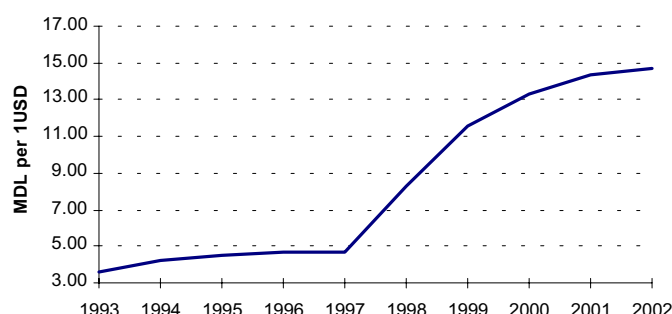
from \$366m at the beginning of 1998 to \$144m at end of the year, i.e. by \$222m. The difference were obviously debt service payments.

Starting November 2, 1998 the NBM withdrew from selling hard currency at the Interbank Currency Exchange, letting the commercial banks to directly influence the exchange rate. As a result, the leu has depreciated sharply from 6.40 lei/1USD at 1 November to 9.71 lei/1USD at 1 December 1998. Then, the situation in the foreign exchange market has stabilized due to the NBM's strong enforcement of the 15% reserve requirement and 10% T-bills holding requirement imposed to commercial banks. And, for the first time after the crisis, the leu started to appreciate (and NBM even managed to buy \$16m in December), at 1 January 1999 the rate was 8.32 lei/1USD. Further on, depreciation started again but in a slow pace - by end of March the exchange rate was 9.16 lei/1USD. Thus, a new equilibrium of the exchange rate was reached, and the viability of NBM's new non-intervention policy proved to be successful. It is advisable that the policy of non-intervention at the Interbank Exchange for rate stabilization to be maintained in the future as well, and the main concern of the central bank must be to accumulate foreign exchange reserves, so drastically exhausted in 1998.

Analyzing the evolution of the real exchange rate (dollar-leu) it should be pointed out that for the first time since the introduction of the national currency, in 1998 the Moldovan leu has depreciated in real terms against the US dollar by 33.8%. This was due to the high nominal depreciation of the leu upon the dollar (USD/MDL - by 44%), while the inflation rate was at the end of period 18.3%. Consequently, the domestic prices expressed in US dollars have diminished by one third. Previously during 1995-1997 the leu was appreciating in real terms by 10-17% per year.



Exchange rate (end year)



As it was already noticed above, Moldova has a small and open economy, to a great extent influenced by external prices. That is why, it is obvious that in the coming years a further big depreciation in real terms is impossible because huge nominal depreciation of the national currency leads to an considerably increase in prices in the domestic market, generating a respective growth in inflation rate.

This leveling could have as a result an appreciation of leu in real terms, although not such big one as in previous years, so that the competitiveness of Moldovan exports would not be harmed.

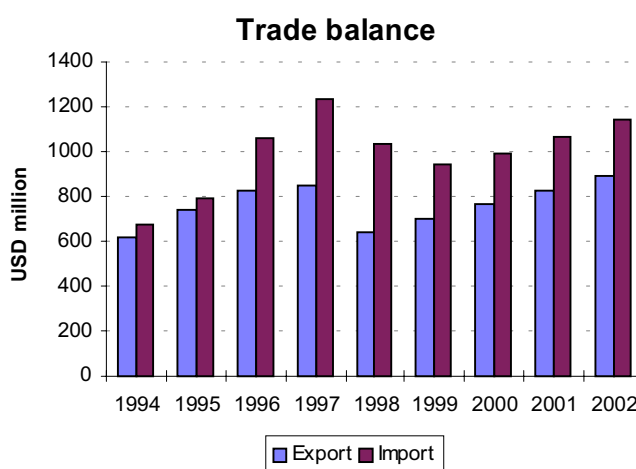
In the scenario the end-year exchange rate for 1999 is forecasted at 11.6 lei/1USD, which, given the inflation forecast, means a depreciation in real terms of leu against USD by 14.4%. In 2000 the exchange rate of the national currency will stabilize further, reaching 13.3 lei/1USD, i.e. a real depreciation by only 2.6%. Further on – the leu starts to appreciate in real terms by 0.6% in 2001 and by 3.5% in 2002. By the end-2002 the nominal exchange rate of Moldovan leu against the US dollar will reach, according to the scenario, 14.7 lei/1USD.

Trade balance

The scenario is based on the assumption that *exports* will be growing continuously, within 8-10% during 1999-2002 (reforms are expanding in the real sector of the economy, more investments into the production sphere are channeled, including FDI, etc.). But only by 2002 the level of exports could overpass the level of 1997. Due to narrow orientation of Moldovan exports towards CIS and Russian markets, their volume in 1998 reduced dramatically after the Russian crisis (by 25%), falling slightly above the volume for 1994. It is clear that Moldova's export potential is much higher (of about \$900m), but a reorientation towards Western markets will need some time - at least 3 years are required in order to improve the quality of exported goods, to adopt respective marketing strategies, and at last but not least - removal of institutional barriers (joining the WTO, etc.).

As regards to the *imports* it should be mentioned that under the circumstances of export reduction in 1998, the import decreased as well (by over 15%), because the country lacking foreign exchange could not finance the imports at the level of previous year. Apart from a 2-fold shrinkage in import of energy resources (because Moldova just could not pay), also there was a reduction of huge imports of consumer goods.

From the same perspective, we forecast a further reduction of imports in 1999 as well - by 9% (especially share of energy imports). Only after 1999 an increase in imports is foreseen (by 6-7%), especially imports of equipment, technology, etc., which could be financed by FDI (growing as well).



Current account of Balance of Payments

The scenario assumes that the current account deficit will gradually diminish, showing a reduction by 3 times in 2002 comparing 1997 (from \$309m to about \$100m), or speaking about ratios to GDP - the reduction would be from 18% to 8%.

As factors contributing to this evolution are, as it can be seen in the annexed tables: trade balance reduction by about \$150m in 1999-2002 against the situation in 1997-1998; reduction of services balance deficit (especially transportation, including imposing an appropriate tax on transit of energy resources through the territory of Moldova); and increase in current transfers (included here are grants that the country receives and income of Moldovan citizens working abroad).

Capital and financial account

Foreign direct investments

Taking into account budgetary and external constraints, it is obvious that under such conditions internal investments are greatly affected. As it was mentioned in the scenarios prepared for the Strategy for Development, the country, having scarcity of financial resources, has a continuous decline in gross internal investment, including investment in production facilities. Therefore, the only hope for revitalizing productions and increasing competitiveness remains the flow of foreign investments. Especially when internal savings are continuously decreasing, which is one of troublesome tendencies taking place in transition economies.

Direct investments will have in this scenario a steady growth. We forecast for year 1999 a flow of FDI of \$150m with a gradual increase further on. Also, we count a lot on the

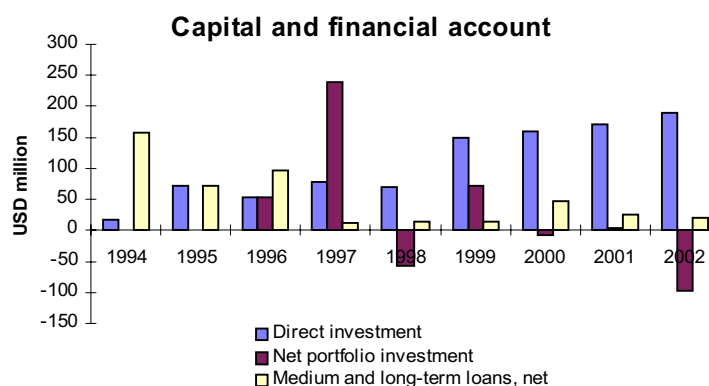
projects of strategic objectives privatization which could additionally bring \$50m in 1999 (in this optimistic scenario) as a result of Moldtelecom privatization, and about \$200m during 2000-2002 obtained from privation of energy sector (although about half of this amount could go for repayment of debts for energy resources delivered by Russia). Thus, by end-2002 the stock of foreign direct investments could reach about \$1bn.

Referring to some priority sectors for upcoming FDI inflows, the following 3 directions can be foreseen: (i) monopolistic sectors, such as telecom industry and energy sector, (ii) processing industry based upon local raw materials, (iii) after entering the WTO and signing of FTA with EU countries (1999-2000), a important flow of FDI would go into the light industry - clothing, textiles, shoes.

Portfolio investments

In this item there are included Moldovan securities (T-Bills and T-Bonds, as well as corporate stock) acquired by non-residents, as well as their servicing. Also, here are included private placements of securities issued by the Government of Moldova on external capital markets - in 1996 the first Eurobond (\$30m) was launched, which was redeemed in 1998, and in 1997 - the second Eurobond (\$75m) which must be redeemed in 2002.

In the figure for 1997 an amount of US\$ 140m was included, which were in fact securities of the Ministry of Finance in favor of Russian company "Gazprom" for gas debt restructuring. In 1998 the Government of Moldova tried to negotiate restructuring of another \$90m in securities but this transaction in the end has not been approved by "Gazprom", however, this figure is included in 1999 figures.



Another aspect is linked with the fact that after the Russian crisis foreign portfolio investors had massively withdrawn their investments in state securities. Most investors redeemed their T-Bills and T-Bonds, immediately converting the lei received into dollars. In this way by end of 1998 about \$30m left the country. It is hard to believe that these investments will return soon into the country, in any case though this will greatly depend on country's positive evolutions in the economic reforms and subsequent rating agencies' reports. The scenario draws the figure of \$5m in T-Bills investments for 1999 with a 5-fold increase up to 2001-2002.

Long and medium term loans

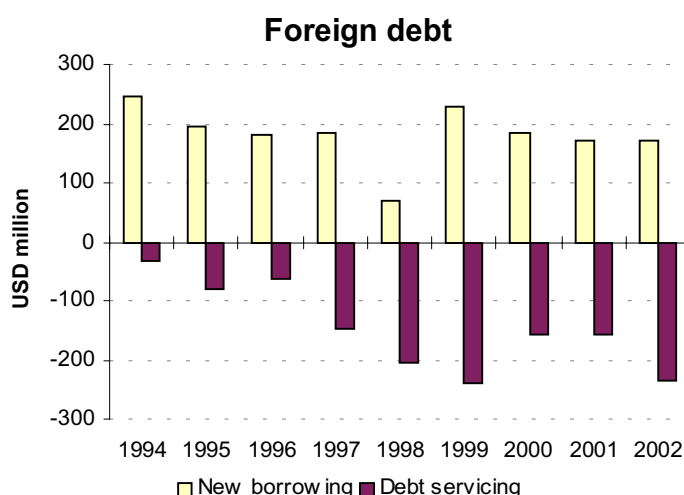
A specific feature of the optimistic scenario is that the country will fully benefit from the support of international financial institutions (however, this support will be conditioned by Moldova's compliance with memorandums concluded with IMF and World Bank).

Therefore, especially because there will be needed considerable financial resources for honoring the obligations toward foreign creditors, and for overcoming financial problems in the period of active implementation of structural reforms, we forecast for the period 1999-2002 an annual flow of \$80-100m of new borrowing that the country will benefit from: especially from World Bank (the remaining part of SAL2, the upcoming new loan SAC and other loans), from EBRD, European Union and other creditors. Also, an important role will have the private creditors providing another US\$ 35-40m per year.

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It should be noted here that the share of loans received for private sector support will be rising continuously, while the amount of credits granted to the Government of Moldova will respectively diminish.

A very important role are having credits provided by IMF to the NBM for completing the foreign exchange reserves. In January 1999 IMF granted a new EFF tranche of \$35m, bringing the total amount disbursed within EFF to approximately \$87.5m. The Executive Board of the IMF also agreed in January to extend the EFF by one year, with five disbursements of \$17.5m (three of them to be granted in 1999) and a sixth of \$14m planned over the remaining 18 months of the program. The IMF and the Moldovan authorities will begin discussions in late April on a new ESAF program, which provides for more concessional terms, in order to replace the EFF program and perhaps provide additional IMF support.



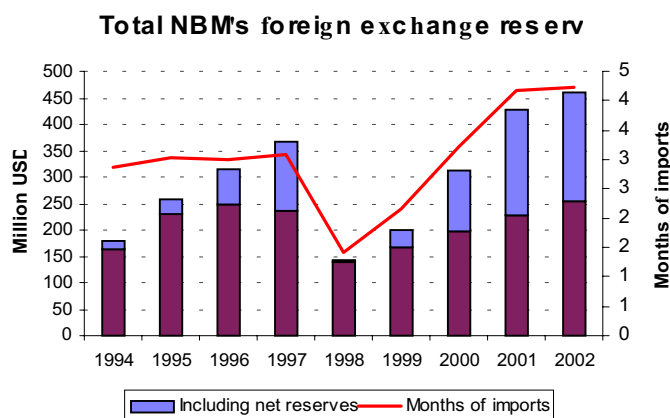
At the same time, considerable amounts of foreign exchange will be needed for *servicing* of foreign debt - repayment of principal and interest for the previously received loans. But this very aspect has been already analyzed at the beginning of this chapter.

NBM's foreign exchange reserves

As it was mentioned already, one of the main priorities of the NBM under the new circumstances will be building-up foreign exchange reserves. In this context, the situation in 1999 will remain complicated, because in spite of new tranches from IMF, which in this optimistic scenario will account for about \$87.5m, NBM has to pay back to IMF about \$70m, plus some other external obligations. During 1999 NBM could also complete its reserves by about \$60m purchasing foreign currency in the market. In the next years the situation will be better, because on one hand the reserves will increase by about \$20-30m per year out of IMF funds, and on the other hand - by \$120-150m per year out of direct conversions of foreign exchange received by the government (privatization revenues, foreign loans), as well as out of purchases of foreign exchange in the interbank market.

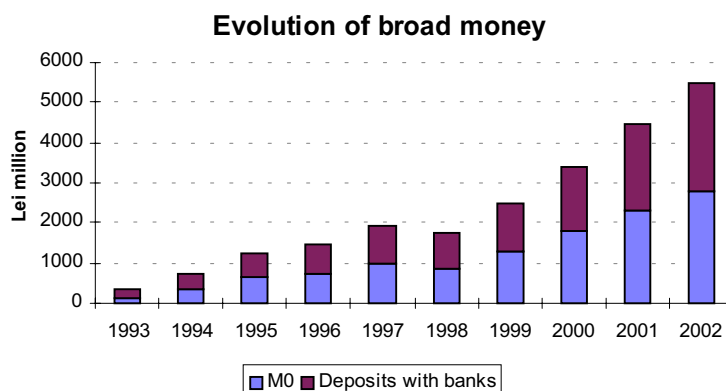
Thus, the scenario shows that by end-1999 NBM's total foreign exchange reserves will increase to \$200m, covering 2.15 months of imports of goods and services

(comparing to 1.42 months in 1998). In 2000 gross reserves will reach the level of 1996 (\$314m), and in 2001 they will surpass the \$400m mark. By end-2002 the reserves will reach \$460m (an increase by 3.2 times comparing to 1998), covering 4.23 months of imports of goods and services. The structure of reserves will also improve - at end-2002 net reserves could exceed \$200m, making up 45% of gross reserves, comparing to the figure of 36% at end-1997.



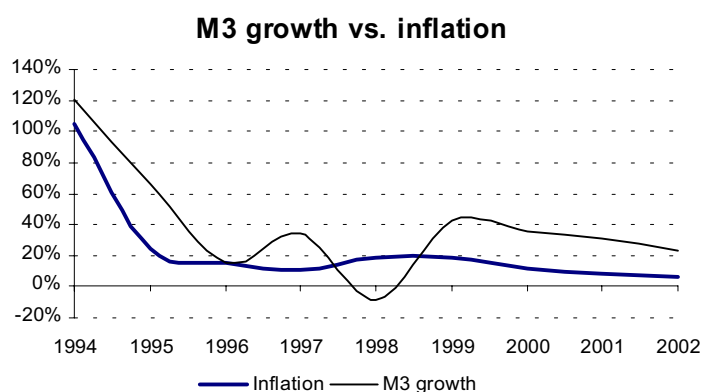
Monetary aggregates

The volume of *lei in circulation* (M_0) will gradually increase in order to satisfy the needs of the economy in cash. Also, if NBM buys hard currency in the market, then an equivalent amount in lei is introduced in circulation, therefore along with the increase of the NBM's foreign exchange reserves, the volume of M_0 will also grow, presumably reaching 2.8bn lei by end-2002 (a 3.3 times growth comparing to 1998). Base money grows at similar pace, while reserve requirement of commercial banks will gradually come down again to 8% from existing 15% (because the excess of reserves represent inert financial resources, which are not channeled in the form of banks' credit investments).



Broad money M_3 is equal to cash in circulation plus deposits (sight, time, and foreign currency deposits) with banking system. By end-2002 broad money could reach according to the scenario 5.5bn lei, i.e. will exceed by 3.1 times the level of 1998. Velocity of M_3 will reduce from 5.0 in 1998 to 2.9 in 2002 reflecting the increase in monetization of national economy from 20% to 35%.

Money multiplier, i.e. the ratio of broad money to reserve money, will gradually increase from 1.66 in 1998 to 1.79 in 2002, reflecting growth of confidence of population and economic agents in banking system. The security in banking sector will be increasing, the role of commercial banks as depository institutions will grow, and respectively the volume of credit investments in country's economy will expand.

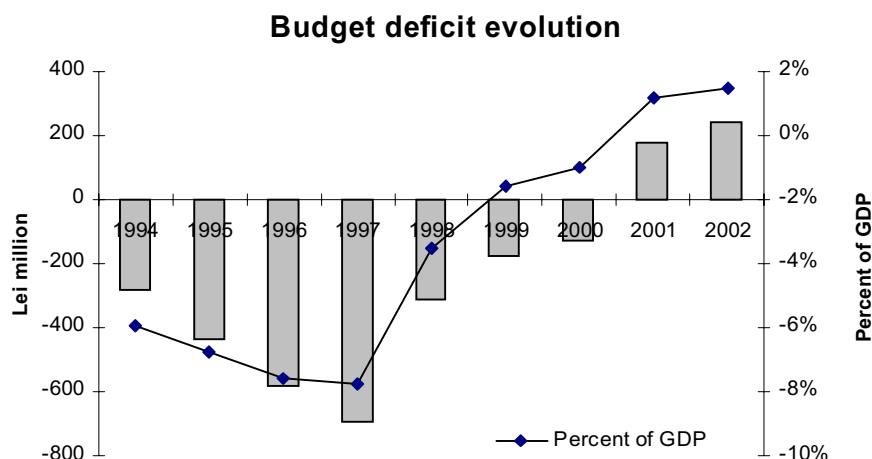


Looking into the structure of deposits, it should be noted that the dollarization ratio (share of foreign exchange deposits in total) grew from 20% in 1997 to 44% in 1998 influenced by events which followed the Russian crisis. In 1999 dollarization ratio will reach according to the scenario 55%, the population preferring (in a devaluation environment) to hold foreign currency deposits. However, along with the stabilization of the national currency and of the macroeconomic environment in general, during the next period the dollarization of deposits will start to decrease gradually, reaching 42% in 2002.

State budget

Under the optimistic scenario of development of economy assumptions were made that the legal environment is created along with respective stimulants for the development of private sector, of entrepreneurial initiative, free competition, prices are set up according to the supply and demand. All these will finally result in a diminishing of the role of state in national economy. Most services for population would be provided by private sector, and share of public financial flows will continuously decrease.

Forecast of the sectors' development of the economy, GDP forecast, evolution of inflation, integration of national economy into the international economic relations at a wider scale, allow us to forecast a relative stable evolution of budgetary system.



Along with optimization and rationalization of public infrastructure, the reform of the fiscal system will be implemented on basis of the Concept of Fiscal Reform in the Republic of Moldova.

As a result of the implemented actions, the budget deficit will continuously reduce to about 160 million lei in 2000, reaching 1% of GDP, comparing to 7.8% in 1997. Already starting with year 2001 the country will have a budget surplus of 1.2-1.5%.

Optimistic scenario foresees, under conditions of consistent and adequate reforms, a reduction of tensions in financial sector, especially in budget sector, after year 2000.

Among key moments to be realized, the following ones can be emphasized:

- reduction of shadow economy and corruption in national economy;
- fiscal reform and complex implementation of Fiscal Code;
- reduction of general fiscal burden through elimination of fiscal exemptions for some branches of the economy, and of individual exemptions; elimination of financial blockages of the economic entities' activities;
- restructuring and privatization of energy sector, the main sector which generates pressure on the budget;
- implementation of social protection and medical system reforms;
- optimization of state's infrastructure;
- ensuring the transparency of public purchases.

Diminishing budget revenue and expenditure as a percentage of GDP reflect the typical situation of a transition economy: (i) fiscal burden on economic agents and individuals should be decreasing for the purpose of stimulating a further economic growth; (ii) reduction of the role of state in economy through applying a function of supervision of compliance with legal framework, and a limited function of redistribution of national assets.

2.3. Inertial - pessimistic scenario

As it was stressed out also in the scenarios elaborated within the Strategy for Development, a very important role has the continuation of normal relations of collaboration between Moldova and international financial organizations, which are also country's main creditors.

If the Government of Moldova continues to ignore IMF & WB recommendations regarding structural reforms in real sector, they could seriously restrict their financial support. This step could mean for Moldova an acceleration of economic instability and extreme political pressures.

It could be a repetition of Bulgarian case, but with a more harmful impact on Moldova, whose economic resources are far less than those of Bulgaria. Thus, it is very important to avoid the pessimistic scenario, because the price that the country will have to pay (or its population which will have to bear it) could be much too high.

The main idea of this scenario is the continuation of depression in Russia, which has an adverse influence on the situation in Moldova. Also, there is an inability of the government to put in place the next economic reforms, or insufficiency of efforts to implement them. As a result, all macroeconomic indicators are worsening, and the country loses another several valuable years of its development.

The crisis could occur already in 1999, in the forth quarter, when it may become obvious that it is not possible to service the foreign debt because of scarcity of hard currency. That is why, we forecast in this scenario that 1999 becomes the year when the Government announces a default of the country, i.e. the incapacity to service the foreign debt, freezing all country's payment obligations.

A "Bulgarian case" happens, but with "Moldovan specifics". On one hand, financial assistance programs of the IMF and World Bank are stopped due to the non-compliance by the Government with the concluded agreements, and, on the other hand, it becomes impossible to get new borrowing from private capital markets abroad because of the downgraded country's credit rating. Negotiations with international financial organizations follow, and finally the latter would grant the needed assistance, but they will certainly impose severe conditions for implementation of the proposed reforms.

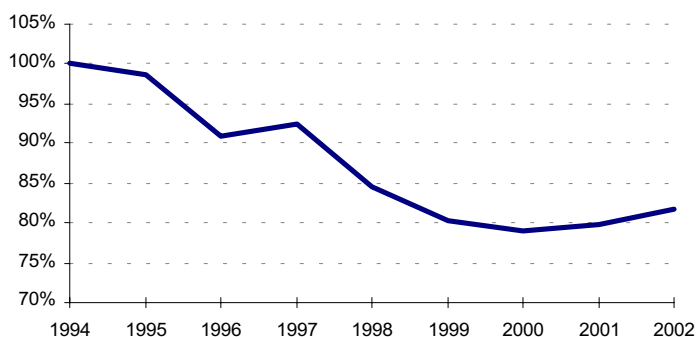
In the end the population suffers most – social indicators worsen, arrears on salaries and pensions reach critical values, unemployment rises, the level of life falls dramatically and the people become poorer.

Main macroeconomic indicators

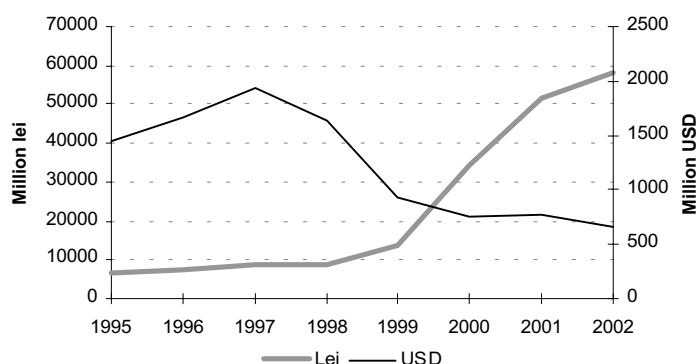
Global Domestic Product

After the slump in 1998, the decline in country's economy continues – according to the scenario real GDP falls in 1999 by another 5%, and in 2000 - by 1.5% more. Obviously, such an evolution of the economy, accompanied by a sharp diminishing of population's standard of living, can not last. After year 2000 a slow economic recovery process starts in the country, expressed by 1% of annual real GDP growth in 2001, and 2.5% in 2002. GDP per capita will reach only \$148 in 2002, comparing to \$314 in the optimistic scenario.

Real GDP evolution



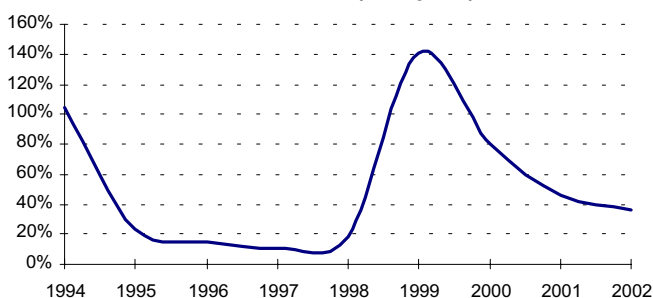
Nominal GDP evolution



Inflation

As it was already mentioned, the country will undergo an acute scarcity of financial resources, which will inevitably lead to new issuance of money in circulation (for Government crediting, imposed on the NBM), i.e. to an increase of inflation rate. In fact it is clear that the prices

Inflation rate (end-year)



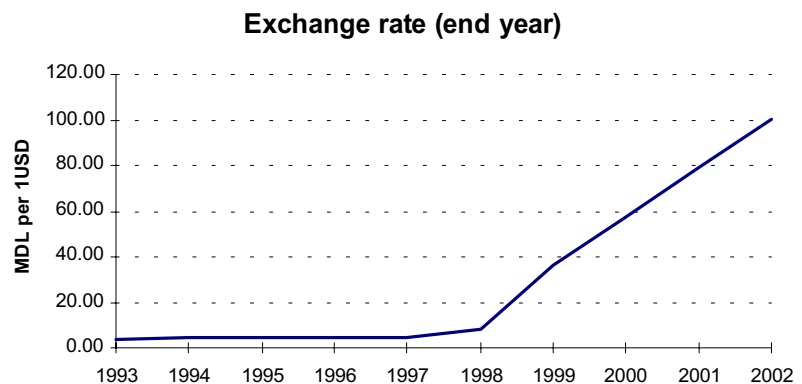
would go up very much also because of the depreciation of the national currency. By end-1999, crisis year, the inflation could reach, according to the scenario, about 140%. In the following years after restoring collaboration with IMF and World Bank we foresee a tendency of gradual reduction in inflation rate to 36% by end-

2002. This would express the success of the Central Bank in implementing the tight monetary policy supported by the IMF.

Exchange rate

One of the negative aspects of the crisis here is massive depreciation of the national currency, accompanied by panic and capital flight.

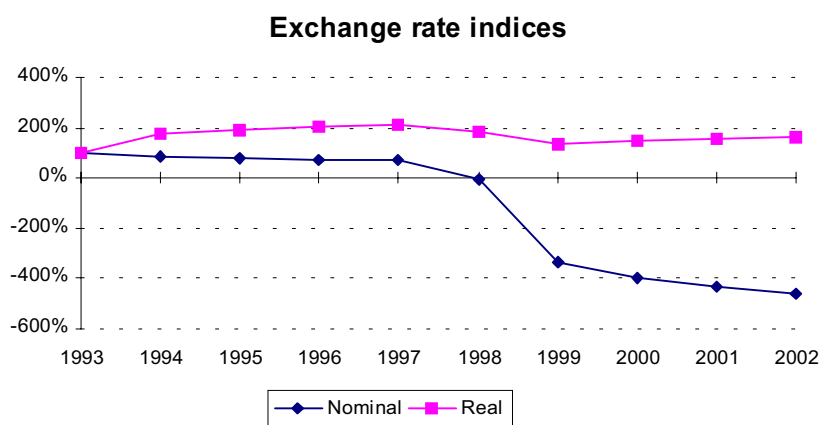
According to this scenario, in October 1999 the leu massively depreciates by 50% in nominal terms against the US dollar. The monthly evolution of the exchange rate can be seen in the table below.



Jan-99	Feb-99	Mar-99	Apr-99	May-99	Jun-99	Jul-99	Aug-99	Sep-99	Oct-99	Nov-99	Dec-99
100%	102%	101%	103%	105%	107%	109%	111%	113%	150%	140%	120%
8.57	8.74	8.81	9.07	9.53	10.19	11.11	12.33	13.94	20.90	29.26	35.12

As a result, the end-year exchange rate goes to 36 lei/1USD, which represents a nominal depreciation by 77% in dollar terms. This exchange rate evolution will lead to increase in prices, so that in real terms the leu could depreciate at end-1999 by 44% against the US dollar.

In the next year a depreciation in real terms is no longer possible, because of the

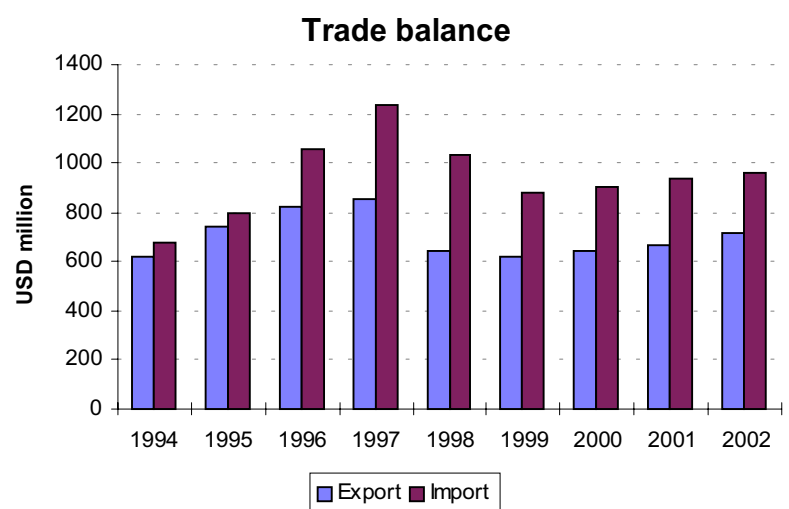


tendency of price leveling, especially after the sharp reduction in local prices during 1998-1999 in USD terms. In 2000 the scenario shows already an appreciation in real terms of leu against the dollar – by 12.5%, the exchange rate showing a relative stabilization. In 2001-2002 the real

appreciation will be within 6-7%. Thus, by end-2002 the nominal end-year rate could be about 100 lei per 1USD.

Trade balance

Due to the complicated situation on the macro and micro level, lack of foreign direct investments and of business confidence, it is clear that country's export potential will be diminished. In 1999 we forecast under this scenario a decline in exports with another 3%, after the 25% reduction in 1998. And in the next years, although export growth rates will be positive, they are still quite modest comparing to the evolutions in the optimistic scenario.



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Also, we foresee a decline in *imports* - by about 15% in 1999, after the 16.6% reduction in 1998. Again, the cause is in lack of resources for imports financing. Starting with year 2000 we forecast an increase in imports caused by the flow of FDI (though a modest one) which bring import of technology, equipment, etc.

Current account of balance of payments

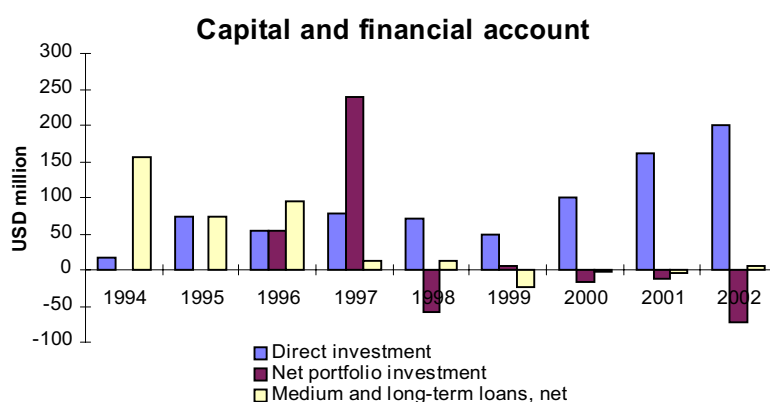
Current account deficit will gradually diminish, though at a slower pace than in optimistic scenario, decreasing by year 2002 by 3 times comparing to 1997. As a share of GDP current account deficit would show a reduction from 18% towards 12%. The factors which could contribute to such an evolution are similar to those outlined in the optimistic scenario.

Financial and capital account

Foreign direct investment

Due to the crisis in the economy, according to the scenario, foreign direct investments will shrink by about 2 times.

Privatization of Moldtelecom in 1999 does not take place because of the unstable economic environment, and it is included only in 2000. Respectively it was extended (for 2001-2002) the privatization of energy sector as well. Thus, by end-2002 the stock of FDI could reach \$800m.

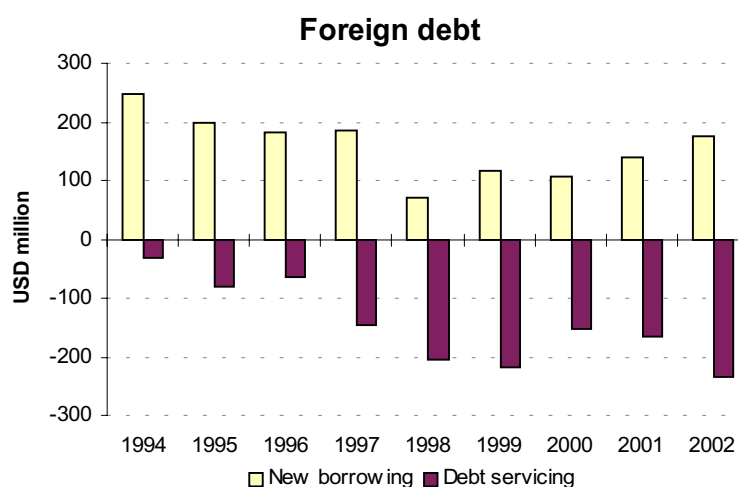


Portfolio investment

There is neither any Eurobond issuance nor massive participation of foreign investors in buying T-Bills. However, the main problem here will be the relations with Russia regarding the debt to equity swaps of Gazprom. According to the scenario, due to the lack of funds servicing of Moldova's energy debt will be temporary frozen in 1999.

Medium and long-term loans

As it was mentioned also in the scenarios elaborated for the Strategy for Development, at this point the country will have to face extremely difficult problems. Because of delays and inconsistency in implementing structural reforms advised by international financial institutions, unwillingness of some local decision makers to implement those reforms, as well as non-compliance of country's governing bodies with the memorandum agreed with the World Bank and IMF, the latter reduce drastically the programs of assistance to Moldova.

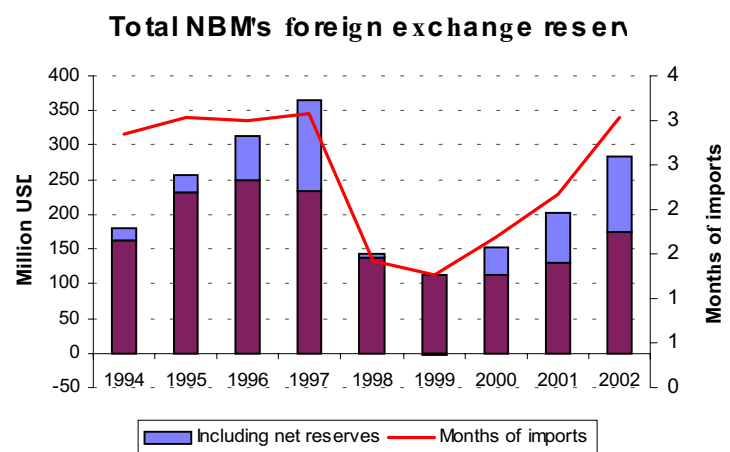


This considerably aggravates the situation on macro level, because it is obvious that without the financial support from international financial institutions granted on quite favorable terms, Moldovan economy will not be able to survive.

So, the new borrowing from international financial institutions (IMF, WB, EBRD and others) are reduced. But at the same time, Moldova has to repay the principal and interest for foreign loans which in 1999 will demand about \$220m, and then about \$150-160m per year in 2000-2001. Where these funds will be taken from? In 1999 we should point at the reduction of NBM's hard currency reserves by another \$32m, but that's evidently not sufficient. A solution here would be foreign debt rescheduling and restructuring if this can be done, but if not, then (like it was in 1998) some debt will not be serviced at all because the country can not finance these expenditures. This accumulation arrears and debt rescheduling is clearly seen in the annexed balance of payments table.

NBM's foreign exchange reserves

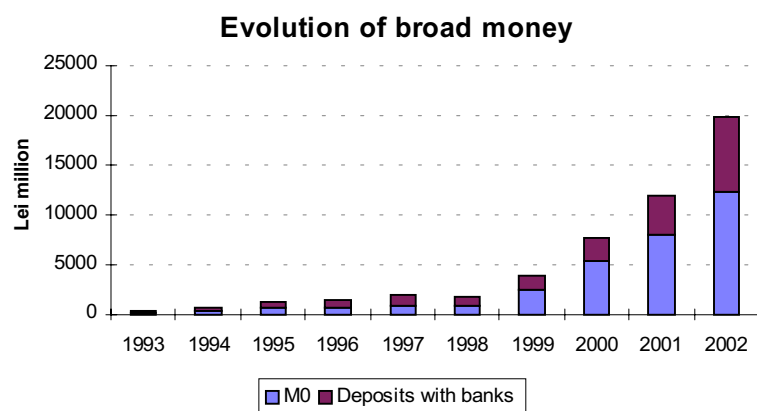
A dramatic aspect of this scenario is the substantial reduction of foreign exchange reserves of the central bank, which will have to: help the Government in servicing its external debt, to cover the BOP overall balance deficit (about \$100m in 1999), and finally - to service the IMF debt (\$70m in 1999). That is why, in 1999 gross NBM's reserves could reduce further (after the dramatic reduction by \$222m in previous year) reaching \$112m at end of the year. In the next years as hard currency comes into the country (investments, credits) NBM starts to gradually build up its reserves, by \$40-50m per year in 2000-2001. Thus, by end-2002 gross reserves could reach only \$285m (covering 3 months of imports of goods and services), which is below the figure for 1996 and 1.6 times less comparing to the evolution in the optimistic scenario. At the same time, net reserves are growing from practically zero in the end of 1998 and 1999 up to \$111m in 2002.



Monetary aggregates

Taking into account the evolution of NBM's gross reserves, it is clear that the sustainability of the monetary policy in this scenario is questionable.

The amount of *lei* in circulation is under pressure, caused by massive depreciation of the national currency, increasing by 3 times during 1999. In the next period high rates of growth of this aggregate are maintained due to the inflationary environment. Also, M_0 aggregate rises



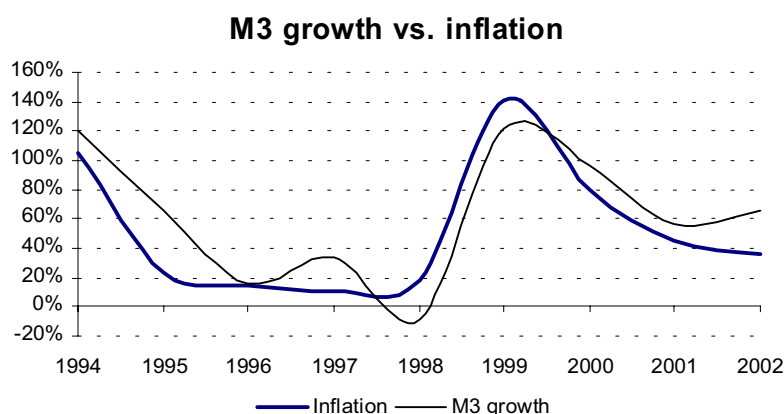
along with the increase in NBM's hard currency reserves. By end-2002 M_0 comes close to 12bn lei (a growth by 14 times comparing to 1998).

Broad money has similar evolution. According to the scenario, by end-2002 the M_3 aggregate could reach according to the scenario about 20bn lei, exceeding by 12 times the level of 1998. Velocity of M_3 will diminish from 5.0 in 1998 to 2.9 in 2002, reflecting respectively an increase in national economy monetization from 20% to 34%.

Money multiplier will be decreasing from 1.66 in 1998 to 1.31 in 1999-2000 showing a considerable reduction of the share of bank deposits in broad money (respectively from 51% to 33%), although in

absolute figures they are growing (even if we assume that 30% of the term deposits in lei and 50% of the deposits in foreign currency are withdrawn from the banking system in 1999, year of crisis). This is explained by the effects of national currency depreciation (the bigger

is lei equivalent of dollar funds). Looking at the dollarization ratio of deposits we see that it is growing considerably from 44% in 1998 up to 75% in 2002.



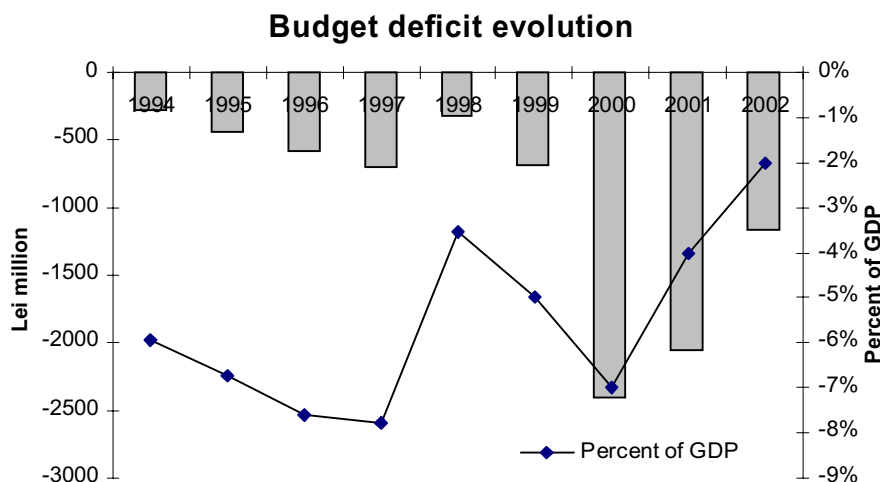
This reflects a more reserved attitude of population towards the banks. Scenario clearly shows that under the given circumstances the population has no more confidence in the devalued leu and prefers to convert available funds in US dollars. People avoiding placing the money on bank accounts, also because of the non-attractive interest rate on deposits - a typical phenomenon in an inflationary environment. And since households deposits (and deposits of legal entities) are a vital input for banks, it becomes clear that in such conditions only strongest banks will survive. Small banks will either go bankrupt or merge with others and as a result few larger banks will remain in the system.

State budget

This scenario describes the situation when the control will be lost on the level of budget deficit under conditions when there would be no measures of acceleration of structural reforms, the process of privatization and liberalization of national economy would be stopped, as well as there would be groundless severe economic protectionism measures undertaken. Moreover, implementation of non-tight monetary and fiscal policies, continuous reduction of real GDP, will generate an aggravation of the situation of state debt (debt rollover can be out of control). Default becomes a reality.

Under such circumstances, the budget and fiscal system would be at a limit of total crisis, budget expenditures being enormous, non-covered by sufficient financial resources. External funds will be more and more difficult to get, because of restrictions set by

international financial institutions and low credit rating of the Republic of Moldova on international financial markets.



Consolidated budget deficit will expand, reaching in 1999 5% of GDP, and in 2000 - 7% of GDP.

In conditions of massive depreciation of national currency in 1999 will considerably increase the lei equivalent of the USD funds needed for repaying the interest for external loans granted to the country. Also, it should be stressed out, that because of the big reduction of new borrowing, the deficit financing out of external sources is sharply deteriorating.

Evolution of budget income and expenditures during 1999-2005 is forecasted taking into account the following assumptions:

- structural reforms will be stopped, old social infrastructure being maintained, old central and local public administration, and reform of force structures will not be implemented;
- taking into account the above stated, the main accent was put on the evolution of inflation, i.e. both public income and expenditures will greatly depend on evolution of prices;
- funds for financing budget deficit will be quite expensive, due to the increase of interest rate.

Under such circumstances, tensions on budget are inevitable, therefore determining the change in social infrastructure, and consequently slow structural reforms starting year 2002. However, it should be mentioned, that the situation in budget-fiscal sector could be even more difficult taking into account the insignificant forecasted economic growth, as well as other structural factors.