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September 2008
IMF Country Report No. 08/320

Republic of Moldova: Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Nonobservance of Performance Criterion—Staff Report; Staff Supplement; and Press Release

In the context of the fourth review under the three-year arrangement under the Poverty Reduction and Growth Facility and request for a waiver of nonobservance of performance criterion, the following documents have been released and are included in this package:

- The staff report for the Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Nonobservance of Performance Criterion, prepared by a staff team of the IMF, following discussions that ended on May 21, 2008, with the officials of the Republic of Moldova on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 30, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement of July 9, 2008 updating information on recent developments.

- A Press Release summarizing the views of the Executive Board.

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

Letter of Intent sent to the IMF by the authorities of the Republic of Moldova*
Memorandum of Economic and Financial Policies by the authorities of the Republic of Moldova*
Technical Memorandum of Understanding*
*Also included in Staff Report

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF MOLDOVA

Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Nonobservance of Performance Criterion

Prepared by the European Department
(In consultation with other departments)

Approved by Lorenzo Giorgianni and Anthony R. Boote

June 30, 2008

Executive Summary

- **Performance under the review has been satisfactory overall, despite slippages**. The requested waiver is due to an administrative delay in adopting State Tax Inspectorate (STI) legislation, which has now been overcome.

- **Growth is set to rebound**. Agriculture is expected to recover strongly following last year's drought. Investors have been attracted by Moldova's low costs, and export prospects have improved with the resumption of wine exports to Russia and a new trade agreement with EU.

- **Inflation is the main concern**. While rising inflation partly reflects regional trends in food and energy prices, strong demand has been adding to inflation pressures.

- **The authorities' response has been appropriate**. Monetary policy has recently been tightened, and the fiscal stance strengthened despite election pressures.

- **Structural reforms have been accelerated**, with an ambitious privatization program that targets the remaining large state-owned companies.

List of Acronyms

ANRE	National Agency for Energy Regulation
ATP	Autonomous Trade Preferences
BEM	Banca de Economii
CIT	Corporate income tax
DSA	Debt sustainability analysis
EBRD	European Bank for Reconstruction and Development
EGPRSP	Economic Growth and Poverty Reduction Strategy Paper
EIB	European Investment Bank
FAD	IMF Fiscal Affairs Department
FSAP	Financial Sector Assessment Program
IT	Inflation Targeting
LOI	Letter of Intent
MFA	EU Macro-Financial Assistance
MEFP	Memorandum on Economic and Financial Policies
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NBM	National Bank of Moldova
NDS	National Development Strategy
PA	Prior Action
PC	Performance Criterion
PER	Public expenditure review
PIT	Personal income tax
PRSC	World Bank Poverty Reduction Support Credit
PSIA	Poverty and Social Impact Analysis
REER	Real Effective Exchange Rate
SB	Structural Benchmark
SIDA	Swedish International Development Agency
STI	State Tax Inspectorate
TA	Technical Assistance
tcm	thousand cubic meters

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I. Introduction

1. **With the growth outlook positive, inflation is the main challenge**. The economy has shown resilience in the face of successive shocks, including a Russian ban on imports of Moldovan wine and a sharp increase in the price of imported natural gas in 2006, and last year's drought. Growth is expected to recover strongly in 2008, with good prospects for the harvest and strong FDI inflows. Macroeconomic stabilization remains the key concern, with inflation under pressure from higher food and energy prices globally, but also from strong demand growth on the back of a recent surge in capital inflows reminiscent of that seen earlier in EU accession states. Demand pressures have also contributed to a widening of the current account deficit to 17 percent of GDP in 2007. The deficit nonetheless remains more than financed by long-term capital, in part reflecting a welcome structural shift from remittances to foreign investment as Moldova evolves into a transition economy. The deficit should gradually unwind, helped by a new trade agreement with the EU, and a resumption of wine exports to Russia.

2. **Performance under the program has been satisfactory**. All end-March quantitative PCs and indicative targets were observed, and all structural PCs were implemented, with the exception of a PC on adopting legislation on the STI, which was implemented with a small delay in June 2008. Given the temporary nature of the deviation, staff supports the authorities' request for a waiver of non-observance of this PC.

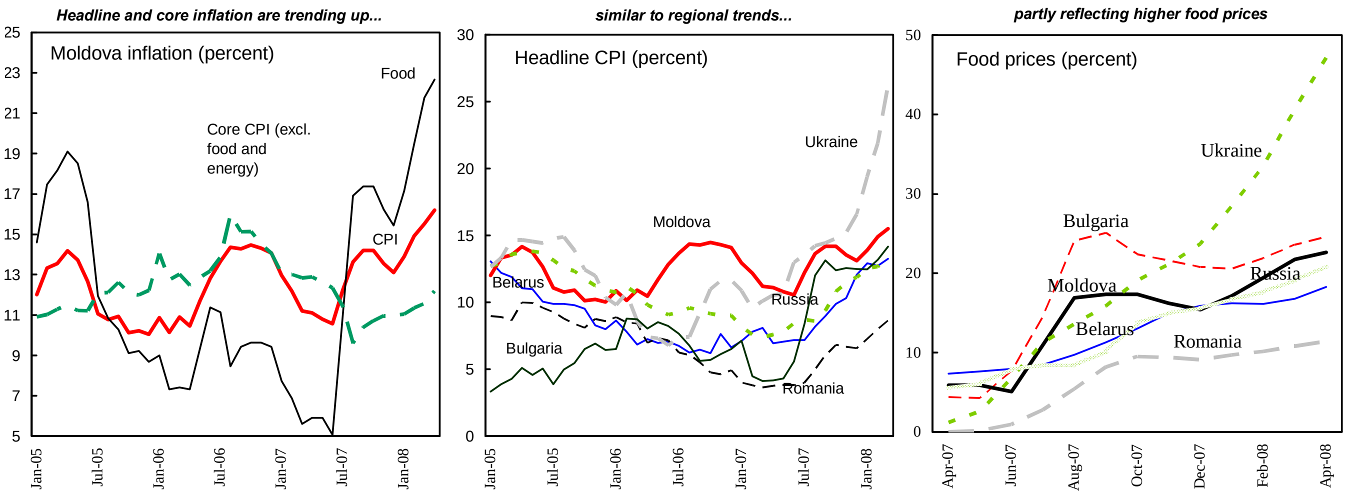
3. **Political pressures have started to build in the run-up to national elections early next year, but so far remain contained**. The authorities' strong commitment to the PRGF arrangement and prospects of growing financial assistance from the EU and international donors has so far supported reform. However, calls to raise spending have strengthened. In the meantime, Prime Minister Tarlev and his cabinet resigned on March 19, to make way for a new government headed by former deputy prime minister Ms. Greceanii, who has been a strong supporter of reform.

II. Recent Developments

4. **Growth in 2007 was slightly weaker than expected due to the drought**. Growth in 2007 is now estimated at 4 percent based on preliminary numbers. Nonagricultural GDP growth, however, remained strong at 9 percent. Early data for 2008 suggest continuing strong investment-driven demand, with investor interest in Moldova boosted by low labor costs and an acceleration of the privatization program.

5. **But inflation is rising.** Rapid growth in food prices, due to the drought and global price trends, was compounded by NBM's slow response to rising inflationary pressures. Inflation reached 16 percent in April, up from 13 percent at end-2007, eroding the real interest rates. Core inflation (non-food, non-energy CPI) also rose to 12 percent in April, compared with 11 percent at end 2007, suggesting strong second-round effects from the drought and mounting demand pressures. At the same time, there are few signs of price

pressures in real estate and assets markets as seen elsewhere in the region, and wage growth, at 8 percent in real terms, remains moderate given productivity gains.



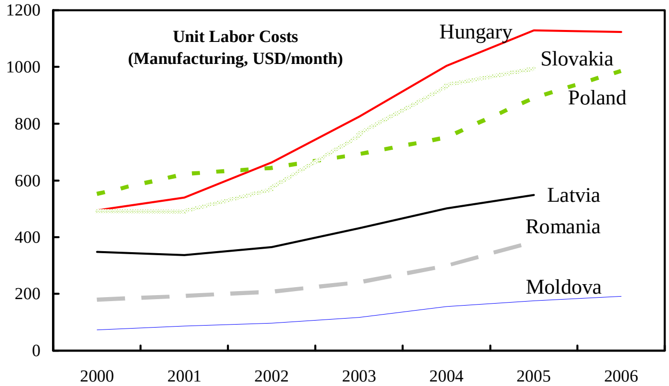
Source: Moldovan authorities; IFS; and Fund staff calculations.

6. **The current account deficit widened in 2007, but remains more than covered by FDI and long-term debt flows**. The recently released preliminary balance of payments data show the current account deficit at 17 percent of GDP, compared to 9 percent previously estimated (Box 1). Strong FDI-driven domestic demand and the impact of the drought on net agricultural imports have undoubtedly played a role. But the main driver was a shift from remittances (which appear in the current account) to foreign investment (capital account) as discussed in Country Report No.08/139.[1] Other capital flows also grew sharply, reflecting in part transfers from parent banks abroad to local subsidiaries to help meet increased reserve requirements, but also higher trade credits. At the same time, large errors and omissions (4 percent of GDP) make analysis of the preliminary balance of payments data difficult as part of these flows may be eventually reclassified into remittances as in the past.

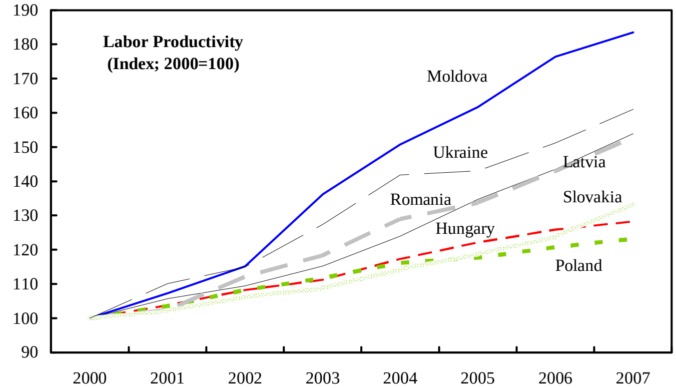
[1] Total investments are estimated to have increased from 28 percent of GDP in 2006 to 33 percent in 2007.

Box 1. Competitiveness in Moldova

Competitiveness in Moldova remains adequate as described in Country Report No. 08/139. Despite demand pressures, the wider trade deficit in 2007 largely reflects the impact of the drought, and FDI-related imports. The real effective exchange rate is broadly in line with fundamentals, and remains only modestly above its level in 2001, in contrast to regional competitors. At the same time, labor productivity has been growing quickly.



Sources: ILO; Moldovan authorities; and Fund staff estimates



Sources: WEO; and Fund staff estimates

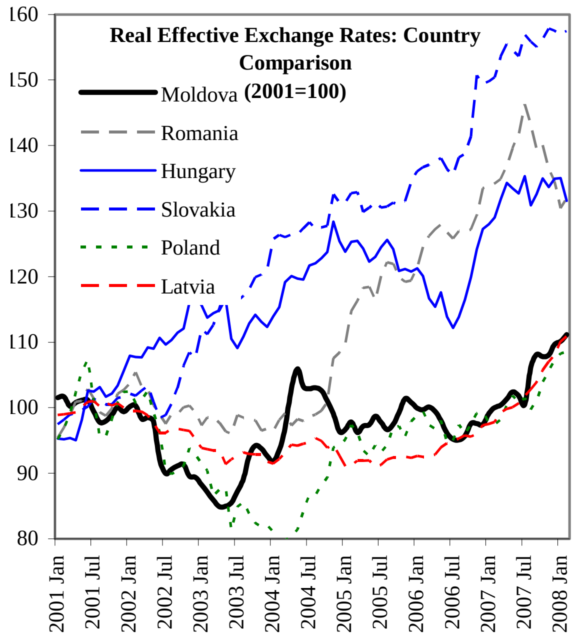
Moldova also remains competitive in lower value-added industries, such as textiles. The following table lists textile export rank, textile exports, USD earnings per month, and UDS GDP per capita. Also included is the 2008 Doing Business Rankings. It shows that compared to what are considered its main competitors for lower value-added business, Moldovan labor costs are low, although the business environment has room for improvement.

Textile Export Competitiveness

Country	Textile Rank	Value (US$ m)	Earn./Month	GDP/capita	Business Rank
Bosnia & Herz.	82	20	569	3,105	105
Botswana	81	14	174	6,757	51
Macedonia	71	45	277	3,102	75
Moldova	78	28	129	991	92
Ukraine	52	244	206	2,291	139

7. **The policy response in early 2008 was mixed**. Monetary policy was slow to react to higher inflation, while weak spending controls in the first two months of the year required a sharp fiscal correction in March.

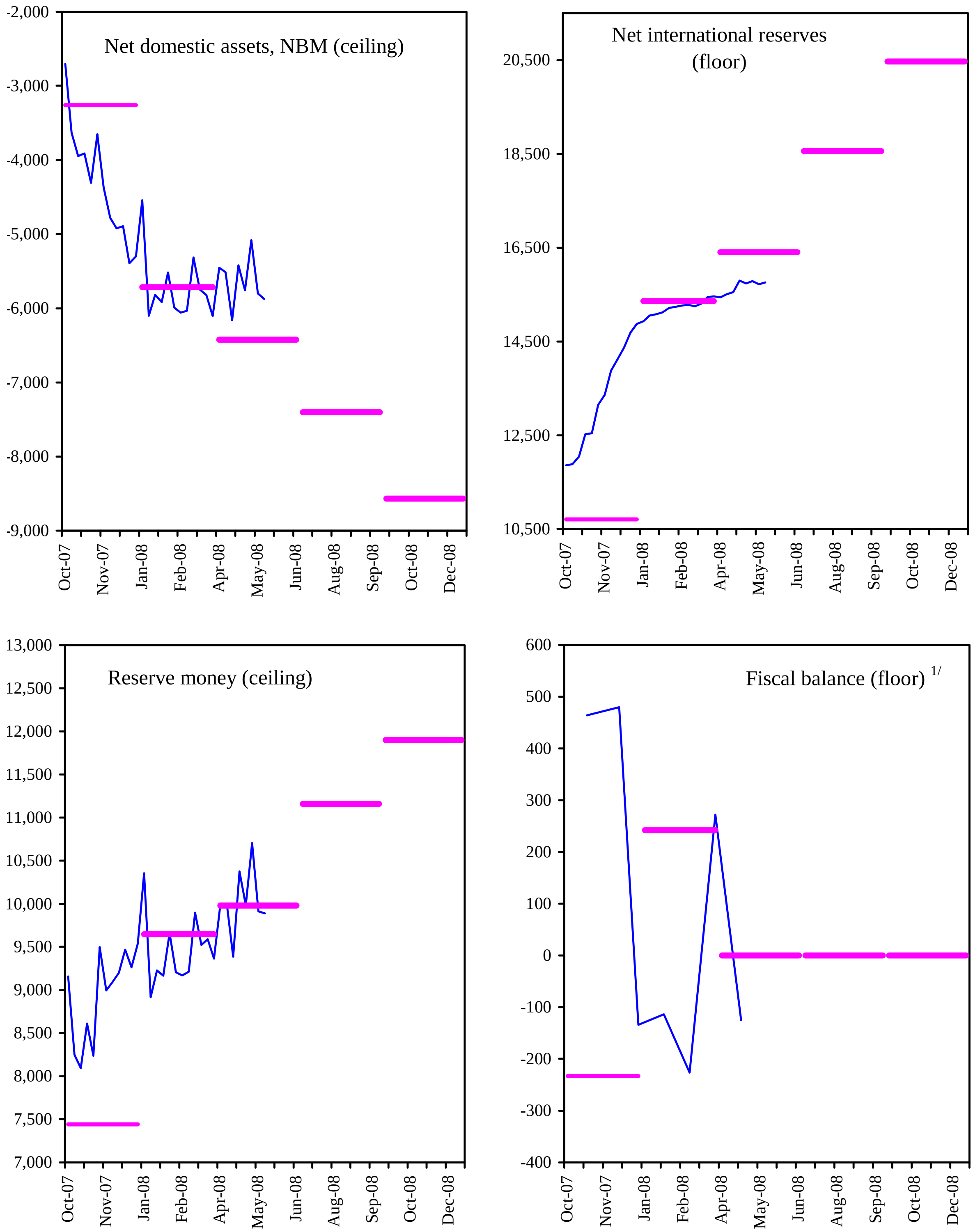
8. **The monetary authorities have continued to play catch-up in responding to higher inflation**. While the NBM gradually increased the sterilization interest rate from 13.5 percent in November to 17 percent in March, the real rate has been gradually eroded. The reserve requirement was raised, but only marginally. More positively, the NBM slowed the build-up of reserves in the first quarter of the year, allowing the currency to appreciate against the dollar, although there was little movement against the euro. Despite these measures, excess liquidity remains and credit growth is strong, adding to demand pressures.



Source: WEO; Fund staff calculations

9. **Fiscal policy has slipped, although the end-March PC on the consolidated budget was met**. While revenue growth remained robust in January and February, lack of expenditure controls caused spending to surge 11 percent in real terms compared with 2007. With the wage bill contained, most of the excess spending was on current expenditure on goods and services, as well as increased transfers to farmers for seeds and fertilizers in response to cash shortages following the drought. Moreover, project spending lagged behind projections because of capacity constraints, accentuating the shift toward current expenditures. However, despite these slippages the end-March programmed surplus of 0.4 percent of GDP was achieved, as the government cut back spending sharply in March, delaying expenditures to April, and import-related revenues continue to overperform.

Figure 1. PRGF Performance, 2007–08
(In millions of lei, unless indicated otherwise)



1/ In accordance with the TMU, the deficit target for Q1 2008 was adjusted by the amount of shortfalls in foreign loan disbursements.
Sources: Moldovan authorities; and Fund staff calculations.

10. **Potential domestic payment arrears are building up, as difficulties in maintaining cost-recovery tariffs for heating continue**. The municipality of Chisinau, in breach of the Civil Code, introduced a retroactive tariff of lei 456 for the period of December 4 to April 14, from the tariff of lei 540 introduced at the time of the last review. As a result, Termocom, the heating producer, is seeking compensation equivalent to lei 200 million that puts further pressure on the consolidated budget. These arrears were in breach of the indicative target on non-accumulation of domestic arrear.

11. **Debt is broadly sustainable.** The March Article IV and Third Review DSA suggests presently-envisaged borrowing can be accommodated. The debt-sustaining non-interest current account deficit is estimated at 20 percent of GDP. Given the positive growth outlook, implementation capacity is likely to be more of a constraint than debt sustainability, with loan disbursements consistently running behind projections.

III. Outlook and Policy Discussions

A. Macroeconomic Stability under Pressure

12. **Growth prospects remain positive, with risks on the upside.** Growth is projected at least 6-7 percent in 2008. Demand is projected to remain strong, even with the expected tightening of policies, on the back of an upsurge in FDI inflows. Robust growth in nonagricultural GDP continues, and agriculture is expected to bounce back from last year's 35 percent drop.[2] However, while a good harvest may help to ease inflation, especially for food, the end-year target of single-digit inflation now appears beyond reach. As a result, the medium-term disinflation path has been revised up by 2.5 percentage points in 2008 and 2009, and by 1 percentage point in 2010. Inflation is now targeted to be reduced below 12 percent by end-2008, with some upside risk, and to single digits in 2009.

Medium-Term Outlook, 2005–10

	2005	2006	2007	2008	2009	2010
			Est.	Proj.	Proj.	Proj.
	(Percent change, unless oterwise indicated)					
Real GDP	7.5	4.8	4.0	6.5	7.5	7.5
Inflation (end of period, y-o-y)	10.0	14.1	13.1	11.5	9.5	7.0
	(In percent of GDP, unless otherwise noted)					
Current account balance	-10.3	-11.8	-17.0	-16.5	-15.7	-15.1
Private investments	18.4	20.7	25.7	25.9	25.3	25.3
GDP, billions of lei	37.7	44.8	53.4	62.8	74.3	84.6

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

[2] The share of agriculture in GDP dropped from 14 percent in 2006 to 10 percent in 2007.

13. **The current account deficit is projected to recover only marginally in 2008**. The resumption of wine exports to Russia is expected to be somewhat slower than previously expected. Nevertheless, non-wine export growth in 2008 is expected to remain strong. While remittances are likely to be affected by the global slowdown, the impact is likely to be moderate as past experience in Moldova suggests that remittance growth tends to be countercyclical, as workers abroad cushion shocks within the country. Higher official international transfers for farmers for seeds and fertilizers will also help the current account position. The current account is projected to remain fully covered with long-term capital inflows, boosted by accelerated privatization.

14. **In the medium-term, demand pressures are projected to wind down only slowly**. The larger-than-expected impact of the drought will unwind quickly, and wine exports gradually recover their full potential. However, investment-driven demand for imports will continue to sustain substantial current account deficits in the near term. This is to be expected given that Moldova is at the start of the transition. Despite appreciation pressures, there is no immediate concern that Moldova will lose its competitive edge as it continues to enjoy low labor costs and rapid productivity growth. However, in the longer term, to ensure that the current account eventually unwinds smoothly, it will be essential to strengthen competitiveness by boosting structural reforms, including ongoing improvements to the business environment.

Sources of Financing of Domestic Demand
(in percent of GDP)

	2006	2007	2008 Proj.
Financial sector	**11.3**	**15.1**	**9.0**
Change in net foreign liabilities	-0.8	5.2	1.9
Change in deposits	14.0	11.7	9.6
Change in claims on NBM	-1.9	-1.8	-2.5
External nonfinancial sector	**8.4**	**13.8**	**14.6**
FDI	6.5	10.2	11.1
Long-term borrowing	1.7	3.6	3.5
Short-term borrowing	0.2	0.0	0.0
Fiscal Primary Balance	**-1.2**	**-0.9**	**-1.2**

Sources: Moldovan authorities, and Fund staff calculations.

B. Strengthening the Program to Face Macroeconomic Strains

15. **The review addressed three main policy challenges:**

- How to arrest rising inflation and resume disinflation;
- How to ensure the budget provides stronger support for disinflation, while preserving overall development and social objectives;
- How to avoid a continuing build-up of quasi-fiscal arrears in the energy sector.

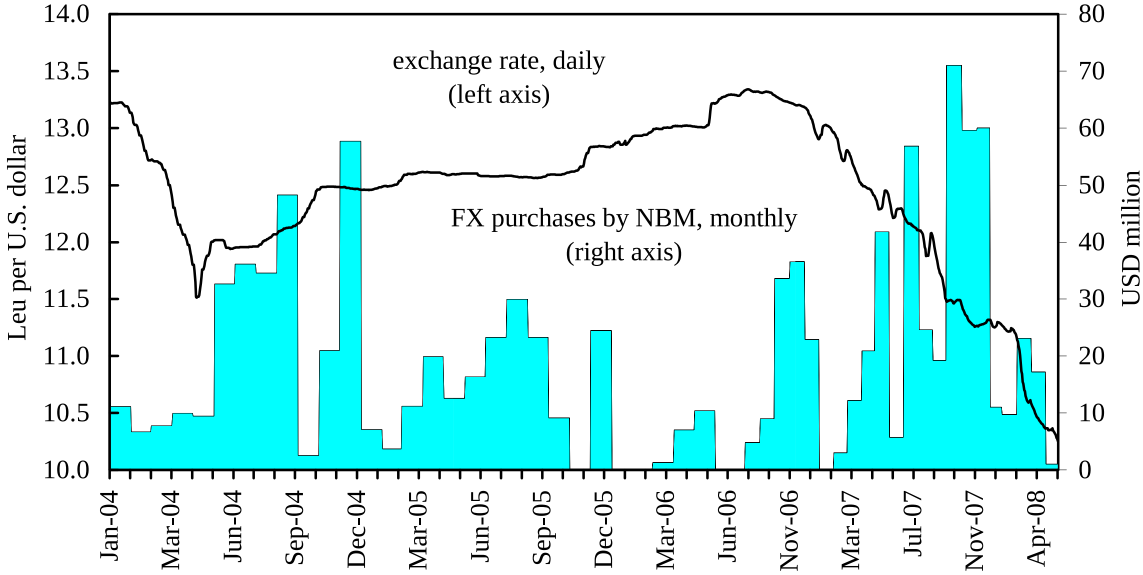
Reestablishing disinflation

16. **In light of the up-tick in inflation, the NBM is to move more aggressively to contain demand pressures**. Specifically:

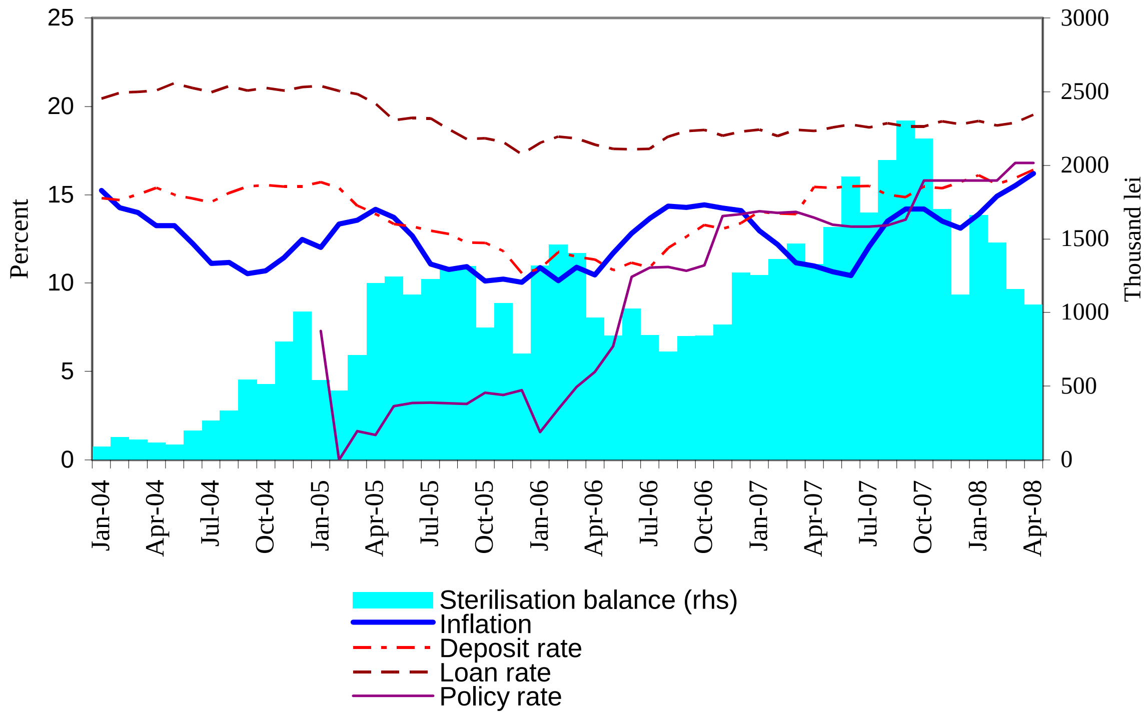
- **Monetary policy has been tightened in the second quarter of 2008**. Given the rising trend in inflation, the NBM raised interest rates on sterilization operations by 2 percentage points to 18.5 percent from May 30 (or to 2½ percent in real terms). Moreover, it has indicated its readiness for further rate hikes to ensure that its main policy rate remains positive in real terms until disinflation is firmly reestablished.
- **Surplus liquidity has been curtailed, to help improve monetary transmission and moderate credit growth**. For that purpose, on May 23, the NBM raised reserve requirements from 16 to 22 percent to become effective from July. Correspondingly, the nominal reserve money path has been adjusted to reflect this change. Excluding the effect of higher reserve requirement, real reserve money growth is programmed to slow to about 6½ percent compared with 10 percent previously. This implies noticeable monetary tightening, consistent with the disinflation objective.
- **The NBM will strengthen its focus on inflation and move away from pursuing multiple objectives.** Costs of sterilization and valuation losses due to appreciation are a matter of concern, but the NBM has committed not to sacrifice the disinflation objective for exchange rate or other considerations. The exchange rate is evolving broadly in line with fundamentals. Although the leu has strengthened against the dollar, appreciation against the euro has been less pronounced. The NBM will continue to allow the exchange rate to be determined by the market, and intervene only to avoid excessive fluctuations. By end-2008, foreign exchange reserves are projected to exceed USD 1.7 billion, which is equivalent to 3.1 months of prospective imports, and to 1.8 times foreign currency deposits.

Figure 2. Liquidity Conditions

Leu/U.S. Dollar Exchange Rate and Foreign Exchange Purchases by the Central Bank, 2004–08



Interest Rates and Central Bank Sterilisation Operations



Source: Moldovan authorities.

- **NBM should step up its effort to strengthen operational capacity and its communication strategy**. As pointed out by the October FSAP update, markets and the public appear confused about NBM's true objectives and the consistency of policy measures. The authorities will benefit from a long-term advisor, who has been provided by the Fund to enhance the NBM's analytical framework.

Fiscal policy is to lend greater support to disinflation:

- **The main challenge is to balance the disinflation objective with large development and social needs**. With revenue overperformance compared to the budget and higher privatization proceeds, the spending appetite has risen in the pre-election period. However, given mounting demand pressures, the authorities have given priority to disinflation. Parliament approved a rectified budget in June targeting a balanced budget for 2008, compared to a deficit of ½ percent of GDP previously programmed. The tightening comes from saving revenue overperformance with a switch in expenditures from goods and services to the new social assistance scheme from October 1, 2008 as well as priority public investments. The authorities and staff agreed that any further budget rectification will be discussed in the context of the fifth review, and will take into account how successful policies have been in resuming disinflation.

- **Steps have been taken to avoid a repeat of the spending overruns in early 2008**. The treasury will tighten spending controls by accelerating the introduction of zero-balance accounts for spending units, and capital budgeting is to be strengthened.

- **The authorities have established an investment fund, which will accumulate privatization receipts**. The fund will be integrated fully into the general government budget and be used to finance major infrastructure projects and other priority investments, such as a pension reform, and possibly costs of reintegration with Transnistria in the future.

Quasi-fiscal arrears in the heating sector are being addressed

17. **Outstanding heating arrears have started to be cleared.** The Chisinau administration agreed to start repaying arrears**,** accumulated from unpaid heating subsidies**,** before the next heating season begins in October. The illegal decision by the Chisinau municipality to introduce a retroactive tariff of lei 456 was challenged in the courts by Termocom, and is expected to be cancelled in the near future.

18. **The authorities are taking steps to avoid a repeat of the heating tariff dispute**. According to Termocom, the cost-recovery price this winter will increase to lei 700 from the

current lei 540 owing to higher prices for gas and electricity. Chisinau is not willing to pay the implied additional subsidy of about 0.4 percent of GDP, and may dispute again the reliability of cost-recovery estimates by Termocom. To avoid a repeat of the earlier situation, the government will facilitate the establishment of a mediator between Chisinau and Termocom that will have binding authority in disputes on heating tariffs. A lifeline tariff is to be introduced for low income households.

C. Other Structural Issues

Financial sector

19. **The privatization of the majority state-owned Banca de Economii (BEM) is progressing well**. Following the announced tender for choosing the privatization advisor on March 28, the authorities have already received a number of bids. The contract with the chosen winner will be signed by end-September, as planned.

20. **The banking sector has proved resilient to external shocks, and the recent global liquidity squeeze had virtually no impact on Moldovan banks**. Although foreign liabilities of the banking system noticeably increased, there appear to be no signs of carry trade or any financial difficulties. Growing external borrowing is accounted for by increased use of credit lines from IFIs as well as by capital injections in the form of loans in three foreign-owned banks from their parent banks. NFA of banks is projected to continue to decline slowly in dollar terms, though the balance sheet impact is weaker due to the envisaged offsetting effect of leu appreciation.

Other reforms

21. **The public sector reform is on track**. Developed in collaboration with the World Bank, the reform focuses on reducing the size of public employment, especially in education, and improving the pay structure to better align pay with skills. By end-September 2008, the government will approve the draft law, which will consolidate all forms of remuneration for civil servants into a new wage grid, and by end-December public sector employment will be reduced by 3000 people.

22. **The authorities are considering accelerating the privatization agenda for Moldtelecom**. This includes possibly launching the privatization tender for a strategic investor earlier than had previously been planned.

Prior Actions, Performance Criteria and Structural Benchmarks

Measure	Due	Status	Note
Proposed prior actions			
Rectify the general government budget, to achieve a zero deficit in 2008, as agreed in MEFP Table 3.			Budget rectifications were passed in first reading on June 30, 2008. Second reading is scheduled for July 4.
The decision by Chisinau municipality, which reintroduced a tariff for heating of 456 lei for the period of December 4 to April 14, will be contested in courts.		Observed	
Termocom will propose a mediator to the Chisinau council as described in the MEFP.		Observed	The formal proposal by Termocom was sent on June 13, 2008.
Performance criteria			
Neither government nor the NBM will provide preferential treatment to Banca de Economii (whether the tax treatment, access to general government deposits, or prudential forbearance).	Continuous	Observed	
Announce tender for privatization advisor to Banca de Economii.	31-Mar-08	Observed	The tender was announced in the FT on March 28, 2008.
Adoption of legislation to (i) give the STI the right to write-off uncollectible tax arrears and (ii) shift all tax audit, assessment, and collection powers to STI.	31-Mar-08	Not observed (implemented with delay)	The legislation was passed on June 27, 2008.
Adopt a new Licensing Law to exclude all entities licensed, regulated and supervised by the NBM and/or the NCFM from its provisions.	31-Mar-08	Observed	The Licensing Law was passed on March 14, 2008.
Sign the contract with the privatization advisor for Banca de Economii with a six-month time frame for bringing the bank to market.	30-Sep-08		
Structural benchmarks			
Heat tariffs received by utilities remain at cost recovery. A lower tariff than provided by ANRE methodology would imply new domestic expenditure arrears under the program.	Continuous	Observed	
Outstanding stock of NBM claims on government fully securitized.	31-Mar-08	Observed	
Introduction of a system whereby the State Treasury ensures that the balances in commercial banks of the social insurance budget (BASS) and the mandatory health insurance fund are zero-ed out on a daily basis.	30-Jun-08		
Remove quantitative restrictions on imports of meat and dairy products.	30-Jun-08	Observed	Import restrictions were lifted on May 23, 2008.
Introduce the targeted social assistance system throughout Moldova.	30-Sep-08		
The government approval of a draft law, which will consolidate all forms of remuneration in base pay for civil servants, with a view to implementing it in the 2009 budget year.	30-Sep-08		
Selection of an advisor through an open tender to assess the modalities for the possible privatization of Moldtelecom.	30-Sep-08		
Reduce public employment by 3000 people.	31-Dec-08		

IV. Staff Appraisal

23. **Moldova's outlook is positive**. Growth is set to recover strongly, agriculture is expected to rebound in 2008, and foreign direct investment is picking up and replacing remittances as the main driver of the economy.

24. **Progress has not come without strains**. Transition is bringing strong FDI-driven domestic demand, appreciation pressures, and a widening trade deficit.

25. **These pressures have complicated disinflation**. Driven mainly by higher food and energy prices, inflation rose to 16 percent in April. Core inflation has also been edging up and the original program objective of achieving single digit inflation by end 2008 is not likely to be reached.

26. **The authorities have reacted appropriately, although with a delay:**

- **Monetary policy has to play the major role**. The NBM has to focus on the inflation objective. It was slow to raise interest rates and tighten reserve requirements, but its commitment to raise rates further if warranted by inflationary pressures is encouraging. The banking system appears well capitalized and sufficiently liquid to tolerate monetary tightening.

- **The exchange rate should be market determined**. The NBM should limit foreign exchange interventions to smoothing out excessive fluctuations. The staff assessment raises no concerns concerning external stability, with some room for further appreciation.

- **Fiscal policy is providing support**. The willingness of the authorities to tighten the fiscal stance in the run up to the elections is commendable. The revised budget does a reasonable job in balancing development needs with disinflation.

27. **The heating sector continues to be a source of arrears**. The decision to facilitate a mediator between Chisinau and the heating company is a welcome step as it should avoid a repeat of earlier tariff disputes, which end up burdening the budget and complicating fiscal management.

28. **The current account deficit reflects recent shocks as well as the changing structure of the economy** and should gradually unwind as the shocks dissipate, although FDI-driven demand pressures will take longer to play out.

29. **The staff recommends completion of the fourth review and granting of a waiver of nonobservance of a performance criterion**. Performance under the program has been satisfactory and the policies for 2008 are appropriately ambitious.