MOLDOVA
2007 Article IV Consultation
Concluding Statement of the IMF Mission

21 December, 2007

With the second wave of European Union accession over, many eyes are now turning to Moldova. Growth potential is high, with a motivated workforce and low costs.

Macroeconomic policies are sound. A prudent 2008 budget is in place, and the National Bank has moved quickly to re-establish disinflation following the impact of the drought. Growth has been remarkably resilient in the face of shocks, and investment is picking up, supported by foreign direct investment (FDI) and strong remittances. Performance under the PRGF[1] arrangement with the IMF has been good and the third review is on track for a IMF Executive Board discussion early next year.

The resolution of the wine embargo, and the approval of the trade agreement with the European Union, provide an opportunity to step up the pace of reforms and boost growth. Key structural reforms aimed at improving the financial infrastructure and fiscal framework agreed earlier under the PRGF program are now in place. The focus going forward should be on growth and, more importantly, growth that comes from strong private sector development, backed by a modern public administration.

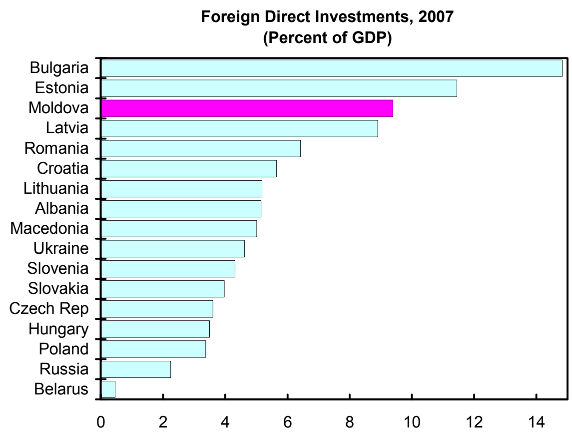
This will not be an easy task. Key challenges for the government are to ensure that growth is supported by appropriate public sector restructuring to met the needs of a rapidly evolving economy, better physical and service infrastructure, energy sector restructuring, a friendly business environment, and better education and social services that make certain the benefits of economic transformation are felt by all.

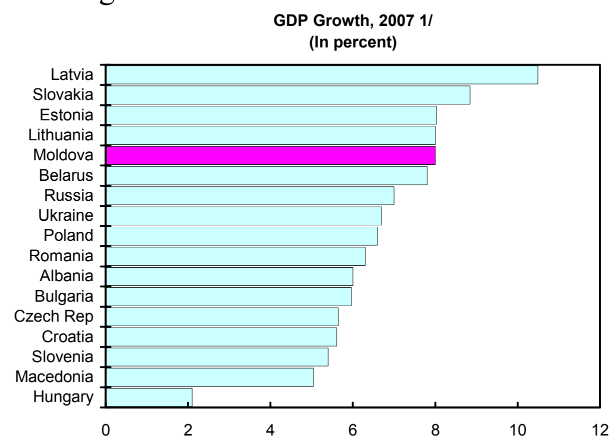
The economy has picked up strongly.

The economy is doing well despite consecutive shocks. Moldova was hit hard by the Russia's ban on imports of Moldovan wine, and a doubling of natural gas prices by Russia's Gazprom. Growth in the first half of 2007 at 8 percent was therefore impressive, although a weaker harvest due to the drought may imply some slowdown in the second half of the year. Export performance has been encouraging, and investments have picked up.

[1] The Poverty Reduction and Growth Facility (PRGF) is a three-year arrangement with the IMF aimed at supporting Moldova through its transition effort.

The pattern of growth is also changing, with developments in Moldova increasingly mirroring those in other transition economies. There are encouraging signs that the earlier model of consumption-driven growth underpinned by remittances is shifting. While large inflows of remittances continue to support growth, they are increasingly flowing into investments rather than consumption. FDI has also picked up and is projected to reach 12 percent of GDP in 2007, compared with 7 percent in 2006. There also signs of a shift of production and employment into manufacturing, particularly textiles, where Moldova's low labor costs continue to provide a competitive advantage.





Source: WEO.
1/ Growth rate for Moldova is actual for H1 2007.

High inflation remains the main concern. Good progress by the National Bank of Moldova (NBM) in reducing inflation since late 2006 was set back by the drought, causing a spike in food prices, in line with regional trends. A renewed effort will be needed to ensure inflation is brought down to single digits in 2008. Also, fiscal policy will need to continue to withdraw fiscal stimulus and support disinflation efforts in early 2008.

The current account is improving. Despite last year's shocks, the current account deficit is projected to narrow to 9 percent of GDP, compared with 12 percent in 2006. While exports have grown, imports grew faster than expected, fuelled by robust remittances and stronger FDI. The deterioration in the merchandise trade balance has been offset by improvements in net income and transfers.

Strong growth performance has presented new challenges.

The current environment is favorable but fragile. Being late to transition, Moldova can benefit from the experience of other countries in the region. This has shown that smooth convergence will depend on a strong fiscal and monetary stance to bring inflation down quickly, and provide more policy flexibility when Moldova faces inevitably mounting capital inflows and appreciation pressures.

While recent trends are similar to those faced by neighboring CEE countries, Moldova has fewer effective policy levers to address these pressures. The role of fiscal policy is limited due to Moldova's low income and high development needs. At the same time, the ability of monetary policy to offset the impact of strong capital inflows and ensure disinflation is constrained by weak transmission channels and underdeveloped financial markets.

Fiscal policy has been sound, but more needs to be done to improve efficiency.

Government finances are healthy. The general government reported a surplus in the last four years owing to robust revenue from VAT and excises on imports, while expenditures were kept in line with budget commitments. Fiscal performance is also strong this year, with revenues driven by higher VAT on imports, and the fiscal targets under the program will be easily met.

Fiscal policy will need to remain prudent to support the disinflation effort. The 2008 budget deficit target of 0.5 percent of GDP is appropriate, even though the budget has been squeezed by the reduction in corporate and personal income taxes. The focus of spending should be shifted from current spending to investment. The public sector wage bill is one of the highest in the region, despite low salaries, and some restructuring will be inevitable if the public sector is to be able to attract and retain high quality staff.

Strong revenue prospects provide an opening for decisive reform of the public sector. This should focus—in line with recommendations of the World Bank's 2006 Public Expenditure Review—on reducing the size of the public sector, especially in education, to allow for improved quality of service, higher education standards, and a pay structure that more closely aligns pay with skills. The ongoing World Bank Public Expenditure Review has identified the implementation of a transparent and uniform remuneration scheme and consolidation of school and health care networks as key reform areas to improve service quality.

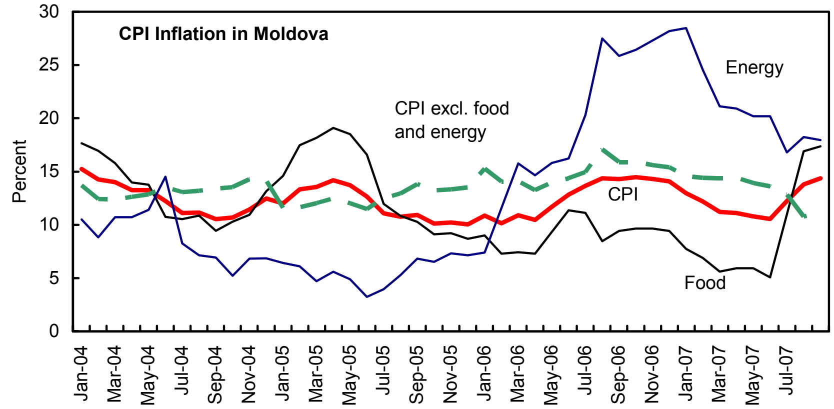
Timely implementation of the new targeted social assistance system in 2008 will be key to reduce poverty. The current system of social assistance based on social categories is poorly targeted. The new, means-testing system, whose methodology was adopted in early October (a slight delay relative to the end-September structural benchmark), promises to considerably improve targeting and should go a long way to mitigate higher energy costs for the poor.

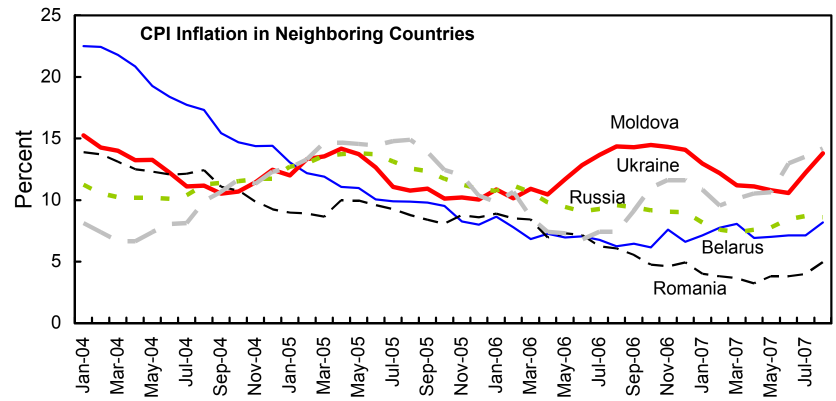
The burden for consolidating macroeconomic stability falls on monetary policy.

Monetary policy bears the brunt of the disinflation effort. Strong appreciation pressures, and a weak transmission process complicate the task of the National Bank. Upside risks to inflation remain, despite the welcome recent monetary tightening, with possible second round effects from the drought. The year-end ceiling on reserve money under the PRGF is likely to be breached. Real interest rates on sterilization operations will need to remain substantially positive until monetary pressures are eased and further tightening may be needed to ensure disinflation is fully entrenched. The movement of the accounts of the Social Fund, the Health Fund, and territorial budgets from commercial banks to the treasury single account at the NBM by end-2007 should ease part of the liquidity pressures.

Given growing inflows of foreign exchange, appreciation pressures are unavoidable. Fighting inflation should continue to be the central focus of monetary policy. While the strengthening of the real effective exchange rate may raise concerns about price competitiveness, it should be realized that the exchange rate is moving broadly in line with fundamentals. Appreciation pressures are the result of capital inflows reflecting high rates of return, and are a normal result of the convergence process, whereby incomes in Moldova will catch-up with those of its neighbors.

Inflation





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

Moldova's financial sector has strengthened but remains underdeveloped. The joint October 2007 Financial Sector mission of the IMF and World bank found that while the banking sector has proved to be remarkably resilient to the series of external shocks, it lags behind some of its peers in intermediating savings. Total assets and credit to the private sector have doubled since 2001, but at 54 percent and 31 percent of GDP respectively, the share of the financial sector in the economy is still small compared with more advanced countries of the region. Although high capital adequacy and liquidity serve as reliable cushions in cases of possible distress, they also indicate weaknesses in operating and risk management capacity. Only some 10 percent of rural households have access to bank accounts.

We are pleased that concerns about the AML regime are being addressed. Revisions to associated laws to bring them in conformity are being prepared with the help of technical assistance from the IMF and others.

The structural reform agenda remains long

Despite recent structural reform efforts, more needs to be done. EBRD transition and World Bank "Doing Business" indicators, as well as World Economic Forum competitiveness point to a weak business environment. Key reform areas include streamlining of regulatory procedures, judicial reform, strengthened bankruptcy procedures, improved business legislation, simplification of licensing requirements, and modernization of the tax administration.

Developments in the heating sector are worrying. Utility tariff reform for gas and electricity has progressed well, with strengthened independence and effectiveness of the energy regulator, ANRE. However, the recent cut in heating tariffs in Chisinau is damaging. The effective heat tariff is well below the cost-recovery level, and growing arrears to energy producers undermine the financial viability of the sector, which will help no-one. Our position remains that tariffs should continue to be raised to cost recovery, with appropriate social assistance for those that cannot afford the higher costs. Across-the-board subsidies for both rich and poor alike are not affordable or equitable.

And distract from other structural reform priorities. The list is daunting, including reduced energy dependence, private sector-led transformation of agriculture, civil service reform, tax administration, business environment, and the social safety net. Changes in the guillotine and business licensing laws are important initiatives for strengthening the business climate, but reducing impediments to business will depend on more than legislative action. The imprint of the state remains high, with extensive involvement of public sector entities in the economy. Policy actions should be carefully assessed to ensure that measures, no matter how well intentioned, do not add to distortions and stunt private sector growth.

A well-planned privatization effort would help. The recently published privatization list is a strong statement that the government is committed to private sector development. Moldova is a small economy, and its needs are great. But a vast amount of state resources, which could be better spent elsewhere, are tied up in entities which could be much better run by the private sector. A transparent privatization effort that targets strategic investors would ease distortions, increase financing for investment, and provide a powerful signal of business-friendly policies. We have encouraged the government to focus its efforts on sectors that will provide a catalyst for growth, particularly in financial and service infrastructure. We strongly support the authorities intention to boost the sale of strategic state enterprises where private involvement can bring new investment and know-how.