Republic of Moldova
Memorandum
of Economic and Financial Policies for 1999

Chisinau, July 29, 1999

Dear Mr. Camdessus

We are pleased to convey to you the attached *Memorandum of Economic and Financial Policies* for the remainder of 1999, describing the policies of the Moldovan government and National Bank and supported by a reformist majority coalition in parliament. We are firmly committed to the promotion of economic stability and the implementation of structural reform in order to realize Moldova's potential for economic growth. During the past year, Moldova faced significant challenges; the economic and financial environment worsened considerably since the regional financial crisis began last August. We have responded by moving to strengthen public finances, while maintaining our liberal external trade and exchange regime. We have also worked intensively with our foreign creditors to reach agreements on debt restructuring and clearing our arrears.

We recognize that these efforts have not been fully successful; the regional crisis has been more severe and longerlasting than we anticipated, and the change of the government in early 1999 slowed our efforts. With agreement with the Fund staff in May on a list of structural measures and revised financial targets for end-June, we have now moved decisively to strengthen policy implementation. All of the measures that were to have been taken prior to the consideration of the program by the IMF Executive Board, as set out in Annex I of the *MEFP*, have been taken and are officially effective.

On the basis of the measures taken to bring the program back on track and satisfactory fulfillment of the end-June targets, we request completion of the fourth review of the program under the extended arrangement. We also hereby request waivers for nonobservance of the quantitative performance criteria for end-June set at the time of the third review as well as the nonaccumulation of external payments arrears. We believe that the policies in the attached *MEFP* are adequate to achieve the objectives of the economic reform program, but are prepared to take additional measures that may be appropriate for this purpose. The fifth review under the

extended arrangement will be based on end-September performance and will focus on budget implementation, the status of large scale privatization, the health of the financial sector and Moldova's record on external debt service payments.

Sincerely yours,

/s/
Mr. Ion Sturza
Prime Minister

/s/
Mr. Leonid Talmaci
Governor
National Bank of Moldova

/s/
Mr. Petru Lucinschi
President
Republic of Moldova

Attachments
Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, DC 20431

REPUBLIC OF MOLDOVA

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 1999

I. INTRODUCTION

1. After the first year of real GDP growth since independence, **economic growth again turned negative in 1998, dropping by 8 ½ percent,** largely because of the severe impact of the crisis in Russia on exports. Both industrial and agricultural production fell on the order of 11 percent in real terms. On the structural side, although some progress was made in mid-year and again in the final quarter, delays in energy reforms and fiscal restructuring, in particular, undermined progress in reducing macroeconomic imbalances. Strong financial measures were undertaken in late-1998/early-1999 which focussed on a sharp tightening of fiscal policy, in the context of the third review of our EFF program. Nevertheless, the real and financial shock from economic crisis in Russia and the region have continued to weigh heavily on the Moldovan economy as evidenced by a collapse of 45 percent in exports in the first half of 1999. As a result, projected economic growth for 1999 has been lowered from a modest recovery of 1 percent to a further decline of 5 percent.

2. In February, 1999, the prime minister resigned and negotiations among coalition party participants and the president to form a new government continued into March. We recognize that delays in policy implementation, especially on the structural side, have contributed to a lack of public confidence in reforms. Also many performance criteria set for December 1998 and March 1999 were missed. The new government led by Prime Minister Sturza, which took office in March, 1999, is firmly determined to create a new momentum of structural reforms designed to foster private sector investment and achieve sustainable economic growth. To this end the program places particular attention on the break up of state farms and development of a land market, the reform and privatization of the energy sector, the strengthening of tax administration and expenditure control, and the rationalization of the public sector. However, with the delays mentioned above and the more difficult external environment, the end-June performance criteria established in November 1998 were no longer attainable. As a result we reached understanding on revised quantitative targets for June with Fund staff, together with a comprehensive set of structural prior actions to establish a short track record of policy implementation. These quantitative targets for June were broadly met, as have all the structural prior actions. On this basis, we request **waivers** for the non-observance of the performance criteria established for end-June. Also, we have accumulated external payments arrears since the third review and request a waiver of non-observance of this performance criterion on the basis of the actions we have taken as explained below (paragraph 34).

3. Notwithstanding these recent achievements, the situation remains very fragile, and will require adherence to a strict policy of financial discipline over a sustained period, to re-establish public confidence in our financial and economic policy. We are well aware that

the progress made in stabilizing the economy since independence is at risk. To this end, we are continuing to take measures as described below, to **ensure that the EFF program remains on track** and to lay the base for sustainable growth in 2000. This memorandum describes our program for the remainder of 1999 as a basis for completion of the fourth review under the EFF arrangement from the Fund. We expect to initiate discussions on a program which could be supported by an ESAF arrangement or possibly a combination of ESAF and EFF resources this fall.

II. MACROECONOMIC AND STRUCTURAL PROGRAM FOR 1999

4. Our program for 1999 calls for a **steady application of tight financial policies and accelerated structural reforms** that should sharply reduce our budgetary financing requirement, reduce domestic arrears and eliminate external ones, reduce the current account deficit, and restore confidence in the leu at a new level. We expect that this will lay the foundation for a recovery of real growth in 2000 with a further reduction of inflation. Curtailing the overall **budget deficit**, to ease pressure on bank financing and stop the accumulation of arrears, remains the key to program success. On a commitments basis, the deficit will be reduced to 3.0 percent of GDP from over 8 percent in 1998 and the preceding two years. A more prudent fiscal policy, establishment of hard budget constraints (including the sharp reduction of barter and offset operations, disconnection of nonpaying customers in the energy sector, and a more proactive application of the bankruptcy law), and accelerated large-scale privatization, should also encourage foreign investment and exports while discouraging excessive energy consumption and theft. Over the short term however, and under the weight of the continuing crisis in Russia, by far Moldova's largest trading partner, economic activity is expected to remain severely depressed. **Real GDP** is expected to decline by 5 percent in 1999, with most of the decline occurring in the first half of the year. **Inflation**, which had declined more quickly than expected early in the year, accelerated in May/June, in part reflecting the sharp depreciation of the leu in May. The program aims to limit inflation in the second half of 1999 to 6 percent and 28½ percent for the year as a whole. **Monetary policy** has been tightened and the NBM will contain domestic liquidity aided by a reduction in bank financing of government. In particular, following a sharp erosion in the demand for lei in late-1998 and early-1999, accompanied by significant dollarization, a key program objective is to restore confidence in the leu. The **external current account** deficit is projected to contract sharply to 9.7 percent of GDP from 17.7 percent in 1998, reflecting the significant decline in domestic demand.

5. We have made significant progress in clearing external arrears, with a heavily discounted buyback of $140 million of bonds occurring in early-June and agreements with Romania and several commercial creditors. Despite our best efforts, it has not yet been possible to conclude negotiations with Russia on official bilateral debt rescheduling, which were at an advanced stage in April, owing to governmental changes in Russia. As of end-June 1999, arrears, direct and guaranteed, on public debt, stood at $90 million, of which $75 million were to Russia, all of which were under negotiation, most at an advanced stage.

III. FISCAL POLICY

6. The keystone in our economic recovery program is the **strengthening of public finances**, building on the measures taken in late-1998 and in the 1999 budget. While revenues were weak in the first quarter of 1999, owing in part to a greater-than-expected impact from the continuing crisis in Russia, we have taken steps in May/June to significantly strengthen tax administration, including the creation of fiscal posts along the Transnistrian administrative border and the establishment of a Large Taxpayers Unit. We are also proceeding with an unprecedented consolidation of local government which will significantly reduce public sector employment over the medium term. Public sector salaries will be contained at their present levels and no increases will be made without prior consultation with Fund staff, in order to contain the wage bill.

7. The 1999 budget has been updated to reflect the impact of the revenue enhancing measures described above, as well as the impact of the continuing crisis in Russia, which has severely affected economic activity and the tax base. The overall deficit on a commitments basis has been raised to 3.0 percent of GDP (Mdl 386 million), from 1.7 percent of GDP in the original program. A cash deficit target of Mdl 407 million or 3.1 percent of GDP (versus 2.6 percent previously) has been set. In addition, about Mdl 110 million, not originally included in the program (0.8 percent of GDP) is now expected to be received as grants from official donors. A reduction in domestic expenditure arrears of Mdl 65 million has been programmed in the second half following the large build-up in the first half. The fiscal deficit on a commitments basis, while loosened from the targets originally approved in the 1999 budget, nevertheless represents a major tightening relative to the levels of 1998 and the previous two years. We also remain committed to capping netting operations at a maximum of 10 percent of revenues in 1999 (from 34 percent in 1998) and eliminating them altogether by 2000.

8. On the revenue side, the government is implementing a program to close the channels of smuggling over the border with Ukraine, especially via Transnistria. The government decision, passed in April featuring permanent and mobile fiscal posts and clear operational responsibilities, represents a significant policy step. The lack of a formal customs and tax collection presence vis-à-vis the Transnistria region has long undermined fiscal revenues. Initial results are encouraging. The **Large Taxpayers Unit**, which had been formed in 1998, but which had not been operationally effective, has now been given the necessary resources and authority by a ministerial order in line with technical assistance from the Fund, and has become fully operational. In an effort to strengthen customs administration, a tender to hire an **import pre-inspection service** to document the content and value of imports, delayed from end-1998 has been announced; a winner will be chosen before end-September, with the service to be fully in place by end-1999. We are committed to maintaining a moderate and transparent tariff regime featuring only three rates. A reduction in the average tariff will be included in the 2000 budget within our 3 rate system in consultation with Fund staff. Submission to parliament of a draft **code on local property taxes, combining the real estate and land taxes,** coordinated with the USAID fiscal reform project, has been set back owing to delays in making the cadastre fully operational. However, we are preparing a valuation method, with foreign technical assistance, which will be ready by end-December for submission to parliament with the draft code on local property taxes.

9. As part of our strategy to strengthen revenue performance and to favor a simple, **transparent** and equitable tax policy, we are determined to resist all calls for tax exemptions, holidays, or deferrals of any kind. Given the severity of the economic slowdown, and the increase in international oil prices, we have agreed to maintain excise duties on petroleum products, alcohol and tobacco in nominal terms until end-September. Collection will be monitored closely and we agree to compensate any revenue losses due to the erosion of the excise duties in real terms with expenditure cuts in the final quarter of the year.

10. Since January 1, 1999, all collection operations of the **Social Fund** have been undertaken (both in cash and in kind) by the State Tax Inspectorate (STI) of the ministry of finance, which has materially improved revenue performance. The ceiling on in-kind contributions accepted by the STI are being sharply reduced from less than 50 percent of revenues in the first half to no more than 25 percent in the second half. As of 2000, in-kind payments will be accepted for clearance of historic debts and up to a maximum of 50 percent only. Further, to conform with the requirements of the Law on Public Pensions passed in October 1998, in-kind receipts will be sold at market prices, and not as was past practice, passed on as pension payments-in-kind, except for those used for historic debt.

11. The 1999 budget featured a sharp reduction in nominal expenditure of almost 1 percent of GDP as compared to last year's outturn. A **partial hiring freeze**, under which no more than one employee can be hired for each two that leave government service has been in effect since January 1, 1999. We are implementing a rationalization plan on **education outlays**, including school closings, increases in the student-teacher ratio closer to international norms, and reducing the teaching week to five days in schools and other educational institutions. **Expenditures on health** are also being rationalized, without a loss of essential services, by closing inefficient and underutilized local hospitals, reducing hospital stays, reducing support staff to international norms, formalizing user charges, improving cost recovery and somewhat reducing doctor training facilities. The rationalization of education and health follows recommendations made by a Fund FAD technical assistance mission in mid-1998, as well as efforts under the World Bank Public Sector Reform (PSR) credit and Health Reform Project. **Subsidies** on vineyards and milk production were also eliminated as programmed. We have also intensified efforts to identify and accept goods from the United States government in connection with the sale of military hardware in 1997. Subsidies to agriculture have been explicitly identified and have been limited to Mdl 75 million as programmed. Numerous other expenditure cuts are being implemented, including a 17 percent cut in the defense budget. No further agricultural support will be provided in any form, including the establishment of procurement funds. Additional measures have been taken to reduce compensations for heating and energy by eliminating various privileges and through better targeting.

12. The Law on **Local Public Finances**, which aims to reform and codify the relations between the central budget an local government budgets as of 2000 as well as set norms for local budget preparation and execution, has been reviewed by Fund staff. The law was submitted to parliament in early June and passed in early July and, as provided for in the program, Fund staff suggested changes were largely incorporated in the law, although further revisions may be necessary.

13. In addition, the **Social Fund Budget** requires modification to rectify serious structural deficiencies. **The following changes will be included in a revised budget to be passed by parliament before end-October 1999**, notably: (i) separate the sources and uses of funds for Social Insurance and Social Assistance and to provide a revised classification; and (ii) several non-priority items and privileges will be eliminated: spas and sanatoria, pensions to former parliamentarians, additional payments to government members. Notwithstanding these measures, the imbalance in Social Fund operations will remain large and further steps will be needed, which we are actively working to identify with the assistance of the World Bank. In the interim we cannot afford any general or special pension benefit increases.

14. We are also pursuing a strong program of **fiscal structural measures** in line with our medium-term objective of fiscal sustainability, increasing the transparency and efficiency of government fiscal operations, and ensuring the timely servicing of external debt. We are continuing to develop a modern **treasury system** in the ministry of finance, with assistance from the Fund, which will improve expenditure management and control and short-term budget forecasting and planning. The system, which is being progressively extended to the local level, beginning with revenues, is expected to be completed in 2000. We have requested significant technical and financial assistance from the World Bank for computerization of the system and linkages to the budget. The Law on **Administrative and Territorial Reform** is being implemented, with the number of local administrations cut from 38 to 11. Local administrations' employment is expected to be sharply reduced, with significant savings to the budget from 2000. Additional savings should be realized in nonwage expenditures and district administration as the new structures are put in place.

15. We are continuing to streamline government operations through the **consolidation of government departments and ministries.** The customs service was made a part of the ministry of finance, the former ministry of privatization is now part of the ministry of economy, and the financial guard has been placed under the STI in the ministry of finance. We have also reduced the central staff of the ministry of agriculture and removed about one-half of agricultural administrators in districts from the government payroll. We are studying proposals for further consolidations at other ministries, and expect to implement further rationalizations in 1999/2000.

16. The Laws on **Public and Private Pensions**, which reforms the existing pay-as-you-go system, became effective on January 1, 1999 and is been actively implemented with a view to strengthening the financial position of the Social Fund. The law increased the retirement age; eliminated privileges; required contributions to the Social Fund to be in cash; and tightened the linkage between individual's contributions and benefits, including

through the establishment of individual social security accounts. We are working with the World Bank to implement these changes and to improve the targeting and efficiency of social protection services under the Social Protection Management project and under the PSR project.

17. We remain firmly committed to avoid any quasi-fiscal interventions through the banking system, notably directed credits from the NBM and commercial banks, including to local administrations. We have ended the practice of guaranteeing loans by the state and strengthened the STI management of debtors. We are implementing a strategy to recover funds from defaulters on government guarantees and firms with large arrears to the state through bankruptcy, restructuring and liquidation proceedings through government decision no. 340.

IV. MONETARY POLICIES AND FINANCIAL SECTOR REFORMS

18. The NBM remains committed to a policy of monetary targeting. The monetary policy objective for the second half of 1999 is to strengthen public confidence in the leu by maintaining tight domestic liquidity conditions, while supporting a strengthening of the banking system. A rebuilding of official reserves coverage to 3 months of imports at current levels is programmed which will require a reduction in credit to the government of Mdl 135 million (11 percent of reserve money at end-June) in the second half. To this end, both interest rates and the nominal exchange rate will be allowed to move to levels consistent with the monetary objectives. In particular, the NBM will limit its foreign exchange market intervention to meeting the program's reserves target and strictly avoid any **administrative** means of influencing the rate. Since early November 1998, the NBM has not intervened in support of the exchange rate, allowing the leu to fluctuate freely as determined in the interbank market. Following a period of stabilization in the first quarter, the currency again came under pressure in May/June depreciating steadily to around Mdl 12/$, before recovering somewhat to around Mdl 11/$ in early July. The authorities are convinced of the appropriateness of a free, market-determined float exchange regime and remain committed to maintaining current international transactions free of any restrictions that could run counter our obligations under Article VIII, sections 2, 3, and 4 of the IMF Articles of Agreement.

19. Notwithstanding the measures taken to tighten liquidity in late-1998, the demand for money has not yet stabilized, and the situation remains fragile. The economy has become much more dollarized, with foreign exchange deposits at end-June representing 35 percent of broad money, up from 10 percent in 1996-98, an underestimate as significant foreign exchange cash balances are held by the public. In the first half of 1999, reserve money growth was held to 18 percent, reflecting an improvement in NIR of $13 million (12 percent of beginning reserve money). Should the demand for money strengthen more than expected, it may be possible, in consultation with Fund staff, to ease the high reserve requirements from their present level of 15 percent. In the interim, and as a first step in reducing the onerous nature of the requirement, the NBM has increased the rate of remuneration on required reserves to 15 percent and will raise it progressively to the level of the rediscount rate by end-December 1999.

20. Consistent with this policy and achieving the inflation objective of 6.0 percent in the second half of 1999, NBM net credit to government will be reduced by Mdl 35 million and Mdl 100 million in the third and fourth quarters of 1999, respectively, following a period of heavy bank financing since late-1998. This will be made possible by adherence to the budget deficit target and the significant external budget support. The **NDA of the NBM** is targeted to decrease in the second half of 1999 by Mdl 130 million (10 percent of reserve money at end-June), allowing for a needed build-up in reserves and contain reserve money growth. Under present conditions, we consider it necessary to maintain the secondary liquid asset sub-ceiling requirement at its present level of 5 percent for the time being. The government is also aware of the danger of decapitalizing the NBM through excessive profit transfers, and a provisional transfer mechanism has been agreed for 1999. From 2000, the budget will specifically provide for the return to an ex-post profit transfer mechanism in conformity with international standard practice.

21. The NBM is also continuing to strengthen its operations through improved accounting and internal auditing, following the recommendations of the report of the NBM's first annual external audit and Fund technical assistance. The NBM will continue the practice of Annual External audits. While a properly financed and structured deposit insurance scheme can build confidence in the banking system, we believe that the present environment is not conducive to the introduction of deposit insurance and will resist calls for its introduction until the financial situation stabilizes and bank soundness is more secure, in consultation with Fund staff. The NBM will support the expected consolidation of the banking system, as a result of the two-step capital adequacy requirement increases in July and December 1999 with a further large increase at end-2000. We will continue efforts to strengthen banking supervision and enforcement of prudential regulations, including removal of management, bank license withdrawals, and encourage mergers of banks not in compliance with minimum capital requirements. **In this regard, the authorities, through the justice and interior ministries, and the prosecutor, undertakes to take the necessary legal and administrative steps to accelerate court procedures to complete the liquidation of closed banks, which has been unacceptably slow and placed an undue burden on the supervisory capability of the NBM**. The situation at the Savings Bank is under careful review following the government's take-over of the bank and installation of new management. A strategic plan to restore the financial condition of the bank or restructure it has been approved by the government and the NBM. The rehabilitation plan is being actively implemented by new management aiming at restoring the bank's capital and liquidity through the effects of the plan by end-1999. The World Bank is studying the banking system and may also provide assistance to the sector, along with that of bilateral donors.

V. PRIVATIZATION AND OTHER STRUCTURAL POLICIES

22. A marked **deepening and acceleration of structural reforms** is an indispensable element to complement our strengthened financial policies aimed at securing economic recovery. In this regard, we have been focussing intensified efforts in the energy sector, which has been the greatest handicap to our reform efforts so far. Negotiations with Gazprom on the privatization of Moldovagas featuring a debt-equity swap have been

completed, and the company officially registered. Gazprom has a majority share in the new joint stock company, with Moldova retaining a 35 percent share. In 1999, we will be undertaking preparations, supported by the World Bank, aimed at offering this share for sale in 2000. **We confirm that this deal removes the government from any financial responsibility for guaranteeing payment for future gas deliveries, directly or indirectly, while existing debts and arrears will be reduced by $47 million by this operation and by the pending issue of $90 million in bonds.** A surcharge on energy tariffs sufficient to service the additional official external debt resulting from the issue of these bonds is in place and will be enforced to coincide with the bond issuance.

23. We are actively implementing a plan to **privatize the electricity sector**. In late-1998, parliament passed enabling legislation to break-up the electricity sector and create seven generation, transmission, and distribution units. Individual privatization plans for the three distribution companies have been approved, a contract with an investment bank advising on the privatization signed, and tenders prepared. The distribution companies will be offered at tender by end-September, 1999 and we expect to complete sales agreements before end-1999. **Preparations to tender the electricity generation companies by March 2000 are underway** With respect to **Tirex-Petrol,** the law on the individual privatization of the company was approved by parliament in July, 1999 and the company will be offered for sale. We expect to complete the privatization of Tirex-Petrol by end-1999.

24. We are also taking steps to complete the privatization of other large-scale objects, despite the difficult investment environment in Moldova and in the region. The most important of these is **Moldtelecom**. Following a failed attempt in 1998, we have contracted for an international financial audit to be completed by end-September, while a law creating an independent regulatory agency has come into effect, with the agency to begin operations before end-September, 1999. We are working closely with the EBRD and the IFC on a privatization strategy involving their financial participation. We will hire an investment bank advisor to assist in the privatization and launch a tender for a majority stake by a strategic investor in the firm before end-1999. **In the interim, Moldtelecom will not be permitted to contract any further external debt, pending its privatization.** The recent commercial borrowing is being reviewed by the EBRD and IFC to ensure its consistency with the privatization strategy. We are also working with investment advisors to develop a privatization strategy for the plants in the **tobacco sector**, and expect to announce a tender for these units by September 30, 1999. We have also recently approved individual privatization plans for five major wineries and will offer them for sale by public tender by end-1999.

25. Another key structural measure involves the liquidation of the state farms and distribution of land to individual farmers, implemented with help from USAID. From a pilot project in 1997, we have expanded the project nationwide to almost 900 former state farms and are aiming at completing the process by mid-2000. At end-1998, 241,000 private farms had been registered, representing some 317,000 hectares (about 30 percent of total agricultural land) with 230,000 parcels titled/registered to participants under the program (representing about 6 percent of agricultural land). By end-June 1999, some 400

collective farms had entered into the privatization procedures and around 8 percent of land titled. We will have processed 600 farms by end-1999, with at least 400 liquidated and individual titles issued representing 40 percent of agricultural land. This program has been supported by **legislation** that has allowed the restructuring of former collective farms to move ahead without tying up the sector in lengthy bankruptcy proceedings, by debt restructuring that transfers social assets (schools, clinics, etc.) to local governments in satisfaction of debt to the public sector.

26. The law on restructuring farm debt approved in July will allow for the distribution of moveable property, vineyards, and orchards outside the bankruptcy process, while allowing fixed assets to be subject to the bankruptcy process while preserving bankruptcy procedures for private debt. We recognize that a proactive approach to bankruptcy is necessary to establish hard-budget constraints for economic agents and eliminate the use of resources by enterprises that are not viable in a market environment. Nearly100 bankruptcy actions (liquidation and restructuring) are now in the courts but few have been completed, in part because of court personnel bottlenecks. To demonstrate our commitment to the bankruptcy process, we will ensure that adequate resources are made available for the full functioning of the bankruptcy courts including the recruitment and training of at least 50 liquidators. By end-September, we will complete bankruptcy proceedings for at least another five enterprises. The **collateral law** has also been amended to provide for simultaneous execution of sale and purchase documents, mortgages and foreclosure procedures.

27. As regards the **tradability of land**, a fixed **fee schedule for notary services** has been approved by parliament and the **National Cadastre** is being progressively put in place with help from the World Bank and others and all 38 regional offices have now been established.

28. We are strengthening our efforts to establish a firm **legal framework** for a market economy, which is a key component to improving transparency and good governance. **The creation of a modern civil code has been unduly delayed and we have taken specific steps to restart the process of approving this fundamental law.** An official draft was submitted to the government on July 21, 1999. By October 31, 1999, we will have approved a draft and submitted it to parliament for consideration.

29. We recognize the importance **that timely** and accurate national statistics play in the formulation and monitoring of macroeconomic policy and performance. We are committed to addressing the shortcomings of our statistical data, especially as regards **the timeliness** and coverage of our national accounts, and will provide additional financial and human resources required to upgrade and develop our statistical performance. In this regard, we shall seek additional technical assistance from the donor community and expedite the implementation of past technical assistance recommendations.

VI. EXTERNAL POLICIES

30. We expect that with the sharp reduction of the fiscal deficit and structural reforms imposing hard-budget constraints on public enterprises, especially in the energy sector, the external current account deficit will be sharply reduced from the unsustainably elevated levels the past few years. Based on preliminary results, in the first half of 1999, the trade deficit was reduced by 60 percent when compared to the same period in 1998, reflecting a drastic compression of imports by 51 percent. Non-energy imports, about three-quarters of total merchandise imports, have been seriously impacted by the 60 percent depreciation of the leu since mid-August, 1998, dropping 58 percent. Energy imports have fallen by 30 percent.

31. On the export side, the collapse of exports to Russia and other BRO countries in the wake of the Russian crisis could only be partially and gradually compensated for by increased exports to new markets. As a result, the level of exports was down by 45 percent in the first half of the year when compared to the same period in 1998. The depreciation of the leu is not expected to result in significant diversification from traditional export markets and increase the profitability of new export ventures in the short term. Accordingly, we are only expecting a moderate recovery of exports to Russia together with a slight rebound of non-energy imports for the remainder of the year. As a result, the current account deficit is expected to be reduced to around 10 percent of GDP from almost 18 percent in 1998.

32. Our difficult external position is being supported by expected balance of payments assistance from official creditors in the second half, in particular from the World Bank ($40 million), and the EU ($16.5 million). This support is needed to help us meet our objective of ensuring timely external debt service payments, as well as permit a significant build-up of foreign exchange reserves to about $200 million, or the equivalent of about three months of imports of goods and services. External debt service in 1999 is expected to represent 43 percent of export earnings, with the external debt stock rising to around 115 percent of GDP.

33. We remain fully committed to a liberal foreign exchange regime and will maintain the exchange rate policy described in paragraph 18, above. We will not impose or intensify any exchange restrictions, introduce or modify any multiple currency practices, conclude any bilateral payments agreements that are inconsistent with Article VIII of the Fund's Articles, or introduce or intensify any import restrictions for balance of payments purposes. We are also committed to maintaining a liberal trade regime and will maintain our simple three tariff rates 5, 10, and 15 percent. We are advancing in discussion on WTO membership, which we expect will be finalized in 1999.

34. We are fully aware of the risks that our **high external debt** poses to the sustainability of the fiscal and external positions. We will therefore carefully monitor and control the future evolution of debt and refrain from contracting nonconcessional external debt and issuing external guarantees by the government and NBM, including by public enterprises. Regrettably, we continued to accumulate external arrears in 1998 and early 1999. Most of

these have now been eliminated through agreements with commercial creditors and a buyback of a $140 million of commercial bonds. We expect that negotiations with the Russian government, which were at an advanced stage in April, 1999 will be completed in the third quarter. However, continued support from official bilateral and multilateral creditors, on the basis of the consultative group meeting held in December, 1998, should, together with the financial and structural measures described above, ensure sufficient external financing for 1999 and help boost foreign investment and confidence.

VII. PROGRAM MONITORING

35. The **prior actions** we have taken for the fourth review under the EFF arrangement are summarized in Annex I. **Structural benchmarks** are summarized in Annex II, while the **performance criteria**, and adjustors, are set out in Annex III. All program purchases will also be subject to financing assurance reviews, which will review progress in the restructuring of the external payment arrears referred to in paragraph 5.

36. The **fifth review** under the EFF program based on end-September 1999 performance will be completed by November 15, 1999. It will focus on budget implementation; the status of large-scale privatization, especially in the energy and telecommunications sectors; the health of the financial sector; and Moldova's record of timely servicing of external debt and clearance of external arrears. It will establish performance criteria for March 31, 2000; the sixth review will be completed before April 30, 2000. We expect to begin discussions on a program that could be supported by an ESAF arrangement or combination of ESAF and EFF resources in the fall of 1999 and expect that it could be in place in early-2000.

/s/
Mr. Anatol Arapu
Minister of Finance

/s/
Mr. Leonid Talmaci
Governor, National Bank of Moldova

/s/
Mr. Alexander Muravschii
Deputy Prime Minister and Minister of Economy and Reform

Moldova: Structural Measures to be Taken by June 15/July 15, 1999

1. Approval of a Ministerial Order on strengthening the Large Taxpayer Unit of the State Tax Inspectorate in line with IMF (FAD) recommendations (June 15)

2. Effective implementation of Government Decree No. 362 so that 30 mobile and 17 fixed fiscal posts at the administrative border with Transnistria are fully operational (June 15)

3. Parliamentary approval of amendments to the collateral law to provide for simultaneous execution of sale and purchase documents and mortgages, as well as land foreclosure procedures (July 15)

4. Introduction by the government of a fixed fee schedule for notaries and notary services on a temporary basis (July 15)

5. Approval by the government in coordination with the NBM of an appropriate plan to restore the financial and operational condition of the Savings Bank based on the results of the diagnostic study with a view to its reprivatization (July 15)

6. Amend Article 54 of the Law on the State Budget for 1999 to establish a temporary, exceptional NBM profit transfer mechanism equal to 80 percent of MOF cash payments for 1999 interest due and revise Annex I accordingly (July 15)

7. Raise NBM remuneration of commercial bank required reserves to 15 percent per annum from 6 percent (July 15)

8. Completion of negotiations on external payment arrears with Russia, the National Reserve Bank, commercial suppliers and creditors under state guarantees (July 15)

9. Initiate restructuring/liquidation program for firms in default of state guarantees and with substantial arrears to the state budget and Social Fund in accordance with Implementation of Government Decision No. 340 (June 15)

10. Complete bankruptcy proceedings for at least two large enterprises (July 15)

11. Announce tender for import pre-inspection service (July 15)

12. Submit for IMF (FAD) review of Law on Local Public Finance (June 15)

13. In preparation for the privatization of a majority stake in Moldtelecom, hire international financial audit firm (June 15), submission to parliament of a law creating an independent regulatory agency (July 15)

14. Submission to parliament of comprehensive individual privatization plan, including debt restructuring plan for Tirex-Petrol in advance of its privatization by end-1999 (June 15)

15. Sign contract with investment bank advising on privatization of electricity distribution companies (June 15)

16. Complete registration of shareholdings of Moldovagas joint venture and initiate company operations (July 15)

17. Submission to the government for approval of an official draft of the new Civil Code (July 15)

18. Review with the EBRD and IFC the $30 million commercial borrowing contract of Moldtelecom (Intracom), with its cancellation or modification, consistent with our legal obligations, if it is found to be inconsistent with the privatization strategy (June 15)

Structural Benchmarks

Benchmark	Target Date	MEFP Paragraph
1. Increase level of remuneration of required bank reserves to ¾ level of discount rate	September 30, 1999	Paragraph 19
2. Launch tender for sale of all electricity distribution companies	September 30, 1999	Paragraph 23
3. Launch tender for privatization of the tobacco sector	September 30, 1999	Paragraph 24
4. Submit the civil code to parliament	October 31, 1999	Paragraph 28
5. Pass revised Social Fund Budget incorporating the structural changes in coverage identified in paragraph 13.	October 31, 1999	Paragraph 13
6. Prepare a property valuation mechanism and submit it to parliament together with the draft code on local property taxes (combining the real estate and land taxes)	December 31, 1999	Paragraph 8
7. Further reduction in average tariff rate in 2000 Budget in consultation with Fund staff	December 31, 1999	Paragraph 8
8. Completion of privatization of Cereale	December 31, 1999	Paragraph 26
9. Launch tender for majority stake by strategic investor in Moldtelecom	December 31, 1999	Paragraph 24
10. Complete liquidation of 400 state farms and title registration to individual farmers of 40 percent of agricultural land	December 31, 1999	Paragraph 25
11. Complete preparations for tender for sale of electricity generation companies	December 31, 1999	Paragraph 23
12. Launch tender for sale of at least 5major state wineries	December 31, 1999	Paragraph 24

Table 1.: Floor on the Stock of Net International Reserves (NIR) and Gross Reserves in Convertible Currencies of the NBM

(In millions of U.S. dollars)

	Minimum Levels [1]	
	NIR	Gross Reserves (Indicative)
Position on June 30, 1999,	-16	149
September 30, 1999 (perf. Crit.)	-10	174
December 31, 1999 (perf. Crit.)	-5	200

[1] The floors will be lowered (increased) for any reduction (increase) in the June 30, 1999 position up to a maximum of $5 million in either direction.

Definitions and adjustors

Net international reserves of the NBM in convertible currencies are defined as gross reserves minus reserve liabilities in convertible currencies. For program monitoring purposes, gross reserves of the NBM are defined as monetary gold, holdings of SDRs, reserve position in the Fund, and holdings of foreign exchange in convertible currencies by the NBM, less any short-term deposits. Excluded from reserve assets are capital subscriptions to foreign financial institutions, long-term nonfinancial assets of the NBM, and assets in nonconvertible currencies, net of deposit liabilities and any pledged amounts. Reserve liabilities in convertible currencies are defined as use of Fund credit, and convertible currency liabilities of the NBM with original maturities of up to and including one year. Excluded from reserve liabilities are liabilities with original maturities longer than one year. For program monitoring purposes, the exchange rate of the SDR against the U.S. dollar has been fixed at SDR 1 per $1.338 and the leu against the U.S. dollar at Mdl 11.0/$.

The program assumes disbursement of the second $20 million tranche of the World Bank's SAC and Euro 15 million from the European Union by end-December, 1999. The targets for end-December, 1999 will be raised, pari-passu, by the equivalent of any external budgetary financing over this amount and lowered for shortfalls resulting from delays in any disbursements beyond December 31, 1999. The targets will be monitored from accounts of the NBM. Data in the agreed format will be reported to the Fund within seven days of the end of each month by the NBM.

Table 2. Ceilings on the Change in Net Domestic Assets (NDA) Of the NBM and Reserve Money (Indicative)
(In millions of Lei)

	NDA	Reserve Money (Indicative)
Position on June 30, 1999	1,431	1,250
Cumulative change from June 30, 1999		
September 30, 1999 (perf. crit.)	-30	40
December 31, 1999 (perf. crit.)	-120	15

Definitions and adjustors

Net domestic assets of the NBM are defined as the difference between reserve money (including currency issued, total reserve deposits of banks and enterprise deposits) and net international reserves of the NBM, (as defined in Table 1, but inclusive of the net position of the NBM correspondent accounts with the central banks of the Baltics, Russia, and other countries of the former Soviet Union (BRO), all expressed in Moldovan Lei). Net international reserves shall be valued as noted in table 1.

The NDA targets assume disbursement of the second tranche of the World Bank SAC loan of $20 million and Euro 15 million from the European Union by end-December, 1999. The end-December, 1999 target will be adjusted upwards for delays in any disbursement beyond December 31, 1999, and lowered for the receipt of any amounts of external budgetary financing above these figures.

Should reserve money exceed its indicative ceiling, the authorities will consult with the staff regarding the appropriate policy response. The indicative targets for the change in reserve money will be monitored from the accounts of the NBM. Data in the agreed format will be reported to the Fund within 7 days of the end of each month by the NBM.

Table 3: Limits on Net Credit to General Government from the NBM
(In millions of lei)

Position at June 30, 1999	1,456
Cumulative change from June 30, 1999	
September 30, 1999 (perf. crit.)	-35
December 31, 1999 (perf. crit.)	-135

Definitions and adjustors

The general government is defined as comprising the republican government budget, including transfers to local authorities and all extrabudgetary funds, including the extrabudgetary fund for external loans and the Social Fund. Any new funds created will be included in the general government. Net credit to general government is defined as outstanding claims of the NBM to general government, including direct credit, holdings of government securities, less deposits.

The targets assume disbursement of the second tranche of the World Bank SAC loan of $20 million and Euro 15 million from the European Union by end-December, 1999. The end-December, 1999 target will be adjusted upwards for delays in any disbursement beyond December 31, 1999 and lowered for the receipt of any amounts of external budgetary financing above these figures.

The limits will be monitored from the accounts of the NBM and the other banks. Data in the agreed format will be reported to the Fund within 10 days of the end of each month by the NBM.

Table 4: Limits on the Overall Cash Deficit and Revenues of General Government
(In millions of lei)

	Cash Deficit	Cash Revenues (Indicative)	
			O/w Excises
Cumulative change from June 30, 1999			
September 30, 1999 (perf. crit.)	192	850	140
December 31, 1999 (perf. crit.)	280	1,900	330

Definitions and adjustors

The general government is defined as comprising the republican government budget, including transfers to local authorities and all extrabudgetary funds, including the extrabudgetary fund for external loans and the Social Fund. Any new funds created will be included in the general government.

The quarterly limits are cumulative and will be monitored from the financing side as the sum of net credit of the banking system to the general government, the Government's net placement of securities outside the domestic banking system, other net credit from the domestic nonbanking sector to the general government, and the general government's receipt of disbursements from external loans for direct budgetary support minus amortization paid. Any assumption of enterprise arrears by the government, beyond the $90 million by Moldovagas in mid-1999, will be included in general government borrowing.

Commodity loans or investment-related external loans obtained by the government will be included in external borrowing.

Government securities in the form of zero-coupon obligations sold at a discount to face value will be treated as financing items in the fiscal accounts, in the amount actually received from buyers. At the time of redemption, the sales value will be recorded as amortization, and the difference between amortization so defined and the face value will be recorded as domestic interest payments.

External commodity loans will be treated as financing items in the fiscal accounts, at the value of the loan in foreign exchange converted into Moldovan lei at market exchange rates the date of the receipt of the loan. The amounts on-lent to domestic enterprises minus domestic counterparts received from these enterprises will be recorded in net lending. Interest payments by the government on these loans to external creditors will be recorded as interest payments on foreign debt and interest paid by domestic enterprises to the government on these loans will be recorded in non-tax revenues. Repayments of principal from domestic borrowers to the government will be treated as negative net lending and repayments of principal by the government to foreign creditors will be recorded as amortization.

Any additional privatization receipts over Mdl 120 million recorded as revenue in the program will be recorded as financing and would not be available to support additional spending. Any amounts received over this will be used to reduce the stock of domestic arrears and the limits of the cash deficit would be raised equivalently.

Cash revenues include all fiscal receipts received in cash and exclude all netting operations as well as external grants, profit transfers by the NBM, and privatization receipts.

For monitoring these limits, data in the agreed format will be reported to the Fund within 30 days of the end of each quarter by the ministry of finance.

Table 5: Limits on the Contracting and Guaranteeing of Nonconcessional External Debt

(In millions of U.S. dollars)

	Maximum Limits		
		Maturity Subceiling	
	Over 1 year	Over 1 year and Under 10 years	Over 1 year Under 3 years
Cumulative change from June 30, 1999			
September 30, 1999 (perf. crit.)	0	0	0
December 31, 1999 (perf. crit.)	16	0	0

External-debt limits apply to the contracting and guaranteeing of medium- and long-term debt of original maturities of more than one year by the general government or the NBM. Excluded from the limits are use of Fund resources, rescheduling and restructured debt operations, and concessional loans that include a grant element of at least 35 percent; but other balance of payments support of maturity longer than one year is covered by these limits, including loans from official creditors and banks. The limits assume disbursement of a 10 year Euro 15 million loan from the European Union in the fourth quarter.

The ten-year average of Commercial Interest Reference Rates (CIRRs) as used by the OECD will be used to assess the concessionality of loans of a maturity of at least 15 years, and a six-month average of CIRRs will be used for maturities of less than 15 years. To both the ten-year and six-month averages, the same margins for differing repayment periods as those used by the OECD will be added.

Other than for normal import trade credits, there will be no contracting or guaranteeing of short-term external debt (i.e. debt of maturity of 12 months or less) by the general government or the NBM throughout the period of the program.

The government will not accumulate any external payments arrears.

Table 6: Ceilings on Domestic Expenditure Arrears of the Government
(In millions of lei)

	Maximum Levels	
	Central Government	General Government (Indicative)
Position on June (preliminary) 30, 1999	795	1,400
September 30, 1999 (perf. crit.)	795	1,400
December 31, 1999 (perf. crit.)	750	1,335

Definitions and adjustors

The central government is defined as comprising the republican budget, including transfers to local governments, and all extrabudgetary funds, including the extrabudgetary fund for external loans and the Social Fund. Any new funds created will be included in the central government.

Expenditure arrears are defined as the difference between payments the central government and local government is legally committed to make and actual payments made. Commitments include, but are not limited to, wage, pension, and energy payments.

Arrears between the republican budget, local governments and all extrabudgetary fund are not counted toward the ceiling.

The ceilings will be adjusted down by the amount of any write off of budgetary energy arrears following the government assumption of the arrears of energy enterprises to RAO Gazprom. The ceilings will also be lowered by any privatization receipts over Mdl 120 million as per Table 4.

For monitoring these limits, data in the agreed format will be reported to the Fund within 30 days of the end of each month by the ministry of finance.