

making investments, while private sector and population will not entrust their savings to the national banking system. Budget crisis will amplify gradually: production is in stagnation, budget incomes are falling with a simultaneous increasing pressure on state expenditures coming from budget sphere. Increasing of external borrowing (and state debt) will become inevitable, as well as financing budget deficit on the account of Central bank's funds.

Social consent regarding necessity to maintain a balanced budget will deteriorate. Pressure of lobbyists on the budget will amplify and keeping a financial stability in the state will consequently become more and more difficult.

That is why, even a mostly efficient macroeconomic maneuvering within such a scenario sooner or later will collapse. World experience shows, that periods of such an economic policy could continue up to 7-10 years. However, finally the situation gets out of hand and a change in economic policy paradigm becomes inevitable. A spontaneous evolution within such a scenario would lead ultimately to a dangerous (more than 50% of GDP) hypertrophy of shadow and criminal economy, would generate exceptional expenditures and disproportion in the level of personal incomes of different groups of population. All these phenomena could lead finally to a collapse of the state, its disappearance from the map of Europe, or become a political basis for setting up an extraordinary power authority, which will use violent methods for stabilization social-economic situation.

An intermediary case, between these two scenarios represents the depressive situation of a half-bankrupted state, slowly transiting towards a new social-economic system under a strong dependence of foreign borrowings of financial resources. Moving closer to Europe will remain a problematic issue for an indefinite period of time.

The movement of Moldova towards Europe, her standards of production and life quality can be accomplished only by merging the energetic and fruitful efforts of the country itself for overcoming the crisis with the multilateral collaboration in the all-European framework.

Deriving from that, "President Petru Lucinschi of Moldova called for a new programme to support economic and democratic transformation in the region - *not extra aid but coordinated aid*. If help comes piecemeal, the problems will never be solved effectively and the CEE risks to become like a sick man, barely getting by, a constant burden and irritation to his wealthier relatives."¹⁰

¹⁰ World economic forum. 1997. Central and Eastern European Economic Summit. Salzburg 9-11 July. Communiqué "Priorities for a region on the rise".

ANNEXES

Annex A. Moldova in a transitional geo-political environment

Moldova as a fragment of Europe

It is now commonplace to define the modern world in terms of *core* (meaning the rich countries of North America, western Europe and Japan) and *periphery* (meaning the poor countries of the third world). If one compares the countries by the size of their economies unimaginable relations can be found. Russia is slightly larger than the Netherlands and yet smaller than Spain. The CIS is the size of Benelux, and the tiny island of Taiwan, is one third the size of China.

Moldova has for centuries been in a peculiar geographical location in Europe. It always represented a border area, first that of Christianity, then of Turkish expansion and later of the Russian empire. Between the wars it represented the last frontier in front of communism's expansion. Presently a new frontier is being established along the old fracture and Moldova now finds itself in a duality again.

From 1991, on the initiative of Russia, Ukraine and Belarus, a treaty was signed establishing the *Commonwealth of Independent States* (CIS). Confronting many difficulties, it finally succeeded in attracting all former Soviet republics, with the exception of the Baltic states. These economies make a de facto ensemble, reliant on Russian energy supplies and inter-industrial exchange. Although the CIS states have in common an imperial and Soviet past, they are in fact very different from many points of view, and it will not be easy to share a common future. They are of very different sizes: in terms of size of territory the ratios are from 1 to 90, for population from 1 to 14 and from density as 1 to 20! The Slavic and Orthodox areas are opposed to the Muslim, mainly Turkophone world, a division more obvious in the Caucasus.¹¹ Privatization is much more advanced in Russia than in central Asia and Belarus. Russia is the only member whose majority of trade is external to CIS, when all other members are more than 50% dependent on inter CIS markets. Two Slavic countries, Russia and Belarus are engaged in a process of integration, while Ukraine has a specific position. Differences between Central Asia and the Caucasus are on the increase.

Being geographically and historically a part of Europe Moldova decisively opted for the way of European integration.

Since Six states created *the European Community* in 1952. the EC expanded in several waves and now has 15 member states. The countries of Central and Eastern Europe plus Turkey, Malta and Cyprus are also knocking on the door.

Internal frontiers also exist inside the EU. The income gap between North and South remains considerable. Greece is the only Orthodox country in the Community. However, the common will of member states has been successful and produced common policies, such as transfers, political dialogue etc. Member states have been able to overcome differences and promote stability. Here lies the attractiveness of the EU for the nations of Central and Eastern European.

¹¹Roger Brunet, Denis Eckert, Vladimir Kolossov, "Atlas de la Russie et des pays proches", RECLUS, Paris, 1995, pp. 203-207.

The EU has replaced the former USSR and CMEA as the main commercial and financial partner of the Central and Eastern European countries. This is why after two to four years of decline their economies began to show the first signs of growth. Integration and reconstruction are under way, but the outcome is still uncertain. If all goes well, economic success in the East will foster prosperity and peace throughout the continent. If not, the prolongation of economic hardship in Central and Eastern Europe could produce catastrophic consequences for Europe.

All the associated countries are eligible to become members of the European Union, yet it is difficult to predict when the first CEEC's will be prepared for integration. A basic model of EU relations with the CEEC's proposes a concentric system of trade agreements with EU as its central circle. The most advanced associated countries would be in the second circle of European integration with a preferential trade regime. The third circle would include all other associated countries. Membership in the three circles should evolve. But at this point, integration of Belarus, the Ukraine, Moldova and Russia even into the third circle seems politically unfeasible. If the political situation changes, there is no economic reason for excluding them, on the contrary, there would be important economic benefits in including them.

Geo-economic ensembles in Europe

The modern economy is characterized by integrational forces into regional transborder geo-economic ensembles. This tendency influences decisions on a political level and encourages countries to form economic alliances. Several pooling economic zones shape European integration. There are ensembles based on trade. The Baltic Sea based on the medieval Hanseatic league is the best example. The others are based on production or mixed integration.

The following geo-economic ensembles emerged in Europe:¹²

North-Western Europe constitutes clearly a "directional core" with the location of large metropolises, centers of political, financial and economic decisions. Common patterns features the *Atlantic facade of Europe*: Scotland, Ireland, Portugal. The *Western Mediterranean* region, is a potential sun belt due to the high quality of living conditions, based on climate, which could attract high tech industries to the region. The *Alpine Europe* includes Switzerland, Austria, the southern lander of Germany, the whole of Padania and the French Rhone-Alps region. These densely populated regions are administrated by metropolises which are not political capitals, have grown fast in the last 20 years, and are based on new industries and trade. This is the second fastest growing ensemble after the directional core. Northern Europe, prosperous, sparsely populated, well protected, is in the process of integration with the European Union and at the same time expands to the Central and Eastern European zones adjacent to the *Baltic Sea*.

Northern Poland, the three Baltic States and the St-Petersburg region of Russia. The other three are basically geopolitical zones in a state of transition: *Central Europe* (the Visegrad countries), *South Eastern Europe* and the *CIS*.

One can note the behavior of countries by their location relative to geo-economic ensembles. Countries belonging to several zones as Germany are among the first promoters of enlargement of the EU and deeper integration.

¹²Michel Foucher, "Les nouveaux visages de l'Europe", Les édition du Conseil de l'Europe, 1995.

By contrary Switzerland finds itself inside such an ensemble and does not need to join the EU due to its already high level of regional integration. Countries located on border-line areas or attracted by external geo-economic ensembles are much more reluctant supporters of integration – as in the example of the United Kingdom balancing between EU and the USA.

A projection can be made on the evolution of space economies deriving from the post Communist block based on historical economic and political assumptions. A traditional industrial center such as Silesia may become the heart of an ensemble including Western Ukraine (ancient Galicia), parts of or the entire former Czechoslovakia. It could also attract Vienna, Hungary and parts of Transilvania into a *Central European ensemble*.

Black Sea co-operation is already institutionalized and its modern founders hope it may re-emerge as a major trading zone as it was for many centuries. With economic growth and the liberalization of trade in the region exchanges will grow considering that 10 countries, six of what have direct access to the sea have joined the *Black Sea Economic Zone*. The transit of Caspian oil through the Black Sea will foster economic activity in the region. Increased Greek activity in this region can be expected due to historic links and also due to Greek minorities which still live around the Black Sea. It is true that no state capitals lay on the Black Sea coast, yet several of them, as Bucharest, Sofia, Ankara, Tbilisi gravitate towards it. The *Balkans* may create a economic *sub-ensemble* mainly due to remoteness from other ensembles.

Ukrainian political independence will certainly lead to an increase of economic independence of the country and may result in an individualized *East European ensemble* from Donetsk to Kiev and, may be, to Minsk and partly to Russia.

In principle the economy of European Russia is self-sufficient and reliant on Siberian and Ural mineral resources. Therefore the consolidation of *Russian economic core around Moscow* but orientated to the East is already taking place. The insertion into several European economic zones will shape Russia position towards Europe. As in the Peter Great's time Russia will enter Europe through its Baltic window – St-Petersburg. Today, as always, the economy of Russia is torn between Europe and Asia and in order to maintain its unity it will tend to a certain degree of isolationism.

Following the described scenarios Moldova will gravitates towards three economic zones: the East-European, the Central European and the Black Sea. Moldova serves to benefit from each of them. The success of Moldova is determined by the integration of all of these zones into an ever close union, starting by a free trade area.

Middle Europe: a region in transition

Several groups of countries can be distinguished by their advance in the reforms (see Map B). The *Central European countries* (the Visegrad group) that border the EU, formed Central European Free Trade Agreement (CEFTA). They have implemented radical reforms, had a low decrease in GDP and relative political stability. Presently they are among the first candidates to join EU, the champions of foreign direct investment and have the highest living standards in the region.

South-Eastern Europe does not border any developed economies, except Greece; until carries the burden of past isolationism. These countries did not succeed to engage in an effective zonal economic cooperation, but all of them as applicants to EU membership have

concluded free-trade agreements with European Union and have reoriented more than 50% of their trade westwards. With the achievement of political stability and economic growth all this countries will join European Union, but at different times.

The *Baltic States* formed the Baltic common market. The proximity and commitment from the West helped them to achieve stabilization and growth by reorienting trade patterns and implementing comprehensive reform programs. They have a second high average level of GDP after the Central European Countries and good chances to join EU in foreseen future.

The former soviet republics, except Baltic States, formed the *Community of Independent States*. Though meant to become primarily an economic union that would foster the links existing under former USSR it failed to establish an real economic union. Moreover all its European members registered continuous fall of GDP since 1989 in such a way that now it is under 50% of its pre-crisis level. This economies did not succeed in gaining larger share in world markets. The various reform programs, more radical in Russia and much less in Belarus had less enthusiastic international support and did not yet bring the stabilization. The CIS also comprise very different countries even in its European part: Russia – a geographically vast self-sufficient economy; Ukraine – a large European-size economy and two small ones – Belarus and Moldova.

Several factors that shape the success of reforms can be named. First, shock therapy has generally given more positive outcomes than gradual reforms and the right-wing governments were more willing to pursue such reforms than the left-wing.¹³ Secondly the penetration of the Western markets was decisive for stopping the fall. The success of such penetration was greatly dependent on the choice in external politic orientation (EU or CIS). Geographically the proximity to developed market economies (EU) favored the most the economies of transition.

Scenarios for the reorganization of the region

There are two shaping factors of the reorganization of the region which stretches from the Baltic to the Black Sea. First relates to economy and more precisely to geo-economy. We have shown above the relative weight of countries in the world economy. At the European level a very intensive flows of goods are registered, mainly between member states of the European Union. Central Europe is already and definitely part of the game. South-eastern Europe has lost a lot of time, because of late transition and ill managed nation building. Russia is an important provider of energy to Western Europe; the EU as a whole is becoming an important partner for Ukraine. And Turkey is also a major economic partner, and in fact is fully integrated into the European economic space.

The plan of pan-European transportation networks launched by the EU shows best the future main trade roots. In the foreseeable future Moldova, Belarus, Ukraine will find themselves as *border states of the EU*. Even if the implementation of migratory measures will put the present open door policy of associated countries at risk, it will certainly have a significant border effect as it was observed for Central Europe.

Euroregions are an opportunity if well managed. European funding for non EU border states are another positive option. Recently (May 1997), at the Black Sea Cooperation summit in Istanbul, the presidents of Ukraine, Romania and Moldova launched the idea of setting up an special

¹³LESZEK BALCEROWICH. "Understanding postcommunist transitions", Journal of Democracy.

cooperation zone on Danube while in Budapest the Romanian and Hungarian prime-ministers agreed upon setting up a euroregion in Bihor.

Recently was launched a proposal to institute a new *Polish-Ukrainian-Romanian trilateral* cooperation framework. These are the three biggest countries in the region that could constitute the skeleton for a new structure of cooperation in the Central and Eastern Europe. When for a long time the decision centers for this region were situated outside, namely Moscow, Istanbul, Berlin or Vienna, the proposed cooperation will constitute an internal counterbalance to this traditional external factors that will until play their rule, through in new forms (see Map C).

A new *American* proposal came when there was an evident vacuum and lack of will to reorganize the Balkan space. Nine nations of Southeast Europe have set out the Southeast European Cooperative Initiative (SECI). A new politico-economic framework could provide the guarantees needed for the major business enterprises to engage in region-wide development efforts.

A report prepared by leading *Russian* policy analysts says re-creation of a Moscow-led union of former Soviet states early next century looks "quite feasible" in the form of voluntary confederation.¹⁴ The study says that only the formation of a new confederation could halt Russia's shrinking global influence thus revealing that current of Russian foreign policy that advocates the principles of zones of influence, namely "the near abroad".

By contrast the *Western Europe* does not want Russia to become "the sick man of Eurasia" as it used to be the case of Turkey in the past. The EU is more and more interested by the access to energy produced around the Caspian sea and central Asia, which give an opportunity for transit countries. There is a more reluctant response in the EU when agricultural products are concerned. The risk is therefore that countries such as Moldova and Ukraine will be denied unlimited access to food markets, for obvious reasons.

Ukrainian drive for political independence obliged its new leaders to look for historical roots. President Kuchma pointed out, "I do not want Ukraine to be in Russia's shadow or to be sidelined in world history. They are not waiting for us. We must push our way into Europe because that is where our future lies". Ukraine formulated its foreign policy strategy as "Cooperation with CIS – Integration with Europe".

There is an interaction between the economic stagnation of a country like *Belarus* and the fact that the nation-building process cannot be freely implemented for mainly internal political reasons.

Moldova to make a choice

Moldova is a particular case of transition due to its high trade dependency on FSU market, which imply political dependence, the small size of the country as well as specific obstacles of its state building. Could Moldova have followed a different transition pattern?

Due to its high trade dependence a isolationist economic policy can be ruled out from the beginning. Two other models could be envisaged deriving from its geographical situation. The actual one, of fostering relations with CIS, was accompanied with gradual, if not slow reforms, low degree of diversification of trade patterns, low FDI and a threefold decrease in GDP for the last 7 years.

¹⁴"Study Released on Post-Soviet Re-Integration". (RFE/RL), Moscow, May 24, 1997.

The other scenario would have been the options for EU integration. The example of Baltic states that were as dependent on Soviet market as Moldova but now have as their main trade partner the EU shows an opportunity of stabilization by trade reorientation. In regional context the Romanian model that in spite of slow reforms and unfavorable geographical context achieved the stabilization already in 1993 and now has an average per capita income four times higher than Moldova, important foreign investment, and a sustained growth is relevant. While Russia is enormous, Ukraine too big and quite far from the Western Europe, Moldova is a small state that could be easier accepted as an associated partner for EU.

There are several factors that influenced Moldova's path. First was the resistance of political forces advocating the reestablishment of political and economical union within CIS. Secondly the relative remoteness of Moldova from the developed market economies. Third cause is the presence of Russian troops in Moldova after their withdrew from Central Europe and Baltic States. This fact indicated that Moldova remained in the Russian sphere of interests even after the fall of the Berlin wall though other factors point out that this is not a status quo.

Annex B. Review of the reform process

1. The initial stages of reform: transformation of the economy and remaining problems

In the seventh year of reforms, despite the transitional difficulties no significant group – from the various political parties, to the trade unions and the general public – opposes the principle of the market orientation for the economy. However, with the passage of time, euphoria and expectations of swift success (e.g. “...the transition will take one an a half to two years.” cf.: Program for the Transition to a Market Economy in the Moldova SSR, 1990), turned into disillusion, depression, and diminishing credibility of the reform process among the majority of the population. This reflects the fact that after some positive developments during 1993-1995, including overall macroeconomic stabilization, and despite forecast of 1.5-3% GDP growth, economic performance in 1996 was weak, with a continuing decline in major economic indicators, and a heightened budget crisis.

Despite the fact that during this period a large proportion of government expenditure (up to 60 per cent) went to meet social needs, the costs of reform were very heavy for the population: real incomes decreased by no less than 40% compared to 1990, wage and pension arrears emerged and grew; although the number of official unemployed only reached 20-24 thousand, there is hidden unemployment of about 200 thousand; the consumption of basic food products (meat, milk etc.) fell, while the share of food in consumer expenditure rose from 38% in 1990 to 61% in 1995.

Eastern European and CIS countries have all experienced similar problems during the first years of transition:

- a decreased capacity of the state to regulate economic processes;
- the disruption of traditional economic links, resulting in a decline in production, and payment defaults by businesses;
- radically decreased budget revenues and large-scale tax evasion;

- a decline in savings and investment;
- inflation;
- a falling standard of living, growing unemployment, and increasing social differentiation;
- increasing volatility of the economy and presence of criminal activities.

The beginning of the transition period in Moldova was complicated by political tensions (1990-92) during the military conflict in the Transnistria region and the confrontation in the South (Gagauzia), which resulted in the disintegration of territorial economic relations. Also, increased dependence on the agricultural sector and therefore on climatic conditions (i.e. the crop failures in 1992, 1994, and 1996) had a negative impact, along with the energy factor (i.e. the almost complete reliance upon the foreign supply of the energy, combined with the inefficient energy consumption.)

The main focus of reform has been on three issues: property reform and privatization; liberalization of enterprises and economic activities in general; and the fight against inflation. Critical steps included the introduction of a national currency (November 1993); reduction of the budget deficit; cutback in budget subsidies and officially directed loans; liberalization of prices, of foreign exchange and trade regimes, and of external economic relations in general.

The sources of income of the population shifted, resulting from the move to the market economy. There was a decline in the share of salaries and wages in total income from 71.1% in 1993 to 40.5% in 1995, combined with an increase from 12.6% to 43.5% of the share of own-account income generated by households (i.e. double employment, income from sale of household products, services, etc.).

Positive results of the initial stage of reforms included:

- the initial changes in the structure of property;
- some positive trends on the macro-level which have increased the credibility of Moldova amongst the international community;
- rapid expansion of the private sector, up to 40-45% of GDP and no less than 50% of total employment;
- the emergence of a group of enterprises (in light industry, canning, wine-making, etc.), which have managed to both increase output and exports.

However, progress with agricultural reform, de-monopolizing of energy sector, transport and telecommunications, as well as in attracting foreign investment have been less impressive. National budget allocations for health, education and culture decreased substantially. Many highly-qualified workers emigrated.

By 1995 many of the prerequisites had been put in place to move from stabilization to renewed economic growth. Indeed, the EBRD Transition Report (1995, p.11) noted that in relation to the main transition parameters (privatization, price liberalization, trade & foreign exchange system, competition policy, banking reform, securities market, legal reform, etc.) Moldova had surpassed its neighbors – Romania, Bulgaria and Ukraine, and the majority of the CIS countries.

Encouraging appraisals of the course of reforms led the President, Parliament and Government to press forward with further concentrated efforts in 1996 which aimed:

- to revive the real economy;
- to accelerate reforms in the agricultural sector;

- to promote enterprise restructuring, including selection and support of reform of specific enterprises – particularly export-oriented “growth points”
- to stimulate of investment – foreign and domestic savings;
- strengthening state regulating policy in the social areas.

What was the outcome? On the one hand, in line with the performance of last 3 years, in 1996 the country achieved substantial success in reducing inflation (15.1% p.a.), and stabilize the exchange rate (\$1=4.6 MDL), with the yearly devaluation of Moldovan Lei of only 0.14 units against US Dollar, and a rise in the exchange rate against the currencies of Russia and Romania, Moldova's chief economic partners. Foreign currency reserves increased by 22% during 1996.

At the same time, there was no improvement in the indicators of real economic activity: the official statistics reported 8% fall in GDP, industrial output falling by 8% and agricultural production by 13%.

In the overall picture of economic life of Moldova, several new processes and phenomena emerged in 1996. From the positive standpoint the following should be mentioned:

- A qualitative evolution of economic enterprises in the country with dynamic new small businesses, employing up to 75 persons, which employ only 12% of the labour force and generate 30% of sales in goods and services.
- An expanding process of enterprise restructuring, both in industry and agriculture.
- Increasing proportion of investment funded through retained earnings of businesses rather than the State budget. In the total amount of investment (650.4 million MDL) the share of the state decreased to 22%, 72% was funded from retained earnings and personal savings, and 6% from external sources. 52% of total investments was in the private sector. In the domain of housing the share of private investments reached 92%.
- Inflationary expectations declined and household savings started to return to the banks. Monetary resources of the population in the form of bank deposits increased by 28%, personal insurance premiums by 33.2%, and property insurance by 20.4%.
- Despite the fall in official estimates of real GDP of 8% in 1996, household budget data suggest that real disposable income grew. Total households increased and consumer expenditures increased by 24% (Jan.-Sept) in nominal terms, which suggests that real earnings increased by 8%. Anecdotal evidence of this can be found in the 21 per cent rise in the number of private vehicles, the expansion of demand for housing and price rises in the residential property sector. The difference between the movement in GDP and household incomes is explained in part by the drop in the ratio of investment to GDP and increase in foreign savings, but also probably reflects the undercounting of the informal economy in the GDP data.
- Social tensions were limited. The official unemployment rate during past three years was 1.5-1.8%, that is, 20-24 thousand people registered, but that does not include about 200 thousand people on unpaid leave. Despite the difficulty for the population to adapt to the harsh realities of the new environment, strikes or other protest actions, have mainly been limited to protests by pensioners and other state-budget dependents.

Negative trends observed included:

- Continued stagnation in a significant part of economy, with at least 40% of enterprises idle or operating at a loss, which causes ongoing difficulties in relation to indebtedness; there is the development of a system of funding by increasing liabilities to suppliers and personnel and delaying tax payments.
- Low degree of observance of budgets, both state and local, i.e. the variance of actual tax collections versus the budgeted one was estimated at 30%, unpaid taxes increased, which caused the non-execution of the budgeted social payments. Debts associated with pensions and wages payable increased.
- After an increase in industrial output in first half of 1996 of 8.7%, there was a severe decline, which ultimately resulted in 8.5% decline for the year.
- Inefficiency and mismanagement in the energy sector, and the absence of supervision and reporting of the use of energy resources had exceptionally negative effects on the external debt, and on the general economic standing of energy enterprises.
- Weaknesses in the external sector included lack of foreign investment, absence of appropriate mechanisms for dealing with foreign partners in relation to export promotion and participation in international tenders (for cement, tobacco, wine, etc.); and the low efficiency of customs controls.
- Limited financial resources for structural change; the discrepancy between the interests of banks and productive enterprises has not been overcome yet; there is an absence of relevant financial institutions to finance exports and small business promotion, including provision of credit to sole-proprietorships and farmers.
- Local public authorities have been passive agents in the reform process, i.e. low initiative in local revenue generation, in small enterprise support, etc.
- There is a substantial “black economy” (probably over 20% of GDP), caused by legislative weaknesses and failures in administrative and judicial institutions, and corruption, leading to uncollected taxes and social security payments.
- In important respects there has been a drop in the quality of life, i.e. safety, health and life security; the quality of education, health, and culture; and growing organized crime.

2. Evaluation of economic performance

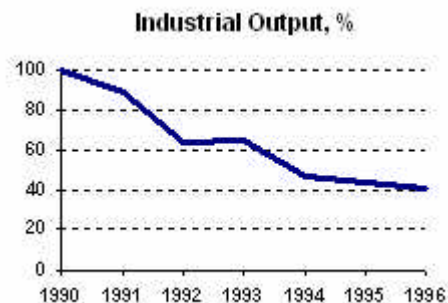
GDP Dynamics and Inflation



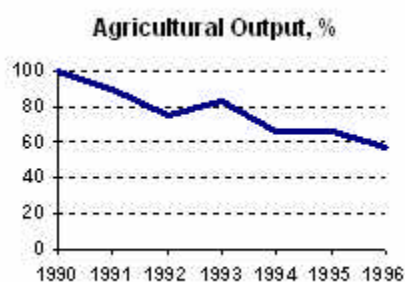
The continuing fall in national output was the most unpleasant surprise of the last year. Despite forecasts, ranging from 2 to 8 per cent and a positive net growth recorded in the first half of the year, at year-end GDP dropped by 8 per cent. GDP per capita calculated at PPP basis fell below \$2000, less than that of other Eastern European countries in transition and Baltic States and similar to other FSU¹⁵ countries.

Industrial production fell by 8.5 per cent, and agricultural production by 13 per cent.

Agriculture still has an important share of national economy, providing more than 40 percent of GDP and more than 50% of employment as well as representing a critical source of self-sufficiency for the population. The comparative figures for Romania are 20 and 35 percent respectively. Agricultural production accounts for a considerable part of Moldovan exports.



The balance of payments remains vulnerable to external shocks, as Moldova is a largely agricultural country, dependent on Russia and the Ukraine for export markets and critical imports of oil, gas and other inputs such as fertilizer and machinery. This vulnerability should diminish over time. For one thing, gas and oil prices are now close to world levels and while these may fluctuate, the prospect of a shock similar to that experienced at the beginning of nineties is remote.



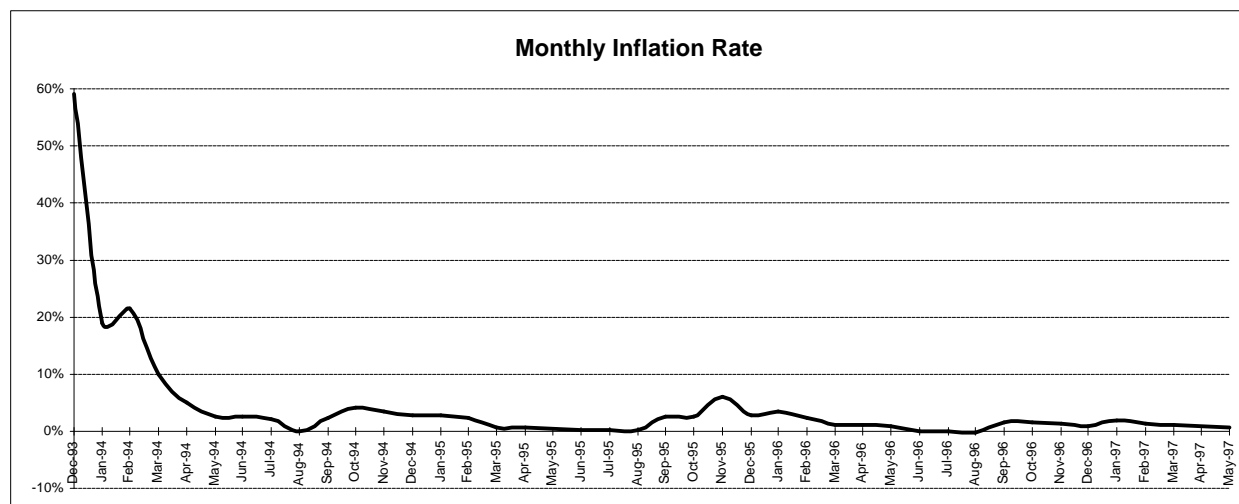
The biggest decrease of agricultural output was of vegetable production, which dropped by 17 percent. Animal production decreased 4 percent. According to the Department of Statistics, in 1996 agricultural production was only 57 percent of 1990 production.

¹⁵ FSU - Former Soviet Union.

Criteria for performance evaluation

Three criteria can be used to judge macroeconomic performance:

- economic growth;
- price stability (low inflation);
- the level of employment



The main achievement of macroeconomic policy was price stability, resulting from tight monetary policy. However, not only has national output decreased since the declaration of independence but there has been a sharp deterioration in the “social safety net”.

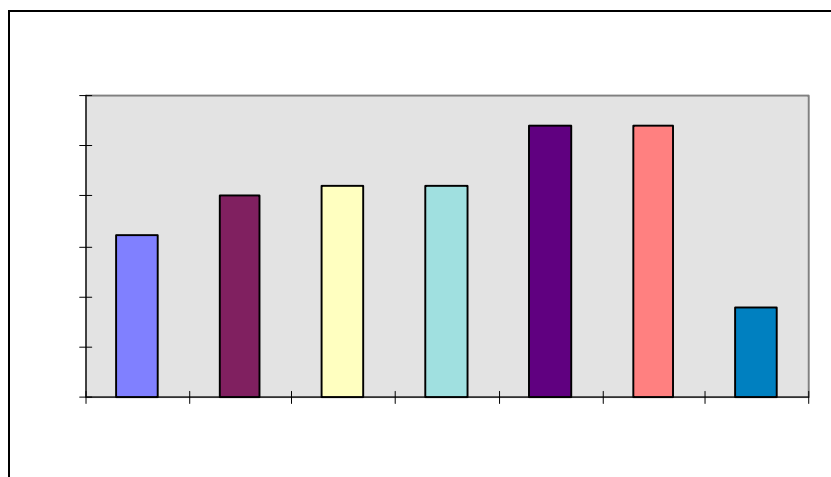
The proportion of basic consumption standards covered by household income decreased from 90 % at the beginning of 1992 to 40% in 1996. Unemployment soared from close to zero to 11% of labor force, according to some estimates. Such a situation can be described as a continuing **depression**.

As GDP decreased 8 per cent, in it's overall decrease, the share of investment fell by 15% and the balance of trade deteriorated by approximately 8%. At the same time, total consumption has risen, along with government expenditures. However, statistical data requires a very careful interpretation because of huge gaps in collection (particular of “informal” economic activities), and the unclear status of Transnistria.

3. The evolution of policy priorities

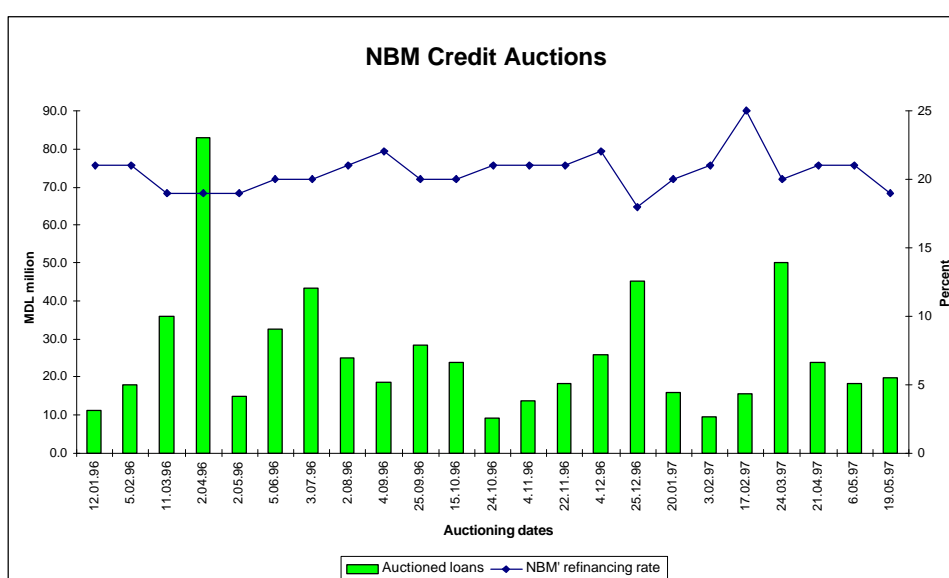
Credit Policy, Savings and Investment

Economic growth requires rising stocks of productive assets, personal skills and knowledge (human capital) and the capacity to make effective use of these assets. While access to foreign savings can ease the constraint on domestic savings temporarily, historically, sustained high rates of investment and growth have not been achieved without strong domestic savings. In this context, low domestic savings should be a matter of concern in Moldova.



It should be mentioned that savings (S) have dropped drastically as a result of the drop in GDP and of the increasing of GDP allocated to consumption and government spending.

Interest rates were relatively high in 1996. Refinance rate of the National Bank of Moldova has stayed at about 20 percent annually, as shown in the chart below:



However interest rates used by commercial banks have been much higher, because of the premium on the commercial risk. High real interest rates led to a drop of Investment.

Foreign direct investment has risen since 1992-93 in absolute terms, although its share in total investment is still not very large. Most foreign direct investment has been in the agricultural sector, particularly wine-making. However, when compared to other CIS members, Moldova's record is quite encouraging, although below those of Eastern European countries in transition and Baltic States.

Budget, Fiscal Policy

After a budget consolidation from a 8.6% deficit in 1993 to less than 5% in 1995, a deterioration to a 10% deficit occurred in 1996 (as a % of GDP). The fiscal situation was aggravated by accumulated arrears' to the budget (more than MDL 600 million), due mostly to problems in payments collection. However, these numbers overestimate the budget deficit for two reasons:

GDP is underestimated (and does not include Transnistria), and because of the methodology used by the Ministry of Finance for handling budgetary data. The World Bank and IMF estimated the deficit at approximately 7.2% (without Transnistria).

Wages, Employment and Real Income

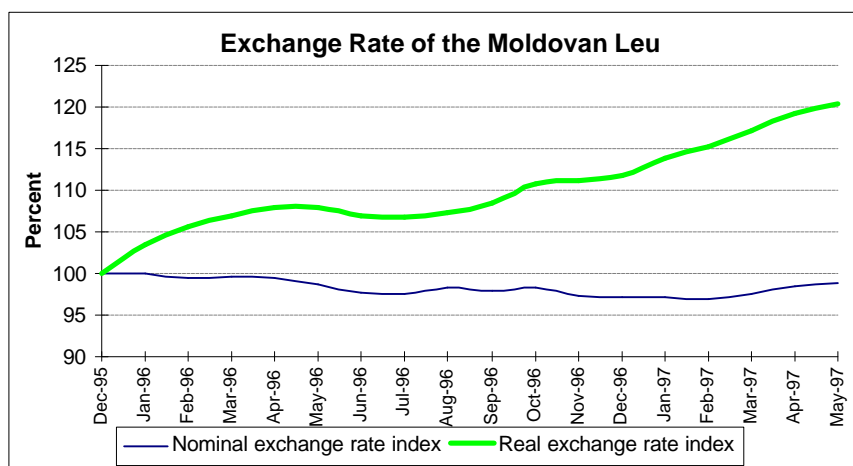
Nominal average monthly wages in 1996 were 186 lei (USD 40). While accumulated salary arrears have risen to 360 million lei.

Year	1992	1993	1994	1995	1996
Wages, MDL	3.5	312	108.4	143	186

Since 1991 the total number of people employed who are susceptible to taxation has decreased by 400-450 thousand. Although the official unemployment rate in 1996 was 1.8 percent of the labor force (economically-active population), this does not take into account hidden unemployment. Actual unemployment is estimated at about 11% of labor force. Labor unit costs have increased in general and specifically in services, raising the cost of non-tradable goods.

Monetary policy

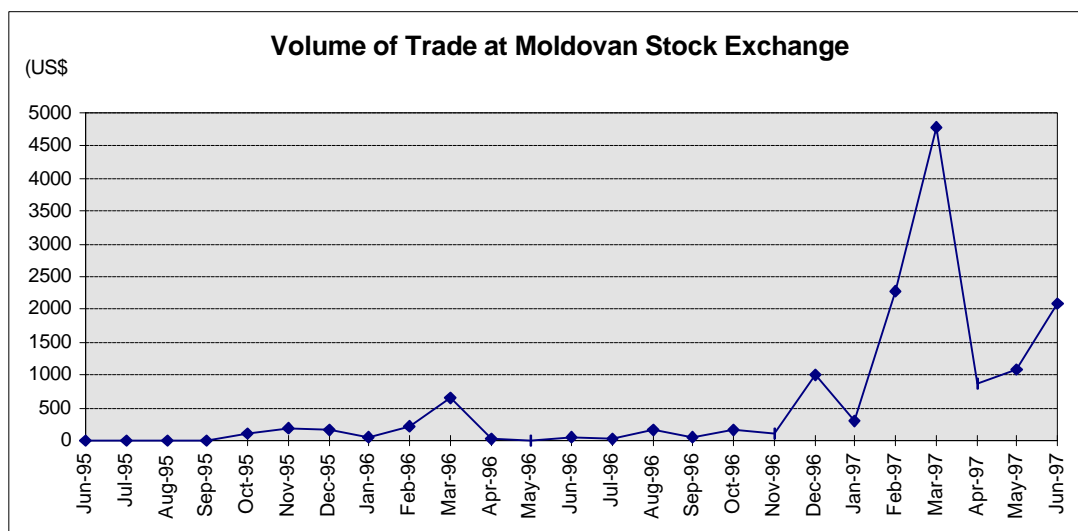
Since the introduction of the national currency in November 1993, Moldova has adopted a tight monetary policy. In 1996 inflation reached the annual level of 15.1%, compared with 23.8% in 1995. Average monthly level of inflation was 1.2% in 1996, while in 1995 it was 1.8%. National Bank of Moldova (NBM) international reserves grew in 1996 by 22%, and as of January 1, 1997 amounted to 313.7 million USD. In 1996 the nominal exchange rate of Moldovan leu depreciated vis-à-vis dollar by 2.6 percent, while the real exchange rate calculated on a CPI basis appreciated by 12.1 percent.



The most important achievement of monetary and credit policy during 1996 was containing the increase of the monetary base to 12.8 percent as compared with 65 percent in 1995. Within this period, the interest rates on T-bills sold in the primary market fell. The interest rate on 91 days maturity T-bills decreased from 44.57% in January 1996 to 24.2% in May 1997; 28-days T-bills - from 40.32% in March 1996 to 22.5% at December, 24 1996.

The Moldovan Stock Exchange started its activities in June 1995. There are about 500 companies with more than 300 shareholders which, in compliance with current regulation, are registered with the Stock Exchange. Of those 16 are actually listed in the market. The national portfolio of securities calculated as a nominal capitalization of the market rose to above MDL 5

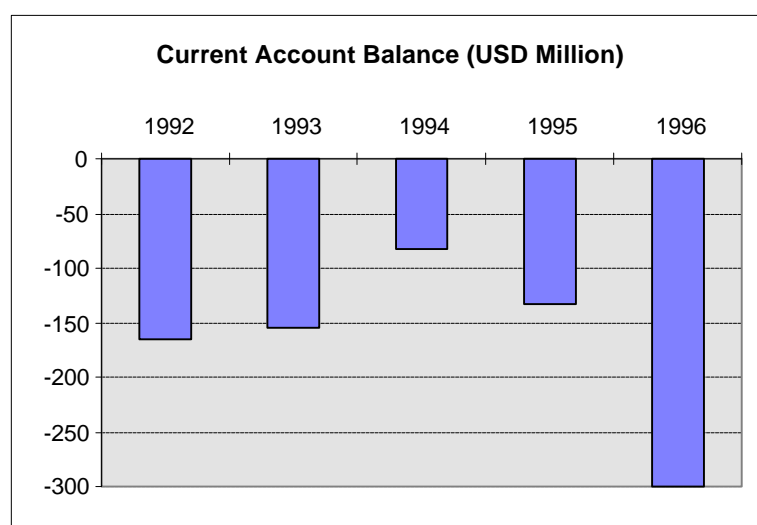
billion. More than 90 percent of this amount are securities issued by private companies; the rest are securities issued by State or banks. In table below the volume of trade at MSE is displayed. The average figure for transactions in 1997 is about \$1M, except for the peak in March, when one transaction amounted to almost \$3M, thus raising the total figure.



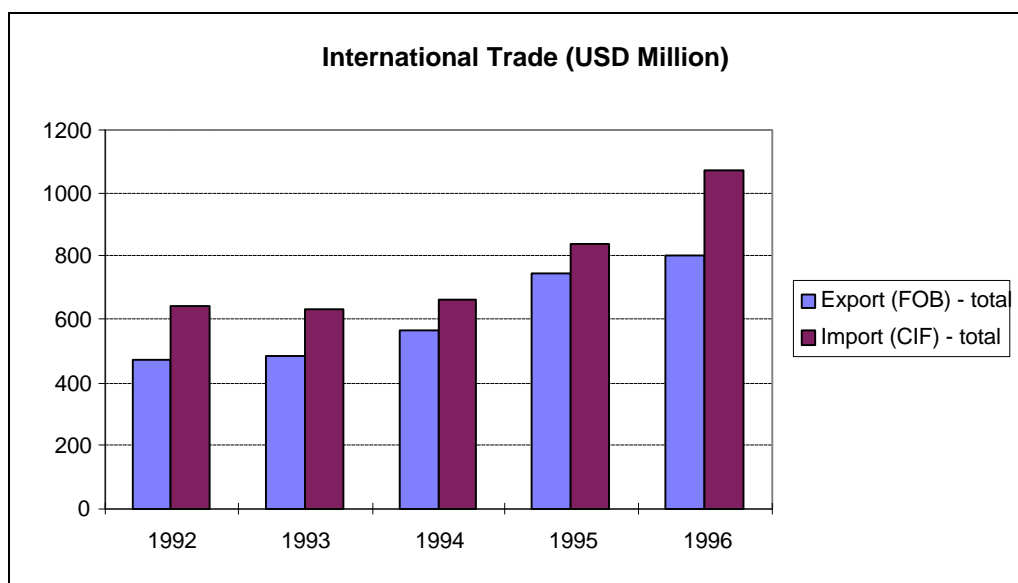
Balance of payments

Moldova is a highly open economy, with exports accounting for about 50 per cent of GDP. As an essentially an agrarian country, Moldova's exports are concentrated in agricultural commodities and processed food and beverages (wine, natural fruit juices, tinned fruits and vegetables, tobacco), while it depends on its neighbors – particularly Ukraine and Russia - for imports of energy, chemicals and many manufactured products. In the pre-reform era about 95 per cent of exports went to the various parts of the former USSR. Disruption of these economic links and recession in the FSU produced a fall in demand for Moldovan exports and in the share absorbed by the CIS countries which by 1996 represented only 68% of the total.

This situation, combined with rising import prices led to a balance of payment deficit of approximately 20% of GDP. In addition to the efforts already made to develop new markets in the EU and Central and Eastern European countries which absorbed 11 per cent of exports each, to stabilize the balance of trade will require economic diversification.

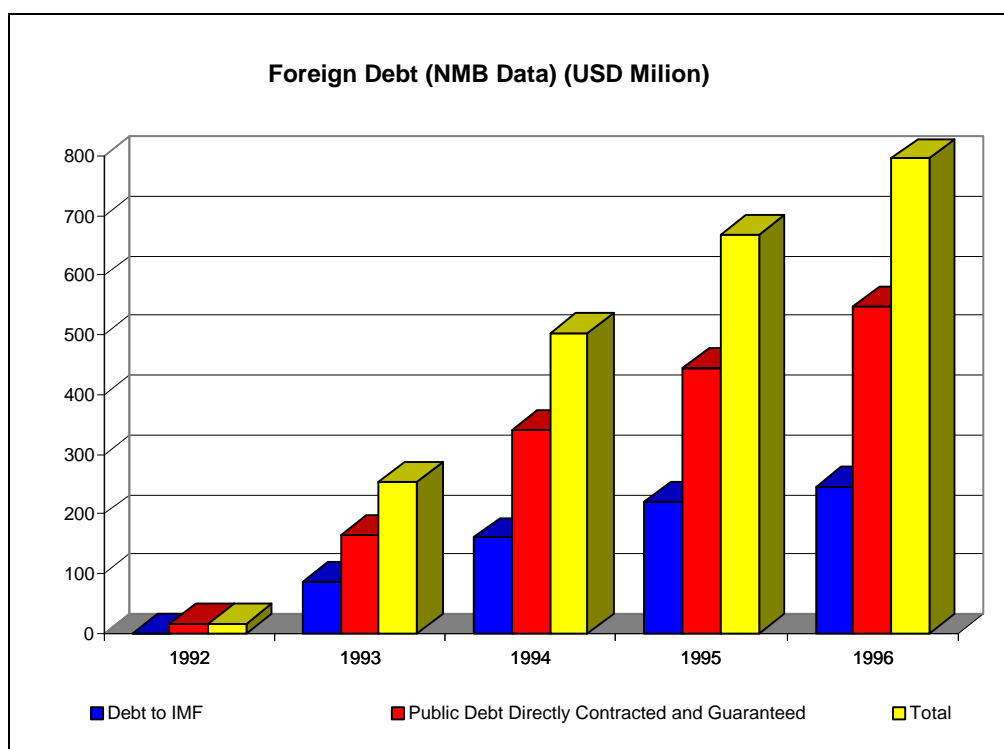


According to preliminary data in 1996 Moldova's trade deficit has grown to 254 million US dollars. Exports reached 801 million USD (which is an 8.5% increase over the previous year), while imports showed a spectacular 30.4 per cent increase to 1056 million USD.



External debt

One of the inherent risks of the transition process is accumulation of foreign debt. Although not excessive by international standards, the burden of foreign debt is growing rapidly. An important part of foreign debt is represented by credits from IMF and World Bank. This trend will continue in the near future.



4. Banking system

Background and legal framework

Moldova's commercial banking system evolved as part of the transition from an administrative and command system towards market economy. During this transition, public finances deteriorated and budget deficit increased, the trade deficit widened and a substantial amount of foreign debt was accumulated. There was a real danger of macroeconomic collapse accompanied by uncontrolled inflation, but due to the tight monetary policy performed by the National Bank of Moldova and supported by the IMF since the introduction of the national currency, Moldova managed to avoid such a crisis. This, along with other positive factors that will be discussed further, made it possible for the banking system to evolve rapidly.

In 1991 the Parliament of Moldova approved the laws "On the National (State) Bank of Moldova" and "On Banks and Banking Activity", which established the basis of the actual banking system of the country. In July 1995 Parliament adopted the new banking laws "On National Bank of Moldova" and "On Financial Institutions", elaborated by NBM in accordance with international standards, upon recommendation and with the assistance of the IMF Legal Department. These laws include new and modern elements directed towards strengthening the role of NBM in drawing up and implementing monetary and foreign exchange policy, and contain the legal basis for a healthy and reliable banking system.

As in most of Western countries, the banking system of Moldova operates on two levels:

- On the first level is the National Bank of Moldova (NBM), the central bank and the sole money issuing entity. NBM sets the monetary, credit and foreign exchange policy, and supervises the activity of commercial banks. The 1991 Law stipulated that NBM is subordinated only to Parliament, and is exercising its functions independently of the executive bodies. The new law "On National Bank of Moldova" approved in 1995 is a further move towards a more independent central bank. This fact has a crucial significance as it eliminates any temptation for the government to finance public expenditure in an inflationary way, thus destabilizing the economy;
- The second level currently comprises 23 commercial banks, which operate in servicing the credit and payments needs of households and commercial sector. The main function of commercial banks is financial intermediation. In formulating the normative environment for the commercial banking system particular importance is given to the minimization of risk and the increasing security and stability of the banking system. The measures adopted so far have played a decisive role in gaining the confidence of the population in banks, as the increase in private deposits in the past couple of years shows. This success also points to the potential for a wider role of banks as financial intermediaries.

Structure of the sector

Decentralization and demonopolization of the banking system are contributing towards the establishment of a market oriented sector, after decades of concentration of financial resources and credit in the hands of the state.

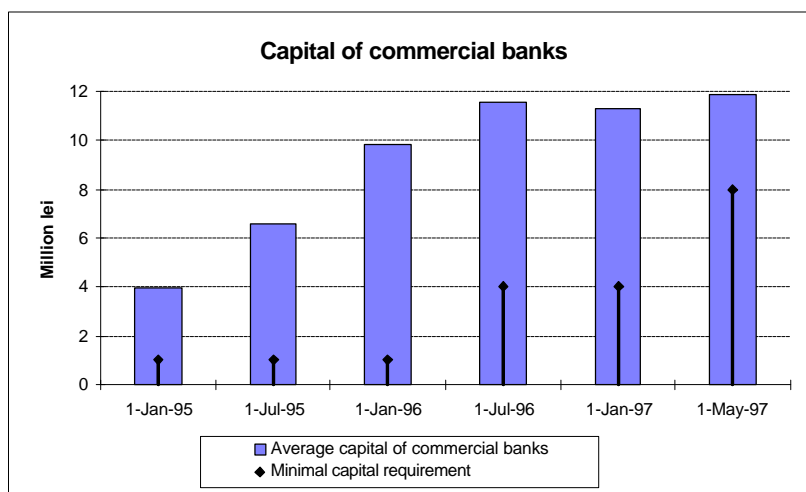
The number of commercial banks of Moldova has grown during 1991-1997, but in a relatively moderate way. At the end 1991 15 commercial banks were operating, and their number reached 22 by the end 1993. Since then this figure did not vary much. As at 1 June 1997 out of the

existing 23 commercial banks, 5 originated from the reorganization of the former state specialized banks, and 18 are new.

Starting 1 January 1997 NBM increased the minimal capital requirement to receive a type-A license, for newly created banks, from 4 to 8 million Moldovan lei (in 1995 it was 1 million lei). Existing banks must comply with the said requirement from 1 January 1998.

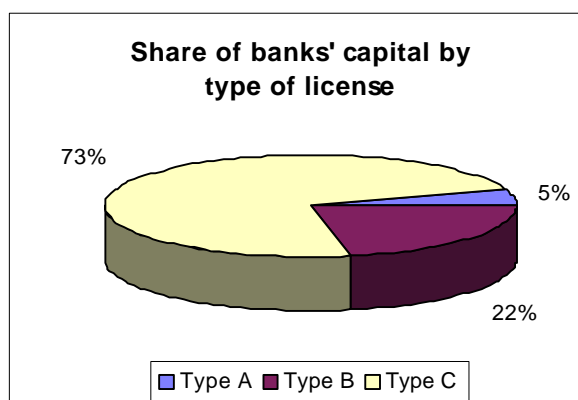
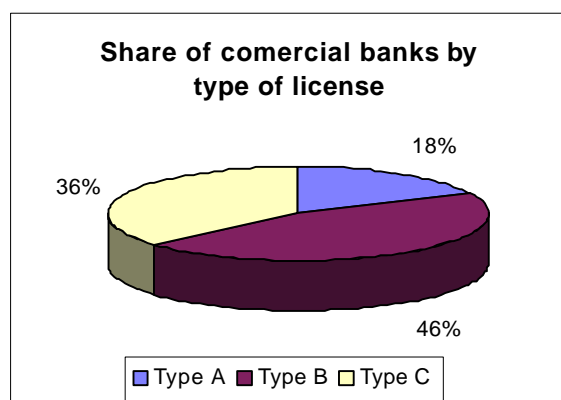
There are three basic types of licenses granted by the NBM to commercial banks, subject to different capital requirements and granting different operating possibilities.

According to the Law “On Financial Institutions”, in order to obtain a type-B license a bank needs to have a total regulatory capital equal to 2 minimal capital requirements, and for obtaining a type-C license capital has to equal 3 times the minimum capital requirements.



Currently:

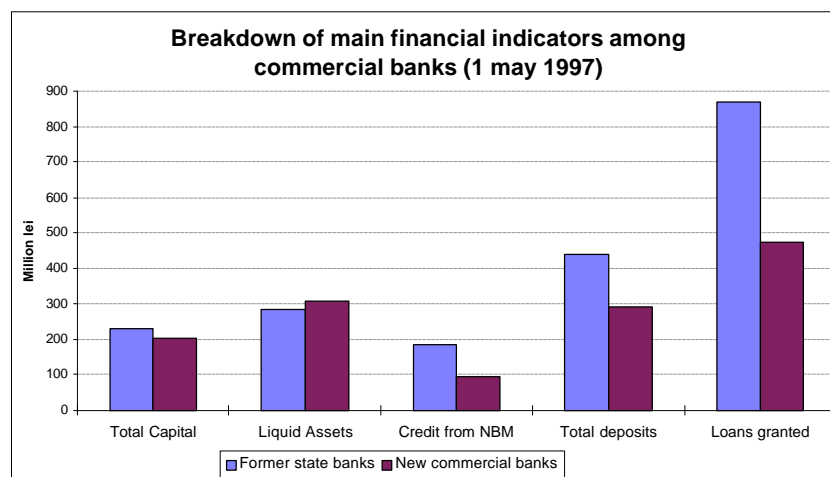
- 5 banks hold type A license, which allows them to perform basic banking operations, as well as cash foreign exchange transactions on the domestic market;
- 10 banks have type B license, which alongside the above mentioned operations enables them also to perform international banking operations;
- 8 banks have type C license and may perform all types of domestic and international banking operations, including dealing in foreign exchange and investment activities.



NOTE: data as of 1 May 1997

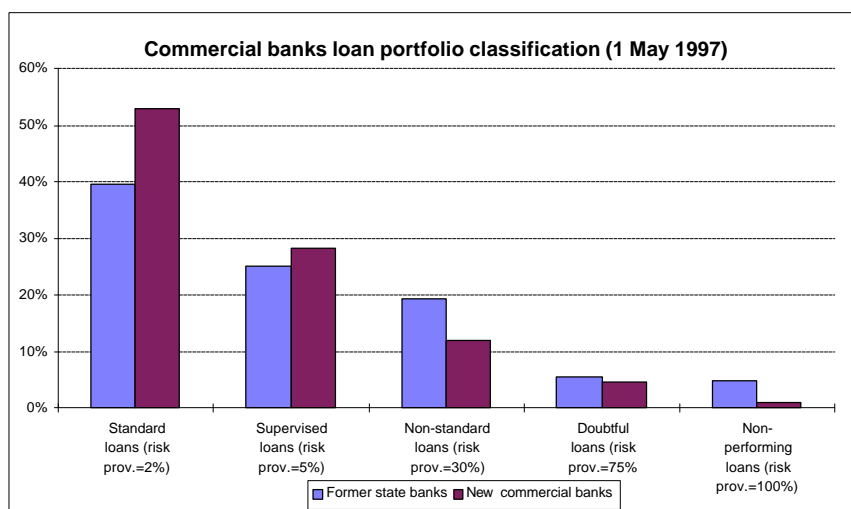
Operating performance

In the chart below appear the main financial indicators of commercial banks in Moldova:



It should be noted, that the capital of 5 former state specialized banks is 13% larger than the capital of other banks, liquid assets are 8% less, deposits are by 52% larger and the volume of loans received from NBM – bigger by 84% than the rest of the banking system. The amount of credit granted is almost twice the size.

On the one hand, these 5 big banks cover a very significant share of the market both in terms of deposits and loans. On the other, it should be emphasized that their financial position is worse than that of the new commercial banks as they carry forward an existing portfolio of bad loans to state enterprises and collective farms. As can be observed in the following chart the share of loans requiring large risk provisions is much greater in the former state banks. In fact, their size of non-performing loans is 5.5 times bigger than that of the other banks.

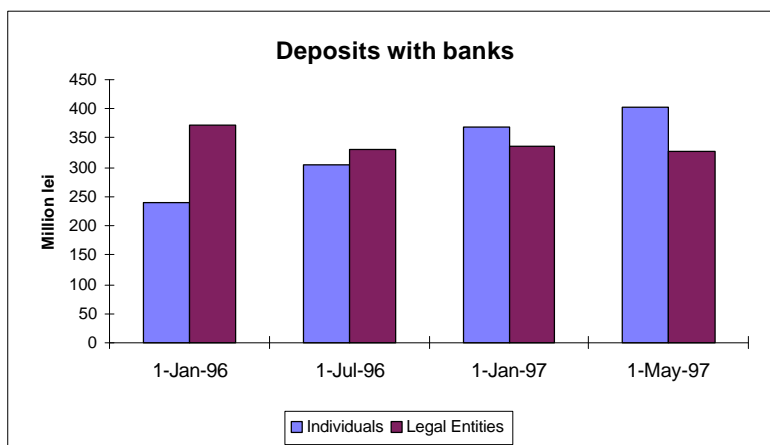


Overall, the composition of loan portfolios where good loans include standard and supervised loans, while bad ones include non-standard, doubtful and non-performing loans, indicates that the former state specialized banks have a share of bad loans (31%) almost 70 per cent bigger than other banks do (18%).

Total regulatory capital in the banking system was 434 million lei as of 1 May 1997, that is 1.7 times bigger than on 1 January 1996.

Total loans disbursed at 1 May 1997 was 1345 million lei and did not vary much from the figure of 1352.1 million lei as of 1 January 1997. Share of overdue debt was 10.7% and 8.4% respectively.

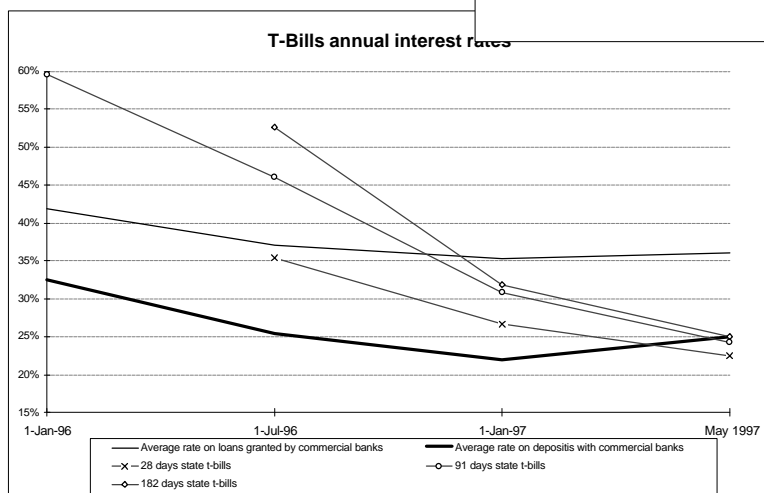
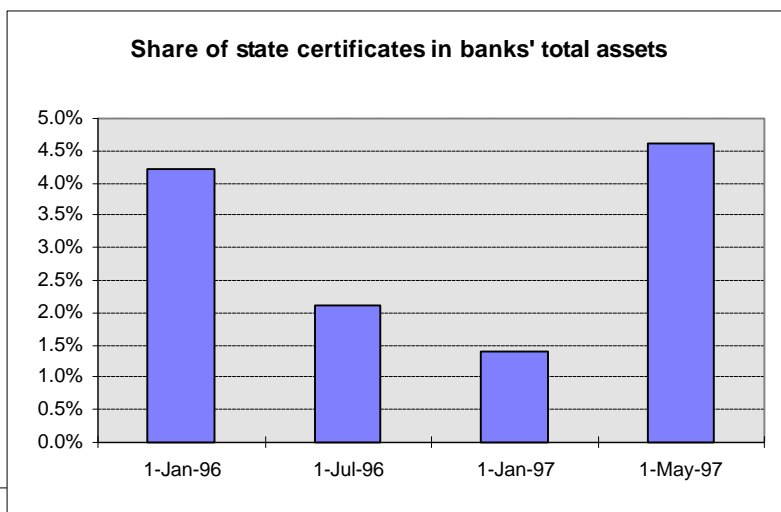
During 1996 and 1997 the confidence of the population in banking system has grown, and this is reflected by the continuous increase of households' deposits with commercial banks. As of 1 January 1997 the amount of funds deposited with the banks has increased by 56 per cent, compared with a year earlier, as of 1 May 1997 the deposits have grown a further 9%. The biggest deposits were made with the banks having a total regulatory capital above 12 million lei.



In 1997 commercial banks have been increasing their investment in government debt (T-bills, so called State Certificates) which reached a total amount of 150 million lei in May 1997 or 4.6% of the banks total assets.

This indicates that banks are today finding an easy option to generate what are essentially risk-free earnings by using households' deposits to fund the state rather than making appropriate risk evaluations, that is acting as bankers and lend to the productive sector. This is of particular concern as Moldovan enterprises, large and small, are suffering from a shortfall in financial resources critical for their development.

However, from the chart below it appears that banks' purchasing of state T-bills will certainly reduce in June, due to the continuous decrease in T-bills interest rates. In May 1997 they already reached the average deposit rate. Thus, banks will have to concentrate on other types of activities for instance more actively granting loans to economic entities.



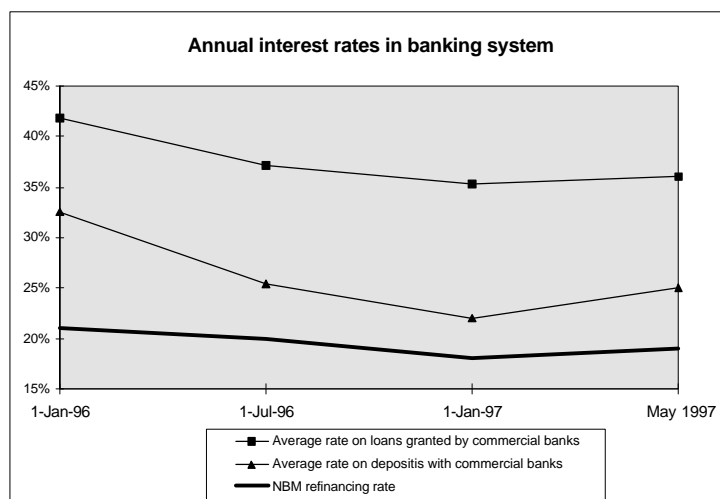
Costs of credit and credit rationing

Average interest rates in the banking system have declined continuously in 1996:

- for deposits – from 32.5% to 25 per cent p.a.;
- for loans granted – from 41.9% to 36 per cent p.a..

The National Bank's refinancing rate remained almost stable at 20%. In 1997 interest rates remained stable.

The movement in interest rates in 1996 shows that there has been some widening of spreads between deposits and loans. Average spreads appear to have increased from 9.4 per cent to 13.3 per cent from 1 January 1996 to 1 May 1997. This is not a very positive indication of competition between banks, nor is it a positive development for existing and potential borrowers, who already pay very high *real* rates of interest on loans received. However, during 1997 the margin has been reducing (at 1 May 1997 it was already 11%).



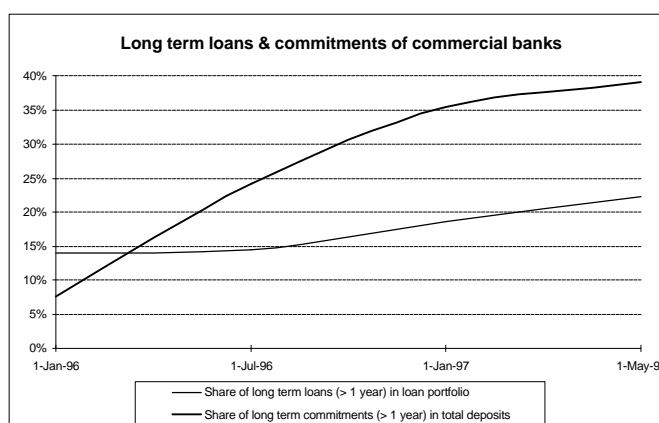
Some banks tried to increase their profits granting very risky loans, respectively widening the margin between deposit and lending rates. As a result, bad loans have limited crediting to new viable enterprises and this incorrect capital allocation has risen the cost of credits.

Another problem here is that the low share of banks' long-term credit investment portfolio. It is well known that one of the main functions of banks is efficient usage of credit resources. It should be stressed out here that of course the main goal of banks is maximization of profit, but the banks should be careful. Because of big risks (economic instability and imperfection of collateral mechanisms), commercial banks refuse to make long term investments in national economy (that in fact could ensure an economic growth).

On the other hand, not dissimilar to the case of most countries, household bank deposits are typically short term: in Moldova the proportion is roughly 60 per cent. Consequently, in view of the prudential requirement to

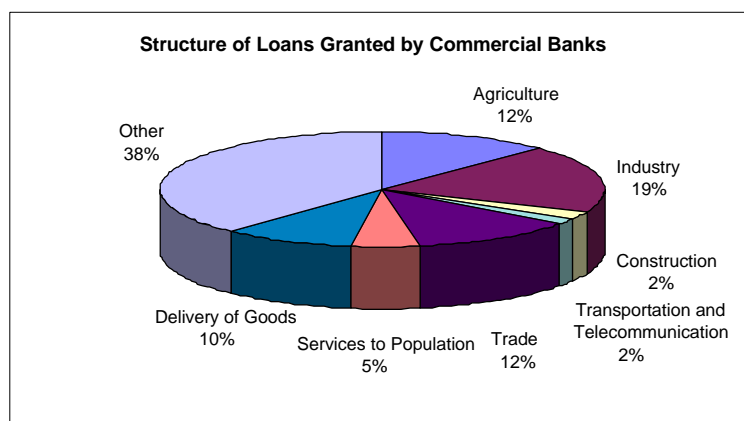
match maturities of assets and liabilities, Moldovan banks' loan portfolios is about 75 per cent short term. And we should not blame commercial banks here, because their reluctance to make long term commitments is also a response to the current economic recession in the country.

However, a positive tendency is that the share of long-term credits is growing continuously, reaching



at 1 May 1997 22 per cent.

In addition to the excessively high real cost of credit faced by all sectors of the economy in Moldova, agriculture also faces a severe problem of credit rationing. This is due partly to the shortcomings in agrarian reform, where the conditions of land-ownership have not been clearly stipulated. Consequently, as land cannot be used by farmers as loan collateral, their access to commercial credit is severely curtailed. Also, the legacy of the old system of collective farms has left many farmer's associations and cooperatives with very large accumulated debt and payment arrears which, again, constrain their possibilities to obtain new loans.



The World Bank and the European Bank for Reconstruction and Development are playing an important role in funding small business and agriculture through credit lines administered by Moldova's commercial banks. There is talk at the moment on whether specialized banking institutions such as investment banks and farmers' banks should be established to provide a more targeted financial support for those businesses that, for different reasons, find it difficult to gain access to the conventional banking system, or do not receive a service appropriate to their needs. This type of initiative could be pursued with the participation of multilateral financial international finance institutions (e.g. World Bank, EBRD) and private investment funds which could contribute a significant share of the initial capital of the new specialized credit and investment institutions.

Efficiency improvements and international presence

In May 1996 the banking system moved to an electronic settlement system which now covers the majority of current transactions. In addition to other significant operational advantages for the commercial banks and their customers, this system allows NBM to monitor more efficiently banks' liquidity. Eleven commercial banks became members and have been connected to the SWIFT system of international payments' transfer. Banks are diversifying their international activity and are setting up groups of dealers in foreign exchange on international markets. A very important role in this context has information base: eleven banks subscribed to REUTERS and one out of them was connected to REUTERS Dealing.

A number of banks are servicing travelers cheques, as well as plastic cards. Some banks have issued VISA cards. In May 1997 Victoriabank became member of VISA International, and through its processing center all VISA cards are now serviced here in Moldova.

Advances in the efficiency and reliability of commercial banking operations in Moldova is testified by an increasing confidence of foreign banks which have opened lines of credit in

foreign currency for the Moldovan banks. Moldovan commercial banks opened correspondent accounts with a number of well known international banks worldwide.

However, our banks are not considered yet by international experts to be strong and reliable. For instance, in the Top 100 Central Europeans banks published in April 1997 issue of the "The Banker" (printed by FT Magazines in London) there are 4 banks from Baltic States, 3 banks from Ukraine, 6 Romanian banks, 11 Slovenian banks, but no banks from Moldova.

No international banks have yet opened branches in the country which reflect a generalized lack of momentum in foreign investment in the national economy, despite macroeconomic stabilization, low inflation and a firm exchange rate. The small size of the country and its underdeveloped productive sector are, conceivably, the reasons discouraging investment decisions on the part of foreigners.

Main problems with the system

There are two sets of problems that affect finance and banking in Moldova. On the one hand there is a problem of availability and cost of credit, partly resulting from insufficient development and limited competition in the commercial banking sector, which continues to keep the real cost of credit at a very high level. There are also indications that credit is being rationed to some sectors of the economy, such as agriculture for instance, due to problems accumulated in the pre-reform era. Lastly, the quality of services offered by banks is mediocre by international standards and the range of financial products is limited.

Access to banking services is limited for the majority of the population also due to a very low density of bank branches in the country. As of 1 May 1997 the total number of branches was 153, the majority belonging to the former state specialized banks Moldova-Agroindbank, Banca de Economii and Banca Socială. This gives an average density of 1 branch per 28,000 inhabitants, against figures in Western Europe that typically are of one branch per 1,500-3,000 inhabitants.

Also, commercial banking system had to face, and still faces a number of problems, such as:

- insufficiency of qualified personnel with experience in modern banking operations, and capable of dealing with international counterparts;
- lack of experience of local bankers;
- weak technical and material base;
- bad communications.

Significant efforts are made by most banks to overcome these constraints. Despite investments for the acquisition of computers and modern banking equipment, as well as training programs for their staff both locally and abroad, it is clear that proper training of a sufficient number of staff is a long process. The areas that appear to suffer most from this shortage are those of credit allocation, loan supervision and legal settlement of problems related to debt reimbursement.

Training programs of banking staff should be encouraged and developed as it is quite clear there is considerable scope for expansion of employment of qualified personnel in this sector.

Regulatory advances

A positive factor which has to be noted here is that the quality of banking supervision, the independence of the central bank and the legal instrumentation in place have resulted in a substantially healthy and stable banking environment, avoiding serious crises in the system of the type seen in Romania, Russia, Latvia and other European countries in transition. Among other measures, since 1992 NBM put in place prudential regulations for all banks, subsequently revised in March 1995, which set standards for the Moldovan banking system compatible with Basle capital adequacy provisions. The most important norms are:

- minimum total regulatory capital/risk-weighted assets (capital adequacy): raised from 4% in 1996 to 6 per cent in 1997, and due to gradually reach a level of 12 per cent by year 2000;
- qualification of commercial banks' loan portfolio and compulsory risk provisions;
- monitoring "big" loans, i.e. loans bigger than 10% of total capital;
- daily monitoring of liquidity in the banking system, ultimately relying upon NBM as lender of last resort;
- limitation of loans to affiliated persons, as well as loans granted to one single client.

From 1 January 1997 banks are obliged to set up 100% of calculated risk provisions (the previous condition was 75%).

In addition to this, from 1 April 1997 NBM has introduced stricter criteria for calculating risk provisions (see table), which corresponds to the international accounting standards. Commercial banks will gradually have to set up fully adjusted risk provisions before 1 January 1998.

On the basis of the above norms a rating system for banks, CAMEL, was introduced and is utilized for evaluation of the financial standing of each bank after on-site inspections carried out by NBM. A number of banks have been the subject of external auditing, conducted by international chartered accountants. In 1995 NBM implemented the new accounting system, based on international standards, which will be generalized with the adoption of the new model chart of accounts by all commercial banks before the end of September 1997.

It has also to be added that commercial banks do not engage in consumer credit. A special item for this will be included in the new chart of accounts to be introduced till autumn 1997.

Finally, it should be stressed out, that adequate accounting and auditing represent the informational infrastructure necessary for a good functioning of financial markets, if real assets can be evaluated correctly. Problem, however, is that in most countries with economy in transition this infrastructure is unfortunately underdeveloped.

Banks' risk provisions in percentage of granted		
<i>Loan portfolio</i>	<i>Previously</i>	<i>Actual</i>
Standard loans	0	2%
Supervised loans	2%	5%
Non-standard loans	5%	30%
Doubtful loans	30%	75%
Non-performing loans	100%	100%

5. Sectoral Development

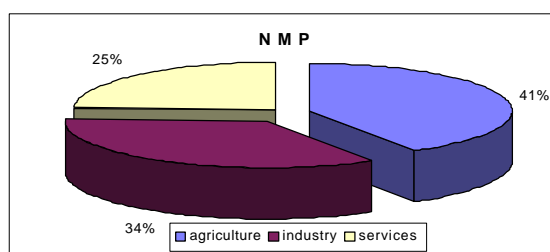
General situation

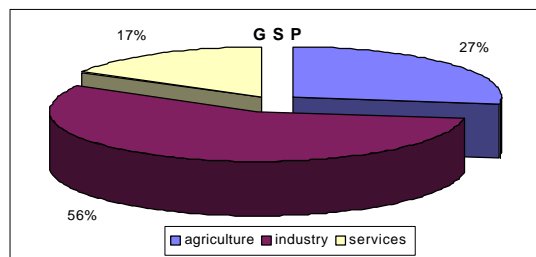
After 1990 the economy of Moldova, as well as of other republics from the former USSR, was struck by a crisis connected to the collapse of the country and transition from the administrative-planned system to the market one. From the old economic system the republic has inherited a number of lacks:

- disproportion in placement of productive forces on territory of republic, presence of problematic regions (in social-economic respect);
- imperfection of the branch structure of economy – totally misdirected development of the agrarian-industrial complex focused mainly on Eastern market, high share of industrial enterprises working, basically, on the military-industrial complex, backwardness of sphere of services;
- the enterprises are equipped with worn out and morally out-of-date engineering and technologies;
- high material and power consumption of production;
- not optimal, from the point of view of market economy, size of the enterprises focused on mass issue of homogeneous production;
- low competitiveness of production, made in the republic, regarding the quality and price;
- increased technological pressure on the environment.

The structure of Moldova's economy in the pre-reform period was determined by its participation in the all-union division of labor. Presence of unique natural-climatic conditions, of fertile soils and settled traditions have designated specialization of the republic on manufacturing agrarian-industrial production. In creation of net material product (NMP) the agrarian-industrial complex held more than 60%, and in volume of global social product (GSP) – 50-55%.

The structure of GSP and NMP by branches of economy in 1990 is submitted in charts below:





Since 1990, during crisis, the economic potential of Moldova has considerably decreased, in industry – by 60%, in agriculture – by 43%. Along with this, together with institutional transformations and changes in structure of property of the enterprises, occurs their adaptation to market system, the competitiveness of production is raising on the basis of introduction of new technologies.

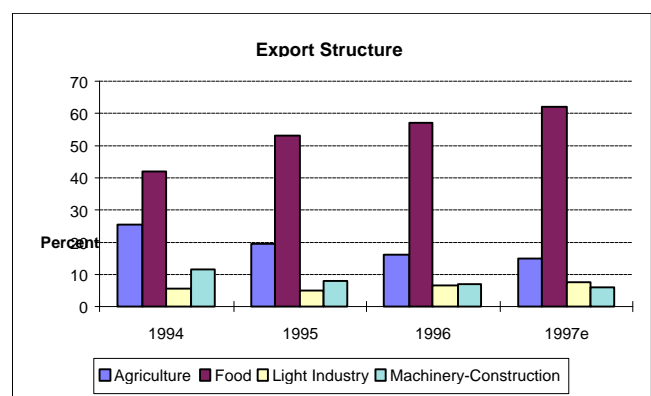
The share of agriculture in GDP structure is insignificantly reducing, basically due to the increase of the share of services and to certain stabilization of the share of industry. The maintained high share of agriculture reduces stability of the economic development of the republic. For increasing stability, the perspective development will be determined by further expansion of sphere of services and, along with concentration of the capital, by amplification of industrial sector.

The high degree of openness of economy (export makes about 50% from the GDP amount) determines Moldova's place in the international division of labor. Being a component of the USSR, 95% of exported production Moldova shipped to other republics of the Union. Owing to liberalization of foreign trade in these regions the Moldovan manufacturers have confronted with a rigid competition in the traditional markets, their goods started to advance to the new Western markets. So, in 1996 the export to CIS countries has decreased up to 68%. For the I quarter of 1997 the total volume of export to the countries of European Union has reached 11.2% and to the countries of Central and Eastern Europe – 11.1%. Foreign exchange economic operations are established with more than 90 countries.

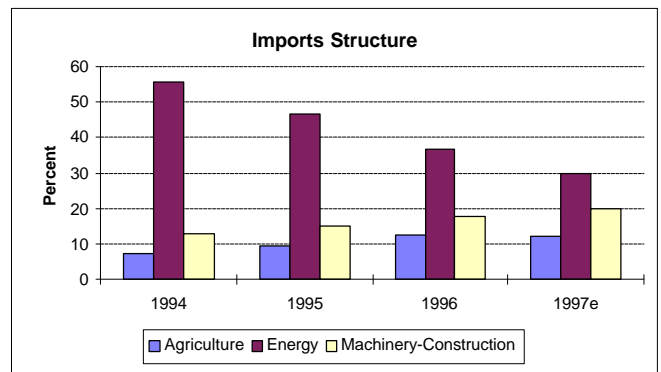
For the period of 1994-1996 (from the first year of circulation of the national currency – leu) the volume of foreign trade turnover of Moldova has increased from 1225 million USD to 1880 million USD, i.e. by 53%. At the same time the deficit of trade balance has increased 2.5 times in 1996 with reference to the last year and compounds 35% of export volume. This had an unfavorable impact on balance of payments of the republic.

Regarding structural changes in exports for the last three years, it is necessary to mention, that there was a positive improvement in this period, but still insufficient for the effective development of economy.

The share of agriculture production in the total volume of export has decreased from 25.4% to 16%, while the share of food production has increased from 42% to 57.2%. Enterprises of light industry managed to increase the share of production only in 1996, which reached 6.7%. As it was expected, machinery-construction enterprises were losing their position on external markets, their share has decreased from 11.5% to 7.0%.



Import structural changes for the last 3 years reflected a positive tendency. It is necessary to mention the increase of the share of machinery-construction production (capital ratio) in total volume of imports – from 12.8% to 17.8%. Also, it should be stressed upon a decrease of the share of the energy products from 55.6% to 36.8%. From our point of view, with the purpose of real improvement of economy, the share of machinery-construction should rise to 30-35% and the share of the energy products has to be reduced to 20-25%.



The share of agriculture and food production in the total volume of imports has increased from 7.5% to 12.4%. However, some imported items as alcohol, dairy products, as milk and meat, of unacceptably low quality, are not always first need products from the social perspective.

The tendency of Moldova's integration in the International Community was outlined extremely clearly.

On export operations for the manufacturers of the republic all restrictions (including existing until recently licensing, imposed quotas and indicative prices) have been practically removed. According to the Law On Budget for 1997 the payments for importation of some kinds of production considered as the sum of the import customs duties and excises on imported production, have appeared unwarrantably high from the point of view of the requirements of World Trade Organization (WTO).

Moldova undertakes efforts for expanding the geography of external relations and cooperation with various trade organizations and unions. Foreign trade activity of the republic with the countries of CIS and Romania is regulated by free trade regime. With the purpose of further expansion of trade connections with the European countries Moldova prepares to enter in WTO.

Agriculture and Food-processing Industry

Moldova is a country with a high share of village population (more than 50%), which because of backwardness of industrial production is compelled to work in the agricultural sector of economy, where 46.1% of the engaged population of the republic works. The solving of problems of effective functioning of agrarian sector, which should take place as a result of agrarian reform, will allow to achieve consolidation of the society and to reduce considerably the probability of social shocks.

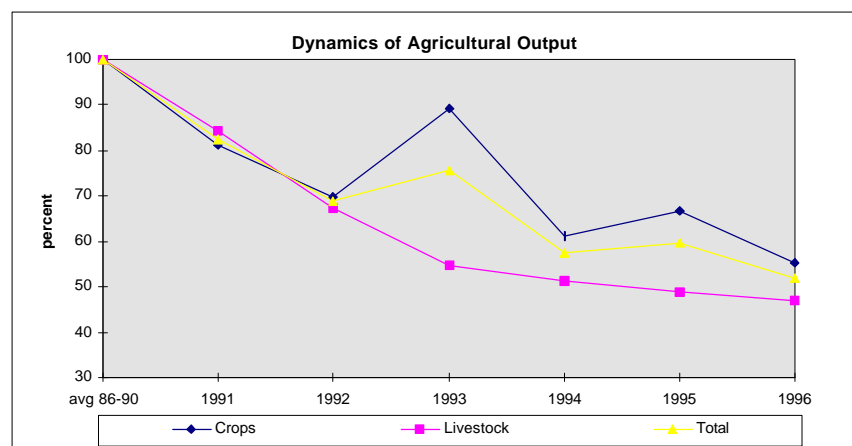
Nowadays the agrarian sector collides with the following problems:

- a large part of agricultural engineering is morally and physically obsolete, for the last 5 years the machinery park practically was not updated;

- the cost of credit resources is high(credit rate of Moldovan banks equals to about 35%), that in conditions of low speed of return on capital in agrarian sector makes these resources practically inaccessible for agricultural enterprises;
- the centralized system of deliveries of mineral fertilizers, chemical means of protection of plants, spare parts for engineering, seeds and fuel-lubricant materials is destroyed, and a new, one based on market and competition, is not created yet;
- the infrastructure of realization of ready production is poorly advanced;
- practically there is no system of insurance of agricultural production.

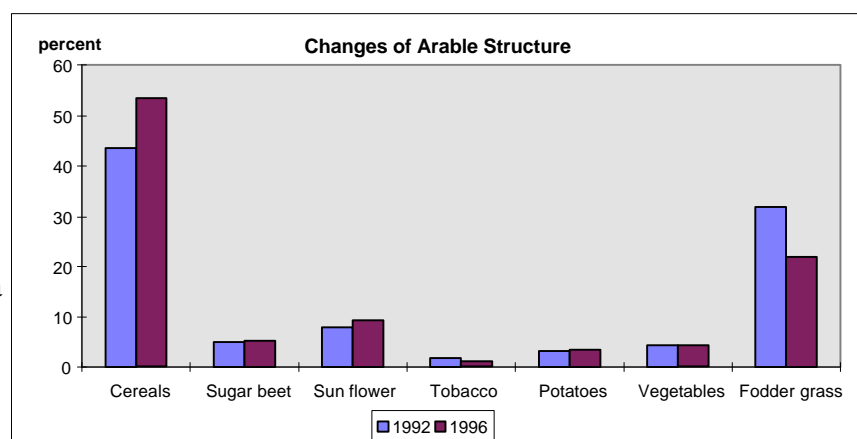
In order to solve these problems the agrarian reform is implemented, which transforms the relations of property in agricultural sector, creates new organizational forms of managing. So, if in 1990 in household plots and peasant farms 18% of agricultural production was made, in 1996 – 48%, including crops, accordingly 13% and 39% and livestock, accordingly 25% and 59% .

The sluggishness in realization of reform negatively affects the agrarian sector. Comparing to 1986-1990 average data the agriculture output constituted 52%, including crops – 55.3% and livestock – 46.8%. A number of factors have conditioned this. On the one hand, unfavorable weather and climate conditions of the last years, on the other hand – lack of intensive land reforms, errors in land and property privatization, loss of traditional external sales markets in the East, insufficient competitiveness of agricultural products of Moldova on Western markets, lowering of demand for agricultural products in the local market.



In the structure of agricultural production (in current prices) about 2/3 belong to crops and about 1/3 – to livestock.

The weather and climate conditions in Moldova are favorable for development of plants growing. The country benefits from exceptionally fertile soils and a moderate climate with a long warm summer period and a short cold winter. Nevertheless, it has a relatively low rainfall. Average of annual precipitation varies from 380 mm in the south to 560 mm in center and north of the country. There are also significant annual variations with three out of ten officially classified as drought years. In addition, the intensive cultivation of land during many years together with the wide use of chemicals has contributed to a substantial fall in fertility. The soil fertility over the last 20 years has

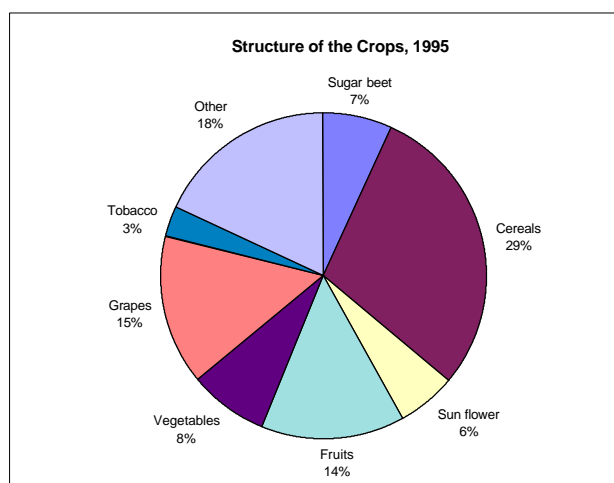


dropped by about 25%. Especially affected have been the areas characterized by high soil erosion. It is the surface area of erosion- affected land at over 650 Th. Ha. Here the drop in soil fertility varies between 40% to 60%.

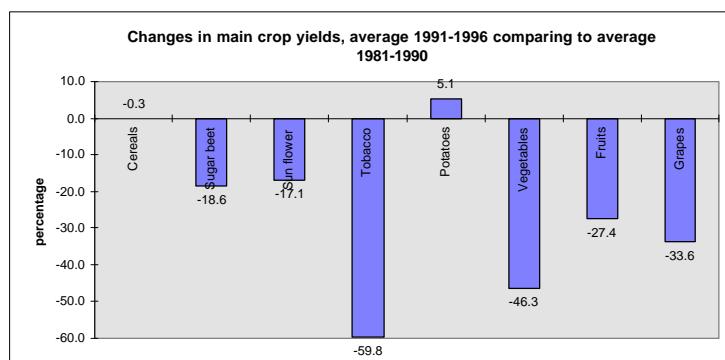
For the last years according to the change of structure of demand, the structure of the sowing areas changes, too. As it is visible on the chart, in comparison with 1992 there has been a sharp increase of the sowing areas of grain cultures and an insignificant increase – of sugar beet, sunflower, potatoes. The areas of gardens and vineyards practically have not changed, though the area of the bookmark of long-term plantings has decreased considerably.

Agricultural enterprises prefer to cultivate grain cultures due to the relative simplicity of processing and realization of ready production both in the local market, and for export. The decrease of the areas of fodder cultures is caused by significant reduction of production of cattle-breeding production. The cultivation of sugar beet, vegetables and sunflower in a greater degree is linked with the demand for this production of the processing enterprises, and tobacco – with the demand on the external market (the need of Moldovan tobacco factory is only 8-10 thousand tons of tobacco annually). Owing to a reduction of volumes of tobacco manufacturing, its export was reduced from 90 thousand tons in 1981-1990 up to 17,8 thousand tons in 1996.

Nowadays in the structure of crops of Moldova – the grain cultures, fruits and grapes (about 60% of plants production) prevail. The expansion of grain cultures production is not represented as rational for Moldova in spite of the fact, that it conducts to expansion of export. To concentrate attention on manufacture of fruits, vegetables and grapes with the subsequent industrial processing and export of final production is much more effective. For this purpose it is necessary to improve essentially the technology and marketing of the processing enterprises.

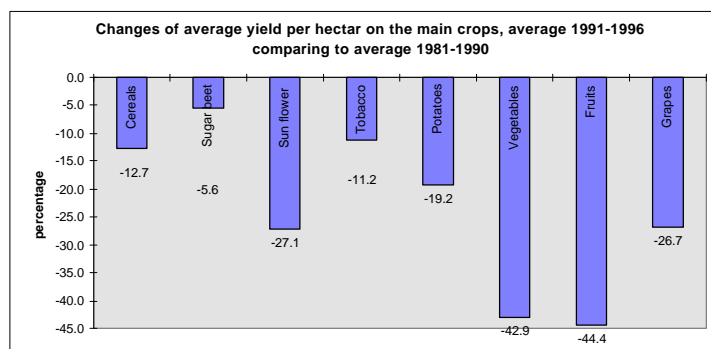


Till 1990 tobacco production of Moldova accounted for 30% of the total production of tobacco in USSR, grapes – 20%, fruits – 13%, vegetables – 10%. During the years of transition period the fall of agricultural production has taken place basically at the expense of decrease of



productivity. Dynamics of these processes is reflected in the charts:

The cattle-breeding production of the Moldovan enterprises was largely intended for home market. The reduction of its manufacturing is caused, on the one hand, by the sharp fall of the standard of living of the population and, on the other hand, by the inefficient for the Moldovan market organizational structures in meat and milk production. In comparison with 1990 production of meat was reduced from 366 thousand tons up to 131 thousand tons (by 64%), milk – from 1511 thousand tons up to 744 thousand tons (by 51%) and eggs – from 1129 million pieces up to 610 million pieces (by 46%). The prospect of development of animal industries is seen in introduction of new technologies for processing meat and milk, and expansion of system of marketing.



The development of the agrarian sector of Moldova is directly connected to the processing industry. The agrarian and industrial complex of the republic is traditionally subdivided in 8 basic subcomplexes: grain-grocery, cattle-breeding, sugar beet, oils, canning, grapes and wines, tobacco and ethereal products. The successful work of the food enterprises in the external market dictates directions of expansion of agrarian sector, as the home market because of its narrowness cannot be determining in this process (from all the subcomplexes only grain-grocery basically works for home market).

A great importance for the republic has export of production of agro-industrial complex. Dynamics of export of various kinds of agricultural and industrial production is submitted in the table:

	1994	1995	1996	1995/1994 percent	1996/1995 percent
Live animals	2.9	33.0	10.7	1137.9	32.4
Meat and edible meat by-products	133.2	201.2	204.2	151.1	101.5
Dairy products	49.0	69.7	50.6	142.2	72.6
Vegetables	27.9	27.0	17.3	96.8	64.1
Fruits and nuts	231.9	144.1	132.0	62.1	91.6
Grains	124.9	113.9	87.7	91.2	77.0
Oilseeds	17.2	29.3	43.3	170.3	147.8
Animal and vegetable fats and oils	45.5	49.5	14.6	108.8	29.5
Sausages and canned meat	7.9	19.2	20.6	243.0	107.3
Sugar	127.8	263.9	236.1	206.5	89.5
Processed vegetables and fruits	201.1	382.7	387.6	190.3	101.3
- including juice	87.2	217.1	198.2	249.0	91.3
Spirits, soft drinks and vinegar	406.2	783.3	1034.6	192.8	132.1
Tobacco and products	144.8	210.0	353.5	145.0	168.3
TOTAL	1520.3	2326.8	2592.8	153.0	111.4

Growth of export of agro-industrial production by 53% in 1995 is considerably due to the transition of local producers towards world prices, however data for 1996 more objectively determine export development tendencies.

In 1995 owing to the insufficient overall performance of Moldovan meat processing and packing factories from the republic, alive animals and stewed meat for the sum of 234 million lei were exported, and in 1996 – the amount is a bit smaller – 215 million lei. However, the given direction of export is harmful for the republic, it is necessary to develop the processing and to export the final production. Export of processed meat products (sausages, meat preserves etc.) in 1996 accounted for only 20.6 million lei, however there is a positive tendency of its growth.

To competitive products of the agrarian and industrial complex, which will determine in the near future Moldova's shape on the external market can be related: wine & cognacs production, natural fruit juices, tinned fruits and vegetables, tobacco and tobacco products. In 1996 in comparison with 1995 the export of grape wines has increased by 35%, champagne – by 83%, cigarettes – 2 times, export of natural juices has decreased a little bit, but still accounts for a considerable amount of 54 thousand tons. The large volume of export of wine stuff (12.7M deciliters) is certainly a negative aspect of export, the work of wine-making enterprises should be in long term directed to the increase of volumes of wine stuff processing within the republic and, hence, on expansion of export of ready production.

After 1995 ten wine-making enterprises were re-equipped with modern equipment (EBRD loan), the construction of a factory for manufacturing glass containers according to the international standards comes to an end, seven canning factories are equipped with modern lines of production and packing of natural juices and canning production.

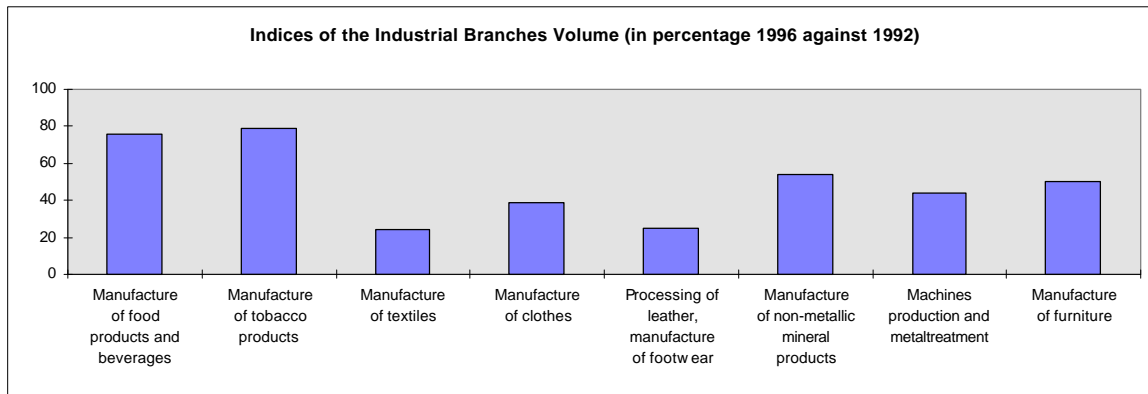
One of prospective directions is export of sunflower' seed, which is constantly growing and in 1996 totaled 43M lei.

The export of sugar, dairy products and vegetative oil will be present in the future, but it will not receive a further essential development. For maintenance of competitiveness of this production, sugar and oils factories are subject to re-equipment. The export of vegetables and fruits will certainly take place in future, too, but it will not play a significant role.

The enterprises of the agricultural and industrial complex will receive an accelerated development only with speeding up of agrarian reform, on the basis of restructuring of economy and creation of effective market structures in agriculture.

Industry

Transition to market economy in the first half of 90's, collapse of economic links, the loss of external markets of production sales, crisis of the country's domestic market, redistribution of property have caused destabilization of economy as a whole and of industrial enterprises activity in particular. There has been a sharp decrease of volumes of industrial production, that is visible in the chart:

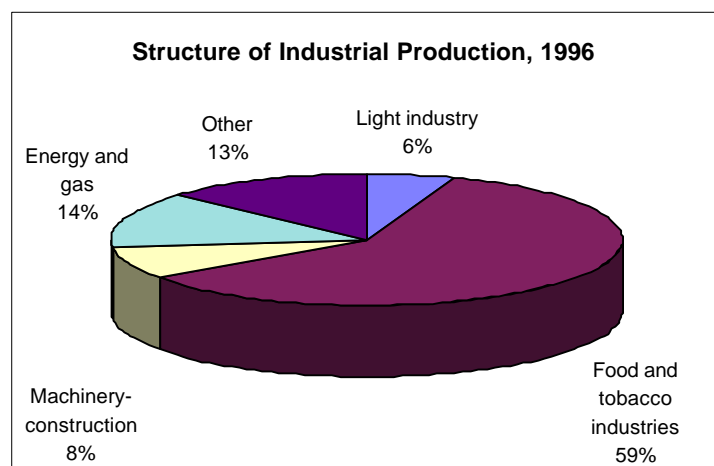


The least decrease of production has been ascertained at enterprises, working on local raw material (food and construction materials industry), and the greatest in light industry and mechanical engineering. The main internal reasons of production fall are application of old technologies, poor quality of production and absence of experience in marketing activity.

The decrease of industrial production has not been overcome because of delaying the process of economy reforming. At the beginning of 1997 (6 years after adoption of Law On Privatization) only the first stage of privatization – voucher privatization – has been carried out in our republic. But it is also known that besides the certain merits of this method, as fast realization and social fairness, there are also a number of lacks: non-determination in property rights, low level of corporate management, do not open access to capital and to qualified working power. The overcoming of these lacks and renewal of industrial manufacturing will be carried out by realization of money privatization.

In order to increase the production efficiency, the change of branch structure of economy of the majority of countries is carried out in the direction of reduction of the agriculture's share and increase of share of industry and sphere of services. Experience shows, that productivity of labor, as one of the main sources of growth of production and increase of its efficiency, is 2 - 3 times lower in agriculture than in industry and 1.5 - 2 times lower than in branches of sphere of services.

Industry is the main sector of economy, which provides stability of the country's development. In structure of Moldova's industry prevails the food industry, however it cannot become the stabilizer of economy, as it directly depends on fluctuations of production in agricultural sector. The majority of the machine-building enterprises worked before on the military - industrial complex of USSR. After its disintegration they lost the markets of production sales and now their large sizes and high level of costs do not practically offer them chances to survive. The share of mechanical engineering in total volume of industry production has decreased from 14.8% in 1992 to 8% in 1995, and there remained just manufacture of relatively simple production.



Within the framework of privatization program for 1997-1998 the control packages of shares of large machine-building enterprises should be sold to the strategic investors according to individual projects. One of the possible variants is restructuring of these enterprises with division into a number of small producing units, i.e. they should not be privatized as a whole.

The first experience is transformation of "Mashfrigcomplect" (manufacturer of industrial refrigerators), where the output has fallen up to 4% from the level of 1989 at number of the workers of 1100 persons. After realization of restructuring on the territory of the enterprise worked 25 private enterprises with an aggregate number of 213 workers.

Moldova's enterprises of light industry are equipped with average level engineering, but in the last years they have lost the markets of production sales, and insufficiency of working capital makes them dependent on suppliers of raw material (light industry basically works on imported raw material and materials). Their production is non-competitive in price, and in quality. The share of light industry production in total volume of industrial production has decreased from 10.6% in 1992 to 6% in 1996.

There are certain laws in dynamics of structural changes of industrial production, confirmed by the world practice. In countries with developed industry the branch structures are characterized by high specific weight of mechanical engineering branches (in 1990 41.2%) and low share of food and light industry (18.7%), for developing countries these parameters make accordingly 21.1% and 35.7%. In developing countries the main reason of impossibility of accelerated development of high technological branches is lack of financial assets, as these branches have high capital intensity. Therefore the originally accumulated limited financial resources are directed to less capital-intensive branches (food and light ones).

Moldova is not an exception and, therefore, on the primary stage of reorganization and revival of industry the main part of national financial resources will be directed to food and then to light branches. Only after sufficient concentration of capital in these branches its overflow into a more capital-intensive branch – mechanical engineering – can begin. For an effective concentration of the capital and its unobstructed overflow between branches it is extremely important to have a developed market of capital in the republic. One of the examples of branch concentration of capital is creation of financial and industrial group in furniture industry (14 furniture enterprises, commercial bank "Mobiasbanca", insurance company, transport company, construction and other companies).

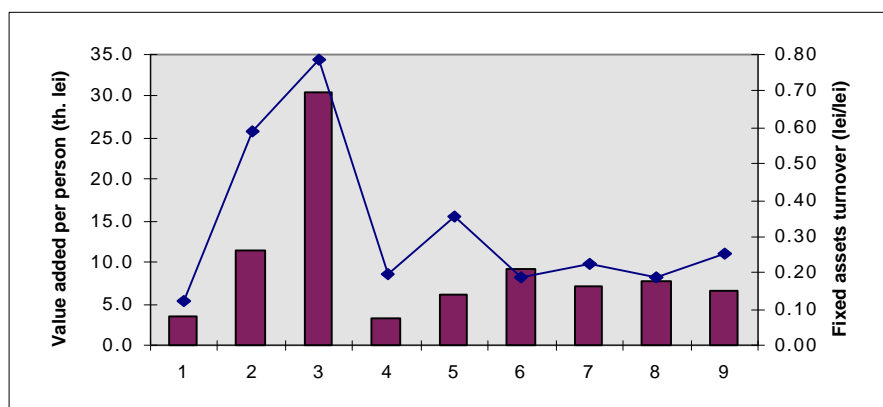
As the recession of production and structural changes in Moldova's industry had been the elemental form of "negative adaptation" to the economy realities, in the second half of 90s it was important to implement a targeted state policy for the restructuring of industry. "The Conception of the Industrial Policy of the Republic of Moldova for 1996-2000" was approved by Government in October 1996. In this document priorities and directions of development of various industries, but also necessary actions of government on realization of industrial policy are described.

The financial and economic situation of industry enterprises continues to remain a difficult one. The stock of finished products still very high. At the same time a number of enterprises, which became adapted to market and work profitably, and others, which lost the achieved positions, have come to light. In manufacturing industry 36,1% of the enterprises have finished 1996 with losses.

Due to technical help of UNIDO the project on introduction of the system of national accounts (SNA) is carried out, its primary stage is improvement of industrial statistics in the country. The work efficiency of the enterprises of industrial sector is determined by various factors and varies between branches. Some parameters of development of enterprises in 1996 – i) creation of value added (VA) per person and ii) production manufacturing in relation to cost of fixed capital assets – with various branches are submitted in the chart:

Chart legend: 1 – Machinery-construction, medical and metal products (average number of workers at

one enterprise -494 persons), 2 – manufacture of food products and beverages (344 persons), 3 – manufacture of tobacco products (373 persons), 4 – textiles and apparel (605 persons), 5-tanning and dressing of leather (904 persons), 6 – publishing, printing and paper products (104 persons), 7 – chemicals and chemical products (222 persons), 8 – other non-metallic mineral products (267 persons), 9– manufacture of furniture (424 persons).



The tobacco branch is the most effective among other industries, in 1996 on one worker it was necessary more than 30 thousand lei VA. To the following group of branches, according to parameter of efficiency, refer manufacture of food products and beverages, publishing, printing and paper products, chemicals and chemical products, other non-metallic mineral products, manufacture of furniture (from 6.6 up to 11.5 thousand lei VA on one worker). The average number of workers at the enterprises of these branches is 100-400 persons, the small and average size of these enterprises promotes increase of their mobility's level, operative reorientation on changing needs of market.

The enterprises of machinery-construction, medical and metal products, textiles and apparel create on the average VA on the level of 3.3-3.5 thousand lei, that practically means their degradation and bankruptcy in prospect. The high level of number of workers at the enterprises of these branches (on the average - 500-600 persons, and at some enterprises the number reaches 2-3 thousand persons) makes them inert, that means vulnerable in conditions of market economy. In this sphere of industry the enterprises require immediate restructuring, and assistance in their adaptation to requests of the market.

The TACIS specialists and Moldovan government have elaborated a program for 6 biggest former military enterprises (Semnal, Sigma, Topaz, Mezon, Micron, Raut). The program provides that these enterprises will start producing such products as TV sets, telephones, medical and navigation equipment, electrical meters etc. The first steps within the program were done by Mezon plant in cooperation with western companies Schlumberger, Fresenius and Motorola.

In order to render assistance to the economic agents for overcoming the crisis situation, the Parliament has adopted in 1996 the law "On Enterprises Restructuring", the realization of which is provided by the enterprises themselves, and agency ARIA. In a number of enterprises encouraging results have already been received. In 1996 in comparison with the previous year the enterprises "Farmaco" and "Tricon" have increased by 2 times volume of production. "Elcas", "Dana", "Ionel", "Floare-Carpet", "Piele" - by 1.5 times. On the majority of restructured

enterprises gaining profit at the expense of reduction of fix costs and sale of unused assets is marked, the quality of produced production has improved and listed products as a result of perfection of technology and input of the new equipment, are updated. At the same time in a number of enterprises the current payments are effected not in complete volume, the enterprises are still far from paying off the overdue debts, the credit indebtedness is growing.

A significant help in stabilization of Moldovan industry can render the foreign investments. For various reasons, more often of political character, Moldova has not yet become a country with a favorable climate for investments. The cancellation of results of the tender in tobacco branch (the tender's winner was announced "Reemstma") has not improved the investment image of Moldova.

Foreign investments are still limited mainly by food-processing industry. At the beginning of 1996 International Finance Corporation has introduced \$2M direct investments in the "Incon" company and, besides, has granted to the company \$8M of credit on favourable terms. These investments will be directed to canning industry (Ungheni, Floresti and Kupchiny factories), and also to increasing of level of vegetables and fruits production, in making new gardens, purchasing of means of chemical protection of plants.

Attraction of foreign investments is in perspective by means of sale of enterprises' shares to the strategic investor. At the beginning of 1996 Ministry of Privatization has offered to sale 60% of the shares of the following state owned enterprises: "Ciment", "Moldcarton", "Tipar-Color", "Floare-Carpet" and a factory of refrigerators. By results of the tender the search of strategic investors and an adviser has been chosen a consortium "Creditanstalt Investment Bank". In portfolio of the consortium there are already a number of offers from foreign investors.

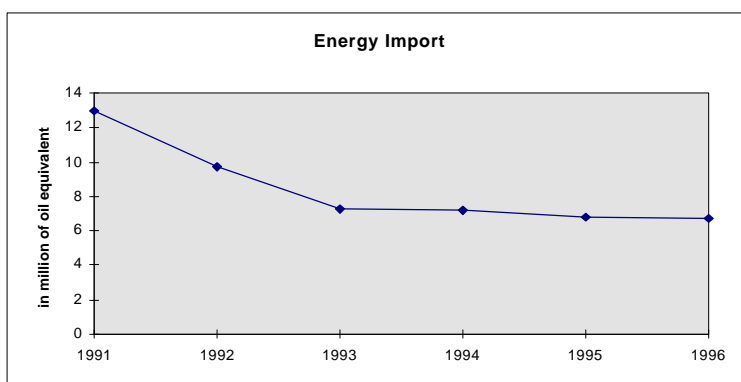
In near future the foreign investments in creation of means of telecommunication are expected, the tender has already been held and the winner in privatization of the company "Moldtelecom" is revealed. Though these investments are directed to sphere of services, with their help telecommunication means on level of international standards will be established, that is a vital condition of expansion of business activity (including in the field of industrial production).

The chances for going into external markets have the following industrial productions (except of food branch): carpets, clothes, footwear, building materials (cement, gyps, wall materials), some kinds of machine-building production (pumps, means of transport, etc.). Development of assembly productions in free economic zones and industrial parks is in perspective.

Energy

Energy sector is the major branch of Moldovan economy, which supplies electricity and heat to enterprises, thus assuring their work. The effective work of this complex ensures the national security. In the overall structure of industrial manufacture the energy complex holds up to about 15%. The energy sector is crucial to the functioning of all sectors of the Moldovan economy.

Given the lack of domestic sources, the sector is dependent on imported inputs (except for a minor contribution from hydro-power). Natural gas constitutes the largest share of energy imports (about 60% in 1996). A significant rise in prices of fuel, the crisis in industrial production, and the sharp fall in household incomes contributed an almost two-fold cut in energy imports since 1991.

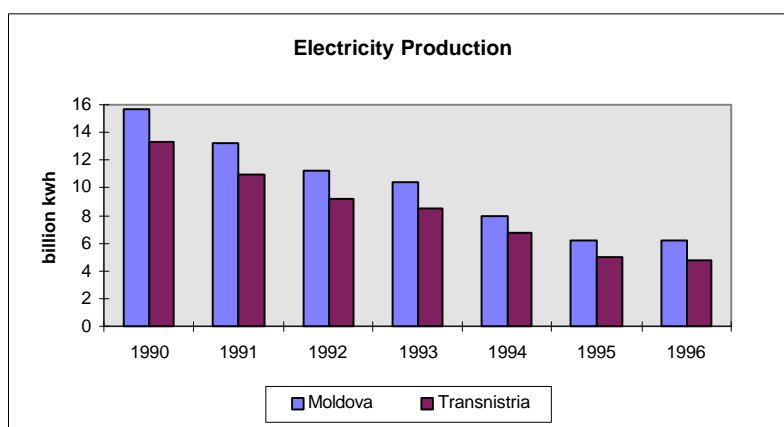


Electric power is produced by an integrated network of power stations: Moldovan CERS with a capacity of 2520 MW, CET-1 (Chi^oin^{au}) – 58 MW, CET-2 (Chi^oin^{au}) – 240 MW, CET B^{al}pi – 28 MW, Dub^asari Hydroelectric Power Station – 48 MW, CERS Coste^oti – 16 MW, plus power generating stations within sugar factories with 100 MW capacity. The total capacity amounts to 3000 MW.

The energy system of the republic is equipped with low and high voltage grids. The latter connect Moldova with the Bulgarian, Ukrainian and Romanian energy systems. During the eighties, 20 to 40% of the electric power produced in the republic was exported to Bulgaria and Romania, making a significant contribution to Moldova's exports.

Heating provided to the municipal and industrial sectors is generated by Heat and Energy Complexes and boiler-stations constructed in large cities and towns. The total capacity of the centralized heating generators is 9.7 thousand Gcal/hour.

The general state of economic crisis is reflected in electricity generation data, as shown in figure. The breakaway ambitions of Transnistria drastically affected the functioning of the energy complex, as more than 85 % of electricity capacity is in Transnistria where the largest electricity generator is located - the Moldovan CERS. By 1996, production of electricity had dropped almost to one third the 1990 level.



SWOT - Analysis of the Major Economic Sectors Development

Strengths

- The natural-climatic conditions favor effective development of agriculture and food-processing industry;
- Attractive geopolitical location;
- The country's internal and foreign trade have been practically liberalized, the first stage of privatization is completed, the agrarian reform is taking place, the stock exchange was established and set into operation;
- The national currency stability and low inflation rate were achieved.

Weaknesses

- Moldova is located in a zone of risky agriculture, with amount of rainfall, especially in the southern regions, being prohibitively low;
- Low speed of capital accumulation;
- Delay in proceeding with market reforms;
- Corrupted state, limitless powers of bureaucracy;
- Political diffusion of republic, existence of the Transnistrian problem;
- Decrease in living standards resulted in a reluctant attitude towards the reform in society.

Opportunities

- State support to re-structuring of insolvent enterprises;
- Bring Moldova to international standards in accounting and taxation;
- Export promotion, increase the share of the West and East European countries in the country's trade balance;
- Rather high level of qualification and inexpensive labor;

Threats

- High level of enterprise indebtedness and lack of financial discipline;
- High interest rates charged by banks for crediting hinders the real sector development.
- Inexperience of the enterprise management to work under market conditions, i marketing divisions;
- The worn out and out-of-date equipment, practical absence of modern technologies;
- Exceedingly high power consumption in manufacture, while lacking own energy resources.

6. Social Reform

Transition to the market economy is inevitably accompanied by social costs. Its overall burden depends largely on conditions prior to reforms, on pattern of transformations and on the level of the population's welfare. In Moldova adjustment to the market economy and the deepening economic recession imposed a heavy burden on the population.

Liberalization and macro-stabilization – the main concerns at initial stages – have produced financial rather than social effects. The decision to stabilize the value of the national currency involved severe budgetary cuts which resulted in curtailment in subsidies and social programs.

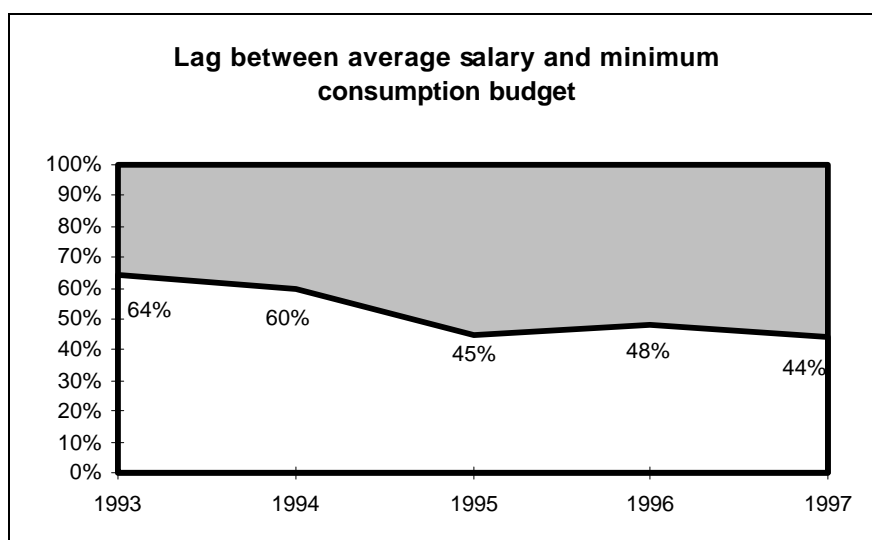
In 1996 there were only 136 million lei of capital investments allocated to the social sphere (68% of the budgeted amount). Although the share of social expenditures seems to be very large - around 16 per cent of GDP in 1997- the rate of social needs covered is only 20-25 per cent. Under these circumstances, the gap between limited public financial resources and enormous social commitments increases dramatically. Because of this shortage of resources, the potential of the social sector to provide accessible services to the population with low income has been severely reduced.

As a result of tough financial constraints, the public provision of health care and education contracted. As an example, more than 1200 kindergartens have been closed with a sharp fall in the number of children enrolled in pre-school education now only about 45 per cent of total number of children aged under 7 years. The same situation emerges in high schools where capacity covers only 2/3 of current needs, and the provision of textbooks is even more

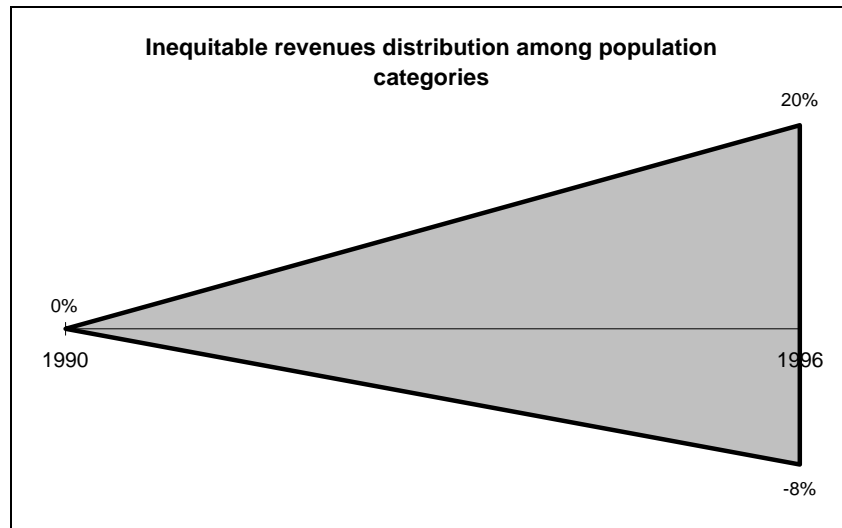
inadequate less than 50% of what is needed. A significant number of the poorer children do not attend schools. At the moment, the rate of enrollment is less than 95 per cent, and about 5 thousand of teenagers are now out of school.

There has been a severe deterioration in health care services. Public medical institutions are not able to guarantee a reasonable level of service. Over the last 5 years the number of people that received primary health care dropped by 11 per cent, while the number of people that were hospitalized has fallen by 22 per cent, with an increase of often ineffective “self-treatment”. The private medical sector is at an initial stage and services provided are too expensive for most potential users. Moreover, primary medical health care is weakly developed, limiting actions for prevention, diagnostics and medical rehabilitation. Secondary medical assistance is inefficient because of lack of modern medical equipment and insufficiency of public funding.

In addition to the availability of public services, standards of living are also based on the population’s income and wealth. Incomes were hit painfully during the transition. Most of the population has experienced falling real incomes although some suffered less than others. Over 1992-1997 average real income levels have dropped at least by 32 per cent. As a result, the average salary at present covers only 44 per cent from the minimum consumer basket (MCB), compared with 64 per cent in 1993. Older people and disabled have been affected most dramatically by the income erosion.



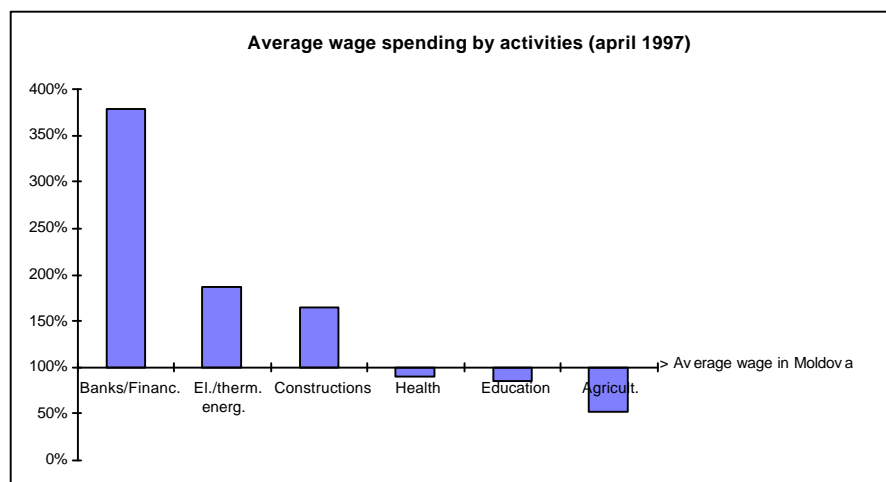
Alongside income decline, social inequality began to worsen. In 1993 the income differential between the poorest 10 per cent and the richest 10 per cent of population in Moldova was 1:7. Now this disparity is 1:11. The richest category of society (top quintile) receives around 30 per cent of total income.



This phenomenon is caused by the following:

- fast increase of wages in the private sector (the coefficient dispersion is approximately 1:6);
- wide wages disparity across sectors of the economy;
- tax evasion by the firms and individuals involved in informal sector and self-employment;
- spread of moonlighting.

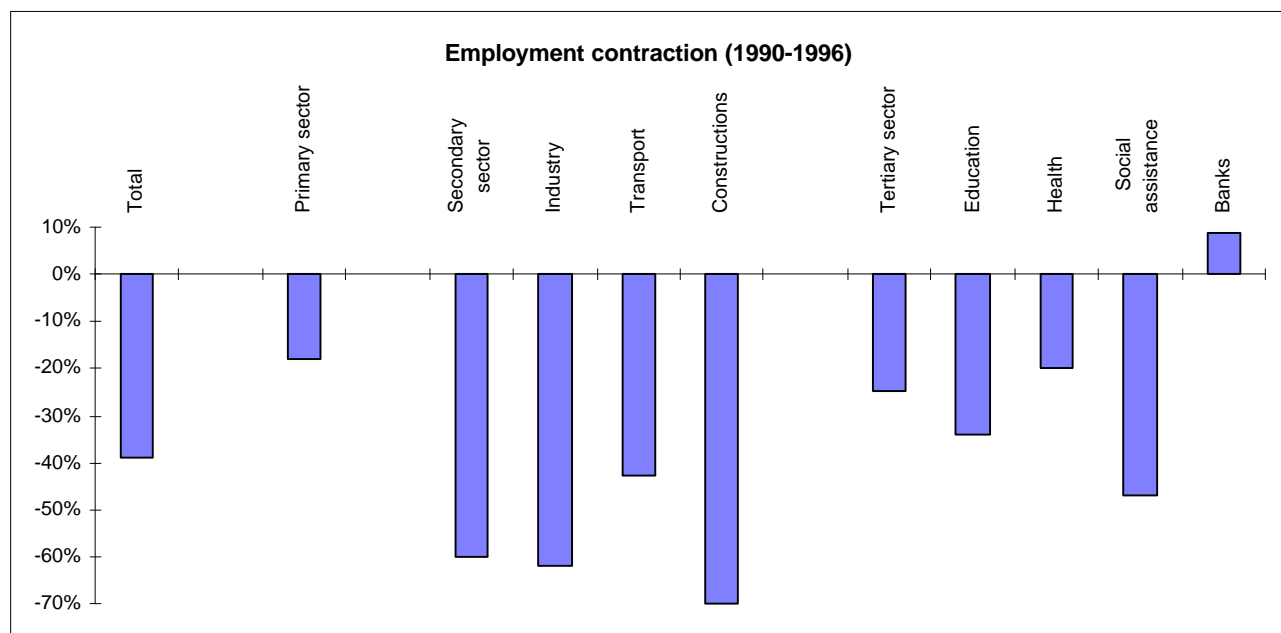
Greater disparity of wages is a normal result of transition. Allowing wages to be determined by the market to create incentives for efficient activity, is essential for successful reform but losers should not be forced into poverty. Their welfare will depend on government's capacity to promote an efficient social policy.



However, the impact of macroeconomic policies on the social situation is illustrated by the following:

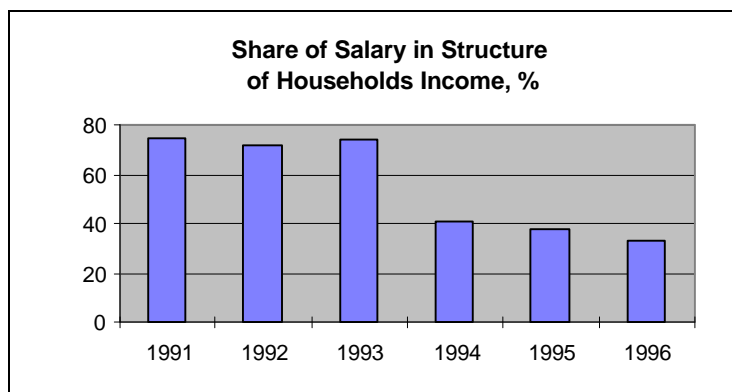
Employment: Liberalization and macroeconomic stabilization has resulted in a steep drop in aggregate labour demand. Facing financial crisis and collapse of traditional business relations, enterprises were forced to cut the number of workers. Compared with 1990, employment has fallen by almost 40 per cent, and in the public sector the decline was 50%. While employment reduction has occurred in all sectors of the economy, it has affected industry particularly (minus 60 per cent), construction (minus 70 per cent), transport (minus 43 per cent), and social assistance (minus 47 per cent). At the same time, in the private sector there was a 20% growth in employment, and it is estimated that the informal sector also experienced a 10% growth. It is estimated that these two sectors now employ almost 48 per cent of the active population. The limited extent of employment opportunities is pushing the unemployed to adopt any available economic survival strategy, in “street” trade, the “gray” economy and informal sector. As only about 1 in 10 of the unemployed is currently registered as such, the official unemployment figure of 1.8%, i.e. 23.4 thousand people, grossly underestimates real unemployment. Moreover, there is widespread hidden unemployment of those still formally in employment but not receiving salaries.

Simultaneously with the contraction in labour demand there has been a massive labour reallocation. The positive reason for the shift of labour is the hope to get a more secure and better paid job, resulting in the labour movements from the secondary sector (industry, transport etc.) toward the tertiary sector (banking, consulting, trading), affecting as much as a quarter of total number of employees. There has also been a slight increase in the share of agricultural employment basically caused by the disappearance of jobs in the cities. Labour migration is also increasing, with many workers going abroad to seek a job (mainly in Greece, Israel, Germany, and Russia).



Declining importance of salaries as main source of income. Frequent increases in salaries, pensions and other nominal retributions have not compensated for the negative effects of inflation. As a result, the real incomes of the population have decreased dramatically. While in 1993 the average salary covered 63.6% of the minimum consumer budget (poverty line), in 1996 this figure fell to 48%. In 1996 the share of the salary in households' income represented only 33.2%, compared to 74.5% in 1993.

These changes reflect the problem of salary arrears (360 million lei as of January 1997), fiscal evasion of employees of the private and informal sector, as well as payment-in-kind of salaries. Even though these figures suggest that there has been an increase of total household income as a proportion of the MCB, the increasing income disparity between households results in a greater number of people living



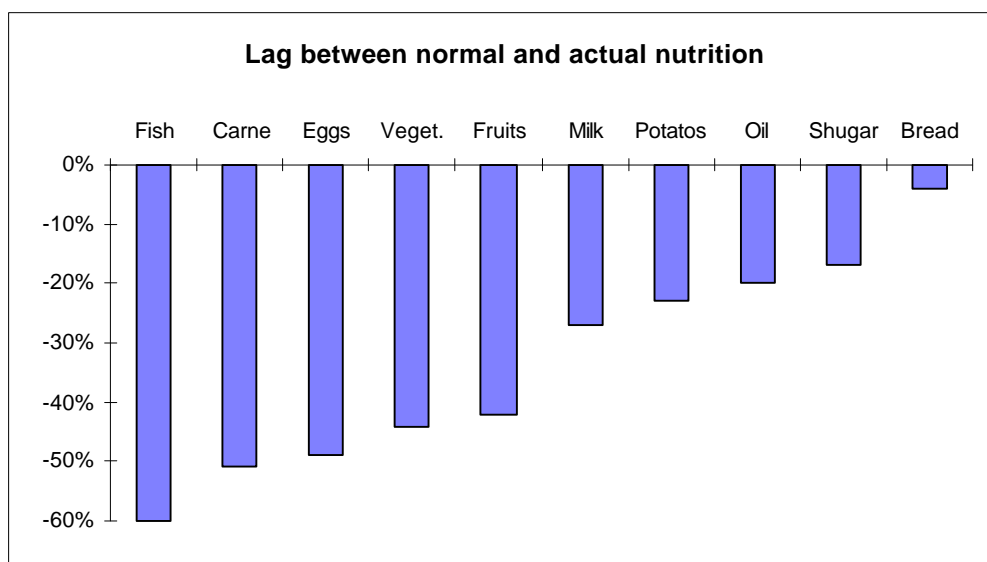
below the poverty line, as testified by the figures below relating to private consumption. Although specific research on poverty in Moldova is at an initial stage (e.g. Alleviation Program supported by the World Bank and UNDP), available statistics data show a tendency of deepening poverty spread among new social groups. In 1993 around 3 per cent of population had an income which was below official minimum wage and in 1996 this had risen to 5.8 per cent. According to some estimates about 3/4 of the population falls below minimum consumer budget (MCB). Around 135 thousand people have monthly income of less than 18 lei. Income dispersion has increased. In 1993 the income gap between the richest and the poorest was 1:7, while in 1996 it was 1:11 (average index in the OECD countries is 1:5). Now, besides older people, disabled and large families, usually considered as groups at risk, poverty often affects unemployed people, employees with low qualification, women and high school graduates.

Average Monthly Salary and Minimal Consumption Budget

	1993	1994	1995	1996
Average monthly salary, lei	31.2	108.4	141.8	186
Minimal consumption budget, lei	49	271	311	388
Share of average salary in minimal consumption budget, %	63.6	40	47	48

Household consumption has declined as a result of the decline in the real income. Meanwhile foodstuffs' consumption in real terms fell an average of 40%. Income deterioration and the spread of poverty, has had a clear impact on consumption. Statistics show a substantial decline in food consumption (one third less) over the period of 1990-1996, affecting all foodstuff, but being more pronounced for fish, minus 70 per cent, milk minus 48 per cent and meat minus 45

per cent. Nutrition standards are obviously falling. When in 1990 the gap between real consumption and consumption "norms" was 20 per cent, by 1997 this gap had grown to 44 per cent. The reduction in budgetary subsidies for the main food products such as bread and milk, as well as for the municipal services and public transportation, has had a strong impact on the levels of consumption of low income groups as levels of compensation have fallen well short of price increases. The sharp deterioration in food consumption patterns is shown in the diagram below.



This decrease had an impact on almost all basic foodstuffs, except for potatoes (+15%) and bread (+3%), staple foods which are poor in vitamins, protein and carbohydrates. As a result, the energy value of consumption has dropped over last 5 years by 15 per cent, and accounts at present for 70 per cent of minimum standards recommended by physicians.

These dramatic changes in living standards were accompanied by a worsening demographic profile of the population.

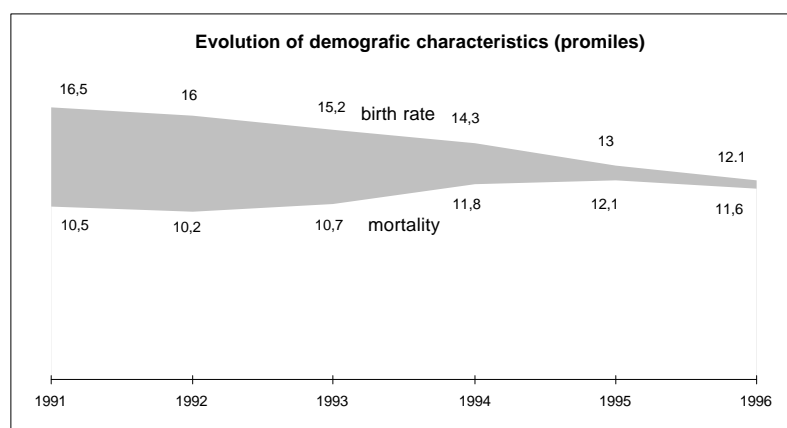
During the period 1991 - 1996, the natural population increase registered a 27% fall to the lowest rate in post-war period. Meanwhile, the mortality rate grew by almost 11 per cent, with a high infant mortality rate, about 20 per thousand. The latter is one of the highest rates in Eastern and Central Europe. Life expectancy has fallen to 65.1 years, much lower than in 1959 when it was 68.1 years. As a result of this, and of net migration, the absolute number of population in Moldova is decreasing and aging.

Demographic Situation of Moldova

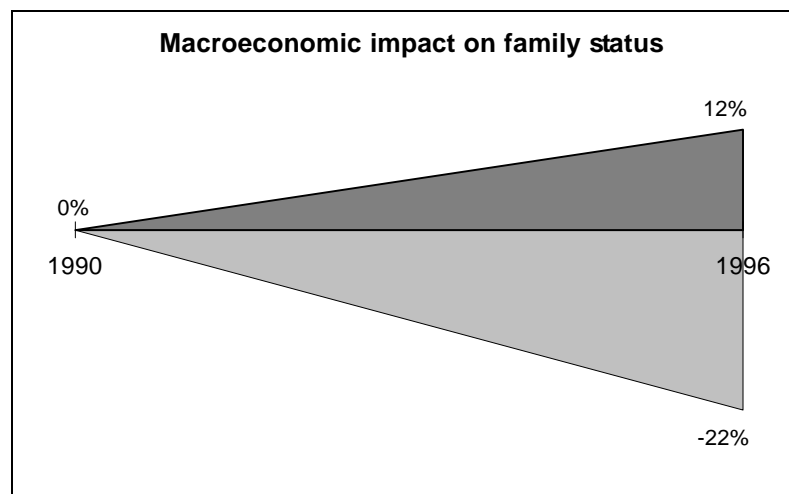
Indicators	1991	1992	1993	1994	1995	1996
Total population , million pers.	4.3663	4.3591	4.3478	4.3527	4.3479	4.3190
Birth-rate (at 1,000 pers.)	16.5	16.0	15.2	14.3	13.0	12.1
Morbidity (at 1000 pers.)	10.5	10.2	10.7	11.8	12.1	11.6
Natural increase (at 1000 pers.)	6.0	5.8	4.5	2.5	0.9	0.5
Infantile mortality (at 1000 born)	19.4	19.9	20.3	20.8	21.2	19.1
Born, thous. pers.	69.7				56.4	52.4
Died, thous. pers.	44.5				53.0	50.5
Life expectancy, years	67.7		67.6	66.0	65.7	65.1

The condition of women. Among groups at risk, women, who carry the responsibilities as mother, as housekeeper, and as employee, were affected the worst during the transition. These are also more frequently than men exposed to economic risk, including job loss, falling real income, and constraints in re-employment. Thus, women account for 73 per cent of redundancies caused by enterprise restructuring. Almost two thirds of registered unemployed are women, who have worse opportunities to find a job (34 per cent against 42 per cent for men). Women were laid off in much greater number than men, reasons being both on the grounds that the tasks/functions they perform were considered non-essential and because the benefits they are entitled to by law (e.g. maternity leave, child care transfers) made women more costly to the employer. And generally there exist some discrimination against women both in the private and informal sectors.

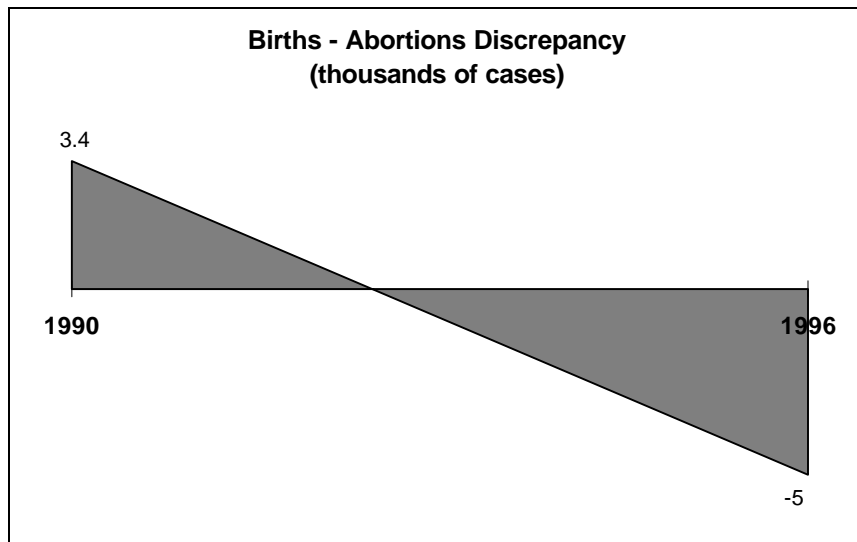
Another thorny problem is the income and wage differentials between women and men.



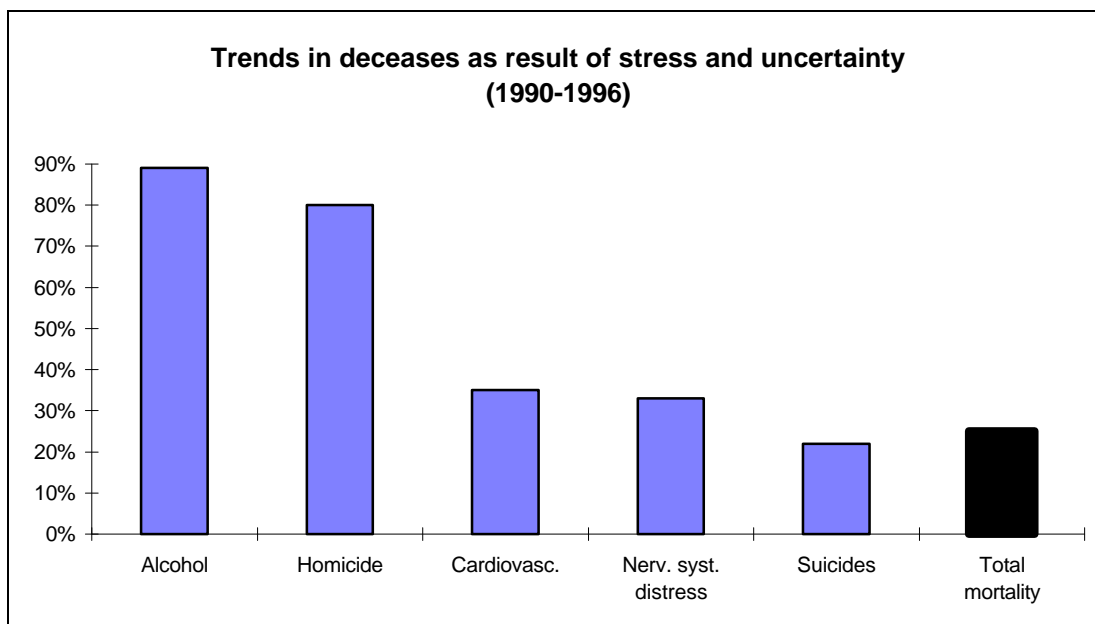
Although the law prohibits any gender discrimination, in reality women earn 20 per cent less than men. Women are employed mostly on low paid jobs, and particularly in the sectors traditionally at the bottom of wages scales: education, health, and social assistance. These sectors account for about 60 per cent of total number of women employed.



Income declines accompanied by uncertainty has a great negative impact on values traditionally accepted by women, especially influencing marriage and fertility. Almost 10 per cent of women do not want to formalize their relations through marriage. The number of marriages has dropped on average by 20 per cent. This affects particularly women aged under 25 years. As the decision to have children depends mostly on women's attitude towards marriage, it is not surprising that the birth rate dropped by an estimated 27 per cent, and by 31 per cent for the age group under 25.



Increasing social problems. Drastic deterioration of living standards brings stress and uncertainty about future prospects. As values and human attitudes are changing, accompanied by poverty and the threat of unemployment, many people are subject to depression and pronounced aggressive anger. These phenomena can lead to alcohol abuse, violence, deterioration of family relations and other social ills. According to statistics, deaths as result of alcohol intoxication, suicides, drug abuse, murders and other factors of stress, have increased by 48 per cent. Violence currently accounts for about 14 per cent of the total accidental deaths. The institution of the family gradually loses its social value. The number of marriages has dropped by 22 per cent, while the number of divorces has risen by 112 per cent reaching a rate of over 50 per cent. The number of marriage crime and corruption have been growing as well, severely reducing people's social security. Overall, these factors intensify the stress of adjustment to the new values of the market economy, and reduce the credibility of public authorities.



Public goods, environment and quality of life. Budgetary rigor has a negative impact on another aspect of living standards, by reducing the volume and range of public goods provided by the government. Delivery of heating, centralized hot water supply, electricity along with maintenance of roads, public transport, sewerage and other public services in acceptable conditions is becoming increasingly difficult. For instance, the operational capacity of roads has

decreased by about 22 per cent, currently covering two thirds of the minimum norms developed to assure traffic security. Budget funding covers only one fifth of estimated needs. Severe strains emerged in the supply of electricity, heat and drinking water. These public services become less accessible for people with low income. Besides, these goods are provided for short periods with long interruptions in delivery.

Some aspects of the quality of the environment has been exerting a negative influence on living standards. In particular, it has been necessary to severely limit water supply. At present, drinking water supply accounts for 85 per cent of minimum needs, and there is a dangerous deterioration of water quality. Almost 60 per cent of wells are polluted by bacteria, at levels exceeding health norms. Soil erosion, accompanied by the excessive use of pesticides worsened the quality of the water tables. At present, at least half of the volume of ground water supplied to population exceeds health standards for nitrates. There are also problems with air quality. Although the quantity of pollutants emission into the air space has decreased over the last period by 60 per cent due to economic decline, air pollution is still high. The level of harmful emissions exceeds standards by 7 -12 per cent, particularly in the highly industrialized areas. In some areas excessive pollution averages more than 100 days per year.

The existing institutional arrangements

The Social Protection System remains centralized, with a rigid structure and ineffective management and social insurance receives inadequate funding to cover its obligations. Social benefits compensate for an estimated 20% of the burden of economic reforms.

The social protection system in Moldova reflects its origin in the former soviet social security system. In principle, the system provides for a wide range of benefits including:

- pensions;
- income support benefits (compensation and indemnities) to families with many children and to those with low incomes;
- social assistance; and
- unemployment benefits;

Financing of social protection programs comes from three sources: compulsory social insurance paid by legal entities regardless of ownership form (30% of payroll in 1997), employees contribution (1% of gross wage) and occasional allocations from the state budget. The distribution of these sources in two last years is as follows:

	1996	1997
Businesses	87.7	72.5
State and local budget	7	25
Employees	2.5	2.5
Other (grants, loans, humanitarian assistance)	2.8	—

Pension benefits constitute the main element of social protection. About 87% of social benefits budget is utilized for pension payments. About 755 thousand people receive different types of state pensions, the majority being old-age pensioners (562.7 thousand people). Average pension in 1996 was 78 lei, which is about 42% of average wage in the country, compared to 60% in 1993. The major problem facing the system of pension benefits is the deficit of its financing. As

a consequence of failure by enterprises to pay social insurance, arrears of pensions at the beginning of 1997 reached 324.1 million lei (equivalent of 4-5 months total pension payments).

Social Fund Liabilities Payable and Receivable (million lei):

	as of 1.01.1995	as of 1.01.96	as of 1.01.97
Receivable liabilities	175,2	313,2	572
In % of total revenues	30	48	56
Payable liabilities, including:	42.1	175	404.1
due on pensions	30.1	128	324.1
due on compensations	12	47	80
In % of total costs	10	27	31

An attempt to settle the pension arrears through payments in kind was made in 1996. About 20% of the total number of pensioners were provided with pensions in kind of a total amount of 109.4 million lei (mainly sugar, vegetable oil and consumer goods).

Income support benefits (compensation and indemnities) constitute probably the most complicated and disputed domain of social protection. With a large assortment of social benefits without sufficient funding, their effect is small. The range of benefit is only 1-13 lei per month. In spite of this, in 1996 175 million lei was allocated to cover income supplements to vulnerable groups.

Social Assistance is offered in two ways: at institutions and at home. The assistance at institutions is distributed through 10 social institutions (houses for old people, asylums, special schools for children with physical and mental handicaps, sanitariums). Annually around 2400 people benefit from these services. These persons are totally dependent on state support.

Social assistance at home is provided by 1930 social services officers distributed between all districts. During 1996 they provided social services to 17.2 thousand lonely old people and invalids. These services consisted of food provision, hot meals, medicines and also some facilities for procurement of firewood, medical assistance, municipal services and others. The total amount of expenditures were of 22.5 million lei and was covered totally by local budgets.

Pensioners over 65 years age and invalids receive prosthetic orthopedic benefits and means of conveyance. During 1996 there were allocated 1.5 million lei for this purpose, while the demand has been 14 million lei. The war and labour invalids are entitled to specialized cars free of charge or at subsidized prices. The funds for these purpose are allocated from the state budget. During the period of 1994-1996 179.2 million lei was allocated for this purpose, which covered only 7% of the demand.

In addition to benefits received from Social Fund, such as pensions, compensation and indemnities, vulnerable persons are entitled to receive social assistance from the Fund for Social Assistance of the Population. Almost 345 thousand (lonely pensioners above 75 years age, disabled persons, families with many children) received assistance in kind and in cash at the total amount of 8.7 million lei during 1996.

Unemployment insurance represents most a new form of the social protection for population. With registered unemployed only 23.4 thousand (1.88% of active population), the expenditures for the assurance of unemployed were very low - around 1% of the total Social Fund's expenditures for 1996. However, unemployment insurance must be placed on a sustainable financial to anticipate the mass lay-off of workers caused by deepening of the agrarian reforms, restructuring of enterprises, and privatization of some infrastructure sectors, such as communications, power engineering, transportation.

7. Comparisons with other transitional economies

Moldova's geo-political position, productivity, resource endowment and location at the crossroads of the Balkans, determine both the current problems facing the country and perspectives for the future development. Moldova is attached to the region of *South-Eastern Europe*, including 9 countries: Slovenia, Croatia, Serbia, Bosnia and Herzegovina, Macedonia, Romania, Bulgaria and Moldova. The majority of these countries are parties of the Black Sea Basin Regional Community. Moldova is the only one of them which is a member of the CIS Economic Union, which accounts for 61% of the country's imports and 68% of exports.

In South-Eastern Europe, besides Slovenia, which has carried out reforms very successfully and Bulgaria and Albania, where reforms have stalled, the majority faced similar problems in the areas of banking and finance, property reform, enterprise restructuring, competition policy, and legal reforms.

According to the EBRD classification (Transition Report 1996), Moldova is in the 11th place among the 25 economy in transition countries of Central and Eastern Europe and the CIS; in the South-Eastern Europe it goes after Slovenia and Croatia.

Progress of transition in the South Eastern Europe:

Country	Enterprises Privatization				Markets and Trade			Financial institutions		Legal reform	Total
	Private sector share of GDP, %	Large-scale	Small-scale	Restructuring	Price liberalization	Trade & foreign exchange system	Competition Policy	Bank reform and interest rate liberalization	Securities markets and non-banking institutions		
Albania	75	2	4	2	3	4	2	2	3	3	24
Bulgaria	45	2	3	2	2	4	2	2	4	4	23
Croatia	50	3	4	3	3	4	2	3	4	4	28
Macedonia	50	3	4	2	3	4	1	3	3	3	24
Moldova	40	3	3	2	3	4	2	2	3	3	24
Romania	60	3	3	2	3	3	1	3	3	3	23
Slovenia	45	3	4	3	3	4	2	3	3	3	29

In common with other countries in transition, in Moldova the state sought to formulate the legal norms and institutions, to regulate five main areas:

- definition and protection of property rights;
- contract relations;

- procedures for the formation and dissolution of enterprises;
- provision of competitive environment (e.g. anti-monopoly legislation);
- procedures of formation of the market institutions specific for the transition period.

The ***practical application*** of the laws, especially in the areas of protection of property rights, anti-monopoly regulation, contract relations, liquidation/bankruptcy procedures has proved difficult. The delay in the application of new Civil Code has been longer than in other countries of the region. Moldova moved fast in opening the economy, swiftly performing mass privatization, reforming of banking sector and controlling monetary supply and liberalizing enterprise activity. Moldova moved more slowly in implementing an enterprise restructuring program, budget reform and overcoming criminality in the economy. Special attention needs to be given to agricultural and social reforms, given the structure of Moldova's economy and demography. Among the ex-Soviet countries, in terms of the contents and profundity of market reforms, Moldova lags behind Baltic States and Armenia. In Euromoney Country Risk rating, Moldova is placed on the 104 position out of 160 countries of the world, following other East-European Countries (except Albania), but leads over Ukraine, Belarus, and majority of the CIS countries (Euromoney, September 1996).

A comparison of situation of the Republic of Moldova with other countries with economies in transition is shown in tables and graphs of Annex D (according to the system of indices).

Annex C. Several directions for further study¹⁶

Stabilization: The inflation seems to be under control. It should be mentioned however, that the policy of maintaining a low inflation rate can finally collapse, in case when this low inflation represents the only positive macroeconomic achievement of the respective country. The country will face sooner or later fiscal crises, or balance of payments crises, as it happened for instance in African countries from franc zone.

External position:

- ***Trade performance:*** according to official statistics, the trade balance has deteriorated further in 1996, with a considerable increase in imports and, essentially, a stagnation in exports. Exports may be understated as there is a flow of unrecorded exports, but is also probable that imports are understated, particularly those subject to tariffs and/or excise duty, where importers have all the interest to minimize tax payments may do so by underinvoicing. In terms of trade balance, the two effects on exports and imports could cancel one another, with a loss of revenue for the government as the main significant result.
- ***Exchange rate:*** The lei/US\$ rate has remained essentially stable in the past two years. While stability was welcomed as an indicator of macro-balance, the maintenance of a stable, almost fixed rate of exchange, in the face of an inflation differential between Moldova and her trading partners results in a real appreciation of the currency, phenomenon noticed in several other countries in transition.

¹⁶ Chapter written by Prof. Brian Van Arkadie and Dr. Gabriele Muzio

How sustainable is this policy in the long run requires closer examination.

Also, a rising trade deficit should have placed pressure on foreign reserves and thus on the value of the currency. The apparent inconsistency of the numbers relating to trade, and the movement of the currency suggests the need for careful examination of the capital account.

- *Capital account:* Available data suggest that foreign direct investment and portfolio investment amounted to some US\$94m in 1996, and there is an additional US\$123m of unspecified “other investment”, but there is little available data on the detailed composition of foreign investment - for example, is it in fact foreign investment (equity or direct) or is it partly external debt?. The data does record a rising stock of external debt. Is this increase in debt largely having the effect of propping up the exchange rate at an unrealistically high level. The compatibility/sustainability of the external indebtedness in terms of Debt/GDP and projected export to debt service ratios needs to be examined with some care, along with the measures needed for future external debt management and monitoring of capital flows.

Privatization:

The problems with the way the privatization process has been conducted have now emerged. The first set of problems arise from the mechanism of voucher distribution. In theory that should have created a widespread popular capitalism with large numbers of small shareholders. In practice, it has resulted in the lack of a structure of ownership and control over the firms. In most cases the old management is still in control, in an ill-defined partnership with the workers, who are often small shareholders of the company. Little transparency exists in the relationship with outside shareholders, largely represented by investment funds. The system appears to have created two different power groups, the management on the one hand and the portfolio investors i.e. those managing the funds, on the other. Nowhere is ownership directly represented. Some observers tend to conclude that the problem is the lack of accountability of companies' management. This is part of the problem but it is questionable whether the "fund managers" have a higher degree of legitimacy as representatives of owners.

Lack of a transparent and well defined relationship between management and owners of privatized entities, with a clear specification of respective rights, duties, obligations and responsibilities generates a high degree of ambiguity and thus uncertainty. This situation is likely to become serious over time as it will limit the possibilities to recapitalize, modernize and develop firms, in the absence of which many firms will have little prospect of survival.

Agricultural Reform

The first need is to clarify what was expected from the reform of the land tenure system which allocates land titles to the whole of the rural population, inevitably in very small individual plots. Are we looking at the formation of a mixed system where peasant agriculture, based on very small-scale units, will exist alongside emerging medium-size farms resulting from formal and informal mechanisms of consolidation of control and operation? And could the two categories also coexist with large-scale units derived from the old collective model? It is probably too early to know what is likely to happen as a result of the new possibilities provided by the new land transfer regulations. However it is probably necessary to conduct some investigation of cases that can provide indications of private sector initiatives that may respond to some sort of embryonic strategy implemented by the individual actors.

Meanwhile, in the transitional period the problems in the sector seem to be aggravated by the continuing dominance of arrangements pre-dating reform, which have survived in a largely informal and unregulated manner. As a result, kolkhozes continue to operate with their internal power structure practically unchanged. There appears to be a paralysis in many of the units due partly to financial constraints caused by the large accumulation of debts, which not only prevent the farms from carrying out maintenance and necessary new investments, but often reduce the level of working capital below the bare minimum needed for effective operation. Even in those farms that sustain themselves despite these constraints, the pursuit of the individual interests of administrators can result in unorthodox product marketing and accounting practices which make accounting information practically meaningless.

The separation between primary production by collective and individual farms on the one hand and processing by largely big-scale agro-industrial units on the other, may have resulted in a significant shift in relative market power from the former to the latter (e.g. in relation to wine production, it is claimed that the price paid for grapes has been declining constantly in the last few years, while the margins of the wineries have been increasing). This is anecdotal evidence, but if true it would have contributed to falling levels of output in the agricultural sector. Further investigation is needed, as there is a real risk that price signals to producers may be severely distorted and thus cause decisions on future crop patterns that are irreversible and wrong as they do not correspond to a realistic view of natural comparative advantage.

A strategy for the agricultural sector should involve serious analysis of the requirements for economically efficient transport marketing and processing, including the requirements for a competition policy which avoids a situation in which farmers are unduly dependent on local monopolies.

From macro to micro analysis:

There has been an emphasis in policy analysis on the macro level. This reflects the fact that many of the critical measures implemented have related to economic stabilization on the one hand and to mass programs for the transfer of state property to the private owners on the other. Both types of action were of a macro structural nature.

And, to an extent, the reform process and the focus on economic stabilization have produced significant results. Moldova has a reasonably sound budgetary process and inflation is essentially under control. However, the picture that emerges from the productive sectors and civil society is not comforting. Production has been declining across the board (i.e. there are many losers and not enough *visible* winners, in the official statistics at least) and even sectors with a strong comparative advantage (e.g. wine making) appear to be declining. On the social level, a number of indicators suggest increasing poverty and rising unemployment, while the umbrella of social protection, even in essential health services, is shrinking. While a degree of stress is inevitable in a system in transition, the intended reward is the evolution of the country's economy rather than stagnation. And continued economic recession could even place in question the success achieved by monetary stabilization, with pressure beginning to emerge in public finances, with a rising budget deficit and trade deficit and increasing external indebtedness. All these elements would not be alarming in the context of a scenario of sustained growth, but they will become worrying if the current situation of stagnation prevails.

Given that the problems with the Moldovan economy do not appear to be caused by any gross macroeconomic mismanagement, it is necessary to complement the recommendations for blanket macro solutions and policy action (e.g. new property legislation, land privatization) with deeper analysis of microeconomic factors influencing growth and stagnation. This exploration could initially be based on informal observation (e.g. anecdotal evidence and discussions with readily available actors in the economy) but could then be refined and made more systematic. It could be conducted on two main levels.

Firstly, it would attempt to come to terms, as much as possible, with that part of the economy which is not properly recorded (the “shadow”, “parallel” . “informal” economy). Failure to adequately interpret these economic activities could lead to fundamental misinterpretations of economic performance (with the resulting risk of misdiagnosis and incorrect policy advice). This is significant not only in *quantitative* but also in *qualitative* terms, as these activities may include elements of the newer and more dynamic section of an economy in transformation, that may reveal trends that are shaping the future economic configuration and potential of the country.

Secondly, key areas of the economy should be explored in depth (the definition of “key area” being derived from existing knowledge of the economic structure and from evidence emerging from the study of the informal economy). At this stage, a number of suggestions come to mind including:

1. Relationship between *agricultural producers and industrial food processors*. Evidence of monopsonistic practices at work - possible interventions to increase competition and increase services available to farmers.
2. *Wine sector*. Same as above. Are giant wineries the best solution for the future? Is marketing expertise inadequate to diversify into non-CIS markets?
3. *Professional training*. The banking sector is one the visible growth areas in Moldova today. In all the assessments of its condition a shortage of well-trained and competent staff is identified as a bottleneck. The establishment of a training center for banking personnel might be a perfectly sound solution to speed up the growth and quality improvement of a sector where employment possibilities are promising for some years to come.

CISR does not have the capacity to mount in-depth or definitive analysis of any of the issues listed above. Its function should be to promote broadly-based recognition of the importance of selected issues, *to underline the priorities* and to point out the direction of further useful work and action. This should also serve as a means to identify areas where foreign financial and operational assistance should be prioritized.