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## **Republic of Moldova: Poverty Reduction Strategy Annual Evaluation Report 2005**

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**International Monetary Fund  
Washington, D.C.**



**GOVERNMENT OF THE REPUBLIC OF MOLDOVA**



**ANNUAL EVALUATION REPORT  
ON THE IMPLEMENTATION OF THE ECONOMIC GROWTH AND  
POVERTY REDUCTION STRATEGY**

**2005**

**Chisinau, 2006**

## LIST OF ACRONYMS

CPAR	Central Public Administration Reform	MEYS	Ministry of Education, Youth and Sports
CIS	Commonwealth of Independent States	MTEF	Medium Term Expenditure Framework
DFID	Department for International Development	MMIF	Mandatory Medical Insurance Fund
EBRD	European Bank for Reconstruction and Development	NGO	Non Governmental Organization
EFA	Education for All	NBM	National Bank of Moldova
EGPRS	Economic Growth and Poverty Reduction Strategy	NBS	National Bureau of Statistics
FSAP	Financial Sector Assessment Program	PAR	Public Administration Reform
EU	European Union	PC	Participation Council
GDP	Gross Domestic Product	PPP	Purchasing Power Parity
GVA	Gross Value Added	SDC	Swiss Agency for Development and Cooperation
HBS	Household Budget Survey	SS	State Securities
HIV/AIDS	Human Immunodeficiency Virus/ Acquired Immunodeficiency Syndrome	SSIB	State Social Insurance Budget
ILO	International Labour Office	TAU	Territorial Administrative Unit
IDA	International Development Agency	TB	Tuberculosis
MDG	Millennium Development Goals	VAT	Value Added Tax
MET	Ministry of Economy and Trade	UNICEF	United Nations Children's Fund
		UNDP	United Nations Development Program
		USSR	Union of Soviet Socialist Republics

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## EXECUTIVE SUMMARY

1. Economic growth and income redistribution policies promoted in the context of Economic Growth and Poverty Reduction Strategy (EGPRS) implementation contributed to higher incomes and improved access of population to social services, which led to higher living standards and poverty reduction. During 2002 – 2004, poverty rates decreased by 14.5 percentage points (p.p.). By 2004, only 26.5% of the population of the Republic of Moldova was poor, i.e. their welfare was below the absolute poverty line (as compared to 40% in 2002). The most essential decrease (by 11.4 p.p.) took place in 2002-2003. In this period, extreme poverty decreased considerably (by 11.2 p.p.). However, in 2004 the pace of poverty reduction slowed down.
2. Together with poverty rate, inequality level also reduced. This trend is reflected by the Gini coefficient that measures inequality at country level and income and consumption distribution by quintiles. As a result, in the period of 2000 – 2004 the Gini coefficient decreased from 0.38 to 0.36. However, the downward trend was not so clear and stable, as in the case of poverty rate, inequality remaining at a relatively high level. In 2004, the richest 20% of households had over 40% of the total consumption, while the poorest 40% benefited from less than 20% of the total consumption.
3. Economic growth is a pre-condition for higher living standards and poverty reduction. Between 2003 and 2004, the estimated average poverty elasticity to average consumption growth was 2.1 %. That means that with each percent of growth, the poverty rate reduces by 2.1%. In 2002-2004, two thirds of reduction of poverty rates (which was empirically decomposed into growth of household consumption and redistribution of consumption between households) can be attributed to consumption growth, and one third is due to inequality reduction, i.e. redistribution among households.
4. Under these circumstances, at this stage Moldova manages to achieve the intermediary targets for poverty reduction identified in the Millennium Development Goals, whereas the slowdown of the poverty reduction pace raises concern.
5. The statistical results relating to the socio-economic development revealed a number of increasing trends in most sectors of the national economy in 2005. The GDP increased by 7.1% as compared to the previous year versus 5% provided in the EGPRS. Consequently, starting with the year 2000 the GDP increased by over 43%. In 2005, the GDP per capita exceeded US\$860. However, the structure of growth has not improved and some challenging trends in the country's macroeconomic development were not overcome. Economic and investment growth took place in the context of slow restructuring of the national economy, reduction of the growth rate in industry and agriculture. The accelerated growth of import led to higher share of net production and import duties in GDP, while the share of the gross value added in the GDP decreased.
6. An encouraging trend in 2005 was the increase of gross capital formation (by 11%), which exceeded both the final consumption growth (by 9.5%) and the GDP growth as a whole (by 7.1%). At the same time, the impact of this indicator on the GDP growth increased from 2.4 to 2.9 %, while the input of the final consumption increased from 2.2 to 9.9%. The increased demand, which was primarily generated by the increased inflow of monetary income from abroad as well as by increased domestic income, in the context of insufficient domestic production in terms of quantity and structure, led to increased imports. Given that exports increased less than imports, and the rate of growth of revenues of Moldovan citizens working

abroad decreased (by 29% vs. 45% in 2004), the current account deficit increased considerably (from 2.7 % in 2004 to 9.8% in 2005).

7. The high level of remittances (30% of GDP), import growth (77.5% of GDP), trade balance deficit (39% of GDP) and the current account deficit (9.8% of GDP) testify to a higher dependency of economic growth and the overall economic situation on external factors. Under these circumstances, and given the deficient economic reform and low level of investments, the country's external vulnerability increases, and the perspective of sustainable economic growth and poverty reduction can become uncertain unless immediate actions are taken in order to improve the current situation.

8. In December 2005, the inflation rate was 10% as compared to December 2004, showing a decrease by 2.5 p.p., as compared to the same period of 2004. The reduction of the overall inflation rate was caused by the reduction of the food price growth rate by 4.4 p.p. and tariffs for services - by 5.2 p.p. At the same time, the non-food price growth rate increased by 3 p.p.

9. Another element of macroeconomic stability is the implementation of a fiscal and budget policy that ensures a balance between budget revenues and expenditures. The efforts of improving mid-term financial planning, tax administration, and financial discipline created premises to execute the budget for 2005 at 100.6% for revenues and 92.7% for expenditures. In revenues formation, direct taxes constituted 35.9%, whereas indirect taxes - 44.1 %. In the structure of indirect taxes, VAT represents the highest share of 71.3%, of which VAT for the imported goods is 88%. Thus, consumption and import taxes still represent the main base for public revenues, and this cannot be considered as a budget sustainability element.

10. Improvement and extension of MTEF contributed to a better resource allocation. In 2005 social sectors still had the highest share in public expenditures - 63.2%, of which social insurance and assistance - 30.3%, education - 19.4%, health care - 11.3%. About 14.1% of the public expenditures were made by economic sectors. Despite these developments, the expenditure framework for some sectors was not totally adjusted to the EGPRS priorities. Thus, expenditures for public investments and economic services, that could facilitate economic growth, remained limited.

11. In Moldova, economic growth is still dependent on the consumption growth. Consumption is mainly satisfied by imports and is mainly financed from remittances. Respectively, the maintenance and acceleration of the current growth rates can be ensured by changes in its structure in terms of transforming the productivity factor into the driving force of growth. Consequently, the increased productivity and competitiveness of the national economy, have to be ensured by continued and enhanced structural reforms, and namely by: (a) further simplification and optimization of the regulatory framework; (b) ensuring stability of the legislative and fiscal frameworks; (c) rehabilitating infrastructure, by promoting the public-private partnership, and by increasing public investments, (e) divestiture and efficient use of assets, which are still in public property, (d) improving access to finance.

12. The State Regulatory Reform, initiated by the Government in 2004 and continued throughout 2005, aims at creating an open, flexible and cost-effective business environment, which will facilitate investments and innovations in business. In the period 2004-2005, a number of actions were undertaken to: (a) simplify and centralize the licensing procedure, (b) optimize the registration procedure, (c) reduce conflicts of interest between the role of inspections and the role of testing the control agents. The Law on revising and optimizing the regulatory framework for the entrepreneurial activity (regulatory guillotine) was developed and

implemented. This allowed for a significant reduction in the number of normative acts that regulate the entrepreneurial activity and reduced the cost of authorization documents.

13. The experience of the first phase of the regulatory reform, as well as the experience of other countries in this field, testifies to the need to transform the regulatory reform into a continued, comprehensive and systematic effort, which will cover the entire Government, and which will be supplemented with sector-specific reforms. A successful implementation of this complex reform depends to a great extent on the level of commitment of different local and central public institutions, some of which show lack of will to ease the regulatory burden or to give away additional income earned under the current system.

14. In order to diminish the tax burden on the business environment and identify those who are acting in the shadow economy, the share of income tax for legal entities was reduced from 18% in 2005 to 15% in 2006. Starting with 2006, agricultural producers are exempted from a number of taxes for a period of five years and have to pay only the land tax (the amount of the annual share is maintained), the VAT (if the turnover exceeds the amount of MDL 200 thou. per year) and the contributions to the state social insurance budget. Overall, the fiscal pressure as the share of fiscal revenues in GDP for 5 years evolved as follows: in 2000 – 24.6%; in 2001 – 24.2%; in 2002 – 25.6%; in 2003 – 27.3%; in 2004 – 29.5%; in 2005 – 31.9%. The tax burden in Moldova is relatively low as compared that of the countries in the region. At the same time, given that the process of defining the fiscal system has not been finalized, a sufficient level of stability cannot be ensured.

15. The absolute indicators relating to the operation of the banking system are compliant with the economic development of the country in 2005 and this creates, in principle, relevant monetary conditions. Given that the nominal GDP increased by 14.7%, the total assets of the banking system increased by 35.4%, the monetary mass in MDL (M2) increased by 36.7%, credit allocations – by 35%, and deposits – by 40%. As a result, the ratio of assets in the banking system to GDP went up from 42 % in 2004 to 49% in 2005. The economy monetization level also increased.

16. At the same time, some of the qualitative characteristics of the banking activity deteriorated and the economy crediting level remained low. Assets return rate as well as banking activity efficiency decreased. The dynamic of interest rates for credits does not fully meet the objective to considerably increase investments and does not lead to increasing the crediting level to the desired extent and for longer terms. The share of bank credits in the total investments in fixed capital has decreased from 4.8% in 2004 to 2.7% in 2005. In this situation, without accelerating economic reforms and diversifying the banking system, the reduction of interest rate can lead to the reduction of the rate of return of the banking activity. At the same time, a bigger diversity of the banking products and lower interest rates can be ensured by a more serious competition among banks.

17. Industrial sector has a special role in ensuring the sustainable economic growth. In the last five years, the cumulative industrial growth was 67.5%. Nevertheless, the growth rates in 2004 - 2005 went down, amounting to 8.2 and 6.3% respectively, while the share of this sector in GDP remained at a relatively lower level – 17%. The limited progress of the industrial sector, under the relevant EGPRS objective, accounts for the low performance of exports, which are treated as an „engine” of the sustainable economic development. Both the growth and the structure of industry determine the dynamics and the diversity of exports.

18. The performance of imports is closely related to the development of the real sector of the national economy, and especially the industry. First of all, Moldova inherited a structure from

the previous economic system that is 70 % dependant on imports. The structural reforms that were implemented from the declaration of independence up to present were not sufficient to change the situation. Thus, more than a half of goods imported to date, especially those that are indispensable for the economic development, cannot be substituted. On the other hand, there is a growth of imports of current consumption goods, such as: chemicals, textiles, foodstuff, drinks and tobacco, plastics, vegetal products, etc. As a result, domestic producers benefit very little from the increased demand, which stimulates economic growth in general. To a great extent, the advantages of this growth are in favour of foreign economies. This testifies to major problems faced in the organization of enterprise activity.

19. The main factors that determine the low performance of domestic enterprises are as follows: deficient corporative management, inadequate productive structures, outdated production capacities and limited access to financial resources. Both legal entities with some state-owned shares and the completely private ones face problems in terms of assets decapitalization.

20. In order to improve the situation, the Government initiated a number of actions to improve the public patrimony management and denationalization. The concept of the Law on management and denationalization of the public patrimony was developed. It identifies the following priorities: enhancement of the public patrimony accounting, optimization of dimensions, structures and methods for the management of public property, especially by introducing corporative management principles. Also, the draft law on amending the law on state enterprises, which is aimed at implementing the corporate management principles in the relevant enterprises.

21. In the same context, the agricultural growth remains to be modest. The agricultural output in 2001-2005 increased by only 16%. In 2005, the agricultural output increased by only 1% (in comparable prices) as compared to the previous year. Agriculture is still characterized by the lowest productivity and remuneration level. It represents almost 18% of GDP and provides jobs to 45% of the total labour force. However, low productivity and small growth in agricultural sector diminished the perspectives for the rest of the economy. Moreover, agriculture has an important role in the context of poverty reduction, as it represents the core activity for many people who are concentrated close to poverty line.

22. Creation of a favourable environment for economic growth in line with the market economy principles depends, to a great extent, on the infrastructure recovery and development, and namely the road network, water supply system, heating system, energy sector, and telecommunications. Following the declaration of independence, public investments in infrastructure were limited and most of them were provided from external resources.

23. Recovery and maintenance of infrastructure implies high costs, which cannot be fully covered by the national public budget. At the same time, delays in the recovery of infrastructure, on the one hand, is dangerous for the economic and social development, and on the other hand, leads to higher recovery costs in the future. In this situation, efforts should be made to increase public investments, especially in those areas where the private sector is not interested to make investments, as well as to develop alternative financing mechanisms such as private-public partnership.

24. The country's transport network infrastructure was considerably depreciated in the transition period and the current efforts to maintain, recover and build roads are insufficient to upgrade the road network.

25. Achieving the objective related to ensuring energy security is still a serious challenge. The increase in price for energy resources is directly affecting the low competitiveness of domestic production as well as the population's welfare in general. In the electric energy sector, efforts to increase energy generation capacities failed, the local power stations were not upgraded and the new energy generation capacities were not developed. The heating system, which is the main debtor for gas consumption, is in a more critical situation. In most localities, the heating system faces financial problems, low level of collection, and lack of investments.

26. Water supply and sewerage system reform is being implemented under EGPRS and MDG commitments that envisage "halving the number of people with no sustainable access to potable water by 2015", which implies that the share of population with access to sustainable water sources should be increased from 38 % in 2002 up to 47.7 % in 2006 and 68.5 % in 2015. Actions undertaken to date are not sufficient, and the achievement of objectives in this area is still a challenge.

27. Access to education has been slightly improved during the last few years. The enrolment rates have been stable except for the enrolment in primary school from the rural areas (NBS data). Children from poor households and from rural households go to school at a later age and leave earlier than children from other households. These children start their school career already with a lag when entering primary school as they missed pre-school. .. The main reasons for not going to school in case of 3-16 year-old children are the schools that are not functioning (33%) and financial difficulties (27%). Poverty analysis shows that the education level is directly related to the living standards of the individual. Households headed by people without secondary education face a considerably higher poverty risk. As a result, poor children that do not have the possibility to obtain a higher level of education than the mandatory one have all the chances to be poor also in future. In this regard, provision of food to children within education institutions is an effective tool to attract children from poor families in the education system.

28. Moldova made progress in achieving MDG objectives in the health sector. Mortality rate for both infants and children under 5 years decreased both in rural and urban areas. Infant mortality rate reduced from 18.3 per 1000 newborn in 2000 to 12.2 in 2005, while the under-five mortality rate reduced respectively, from 23.3 per 1000 newborn in 2000 to 15.3 in 2004. Immunization coverage of children under two amounted to 99.2% in 2004. The maternal mortality rate reduced to 23.5 per 100,000 live births in 2004 up to 18.6 in 2005. So far, no considerable progress in decreasing TB-associated mortality rate was noted. Furthermore, the increased HIV/AIDS prevalence is a special concern. An important problem is non-contagious disease prevention, which is the main cause of morbidity, disability and premature death in Moldova.

29. Pension system reform is implemented slowly and the financial stability of the Social Insurance Budget raises concern. Slowdown in the implementation of Individual Records system and lack of motivation system for both the employers and employees does not contribute to improving the situation.

30. The average old-age pension in 2005 was adjusted by 18.2 %. The amount of the old-age pension (adjusted to the consumption price index) was 300.9 MDL, and represented an increase by 39%.

31. The social assistance programs have the highest share in the total public expenditures. In the period 2000-2005, the share of transfers to the population in the total discretionary expenditures increased from 28.9% to 31.6%, and their share in GDP increased from 8.7% to 10.4%. The performance of social assistance programs was still low over the last years because

of inadequate targeting of resources. The poverty profile shows that the poverty rate among households, whose main income is obtained from social transfers, is higher than the average poverty rate. 36% of population that live in such households is poor and 20% - extremely poor. The households headed by pensioners have a higher poverty risk (31%).

32. Despite the importance and relevance of regional policies in the context of promotion of sustainable economic growth, the progress achieved in this respect is insufficient. So far, no regional development policy was defined. With the support of the development partners, a study was carried out and a main draft law was developed for a further legal framework in this field. In this context, it is suggested to specify the main functions of different central administrative bodies in the field of regional development.

## INTRODUCTION

33. This report is the first annual report evaluating the EGPRS implementation since its approval by the Parliament on December 2, 2004. The main purpose of the report is the evaluation of progress made in achieving the set objectives, as well as assessing the trends in economic and social development of the country in general.

34. Besides estimating the degree of completion by the assigned institutions of policies and activities provided in the Strategy, the Report intended to evaluate the relevance, efficiency, effectiveness, sustainability and the impact of these on the development of social and economic indicators. At the same time, the analysis of policies impact is a difficult task. The outcome of most of the policies/activities undertaken can be observed after a period of time that can last several years. In the situation when only a year has passed after the Strategy's approval, it is difficult to obtain measurable results for all the undertaken actions. Accordingly, the report does not consider strictly the period since the approval of the document. It analyses the development in the last two years and for certain phenomena identifies trends for the last five years – the period of economic recovery.

35. Moreover, the Report evaluates, on a selective basis, the fulfilment of the EGPRS commitments. Taking into account the multitude and complexity of the objectives provided in the Strategy, it was not possible to have in this report an in-depth evaluation of all these objectives. The areas were chosen considering the seven priorities identified within EGPRS, as well as considering the importance/relevance of certain areas of activities for achieving the poverty reduction and economic growth objectives in the existent situation. Thus, since poverty analysis shows that two thirds of poverty reduction is due to economic growth, whereas one third – due to redistribution policies, priority was given to the analysis of policies and activities that have a direct impact on economic growth and redistribution between the households.

36. It is necessary to mention, that the current report represents the position of the Government of the Republic of Moldova. However, the evaluations and findings of the report are based on different studies and analysis in the areas covered by the Strategy carried out by development partners, civil society and academia. Also, the report was developed with the support of the UNDP/UNICEF/SDC Joint Programme “Support to Strategic Policy Formulation, Monitoring and Evaluation”.

37. The draft Report was presented at the EGPRS National Forum organized on March 23, 2006 with the participation of all interested stakeholders: Parliament, Presidency, central and local public administration, civil society, business community, and Moldova's development partners. The Report was finalized taking into consideration the comments expressed during and after the Forum.

## 1. POVERTY AND INEQUALITY EVOLUTION IN 2002 – 2004<sup>1</sup>

### Poverty definition and its evaluation

38. The living standard of a household is determined both by the monetary aspect<sup>2</sup>, as well as by the non-monetary factor<sup>3</sup>. In order to measure poverty, two poverty lines have been defined: extreme and absolute poverty lines, identifying poor and the very poor households (Annex A1). Extreme poverty line is based on the minimum ratio of calories per day, and the absolute poverty line makes a supplement for the non-food goods and services to the extreme poverty line. Poverty analysis uses the data from HBS, implemented by the National Bureau of Statistics (NBS). The methodological principles for the evaluation of the absolute poverty line have been identified in the EGPRS.

### Dynamics of poverty and inequality

39. Poverty in Moldova is strongly correlated with economic growth. The evolution of the absolute poverty incidence over time shows that poverty increased sharply from 1998-1999 (Figure 1). Seventy one percent of the Moldovan population was poor in 1999 based on the absolute poverty line. The extremely high poverty incidence in 1999 reflects the serious impact of the Russian financial crisis on Moldova. Since 2000 poverty rates have decreased constantly and by the year 2004, only 26.5% of the Moldovan population was poor, i.e. their well-being was below the absolute poverty line. The most important decrease has taken place between 2002 - 2003. In this period of time the rate of extreme poverty has also decreased significantly (11.2 p.p.).

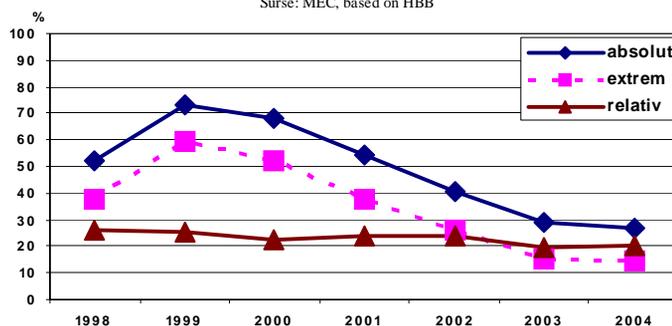
40. Other poverty indicators have illustrated similar trends.

Poverty became deeper and more severe in the period of the economic crisis, but after the economic recovery, the poverty gap (the average gap between expenditures of the poor and the poverty line) and poverty severity (measuring the distance of the poor from the poverty line) started to decrease again (Annex A2).

41. Parallel with declining poverty rates, the level of inequality has been decreasing as well. This trend is reflected in the developments of the Gini coefficient, which is a measure for the level of inequality in the country, and the distribution of income and consumption across quintiles. Thus, between 2000 – 2004, the Gini coefficient has decreased from 0.38 to 0.36 (Table 1). However, inequality remains at a high level in Moldova compared to other countries

Figure 1  
Poverty rate dynamics, 1998 – 2004

Source: MEC, based on HBB



<sup>1</sup> Poverty evolution is thoroughly analysed in the MET “Poverty and Policy Impact Report” (published on [www.mec.md](http://www.mec.md) and [www.scers.md](http://www.scers.md)).

<sup>2</sup> Income and consumption are examples of monetary indicators of poverty.

<sup>3</sup> Examples for non-monetary indicators of poverty are: access to education and medical services, availability, and/or quality of living space.

in the region.<sup>4</sup> The downward trend is not as explicit and steady as with the poverty rates. The problem of inequality is aggravated by the fact that poor people receive part of their income in kind. Consequently, the access of poor people to goods and services becomes limited. Thus in 2004, the richest 20% of households had more than 40% of the total consumption, and the poorest 40% of households had less than 20% of the total consumption. Over time, the distribution remained quite stable.

**Table 1. Distribution of consumption expenditures between 2000 – 2004<sup>1</sup>**

	2000	2001	2002	2003	2004
<i>Share of consumption expenditures by groups of quintiles (20%) of population:</i>					
TOTAL	100	100	100	100	100
I Quintile	6.8	6.5	6.8	7.5	7.2
II Quintile	11.2	10.7	11.1	11.6	11.6
III Quintile	15.3	15.0	15.6	15.7	15.7
IV Quintile	21.5	21.6	22.2	21.6	21.5
V Quintile	45.2	46.2	44.3	43.6	43.9
Gini by consumption expenditures per capita	0.380	0.388	0.372	0.356	0.361
90/10 distribution, mean of consumption expenditures by adult equivalent	10.45	10.85	9.40	8.39	9.10

Source: MET, on the basis of HBS

Note: 1\ The figures are weighted and representative at the national level

42. There is a close link between the economic growth, inequality and poverty reduction. Between 2002 – 2004, the economic situation of the Republic of Moldova has improved, and poverty has decreased. Economic growth represents the main condition for increasing living standards and achieving poverty reduction. Without economic growth, poverty reduction is extremely difficult. In such situation, just the redistribution of income from richer households to the poorer can result in lower poverty rates.

43. The estimated average elasticity of poverty with respect to growth in average consumption was – 2.1 over 2003 and 2004. This means, for each one percent increase in growth, poverty rates fall by 2.1%. This is slightly less than the –2.9 estimated by the World Bank for the period 2000 to 2002.<sup>5</sup> However, the level of elasticity is comparable with other countries, such as Romania (average of –2 between 1999 and 2001).<sup>6</sup>

44. Between 2002 and 2004, poverty rates (empirically decomposed into growth of household consumption and redistribution of consumption between households) decreased with 14.5 p.p. Two third of this decrease can be attributed to growth in consumption and one third of the poverty reduction is due to lower inequality, i.e. redistribution between households. The greatest poverty reduction occurred in small towns, 18.6 p.p., and is largely due to the increase in the population's consumption (17.2%). One sixth of the reduction is due to decrease in inequality. In 2003 – 2004, poverty reduction slowed down and the 2.5 p.p. change from 2003 to 2004 is determined by the decrease in inequality.

45. The Millennium Development Goals for Moldova aim at halving the poverty rate until 2015, using the international poverty line of 2.15 USD PPP per capita per day. Initially, in order to monitor this objective poverty has been defined in terms of income. Based on the income

<sup>4</sup> Gini coefficients for selected other countries: Albania 0.28 (2002), Armenia 0.28 (2001), Romania 0.29 (2002), Georgia 0.36 (2001), Tajikistan 0.33 (2003) (World Bank, 2004: p. 9).

<sup>5</sup> The World Bank (2004), *Recession, Recovery and Poverty in Moldova*, Report No. 28024-MD, Washington DC: p. 4.

<sup>6</sup> Ibid.

definition, the poverty rates accounted for 27.8% in 2004 compared with the target of 28% set for the 2006. However, due to the unreliability of income data collected in the HBS, poverty should be assessed using consumption expenditures. Data on expenditures collected with the HBS represent a more reliable estimate of the welfare level of the population and are preferred for the poverty rates calculation, including for the purpose of monitoring MDG. The table 2 shows the evolution of poverty rates considering both approaches. A preliminary conclusion for this subject is that for the moment Moldova manages to achieve the intermediate targets of poverty reduction, but the slow down of the poverty decrease raises concerns.

**Table 2. Poverty Reduction MDG achievement**

	2000	2001	2002	2003	2004
International poverty line of 2.15 US dollars PPP per capita /day (MDL/per capita /month)	167.5	183.9	193.7	216.2	239.5
Poverty rate (income per capita )	64.5	52.4	29.9	28.9	27.8
Poverty rate (expenditures per capita)	63.5	50	25.6	25.1	23.9

Source: MET on the basis of HBS

### Demographic and other poverty aspects

46. Area of residence, source of income, household composition and the characteristics of the household head are important when determining poverty risk of a household. Considering the area of residence, there are significant differences between the urban and rural areas. The most essential poverty reduction has been registered in the big cities. Poverty risk in the big cities, Chisinau and Balti, is about five times smaller than in small cities and rural areas. Just 7% of the population of big cities was considered poor in 2004, compared to one third in the other regions. The consumption level of the households in the big cities is estimated to be 30% higher than in the rural areas.

47. Households living in small cities are in a less favourable situation. The living conditions in these localities are more difficult, and as a result, each third person was living in absolute poverty in 2004. At the same time, the positive trends in the economic development had a positive impact on the poverty depth, which approached the level of poverty depth in rural areas in 2004.

48. In the rural areas, poverty reduction has stagnated in 2004. Rural residents earn the main income from the agricultural activity and social transfers. Widespread rural poverty is associated with the fact that a considerable share of rural population is involved in the agricultural sector, which is characterized by low labour productivity and reduced incomes. The farmers and the employees in the agricultural sector represent 40% and 18% accordingly out of the total poor population in the rural area. Given that in Moldova the majority of the rural households, and about 66% of the households of small towns, have land plots, the draught from 2003 and the deterioration of the material situation of the rural households in 2004 has generated an increase of extreme poverty<sup>7</sup>.

49. Individuals over 75 years and children have the highest risk of living in poverty. Children living in rural areas face a 2.6 times higher poverty risk than those living in urban areas. Large households and those with many children are also confronted with an increased risk of living in poverty. The poverty rates increase with the number of children present in a household. Forty percent of the households with 3 or more children are considered poor. The

<sup>7</sup> The increased prices for fuel also contribute to production expenditures increase, as they constitute the biggest part out of the total expenditures of the agricultural producers.

risk associated with the presence of children in the household is much higher in the rural area than in the urban area.

50. Education represents another factor that influences the level of poverty. Individuals with a higher level of education have a better position in the labour market and frequently earn more than those with lower education. Most of the poor individuals (41%) are living in households with a head with incomplete secondary or primary education.

51. Employment does not ensure an adequate protection against poverty. Sixty eight percent of the poor live in households whose heads are employed. Persons from households, whose heads are employed in agricultural activities, especially as agricultural workers, are exposed to the highest risk of poverty. Usually, these are unskilled workers whose income is much lower than that of the other socio-economic groups. The poverty risk in the households, in which the social benefits represent the main source of income, is the biggest. More than 36% of these households are poor.

### Chronic and subjective poverty

52. Based on the analysis of the panel data of the HBS, approximately one third of the sampled households have been chronically poor, and two fifths were occasionally poor in the period of 2001-2004<sup>8</sup> (Table 3).

53. Chronic poverty is a serious problem, especially in small towns. Over a half of households were chronically poor in the period between 2001-2004. Temporary poverty is a bigger problem in the rural areas. As a result of the research we can observe that 43% of households were considered poor at least once in four years, even though their average consumption over the period was above the poverty line. Volatility of incomes in the households that are involved in agriculture represents the main factor that explains the relatively high share of temporarily poor households.

**Table 3. Persistent poverty by area of residence, 2001-2004, %**

	Total households		Chronic Poverty		Temporary poverty		Non-poor	
	Structure	Incidence	Structure	Incidence	Structure	Incidence	Structure	Incidence
Big cities	13.7	5.9	13.5	10.8	31.1	26.1	55.5	
Small cities	17.5	28.8	51.7	14.9	33.8	8.7	14.6	
Rural	68.8	65.3	29.7	74.3	42.6	65.2	27.7	
<i>Total</i>	100.0	100.0	31.3	100.0	39.5	100	29.2	

*Source:* MET, on the basis of HBS panel data

54. The chronic poverty risk increases with the number of children in the household. About 6 out of 10 households with 3 or more children lived in chronic poverty during the research period. Households of this kind are about two times more exposed to chronic poverty, than those who have one child or no children at all. The biggest temporary poverty incidence rate is for households with two children and households with no children. About 44% out of the households with 2 children, had on average consumption expenditures level higher than the poverty line, but were at least once poor in 4 years.

55. In order to provide a comprehensive assessment of poverty in the Republic of Moldova, the subjective perception of the population has been evaluated as well. Approximately 46% of

<sup>8</sup> In order to differentiate chronic poverty from the temporary poverty, we have used the categories described by Hulme and Sheperd (2003). Chronically poor households are households that have been poor in every year (persistently poor) and households whose average consumption level over the four years has been below the average poverty line (usually poor). Temporarily poor households (transient poverty) have been poor at least once during the four-year period, but have an average consumption level higher than the poverty line.

the interviewed households were considering themselves poor in 2004. In rural areas more households consider themselves poor (48%) than in the urban area (43%), confirming the results of the quantitative analysis. Nevertheless, the difference is much smaller in the context of the subjective method.

56. Subjective poverty rates are higher than those based on monetary evaluation of poverty. Seventy five percent of the households that consider themselves poor are not poor according to the monetary indicator. Twenty nine percent of the households, that consider themselves not poor, are objectively poor. Clearly, the subjective perception of the living standard is a relative concept that depends also on other factors besides the monetary welfare.

57. For the majority of respondents the notion of poverty, regardless of the place of residence or if they are considering themselves as poor or not, is associated with low income (78%). Bad health, insufficient nutrition, bad living conditions, low educational level and economic security, are other aspects related with the subjective perception of poverty.

## Conclusions

58. Economic growth policies and income redistribution undertaken in the context of EGPRS implementation have contributed to the increase in income and improved access of population to the social services.

59. The overall trend of decreasing poverty and inequality continued in 2004. Twenty seven percent of the population lived in absolute poverty in 2004, with a level of welfare of less than MDL 328 per month per adult. Each seventh citizen (15%) can be considered to be extremely poor, which means that his/her consumption was below the extreme poverty line of MDL 257 per month. Inequality rates have reduced, but to a smaller extent and not as constant as the poverty rates. As for the moment, Moldova is accomplishing the intermediary targets of poverty reduction set in MDGs, but the slowdown of poverty reduction pace in 2004 raises concerns.

60. Poverty is strongly correlated with economic growth. Over the period of 2002 – 2004, poverty rates decreased with 14.5 percentage points. About two third of the decrease in poverty rates can be attributed to economic growth, and one third to redistribution between households. The redistribution from wealthier to poor households also contributed to the reduction of poverty, especially in rural areas, while economic growth was more important in small towns for the decrease in poverty.

61. The poverty profile of Moldova is characterized by large differences between urban and rural areas. Poverty reduction in rural areas stagnated in 2004. It even slightly increased. The slowdown of poverty reduction in rural areas as observed in 2004 can be mainly attributed to negative growth of household consumption. The drought in 2003 had a detrimental impact on farming households and is most probably the main factor underlying the disappointing poverty developments in rural areas. The poverty risk in the two main cities, Chisinau and Balti, is almost five times less than in small towns and rural areas. Only seven percent of the population living in the big cities was poor in 2004, compared to one third in the other regions.

62. Children and the very old people (75+) are the most vulnerable groups. They have a higher poverty risk than the rest of the population. Especially vulnerable are infants living in rural areas. This needs to be taken into account when promoting social protection policies targeted to the poor.

63. One third of the population was chronically poor between 2001 and 2004. Forty percent could be considered to live in transitory poverty, which means that they have been poor at least

once during one year. In small towns, more than half of the population is chronically poor, and one fourth was chronically living below the extreme poverty line. This applies only to 13% of the population in the two major cities.

64. Poverty is not deep and most of the households are concentrated close to the poverty line. Accordingly, promotion of certain efficient policies targeted towards the poor people can have a significant impact in achieving the poverty reduction objectives.

## 2. ECONOMIC DEVELOPMENT TRENDS

### Macroeconomic evolution and quality of economic growth

65. Statistics with regard to socio-economic development show the maintenance of economic upward trends in most sectors of national economy in 2005. The base case scenario of the forecast set out in the EGPRS suggested a 5% increase of the Gross Domestic Product (GDP) in 2005. In reality GDP reached MDL 36.7 billion, 7.1% more (in comparable prices) compared to the previous year. Starting with 2000, GDP growth exceeded 43%, while during 1992-1999 it decreased by almost 60%. In 2005, the GDP per capita exceeded US\$860<sup>8</sup>.

66. In 2005, gross value added (GVA), i.e. GDP production component, increased by 4.5%, while taxes on products and imports increased by 22.5% (Table 4). Import taxes accounted for the largest share. The value added in the area of goods production increased by 2.9%, and by 5.1% in services rendering area.

**Table 4. Gross Domestic Product by categories of resources**

	Growth						Structure					
	2000	2001	2002	2003	2004	2005	2000	2001	2002	2003	2004	2005
<b>Gross value added</b>	<b>100.3</b>	<b>105.8</b>	<b>106.5</b>	<b>104.2</b>	<b>108.3</b>	<b>104.5</b>	<b>87.5</b>	<b>88.0</b>	<b>87.3</b>	<b>85.2</b>	<b>85.9</b>	<b>83.6</b>
<b>Goods - total</b>	<b>105.8</b>	<b>107.2</b>	<b>102.7</b>	<b>101.2</b>	<b>114.0</b>	<b>102.9</b>	<b>41.7</b>	<b>41.1</b>	<b>38.3</b>	<b>35.9</b>	<b>34.7</b>	<b>31.2</b>
Agriculture	102.3	107.4	105.1	89.1	120.4	101.8	25.4	22.4	21.0	18.3	17.6	14.3
Industry- total	110.8	107.0	99.8	116.0	107.4	104.1	16.3	18.7	17.3	17.6	17.1	17.0
Processing industry	115.9	105.5	102.9	117.8	107.8	102.2	14.2	15.8	14.9	15.4	14.5	14.5
Electricity, gas, water	93.6	117.0	80.5	103.0	100.9	115.4	1.9	2.7	2.2	1.9	2.2	2.1
<b>Services - total</b>	<b>90.2</b>	<b>104.8</b>	<b>109.4</b>	<b>107.1</b>	<b>104.0</b>	<b>105.1</b>	<b>48.2</b>	<b>49.2</b>	<b>51.0</b>	<b>51.6</b>	<b>53.5</b>	<b>54.4</b>
Construction	69.7	124.5	105.7	116.7	127.4	101.0	2.7	3.1	2.9	2.9	3.4	3.5
Trade	76.1	100.9	103.4	106.4	95.9	102.1	12.5	12.0	11.0	10.7	10.6	10.6
Transportation and communications	121.4	109.1	109.4	109.0	105.2	106.8	9.5	10.4	10.0	10.8	11.8	12.1
<b>Financial intermedearies services</b>	<b>46.4</b>	<b>110.2</b>	<b>101.2</b>	<b>122.7</b>	<b>102.9</b>	<b>91.8</b>	<b>-2.4</b>	<b>-2.3</b>	<b>-2.1</b>	<b>-2.3</b>	<b>-2.3</b>	<b>-2.0</b>
<b>Net taxes on products and imports</b>	<b>117.2</b>	<b>108.6</b>	<b>117.7</b>	<b>123.4</b>	<b>102.1</b>	<b>122.5</b>	<b>12.5</b>	<b>12.0</b>	<b>12.7</b>	<b>14.8</b>	<b>14.1</b>	<b>16.4</b>
<b>GROSS DOMESTIC PRODUCT</b>	<b>102.1</b>	<b>106.1</b>	<b>107.8</b>	<b>106.6</b>	<b>107.4</b>	<b>107.1</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Source: NBS

67. GVA growth in agriculture decreased from 20.4% in 2004 to 1.8% in 2005 and that of industry decreased from 7.4% down to 4.1%. In electricity, gas and water supply sectors, GVA increased by 14.5, transportation and communications sectors registered a 6.8% increase, and processing industry, agriculture and constructions increased by 2.2%, 1.8% and 1% respectively.

68. The irregular evolution of GDP components led to changes in its structure. Due to an increase of 16.4% of taxes weight in GDP, the share of production sector reduced from 88% in 2000 to 83.6% in 2005, of which the share of goods production shrank from 42 to 31%, whereas the share of services increased from 48 up to 54%.

69. A positive trend is the growth of gross capital formation (11%), which exceeded both final consumption growth (9.5%) and the increase of GDP (7.1%). At the same time, the impact of this indicator on GDP growth increased from 2.4 up to 2.9%, i.e. by 0.5 p.p., while the contribution of final consumption increased from 2.2 to 9.9%, i.e. by 7.7 p.p. The absolute growth of final consumption exceeded GDP growth by 40%, while domestic demand (final consumption and gross capital formation) increased almost twofold. From 2000 until present,

<sup>8</sup> The revised figure of population according to census data from 2004 was used for calculations in the report.

the growth of final consumption and domestic demand exceeded the GDP growth on average by 12% and 13% respectively (Table 5).

70. While the growth of public and private administration final consumption is largely due to the introduction of the medical insurance system, the increase of final household consumption was largely due to money transfers from Moldovan citizens working abroad and, to a smaller extent, due to a 20% increase in the average wage (Figure 2). According to preliminary data of the balance of payments for 2005, remittances of citizens working abroad made up US\$890 million (30% of GDP versus 27% in the previous year), which is a 29% increase or US\$188 million more than the previous year level.

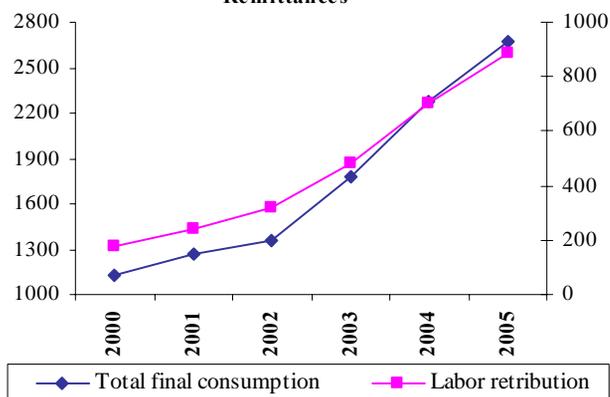
71. The increasing demand that was largely due to the intensification of inflow of remittances from abroad, coupled with insufficient domestic production in terms of volume and structure, resulted in an increase of imports. In the upshot, over 82% of the increase in the domestic demand is satisfied by growing imports. On the other hand, in 2005, the amount of domestic and aggregate growth increased to 138 and 191% of GDP, compared to 130 and 182% in 2004. This was only possible due to the increase of imports, which led to a raise in the negative balance of net exports (Figure 3). During the previous year, the amount of imports in current prices grew by 30% and increased virtually twice, compared to the GDP growth, while exports increased only by 19%.

72. According to the 2005 balance of payments data, the level of imports of goods and services coverage by exports decreased from 62% in 2000 and 57% in 2004 and down to 50% in 2005. At the same time, the ratio of trade deficit in the GDP increased from 23% to 29% and to 39% respectively.

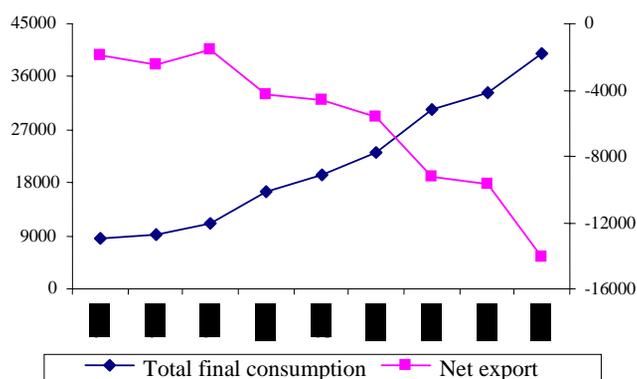
73. The modest performance of exports was caused also by difficulties in traditional export markets, like the emergence of additional problems regarding the export of alcoholic beverages to the Russian Federation, i.e. introduction of new excise stamps as well as hold up of agricultural

	2000	2001	2002	2003	2004	2005
<b>Total final consumption</b>	<b>117.2</b>	<b>104.4</b>	<b>109.7</b>	<b>115.4</b>	<b>102.0</b>	<b>109.5</b>
Final household consumption	120.7	106.1	105.9	118.5	106.2	110.1
Final consumption of public and private administration	100.4	94.2	131.4	103.2	83.8	106.3
<b>Gross capital formation</b>	<b>111.9</b>	<b>105.2</b>	<b>101.1</b>	<b>113.5</b>	<b>110.5</b>	<b>111.0</b>
Gross fixed capital formation	91.3	117.3	105.7	118.6	108.2	110.2
<b>Net export</b>	<b>224.6</b>	<b>98.5</b>	<b>109.1</b>	<b>148.8</b>	<b>91.8</b>	<b>118.8</b>
Export	109.5	117.2	119.0	119.2	111.0	117.6
Import	132.3	110.6	115.7	128.7	103.6	118.1
<b>GROSS DOMESTIC PRODUCT</b>	<b>102.1</b>	<b>106.1</b>	<b>107.8</b>	<b>106.6</b>	<b>107.4</b>	<b>107.1</b>

**Figure 2. Relationship Final consumption – Remittances**



**Figure 3. Relationship Final consumption – Net export**



products imports from Moldova. Alongside, high sanitary and phytosanitary norms in European Union countries are an impediment to the export of animal origin products to these countries and Romania. Generally, even though in 2005, exports to European Union countries and to Central and Eastern Europe increased by 9.5 and 15% respectively, the non-compliance of the national quality system with European standards, a more advanced preferences system and structural funds granted to countries with an advanced level of integration, results in a reduction of Moldovan products competitiveness, both on external and domestic markets.

74. Another factor that on the one hand, contributed to the increase of import value and on the other to the decrease of export competitiveness was the rise in fuel prices. The amount of mineral products (fuel, electricity, etc.) imported in 2005 increased by 31.3% and accounted for 22% of total imports. Generally, besides energy sources, the following categories prevail in the structure of imports: automobiles and devices, electric appliances and parts thereof (13.9%), products of the chemical industry (10.1%), textile items and products (7.8%) and common metals (7.0%). Most of these goods are non-substitutable. However, the large and growing amount of imports has also an objective explanation, as Moldova inherited an economic structure that is dependable on imports in amount of 70%.

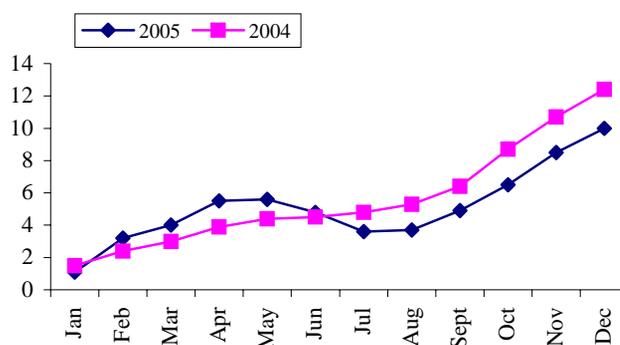
75. Another medium term objective is the decrease of inflation aimed at ensuring favorable conditions for free initiative and investment activities, as well as for the protection of population's real incomes. Ensuring a relatively stable price level is a compulsory prerequisite for a sustained economic growth.

76. In April 2005, inflation was 5.5% higher compared to December 2004 (Figure 4) and exceeded 14% compared to April 2004. The problem was that from November 2004 until January 2005, inclusively, the NBM purchased more than US\$85 million, increasing the money supply by more than MDL 1 billion. During the first two months of the previous year, money supply increased by 1% (MDL 117 million) and bank reserves grew by 44% (MDL 710 million). In this case, there was a great risk of targeting the huge liquidity flow into channels of monetary circulation, thus speeding up the inflationary process.

77. By applying sterilization market tools (issuance of NBM certificates and deposit auctions), by June 2005, NBM reduced the currency base and bank reserves by 2 and by 10% respectively, compared to the beginning of year level. The average monthly amount of financial means attracted in 2005, exceeded MDL 700 million, while throughout the previous year, attracted financial means made up MDL 230 million, including operations with state securities. As a result, inflation climbed down, while the seasonal summer decrease of prices for fruits and vegetables actually created deflation.

78. In December 2005, the inflation rate was 10% compared to December 2004, registering a 2.5 p.p. decrease compared to the respective period of 2004. The reduction of the general level of inflation was influenced by a decrease in the growth rate of food products by 4.4 p.p. and that of tariffs for services by 5.2 p.p. Concurrently, the prices for non-food items grew by 3 p.p.

Figure 4. Inflation rate at the beginning of the year



79. The national currency exchange rate policy is another important factor that defines country's macroeconomic stability. The exchange rate dynamics, which defines the external aspect of national currency stability, is essential, both for economic agents, natural persons and overall economy.

80. NBM policy concerning MDL exchange rate is targeted to the lessening and non-admission of sudden fluctuations of MDL exchange rate by using indirect tools for the management of monetary liquidity. As mentioned above, the sudden increase of liquidities at beginning of the year caused grave risks with regard to the intensification of inflationary and depreciation processes. An important factor of liquidity growth was the flow of remittances of Moldovan citizens working abroad – a trend that has been in place for a number of years.

81. Although the inflow of foreign exchange during the current year increased, not only was NBM able to control the monetary factors of inflation but it prevented an excessive appreciation of MDL through the purchase of surplus currency. This also helped avoid sudden changes of MDL exchange rate (Figure 5). It was largely due to the use of above mentioned sterilization tools.

82. Throughout the year, NBM purchased more than US\$170 million on the foreign exchange market and issued over MDL 2.2 billion. With all that, in 2005, the monetary base increased by 31.8%, money supply M2 by 36.7% and the money supply M3 by 35%. At the

same time, the national currency depreciated by 3%. Official foreign exchange reserves at the end of 2005 were at US\$597.4 million covering 2.7 months of imports.

83. Meanwhile, the analysis of the structure and factors of economic growth in Moldova in 2005 shows a large dependence of country's economy on external economic factors. This highlights the particular importance of balance of payments situation and the trends in relations with "the rest of the world". The trade deficit grew by 51% versus 21% in 2004 and reached the level of US\$1.1 billion. Consequently, its ratio to GDP increased from 29 to 39%. If in 2004, the growth of the trade deficit was to a large extent funded on the expense of increasing current incomes and transfers, resulting in a decrease of the current account deficit, the situation changed in 2005. If in 2004 the amount of remittances grew by US\$217 million and the trade balance deficit by US\$131 million, in 2005 the growth was US\$188 and 386 million, respectively. As a result, the current account deficit increased more than twice and amounted to **US\$213** million with its ratio in the GDP increasing from 2.7 to 9.8%.

84. In these circumstances, two tendencies occurred in 2005. Firstly, the pace of remittances growth decreased; in 2005 this growth was 27% versus 45% in

Figure 5. Exchange rate (end of period)

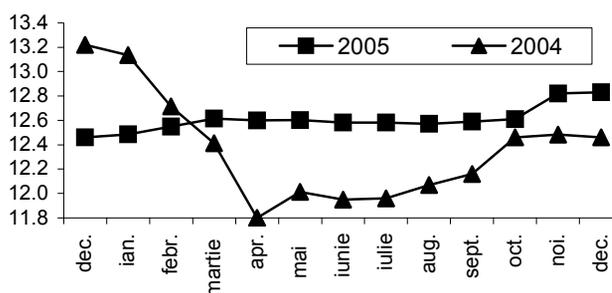
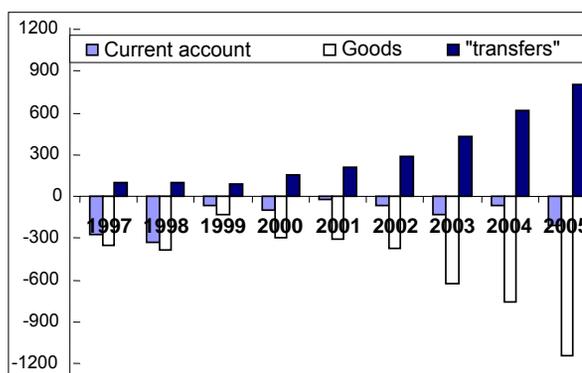


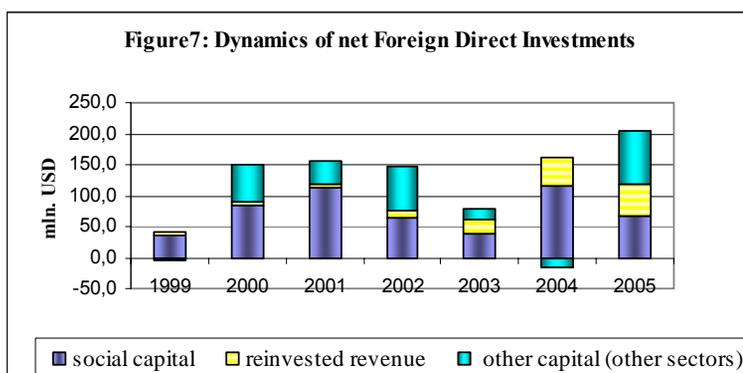
Figure 6. Foreign currency availability



2004. The smaller rate of transfers' growth did not allow covering the increase of imports. Secondly, the incomes of Moldovan citizens working abroad and the increase in labor retribution and other incomes are enough however to fund consumption imports (Figure 6). Meanwhile, another component of imports and namely imports of investment goods and raw materials exceeds the capacities of the domestic economy, as the currency revenues from exports and remittances are not sufficient to pay for it. A part of investment imports and raw materials is funded on the expense of credits, which leads to the increase of country's external debt.

85. Thus, while the state debt decreased by 12%, private debt increased by 19%, causing a 5% growth of external debt. In the structure of private debt, commercial loans grew by 29%, long-term loans grew by 11% and direct investments credited by the parent firm increased in the amount of 50%. Out of the total growth of private external debt in amount of US\$192 million, US\$50 million account for commercial loans, US\$28 million account for long-term loans and US\$92 million are direct investments, credited by the head firm. Therefore, the increase of imports and trade deficit occurs not only on the expense of increasing consumption demand fuelled by remittances but also as a result of an increased demand for investment goods and raw materials, which in turn are funded from loans (respectively an increased debt). This is the reason for the essential increase of the current account deficit.

86. Investments have an important role in ensuring a sustainable economic growth. Relatively high interest rates for loans and reduced lending terms grant an even greater role to direct foreign investments. In 2005, the value of direct foreign investments increased by 44% of which investments in economy grew by 41%. It should be mentioned however that investments in social capital decreased from US\$116 million in 2004 to US\$65 million in 2005 (44%). Generally, investment growth was mainly caused by an increase of investments in other capital (loans from parent firms) from "minus" US\$16 to 84 million, as well as the increase of re-invested revenue by 15% up to US\$53 million.



87. The analysis of foreign direct investment dynamics during the last 7 years shows that a serious growth of investment in social capital takes place especially in the context of privatization through capital increase at the time of purchase and later at the time of accomplishing investment commitments (Figure 7). During a passive privatization process, foreign investments in social capital remain rather modest.

## Conclusions

88. Despite the fact that in 2005, GDP growth exceeded EGPRS parameters, the attempts to improve growth quality and reverse some alarming macroeconomic trends have failed. Economic and investment growth occurred on the background of a slow economic restructuring, decrease of industrial growth rate, especially in the processing industry. Imports grew faster than the GDP determining an increase in the share of net taxes on products and imports.

89. Gross capital formation increased by 11%, which exceeds GDP growth and is slightly greater than final consumption growth. On the other hand, the growth of households' final

consumption is virtually equal to the increase of investments in fixed capital. The growth of final consumption and the gross capital formation is defined to a large extent by the flow of remittances from abroad and partially from wage growth. Domestic and aggregate demand is largely satisfied by imports. As a result, any measures to limit imports may lead to GDP decrease and a reduction of final consumption and investments. In this case, there is need for rational policy to stimulate the export of goods and services, especially based on extending current industries oriented to exports and creation of new industries of this type.

90. The import of investment goods and raw materials is funded from export revenues and partially on the account of an increased external debt. At the same time, the increase of the trade deficit is not fully offset by the increase of other components of the current account (balance of services, incomes and current transfers), which led to a significant increase of the current account deficit.

91. Exports to eastern markets are affected by the emergence of new barriers, especially in the case of exports to Russia. Meanwhile, Moldovan products competitiveness, both on the European and domestic markets is reduced because of the non-compliance of the national quality system with Europeans standards, as well as the differences in the system of preferences and structural funds to countries that are at a more advanced level of integration.

92. The higher growth of imports versus exports has an objective explanation, since Moldova inherited an economic structure that is dependable on imports in amount of 70%. Generally, in 2005, the structure of imports continues to be dominated by the following categories: 22% energy sources, automobiles and devices, electric appliances and parts thereof (13.9%), products of the chemical industry (10.1%), and common metals (7.0%). Most of these goods are non-substitutable.

93. The big flow of remittances (30% of the GDP), imports increase (77.5% of GDP), deficit of trade balance (39% of the GDP) and the deficit of the current account (9.8% of GDP) highlights an increased dependence of economic growth and overall economic situation on external factors. In these circumstances and in case of insufficient restructuring of economy, and a low level of investments, country's external vulnerability is growing, therefore the prospect of economic growth sustainability and poverty reduction may become uncertain if there is no immediate action for recovery. These actions are as follows: real optimization of business climate, creating conditions that would favor the funding by financial institutions, including commercial banks but also direct foreign investments of prospective investments projects, improving the management of state assets, promotion of public and private partnerships in the creation of production infrastructure etc.

### **The evolution of revenues and expenditures. Public finance management**

94. During this period, budgetary policy was focused on continuing the efforts to introduce elements of medium term financial planning, as well as the extension of program budgeting. The budgetary and fiscal legislation reform continued. The link between the budgetary process and regulatory reform was ensured providing for the reduction of paid services, rendered by state bodies funded from special means earmarked in the national public budget.

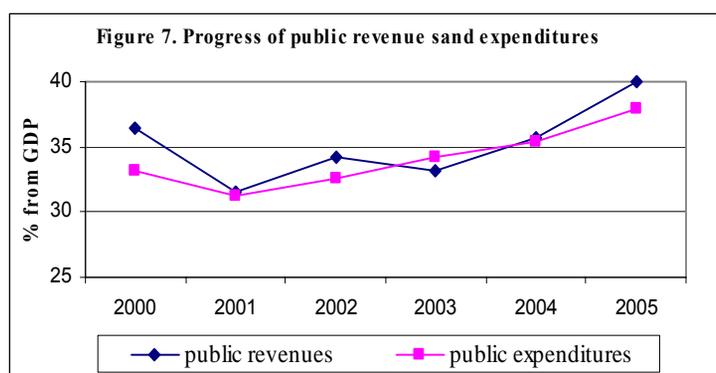
95. The Medium Term Expenditures Framework (MTEF) for 2006-2008 is characterized by development and improvement, extending the application of elements of analysis and strategic planning of public expenditures. The agricultural sector was additionally included in the MTEF (2006-2008) by drafting the respective technical note. MTEF started at the local level by involving the strategic analysis of three pilot rayons – Orhei, Ungheni and Glodeni.

96. In view of consolidating financial discipline, efforts continued for the development of the treasury system in 2005, and enhancement of budget execution procedures. During 2005, a Public Financial Management Project was under preparation. The loan agreement with IDA was ratified by the Parliament in November 2005. The concept paper regarding the new information system integrated with public financial management, the modernization plan, as well as the design of the future system was developed within the framework of the project. The mechanism of executing the revenues of the state social insurance budget through the treasury system was developed in cooperation with the National Social Insurance House. Starting with January 1<sup>st</sup>, 2006 these revenues are being managed through the treasury system.

97. During the current year, the Ministry of Finance started the process of adjusting the budgetary classification to GFS 2001 standards of the International Monetary Fund. Concurrently, the adjustment of Methodological norms regarding the accounting in the public system to international standards was initiated. During the previous year, the draft Law on public debt and state guarantees, and draft Law on audit were developed.

98. In the context of an efficient use of public expenditures through monitoring of performance indicators, the annual Report on budget execution for 2004 included an analysis, which describes programs execution through the prism of performance indicators. A quarterly financial report was created in 2005, regarding the execution of program budgets and currently published on Government's web page.

99. In 2005, as a result of these actions, the national public budget accumulated revenues in amount of MDL 14.7 billion, which is 3.3 billion or 28.8% more than in 2004. The state budget collected revenues in amount of MDL 9.1 billion, which is 37.9% more than compared to the respective period of the previous year. The main revenues made up MDL 7.8 billion, exceeding by 40% the level of collections from 2004. The revenue part of ATUs budgets in 2005, increased by MDL 843 million or by 28.7% compared to 2004.



100. According to preliminary estimates, total public expenditures grew from MDL 11.3 billion in 2004 to MDL 13.9 billion in 2005, with a concurrent increase of all elements of the global expenditures framework.

101. The structure of budgetary revenues did not suffer any significant change. The main part of fiscal payments was created by indirect taxes and fees on external trade transactions, followed by contributions for medical and social insurance. Contributions to the social insurance and medical budget are similar to taxes but are not identical from the point of view of tax legislation, since the first ones become onerous, in case if payment of insurance is required: illness, child birth etc. and therefore are different from taxes and fees.

102. Direct taxes made up MDL 5,272.1 million or 35.9% in the total amount of national budget revenues. Indirect taxes accounted for MDL 6,475.9 million (44.1%) and were collected at a level of 100.4% compared to annual reviewed provisions. Throughout the reporting year, other revenues (including revenues from special means and funds, grants, proceeds from privatization and sale of public goods) were collected at a level of 102% as compared to budget

provisions, from the account of reducing the amount of special means (paid services) in the context of the regulatory reform. At the same time, the share of above-mentioned revenues within the national budget made up 20% (by 2.4% more than in 2004).

103. The major share in the structure of indirect taxes, and namely 71.4% relate to VAT, which makes up MDL 4,623.2 million of which VAT on goods and services rendered in Moldova – MDL 1,577.6 million, VAT on imported goods – MDL 4,051.8 million (87.6%); VAT refunds on goods and services exported and delivered at decreased rates – MDL 1,006.2 million (22%). During the reported year, excises made up MDL 1,171.96 million or 18.1% from the total amount and taxes on external trade and operations – 10.6% from total indirect taxes.

104. Thus, taxes on consumption and import continue to represent the basis for the creation of budget revenues – a fact that cannot be viewed as an element of fiscal sustainability. The medium term forecast for 2006-2008 indicates that the structure of national budget revenues will not change. The share of taxes in the GDP will be maintained at the level of 35%-36%. Just as in 2005, taxes on consumption and import will prevail.

105. In 2005, public expenditures did not achieve the forecasted amount of 7.3%. The analysis of the structure of public expenditures in the reporting period shows that almost 63.3% from public expenditures account for socio-cultural expenses of which for social assistance and insurance – 30.4%, education - 19.3%, health protection 11.3%. Approximately 14.1% of public expenditures account for expenditures related to economy sectors. Compared to 2004, public expenditures in the socio-cultural area registered an increase of 24.9%, and public expenditures for economic development increased by 45.4%, compared to the general growth of 23.8% of national public budget.

106. In 2005, MDL 616.6 million from budget expenditures were used to finance capital investments, by 2.8 times more than in 2004, concurrently their share in the total amount of main expenditures of the state budget increased (from 4.1% in 2004 to 8.9% in 2005). However, expenditures for public investments and economic services remained compressed. Given the unsatisfactory and deteriorated state of public infrastructure this low level of expenditures inhibits the prospects for an economic growth in the future.

107. Public debt decreased from 73% of GDP in 2000 to 33.2% in 2005, while the external public debt – from 60% of GDP to 23% during the same period. In 2005 state debt made up a total of MDL 12.2 billion, increasing by MDL 262 million compared to the beginning of the year as a result of increased internal debt and exchange rate fluctuations. In 2005, US\$ 52.4 million were used to service the external debt. Concurrently, a special account was opened in order to pay off the debt to the Paris Club. At the end of the year, almost MDL 100 million were deposited on this account, with another MDL 100 million planned to be collected this year.

### **Funding EGPRS priorities**

108. Monitoring the funding of EGPRS actions and measures is an important element of the monitoring and evaluation system. MTEF that was developed as a tool to plan public financial resources for a medium term should define the allocation of funds for the strategy goals within real budgetary and fiscal limits.

109. It is difficult to track the allocation of financial resources for EGPRS priorities for two reasons: (i) costs of actions and programs set out in the EGPRS are rather approximate, since public institutions have reduced capacities for medium term budget formulation and (ii) current budget classification does not allow tracking the allocations separately by actions. Moreover,

within the previous MTEF, some public institutions formulated other priorities than those agreed in the EGPRS.

110. Despite these limitations, the Ministry of Finance was able to present an estimation of the general distribution of resources by areas included in the strategy. The total allocated amount for the areas included in EGPRS was MDL 2,042.7 million of which 1,392 million were allocated in 2005. At the same time, only a part of these resources may be tracked for specific actions of EGPRS and namely:

- for *private sector development*, MDL 104.8 million allocated versus MDL 83.8 million as provided by the strategy. Most of the funds were allocated for the optimization of customs procedures, creation of the informational climate in the customs sector and creation of the real estate cadastre.

- for the *public administration reform*, out of MDL 26.3 million set out in the strategy, MDL 17.7 million were allocated. Public finance management and legal system enhancement were prioritized.

- for the *development of infrastructure, industry and agriculture* - MDL 910.4 million versus MDL 610.6 million as provided in the strategy

- for *environment protection*, MDL 54.6 million versus MDL 108.5 million

- for *education, health protection, social protection, labor market development and youth policy* - MDL 256 million versus MDL 314.9 million were allocated.

Within the framework of the strategy, actions related to tax administration enhancement and financial sector development received funding. In this sense, MDL 4 million compared to forecasted amounts of MDL 4.1 million were allocated.

111. Generally, actions set out in the EGPRS were funded both from the national public budget and from external sources, subject to priority areas/actions. This was possible as a result of changes made to the format of the national budget and inclusion of financial means from loans and grants.

112. The monitoring of financial coverage of priority actions provided in the EGPRS highlighted the need to specify the cost of priority actions, taking into account all funding sources and the need to enhance the current system of planning and budget forecasting. To a certain extent, social area represents an exception.

113. The problem of enhancing strategic methods used while planning public revenues and expenditures is subject to improvement during 2006-2007 and will be carried out by the Ministry of Finance with the support of the World Bank. Concurrently, at present, a better collaboration at the level of relevant public institutions is needed, in order to ensure a better quantification of EGPRS costs and a better adjustment of MTEF priorities to those of EGPRS. This will allow the state bodies to reason the policy promoted and measures of accomplishment, whereas the Ministry of Finance and other bodies will be able to correlate the mandates (qualitative and quantitative indicators) of respective bodies with the funding.

## **Conclusions**

114. Efforts aimed at improving medium term financial planning, enhancement of tax administration, consolidation of financial discipline, allowed the budget execution at a level of 100.6% for the revenues part and 92.7% for the expenditures part. Direct taxes made up 35.9 % and indirect taxes- 44.1%. The major share in the structure of indirect taxes, and namely 71.4%

is VAT, which makes up MDL 4,623.2 million of which VAT on imported goods – (87.6%). For the reporting year, excises accounted for 18.1% of the total amount and taxes on external trade and external operations – 10.6% from total indirect taxes. Hence, taxes on consumption and imports continue to represent the basis for the creation of budget revenues – a fact that cannot be considered as an element of tax sustainability.

115. MTEF improvement and broadening allowed for a better allocation of resources. Social sectors continued to account for most of public expenditures – 63.3% of which insurance and social assistance accounted for 30.4%, education – 19.4%, health protection – 11.3%. Approximately, 14.1% of public expenditures account for expenditures for economic sectors. Compared to 2004, they registered a growth of 45.4% versus the general 23.8% growth of public budget expenditures.

116. Despite these progresses, expenditures framework was not fully adjusted to EGPRS priorities. Moreover, the increase of allocations within MTEF is not necessarily followed by a real progress related to the improving the efficiency of funds use. MTEF for 2006-2008, and the budget for 2006 continue to be socially oriented, ensuring a reasonable coverage of EGPRS priorities in social sectors including the funding of social infrastructure. Meanwhile, expenditures for public investments that could favor economic growth remain to be compressed. Given the unsatisfactory and deteriorated state of public infrastructure in Moldova, this low level of expenditures inhibits the prospects for a future economic growth.

117. During the process of EGPRS elaboration for 2007-2009, a more serious dialogue between relevant institutions was initiated with regard to the need of a better reflection of EGPRS and MTEF priorities. To this end, modifications in the action plan for MTEF development were introduced for a better synchronization with the process of monitoring and assessment of EGPRS implementation, which would allow for better information at the level of setting the sector ceilings for public expenditures and distribution of priorities within sectors.

### 3. ECONOMIC INFRASTRUCTURE

118. Findings and conclusions of the previous chapter indicate very clearly that currently, consumption, which is mainly satisfied from imports and is funded largely from remittances, represents a major source of GDP growth. The huge deficit of trade balance and that of the current account would not be sustained in the future, unless measures are taken to define the answer of domestic supply. Supporting and speeding up current growth pace might be ensured only by influencing its structure in view of transforming productivity in a driving force of growth. Productivity growth and that of national economy competitiveness will be ensured through continuing and amplifying structural reforms, namely: (a) further simplification and optimization of the regulatory framework; (b) ensuring the stability of the legal and fiscal framework; (c) infrastructure rehabilitation, including through promotion of public and private partnerships, but also through increase of public investments, (d) ensuring the consolidation of the innovative dimension of the development, (e) divesture of state property and improving the management of state assets, and (f) improving access to financing.

#### **Regulatory framework**

119. The state regulatory reform, initiated by the Government in 2004 and continued throughout 2005 is aimed at creating an open, flexible and cost reduced business climate that would facilitate investments and innovations in business. Only this type of environment will help Moldova adjust rapidly to new market risks and opportunities, and ensure the competitiveness of domestic production.

120. This reform, which represents a complex and long-term effort, envisages two major stages: (i) deregulation and simplification, and (ii) consolidation of the capacity of good regulation within Government institutions. During 2004-2005, a number of actions were taken within the first stage and namely (a) simplification and centralization of licensing procedure, (b) optimization of the registration procedure, (c) reduction of conflicts of interest between the role of inspections and the testing role of control agencies. The Law on reviewing and optimizing the legal framework regarding the regulation of business activities (regulatory guillotine) was drafted, allowing for a significant reduction of the number of normative acts that regulate business activity, and decreased the cost of authorization documents.

121. In view of ensuring a better transparency of the regulatory framework, the List of authorizations, permits and certificates issued for business activities was approved. It was created as a practical guide comprising authorizations, certificates and permits for entrepreneurs. For each of these, the issuing agency is expressly indicated, as well as the validity term and their cost (if they are no free charge), thus excluding the levying and collection by public administration authorities of illegal payments for authorizations. The list comprises 125 authorization documents of which 82 are issued free of charge. As a result of these actions, the number of licensed activities decreased to 37. The number of authorizations and licensing permission was reduced from 360 to 49. The validity term for 7 types of authorizations was increased from 1 to 3-5 years. Concurrently, the term of issuing the documents was reduced from 30 to 10 days at most (except for those for which respective laws, agreements and international conventions provide otherwise).

122. The experience gathered during the first stage of regulatory reform, as well as the experience of other countries in transition, points out the need to transform the regulatory reform in an ongoing, comprehensive and systematic effort of the entire Government, that could be supplemented by specific sector reforms. To this end, the Concept of regulatory reform based on the regulatory guillotine was developed representing the road map of the long term reform.

At present, the draft of the national Strategy with regard to the regulatory reform is being finalized and together with the implementation action plan will be proposed for discussion to counterparts in the first half of the current year. In compliance with the Concept, the second stage of the regulatory guillotine will start following a Parliament approval of the Law on basic principles and mechanisms of regulating the business activity, and will be completed by the end of 2007. This law will ensure the review and simplification of the legal framework (primary) that regulates the business activity.

123. The concept, presupposes as well capacity building in the area of good regulation, including through the creation of the regulatory management system for the control of the quality of laws and regulations, improvement of transparency, laws and regulations enforcement. An important element of reforms is the creation and institutionalization of the system of assessment of the regulatory impact, which is an activity that will be initiated during the current year.

124. The successful implementation of this complex reform depends to a great extent on the level of involvement of various public institutions of which some appear unwilling to ease the burden of regulations or renounce on the additional income they receive within the current system. The experience of the first stage of accomplishing the regulatory reform shows that the fight against inefficient and excessive regulations is difficult to implement, since public administration continues to introduce new regulations that are sometimes contradictory with previous decisions.

125. Studies carried out during the analyzed period clearly point out that though licensing procedures were reformed and consolidated within the Licensing Chamber; there are many reserves in relation to this matter. Thus, the need to introduce the principle of One Stop Shop in the licensing procedure and the examination of the possibility of applying the declarative principle for some types of activity is obvious. Equally, it is necessary to analyze the need and procedure of issuing certain permits that are similar to licenses called “authorizations” that appeared when the number of licensed activities was reduced.

126. The issue of enterprises liquidation remains a major problem. Currently, the procedure of enterprises liquidation lasts for more than one year and requires a large number of documents, such as, publishing the announcement in two consecutive issues of the Official Gazette, certain payments for the publishing and for services provided by the State Registration Chamber and State Archive Service. Even though this issue was identified and qualified as one that requires immediate attention, progresses in the simplification of procedure is null at the moment.

127. Excessive reporting represents another serious issue for enterprises. While for large companies it is relatively easy to afford costs associated with fulfillment of requirements with regard to reporting, small companies suffer a lot as a result of this provision. The current arrangement of filling in various declarations is difficult: absence of a centralized information system of reporting involves certain expenses and time during the manual filling out of various forms with the same figures for various public authorities.

### **Fiscal policy**

128. Following the objectives set forth in the EGPRS, the 2005 fiscal policy was consistent and predictable and was achieved through a gradual and planned reduction of the natural persons income tax rate, increase of personal and special relieves, reduction of the income tax rate on business activity, liquidation of fiscal facilities on indirect taxes unjustified from the

economic point of view, development of new provisions and enhancement of existent provisions with regard to the application of tax legislation, and optimization of tax administration.

129. In order to support small income population and gradually transfer the burden on medium and high income population, the low and medium income tax rate on natural persons was reduced with no modifications to the annual tax grid, from 9 to 14% set for 2005, to 8 and 13% in 2006. The maximum rate of natural persons' income tax will be maintained at a level of 20%. Further, personal annual relieves were increased from MDL 3,960 in 2005 to MDL 4,500 in 2006 and annual relieves for people under care (children, parents, other family members, etc) from MDL 600 in 2005 to MDL 840 in 2006.

130. Generally, the reduction of income tax rate had a positive result, both for natural persons and economic agents. In 2005, natural persons saved an additional MDL 60 million. According to estimations for 2006, the amount will make up approximately MDL 90 million that will be received from the reduction of income tax rates and relives increase.

131. The reduction of income tax rate on business activity from 20% in 2004 down to 18% in 2005 and 15% in 2006, contributed to saving MDL 70 million in 2004 and MDL 112 million in 2005. These funds were allocated for industry development and reduction of arrears to the budget. According to 2006 estimates, funds from the reduction of income tax rate will amount to MDL 100 million Besides, fiscal facilities to income tax offered to economic agents who make investments in the purchase of fixed funds and constructions, small business entities contributed to saving from MDL 240 million to MDL 280 million, or 35% from this tax collections to the budget.

132. Concurrently, there is a large group of inert activities, which are characterized by a null reaction to fiscal facilities. This measure had no influence on 47% of economic agents from the total number of businesses who are involved in business activity, since, both during 9 months of 2004, the respective period of 2005, and the same period of 2005, the activity of these enterprises was non-profitable.

133. The analysis of cost price structure in the economy, both in 2004 and 2005, shows that the share of direct taxes in the cost price, except for compulsory payments to social fund and for medical insurance is so insignificant that it has no serious influence on the cost price or on the price of goods. Throughout 9 months of 2004, direct taxes made up 0.5% in the cost price and 0.6% for the same period of 2005.

134. Taking into account compulsory payments to the social and medical insurance budget, these values are a bit higher and made up 4.4% for 9 months of 2004 and 4.8% for 9 months of 2005. Such a stability of social expenses in the cost price, shows that the policy in the field of compulsory contributions for social and medical social insurance, which is aimed at transferring the fiscal burden from economic agents to natural persons, virtually did not change the fiscal behavior of economic agents, and these expenditures are limited by them by means of indicating a reduced growth of labor retribution fund.

135. Hence, for 1 MDL indicated in the profit balance in the overall economy, the fiscal burden for the first 9 months of 2004 made up 1.9 MDL, for 9 months of 2005 -1.8 MDL (fiscal payments less the payments for the social and medical insurance were taken into account). The fiscal pressure as a proportion between the fiscal payments and GDP was not established during 2005. It made up 32.5% in the 1<sup>st</sup> quarter, 31.3% in the 2<sup>nd</sup>, 25.1% in 3<sup>rd</sup> but registered a decreasing trend. The overall fiscal pressure was about 32%. Fiscal pressure as a proportion between fiscal revenues and GDP is not large. Concurrently, the presence of a large number of

non-profitable enterprises shows the existence of more issues besides those related to fiscal policy.

136. The broadening of the fiscal base within the fiscal policy promoted in the field of indirect taxes was achieved as a result of reducing fiscal facilities both for equipment, drugs and other imported goods and local goods, which contributed to the reduction of the amount of unjustified fiscal facilities for this tax until MDL 555 million according to estimates for 2006 and MDL 1.018 million in 2004. Saved funds were used firstly for the support, development and improvement of agricultural sector infrastructure where the poorest population is employed.

137. As a result of canceling the voluntary registration of VAT payers, VAT policy as a main source of revenues to the budget, created discriminatory conditions for the activity of small and medium business entities. This issue will be considered in the context of developing a strategy on fiscal administration reform.

138. The implementation of the policy in the fiscal area through property tax, as one of the main sources of local budget revenues was targeted at the broadening of the tax base by levying taxes on natural persons, dwellers of non-privatized apartments in 2005. This action does not comply exactly with strategy's objectives. The improvement of fiscal administration process did not allow for an essential increase of revenues from this tax in 2004-2005, by transferring the fiscal pressure from owners of properties with a high level of comfort to the owners of simple properties. During 2000-2005, the amount of real estate tax grew only by 18.9% until MDL 36.5 million in 2005, in spite of a sudden growth in the real estate constructions and commercial properties during these years.

139. Generally, the objective of diminishing the fiscal pressure set forth in the Strategy was not fully accomplished. The fiscal pressure, as a share of taxes in the GDP during 5 years, has evolved as follows: 24.6% in 2000; 24.2% in 2001; 25.6% in 2002; 27.3% in 2003; 29.5% in 2004; 31.9% in 2005. The increase of fiscal burden indicator is determined by the increase of imports, and to a smaller extend by the elimination of some inefficient tax facilities, which deteriorated the fiscal administration system. The fiscal pressure may be reduced by decreasing the amount of imported goods and services, although according to estimations, the reduction of imports by at least 1% may lead to loss of budget revenues in amount of MDL 63 million. By all estimates, the fiscal burden in Moldova is relatively low compared to countries in the region.

140. To improve and streamline tax administration, a series of measures were carried out for the enhancement of tax collection mechanisms. Throughout 2005, formulas were developed with regard to a computerized selection of taxpayers subject to verification. As a result of errors compilation (maximum probability with regard to law infringement by taxpayers) overall risk degrees were assessed subject to which the selection of taxpayers is done at document control. To minimize the direct impact of the human factor, the number of fiscal controls carried out on the basis of risk factors for 2005 was 60% and it is envisaged to select 70% of economic agents in 2006.

141. From January 1<sup>st</sup>, 2006 permanent fiscal posts are liquidated within enterprises producing ethyl alcohol and strong alcoholic beverages. Fiscal control within these enterprises will be carried out by fiscal bodies through operative verifications. A series of actions related to the enhancement in the IT field of the fiscal area will be carried out, as well.

142. Taking into account the fact that the fiscal policy as a tool for economic growth and poverty reduction is linked to other economic levers, such as public administration reform, institutional and legal reform, essential results of the fiscal policy will emerge only after the implementation of mentioned reforms.

## Financial system

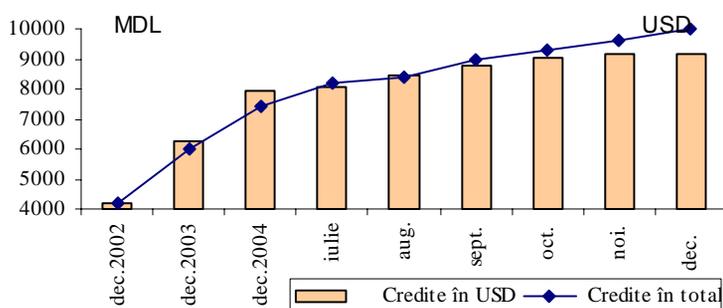
143. The National Bank and the overall banking system have an important place in the economic system and play a significant role in ensuring economic growth. The results of banks activity registered during the last years show progress in this area. FSAP mission assessed the banking supervision and regulation comprehensive enough and generally compliant with the main principles of Basel Committee for an efficient banking supervision. Generally, the banking system proves reasonable levels of revenues, capitalization and liquidity, as well as a reduced level of non-performing assets.

144. The strengthening of country's banking system continued through 2005. Consolidated assets of the banking system increased by 35.4% compared to 25% in 2004. As a share of GDP, bank assets increased from 42 to 49%. The level of monetization of economy (ratio of money supply M2 to the GDP) increased from 25% in 2004 to 30% in 2005. Equally, the degree of banking operations dolarization decreased from 56% in 2003 to 44% in 2005. Capital multiplier increased – an indicator of a further consolidation of the banking system. If in 2003, one unit of capital accounted for assets valued at 4.76% than in 2005 it was already 5.98.

145. Approximately, 60% from the assets of the banking system are composed of loans and they ensure 60% of banks' income. Due to insufficient floating capital at enterprises and the low level of domestic and foreign investments, the role of banking system as the main creditor of the economy grows significantly. Therefore, conditions for loans granting, amounts and loans terms, as well as the interest rate are important prerequisites of efficient restructuring of the economy and economic growth.

146. During 2004-2005, loans to economy in national and foreign currency increased by 1.8 and respectively 1.4 times (Figure 9). The total amount of loans granted in 2005 in MDL and USD made up MDL 9.0 and 4.4 billion and increased compared to 2004 by 58% and 27% respectively. The share of loans in national currency in the total amount of loans grew from 57% in 2003 and 58% in 2004 up to 63% in 2005. Meanwhile, the share of deposits in MDL in the total amount of deposits grew from 50 and 55 to 58% accordingly.

Figure 9. Crediting of the economy



147. As of 31.12.2005 the share of loans to industry and trade made up 48.1% registering an increase of 2.5 p.p. compared to the situation at the end of 2003 and loans to agriculture and food industry - 24%, registering a decrease during the last two years by 4.8 p.p. The biggest growth during the respective period was registered by consumption loans by 5.1 p., accounting for 7.8% in the total amount of loans offered as of 2005 year end.

148. An important feature of the crediting process which characterizes directly its investment orientation is credit terms. Loans granted for over one year made up only 46% of all loans in MDL and 60% from loans provided in foreign currency. A positive thing is the fact that compared to the respective period of the previous year the rate of these loans grew from 31 to 46%. As an absolute value this means that the value of loans provided for 1 year and mostly in

MDL was MDL 2.4 billion and US\$8.4 million. The fact that approximately 60% of loans in MDL are offered for up to one year, limits significantly the investment activity. As a result, the share of bank loans in the total amount of investments in fixed capital decreased from 5.7% in 2003 and 4.8% in 2004 down to 2.7% in 2005.

149. An important reserve for the increase of bank loans share in the amount of investments is the growth of loans attractiveness, including and especially through the optimization of banks interest rate. A decrease of loans interest rates and especially for long term loans will significantly improve the demand and lead to an increase of investments in the economy.

150. At the same time, while interest rates for deposits in MDL decreased in 2005 from 15.5 to 10.6% (by 31%) interest rates for loans in MDL decreased only by 18% from 21.1 to 17.3%. As a result, the interest rate margin for loans increased from 5.6 to 6.7%. The net margin of the interest rate reduced from 8.46% in 2004 to 6.42% in 2005 i.e. by 24%. As a result, assets profitability decreased by 15% and the banking activity efficiency indicator decreased by 3.5%.

151. Banking credits remain an important source of real sector financing. The situation described above, characterized by the increase in the banking margin and the decrease in the banking sector efficiency shows not only a reduced level of competition in the banking sector, but also the inexistence of a competitive environment between the banking segment and the other segments of the financial market.

152. In this respect, there is a need to stimulate the creation of a competitive environment on the financial services market. This is feasible only by improving the regulatory mechanisms and through consolidating the supervision of non-banking segments of the financial market with the objective to increase the competitiveness and attractiveness of non-banking financial instruments.

153. During the reporting period, actions were taken to revitalize the insurance market. The assets of insurance companies in the 3<sup>rd</sup> quarter of 2005, compared to the same period of 2004 increased by 17%. The structure of insurance had some positive changes, as well. In 2005, compared to 2004, the market of compulsory insurance revived, its share in the total amount of insurance grew from 14.1% in 2004 up to 20.7% in the 3<sup>rd</sup> quarter of 2005, whereas the share of voluntary insurance of assets from 17.4% up to 31.5%.

154. With regard to civil insurance, its share grew by 4 times from 8.6% in 2004 to 32% in the 3<sup>rd</sup> quarter of 2005, which demonstrates increased responsibility of drivers and an increase in the credibility of the insurance system in general. It is important that the share of insured assets of agricultural producers grew within the system of voluntary insurance of assets. However, the system of insuring agricultural producers requested Government support and to this end, Government established funding arrangements in 2005, aimed at insuring agricultural production risks through insurance agencies.

155. In view of improving the legal and normative framework of the insurance system, the enhancement of the regulation and supervision mechanism of requirements towards financial assets of insurance companies was and continues to be carried out. The process of setting insurance premiums and payments in case of emergence of insured cases is enhanced. During the reporting period, the activity of adjusting normative acts in the area of insurance to the legal norms of Republic of Moldova and international norms continued.

156. The market of corporative movable estate has not yet become a tool to ensure the economy with quality services. Not only did the movable estate market fail to re-establish its position as provided in the strategy but on the contrary it lost ground. The total amount of



















































































































