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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT AND

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A PROPOSED LOAN
IN THE AMOUNT OF US$9 MILLION

AND

A PROPOSED CREDIT

IN THE AMOUNT OF SDR 13.7 MILLION
(US$21 MILLION EQUIVALENT)

TO THE REPUBLIC OF MOLDOVA

FOR THE

FIRST DEVELOPMENT POLICY OPERATION

February 27, 2014

Poverty Reduction and Economic Management Unit
Belarus, Moldova and Ukraine Country Unit
Europe and Central Asia Region

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MOLDOVA - GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of February 21, 2014)

Currency Unit = Moldovan Lei
US$1.00 = MDL13.53

ABBREVIATIONS AND ACRONYMS

AIPA	Agency for Interventions and Payments in Agriculture	LDP	Letter of Development Policy
BEM	Banca de Economii	MAFI	Ministry of Agriculture and Food Industry
CAR	Capital Adequacy Ratio	MDL	Moldovan Lei
CPAR	Country Procurement Assessment Report	MOF	Ministry of Finance
CPI	Consumer Price Index	NBM	National Bank of Moldova
CPS	Country Partnership Strategy	NCFM	National Commission on Financial Markets
DCFTA	Deep and Comprehensive Free Trade Area	NDS	National Development Strategy
DPO	Development Policy Operation	NPL	Non-Performing Loan
DSA	Debt Sustainability Analysis	PEFA	Public Expenditure and Financial Accountability
EBRD	European Bank for Reconstruction and Development	PER	Public Expenditure Review
EA	Environmental Assessment	PFM	Public Financial Management
ECA	Europe and Central Asia	PPA	Public Procurement Agency
EU	European Union	PPP	Purchasing Power Parity
FCRS	Financial Control and Revision Service	PSIA	Poverty and Social Impact Analysis
FDI	Foreign Direct Investment	RBI	Risk-Based Inspections
FMIS	Financial Management Information System	RHS	Right-Hand Side
GDP	Gross Domestic Product	RIA	Regulatory Impact Analysis
GFS	Government Finance Statistics	SDR	Special Drawing Rights
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit	Sida	Swedish International Development Cooperation Agency
GMI	Guaranteed Minimum Income	SME	Small and Medium Enterprise
IBRD	International Bank for Reconstruction and Development	TSA	Treasury Single Account
IDA	International Development Association	USAID	U.S. Agency for International Development
IFC	International Finance Corporation	US$	United States Dollars
IMF	International Monetary Fund	WB	World Bank
JSAN	Joint Staff Advisory Note	WBG	World Bank Group

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MOLDOVA

FIRST DEVELOPMENT POLICY OPERATION

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SUMMARY OF PROPOSED OPERATION AND PROGRAM

MOLDOVA

FIRST DEVELOPMENT POLICY OPERATION

Borrower	REPUBLIC OF MOLDOVA
Implementation Agency	Ministry of Finance, State Chancellery
Financing Data	IDA credit of SDR13.7 million (equivalent to US$21 million*) and IBRD loan of US$9 million ** of which, SDR 2.5 million (US$3.9 million) from cancellation of Public Financial Management Technical Assistance Project (P082916), SDR 1.5 million (US$2.3 million) from cancellation of Emergency Agriculture Support Project (P143202), and SDR 0.1 million (US$ 0.2 million) from the Quality Education in the Rural Areas of Moldova Project (P090340).* IDA blend terms: grace period – 5 years, years to maturity – 25 IBRD terms: IBRD Flexible Loan in US dollars plus fixed spread, with 30 year maturity, including 5 years of grace period, level repayment of principal and commitment linked repayment schedule.
Operation Type	Programmatic (1 of 2), single-tranche
Pillars of the Operation and Program Development Objective(s)	The proposed operation is built around three pillars, which are also the PDOs: Pillar A: Strengthen the regulatory framework to improve predictability of the business environment, facilitate competition and reduce regulatory compliance costs. Pillar B: Strengthen financial sector stability, promote transparency of shareholding and ease conditions for access to finance. Pillar C: Improve the public investment management framework, make investment subsidies in agriculture more efficient and equitable and improve the coverage of well-targeted social assistance programs.
Result Indicators	Inspection coverage (except tax, customs and financial) Share of proposed customs- and tax-related legislation and regulations that affect companies, which have a Regulatory Impact Assessment (RIA) reviewed by the RIA Secretariat before adoption. Number of State Aid providers/grantors that are connected and report to the state aid automated information system Number of new registered varieties of seeds and seedlings Share of public interest entities whose registers of securities' owners were transferred to a Central Securities Depository (CSD) Share of commercial banks' loans secured by movable collateral Prudential indicators of Banca de Economii (BEM) Share of tenders for banking services by public entities and fully or majority state owned companies that are price-based and that include criteria of the regulatory minimum required CAR and liquidity ratios Share of multi-year investment objects with non-continuous funding Project proposals prepared in compliance with the requirements of the regulation on public capital investment Share of subsidies supporting high-value agriculture (HVA) and share of subsidies allocated to individual producers Monthly number of *Ajutor Social* and Heating Allowance recipients
Overall risk rating	Substantial
Operation ID	P143283

IBRD AND IDA PROGRAM DOCUMENT

FOR A PROPOSED LOAN AND CREDIT

TO THE REPUBLIC OF MOLDOVA

1. INTRODUCTION AND COUNTRY CONTEXT

1. **This program document presents a proposed First Development Policy Operation (DPO-1) for an amount of US$ 30 million.** This operation, the first in a programmatic series of two, supports efforts of the Government of the Republic of Moldova to improve the business climate, promote financial sector stability and development, and improve the equity and efficiency of public expenditure. It is aligned with the National Development Strategy "Moldova 2020". The proposed operation supports the World Bank Group's goals of ending extreme poverty and promoting shared prosperity. It is a key component of the Moldova Country Partnership Strategy (CPS) for FY2014-17, discussed by the Board of Executive Directors on September 5, 2013. This DPO series builds on and deepens the structural reform agenda advanced under the Competitiveness Development Policy Operation, which was approved by the Board of Executive Directors on November 1, 2012.

2. **Moldova's recent economic performance reduced poverty and promoted shared prosperity.** The national poverty and extreme poverty rates[1] fell from 30.2 percent and 4.5 percent in 2006 to 16.6 percent and 0.6 percent respectively in 2012, making Moldova one of the world's top performers in terms of poverty reduction. Similarly, consumption growth among the bottom 40 percent of the population outpaced average consumption growth: estimates for 2006-11 suggest an annualized overall growth in consumption of 2.9 percent over the period, as compared to 5.8 percent for the bottom 40 percent (see Figure 1). These developments were driven by economic growth and the associated growth in labor earnings, as well as by an increase in private transfers such as remittances.

Figure 1:
National poverty rates in Moldova, percent

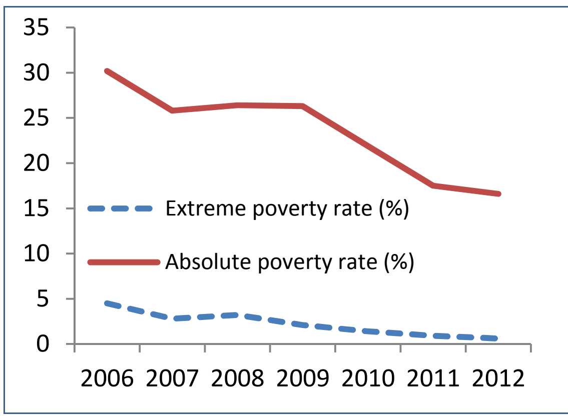
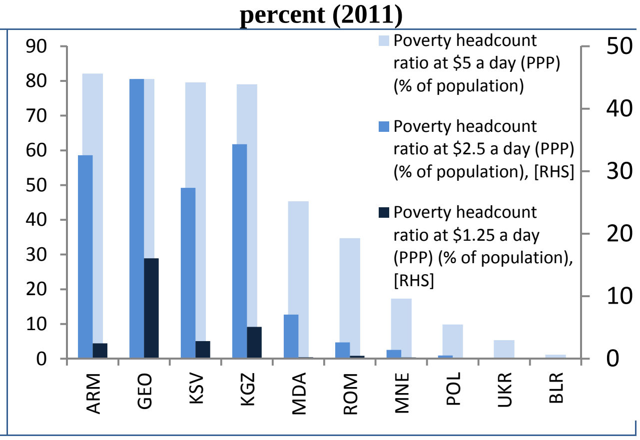


Figure 2:
Poverty Headcount at US$ 5, 2.5, 1.25 a day (PPP), percent (2011)



Source: National authorities, *ECATSD*.

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[1] The National Bureau of Statistics calculates national poverty indicators based on the Household Budget Survey data. The extreme poverty line represents the monetary value of food items only, defined in terms of the minimum of daily calories intake, equal to 2.282 kcal per household member per day, adjusted to the adult equivalent.

3. **Despite a sharp decline in poverty, Moldova remains one of the poorest countries in Europe.** Based on the Europe and Central Asia (ECA) standardized poverty lines of US$ 5/day and US$ 2.5/day at Purchasing Power Parity (PPP), 45 percent of the population was poor and 7 percent was extremely poor in 2011 (see Figure 2).[2] The most vulnerable groups at risk of poverty in Moldova remain those with low education levels, households with three or more children, those in rural areas, families relying on self-employment, the elderly, and Roma. The likelihood of escaping poverty has remained significantly lower for those employed in agriculture than for those employed in other sectors. Farmers and agricultural workers account for 40 percent of Moldova's poor and 44 percent of those in the bottom 40 percent of the population. Moldova performs well in some areas of gender equality, yet disparities persist in education, health, economic opportunity and agency[3].

4. **European integration anchors the Government's policy reform agenda, but periodic political tensions pose risks to reforms.** Negotiations with the European Union (EU) on an Association Agreement and a Deep and Comprehensive Free Trade Area (DCFTA) were recently finalized and draft agreements were initialed in November 2013. The visa liberalization dialogue is also progressing. Yet, there are differing views in society on the appropriate direction, pace and depth of reforms. These were reflected in differences not only between the majority and the opposition but also within the ruling coalition and have hampered reforms. These tensions led to the resignation of the Government after a no-confidence vote in March 2013. In May 2013, the Parliament elected a new Prime Minister who has formed a government from the ruling coalition.

5. **The proposed operation aims to address key constraints to inclusive growth by consolidating reform efforts in three areas.** Upward economic mobility in recent years (2006-2011) has been strongly associated with employment in the manufacturing sector and the services sector[4]. This underlines the key role of improving export competitiveness and the business climate for SMEs in sustaining poverty reduction and shared prosperity. In the agriculture sector (the main sector of employment for the poor), it is especially crucial to enhance productivity and market access for farmers (with access to better technologies and with investments to reduce output volatility and improve compliance with EU food safety and quality standards). While during the 2008-09 crisis an increase in poverty was averted by large increases in public sector wages, pensions and social protection payments, continued progress towards reducing poverty and promoting shared prosperity should be supported in a fiscally sustainable way, by maintaining macroeconomic stability, fostering strong private-sector led growth and improving the efficiency of public programs. Accordingly, the proposed operation is built around three pillars, which are also the Program Development Objectives. The first pillar of the operation seeks to strengthen the regulatory framework to improve predictability of the business environment, facilitate competition, and reduce regulatory compliance costs. The second pillar aims at strengthening financial sector stability, promoting transparency of shareholding and easing conditions for access to finance. The third pillar seeks to improve the public investment management framework, make investment subsidies in agriculture more efficient and equitable, and improve the coverage of well-targeted social assistance programs. The reform program

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[2] 0.2 percent of the population lived below the US$ 1.25 per day threshold.
[3] Agency is the "ability to make choices to achieve desired outcomes". (*World Development Report*, World Bank, 2012).
[4] "Moldova, A Story of Upward Economic Mobility", World Bank, 2013 (forthcoming).

builds on strong complementarity with other World Bank Group (WBG) instruments in Moldova, including investment projects and analytical and advisory activities. In addition, although not a formal continuation of the previous program, the first two pillars of this series support the implementation of select laws supported by the Competitiveness DPO (approved in FY2013).

2. MACROECONOMIC POLICY FRAMEWORK

6. **Despite substantial macroeconomic risks, Moldova's economic performance over the last few years has been relatively strong, aided by improved economic management, particularly in what regards fiscal, monetary and exchange rate policy.** As a result, the existing macroeconomic framework is considered adequate for this DPO to proceed, even though macroeconomic risks associated with vulnerabilities to external and climatic shocks, institutional weaknesses and related slippages in the implementation of macroeconomic and structural reforms, mainly in the financial sector, will continue to be substantial over the short and medium term.

2.1 RECENT ECONOMIC DEVELOPMENTS

7. **As a small open economy in which agriculture has a significant role[5], Moldova's growth performance has been strong but volatile.** The economy recovered from the 2008-09 global economic crisis with average annual GDP growth exceeding 5 percent over 2010-13. As a result, Moldova experienced the highest cumulative GDP growth, relative to the pre-crisis year of 2007, of all regional partners (see Figure 3). However, growth has been volatile, reflecting vulnerability to climatic and global economic conditions. In 2010–11, remittances and investment fueled domestic demand, and growth in exports was strong.[6] Real GDP grew by 7.1 percent in 2010 and 6.8 percent in 2011. In 2012, GDP contracted by 0.7 percent, as the economy was hit by a drought-induced contraction in agriculture (-22.3 percent) and weaker external demand due to the Eurozone crisis. Finally in 2013, growth rebounded, driven by a record harvest in agriculture, with GDP increasing by 8% over the first nine months of 2013. As Figure 4 indicates, private consumption was the main growth driver on the expenditure side (+7 percent), fueled by remittances and wage growth. In the first three quarters, real exports grew 8.6 percent, driven mainly by sales to major trading partners, in particular Turkey and Romania. Fixed investments grew by 3.2 percent, still short of potential and thus underlining the importance of structural reforms.

8. **In this context, improved macroeconomic management has strengthened Moldova's ability to deal with shocks.** Supported by an International Monetary Fund (IMF) program until April 2013, macroeconomic management has substantially improved in recent years. Moldova's policies of maintaining low fiscal deficits, flexible exchange rates and inflation targeting have reduced key macroeconomic risks, and brought fiscal deficits below 3 percent (from 6.3 percent in 2009) and inflation to 5 percent (from 7.4 percent at the end of 2010). Moldova has low public debt levels and has managed to accumulate record-high foreign exchange reserves.

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[5] On average, agriculture accounted for 14.1 percent of total value added in 2010-12.

[6] In particular, in 2011 Moldova managed to increase exports to almost all EU trading partners (except Ireland, Sweden and Slovenia) and to major eastern partners (Russia, Ukraine and Kazakhstan). Exports of manufactured goods and machinery and equipment grew by over 70 percent, textiles products -- by 34 percent, agricultural and food products -- by 25 percent.

Figure 3:
Real GDP indexes, 2007=100

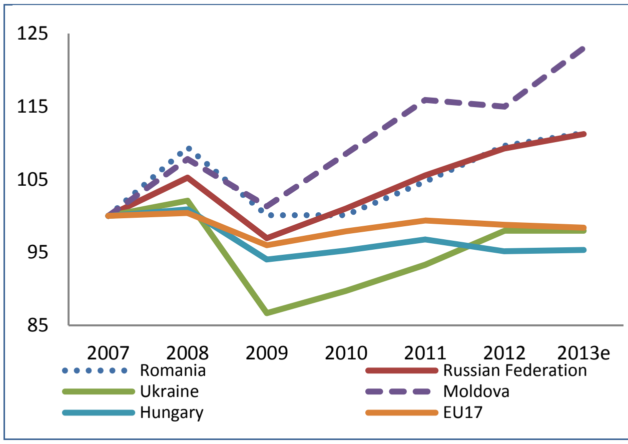
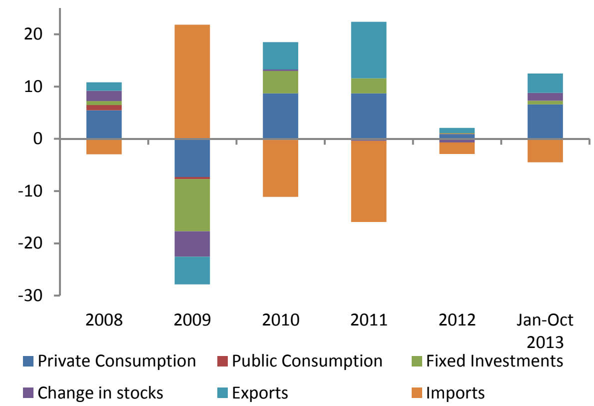


Figure 4:
GDP Growth Decomposition in Moldova, percentage points



Source: National authorities, World Bank staff calculations.

9. **Moldova has kept fiscal deficits under control.** Since 2009, Moldova has managed to restrain transfers and public consumption (including the wage bill and purchases of goods and services). Good GDP performance and revenue collection supplemented government actions to control expenditures and improve efficiency, reforms in the education sector (school network rationalization) and in social assistance (introduction of a new targeted program and reduction of previous categorical compensation schemes). As a result, the fiscal deficit of the general government has declined by 4 percentage points of GDP in four years since 2009, to 2.1 percent of GDP in 2012. Consolidation continued in 2013 as the wage bill decreased to 8.4 percent of the estimated GDP. Overall, driven by higher economic growth, budget revenues grew by 10.1 percent y/y in 2013. Meanwhile, government spending lagged (with a 96.4 percent execution rate), so that the deficit narrowed to 1.8 percent of estimated GDP in 2013. Going forward, as fiscal discipline needs to be maintained, addressing Moldova's infrastructure needs and social pressures will require increasing the efficiency of public resource use.

10. **Monetary policy has been consistent with the inflationary target of 5+/-1.5 percent.** Since 2010, the National Bank of Moldova (NBM) has allowed greater flexibility of the exchange rate and has been implementing a policy shift toward inflation targeting. The NBM has maintained Consumer Price Index (CPI) inflation within the target range for almost two years. In 2013, a good harvest contributed to disinflationary pressures. In the first half of the year, the inflation rate decelerated close to the lower bound of the target range. In response to disinflationary pressures, the NBM loosened monetary policy by lowering the benchmark interest rate by 100 b.p. to 3.5 percent in April 2013. The NBM allowed moderate depreciation of the local currency since the February-March peak (by 7.5 percent and 11 percent with respect to US$ and euro respectively, as of end-December 2013). M3 money supply accelerated to 26.5 percent y/y, while the credit to the private sector grew by 18.8 percent y/y in December 2013. As a result, consumer inflation picked up to 5.2 percent y/y by end of 2013.

Figure 5:
Money Supply, Consumer Price Index and Base Interest Rate in Moldova, percent change y/y

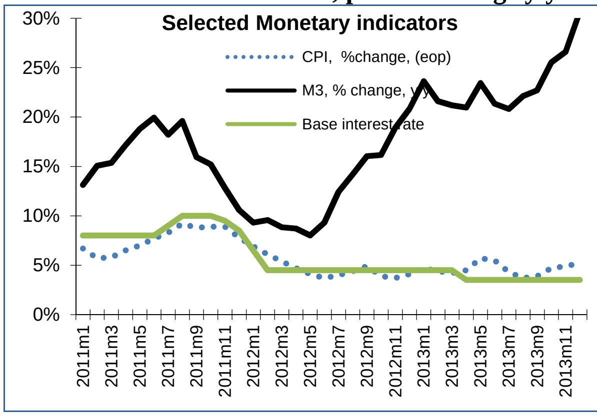
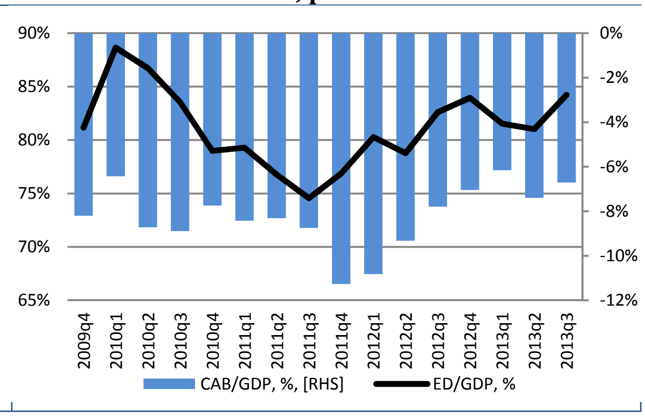


Figure 6:
Current Account Balance and External Debt in Moldova, percent GDP



Source: National authorities, World Bank staff calculations.

11. **The current account deficit narrowed to single digits, while the National Bank of Moldova (NBM) managed to boost foreign exchange reserves.** From 11.3 percent of GDP in 2011, the current account deficit narrowed to 7 percent in 2012 and 5.4 percent in January-September 2013. While the trade deficit remained large, export growth (10.7 percent) outpaced import growth (7.1 percent) in the same period. On the back of inflows from Commonwealth of Independent States (CIS) countries, growth of remittances remained strong at around 10.6 percent in January-September 2013, reaching the record high levels of 2008. Although Foreign Direct Investment (FDI) recovered to 2.8 percent of GDP, it has not reached pre-crisis levels. This underscores the importance of reforms to attract investments, achieve sustained recovery, and spur modernization. As of end-September 2013, total external debt stood at 79 percent of GDP (see Table 1). Overall, the external position was strong and enabled accumulation of foreign exchange reserves, now covering more than 5 months of future imports.

Table 1. External Debt Level and Structure

	2005			2009			September 2013		
	US$ (million)	Share of total, percent	Percent GDP	US$ (million)	Share of total, percent	Percent GDP	US$ (million)	Share of total, percent	Percent GDP
Monetary authorities	95.4	4.7	3.2	153.3	3.5	2.8	449.6	7.2	5.7
General Government	654.0	32.0	21.9	957.5	22.1	17.6	1,276.3	20.5	16.2
Banks	86.1	4.2	2.9	457.6	10.6	8.4	646.2	10.4	8.2
Other sectors	935.4	45.8	31.3	1,905.5	44.0	35.0	2,757.8	44.4	35.1
o/ w intercompany lending	270.0	13.2	9.0	853.2	19.7	15.7	1088.4	17.5	13.8
Total external debt	**2,041.0**	**100.0**	**68.3**	**4,327.1**	**100.0**	**79.6**	**6,218.3**	**100.0**	**79.1**
Long-term external debt	1,285.4	63.0	43.0	2,999.1	69.3	55.1	4,372.7	70.3	55.6
Short-term external debt	755.6	37.0	25.3	1,328	30.7	24.4	1,845.6	29.7	23.5

Source: National Bank of Moldova

12. **Finally, while Moldova's banking sector has generally performed well, chronic asset quality problem with a domestic systemically important bank and weak governance in some institutions pose risks to financial sector stability and growth.** The banking system's liquidity ratio was at 33.8 percent by the end of 2013, largely unchanged during the past three years. The system's capital adequacy ratio (CAR) stood at 23.4 percent, well above the 16 percent required by NBM. The ratio of nonperforming loans (NPLs), which peaked at 17.8

percent of total loans in mid-2010, decreased gradually over the last three years, reaching 11.6 percent as of end-2013. However, there is substantial variation among individual banks on each of these three prudential ratios. In addition, a domestic systemically important bank, partially owned by the state (Banca de Economii, BEM), has been experiencing chronic asset quality and undercapitalization problems. The capital position at BEM deteriorated after mid-2012. In August 2013, the bank's capital was increased. As a result of this increase, the state has lost its majority position in BEM and has been diluted to a blocking minority (33.3 percent + 1 share) position. Furthermore, weak governance throughout the system, as shown by the lack of shareholder transparency and protection of property rights, restrains further growth and competition in the financial sector. In addition, a Constitutional Court's ruling on October 1, 2013 on the NBM Law raised risks to the effectiveness of monetary policy and banking regulation, although the government has moved swiftly to put in place mitigating legislative measures and committed to further remedial actions (see Box 1 and Section 4).

Box 1: Banking Sector in Moldova

The banking sector of Moldova has generally recovered well in the aftermath of the global financial crisis. Many banks have remained liquid, well capitalized, and profitable. The five largest banks account for nearly 70 percent of total assets and over 74 percent of total deposits in the system. Four of the largest 5 banks are domestically owned. The banking sector in Moldova presents limited exposure to foreign assets and institutions. Out of 14 banks operating in the country, only four are majority foreign-owned, accounting for approximately 20 percent of banking assets at end-June 2013. Italian and French banks are the most important foreign actors in the sector, with a combined 13 percent of assets. The volume of parent bank financing is insignificant; therefore no de-leveraging is expected to take place.

While the overall banking performance indicators show positive trends, there are problems. Banca de Economii (BEM) – a systemically important bank in which the state currently has a minority share – has experienced chronic asset quality and undercapitalization problems. Moreover, weak governance in some institutions (lack of shareholder transparency and protection of property rights) restrains further growth and competition. As an example, early in 2013, one of the largest Moldovan banks was subject to a hostile takeover by non-transparent investors where there was a rapid transfer of ownership of shares to individuals/companies in blocks below the 5 percent change-of-control-reporting threshold. The court of first instance has prevented NBM from issuing a decision on whether the new shareholders acted in concert. NBM appealed this decision and the Appeal Court of Chisinau cancelled the decision of the court of first instance. Finally, the ruling by the Constitutional Court on October 1, 2013, declaring Article 11(4) of the NBM Law unconstitutional could have serious ramifications. Article 11 (4) provides that legal action in court of law against the decision of the NBM shall not stay the purported action or decision except in the case of revocation of license and liquidation of a bank. This Constitutional Court decision rendered all regulatory actions of the National Bank vulnerable to a stay, pending final decision of the court including those on monetary and currency policy, special administration of banks and other important supervisory measures. While the decision did not curtail NBM from exercising its powers under the law, it could affect the effectiveness of monetary policy and bank regulation measures. One of the Prior Actions of the proposed operation clarifies the legal framework to strike a balance between the effectiveness of NBM's actions as a central bank, supervisor, and resolution authority, and its accountability through judicial review.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

13. **We expect GDP growth to rise to 7.5 percent in 2013, before decelerating to 3 percent in 2014.** In the medium term, we project growth to be around 4.5 percent. Recovery in agricultural production, after the severe drought and contraction of output in 2012, is going to be the key factor behind the expected higher outturns in the second half of 2013, explaining more than half of growth. In addition, strong growth of remittances, in particular driven by large-scale infrastructure investments in Russia, is expected to support continued growth of consumption and investment. In 2014, both factors mentioned above are going to fade, reducing the projected growth trajectory. Meanwhile, external demand from Moldova's largest trade partners is likely to be muted. Economic growth in the Russian Federation is slowing, while the recovery in the EU is expected to remain weak. From 2015 and on we expect external demand to pick up, fuelling both Moldovan exports and remittances to Moldova.

Table 2. Key Macroeconomic Indicators

	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Real economy								
Nominal GDP, *MDL million*	60.4	71.9	82.4	88.3	99.2	107.1	117.5	129.5
Real GDP, *percent change*	-6.0	7.1	6.8	-0.7	7.5	3.0	4.0	4.5
Per Capita GDP, *US$ Atlas Method*	1570	1820	1980	2140	2390			
Contributions:								
Consumption percent points of GDP	*-0.1*	*8.5*	*8.5*	*1.0*	*8.0*			
Investment percent points of GDP	*-0.1*	*4.6*	*2.7*	*-0.6*	*1.3*			
Net exports percent points of GDP	*-8.8*	*-4.4*	*-4.7*	*-1.2*	*-1.9*			
Imports, *percent volume change*	-23.6	14.3	19.7	2.2	7.6	5.6	7.6	7.2
Exports, *percent volume change*	-12.1	13.7	27.4	1.7	10.2	6.1	6.0	6.1
Unemployment rate (ILO definition), *percent*	6.4	7.4	6.7	5.6	4.1			
GDP deflator, *percent change*	2.2	11.3	7.2	7.6	4.6	4.9	5.5	5.5
CPI (eop), *percent change*	0.0	7.4	7.6	4.6	5.2	4.6	5.7	4.5
Fiscal Accounts								
Expenditures, *percent GDP*	45.3	40.8	39.0	40.0	39.0	40.7	39.9	39.5
Revenues, *percent GDP*	38.9	38.3	36.6	37.9	37.2	38.1	38.0	37.8
General Government Balance, *percent GDP*	-6.3	-2.5	-2.4	-2.1	-1.8	-2.6	-1.9	-1.7
PPG debt[1] (eop), *percent GDP*	29.0	31.9	30.3	33.2	32	33.1	32.9	32.0
Selected Monetary Accounts								
Base Money, *percent change*	16.8	14.2	7.4	21.9	28.4	19.0	13.1	12.5
Credit to non-government, *percent change*	-5.0	12.7	15	16.1	17.1	16.1	14.5	13.8
Interest (key policy interest rate), *percent*	5.0	8	8.5	4.5	3.5			
Balance of Payments								
Current Account Balance,[2] *percent GDP*	-8.2	-7.7	-11.3	-6.8	-6.0	-6.1	-7.2	-8.0
Imports, *percent GDP*	73.4	78.7	86.0	83.9	84.3	84.0	83.4	82.4
Exports, *percent GDP*	36.8	39.4	45	43.4	44.9	44.6	43.6	42.3
Foreign Direct Investment, *percent GDP*	2.5	3.3	3.5	2.1	2.5	2.7	2.8	3.1
Gross Reserves[3], *million US$, eop*	1480	1717	1965	2515	2820			
In months of next year's imports	*4.4*	*3.4*	*3.9*	*4.6*	*5.3*			
Percent of short-term external debt	*90.4*	*80.7*	*80.9*	*89.9*	*113*			
External Debt, *percent GDP*	80.2	82.3	77.6	82.1	80.8	79.3	75.8	71.6
Terms of Trade, *percent change*	0.1	0.0	-1.4	-0.8	0.2	-0.5	-0.1	-0.3
Exchange Rate, *MDL/US$ (average)*	11.1	12.4	11.7	12.1	12.6			
Memo:								
Nominal GDP, *US$ million*	5437	58133	7016	7284	7873			

Notes: [1] *includes the state debt, debt of national bank, debt of administrative-territorial units, debt of public institutions, debt of majority state owned companies;*
[2] *according to IMF's Balance of Payments Manual, 5th edition the definition of Current Account is based on standard representation of current account. Standard representation of Current Account, compared with analytical one, includes current official transfers to/from the Government;*
[3] *Gross Reserves in months of next year's imports is the ratio of total gross reserves to estimated next year's average monthly import.*
Source: National authorities, WB staff calculations.

14. **The current account deficit will gradually widen in the medium term.** Due to strong export growth, the current account deficit will remain relatively low (-6 percent of GDP) in 2013. In the medium term, we assume the current account deficit will gradually increase but remain in single digits by the end of 2016. In the base case, inflows of private and public external debt will ensure financing of the current account deficit, and will allow a moderate increase in foreign exchange reserves. FDI is projected to increase to 3 percent of GDP, with higher inflows expected if Moldova signs the Association Agreement with the EU.

Table 3. Balance of Payment Financing Requirements and Sources

	2012	2013e	2014f	2015f	2016f
Financing requirements (US$ million)	**2845**	**3261**	**3626**	**3947**	**4409**
Current account deficit	511	472	519	675	845
Long-term debt amortization (excl. IMF)	476	597	632	597	545
Short-term debt amortizations	1857	2193	2475	2675	3019
Other short-term capital outflows	0	0	0	0	0
Financing Sources (US$ million)	**2845**	**3261**	**3626**	**3947**	**4409**
FDI and portfolio investments (net)	155	208	245	268	316
Net Capital account	-35	-35	-37	-39	-41
Long-term debt disbursements (excl.	1212	934	953	885	857
Short-term debt disbursements	2193	2475	2675	3019	3380
Change in reserves	-636	-302	-181	-153	-65
IMF credit (net)	138	-26	-30	-45	-82

Source: National authorities, WB staff calculations.

15. **Monetary policy is anticipated to remain adequate, with inflation projected to be within the target range of 5 percent +/- 1.5 percent.** In the short term, monetary policy will take a more neutral stance (compared to easing during 2013), since the headline inflation is close to the mid-point of the target range. Through 2014, consumer inflation is expected to be within 4-5 percent range. In 2015, as global inflation picks up and domestic administrative prices are adjusted, we expect the CPI to near 6 percent.

16. **The budget deficit is projected to remain under 3 percent of GDP in the medium term**. The adopted Budget Law for 2014 targets a 2.6 percent deficit. After parliamentary elections, the budget deficit is projected to decrease below 2 percent of GDP by the end 2016. In the medium term, achieving sustainable deficits will be more challenging. On the expenditure side, social and demographic challenges will intensify, including existing commitments on social insurance and pensions. Ageing will increase the pensions bill and fuel the demand for healthcare services, while public sector spending on education and health in particular remains high and inefficient. Intergovernmental fiscal relations should be reformed in a way that is consistent with fiscal discipline and reduces the inefficiencies stemming from small, fragmented local governments. Further expenditure adjustments are needed to make space for pressing public investment needs in the medium term. On the revenue side, institutional weaknesses are reflected in tax collection issues. Moreover, Moldova could experience a decline in external assistance, making it important to preserve fiscal sustainability in the medium term.

Table 4. Key Fiscal Indicators, percent GDP

	2010	2011	2012	2013e	2014f
Overall Balance	-2.5	-2.4	-2.1	-1.8	-2.6
Total Revenues (and grants)	**38.3**	**36.6**	**38.0**	**37.2**	**38.1**
Tax revenues	30.7	30.5	31.8	31.7	32.6
Corporate Income tax	0.7	0.7	2.2	2.1	2.2
Personal Income tax	2.2	2.1	2.3	2.2	2.3
VAT	12.7	12.7	12.1	12.3	12.5
Excises	2.9	3.2	3.3	3.5	3.6
Taxes on international trade	1.5	1.4	1.5	1.4	1.5
Other revenues	0.5	0.5	0.5	0.6	0.5
Social benefits	10.4	10.0	10.1	9.8	10.1
Non-tax revenues	2.6	2.0	2.4	2.1	2.2
Grants	2.8	2.1	1.9	2.1	2.3

	2010	2011	2012	2013e	2014f
Expenditures (economic cl.)	**40.8**	**39.0**	**40.1**	**39.0**	**40.7**
Current expenditures	36.1	33.8	33.9	31.9	33.4
Wages and compensation	10.3	9.5	9.6	8.4	8.6
Goods and services	9.3	8.8	8.9	8.9	9.5
Interest payments	0.8	0.8	0.8	0.5	0.7
Current transfers	14.3	13.5	14.1	13.7	14.2
Capital expenditures	4.8	5.2	6.3	7.2	7.3
General Government Financing	**-2.5**	**-2.4**	**-2.1**	**-1.8**	**-2.6**
External (net)	2.9	0.7	1.4	0.5	1.6
Domestic (net)	-0.4	1.7	0.7	1.2	1.0
of which: privatization	0.5	0.4	0.3	0.3	0.3
Expenditures (functional cl.)					
General services	1.9	1.8	2.0	2.1	1.9
Defense	0.3	0.3	0.3	0.3	0.4
Public Order and safety	1.8	1.9	1.9	1.9	2.1
Economic affairs	4.5	4.4	5.2	5.9	6.8
Health	5.6	5.2	5.4	5.3	5.2
Education	9.2	8.3	8.4	7.1	7.3
Cultural, sports, recreational, religious	0.8	0.9	1.0	1.0	1.0
Social Protection	14.3	13.4	13.2	12.8	13.6

Source: National authorities, WB staff calculations.

18. **While the Debt Sustainability Analysis (DSA) framework indicates a low risk of debt distress, overall debt sustainability is vulnerable to adverse exogenous shocks.** The draft Joint IMF-WB DSA (2014) suggests that the overall public sector debt dynamics are sustainable. While the DSA framework points to a low risk of debt distress over the medium term, stress tests indicate that debt sustainability is vulnerable to exogenous shocks (Figure 7). All external debt indicators remain under the thresholds under the standard bound tests and alternative scenarios (Figure 8). However, significant private external debt poses roll over risks to debt sustainability. On the positive side, recent improvements in the foreign reserve position have enhanced resilience to adverse shocks.

Figure 7:
Public and Publicly Guaranteed Debt Dynamics as a Share of GDP

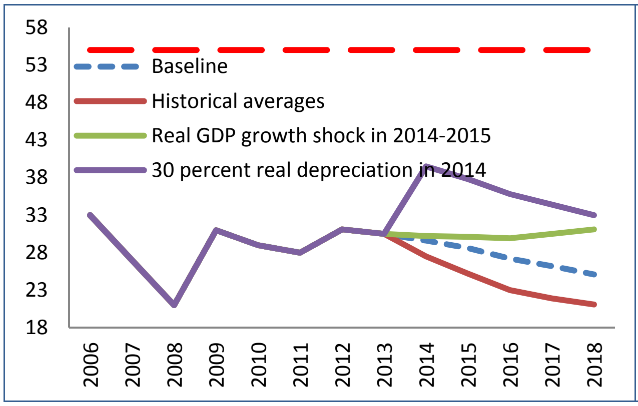
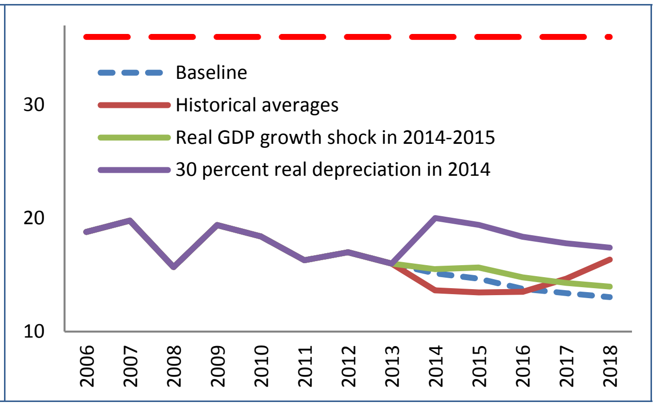


Figure 8:
External PPG Debt Dynamics as a Share of GDP



Source: Joint IMF and World Bank DSA, 2014.

19. **Risks to the macroeconomic outlook and banking sector risks are high.** First, weaker growth of key trade partners could undermine exports and remittance flows. Second, a negative oil price shock could slow Russia's growth further, resulting in a drop in remittances from and exports to Russia. Third, a still large structural current account deficit poses vulnerability to

sudden stops in private inflows or external aid. In particular, slippages in implementing macroeconomic and structural reforms could potentially reduce external support and complicate efforts to finance the current account. Fourth, agriculture remains vulnerable to extreme weather conditions, and could continue posting double-digits variations of output. Fifth, significant risks exist due to credit quality, liquidity and capital adequacy concerns at select banks and due to concerns over effective enforcement powers of the regulator (see Paragraph 12 and Box 1). Moreover, poor governance throughout the system, with weak protection of property rights and lack of shareholder transparency, makes banking system more vulnerable to shocks and could mask deeper underlying problems. While authorities make efforts to reduce macroeconomic risks, some of them are inherent to the economic structure and may not be fully mitigated in the short to medium term.

20. **The existing macroeconomic policy framework is adequate for this DPO to proceed.** This DPO contributes to macroeconomic policy resiliency through support to restore the effectiveness of monetary policy and banking supervision, to make public expenditure more efficient and to spur growth by removing constraints to private enterprise.

2.3 IMF RELATIONS

21. An IMF program, comprising a combined Extended Credit Facility/Extended Fund Facility in the amount SDR368 million (about US$588 million), expired on April 30, 2013. SDR320 million (about US$490 million) had been allocated to Moldova after 5 programs reviews. According to staff assessment,[7] the program largely achieved its main objectives, notwithstanding the non-completion of the last program review. Key accomplishments include reducing the budget deficit, keeping inflation in check, rebuilding international reserves, and preserving financial stability. Against the backdrop of a political crisis[8], the final review was not completed as government took fiscal measures that put at risk the gains under the program in achieving and maintaining fiscal discipline, and as disagreements emerged on how to deal with BEM's financial situation. An IMF team conducted post-program monitoring discussions with the Moldovan authorities during September 18 - October 1, 2013. At the authorities' invitation, an IMF mission discussed a possible precautionary program during January 15-29, 2014. The mission discussed the policies that could form a basis for an IMF-supported program, including policies to safeguard fiscal sustainability, maintain prudent monetary policy stance, and strengthen the financial sector. No agreement was reached as of mid-February, but discussions are expected to continue in the coming weeks. The IMF's Letter of Assessment is provided in Annex 3.

3. THE GOVERNMENT'S PROGRAM

22. **The Government's medium-term strategy is reflected in the National Development Strategy (NDS), approved by Parliament in 2012 and covering 2012-2020.** The NDS calls for a shift from the current consumption-based growth model towards a growth model based on raising investments, increasing productivity and competitiveness, developing export industries, and promoting a knowledge-based society.

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[7] See Concluding Statement of the IMF Mission to the Republic of Moldova, June 25, 2013.
[8] A protracted political crisis culminated with the Government's resignation after a no-confidence vote in March 2013.

23. **The NDS focuses on seven national development priorities, with the objectives of "ensuring qualitative economic growth and, implicitly, poverty reduction":**[9]

(1) Aligning the education system to labor market needs to enhance labor productivity and increase employment in the economy;
(2) Increasing public investment in national and local road infrastructure to reduce transportation costs and increase speed of access;
(3) Reducing financing costs by increasing competition in the financial sector and developing risk management tools;
(4) Improving the business climate, promoting competition policies, streamlining the regulatory framework and applying information technologies in public services for businesses and citizens;
(5) Reducing energy consumption by increasing energy efficiency and using renewable energy sources;
(6) Ensuring financial sustainability of the pension system to secure an appropriate rate of wage replacement;
(7) Increasing quality and efficiency of justice and fighting corruption to ensure equitable access to public goods for all citizens.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

24. **The proposed operation (first in a programmatic series of two) supports three areas, selected based on their expected impact on poverty reduction and shared prosperity, and the World Bank Group's comparative advantage (through supporting analytical knowledge and ongoing sectoral engagement).** As the Moldova Country Economic Memorandum[10] (2011) suggested, spurring private-sector led growth (by improving the business climate, financial transparency and stability and access to finance) together with making public investment more efficient and equitable are necessary conditions to support the emergence of a new growth model in Moldova and to achieve inclusive growth. The first two pillars of the operation directly support two of the seven national priorities in the NDS: "improving the business climate" (Pillar A) and "reducing financing costs" (Pillar B). With respect to business climate and the financial sector, the operation benefits from substantial analytical work and high complementarity with ongoing operations (as described in table 5 and section 4.3). The third pillar of the operation directly contributes to increasing the efficiency of public expenditures, which was identified in the NDS as a determining factor in the successful accomplishment of national priorities. The design of this pillar benefitted from in-depth complementary analytical work. Improving the public investment management framework, making investment subsidies in agriculture more efficient and equitable and improving the coverage of well-targeted social assistance programs is expected to contribute to poverty reduction and shared prosperity while maintaining fiscal sustainability.

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[9] See JSAN on the NDS for a more detailed discussion. http://documents.worldbank.org/curated/en/2013/08/18337793/

[10] *After the Global Crisis: Promoting Competitiveness and Shared Growth*, Moldova Country Economic Memorandum, The World Bank, 2011.

25. **This DPO was designed taking into account lessons learned from previous operations, notably the preceding Competitiveness DPO (2012), Economic Recovery DPO (2010) and Poverty Reduction Support Credits (PRSCs, 2006-2008).** In particular, following lessons learned from PRSCs, the operation's design is selective and adjusted to the country's administrative capacity, with fewer policy areas. Also, where legislative amendments are required to implement reforms, prior actions involve both government and parliamentary adoption. Indeed, past experience has shown that in Moldova's uncertain coalition environment, sustainability of reforms requires broad political leadership and endorsement. In addition, as in previous operations, program design is underpinned by strategic and extensive analytical work, as well as technical assistance.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

PILLAR A: STRENGTHEN THE REGULATORY FRAMEWORK TO IMPROVE PREDICTABILITY OF THE BUSINESS ENVIRONMENT, FACILITATE COMPETITION AND REDUCE REGULATORY COMPLIANCE COSTS

26. **High transactions costs and unpredictable rules of the game negatively affect productivity, competitiveness, and job creation in Moldova.** Moldova ranked 78th out of 189 economies in the 2014 Doing Business report, and 87th out of 144 economies in the World Economic Forum's 2012-13 Global Competitiveness Report. Levels of competition are generally low compared to other countries in the region, and there have been proven instances of collusion, cartels, and abuse of dominant positions. Advantages granted by government (state aid) may also distort competition. In addition, companies cite burdensome, overlapping and often unclear regulatory requirements and substantial barriers in many aspects of the business environment – from obtaining authorizations to importing goods, and getting credit – as the source of time-consuming procedures that reduce real returns to companies. Some of these restrictions are sector-specific. For instance, lengthy and costly procedures for testing and registering new plant varieties represent an administrative barrier to the free flow of advanced technologies embedded in seeds and seedlings, thus harming Moldovan farmers' productivity and ability to compete internationally.

27. **The proposed operation seeks to strengthen the business environment facing Moldovan companies and farms.** Supported measures aim to reduce the burden of regulatory and compliance requirements and to enhance competition. In agriculture, the operation supports easing seed regulations, which is critical for improving productivity, reducing costs in the sector and enhancing farm incomes.

Prior Action 1. Government adopts a decision establishing the framework Risk-Based Inspections (RBI) Methodology.

28. The Inspection Law (enacted in 2012 and supported by the Competitiveness DPO) requires elaboration and adoption of the RBI framework. Since there is no horizontal interaction between inspectorates even when their mandates overlap or are complementary, inspections are excessive, costly and a source of uncertainty for businesses. The RBI approach is expected to optimize inspection activities based on risk analysis, and is expected to yield improvements in compliance, reliability and safety while reducing burden for the private sector.

29. This prior action was completed with the passage of Government Decision 694 establishing the Framework RBI Methodology on September 5, 2013 (published in *Monitorul Oficial* No. 198-204 on September 13, 2013).

Trigger for DPO-2. Government adopts a decision establishing sector RBI methodologies based on the framework RBI Methodology and creates an online State Registry of Inspections, which serves as an inspection management system.

30. The Inspection Law also foresees elaboration and adoption of sector Risk-Based Inspections methodologies (of which 27 methodologies are under direct control of the Government) and creation of a State Registry of Inspections. The registry will be publicly-available (online), and will improve the transparency and predictability of inspections. The registry will also serve as a management system, based on automated recordkeeping and tracking. In this way, it will cut down costs, while helping the private sector.

Prior Action 2. Enact[11] *amendments to legislation to ensure that customs- and tax-related legislation and regulations that affect companies be accompanied by a Regulatory Impact Analysis (RIA).*

31. Application of a Regulatory Impact Analysis (RIA) to tax and customs policy and administration proposals would help evaluate the potential impact of different policy options (identifying costs, benefits and distributional impacts) through a transparent process (using the Public Private Dialogue platform – National Working Group), and promote simplification of the regulatory environment. This reform extends the existing RIA requirements and processes to tax and customs policy and administration. The reform involves amendments to the Tax Code and the Customs Code, as indicated in the 2013-2014 Road Map to Eliminate Business Barriers (Government Decision No. 765 as of September 25, 2013). Improving transparency is especially important, as unpredictability in the rules surrounding customs and tax administration were the two largest barriers to doing business cited by private sector representatives in the study on policy priorities for private sector development (World Bank, 2013).

32. This prior action was completed with the passage of Law No.324 "On amendment and completion of some legislative acts" on December 23, 2013 and its publication in *Monitorul Oficial* No.320-321 on December 31, 2013.

Prior Action 3. Enact secondary legislation required to implement the Law on Competition and the Law on State Aid, including a Parliamentary decision on the structure of the Competition Council.

33. The Law on Competition and the Law on State Aid were enacted in September 2012, and were supported by the Competitiveness DPO. Secondary legislation is needed to complete the legal framework governing competition and state aid, and allow the Competition Council to effectively exercise its duties and responsibilities. That includes 5 regulations for the Law on Competition, 12 regulations for the Law on State Aid, and a Parliamentary decision on the structure and budget of the Competition Council.

[11] 'Enacted' means 'approved by the Parliament, signed by the President and published in official gazette *Monitorul Oficial*'.

34. This prior action was completed with the passage of the Parliamentary Decision No. 278 on November 21, 2013 on approval of the staffing limits and organizational structure of the Competition Council and approval by the Competition Council Board of 17 regulations for the effective implementation of the Law on Competition and the Law on State Aid.

Trigger for DPO-2. Government adopts a regulation setting up the information collection mechanism for all state aid, to ensure that all state aid grantors comply with their obligations under the Law on State Aid and state aid secondary legislation.

35. This measure is expected to enable enforcement of the Law on State Aid through the implementation of an integrated record-keeping system. This measure is part of the Government's competitiveness roadmap. It will provide for greater transparency of all state aid transactions on an ongoing basis. The World Bank Group's Competition Policy Team is to provide technical assistance to the Competition Council to help implement this action.

Prior Action 4. *Government adopts a decision reducing the testing and registration period for seeds and seedlings to: (i) 1 year for all annual crops listed in the EU Catalogue, and (ii) 1 harvest year for multiannual (fruit trees) crops listed in the EU Catalogue.*

36. This measure will reduce the testing and registration period for all crops registered in the EU (from three years to one year), with the aim of giving Moldovan farmers faster access to advanced technologies.[12] Some progress in this direction was made in 2012, when the Government of Moldova liberalized the import of EU-registered varieties for a number of minor crops that are underrepresented in the national catalogue (supported by the Competitiveness DPO). Quicker access to a wider range of new seeds and seedling varieties will improve Moldovan farmers' competitiveness by lowering input costs, improving productivity and enhancing incomes.

37. This prior action was completed with the passage Government Decision No. 964 "On supplementing paragraph 29 of the Regulation on testing and acceptance of varieties in the Catalogue of Plant Varieties" on December 4, 2013 (published in *Monitorul Oficial* No. 284-289 on December 6, 2013, effective immediately).

PILLAR B: STRENGTHEN FINANCIAL SECTOR STABILITY, PROMOTE TRANSPARENCY OF SHAREHOLDING AND EASE CONDITIONS FOR ACCESS TO FINANCE

38. **Lack of shareholder transparency, weak property rights, weak governance and limited enforcement powers of financial sector regulatory agencies hamper financial sector stability and growth in Moldova.** Various financial market participants, such as independent registrars and brokers, have been allegedly used by powerful political and economic groups to illegally gain ownership of private assets and re-direct financial flows for private benefits. Weak governance is considered to have facilitated many questionable transactions in the financial sector. The Constitutional Court's ruling on October 1, 2013 declaring that Article 11(4) of the National Bank of Moldova Law is unconstitutional, could severely impact the effectiveness of the NBM's monetary policy and bank regulation measures. In the banking sector, lack of transparency on ultimate beneficial ownership pose significant governance issues as it is difficult to assess in particular the extent of related parties lending.

[12] New plant varieties are considered all varieties not yet registered in the national catalogue. That includes varieties in the EU Catalogue that have not yet undergone domestic testing and registration.

39. **The objective of this pillar is to support the Moldovan authorities to build a more sustainable, resilient and transparent financial sector.** The proposed actions address priority reforms in the areas of the corporate shares registry, the integrity of shareholders' ownership rights, corporate governance standards, shareholder transparency, and proper supervision by NBM and the National Commission on Financial Markets (NCFM). Reforms proposed under this pillar are also aimed at enhancing access to finance, which continues to constrain private sector development, especially for SMEs and entrepreneurs.

Prior Action 5. *Government adopts and submits to Parliament amendments to the Law on Capital Markets to consolidate the share registry function of corporate securities and merge it into the depository function for corporate securities.*

40. Weak governance in some institutions, as shown by the lack of shareholder transparency and protection of property rights stifles further growth and competition in the financial and private sector. In this respect, deficiencies in the current securities registration system have contributed to violations of shareholders' rights and hostile takeovers of companies in Moldova in recent years. Due to opposition by some market operators, the reform of the securities registry model was not covered by the Capital Market Law (enacted in 2012 and supported by the Competitiveness DPO). Despite NCFM's extensive jurisdiction over the existing independent registrars, numerous deficiencies remain in the securities ownership registration system. The supported reforms aim to enhance the efficiency and integrity of the corporate share registry function in Moldova, and bring it in line with international good practice. This measure consolidates the share registry function of corporate securities and merges it into the depository function for 'public interest entities', as defined by the amendments.

41. This prior action was completed with the passage of Government Decision No 1028 "On approval of the draft law amending law No 171 from July 2012 on capital markets" on December 19, 2013. (Published in *Monitorul Oficial* No. 312-314/1172 on December 31, 2013). This law was registered in Parliament on December 24, 2013, as draft law No. 537.

Trigger for DPO-2. Enact the amendments to the Law on Capital Markets to consolidate the share registry function of corporate securities and merge it into the depository function for corporate securities.

42. See above (Prior Action 5).

Prior Action 6. *Enact the amendments to the Laws on NBM, on Administrative Court, and Code of Civil Procedure to clarify the legal framework for contesting the acts of the NBM.*

43. The Constitutional Court's ruling on October 1, 2013 declaring that Article 11(4) of the National Bank of Moldova Law is unconstitutional, could impact the effectiveness of its monetary policy and bank regulation measures. The authorities sought to take quick remedial actions by preparing legal amendments to strike a balance between the effectiveness of NBM's actions as a central bank, supervisor, and resolution authority, and its accountability through judicial review. The World Bank financial sector and legal teams have reviewed and commented on the draft amendments. In general, the amendments represent a step in the right direction, as they establish a framework for filing complaints against the NBM. Key provisions include: establishing that cases against NBM can only be filed where NBM has its office, requiring evidence and proof of irreparable damage before seeking the suspension of NBM acts; establishing an internal appeal process within NBM; limiting the basis of review of issues related

to monetary and foreign exchange policy to questions on compliance with procedures; giving the defendant (NBM) a chance to defend its administrative actions and not allowing decisions without letting the defendant know; and finally, allowing for the suspension of NBM decision only in extreme cases. The adopted legal amendments adequately address risks to the conduct of monetary and foreign exchange policy and have reduced risks for banking regulation and supervision.

44. This prior action was completed with the passage of the Law No.343 "On amendment and completion of some legislative acts" on December 24, 2013, and its publication in *Monitorul Oficial* No. 17-23/54 on January 24, 2014.

Trigger for DPO-2. Enact measures to further strengthen the framework for contesting NBM acts related to banking regulation and supervision.

45. With respect to banking regulation and supervision, the authorities indicated they intend to continue strengthening the framework for contesting the NBM acts. The World Bank will continue to work closely with the IMF to ensure that reforms effectively reduce risks.

Trigger for DPO-2. Enact amendments to the Pledge Law to increase use of movable assets as collateral.

46. High collateral requirements are an important factor in constraining access to finance for private companies and entrepreneurs in Moldova. Currently, commercial banks are reluctant to accept movable assets as collateral, as they perceive them too risky and prefer immovable collateral in the form of real estate. This reform could increase lending secured by movable collateral, which would broaden access to finance for SMEs.

<u>Prior Action 7.</u> *NBM instructs an independent diagnostic audit of BEM and an auditor is selected competitively to carry out said audit in compliance with terms of reference agreed with the NBM.*

47. Significant financial sector risks exist due to credit quality and capital adequacy concerns at BEM - a domestic systemically important bank, partially owned by the state. As a result of a recent capital increase, the State has lost its majority position in BEM and now holds a blocking minority (33.3% + 1 share) position. On December 09, 2013 NBM has issued its order for an external independent diagnostic audit of BEM. Terms of reference for the audit have been agreed with World Bank and IMF teams. The proposed independent diagnostic audit by a reputable third party is important in order to assess recent transactions concerning BEM and establish a reliable baseline of BEM's financial position.

48. This prior action was completed with the signature of a contract between BEM and the competitively selected auditor on February 5, 2014. As per NBM's order on the special diagnostic audit of BEM, the tender results and the engagement letter with the selected auditor have been approved by the NBM.

Trigger for DPO-2. Complete an external independent diagnostic audit of BEM.

49. See above (Prior Action 7). Completion of the audit implies its submission to the NBM.

Trigger for DPO-2. BEM adopts a time-bound medium-term restructuring strategy designed to restore long-term viability approved by BEM Supervisory Board and acceptable to the NBM.

50. Based on the results of the independent diagnostic audit of BEM, a restructuring plan shall be devised and implemented. The objective of the plan should be to restore the bank to positive operating cash-flows within 12–18 months. The plan should also provide for a time-bound schedule for revision of credit policies and procedures in line with best international practice, restructuring of the bank's governance arrangements, and be based on a new business strategy oriented towards a diversified credit portfolio away from state enterprises and large corporate borrowers. Implementation of the restructuring plan should put BEM on sustainable governance and operational footing going forward.

Trigger for DPO-2. Government adopts a policy requiring all public entities and fully or majority state-owned companies to conduct price-based public tenders for banking services which incorporate at least the regulatory minimum required CAR and liquidity ratios.

51. In December 2012, the State Treasury competitively selected BEM for provision of banking services. The key qualifying criterion in the selection was its geographical presence, although there were concerns about capital adequacy at BEM. The proposed reform would ensure that, looking forward, all relevant public institutions' accounts are placed with financially solid commercial banks, which are in observance of NBM's prudential requirements.

PILLAR C: IMPROVE THE PUBLIC INVESTMENT MANAGEMENT FRAMEWORK, MAKE INVESTMENT SUBSIDIES IN AGRICULTURE MORE EFFICIENT AND EQUITABLE AND IMPROVE THE COVERAGE OF WELL-TARGETED SOCIAL ASSISTANCE PROGRAMS

52. **Existing inefficiencies and inequities in the allocation and implementation of public investment resources, including in the agriculture sector, and the erosion of coverage in well-targeted social assistance programs reduce the effectiveness of public spending for reaching national strategic objectives and promoting inclusive growth.** In 2008-12, capital expenditures averaged 5.7 percent of GDP. But urban and rural infrastructure is in an advanced state of disrepair. Transforming the economy will require significant upgrades in infrastructure through public investments, particularly in transport, energy and agriculture. However, inadequate appraisal of investment projects does not ensure cost effectiveness. Funding for ongoing capital expenditures is not continuous. This lengthens implementation periods and delays service improvements. In agriculture, public support for investment is captured by a small number of large farms investing in traditional technologies and equipment, and therefore does not concentrate sufficiently on promoting innovation and competitiveness. Agricultural support to small or individual farmers is modest, and does not reflect their current and potential role in high-value agricultural production. Likewise, efficiency in assisting the poorest is eroded by diminishing coverage of the best-targeted social assistance programs.

53. **The proposed operation supports reforms in public investment management, public support for agriculture and social assistance that will make more effective and equitable use of limited public resources.** While available fiscal space is a constraint, the supported reforms in public investment management aim to improve efficiency to better utilize existing resources and to be able to satisfactorily implement good projects when more resources become available. In agriculture, it is proposed to allocate investment support to foster modernization and innovative practices, increase market competitiveness, and at the same time reduce vulnerability and improve equity. In social assistance, well-targeted programs are to be adjusted to reduce poverty in a cost-effective way.

<u>Prior Action 8.</u> Government adopts regulation on public capital investment to set up transparent and efficient mechanisms for planning, implementing and monitoring public investment projects.

54. The new Government Regulation on public capital investment ensures projects are prepared, screened (and when warranted, fully appraised) prior to selection and establishes rules for inclusion in the Budget Law. Implementation is to begin during 2014 (for preparation and implementation of new projects, and monitoring of ongoing projects). Implementation of this new regulation has the potential to make public capital expenditures more effective by raising the quality of project preparation, improving budgeting to manage the entry of new projects into the budget so that they are consistent with the available fiscal space after allocations for efficient implementation of ongoing projects, and strengthening project implementation and monitoring.

55. This prior action was completed with the passage of Government Decision 1029 "On approval of the Regulation on public capital investments" on December 19, 2013 (published in *Monitorul Oficial* No. 311/1157 on December 29, 2013).

Trigger for DPO-2. Government adopts guidelines for implementation of the regulation on public investment by local governments.

56. Taking into account capacity constraints at the local level, simple guidelines will help local governments better prepare projects and comply with the new regulation on public investment.

Trigger for DPO-2. Government introduces the following changes to the annual Government regulation on the agricultural support fund for 2014: (i) narrowing the scope of the largest investment subsidy programs to better target innovative practices and focus support to sectors/products with comparative advantages; and (ii) capping (or reducing the caps of) subsidy sizes allowed per one beneficiary.

57. Better targeting of public support is key in the agriculture sector, where measures to enhance agricultural productivity could increase the incomes of the most vulnerable segments of the population, while also boosting exports. Despite notable progress in recent years, the present agricultural subsidy system could be strengthened by taking a more targeted approach to stimulating investments in innovation and high value sectors, as well as reaching higher inclusion of small and medium farmers. For the largest machinery program (presently accounting for over 40 percent of the total subsidy fund), the maximum subsidy size will be reduced by at least 20 percent. These strategic re-allocations are expected to lead to a more equitable (a larger share of subsidies benefitting individual farms) and efficient (more subsidies going to innovative and high value agriculture -related machinery and equipment) distribution of agricultural investment subsidies.

<u>Prior Action 9.</u> Enact amendments to the Budget Law for 2013 and to Government regulation to adjust parameters of Ajutor Social (increase GMI to MDL680) and Heating Allowance (increase benefit size to MDL250) targeted benefit programs.

58. Similar to other countries in the region, Moldova operates an extensive social safety nets system (2 percent of GDP). However, overall targeting accuracy is low, with only 44 percent of total benefits received by the poorest population quintile. Since its introduction in 2009, the *Ajutor Social* program has demonstrated exceptionally strong targeting accuracy, with 70 percent of transfers reaching the poorest quintile. Between 2010 and 2012, its coverage rose from 14.6 percent to 18.8 percent of the bottom quintile. But since mid-2012, coverage of this program

(and the related Heating Allowance program) has been falling. In June 2013, the monthly number of *Ajutor Social* beneficiaries fell below 30 thousand households, from 50 thousand in early 2012. A key factor has been that the Guaranteed Minimum Income (GMI) — the income eligibility threshold in both programs—has not been revised since 2012. Adjustment of parameters of social safety net programs of last-resort is needed to prevent erosion of the eligible household base. Parameters of the *Ajutor Social* and accompanying Heating Allowance programs were amended as follows: (i) increase the income threshold from the current MDL640 to MDL680; (ii) raise the passing score for the proxy means-test; and (iii) increase the amount of the Heating Allowance benefit from MDL200 to MDL250. The measures did not require additional funding in the 2013 budget as there was room to increase spending within the available budget for the *Ajutor Social* and Heating Allowance programs.

59. This prior action was completed with the passage of the Government Decision No.793 "On amendment of Government decision 1167 as of October 16, 2008" on October 8, 2013 (and publication in *Monitorul Oficial* No. 222-227/897 on October 11, 2013) that raised the passing score for the proxy means-test and increased the amount of the Heating Allowance. Furthermore, the 2013 Budget Law was amended on November 15, 2013 to raise the GMI to MDL680 (published in *Monitorul Oficial* No. 281-283 on November 30, 2013).

Trigger for DPO-2. In the Budget Law for 2014 adjust parameters of the Ajutor Social program (increase GMI to MDL700).

60. Continuing parameters adjustments supported by the DPO-1 (see above), the GMI threshold should be raised to MDL700 in 2014. The estimated fiscal cost of Prior Action 9 and the trigger for DPO-2 for the 2014 budget is 0.2 percent of GDP.[13]

Table 5: DPO-1 Prior Actions and Analytical Underpinnings

Prior actions	Analytical Underpinnings
Pillar A: Strengthen the regulatory framework to improve predictability of the business environment, facilitate competition and reduce regulatory compliance costs	
Government adopts a decision establishing the framework Risk-Based Inspections (RBI) Methodology.	Legal and Institutional Mapping of Inspections, IFC, 2012. Inspection Survey, IFC, 2013. World Bank. "Policy Priorities for the Private Sector Development in Moldova", June 2013.
Enact amendments to legislation to ensure that customs- and tax-related legislation and regulations that affect companies be accompanied by a Regulatory Impact Analysis (RIA).	Introduction and application of RIA methodology, legal framework and institutional structure through the Competitiveness Enhancement Project, 2008-2013. World Bank. "Policy Priorities for the Private Sector Development in Moldova", June 2013.
Enact secondary legislation required to implement the Law on Competition and the Law on State Aid, including a Parliamentary decision on the structure of the Competition Council.	World Bank. "Policy Priorities for the Private Sector Development in Moldova", June 2013. World Bank. "Competition Policy: Encouraging Thriving Markets for Development", ViewPoint Note 331, September 2012.
Government adopts a decision reducing the testing and registration period for seeds and seedlings to: (i) 1 year for all annual crops listed in the EU Catalogue, and (ii) 1 harvest year for multiannual (fruit trees) crops listed in the EU Catalogue.	World Bank. "Steps to Improve Farmer Access to New Technology and to Rebuild Moldova's Seed Industry", 2007. World Bank. "Regulations for Seed and Fertilizer Markets: a good practice guide for policymakers", 2001.

[13] Without the adjustments, the allocations for the programs would decline by 0.1 percent GDP. With the adjustments, the allocations would increase by 0.1 percent GDP.

Prior actions	Analytical Underpinnings
Pillar B: Strengthen financial sector stability, promote transparency of shareholding and ease conditions for access to finance	
Government adopts and submits to Parliament amendments to the Law on Capital Markets to consolidate the share registry function of corporate securities and merge into depository function for corporate securities.	World Bank. Technical Note on Efficiency and Integrity of the Securities Registration System and Possibilities for Reform, June 2013. IMF. Single Central Securities Depository Design and Functionalities, May 2013. World Bank. Technical Note on Capital Market Development in the Republic of Moldova, April 2012.
Enact the amendments to the Laws on NBM, on Administrative Court, and Code of Civil Procedure to clarify the legal framework for contesting the acts of the NBM.	Legal opinions from WB experts.
NBM instructs an independent diagnostic audit of BEM and an auditor is selected competitively to carry out said audit in compliance with terms of reference agreed with the NBM.	WB and IMF experience in other countries in the region.
Pillar C: Improve the public investment management framework, make investment subsidies in agriculture more efficient and equitable and improve the coverage of well-targeted social assistance programs	
Government adopts regulation on public capital investment to set up transparent and efficient mechanisms for planning, implementing and monitoring public investment projects.	World Bank. Public Expenditure Review: "Making Public Investment Work for Competitiveness and Inclusive Growth in Moldova", 2013.
Enact amendments to the Budget Law for 2013 and to Government regulation to adjust parameters of Ajutor Social (increase GMI to MDL680) and Heating Allowance (increase benefit size to MDL250) targeted benefit programs.	On-going analytical work for policy monitoring and implementation support of Strengthening the Effectiveness of the Social Safety Net RBF Project.

4.3 LINK TO CAS AND OTHER BANK OPERATIONS

61. **The proposed operation is a key component of the CPS for FY14-17.** The CPS discussed by the Board in September 2013 includes three pillars: (i) Increasing competitiveness; (ii) Enhancing human capital and minimizing social risks; (iii) Promoting a green, clean, and resilient Moldova. The DPO operation will directly support the first pillar of the CPS, improving economic competitiveness. It will also contribute to the second pillar (minimizing social risks) by strengthening the efficiency of the social assistance system. In addition, reforms aiming at making public expenditure more efficient and equitable support the cross-cutting governance theme of the CPS.

62. **The reform program supported by this operation builds on strong complementarily with other World Bank Group instruments in Moldova, including investment projects and analytical and advisory activities.** The operation is complemented in each area by technical assistance and investment lending. TA in investment climate reform and competition policy has strongly informed the policy reforms in these areas. On the investment side, the *Competitiveness Enhancement Project II*, planned for FY15 will complement the DPO series with Regulatory Reform, SME Development and Access to Finance components. Reforms in the financial sector are also supported by the programmatic Financial Sector Development technical assistance. Reforms in public investment management are supported by technical assistance under the programmatic Public Expenditure Review and the Trust Fund for Strengthening Public Investment Management. In social assistance, the DPO complements the on-going *Strengthening the Effectiveness of the Social Safety Net* results-based SIL.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

CONSULTATIONS

63. **Since 2010, the Government has enhanced consultations on policy reforms.** In 2010, the Government streamlined the role of the National Council for Participation. Members of the Council include civil society organizations and the Council is consulted on Government regulations before being adopted. Moreover, all legislative measures and reforms are subject to a thorough consultation process with social partners, civil society and groups likely to be impacted. In addition, during the preparation of the National Development Strategy "Moldova 2020", the Government has introduced an interactive web site (http://particip.gov.md/) to solicit comments and suggestion. For the Government Program itself, as well as to inform debate and agreement in Parliament, consultations were undertaken with the NGO community. On agriculture subsidies, the Ministry of Agriculture and Food Industry carries out consultations every year with stakeholders in the sector regarding the annual support program, prior to its finalization and approval through a Government decision.

COLLABORATION WITH OTHER DEVELOPMENT PARTNERS

64. **The World Bank Group continues to maintain close collaboration with other development partners, including in the areas covered by the operation.** The WBG maintained close dialogue with the EU delegation. Moldova benefits from considerable external support, especially from Europe. In order to advance Regulatory Reform in Moldova, the WBG team has worked closely with the USAID-funded BRITE project to ensure complementarities and synergies. The Bank has regularly consulted with USAID, Sida, EBRD and GIZ on major financial and private sector development issues. The WBG team has worked closely with the IMF on macroeconomic and financial sector issues.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

POVERTY AND SOCIAL IMPACT

65. **The policies and reforms supported by the operation are expected to have positive distributional impacts and thus help reduce poverty and promote shared prosperity.** These goals, resting on strong growth, equity and environmental sustainability, can be achieved through equitable, efficient and sustainable fiscal policy; fair and transparent institutions and public goods; sound risk management and environmental policy; and well-functioning markets. Within this framework, all policy actions supported by the operation are expected to contribute to stronger growth, higher living standards and greater equity over the long term, while specific measures under the three pillars are also likely to have direct and positive distributional impacts over the short term. Specifically, Pillars A and B will directly contribute to higher growth by helping provide opportunities for business growth, supporting fair and transparent institutions and improving the functioning of financial markets. Pillar C will contribute to stronger growth and greater equity by making fiscal policy more equitable and efficient.

66. In addition, measures aimed at improving farmers' access to modern technologies (seeds), refocusing investment subsidies in agriculture, increasing access to financial services,

and improving the coverage of the *Ajutor Social* program are expected to have direct (positive) distributional impacts so that they constitute the focus of the PSIA that was conducted in preparation for this operation[14].

67. **Measures to enhance agricultural productivity are expected to benefit the rural economy, where Moldova's poorest and most vulnerable people live.** Rural poverty rates in Moldova remain high at 30 percent (to compare with 10 percent in urban areas in 2010). Poverty rates are highest among farmers and agricultural workers (at 36 and 45 percent respectively) and 44 percent of those in the bottom 40 percent of the population are farmers or agriculture workers. These two categories are also highly vulnerable to falling into poverty due to the variability of agricultural incomes.

68. **Improving access to better-performing seeds should raise yields and incomes for farmers.** While data is not available on the varieties used by small farms and the associated yields, anecdotal evidence of smuggling of advanced seeds that are not in the catalogue (especially for grains), signals that farmers are willing to pay above-market prices for these seeds—most likely due to the fact that they are more productive than those available in domestic markets. The proposed measure is therefore expected to benefit all farmers, and impacts are expected to be larger among smaller farmers in so far as they face greater information and monetary constraints in accessing modern technologies.

69. **Likewise, the trigger for DPO-2 on refocusing agriculture subsidies on innovation and competitiveness, while increasing the inclusion of small farms in the agriculture support program is expected to be pro-poor.** Investment in agriculture production and resilience can bring about substantial poverty reduction, provided limited public resources are better targeted. The impact of the proposed changes to the subsidy program on employment in commercial farms is unknown but is likely to be small, as subsidies cover a relatively small share of their investments[15].

70. **Increasing the share of investment subsidies allocated to individual producers will support investment and productivity in the small-scale agriculture sector, in which most poor and vulnerable farmers work.** Absent data on characteristics of subsidy recipients that could proxy for poverty status, it is not possible to calculate an estimate of the poverty impact of the proposed changes in the agriculture subsidy program. However, information on the incidence and size of existing subsidies suggests that small farmers, among whom the por and vulnerable are over-represented, stand to benefit the most from the proposed reform. Subsidy data is monitored according to the legal status of farms (individual versus corporate). Census data shows that overall, most corporate subsidy recipients are large farms[16]. Corporate farms received about 75-80 percent of agricultural subsidies over the past three years. Also, between 2010 and 2012, the average size of the subsidy received by the corporate sector has been increasing, while the gap between the average subsidy amounts received by smaller and larger farms has been

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[14] This section summarizes a background note analyzing the poverty, social, shared prosperity and gender impacts of prior actions conducted for this operation. The impacts of the proposed prior actions were assessed to the extent possible and under important data constraints and limitations. Simulations were conducted to estimate the impacts of social assistance measures.

[15] For corporate farms, the average subsidy received stood at 10 percent of the invested amount in 2013. It was 14 percent for individual farms.

[16] 71 percent have more than 100 hectares of land, and 98 percent have more than 5 hectares of land. By contrast, in the individual sector, 85 percent of subsidy recipients have less than 5 hectares of land.

widening. Meanwhile not only are individual farms less likely to receive a subsidy, they also have more limited access to credit and other sources of external funding. According to the 2011 agricultural census, 29.8 percent of all corporate farms received a subsidy, to compare with 6.9 percent of individual farms[17].

71. **The prior action aimed at increasing access to financial services (by facilitating the use of movable collateral) will benefit small and medium-size enterprises.** It will therefore support growth in the medium term through enhanced investment and will indirectly support employment and poverty reduction. The 2009 Enterprise Survey indicated that almost a third of firms with fewer than 10 employees that applied for a loan were rejected. The availability of movable collateral and the anticipated response of lending institutions are unknown, so that the expected impact of this measure on access to finance cannot be quantified a priori. However, consistent with evidence from international experience[18], raising the use of movable collateral is expected to benefit small firms in the service sector, which have limited fixed assets. These firms employ a large segment of the poor and vulnerable (as well as women).

72. **By improving the preparation and implementation of investment projects, public investment management reforms are expected to help improve service delivery and therefore help provide equal opportunities for all.** There are large inequalities[19] in access to public services such as improved water and sanitation resources, education and health. More cost-effective investments in these sectors should help close existing gaps in the long run and thereby provide more equal opportunities, especially for the rural poor and those in the bottom 40 percent. In the water and sanitation sector in particular, improvements in public investment management are expected to help increase absorption of donor funds for investment and repairs to water supply and sewage systems, especially outside the capital[20].

73. **Adjustments to the *Ajutor Social* and heating allowance programs will stop the decline in the number of beneficiaries and reduce vulnerability of the poorest during the cold season.** Since its introduction in 2009, the *Ajutor Social* has persistently demonstrated exceptionally strong targeting accuracy, with more than 70 percent of transfers reaching the poorest population quintile. The *Ajutor Social* program proved to be a major contributor to improving efficiency and equity of the social safety net over recent years. However, the program`s income eligibility threshold—GMI—was not revised since 2012, despite overall income (and pensions) increases. As a result, the monthly number of *Ajutor Social* beneficiaries fell below 30,000 households in the fall of 2013, from 50,000 in early 2012. Simulations conducted for the PSIA indicate that without adjustment, the *Ajutor* program would have further shrunk, leading to fewer recipients for the accompanying heating allowance program and

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[17] Similarly, 14.2 percent of corporate farms had a bank loan relative to 0.2 percent of individual farms.

[18] See "Collateral Registries for Movable Assets", Inessa Love, Maria Soledad Martinez Peria and Sandeep Singh, World Bank Policy Research Working Paper, 6477, June 2013. Using firm-level data for 73 countries, the paper shows that introducing collateral registries for movable assets increases firms' access to bank finance and finds some evidence that this effect is larger among smaller firms.

[19] Inequality in access to sewage is high: 90 percent of those with no access to sewage live in rural areas, and only about 5 percent of the rural population is connected to sewage systems. In rural areas, access to markets, health and education are also hampered by the particularly poor state of local roads: only 22 percent are in fair condition and the rest in poor to bad condition.

[20] Both urban and rural infrastructure is in an advanced state of disrepair, but inadequate resources and capacity constrain spending in areas where the need is most significant. In recent years, geographic disparities have increased, to the detriment of secondary and tertiary cities.

increasing the vulnerability of poor households over the heating season. Adjustment of the program parameters will allow halting the erosion of its coverage and increase the number of beneficiaries. With restored take-up, the *Ajutor Social* program is projected to transfer an average of MDL852 monthly to almost 30,000 families by the end of 2014.

74. **Simulations suggest that taken together, changes in *Ajutor Social* and the targeted Heating Allowance programs could reduce the poverty rate by 0.5 percentage points during the 2014-2015 heating season.** With parameter changes, the simulated poverty rate stands at 13.5 percent, to be compared with an estimated 14.7 percent without the *Ajutor social* and heating allowance program, and 14 percent with the programs under current rules. It is important to note that most of the estimated impact on poverty is due to the *Ajutor Social* program since the average benefit amount per household is much larger (and the program is year round) compared to the benefit amount for the targeted Heating Allowance. In addition, given that *Ajutor Social* aims to reach the poorest (with a lower eligibility threshold), for most eligible households the benefit amount may not lift the household out of poverty. This limits the impact on the poverty headcount but still reduces the depth of poverty.

75. **The other prior actions are not expected to have a negative or direct effect on the poor.** The prior actions aimed at removing administrative constraints on businesses, reducing barriers and controls/inspections, and enhancing competition are all expected to stimulate growth and competitiveness, and thereby indirectly contribute to poverty reduction and shared prosperity.

GENDER IMPACT

76. **Actions supported by this operation are likely to have a positive impact in reducing gender disparities in the medium term by promoting employment growth in sectors that have a high share of women's employment.** Actions supported by this operation will facilitate export growth in agriculture, a sector that has a high share of women's employment – accounting for 23.2 percent of total women's employment in 2012. Improvement to the business climate will also facilitate growth in the service sector, where the largest share of employed women works.

77. **Easing access to finance, especially for SMEs, will help provide opportunities for women entrepreneurs.** Improvements in the business environment combined with easing access to finance will help increase economic opportunities for women in both rural and urban areas. Overall, entrepreneurship rates in Moldova among employed persons are low and less than half the ECA average (1.0 percent vs. 2.3 percent). Moreover, Moldovan women are much less likely to be employers than men. For example, 0.6 percent of all employed women are entrepreneurs compared to 1.3 percent of men in Moldova. Although there was no systematic difference in collateral requirements for firms headed by females and firms headed by males, access to credit by firms run by a female top manager was lower. This was especially true for firms with fewer than ten employees: 12.4 percent of those run by a female manager had a loan (versus 29.2 percent for male managers) and 37.6 percent applied for a loan and were rejected (as opposed to 28.3 percent for those with male managers).

78. **Increasing inclusion of small farms in the agriculture support program will benefit female farmers.** The 2011 agricultural census indicates that 36.4 percent of individual farms and 14 percent of corporate farms have a female head. For both individual and corporate farms, the share of subsidy recipients is slightly lower among female-headed than male-headed farms, with 27.1 percent of all female-run corporate farms receiving a subsidy (30.2 percent for male-run

farms) and 6.1 percent of all female-run individual farms receiving a subsidy (7.4 percent for male-run farms).

79. **While there are no gender-specific criteria for eligibility for the supported *Ajutor Social* and Heating allowance programs, 60 percent of adult recipients in 2013 were women.** The proposed policy action is not expected to substantially modify the gender incidence of these programs.

5.2 ENVIRONMENTAL ASPECTS

80. **The DPO environmental assessment (EA) conducted based on the WB toolkit[21] shows that while Pillars A and B of proposed DPO series are either neutral or beneficial for the environment and would indirectly generate a series of economic, social and environmental benefits, one of the indicative triggers for Pillar C might also cause some adverse environmental impacts.** A more efficient system of agricultural subsidies would stimulate development and implementation of new investments in this sector. These investments might be directed to better resource management or climate change adaptation technologies. Additional investments in agriculture could also cause some negative impacts if they are associated with land degradation, soil and water pollution, or occupational hazards as a result of increased pesticide use in agriculture[22] for example. If agriculture subsidies are provided not taking into account environmental requirements, it could also lead to negative environmental and health impacts and risks.

81. **The existing EA legal and administrative basis is overall well developed and generally in compliance with good international practices, including the WB safeguards policies.** Furthermore, previous and ongoing Bank operations (*Competitiveness Enhancement I* and *II*, and *Rural Investment and Services II* projects) provided and will provide further assistance in strengthening EA capacity, ensuring that there will be no significant environmental effects from the forthcoming new investments[23]. Nevertheless, the 2013 annual regulation of the Agency for Interventions and Payments in Agriculture (AIPA)[24] which administers the system does not provide requirements on EA for proposed activities, compliance with environmental requirements and/or necessary authorizations and/or permits. The DPO suggested and the Ministry of Agriculture and Food Industry (MAFI) and the AIPA agreed to develop a special

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[21] "Assessing the Environmental, Forest, and Other Natural Resource Aspects of Development Policy Lending" http://www.wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2010/08/18/000356161_20100818054032/Rendered/PDF/561680WP0Box341IC10WBDPLTooklitCRA1.pdf

[22] A series of activities targeted at raising awareness and educating potential beneficiaries on safe pesticide handling and use of Integrated Pest Management to enhance sustainability and reduce human and environmental exposure to dangerous products within the *Agriculture Competitiveness* project will address potential increase in pesticide use

[23] The projects' Environmental Management Frameworks (EMFs) stipulate all environmental requirements for investments in agriculture and agro-processing sectors that should be included in technical specifications and in the contracts for implementing civil works. Supervision and monitoring of environmental performance to date have been done adequately. Furthermore, the Ministry of Environment responsible for reviewing EA studies as well as for conducting state ecological control has adequate capacity to ensure proper enforcement of environmental legislation and implementation of Environmental Management Plans (EMPs).

[24] Government Decision no. 152 from February 26, 2013 on the use of subsidy funds for 2013.

section in the annual AIPA Regulation for 2014 to include EA rules and the minimum environmental requirements and environmental due diligence procedure for proposed activities.[25]

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

82. **Public Financial Management (PFM**). As noted in the 2011 PEFA assessment, there has been a marked improvement over the past several years. The fiduciary risk for the proposed DPO is regarded as acceptable. Progress achieved in the main areas of PFM reforms and the remaining weaknesses are summarized below.

83. **Budgeting**. The Government has been consolidating budget formulation and increasing the policy focus of budgets. There has been an improvement in medium-term budgeting in recent years. The majority of sector budgets are based on reasonable plans and cost estimates within the aggregate hard budget constraint. The disruption observed during 2010 and 2011 budget preparation was overcome by the government, and the 2012 budget was approved in time. However, there is still room to improve detailed processes as well as organizational capacities and skills in central and local government institutions.

84. **Budget Transparency**. In collaboration with the World Bank, Moldova became one of the few countries in the world to publish on the internet item level budget execution data for all institutions in the budget.[26]

85. **Internal controls over budget execution**. The Treasury system, implemented through the FMIS currently operated by the MOF, is the main factor in providing proper authorization processes and controlling expenditure, ensuring that budget institutions do not exceed the available appropriation and the monthly allocation. The financial control system can be considered as sound. The development of the Treasury Single Account (TSA) system was finalized in March 2007 when all budgets were executed via the TSA, held in the NBM. Expenditure control is concentrated in the State Treasury within the Ministry of Finance and in the Territorial Treasuries. A mid-term debt management strategy has been developed with donor support which includes a fiscal risk analysis and indicators for risk monitoring.

86. **Procurement**. An assessment of country procurement (CPAR) was conducted by the Bank in 2010 to assist the Government in defining the next phase of procurement reform. Procurement procedures are favorable, but the core challenge is compliance. The practice of single source tendering has been significantly reduced. The 2007 Public Procurement Law (PPL) brought Moldovan legislation in line with international good practice, and provides a good basis for the public procurement system. The main challenge remains the lack of secondary legislation and sub-optimal institutional arrangements for a complaints review mechanism. With the main objective to align the public procurement system with EU Directives by the end of 2014, the Public Procurement Agency (PPA, subordinated to the MOF), has developed a new PPL which addresses the issue of the complaints review mechanism by creating a separate agency. The PPA has registered good results. The e-procurement system has been launched in November 2012. All

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[25] For example, these are developed in the EU CAP Regulation (Council Regulation (EC) No 1782/2003 of 29 September 2003), known as “eco-conditionalities” for direct agricultural payments that are based on food safety and environmental protection requirements, making the receipt of subsidies contingent on compliance with the Regulation.

[26] The BOOST database, available at website of the Ministry of Finance (http://mf.gov.md/actdoc/BOOST), is an analytical tool to monitor the efficiency and transparency of the use of public funds.

central public authorities and some 100 public institutions subordinated to them currently use the system. All local public authorities plan to start using the system by end- 2014.

87. **Accounting and reporting.** With help of the Bank's PFM project, the Government is changing public sector accounting and reporting. A new integrated budget classification and chart of accounts is being developed on the basis of the GFS 2001 standards, to be launched with a new FMIS. It is expected that in the medium term the Government will maintain cash-based accounting for the treasury and modified cash-based accounting for budget institutions.

88. **Internal auditing.** The move from the inspection system and the concept of a centralized internal audit service to the concept of Public Internal Financial Control (PIFC), in line with the requirements of EU partnership agreements, represents significant progress. New legislation has been enacted, and the methodological basis for internal audit has been set. However implementation still lags behind. Further to the change of scope of the Court of Accounts (CoA) on certification of the accounts of the State, a reorganization of the Financial Control and Revision Service (FCRS) has started. The FCRS continues to carry out an inspection function mainly of smaller budget institutions, focusing, however, primarily on ex-post control of budget execution, and on compliance. This practice will continue until a system of financial management and control is established, and will then gradually refocus its activities into an investigation body for fraud and irregularities.

89. **External auditing.** The CoA aims to develop into a modern Supreme Audit Institution and has made steps in that direction over the last few years. A new Law on the Court of Accounts, in line with international standards, was approved in 2008. The shift from external financial control to regularity audits was the key change. The CoA, with the support of development partners, has made progress in implementation of its strategic development plan and is now well advanced in its transformation into an external audit body using international auditing standards. The CoA has initiated several performance auditing engagements, and is also currently executing the second phase of strategic institutional development strategy.

90. **Central Bank and Foreign Exchange Management.** The IMF updated its safeguards assessment of the NBM in 2010 and concluded that the recommendations of the 2006 safeguards assessment have been implemented. The updated assessment provided a set of recommendations focused on mitigating new risks and further strengthening the NBM safeguards framework. NBM financial statements have received unqualified (clean) audit opinions from external auditors Deloitte and Touche (2009) and KPMG (2010, 2011 and 2012). There are no additional fiduciary safeguards considered necessary for management of the foreign exchange.

91. **Disbursement and Fund flow**. The proposed operation will follow IDA's and IBRD's disbursement procedures for development policy operations. The untied finances will be disbursed against satisfactory implementation of the policy program and not tied to any specific purchases. Once the loan is approved by the Board and becomes effective, the proceeds of the operation will be deposited by IDA/IBRD into the existing treasury US$ account used for receiving support from donors and for making external payments opened by the MOF/ State Treasury with the NBM, which forms part of the official foreign exchange reserves. The funds will be used for domestic budget expenditures or repayment of foreign debt. The Recipient shall ensure that upon the deposit of the funds into said account, an equivalent amount is credited in the Recipient's budget management system, in a manner acceptable to IDA/IBRD. The Recipient will report to IDA/IBRD on the amounts deposited in the foreign currency account and credited

to the budget management system. If the proceeds of the loan are used for ineligible purposes as defined in the Financing/Loan Agreement, IDA/IBRD will require the Recipient to, promptly upon notice from IDA/IBRD, refund an amount equal to the amount of said payment to IDA/IBRD. Amounts refunded to IDA/IBRD upon such request shall be cancelled.

92. **Accounts and Auditing.** The administration and accounting of the loan proceeds will be the responsibility of the State Treasury of the MOF. The Treasury will follow standard country rules for administration and accounting. The Government will maintain accounts and records (in a form acceptable to the Bank), or ensure that such items are maintained, showing that credit disbursements were in accordance with provision of the Financing/Loan Agreements. The MOF will be responsible for the DPO administration and for preparing the withdrawal application. The DPO will be subject to ratification by Parliament before it becomes effective. The MOF, with the assistance of the NBM, will maintain records of all transactions under the DPO in accordance with sound accounting practices. Within 30 days of the NBM being credited, the MOF will provide to the Bank a confirmation that the amount of the DPO has been credited to an account that is available to finance budgeted expenditures. As the fiduciary risk of this operation is deemed to be acceptable, no audit of the deposit account is required and no additional risk mitigation measures are needed.

5.4 MONITORING AND EVALUATION

93. **The State Chancellery will steer the administration of this operation, as the main body responsible for policy coordination.** The State Chancellery will be responsible for the supervision of this operation and for progress monitoring in the policy areas supported by the operation, using the standardized approach to policy monitoring. Arrangements for monitoring results indicators are unchanged relative to previous DPOs. It is expected that coordination of monitoring and program implementation will remain adequate, and data collection timely.

6. SUMMARY OF RISKS AND MITIGATION

94. **This proposed operation faces a number of risks.** The main risks that could subsequently jeopardize achievement of the intended development results include: (i) political and governance; (ii) macroeconomic; (iii) operational design, implementation and sustainability; and (iv) sector policies and institutions. The overall risk rating level of the proposed DPO is substantial.

95. **Political and governance risks.** There is a risk that some measures may be reversed, or that the pace of reform could slow down should there be changes in Government after the next parliamentary elections scheduled for late 2014 – early 2015. Moreover, early parliamentary election before the term of the current Parliament expires is still a possibility. Special interest groups that prevented reform in the past are still present and could regain their strength should there be another change in Government. Weaknesses in governance could potentially undermine the independence and effectiveness of public institutions and agencies. To partially mitigate these risks, the Bank team consulted with Parliamentarians, and many proposed policy measures require parliamentary passage. In addition, the policy actions across all three pillars of this operation help increase transparency and promote good governance. Finally, donors, including the Bank, stay engaged in policy dialogue, technical assistance and awareness campaigns.

96. **Macroeconomic risks.** Main risks relate to worsening economic dynamics of key trade partners; a negative oil price shock; a large structural current account deficit, vulnerability of

agriculture to extreme weather conditions; credit quality, liquidity and capital adequacy of select banks (see paragraph 18 for a more detailed exposition). Risks are partially mitigated by Moldova's prudent and flexible macroeconomic policies, by continuing consultations with the IMF, and by measures under Pillar B of the proposed operation. In addition, the findings of a Financial Sector Assessment Program being carried out in the first quarter of 2014 may also inform the policy dialogue and reform agenda of future World Bank support. Still, these macroeconomic risks may not be fully mitigated.

97. **Operational design, implementation and sustainability.** Weak implementation capacity could undermine the effectiveness of reforms. The success of reforms will depend on the Government's implementation capacity, including the effectiveness of relevant agencies – Competition Council, Ministry of Finance, Ministry of Economy, NBM, NCFM, MAFI, Ministry of Labor and Social Policy and State Chancellery. This risk is mitigated by ongoing investment projects and technical assistance undertaken by the Bank and other donors to strengthen the capacity of select agencies.

98. **Sector Policies and Institutions.** The Constitutional Court's ruling on October 1, 2013 declaring that Article 11(4) of the National Bank of Moldova Law is unconstitutional, amplifies vulnerability from macroeconomic risks and risks to banking sector stability. These risks in turn raise implementation and sustainability risks for proposed policy measures in Pillar B. Prior action 6 and the related trigger in the same Pillar is expected to partially mitigate such risks.

ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions and Triggers		Results
Prior Actions under DPO-1	**Triggers for DPO-2**	
Pillar A--- Strengthen the regulatory framework to improve predictability of the business environment, facilitate competition, and reduce regulatory compliance costs		
Government adopts a decision establishing the framework Risk-Based Inspections (RBI) Methodology.	Government adopts decisions establishing sector RBI methodologies based on the framework RBI Methodology and creates an online State Registry of Inspections, which serves as an inspection management system.	Reduced inspection coverage (except tax, customs and financial). *Baseline: 100 percent (2013)* *Target: 80 percent (2015)*
Enact amendments to legislation to ensure that customs- and tax-related legislation and regulations that affect companies be accompanied by a Regulatory Impact Analysis (RIA).		Share of proposed customs- and tax-related legislation and regulations that affect companies, which have a RIA reviewed by the RIA Secretariat before adoption. *Baseline: 0% (2012) Target: 100% (2015)*
Enact secondary legislation required to implement the Law on Competition and the Law on State Aid, including a Parliamentary decision on the structure of the Competition Council.	Government adopts a decision setting up the information collection mechanism for all state aid, to ensure that all state aid grantors comply with their obligations under the Law on State Aid and state aid secondary legislation.	Number of State Aid providers/grantors that are connected and report to the state aid automated information system *Baseline: 0 (2013); Target: 183 (2015)*
Government adopts a decision reducing the testing and registration period for seeds and seedlings to: (i) 1 year for all annual crops listed in the EU Catalogue, and (ii) 1 harvest year for multiannual (fruit trees) crops listed in the EU Catalogue.		Number of new registered varieties: *Baseline: 145 (2013); Target: 160 (2015)*
Pillar B--- Strengthen financial sector stability, promote transparency of shareholding and ease conditions for access to finance		
Government adopts and submits to Parliament amendments to the Law on Capital Markets to consolidate the share registry function of corporate securities and merge into depository function for corporate securities.	Enact the amendments to the Law on Capital Markets to consolidate the share registry function of corporate securities and merge into depository function for corporate securities.	Share of public interest entities (as defined in the amended Capital Market Law) whose registers of securities' owners were transferred to a Central Securities Depository (CSD) *Baseline: zero (2013); Target: 100% (2015)*

Prior actions and Triggers		Results
Prior Actions under DPO-1	**Triggers for DPO-2**	
Enact the amendments to the Laws on NBM, on Administrative Court, and Code of Civil Procedure to clarify the legal framework for contesting the acts of the NBM.	Enact measures to further enhance the framework for contesting NBM acts, in particular related to banking regulation and supervision.	
	Enact amendments to the Pledge Law to increase use of movable assets as collateral.	Share of loans in the system secured by movable collateral *Baseline: 33% (June 2013)* *Target: 36.3% (2015)*
NBM instructs an independent diagnostic audit of BEM and an auditor is selected competitively to carry out said audit in compliance with terms of reference agreed with the NBM.	Complete an external independent diagnostic audit of BEM. BEM adopts a time-bound medium-term restructuring strategy designed to restore long-term viability approved by BEM Supervisory Board and acceptable to the NBM.	BEM operates in accordance with prudential norms, as measured by the Capital Adequacy Ratio (CAR), Total Normative Capital (TNC), Liquidity Ratio, Principle II (LR) and Large Exposure (LE) established by NBM. *Baseline (end-2013): CAR – 26.03%, TNC - MDL 555 million, LR – 66.06%, LE – 16.63%-18.89% of TNC* *Target: comply with NBM requirements (2015), CAR* ≥16%, *TNC > MDL 200 million, LR* ≥20%, *LE* ≤15% of TNC
	Government adopts a policy requiring all public entities and fully or majority state owned companies to conduct price-based public tenders for banking services which incorporate at least the regulatory minimum required CAR and liquidity ratios.	Share of tenders for banking services by public entities and fully or majority state-owned companies that are price-based and that include criteria of the regulatory minimum required CAR and liquidity ratios *Baseline: zero (2013); Target: 100% (2015)*

Prior actions and Triggers		Results
Prior Actions under DPO-1	**Triggers for DPO-2**	
Pillar C: Improve the public investment management framework, make investment subsidies in agriculture more efficient and equitable and improve the coverage of well-targeted social assistance programs		
Government adopts regulation on public capital investment to set up transparent and efficient mechanisms for planning, implementing and monitoring public investment projects.	Government adopts guidelines for implementation of the regulation on public investment by local governments.	Proportion of multi-year investment objects with non-continuous funding. *Baseline: 33 percent (2006-2011)* *Target: 20 percent (2015)* Project proposals prepared in compliance with the requirements of the regulation on public capital investment for project identification and preliminary assessment *Baseline: 0% (2013); Target: 100% of all new domestically-funded projects costing over 5 million MDL that are included in the 2015 budget submission.*
	Government introduces the following changes to the annual regulation on the agricultural support fund for 2014: (i) narrowing the scope of the largest investment subsidy programs; and (ii) capping (or reducing the caps of) subsidy sizes allowed per one beneficiary.	The share of subsidies supporting high-value agriculture (HVA) sectors: *Baseline: 38.6 % (2013); Target: 42.5% (2015)* The share of subsidies allocated to individual producers: *Baseline: 24.4% (2013); Target: 27% (2015)*
Enact amendments to the Budget Law for 2013 and to Government regulation to adjust parameters of *Ajutor Social* (increase GMI to MDL680) and *Heating Allowance* (increase benefit size to MDL250) targeted benefit programs.	In the Budget Law for 2014 adjust parameters of the *Ajutor Social* program (increase GMI to MDL700).	Monthly number of *Ajutor Social* recipients *Baseline: 23,339 households (October 2013);* *Target: 30,000 households (2015)* Monthly number of *Heating Allowance* recipients *Baseline: 30,249 households (November 2013);* *Target: 75,000 households (2015)*

ANNEX 2: LETTER OF DEVELOPMENT POLICY

GUVERNUL
REPUBLICII MOLDOVA

GOVERNMENT
OF THE REPUBLIC OF MOLDOVA

Nr. 2504-63 Chişinău „14" februarie 2014

Letter of Development Policy:
Moldova Economic Growth and Poverty Reduction Reform Program

To the attention of Mr. Jim Yong KIM
President
World Bank
1818 H Str., N.W.
Washington D.C., 20433

Dear Mr. Kim,

I would like to begin by expressing my deep and sincere gratitude for the continuous support the World Bank has offered for Moldova's development over the years. The development results that Moldova achieved with the World Bank's technical assistance, investment projects and policy lending span a number of areas, including financial sector, business environment, education and health, social protection, energy and environment and are both highly appreciated and visible by Moldovan people.

World Bank's policy advice and lending have been critically important for my country in the aftermath of the landmark democratic changes taking place in 2009. As you may know, in early 2009, before the democratic Alliance for European Integration came to power in result of general elections, the Republic of Moldova was on the verge of financial collapse and found itself politically isolated. The budget deficit reached menacing heights, while the economy was in full decline. On this background, the progress we achieved since 2009 makes me proud and optimistic. Following four years of structural reforms and tighter budgetary rules, Moldova managed to achieve a balanced budget, while expenditures have been rationalized. In 2010-2013 Moldovan economy has grown by over 22 percent, which is one of the highest growth rates in Europe. This gave the fiscal room to approve modest, but sustainable increases in pensions and social allowances. Negotiations on the Association Agreement with the European Union, which includes a Deep and Comprehensive Free Trade Area, have been successfully completed, with the Agreement expected to be signed in middle 2014. Developing and consolidating democratic principles based on the rule of law and promoting greater transparency and integrity of the judiciary have been key priorities defining the reform of the justice sector that we initiated since 2011.

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Considering high expectations of our development partners and of the domestic public, the mandate of Government of the Republic of Moldova has not been an easy one. Domestic and foreign factors – such as political crisis settled only one year ago, echoes of global financial and economic crises, hostile takeovers taking place in the financial sector, external geopolitical pressures – all these have inevitably affected the quality of governance. However, the Republic of Moldova has firmly pursued its development path even under these difficult circumstances. The democratic processes initiated in 2009 have gained strength and their impact is already visible in such critical areas as human rights and media freedom. Moldovan economy has been showing steady growth, the European integration course has gained pace, and democratic institutions have been come more functional, while the foreign policy stance and external relations improved dramatically.

In 2011 the implementation of the 2008-2011 National Development Strategy was completed, and a new **National Development Strategy - „Moldova 2020"** - has been developed through a transparent process involving consultations with all relevant stakeholders. The „Moldova 2020" Strategy reflects a coherent vision of long-term sustainable economic development model and has been underpinned by a diagnostic study of critical constraints to economic growth. With the broader goal of ensuring economic growth and poverty reduction, the „Moldova 2020" National Development Strategy is focused on seven cross-cutting development priorities:

1. Education: relevant for a career
2. Roads: in good condition, anywhere
3. Finance: affordable and cheap
4. Business: with clear rules of the game
5. Energy: delivered safely, used efficiently
6. Pension system: equitable and sustainable
7. Justice: responsible and incorruptible.

Achieving these goals involves modernization of public services, further liberalization of the economy, development of a more transparent and stable financial sector, a more favorable investment climate, providing more efficient support schemes to the SMEs, higher investments to modernize the infrastructure, exports' diversification and promotion, creation of new and better paid jobs, an enhanced and better-targeted social protection to support the most vulnerable categories of the population.

In 2009-2011 the Government successfully implemented the anti-crisis program. Learning the lessons of the previous crisis, we are determined to act swiftly should a new wave of crisis emerge and the current strategic planning framework (which includes the National Financial Stability Committee and the Inter-ministerial Committee for Strategic Planning) allows the Government to react promptly in this regard. A new anti-crisis program is currently not deemed necessary: ensuring policy consistency and continuity of actions is our key strategy. However, if significant deterioration of the economic situation occurs, a reconsideration of short-term policy priorities and adoption of an anti-crisis reforms package will be sought.

Raising living standards and reducing poverty by creating conditions necessary for strong and balanced economic growth it the key objective we are ultimately pursuing as part of our economic policies. Sound policies to promote macroeconomic and financial stability combined with structural reforms to increase the economy's growth potential and inclusiveness: these are the factors that my Government sees as crucial preconditions to maintain and further consolidate the Moldova's development successes of 2010-2013.

A. Background

Poverty profile and trends. The Republic of Moldova achieved great success in reducing poverty. In 2012 the poverty rate was 16.6 percent, while in 2006 the indicator was 30.2 percent. The reduction in extreme poverty rate is equally impressive, going from 4.6 percent in 2006 down to 0.6 percent in 2012. The poverty gap index went from 7.9 percent to 2.9 percent in the same period of time, giving me the confidence that the country is on the right track towards achieving its Millennium Development Goals. Poverty reduction continues to be a fundamental priority for the Government of the Republic of Moldova. The „Moldova 2020" National Development Strategy envisages getting 149 thousand citizens (or over 20 percent of those who are currently poor) out of poverty by 2020. Progress in poverty reduction is possible as a result of enhancing well-targeted social support and employment programs for the population, especially in the rural areas, as well as promoting measures for agriculture modernization and for the SMEs development.

Key economic developments in 2009-2012. Moldova's remarkable recovery from the severe economic recession of 2009 was possible due to the consistent implementation of sound macroeconomic policies and structural reforms. During 2010-2013, Moldova's economic performance was among the strongest in the region, despite the output decline in 2012 due to a severe drought. Economic activity grew cumulatively by about 22 percent; inflation was brought under control following the successful implementation by National Bank of Moldova (NBM) of the inflation targeting strategy; real wages increased by about 12 percent over the same period; the fiscal deficit significantly narrowed from -6.4 percent of GDP in 2009 to -2.1 percent in 2012, allowing public debt to remain at a comfortable level of about 30 percent of GDP; all external buffers were built up.

Current economic situation and short-term prospects. In the first nine months of 2013 economic activity registered significant progress. The GDP posted a sound 8 percent increase compared to the same period of 2012. Monetary and exchange rate policy is adequate: inflation rate is within the NBM's targeted range of 5±1.5 percent; floating exchange rate of national currency allowed for a gradual depreciation of the national currency, foreign reserves account for more than 5 months of imports. Wages and pensions increased 2.5 percent year-on-year, while unemployment rate decreased to 4.1 percent from 5.6 percent a year earlier. In 2014, economic activity is expected to slow down a bit, with GDP expected to rise by 4-5 percent. This reduction is growth is not a reason for concern, considering that in 2013 agricultural sector recovering from a severe drought accounted for a significant proportion of the growth. The growth is underpinned by a number of assumptions, including: improvement of economic and financial situation regionally and globally, more intense exports promotion, further improvement in the business regulatory environment, attraction of new foreign investors, promotion of a prudent fiscal policy and of a robust monetary policy.

B. Policy implementation

Supported by World Bank's programmed policy actions, the Government of the Republic of

Moldova has undertaken to implement a number of reforms aiming at enhancing the country's economic competitiveness and to promote a more inclusive and sustainable economic development model. These reforms encompass three pillars:

- Improve predictability of the business enabling environment, create even conditions for competition, and reduce regulatory compliance costs;
- Strengthen financial sector stability, promote transparency and improve access to finance;
- Make public investment, investment subsidies in agriculture and social assistance more efficient and equitable.

The agreed policy areas were selected based on relevant national strategies, including "Moldova 2020" National Development Strategy, and the World Bank's Country Partnership Strategy for the Republic of Moldova for the period FY14-17. The Government has achieved considerable progress in the implementation of the reform agenda. Moreover, the Identification visit for the first Moldova DPO Series took place in mid-September 2013 and the implementation of the agreed policy measures was mostly accomplished by end-December 2013, thus the Government proved its commitment and ambition to achieve sustainable results.

It is important to add that the identification mission discussed the content of the program to be supported over two-operation series ("prior actions" for the first DPO and "triggers" for the second DPO), and that the Government assumes disbursement of DPO2 according to our Budget law for 2014. This is why it is my huge request to process the DPO2 consistently with a Board discussion not later than September 2014.

I. Improve predictability of the business enabling environment, create even conditions for competition, and reduce regulatory compliance costs

Competition is an essential factor for modernizing the national economy, for improving business environment and raising attractiveness for both launching new businesses and development of existing ones. To ensure effective and fair competition, the Republic of Moldova intends to develop and implement a national program in the field of competition and state aid by undertaking the best practices to prevent, suppress and limit the anticompetitive activities of economic agents and of public administration authorities.

In medium and long run, the Government of the Republic of Moldova is committed to create a functional market economy characterized by the firms' capacity to promote innovation based on fair competition for resources and clients. The ultimate winners of a free competition are consumers that benefit from goods and services purchased at a fair price and a quality commensurate with the price. A more favorable business environment makes the country more attractive to foreign direct investment and is conducive to creation of new enterprises and wider employment.

The authorities of the Republic of Moldova have already recorded remarkable progress in implementing the policy actions related to the achievement of the assumed commitments during the program:

- On 5 September 2013, the Government enacted the framework Risk-Based Inspections (RBI) Methodology. The RBI approach is expected to optimize inspection activities based on risk analysis, and to yield improvements in compliance, reliability and safety.

Further under the DPO 2, the Inspection Law will be replenished with 27 sector Risk-Based Inspections methodologies and the State Registry of Inspections will be created.

- By the Government decision no. 765 of 25 September 2013 the Roadmap on the Government's actions to remove critical constraints to the business environment was approved. The roadmap represents an agenda of the Government, with short-term and concrete actions aimed at eliminating the key obstacles to the businesses environment, especially for small and medium enterprises and improving the investment climate. The Roadmap pays special attention to a number of areas that the World Bank's Ease of Doing Business rating identified as critical for Moldova, namely connection to the electricity supply, construction permits, cross-border trade and in particular, ensuring the investors' protection.
- By the Law no. 324 of 23 December 2013 a number of amendments to the legislation and regulator acts were enacted to ensure that customs and tax-related legislation and regulations that affect companies are accompanied by a Regulatory Impact Analysis (RIA). The application of RIA to tax and customs policy and administration proposals would evaluate the potential impact of different policy options through a transparent process (using Public Private Dialogue platform – National Working Group), and promote further simplification of the regulatory environment.
- The Plenum of the Competition Council adopted 17 regulations needed to complete the legal framework governing competition and State aid, and to allow the Competition Council to effectively exercise its duties and responsibilities. A Parliamentary decision on the structure of the Competition Council was approved, setting the necessary conditions for the Council to be fully functional in terms of human resources.
- On 4 December 2013, the Government adopted the Government decision no. 964 that will reduce the testing and registration period for all crops registered in the EU (from three years to one year), with the aim of giving Moldovan farmers faster access to wider range of varieties.

II. Strengthen financial sector stability, promote transparency and improve access to finance

Facilitating access to finance will lead to a significant increase in financing volumes through the banking and non-banking sectors. The "Moldova 2020" National Development Strategy envisages the country to achieve a credit penetration rate of 50% of GDP by 2020. Achieving this level of growth of financing is in itself an ambitious task, sensible to global and local economic and financial risks. However, we deliberately engaged to pursue such an ambitious goal as we firmly believe that a more robust financial sector is of key importance for channeling more investments into the economy.

In this context, the Government of the Republic of Moldova highly appreciates that the World Bank's Moldova Country Partnership Strategy for the period FY14-17 envisages to supports Moldova to boost shared prosperity and reduce poverty by capturing the full benefits of openness and integration with the EU and the broader global economy. More than that, one of the three pillars of the Strategy - *Increasing Competitiveness* - is oriented to continue institutional reforms related to the business enabling environment and governance, access to finance, transparency in the financial sector, and targeted activities to boost companies' competitiveness are needed to reduce barriers and translate economic openness into concrete benefits, such as more jobs and higher income.

While Moldova has already achieved certain progress in strengthening its financial sector, we acknowledge that a number of challenges remain to be addressed, such as undoing the negative effects of a Constitutional Court decision limiting the NBM powers, strengthening the corporate management in the banking sector, increasing the ownership transparency and addressing the corporate governance and management issues undermining the performances of the *Banca de Economii din Moldova* (BEM). In order to address them government supported the implementation of the following:

- On December 19, 2013, the Government approved and submitted to the Parliament the amendments to the Law on Capital Markets and related legislation on securities registration. The supported reforms aim to enhance the efficiency and integrity of the corporate share registry and bring it in line with best international practices.
- The Constitutional Court (CC) ruling from October 1, 2013 created the need for amendments to legislation that would ensure constitutionality of NBM powers. On December 24, 2013 Parliament approved a law, which partly restores the powers of the NBM affected by the CC ruling. These amendments are needed, even though not sufficient, to safeguard financial stability. The NBM, in consultation with the Government, has already developed a draft of additional legislative amendments to fully restore its regulatory capacities and the Government is committed to intervene for the Parliament to approve the needed amendments.
- By the NBM Order no. 16-003/154-3602 of December 9, 2013 an external independent diagnostic audit of BEM was ordered and a competitively-selected and reputable international auditor will start the implementation of the audit. The proposed independent diagnostic audit by a reputable third party is important in order to assess recent transactions concerning BEM and establish a reliable baseline of BEM's financial position. On February 5, 2014, BEM signed the contract with the selected company, which will present the audit reports over the next 3 months.

III. Make public investment, investment subsidies in agriculture and social assistance more efficient and equitable

A number of inefficiencies and inequities in the allocation and implementation of public investment resources, including in the agriculture sector, and the recent erosion of coverage in well-targeted social assistance programs risk to reduce the effectiveness of public spending and to preclude the country from reaching national strategic objectives and from promoting inclusive growth. This is why we are fully committed to address the existing policy and regulatory shortcomings and to achieve a much higher efficiency in using the public resources.

- The 2014 budget provides resources to strengthen the flagship social programs *Ajutor Social* and heating allowance for the poorest in line with Government commitment to poverty reduction. A 25 percent increase in the heating allowance and a 9 percent increase in the minimum monthly income guaranteed by the state (*Ajutor Social*) have been approved. While promoting stronger and more inclusive economic growth is our main poverty reduction strategy, we are convinced that shifting away from poorlytargeted programs and regressive generalized-price subsidies towards better-targeted social programs is an important policy to ensure that vulnerable groups of the population are protected.

- The Government has already approved the normative framework on public investment management, including a Government Regulation on public investment management. The Government Decisions establishes the Ministry of Finance as the body responsible for coordinating project selection. Implementation of this regulatory framework will make public capital expenditures more effective by raising the quality of project preparation (through adequate screening and appraisal mechanisms), improving budgeting to manage the entry of new projects into the budget so that they are consistent with the available fiscal space after allocations for efficient implementation of ongoing projects, and strengthening project implementation and monitoring.
- Despite notable progress in recent years, the present agricultural subsidy system could be strengthened by taking a more targeted approach to stimulating innovation and high value sectors, as well as reaching higher inclusion of small and medium farmers into subsidy schemes. To this end, Government will revise current subsidy measures. For the largest machinery program (presently accounting for over 40% of the total subsidy fund), the maximum subsidy size will be reduced by at least 20%. These strategic re-allocations are expected to lead to a more equitable (a larger share of subsidies benefitting individual farms) and efficient (more subsidies going to innovative and high value agriculture - related machinery and equipment) distribution of agricultural investment subsidies.

Finally, I take this opportunity to assure you that the Government of Republic of Moldova is fully determined and committed to continue actions and reforms that are necessary to improve performance in priority areas, such as governance, infrastructure, health, education and social services. This will boost the private sector development, enhance the quality of public services and ensure the country's sustainable development. I would like to stress that we consider maintaining macroeconomic stability and enhancing the stability of the financial sector as two key prerequisites to achieve our development aims. Taking into consideration that the proposed operation is a key component of the Moldova Country Partnership Strategy (CPS) for FY2014-17, the Government expresses its commitment and willingness to implement agreed triggers for DPO2 as drafted in the Policy and Results Matrix. I am fully confident that the Republic of Moldova can rely on continued support from you personally and from the World Bank.

Sincerely yours,

Leancă

Iurie LEANCĂ
Prime Minister of the Republic of Moldova

ANNEX 3: FUND RELATIONS ANNEX

INTERNATIONAL MONETARY FUND

Republic of Moldova—Assessment Letter for the World Bank
February 12, 2014

Background

Moldova's recovery from the severe recession of 2009 was largely the result of consistent implementation of sound macroeconomic policies and structural reforms. During 2010–13, Moldova's economic performance was among the strongest in the region, despite a decline in output in 2012 due to a severe drought. Economic activity grew cumulatively by about 22 percent; inflation was brought under control; real wages increased by about 12 percent; the fiscal deficit was significantly reduced, allowing public debt to remain at a comfortable level of about 30 percent of GDP; and external buffers were built up. At the same time significant progress was achieved in reducing poverty.

Recent Developments and Outlook

The economy is strongly recovering from the 2012 contraction.

- **Growth:** Following a decline in real output of 0.7 percent in 2012, economic activity rebounded strongly. In 2013, real GDP is projected to have increased by 7½ percent, led by exports, private consumption, and investment. Activity in 2014 is expected to moderate to 4 percent, reflecting the anticipated slowdown in agriculture following last year's rebound, but supported by the recovery in trading partners.
- **Inflation:** Inflation closed at 5.2 percent in 2013 and it is expected to remain within the National Bank of Moldova's (NBM) target range of 5±1.5 percent in 2014.
- **Fiscal position:** The overall budget deficit narrowed to an estimated 1.8 percent of GDP in 2013 from 2.2 percent in 2012, partly due to the under execution of planned investment projects because of financing constraints. The 2014 budget is in line with a general government deficit of 2.6 percent of GDP (4½ percent of GDP excluding grants).
- **External position:** The external position also showed significant strengthening, with the current account deficit estimated to have narrowed further to 7.1 percent of GDP in 2013, compared to the peak of 12.3 percent of GDP in 2011. As a result, gross international reserves increased to US$2.8 billion, equivalent to 5 months of imports and just over 100 percent of short-term external debt.
- **Banking sector:** The banking sector in aggregate seems to be well capitalized, profitable, and liquid, but the share of nonperforming loans remains high and overall capitalization has decreased in relation to past years. Moreover, notwithstanding a recapitalization of Banca de Economii (BEM)—the fourth largest bank by assets,

which had seen a steady deterioration in its financial situation since 2010—by a group of private investors in 2013, the quality of BEM's assets remains uncertain. In recent months, some of the other systemically-important banks have also breached the regulatory capitalization and liquidity requirements.

- **Central bank independence:** A Constitutional Court (CC) ruling in October 2013 declared as unconstitutional the provisions of the NBM law prohibiting the suspension of certain NBM decisions, potentially curbing the NBM powers to effectively carry out its functions as monetary authority and as banking sector regulator. A law passed last December attempts to align the NBM powers to the CC ruling; however certain concerns persist, particularly that the legal procedures for the court review of the NBM decisions may still hinder NBM effective supervisory action (including with respect to decisions to enforce fit-and-proper requirements for ultimate beneficial owners and controllers in banks)..

Notwithstanding the broadly positive outlook for 2014, risks are to the downside. The sluggish recovery in Europe, the slowdown in Russia, and the uncertainties related to BEM and other banks represent risks to the macro-financial outlook. Moldova remains highly vulnerable to fluctuations in remittances from workers abroad (24 percent of GDP), exports to the EU and CIS countries (90 percent of total exports), and donor support (about 10 percent of government spending). Risks related to trade tensions and slower growth in remittances (as construction work for the Winter Olympics in Sochi draws to a close) could also be important in 2014.

Policy Challenges

Maintaining the strong economic performance and progress in poverty reduction of recent years requires creating the conditions for strong and balanced economic growth. Preserving macroeconomic stability will require policies to be focused on: safeguarding fiscal sustainability, maintaining prudent monetary policies, and strengthening the financial sector.

Fiscal policy

The fiscal position has improved significantly in recent years, but there is no room to deviate from prudent policies and critical medium-term challenges remain. The 2014 budget is consistent with the objectives of preserving social expenditure and investment in critical infrastructure. However, the projected structural general government deficit excluding grants (4½ percent of GDP) remains higher than the expected level of external assistance over the medium term (estimated at 2-2½ percent of GDP). Ensuring sustainability requires therefore significant medium-term fiscal consolidation that needs to be achieved through a combination of disciplined policies and structural fiscal reforms. In particular:

- *Wage policy.* Limiting public sector wage adjustments, which have sharply exceeded those in the private sector, to inflation.
- *Utility tariffs.* Ensuring an adequate level of utility tariffs and fostering payment discipline to prevent build-up of losses in state-owned and provide adequate resources to invest.
- *Taxation.* Refraining from granting ad hoc tax benefits that risk eroding the tax base by further weakening tax administration and creating tax avoidance opportunities.
- *Pensions.* Reforming the social security system to put the pension fund on a sustainable financial footing while dealing with demographic pressures and reversing the decline in pension benefits relative to wages. Critical to supporting this process will be avoidance of ad hoc pension increases.
- *Fiscal decentralization/public administration.* Revisiting the fiscal decentralization model to promote budgetary discipline, including by adopting, in the near term, tight debt limits at the sub-national and local government levels and, over the medium term, consolidating the very large number of local governments.

Monetary policy

Maintaining inflation within the the NBM's target range and strengthening the monetary transmission mechanism are the main challenges for monetary policy. Since the beginning of 2012, the NBM has been successful in keeping inflation within its target range. The NBM needs to remain vigilant and be ready to adjust policies as needed, including tightening monetary policy. Over the medium term, the success of the inflation targeting regime hinges on strengthening the monetary transmission mechanism. This will require fostering the development of the interbank money market to ensure that interbank rates are more responsive to changes in the NBM base rate.

Strengthening the financial sector

Ensuring the NBM's independence and effectively guaranteeing its powers to perform its supervisory and regulatory functions is the most pressing challenge in the near term, as underscored by a court decision this week suspending a recent NBM regulation limiting banks' exposure to foreign banks. The government should promptly work out a solution to the challenges posed by the CC ruling to allow the NBM to continue close monitoring of the banks and to ensure compliance with regulatory and supervisory requirements, such as with respect to fit-and-proper requirements of bank owners and ultimate controllers, within the constitutional limits.

Successful rehabilitation of BEM and enforcing regulatory requirements should be a priority. Based on the diagnostic study that is due to be carried out by an independent and internationally reputable auditing firm in the coming weeks, the NBM needs to expeditiously request BEM to prepare an action plan to resolve impaired assets and restore compliance with regulatory norms. The NBM also needs to expeditiously address the emerging weaknesses in other banks by agreeing with their shareholders on a time-bound remedial action plan to address the capitalization and liquidity needs, and concerns about their risk management practices. Corporate governance in banks also remains a concern. The NBM must be empowered to and stand ready to effectively implement the legal norms pertaining to ultimate beneficial owners and controllers in banks.

IMF Relations

- On September 28, 2012, the IMF Board concluded the 2012 Article IV Consultation and fifth reviews under the Extended Credit Facility and the Extended Fund Facility (ECF/EFF).
- On April 30, 2013, the ECF/EFF IMF-supported program expired without completion of the final reviews as fiscal initiatives were undertaken that put at risk the gains under the program in achieving and maintaining fiscal discipline, and disagreement on how to deal with BEM's financial situation.
- On August 28, 2013, the IMF Board decided to engage the Republic of Moldova on Post-Program Monitoring (PPM). IMF Board consideration of the 1st PPM report was put on hold following the authorities' request for a new program.
- On January 15-29, 2014 an IMF mission visited Chisinau to discuss a possible precautionary program to be supported by a combined SCF/SBA. It is expected that discussions will continue in the coming weeks.

Table 1. Moldova: Selected Economic Indicators, 2009–18 1/

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
					Projection					
I. Real sector indicators	(Percent change, unless otherwise indicated)									
Gross domestic product										
Real growth rate	-6.0	7.1	6.8	-0.7	7.5	4.0	5.0	5.0	5.0	5.0
Agricultural	-9.9	7.4	5.2	-20.4	30.0	0.0	5.0	5.0	5.0	5.0
Non-agricultural	-5.6	7.1	7.0	2.0	4.7	4.6	5.0	5.0	5.0	5.0
Demand	-15.1	9.2	8.3	0.4	7.2	3.8	4.0	4.5	4.3	4.3
Consumption	-6.9	7.3	7.5	0.9	5.9	3.8	3.9	4.3	4.2	4.2
Private	-8.0	9.6	9.4	1.0	7.2	3.4	3.8	4.5	4.6	4.4
Public	-2.0	-1.1	-0.7	0.6	-0.3	5.7	4.1	3.4	2.4	2.9
Gross capital formation	-30.9	17.2	13.0	1.8	9.5	3.8	4.5	5.0	4.8	4.9
Private	-32.1	18.5	11.3	-3.9	4.5	3.5	5.9	5.5	5.5	5.0
Public	-26.4	12.4	19.3	21.6	23.4	4.5	1.3	3.9	3.1	4.6
Nominal GDP (billions of Moldovan lei)	60.4	71.9	82.3	88.2	99.2	109.0	120.2	132.5	146.1	161.1
Nominal GDP (billions of U.S. dollar)	5.4	5.8	7.0	7.3	7.9	8.3	8.9	9.7	10.5	11.4
Consumer price index (average)	0.0	7.4	7.6	4.6	4.6	5.9	5.3	5.0	5.0	5.0
Consumer price index (end of period)	0.4	8.1	7.8	4.0	5.2	5.6	5.0	5.0	5.0	5.0
GDP deflator	2.2	11.1	7.3	7.9	4.6	5.7	5.0	5.0	5.0	5.0
Average monthly wage (Moldovan lei)	2,748	2,972	3,194	3,478	3,760	4,200	4,580	4,960	5,450	5,990
Average monthly wage (U.S. dollars)	247	240	272	287	299	319	339	364	393	424
Unemployment rate (annual average, percent)	6.4	7.4	6.7	5.6	5.5	5.6	5.4	5.2	5.0	5.0
Saving-investment balance	(Percent of GDP)									
Foreign saving	9.5	9.6	12.3	7.7	7.1	7.8	7.6	7.4	7.3	7.1
National saving	13.1	13.0	11.0	16.0	17.0	16.2	16.2	16.2	16.2	16.2
Private	14.8	10.4	8.1	11.7	11.6	11.4	11.2	11.0	10.6	10.2
Public	-1.7	2.6	2.9	4.3	5.4	4.8	5.0	5.2	5.6	5.9
Gross investment	22.6	22.6	23.3	23.6	24.1	24.0	23.8	23.7	23.5	23.3
Private	17.6	17.9	18.1	17.4	16.8	16.8	16.9	16.8	16.8	16.7
Public	5.0	4.8	5.2	6.3	7.2	7.2	7.0	6.9	6.7	6.6
II. Fiscal indicators (general government)										
Primary balance	-5.1	-1.8	-1.6	-1.4	-1.3	-2.0	-1.4	-1.1	-0.4	-0.1
Overall balance	-6.3	-2.5	-2.4	-2.2	-1.8	-2.6	-2.0	-1.6	-1.1	-0.7
Stock of public and publicly guaranteed debt	32.4	30.5	29.0	31.1	30.2	29.4	28.3	27.0	25.9	24.9
III. Financial indicators	(Percent change, unless otherwise indicated)									
Broad money (M3)	3.2	13.4	10.6	20.8	26.5	12.3	...	...	...	...
Velocity (GDP/end-period M3; ratio)	1.8	1.9	2.0	1.8	1.6	1.5	...	...	...	...
Reserve money	-10.1	15.9	18.4	22.9	31.9	10.3	...	...	...	...
Credit to the economy	-4.9	12.7	15.0	16.1	18.8	11.9	...	...	...	...
Credit to the economy, percent of GDP	39.5	37.4	37.6	40.7	43.0	43.8	...	...	...	...
IV. External sector indicators	(Millions of U.S. dollars, unless otherwise indicated)									
Current account balance	-516	-559	-863	-559	-557	-646	-684	-724	-768	-815
Current account balance (percent of GDP)	-9.5	-9.6	-12.3	-7.7	-7.1	-7.8	-7.6	-7.4	-7.3	-7.1
Remittances and compensation of employees (net)	1,124	1,273	1,549	1,745	1,912	1,940	2,035	2,117	2,190	2,257
Gross official reserves	1,480	1,718	1,965	2,515	2,820	2,852	2,923	3,044	3,212	3,463
Gross official reserves (months of imports)	3.9	3.4	3.9	4.6	4.9	4.6	4.4	4.3	4.2	4.2
Exchange rate (Moldovan lei per USD, period avge)	11.1	12.4	11.7	12.1	12.6	13.2	13.4	13.6	13.9	14.1
Exchange rate (Moldovan lei per USD, end of period)	12.3	12.2	11.7	12.1	13.1	13.3	13.6	13.7	14.0	14.2
Real effective exch.rate (average, percent change)	5.4	-7.4	5.3	4.5	-3.3	-0.9	0.0	0.0	0.0	0.0
Real effective exch.rate (end-year, percent change)	-16.5	5.4	10.2	-3.9	-2.6	0.0	0.0	0.0	0.0	0.0
External debt (percent of GDP) 2/	80.2	82.0	77.6	82.7	82.5	83.6	81.7	79.9	79.2	78.8
Debt service (percent of exports of goods and services)	19.9	18.6	15.7	15.6	14.7	15.5	14.9	14.4	15.3	16.4

Sources: Moldovan authorities; and IMF staff estimates.

1/ Data exclude Transnistria.

2/ Includes private and public and publicly guaranteed debt.