



REPUBLIC OF MOLDOVA

August 2013

POVERTY REDUCTION STRATEGY PAPER—JOINT STAFF ADVISORY NOTE

This paper on Moldova was prepared jointly by the staffs of the Fund and the International Development Association, on the poverty reduction strategy paper for Republic of Moldova. It is based on the information available at the time it was completed on August 1, 2013. The views expressed in this document are those of the staff teams and do not necessarily reflect the views of the government of Macedonia or the Executive Board of the IMF.

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REPUBLIC OF MOLDOVA

POVERTY REDUCTION STRATEGY PAPER—JOINT STAFF ADVISORY NOTE ON THE NATIONAL DEVELOPMENT STRATEGY 2012–2020

August 1, 2013

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OVERVIEW

1. The National Development Strategy (NDS)—known as "Moldova 2020"—was approved by the Parliament of the Republic of Moldova on July 11, 2012 and officially published on November 30, 2012. The NDS unifies in one document the government's poverty reduction strategy and development vision, although it coexists with other strategic documents such as "Re-think Moldova" or the Government Action Plan for 2011–2014 "European Integration: Freedom, Democracy, Welfare." As with previous strategies, the inclusive and participatory process in elaborating the NDS will contribute to implementation. Public consultations were held and the text of the NDS has been accessible on the government's website for participation.

2. The NDS presents a selective medium-term strategy that focuses on seven national development priorities: (1) Aligning the education system to labor market needs in order to enhance labor productivity and increase employment in the economy; (2) Increasing public investment in national and local road infrastructure, in order 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 in order to secure an appropriate rate of wage replacement; and (7) Increasing quality and efficiency of justice and fighting corruption in order to ensure equitable access to public goods for all citizens.

3. Despite a sharp decline in poverty in the 2000s, Moldova remains one of the poorest countries in Europe. National poverty estimates indicate positive trends in poverty reduction. Published reports indicate that the national poverty rate fell from 30.2 percent in 2006 to 17.5 percent in 2011. Based on the Europe and Central Asia (ECA) regional poverty line of USD5/day (PPP) 94 percent of the population was poor in 2002 but this had declined to 55 percent by 2011. The incidence of extreme poverty (based on a USD 2.5 PPP poverty line) declined dramatically over the same period from 57 to 10 percent. Both rural and urban areas benefited from sharp poverty reduction, but poverty reduction occurred faster in urban areas. Recent economic performance has also promoted shared prosperity with growth in consumption of the bottom 40 percent of the population outpacing average growth (estimates for the period 2006–2011 suggest average annual consumption growth of 3 percent, as compared to an average 6 percent for the bottom 40 percent). However, based on the ECA regional poverty line, Moldova's poverty rate is more than double the 25 percent ECA average, with extreme poverty also significantly higher than the regional average of 6 percent.

4. The previous National Development Strategy (2008–2011) was presented to the Boards of IDA and the IMF in 2008. The NDS proved to be an effective mechanism to mobilize support from development partners. One evaluation report on the implementation of the National Development Strategy during the period 2009–2010 was prepared, but no final report over the strategy period was produced. The 2010 report noted that the new Government that took office in 2009 implemented some of the reforms envisaged in the strategy and initiated new ones required by the financial and economic crisis of 2008–2009 and the floods of 2010. The report notes that an increased focus was placed on improving social assistance, reinforcing democratic institutions, strengthening the European integration process, as well as relations with trade and development partners.

PRIORITIES AND CRITICAL AREAS FOR SUCCESS

A. Roadmap for Pro-poor Economic Growth

5. The NDS correctly argues that Moldova needs to add productivity-enhancing investment and exports as growth drivers to its traditional consumption-based growth model. As the NDS acknowledges, the strong pace of growth observed in the mid-2000s was driven by domestic consumption fuelled by remittances, which are expected to taper off in the medium term. The NDS appropriately calls for a shift from the current consumption-based growth model towards one based on raising investments, increasing productivity and competitiveness, developing export industries, and promoting a knowledge-based society.

6. The rate of GDP growth projected under the NDS will require maintaining sound macroeconomic policies and strict implementation of the reforms envisaged in the NDS. GDP growth (rising gradually to almost 7 percent by 2020) targeted under this strategy is appropriately ambitious in view of Moldova's conditions and other countries' experience but it will require macroeconomic stability and timely implementation of all envisaged structural reforms to enhance

productivity, investment, and exports. Similar to other transition economies, convergence with the European Union provides opportunities for growth but infrastructure upgrades and improving the business climate are essential. At the same time, there are risks. A protracted slowdown in Europe and/or Russia with substantial impact on remittances, exports, and FDI, could threaten this growth outlook in the near term. It would be useful to provide further detail about the assumptions, for instance regarding future remittances and labor migrations, underlining the growth projections to enable critical evaluations over time.

7. It would be useful to incorporate a comprehensive macroeconomic framework in the NDS to underpin the growth strategy and emphasize the need to maintain macroeconomic stability. A strong reform program and corrective policies following the sharp 2009 recession have largely restored macroeconomic stability and considerably improved macroeconomic performance in Moldova. The adoption of an inflation targeting regime has helped anchor inflation around the 5 percent target, thus mitigating its effects on the poor, although it continues to be buffeted by volatile food and energy prices. Tax policy and administration reforms, combined with expenditure rationalization, have brought the fiscal deficit close to a sustainable level, promoting private enterprise, while enhancing priority social and capital spending. Trade liberalization and investment have also promoted exports helping to gradually lower the current account deficit. Continued efforts, including further fiscal consolidation, will be needed to secure these gains.

8. Moldova's public debt outlook is favorable, with low risk of debt distress, but the high private debt is a concern. Public and publicly-guaranteed (PPG) debt has been steadily declining, supported by prudent fiscal policy—as of end-2012 PPG debt stood below 30 percent of GDP. There appears therefore to be some room for modest borrowing to finance priority projects, provided such borrowing remains prudent and prioritized. In this regard, the NDS could identify measures that will be taken to improve the allocation of capital expenditure, taking into account implementation capacity. The assessment of public debt sustainability should also take into account the country's overall debt position, given Moldova's limited debt-servicing capacity. While public debt is relatively low, private external debt in Moldova is about 60 percent of GDP, and is likely to increase over the medium term, with a rising share of short-term debt, thus raising vulnerability to external shocks.

9. Staffs generally concur with the focus on increased financial intermediation. Staffs agree that further consolidation of the deposit base by promoting the flow of a larger proportion of remittances through the banking sector and greater competition should be encouraged. Staffs acknowledge progress in creating a legal framework for the development of the non-banking financial sector, but further strengthening of the regulatory and supervisory functions is needed. Staffs also note the recent progress achieved in the area of credit reporting. The strategy correctly identifies that reforms aimed at improving the collateral framework are needed, and staffs encourage the Government and National Bank of Moldova (NBM) to ensure their proper implementation. At the same time, such issues as financial consumer protection, financial literacy and inclusion have been largely absent in the strategy, but are important elements for achieving the strategy's goal.

10. The strategy could provide a substantive discussion on the topic of shareholder transparency and corporate governance in the banking and broader financial sector. Staffs draw special attention to the need to develop and fully enforce the applicable legal framework for enhanced shareholder transparency including Ultimate Beneficial Ownership, as well as to adhere to international corporate governance standards. As well, additional legal reforms need to be considered to strengthen NBM's independence and reduce the ability of the courts to interfere. In addition, corporate financial reporting reforms are not specifically mentioned in the Moldova 2020 strategy, though they are important for access to finance, financial stability, compliance costs faced by companies, tax assessments, and governance of state-owned enterprises, as well as EU integration and legislative harmonization. While the Government has undertaken significant reforms in this area, further reform steps are needed, including building a strong audit oversight system and strengthening the public registry of financial statements in the National Bureau of Statistics.

11. Staffs welcome the strategy's focus on establishing and ensuring implementation of clearer rules of the game for business. Staffs agree that this would enhance investor confidence in the business environment in Moldova and, as a result, increase investment flows, including FDI. Further regulatory reforms and strengthening of the rule of law are necessary. Staffs encourage focus on specific improvements in trading across borders, in particular customs administration, as well as tax administration. Competition and the court system are addressed in the strategy, and indeed both present substantial barriers. Further emphasis on making it easier to close a business, which impacts competitive behavior and access to finance, would bring greater gains than improvements in starting a business. The emphasis needs to be on food safety and phytosanitary requirements, to facilitate entry of agriculture and food products into the EU and other export markets.

12. To translate improvements in the business environment into increased revenue and jobs, greater attention must also be placed on company- and industry-level competitiveness. Management training, better access to market information, improved access to finance, and identification and removal of industry-specific constraints can help boost competitiveness and exports. Additionally, vocational and tertiary education should be improved to meet the needs of the labor market, consistent with the first pillar of Moldova 2020.

13. The NDS recognizes the importance of adequate road rehabilitation and maintenance for economic and social development in Moldova. In particular, the NDS rightly recognizes the need to improve not only national roads, which are important for broader economic development, but also local roads in order to achieve targets in the education and health sectors. Staffs also support the Government's focus on efficiency improvement in road maintenance.

14. At the same time, staffs call for caution with respect to the affordability of the road sector targets envisioned in the NDS. Restoring eighty percent of roads by 2020 would mean that Moldova would fully recover from the very large backlog in road rehabilitation and maintenance and reach road condition indicators similar to the most developed countries within the period of this NDS. Making this a reality would require a level of investment and maintenance

expenditures which will be hard to mobilize, given the numerous other needs of the country. Such an approach would also run the risk of displacing other needed investment and non-investment priority expenditure, if fiscal sustainability is to be preserved. Carrying out adequate cost-benefit analysis would help the authorities better identify good projects and prioritize them. The NDS refers to potential investment in roads by the private sector through PPP arrangements but this will require the establishment of adequate PPP legislation and very significant capacity building in the public sector. The opportunities for PPPs in the road sector may also be limited by the relatively low traffic levels on most of Moldova's roads. Lastly, the report should further emphasize the importance of greater transparency and effective competition in order to prevent waste, fraud and abuse in this sector.

15. Staffs broadly concur with the proposed strategic vision for the development of the energy sector, but reforms (along with capacity building) should be implemented with strong attention to governance and regulatory framework, affordability and financial sustainability. The strategy rightly focuses on ensuring energy security and increasing energy efficiency. However, Staffs would welcome a comprehensive reform program for this sector which incorporates capacity building as well. Comprehensive reforms of the sector should focus on improved governance, a transparent regulatory framework, and financial sustainability balanced with energy affordability. When these conditions are met, the energy sector should be able to attract crucially-needed investment capital.

16. Although agriculture is not among the seven priority areas in the NDS, it remains a mainstay of the economy and it will be necessary to address output volatility, low market competitiveness and vulnerability to climate change. With 12 percent of GDP, agriculture employed 28 percent of the labor force in 2010 and, when combined with the agro-food sector, it represented about 50 percent of total exports. Climate hazards result in high volatility of agricultural output. Competitiveness is hampered by a complex set of factors, including distortions and imperfections in agriculture input and output markets, poor quality public services in areas like agricultural education, delays in farm restructuring, underdeveloped land markets, lack of access to finance, and unsustainable soil management. Most agricultural produce grown in Moldova, especially high value products, do not meet market rigor for safety, quality, quantity, variety, or packaging. The private sector requires support in their efforts to embark on the sophisticated and costly process of adopting and implementing EU food safety and quality standards.

B. Promoting Human Development

17. In promoting Human Development, the NDS focuses on education and pensions. Although the sector is not among the seven priority areas in the NDS, it will be important to continue reforms to improve efficiency, accessibility and quality of health care (including by optimizing and upgrading the hospital network and reforming health financing).

18. The NDS correctly emphasizes the need to upgrade education and skills to meet the requirements of the labor market, enhance labor productivity, and increase employment. The strategy emphasizes modernizing the vocational education system and continuous labor force

training, enhancing partnerships between education institutions and labor markets, improving the quality of education, and reforming the research and innovation system. In order to adequately design labor policies, the authorities would benefit from strengthening labor market analysis by making stronger efforts to distinguish between cyclical and structural determinants of unemployment. As it seeks to catalyze new sources of growth in the economy, the Government may wish to consider developing mechanisms to coordinate and promote innovation activities, such as through the development of ICT-enabled services, and with a significant focus on skills development. The proposed measures to develop partnership between education and labor market representatives and eliminate corruption factors in the education system could lead to improvements in labor market outcomes. The NDS and subsequent action plans would benefit from the clear identification of the costs of proposed measures and more specific monitoring indicators. Participation in international skills assessments such as the OECD Program for the International Assessment of Adult Competencies (PIAAC) could facilitate monitoring and help design appropriate skills and labor market policies. Also, Governance in the sector could be improved, including through social accountability mechanisms and greater emphasis on beneficiary engagement in monitoring sector performance and voicing demand for improved service delivery. Simultaneously, efforts should continue to increase efficiency of public spending in education by continuing the optimization of the secondary school network, enhancing quality in optimized schools, and raising access to quality preschool education.

19. The NDS rightly identifies the two main issues facing the pension system: equity and sustainability. The indexation formula and particularly the non-valorization of past earnings are the main factors explaining the low and declining replacement rate. At the same time, the small number of contributors compared to pensioners is expected to worsen further due to demographic trends, which threatens fiscal sustainability of the pension scheme. The strategy outlines reform measures to enhance social and fiscal sustainability of the Pay-As-You-Go pension pillar by introducing parametric changes.

20. But ensuring social and fiscal sustainability of the Pay-As-You-Go pension pillar will require more decisive policy reforms. Recent policy developments were modest and insufficient to move forward the longstanding reform agenda. They included steps to increase the contribution period required to qualify for full-size old-age pension and to make special pension benefits converge to regular benefits, but the adopted increase of the contribution period for women has been revoked by the Constitutional Court. Important reforms could include equalizing retirement ages for both men and women at 62 and making further increases to reflect higher life expectancy; better linking benefits and contributions for all groups, including farmers and emigrants; and valorizing past earnings with inflation to halt the sharp drop in the replacement rate. In any event, reforms should be implemented in a package so as not to undermine the fiscal sustainability of the pension scheme. Finally, alleviation of poverty in the old age should be considered in a broader context of available social security policies and programs. Regarding fully-funded pension schemes (the so-called “second pillar”), staffs agree that a thorough evaluation of the prerequisites and time-line is in order (particularly with respect to the strength of the financial system). It should be

noted that in addition to social and fiscal sustainability, pension reform would also have a beneficial impact on savings mobilization and development of financial markets.

C. Addressing Governance Challenges

21. To achieve the goals of the NDS, the Government of Moldova will need to strengthen public finances and public investment management. Staffs welcome the synchronization of sectoral expenditure plans and program-based budget planning. Staffs also support the links proposed between the NDS, sectoral strategies and MTBF. At the same time, unpredictability of resources for multi-year investment projects has reduced credibility of the budget and could limit the ability of Moldova to achieve NDS goals. In this regard, budget reform, public investment management, internal audit, management control, and expenditure management (including cash planning) should be strengthened.

22. The NDS could benefit from an increased focus on improving efficiency and effectiveness of public service delivery, and building capacity in central and local public administration. The NDS can prioritize and sequence service delivery by identifying key areas of improvement such as re-engineering and streamlining of procedures; integration of services; smart regulation; data warehouse and data centers services to streamline access to data; centralized registries with quality data, open data and remote access; and uniform procedures for services delivered by municipalities. Increasing the capacity of the public administration at the central and local level to evaluate, set, implement and manage policy priorities that would support the strategic goals will also be essential.

23. Staffs share the concerns about dysfunction in the justice system as identified by the NDS and fully agree that improvement of the judiciary should be a priority. Staffs believe that strong political will and forceful actions, along with the specific objectives outlined in the Strategy will be critical for turning the situation around in the coming years. The report could also emphasize the importance of judicial awareness in the population and involvement of the young representatives of the judicial profession for the effective implementation of the justice sector reform strategy. At the same time, caution should be exercised not to commit unaffordable amounts of scarce budgetary resources to the sector, e.g., by raising the wages of judges and prosecutors several times, as currently proposed. Also, the monitoring indicators and targets set could be improved (for example, by using experiential surveys with people who had recently an actual experience with the courts [court user surveys] instead of relying only on perception surveys as is currently proposed).

TARGETS, INDICATORS, MONITORING AND EVALUATION

24. The NDS establishes an integrated framework for implementation, monitoring and evaluation. The framework ensures coherence between various national and strategic planning documents and coordinates implementation and monitoring of the strategy between ministerial subdivisions. It also establishes an efficient process for reviewing the strategy periodically.

25. Staffs welcome the authorities' plan to integrate the implementation of NDS in the fiscal process and ensure consistency of NDS financing needs with budget planning. In this regard, an annual Action Plan to cost and operationalize the goals set forth in the NDS could help better integrate policy objectives into the medium-term expenditure framework.

26. Staffs welcome the authorities' plans to maintain extensive consultations with civil society and other stakeholders throughout the implementation of the NDS. We commend the Government for retaining in particular the role of the National Participation Council, which includes representatives of various NGOs, private sector, and trade union stakeholders.

CONCLUSION

27. Bank and Fund staffs believe the NDS provides a good basis for inclusive growth in Moldova, but that implementation will be key. The focus on pro-poor economic growth (through private sector development and improved infrastructure), human development and governance is appropriate given Moldova's current situation. The consolidation into one document of the priorities should enable efficient monitoring and coordination among development partners offering assistance. At the same time, particular attention should be given to the relation between this new National Development Strategy with existing national and sectoral strategies, and how they will inform the preparation of the Medium-Term Budgetary Framework as well as the annual Budget Laws. Implementation risks, particularly those emerging from external terms of trade shocks, weakness in implementation capacity, and the political cycle need to be actively managed.

28. Staffs recommend that special attention be given to the following areas for implementing and strengthening the NDS:

- **Monitoring and evaluation.** The successful implementation of the NDS will critically depend on continued efforts to strengthen the monitoring framework and capacity of key line ministries to develop and implement annual action plans, and integrate these actions into the medium-term expenditure framework.
- **Public Administration Reform.** The NDS could place greater emphasis on civil service management reforms, which is key to the success of other reforms.

- **Business environment.** Priority should be given to improving corporate governance in the financial sector and the broader economy, particularly in light of recent ownership disputes in the banking sector. In this regard, reforms in the justice sector are essential to protect investors and foster investment.
- **Physical infrastructure development.** Moldova's aging infrastructure is a significant bottleneck to inclusive growth. Priority should be given to investment in energy, telecommunications, transportation, water, and sanitation infrastructure, possibly with private sector partnerships.
- **Human resource development.** A competitive labor force is key to Moldova's future development. The NDS should ensure that the educational system is aligned with European standards and is responsive to labor market needs.. Improving incentives to health care providers to both improve efficiency and deliver quality health services will be critical in Moldova's efforts to meet the MDGs.