



Nr. 21-26-05-100

Chişinău

„ 8 ” noiembrie 2016

LETTER WITH REGARD TO THE DEVELOPMENT POLICY

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

Moldova Economic Growth and Poverty Reduction Reform Program

Dear Mr. Kim,

Despite external challenges, Moldova's economic performance in the last few years has been strong; however, the economy is slowing and downside risks are materializing.

Moldova's economic outlook is prone to considerable immediate challenges. On the back of a prolonged recession in the Russian Federation and uncertainty in Europe, macroeconomic and fiscal stabilization is an important short-term challenge. Moldova's growth is slow, its public debt has recently increased, so it has limited fiscal space. The authorities began to take steps to address the governance problems throughout the financial sector.

Implementation of structural reforms in combination with prudent monetary and fiscal policies in Republic of Moldova has reduced external and structural vulnerabilities resulting in an improved economic situation.

Thus, after a recession in the second half of 2015, the economy of Moldova grew at 1.3 percent year-on-year in the first half of 2016.

In the conditions of an austere state budget, Moldova would significantly benefit from an Agreement with the International Monetary Fund (IMF) on a reform program to be supported by a three-year Extended Credit Facility and Extended Fund Facility (ECF/EFF) arrangement. This agreement is now subject to approval by the IMF Management and the Executive Board. Decision by the Executive Board is expected to be carried out in November 2016, following the authorities' implementation of a number of prior actions.

In the longer term, sustainable progress requires a rebalancing of the drivers of growth in Moldova. As the impact of remittances and public transfers moderates, this growth model needs

to be increasingly driven by higher private sector growth and job creation. For this, the rule of law and the accountability of institutions should be strengthened, including in the financial sector, and the efficiency and equity of service delivery should be improved. Raising the quality, equity, and relevance of education and training systems is a top priority as well. Supporting priorities include reforming the social protection system, particularly pensions, improving the business regulatory framework, and ensuring sound macroeconomic and fiscal management.

The National Development Strategy "Moldova 2020", approved in 2012, comes to present a vision of cohesive long-term sustainable economic development based on a diagnostic study of constraints to economic development. In this sense, it will consolidate and will guide the sectoral approach characteristic for the governance program, the objectives of which are outlined for the entire mandate period.

As long-term strategic objectives, the National Development Strategy "Moldova 2020" is focused on the following development priorities:

1. Aligning the education system to labour market needs in order to enhance labour productivity and increase employment in the economy;

2. Increasing public investment in the national and local road infrastructure, in order to reduce transportation costs and increase the 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;

7. Increasing the quality and efficiency of justice and fighting corruption in order to ensure an equitable access to public goods for all citizens.

8. Agricultural and food products' competitiveness and sustainable rural development

Overall, the **Government's objectives** remain unchanged: reducing poverty through macroeconomic stability and sustainable growth. Achieving these goals imply the modernization of public services and liberalization of the economy, the financial system development, favourable investment climate, motivation of the small and medium-sized businesses development, modern infrastructure, diversification and exports promotion, creation of new jobs, and enhanced social protection to vulnerable categories of the population. These objectives,

which include the achievement of the Sustainable Development Goals, are reflected in the Government Activity Plan and in other policy documents.

A. Background

1. Poverty profile and trends. Poverty reduction continues to be a fundamental priority for the Government of the Republic of Moldova. The National Development Strategy „Moldova 2020” traces the major objective of getting 149 thousand citizens, or over 20 percent of the poor, out of poverty by 2020. Progress in poverty reduction is possible as a result of implementing various social support and employment programs for the population, as well as promoting measures for agriculture modernization and small and medium business development.

2. The poverty rate significantly declined in Moldova between 2007 and 2015. Over the period, the national poverty rate fell from 26.0 percent to 9.6 percent, although the downward stagnated during the global financial crisis of 2008-09. In 2015, the poverty threshold was on average MDL 1,378.9 per month per person, showing an increase of 9.7 percent as compared with 2014. Moldova’s remarkable recovery from the severe recession of 2009 was largely the result of the consistent implementation of sound macroeconomic policies and structural reforms.

3. In 2010–15, both poverty rates fell by half, and rural poverty remained at almost five times the level of urban poverty (14.5 percent and 3.1 percent, respectively). A similar gap existed between the urban Chişinău, the capital, which accounts for 23 percent of the population, and the rest of the country. Although the gap has shrunk in the last decade, poverty in other regions is still more than five times the rate in Chişinău.

4. In the first half of 2016, driven by consumption, the economy increased 1.8 percent as compared to the same period last year. However, due to tighter monetary conditions, fixed investments decreased 6.7 percent, while change in inventories has contributed 4 percentage points to the growth. With the stabilization of the exchange rate, net export had a negative contribution of 3 percentage points to the growth.

5. In the first nine months of 2016, national public budget revenues totaled MDL 32,470.3 million, which represents 24.5% of GDP. Compared with the same period of 2015, revenues increased only by 2.0 percent, as a result of suspended financial assistance in the form of grants for the budget support. External grants to the national public budget amounted to MDL 252 million, from which grants for externally funded projects component of the budget accounted 99.6 percent.

6. At the end of September 2016, the national public budget expenditure amounted to MDL 33,516 million, or 25.3% of GDP. National public budget execution resulted in a deficit of MDL 1,045.7 million, or 0.8 % of GDP.

B. Policy implementation

Taking into account the World Bank's supported programmed policy actions, the Government of the Republic of Moldova has undertaken a number of reforms aiming at enhancing the competitiveness:

- Strengthen the regulatory framework to improve predictability of the business environment, facilitate competition, and reduce regulatory compliance costs;
- Strengthen financial sector stability, promote transparency of shareholding and ease conditions for access to finance;
- 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 agreed policy areas were selected based on the National Strategies and the World Bank's Country Partnership Strategy for the Republic of Moldova for the period FY14-17. It is imperative to note that the World Bank's identification mission discussed the content of the program to be supported over the two-operation series ("prior actions" for the first DPO and "triggers" for the second DPO), and that the Government assumes the disbursement of DPO2, that is why it is respectfully requested to process the Operation consistently with the Board discussion no later than November 2016.

I. Strengthen the regulatory framework to improve predictability of the business environment, facilitate 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 and development of new businesses. 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 the medium and long run, the Government of the Republic of Moldova is focused to create a functional market economy characterized by the capacity to promote innovation based on fair competition for resources and clients. Ultimately, the winners are consumers that benefit from goods and services purchased at a fair price and a quality commensurate with the price. A favourable business environment is attractive to foreign investment and creation of new enterprises.

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

- The Government of the Republic of Moldova has initiated the implementation of a number of reforms aiming to improve the inspection environment for businesses. Until now, the Government has adopted 20 RBI methodologies and has adjusted 11, based on the RBI Methodology framework. On July 21, 2014 the State Registry of Inspections (SRI) (<https://rsc.gov.md>) has been launched and up to date there are 26 institutional bodies in total that collect and store data on planned and ad-hoc inspections. On October 28th 2016, a new law had been adopted and published which has the following purpose: to reduce the number of inspectorates from 33 to 13, to enforce the consolidation of inspectorates, to revise the sanctioning mechanism; to effectively and efficiently dispute resolution instruments and the promotion of voluntary compliance activities. By the Law no. 324 from 23 December 2013 were enacted more amendments to the legislation and normative acts to ensure that customs and tax-related legislation and regulations that affect companies be 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 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 allow Competition Council to effectively exercise its duties and responsibilities. As well as a Parliamentary decision on the structure of the Competition Council was approved.
- On 4 December 2013, the Government by an amendment adopted a decision (Government decision no. 964) that reduced 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.

II. Strengthen financial sector stability, promote transparency of shareholding and ease conditions for access to finance

Facilitating access to finance will lead to a significant increase in financing volumes through the banking and non-banking sectors as a percentage of GDP (up to 50% by 2020). Achieving the planned level of growth of economy financing is in itself an ambitious task, sensible to global economic and financial risks, as well as to local ones. But, being reached, such an increase will have a direct impact on gross domestic production and income by converting loans into new investment.

The Government of the Republic of Moldova appreciates that the Country Partnership Strategy for the Republic of Moldova for the period FY14-17 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 help improve companies' competitiveness are needed to reduce barriers and translate economic openness into concrete benefits of more jobs and higher income.

The authorities of the Republic of Moldova have recorded progress in implementing the actions related to strengthening financial sector stability:

- The Government made amendments to the Law on the National Bank of Moldova to consolidate the corporate securities registration function into a single central securities depository.
- The three banks: Banca de Economii, Banca Socială, and Unibank were liquidated in order to maintain a stable banking system.
- By the Decision No.387 from 28th of May 2014 (published in the Official Gazette of the Republic of Moldova, 2014, No.142-146, article 431), the Government of the Republic of Moldova has approved the Regulation on purchasing financial services by the state/municipal enterprises and commercial companies with fully or majority public capital which sets out rules about the procedures that have to be followed by the state-owned companies in order to conduct public tenders for banking services, mentioning also that the bank has to fulfil the prudential criteria established by the national legislation, especially to respect the limits of the total regulatory capital, the degree of risk weighted capital and the liquidity indicators according to principle I and II. Therefore, for all state-owned companies it is mandatory to abide the rules established by the Government regarding the tenders for banking services. The Ministry of Finance selects financial institutions to perform operations related to the execution of the budgets under the legislation on public procurement, establishing conditions and requirements for compliance of financial institutions to the prudential regulating indicators approved by National Bank of Moldova.
- The Pledge Law was amended in order to facilitate the use of movable assets as collateral.
- In order to implement the action „Strengthen the supervisors' independence and improve resiliency of the financial system through enacting amendments to the NBM Law, NCFM Law, and other legislation” part of Pillar B „Strengthen financial sector stability, promote transparency of shareholding and ease conditions for access to finance”, by the Law No.62 from the 8th of April 2016 (published in the Official Gazette of the Republic of Moldova, 2016, No.123-127, article 248), the Parliament of the Republic of Moldova approved amendments to the National Bank Law (No.548-XIII from 21st of July 1995), National Commission for Financial Markets Law (No.192-XIV from 12th of November 1998), Administration and Privatization of Public Property Law (No.121-XVI from 4th of May 2007) and to the Capital Market Law (No.171 from 11th of July 2012), which aim to strengthen the independence of the National Bank of Moldova (NBM) and the National Commission for Financial Markets (NCFM), to provide full legal protection and

assistance to all NBM and NCFM employees for actions taken in good faith, to remove the need of performing the juridical expertise of the NBM and NCFM normative acts, to create the single central depository, etc.

III. 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 authorities of the Republic of Moldova recorded substantial progress in implementing the actions related to the improvement of the public investment management:

- The 2015 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. The parameters of the *Ajutor Social* program have been adjusted in the Budget Law for 2015 and subsequent amendments, reflecting the GMI increase from MDL 720 to MDL 900. Additionally, as of November 1st 2015, the heating allowance has increased from MDL 250 to MDL 315. These changes have provided the possibility to support through welfare programs a greater number of families in need.

Ultimately, the Government aim is to make these well-targeted social programs the mainstay of our poverty alleviation strategy as we shift away from poorly-targeted programs and regressive generalized-price subsidies.

- The Ministry of Finance approved the Order nr.185 from 3rd of November 2015 regarding the approval of the instructions on the management of capital investment projects. The Order has been approved in order to ensure the implementation of the Government Decision nr.1029 from 19th December 2013 on public capital investments, and includes budget instructions, with guidelines and data requirements for submitting information on local project concepts. On 26th October 2016, the aforementioned Government Decision was amended and the scope was broadened to all investment projects, except those that are regulated by other legislative acts.

In 2015, the Ministry of Finance received project proposals according to the Government Decision nr.1029 from December 19, 2013. However, in 2015, only the projects that started in the previous years and ongoing projects were included in the state budget, therefore they do not have to be assessed according to the new legal framework.

Implementation of this regulatory framework will have the potential to make the 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.

Additionally, the regulatory framework for PIM was strengthened by (i) enacting provisions of the Law on Public Finance and Fiscal Budgetary Responsibility on the

principles of the PIM system and the public investment financing; (ii) amending the regulation on public investment to expand its coverage; and (iii) adopting guidelines for project preparation cycle.

- 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. The Government adopts the annual regulation on the agricultural support fund for 2016 to: (i) narrow the scope of the largest investment subsidy program; and (ii) cap (or reduce the caps of) subsidy sizes allowed per one beneficiary.

The Government is committed to preserve the sustainability and continuation of the Ajutor Social and Agricultural programs, since poverty reduction remains to be the fundamental priority.

Finally, I take this opportunity to assure you that the Government is fully determined and dedicated to its commitment to continue actions and reforms that are required to improve performance in priority areas, such as governance, infrastructure, health, education and social services, and give a new impetus to private sector development with a view to contributing to better quality services for Moldovan citizens and ensuring the country's sustainable development. 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 sustain progress achieved by the DPO2 prior actions as described in the Policy and Results Matrix. I have full confidence that the Republic of Moldova can count on continued support from you personally and from the World Bank.

Sincerely yours,



**Prime Minister of the Republic of Moldova
Pavel FILIP**