PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

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Operation Name	Second Development Policy Operation
Region	EUROPE AND CENTRAL ASIA
Country	Moldova
Sector	General public administration sector (30%); Banking (20%); Public administration- Industry and trade (20%); General finance sector (20%); General agriculture, fishing and forestry sector (10%)
Operation ID	P149555
Lending Instrument	Development Policy Financing
Borrower(s)	THE REPUBLIC OF MOLDOVA
Implementing Agency	MINISTRY OF FINANCE
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Corporate Review Decision	October 21, 2016

I. Country and Sector Background

Moldova has experienced rapid growth and poverty reduction over the past decade, although deterioration in external conditions and increased governance challenges since 2014 have led to slower growth. Since the early 2000s, the economy has expanded by an average of 5 percent a year. Poverty declined substantially to 11 percent in 2014 from 26 percent in 2007 (using the national poverty line) and from much higher levels earlier in the decade. Consumption growth among the bottom 40 percent of the population was consistently higher than average consumption growth. Since 2014, however, external conditions have deteriorated significantly with the slowdown in the European Union (EU) and the Russian Federation on which Moldova is dependent for trade and remittances. This, together with a series of summer droughts and increased governance challenges, particularly in the financial sector, have resulted in slower growth in Moldova. The economy contracted by 0.5 percent in 2015 and public and guaranteed debt increased to 46.6 percent of gross domestic product (GDP) from 38.2 percent a year earlier. A rebound in agriculture, in 2016, together with recent reforms are helping Moldova respond to adversity. Growth is projected to improve modestly to 2.2 percent in 2016.

Progress in poverty reduction has been driven largely by remittances and pensions, with the reform program supported by DPO-2 taking initial steps toward addressing the medium-term challenge of shifting toward greater sustainability. Remittances have made a significant contribution to domestic income, which has fueled private consumption and, together with exports, driven economic growth. Remittances, mainly going to rural areas where many of the poor are, have also contributed to poverty reduction and the welfare improvement of the bottom 40. Pensions have also played an important role in raising incomes among the population, although mainly in urban areas. At the same time, employment has declined, led by falling labor force participation rates among both men and women which have reached very low levels compared to other countries. This declining labor supply is largely explained by a combination of greater emigration flows, the segment of the inactive labor force who have future migration plans, and informal workers who drop out of the labor force, all symptoms of low labor demand and limited availability of productive jobs. In fact, the lack of jobs and the wage differential with richer neighboring countries continue to motivate emigration. Going forward, the reforms to improve the business climate, enhance financial sector stability, and improve expenditure efficiency should help Moldova move toward a more sustainable model of growth and poverty reduction driven by private sector job creation.

European integration has anchored the government's policy reform agenda since 2009, but political instability and governance challenges have slowed the pace of reform. Negotiations between Moldova and the EU on an Association Agreement and a Deep and Comprehensive Free Trade Agreement began in 2010 and were concluded on June 27, 2014, with the signing of both documents. Visa-free access for Moldovan citizens travelling to the Schengen area went into effect in April 2014. However, periodic breakdowns in pro-European coalitions made progress uneven. Governance challenges have continued to take the center stage, as exemplified by the banking fraud revealed in 2014 that involved the loss of the equivalent of over 10 percent of the country's GDP. After a period of short-lived governments, the Government of Mr. Filip was appointed in January 2016, dedicating policy efforts on stabilizing the macroeconomic situation, increasing transparency, and addressing identified weaknesses in the financial sector.

The proposed operation supports the efforts of the Moldovan authorities to address key constraints to inclusive and sustainable growth by consolidating reform efforts in three areas. 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, focusing on the quality of public spending, seeks to improve the public investment management (PIM) framework, make investment subsidies in agriculture more efficient and equitable, and improve the coverage of well-targeted social assistance programs. The reform program builds on strong complementarity with other World Bank Group 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).

II. Operation Objectives

The proposed DPL series supports the Government of Moldova's to improve the business climate, promote financial sector stability and development, and improve the equity and efficiency of public expenditure. The proposed operation is the second in a planned programmatic series of two single-tranche operations supporting key policy and institutional reforms with three development objectives:

- 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.

The Pillar A seeks to improve the business environment facing Moldovan companies and farms. Supported measures aim to reduce the burden of regulatory and compliance costs of state inspections and to enhance competition and to set up an institutional mechanism for information collection on all state aid to increase transparency on how state aid is granted and contribute to a more efficient use of state budget resources.

The objective of the Pillar B is to support the Moldovan authorities to build a more sustainable, resilient, and transparent financial sector that can prudently expand access to financial services. The policy 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 NCFM. Reforms under this pillar are also aimed at enhancing access to finance, which continues to constrain private sector development, especially for SMEs and entrepreneurs.

Pillar C focuses on 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. 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, poverty reduction and promoting shared prosperity. Transforming the economy will require significant upgrades in infrastructure through public investments. Moreover, adequate appraisal of investment projects ensures cost effectiveness. Agricultural support to small or individual farmers is still modest, and does not reflect their current and potential role in high-value agricultural production.

III. Rationale for Bank Involvement

This operation (second in a programmatic series of two) supports efforts of the Government to improve the business climate, promote financial sector stability and development, and improve the equity and efficiency of public expenditure, and is aligned with the National Development Strategy "Moldova 2020" (NDS). The three pillars of the operation directly support three of the eight national priorities in the NDS: "improving the business climate" (supported by Pillar A), "reducing financing costs" (supported by Pillar B), and "ensuring competitiveness of agro-food products" (supported by Pillar A and C). In addition, improving the public investment management framework is expected to contribute to efficiency of public spending, and ultimately, to growth. Increasing the coverage of well-targeted social assistance programs is expected to contribute to poverty reduction and to increase shared prosperity, while maintaining fiscal sustainability. The reforms supported in this DPL series are informed by substantial technical assistance and analytical work. This includes both recently completed and ongoing activities, with strong collaboration with other development partners.

This 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.

IV. Tentative financing

Source:		($m.)
Borrower/Recipient		0
International Development Association		17.8
International Bank for Reconstruction and Development		27.2
	Total	45

V. Institutional and Implementation Arrangements

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, complements the DPO series with Regulatory Reform, SME Development and Access to Finance components. The World Bank Group's Competition Policy Team provided technical assistance to the Competition Council to help implement the state aid registry. Reforms in the financial sector are also supported by the programmatic 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.

VI. Risks and Risk Mitigation

The overall risks to this operation are substantial. Key risks are: (i) political and governance; (ii) macroeconomic; (iii) sector policies and institutions and (iv) institutional capacity for implementation and sustainability. The overall risk rating level of the proposed DPO is substantial. To partially mitigate these risks, the Bank team has consulted with Parliamentarians as 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, development partners, including the International Monetary Fund and the European Commission remain engaged in policy dialogue, technical assistance, awareness campaigns and financing (including three-year IMF EEF program

VII. Poverty and Social Impacts (PSI) and Environmental Aspects

The policies and reforms supported by the operation are expected to have positive distributional and gender impacts and thus help reduce poverty and promote shared

prosperity. Pillar C will make fiscal policy more equitable and efficient and therefore have a direct effect on poverty reduction and the promotion of shared prosperity. Pillars A and B will contribute to the twin goals indirectly by helping provide opportunities for business growth, supporting fair and transparent institutions and improving the functioning of financial markets, thereby enabling higher growth. No measure is expected to have negative distributional or gender impacts. Measures under pillar A are expected to promote employment growth in sectors that have a high share of women's employment such as agriculture (which accounts for 27.3 percent of women's employment) and services, where the largest share of employed women works.

Among the measures expected to have a direct positive impact on poverty, the measures to increase the inclusion of small farms in the agriculture support program are expected to be pro-poor and to contribute to strengthen the livelihoods of the rural poor. According to the 2011 agricultural census overall most corporate subsidy recipients are large farms, with 30 percent of all corporate farms receiving subsidies against 7 percent of individual farms. For both individual and corporate farms, the share of subsidy recipients is slightly lower among female-headed than male-headed farms. Redirecting resources to small farmers is the more important considering the high incidence of poverty in rural areas vis a vis urban ones (14.5 percent versus 1 percent in big cities and 5.7 percent in small towns), and the particularly high incidence of poverty among farmers and agricultural workers (12.5 and 13.9 percent respectively).

The measures aimed at facilitating the use of movable collateral, based on international experience, can be expected to benefit smaller firms in the service sector which have limited fixed assets, and therefore have a positive (if small) distributional impact. The cogency of the constraints faced by smaller firms in accessing credit is illustrated by the 2013 Enterprise Survey which indicates that over a third of firms with fewer than 20 employees, and in particular those managed by women, that applied for a loan were rejected. To the extent that these measures extent to agricultural enterprises the poverty reducing impact of these measures will be amplified (about 6.5 percent of the poor lives in households engaged in entrepreneurial activities outside of agriculture, but the share rises to 23 percent when agriculture is included).

The parametric changes in the *Ajutor Social* social assistance program of last resort have explicit positive pro-poor and gender impact. Indeed, the rationale for the changes is to stop the erosion of the potential beneficiary base of the program. By directly supporting the income of a significant proportion of the poorest households in the country, these measures were estimated to reduce poverty by as much as 0.5 percentage points, with additional improvements in the livelihoods of the poor not captured by a decrease in poverty incidence (but in lower depth and severity of poverty). The proposed policy action is not expected to substantially modify the gender incidence of these programs, but as 57 percent of adult recipients of *Ajutor social* in 2015 were women, this measure is expected to have a positive gender impact.

The withdrawal of the licenses from BEM, Banca Sociala, and Unibank and their liquidation has affected negatively the workers who lost their jobs and were not absorbed by other banks. The country's regime of severance packages (growing with years of tenure in the job so that for example it would provide 9.6 weeks of salary for those employed for one year, and 18.6 weeks of salary for those with 10 years of tenure) was applied to cushion the shock on those who lost their job. Given wage levels in the banking sector (almost twice as high as the average for the economy) those severance packages were quite generous (the equivalent of 6.3 times the poverty line for those with one year of tenure in the job and of 27 times the poverty line for those with ten years of tenure). In addition, because of their higher than average wages, workers in this group were not among the most poor and vulnerable (in 2015 only 9 percent of workers in the financial sector were among the bottom 40 percent). Finally, there is at least anecdotal evidence that several employees from the banks that were liquidated were reabsorbed elsewhere in the sector. Other negative impacts of the bank liquidations, such as the losses for the depositors were fully compensated for during the liquidation process.

The DPO environmental assessment (EA) and of the proposed priority actions shows most of them are either neutral or beneficial for the environment (see Annex 4). Measures in Pillar C to improve the public investment management framework and make investment subsidies in agriculture more efficient and equitable would eventually lead to better natural resource management, promotion of organic agriculture, energy efficiency and climate change adaptation technologies. Existing EA legal and administrative frameworks in the country is overall well developed and in compliance with good international practices. The PIM regulation requires environmental assessment for projects, and as such would help mitigate the potential environmental impacts.

VIII. Contact point

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