COMMISSION OF THE EUROPEAN COMMUNITIES

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Proposal for a

COUNCIL DECISION

providing further macro-financial assistance for Moldova

(presented by the Commission)

EXPLANATORY MEMORANDUM

Economic situation and progress with stabilisation and reform in 1994

The authorities of Moldova initiated the transition to a market economy in 1990 and adopted in spring 1993 a more ambitious programme for stabilisation and structural adjustment. Since then, the government has worked in close coordination with the IMF and the World Bank to further elaborate its economic reform strategy.

Following the introduction, in November 1993, of its national currency - the Moldovan leu-, Moldova has taken decisive steps towards financial stability in the context of the economic programme supported by an IMF stand-by arrangement (approved in December 1993) and complementary assistance from the international community, including EU macro-financial assistance of up to ECU 45 million.

The programme was implemented in a very difficult environment. Real GDP is estimated to have fallen by about 22 percent in 1994, compared with an anticipated decline of 3 percent. This is in part attributable to the continuing disruptions to output and trade associated with the collapse of central planning. Industrial production fell by about 30 percent in the first half of 1994, before stabilising in the second half of the year. A severe drought, followed by flooding and hail storms, devastated key crops in this mostly agricultural country in the third quarter of 1994.

Despite this unfavourable economic environment, the Moldovan authorities demonstrated considerable resolve and consistency in the pursuit of financial stabilisation. Reviews under the IMF stand-by arrangement were successfully completed in June and December 1994, and all performance criteria for end-December 1994 were met. The key objective of the programme was a rapid and sustained reduction in the rate of inflation based on the introduction of the leu, and a stabilisation of the exchange rate. As a result of the firm implementation of the programme, inflation decelerated sharply in 1994. The monthly rate of inflation fell from an average rate of about 20 percent in the fourth quarter of 1993 to an average rate of about 3 percent in the fourth quarter of 1994. As inflation subsided, the exchange rate stabilised and the credibility of the leu was enhanced as reflected by the reversal of currency substitution, allowing a decline in nominal and real interest rates.

Fiscal deficit for 1994 was contained to 8 percent of GDP, despite the greater-than-expected decline in real output and inflation. However, liquidity problems in the enterprise sector impeded tax collection and resulted in the assumption by the Government of guaranteed loans to enterprises in default. Furthermore, expenditure arrears rose by some 1 1/2 percent of GDP, including arrears on wages, as a result of the application of a strict cash management system.

The balance of payments remained under severe pressure throughout 1994 primarily as a result of higher prices for imported energy and the effects of natural disasters. Based on preliminary data, the current account deficit was equivalent to 10 percent of GDP. Moldova was highly dependent on foreign assistance, the disbursement of which (US$ 370 million) covered some 50 percent of total imports. The IMF and the World Bank contributed some 38 percent of total foreign assistance, Russia some 36 percent (primarily in the form of arrears by Moldovan enterprises for energy imports), and other bilaterals some 26 percent, including the EU (ECU 25 million corresponding to the first tranche of the macro-financial assistance), Japan (US$ 30 million), the US (US$ 20 million) and Romania (US$ 10 million). With the pace of disbursements in foreign assistance increasing late last year, gross reserves of the central bank reached the equivalent of 3 months of imports at end-1994.

The progress made in terms of structural reform in 1994 was mixed. State enterprises remained largely unresponsive to market forces (which resulted, inter alia, in the increase in arrears to the budget and to external suppliers of energy as indicated above), owing in part to the weakness of the bankruptcy and liquidation process, and delays in privatisation. However, towards the end of the year, there was a substantial acceleration of reform efforts, as the authorities recognized that further delays in implementing structural reforms threatened to undermine the stabilisation gains. A new streamlined auction procedure was introduced, that facilitated the implementation of an ambitious schedule for the auction of state enterprises. The Government also decided to identify and initiate liquidation proceedings against seven of the most problematic state enterprises.

Economic programme for 1995/96

At this critical juncture of the reform process, the Moldovan authorities have formulated an ambitious strategy for 1995 with the objective of consolidating the progress in stabilisation and intensifying structural reforms. The programme that is supported by a new IMF stand-by arrangement approved in March 1995 requires further complementary financing from the international community.

The programme aims at economic growth of 1 1/2 percent, led by a recovery in the agricultural sector with the return of normal weather conditions, a reduction in the annual rate of inflation to about 10 percent and the containment of the deficit in the current account of the balance of payments. To meet these objectives, fiscal policy is centered on sharply reducing the budgetary deficit to the equivalent of 3 1/2 percent and monetary policy is to remain tight. The acceleration of structural reforms in late 1994 is to be sustained in 1995 through an accelerated privatisation programme, the establishment of the legal basis for bankruptcy proceedings, the strengthening of the capital base of the banking system and the development of indirect, market-based monetary controls.

The programme entails considerable risks, both domestic and external. The task of implementing a systemic change is inherently difficult; it is further complicated by the conditions of trade and payments disruptions. Furthermore, key elements for the success of the programme, such as improvements in tax administration and the enforcement of enterprise financial discipline can only be implemented gradually, and will require the maintenance of a large consensus among a population that has suffered from a severe erosion of its purchasing power.

The external position of Moldova will remain under severe pressure in 1995. The effects of the terms-of-trade shock caused by the increase in imported energy prices to world market level will continue, and although the programme does not target a further increase in the gross international reserve position of the central bank, Moldova will remain highly dependent on foreign assistance. In 1994, Moldovan enterprises had largely resorted to external arrears to their Russian suppliers of natural gas. By end-94, cumulated arrears amounted to about US$ 120 million, of which US$ 52 million have been cleared through a debt-equity swap operation in the course of 1995. Moldova is now expected to begin reducing the outstanding arrears, and further amortisation payments are due in 1995 to the Russian Federation and to the EU (ECU 27 million). In the circumstances, anticipated foreign loan disbursements of some US$ 200 million under existing commitments (including US$ 144 million from the IMF and the World Bank, US$ 24 million from the EU - corresponding to the ECU 20 million second tranche of macro-financial assistance -, and a similar amount from other bilaterals - mostly the US and Japan) will leave a financing gap of about US$ 50 million. Further commitments from creditors and donors that participated in providing exceptional financing to Moldova in 1994, including the EU, Japan and the US have been contemplated in the Consultative Group meeting held in March. Actual disbursement of this external assistance will be critical to sustain the policy efforts required from the Moldovan authorities in the framework of the programme for 1995.

In the first quarter of 1995, the Moldovan authorities have strictly implemented the financial policies contemplated in their programme. Based on preliminary data, all performance criteria for end-March have been met, including a better-than-expected foreign exchange position of the central bank. This has resulted in a stable exchange rate and a containment of inflationary pressures.

The acceleration of the reform efforts that started in the last quarter of 1994 is expected to continue in 1995. In particular, a new ambitious privatisation programme covering 1995 and 1996 has been approved by the Parliament on 15 March, that covers a substantial portion of the remaining state assets, and introduces along the existing voucher system, privatisation for cash (in order to provide new liquidity to enterprises for post-privatisation restructuring and to open privatisation to the participation of foreign investors). A "wait and see" attitude of enterprise managers in anticipation of the adoption by Parliament of this new privatisation programme was however partly responsible for the slowing down of the privatisation process in the first quarter of 1995. The pilot liquidation of seven enterprises is now well under way; the Liquidation Committee, that performs asset sales and the payments of creditors, has been formed, and three of these enterprises have been liquidated, while two others found sufficient resources to clear their outstanding liabilities. A bankruptcy law has been drafted with the assistance of the IMF. Import tariffs have been reduced to 30 percent since end-March. With respect to the banking sector, the central bank has started auctioning State certificates in March. And the Government is preparing two new laws: the law on the central bank, which sets out the responsibilities of the NBM and the criteria which should guide the conduct of the monetary policy, and the law on financial institutions, which provides the framework for the NBM supervision of commercial banks.

Previous macro-financial assistance to Moldova

On 13 June 1994 the Council of the European Union decided to grant the Republic of Moldova a loan of ECU 45 million with a maximum duration of ten years (Council Decision 94/346/EC) to assist the country in its transition efforts and to strengthen the reserve position of the central bank. The Community loan was part of an overall package mobilised by the international donor community in favour of Moldova to complement the resources provided by the IMF and the World Bank.

The Community loan was to be disbursed in two tranches, upon the fulfillment of conditions specified in the Memorandum of Understanding (MOU) attached to the loan agreement. The first tranche, of ECU 25 million, was disbursed in December 1994, on the basis of the successful completion of the first programme review under the IMF stand-by arrangement. The disbursement of the second tranche, of ECU 20 million, was conditional upon a successful track record of the IMF stand-by arrangement and subject to a positive evaluation by the Commission of performance criteria and of progress made with respect to structural reform. These conditions have been fulfilled and the Commission disbursed the second tranche on 7 August 1995.

Financing needs for 1995 and proposed further macro-financial assistance

On 20 March 1995, a Consultative Group meeting for Moldova took place under the auspices of the World Bank. At the meeting, the IMF indicated that it had reached an agreement in principle with the authorities on the main parameters of the programme for 1995. The Fund also indicated that for the programme to be successful, complementary financial support of some US$ 50 million for the programme period would be needed over and above financing that would be provided by the IMF and the World Bank and earlier bilateral commitments. With a view to meeting Moldova's residual financing needs, the ECOFIN Council reached on the same day an understanding on the opportunity to grant Moldova Community assistance of ECU 15 million in the form of a balance of payments loan facility.

The prospect of a further Community loan to Moldova, together with assistance commitments by a number of other bilaterals (the USA, Japan, the Netherlands), as well as indications given by Russia on rescheduling of arrears on gas payments, allowed the IMF to conclude that the authorities programme could be adequately financed. Accordingly, on 22 March 1995, the IMF Executive Board approved the financing arrangement with Moldova. The IMF intends to make available to Moldova for the programme period (April 1995 to March 1996) resources amounting to about US$ 90 million in the form of a stand-by arrangement.

The present proposal by the Commission is made as a follow up to the understanding reached by the ECOFIN Council in March 1995.

Main features of the loan

The Commission is proposing that the Community would grant Moldova a balance of payments loan of up to ECU 15 million with a maximum duration of ten years.

The assistance would be granted in complement to the resources made available by the IFI's, and in particular by the IMF under the agreed stand-by arrangement. The loan would be disbursed in a single tranche, conditional upon compliance with a limited number of conditions based on the government's economic programme supported by the IMF.

The proposed duration of the loan (ten years), which is shorter than the duration of the World Bank Structural Adjustment Loan (20 years), is consistent with the medium-term balance of payments outlook for Moldova, which is expected to face substantial financing needs for the years ahead.

As in the case of similar operations in favour of Central and Eastern European countries, the Community would provide the funds through market borrowing with a guarantee by the general budget. Moldova would subsequently borrow from the Community. The borrowing and lending operations would be perfectly matched and without any commercial risk for the Community.

In accordance with the Guarantee Fund mechanism, the budgetary implications of a decision to make available assistance of up to ECU 15 million to Moldova would be a ECU 2.25 million provisioning of the Fund.

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Proposal for a

COUNCIL DECISION

providing further macro-financial assistance

for Moldova

The COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 235 thereof,

Having regard to the proposal of the Commission[1] submitted after consulting the Monetary Committee,

Having regard to the opinion of the European Parliament[2],

Whereas Moldova is undertaking fundamental political and economic reforms and is making substantial efforts to implement a market economy model;

Whereas Moldova on the one hand and the European Communities and their Member States on the other hand, have signed a Partnership and Cooperation Agreement which will help the development of a full cooperation relationship;

Whereas the authorities of Moldova have requested financial assistance from the international financial institutions, the European Community and other bilateral donors, and whereas, over and above the estimated financing which could be provided by the IMF and the World Bank, a residual financing gap of some US$ 50 million remains to be covered in 1995, in order to support the policy objectives attached to the government's reform effort;

Whereas Moldova has agreed with the International Monetary Fund (IMF) on a stand-by arrangement in support of the country's economic programme and whereas this arrangement has been approved by the IMF Board on 22 March 1995;

Whereas, by Decision 94/346/EC [3], the Council approved macro-financial assistance for Moldova of up to ECU 45 million; whereas, however, further official support is required in order to support the balance of payments, consolidate the reserve position and comfort the necessary structural reforms in this country;

Whereas an additional Community loan facility to Moldova is an appropriate measure to help easing the country's external financial constraints;

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3 OJ N° L155, 22.6.94, p.27

Whereas the Community loan facility should be managed by the Commission;

Whereas the Treaty does not provide for the adoption of this Decision, powers other than those of Article 235,

HAS DECIDED AS FOLLOWS :

Article 1

1. The Community shall make available to Moldova a long-term loan facility of a maximum principal amount of ECU 15 million with a maximum duration of ten years, with a view to ensuring a sustainable balance-of-payments situation, strengthening the country's reserve position and comforting the implementation of the necessary structural reforms.

2. To this end the Commission is empowered to borrow, on behalf of the European Community, the necessary resources that will be placed at the disposal of Moldova in the form of a loan.

3. This loan will be managed by the Commission in close consultation with the Monetary Committee and in a manner consistent with any agreement reached between the IMF and Moldova.

Article 2

1. The Commission is empowered to agree with the Moldovan authorities, after consulting the Monetary Committee, the economic policy conditions attached to the loan facility. These conditions shall be consistent with the agreements referred to in Article 1(3).

2. The Commission shall verify at regular intervals, in collaboration with the Monetary Committee and in close coordination with the IMF, that the economic policy in Moldova is in accordance with the objectives of this loan facility and that its conditions are being fulfilled.

Article 3

1. The loan shall be made available to Moldova in a single tranche, which shall be released subject to the provisions of Article 2 and subject to satisfactory progress being recorded in Moldova's application of the stand-by arrangement agreed with the IMF.

2. The funds shall be paid to the National Bank of Moldova.

Article 4

1. The borrowing and lending operations referred to in Article 1 shall be carried out using the same value date and must not involve the Community in the transformation of maturities, in any exchange or interest rate risk, or in any other commercial risk.

2. The Commission shall take the necessary steps, if Moldova so requests, to ensure that an early repayment clause is included in the loan terms and conditions, and that it may be exercised.

3. At the request of Moldova, and where circumstances permit an improvement in the interest rate on the loans, the Commission may refinance all or part of its initial borrowings or restructure the corresponding financial conditions. Refinancing or restructuring operations shall be carried out in accordance with the conditions set out in paragraph 1 and shall not have the effect of extending the average maturity of the borrowing concerned or increasing the amount, expressed at the current exchange rate, of capital outstanding at the date of the refinancing or restructuring.

4. All related costs incurred by the Community in concluding and carrying out the operation under this Decision shall be borne by Moldova.

5. The Monetary Committee shall be kept informed of developments in the operations referred to in paragraphs 2 and 3 at least once a year.

Article 5

At least once a year the Commission shall address to the European Parliament and to the Council a report, which will include an evaluation, on the implementation of this Decision.

Done at Brussels,

For the Council

The President

FINANCIAL RECORD

1. Budget line concerned

   Article (...) reflecting the budget guarantee for the Community loan facility to Moldova (to be created through an amending and/or supplementary Budget).

2. References(legal base)

   Article 235 of the Treaty

3. Classification of the Expenditure

   Obligatory

4. Description and Justification for the action

   a) Description of the action

      The budget entry reflects the commitment of the budget guarantee associated with the Community's borrowing and corresponding lending operations to Moldova.

   b) Justification for the action

      The viability of Moldova's external accounts heavily depends on external financial assistance from official sources.

5. Nature of the expenditure and method of calculation

   a) Nature of the expenditure

      Potential activation of budget guarantee for the Community borrowing aimed to fund the loan to Moldova.

   b) Method of calculation

      A token entry is proposed given that the amount and timing of any call on this budget line cannot be calculated in advance and because it is expected that this budget guarantee will not be called.

6. Effect of the action on intervention credits

Only in the case of an effective call on the guarantee.

7. Financing of intervention expenditure

- Recourse to the Guarantee Fund established by Council Regulation (EC, EURATOM) n° 2728 of 31 October 1994.
- In case the Guarantee Fund did not contain sufficient resources, additional payments would be called up from the budget by transfer, by reutilisation of reimbursed amounts (Article 27(3) of the Financial Regulation of 1977), or by amending and/or supplementary Budget.
- In order to fulfill its obligations, the Commission can provisionally ensure the debt service with funds from its treasury. In that case, Article 12 of the Council Regulation (EEC, EURATOM) no. 1552/89 of 29.5.1989 will apply.

ANNEX

BUDGETARY RESOURCES NECESSARY FOR THE PROVISIONING OF THE GUARANTEE FUND IN 1995 AND MARGIN UNDER THE RESERVE FOR GUARANTEES (IN ECU MILLION)

Operations	Basis of the Calculation	Provisioning of the Fund[1]	Reserve Margin
			323[2]
Project related assistance			
EIB/CEEC	1121	157	166
EIB/MED	52.5	7.3	158.7
EIB/PVDLA	139	19.5	139.2
EIB/SOUTH AFR.	125	18.7	120.5
EURATOM	50	7	113.5
Macro-financial assistance			
Bulgaria	40[3]	6	107.5
Belarus	75[4]	11.25	96.2
Ukraine-II	200[5]	30	66.2
Moldova-II	15[5]	2.25	64

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1 According to the provisioning rules provided in the Council regulation (EC, EURATOM) n° 2728/94 of 31 October 1994. After a first drawing of the Guarantee Fund, and in compliance with Article 5 of the Regulation, the rate of provisioning for new operations is being increased from 14 % to 15% in 1995. For 1995, all EIB and EURATOM operations approved in 1993 and 1994 have been provisioned with a 14% rate. New macro-financial assistance operations have been provisioned with a 15% rate.

2 Reserve amount in 1995 under the financial perspective.

3 Commission proposal (COM(94)118 of 21.11.1994, 94/0103(CNS)) to increase the maximum amount of the existing loan facility to Bulgaria from ECU 110 million to ECU 150 million.

4 Council decision of 10 April 1995.

5 Commission proposal.

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