COMMISSION OF THE EUROPEAN COMMUNITIES

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99/0213 (CNS)

Proposal for a

COUNCIL DECISION

providing supplementary macro financial assistance to Moldova

(presented by the Commission)

EXPLANATORY MEMORANDUM

Introduction

Until 1991, Moldova was a highly integrated Soviet Republic. Since the country became independent, the Moldovan economy contracted by about two thirds. The transition from a command to a market economy, and, even more importantly, the disruption of the close input and output relations with the other former Soviet republics, provoked a severe crisis throughout the economy.

Implementing economic reform was hampered by the small size and the narrow base of the economy, since about 70% of total output is generated in the agricultural sector. Moreover, the concentration and effective isolation of the country's heavy industry and energy sectors within the separatist Transnistrian Moldovan Republic exercised considerable leverage over the central government in Moldova.

In early 1993, Moldova embarked on a comprehensive programme of economic stabilization and market reforms backed by the IMF, the World Bank and the EBRD. Subsequently, substantial progress was made: in 1995, GDP contraction had decelerated to just 1.4%, accompanied by significant reductions of both fiscal and external deficits.

In May 1996, the board of the IMF approved an extended fund facility arrangement (EFF) of SDR 135 million for Moldova. The new programme aimed at accelerating and deepening structural reforms and consolidating the stabilization effort. However, the pace of reforms had been slowing, in particular as regards fiscal consolidation and the restructuring of the industrial and agricultural sectors. After some delay, the second review of the EFF was completed in July 1997.

During this period, the European Community supported Moldova’s transition through various means, including macro-financial assistance. In total, the Commission provided two macro-financial assistance packages worth ECU 45 million and ECU 15 million (Council Decisions EC/94/346 and EC/96/242). In both cases, the Community loans were part of an overall package mobilised by the international community to complement the resources provided by the IMF and the World Bank. Debt servicing of the Community loans went according to the agreed scheduling.

Reforms stalled in 1997 and the International Financial Institutions (IFI’s) decided to suspend their lending activities. In March 1998 a new, reform oriented government approached the IFI’s to renew cooperation. A few months later, however, the eruption of the Russian financial crisis led to a dramatic worsening of the economic situation.

To increase their financial support in favour of six NIS countries, including Moldova, identified as being particularly affected by the Russian crisis, the IMF and the World Bank took the initiative in convening a Consultative Group (CG) on 11 December 1998. Given that Moldova declared its commitment to make strong efforts in terms of macro-economic stabilisation and structural reform in the context of programmes supported by the IFI’s, the EC and other bilateral donors were asked to make an exceptional complementary effort.

Consequently, on 20 January 1999 the Commission announced, amongst other measures, that it planned to provide a € 15 million package of macro-financial assistance to Moldova.

Recent economic developments in Moldova

In the run-up to the elections in March 1998, a loosening of fiscal policy created major macro-financial imbalances, which in turn began to affect the real economy and to threaten the still very vulnerable stabilization.

The financial crisis in Russia dramatically exacerbated these problems. Substantial revenue shortfalls, mainly from the lost VAT and excise revenues on exports to Russia led to a dramatic increase of budget expenditure arrears in 1998 of about 10% of GDP in 1998. Although the previous government reduced its spending considerably since August, the general government budget deficit exceeded 7% of GDP in 1998. The debt load is increasing dramatically and amounted to 66% of GDP at the end of 1998. Re- entering international capital markets is not realistic in the short term. Privatisation receipts have virtually dried up and foreign investors have recently offered extremely low prices for Moldovan assets. Further debt restructuring and heavy reliance on the International Financial Institutions (IFI) appears the only reasonable option in the near future.

Moldova's trade depends mainly on Newly Independent States (NIS) markets, which accounted for 76% of total exports as of June 1998 (Russia alone 62%). In addition, the country has practically no raw materials and relies heavily on energy imports. As a direct consequence of the current problems, Moldova’s export share to Russia and the other NIS fell substantially, whilst the needs for energy imports did not drop accordingly, which led to additional foreign debts to Russian energy providers. In December 1998, Moldovagas’ debt to Russian Gazprom amounted to over 10% of GDP.

In 1998, the deficit on the external accounts amounted to 23% and 16% of GDP for respectively the trade and current account balance. Capital flight and the lack of borrowing possibilities reduced net capital account inflows sharply. In the last quarter of 1998, strong pressures on the Moldovan leu forced the National Bank to support the exchange rate forcefully. However, after having lost about half of the international reserves, they decided to cease intervening in late 1998, when foreign reserves amounted to US$ 167 million or only 1,5 months of imports.

In the half year to March 1999, the leu fell by 70% to around 10 to the US$. Domestic demand, already sluggish before the Russian crisis, has been deteriorating further by a worsening investment climate in a context of high real interest rates and a crowding out by public financing needs. Increases in salary and pension arrears significantly weakened consumption prospects (public sector wages arrears account for about US$ 1.5 billion) . The industrial and agricultural sectors lost their traditional markets in the NIS and experienced a substantial output decline (reportedly, industrial and agricultural output fell by 11% and 7% respectively in 1998). Hence, Moldova's growth performance was affected profoundly as GDP is estimated to have fallen 8,6% in 1998.

The main immediate impact of the crisis is most felt on the social front. Private transfer and family support systems are under strong pressure. This might result in a substantial increase in poverty.

The economic programme for 1999

As the EFF had been off-track for about 15 months, chiefly because of missed targets on public finances, the new, revised programme's key issue is fiscal policy tightening, mainly via tax and administration reforms, a new pensions bill and rationalized social and health expenditures. As a result, the general government deficit should decline from 7% in 1998 to less than 2% in 1999. The underlying growth assumption of 1% in 1999 is highly dependent on this year's harvest, as agriculture generates about one third of total output.

In the present environment, monetary policy should focus chiefly on avoiding a default in the treasury bill market and meeting foreign obligations, while preserving the payments system. Monetary policies have already been tightened by increased reserve requirements. Under the new tight policy mix, inflation is expected to drop to 15% by the end of 1999.

Along with a recovery and a diversification of exports the current account deficit is expected to narrow by 4% to 12,8% of GDP. A further rationalization of energy consumption should reduce the current account deficit further to 6-7% by 2003/2004.

Debt is being rescheduled when possible, and the bulk of the external financing needs are to be covered by IFI's and bilateral donors. Enhanced privatization efforts and a debt-equity swap between Moldovagas and Gazprom are the key structural measures.

The previous government of Moldova has already been making vigorous efforts to implement the policies that underlie the EFF and remained firmly committed to the above measures. Consequently, the IMF concluded in its third review under the Extended Fund Facility, approved on 29 December 1998, that the programme agreed with the Moldovan authorities deserved full support of the international community as the overall economic framework should suffice to put the Moldovan economy back on the rails, thereby restoring macro-imbalances and fostering reforms.

To date, however, the IMF has not made any disbursement. The fall of the previous government in February and the subsequent political problems had created great uncertainties regarding future economic policies. In addition, the end-March performance criteria under the EFF were missed. Consequently, the IMF put all disbursements on hold and decided to check the relevant criteria once more in mid-July.

Moldova's external financing needs and the proposed macro-financial assistance.

Moldova's external position deteriorated dramatically from the onset of the Russian crisis, in mid-1998. Sharply lower exports to Russia and the other NIS combined with a rapidly deteriorating capital account, due to mass capital flight and the lack of borrowing possibilities, took the deficit on the 1998-balance-of-payments to over US$ 300 million, or about 17% of GDP, whilst the reserves melted down to about one month of imports.

In 1999, the rapid depreciation of the leu accompanied by a renewed fiscal tightening and a contracting economy should narrow the current account deficit significantly. However, given the continuation of poor prospects of foreign investment and the lack of access possibilities to capital markets, Moldova's financing needs are bound to remain substantial in the short and medium term.

Under these dire circumstances, international donors were asked to provide additional balance of payments assistance for 1999. The IMF-programme foresees a financing gap of US$ 162 million. The Fund and World Bank will provide US$ 37 and US$ 60 respectively, so that complementary bilateral financial support of US$ 65 million would be needed.

In January 1999, the Commission considered that the Community should make available to Moldova a third balance of payments loan of up to € 15 million with a maximum duration of 10 years, a grace period of 5 years included.

The Commission still considers the proposed € 15 million as an appropriate reference amount for the Community's support to the balance of payments of Moldova. This support would help the consolidation of the country's official reserves position and sustain the reform efforts of the authorities. It would contribute to the financing of the country's residual financing needs, together with the commitments from other bilateral donors and eventual recourse to the capital markets.

The proposed duration and the attached grace period is consistent with the medium term balance-of-payments outlook of the country, which is expected to face substantial financing needs for the years to come.

The assistance would be granted in the context of the EFF and would complement resources made available by the IMF and other donors. The Commission welcomes the efforts made by the authorities to work in close collaboration with the IMF so as to succeed the EFF by another programme in order to reverse the substantial deterioration of Moldova's economic situation.

The proposed balance of payments loan of up to € 15 million would be released in one tranche, subject to a satisfactory track record of Moldova's macro-economic programme agreed with the IMF and to progress with respect to structural reforms (in the context of the EFF and/or any successor arrangement with the IMF).

It is worth noting that progress with stabilization and reform in Moldova has slowed down in recent months, as there was a governmental vacuum. The end-March performance criteria under the EFF were not observed, and the IMF has consequently held up the disbursement of the relevant tranches, which will only be released when the conditions are met. The Commission is closely monitoring the situation and takes the view that, despite the recent problems, the authorities remain committed to stabilisation and reform. Indeed, the new government which was appointed mid-March has endorsed the previous government's commitment to the IMF programme and has already implemented several among the agreed prior actions. The Community's assistance will be implemented only after the EFF has been brought back on track and could therefore serve as an additional incentive for the effective implementation of the necessary reforms next to being instrumental in alleviating the additional social costs risen after the Russian crisis.

Similar to the two previous loans in favour of Moldova, 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 the decision to make available an assistance of up to € 15 million to Moldova would imply an € 2.1 million provisioning of the Fund.

The Commission requests accordingly the Council to adopt the attached proposal for a Decision providing supplementary macro-financial assistance to Moldova.

99/0213 (CNS)

Proposal for a

COUNCIL DECISION

providing supplementary macro financial assistance to Moldova

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 308 thereof,

Having regard to the proposal from the Commission[1],

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

(1) Whereas the Commission consulted the Economic and Financial Committee before submitting its proposal;

(2) Whereas Moldova is undertaking fundamental political and economic reforms and is making substantial efforts to establish a market economy;

(3) 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 entered into force 1 July 1998;

(4) Whereas the authorities of Moldova have agreed with the IMF on a macro-economic programme supported by a three-year Extended Fund Facility, approved in May 1996 and have expressed their intention to subsequently continue this programme in the context of a new Fund Facility;

(5) Whereas the Moldovan authorities have requested financial assistance from the International Financial Institutions, the Community and other bilateral donors; whereas over and above the extended financing by the IMF and the World Bank a substantial residual financing gap remains to be covered in the coming months to strengthen the country's reserve position and support the policy objectives attached to the authorities reform efforts;

(6) Whereas Moldova has been particularly affected by the Russian financial crisis and is presently facing particularly difficult economic and social circumstances;

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1 JO .. 1999 providing exceptional financial assistance to Moldova

2 JO .. 1999

(7) Whereas financial assistance from the Community in the form a long term loan with a substantial grace period is an appropriate measure to help the beneficiary country at this critical juncture;

(8) Whereas this assistance should be managed by the Commission;

(9) Whereas the Treaty does not provide, for the adoption of this decision, powers other than those of Article 308,

HAS DECIDED AS FOLLOWS:

Article 1

1. The Community shall make available to Moldova a long-term loan facility of a maximum amount of EUR 15 million with a grace period of five years and a maximum maturity of ten years, with a view to ensuring a sustainable balance of payments situation, strengthening the country's reserves 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 Economic and Financial 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 Economic and Financial Committee, the economic policy conditions attached to the loan. These conditions shall be consistent with the agreement referred to in Article 1 (3).

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

Article 3

1. Subject to the provisions of Article 2, the loan shall be made available to Moldova in a single tranche on the basis of a satisfactory track record on the implementation of an upper credit tranche 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 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.

3. At the request of Moldova, and when circumstances permit an improvement in the interest rate of 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 shall be borne by Moldova.

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

Article 5

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

Done at Brussels,

For the Council
The President

ANNEX

BUDGETARY RESOURCES NECESSARY FOR THE PROVISIONING OF THE GUARANTEE FUND IN 1999 AND MARGIN UNDER THE RESERVE FOR LOANS AND LOAN GUARANTEES IN FAVOUR OF THIRD COUNTRIES

(€ million)

Operations	Basis of the calculation[3]	Provisioning of the Fund[4]	Reserve Margin
			346.0 [5]
Operations decided			
EIB/New mandates[6]			
CEEC	872.9	122.2	223.8
ALA	218.1	30.5	193.3
South Africa	143.5	20.1	173.2
MED	351.4	49.2	124.0
FYROM	38.5	5.4	118.6
Bosnia	42.0	5.9	112.7
EIB/Old protocols[4]			
Syria	-30	-4.2	116.9
Macro-financial assistance			
Albania III	20	2.8	114.1
Bosnia I	20	2.8	111.3
Operations proposed			
EIB/Turkey[7]	105	14.7	96.6
EIB/Croatia [8]	35	4.9	91.7
Macro-financial assistance			
Bulgaria IV[9]	100	14.0	77.7
Romania IV[9]	200	28.0	49.7
FYROM II[9]	50	7.0	42.7
Tajikistan[9]	75	10.5	32.2
Moldova III[9]	15	2.1	30.1

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3 The provisioning basis is calculated by applying the relevant guarantee cover rate, namely 70% (EIB loans new mandates), 75% (EIB loans old protocols) or 100% (macro-financial assistance loan).

4 In accordance with the provisioning rules in Council Regulation (EC, Euratom) No 2728/94 of 31 October 1994, the Fund having reached its target amount on 31 December 1997, the provisioning rate has been reduced to 14%.

5 Amount of the Reserve for loans and loan guarantees in favour of third countries for 1999 under the financial perspective.

6 Annual amounts of loans scheduled to be signed in 1999 and correction of amounts already provisioned in the Fund to take account of actual signings at the end of 1998: transfer 5/99 to the Guarantee Fund.

7 Proposal for a Council Regulation on a special financial cooperation measure for Turkey (COM(95) 389/3).

8 EC/Croatia cooperation agreement (SEC(95) 180/final).

9 Commission proposal.

FINANCIAL STATEMENT

1. TITLE OF OPERATION

Supplementary macro-financial assistance to Moldova.

2. BUDGET HEADING INVOLVED

Article B0-213 - European Community guarantee for the borrowing programmes contracted by the Community to provide financial assistance to the countries of the Commonwealth of Independent States

3. LEGAL BASIS

Article 308 of the Treaty

4. DESCRIPTION OF OPERATION

a) Description of the action

Provision of a Community loan (to be financed by Community borrowing in the international capital market) in the amount of up to € 15 million to the beneficiary country with a view to ensuring a sustainable balance of payments situation, strengthening the country's reserves position and comforting the implementation of the necessary structural reforms.

b) Justification for the action

The sustainability of the beneficiary country's economic reforms heavily depends on external financial assistance from official sources.

5. CLASSIFICATION OF EXPENDITURE OR REVENUE

Compulsory.

6. TYPE OF EXPENDITURE OR REVENUE

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

7. FINANCIAL IMPACT

7.1 Method of calculating total cost of operation (relation between individual and total costs)

a) Method of calculation

The evaluation of the amounts of the assistance deemed necessary is based on the present estimates of the beneficiary country's residual external financing needs.

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 the budget guarantee will not be called.

b) Effect of the action on intervention credits

The budget entry reflecting the budget guarantee for the loan will be activated only in the case of an effective call on the guarantee.

7.2 Itemised breakdown of cost - Schedule of commitment and payment appropriations

(i) Eventual call on the budget guarantee

– 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:

  - Of any margin remaining in the Reserve for guarantees

  - Of any late payments to the budget for which the budget guarantee has been activated (under article 27(3) of the Financial Regulation).

– In order to fulfil 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) n° 1552/89 of 29.5.1989 will apply.

8. FRAUD PREVENTION MEASURES

The funds will be paid directly to the Central Bank of the beneficiary country only after verification by the Commission Services, in consultation of the Economic and Financial Committee and in liaison with the IMF and World Bank Services, that the macro-economic policies implemented in this country are satisfactory and that the specific conditions attached to this assistance are fulfilled.

9. ELEMENTS OF COST-EFFECTIVENESS ANALYSIS

9.1 Specific and quantified objectives

By supporting the beneficiary country's macro-economic reform efforts and complementing financing by the International Community provided to this country in the context of an IMF agreed programme, this assistance would underpin the transition towards market economy, improve growth prospects and alleviate social strains.

9.2 Grounds for the operation

– Higher access for Moldova to International Financial Institutions' financial facilities is limited. Hence, during the Consultative Group meeting on 11 December 1998, the International Monetary Fund and the World Bank were asking bilateral donors, in particular the Community, to make an exceptional complementary effort.

– Choice of ways and means :

  Owing to its social and economic situation and to its extremely vulnerable balance of payments, Moldova should be supported with macro-financial assistance.

– Main factors of uncertainty which could affect the specific results of the operation:

  Further negative developments in the economic and financial situation of the whole region and, in particular, of the beneficiary country.

9.3 Monitoring and evaluation of the operation

This exceptional assistance is of macro-economic nature and its monitoring and evaluation are based on a satisfactory track record of the IMF supported adjustment and reform programmes that the beneficiary country is implementing.

The monitoring of the action by the Commission services will take place on the basis of a genuine system of macro-economic and structural policy indicators to be agreed with the authorities of the beneficiary country. The Commission services will also remain in close contact with the IMF and World Bank services in order to benefit from their assessment of the recipient country's stabilisation and reform achievements.

An annual report to the European Parliament and to the Council is foreseen in the proposed Council decision, which will include an evaluation of the implementation of this operation

10. ADMINISTRATIVE EXPENDITURE (SECTION III, PART A OF THE BUDGET)

This action is exceptional in nature and will not involve an increase in the number of Commission staff.