COMMISSION OF THE EUROPEAN COMMUNITIES

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Annex to the

Proposal for a
COUNCIL DECISION

Providing Community macro-financial assistance to Moldova

Ex ante evaluation statement

Macro-financial Assistance to Moldova

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Ex ante evaluation statement

Macro-financial Assistance to Moldova

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1. PROBLEM ANALYSIS AND NEEDS ASSESSMENT

1.1. Recent economic developments and prospects

In the initial phases of transition to market economy, Moldova was considered as one of the most advanced reformers in the CIS. However, towards the end of the nineties and in the beginning of the current decade, the initial reform course slowed down while the government's administrative interference in the economy increased. Moldova's poor performance in the area of structural reforms resulted in a significant deterioration of the business climate and led the Breton Woods Institutions to discontinue their programmes. In the absence of working financing arrangements with the IMF during most of the current decade, two EU MFA operations in favour of Moldova could not be implemented: a medium-term loan of EUR 15 million granted in 2000 (Council Decision 2000/452/EC of 10 July 2000) and a grant of an identical amount replacing the former (Council Decision 2002/1106/EC of 19 December 2002).

Between 2001 and 2005, Moldova's economy grew at an average annual growth rate of 7%. GDP per capita, thanks also to a substantial real exchange rate appreciation in 2004, more than doubled from its trough in 2000 but still remained, at USD 812 (estimate for 2005), the lowest in Europe. Moldova is the only country in Europe to be classified as low-income by the World Bank. Growth has been driven by domestic demand, primarily by private consumption and housing construction, boosted by booming remittances, that have increased over time to more than 30% of GDP (in 2005).

Structural reforms re-appeared on the Moldova's policy agenda in 2004, notably with the adoption by the government of the Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) in May 2004, setting medium-term priorities for government action. The government's commitment to reforms has been reinforced by its European aspirations, confirmed by the adoption in February 2005 of the EU-Moldova European Neighbourhood Policy (ENP) Action Plan.

For most of 2005, the government pursued an economic programme intended to demonstrate this renewed stabilisation and reform commitment. Monetary policy had to absorb upward pressure on the exchange rate of the leu and on prices generated by large inflows of remittances. In the course of 2005, inflation moderated gradually, largely as a result of a sharp increase in the sterilisation efforts by the National Bank of Moldova (NBM); the gradual easing of inflationary pressures also allowed a moderate depreciation of the exchange rate. The fiscal policy remained prudent for most of the recent period. Already in 2004, due to a strong revenue performance and despite fiscal loosening in the run-up to the parliamentary elections in March 2005, the budget surplus approached 1% of GDP. In 2005, fiscal revenue, primarily revenue from VAT on imported goods, increased further and the general government surplus widened to 1.7% of GDP, despite a significant increase in public spending,

1.2. PRGF programme

Towards the end of 2005, the authorities and the IMF resumed discussions on a new IMF-supported programme and in February 2006 reached an agreement on a three-year financing arrangement under the Poverty Reduction and Growth Facility (PRGF). The arrangement was approved by the IMF Board in May 2006.

The PRGF programme is designed to maintain macroeconomic stability and in this way to support growth and poverty reduction, particularly in the context of continued strong inflows of remittances and substantially higher prices for imported energy. Under the programme, the government is committed to limit the budget deficit to 0.5% of GDP (level of fiscal deficit considered to be appropriate to ensure the right balance between the objectives of supporting disinflation and meeting the country's extensive development and investment needs), and to normalise the financial relations with Paris Club creditors. An agreement with the Paris Club on restructuring of Moldova's official debt was indeed concluded in May 2006, following the approval of the PRGF arrangement. The National Bank is aiming at increasing foreign exchange reserves to at least three months of imports by end-2008. The priority structural policy measures include in particular actions in the areas of foreign trade liberalisation, corporate governance, banking sector reform and tax administration.

By the time of the adoption of the programme, it was assumed that the contemplated macroeconomic and structural policies would translate into still satisfactory (albeit decelerating) GDP growth, of 6% in 2006 and 5% in 2007-2008, a gradual reduction of inflation to about 7% by end-2008 and current account deficits in the neighbourhood of 5% of GDP.

1.3. Moldova's financing needs

Already in 2005, Moldova's external accounts had shown a marked deterioration. While the value of imports increased by nearly 30% in 2005, reflecting the increase of import prices (fuel oil import prices had risen by more than 40% in 2005) and volumes (to accommodate the rising domestic demand), the growth of exports was much more modest. As a result, the trade and current account deficits widened from respectively 29% and 2% of GDP in 2004 to nearly 41% and more than 8% in 2005.

Moldova's external vulnerability has been further highlighted by the developments since the beginning of 2006: first, by the doubling of the price of the natural gas imports from Russia (the prices went up from USD 80 per thousand cubic meters at the end of 2005 to USD 110 in January 2006 and to USD 160 in July 2006) and by the Russian ban on imports of Moldovan wine introduced at the end of March on consumer protection grounds.

For 2006, the impact on the balance of payments of the increase of the gas prices is likely to exceed 5% of GDP. The impact of the wine ban may be even larger given that Moldova's exports of wine and alcohol in 2005 represented nearly 30% of all exports, of which 80% was exported to Russia. It is still not clear how long the wine ban may last and to what extent the Moldovan exporters can find alternative markets. Moreover, Moldova's authorities fear that Russia may increase further gas prices in 2007-2008, to levels comparable to prices charged to the Western European countries (currently, over USD 200 per thousand cubic meters).

The developments since the beginning of 2006 suggest that prospects for achieving the macroeconomic results contemplated in the PRGF programme are very weak. In particular, it is now projected that the current account deficit will be substantially larger and the GDP growth much weaker. Also, inflation is expected to be stronger than anticipated. Table 1 summarises the current IMF staff projections of Moldova's main economic indicators.

Table 1. Moldova: Main Economic Indicators, 2004-2008

	2004	2005	2006	2007	2008
		est.	IMF staff projections		
Real sector					
Real GDP growth (% change)	7,4	7,1	3,0	3,0	5,0
Inflation CPI (end of period)	12,6	10,0	12,0	10,0	8,0
GDP per capita, in USD	721	812			
Fiscal Sector					
Total revenues, % of GDP	35,4	39,5	40,5	41,7	41,0
Total expenditure, % of GDP	34,6	37,9	41,1	42,0	41,3
Central govt. balance, % of GDP	0,8	1,7	-0,5	-0,3	-0,3
External sector					
Current account balance, % of GDP	-2,0	-8,3	-10,5	-6,8	-4,3
Trade balance, % of GDP	-29,0	-40,8	-53,1	-58,4	-57,8
Workers' remittances, % of GDP	25,4	32,0	36,8	41,0	41,8
Foreign direct investment flows, % of GDP	3,7	7,7	7,0	7,0	7,0
External Vulnerability					
External Public & Private Debt, % of GDP	63,8	54,8	52,2	56,7	55,3
Debt Service as % of exp. of goods/services	21,0	20,3	16,7	14,4	14,1
Import cover (months)	2,1	2,2	2,1	2,4	2,7

In view of these developments, achieving the government's objectives will require, first, some adjustment of the PRGF programme and, second, additional exceptional financing. Currently available financing comprises concessional loans from the Bretton Woods Institutions, debt relief by official creditors (in the context of the May 2006 Paris Club Agreement) and grants from bilateral donors and the European Union, under the EU Food Security Programme (FSP). Budgetary support under the EU FSP for Moldova amounts to EUR 9.2 million, out of which EUR 5.2 million is expected to be disbursed in 2006 and the remaining EUR 4 million – in the first months of 2007.

Based on preliminary estimates made by IMF staff, Moldova's overall external financing needs in 2006-2008 (period covered by the PRGF programme) are expected to exceed USD 370 million. Residual financing needs, i.e. needs calculated taking into account the identified financing sources (including the Paris Club rescheduling) are about USD 20 million in 2006 and USD 135 million in 2007-2008 (see Table 2).

Table 2. Moldova: External Financing Requirements, 2006-2008

in million USD

	IMF staff projections			
	2006	**2007**	**2008**	**2006-8**
Balance of payments	-59,7	14,6	63,8	18,7
Current account (excl. Official grants)	-341,3	-264,7	-200,4	-806,4
Capital and financial account, net (excl. WB PRSC)	281,6	279,3	264,2	825,1
Gross reserve accumulation	-5,0	-154,6	-175,1	-334,7
Accumulation of arrears (2006.Q1-Q2)	11,9			11,9
Repayment of arrears (2006.Q2)	-68,1			-68,1
Total financing needs	**-120,9**	**-140,0**	**-111,3**	**-372,2**
Identified financing sources	**101,0**	**61,8**	**55,5**	**218,3**
IMF PRGF	32,8	32,8	32,8	98,4
World Bank PRSC		10,0	10,0	20,0
EU FSP	6,5	5,0		11,5
Paris Club rescheduling	61,7	14,0	12,7	88,4
Residual financing needs	**-19,9**	**-78,2**	**-55,8**	**-153,9**

Source: IMF

It is in this context that the Commission is proposing an EU MFA operation for Moldova intended to contribute to covering the financing needs in 2007 and 2008.

2. OBJECTIVES AND RELATED INDICATORS OF THE MACRO-FINANCIAL ASSISTANCE

2.1. Objectives

The objectives of the proposed macro-financial assistance operation are to:

- Contribute to the financing of Moldova's balance of payments and reserve build up in the context of a deterioration of Moldova's trade and current account balances in the short run;
- In this way, help Moldova alleviate the financial constraints on the implementation of the PRGF programme;
- Facilitate and encourage efforts of the authorities of Moldova to implement reforms identified under the EU-Moldova ENP Action Plan and the Economic Growth and Poverty Reduction Strategy Paper.
- Detailed macroeconomic and structural reform objectives will be further defined in the context of a Memorandum of Understanding, to be agreed with the authorities.

2.2. Indicators

To monitor the fulfilment of the objectives of the programme throughout the implementation period of the assistance, the Commission will use two types of indicators:

- Adherence to IMF-supported programmes; it will be a sine qua non for the implementation of the assistance;

- Specific indicators in the areas of relevant structural reforms; those indicators linked to specific structural policy conditionality will be specified in the aforementioned Memorandum of Understanding. They will follow the policy lines anchored in the IMF-supported economic programme, as well as the EU-Moldova ENP Action Plan and the Economic Growth and Poverty Reduction Strategy Paper.

3. ALTERNATIVE DELIVERY MECHANISMS AND RISK ASSESSMENT

3.1. Delivery mechanisms

The foreseen macro-financial assistance will be provided in the form of grants. Given Moldova's low level of development, it continues to be deemed appropriate (as it was the case also in the 2002 Council decision) to provide this assistance in the form of straight grants.

Macro-financial assistance is an untied and undedicated macroeconomic support, which helps the beneficiary meet its budgetary and external financing needs. Moreover, as experienced with similar operations, including in Moldova, the economic policy conditionality attached to this support strengthens the stabilisation and reform process.

3.2. Risk assessment

There are both fiduciary and policy risks related to the macro-financial assistance.

There is a risk that this assistance, which is not dedicated to specific expenses (contrary to project financing, for example), would be used in a fraudulent way, like any other type of assistance. Generally speaking, this risk is related to factors such as the independence of the central bank, the quality of systems and procedures related to the management, control and oversight functions in the financial circuits and processing of such assistance, IT security and internal/external audit capacity of the beneficiary authorities.

To mitigate the risks of fraudulent use, several measures will be taken. The Memorandum of Understanding and the grant agreement will comprise a set of provisions on inspection, fraud prevention, audits, and recovery of funds in case of fraud or corruption. Also, the assistance will be paid to clearly identified accounts of the Finance Ministry in the National Bank of Moldova. Moreover, before the agreement on the Memorandum of Understanding is reached, the Commission services will assess the reliability of financial circuits and administrative procedures that are relevant to this type of assistance and will determine whether the framework for sound financial management of macro-financial assistance is sufficiently effective in Moldova (for details, see Financial Statement, section 9). In the light of this evaluation, specific mechanisms applying to the management of the funds by the beneficiaries may be introduced in agreement with the national authorities. The Commission may also use other assistance instruments at its disposal, notably technical assistance under the Food Security Programme and Tacis or subsequent equivalent programmes, to help the beneficiary authorities improve their public finance management systems if this area is not sufficiently covered by other donors.

Finally, the assistance will be liable to verification, control and auditing procedures under the responsibility of the Commission, including the European Antifraud Office (OLAF), and the European Court of Auditors.

Furthermore, there is a risk that reform measures will not be implemented as expected. This risk is largely determined by the overall quality of the policy and institutional environment in the country and above all by the political commitment of the authorities to reforms. The Commission services will maintain close contacts with the authorities during the implementation of the macro-financial assistance in order to address quickly any concerns that may arise.

4. ADDED VALUE OF COMMUNITY INVOLVEMENT

By providing financing complementary to resources made available to Moldova by the Bretton Woods Institutions, the Community would encourage and strengthen the implementation of the adjustment and reform programmes. This will be particularly important in the areas targeted by the programme's conditionality. Moreover, the effect of the Community's involvement will be strengthened as a result of the synergy with other Community programmes for the region, notably the Food Security Programme and Tacis, which target institution and capacity building in the longer-term, partly in the same policy areas. The macro-financial assistance is a policy-based instrument and would therefore also contribute to the process of re-orienting the Community's future assistance to Moldova further to that direction under the new European Neighbourhood and Partnership Instrument that will become operational in 2007.

In a broader perspective, the assistance programme will support the European Union's strategy towards Moldova, in particular in the context of the European Neighbourhood Policy. The ENP Action Plan, aiming at establishing an increasingly close relationship between the EU and Moldova, has emerged as a powerful driver for the authorities' stabilisation and reform efforts.

5. GENVAL CRITERIA

The Commission services have given due consideration to the five Genval criteria.

Exceptional character:

Moldova's financing requirements in 2007-2008 result from exceptional circumstances – balance-of-payments shocks and, to a lesser extent, need to mobilise resources for the clearance of accumulated arrears on the official debt. Also, the unfavourable external environment adds substantially to the financing needs associated with the implementation of the policies foreseen in the PRGF arrangement – and, more generally, of the policies contemplated in the ENP Action Plan and the EGPRSP over the medium-term. Within the overall financial effort of the international community, the EU MFA will be specifically responding to the unfavourable external environment resulting from the external shocks.

The exceptional character of the foreseen MFA is further stressed by the limited timeframe of the programme. The Commission services intend to limit the duration of the implementation of the assistance to 2007 and 2008, which is shorter than the total duration of the PRGF arrangement (it expires in 2009). Moreover, the Commission services intend to re-assess at the end of 2007 the EU contribution to meeting Moldova's financing needs in 2008. In determining the actual amount of this contribution, the Commission services intend to take into consideration progress in the implementation of the PRGF arrangement, of the EGPRSP and of the EU-Moldova Action Plan, and the expected development of budgetary support operations under the future European Neighbourhood and Partnership Instrument (ENPI). It is anticipated that the first disbursement under ENPI sectoral and/or general (macroeconomic) budgetary support will take place in 2008.

Political pre-conditions:

Since 2004, Moldova is one of the EU partner countries in the framework of the European Neighbourhood Policy. It is also, together with Ukraine, the only Eastern European country that has been implementing a joint ENP Action Plan. The ENP aims at developing an increasingly close relationship between the EU and the partner countries, going beyond past levels of cooperation, at deepening political cooperation including in the area of foreign and security policy and in the resolution of the conflict in Transnistria, and at promoting economic growth and poverty reduction.

Complementarity:

The Community MFA will be complementary to external financing coming from three main sources: (i) the Bretton-Woods Institutions, (ii) the Paris Club debt restructuring, and (iii) budget support provided by the bilateral donors and the Community, under the Food Security Programme. In this context and in the short run, MFA will both increase substantially the European Union's leverage on Moldova's policy making and strengthen the country’s European aspirations, and provide a highly valuable bridge financing to help the country weather the effects of the unfavourable external environment. Also, in 2006-2008, the Community will continue supporting the implementation by Moldova of the EU-Moldova Action Plan and of the EGPRSP through technical assistance and project financing provided under Tacis and the future ENPI.

Conditionality:

As usual with this type of assistance, disbursements under this macro-financial assistance will be subject to progress in the implementation of (i) the PRGF arrangement with the IMF, and (ii) specific structural reform measures that will be further defined in the context of a Memorandum of Understanding. Given the nature of the planned operation, in defining the conditionality in the area of structural policies, particular attention will be paid to public finance management with a view to strengthening efficiency, transparency and accountability. Also, the Commission may consider targeting specific sectoral policies of particular importance, identified as such in the EU-Moldova ENP Action Plan.

Financial Discipline:

The Commission services propose to limit the macro-financial assistance to Moldova to an amount of EUR 45 million, to be disbursed over a period of in principle two years. This corresponds to approximately one-third of the residual financing needs identified by the IMF for the years 2007-2008, i.e. needs calculated in taking into account financing provided by the BWIs but not that expected to be provided by the Paris Club creditors. Residual financing needs defined in this way amount to some USD 160 million or EUR 130 million (at the current exchange rate between the USD and EUR). The assistance will be financed from the commitment appropriations for 2007 under budget line 01.03.02, subject to availability of budgetary resources.

Concerning sound financial management, the Commission services are taking action in order to fulfil the requirements of the Financial Regulation. In the context of the multi-donor coordination in the area of public finance management, the Commission has co-funded, under the technical assistance component of the Food Security Programme, a Fiduciary Risk Assessment (FRA) of Moldova. The final report will be available shortly. Based on its findings and, if necessary, on a complementary Operational Assessment (OA) of the reliability of financial circuits and administrative controls at the Ministry of Finance and the National Bank of Moldova, the Commission services will determine whether the framework for sound financial management of macro-financial assistance is sufficiently effective in Moldova. Also, the results of the FRA and possibly of the OA will be used for the definition of appropriate conditionality in the area of public finance management, to be included in the Memorandum of Understanding.

6. PLANNING FUTURE MONITORING AND EVALUATION

This assistance is of exceptional and macro-economic nature and its monitoring and evaluation will be undertaken in line with the standard Commission procedures:

6.1. Monitoring

The monitoring system will be ensured by the provision of reports and data by the authorities, as to be set out in the Memorandum of Understanding, and the organisation of review missions in Moldova by Commission staff. Although this assistance is centrally managed, where appropriate, Commission Delegation on the spot may also be called to provide additional reporting.

In particular, 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 Moldova. Given the nature of this assistance, special emphasis of the conditionality is expected in the area of public finance, and would be defined in close consultation with the IMF and the World Bank, benefiting from their assessment of the recipient’s stabilisation and reform. In this process, the Commission services may also monitor key areas to be identified in the above-mentioned Fiduciary Risk Assessment and possibly Operational Assessment.

An annual report to the European Parliament and to the Council on the implementation of this assistance is foreseen in proposed text of the Council Decision on MFA to Moldova.

6.2. Evaluation

In the context of DG ECFIN Multi-annual Evaluation Programme, two to three ex-post evaluations of MFA operations are planned per year. It is in this framework that an independent evaluation of the assistance will be carried out by duly authorised representatives of the Commission in due course. A provision foreseeing the ex-post evaluation will be included in the Memorandum of Understanding. Financial resources for this evaluation will be drawn from the corresponding MFA budget line.

7. ACHIEVING COST-EFFECTIVENESS

In implementing the programme, the Commission will be guided by the following principles:

- The assistance will be made available by the Commission to Moldova in principle in at least three grant instalments. Each instalment will be released on the basis of a satisfactory track record in implementing the macro-economic programme under the IMF's Poverty Reduction and Growth Facility and the specific economic policy conditions attached to the assistance. The latter will be negotiated with the authorities as soon as possible and laid down in a Memorandum of Understanding concluded to this effect.

- The assistance will be made available by the Commission to Moldova in principle in at least three grant instalments. Against the current precarious financial situation of Moldova, it is envisaged to release a first tranche as soon as appropriate after the Council has adopted the proposal, and a Memorandum of Understanding and a grant agreement have been agreed on. The subsequent tranches of the proposed assistance will be made available by the Commission to Moldova on the basis of a satisfactory track record of the implementation of the PRGF programme of and the economic policy and financial conditions attached to the assistance.

- In negotiating specific policy conditions, the Commission will draw on all the expertise, including in the Bretton Woods Institutions and in bilateral and multilateral aid agencies active in the same areas. In addition, the Commission will aim at synergies with other Community policies and instruments that could be used to support the implementation by the beneficiary of the relevant measures (notably the Food Security Programme and Tacis technical assistance programme). Where appropriate, links to any related actions under the European Neighbourhood Policy can also be established.

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