COMMISSION OF THE EUROPEAN COMMUNITIES

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2002/0236 (CNS)

Proposal for a

COUNCIL DECISION

On providing further supplementary-financial assistance to Moldova

(presented by the Commission)

EXPLANATORY MEMORANDUM

INTRODUCTION

In early 1993 Moldova embarked on a comprehensive programme of economic stabilisation and market reforms, backed by the IMF and the World Bank. By 1995, inflation and the fiscal deficit had been brought under control, while good progress was also made with structural reform, notably in the areas of taxation, price liberalisation and privatisation.

During this initial stage of transition to a market economy, the European Community has supported Moldova 's through various means, including macro-financial assistance. The Community provided two macro-financial assistance packages worth EUR 45 million and EUR 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 IFIs. Moldova has so far serviced scrupulously its external financial obligations towards the Community and, according to the agreed scheduling, repaid EUR 18 million in principal between December 2000 and August 2002.

In March 1998, the IMF and the World Bank called a new donor meeting in order to mobilise financing in support of Moldova’s new economic programme supported by the IFIs. In this framework, the Council approved a new macro-financial assistance loan for Moldova of EUR 15 million, with a maximum duration of ten years and to be disbursed in two tranches (Council Decision 2000/452/EC of 10 July 2000). By the time the Council Decision was taken, Moldova’s arrangement with the IMF under the Extended Fund Facility (EFF), approved in May 1996, expired (in May 2000). It was replaced, in December 2000, by a new three-year arrangement under the Fund’s Poverty Reduction and Growth Facility (PRGF). After the adoption of the arrangement, Moldova was able to draw SDR 18.48 million (some USD 24 million) under the PRGF at the turn of 2000/2001, but the programme went off track in the spring of 2001. The IMF resumed its lending to Moldova in July 2002, after the successful completion of the First Review under the PRGF Programme. At the same time, the World Bank resumed its own financial support to Moldova with the approval of a new Structural Adjustment Credit (SAC III).

Meanwhile, the foreign debt situation of the country has seriously deteriorated. In order to address the issue of Moldova’s foreign debt sustainability (as well as that of six other CIS-countries), the World Bank, the IMF, the ADB and the EBRD prepared a joint study and organised a seminar on “Poverty Reduction, Growth and Debt Sustainability in Low-Income CIS Countries”. The study and the seminar conclude *inter alia* that Moldova’s financial sustainability requires debt and debt servicing alleviation and urge donors to help the country with more concessional forms of assistance. As a follow-up to the seminar, a ministerial meeting on the same issue (so-called “CIS-7 Initiative”) was held in Washington on April 20 and endorsed a statement calling for “more concessional support (such as grants), as well as debt restructuring or debt relief where needed”.

Moldova’s external financing needs for the period covered by the current programme supported by the IMF and the World Bank comprise a substantial amount of foreign debt, owed to both official and private creditors. In view of the country’s limited financial resources, Moldova will need to either restructure or to refinance most of its debt servicing obligations. It is also foreseen in the economic programme that Moldova will refrain from attracting new non-concessional external financing.

Against this background and consistent with the request from the Moldovan Prime Minister Tarlev to President Prodi of 9 April 2002, the Commission is now proposing that the Community macro-financial loan to Moldova approved in July 2000 be cancelled and replaced by a straight grant of an equivalent amount. This new macro-financial assistance will be disbursed in at least two tranches under similar conditions to those foreseen for the disbursement of the loan and will be complementary to financing provided by the IFIs.

RECENT ECONOMIC DEVELOPMENTS

Growth

Real GDP grew by 6.1% year on year in 2001, after a moderate rise in 2000. Despite slow reforms and a relatively weak external environment, the economy is still expected to grow at an annual rate of around 4.8-5% in 2002-03. This reflects an extremely low base period - following years of steep economic decline - as well as the accumulated effects of a gradual reform process. Moldova's economy will also benefit from relative macroeconomic stability and generally solid import demand in Russia.

The relatively strong performance seen in 2001 is mainly the result of the industrial sector's strong recovery, in combination with the halt in the agricultural sector's decline. The latter, which still accounts for about half of total exports, has benefited from the successful farm privatisation and associated reforms implemented in recent years. However, without strong growth in investments and further liberalisation, Moldova's agricultural sector will not be able to diversify into higher value-added commodities or seek out more lucrative and reliable markets outside the CIS. Even the moderate pace of growth that is currently expected (on the assumption that the important agricultural sector does not suffer from adverse weather conditions) would be jeopardised if reforms in the sector were not sustained.

Inflation

Consumer price inflation fell to 6.4% by the end of 2001, down from 18.5% in 2000 and 43.8% in 1999. The significant disinflation recorded in 2001 reflects restrained growth in the money supply, relative currency stability and an improved agricultural harvest. These factors continued to hold down inflation over the first part of 2002, with a fall in food and gasoline prices keeping total inflation over the first three months of the year down to only 1.4%.

Budget

The tightening of the fiscal policy achieved since the Russian crisis of 1998 continued in 2001: the general government deficit that still exceeded 8% of GDP in 1998 was cut to less than 1% in 2000 and changed into a surplus o 0.5% in 2001. However, the 2001 performance reflected insufficient external financing rather than improved revenue performance. As a result, some new external arrears were accumulated towards the end of 2001 and severe expenditure cuts had to be made. All in all, the authorities only partly achieved their goal of maintaining a tight fiscal stance while maintaining and enhancing social expenditure, in line with the objectives of the I-PRSP (Interim Poverty Reduction Strategy Paper, prepared in cooperation with the World Bank and serving as a basis for the Bank’s lending programmes).

The budget for 2002 adopted in November last year foresees a consolidated deficit of around 1.4% of GDP. However, this budget will be revised in view of, on the negative side, unbudgeted wage increases and lower than planned VAT collection, and, on the positive side, lower interest payments.

Monetary and exchange rate policy

The easing of inflationary pressures has allowed the National Bank of Moldova (NBM) to gradually loosen its monetary stance through 2001, through lowering reserve requirements (from 13% to 10% in October 2001) and interest rates. Since end-February 2002, the NBM's basic rate stands at 13.0%, down from 21.0% in January 2001. The result of this policy has been a rapid growth of deposits and credits to the economy

After almost a year of remarkable stability in 2001, since the start of this year the Moldovan leu (MDL) showed increased volatility sparked by a seasonal rise in US dollar demand and concerns over political stability. Between mid-February and mid-March the currency lost more than 3% of its value, but it has recovered somewhat since then. Further currency weakening could be seen through mid-2002, reflecting the political situation and concerns over the government's debt-servicing abilities.

Current account

In 2001, the current account improved considerably. While the size of the current account deficit remained virtually unchanged compared to 2000 (USD 119 million against 121 million the year before), it represented only 7.4% of GDP, down from 8.4% in 2000. This gradual improvement of the current account was continuing in the beginning of 2002. The main source of the improvement of Moldova's external account is the 20% surge in remittances from Moldovans working abroad (estimated to equal well over 10% of GDP annually). At the same time, equally strong growth in exports, resulting mainly from the improved performance of the agriculture, was not sufficient to narrow the trade deficit in view of continued high levels of imports.

Privatisation

Privatisation of the wineries, tobacco plants and utilities were earlier conditions set by both the IMF and the World Bank. The Communist Party consistently opposed the sales when in opposition, but after coming to power was forced to support them as the restoration of relations with the IFIs grew more urgent.

Moldova has failed to complete any major privatisation since February 2000, so that the government earned a meagre MDL 32.6 million (USD 2.5 million) from small-scale privatisations in 2001. It already abandoned the sales of two of its major wineries at the end of 2001 because the offers, from Russian and local companies, were too low.

The government has more ambitious plans for 2002, with between 350 and 500 companies up for sale. This includes plans to sell majority stakes in two of the country's five electricity distributors this year after two previous failed attempts. Union Fenosa (Spain) bought the other three distributors for USD 25.2 million in 2000 and promised to invest a further USD 67 million.

Foreign debt

Moldova's external debt situation is a major source of concern. Although in 2001 the total external debt decreased (due to the halt in external financing, notably from the IFIs), it still represented more than 90% of GDP. Public and publicly guaranteed debt represents about two-thirds of the total debt stock. The external debt is expected to rise again in the coming years with the resumption of foreign financing.

The year 2002 is critical for Moldova as regards foreign debt service, which has soared to an annual 250 million dollars. The foreign debt service, if paid entirely, represents almost one-third of export revenue. Debt service on public and publicly guaranteed debt alone absorbs 18% of export receipts and more than 50% of the Central Government revenue.

Already in 2001 Moldova raised the spectre of default on 1997 Eurobonds with late payments on two occasions. The government is currently negotiating a comprehensive restructuring of outstanding amounts on the Eurobonds (USD 40 million) and of its debt arrears owed to Russia’s Gazprom on natural gas deliveries.

THE ECONOMIC PROGRAMME AGREED WITH THE IMF AND THE WORLD BANK

The new programme aims at achieving a primary budget surplus of at least 2% of GDP over the coming years. The debt burden will be stabilised, and wage and pension arrears will be reduced. Principally better revenue collection should contribute to the improvement of the fiscal situation. The share of education and health care in government spending will be increased, while subsidies will be limited. Monetary policy will aim at keeping annual inflation at less than 8%, as well as at increasing the level of international reserves to be equivalent to three months of imports in 2003.

The structural reform agenda of the programme covers a wide range of policies, such as fiscal and financial sector reform, governance and transparency, privatisation in key sectors of the economy (wineries and telecommunications), improving delivery of social services and strengthening the legal and regulatory framework.

MOLDOVA’S FINANCING NEEDS

Moldova’s external financing needs are estimated to be over USD 210 million for the period 2002-2003. Out of this amount, more than half is expected to be covered by new financing from the IFIs: USD 80 million by the IMF (under the current PRGF arrangement) and USD 30 million by the World Bank (under the Structural Adjustment Credit III). Under the current financing assumptions, the bulk of residual financing gap of about USD 100 million (more than USD 80 million) is to be covered by Moldova’s private creditors, through restructuring of Eurobonds and of Gazprom promissory notes. The IMF assumes that the rest of the financing gap – about USD 18 million (the equivalent of about EUR 20 million, at the exchange rate at the time the projections were prepared) – would be filled by the EU macro-financial assistance in the form of grants. Although the Fund does not see at present any urgent need for a Paris Club treatment of Moldova’s debt to official creditors, the possibility of such treatment has been repeatedly raised by Moldova’s government.

THE PROPOSED MACRO-FINANCIAL ASSISTANCE

In view of the deterioration of the foreign debt situation of the country, Moldovan Prime Minister Tarlev requested in a letter of 9 April 2002 to President Prodi the conversion of the EUR 15 million loan decided in 2000 into a grant. This request is consistent with the commitment of the authorities to refrain from new borrowing on non-concessional terms made in the context of the economic programme for 2002-2003 agreed with the IMF. It is also consistent with the strong consensus within the donor community that Moldova should receive more concessional support, confirmed at the above-mentioned ministerial meeting on the CIS-7 Initiative in favour of the poorest countries of the CIS, including Moldova.

Against this background, the Commission proposes to cancel the existing decision on macro-financial assistance to Moldova in the form of a loan of up to EUR 15 million (Council Decision 2000/452/EC) and to replace it with a straight grant of an equivalent maximum amount. Given that the Guarantee Fund has already been provisioned with EUR 2.25 million in 2000 as a result of the adoption of the Council Decision 2000/452/EC, the corresponding deprovisioning will be implemented next year.

The Commission considers that the proposed assistance is an appropriate reference amount for the Community's support to the balance of payments of Moldova. The proposed assistance amount is consistent with Moldova's residual financing needs, taking also into account the financial outflow resulting from the settlement of Moldova's debt re-payments to the Community (EUR 46 million between 2002 and 2006). This support would help the consolidation of the country's official reserves position and sustain the reform efforts of the authorities. It would also contribute, together with assistance from IFI's and other bilateral donors to the appropriate coverage of the country's external financing needs.

Without prejudice to the competencies of the budgetary authority, the Commission considers that the new assistance would have to be implemented in at least two instalments from 2002 to 2004, within the limits of Category 4 of the financial perspective for the 2000-2006 period.

Accordingly, the Commission requests the Council to adopt the proposed decision and to allow Moldova to benefit from the new financial assistance package.

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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],

Whereas:

(1) The Commission has consulted the Economic and Financial Committee before submitting the proposal,

(2) Moldova is undertaking fundamental political and economic reforms and is making substantial efforts to sustain its progress in transition,

(3) Moldova, on the one hand, and the European Community and its Member States on the other hand, have signed a Partnership and Cooperation Agreement, which entered into force 1 July 1998,

(4) The authorities of Moldova have agreed with the IMF on a macro-economic programme supported by a three-year PRGF, approved in December 2000, and have expressed their intention to subsequently continue this programme in the context of a new appropriate Fund Facility,

(5) By Decision 2000/452/EC of 10 July 2000[3] the Council has made available to Moldova macro financial assistance up to EUR 15 million, in the form of a long-term loan,

(6) Moldova's foreign debt situation has become increasingly preoccupying and the country is facing very high debt-to-export and debt-to-central-government-revenue ratios,

(7) The Moldovan authorities have requested financial assistance on a concessional basis from the International Financial Institutions, the Community and other bilateral donors. Over and above the financing from the IMF and the World Bank a substantial

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residual financing gap remains to be covered to comfort the country's foreign debt sustainability, strengthen the country's reserves position and support the policy objectives attached to the authorities' reform efforts,

(8) The IMF, the World Bank, the ADB and the EBRD took the initiative in convening, on 20 April 2002, a ministerial meeting on an Initiative in favour of the low-income CIS countries, aiming at, inter alia, providing increased financial support on a concessional basis to the poorest countries of the CIS, including Moldova,

(9) Moldova became eligible to highly concessional loans from the World Bank and the IMF, and is facing particularly critical economic, social and political circumstances,

(10) In these circumstances and without prejudice to the powers of the budgetary authority, the Community macro-financial assistance to Moldova should be made available in the form of a grant, as an appropriate measure to help the beneficiary country at this critical juncture,

(11) This assistance should be managed by the Commission,

(12) 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 macro financial assistance in the form of a straight grant with a view to ensure a sustainable balance-of-payments situation and strengthening the country's reserve position.

2. The assistance shall amount to a maximum of EUR 15 million.

3. The assistance 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 financial assistance. 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 Economic and Financial Committee, and in co-ordination with the IMF, that economic policy in Moldova is in accordance with the objectives of this financial assistance and that its conditions are being fulfilled.

Article 3

1. The assistance shall be made available to Moldova in at least two instalments. Subject to the provisions of Article 2, the first instalment is to be released on the basis of a satisfactory track record of Moldova's macro-economic programme agreed with the IMF in the context of the present Poverty Reduction and Growth Facility or of any successor upper credit tranche arrangement.

2. Subject to the provisions of Article 2, the second and any further instalments shall be released on the basis of a satisfactory continuation of Moldova's macroeconomic programme and not before three months after the release of the previous instalment.

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

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

Article 4

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

Article 5

1. This Decision shall take effect on the day of its publication in the Official Journal of the European Communities. It will expire three years after the date of its publication.

2. Council Decision 2000/452/EC is hereby repealed.

Done at Brussels,

For the Council
The President

FINANCIAL STATEMENT

1. TITLE OF OPERATION

Supplementary macro-financial assistance to Moldova.

2. BUDGET HEADING INVOLVED

Article B7-528: Macro-economic assistance to the partner countries of Eastern Europe and Central Asia.

3. LEGAL BASIS

Article 308 of the Treaty

4. DESCRIPTION OF OPERATION

a) Description of the action

Provision of a Community grant in the amount of up to EUR 15 million to the beneficiary country with a view to improving the country's foreign debt sustainability, supporting its government's reform efforts and alleviating the social hardship linked with reforms.

b) Justification for the action

The sustainability of the beneficiary country's foreign debt situation, as well as economic reforms, heavily depends on external financial assistance from official sources, at concessional terms.

5. CLASSIFICATION OF EXPENDITURE OR REVENUE

– Non compulsory.

6. TYPE OF EXPENDITURE OR REVENUE

– Straight grant (100% subsidy), which would be released in successive instalments.

– The Community grant will not be reimbursed.

7. FINANCIAL IMPACT

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

1. 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.

2. b) Effect of the action on intervention credits

The budget entry corresponding to the assistance will be activated subject to compliance with a number of policy conditions to be agreed with the authorities of the beneficiary country.

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

The financing of the expenditure will be secured in annual or six-monthly instalments from 2002 onwards within the limits of Category 4 of the new Financial Perspectives for the 2000-2006 period.

The following schedule of appropriations is proposed (in million EUR):

	2002	2003	2004
Commitment appropriations	5	5	5
Payment appropriations	5	5	5

– Recourse to budget line B7-528 if one or more of the beneficiary countries of grant macro-financial assistance under this budget line does not satisfy all the necessary criteria for full disbursement.

– In case budget line B7-528 does not contain sufficient resources, the needed amount may be transferred either from within the chapter B7-52 or from resources available within Heading 4 of the Financial Perspectives for the 2000-2006 period.

7.3 Operational expenditure for studies, experts etc. included in Part B of the budget

All related costs incurred by the Community in concluding and carrying out the operations under this Decision shall be borne by the beneficiary country.

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.

Financial assistance operations under this Decision will be subject to audit by the relevant Commission services and the Court of Auditors, to be carried out on the spot whenever and wherever appropriate.

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 not only underpin the transition towards market economy, improve growth prospects and alleviate social strains. The assistance would also help the country servicing its outstanding external financial obligations, including those towards the Community.

9.2 Grounds for the operation

Higher access for Moldova to International Financial Institutions' financial facilities is limited. Hence, during the Consultative Group meeting in December 1998, the International Monetary Fund and the World Bank were asking bilateral donors, in particular the Community, to make an exceptional complementary effort. Moreover, the IMF, the World Bank, the ADB and the EBRD took the initiative in convening a ministerial meeting in April 2002 on an Initiative in favour of seven low-income CIS Countries, aiming at providing increased financial support on a concessional basis to the poorest countries of the CIS, of which Moldova.

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.