Ex post evaluation of MFA operations in Moldova

Framework contract ECFIN-160-2005

Final report

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List of abbreviations

AIDCO	Europe Aid Co-operation Office
DG ECFIN	Directorate General Economic and Financial Affairs
EBRD	European Bank of Reconstruction and Development
EC	European Commission
EFC	Economic and Financial Committee (of the Council)
EGPRSP	Economic Growth and Poverty Reduction Strategy Paper
ENP AP	European Neighbourhood Policy Action Plan
ENPI	European Neighbourhood Policy Instrument
EU	European Union
FSP	Food Security Programme
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GoM	Government of Moldova
IFI	International Financial Institution
IMF	International Monetary Fund
INTOSAI	International Organisation of Supreme Audit Institutions
MoF	Ministry of Finance
MEUAP	Moldova European Union Action Plan
MFA	Macro Financial Assistance
MTEF	Medium Term Expenditure Framework
OA	Operational Assessment
PFM	Public Financial Management
PRGF	Poverty Reduction and Growth Facility
REER	Real Effective Exchange Rate
PEFA	Public Expenditure and Financial Accountability
RELEX	External Relations
SPSP	Sector Policy Support Programme
SSBS	Social Sector Budget Support
TA	Technical Assistance
TACIS	Technical Assistance for the Commonwealth of Independent States
UK	United Kingdom
WB	World Bank

Executive summary

Background

1. The European Commission provided Macro Financial Assistance (MFA) to Moldova in the period from September 2007 to December 2008. The MFA consisted of a grant of EUR45 million that was disbursed in three tranches.

2. The objective of this assistance was to support Moldova's balance of payments and the reserve build-up and, in this way, help Moldova alleviate the financial constraints on the implementation of its economic reforms programme. It also referred to the residual financing gap remaining to be covered after International Monetary Fund (IMF), World Bank (WB), and other EU financing and Paris Club rescheduling.

3. The grant part of the first tranche amounted to EUR20 million, and was released in September 2007. The first tranche was conditional upon the fulfilment of two prior administrative actions, a satisfactory track record under the IMF programme, and the signing of the MoU. The second tranche (a grant of EUR10 million) was released in August 2008 after the conditionalities agreed in the MoU were deemed to have been fulfilled. The second tranche was disbursed four months later than scheduled which caused problems to the Moldovan Government that could not count on MFA resources to meet IMF deficit ceilings and had to cut expenditure accordingly. The third tranche (a grant of EUR15 million) was disbursed in December 2008.

4. In 2007, the MFA accounted for about 28 percent of the total financial assistance for Moldova, and roughly half of EC assistance for that year. In 2008, the MFA accounted for 23 percent of total financial assistance, and about 30 percent of EC assistance for that year.

Evaluation objectives and approach

5. The main objectives of this ex-post evaluation of MFA are to (a) assess the effects of the MFA operation in Moldova and (b) to learn key lessons, which can be applied to future interventions and/or the possible need for a reorientation of the present approach.

6. The evaluation focused on three core areas of effects: (i) macroeconomic stabilisation; (ii) sustainability of the fiscal and external financial situation; and (iii) structural reforms. In addition, the implications of the design and implementation of the MFA operation were considered.

7. The evaluation employed seven instruments: (i) data collection and analysis; (ii) a literature review; (iii) a preparatory questionnaire to prepare for the structured

interviews; (iv) structured interviews with key informants; (v) macroeconomic modelling; (vi) case studies; and (vii) a 'Delphi technique' questionnaire to verify and support the findings from the interviews. The evaluation was based on the triangulation of all the findings resulting from the application of all the evaluation instruments.

Structural reforms

8. The MFA operation in Moldova included a total set of twelve conditionalities grouped along three main policy areas: 1) reform of the social assistance legislation; 2) public internal financial control; and 3) public procurement. The conditionalities were agreed in the Memorandum of Understanding (MoU) and were linked to the second and third tranches. The conditionalities were not explicitly phrased in terms of structural effects to be achieved in the medium term, but these can be broadly understood as follows: equity objectives on poverty alleviation and income redistribution to the poorest layers of the population; increased effectiveness and control on public expenditure; and increased efficiency and transparency of public demand for goods and services.

9. The donor coordination process in Moldova resulted in a Development Partnership Framework signed between the Government, IDA, the Netherlands, the United Kingdom (DFID), Sweden (SIDA), the UN, IMF, and EU. This framework commits the parties to joint reviews, harmonization of indicators, and prior actions and synchronization with Government budget cycles with a view to reducing transaction costs of assistance to the Government. Consequently, various aspects of the social assistance reform were included as conditionalities in different programmes although with slightly different wording.

10. There was also clear complementarity of MFA conditionalities with those attached to other EU programmes. One of the main conditionality areas of the European Neighbourhood Policy Instrument (ENPI) sector budget support was the reform of the social benefit system. About a third of tranche disbursements are directly or indirectly related to the social assistance reform. In 2008 the ENPI evaluation report concluded that not all the benchmarks had been met and tranche disbursement would have to be cut accordingly.

11. The review missions preceding the disbursement of the second and third tranche concluded that all the reform conditions for the release of these grants were fulfilled with the exception of the condition on the preparation of the framework legislation on Public Internal Financial Control. The Commission partially waived this condition. The Moldovan government supported by World Bank and SIGMA experts deemed the draft law to be immature. Insisting on the conditionality could have had a negative effect by forcing an immature law upon the Moldovan government.

Macroeconomic stabilisation

12. 12. In 2006 and 2007, the Moldovan economy was surprisingly resilient in the face of successive shocks, including the Russian ban on imports of Moldovan wine, a sharp

increase in the price of imported natural gas in 2006 and the drought that hit the country in 2007. In 2006, real economic growth was weaker than in recent years due to the disruption of exports and higher price of energy. In 2007, economic growth was weaker than expected due to the drought. Moldova's resilient performance during 2006-2007 was supported by inflows of foreign capital. Capital inflows, primarily in the form of remittances, largely compensate the trade deficit which approached 50% of GDP in 2007.

13. Curbing inflation has been a major challenge in Moldova during 2006-2008. Despite the sterilisation efforts of the National Bank of Moldova (NBM) and restrictive fiscal, inflation was persistent and reached 16 per cent in April-May 2008. This inflationary surge of early 2008 was mainly driven by the rapid growth in food prices caused by the drought and world trends. Since mid-2008 inflationary pressures eased substantially and Moldova entered a deflation in April 2009.

14. International reserves of the NBM continued to accumulate during 2007-2008, and reached beyond the target of three months of imports set in the PRGF programme.

15. The financial crisis did not seriously affect the Moldovan economy in 2008 due to its low exposure to the international financial system. However, the global economic slowdown, particularly in the EU, Ukraine and Russia, has hit the Moldovan economy in 2009 hard as it relies heavily on remittances from Moldavians abroad and on exports to these markets. Export markets have shrunk and foreign direct investments have fallen sharply. Real GDP is projected to shrink by at least 9 percent in 2009. Reserves are expected to fall to pre-2007 levels in 2009 and 2010.

16. With regard to public finance, expenditures and revenues have grown rapidly by nearly 10 percentage points of GDP over the last 5 years, primarily on social spending, including the pension and health insurance funds. Relative to other countries, revenues are 8 percentage points of GDP higher than the average of countries of similar income levels. As such, Moldova has little room to create fiscal space by increasing revenue mobilization.

17. With the elections in sight in 2008, expenditures went up drastically (pensions, wage increases). Moreover, the crisis decreased demand causing falling imports, which will have an adverse effect on budget revenue from excise taxes and duties in 2009. Whereas the budget deficit was kept below 0.5% of GDP during 2007-2008, the IMF noted that without additional measures, it will increase to above 11 percent of GDP in 2009.

External sustainability

18. Moldova was starting the 2000s decade with high external debt, exceeding 100% of GDP. While nominal value of external debt stayed broadly constant, strong economic growth combined with real exchange rate appreciation helped in bringing the ratio of external debt stock to GDP to 56% as of 2005. In subsequent years this ratio stayed broadly constant. External debt service, after a peak in 2006 declined significantly in

2007. Servicing of foreign public and publicly guaranteed debt declined from close to 10% of public sector revenues to well below 5% in 2007.

19. Overall, Moldova's debt dynamics is sustainable with low risk of debt distress, even in light of the economic crisis. A substantial downward revision of GDP growth prospects will translate into worsened public debt and public debt service to GDP indicators but the relative strength of the leu against the USD and the Euro have been mitigating the negative effects. In particular, worsening of the external debt to GDP ratio will likely be modest assuming stability of the leu at current levels. The downward revision of export outlook will lead to a worsening of foreign debt / debt service to export ratios.

Design and implementation of MFA

20. By far the most important weakness of the MFA operation in Moldova appears to have been the relatively slow reaction time in terms of disbursement. It took as long as sixteen months to have the first MFA funds disbursed from the moment of the official request and more than twenty months from the moment when informal preparatory works started. Seven months were spent for Council and Parliament approval. In practical terms the distinction between the MFA and ENPI became a bit blurred in the eyes of the beneficiaries, as both appeared as medium term budgetary support instruments.

21. A second design issue worth mentioning is that the MFA poorly fits with conditionalities related to medium term legislative reforms requiring extensive political debate, a long approval period or sufficient "absorption" time to translate into concrete achievements. Such conditionalities endanger the disbursement of funds, irrespective of the existence of a genuine Government's commitment to their implementation. At the end of the MFA operations these conditions either did not lead to the expected results or had to be waived before the disbursement of the third tranche.

22. A factor of success of the MFA operation in Moldova was the synergic action reached with other EU and IFI programmes in achieving structural reforms. Conditionalities remained focused on a few clearly identified areas which avoided dispersion of resources. However, a common policy matrix as a reference for co-ordinated action was missing, and conditionalities were often phrased in a slightly different language and with different timeframes which proved to be a cause of confusion for local counterparts.

23. In terms of conclusions on implementation, there is broad support to the fact that one of the most notable consequences of having an IMF programme in place supported by the MFA is its signalling effect to investors on the credibility of the government market-oriented reforms and the stability of the macroeconomic framework.

24. One of the major problems of MFA implementation from the point of view of Moldovan authorities remains its difficult synchronisation with the parallel IMF reviews. MFA tranches could not be always used to comply with IMF benchmarks as

originally planned and this reportedly led to temporary cuts in Government expenditure and other treasury problems.

Net impact of MFA

25. In financial terms, the MFA provided to Moldova in 2007 and 2008 was justified given the balance of payments problems in 2006 and 2007. Although the external economic situation turned out to better than foreseen during 2007-2008 as the Russian ban on wine imports did not materialize as was expected in 2006, Moldovan balance of payment experienced a setback due to the consequences of the drought for Moldova's agricultural production.

26. Although the objectives on macroeconomic development have been achieved during the term of implementation of the MFA operation, the results have appeared not to be sustainable. Since the end of 2008, economic and public finance indicators have altered negatively and deteriorated further during 2009 as a result of the economic crises and lax fiscal policy of the Moldovan government in the election year.

27. In our estimation of the net macroeconomic impact of MFA, we assume that the IMF would have implemented the PRGF program without modification even if MFA had not existed. This is considered likely since the IMF Board's requirement for the PRGF - coverage of the first year of the financing gap - was satisfied through Paris Club Debt rescheduling. The counterfactual scenario is that "if MFA had not been provided, the government of Moldova would have cut its capital investment expenditures". The MFA is found to have boosted cumulative economic growth in Moldova by around 0.6% during 2006-2008.

28. MFA has had a positive but small role in affecting the medium- and long-term external sustainability prospects. These effects mainly stem from positive impact on economic growth during 2006-2008 that consequently affected debt to GDP indicators.

Recommendations

29. In order to strengthen the operational reinforcing impact of the MFA on structural reforms, it is necessary to address the overlap between the MFA and the ENPI budget support. We suggest to alter the design of the MFA in such a way that the MFA is more clearly distinguished as a separate EC-instrument that cannot be confused with the budget support instrument that exists under ENPI. Given the strategic importance of such a repositioning of the MFA instrument, we do not provide a specific recommendation. Instead, we provide broad options for a more distinct profile for the MFA instrument that the Commission could take into consideration: diversification of the MFA by 1) shorting its timeline; 2) focusing on the conditionalities in the external sector; 3) refraining from conditionalities at all; 4) focusing on political impact rather than structural reforms.

30. Alterations in the political willingness of the beneficiary country to maintain sustainable macroeconomic policies beyond the term of implementation of the MFA can not be controlled. However, in the case of Moldova, closer monitoring of the

political response to the changing economic circumstances would have revealed a shift in the commitment of the country to sound macroeconomic policies. It is recommended to better monitor the economic policies of the beneficiary country and employ the option not to disburse any tranches as an instrument to maintain the beneficiary country's commitment to sound macro economic policies.

31. As the MFA is supposed to address extraordinary balance of payment difficulties, there is a need to make the MFA preparation process much quicker and possibly leading to disbursement of funds within a 9-month period. This is likely to require an anticipation of the moment the official request is received to before the IMF programme is agreed. MFA preparation should already include the operational assessment that should therefore become part of the feasibility studies. Ideally the MFA should go before the Council already ready for approval without the need to define conditionalities during the process. This could require more extensive recourse to prior actions. Finally, the Council approval and Parliament consultation should take place, to the extent possible, within the framework of predefined timeframes.

1 Introduction

This Report provides an evaluation of the Macro Financial Assistance granted by the European Union to Moldova in the period 2007 – 2008.

The Report has been prepared by a consortium led by ECORYS Netherlands in association with CASE – Centre for Social and Economic Research (Poland) and Economisti Associati (Italy) as part of the framework contract ECFIN-160-2005 with DG ECFIN.

The structure of the Report is as follows:

- Chapter 2 outlines evaluation objectives and methods;
- Chapter 3 presents the basic information about the MFA operation;
- Chapter 4 focuses on actual reform progress and the impact of MFA's structural conditionality's thereupon;
- Chapter 5 analyses the macroeconomic developments an the impact of the MFA, including the indirect impact of the structural conditionality's, thereupon;
- Chapter 6 considers the impact of the MFA operation on the external economic situation of Moldova (balance of payment and debt sustainability);
- Chapter 7 elaborates on specific issues relating to the design of the MFA operation;
- Chapter 8 presents the conclusions and recommendations.

In the annexes, we have documented our data sources. It consists of literature references, a list of interviewed people, an explanation of the modelling approach, interview reports and results from the Delphi questionnaire.

2 Evaluation objective and approach

2.1 Objective of the Evaluation

The European Council approved the provision of Macro Financial Assistance (MFA) to the Government of Moldova (GoM) on 16 of April 2007.[1] Under its Financial regulation (art. 27.4), the EC is legally obliged to evaluate its main programmes, including MFA. The main objectives of this ex-post evaluation of MFA are to:

i. assess the effects of the MFA operation in Moldova; and
ii. learn key lessons, which can be applied to future interventions and/or the possible need for a reorientation of the present approach.

2.2 Methodology of the Evaluation

2.2.1 Evaluation questions

Our evaluation questions are formulated in line with the Terms of Reference and the **Guidelines for the Ex Post Evaluation of MFA Operations.**

Table 2.1 contains the main and subsidiary evaluation questions. It shows that the evaluation questions broadly focus on the effects of the MFA operation in three domains:

1. Macroeconomic stabilisation;
2. Sustainability of the external financial situation;
3. Structural reforms.

For each domain, the effects are assessed over specific time horizons:

- the effects on macroeconomic stabilisation and structural reforms on the economy and institutions on short and medium term (within 4 years of the first disbursement);
- the effects on external financial situation on medium to long term (3 or more years after the initial disbursement).

The initial disbursement of the MFA to Moldova took place in 2007 (see chapter 3). Accordingly, the short and medium term effects are assessed up till 2011. The medium to long term effects refer to the period after 2010. We note that this implies that our analysis will to a substantial extent rely on projections and expectations.

[1] Council Decision 2007/259/EC published in OJ L 111, 28.4.2007, p.69).

Table 2.1 Evaluation questions from the Guidelines

Nr.	Evaluation Question
Q1	**To what extent has the MFA been effective in terms of the short-term macroeconomic stabilisation of Moldova?**
1.1	What are the short and medium term macroeconomic objectives?
1.2	To what extent have the short and medium term objectives of the assistance been achieved?
1.3	What has been the contribution of the grants provided by the operation to the achievement of the objectives?
Q2	**To what extent has the MFA been effective in terms of supporting structural reform?**
2.1	What are the short and medium term expected structural effects of the assistance?
2.2	How relevant are the short and medium-term expected structural effects of the assistance to the needs of the country?
2.3	To what extent have the short and medium term expected structural effects of the assistance occurred as envisaged?
2.4	What has been the contribution of actions resulting from the respect of structural conditionality criteria to the occurrence of expected structural effects?
2.5	To what extent have structural effects been enhanced, if at all, by complementarities between the MFA and other EU instruments?
Q3	**What have been the indirect and/or unexpected effects of the MFA?**
3.1	What, if any, has been the contribution of actions resulting from the respects of structural conditionality criteria to the achievement of short and medium-term macroeconomic objectives of the assistance (i.e. indirect effects of structural conditionality criteria)?
3.2	Has the assistance given rise to any unexpected short and medium-term structural and/or macroeconomic effects?
Q4	**To what extent has the MFA contributed to returning the external financial situation of the country concerned to a sustainable path over the medium to longer-term?**
4.1	How did the external financial situation of Moldova evolve prior to and during the MFA operation?
4.2	What are the main internal and external factors on which the current trend in the country's external financial situation and its prolongation into the future are conditional?
4.3	How is the country's external financial situation likely to evolve in the 5 years following the final disbursements given the likelihood of changes to current conditions?
4.4	What is the MFA contribution to medium and long term external sustainability prospects?[2]
Q5	**How has the way in which the MFA operation was designed and implemented conditioned its effectiveness and efficiency?**
5.1	In what way has the design and implementation of the MFA conditioned the performance of the MFA operation in respect to its cost and its objectives?

2.2.2 Evaluation approach

For the attribution of effects to the MFA operation, we have followed a five step approach in accordance with the Guidelines for ex post evaluation of MFA.

[2] This question is not included in the Guidelines for the Ex Post Evaluation of MFA Operations.

The **first step** has been to describe the MFA operation in terms of its design, objectives and its relevance.

The **second step** has been to identify the gross macroeconomic and structural effects. These gross effects are equal to the observed developments after the disbursement of the grant.

The **third step** has been to establish a counterfactual situation. This refers to the most likely scenario in the domain of macroeconomic stabilisation and structural reform in case no MFA would have been granted to Moldova. In order to establish the counterfactual situation we have, based on the Guidelines, answered two additional evaluation questions (see Table 2.2). In determining the counterfactual situation we have also included the analysis of the unexpected and indirect effects of the MFA operation.

Table 2.2 Additional subsidiary evaluation questions to determine the counterfactual

No	Question
Q 0.1	What arrangement would have been implemented if the MFA had not been granted?
Q 0.2	What are the structural and macroeconomic effects of the most likely implementation scenario?

The **fourth step** involved the determination of the net effects of the operation. The net effects followed out of the comparison between observed/expected developments and the counterfactual situation. The evaluation of net impact will try to distinguish possible MFA 'reinforcing effect' on structural reforms at two levels of analysis:

a. **political reinforcing effect:** all relevant actors were familiar with the MFA conditions and perceived them as an incentive to continue their reform efforts (an overall increase of chances of happening);
b. **operational reinforcing effect:** the reinforcing effect led to a verifiable speeding up of reform implementation (the lack of pre-emptive effects of other instruments).

In the **final step**, some observations are provided on the design of the MFA approach given the findings on the previous chapters.

2.2.3 Evaluation methods

To conduct the three steps of the evaluation approach, we have collected data by means of a variety of evaluation methods. Our conclusions are based on the triangulation of the findings of the various sources.

Document analysis
We have analysed the documents available in the files of the European Commission and documents prepared by the main IFIs (World Bank and IMF). Annex I lists the reports and documents that we have consulted in preparing this Final Report.

Interviews with key officials
We have conducted interviews with EC officials in Brussels, stakeholders of the Moldovan authorities and representatives of the main IFIs. Annex II lists the key stakeholders that we have interviewed in preparing this Final Report.

Delphi Questionnaire
In addition to the interviews, we have collected the perceptions of the key stakeholders on the counterfactual in a more structured and transparent manner by means of the Delphi questionnaire. The method is iterative: experts are interviewed on the basis of a structured questionnaire and aggregated results are then circulated, inviting panel members to reconsider their position in the light of other respondents' opinions. Through this process the variance of answers is normally reduced and opinions tend to converge towards the "correct" answer.[3] The results of the Delphi Questionnaire are included in Annex III.

Macroeconomic modelling
A modelling approach (see Annex IV) has mainly been used to derive the quantitative implications of the counterfactual scenario for the main macroeconomic variables.

Stakeholder workshop
We will discuss our findings and preliminary conclusions and recommendations in a workshop with the main stakeholders in Chisinau at the end of the evaluation.

[3] See for example Rowe, G. and G. Wright: Expert opinions in Forecasting: The Role of the Delphi Technique. In: J. S. Armstrong (Ed.), *Principles of Forecasting - A Handbook for Researchers and Practitioners*. Kluwer Academic Publishers, 2001;

Table 2.3 Data collection methods to answer the evaluation questions

Evaluation steps	Core areas	Questions	Methods
Step 1 to describe the MFA operation in terms of its design, objectives and its relevance		Q 1.1 Q 2.1 Q 2.2	• Document analysis; • Interviews with officials; • "Delphi" questionnaire.
Step 2 to identify the gross macroeconomic and structural effects	• Macro economic stabilisation; • Structural reform; • External sustainability.	Q 1.2 Q 2.3 Q 3.1 Q 3.2 Q 4.1 Q 4.2 Q 4.3	• Document analysis; • Interviews with officials; • Modelling; • Case study; • "Delphi" questionnaire.
Step 3 to establish a counterfactual situation		Q 0.1 Q 0.2	• Interviews with officials; • Macroeconomic modelling; • Case study; • "Delphi" questionnaire.
Step 4 to determine the net effects of the operation	• Macro economic stabilisation; • Structural reform; • Ext. sustainability.	Q 1.3 Q 2.4 Q 2.5 Q 4.4	• Desk analysis.
Step 5 to draw conclusions on the design of the MFA		Q 5.1	• Desk analysis; • Workshop.

3 MFA Operation in Moldova

3.1 Background to MFA operation

3.1.1 Economic and political context in Moldova

Since 1991, after the breakdown of the Soviet Union, Moldova is an independent state with a new constitution adopted in 1994.[4] The Moldovan economy has experienced a number of shocks. First, conflict with the separatist province of Transnistria implied that the Chisinau government lost control over the country's eastern border, as well as its main energy and industrial plants, as Transnistria used to produce 40% of the Country's GDP and 90% of its electricity. Then, the 1998 Russian economic crisis hit the Moldovan economy particularly hard. In the 1998-99 periods alone, Moldova's industrial output fell by 25 per cent, agricultural output by 20 per cent and exports decreased by almost half.

As a result of all this, Moldova underwent one of the most dramatic transition processes in Eastern Europe with substantial drops in GDP and gross capital formation. In 1999, GDP was estimated only at 34% of the 1989 level, industrial output 32% and agricultural output 50%[5]. This has spurred a massive migration process to both Russia and Western Europe and caused widespread poverty. Estimates of the total number of migrants vary in the range of some 500,000-700,000 units including seasonal migrants. Remittances have been estimated at 35-40 % of GDP, which is a record figure in Europe. Although slightly improved from the dramatic levels of the late nineties absolute poverty remains a problem particularly affecting the children and the elderly in rural areas. GDP per capita remains together with Kosovo among the lowest in Europe and according to Government Statistical Sources some 50% of the population live below the national poverty line.

After the 1997 crisis and the disruption of all relations in manufacturing, Moldova trade relations with Russia have increasingly lost importance and reoriented mainly to exports of agricultural products (particularly fresh fruits and vegetables) wine, and tobacco. However, in balance of account terms these items were supplemented by the fact that Russia came to account for an estimated 60% of total workforce migration, including as high as 75% of male migration mainly in the construction industry. On the import side Moldova found itself dependent on Russia for almost all of its energy supplies and has suffered the usual transition problems from subsidised prices accordingly, including a number of energy crisis and sudden power cut-offs [6].

4 The Communist Party that was previously banned was relegalised in 1994.

5 Government of Moldova, Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) Chapter 3, 2004.

6 So, among others, Moldova's dependence on Russian energy was underscored at the end of 2005, when a Russian-owned electrical station in Moldova's separatist Transnistria region cut off power to Moldova and Russia's Gazprom cut off natural gas in disputes over pricing, and again in January 2009, during a similar dispute.

After the new constitution was adopted Moldova has undergone six rounds of parliamentary elections, of which two in 2009. The political cycles in Moldova went from 1994 to 1998, from 1998 to 2001, from 2001 to 2005 and from 2005 to 2009. The Communist Party that had been outlawed till 1994 won both the 2001 and the 2005 elections. Although initially supportive of a political union with Russia and Belarus, the relations between the Communist-led Moldovan Government and Russia have gone through notable up and downs. Lack of progress on the settlement of the Transnistria issue together with political developments in Ukraine and Georgia had led to a certain weakening of relations when the 2005 elections took place. Therefore the newly-elected Moldovan Government together with the implementation of a European partnership agenda that ranked high among the political priorities at that time found itself to cope with further disruption in trade relations with Russia.

In 2005 a first ban to imports of Moldovan fresh agricultural products and meat to Russia was enacted because of alleged sanitary reasons. This was complemented at the beginning of 2006 by an even more potentially disruptive embargo in the import of Moldovan wine to Russia, also because of alleged sanitary reasons. The ban was eventually lifted at the end of 2006[7], and trade actually restarted with some difficulties one year later. Prior to the ban, the wine industry was estimated to account for somewhere near 25 percent of Moldova's gross domestic product (GDP), with 80 percent of production exported to Russia. Therefore, also as a result of the ban Moldova's trade deficit with Russia ballooned to US$193 million from January to November 2006, compared to an $86 million surplus during the same period in 2005. The Moldova-Vin export agency estimated the loss in sales for the wine industry at over $180 million between March 2006 and January 2007. Wine production dropped dramatically as well. Companies reported a 63% decrease in bottled wine as compared to 2005. The indirect effects on the whole economy were even larger because of widespread interlinks with the wine industry. Moldova's National Statistics Bureau estimated that industrial production dropped by 6.9% in 2006 compared to 2005. This was the first time in six years that Moldova had posted such a loss. Also 2007 would prove a difficult year for the wine industry, but this time because of the worst drought hitting the country since 1946 which caused a cut in production of more than one third.

However, neither the ban on wine imports nor the parallel decision to double the price Moldova paid for Russian natural gas managed to reverse the overall positive trends in Moldovan GDP growth caused by two-digit growth in construction and nearly two-digit growth in services. The deterioration of Moldova’s trade and current account balance was offset by buoyant remittances and FDI flows that kept the 2005 record levels of some US$250-260 million. GDP growth just slowed down in 2006 from an anticipated 7% to some 4% to resume in 2007-08 the growth patterns achieved throughout the 2000-05 period. Wine trade was re-oriented towards Romania first, and then when Romania entered the EU, Moldova was granted an EU autonomous trade preferences status in 2008. In the meantime higher quality standards and other factors allowed a resumption of export flows to Russia and other former Soviet Union countries.

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[7] The deadlock was not broken, however, until Moldova threatened to block Russia's entry into the World Trade Organization (WTO). In November 2006, an agreement was reached between the two countries whereby Moldova would support Russia's entry into the WTO, and Russia would lift its embargo on Moldovan wine.

Due to its unbalanced nature and other structural weaknesses the Moldovan economy remains highly vulnerable to energy crises, vagaries in agricultural production, trends in remittances and FDI flows. Also, the presence of an illegal separatist regime in Moldova's Transnistria region continues to represent a sizeable systemic risk to economic stability. The deteriorating global economic crisis only partly affected the Moldovan economy in 2008 due to its limited exposure to the international financial system, but a global economic slowdown, particularly in the EU, Ukraine and Russia, has hurt the economy in 2009 as Moldova relies heavily on remittances from Moldovans abroad and on exports to these markets. However, so far this has resulted in an improved balance of trade. The effects of the crisis have been compounded by growing fiscal imbalances caused by massive electoral spending at the end of the political cycle.

3.1.2 Moldovan structural reforms agenda

In the period under consideration Moldova's policy agenda for structural reforms was guided by two key strategic planning documents respectively in the field of the fight against poverty and approximation to the EU:

- the Economic Growth and Poverty Reduction Strategy Paper (EGPRSP); and
- the Moldova-European Union Action Plan (MEUAP).

The EGPRSP was designed as a government tool to accomplish the medium and long-term development goals of economic growth and poverty reduction. The MEUAP was developed in line with the objectives of the EGPRSP but with greater attention to justice and human rights, two of the main concerns of the EU.

In 2007, the EGPSRP and MEUAP were consolidated into one policy matrix, the National Development Strategy (NDS 2008-2011). The NDS brought into line the national macroeconomic objectives of economic growth and poverty reduction with the longer term objective of EU accession. The main priorities of the NDS have been streamlined into the following categories:

- strengthening democracy based on the rule of law and respect for human rights principles;
- settlement of the Transnistria conflict and reintegration of the country;
- enhancing the competitiveness of the national economy;
- developing human resources, enhancing employment and promoting social inclusion;
- regional development.

3.1.3 Recent progress in Structural Reforms

In April 2008, the EU published the second progress report evaluating the implementation of the MEUAP [8]. The report identifies a number of positive developments in the field of structural reforms in 2007, some of which are reflected in the table below.

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8 Source: SEC (2008) 2381.

Table 3.1 Progress of Moldova in various reform areas

Reform area	Developments
Price liberalisation	Most prices have been liberalised
Trade liberalisation	Relatively liberal international trade policy, but restrictions still exist on some key commodities. Moldova became a member of the WTO in June 2000. In early 2008 the EU granted the Republic of Moldova Autonomous Trade Preferences (ATPs).
Exchange regime	Increasingly, floating exchange rate of the leu with limited official intervention by the National Bank of Moldova. No restrictions on current international transactions in conformity with Article VIII of the IMF's Articles of Agreement.
Foreign Direct Investment	Unlimited repatriation of capital and profits and no limitations on holding foreign currency bank accounts. Adequate overall legislation, but implementation is often problematic, which weakens the business climate. A new investment law introducing equal treatment of domestic and foreign investors adopted in 2004. FDI increased to over 9% of GDP in 2007 but is still modest.
Monetary policy	The National Bank of Moldova is gradually moving to inflation targeting but inflationary pressures in 2007, mostly resulting from capital inflows, did not allow a meaningful deceleration of inflation. Inflation again accelerated in the beginning of 2008. The National Bank expected to pursue a tighter policy course aimed at increasingly privileging control of inflation over exchange rate stability while still continuing to accumulate forex reserves, which exceeded for the first time the equivalent of three months of imports.
Public Finance	Budget revenue continued increasing in 2007 reflecting rising revenue from taxation of consumption. As expenditure was also increased, the budget was still in small deficit (a quarter of a percentage point of GDP). Public external debt went down to less than 20% of GDP. Reform of Public Finance Management continued, with progress achieved in particular in developing the Medium-Term Expenditure Framework, in moving towards the single Treasury account, in strengthening tax administration and in developing the system of public internal financial control.
Privatisation and Enterprise Restructuring	Progress is being achieved in strengthening bankruptcy procedures, management of state property and simplification and streamlining of the regulatory environment of the enterprises. Yet enforcement remains a serious concern and business environment suffers from state intervention and formal and informal business restrictions. Also, the privatisation process was stalled for several years, only to be revitalized in 2008.
Financial Sector Reform	Restructuring and consolidation of the financial sector progressed, with significant foreign investments. Further strengthening is crucial to mobilize savings and promote investment

3.2 Macro Financial Assistance to Moldova

3.2.1 Preamble to the MFA operation

Since independence there had been a well established tradition of MFA operations with Moldova totalling EUR 87 million. Moldova last received Macro Financial Assistance (MFA) in the form of loans from the EC both in 1994 (EUR 45 million) and 1996 (EUR 15 million) and related payments were last serviced in August 2005. In July 2000, there was another attempt to have a new MFA operation for a maximum amount of EUR 15 million in the form of a loan but this was stopped by the change in Government. In

December 2002, the loan was replaced by a new Council Decision of the same amount, this time in the form of a grant. However, no disbursements could take place before the expiry of the decision at the end of 2005 because Moldova had no working arrangement with the IMF which was an essential precondition for the MFA. The last Poverty Reduction and Growth Facility (PRGF) went off track in early 2003 and expired in December 2003. Consequently, budgetary assistance to Moldova was possible only under the Food Security Programme that had a less strict interpretation of compliance with IMF requirements in its disbursements.

Talks about a possible new MFA operation in Moldova started in 2005 driven by the broader shift in the economic policy stance of the Government of Moldova (GoM) and the resumption of negotiations with the IMF. Preparation of the new MFA became more urgent in January 2006 when Moldova was first confronted with increased energy prices demanded by Russian gas suppliers and then faced with the Russian wine embargo. The MFA was then a component of the whole policy package the EC designed in response to the crisis. Since the lack of an IMF arrangement made reaching a quick MFA agreement unlikely, emergency resources as high as EUR 15 million from the Tacis programme were first set aside and an MFA operation was put in the pipeline as a likely option for more medium term developments.

The role of the energy crisis in initiating the new MFA becomes apparent from the following excerpt taken from an internal Commission note dated 16/1/2006:

> "I very much share your assessment of the energy situation in Moldova. The expected sharp increase of gas import prices will further widen the Moldovan trade deficit and increase accordingly the country's financing needs in 2006 (…) In case it is confirmed that there is scope for Community macro-financial assistance (MFA) – which is indeed a well suited instrument to address balance-of-payments shocks, like the one currently faced by Moldova – DG ECFIN will start the preparation of a proposal for a Council Decision on such a programme".

On 6-10 February 2006, a DG ECFIN team conducted a mission to Moldova. The two main objectives of the mission were:
- To coordinate policy messages with the IMF team completing negotiations of a new PRGF arrangement with Moldova;
- To evaluate the impact on the short run of the higher natural gas import prices on the Moldovan economy.

On 10 February 2006, the IMF mission and the Moldovan government announced an agreement on an economic programme to be supported by a three-year financing arrangement under the Fund's Poverty Reduction and Growth Facility (PRGF). The Board of the Fund concluded the 2006 Article IV consultation and approved the three-year PRGF arrangement on 5 May 2006.

Total IMF financing amounted around US$117 million. US$32 million would be disbursed in 2006 leaving a residual financing gap of US$60.7 million to be covered.[9] An agreement to reschedule debt repayments by the Paris Club in May 2006, reducing

[9] The equivalents of SDR 80,08 million over the entire program and SDR 22,88 million in 2006.

Moldova's payments to the Paris Club over the programme period (May 2006 – May 2009) by nearly US$90 million, almost settled the financing gap for 2006.

On 25 May 2006, with reference to the new IMF program and the debt rescheduling negotiation, the Government of Moldova formally requested further financial assistance of the European Commission to support the Moldovan reform program (as laid down in the EGPRSP, the EU-Moldova Action Plan and the Millennium Challenge Account). It was also referred to the decline of industry resulting from Russia's imports restriction of Moldovan wine. On behalf of the Commission, Mr. Almunia confirmed on 22 June 2006 his intentions to make a proposal for Community macro-financial assistance to Moldova.

3.2.2 The design of the MFA operation

After consultation of the Economic and Financial Committee (EFC), a draft proposal for a Council Decision was submitted on the 9th of October 2006.[10] The ex ante evaluation statement referred to a residual financing need of Moldova of US$20 million in 2006 and US$134 million in 2007-2008 (see Table 3.2). The draft proposed MFA amounted to EUR 45 million (see Table 3.3).

Table 3.2 External financing requirements of Moldova, 2006-2008[11]

	IMF staff projections			
	2006	2007	2008	2006-8
Balance of payments	-59.7	14.6	63.8	18.7
• Current account.	-341.3	-264.7	-200.4	-806,4
• Capital account.	281.6	279.3	264.2	825,1
Gross reserve accumulation	-5.0	-154.6	-175.1	-334.7
Accumulation of arrears	11.9			11.9
Repayment of arrears	-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
• WB PRSC.		10.0	10.0	20,0
• EU FSP.	6.5	5.0		11,5
• Paris Club.	61.7	14.0	12.7	88,4
Residual financing needs	**-19.9**	**-78.2**	**-55.8**	**-153.9**

The draft proposal was discussed by the European Parliament and by the Council group of financial counsellors. With some minor amendments, the proposal was approved by the Council on 16 of April 2007.[12] The Council Decision included the following objectives:

10 SEC (2006) 1258.
11 Source: Annex to the Proposal for a Council Decision – ex ante evaluation statement (SEC/2006-1258).
12 Council Decision 2007/259/EC published in OJ L 111, 28.4.2007, p.69).

"The objective of this assistance is to support Moldova's balance of payments and the reserve build-up and, in this way, help Moldova alleviate the financial constraints on the implementation of its economic reforms programme."

The assistance was divided over three tranches. No prior action for the disbursement of the first tranche was envisaged. Its disbursement was made conditional upon the signing of the Memorandum of Understanding (MoU) by the Moldovan government. Disbursement of the second and third tranche was made conditional upon progress made with respect to economic stabilisation (as monitored by the PRGF programme) and structural reforms as agreed in the Memorandum of Understanding.

Table 3.3 Design of the MFA operation in Moldova

<table>
<tr><th>Tranche</th><th>Grant</th><th colspan="2">Conditional upon</th></tr>
<tr><td>1st tranche</td><td>EUR 20 mln</td><td>Signing of the Memorandum of Understanding</td><td rowspan="3">Satisfactory track record in the implementation of the current three-year arrangement under the PRGF</td></tr>
<tr><td>2nd tranche</td><td>EUR 10 mln</td><td rowspan="2">Positive evaluation by the EC of progress made with respect to economic stabilisation and structural reforms as agreed in the Memorandum of Understanding</td></tr>
<tr><td>3rd tranche</td><td>EUR 15 mln</td></tr>
</table>

3.2.3 The implementation of the MFA operation

First tranche

Following the Council Decision, the MoU was prepared. The Commission drew upon the following inputs to identify the policy conditions to be attached to the disbursement of the MFA:

- The Public Financial Management Performance Report (PFMPR);
- The Fiduciary Risk Assessment (FRA);
- The Operational Assessment Report;
- Findings of the preparatory work conducted for the first annual Poverty Reduction Support Credit (PRSC-1);
- Findings of the preparatory work of the future budget support operation for Moldova implemented under the European Neighbourhood and Partnership Instrument (ENPI).

The first tranche was disbursed after the MoU was signed on 27 September 2007, i.e. 21 months after the first exploratory mission and 16 months after the formal Moldovan request. The MoU included detailed conditionality's in three reform areas that had been agreed during the summer of 2006 with a view to second and third tranche disbursement tentatively scheduled respectively in April and November 2008 together with the PRGF reviews (see Table 3.4).

Table 3.4 Structural reform conditionality's attached to the MFA operation in Moldova 2007-2008

Conditionality's listed in the MoU
1. Management of Social Assistance Benefits Programmes
a. Prepare draft legislation on a new system of targeted income support in replacement of the current nominal compensations scheme and submit it to Parliament.
b. Prepare regulations on implementing the new legislation and develop a time-bound action plan to introduce the new system.
c. Integrate the principles of the new system of targeted social allowances in the preparation of the budget for 2008.
d. Adopt the new legislation on targeted income support in view of the start of its implementation throughout the country by end-September 2008.
e. Integrate the new system of targeted allowances in the preparation of the Medium-Term Expenditure Framework for 2009-2011.
2. Public Internal Financial Control (PIFC)
a. Prepare, in co-operation with the European Commission, and adopt a revised Government PIFC Policy/Strategy Paper and time-bound action plan outlining the approach to implementing the PIFC system.
b. Prepare draft framework legislation and submit it to the Parliament.
c. Prepare an implementation plan to facilitate understanding and acceptance of PIFC throughout the public sector, including training and development of methodological guidelines and providing the PIFC bodies with adequate budgetary resources and staff.
3. Public Procurement
a. Prepare an Action Plan for the implementation of new legislation on public procurement promulgated in July 07.
b. Adopt implementing rules and start implementing the new Public Procurement Law.
c. Prepare a time-bound Action Plan for the development and strengthening of the Procurement Agency, including adequate budgetary resources, staff and equipment, training and capacity building.
d. Develop an effective monitoring system allowing the Procurement Agency to monitor the procurement by procuring entity.

A chapter 4 deal with the structural reform conditionality's in detail. It discusses their origin and potential synergy or overlap with conditionality's of other donors.

Second tranche
A mission to Moldova to review the MFA conditionality for disbursement of the second tranche was conducted in the period 4-7 March 2008. The mission concluded that all the reform conditions for the release of the second grant were fulfilled. Also, the third review of the under the IMF PRGF programme was successfully completed and the Fund released the payment. After consultation of the EFC and the Commission, the second tranche was disbursed in August 2008, i.e. four months later than scheduled which caused problems to the Moldovan Government that could not count on MFA resources to meet IMF deficit ceilings and had to cut expenditure accordingly.

Third tranche
On September 29 2008, immediately after approval of the social assistance reform, the Moldovan government sent a Statement of Compliance indicating the progress made on

the various conditionality's attached to the disbursement of the third tranche. The release of the third tranche was initiated with note to the EFC. The note concluded:

> "Macroeconomic performance of Moldova has been satisfactory. The economy remains however extremely vulnerable to shocks and the authorities fear that the current global slowdown will have an impact on the Moldovan economy. The Commission services estimate that all policy conditions laid down in the MoU attached to the release of the second grant instalment of the MFA are met, albeit with qualifications. In particular, the Commission services consider that the condition on the preparation of the framework legislation on Public Internal Financial Control should be partially waived."

To speed up the process of consultation within the Commission, a fast track consultation was launched on 10 December 2008. Following this procedure, an interdepartmental meeting was held 15 December. Participating services (DG AIDCO and RELEX) agreed with DG ECFIN's assessment that Moldova complied with the conditions for the disbursement of the grant instalment. The disbursement still took place at the very end of 2008. Reception of the third tranche was confirmed by the Government of Moldova on 20 January 2009.

3.2.4 Chronological overview of MFA implementation and dynamics of events

Table 3.5 presents a detailed overview of political, economic, and other events indirectly or directly relevant for the MFA operations.

Table 3.5 Chronological overview of events relevant for the MFA operation

Date	Event
1994	Macro Financial Assistance (MFA) to Moldova (loan, EUR 45 million)
1996	Macro Financial Assistance (MFA) to Moldova (loan, EUR 15 million)
July 2000	Council decision for new MFA (EUR 15 million) in the form of a loan
December 2002	New Council decision replacing the loan into a grant (expired in 2005 without disbursements)
December 2003	Expiration of the PRGF arrangement between IMF and Moldova. No new arrangement was agreed.
December 2004	Approval of Economic Growth and Poverty Reduction Strategy paper (EGPRSP) by Moldovan Parliament
Early 2005	Approval of ENP Action Plan and 'implementation tool'
6-7 October 2005	Visit of Commissioner Ferrero Waldner to Moldova
10 October 2005	Meeting of DG ECFIN with IMF and WB on Moldova
January 2006	Energy crisis in Moldova
6-10 February 2006	DG ECFIN mission to Moldova
March 2006	Russia imposes a ban on Moldovan wine imports
5 May 2006	Approval of a three-year PRGF arrangement with Moldova by the IMF Board
12 May 2006	Agreement in the Paris Club on the restructuring of official debt of Moldova
25 May 2006	Formal Moldovan request for further MFA assistance
22 June 2006	Confirmation by the European Commission of its willingness to grant MFA to Moldova
31 July 2006	Start of consultation procedure with the Economic and Financial Committee of the Council

Date	Event
15 September 2006	Approval of Economic and Financial Committee for MFA operation
9 October 2006	Submission of proposal for a Council Decision on Providing Community macro-financial assistance to Moldova
1 December 2006	Report of the European Parliament on the proposal for a Council Decision on Providing Community macro-financial assistance to Moldova
30 Jan – 2 Feb. 2007	ECFIN mission to Chisinau to hold preliminary discussions with Moldovan policy makers and representatives of the IFI's on the conditions for future disbursement
14 February 2007	Adoption of the European Parliament's report on proposed exceptional financial assistance to Moldova
20 February 2007	Meeting of the Council Group of Financial Counsellors
18 – 23 February 07	ECFIN mission to prepare an operational assessment of the functioning of the structures in Moldova dealing with the management of the MFA
16 April 2007	Council approval of the MFA to Moldova
August 2007	Consultation procedure with the Economic and Financial Committee and the Inter-Service Consultation procedure for the financing decision
27 September 2007	Signing of the Memorandum of Understanding and disbursement of the first tranche of EUR 20 million
14 November 2007	Proposal for a Council Regulation introducing autonomous trade preferences for Moldova
4-7 March 2008	ECFIN mission to Moldova to review the MFA conditionality
May – June 2008	Consultation procedure with the Economic and Financial Committee and the Inter-Service Consultation procedure for the release of the 2nd tranche
10 July 2008	Completion of the Fourth Review of the PRGF
13 August 2008	Disbursement of the second tranche
29 September 2008	Statement of Compliance by the Moldovan government and payment request of the 3rd tranche
15 December 2008	IMF and GoM reached agreement on additional Memorandum of Understanding guiding the disbursement of the fifth tranche of the PRGF in early 2009[13]
December 2008	Consultation procedure with the Economic and Financial Committee and the Inter-Service Consultation procedure for the release of the 3rd tranche
End December 2008	Disbursement of the third tranche
14 February 2009	IMF Mission does not perform fifth PRGF review and the programme goes de facto off track until expiring the following May

[13] The IMF mission noted good performance under the program and conditionalities, with some exceptions, implemented as scheduled. It was agreed the need to mitigate any impact of the global financial crisis on Moldova through an updated Memorandum of Economic and Financial Policies (MEFP) for 2009. The transfer of the next tranche of about US$18 million was postponed to early 2009 and the following IMF mission tentatively scheduled for late February 2009.

3.3 Other Budget Support to Moldova

3.3.1 Programs of other international donors

IMF support

After the 2002 PRGF went off track for several years, the Republic of Moldova had no agreement about such an IMF programme. The 'Economic Growth and Poverty Reduction Strategy' (EGPRSP) of the Government of Moldova was submitted to the IMF and the World Bank in April 2006. On May 5th 2006, a three year IMF Poverty Reduction and Growth Facility (PRGF) was agreed, including the access to 65 percent of Moldova's quota (80.08 million SDR). The main objective of the IMF programme was to maintain macroeconomic stability, particularly in the face of strong inflows of remittances and sharply higher prices for imported energy. It also strove to improve the performance of the financial sector. The programme successfully underwent four reviews (respectively in November 2006, June 2007 and February and July 2008) but then expired without disbursement of the fifth tranche.

World Bank support

Moldova joined the World Bank in 1992. Two years later it joined the International Development Association (IDA). In the context of its membership, the World Bank Group has supported Moldova for a total amount of US$689.4 million since the inception of the World Bank's program.

The World Bank's Country Assistance Strategy (CAS) for Moldova for 2005-2008 was endorsed by the World Bank's Board in December 2004. It focuses on three strategic priorities, aligned with the country's plans for poverty reduction detailed in its Economic Growth and Poverty Reduction Strategy Paper:[14]

- Reducing poverty by promoting economic stability, growth, and employment;
- Improving access to social services and minimizing environmental risks;
- Improving governance and fighting corruption.

The CAS for Moldova envisaged a lending programme of between US$90 million and US$137 million. As of December 2007, the Bank's active portfolio was comprised of 11 IDA–funded investment operations and 13 Bank–administered grants. Total net IDA commitments reached US$258.4 million, of which about 75 percent is undisbursed.

Given a more favourable policy environment, improvement in economic management, progress toward satisfying the CAS triggers, and the resumed program with the IMF, the Bank and a number of bilateral donors are providing budget support to assist in the implementation of policy reforms under the Economic Growth and Poverty Reduction Strategy (EGPRSP) during fiscal years 2006–09. The World Bank's budget support to Moldova is granted under the Poverty Reduction Support Credit (PRSC). During the period of MFA implementation, two tranches of each US$10 million each have been disbursed. A third tranche scheduled in 2009 was not disbursed because of discontinuation of the IMF PRGF and pending the establishment of a new government.

[14] A new CAS is approved in December 2008 and applies to the period 2009-2012.

3.3.2 Other EU support to Moldova

The EU-Moldova Partnership and Cooperation Agreement entered into force in July 1998 and set a framework for trade liberalisation, legislative harmonisation, cooperation in a range of sectors and political dialogue. Before the last MFA operation the EU had provided more than EUR300 million of assistance to Moldova since 1991. This includes assistance under the Tacis programme (including its national, regional and cross-border components) as well as support under thematic budget lines such as the Food Security Programme (FSP) and the European Initiative for Democracy and Human Rights (EIDHR), previous MFA and humanitarian assistance provided by ECHO.

The Food Security Programme (FSP), in particular, was a budgetary support scheme designed to address poverty and to improve food security, including measures in the agriculture sector, land and social reform, and public finance management. There were three FSP operations in Moldova. The FSP for FY2002 and the FSP for FY2004 were completed and evaluated in 2005, resulting in disbursements of EUR18.3 million into the State treasury. The FSP grant for FY2006 consisted of the provision of a foreign exchange facility of additional EUR9.2 million including further EUR0.8 million for technical assistance. As in the case of FSP 2004, the first instalment of EUR1.2 million under the FSP 2006 was disbursed without specific sector related conditions, therefore treated as general budget support. The other strands had sector conditionality strings attached and were to support specific reforms in social assistance, agriculture and public finance. The EC-FSP 2006 was the last FSP for Moldova and would be replaced by the European Neighbourhood Policy Instrument (ENPI). On paper the FSP budget support was also conditional upon the existence of an approved IMF programme but the 2002 and 2004 funds were nevertheless disbursed, based on the IMF assessment (under Article IV) that the government conducted a sound economic policy.

Additional EUR5 million ECHO support was provided within the framework of an UN-led emergency operation to counter the impact of the 2007 drought.

3.3.3 MFA as part of total support

Table 3.6 gives an overview of all financial assistance to Moldova in the period 2007 to 2008. This table shows that in the years the MFA tranches were disbursed, the MFA assistance accounted for around 15 percent of the total financial assistance.

Table 3.6 The share of MFA in total budget support of IMF, World Bank and EC (in million EUR)[15]

	2007	2008
PRGF / IMF (in million USD)	23.5	25.9
PRSC / World Bank (in million USD)	6.85	7.15
ENPI / EU	21	58.1
Food Security Program / EU	Closed in 2006	
MFA (in million EUR)	20	25
Total	**70.9**	**111.15**
MFA as % of total budget support	28.2 %	22.5 %

15 IMF amounts are US$34.3 million in 2007 and US$36.2 million in 2008 against exchange rates de dato 31/12/07 and 31/12/08. The WB amounts are 10 million USD in both years.

4 Impact on structural reforms

4.1 Introduction

Table 4.1 presents the evaluation questions which analyse the impact of MFA on structural reforms. This chapter explains our approach of these evaluation questions.

Table 4.1 Relevant evaluation questions for analysing the impact of structural reforms

	Impact of structural reforms
Q2.1	What are the short and medium-term expected structural effects of the assistance (in the context of the recipient country's reform programme)?
Q2.2	How relevant are the short and medium-term expected structural effects of the assistance to the needs of the recipient country?
Q2.3	To what extent have the short and medium-term expected structural effects of the assistance (in the context of the recipient country's reform programme) occurred as envisaged?
Q0.1	What arrangement would have been implemented if the MFA had not been granted?
Q0.2	What are the structural and macroeconomic effects of the most likely implementation scenario(s)?
Q2.4	What has been the contribution of actions resulting from the respect of structural conditionality criteria to the occurrence of expected structural effects?
Q2.5	To what extent have structural effects been enhanced, if at all, by complementarities between the MFA and other EU instruments?
Q3.2	Has the assistance given rise to any unexpected short and medium-term structural effects? What were they and how did they occur?

The MFA operation in Moldova included a total set of twelve conditionality's grouped along three main policy areas:

1. reform of the social assistance legislation (section 4.2);
2. public internal financial control (section 4.3);
3. public procurement (section 4.4).

The conditionality's were not explicitly phrased in terms of structural effects to be achieved in the medium term, but these can be broadly understood as follows:

1. equity objectives on poverty alleviation and income redistribution to the poorest layers of the population;
2. increased effectiveness and control on public expenditure;
3. increased efficiency and transparency of public demand for goods and services.

4.2 Social assistance legislation

4.2.1 Relevance

Table 4.2 below reiterates the conditionality's in the domain of social assistance legislation and provides a more detailed breakdown of anticipated deadlines, although actual implementation made the disbursement of the last two tranches a bit later in time than originally anticipated.

Table 4.2 Conditionality's on the Management of Social Benefits Programmes included in the MFA MoU

Conditionality's listed in the MoU
2nd Tranche (originally envisaged for April 2008)
Prepare draft legislation on a new system of targeted income support in replacement of the current nominal compensations scheme and submit it to Parliament
Prepare regulations on implementing the new legislation and develop a time bound action plan to introduce the new system
Integrate the principles of the new system of targeted social allowances in the preparation of the budget for 2008.
3rd tranche (originally envisaged for November 2008)
Adopt the new legislation on targeted income support in view of the start of its implementation throughout the country by end-September 2008
Integrate the new system of targeted allowances in the preparation of the Medium-Term Expenditure Framework for 2009-2011.

At the time the conditionality's were formulated there was broad consensus on their relevance and appropriateness in the Moldovan context as also demonstrated by the results of the Delphi survey in Annex III.

The ineffectiveness of the nominal compensation schemes envisaged in the Moldovan social assistance legislation to cushion really vulnerable groups from poverty had long been known to both the donor community and the Moldovan Government. According to World Bank sources, at the end of the 1990s it was estimated that some 57% of the non-poor (including 25% of those in the richest 10 per cent of the population) were getting some form of subsidies, while some 40% of the poorer households got none.

However, until the late 1990s there were strong reservations on the feasibility of an alternative income-based approach in Moldova, because of the operational difficulties created, among others, by the widespread recourse to self-consumption of agricultural produce, massive unofficial migration abroad with related 'hidden' cash remittances flows and a sizeable grey economy. Income-based targeting was therefore deemed inadvisable in a context where the administrative structure was too weak to support true verification of family incomes. Proxy means-tested schemes, that had been found to work relatively well elsewhere in the former Soviet Union, were not deemed as feasible in Moldova because of the generally perceived low quality and limited reliability of the underlying household survey data.

The need to somehow reform the existing system remained high on the local political agenda. In 2000, after the Moldovan Parliament had called for an improved targeting of benefits, a first simplification and streamlining of the social benefit mechanism, that however remained nominal in nature, was achieved. This still provided different compensation schemes to some eleven different categories of the population ranging from the disabled to victims of political repression and from war participants and their spouses to victims of the Chernobyl disaster.

After the 2000 reform, when the MFA conditionality's were proposed, only 20.5% of the beneficiaries were estimated to belong to the poorest decile and only 42.3% of the poorest Moldovan was targeted by the system. The number of total beneficiaries was estimated at some 700,000 individuals, i.e. as high as 21% of the total population. The poorest decile could therefore receive just less than 9% of their total consumption net of the benefit. It is therefore no surprise that the system was found to have little impact on poverty and reduced the poverty gap and poverty severity respectively by 19.1% and 20.7% at a total annual cost of some 355 million Lei (some 0.7% of GDP at 2008 prices)[16].

Only in the following years, while agreeing the Integrated Poverty Reduction Strategy Paper, a broad consensus was reached within the donor community on the advisability and feasibility of moving towards some kind of proxy-means scheme. In 2003 the Moldovan Government gave instructions to two ministries and the statistical office to devise new arrangements for the optimisation of the system. A 2004 USAID project demonstrated the feasibility of proxy-means testing in the Moldovan context but the underlying model was found too complex for implementation and too difficult to explain to the population by local counterparts. In 2005, the issue was included in the EU-Moldova Action Plan (see text box 4.1).

Box 4.1 The Welfare Priorities of the 2005 EU Moldova Action Plan

Take significant steps to address poverty, notably by improving targeting and effectiveness of social assistance:

- Adopt and progress in implementation of the Economic Growth and Poverty Reduction Strategy Paper (EGPRSP), identifying short term and long term priorities, endorsed by international donors based on the three pillars of poverty reduction identified in the IPRSP of 2002; in particular implement relevant conditionalities on Poverty Alleviation and on Social safety net agreed within the framework of the EU Food Security Programme.

Redirect public expenditure to significantly address child poverty and to increase primary school enrolment:

- Implement relevant conditionalities on Poverty Alleviation and on Social safety net agreed within the framework of the EU Food Security Programme;
- Develop community based child protection measures in particular in the countryside in collaboration with local governments;
- Rationalise child benefits and improve effectiveness of assistance to families in need;

16 See on this point Ludovico Carraro: "Informing the reform of cash benefits in Moldova: Insights from the analysis of the 2006 Household Budget Survey", January 2008 Oxford Policy Management.

- Remove factors limiting access to education for poor families' children and improve their access to primary and secondary education, in particular in the country side.

After another pilot study funded under the EU Food Security Programme found evidence that the nominal compensation mechanism was not really aimed at the poorest families, the European Union became particularly vocal in urging for these reforms that were attached as FSP conditionalities and even led to cuts in FSP financial support disbursements because of lack of progress in implementation. In parallel, the IMF and the WB carried out a study to demonstrate the feasibility of a simpler proxy-means tested mechanism that the Government declared worth considering provided support was given by the donor community for implementation. The World Bank then gathered support from SIDA and DFID to include the matter in a subsequent loan and provide TA accordingly (resulting in an OPM project in place from 2007). An EU TA project to support the reform came into the field at the end of 2008 after its tendering procedure was delayed by some time to avoid excessive absorption capacity issues with the DFID-OPM project.

4.2.2 Gross impact – actual structural reform outcomes

The proposed reform had different objectives and reflected slightly different agendas. First of all, and common to the actors involved, there was the objective of improving and better targeting the outreach of the scheme to the real poor. This did not actually imply full consensus on the best means to this end. In some stakeholders' view this had to happen through recourse to proxy testing techniques while others were opener in methodological terms. Then there were different understandings as to whether this was to come at an additional cost for the budget and whether fight against poverty was to be considered as the only objective of social assistance. Finally, to some, the reform could also serve as an enabling mechanism to reduce price distortions and public subsidies in the energy sector while cushioning at the same time the poorest layers of the population.

As far as impact on poverty is concerned it is too early to judge based on factual evidence on the ultimate impact of the reform and a preliminary assessment based on concrete data will be possible only at the beginning of 2010. As reported in the annex the expectations of the stakeholders are overly positive in this respect, although those closer to actual implementation might have a more cautious attitude and are concerned about possible flaws in reform design and unintended consequences. The new law on social benefits was finally voted on 25 September 2008 and promulgated the day after – just in time for the start of its implementation in October 2008. The implementing regulations were subsequently approved by the Government on 16 October. The introduction of the new system is being made gradually: until the end of 2008 it was limited to families with disabled persons; in January 2009, it has been be extended to families with children and it is only from July 2009 that it applies to all the remaining categories of population.

Official Government estimates are that at full regime the system will cover some 72,000 families with total expected 200-250,000 beneficiaries as compared to the present 200,000 holders of nominal benefits which correspond to some 700,000 final beneficiaries. Latest available data, however, report some total 16,000 beneficiary families for a total projected expenditure of some 100-120 million Lei as compared to the 202 million originally allocated. It is difficult to say whether this depends on seasonal factors, still insufficient awareness about the reform among potential beneficiaries, or the crowding out effect that other forms of social spending (pensions and other forms of benefits) could have had in a year of electoral spending.

In theory at full regime each family should be entitled to a monthly 430 Lei compensation for a total estimated cost at full regime of some 400 million Lei, roughly equal to some 1% of GDP. This should allow a 40% or so reduction in poverty gap, and a 50% reduction in the severity of poverty. Some 1,215 social assistants have been trained to run the scheme countrywide and the total administrative costs are estimated at less than 2% of its total costs, if the 72,000 target is reached. The estimate of the gross impact on poverty alleviation has been entrusted to the National Statistical Office that is supposed to provide its preliminary results by early next year when the effectiveness of the scheme will be at any rate reconsidered with a view for further improvements.

The current system is strictly speaking not based on proxy testing. The mechanism actually put in place through the implementation by laws that were hastily approved in October 2008 no longer includes income disregards as an incentive to work and, most importantly, proxies have not been understood as objective statistical criteria and probability indicators, but as score coefficients subject to political negotiation that are simply summed up and represent de facto a categorical filter mechanism. The ultimate consequences of this are unclear. It appears as a matter of concern to TA specialists who deem the scheme too lax for management purposes[17]. If their simulations proved correct, the total cost at full regime would almost double the officially budgeted figure and impact on poverty would be negligible with as high as 48% of benefits going to the non-poor. On the other hand, Government sources are concerned that the mechanism could actually be too restrictive, because simulations based on outdated household survey data would poorly reflect income distribution patterns that are highly volatile, which would explain the substantial number of applicants that drop out of the scheme during biannual revisions (as high as 6-7% of the total). The potentially distorting effect of income disregards is however acknowledged by all parties concerned and a possible aspect of future reconsiderations.

Also in the light of this, no final conclusion can be drawn on the total cost of the reform and its long-term financial sustainability. During 2009 both the old nominative compensation scheme and the new one have been financed, which comes at a total anticipated cost for the budget of 417 million Lei (202 +215 million Lei, i.e. some 1%-1.25% of GDP depending on projected total GDP drop), which, however, appears unlikely to be fully disbursed and presently pointing closer to a total 0.7% GDP cost. The Ministry of Social Affairs has asked for a total 400 million Lei financing of the new scheme only in 2010 and for discontinuation of the old one. However, it is unclear whether this is constitutionally possible in the light of existing individual rights. There are

[17] According to past simulations made by the OPM TA in place in Chisinau 80 % of Moldovan households would pass the income text, and as high as 90% of all who pass the income text would also pass the proxy text. These concerns are further reinforced by the fact that so far only some 3% of potential beneficiaries have reportedly failed the proxy test. See D Malhotra, A Hurrell and A. Thompson, The Evolution of the Policy Framework Governing Cash Transfer in Moldova, OPM Paper March 2009.

several unknown factors on which the total cost will ultimately depend. The impact of the crisis on actual number of applicants and trends in remittances, indexation of benefits because of prices increases, level of awareness about the system among the population and transaction costs for applicants, distorted incentives to remain unemployed and the effect of other social expenditure measures.

Apart from the political uncertainties on the ultimate fate of the old nominal compensation scheme, the risk of overspending remains an open issue on paper, but poorly supported so far by hard evidence. The number of detected frauds is currently very limited, although the IT system admittedly remains vulnerable.[18] A number of potential beneficiaries could have incentives to abandon their current legal jobs to enter the black market, but they will do so only if they trust the long term reliability of the reform. Last but not least, there seems to be the intention of financing eventual needs for further social assistance expenditure by means of an overall reform of the pension system leading to savings in other areas so that it could result cost-neutral.

There are very preliminary indications that the reform could play an indirect role in easing liberalisation of utilities and energy prices. In the original 2006 IMF and WB feasibility study it appeared the intention of considering the reform of the social benefit legislation as an enabling mechanism to tackle the restructuring of the heavily subsidised energy prices and particularly poorly efficient district heating system thereby contributing to the solution of a sizeable quasi fiscal deficit.[19] The nominal compensation mechanism was structured in a way to be linked to energy price increases so that a doubling of the latter would trigger a doubling of social benefit expenditure without much relief for the most vulnerable. While election time did not make any reform of energy pricing possible, some connection between the two reforms has started to appear, as there are talks about revising the level of benefits in the light of the recent decision of the Chisinau mayoralty to substantially increase both the price of water and that of energy.

4.2.3 Cross conditionality

Reform of social assistance was considered a priority area by different components of the donor community and not only by the EU. In a simplified way one could say there were two main strands leading to action in the area of social assistance: one stemming from the EU Food Security Programme and then continued under the MFA first and ENPI sectoral budget assistance and another one resulting from the joint efforts of the World Bank, DFID and SIDA.

Cross conditionality with WB, DFID and SIDA

In Moldova there has been very strong Donor Coordination between the EU, the WB, the United Kingdom (DFID), Sweden (SIDA), and the Netherlands. In 2005 joint collaboration in the preparation of a single policy framework for the WB PRSC

[18] In 2006, social assistance programs are administered by several government agencies, including NSIH, Ministry o f Health and Social Protection, Territorial Social Assistance Offices, and Territorial Social Insurance Offices, each of which have independent beneficiary registries and payment databases limiting cross checking of beneficiaries.

[19] R. Gillingham and M El Said Welfare and Distributional Effects of Energy Tariff Increases, IMF April 2007.

programme was catalytic in starting improved donor harmonization in Moldova. During preparation of the PRSC, DFID, SIDA, and IDA carried out joint missions in consultation with the European Union. This harmonization process was carried forward through a Development Partnership Framework signed between the Government, IDA, the Netherlands, the United Kingdom (DFID), Sweden (SIDA), the UN, IMF, and EU entitled "Co-ordination and Harmonization of Government and Donor Practices for Aid Effectiveness in the Republic of Moldova" signed in Chisinau on May 29, 2006. This Partnership Framework commits the parties to joint reviews, harmonization of indicators, and prior actions and synchronization with Government budget cycles with a view to reducing transaction costs of assistance to the Government.

In this strong co-ordination context, various aspects of the social assistance reform were included as conditionalities in different programmes although with slightly different wording. The World Bank made a conditionality under **PRSC2** (a US$10 million tranche) that the Government would: (i) adopt a time-bound social assistance reform action plan for improved poverty targeting including converting some of the categorical targeting to means-tested ones, and (ii) design a unified database of the beneficiaries of cash-equivalent social assistance programs. Under *PRSC3* (another US$10 million tranche), the government was expected to: (i) begin the implementation of the action plan; and (ii) start the installation of the unified database. Then for its IV PRGF review in 2008 the IMF included as a structural benchmark the introduction of a targeted social assistance mechanism throughout Moldova by September 30. However, there is general consensus on the fact that the Fund did not play a leading role in this area, but simply acted to further reinforce existing conditionalities.

Complementarity with other EU programmes

The reform of the social benefit system has also been one of the main conditionality areas of the EUR20 million ENPI sector budgetary supports in the social sector agreed between the Commission and the Moldovan Government in 2007. The related policy matrix includes three sets of benchmarks and indicators respectively for 2007, 2008 and 2009 as reported in the table below. Around 25% to 37.5% of tranche disbursements are directly or indirectly related to the social assistance reform. In 2008 the ENPI evaluation report concluded that not all the benchmarks had been met and tranche disbursement would have to be cut accordingly.

Table 4.3 Social Benefit Reform Related Benchmarks and Indicators under the ENPI Sector Support Programme

2007 Actions	2008 Actions	2009 Actions
Design of a new social benefit scheme		
• Elaboration of principles and modalities for the reform of the social payments; • Estimation of the cost of the new benefit packages on the budget assessed and forecast of additional income for beneficiaries made; • New law on social benefits drafted and approved by the Government • Information and awareness campaign prepared.	• Organisational structure of the social benefit system management determined; • Methodology for income-based testing developed; • Information and awareness campaign implemented nationwide; • The ToRs of the poverty impact assessment survey elaborated and agreed upon.	• An independent evaluation of the performance of the new system carried out; • Improvements to the system proposed; • Evaluation of the information and awareness campaign; • Incidence on poverty assessed according to agreed ToRs.
Implementation of a new social benefit scheme		
• Draft regulation on establishing the amount of and social assistance payment; • Social workers recruited and trained.	• Implementation of new system starts nationwide; • Cumulatively at least 900 social workers recruited and trained; • Capacity of social assistants evaluated.	• New system operational in the whole country; • In total 1135 social workers recruited and trained; • Capacity of social assistants evaluated.
Monitoring Arrangements		
	• Methodology of monitoring the implementation of social assistance policy developed.	• The monitoring system produces aggregated data on the implementation of the reform; • The outcomes of the monitoring system feed into the poverty reduction policy formulation process and the budget preparation processes.
Budgetary preparation		
• Budget 2008 prepared taking into account the principles of the new system.	• Budget 2009 prepared on the basis of the new system; • Development of the Mid term economic framework 2009-11 to adjust to the reform.	• Budget 2010 prepared based on the performance of the system; • MTEF 2010-12 updated for the new system.

4.2.4 Net impact

As can be seen from the paragraph above it is very difficult to assess any specific net impact of the MFA in sponsoring the social assistance reform because of the co-operative efforts of the donor community and the co-existence of parallel EU sector budgetary assistance on the same subject. In particular, the latter was particularly prominent in the eyes of the beneficiaries as it provided direct budgetary support to their efforts, something that the MFA could not achieve, being a general budgetary support instrument.

On the positive side it is clear that the combination of MFA and IMF adoption timeframe played a substantial role in finally settling the Parliament approval deadlock the reform found itself in after it had been submitted to Parliament and therefore substantially contributed to speed up the reform process, as well as the joint MFA and ENPI policy matrixes help build a clearer financial framework to have the system actually implemented. In December 2007, a programme to increase the efficiency of the social assistance system for the period 2008-2010 was approved at a cost of estimated EUR6.5 million. These allocations were already foreseen in the Medium-Term Expenditure Framework (MTEF) for 2009-2011 approved by the government in April 2008. The cost of the introduction of the new system in 2009 was estimated to be to slightly over 200 million Lei; and projected to exceed 450 million Lei by 2011.

On the negative side the MFA and the other instruments have failed so far to achieve a full replacement of the old nominal compensation system. At the time of second tranche disbursement the Moldovan Government was found on track as far as social assistance benefits were concerned. Draft legislation was pending in Parliament and had already been approved in the first reading. But the issue of whether this was to replace the old system was never raised, and the position that the two systems could actually coexist, although with one more or less frozen, finally prevailed. The MFA was the only instrument to have a conditionality attached to the implementing regulations. But these were found at the time of second tranche disbursement “ready to be adopted immediately after approval” which hindered any assessment on whether a genuine proxy means tested scheme was to be achieved or the EU was neutral as regards the implementation mechanisms provided the ultimate result would be achieved. So the MFA had an indirect and possibly unintended impact in shaping the contents of the reform.

All in all the joint EU effort had a clear **political reinforcing effect:** all relevant political actors were supportive of MFA conditions and perceived them as an incentive to continue their reform efforts and to win resistances to change. In addition, there is evidence that in 2006 DFID estimated to have a reformed system in place by 2009/2010, so it can be reasonably concluded that additional EU pressure also through the MFA managed to buy time and to have the reform in place at least one year earlier than could have been otherwise possible. In other words, there are clear signs that the MFA conditionalities had an **operational reinforcing effect** [20] leading to a verifiable speeding up of reform implementation. Without the MFA, the reform would have been implemented although on a longer time frame and this is also the overwhelming impression of participants to the Delphi survey.

[20] Operational reinforcing effect implies that a verifiable speeding up of reform implementation took place.

Unexpected effects
MFA did not give rise to any unexpected effect.

4.3 Public Internal Financial Control

4.3.1 Relevance

Table 4.3 reiterates the conditionalities in the domain of Public Internal Financial Control. Below the table, additional clarification on source and rational is given.

Table 4.3 Conditionalities in the domain of Public Internal Financial Control included in the MoU

Conditionalities listed in the MoU
2nd tranche
Prepare, in co-operation with the European Commission, and adopt a revised Government PIFC Policy/Strategy Paper and time-bound action plan outlining the approach to implementing the public internal financial control system.
3rd tranche
Prepare draft framework legislation and submit it to the Parliament.
Prepare an implementation plan to facilitate understanding and acceptance of PIFC throughout the public sector, including training and development of methodological guidelines and providing the PIFC bodies with adequate budgetary resources and staff.

The internal control system in Moldova was typical for CIS-countries. Although the types of problems identified by inspectors do not suggest that there is widespread malpractice or maladministration, the internal control system was characterised as centralised, rigid and sometimes even excessive. It constituted mainly of ex-post verifications of the execution of the budget and only to a limited extent, system audit was carried out.

The conditionality on Public Internal Financial Control originates in the European Union Moldova Action Plan (EUMAP) that was ratified in March 2005. Section 42 of this Action Plan contained the commitment to (i) develop a strategy and policy paper for the Public Internal Financial Control system (managerial accountability and internal audit) and (ii) to establish legislative framework for public internal financial control.

In 2006, the Public Expenditure and Financial Accountability review found weaknesses in the internal audit function (see Table 4.3) and in 2006 the World Bank had started its Public Finance Management project that included a component on internal control.

The Operational Assessment conducted in February 2007 observed that the internal auditing function of the Government is still at an early stage of its development. It recognised that the government is currently working on the development of a new conceptual framework and law on internal audit based on the agreement of the EUMAP, but it noted that no clear timeframe has been specified yet.

4.3.2 Gross impact – actual structural reform outcomes

The Financial Control and Revision Service (FCRS) of the Ministry of Finance (MoF) have been leading the introduction of the PIFC reform. The main achievements are the following:

- Development and approval of the Concept on Public Internal Financial Control (Government Decision no. 1143 of 04.10.2006);
- Establishment of the Division for Public Internal Financial Control System Harmonization within the FCRS in May 2007;
- Development and approval of the National Internal Audit Standards compliant with international standards together with the Court of Accounts in November 2007 (MoF Order No 92 as of 27.11.2007 and Court of Accounts Decision No. 82 as of 29.11.2007);
- Development and approval of the Code of Ethics for Internal Auditors and the Charter of Internal Audit (Sample Regulations on the performance of internal audit) in December 2007 (MoF Order no 111 as of 26.12.2008);
- Approval by government of the Strategy for Public Internal Financial Control in 2007-2009 in January 2008 (G.D. no. 74 of 29.01.2008) including an Action Plan and followed by training strategy;
- Transfer of the Division for Public Internal Financial Control System Harmonization to the MoF in March, 2008;
- Carrying out pilot audit missions, by involving the staff from the Financial Control and Revision Service and the Division for Public Internal Financial Control System Harmonization, including some joint missions with internal audit units during 2008;
- Approval of amendments to the Law on Budgetary Process and Budgetary System no. 847-XIII as of 24.05.1996. The amendments provide a legal basis for PIFC including accountability arrangements for the management of public funds as well as for the implementation of a system of internal audit. The amendments were approved by the Parliament through the Law no. 172-XVI as of 10 July 2008 and are to be applied starting from 1 January 2009;
- Development and approval of the Methodological Norms for Internal Audit in the Public Sector in December 2008 (MoF Order no 118 as of 29 December 2008);
- Development of Internal Audit Manual, published in December 2008;
- Development and submission to the Government for approval of the Draft Law on Public Internal Financial Control in December 2008. However, after review of the draft law, government felt that the draft law was not yet ready for submission to Parliament. It was supported by experts from the World Bank and SIGMA. In a strict sense, the conditionality was therefore not achieved. The Law on PIFC is being currently developed on the basis of the comments provided by the World Bank, European Commission and SIGMA.

From this list of achievements, it can be inferred that the Normative and Legal framework for Internal Control and Audit has been substantially improved. However, the effect of these actions has not been reflected in the PEFA scores. The PEFA indicators that aim to capture actual performance rather than formal procedures did not identify strong impact of the reforms and scored the dimensions similar to the 2006 assessment (see Table 4.4).

Table 4.4 Indicator 21, PEFA Moldova 2006 and 2008

	Overview of the indicator	Score 2006	Score 2008	Conclusion
PI-21	Effectiveness of internal audit	C+	C+↑	
Dim i	Coverage and quality of the internal audit function	C+	C+↑	The function is operational for at least the most important central government entities and undertakes some systems review (at least 20 percent of staff time), but may not meet recognised professional standards.
Dim ii	Frequency and distribution of the reports	C	C	Reports are issued regularly for most government entities, but may not be submitted to the ministry of finance and the SAI.
Dim iii	Extent of management response to internal audit findings	A	A	Action by management on internal audit findings is prompt and comprehensive across central government entities.

Among others it is observed that currently, there are 15 internal audit units within the central public authorities and most of them were set up prior to the beginning of the project. From the total number of internal audit units only 3 units carry out internal audit activities according to the standards and methodology developed within the project. Most of them, despite their title, continue to perform financial control and revision functions rather than internal audit.

4.3.3 Cross conditionality

Cross conditionality with World Bank

At the same time as the EUMAP was agreed, the World Bank agreed in May 2005 a Public Financial Management project with the Government of Moldova in the amount of US$15.3 million. The project comprises four components:

1. Budget Planning and Execution (methodologies and information systems);
2. Internal Control and Audit;
3. Financial Management Training Capacity and Training; and
4. Project Management, Monitoring and Evaluation.

The project was developed independently of the EUMAP and reflected choices on the basis of the WB's Country Assistance Strategy (2004) and the recommendations of Bank's previous analytical work such the 2002 Public Expenditure Management Review and the 2003 Country Financial Accountability Assessment.

Component 2 appeared to be in the same domain as the EUMAP's objective to implement the PIFC reform as can be inferred from its three subcomponents:

i. Normative and Legal Framework for Internal Control and Audit;
ii. Transformation of Financial (Compliance) Control into Internal Audit Function;

iii. Expanding the Internal Audit System to Line Ministries and Sub-national Entities.

In principle, the EUMAP and the corresponding MFA conditions could be at odds with the aims and objectives of the World Bank when it agreed the PFM project. In practice, no significant tensions have occurred. Informally, a division of work was agreed between the Bank and the EU along the following lines. The EU provided the normative framework by means of its PIFC concept. The WB project, through its contractor International Management Consultants Ltd provided the technical assistance to support the Moldovan government to design appropriate laws, regulations, manuals and training.

Complementarity with other EU programs

In follow up of the EUMAP, the second instalment of the Food Security Program in 2006 (EUR 4 million) contained the following conditionality **'Elaboration and approval of the Concept for internal audit in public sector'** in its MoU.

The ENP Action Plan included the following conditionality on Public Internal Financial Control:

- Development of a strategy and policy paper for the public internal financial control system (managerial accountability and internal audit);
- Establish legislative framework for public internal financial control;
- Gradual harmonization with the internationally agreed standards (IFAC, IIA, INTOSAI) and methodologies, as well as with EU best practices for the control and audit of public income, expenditure, assets and liabilities.

The reform of PIFC has also been included in the EUR20 million ENPI Social Sector Budget Support (SSBS) program agreed between the Commission and the Moldovan Government in 2007. The related policy matrix includes benchmarks and indicators respectively for 2007, 2008 and 2009 as reported in the Table 4.5.

Table 4.5 PIFC related Benchmarks and Indicators under the ENPI Sector Support Programme

Actions 2007
PIFC Strategy paper approved by GoM
Mof FCRS regulation amended – provisions for new functions for new functions carrying out the audit of Internal Control Systems (ICS) in the public sector
Central harmonisation unit for internal audit and internal control is established
Launching the internal training module on internal audit and internal control
Actions 2008
PIFC legislation drafted
Audit missions by the Central Service for Internal Audit in selected public institutions
Completion of at least two pilot internal audit missions
Other actions (elaborating of training modules for internal auditors, for managers, internal audit module, etc) aligned with the PFM project
Identification of the necessary resources for PIFC implementation
Actions 2009
Adopted PIFC legislation
Audit missions by the Central Service for Internal Audit in at least 30% of the public institutions
Training managers on risk management
Other actions (training of internal auditors) aligned with the PFM project
Implementing internal control in selected public institutions

Counterfactual
Answering the question how reform developments would have involved in the absence of the MFA and its associated conditionality on PIFC reform needs to take the attention given to the reform area by the World Bank and the ENPI (both action plan and in the policy matrix attached to the SSBS). In addition, representatives of the Financial Control and Revision Service (FCRS) emphasize own ownership of the Moldovan government in driving the reform. From the various external incentives, they consider the ENPI as the most important.

However, both the FCRS and the President's Office were aware of the MFA and the condition that the draft law was supposed to be submitted to Parliament. Therefore, we assume that in the absence of the MFA, actual reform progress would not have been affected. However, in the absence of less pressure would have existed on the submission of the draft law to Parliament, and we expect that, consequently, debates on the issue whether or not to submit to Parliament would have given less weight.

4.3.4 Net impact

The MFA has a **political reinforcing effect** as all relevant actors were familiar with the MFA conditions and perceived them as an incentive to continue their reform efforts and increased therefore the overall probability of reform progress in the domain of PIFC.

The MFA could have an **operational reinforcing effect** by speeding up of reform implementation reflected by Parliamentary approval of the PIFC law. In practice, such operational reinforcing effect did not occur as government supported by World Bank and SIGMA experts deemed the draft law to be immature. The waiver of the conditionality by DG ECFIN is to be commended. Insisting on the conditionality could have had a negative effect by forcing an immature law upon Moldovan government.

MFA did not give rise to any unexpected impact on structural reforms.

4.4 Public Procurement

4.4.1 Relevance

Table 4.6 reiterates the conditionalities in the domain of public procurement. Below the table, additional clarification on source and rationale is given.

Table 4.6 Conditionalities in the domain of public procurement included in the MoU

Conditionalities listed in the MoU
2nd tranche
Prepare an Action Plan for the implementation of the new legislation on public procurement promulgated in July 2007.
3rd tranche
Adopt implementing rules and start implementing the new Public Procurement Law.
Prepare a time-bound Action Plan for the development and strengthening of the Procurement Agency, including adequate budgetary resources, staff and equipment, training and capacity building.
Develop an effective monitoring system allowing the Procurement Agency to monitor the procurement by procuring entity.

The conditionality on Procurement originated from the findings of the Public Expenditure and Financial Accountability (PEFA) Assessment Report in 2006 (score given in Table 4.7) and from consultation with the World Bank. The World Bank Country Procurement Assessment Report 2003 (CPAR) had reported that single source tendering was happening ‘far too often, often in contravention of the procurement law’ (p. vii). The main reasons mentioned included:

i. lack of knowledge among procuring staff;
ii. influence on the procurement process to encourage procurement from a specific local company;
iii. limited market concentration - limited number of suppliers (monopolies);
iv. problems with the execution of the Budget forcing procuring entities to delay procurement until the end of the fiscal year and choose the fastest method.

The emphasis on public procurement was also justified by the fact that Government was approving new legislation on the subject.

Table 4.7 MFA-relevant PEFA indicator on public procurement for Moldova

	Overview of the indicator	Score 2006	Score 2008
PI-19	**Competition, value of money and controls in procurement**	**C+**	**B**
	(i) Evidence on the use of open competition for award of contracts that exceed the nationally established monetary threshold for small purchases (percentage of the number of contract awards that are above the threshold).	C	B
	(ii) Extent of justification for use of less competitive procurement methods.	C	C
	(iii) Existence and operation of procurement complaints mechanism.	B	B

Since then recourse to single source tendering has reportedly decreased although these data have never been verified by external parties. According to various sources the major problem was that the procuring entities were not consistently applying the law, and that this was attributable to a lack of training and insufficient oversight in the form of internal controls. So progress in coverage of entities applying the law is another relevant indicator. The legal provisions for complaints were, in general, clear and provide for oversight by the Procurement Agency. However, the Agency could be in conflict of interest with its role in procuring material resources for the Government. The Procurement Agency was reportedly understaffed.

4.4.2 Gross impact – actual structural reform outcomes

Following the promulgation in July 2007 of the new legislation approved by the Parliament in April 2007, the Government adopted in December 2007 an action plan for its implementation. The action plan foresees the adoption of a certain number of regulatory acts and sets concrete objectives in the areas of publicity and transparency of the public procurement, capacity building of the stakeholders, strict supervision of procurement, the development of e-procurement, as well as the acceleration of the process of the accession of the Republic of Moldova to the WTO Agreement on Public Procurement.

The Action Plan for the implementation of the Public Procurement Law triggered the adoption of 20 Government Regulations by the end of 2008. These range from procurement of goods and services through bidding, procurement through Commodity Exchanges, the establishment of a Government Commission for public procurement supervision independent of the public procurement agency, design works, procurement from one source, development of standard documents, introducing the concept of the Public Procurement portal, etc. The regulations are based on the EU model.

Among them the Action Plan for the development of the Public Procurement Agency was approved in September 2008, including targets in the fields of increasing transparency of its activities, human resources, and cooperation with similar agencies in the European Union. In parallel, the Public Procurement Agency was strengthened in terms of staffing and restructured.

In May 2008, to improve the monitoring of procurement by procuring entities, the Government established a Government Commission for public procurement supervision. At the same time, an internet portal has been developed and e-procurement is to be launched.

Although notable progress has been made, many issues in public procurement still exist. Table 4.7 provides the outcome of the PEFA Assessment Report in 2008 on PI-19. On the first sub indicator on open competition, the report states that available data on public contract awards show that more than 50% but less than 75% of contracts above the threshold are awarded on basis of open competition, but that the data may not be accurate. On the second sub indicator the Report concludes that justification for use of less competitive methods is weak or missing. Performance on the third sub indicator has also not improved: a process (defined by legislation) for submitting and addressing procurement process complaints is operative, but lacks ability to refer resolution of the complaint to an external higher authority. The Public Procurement Office has several functions including state aid and reserves, and does not have an independent complaints system in place. The Government of Moldova has asked for more time to implement the reform under the FSP. Now the reform is in place on paper, but not much has really happened.

In 2009, the Procurement Agency expects that open tendering procedures will cover 75% of the total. The Agency is also working on responding to complaints and in cancelling contracts resulting from unjustified extraordinary procedures.

4.4.3 Cross conditionality

To get insight in the progress of the implementation of the reforms in Public Procurement without the existence of MFA, cross-conditionality with other donors is investigated below.

Cross conditionality with other donors
Table 4.8 gives an overview of the conditionality attached to the WB's PRSC.

Table 4.8 Public procurement related Benchmarks and Indicators Under the WB's PRSC

Issue	PRSC- I (2007)	PRSC - II (2008)	PRSC - III (2009)	Outcome
Public Procurement.	Increased competition for public procurement contracts (decline in single source procurement from 51% to 45% of the value of contracts awarded; increased use of open tendering from 28% to 40% of value of contracts awarded).	Enactment of new Public Procurement Law which includes an Independent Procurement Agency with appropriate staffing and funding, in accordance with the Government's central public administration reform.	Maintain Independent Procurement Agency with appropriate staffing and funding.	No more than 10% of number contracts and 10% of the total value of contracts awarded by single source procurement. At least 50% of number contracts and 70% of the total value of contracts awarded by open tender.
		Development of an Action Plan approved by Government.	Implementation of Action Plan.	Publication of an Annual public report on the conduct and results of public procurement.

In 2005, the World Bank provided technical assistance to the Procurement Agency to support the drafting of the 2007 Public Procurement Law and the introduction of the website.

Complementarity with other EU programs

The 2006 FSP did not have any conditionality related to Public Procurement.

The ENP Action Plan included the following conditionality on public procurement:

(40) Develop conditions for open and competitive award of contracts between the parties, in particular through calls for tenders, in line with Article 54 of the PCA.

Public procurement has also been included as policy item in the ENPI Social Sector Budget Support (SSBS) program agreed between the Commission and the Moldovan Government in 2007. The related policy matrix includes benchmarks and indicators respectively for 2007, 2008 and 2009 as reported in the Table 4.9.

Table 4.9 Public procurement related Benchmarks and Indicators under the ENPI Sector Support Programme

Actions 2007
New PP law adopted and published with clear organisational and legal separation of duties between the advisory, supervision and monitoring function.
Training delivered to experts responsible for public procurement (both for beneficiaries and business communities).
Actions 2008
Government approval of secondary legislation implementing the new law on PP.
Drafting of Public Procurement guidelines both for beneficiaries and business community (Q1 2008).
Improved PP website with up-to-date information on PP, tenders, contracts, downloadable documentation, forms etc.
Pilot IT Procurement to 1 to 2 ministries.
Training delivered to contracting units and the business community.
Actions 2009
Training delivered to contracting units and the business community.
Expanding IT Procurement to additional 3-4 contracting authorities (selected on the basis of their higher procurement amounts).

The first three conditionalities attached to MFA (Action Plan for the implementation of the 2007 Public Procurement Law; Implementation of the new Public Procurement Law; Action Plan for the development and strengthening of the Procurement Agency) clearly overlap with the WB's PRSC conditionality. The ENPI conditionality includes the conditionality on separation of duties between the advisory, supervision and monitoring function, as well as on introducing e-procurement. These conditionalities relate to the last MFA-conditionality (Develop an effective monitoring system). In general, the ENPI conditionalities have a more distinct focus on training than the conditionalities attached to MFA and PRSC.

Counterfactual

As all conditionalities related to Public Procurement that were attached to MFA, were also attached to ENPI and/or the World Bank's PRSC, and the government had a clear reform agenda in the area of Public Procurement, it seems reasonable to suggest that without MFA, these reforms would have been implemented. Technical assistance to support the drafting of the new Public Procurement Law was provided by the World Bank in 2005. The existence of the new law inevitably implied implementation would follow.

4.4.4 Net impact

Assessing the net impact of the MFA in pushing the reform is complicated by the co-existence of the overlapping PRSC-conditionality as well as parallel EU assistance on the same subject. It clearly follows from the structured interviews that the Moldovan government would have implemented the public procurement reforms if MFA had not existed, both since the government had to meet indicators in public procurement linked to other programs and because the new Procurement Law was in place and awaiting implementation.

However, it has been indicated that the conditionality made the Procurement Agency identify its key priorities for 2007 and 2008. The conditionalities were set in close consultation with the authorities, and attempts were made to choose conditionalities similar to those attached to other programs. MFA therefore seems to have impacted the identification of the key reforms to be implemented. In doing so, MFA had a **political reinforcing effect** as all relevant actors were familiar with the MFA conditions and perceived them as an incentive to continue their reform efforts and increased therefore the overall probability of reform progress. The support helped the Procurement Agency to stay focused and change priorities within the Agency.

It can be concluded from the interviews that the fact that the public procurement conditionality was linked to MFA had a clear **operational reinforcing effect**, i.e. it speeded up reforms in public procurement. The time period of the MFA - hence the period of time in which the conditionalities had to be satisfied - was limited to 2007-2008. The implementation of the conditionalities required time, financial resources, human resources and in some cases, a mentality change (capacity building of both staff and the business community).

MFA did not give rise to any unexpected impact on structural reforms.

4.5 Conclusions

As can be seen from the paragraph above it is very difficult to disentangle the net impact of the MFA in sponsoring the reform because of the co-operative efforts of the donor community and the co-existence of parallel EU assistance on the same domains.

There is clear evidence that MFA had a political reinforcing effect in all domains given the strong monitoring system in place by the Moldovan government and the pressure put on the various Ministries responsible for the fulfilment of conditionalities.

The presence of a concrete operational reinforcing effect is harder to establish. It can be reasonably concluded that the MFA contributed to speed up reform of the social assistance legislation and help strengthen the procurement agency with more staff resources. The combination of MFA and IMF pressure played a notable role in settling the Parliament deadlock of the social assistance reform and there are convincing indications that without MFA pressure, strengthening of the procurement agency would probably have not happened in the same terms and with the same speed. The sectoral budget support nature of ENPI has played a wider role in easing budgetary constraints to social assistance reform than in mobilizing resources for public procurement purposes.

The MFA could have had a clearer operational reinforcing effect by speeding up implementation of the PIFC law as it insisted as the only program on submission of the draft law to Parliament before the end of 2008. In practice, such specific operational reinforcing effect did not occur as the conditionality was waived by DG ECFIN. Therefore any MFA operational reinforcing effect is more generic and more blurred in terms of specific visibility.

5 Impact on macroeconomic stabilisation

5.1 Introduction

In this chapter, we explain our approach for the first group of evaluation questions linked to the area macro economic stabilisation (see Table 5.1).

Table 5.1 Relevant evaluation questions for analysing the impact on macroeconomic stabilisation

No	Impact on macroeconomic stabilisation
Q1.1	What are the short and medium-term macroeconomic objectives of the assistance?
Q1.2	To what extent have the short and medium-term macroeconomic objectives of the assistance been achieved?
Q0.2	What are the structural and macroeconomic effects of the most likely implementation scenario(s)?
Q1.3	What has been the contribution of the grants and/or loans provided by the MFA operation to the achievement of MFA objectives?
Q3.1	What, if any, has been the contribution of actions arising as a result of the structural conditionality criteria to the achievement of the short and medium-term macroeconomic objectives of the assistance (i.e. the indirect effects of structural conditionality criteria)?
Q3.2	Has the assistance given rise to any unexpected short and medium-term macroeconomic effects? What were they and how did they occur?

5.2 Macroeconomic objectives of the intervention and their relevance

Q1.1: What are the short and medium-term macroeconomic objectives of the assistance?

5.2.1 Objectives

In April 2007, the Council of the European Union adopted decision 2007/259/EC to provide macro-financial assistance (MFA) to Moldova in the form of a grant facility of up to EUR45 million. The Council Decision explicitly states the objectives of the assistance:

> "The Community shall make available to Moldova macro financial assistance […] with a view to supporting Moldova's balance of payments and alleviating the financial constraints on the implementation of the government's economic programme."

The Decision further specifies the reasons for the above-mentioned objectives:

> "Moldova has substantial financing needs arising from a significant deterioration of its financial position" and "over and above the financing from the IMF and the World Bank, a substantial residual financing gap remains to be covered to improve the country's balance of payments, strengthen the country's reserves position, and to support the policy objectives attached to the authorities' reform efforts."

Table 5.2 recapitulates the macroeconomic objectives of the MFA as stated in the Council Decision.

Table 5.2 Macroeconomic objectives of the MFA granted to Moldova

	Objectives	Source
1	To support Moldova's balance of payments	Council Decision 2007/259/EC
2	To alleviate the financial constraints on the implementation of the government's economic programme	
3	To support the country's reserve build-up	

In addition, the Council Decision and the MoU stated that the release of the MFA tranches was conditional upon a satisfactory track record in the implementation of the three-year arrangements under the IMF's PRGF. Although the quantitative macro-economic performance criteria and benchmarks stipulated under the IMF-arrangement have a short term nature, they can also be considered as part of the macroeconomic objectives of the MFA:

- Quarterly floor for general government fiscal balance - Adjusted floor for general government fiscal balance;
- Quarterly ceiling on net domestic assets of the National Bank of Moldova (NBM);
- Quarterly floor on net international reserves of the NBM;
- Quarterly ceiling on contracting or guaranteeing of non-concessional external debt of the general government.

The achievement of these criteria will be discussed in paragraph 5.3.4.

5.3 Gross impact – actual macroeconomic outcomes

Q1.2: To what extent have the short and medium-term macroeconomic objectives of the assistance been achieved?

To answer this question we have analysed actual macroeconomic developments on the basis of macroeconomic indicators relating to the macroeconomic objectives. The information in this chapter is largely based on IMF International Financial Statistics (IFS). Since the macroeconomic situation has changed drastically in the past year due to the global economic crisis, we have also made use of unpublished confidential IMF-data that have been provided to the evaluation team during the interviews. All projections given are based on the latter data. Projections made in last year's IMF Country Reports are excluded from this report.[21]

Table 5.3 presents the macroeconomic indicators which we will use to assess the progress in achieving macroeconomic stabilisation. They are grouped in two categories: macro economy and public finance. The indicators relating to balance of payments and debt sustainability are discussed in chapter 6 that focuses on the external sustainability of the Moldovan economy.

Table 5.3 Selected macroeconomic indicators to assess the achievement of the macroeconomic objectives

Macroeconomic stabilisation	Effect indicators
Macro economy	• Growth rates in GDP and components; • Inflation; • Interest rate; • Exchange rate.
Public finance	• Level of government revenue; • Level of government expenditure; • Deficit; • Financing of the deficit; • Existence of quasi-fiscal operations.

5.3.1 Macroeconomic performance

Economic growth

Figure 5.1 shows GDP growth and CPI during 2003-2009. Except for the years 2006 and 2007, the economy of the Republic of Moldova continued growing at a rate of around 7-8 percent.[22] Non-agricultural GDP is estimated to have increased to 8 to 9%. Economic growth is exclusively due to the services sectors, notably construction and trade, which are financed by domestic demand (driven by remittances).

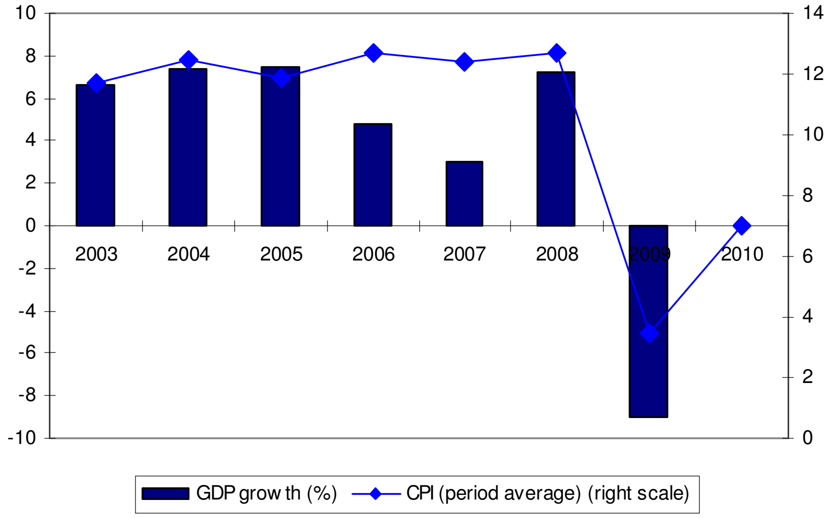
In 2006 and 2007, the Moldovan economy has been surprisingly resilient in the face of successive shocks, including the Russian ban on imports of Moldovan wine, a sharp increase in the price of imported natural gas in 2006 and the drought that hit the country in 2007. In 2006, real economic growth was weaker than in recent years due to the disruption of exports and higher price of energy. In 2007, economic growth was weaker than expected due to the drought. Growth of non-agricultural GDP remained strong at 9 percent.

Moldova's resilient performance during 2006-2007 was supported by inflows of foreign capital. Capital inflows, primarily in the form of remittances, largely compensate the trade deficit which approached 50% of GDP in 2007.

21 At the time of publication of this report, more recent IMF data may have been published.

22 The slowdown in 2006 and 2007 are caused by external shocks. Unfavourable weather conditions in 2006 (drought) reduced agriculture's output by nearly a quarter. Also the Russian ban on wine exports introduced in 2006 has had persistent effects.

Figure 5.1 GDP growth and CPI 2003-2009



Strong investment-driven demand continued in 2008, with investor interest in Moldova being boosted by low labour costs and an acceleration of the privatization program. Information from the banks and investment data suggest that foreign capital is increasingly used for investment rather than for consumption. This reflects a changing pattern of growth, from a model of consumption-driven growth financed by remittances to investment-driven growth, mirroring similar developments in other transition economies.

The financial crisis did not seriously affect the Moldovan economy in 2008 due to its low exposure to the international financial system. However, the global economic slowdown, particularly in the EU, Ukraine and Russia, has hit the Moldovan economy in 2009 hard as it relies heavily on remittances from Moldavians abroad and on exports to these markets. Export markets have shrunk and foreign direct investments have fallen sharply. Money transfers from Moldavians abroad via official channels fell to US$65 million in January from US$90 million a year ago, the latest data from the National Bank of Moldova (NBM) showed. Real GDP is projected to shrink by at least 9 percent in 2009, according to unpublished IMF data received in July 2009.[23]

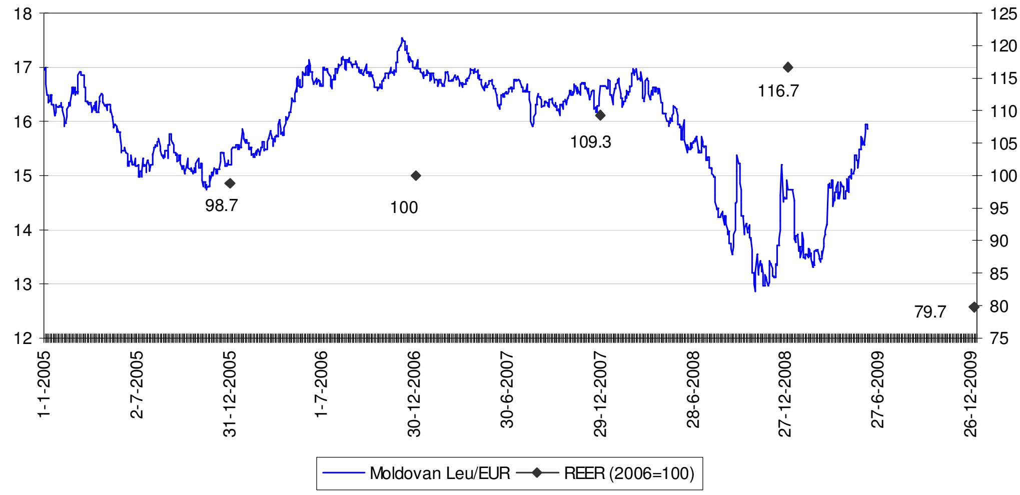
Inflation

Curbing inflation has been a major challenge in Moldova in recent years. The surge in inflation in 2006 (price rises increased 14%, against a target of 10% set at the time of the PRGF in May 2006) were partly due to the increased cost in energy imports. Despite the sterilisation efforts of the National Bank of Moldova (NBM) and restrictive fiscal policy (the budget deficit has been very low and has resulted in a further reduction of public debt, to just over 20% of GDP), inflation was persistent and reached 16 per cent in April-May 2008. This inflationary surge of early 2008 was mainly driven by the rapid growth in food prices caused by the drought and world trends. Since mid-2008 inflationary

[23] The World Economic Outlook, published in April 2009, expected the Moldovan economy to shrink by 3.4 percent in 2009.

pressures eased substantially with CPI falling to 7.3% at end-2008 and Moldova entering a deflation in April 2009.

Figure 5.2 Nominal exchange rate (Leu/EUR) 2005-2009, and REER 2005-2009 (annual average; 2006=100)



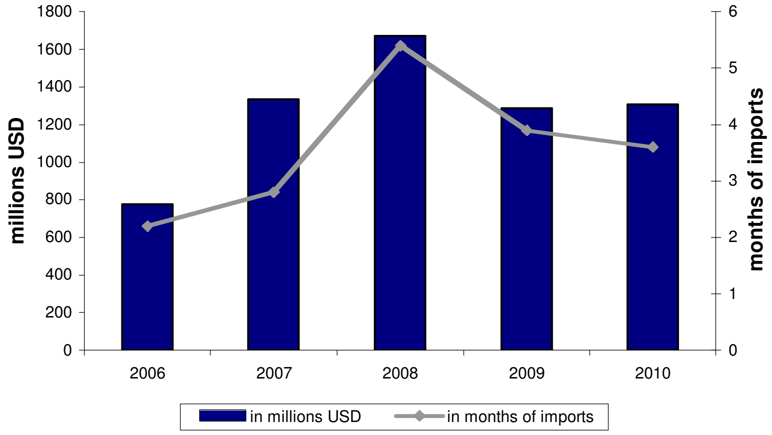
Source: Nominal exchange rate: National Bank of Moldova. REER: IMF unpublished data for 2006-2009; IMF's IFS for 2005; own calculations. Data for 2009 are projections.

Strong inflows of foreign exchange and the global weakening of the US dollar continue to put pressure on the Leu. In 2007, the Leu's real effective exchange rate appreciated by more than 10%.

The heavy foreign exchange interventions of more than USD 500 million to defend the leu have eroded competitiveness and drained liquidity from the financial system, weakening the banks' ability to provide credit to the economy. Pressures on the leu have eased recently due to depressed import demand, allowing some foreign exchange purchases by the National Bank of Moldova.

International reserves of the NBM continued to accumulate during 2007-2008, and reached beyond the target of three months of imports set in the PRGF programme (Figure 5.3). Reserves are expected to fall to pre-2007 levels in 2009 and 2010.

Figure 5.3 Total gross reserves in millions USD and in months of imports



Source: IMF unpublished data. 2009-2010 are projections.

5.3.2 Public Finance

Public expenditures and revenues have grown rapidly by nearly 10 percentage points of GDP over the last 5 years, primarily on social spending, including the pension and health insurance funds (see Table 5.4). Relative to other countries, revenues are 8 percentage points of GDP higher than the average of countries of similar income levels. As such, Moldova has little room to create fiscal space by increasing revenue mobilization.

Table 5.4 General Government Budget 2001, 2003, and 2006-2010 (in percent of GDP)

	2001	2003	2006	2007	2008	2009	2010
Revenues and grants	**29.2**	**34.0**	**39.9**	**41.8**	**39.1**		
of which							
• Taxes.	24.4	27.5	33.3	34.1	32.8		
• Grants.	0.9	0.3	0.7	1.8	1.8		
Expenditure and net lending	**29.4**	**33.3**	**39.6**	**42.0**	**39.1**		
of which							
• Current expenditure.			**32.0**	**34.6**	**31.1**		
• Wages.			9.2	9.1	8.8		
• Goods and services.			8.3	9.0	8.4		
• Interest payments.	4.2	2.1	1.0	1.2	1.2		
• Capital expenditure.			7.8	7.6	8.1		
Overall balance (cash)	**-0.4**	**0.2**	**0.2**	**-0.2**	**0.0**		
Primary balance (cash)	**3.8**	**2.3**	**1.2**	**0.9**	**0.2**	**-9.8**	**-9.1**
Financing	**0.4**	**-0.2**	**-0.2**	**0.2**	**0.0**		
• Domestic.	2.2	0.4	-0.6	-0.3	-1.2		
• Foreign (excl. project loans).	-3.3	-1.7	-1.4	-0.6	-0.5		
• Privatization.	0.4	0.2	0.9	0.8	0.5		
General government debt			**33.1**	**27.7**	**24.8**	**27.1**	**27.2**
of which							
• External debt.			25.6	21.0	14.3		

Source: IMF Country Reports 06/184 and 08/320; IMF unpublished data. Projections in grey.

Last year's Public Expenditure Review highlights the main issues in Moldova: the growth implications of a large government; the low expenditure allocations to important items such as road maintenance; inefficiencies in major expenditure items (such as education spending).[24] To accelerate growth, Moldova is advised to focus reform efforts on increasing the efficiency of public resources to yield increased space for public investment spending while leaving room for the private sector. Especially, specific reforms to reduce the civil service need to be developed and implemented.[25]

For the fiscal year 2008, Parliament approved a rectified budget targeting a balanced budget for 2008. The balance is achieved by using savings from revenue over performance. Also, steps were taken in 2008 to avoid a repeat of the spending overruns. The government also announced a switch in expenditures from goods and services to the new social assistance scheme from October 2008 as well as priority public investments. The authorities have established an investment fund, fully integrated into the general government budget, to finance major infrastructure projects and other priority

[24] Source: Republic of Moldova: Improving Public Expenditure Efficiency for Growth and Poverty Reduction. World Bank Report No. 37933-MD, February 2008.

[25] Source: Country partnership strategy for the Republic of Moldova for the period FY2009-FY2012. World Bank Report No. 46822-MD, December 2008.

investments, such as a pension reform, and possibly costs of reintegration with Transnistria in the future.

However, with the elections in sight, expenditures went up drastically (pensions, wage increases). Moreover, the crisis decreased demand causing falling imports, which will have an adverse effect on budget revenue from excise taxes and duties in 2009. Whereas the budget deficit was kept below 0.5% of GDP during 2007-2008, the IMF noted that without additional measures, it will increase to above 11 percent of GDP in 2009.

5.3.3 IMF PRGF Performance criteria

The specific macroeconomic objectives coincide with the IMF quantitative performance criteria of its arrangement under the Poverty Reduction and Growth Facility (PRGF). The implementation of the MFA concurred with the three-year programmes 2002-2005 and 2006-2009. Table 5.5 shows the assessment of these criteria by the IMF. It concludes that during the implementation of MFA, Moldova performed on each criterion in accordance with the set benchmarks.

Table 5.5 Performance of Moldova on the quantitative performance criteria in the period 2006 - 2008 (end of March benchmarks; 2006 end of Sep)

Objective (in millions of Lei)	2006		2007		2008		IMF
	Prog	Act	Prog	Act	Prog	Act	assessment
Floor for general government fiscal balance -	-303		-144		150		Met
Adjusted floor for general government fiscal balance	-201	317	-44	386	242	277	
Ceiling on net domestic assets of the NBM (level)	-477	-652	-997	-2,003	-5,713	-6,130	Met
Floor on net international reserves of the NBM (level)	7,866	6,845	7,737	8,500	15,359	15,495	Met
Ceiling on contracting or guaranteeing of non-concessional external debt of the general government	0	0	0	0	9	9	Met

During the first six months of the PRGF arrangement, all quantitative performance criteria and indicative targets were met with the exception of the international reserves target in 2006, which was missed because of the shocks (imports ban on Moldovan wine, rising import prices for natural gas).

In 2007, the authorities proposed to modify the program by increasing the ceiling on non-concessional borrowing, which was accepted. This accommodated an EBRD/EIB road rehabilitation project and a health project by the CEB (both projects co-financed by IDA). During the third review, all end-September 2007 quantitative PCs were observed. A quantitative benchmark on non-accumulation of domestic expenditure arrears was missed as Chisinau failed to fully pay the heating subsidies it decided to grant to households. The indicative target on reserve money has also been missed as the National Bank of Moldova (NBM) has pursued the multiple objectives of inflation, low interest rates and exchange rate stability in the face of strong foreign exchange inflows.

During the fourth review, all end-March quantitative PCs and indicative targets were observed and the review was completed in September 2008.

In the fourth quarter of 2008, the economy of Moldova was affected by the global economic crises. The IMF entered into negotiation with the government of Moldova to adjust the quantitative benchmarks in line with the new economic reality facing the Moldovan economy. However, no agreement was reached. Consequently, a fifth and a sixth review did not take place and the program expired in May 2009 without disbursement of the 5th and 6th tranches.

5.3.4 Conclusions on gross impact

From the description of the development of the macroeconomic development in general it is concluded that the objectives have been achieved:

- The macroeconomic situation turned out better than foreseen during 2007-2008 as the Russian ban on wine imports did not materialize as was expected in 2006;
- GDP growth was strong during the period 2006 – 2008;
- Growth was slightly weaker than expected in 2007 due to the drought that hit Moldova's farmers;
- The budget deficit was small (below 0.5% of GDP) and in control during 2007-2008;
- Reserves accumulated more than foreseen as a consequence of increased remittances and foreign direct investments and reached well beyond the target of three months of imports set in the PRGF programme;
- The outlook for the various economic and public finance indicators has altered negatively at the end of 2008. The indicators are expected to further deteriorate in 2009 as a result of the economic crises and lax fiscal policy of the Moldovan government in the election year.

5.4 Counterfactual analysis

5.4.1 Most likely macroeconomic scenario

Q.0.1 What arrangements would have been implemented if the MFA had not been granted?

A counterfactual analysis is based on "conditional statements", addressing what would be the case if circumstances had been different. For the MFA, the counterfactual analysis requires answering the question **"what arrangements would have been implemented if the MFA had not been granted?"**.

Answering this counterfactual question requires educated guesses of key stakeholders in the process about the most likely chain of events that could have taken place if MFA had not been there. A key element in these assessments will be represented by asymmetric information on the consequences and risks of the financing gap. IFI, EC and donors are assumed to behave on the basis of IMF estimates of the financing gap. Although the official information is the same, actors may differently assess the risks associated with the gap.

In order to identify the counterfactual we have used structured interviews with key stakeholders and decision makers in the Moldovan government and experts from the IMF and WB. Below, we briefly outline some possible counterfactual scenarios with regard to the financial part of the MFA assistance (Table 5.6).

Table 5.6 Possible counterfactual scenarios if the financial assistance had not been granted

Actor	Counterfactual scenario	Probability
IMF	• Higher program amounts in April 2006.	Not likely
	• Delay in the program given that no case could be presented to the Board in April 2006.	Possibility that was noted by IMF
WB	• Higher program amounts.	Not likely
EC	• Additional support from FSP.	Not likely, as FSP closed in 2006
	• Advancing ENPI budget support.	The probability of this option still needs to be determined
Bilateral donors	• Further debt rescheduling/cancelling behaviour.	Not likely, it was already significant
	• Request to turn funds from technical assistance to budgetary support.	Not likely, donors are not willing
Moldovan government	• Adjustment of fiscal policy.	Likely given that IMF program is in place
	• Recourse to other sources of financing.	Likely in case that no IMF program would be in place
	• Menacing a financial crisis.	Not likely, political commitment to EU showed preparedness not to go on their own

Crucial was the IMF's Poverty Reduction and Growth Facility (PRGF). We distinguish two scenarios:

Scenario I: IMF would have implemented the PRGF program without modification even if MFA had not existed. This scenario is considered likely, because the IMF Board's requirement for the PRGF is that only the first year of the financing gap is fully covered. The second and third year can remain open. Hence, the Board's requirement was satisfied as the first year was covered by the IMF program and debt rescheduling by the Paris Club.[26]

[26] The likelihood of this scenario is strengthened by the fact that - although it was expected that MFA would take place - no formal decision had been taken at the time of the decision on the Fund's PRGF.

If this scenario would have been followed, it would have become apparent that the EC would provide sectoral budget support under the ENPI in 2007 and 2008 and that the financing gap was less problematic. In 2007, EUR 21 million under the ENPI were used for a budget support operation aiming at modernising the social assistance system. In 2008, ENPI continued to support Moldova's internal reform efforts and allocated assistance for a total amount of EUR 62 million.[27]

In 2007, it also became clear that Moldova was able to build up reserves and that the Russian wine ban had a less adverse macroeconomic impact than foreseen in 2006.

In scenario I, the budget would have been short of revenues for EUR 20 million in 2007 and EUR 25 million in 2008.

Given the presence of the IMF program, expenditure cuts would have been required in the absence of MFA. As indicated in budget information, the most likely expenditure cuts would have been in 'capital investment'. In 2007, a supplement to the budget was introduced. Based on figures provided by the Moldovan Ministry of Finance, the majority of the extra resources of the third supplementary budget (dated 7 December 2007) [28] were spent on 'Agriculture, forestry, fishery and water service'. Spending on 'Increase assets of Railway station; 'Compensations for Electricity; and 'Job creation' was also increased.

In this scenario, even without the existence of MFA, the signalling effect to foreign investors would have been there since both the IMF and the EU were present in the country (the latter through the EU Moldova Action Plan and Food Security Programme).

Scenario II: In this scenario, the IMF Board would not have approved the PRGF given that the financing gap in 2007 and 2008 could not be fully covered in the absence of MFA support. In this scenario, it would be likely that Moldova would have turned to other donors for support (most likely is Russia). The probability is supported by current developments; as the forthcoming new PRGF awaits the upcoming election and establishment of a new government, Moldova is exploring its possibilities to receive loans from other countries, in particular now the country is faced with the effects of the economic crisis.

In this scenario, the BoP would be adversely impacted through the negative signalling effect that non-approval of the Fund's PRGF would have on foreign investors and European donors. FDI boomed in 2006 and 2007. Non-approval of the PRGF would have given a negative signal to European investors.

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[27] The ENPI Annual Action Programme 2008 (EUR 45.7 million, topped up with EUR 16.6 million from the Governance Facility) was allocated to a large (EUR 46.6 million) budget support operation for the modernisation of the primary health care system, to a project on border and migration management (EUR 10 million) and sectoral technical assistance and twinning (EUR 5.7 million). This support was a part of the indicative amount of €209.7 million, allocated for the period 2007-2010 under the ENPI.

[28] The MFA tranche was disbursed in September 2007.

5.4.2 Macroeconomic consequences in counterfactual scenario

Q0.2 What are the structural and macroeconomic effects of the most likely implementation scenario(s)?

The counterfactual is determined by answering question 0.1 and consists of three parts:

i. macroeconomic scenario (see section 5.4.1);
ii. structural reform scenario (see section 4.4);
iii. unexpected events scenario (see section 4.5).

i. Macroeconomic effects of the counterfactual macroeconomic scenario

Below, the macroeconomic consequences of the two scenarios are determined based on a quantitative modelling approach. The applied macroeconomic model is basically similar to the model employed in previous evaluations (evaluation of MFA in the Former Yugoslav Republic of Macedonia, Romania, and Tajikistan, Serbia and Montenegro and Albania).[29] All the improvements and refinements that were introduced at subsequent stages have been incorporated. One specific feature calling for an extension of the model is that one of the counterfactual scenarios analysed at this stage of the evaluation involves changes in the flows of foreign direct investments. This requires introducing FDI to the model. Given the relative strengths of FDI-related effects (as compared to the magnitude of changes of other variables in the model) these have become the dominant factors in determining GDP dynamics. No other specific features of the Moldovan economy have been identified and hence no significant changes have been introduced to the model apart from the potential analysis of FDI effects. Given the significantly increased volatility of all macroeconomic variables due to the ongoing global crisis and the fact that the modelling period pertained to future (forecast) data particular emphasis was put on the sensitivity analysis taking into account alternative values of all key parameters. Annex IV provides a more detailed description of the quantitative modelling approach.

In the 1st counterfactual scenario the key differences in macroeconomic performance relative to the actual scenario can be described as follows (Table 5.7). Decreased government grants under the tight budget constraint leads to full adjustment on the expenditure side, specifically in the reduction of public investment outlays. The direct impact of lack of MFA grant in the current account is partly offset by lower import demand. No changes are assumed to have taken place in the capital account and remaining part of the adjustment is via declining official reserves. This in turn is related to slower growth of broad money. The combined effects of slower growth of monetary aggregates and a slight weakening of the leu exchange rate (linked to lower imports) on price developments leads to marginally lower inflation.

29 We have not been informed about the final recommendations of the meta-evaluation of the MFA evaluation projects. The interim recommendations did not give reason for further adjustment of the approach. However, in follow up of these interim recommendations, the final report will contain a more comprehensive documentation of the modelling approach.

Table 5.7 Scenario I: Indicative net macroeconomic impact of MFA (difference between actual and 1st counterfactual scenario) – annual developments

	2006	2007	2008	2009
General government revenues & grants (billion leu)	0.0	0.33	0.38	0.0
General government expenditures (billion leu)	0.0	0.33	0.38	0.0
Current account (%GDP)	0	0.4	0.4	0.0
GDP growth rate (% per annum)	0.0	0.3	0.3	0.0
Inflation rate (% points)	0.0	0.1	0.0	0.0
Exchange rate (leu per euro)	0.0	-0.1	-0.1	0.0

Note: Only net effects without actual and counterfactual values are presented because the actual series are partly forecast. This does not affect modelling results. Source: Project database (IMF IFS data and IMF forecasts) and estimations from the model.

In the 2nd counterfactual scenario the key differences in macroeconomic performance relative to the actual scenario can be described as follows (Table 5.8). Decreased government grants lead to higher government borrowing as there is no force to support fiscal prudence. Government expenditure is not affected. At the same time PRGF loans are replaced by borrowing on non-concessional terms. Worsened macroeconomic stability perceptions lead to a 10% decline in FDI inflows during 2006-2008. The BoP adjustment occurs mostly by a contraction in import demand (and resulting lower current account deficit) and partly by changes in international reserves. Lower imports are related to slightly weaker counterfactual exchange rate of the leu. The impact on GDP growth is mainly determined by lower FDI and hence lower private investment expenditure which is partly off-set by lower imports.

Table 5.8 Scenario II: Indicative net macroeconomic impact of MFA (difference between actual and 2nd counterfactual scenario) – annual developments

	2006	2007	2008	2009
General government revenues & grants (billion leu)	0.0	0.33	0.38	0
General government expenditures (billion leu)	0.0	0	0	0
Current account (%GDP)	-0.4	-0.1	-0.1	0
GDP growth rate (% per annum)	0.7	0.9	0.9	0.0
Inflation rate (% points)	0.0	0.0	0	0.0
Exchange rate (leu per euro)	-0.2	-0.3	-0.3	0.0

Note: Only net effects without actual and counterfactual values are presented because the actual series are partly forecast. This does not affect modelling results. Source: Project database (IMF IFS data and IMF forecasts) and estimations from the model.

ii.Indirect macroeconomic effects of structural conditionality

Q3.1: What, if any, has been the contribution of actions resulting from the respect of structural conditionality criteria to the achievement of short and medium-term macroeconomic objectives of the assistance (i.e. the indirect effects of structural conditionality criteria)?

In Chapter 4, we have analysed the net impact of the structural reforms. In Table 5.8, we summarize the conclusions in terms of four steps.

Table 5.8 Possible counterfactual scenarios if the financial assistance had not been granted

Domain of conditionality	Potential macroeconomic impact	Gross macroeconomic impact based on presence of operational reinforcing effect	Net macroeconomic impact
Social assistance scheme	Yes, less quasi fiscal deficit via link of district heating	Speeded up the reform but side effect did not materialise	None
	Higher part of income used for consumption	Speeded up reform, magnitude on consumption still to be determined	To be determined
Public Internal Financial Control	PIFC should result in more effective spending. However, no studies/reports are available to support and/or quantify this claim	None	None
Public Procurement	More competitive public procurement could result in increased efficiency in public spending and budget deficit control [30]	No operational reinforcing effect was identified	None
	Contribute to foster private investment	No operational reinforcing effect was identified	None

iii. Unexpected macroeconomic results

Q3.2: Has the assistance given rise to any unexpected short and medium-term macroeconomic effects? What were they and how did they occur?

As described in Chapter 4, two social assistance systems exist in parallel. The cost of the existing nominal compensation social assistance system is approximately 0.5 % of GDP. The new income-based system has been introduced in three phases. Per 1 July 2009, the third phase was implemented. The system is expected to be working at full regime at the end of 2009. The fully operational system is estimated to cost approximately 1% of GDP. It remains unclear if the old system will phase out in the coming years.

[30] A study carried out by the EC's Directorate General for the Internal Market, looking at prices actually paid by a sample of contract awarding authorities in 2002, for goods, services and works, showed that the prices effectively paid in purchases where procurement rules were not applied appeared to be 34% higher than prices when these rules were applied.

The parallel existence of the two systems would have most likely occurred also without macro-financial assistance given the emphasis of other budget support hinging on the new law. However, MFA has speeded up the approval of the new law. Consequently, we assess that without MFA the parallel existence of the two systems would have started at a later point in time, i.e. MFA gave rise to additional expenditures (of approximately 0.5% of GDP) in 2009.

5.5 Conclusions: net impact on macroeconomic stabilisation

Q1.3: What has been the contribution of the grants and/or loans provided by the MFA operation to the achievement of MFA objectives?
Comparing the actual developments with counterfactual results allows initial estimations of the net impact of MFA to Moldova. The estimates presented below have been validated against opinions of key stakeholders in the second field visit and will be discussed with the Steering Group.

Total net impact
Paragraph 5.4.2(i) describes the key differences in macroeconomic performance of each macroeconomic counterfactual scenario relative to the actual scenario. Scenario I envisages that IMF would have implemented the PRGF program without modification even if MFA had not existed. In Scenario II, the IMF Board would not have approved the PRGF given that the financing gap in 2007 and 2008 could not be fully covered in the absence of MFA support. Scenario I is considered more likely since the IMF Board's requirement for the PRGF - coverage of the first year of the financing gap - was satisfied through Paris Club Debt rescheduling.

The indicative net macroeconomic impact of MFA was estimated by the difference between actual and counterfactual I scenario. Through the quantitative modelling approach described in paragraph 5.4.2, the MFA is found to have impacted the Moldovan economy in the following ways:
- MFA boosted cumulative economic growth in Moldova by around 0.6% during 2006-2008;
- MFA slightly reduced the current account deficit during 2007 and 2008 (to the tune of 0.4% of GDP each year);
- MFA resulted in minimally higher inflation and a slightly stronger leu foreign exchange rate.

Assuming the second counterfactual scenario as a base, the quantitative modeling exercise described in paragraph 5.4.2 would suggest the following net effects of the MFA on the Moldovan economy:
- MFA boosted cumulative economic growth in Moldova by around 2.8% during 2006-2008;
- MFA slightly widened the current account deficit during 2006 and 2008 (to the tune of 0.4% of GDP in 2006 and 0.1% of GDP in 2007-2008);
- MFA had a negligible impact on inflation and resulted in a slightly stronger leu foreign exchange rate.

6 Impact on external sustainability

6.1 Introduction

Table 6.1 presents the evaluation questions that analyse the impact of MFA on external sustainability. This chapter contains our answer to these questions.

Table .6.1 Evaluation questions on the MFA's contribution to external sustainability

No	To what extent has the MFA contributed to returning the external financial situation of the recipient country to a sustainable path over the medium to longer term?
Q4.1	How did the external financial situation of the recipient country evolve prior to and during the MFA operation?
Q4.2	What are the main internal and external factors on which the current trend in the country's external financial situation and its prolongation into the future are conditional?
Q4.3	How is the country's external financial situation likely to evolve in the five years following the final disbursement, given the likelihood of changes to current conditions?
Q4.4	What is the MFA contribution to medium and long term external sustainability prospects?

The fourth of the above questions is not part of the specific evaluation questions as mentioned in the methodological guidance for the ex post evaluation of MFA. However, based on the experience from previous evaluations we explicitly address this question on the impact of MFA on external sustainability and underline this key dimension of the objectives of the MFA instrument.

6.2 Gross impact – actual evolution of external sustainability indicators

4.1: How did the external financial situation of the recipient country evolve prior to and during the MFA operation?

To answer this question we analyse actual developments on the basis of indicators relating to external financial situation. Unless a source is explicitly stated, the information in this paragraph is based on IMF reports listed in the References.

Table 6.2 presents the macroeconomic indicators that are used to assess the progress in achieving external financial stability. They are grouped in two categories: balance of payments, and debt sustainability.

Table 6.2 Selected macroeconomic indicators used in the assessment of external financial situation

Macroeconomic stabilisation	Effect indicators
Balance of payments	• Current account balance; • Components of current account: exports, imports, current transfers; • Capital and financial account balance; • Inflow of foreign direct, portfolio and other investment; • International reserves; • Remittances.
Debt sustainability	• Domestic and foreign debt; • Debt service payments; • Foreign-currency debt ratings; • Liabilities of banks.

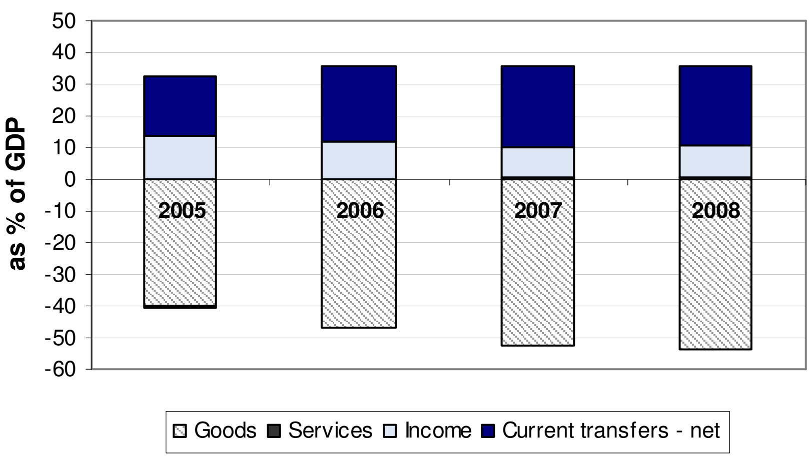
6.2.1 Balance of payments

Current account

Current account developments were primarily shaped by the dynamics of imports, exports and remittances. All three major categories of the current account have been rising for the last several years, albeit with differing dynamics.

Between 2001 and 2006 exports of goods and services (expressed in USD) have been rising at an annual average rate of 16%, while imports have seen much stronger gains, averaging 24% annually. 2005 and 2006 saw particularly diverging export/import trends with much faster expansion of imports. As a result, the trade deficit widened to around 40% of GDP in 2005 and 47% of GDP in 2006. This is a very large deficit in international comparison. During 2007-2008 export performance improved somewhat rising at an average annual rate of 27%, but imports surged by 35% annually in USD terms leading to yet wider trade deficit, exceeding 50% of GDP (Figure 6.1).

Figure 6.1 Components of the current account of the balance of payments 2005-2008 (in percentage of GDP)

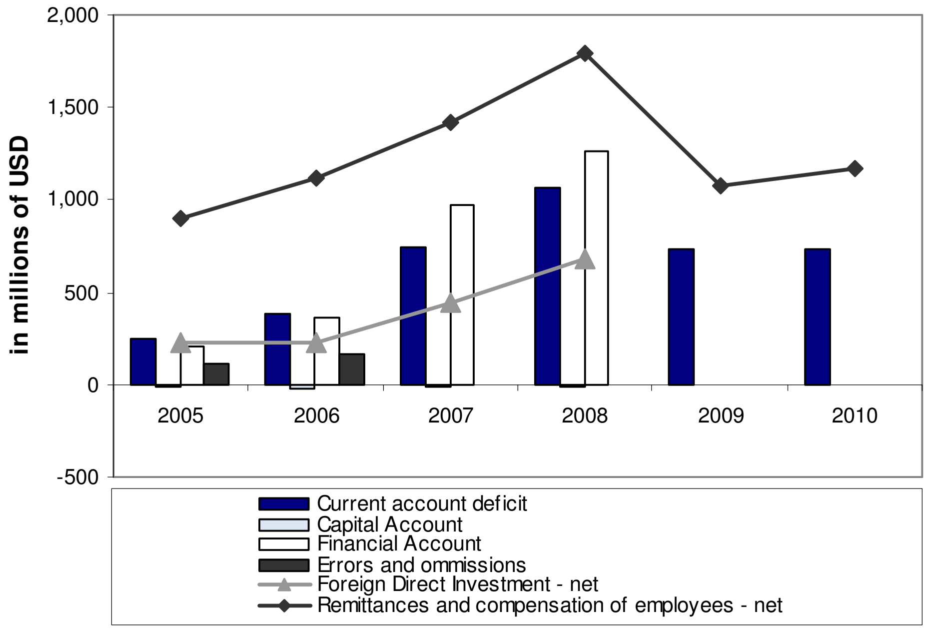


Source: IMF IFS.

Improvement in export performance may be partly related to the end of Russian restrictions on selected imports from Moldova (especially wines), while autonomous trade preferences (ATP) granted by the EU in 2008 cushioned the negative impact of Romania's accession to the EU (given the FTA between Romania and Moldova that was in place before 2007).

Following a period of modest current account deficits during 2001-2004, they widened substantially in 2005 and 2006 to 10% and almost 12% of GDP, respectively. In 2007 and 2008 current account deficit increased yet further to around 16% of GDP. These are very high levels of deficits in international comparison.

Figure 6.2 Current account, FDI, and remittances 2003-2010 (in million USD)



Source: IMF IFS for 2005-2008. Data for 2009-2010 are projections based on unpublished IMF data.

The evolution of the trade balance was to a significant extent determined by several external shocks: on the export side Russian ban on Moldovan wines that were in place between March 2006 and October 2007 (with its effects extending well into 2008 and beyond) and on the import side significant increase of prices of energy commodities between 2005 and 2008. Among the more permanent factors, behind-the-border barriers related to Moldovan policies have been hindering fulfilment of the Moldova's export potential.

One other crucially important element of the current account is the remittances and compensation of employees items (the latter classified under income heading in the current account). Given their similar characteristics for simplicity we refer to them jointly as remittances. The nominal value of remittances increased almost six fold between 2001 and 2006 stabilising at just above 30% of GDP during 2005-2008. This implied a strong nominal growth of remittances until 2008. Between 2006 and 2008 nominal USD value of remittances increased by 60%. It is worth noting that the measurement of remittances is likely subject to a wider error margin than in the case of foreign trade. In particular, the distinction between FDI inflows and remittances might not always be clear cut.

The global economic crisis has had an effect on foreign trade and remittances patterns from late 2008 and especially in early months of 2009 with exports contracting by around 20% your-on-year in the first half of 2009 according to preliminary data. During the same period imports fell by around 35%.

6.2.2 Debt sustainability

Moldova was starting the 2000s decade with high external debt, exceeding 100% of GDP. This was a result of economic decline throughout most of 1990s and significant exchange rate depreciation. In the early 2000s while nominal value of external debt stayed broadly constant, strong economic growth combined with real exchange rate appreciation helped in bringing the ratio of external debt stock to GDP to 56% as of 2005 (Table 5.2). In subsequent years this ratio stayed broadly constant. Importantly, there has been a visible change in the structure of foreign debt with public and publicly guaranteed part of it steadily declining (to a forecast level of below 20% of GDP in 2008) and increasing importance of private sector debt, especially related to FDI. Additionally, private debt has recently become more often denominated in Euros (20% of the total in 2006, up from just 6% in 2002) which should gradually improve the match between currency denomination of debt on the one side and export revenues and remittances on the other side.

One recent episode of moderate debt distress occurred in 2006, when external debt service was particularly high, equivalent to around 20% of exports of goods and services. Still, the debt sustainability analysis (DSA) carried by the IMF and the World Bank in early 2006 concluded that Moldova had faced short-term liquidity difficulties, but not a structural debt sustainability problem[31].

External debt service, after a peak in 2006 declined significantly in 2007. The 2006 debt restructuring with the Paris Club of creditors played its role here. Servicing of foreign public and publicly guaranteed debt declined from close to 10% of public sector revenues to well below 5% in 2007.

Public sector debt declined from around 60% of GDP in 2003 to below 35% of GDP in 2006 and below 25% of GDP in 2008. After a peak in 2005-2006 public debt service eased to 6-7% of revenues during 2007-2008.

[31] See IMF, Moldova Country Report no. 06/184.

Table 6.2 Selected public sector and external debt indicators, 2003-2009

	2003	2005	2006	2007	2008	2009
External debt (nominal), % of GDP	88.7	56.2	57.4	58.2	56.2	55.1
o/w public and publicly guaranteed (PPG), % of GDP	*52.5*	*27.4*	*25.9*	*21.2*	*17.4*	*15*
NPV of external debt, % of GDP	..	..	50.3	52.1	50.9	50.3
NPV of external debt, % of exports	..	..	110	112	104	98
Debt service-to-exports ratio, %	19.8	16.5	18.7	8.8	11.2	13.3
PPG debt service-to-exports ratio, %	12.5	7	5.5	4	3.2	2.6
PPG debt service-to-revenue ratio, %	..	9.5	6.4	4.4	4	3.5
Public sector debt, % of GDP	60.3	38.0	34.4	27.6	22.0	18.6
o/w foreign currency denominated	*49.8*	*27.9*	*25.8*	*20.3*	*16.0*	*13.3*
NPV of public sector debt-to-revenue ratio, %	146.9	87.6	64.3	46.0	37.7	32.6
Debt service-to-revenue ratio, %	6.2	8.9	9	6.5	6.6	5.2

Notes: 2007 figures are estimates while 2008-2009 are projections. NPV stands for net present value. Calculations of NPV assume that NPV of private sector debt is equivalent to its face value.
Sources: 2003 figures: IMF CR 06/184; figures and projections from 2005 onwards: IMF CR 08/139. An update of the forecasts will likely show stabilisation of public sector debt as a share of GDP at levels from around 2007 rather than a continued decline. In view of less optimistic export outlook foreign debt service to export ratios is also expected to worsen.

Overall, the most recent DSA from February 2008 concludes that debt dynamics is sustainable with low risk of debt distress. The assumptions of the basic scenario underpinning this outlook have been more recently verified negatively due to the adverse effects of the ongoing economic crisis. The following observations can be made:

- Some debt indicators, especially related to 2009-2010 have worsened. Specifically, a substantial downward revision of GDP growth prospects translates into worsened public debt and public debt service to GDP indicators;
- The relative strength of the leu against the USD and the Euro has been mitigating the negative effects. In particular, worsening of the external debt to GDP ratio will likely be modest assuming stability of the leu at current levels;
- Downward revision of export outlook will lead to a worsening of foreign debt / debt service to export ratios.

While the 2008 DSA assessment is clearly too optimistic given the crisis developments based on the information currently available we still evaluate risks to the external and public debt outlook as low.

6.3 Identification of major risks

4.2: What are the main internal and external factors on which the current trend in the country's external financial situation and its prolongation into the future are conditional?

In this section we present our analysis of the key risk factors to external sustainability that are based on data analysis, and opinions and assessments Moldovan policy makers, international financial institutions, and independent experts. The following potential sources of risk have been identified:

- global economic crisis;
- decline in inflow of remittances;
- weak export performance;
- political instability, in particular related to the Transnistria.

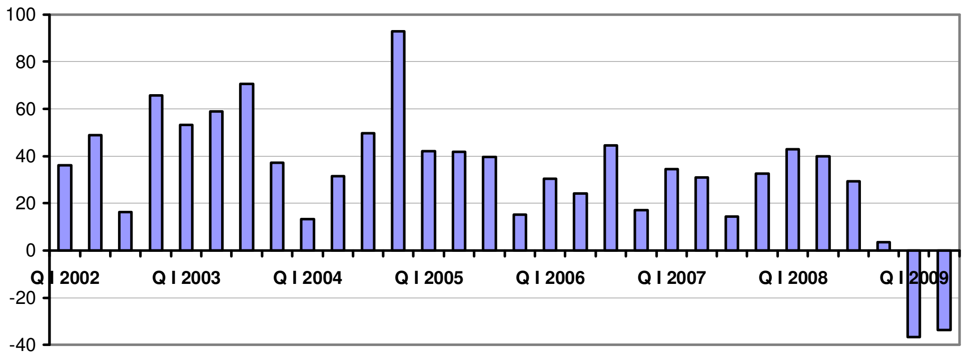
Global economic crisis

The ongoing economic crisis seriously affecting all major Moldova's trade partners constitutes a significant short to medium-term risk to the country's external financial situation. According to the October 2009 edition of the IMF World Economic Outlook European Union economy will likely contract by 4.2% in 2009 with only a very modest 0.5% recovery in 2010, while Russia may see a recession of 7.5% in 2009 before returning to a weak 1.5% growth in 2010. Moldova has been relatively resilient to the crisis until late 2008 but the situation has been rapidly deteriorating since the turn of 2008/2009. Strong contraction of foreign trade (20% contraction of exports in the first half of 2009) and remittances (see below), deflationary tendencies and severe recession forecast for 2009 do not bode well for the external financial situation. Widening public finance deficit will be a significant challenge. The prolongation and / or deepening of the crisis could further complicate the situation of Moldova.

Remittances

The key role played by remittances in the BoP is likely to continue but the scale of recession and employment contraction in the EU and Russia – the two main destinations for Moldovan emigrants – suggests a potentially significant decline in the inflow of remittances, at least in the short term (2009-2010). National Bank of Moldova BoP data for 2008 and first half of 2009 show a major slowdown in remittances inflows at the end of 2008 and a drastic decline in the first half of 2009. The growth dynamics (in nominal USD terms) which was above 40% in the first half of 2008, came to a standstill in the last quarter of 2008 while the first half of 2009 saw a contraction of around 35% (Figure 6.3). While quarterly data can contain substantial noise, it appears that contrary to earlier expectations, the decline in remittances can be quite substantial in the near future. Such strong negative shocks to remittances could exert a pressure on the exchange rate, limit the availability of resources for the financial sector and also increase credit risk, because part of bank lending is based on the borrowers' earnings from remittances.

Figure 6.3 Annual dynamics of remittances, 1Q 2002 – 2Q 2009 (% change yean-on-year)



Source: National Bank of Moldova.

Export performance

Moldovan export performance has not been particular strong for the last years. Despite a significant potential in wine making, other agricultural production and light industries (in particular textiles), a combination of domestic regulatory impediments with external shocks (such as a ban on wine sales in Russia) have exerted a negative pressure. It appears that domestic regulations and policies are a particularly important drag on exports. These are related, inter alia, to export licensing, repatriation of export earnings, VAT system, etc (see text box 6.1). The improvement of the foreign trade regime allowing for continued and accelerated development in export sectors is a necessary condition for ensuring macroeconomic stability in the longer term perspective.

Box 6.1 Barriers to export in Moldova

In recent years, the Moldovan government made good progress in implementing several reforms in customs (tariff classification, IT-system, harmonized system for the classification of goods, one-stop-shop, protection of intellectual property rights), and phyto-sanitary issues (align with EU standards inter alia as regards hygiene rules in the food processing industry and animal identification). In 2007, Moldova reached the formal requirement for receiving additional Autonomous Trade Preferences (ATPs) from the EU, as foreseen in the EU-Moldova Action Plan. Trade tariffs do not impose a barrier to trading with Moldova. The weighted import customs tariff in 2007 was on average 4.3%, well below the average 8.5% within the members of the World Trade Organization (WTO). Exports from Moldova are not subject to customs tariffs. Based on its low tariffs, the IMF classified Moldova as the most liberal trade regime compared to other countries in transition.

However, non-tariff barriers and trade restrictive measures do pose difficulties to trade with the country. Despite progress in reforming the customs service in recent years, several barriers to export remain:[32]

Customs clearance: complicated registration procedure

A large number of documents (commercial invoice, sales contract, the certificate of origin, the certificate of conformity compliance, and transport documentation) should be submitted. The customs officers are allowed to request more information. Only the original contract with the manufacturer is accepted.

Export licenses are not based on a classification

Traders lack information on what range of goods are covered by an export license, as no classification exists. This leads to inconsistent application of the licensing. Moldova is ranked furthest from the EU Member States on “Dealing with Licenses”. Costs of licenses are an important constraint for small companies in particular.

Reimbursement of Value Added Tax (VAT) is difficult

Value added tax paid on both domestic and imported inputs is subject to reimbursement upon export of finished goods. According to many surveys about 40% of export VAT refund requests are being satisfied on a regular basis and the average time lag of reimbursement (typically, in the form of offsets)

[32] Source: A free trade area between the Republic of Moldova and the European Union: feasibility, perspectives and potential impact. Expert Grup, 2009.

is about six months. Only 56% of exporters actually applied for a refund. The average reported cost of delays is equivalent to 9.5% of export earnings.[33]

Transnistria
Finally, there are some risks related to the domestic political situation and especially the unresolved status of Transnistria. Following the turbulent first half of 2009 in domestic politics, early elections and forming of the government in September 2009 decreased the risks somewhat, but not entirely. Intensification of conflicts either on the internal scene or involving also other countries could have negative effects on the quality of domestic economic policies and / or could lead to further trade restrictions (similarly to the 2006-2007 wine export ban to Russia) with potential adverse effects on external financial situation.

6.4 Projections for external sustainability

4.3: How is the country's external financial situation likely to evolve in the five years following the final disbursement, given the likelihood of changes to current conditions?

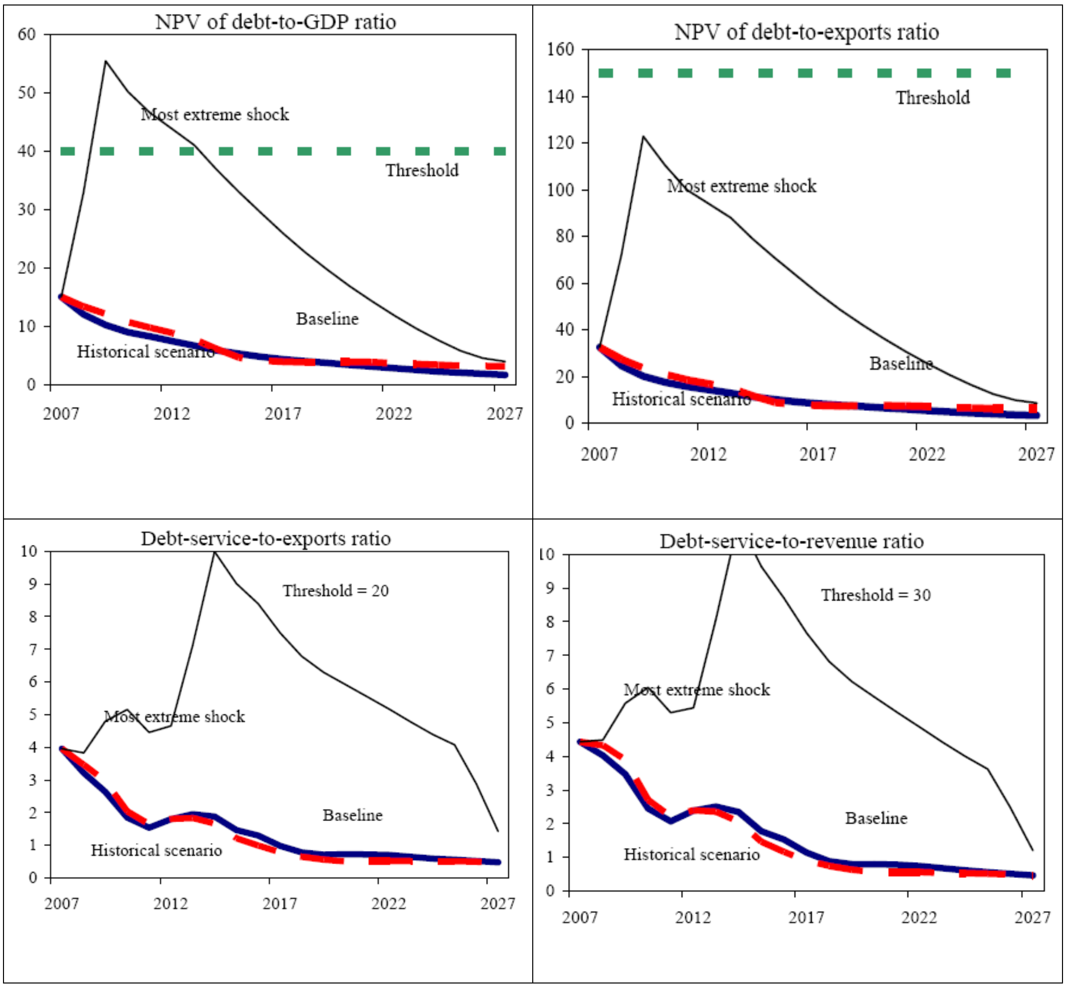
IMF / World Bank debt projections
This section provides an analysis of the external sustainability based on the most recent available data. The major source is the IMF/World Bank external and public debt sustainability analysis. The most recent update was published in February 2008.

The global economic crisis that has hit all Moldovan trade partners as well as Moldova has led to realisation of radically different macroeconomic scenarios, during 2008 and especially 2009 than those analysed in the February 2008 DSA. For this reason we do not present and discuss in detail the now outdated projections. Instead we briefly cover the results of sensitivity analysis in the DSA and specifically the most pessimist scenarios. Given that the new DSA is not available at the time of preparing the draft final report we can only draw conclusions based on the appropriate scaling of the pessimistic scenarios discussed below taking into account more precise forecasts for developments in the Moldovan economy during 2009-2010.

Figure 6.4 plots the dynamics of key foreign debt indicators including for the "most extreme shock" scenario defined as the one resulting in the worst performance of a given parameter by 2017. This scenario is characterised by the combination of the following assumptions:
- Real GDP growth at historical average minus one-half standard deviation in 2008-09;
- Export value growth at historical average minus one-half standard deviation in 2008-09;
- US dollar GDP deflator at historical average minus one-half standard deviation in 2008-09;
- Net non-debt creating flows at historical average minus one-half standard deviation in 2008-09.

33 Source: World Bank exporter survey.

Figure 6.4 Debt Sustainability Analysis: selected indicators – focus on the “most extreme shock” scenario.



Source: Extracted from IDA and IMF, Republic of Moldova. Debt Sustainability Analysis, 20 February 2008, page 8.

The currently unveiling crisis (2009-2010) is in some dimensions likely to be more severe than the above scenario. In particular the contraction of GDP and exports is bound to be yet deeper. On the other hand, one can expect policy adjustment in view of such an unprecedented crisis. Overall, this scenario can be seen as somewhat close to the current consensus view of the likely near term economic developments and hence its consequences for debt sustainability are relevant.
Based on currently available information we conclude that the external debt position of Moldova appears sustainable with relatively low risks over the next several years. The current economic and financial crisis will likely have one-off effects significantly worsening debt indicators but given the favourable initial position this should not cause major distress.

This view can be supported by the comparison of debt sustainability indicators against some relevant benchmarks. The profiles of selected debt indicators portrayed in Figure 6.4 are drawn against thresholds that are commonly used in the IMF / World Bank analysis.

The idea behind this approach is that "safe" levels of respective debt indicators should depend on the overall quality of policies in any given country. A motivation is an intuitive observation that worse economic policies may call for a much more cautious approach in assessing external sustainability as compared to countries with established record of responsible macroeconomic policy making. The approach is described in the IMF and World Bank staff paper of March 2005.[34]

The quality of policies is proxied by the World Bank's Country Policy and Institutional Assessment (CPIA) – recentlyy renamed IDA Resource Allocation Index (IRAI). These assessments are made annually and have been available to the public since June 2006 when the 2005 ratings were released for the first time. CPIA ranking is used for classifying low-income countries into three groups, with weak, medium and strong policies respectively. The arbitrarily decided dividing points for this classification have been set at CPIA 3.25 (between weak and medium) and 3.75 (between medium and strong). In the next step, for each group of countries the indicative sustainable debt thresholds are defined in terms of relationships between net present value of debt stock and debt service to GDP, exports and budget revenues excluding grants. These debt thresholds (using the 'preferred' version of CPIA dividing points) are presented in Table 6.3.

Table 6.3 Debt-burden thresholds in the option preferred by IMF staff

	NPV of debt as % of exports	NPV of debt as % of GDP	NPV of debt as % of revenues	Debt service as % of exports	Debt service as % of revenues
Weak policy (CPIA ≤ 3.25)	100	30	200	15	25
Medium policy (CPIA 3.25< to < 3.75)	150	40	250	20	30
Strong policy (CPIA 3.75≤)	200	50	300	25	35

Source: IMF and IDA (2005) Operational framework for debt sustainability assessment in low-income countries – further considerations, 28 March.

Moldova is classified in the medium policy performance group with an outlook for an upgrade (for debt sustainability analysis 3-year averages are relevant rather than annual data).

Balance of payment, international reserves

Current account deficit is expected to narrow during 2009-2010, mainly on the back of significantly reduced import demand. The improvement of the balance on trade in goods and services will be partly canceled by lower inflows of remittances. According to the IMF projections published in October 2009 edition of the World Economic Outlook current account deficit may still amount to around 12% of GDP. Remittances may stabilise at a lower level of just above 1 billion USD annually during 2009-2010, i.e. 20-

[34] IMF and IDA (2005) Operational framework for debt sustainability assessment in low-income countries – further considerations, 28 March.

25% of GDP, compared to around 30% of GDP during 2006-2008. Such a scenario implies a still large current account deficit in international comparison and related risks to the stability of external financial situation. International reserves are expected to decline somewhat in nominal terms from the levels seen in 2008, but in relation to imports the ratio will still be significantly higher than during 2006-2007. IMF projections indicate gross official reserves corresponding to 3.6-3.9 months of imports during 2009-2010.

6.5 MFA contribution to medium and long-term external sustainability

4.4: What is the MFA contribution to medium and long term external sustainability prospects?
This section provides a qualitative discussion of the key channels of MFA impact on medium- to long-term external sustainability. Where possible, also a quantitative estimate of the effects is made.

6.5.1 Channels of influence

Based on the analysis presented in other sections of this report we have identified the following channels through which the MFA operation in Moldova could have influenced the external sustainability in the medium- to long-term perspective:

- direct impact on GDP level and thus on debt to GDP indicators;
- possible direct impact on the composition of public debt;
- effects of selected structural reforms.

Impact on GDP growth and hence on debt to GDP indicators
The MFA operation supported somewhat higher economic growth during the 2006-2008 periods resulting in the higher GDP level as of 2009 (and beyond) than would be the case in the absence of the operation. **Ceteris paribus**, this results in a marginal improvement of the future path of debt to GDP ratios. This effect can lower debt stock to GDP ratios by around 0.1-0.3 percentage points in the forecast horizon till 2012. Hence, while the effect is positive it is also small.

It is worth reminding that this magnitude of effects is smaller than typical levels of volatility of debt sustainability indicators related to volatility of economic variables such as exchange rates or interest rates.
The exercise with calculating counterfactual ratios of debt indicators to GDP cannot really be repeated with other typical debt sustainability indicators using exports or international reserves as denominators. This is because the counterfactual medium- to long-term trends of these variables cannot be derived on the basis of the simple macroeconomic consistency modelling framework applied in this evaluation.

Level and composition of debt
In the second of the analysed counterfactual scenarios MFA is assumed to have allowed for favourable terms of financing the government expenditures (that are assumed to be identical between actual and counterfactual scenarios). Specifically, lack of MFA would imply (1) that the MFA grant is replaced by foreign borrowing on non-concessional terms

and (2) that the MFA PRGF is replaced by foreign borrowing on non-concessional terms. The combined effect of these two mechanisms implies a net MFA impact on reduction of the public debt to GDP ratio to the tune of 0.1-0.2 percentage points in the forecast horizon till 2012. It is difficult to provide any precise estimates of the net effects on debt service indicators, but the magnitude of these changes would likely be very small in the horizon until 2012. Importantly, such a magnitude of net effects only materialises when the second (less likely) counterfactual scenario is taken as a base.

In the first counterfactual scenario IMF lending is not affected and general government investment expenditure is reduced instead of new borrowing replacing the MFA grant. Taking a longer-term perspective of the external sustainability analysis it cannot be ruled out that at some point during 2010-2012 some public investments projects that (in the first counterfactual scenario) had cancelled during 2007-2008 would be eventually financed, possibly with additional debt issuance. This would imply a very small medium- and long-term effect of the MFA on external sustainability of below 0.1 percentage point for the debt/GDP ratio.

Effects of structural reform – social assistance legislation
As discussed in section 4.2 of this report, the MFA conditionality related to social assistance legislation might have had the unintended effect of additional public expenditure related to the parallel functioning of the two systems of approx. 0.5% of GDP in 2009. To the extent that higher than otherwise needed expenditures on the systems could lead to higher public finance deficit financed by higher borrowing this could imply a negative net MFA effect on medium- to long-term external sustainability. The quantification of this possible effect is very difficult given lack of strong basis for the quantitative assessment of actual additional costs related to the mode of introduction of social assistance reforms.

Effects of structural reform – public internal financial control
Quality of public finance management can arguably be important element affecting long-term external sustainability. As discussed in section 4.3 of this report, MFA included conditions related to public internal financial control and we find a political reinforcing effect of these conditions. However, no operational reinforcing effect materialised. Overall, we conclude that it is not possible to identify any meaningful MFA impact on medium- and long-term external sustainability through this channel.

Other structural reforms improving the long-term growth and/or export potential
A stronger long-term economic development potential and more specifically also export potential would be of key importance for limiting the future long-term risks to balance of payment and debt sustainability. However, in the case of the MFA operation in Moldova we have not identified any significant transmission from the operation to structural reforms that could boost long-term export and GDP growth paths.

6.5.2 Conclusion

The discussion above leads to the conclusion the MFA has had a positive but small role in affecting the medium- and long-term external sustainability prospects. These effects mainly stem from positive impact on economic growth during 2006-2008 that consequently affected debt to GDP indicators. Another channel that is also assessed to be potentially relevant, but not very likely to occur is related to a potential increase in non-concessional borrowing in absence of the MFA. We did not identify other aspects of external sustainability on which MFA had meaningful impact.

7 Design and Implementation

7.1 Introduction

Table 8.1 below shows the fifth generic evaluation question. This question focuses on the impact of the design and implementation of the MFA operation on its performance.

Table 7.1 Evaluation question on design and implementation effectiveness and efficiency

	How has the way in which the MFA operation was designed and implemented conditioned its effectiveness and efficiency?
1	In what way has the design and implementation of the MFA conditioned the performance of the MFA operation in respect to its cost and its objectives? (Q5.1)

7.2 Design issues

We have identified nine design issues:

i. The cost consequences of coping with fast changing circumstances;
ii. Forecasting risks in designing the time horizon of the operation;
iii. The overall appropriateness of the grant delivery mechanism;
iv. Slow reaction time to emergency crises and overlapping with other Commission instruments;
v. Availability of studies as a precondition to draft a conditionality;
vi. Availability of a homogenous domestic reform programme framework;
vii. Lack of a common matrix of conditions between donors;
viii. Short and medium term structural reforms;
ix. Formulation of conditionality.

i. The cost consequences of coping with fast changing circumstances

The design of the Moldova MFA operation was characterised by rapidly changing macroeconomic circumstances and a very fast development of events in the trade crisis with Russia. This went through at least three increasingly dramatic consecutive steps: 1) a first energy price increase during winter 2005; 2) the ban on wine exports during spring 2006; and 3) a second energy crisis before the summertime. This caused notable uncertainties as to the optimal size and duration of the operation. The final decision was to increase the total amount of financial support provided and dilute disbursements over time to anticipate higher adjustment needs for 2007 and 2008. As a result of this, the original preparatory work carried out between late 2005 and early 2006 was made partly irrelevant and triggered some minimal duplication of MFA preparation costs.

ii. Forecasting risks in designing the time horizon of the operation

With the benefit of hindsight, it can be said that the macroeconomic shock proved more limited than originally anticipated due to a number of favourable countervailing circumstances and that the unprecedented total amount of the MFA support provided was in excess of the real balance of payments requirements. Also the need to have support extended over a biennial operation structured along three tranches appears less compelling than it could have been expected at that time. So the MFA assumptions were based on forecasts probably erring on the side of caution. But this can hardly be considered a flaw in design, as this reflected the best projections available at that time.

Some stakeholders have questioned the appropriateness of the practice of releasing tranches on a biannual basis, more or less mirroring the disbursement patterns of the IMF and maintain that annual tranches (similar to what the WB routinely does in similar circumstances) could achieve the same purposes in a simpler and probably quicker way.

iii. The overall appropriateness of the grant delivery mechanism

The choice of the grant instrument appears appropriate and totally justified in the light of circumstances. The grant nature of the MFA represented a decisive incentive for the Moldovan Government to enter the agreement. The MFA appeared as one of the few donor sources available for genuine general budgetary support. A € 45 mn grant was sizeable enough to make the difference and raise substantial Government attention. Moreover, differently from other forms of support, it was considered by beneficiaries as very cost-effective in administrative and monitoring terms.

iv. Slow reaction time to emergency crises and overlapping with other Commission instruments

By far the most important weakness of the MFA operation in Moldova appears to be the relatively slow reaction time in terms of disbursement. It took the Commission as high as sixteen months to have the first MFA funds disbursed from the moment of the official request and more than twenty months from the moment when informal preparatory works started. So in practical terms the distinction between the MFA and ENPI became a bit blurred in the eyes of the beneficiaries, as both appeared as medium term budgetary support instruments. In similar occasions this confusion could even become more apparent if ENPI were ever to move towards the provision of general budget support, as MFA and ENPI were distinguished in Moldova mainly by the nature of the budgetary support provided: general in one case and sectoral in the other one.

It is a paradox of European policymaking that the instrument to provide short to medium term financing in balance of payment crisis situations actually requires a much more cumbersome and lengthy approval procedure than the instrument to provide medium-to-long term financing for structural reform purposes. The table below summarises and compares the timelines of the MFA and ENPI approval procedures.

Table 7.2 Timelines of the MFA and ENPI approval procedures

MFA in Moldova	ENPI Ordinary Procedure
Answer to official request 1 month	Preparatory work 4 months
Preparation of proposal 4 months	Finalisation of proposal 1 month
Council approval, Parliament review and Operational Assessment 7 months	Member States Consultation and Parliament Right of Scrutiny 3 months
Adoption of Decision 3 months	Adoption of Decision 1 month
Finalisation of MoU 1 month	Finalisation of MoU 1-3 months
TOTAL 16 months	**TOTAL 10-12 months**

As can be seen the ordinary ENPI preparation process is quicker than the MFA and closer to the average WB program approval timeline. Even if one discounts the fact that ENPI is a routine procedure based on predefined time schedules, while the MFA is more unpredictable in terms of timing, it can be concluded that at any rate ENPI could theoretically allow for disbursement of general budgetary support in some 18 months, which is comparable to MFA reaction time under an emergency situation.

The ENPI has a number procedural advantages over the MFA: 1) a permanent management committee operating on qualified majority rather than unanimity, 2) a mechanism of *ad hoc* working groups in Parliament that can be quickly mobilised, 3) no need to have the policy matrix of conditionalities approved or discussed, as this remains a separate Commission document for internal management purposes only.

v. Availability of studies as a precondition to draft a conditionality

The MFA is a relatively cheap operation with very limited investment in preparatory work. The selection of conditionalities was therefore strongly influenced by the availability of parallel preparatory studies. In particular, the findings of PEFA first and the operational assessment then was used to better fine tune conditionalities in the public procurement and PIFC areas, while the reform of social benefits could extensively draw on the preparatory work carried out under the Food Security Programme and the parallel research jointly carried out by the IMF and the WB.

vi. Availability of a homogenous domestic reform programme framework

MFA design in Moldova and related selection of conditionalities could not make reference to any previously agreed Government's own reform agenda, as this would be tentatively developed later in the process under the form of a National Development Plan. So recourse had to be made to bilateral instruments such as the EU-Moldova Action Plan or other external sources. Although this is not the ideal situation, in this particular case, this did not negatively impact local ownership of proposed reforms.

vii. Lack of a common matrix of conditions between donors

A factor of success of the MFA operation in Moldova was the synergic action reached with other EU and IFI programmes in achieving structural reforms. Conditionalities remained focused on a few clearly identified areas which avoided dispersion of resources. This was possible also because of reasonable consensus in the donor community and among IFIs on priority areas. However this fell short of achieving a truly common policy matrix as a reference for co-ordinated action, and conditionalities were often phrased in a slightly different language and with different timeframes which proved to be a cause of confusion for local counterparts.

viii. Short and medium term structural reforms
It is confirmed that the MFA poorly fits with conditionalities related to medium term legislative reforms requiring extensive political debate, a long approval period or sufficient "absorption" time to translate into concrete achievements (say from two to three years). By their own nature such conditionalities endanger the disbursement of funds, irrespective of the existence of a genuine Government's commitment to their implementation. At the end of the MFA operations these conditions either did not lead to the expected results or had to be waived before the disbursement of the third tranche.

ix Formulation of conditionality
MFA conditionalities in Moldova were 'process conditionalities' that did not explicitly consider in their wording the concrete objective that was aimed at or how to measure its achievement. This reflects the limitations of the information system available that would have hindered verification of any outcome or impact-type conditionality for a long time.

7.3 Implementation issues

We have identified four implementation issues:

i. Predictability for budgetary programming purposes;
ii. Signalling effect;
iii. Monitoring and information exchange provisions;
iv. Co-existence with sector budgetary support.

i. Predictability for budgetary programming purposes

One of the major problems of MFA implementation from the point of view of Moldovan authorities remains its limited predictability and reliability for budgetary programming purposes. The management of the Moldovan Treasury was planned based on the wrong expectation that the IMF and the MFA programmes would run exactly in parallel, also as far as the timing of conditions compliance check was concerned. When the two processes actually went slightly misaligned in their timing Moldovan authorities realised that MFA tranches could not be used to comply with IMF benchmarks as originally planned and this reportedly led to temporary cuts in Government expenditure and other treasury problems. The point is particularly sensitive when disbursement takes place near the end of the year as the money has already been committed and non disbursement would leave a larger fiscal gap.

ii. Signalling effect
There is broad support to the fact that one of the most notable consequences of having an IMF programme in place supported by the MFA is its highly intangible signalling effect to investors on the credibility of the government market-oriented reforms and the stability of the macroeconomic framework. Some interviewees extended this endorsement effect even to economic and fiscal reforms that took place after the programmes had been agreed (the tax amnesty, the 0% corporate reinvestment tax, etc.). It is certainly true that

Moldova experienced a notable growth in FDI in the period concerned (+96% from 251 US$ to US$ 493 between 2006 and 2007 and another + 44% between 2007 and 2008 when it reached a record US$ 713 mn). This is in line with similar parallel trends in the former Soviet Union region and in Russia in particular (where growth was +85% and 27% respectively). In the same period Moldova also created an agency with specific responsibilities for FDI attraction and enacted fiscal policies accordingly. So any specific net impact of the IMF MFA is hard to disentangle in quantitative terms.

iii. Monitoring and information exchange provisions

One of the factors that contributed to the success of the MFA operation in Moldova has been the systematic and high level monitoring of progress in conditionalities. This depended on the existence of an **ad hoc** office attached to the Prime minister's office entrusted with donor co-ordination and all Ministries involved in the implementation of conditionalities were monitored through quarterly meetings of a steering committees created for that purpose. The practice was inherited by similar mechanisms put in place for the management of the FSP. This allowed the MFA conditionalities to remain high in the political agenda and raised overall political awareness.

iv. Co-existence with sector budgetary support

The issue of how to improve co-existence with ENPI sectoral budgetary support came out fairly frequently during the interviews. From the beneficiary's point of view this just entails minor additional administrative costs (two steering committees, two reporting mechanisms in place, etc.). From the viewpoint of the EU, there might appear the necessity to better distinguish between the purposes and related implementation features of the two instruments. At present the only distinction that is apparent to counterparts is that the MFA is perceived as a relatively "light" tool providing general budgetary support, while the ENPI SBS is seen as tougher in its assessment of fulfilment of structural reform benchmarks (substantial resources are allocated to external monitoring and evaluation and mechanisms are in place to cut disbursements based on measurement of progress achieved) and therefore more costly to manage. This perception of overlapping is further reinforced in the Moldovan case by the choice of having the MFA and ENPI conditionalities as broadly coincident, which certainly helped to achieve synergies but also contributed to create a certain confusion.

8 Conclusions and recommendations

8.1 Introduction

This chapter provides conclusions on the net impact operation on macroeconomic stabilisation, structural reforms and external sustainability. Based on the conclusions in section 8.2, recommendations are suggested in section 8.3.

Table 8.1 Evaluation question on the design and implementation effectiveness and efficiency

	Net impact of MFA
	Net impact
1	What has been the contribution of actions resulting from the respect of structural conditionality criteria to the occurrence of expected structural effects? (Q.2.5)
2	What has been the contribution of the grants and/or loans provided by the MFA operation to the achievement of MFA objectives? (Q1.3)
3	What, if any, has been the contribution of actions arising as a result of the structural conditionality criteria to the achievement of the short and medium-term macroeconomic objectives of the assistance (i.e. the indirect effects of structural conditionality criteria)? (Q3.1)
4	What is the MFA contribution to medium and long-term external sustainability prospects? (Q.4.4)

8.2 Conclusions

In line with the three main objectives of the MFA operation, our conclusions distinguish between the impact on structural reform, macro-economic stability and external sustainability.

8.2.1 Conclusions on impact on structural reforms

Relevance
The selection of conditionalities was based on thorough diagnostic studies and addressed issues that were of concern to both the European Commission and the Moldovan Government.

Political reinforcing effect
A large degree of cross-conditionality with conditionalities attached to World Bank and other European Union support existed. The high extent of cross-conditionality with other EU and donor support in all three MFA conditionality domains (social assistance, public

internal financial control, and public procurement) makes it difficult to disentangle the net impact of the MFA in sponsoring the reforms. Especially, the overlap between the MFA conditionalities and the EC ENPI budget support instrument has reduced the distinct contribution of the MFA.

Nevertheless, there is clear evidence that MFA had a political reinforcing effect in all domains. A high level of political awareness existed of all MFA conditionalities. The strong monitoring system in place by the Moldovan government and the pressure put on the various Ministries responsible for the fulfilment of conditionalities.

Operational reinforcing effect
We also conclude that the MFA had an operational reinforcing effect by contributing to faster decision making in reforming the social assistance legislation by the Moldovan authorities. The combination of MFA and IMF pressure played a notable role in settling the Parliament deadlock of the social assistance reform.

However, it cannot be concluded for the time being that the reform in social assistance spurred by MFA will positively impact poverty. A number of indicators suggest some caution: the absorption capacity is projected to be half the money budgeted for, the total number of beneficiaries has slightly decreased since the system has become fully operational (July 2009), and the fiscal costs of the reform are uncertain as the future of the old scheme is yet to be decided upon politically.

With regard to public procurement, we have also found convincing indications for the presence of an operational reinforcing effect of the MFA operation. We conclude that in the absence of the MFA, the capacity of the procurement agency would not have been strengthened by as many staff resources and by the same speed as we have actually observed. However, we have no evidence that the increased capacity of the procurement agency has so far affected the quality of the public procurement operations in Moldova.

Finally, with regard to the implementation of PIFC, the MFA could have had a clear operational reinforcing effect as DG ECFIN would have insisted, as the only donor, on submission of the draft law to Parliament before the end of 2008. In practice, such specific operational reinforcing effect did not occur as the conditionality was waived by DG ECFIN. Therefore, the role of the MFA in furthering reforms in the domain of PIFC is more blurred in terms of specific visibility. However, we note that the waiver that was provided was granted on justified grounds that the draft law was not sufficiently mature to be presented to Parliament.

8.2.2 Conclusions on macroeconomic impact

Relevance
In financial terms, the macro financial assistance provided to Moldova in 2007 and 2008 was justified given the real balance of payments problems that the country experienced in 2006 and 2007. Although the external economic situation turned out to better than foreseen during 2007-2008 as the Russian ban on wine imports did not materialize as was

expected in 2006, Moldovan balance of payment experienced a setback due to the consequences of the drought for Moldova's agricultural production.

Gross impact

Although the objectives on macroeconomic development have been achieved during the term of implementation of the MFA operation, the results have appeared not to be sustainable. During the period 2007 – 2008, the rreserves accumulated more than foreseen as a consequence of increased remittances and foreign direct investments and reached well beyond the target of three months of imports set in the PRGF programme. However, since the end of 2008, economic and public finance indicators have altered negatively and deteriorated further during 2009 as a result of the economic crises and lax fiscal policy of the Moldovan government in the election year.

Net macroeconomic impact

In our estimation of the net macroeconomic impact of MFA, we assume that the IMF would have implemented the PRGF program without modification even if MFA had not existed (referred to earlier as Scenario I). This is considered likely since the IMF Board's requirement for the PRGF - coverage of the first year of the financing gap - was satisfied through Paris Club Debt rescheduling. The counterfactual scenario is that "if MFA had not been provided, the government of Moldova would have cut its capital investment expenditures". By estimating the difference between the actual and this counterfactual scenario through the quantitative modelling approach, the MFA is found to have boosted cumulative economic growth in Moldova by around 0.6% during 2006-2008.

The indirect macroeconomic impact of MFA is based on the assumption that government agreements with the IMF and the EC supported a climate of confidence triggering FDI ('signaling effect'). The presence of such an indirect financial impact of the MFA is based on a second counterfactual scenario: "in case the MFA would not have been granted, the IMF PRGF scheme would have been delayed". On this case, the Moldovan government would have attempted to solve its financing needs via other partners (Russia and/or China). The plausibility of this scenario is low given that the MFA was not strictly required to fill the financing gap that was identified by the IMF as the ENPI budget support was not included in the calculation of the financing gap.

8.2.3 Conclusions on impact on external sustainability

MFA has had a positive but small role in affecting the medium- and long-term external sustainability prospects. These effects mainly stem from positive impact on economic growth during 2006-2008 that consequently affected debt to GDP indicators. Another channel that is also assessed to be potentially relevant, but not very likely to occur is related to a potential increase in non-concessional borrowing in absence of the MFA. We did not identify other aspects of external sustainability on which MFA had meaningful impact.

8.3 Recommendations

In our recommendations, we link the above conclusions on the relevance and impact of the MFA to our observations on the design of the MFA in chapter 7.

Strengthening the operational reinforcing impact of the MFA
In order to strengthen the operational reinforcing impact of the MFA on structural reforms, it is necessary to address the overlap between the MFA and the ENPI budget support (in cases that ENPI budget support is provided to the beneficiary country).

We suggest to alter the design of the MFA in such a way that the MFA is more clearly distinguished as a separate EC-instrument that cannot be confused with the budget support instrument that exists under ENPI. Given the strategic importance of such a repositioning of the MFA instrument, we do not provide a specific recommendation. Instead, we provide broad options for a more distinct profile for the MFA instrument that the Commission could take into consideration:

1. Diversify the MFA by shorting its timeline:
   The MFA could concentrate on a few conditionalities to be achieved very quickly (also in the form of prior actions) and limit its disbursements to a maximum of two tranches. ENPI is supposed to take care of follow-ups and to be concerned with the details of medium to long term reform implementation;

2. Diversify the MFA by focusing on the conditionalities in the external sector:
   The MFA conditions could be more strictly related to the external sector and/or balance of payment objectives (for example competiveness of industries and trade related issues) while ENPI remains responsible for broad structural reform and PFM reform of public finance management practices;

3. Diversify the MFA by refraining from conditionalities at all:
   The MFA could be simplified by refraining from structural conditionalities at all and simply contribute to balance of payment problems of a beneficiary country by topping up the disbursements of the IMF. This would however remove from the MFA any component of policy dialogue between the EU and the beneficiary country.

4. Diversify by focusing on political impact rather than structural reforms:
   The MFA could include only a few conditionalities with a political relevance rather than to get involved in technical reform issues. Such political conditionalities would strengthen the visibility of the EU as a political factor in the beneficiary country.

Ensuring continuity in the enhancement of the macro-economic stability
Alterations in the political willingness of the beneficiary country to maintain sustainable macro-economic policies beyond the term of implementation of the MFA can not be controlled. However, in the case of Moldova, closer monitoring of the political response to the changing economic circumstances would have revealed a shift in the commitment of the country to sound macro economic policies. It is recommended to better monitor the economic policies of the beneficiary country and employ the option not to disburse any

tranches as an instrument to maintain the beneficiary country's commitment to sound macro economic policies.

Increasing the impact on external sustainability
As the MFA is supposed to address extraordinary balance of payment difficulties, there is a need to make the MFA preparation process much quicker and possibly leading to disbursement of funds within a 9-month period. This is likely to require:

- an anticipation of the moment the official request is received to before the IMF programme is agreed. The request could be made conditional to the approval of the IMF;
- MFA preparation should already include the operational assessment that should therefore become part of the operation feasibility studies. Ideally the MFA should go before the Council already ready for approval without the need to define conditionalities during the process. This could require more extensive recourse to prior actions;
- the Council approval and Parliament consultation should take place, to the extent possible, within the framework of predefined timeframes.

Annex I Consulted documents

EC documents

- EC Council Decision Providing Community macro-financial assistance to Moldova. 2006/0184 (CNS), 2006;
- Memorandum of Understanding between the European Community and the Republic of Moldova, ECFIN/D/3/2007/REP/53792, 2007;
- Proposal for a Council Decision Providing Community macro-financial assistance to Moldova, SEC(2006) 1258, 2006;
- Ex ante evaluation statement. Commission Staff Working Document. Annex to the Proposal for a Council Decision Providing Community macro-financial assistance to Moldova Macro-financial Assistance to Moldova. SEC(2006) 1258, 2006;
- European Neighbourhood and Partnership Instrument. Republic of Moldova National Indicative Programme 2007-2010;
- Implementation of the European Neighbourhood Policy in 2008: Progress Report Republic of Moldova, SEC (2009) 514/2.

IMF documents

- Republic of Moldova: Article IV Consultation 2006. IMF Country Report No. 06/184, May 2006;
- Republic of Moldova: Article IV Consultation 2007. IMF Country Report No. 08/139, April 2008;
- Republic of Moldova: IMF Country Report No. 08/320. IMF, September 2008.

World Bank documents

- Moldova: Results and the World Bank 2006. World Bank;
- Country partnership strategy for the Republic of Moldova. World Bank Report No. 28556-MD, November 2004;
- Country partnership strategy for the Republic of Moldova for the period FY2009-FY2012. World Bank Report No. 46822-MD, December 2008;
- Republic of Moldova: Improving Public Expenditure Efficiency for Growth and Poverty Reduction. World Bank Report No. 37933-MD, February 2008.

Moldovan documents

- National Bank of Moldova: Annual Report 2008, June 2009.

Other documents

- Operational Assessment commissioned by DG Economic and Financial Affairs, Final report 18 April 2007;
- Republic of Moldova Public Expenditure and Financial Accountability Assessment Public Financial Management Performance Report. April 2006.

Annex II List of Interviewees

Table AII.1 Persons interviewed

Organisation	Name	Role/Involvement in the MFA operation
European Commission		
EC, DG AIDCO	Jose Leandro	Head of Unit “Quality Operations” for macroeconomic support
EC, DG RELEX	Hilde Hardeman	Head of Unit Russia and Northern Dimension Policy
EC, DG ECFIN	Andreas Papadopoulos	Previous task manager Moldova, Deputy Head of Un Head of Unit Russia and Northern Dimension Policy it Economic Affairs of Mediterranean countries, Russia and the NIS, Economic Aspects of Neighbourhood Policy
EC, DG ECFIN	Ronald Albers	Current task manager Moldova Economies of the Mediterranean countries, Russia and the new independent states and EFTA countries
EC, DG TRADE	Ms Mia Hurrta	Bilateral trade relations with Russia and Moldova; responsible for ATP-file
EC, DG AIDCO	Mr Pierre Lejeune	International Aid / Cooperation Officer, Geographical coordination and supervision for Europe
EC Delegation Moldova	Martin Kaspar	Head of Operations Section
	Oleg Hirbu	Economist
	Speranta Olaru	Desk manager
Moldovan institutions		
MoF	Nina Lupan	Deputy Minister of Finance
	Vasile Bulicanu	Head of Budget Planning
	Liuba Ivancicova	Deputy director of Budget Synthesis Department
	Alexandru Gincu	Deputy Head European Affairs
	Emilia Prujanschaia	Head of Macroeconomic Analysis Division
	Di Borta	Director General Service of Financial Control
	Ion Sirbu	Head of the Central Harmonisation Unit of Internal Audit and Control
National Bank of Moldova	Leonid Talmaci	Governor of National Bank of Moldova in 2006/7 (signed the MoU)
	Marin Molosag	Deputy Governor
	Aurelia Busuioc	External Relations Department
Office of the first Deputy PM	Dumitru Udrea	Adviser to the first Deputy Prime Minister (mrs

Organisation	Name	Role/Involvement in the MFA operation
		Grecianii)
Ministry of Social Protection	Galina Balmos	Minister in 2007
	Iurie Bucinschi	Deputy Minister in 2007
	Lilia Curajos	Focal Point, Head of External Department
Agency for Material Resources and Public Procurement	Ion Turcan	Head of Agency
	Teodor Potriniche	Deputy Head of Agency, Head of Public Procurement department
State Audit Institution	Gheorghe Cojocani	Court of Account of the Republic of Moldova (CCRM)
Other donors / Technical assistance		
?	DFID/OPM	TA Social benefits project
?	Sofreco	TA Social benefits project
International Financial Institutions		
World Bank	Lawrence Bouton	Senior Economist, Poverty reduction and economic Management Unit (PER Moldova in 2005)
	Svetlana Proskurevska	PFM Project Director
	Elena Niculina	Senior Economist HQ
	Iaroslav Baclajanski	Senior Economist (local)
	Erwin H.R. Tiongson	Senior economist HQ
IMF	Tom Richardson	IMF head of mission (from 2006 – mid 2008)
	Nicholas Giogasvili	Country officer (until April 2009)
	Graham Justice	IMF head of mission (since mid 2008)
	Johan Mathisen	Resident Representative

Annex III Results of Delphi Questionnaire

A total of 10 questionnaires were filled in and returned, of which six from Moldovan Government counterparts and four from international financial institutions. Not all respondents felt equally confident to answer all sections so in a number of areas the total number of responses is lower than ten. Quantitative patterns are however significant to highlight areas of consensus and areas of disagreement but for counterfactual purposes where only qualitative information could be elicited.

Relevance of the MFA operation

There is overwhelming consensus on the overall relevance and appropriateness of the MFA operation to stabilize the macroeconomic framework in the 2007-2008 periods. No major differences can be seen between different categories of respondents.

Table AIII.1 Relevance of the MFA intervention in 2007 and 2008 to stabilise the macroeconomic framework

Very Relevant	Fairly Relevant	Not Really Relevant	Largely Irrelevant	Don't know
4	4			2

Much in the same vein, there is widespread consensus on the specific importance of the role played by the MFA also in terms of size and nature of financial contribution in the framework of the broad range of budgetary support instruments (IMF, Paris Club agreement, ENPI budgetary support) deployed at the same time.

Table AIII.2 The specific role played by MFA in the stabilisation process

Very Important	Important	Of some use	Marginal	Don't know
2	7			1

There is overwhelming consensus on the MFA having represented mainly a budgetary support instrument for Moldova, although in the specific circumstances of the Country at that time possible effects on the balance of payments cannot be neglected. The facilitation effect on the reform of social assistance is slightly more easily recognized than effects in other areas that are less visible and of some importance only to sector specialists.

Table AIII.3 The MFA specific importance in terms of expected structural effects

	Very Important	Important	Of some use	Marginal	Don't know
BoP support	4	5			1
Budgetary support	6	1			3
Facilitation of structural reforms **of which**:					
Social Assistance	*3*	*4*	*1*		*2*
Public Procurement	*2*	*2*	*1*		*5*
PIFC	*2*	*1*	*1*		*6*

In comparative terms the reform of social assistance clearly appears a more important issue then reform in other areas and, possibly, public procurement appears to respondents as slightly more important than PIFC. There is broad consensus on the main rationale behind the need for reform. Interestingly, some Moldovan respondents highlight that cost considerations were from their point of view also important aspects in the reform of social assistance (an item hardly considered in the official policy debate on the reform) and emphasise problems with timing in the discontinuation of the old nominal system.

Table AIII.4 Relative importance of the proposed reforms and rationale behind

4A	A priority that came at the wrong time	A minor issue, hardly relevant issue	Fairly helpful although maybe not decisive	Very important issue and top priority
Social Assistance Benefit Reform				
Reason why	*Not a problem at all*	*Hardly a problem*	*Somewhat of a problem*	*A major problem*
Total cost for the State budget	*1*	*1*	*4*	*1*
Leakages to wrong beneficiaries	*2*		*1*	*4*
The poor were insufficiently targeted				*7*
The system was too complicate to manage	*1*	*2*	*3*	

4B	A priority that came at the wrong time	A minor issue, hardly relevant issue	Fairly helpful although maybe not decisive	Very important issue and top priority
Public Procurement Reform				
Reason why	*Not a problem at all*	*Hardly a problem*	*Somewhat of a problem*	*A major problem*
Limited value for money in procurement		1	5	
Too many single supplier procedures			4	2
Insufficient monitoring of procurement institutions			3	2
Understaffing at the procurement agency			2	3

4C	A priority that came at the wrong time	A minor issue, hardly relevant issue	Fairly helpful although maybe not decisive	Very important issue and top priority
Public Internal Financial Control				
Reason why	*Not a problem at all*	*Hardly a problem*	*Somewhat of a problem*	*A major problem*
Overall effectiveness and reliability of budgetary management		1	2	
Too weak controls in personnel expenditure		2	2	
Too weak controls in non-personnel expenditure			4	
Excessive reliance on ex post controls only			2	2

There have been relatively few suggestions on possible alternative items that could have been considered as relevant areas for conditionalities at that time. Some respondents mentioned the underdeveloped area of revenue administration reform as just as important and unduly neglected from the donor community and IFI. Along these lines others mentioned insufficiently developed areas such as debt management or budgeting.

Impact of the MFA operation and sustainability of the results achieved

There is a good degree of overall perceived confidence in the progresses achieved in the social assistance reform area with some diverging views on final cost issues. There is broad consensus on some progress achieved in the PIFC area, while as far as public procurement is concerned opinions are more polarised and progress so far is perceived as more notable on procedural aspects than final outcome.

Table AIII.5 Progress achieved in the different policy areas covered by MFA

	Worsened	The same	A bit better	Much better
Social Assistance Benefit Reform				
Total cost for the State budget	2		3	2
Leakages to wrong beneficiaries		4		
The poor will be better targeted			3	4
The system is simpler to manage		2	4	1
Public Procurement Reform				
Better value for money in procurement	1	1	2	
Too many single supplier procedures	1	3		1
Better monitoring of procurement institutions		1	1	2
Staffing at the procurement agency		2		2
Public Internal Financial Control				
Overall effectiveness and reliability of budgetary management			4	
Controls in personnel expenditure			3	1
Controls in non-personnel expenditure			3	1
Excessive reliance on ex post controls only			4	

The same patterns of response can be broadly seen also in the degree of confidence about the sustainability of the reform. Some more limited scepticism, especially from some Moldovan counterparts on the long term viability of the social assistance reform which is generally considered as highly sustainable and slightly more diverging views on the possible ultimate effect of public procurement reform. PIFC is much more neutral also because of the very limited number of respondents who claimed to be sufficiently informed to give an answer.

Table AIII.6 Sustainability of the results achieved

	Not Confident	Hardly Confident	Fairly Confident	Very Confident
Social Assistance Benefit Reform				
Total cost for the State budget			4	2
Leakages to wrong beneficiaries		1	1	4
The poor will be better targeted			1	5
The system will be simpler to manage	1	1	4	
Public Procurement Reform				
Limited value for money in procurement		2	2	
Too many single supplier procedures			3	1
Better monitoring of procurement institutions			3	1
Staffing at the procurement agency		1	2	1
Public Internal Financial Control				
Overall effectiveness and reliability of budgetary management			2	1
Controls on personnel expenditure			2	1

	Not Confident	Hardly Confident	Fairly Confident	Very Confident
Controls on non-personnel expenditure			2	1
Excessive reliance on ex post controls only			2	1

Counterfactual and Net Impact

There is a prevailing view that if the MFA had not existed the most likely counterfactual would have been represented by the need for increased fiscal adjustment in terms of cuts in investments for infrastructure and possibly less resources available for social assistance and job creation. In the longer run local counterparts anticipate more extensive recourse to underused WB resources and assume that the MFA conditionalities would have been incorporated one way or another in the programs of the two IFIs.

Table AIII.7 What would have happened in your opinion if the MFA had not existed?

	Very unlikely	Unlikely	Likely	Very Likely	Don't know
More need for monetary adjustment	2		3	1	4
More need for fiscal adjustment	1		3	3	3
Inflationary Pressures	1	1	2	1	5
Deterioration of the debt position		4	1	1	4
More requests for assistance due to humanitarian crisis		1	4		1
Increased IFI support		1	3	1	6
Increased donor support from other sources		4			6
Increased EU support from other instruments		2			8

The net impact of the MFA is therefore perceived mainly in raising the political profile and speeding up the reform process in social assistance and in raising political awareness about the need to increase the resources available for the public procurement agency. Perception on PIFC issues are much more blurred also because of the very limited number of respondents who declare themselves as sufficiently informed.

Table AIII.8 The European added value of the MFA

	Very unlikely	Unlikely	Likely	Very Likely	Don't know
Social Assistance Benefit Reform					
Raised the issue in the political agenda as a European priority			2	5	3
Speeded up the reform process to meet the MFA deadlines			4		6
Shaped the contents of reform towards alignment with European best practices				3	7

	Very unlikely	Unlikely	Likely	Very Likely	Don't know
Public Procurement Reform					
Raised the issue in the political agenda as a European priority			3		7
Speeded up the reform process to meet the MFA deadlines			1	1	8
Shaped the contents of reform towards alignment with European best practices				2	8
Public Internal Financial Control					
Raised the issue in the political agenda as a European priority			1		9
Speeded up the reform process to meet the MFA deadlines		1			9
Shaped the contents of reform towards alignment with European best practices				1	9

Annex IV Modelling approach to the counterfactual

The aim of the quantitative modelling approach is to construct a realistic and internally consistent counterfactual scenario for short-term macroeconomic outcomes in the absence of the MFA intervention, compare this counterfactual to an actual outcome (or – as in the case of Moldova – baseline forecast) and therefore to establish an estimate of the net effect of the MFA intervention.

The description contained in this annex concentrates on the model used in the evaluation of the MFA operation in Moldova. However, given it's more detailed character than was typical in reports evaluating previous MFA evaluations conducted by the same consortium it can also be considered as an indicative guide to modelling exercises carried in previous evaluations. This is because the current model is broadly similar to the models employed in previous evaluations (evaluation of MFA in Romania, the Former Yugoslav Republic of Macedonia, Tajikistan, Albania). However, some new features and adaptations have been introduced to better adapt the model to the specific features of the Moldovan economy and features of the MFA operation in Moldova (see below).

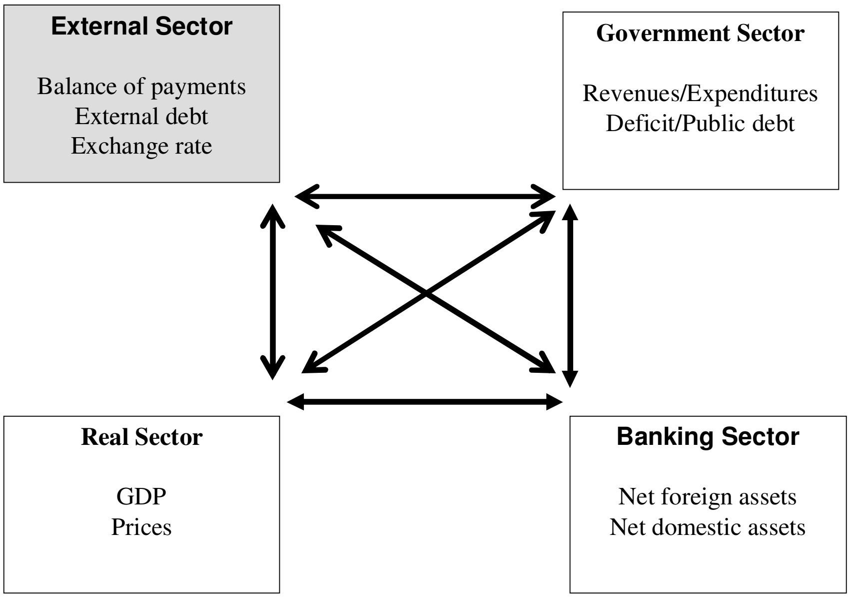
The description focuses on the model developed for Moldova and does not discuss some country-specific solutions that were adopted in previous evaluations in order to capture the key characteristics of specific MFA operations, various channels of their interactions with economies and specific features of analysed economies.

General description

The model takes the key assumptions on counterfactual scenarios as an input. It then uses these assumptions to construct a consistent counterfactual path for other macroeconomic variables of interest. This allows to compare actual with counterfactual outcomes of selected variables (such as GDP growth, price, exchange rate developments, etc.) and provide a quantitative estimate of the net effect of an MFA operation.

An important requirement for the model to yield meaningful counterfactual is its macroeconomic consistency, i.e. ensuring that budget constraint is observed for all participants in the economy. The model is built from four basic blocks, corresponding to basic economic sectors: real, external, government and monetary/banking. The corresponding key macroeconomic identities just tell us that valued added in domestic production equals total expenditure (national account identity), that any government expenditure in excess of government revenues equals public sector borrowing and money creation (fiscal identity), that excess of foreign exchange expenditure over earnings equals foreign borrowing and changes in reserves (BoP identity) and that the increase in the money supply corresponds to the increase in domestic credit and foreign reserves (monetary identity) (Easterly, 1989)[35]. Figure XXX illustrates the 4 sectors graphically.

Figure AIV.1 The basic structure of the model that recognizes links and ensures consistency among four basic economic sectors: real, external, government and banking



Given that the MFA is an instrument that addresses the financing gap in the balance of payment (BoP), counterfactual scenarios are constructed staring from relevant changes in BoP entries related to MFA tranches and then possibly also other international financial flows (e.g. IMF disbursements, World Bank programmes, other multilateral and bilateral assistance). The external sector is at the centre of the quantitative analysis.

The model relies on annual data for Moldova from the IMF's International Financial Statistics (historical data) and background database for the IMF country reports (forecast for 2009-2010). In some instances additional checks have been made using data from the National Bank of Moldova.

Such a simple modelling approach corresponds to macroeconomic consistency frameworks used by international financial institutions (especially the IMF). An important advantage is related to modest data needs and no computational problems. The quantitative results can be immediately compared with conclusions of qualitative analysis.

New features in the Moldovan model

In the case of Moldova one important new element has been introduced in the modelling exercise, namely foreign direct investment inflows. This is motivated by the choice of one

35 William Easterly (1989), A consistency framework for macroeconomic analysis, WPS 234, World Bank.

of the counterfactual scenarios where in the absence of the MFA the reduction of the FDI inflows is one of the key elements.

Incorporating FDI in the model is quite difficult as there is no widely accepted consensus on the FDI effects on such key variables as overall investment, productivity and economic growth.

An important practical question concerns the link between FDI and total investment in Moldova. In principle, one could think of either a crowding-out effect, where FDI tend to displace some investment of domestic companies that would otherwise take place or a crowding-in effect where FDI motivates domestic companies to increased investment, e.g. due to perceptions of increased demand for their services and products.

The link between FDI and economic growth is also subject to several theoretical and empirical controversies and it is difficult to present any consensus view. A brief survey of approaches and controversies can be found e.g. in Hunya, Holzner and Wörz (2007)[36].

In the neoclassical growth model, FDI has a one-off level effect on output, just as additional domestic investment. No permanent impact on growth rate can be derived, but the impact can still be quite persistent if a transition to the new steady state takes a long time. In endogenous growth models, the potential role of FDI is more significant. Here, in addition to the direct, capital-augmenting effect, FDI may also exert indirect permanent effects on the growth rate. Here, FDI is assumed to be more productive than domestic investment. FDI inflows can permanently increase the growth rate when spill over effects and technology and know-how transfers offset the effects of diminishing returns to capital.

While FDI effects in the two classes of models differ in important ways, both strands of theory suggest a positive link between FDI inflows and economic growth in a host country. However, the empirical evidence on this is mixed. On the pessimistic side, Herzer, Klasen and Nowak-Lehmann (2006) find that in the vast majority of countries FDI has no statistically significant long-run impact on growth[37]. In some countries they do find evidence of FDI contributing positively to growth but in other countries there is evidence of growth-limiting effects of FDI in the short or long term. Other studies point to more positive results (a survey can be found e.g. in Hansen and Rand, 2006)[38]. One feature of the results that is stressed by different authors is the large heterogeneity of experiences among countries. In particular, the concept of "absorptive capacity" of FDI recipient countries (or industries) appears useful in describing the diverging patterns of growth effects of FDI (Bijsterbosch and Kolasa, (2009), Borensztein, De Gregorio and Lee (1998)[39]). Among factors important in determining the absorptive capacity human

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36 Hunya, Gábor, Mario Holzner and Julia Wörz (2007), "How to Assess the Impact of FDI on an Economy", mimeo, Stability Pact for Soith Eastern Europe.

37 Dierk Herzer & Stephan Klasen & Felicitas Nowak-Lehmann D. (2006), 'In search of FDI-led growth in developing countries', Ibero America Institute for Econ. Research (IAI) Discussion Papers 150, Ibero-America Institute for Economic Research.

38 Hansen, H., Rand, J. (2006), 'On the causal links between FDI and growth in developing countries', *The World Economy* 29 (1), pp. 21–41.

39 Martin Bijsterbosch & Marcin Kolasa, 2009. "FDI and productivity convergence in central and eastern Europe - an industry-level investigation," Working Paper Series 992, European Central Bank. Borensztein, E. & De Gregorio, J. & Lee, J-W.,

capital, private and public infrastructure, legal environment, etc. may be playing an important role.

In view of such controversies we decided to incorporate FDI in a quite a simplified manner. FDI is assumed to increase the level of domestic investment by a value determined by the "crowding-in" coefficient. Its default value is set at 1.5, i.e. a unit increase in FDI boost domestic investment in the same year by 1.5. Such a choice is consistent with results of an empirical investigation by Borensztein, De Gregorio and Lee (1998) who find the "crowding-in" effect of FDI in their sample of FDI inflows to developing countries. Their results suggest that a unit increase in FDI inflow to a country can be associated with a 1.5 to 2.3 increase in total investment in this country. Taking the value close to the lower end of these estimates appears plausible in the case of Moldova. Such a value should account for the fact that the model is not able to capture potential longer term positive consequences of FDI (e.g. as relates to transfer of technological and managerial know-how) that could materialise with a lag of several years.

Structure of the model

The model is linear and primarily works on differences between the analysed scenarios. Most equations used in the model describe the difference between counterfactual and actual values of variables. The difference in the values of a variable of interest X is explained by a function F of differenced explanatory variables (e.g. Y, Z):

DIF (X) = F [DIF (Y), DIF (Z)]

where DIF (…) denotes the difference between counterfactual and actual values of a variable, F [] is a function (identity or behavioural equation as discussed below). The advantage of such specification is the strong focus on variability related to the MFA intervention and the straightforward interpretation of obtained results in terms of net impact of the intervention. Also, it allows for overcoming problems related to breaks in the historical macroeconomic series making the comparison of levels of variables infeasible. Finally, it allows for carrying a meaningful analysis in a situation when forecasts rather than actual data need to be considered as the basis for the actual scenario. This last feature is important as the MFA operation in Moldova was completed in 2008 and at the time of writing this report (2009), historical data (at annual frequencies) were available only until 2008.

Identities and behavioural equations

Two major types of equations are used in the model: identities and behavioural relations.

Identities are equations that must hold by definition to ensure accounting consistency (e.g. balancing balance of payment, financing budget deficit, equating assets and liabilities of the banking sector). The only necessary assumption in simulating the counterfactual in case of identities is the determination of size of adjustment of each of the variables entering the identity in response to a given shock. Often this choice is conditional on policy response or external factors and assumptions in this respect are

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1998. "How does foreign direct investment affect economic growth? 1," Journal of International Economics, Elsevier, vol. 45(1), pp. 115-13.

based on information gathered during interviews with policy makers and analysts in Chisinau, Washington and Brussels.

In case of behavioural relations (e.g. exchange rate, inflation and import equations), their functional forms are designed to best reflects the economic impact that should take place according to the economic theory, ideally confirmed by available statistical evidence and taking into account limitations in data availability and quality. The modelling assumption involves the choice of the variables that are best in explaining dynamics of an independent variable and in quantification of the size (elasticity) of the impact. The elasticity can be calibrated or assumed depending on available evidence from Moldova and other similar economies.

BoP equations

The first essential equation necessary for establishing the counterfactual is the identity describing the balance of payment.

DIF (MFA grant + other CA items) + DIF (MFA loan + other KA items) = DIF (international reserves)

where DIF is the difference between counterfactual and actual value as defined above, CA is current account and KA is capital and financial account. The absence of the disbursement of the MFA grant is reflected as a drop in current account.

In the first of the analysed counterfactual scenarios the adjustment is assumed to take place through other current account items, primarily imports as well as through a change in reserves. Specifically, in the baseline specification for the first of the analysed scenarios, imports contract by 40% of the decline in public (and private) investment expenditure (see below the description of the model's fiscal block), while the remainder part of the adjustment takes place via a fall in international reserves.

DIF (imports) = III * DIFF (domestic public & private investment)

DIF (reserve accumulation) = DIF (MFA grant) – DIF (imports)

where III constant (import intensity of investment) is set at 0.4 while other values are analysed as part of the sensitivity analysis.

In the second counterfactual scenario, lack of MFA grant leads to a decline in a 10% in FDI inflows. The adjustment to this combined negative shock is assumed to take place via identical channels as in the first scenario, via a contraction of imports and a change in reserves.

Specifically, in the baseline specification imports contract by a constant share of the decline in public and private investment expenditure (see below the description of the model's fiscal block and the real sector block), while the remainder part of the adjustment takes place via a fall in international reserves.

DIF (imports) = III * DIFF (domestic public & private investment)

DIF (reserve accumulation) = DIF (MFA grant) – DIF (imports)

with III constant set at 0.4 and other values of import intensity of investment demand being analysed as part of the sensitivity analysis.

Fiscal accounts
The second core identity used in the formulation of the counterfactual describes budgetary accounts. The stylised version of this equation is given by

DIF (government expenditures) – DIF (MFA grant & other government revenues) = DIF (Deficit Financing)

From the perspective of the budgetary identity the counterfactual scenario without the MFA grant assistance implies lower government revenues (due to lack of the MFA grant). In order to balance its books, the government needs to adjust its expenditures program and/or revenue collections and/or identify alternative sources of deficit financing. The counterfactual is determined by availability of alternative sources of financing and policy decisions about fiscal tightening.

In the case of Moldova, following the discussion with IFIs and Moldovan government officials we analyse two possible counterfactual scenarios with very different fiscal adjustment paths. In the first scenario, the government reacts to lower revenues by cutting its expenditure so that the deficit is kept unchanged. Specifically, the expenditure cuts are concentrated on capital investment items:

DIF (government capital expenditure) = DIF (MFA grant)

In the second scenario, lack of MFA assistance implies also lack of IMF's PRGF support. Budget expenditures are not affected and new deficit financing source is identified that fully covers borrowing needs in the new environment. The other source of lending is assumed to be on non-concessionary terms which matters for government expenditure on debt servicing in subsequent years and more generally on MFA impact on external sustainability[40].

DIF (Deficit Financing) = DIF (public expenditure on debt service) - DIF (MFA grant)

Monetary sector
The third core identity describes the accounts of the banking sector. This stylised presentation illustrates key linkages with balance of payment situation that determines through series of auxiliary identities the net foreign assets (NFA), and budgetary accounts that determine the size of credit to the government (NDC government), with adjustment in other items of net domestic assets (NDA) determining the change in money supply.

[40] Loans under the PRGF carry an annual interest rate of 0.5 percent, with repayments made semi-annually, beginning 5½ years and ending 10 years after the disbursement.

DIF (NFA) + DIF (NDC government) + DIF (NDA other) = DIF (Money Supply)

In contrast to some previous MFA evaluations, especially of the MFA operation in Albania, in the case of Moldova the model of the monetary sector does not play an important role in determining the counterfactual outcomes.

An important element is the link between official international reserves and money supply. It is determined by the assumption that the reserves are funded by outright purchases of foreign exchange against sales of domestic currency. Hence, shifts in international reserves affect monetary aggregates (and also inflation and the exchange rate). In the model, the changes in M3 aggregate are a fixed fraction of changes in international reserves:

DIF (M3) = M3R * DIF (international reserves)

with a baseline value of the M3R coefficient set at 0.4, and other values tested as part of the sensitivity analysis.

Real sector

An important element of the model in the second of the analysed scenarios is the link between FDI inflows and total private investment expenditure. As discussed above, we postulate a fixed a crowding-in coefficient CI:

DIF (private investment expenditure) = CI * DIF (FDI inflows)

with a baseline CI value set at 1.5 and other values analysed as part of the sensitivity analysis.

In the model, exchange rate is determined by the reverse of the simplified import demand equation that allows deriving nominal exchange rate response in the counterfactual that is consistent with development of imports (as predicted by the BoP equations). Specifically, a constant value of the exchange rate elasticity of imports is assumed:

%DIF (exchange rate) = EREI * %DIF (imports)

with a %DIF denoting a percentage change and a baseline value of the EREI coefficient set at 0.4, and other values tested as part of the sensitivity analysis.

The next important behavioural equation that predicts counterfactual inflation rates is based on the standard theory of inflation, where price increases are related to money stock and real incomes. Given the very low magnitude of changes in the real income dynamics this mechanism is excluded for simplicity. On the other hand, we add a possibility of the exchange rate pass-through. Specifically, we assume fixed inflation elasticity's of exchange rate and M3:

DIF (inflation rate) = IEER * DIF (exchange rate growth) + IEM * DIF (money growth rate) with the values of coefficients IEER and IEM set at 0.2 and 0.15, respectively and other values tried as part of the sensitivity analysis exercise[41].

GDP deflator in the counterfactual scenarios is assumed to be driven by identical forces that determine the CPI:

DIF (GDP deflator) = DIF (inflation rate)

The GDP identity calculates a change in nominal GDP resulting from diverging paths of public and private investment, consumption and net exports.

DIF (nominal GDP) = DIF (government expenditures) + DIF (private consumption expenditure) + DIF (private investment expenditure) + DIF (net exports)

Finally, counterfactual real GDP growth dynamics is derived from the nominal and price change figures:

GDP growth rate = nominal GDP growth / GDP deflator.

Sensitivity analysis

Tables in the main text of the report present range estimates or point estimates of potential impact of the MFA intervention that are related to the model specification and assumed parameter values. Given the intrinsic uncertainty related to the model and data, interpretation of results should be concentrated on signs and relative size of effects, rather than on particular numerical values. Nevertheless, the qualitative results are quite robust to modifications in the parameter values within the reasonable range, with resulting variation of estimated effects still fitting the qualitative description quite well.

[41] The values are similar to relevant long-run elasticity's obtained by Gigineishvili, Nick (2007), In Search of Monetary Transmission in Moldova, in: IMF Country Report no. 08/134.