

Country diagnostics are an EBRD tool to identify the main obstacles to entrepreneurship and private sector development and to help shape the Bank's strategic priorities and project selection in new country strategies. Each diagnostic informs the EBRD's policy engagement with the authorities in the country.

Each country diagnostic assesses the progress and challenges of the country of operations in developing a sustainable market economy. Private sector development and entrepreneurship are at the heart of the Bank's mandate in the regions of operation of the bank, but the private sector in all EBRD countries faces a range of problems and obstacles. The diagnostic highlights the key challenges facing private companies and shows where each country stands vis-à-vis its peers in terms of six qualities of transition – competitive, well-governed, resilient, integrated, green, and inclusive – and points out the main deficiencies and gaps in each quality.

The diagnostics draw on a range of methodologies and best practice for assessing how big different obstacles are. Extensive use is made of in-house expertise across the EBRD, along with surveys such as the Business Environment and Enterprise Performance Survey (BEEPS) and the Life in Transition Survey (LiTS), as well as other cross-country surveys and reports from institutions such as the World Bank, World Economic Forum and OECD. For some larger countries, the diagnostics also draw on specially commissioned studies of selected issues that are critical for private sector development in the country.

The diagnostics are led by the EBRD's Country Economics and Policy team, drawing substantially on the expertise of sector, governance and political experts in the Economics, Policy and Governance department (EPG) and consulting widely with relevant experts across the EBRD when preparing the final product. The diagnostics are shared with the EBRD Board during the country strategy process and published during the public consultation period.

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European Bank
for Reconstruction and Development

Moldova Diagnostic

*Assessing Progress and Challenges in
Unlocking the Private Sector's Potential and
Developing a Sustainable Market Economy¹*

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Executive summary

This paper presents results of a diagnostic exercise that analyses the main obstacles that constrain the capacity of the private sector to develop and to advance Moldova's transition towards a sustainable market economy conducive to vibrant growth. The analysis draws on and informs the recently adopted EBRD methodology for measuring transition, which is based on the following six desirable qualities of a sustainable market economy: *competitive, integrated, well-governed, resilient, green and inclusive*.

The analysis is set up in the context of a complex set of domestic and external challenges faced by Moldova. Over the past year, Moldova has achieved some degree of political and economic stabilization. After the appointment of the new government in January 2016, the ruling coalition has proved stable, while street protests have ceased. External and inflationary pressures have eased after the 2015 recession. The authorities passed sufficiently strong reform steps to secure a three-year IMF programme, which re-opened international budget support and helped to ease government funding pressures. Efforts were made to streamline regulations, reduce informality and improve tax and customs administration.

The main obstacles for private sector development are as follows:

- The scale of emigration and the accompanying decline in labour force availability hold back competitiveness and the development of high-potential private firms. The latest round of the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS) shows that about one in three firms regards lack of skills as a major or very severe constraint.
- Governance in public institutions is weak and acts as a serious constraint on private sector activities. The unreformed judiciary, complex legal processes, excessive bureaucracy, tax and customs administration-related constraints and the rule of law issues undermine private investors' trust in the economy. There are also governance and performance challenges in the loss-making state-owned enterprise (SOE) sector, which makes eventual privatisation of these companies more difficult and reduces availability of public resources for improving private sector framework conditions.
- Banking and energy sector vulnerabilities undermine the private sector's resilience to shocks. Concerns about opaque ownership, related party lending, weak corporate governance and portfolio quality in the three largest banks pose risks to financial stability and restrict access to finance for businesses, especially for SMEs. Reliability and affordability of energy supply remain an important concern for businesses.
- High energy intensity, and low resource efficiency are key green challenges faced by Moldova. The private sector can potentially play an important role in diversifying the energy system by a more efficient use of renewable energy sources, by implementing energy efficiency measures, and by significantly improving the productivity of materials and water utilization.
- Addressing logistical constraints to international trade and transit would allow the private sector to access more easily large external markets. Rehabilitation of key infrastructure, including energy infrastructure of cross-border significance, and international, national and local roads and railways, would enhance economic ties with the EU and other regional trade partners and create incentives for private investors.

This diagnostic document consists of the following sections: 1) political economy and governance, 2) private sector performance and prospects, and 3) key obstacles to private sector development. Annex 1 contains a quality-by-quality description of main transition gaps, and Annex 2 has a short overview of recent macroeconomic developments and outlook.

1. POLITICAL ECONOMY AND GOVERNANCE

Moldova's reform agenda is driven by the country's commitment to European integration as an official strategic goal. However, the reform progress has been complicated by several political economy factors, including significant vulnerabilities related to good governance and the rule of law, the weak system of checks and balances, and frequent political instability.

The authorities have pursued, albeit unevenly, a reform agenda aimed at transforming Moldova into a European democratic state. In June 2014, Moldova and the EU concluded a landmark Association Agreement, including a Deep and Comprehensive Free Trade Agreement (DCFTA), which provides an important additional framework for political and economic reforms and commits Moldova to converge its legislation and regulations with those of the EU across a broad range of areas. After provisional application in September 2014, the Agreement fully entered into force as of 1 July 2016. Having met all the benchmarks, Moldova also became the first Eastern Partnership country to qualify for visa liberalisation with the EU in April 2014.

To ensure further progress with reforms and European integration, Moldova needs to address its long-standing vulnerabilities related to the functioning of independent institutions and the rule of law. Problems in these areas were highlighted by a major bank fraud in 2015, involving three large banks in the country. Corruption remains a serious problem. Transparency International ranks Moldova 123rd out of 176 countries on its 2017 Corruption Perceptions Index. The independence of the judiciary is limited. State institutions and law enforcement are often politicised, while business interests have significant influence over the country's political life and decision making. As a result, economic and governance reforms lag behind, and public trust in state institutions is low, weakening the state capacity to implement reforms.

The weak system of checks and balances between branches of power inhibits the efficient functioning of the state. Moldova is a parliamentary republic, with executive powers exercised by the government which is headed by the prime minister. Legislative power is vested in the 101-member National Assembly (parliament). The President, who is the head of state, has limited constitutional powers. The reintroduction of the direct vote to elect the President in 2016 could potentially bolster the system of checks and balances, but this has also created new tensions over executive powers and the country's geopolitical orientation. At present, the government and the President represent opposing political camps while the tradition of cohabitation is nascent.

Strengthening democratic political stability is another challenge and a key task, critical for sustaining the enabling reform environment. Moldova has experienced frequent bouts of political instability, arising from political competition as well as from the deep-seated divisions in the society along identity and geopolitical lines. Political stability has strengthened over the past year but remains fragile.

The Transdnistrian conflict has been 'frozen' since 1992. While a comprehensive, peaceful settlement remains to be reached, the unresolved conflict is an additional risk factor for Moldova's stability, particularly in the context of the changed geopolitical environment.

2. PRIVATE SECTOR: PERFORMANCE AND PROSPECTS

The private sector's contribution to GDP has grown dramatically during the transition. In common with other ex-Soviet republics, Moldova entered the transition in the early 1990s with a weak economy, dominated by state-owned companies. The private sector share of GDP in 1995 was estimated at 57 per cent, according to the National Bureau of Statistics of Moldova (NBS). By 2015, this share had risen to an estimated 78 per cent according to the same NBS methodology. Over the same period, the share of foreign-owned and joint ventures increased from less than 1 per cent to approximately a quarter of GDP, reflecting increased openness of the economy to cross-border investment.²

A relatively small number of large enterprises represent the backbone of the private sector. In 2015, the average private sector firm in Moldova employed approximately 11 workers. Private sector companies that employed more than 50 workers accounted for just 3 per cent of the total number of operating enterprises. Yet these companies generated slightly more than half of total employment and almost 60 per cent of total value added. On the other hand, non-agriculture micro and small companies that employed fewer than 10 workers account for approximately 83 per cent of the total but generated only approximately 13 per cent of total value added and approximately 22 per cent of employment. Almost half of micro and small enterprises were concentrated in the trade sector. Mid-sized companies employing between 10 and 49 workers outside of the agriculture sector amounted to approximately 14 per cent of total number of enterprises, accounting for approximately 25 per cent of employment and 29 per cent of value added.³

Although the private sector accounts for the lion's share of economic output, the significant presence of SOEs limits business opportunities for private firms in some sectors. The total value of SOE assets is estimated at approximately one third of GDP⁴ and 10 per cent of the corporate sector's assets.⁵ While the total number of SOEs registered in Moldova is estimated at approximately 1400, the top ten of these enterprises control three-quarters of all SOE assets. In areas such as gas import and distribution, electricity networks, telecommunications, railways, and other transport, including national airline and road infrastructure SOEs play a dominant role. According to the World Bank, the dominance of large SOEs and state-owned monopolies in the economy suggests that these companies are likely to receive preferential or favourable treatment (especially through exemptions, rebates, deferrals or rescheduling the payment of taxes), making it difficult for potential private sector competitors to operate in some sectors.⁶

A more dynamic private sector could accelerate Moldova's growth rates, which have trailed behind peers. Moldova's economic performance in the past two decades fell short of other small post-Soviet economies. The size of Moldova's economy increased approximately 1.8 times in real volume terms between 1995 and 2015. In comparison, the volume of real GDP of Armenia and Georgia more than tripled.

² The National Bureau of Statistics (NBS),

http://www.statistica.md/public/files/serii_de_timp/conturi_nationale/serii_anuale/Grafic_Str_PIB_forme_propr.xls

³ Data in this paragraph is based on 2015 Annual Structural Survey of the National Bureau of Statistics of Moldova. Enterprises operating in agriculture, financial intermediation, government administration, education, healthcare and arts were excluded from the survey.

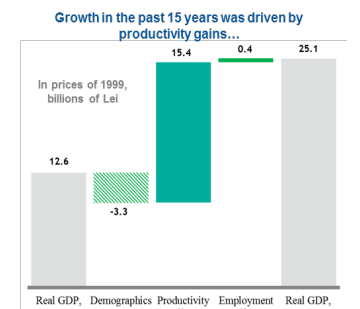
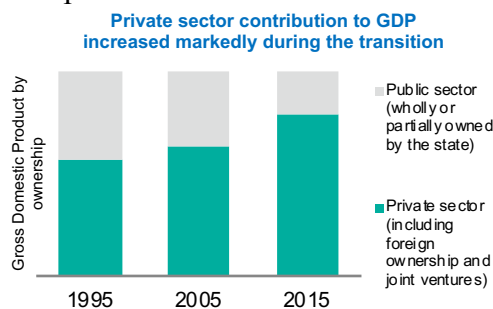
⁴ The ratio of SOE assets to GDP is calculated by the World Bank on the basis of MOF reports and GDP data for 2015.

⁵ World Bank, Support to State Owned Enterprises (SOE), Preliminary Diagnostics and Reform Assessment, Working Draft, September 2016

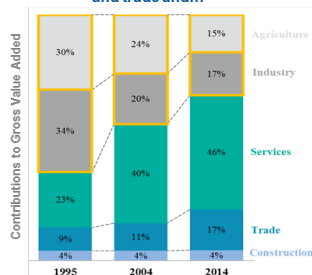
⁶ Ibid

Moldova's transition from a centrally planned economy has involved a shift in resources from collective agriculture and state-managed industry to a more services-oriented economy, with the private sector in the driving seat. During the transition, the economy has increasingly been opened to international trade and cross-border competition. Inefficiencies which have accumulated in the agriculture and industrial sectors, as well as the destruction of industrial value chains and technological and infrastructural decay from years of underinvestment paved the way for a major structural transformation and growing private sector involvement. The contributions of both agriculture and industry to Gross Value Added (GVA) declined by around half over the past two decades. On the other hand, GVA by services (including public administration, financial intermediation, transport and communication, education, healthcare, hospitality related sectors and other services) doubled in this period and now accounts for almost half of the total value created in the economy. In other words, it is now more than agriculture and industry combined. The share of trade has increased significantly from below 10 per cent of total GVA in 1994 to almost one-fifth of the total.

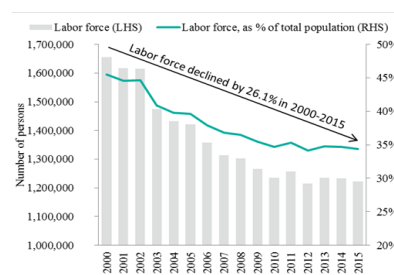
This structural transformation has boosted private sector productivity but also created major social challenges. Over the past two decades, factors of production in Moldova have been drifting from low value agricultural activities towards private industries with higher value added per worker. The market-driven reallocation of resources and modernization of non-agriculture sectors of the economy from a very low post-Soviet base boosted productivity of the private sector and GDP growth. Over the past ten years, the stock of fixed assets per employee increased by 45 per cent in real volume terms. However, migration has become a dominant workers' response to the transition challenge because of an insufficient supply of well-paying non-agricultural jobs in Moldova and generally better income-earning conditions abroad compared to those in even the relatively productive domestic industries. As in many other transition countries, the productivity gains brought by transforming the economy from being mainly state-run to a more market-oriented, private sector-driven model have tapered off in recent years.⁷ Growth in recent years has instead been primarily consumption-driven.



... due to transformation from agriculture and industry towards more prominent role of services and trade and...



... due to migration driven population decline which shrank labor force (hence more output per worker).



Source: National statistical authorities, Eurostat and EBRD calculations
 Notes: Demographics imply changes in population and share of economically active population in total population.
 Employment effect includes changes in workforce participation and employment rates.
 Productivity effect is growth in labor productivity, measured by real GDP per employee.

⁷ See the EBRD Transition Report 2013 (*Stuck in Transition?*) for an analysis of this phenomenon.

3. KEY OBSTACLES TO PRIVATE SECTOR DEVELOPMENT

3.1 Migration from Moldova reduces the country's human capital and hinders private sector development.

Emigration from Moldova is among the largest in the world, according to the World Bank's 2015 Golden Aging report. In 2012, the International Organization for Migration (IOM) concluded that an estimated one-quarter to one-third of the working-age population was involved in a migration experience.⁸ According to the IOM, the main "push factor" for Moldovan migrants was economic: poverty, lack of adequate employment opportunities and low salaries. Higher living standards abroad in conjunction with relatively easy access of many Moldovan workers to the EU labour market through Romanian citizenship served as a "pull factor".

The outward migration of much of the economically active population has had a negative impact on private sector growth potential. With a majority of overall migrants leaving the country between the ages of 15 and 39, emigration causes a significant loss of human capital.⁹ As a result of migration trends and, to a lesser extent, population aging, Moldova's labour force declined by 26.1 per cent between 2000 and 2015 according to the official statistics, which could underestimate the true scale of the labour force contraction. In essence, a large portion of the labour force which could have contributed to value creation in Moldova's economy left the country in pursuance of better income earning opportunities. As a result, private companies often face difficulties in finding qualified staff. According to the latest round of the EBRD-World Bank BEEPS, 31.2 per cent of businesses reported that an inadequately educated workforce was a major or very severe problem for their operations, highlighting the extent to which emigration has caused problems for growing businesses. In particular, firms in labour intensive industries (e.g. manufacturing of automotive parts, processing industries) cite this problem as an impediment to business development and greenfield investment.

These migration-related constraints on private sector development and investment contribute to a vicious cycle that exacerbates the country's economic weaknesses. On the one hand, lack of adequate employment opportunities and poor living conditions fuel outward migration of the labour force, especially from the agriculture sector. On the other hand, the shortage of an adequately skilled workforce prevents private companies from creating jobs. To interrupt this negative feedback loop and reap the potential economic benefits of reverse migration, Moldova needs to address the "push factors" of outward migration. This can only be accomplished through bold simultaneous reforms to change the rules of the game in the financial and real sectors and to overhaul Moldova's image, thus boosting the confidence of investors, consumers, lenders and depositors.

Emigration is a predominately rural phenomenon which affects both young men and women in Moldova. The results of the 2012 Moldova Labour Force Migration Survey show that 32 per cent of migrant workers were women and 68 per cent were men. There is a prevalence of rural compared to urban emigration, with almost 70 per cent of the migrants coming from rural households. The main destination countries include Russia for men, and Russia and Italy for women.¹⁰ While those who leave the country are able to take advantage

⁸ International Organization for Migration, 2012, Extended Migration Profile of the Republic of Moldova.

⁹ Migration Policy Institute, 2015, Children Left Behind: The Impact of Labor Migration in Moldova and Ukraine.

¹⁰ International Labour Organization, 2013, Labour Force Migration Survey of Moldova and Ukraine Brochure.

of increased economic opportunities, migration poses significant development challenges affecting those who stay behind, and limits potential for private sector growth. Moldova is also an origin and transit country for human trafficking, with the majority of victims being women and children.

3.2 Agricultural productivity is constrained by fragmentation and lack of investment.

Private businesses dominate agriculture, but the sector is fragmented and inefficient along the entire value chain. The land privatisation process that took place in the 1990s resulted in over one million new landowners. Average land holding is very small (2.5 hectares).¹¹ Small landholders get poor access to higher value markets and have limited capacity in coping with market and weather risks. Such excessive fragmentation of agricultural land negatively affects productivity, and the quality and financial viability of agricultural production. Lifting the restrictions on foreign ownership on agricultural land¹² could be one of the potential avenues to increase private foreign investment in the sector and boost private sector productivity. Extension services and irrigation system are outdated and characterized by structural inefficiencies.

As a result, agriculture is the least productive sector in the economy but employs the largest portion of the workforce (even though the number of workers in this sector declined by more than half in 2000-2015). The agriculture sector accounted for 12.2 per cent of GDP in 2016. The dependence of Moldova's economy on agriculture means that annual GDP growth is disproportionately affected by the agricultural harvest in any given year. About 90 per cent of agricultural production is rain-fed. Bumper harvests are often followed by droughts. The negative output growth in agriculture in 2009, 2012 and 2015 dragged the economy each time into recession. Almost 30 per cent of female employment is in the agriculture sector, with shocks in the sector having significant implications for women's economic opportunities.

Subsidization of agriculture by the state is significant but ineffective in stimulating private investment. In 2015, the World Bank estimated that the government support for agriculture amounted to 2 per cent of GDP, made up of tax relief (0.6 per cent of GDP) and direct spending (totalling 1.4 per cent of GDP, equally divided between subsidies, services and donor programmes). This is higher than in many countries in Europe and Central Asia, including EU member states such as Bulgaria and Romania.¹³ According to the World Bank, the level of support is close to the limit of what the current fiscal envelope can support. Agriculture is one of the least taxed sectors of the economy, but this low taxation regime is ineffective in addressing the challenges for scaling up productivity-enhancing investment in the sector.

Increasing the competitiveness of agribusiness exports and reorienting production towards high value markets such as the EU are important challenges for the private sector. This will require the introduction of new varieties and significant improvements in food safety standards and traceability. Post-harvest facilities (such as handling of produce, storage, sorting and grading, packaging and labelling) are key in determining the quality of products and in ensuring access to external markets. In Moldova, these facilities are in poor

¹¹ About 86 per cent of producers have holdings of less than 2 hectares, 12 per cent have holdings between 2 and 5 hectares and only 2 per cent of farmers have holdings of more than 5 hectares.

¹² As per the current Land Code, agricultural land may not be sold to foreign individual, legal entities, or local legal entities with foreign capital.

¹³ World Bank, 2015, Moldova. Special Topic: Public Support to Agriculture.

condition. While standards are not yet fully harmonized with EU requirements, the recent reform of food safety institutions and the creation of the national authority for food safety (ANSA) are steps in the right direction. Presently, very few producers comply with the EU standards in terms of safety, quality, traceability, labelling and certification. Integration of suppliers with (international) retailers could be a way to stimulate improvement in the competitiveness of suppliers.

Agriculture activities have environmental and social implications. The biodiversity of the natural habitats has been altered and affected by intensive grazing, soil erosion, salinization, and intensive use of fertilizers. Soil degradation causes significant economic damage each year, including losses from erosion, landslides, and agricultural production losses. Subsistence farming households, which cannot afford to address the problem, are particularly affected by erosion and soil fertility losses.

3.3 Banking sector vulnerabilities imply limited access to finance for the private sector, especially SMEs.

Moldova's banking sector remains highly problematic and vulnerable and is a major constraint on private sector development. Moldova has a relatively small and underdeveloped banking sector (11 banks, €3.5 billion of assets as of YE 2016, circa 57 per cent of GDP), with the lowest credit penetration (27 per cent of GDP in 2016, down from 31 per cent of GDP in 2015) among regional peers. The banking sector was severely damaged by large-scale money laundering in 2014 and a major fraud (up to US\$ 1 billion, or 12 per cent of GDP) in 2015-2016, which undermined financial stability (three banks with a third of system assets were subsequently closed) and led to significant macroeconomic and political ramifications. Banking sector reform is now a top priority, supported by the EBRD, IMF and others, and, if successful, may enable the entry of new strategic foreign investors on the market.

Access to finance is a severe problem for the private sector. Credit activity has been on a decline partly due to broader macro and political uncertainty, weak business demand, and tightened lending policies in the large banks under NBM supervision. The banking sector loan portfolio declined by 9 per cent in 2016. The problem is particularly acute for small firms, which typically face interest rates of around 11 per cent for local currency loans, along with onerous collateral requirements. The banking sector remains underdeveloped from the perspective of product offering, reliance on collateral-based lending, and weak risk management practices. Enforcement of collateral is subject to lengthy and unpredictable court proceedings,¹⁴ which may feed into a higher cost of borrowing for private companies. Alternative sources of finance are scarce.

The weak balance sheet of the banking system poses risks for the rest of the private sector. While banks' reported capitalisation is adequate (according to the NBM, CAR of approximately 30 per cent as of December 2016 vs. 16 per cent regulatory minimum), it may be under pressure due to asset quality deterioration (according to the NBM, NPLs increased from approximately 10 per cent in 2015 to 16.4 per cent in 2016 with even higher levels in banks under the NBM's special supervision/administration), unrealised bad exposures, likely under-provisioning and related partly lending. The definition and aggregation criterion of related parties has been tightened, but the ability to unwind related party lending under the new framework is untested.

¹⁴ SME Policy Index, 2016.

Major problems with governance and shareholder transparency in the three largest banks are being addressed. Major improvements in governance and transparency are required to attract new strategic foreign investors into the banking sector. Presently, the three largest banks (accounting for ca. 65 per cent of sector assets), all of which have opaque ownership, remain under the National Bank of Moldova's (NBM) special supervision (MAIB and VB) and special administration (MICB). To clean up these banks, the NBM blocked shares of non-transparent shareholders at MAIB (43 per cent of shares) and MICB (ca. 60 per cent of shares) and is seeking to attract fit and proper investors. At VB, the Board of Directors became operational again in October 2016 (after close to two years). Intense discussions have been underway on the replacement of VB's non-transparent shareholder (38 per cent stake). The NBM continues to closely monitor these banks, including by carrying out on-site inspections. Plans for 2017 include full identification of ultimate beneficiaries, unwinding of related-party lending and full-scope on-site verifications for all banks in the country.

The NBM's independence and supervisory capacity has been enhanced. Renewal of the central bank management team and update of NBM legislation have increased the central bank's operational independence and credibility. The NBM is benefiting from external TC which should help with the implementation of reforms. Over time, these reforms should result in a more efficient banking system, better serving the needs of the private sector.

3.4 Energy sector problems and lack of diversification reduce the reliability of supply for private companies.

Energy sector vulnerabilities complicate investment planning for private companies. Considerations of reliability and affordability of energy supply factor importantly into investment decisions, especially for industrial firms that absorb large amounts of energy as production inputs. This is supported by the findings of BEEPS V, where electricity issues rank prominently on the constraints list of large companies. The share of firms reporting that an informal payment was expected for an electrical connection increased significantly since BEEPS IV, from 1.6 per cent to 23 per cent. In the World Bank's Doing Business 2017 report, Moldova ranks 73rd out of 190 countries in getting electricity.

Moldova depends on one foreign dominant supplier of gas and one dominant supplier of power located in Transdnistria. The Ukrainian interconnector and Kuchurgan thermal power plant, which supply approximately 70 per cent of Moldova's electricity, are located in Transdnistria. The power sector has been unbundled and tariffs are set by the national energy sector regulator (ANRE). The price of electricity for suppliers is set in US dollars while the end user tariff is set in local currency. The financial conditions of energy sector operators have deteriorated in recent years, mainly because the regulator did not allow the pass through of the exchange rate depreciation to customers, pushing the operators into accumulation of losses in 2012-2015. Financial challenges in the electricity sector give rise to reliability concerns and can entail shortages of requisite infrastructural investments.

Moldova's energy sector is characterised by heavy dependence on imports, and energy intensity levels are five times¹⁵ the EU average. Only a fraction of energy demand is met by domestic sources. The level of renewable energy sources in the energy mix is low. Hydro currently makes up only 0.8 per cent of the total primary energy supply (with an addition of 8.7 per cent from biofuels and waste). Barriers to investment in renewable energy and energy efficiency are significant. Many private companies lack technical and managerial capacity and have limited borrowing capacity. Modern and transparent corporate structures are

¹⁵ International Energy Agency

lacking, which deters lenders and investors. Due to the paucity of modern resource-efficient technologies deployed in the country so far, there is little awareness and understanding of such technologies in the market.

Diversification and energy security could reduce riskiness of investment in the country.

Almost all natural gas consumed in Moldova comes from Russia. Moldova has no gas storage capacity. Moldova's gas sector is dominated by a single company, Moldovagaz, owned by Gazprom (50 per cent plus one share), the state of Moldova (35.33 per cent), and administration of Transnistria (13.44 per cent; Transnistria's share transferred under the control of Gazprom). The transmission network operator is Moldovatrangaz, which is a daughter company of Moldovagaz. The Iași – Ungheni Interconnector between Romania and Moldova became operational in the first quarter of 2015, although the pipeline can only supply a small region around Ungheni which consumes 3-5 per cent of Moldova's annual gas consumption.¹⁶ Construction of the pipeline between Ungheni and Chisinau, supplemented with a new gas compression station in Romania, could provide much larger diversification benefits. At the end of 2016, the EBRD and EIB signed a loan agreement to provide financing for the infrastructure.

Moldova is already a member of the EU Energy Community and has subscribed to the Third Energy Package, which should increase potential for private sector investment in the sector. As part of the agreement with the EBRD, EIB, EU and the Energy Community Secretariat, Moldova is expected to implement a comprehensive Energy Sector Reform Action Plan (ENERSAP). The ENERSAP envisages a plan to foster market liberalization, enhance energy security and promote Moldovan energy market convergence towards the EU. These reforms should encourage further involvement of private companies in the sector.

Moldova needs significant external technical and financial support, including grant financing, in order to be able to achieve a green economy transition. Due to the low borrowing capacity of the public sector, concessional financing, PPP and other structures need to be used to develop the country's energy infrastructure with increased involvement of private players and minimal requirement for public sector co-financing.

¹⁶ Romanian Energy Regulatory Authority, Energy Community and International Energy Agency.

ANNEX 1 – QUALITIES OF A SUSTAINABLE MARKET ECONOMY

Moldova ranks 28th out of 36 countries of operations in the EBRD’s Average Transition Quality (ATQ) scores. This index is based on a simple average of scores for the six transition qualities: competitive, well-governed, resilient, integrated, green, and inclusive. The country’s ranking is dragged down by low scores in governance, competitiveness and green economy in particular (Chart 1).

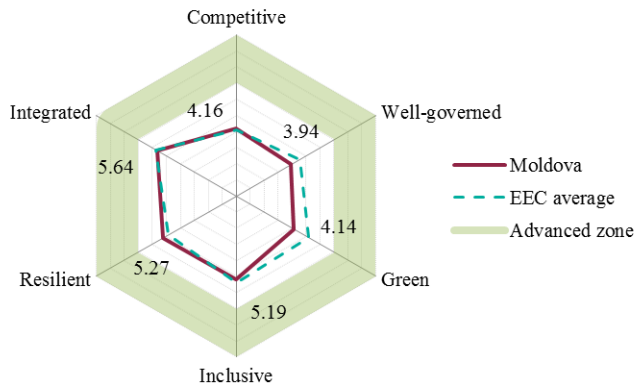


Chart 1: Moldova – Average transition Qualities

Source: EBRD calculations

Note: The level of development within each of the qualities is measured from 1 to 10, with 1 meaning little or no progress and 10 representing the frontier.

The following pages provide brief snapshots of each quality.

COMPETITIVE [ATQ = 4.16]

Moldova's small domestic economy is constrained by its monopolistic set-up and political economy hurdles. This also translates into limited global competitiveness, despite the country's trade openness, relatively low labour costs and proximity to wealthy export markets.

Market structures and institutions:

- Moldova's domestic market is small and **private sector competitiveness** is limited by monopolistic market structures. Corporate activity is often dominated by relatively few business groups, and liberalization efforts are constrained by traditional linkages between business and politics. The Competition Council lacks institutional, operational and financial independence.
- The difficult **business environment** deters entry of new firms and expansion of existing companies. Despite some progress, key hurdles remain, for example in the dimensions of enforcing contracts or obtaining basic production inputs (electricity, permits).
- At around 27 per cent of GDP, **credit penetration** is shallow compared to the regional peers. Structural challenges in the banking sector and lack of alternative sources of financing impede **access to finance for SMEs**. Moldova's SME sector is affected by burdensome regulations and lacks skills, business acumen and know-how to benefit more fully from the DCFTA with the EU.
- **Privatisation** is affected by lack of international interest, political and economic volatility and small size of the domestic market.

Economic complexity index: ranked 59th (-0.12) out of 124 countries (Harvard CID, 2014).

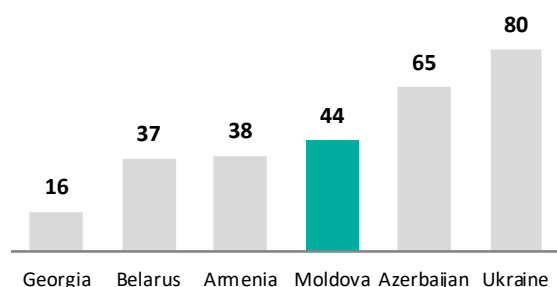
Strength of the knowledge economy: ranked 46th out of 128 countries, and 31st on knowledge outputs (Global Innovation Index)

Capacity to create value-added:

- The **export structure** has evolved but remains dominated by relatively low-complexity agricultural products. The structural transformation of the economy has tapered off in recent years, leaving the share of **agriculture** – the least productive sector – sizable and much larger than in more advanced European economies.
- Moldova's labour regulations require significant improvement. Migration-driven **brain drain** deprives the country of skilled workers and the unreformed system of education generates **skills mismatches**.

Ease of Doing Business 2017

Rank (out of 190)



Source: World Bank, Doing Business 2017.

Selected key indicators from ATQ

Source: EBRD calculations.

WELL-GOVERNED [ATQ = 3.94]

Public governance and rule of law challenges are significant. Poorly formulated legislation often leads to arbitrary interpretations and inspections. The unreformed court system (especially district courts) means that some businesses seek solutions outside of the formal court system. Lengthy non-transparent judicial processes, underpaid civil servants and judges undermine the ability to fight corruption, and they diminish investors’ trust as they are less able to seek timely and impartial legal redress through the domestic legal system. In some instances, legal base may be less of a problem compared to the enforcement of the law.

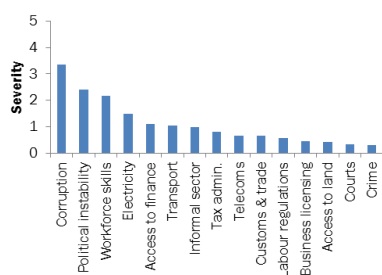
- **Corruption** is identified as the main obstacle by the private sector. In BEEPS V, almost 40 per cent of firms deem it a major or very severe obstacle. Informal payments in Moldova were reported to be more frequent than elsewhere in the Eastern Europe and the Caucasus.
- Unreformed judiciary, lengthy and non-transparent legal processes and the **rule of law** challenges undermine governance.
- Despite efforts made recently to streamline the **regulatory framework**, the number of permits, authorizations and inspections is perceived to be significant, with some of them overlapping.
- Changes in **tax and customs legislation** – sometimes with immediate or retroactive application – hinder business planning and investment.
- Generally low tax rates in Moldova can incentivize investment, although the brunt of the problem lies with complex penalties-based tax administration. **VAT refunds** have been reported as a problem affecting firms’ working capital.
- The **corporate governance** legislation and practices suffer from a number of weaknesses. According to the 2016 EBRD’s assessment, Moldova is assessed as weak or very weak in structure and functioning of boards (low effectiveness and lack of independence), in internal control (low quality of framework, shortcomings in the audit committee functioning and independence) and in corporate governance structure and institutional environment. In line with good international practice the environmental, health and safety and labour requirements are yet to be embedded at corporate and operational levels. Women’s participation in corporate decision making remains extremely low at 3 per cent¹⁷.
- There are governance and performance challenges in the **SOE sector**. It is loss-making, mainly due to losses in several large enterprises, particularly in the energy sector.

123rd out of 176 countries on Transparency International’s Corruption Perceptions Index.

Less than fifth of Moldovan respondents have trust in country’s institutions (LiTS)

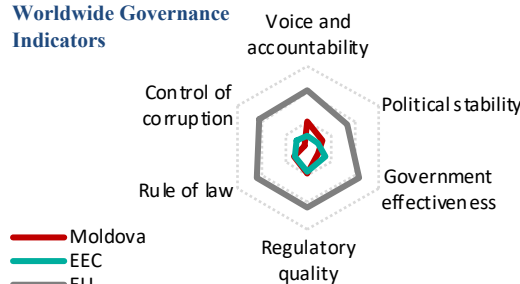
110th out of 180 countries in Index of Economic Freedom 2017 (The Heritage Foundation), with low scores in the rule of law indicators.

Business environment obstacles in Moldova (BEEPSV)



Source: EBRD, BEEPS V

Worldwide Governance Indicators



Source: World Bank, Worldwide Governance Indicators

¹⁷ European Bank for Reconstruction and Development, 2016, Corporate Governance Sector Assessment.

RESILIENT [ATQ = 5.27]

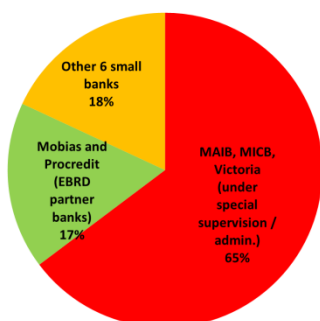
Economic resilience is weak due to banking and energy sectors vulnerabilities and the narrow economic base concentrated in agriculture. Moldova’s growth in the recent years has been volatile, driven by one-off factors such as droughts. GDP per capita in 2015 stood at US\$ 1,800, the lowest in Europe (5,000 current international dollars in PPP terms). Moldova is exposed significantly – through remittances, trade, financial and energy sector linkages – to countries in recession or in a slow recovery phase: Russia, Ukraine and Belarus. The leu depreciated against the US\$ by 16 per cent in 2014, by 21 per cent in 2015 and by 2 per cent in 2016 due to lower export proceeds, remittances and external loan disbursements. This volatility over-stretches dollarized corporate and financial sector balance sheets and complicates longer-term business planning.

- A new **3-year arrangement with the IMF**, signed in November 2016, will ease fiscal pressures and serve as an anchor for reforms. Front-loaded measures (prior actions) were undertaken to strengthen banking surveillance and supervision capacity and to tighten related-party lending and anti-money laundering rules, although the ability to enforce them effectively remains uncertain.
- The **banking sector** is beset by opaque ownership and governance issues. Large scale fraud and liquidation of three banks (approximately one third of the sector assets) in 2015 dealt a significant blow to Moldova’s international image. Although some steps have been taken to address the problems, vulnerabilities (non-transparent ownership, related party lending, weak corporate governance and portfolio quality concerns) in Moldova’s three largest banks remain.
- The **banks’** record of investing into high-yielding government securities in 2016 and excessive dependence on collateral-based lending limit funding to the real sector and create interlocking exposure between the weak sovereign and the banks.
- **Foreign presence** in the banking sector is low with four foreign-owned banks representing approximately 26 per cent of sector assets.
- Moldova’s **energy sector** is dependent on one foreign dominant supplier of gas and one dominant supplier of power located in Transdnistria.

Banking sector assets declined by close to a third in nominal terms after closure of three banks affected by the fraud in 2015.

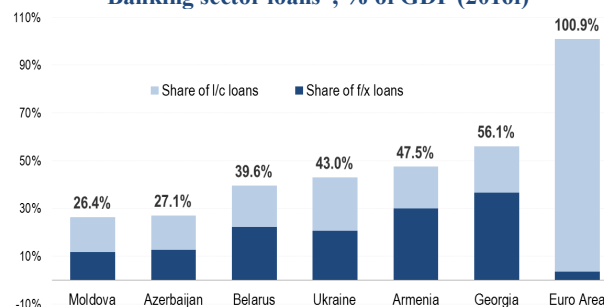
Oil and gas accounted for 29% of total import of goods in 2016.

Structure of the banking sector assets (2016)



Source: National Bank of Moldova and EBRD calculations.

Banking sector loans*, % of GDP (2016f)



* As of December 2016 except for Belarus (November), Ukraine (November) and Euro Area (September).

Source: National statistical authorities and central banks, ECB and EBRD calculations.

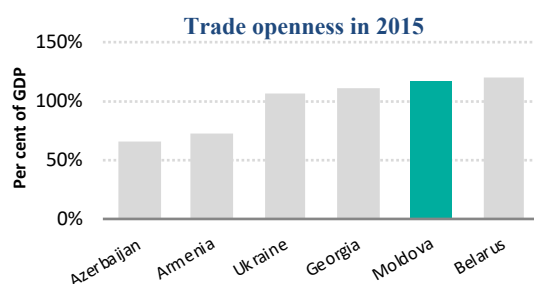
INTEGRATED [ATQ = 5.64]

International trade and transit is constrained despite a broad network of free trade arrangements. Moldova's economy is favourably positioned between two large external markets – the European Union (EU) and the Commonwealth of Independent States (CIS). Moldova has been a full-fledged member of the World Trade Organisation (WTO) since 2001. Moldova has active free trade agreements in place with more than 40 countries, including EU-28 member states through the Deep and Comprehensive Free Trade Area (DCFTA) and members of the CIS. Moldova has preferential trade regimes with Norway, Canada, Switzerland, Japan and the USA. At the same time, the low quality of roads and port infrastructure creates bottlenecks for cross-border trade.

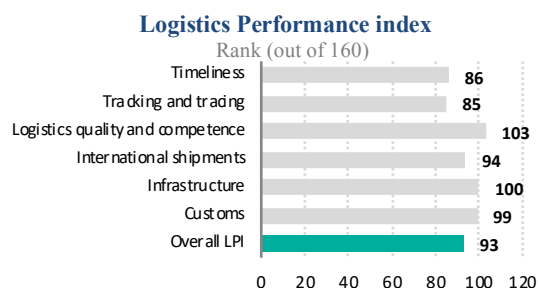
- Moldova's measure of **trade openness** (exports + imports) is approximately 117% per cent of GDP, higher than in Armenia, Azerbaijan, Georgia and Ukraine but lower than in Belarus.
- In the World Bank Logistics Performance Index 2016, Moldova's score is below the world average and the average score of the EBRD countries of operation. In WEF's GCI 2016-2017, Moldova ranks nearly at the bottom in terms of **quality of roads** (132nd out of 138 countries) and **port infrastructure** (127th out of 137 countries). The condition of Moldova's **state railway** (network and rolling stock) is generally poor.
- Implementation slippages and the lack of prioritization affect development of **critical national roads** linking Moldova to international markets, for instance linking Chisinau to the Port of Giurgiulești – Moldova's only port accessible to seagoing vessels in the South of Moldova. Improvements to road traffic safety are needed to reduce numbers of fatalities and accidents.
- Implicit import and export monopolies, customs administration-related constraints and the unreformed National Food Safety Agency represent obstacles to Moldova's **international trade**.
- **Foreign direct investment** levels are the lowest in the EEC region. The FDI stock per capita was just US\$ 870 in 2015, compared to EEC average of US\$ 1,827 and to the regional frontrunner Georgia with US\$ 3,131.
- **Free Economic Zones (FEZ)** simplify customs procedures, especially for a just-in-time production mode where delays in crossing borders need to be ruled out. The largest FEZ companies (e.g. Italian Triveneta, German Draxlmaier, Austrian Gebauer & Griller) in Moldova import most of their inputs and export outputs as part of their cross-border value added chain management. According to the World Bank, investments in FEZ represented 80 per cent of total FDI stock in Moldova in 2009-2014.

93rd out of 160 countries on World Bank Logistics Performance Index 2016.

118th out of 138 countries in Transport Infrastructure category of the Global Competitiveness Report 2016-2017.



Source: IMF, WEO and EBRD calculations.



Source: World Bank, Logistics Performance Index.

GREEN [ATQ = 4.14]

High energy intensity and low resource efficiency are the key challenges in Moldova.

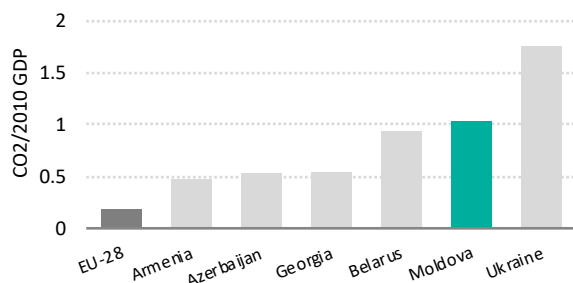
The energy sector has high dependence on imported sources of energy, a low level of renewable energy sources in the energy mix, and high energy/carbon intensity. Productivity of water and materials utilization ranks in the lowest quintile in the world and has space for significant improvement.

- There is substantial potential for **energy efficiency** improvements with energy intensity estimated to be five times¹⁸ the EU average. The energy supply infrastructure is old and has moderately high supply losses. End-use consumption is inefficient because large segments of the public and private sector facilities were built during the soviet-era. The residential sector has the highest potential for energy saving with about 40 per cent share of the final energy consumption used mainly for space heating.
- A higher share of **renewables** would support the country’s efforts to diversify away from imported hydrocarbons, as well as to significantly decarbonise the economy. The share of renewables in the energy mix is about 9 per cent, primarily from solid biomass. However, over-logging for fuel wood causes serious reduction in forest regeneration capacity and loss of habitats. Moldova has significant untapped renewable energy potential, particularly in solar, wind, and biomass.
- Moldova is among the bottom fifth of countries in the world¹⁹ in terms of both **material productivity** in industrial and agricultural sectors and **water productivity**. Landfilling tariffs are low and do not incentivise resource efficiency. Moldova suffers from a lack of sustainable water management. Domestic consumption of water is significantly subsidized. Less than 10 per cent of country’s wastewater treatment plants are in satisfactory condition, and funding is required to upgrade outdated infrastructure.
- Other issues include **climate change** and **poor air quality**. Climate change and droughts are increasingly affecting the agriculture sector, with projections indicating a further intensification of water scarcity and seasonal droughts leading to increased supply limitation. In terms of air quality, SO₂ emissions have almost doubled between 2005 and 2011 due to increased number of transport and exposure to PM_{2.5} is 1.3 times higher than the EU average.
- There are gaps in other **environmental laws**, including waste, water and air quality. Moldova is a member of the EU Energy Community and has signed up to the **third Energy Package**. Moldova has signed the Paris Agreement, which is yet to be ratified as of May 2017.

Less than 20% of annual waste is recycled in Moldova (Eurostat)

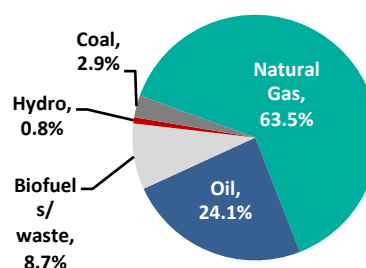
Moldova ranks 141 out of 172 globally for water productivity (Eurostat)

Carbon intensity (2014)



Source: International Energy Agency.

Composition of total primary energy supply (2014)



Source: International Energy Agency.

¹⁸ International Energy Agency

¹⁹ World Bank, World Development Indicators and Vienna University of Economics and Business, Global Material Flows Database

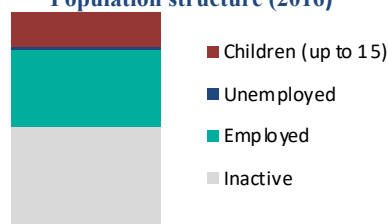
INCLUSIVE [ATQ = 5.19]

Emigration, demographic decline and shortcomings in the education system are the main challenges for good labour market performance and inclusive growth. Moldova's labour force participation rate is significantly below regional peers and below the EU average. Only approximately 40 per cent of the population (age 15+) is currently in employment, well below the EU average of 52 per cent. At 40.1 per cent, female labour force participation is one of the lowest in the EEC. Among certain groups of women such as Roma, the employment rate drops to 16 per cent pointing to structural barriers for their economic inclusion. Labour market challenges are exacerbated by a mismatch between educational outcomes and labour market demands. Discrimination in the workplace can be experienced by vulnerable groups and minorities.

- **Unemployment** is relatively low, at 4.2 per cent in 2016, but hides high levels of **underemployment** in various economic sectors, especially agriculture and services. Informal employment is predominant within rural agriculture based on subsistence farming as well as in trade and construction.
- The service sector is the main source of formal employment for **young workers**. Unemployed youth report 'low wages in available jobs' and 'not enough jobs' as the main obstacles to finding employment.
- Moldova experiences a mismatch between the skills of young labour market entrants and the requirements of the labour market. According to BEEPS V, 31.2 per cent of businesses identify an **inadequately educated workforce** as a major or very severe constraint to their firms' operation.
- There is an oversupply of university students majoring in social sciences, education, and humanities rather than in STEM subjects. **Qualifications** do not match the requirements of the labour market and school-to-work transition is slow.
- Despite high levels of educational attainment, there is a need to improve quality and relevance of **training**. Access to education is widespread with an average of 11.3 years of schooling for population aged 25-29. Challenges to education include shortage of teachers, quality of teaching materials and curriculum, and lack of centralized quality control. Secondary technical vocational education remains unattractive. Training in skills is considered of poor quality and often bears little relation to the needs of the labour market.
- Moldova exhibits large **gender** segregation in the labour market with women concentrated in agriculture and the service sector. The gender pay gap is high with women earning 74 per cent of what men earn (WEF, 2015). Access to finance is low for both, men and women, with only 19 per cent of women and 16 per cent of men having a bank account²⁰. Moldova has one of the highest rates of trafficking in the region²¹.

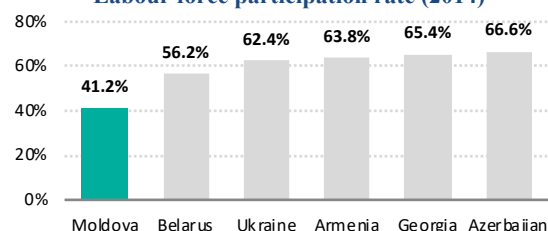
Male and female labour force participation (15+, 2016, National Bureau of Statistics) stand at 45.4 and 40.1 per cent, the lowest in the EEC. According to BEEPS V, approximately 32% of companies offer formal training programs for permanent employees.

Population structure (2016)



Source: World Bank, WDI and EBRD calculations.

Labour force participation rate (2014)



Source: World Bank, WDI.

²⁰ World Bank Group Findex, 2014.

²¹ International Organisation for Migration, 2012, Extended Migration Profile of the Republic of Moldova.

Economic stabilization has been underway since 2016. Following 0.5 per cent year-on-year (y-o-y) economic contraction in 2015, real GDP grew by 4.1 per cent y-o-y in 2016 on the back of a good agricultural season. Agricultural output increased by 18.2 per cent y-o-y. In the same period, growth was mainly driven by household consumption (up by 3.6 per cent y-o-y in real terms) and recovery of exports (up by 8.8 per cent y-o-y in real terms). On the other hand, the contribution of investment was negative with gross fixed capital formation shrinking by 3 per cent y-o-y in real terms.

External and inflationary pressures have eased. The Moldovan lei stabilized in 2016, after depreciating by 34 per cent in 2014-2015. The decline in remittances (16 per cent of GDP in 2016) slowed from 30.0 per cent y-o-y in 2015 to 4.4 per cent y-o-y in 2016. Official reserve assets increased from US\$ 1.8 billion at end-2015 to US\$ 2.2 billion at end-2016, lifting import coverage to approximately 6 months (also thanks to import compression). Amid tight monetary conditions and stable lei, inflation decelerated from 13.6 per cent y-o-y in December 2015 to 2.4 per cent y-o-y in December 2016. Public debt increased from 25 per cent of GDP in 2014 to 38.3 per cent of GDP in 2016, mainly on the account of emergency assistance provided by the NBM to the three failed banks.

Macroeconomic stabilization is supported by the new IMF programme. A three-year IMF arrangement for Moldova (US\$ 179 million) approved in November 2016 aims, among other things, at urgent governance and stability improvement in the banking sector. It is expected to reduce funding pressures through tranche disbursements under the programme and by unlocking budget support from the World Bank, European Union and Romania. The IMF programme is essential for catalysing reforms.

The short-term outlook is positive but significant risks remain. According to the latest EBRD forecast (May 2017) Moldova's economy will grow by 3.0 per cent in 2017 and 3.5 per cent in 2018. However, longer-term prospects are uncertain due to small size of the economy, narrow economic base, low levels of investment, and financial sector and demographic challenges. Moldova's narrow economic base concentrated in agriculture leads to volatile and unpredictable growth.