



Expert Grup
CENTRU ANALITIC INDEPENDENT

Business & Economie





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Summary

A number of 'revolutionary' initiatives and failed expectations marked the **legal framework** in 2007. The triple presidential initiative on liberalisation of capital, fiscal amnesty and income tax reform was the event of the year. Certain effects of this reform are already observed, in particular, the financial autonomy of local public authorities has been deteriorated more once the zero tax on revenue reinvested by companies was introduced. The implementation of the European Union – Moldova Action Plan was halted, while the incapacity to implement the 2nd round of the regulatory reform was the failure of the year.

The **industry** had mixed trends in 2007. The first three months met the common trends of 2006. The positive dynamics of the industry in the 2nd and 3rd quarters made one think that this sector will recover by the end of the year through an internal restructuring from the recession produced by the Russian embargo introduced in March 2006. In July-September 2007 the industrial production exceeded the production volume of 2006. But in the last three months of the precedent year the industry has faced negative influences of the agriculture, which suffered a serious decline after the July-August drought. In addition, the negative effects of the Russian commercial embargo continued to manifest.

By contributing with 15.1 to the GDP, the **agriculture** got through many challenges in 2007. On one hand, many problems related to the sale of agricultural production in Romania have emerged, as this country joined the EU on January 1, 2007, while on the other hand, the crisis in wine sector stopped the exports to Russia. Although exports of wines, livestock and phyto-technical crops have been partly resumed in late 2007, Chile, China, etc., are already occupying the Russian market and this

reduces the optimism of exporters of Moldovan agricultural production. At the same time, the grave drought last year has seriously reduced some crops and revealed key problems of the agriculture, in particular, the lack of an efficient mechanism to subsidise farmers and insure risks in agriculture, the lack of a methodology to elaborate and implement the irrigation in agriculture at national level, etc.

The service sector achieved natural rises in 2007, following an increased consumption by population related to the growth of remittances up to a record of one billion dollars on background of larger imports than in 2006. In particular, retail sales, pay-for services, telecommunication, insurance and advertising services have grown and the quality of passenger and commodity carriage services has improved.

Although the annual **inflation** in 2007 was 13.1 percent and it was lower than in 2006, authorities have failed to maintain this rate in the limits set in the IMF Memorandum on economic and financial policies for 2007. The NBM optimism in the 1st quarter was materialised in a hurried reduction of the basic interest rate, which was further increased by 2.5 percentage points after evolutions at the beginning of the 2nd trimester, this being the greatest rise in the past seven years. The following main factors have hit the stability of prices: the summer 2007 drought which fuelled the inflation on food products; the higher electricity tariff for final consumers, which increased the prices of services in August; and massive remittances that the National Bank of Moldova cannot control.

The **labour market** encountered many challenges with a long-term effect in 2007, in particular, the insufficient rise of salaries in budgetary sector, the lack of qualified labour



force for many companies, inappropriate professional education of young specialists who do not meet requirements of companies, incoherent and faulty contribution by authorities to improve the quality of education, hitting directly the labour market. The real salary increased by 8 percent in 2007, compared with 2006, up to 2,063 lei. Although the 'statistical' unemployment has declined from 11.1 percent in 1999 down to 5 percent in 2007, it decreased in connection with the continued emigration of labour force, especially of youths.

Like in the precedent years, the **budget** incomes have over-fulfilled the plan, with the highest share belonging to indirect taxes, so that the Government is granted a respite to implement reforms, which would encourage the domestic economy. Expenses have been executed below the plan and allocations to sectors intensified in late 2007 because of the lack of an adequate financial management. Year 2007 was marked by liberalisation of economy, which will give an impulse to budgetary revenues the next years, though it did not have an effect on the budget in 2007. As regards allocations for 2008, they will be targeted at increasing salaries in budgetary sector and transfers to budgets of administrative territorial units affected by the zero tax on reinvested profit of economic agents.

After being empowered to control the inflation in 2006, the National Bank of Moldova should intensify its presence on currency market and use available tools more efficiently in 2007. The essential change in the NBM-promoted **monetary policy** was the rise of the interest rate on securities transacted within REPO operations from 13.5 percent up to 16.0 percent. The announcement regarding possible introduction of an official inflation targeting was followed by an international seminar at which the bank community and

monetary policy researchers discussed prospects of adopting this strategy in Moldova. The previous rise of the REPO rate and mandatory reserves of commercial banks produced the first moderate results, with prices increasing by 1.3 percent in November, compared with 1.6 percent in September-October, and 2.2 percent in August. It seems that the higher REPO rate had a certain effect. The annual inflation rate in October was 14 percent and it fell down to 13.5 percent in November and 13.1 percent in December.

Foreign investors have intensively joined the **banking system** in 2007. Thus, Austrian, French and Italian investors purchased Unibank, Mobiasbank and Eximbank. This boosted the competitive spirit on banking market and developed the structure of bank assets, reducing the concentration of assets of the five biggest banks from 66.43 percent down to 63.82 percent. The banking sector has generally achieved a 29-percent growth of liquidity in 2007 sustained by a rise of deposits by over 40 percent, so that banks offered by over 50 percent more credits than in 2006.

The **non-bank financial sector** has also achieved impressive dynamics. Resources of the insurance market have grown by 25 percent, compared with the precedent year. But premiums collected on the basis of mandatory insurances have been the main source of many companies, as they increased by more than 14.5 percent, compared with 2007. The capital market has permanently developed, particularly in the second half of the year. Most of transactions envisaged bank securities, which covered more than 76 percent of all deals. The volume of transactions for 2007 has increased threefold compared with the precedent year. However, the capital market is still closed and this obstructs its further development and discourages new investors from participating in this market.

The **foreign trade** deficit of Moldova has increased by 43 percent, compared with 2006, up to a record of 2.348 billion dollars. This evolution is based on the same reasons: high internal demand and low competitiveness of exports. Moldovan producers will be able to maximally enjoy the asymmetrical trade regime with the EU unless they meet European quality standards and exploit new niches on community market.

The **petrol** price has increased much and was very volatile in 2007. But unlike 2006, fundamental factors influenced the petrol prices in 2007, in particular, the growth of the global oil consumption and fall of the U.S. dollar, the main currency of oil transactions.

Fears regarding recession of the U.S. economy and deceleration of global economic growth may cut petrol prices.

Prices on the **grain market** have strongly grown in 2007 due to a significant rise of the demand over the production level. The supply was affected by bad weather in producing countries, dearer transportation and depreciation of the dollar.

The **dollar** has depreciated much versus **euro** in 2007. The difficult condition of the U.S. economy and problems of the mortgage market exercised negative influences starting mid-2007. Short-term prospects for the U.S. currency are not very good.

The **Russian economy** has grown by 8.1 percent in 2007 and it achieved a strong acceleration in the 4th quarter. The growth is based in continuation on expansion of the investment demand, augmentation of the building and industry sector.

The **Ukrainian economy** is on the rise and it has grown by 7.3 percent in 2007. The economic growth is further fuelled by expansion of the internal demand of

consumption and investments. The economy will maintain the increasing trend on a short term, but political risks persist so far.

The economic condition in the **European Union** is comfortable in continuation, but producers face unfavourable conditions related to the strong euro and tight situation on credit market. Also, there are risks related to the continued appreciation of the single currency and evident fall of the U.S. economy, which is the main market for European exports; dear energy resources; difficult situation on credit market.

The **Romanian economy** has developed much in 2007. There are positive trends in almost all sectors, except for industry, as its expansion has floundered in late 2007. Serious risks have origins in the permanent rise of the current account and budgetary deficits.





Legal framework

Year 2007 was very interesting in terms of changes in the normative and legal framework on business.

A triple presidential initiative on liberalisation of capital, tax amnesty and income tax reform was the event of the year. This initiative cannot be rigorously evaluated in terms of economic impact. However, certain effects are already clear; in particular, the financial autonomy of local public authorities has deteriorated more once the zero tax on reinvested profit of companies was introduced. Also, pardoned fiscal arrears exceeded twofold the initial estimates (4.2 billion lei, compared with planned 2 billion lei).

In February 2007 the Government approved the action programme on implementation of the European Union – Moldova Action Plan,¹ establishing among others some actions aimed to improve the functioning of the economic system in accordance with the plan. Unfortunately, the Action Plan was not adequately implemented in 2007 because of the shortage of qualified human resources in public service, absence of clear priorities, uncoordinated implementation process and institutional rivalries which are unnecessary for such a document of national importance. EXPERT-GRUP will release soon an in-depth analysis on implementation of the economic chapter of the Action Plan.

The reform strategy on state regulatory framework concerning entrepreneurship was adopted on February 1, 2007, and the Parliament created a special commission in March to optimise the legal framework on entrepreneurship. But as forecasted in the first issues of BER in 2007, the inertia of ministries and other central authorities has compromised the progress of the reform, as they did not release analyses regarding the impact of legislation on entrepreneurship in their areas of responsibility. In July, the Parliament modified the law on basic regulatory principles on

entrepreneurship,² extending (again) the implementation term of the regulatory reform from August 11 to November 30, 2007. It argued that principles of the law have not been transposed in the national legislation and conflicts and legal confusions have not been remedied so far. In reality, the reform is delayed because some state control bodies and ministries do not warm the modification of certain laws. So far, the Government failed to submit to the Parliament an acceptable draft law on implementation of basic entrepreneurship principles. Earlier, the Parliament had turned down a draft law in this respect.

After being delayed for a couple of years, the National Agency for the Protection of Competition³ (NAPC) was created in 2007, with the Parliament nominating NAPC directors and deputy directors. Of course, the appointment of directors is not enough to make the Agency functional. A short-term priority is to endow the Agency with human, financial and technical resources needed for an effective functioning and to set up the necessary regulatory instruments for NAPC. Instead, the Agency has started handing in penalties immediately after being created, challenging grounded protests of the agents concerned.

Several important laws and normative acts regulating the quality infrastructure have been published in 2007, being long-awaited by the business community and consumers in Moldova. They include among others the law on technical regulatory activity, which will enter into force after six months. By adopting this law, legislators pledged to remedy technical obstacles on way of trade.⁴ The same legislative package includes important amendments to the law on standardisation.⁵ Another great novelty is the law on general security of products, which introduces obligations, specific competences and tasks in the food security sector. Also, many technical norms by the Ministry of Agriculture

² Law # 235-XVI from July 20, 2006;

³ Parliament Decision # 21-XVI from February 16, 2007;

⁴ Law # 420-XVI from December 22, 2006;

⁵ Law # 1016-IV from March 6, 2007 concerning modification and completion of the Law # 590-XIII on standardisation from September 22, 1995;

¹ Government Decision # 113 from 3 February 2007;

and Food Industry aimed to harmonise the legal framework with the European sanitary and veterinary legislation have been adopted in 2007. Almost all norms have been drafted in 2006 but published in 2007 only. Both domestic and international experts have criticised the Government in the past years for stagnating the implementation of European sanitary standards. In spite of the late publication, Moldova has remedied serious drawbacks.

The National Commission for Securities authorised several investment funds in 2007 to cease their quality of professional participants in the securities market. The investment funds concerned had been active participants in the privatisation process in the 1990s and their dissolution now means both their failure to turn into important players on financial market and failure of the policy on enhancing welfare of population via these funds. The major result of investment funds was nothing but dissipation of property rights on tens and hundreds of thousands of holders of doubtful securities.

The abrogation of the January 22, 1991 law on property⁶ and January 14, 1992 law on rent⁷ were two symbolic events. The two laws had been considered pillars of economic reforms in the first phase of transition in the first half of the 1990s. They have been abrogated because of the maturation of Moldovan legal framework and this is a proof that the economic system is succeeding to a new level.

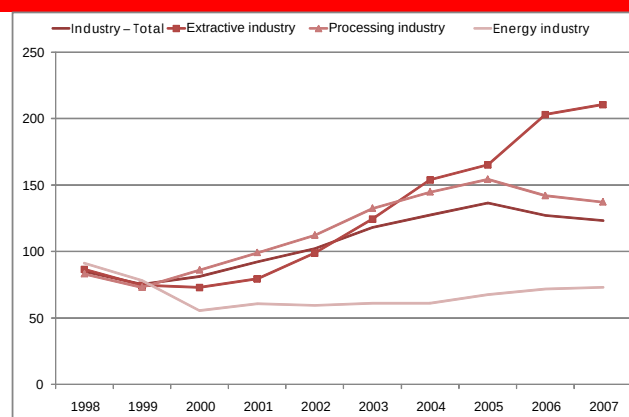
Industry and constructions

The industry had mixed trends in 2007. The positive dynamics of the industry in the 2nd and 3rd quarters made one think that this sector will recover through an internal restructuring by the end of the year from the recession produced by the Russian embargo introduced in March 2006. In July-September 2007 the industrial production exceeded the production volume of 2006. But in the last three months of the precedent year the industry faced negative influences of the agriculture, which suffered a serious decline after the July-August drought. In addition, the

negative effects of the Russian commercial embargo continued to manifest. Many important wine companies did not bottle wines in 2007. At the same time, the production of several branches has declined in continuation but not because of weather or commercial barriers.

Therefore, the industrial growth indicators for 2007 were negative, -2.7 percent. In constant prices, the industrial production was larger in 2007 than in 2003, but smaller than in 2004 (Diagram 1).

Diagram 1 Evolution of industrial production, in constant prices, 1997=100%



Source: Expert-Grup estimates based on NBS accounts

The sugar and wine industries have obstructed the resumption of economic growth of industry in general. The production volume of the sugar industry was below 50 percent of the production made in 2006. Such a collapse of the production was linked to the compromised sugar beet crop after the summer 2007 drought. At the same time, the smaller production signals the incapacity of the “national sugar industry” (and its structural precursors, particularly the sugar beet growing branch) to adapt technologically and logistically (by diversifying raw material suppliers) to weather changes and foreign shocks. In this context, protecting the branch via commercial “safeguard” taxes and subsidising of sugar beet production cannot be efficient and it is done on account of consumers’ interests.

The continuous postponement of spirits exports to the Russian Federation has maintained the

⁶ Law # 54-XVI from March 2, 2007;

⁷ Law # 83-XVI from March 29, 2007;



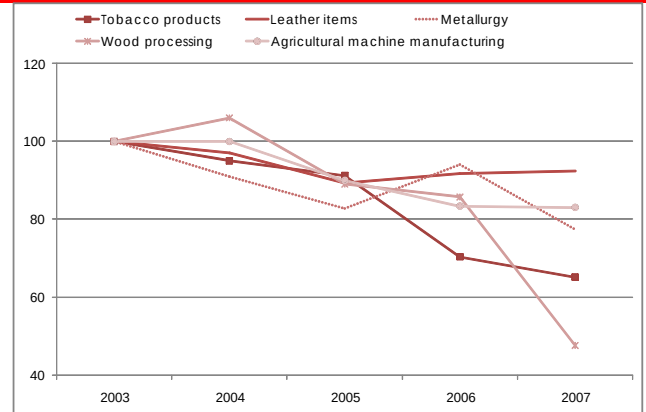
wine industry in an uncertain situation. On one hand, wine producers realised that they should diversify the markets, ensure the quality and achieve an 'a-going' repositioning of their wines on European markets. On the other hand, the marketing and management needed to join new markets and introduction of quality control procedures imply high costs, which many producers do not want to assume.

Thus, the recession of the wine industry went on, and wine production made in 2007 was by 30 percent smaller than in 2006 and by over 60 percent smaller than in 2005. The situation of spirits is almost the same. So, after two years of recession, the spirits and wine industry joins the category of traditional "falling stars" of Moldovan industry, which already includes some relatively important branches such as tobacco, leather, metallurgy, wood processing and agricultural machine manufacturing (Diagram 2).

All these branches have been on a constant decline in the past four years. The recession of the tobacco industry (-40 percent compared with 2003) is especially grave and it confirms on one hand the inefficiency and needlessness to subsidise this branch and on the other hand the necessity of urgently privatise the Tutun CTC Company.

The industry would have faced a more serious recession should the decline of the sugar and wine industry be uncompensated by a positive evolution of other branches. The 24-percent production growth of meat processing industry was the greatest achievement in this regard. It was the combined result of removal of export barriers and introduction of better commercial tariffs. At the same time, the production growth was particularly conditioned by a higher number of butchered cattle following the 2007 drought, which encouraged the migration of added value from meat producers to processing companies.

**Diagram 2 „Falling stars” of Moldovan industry
(production indicator, 2003=100%)**



Source: Expert-Grup estimates based on NBS accounts

In spite of raw material supply problems, fruit and vegetable processing and canning branches and dairy industry have maintained a positive growth (+10.6 percent and +3.4 percent). Hot weather on summer 2007 had also a positive effect on certain producers, increasing the mineral water production and other fresh drinks (+29.5 percent) and beer (+10.5 percent).

A symptomatic evolution is observed in extractive industry, as its production volume has increased less in 2007 than in 2006: +3.6 percent, compared with 23 percent. Indeed, if one eliminates year 2006, it may observe that year 2007 confirms the trend of reducing the expansion paces of extractive industry, after a record growth of 26 percent was achieved in 2003. The extractive industry has weakened because of two economic factors: slower intensity of constructions and lack of major investments to extend the scale of activity. According to Expert Group estimates, investments in extractive industry accounted for 5 million dollars only in 2007. Litigations related to property on the Cosauti stone quarry followed by cessation of its functioning have also contributed to the reduction of rise pace of mine production.

Agriculture

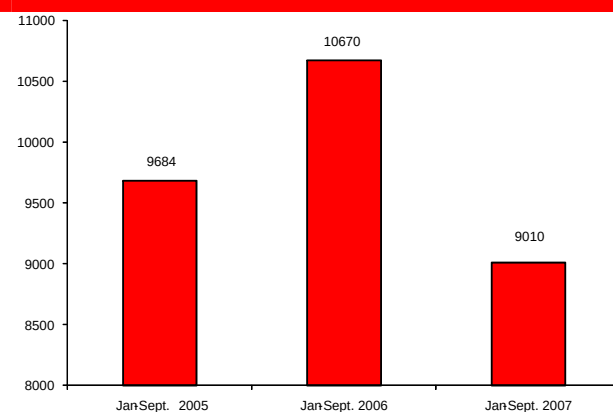
By contributing with 15.1 to the GDP, the **agriculture** got through many challenges in 2007. On one hand, many problems related to the sale of agricultural production in Romania have emerged, as this country joined the EU on January 1, 2007, while on the other hand, the crisis in wine sector stopped the exports to Russia. Although exports of wines, livestock and phyto-technical harvest have been partly resumed in late 2007, Chile, China, etc., are already occupying the Russian market and this reduces the optimism of Moldovan crop exporters. At the same time, the grave drought last year has seriously reduced some crops and revealed key problems of the agriculture, in particular, the lack of an efficient mechanism to subsidise farmers and insure risks in agriculture, the lack of a methodology to elaborate and implement the irrigation in agriculture at national level, etc. An agricultural crop worth 9 billion lei was harvested in January-September 2007, compared with 10.7 million lei in 2006 (Diagram 3). Given this situation, the National Agribusiness Fund adopted in November an alternative draft sustainable agriculture development strategy to the strategy that authorities have elaborated in a hurry within 2 months.

The drought had a strong impact on agriculture, as this sector has lost about one billion dollars, including one billion lei for the first-group grains and vegetables, 1.7 billion lei for meat production, 1.4 billion lei for milk production, facing a serious harm of young vineyards, orchards and autumn crops. The vegetal sector has suffered largest losses for maize – 75 percent, sunflower – 69 percent, barley – 57 percent, autumn wheat – 54 percent, potatoes and vegetables – about 40 percent, fruits – 35 percent.⁸

At the same time, the honey crop was threefold smaller than in 2006, raising prices by 30 percent and challenging pessimistic prospects for the 2008 agricultural year. The vegetal oil production has also decreased, and therefore,

the oil price has grown twofold because of double acquisition prices of seeds (from 2.5 up to 5 lei per kilogram).

Diagram 3 Value of agricultural production, million lei, current prices



Source: Expert-Grup estimates based on NBS accounts

Consequences of the drought have also hit the earnings of people, with rural population suffering the most. On one hand, their real earnings have declined much, while on the other hand dairy prices have grown by 9-10 percent, bread prices by up to 30 percent, etc.

The lack of irrigation possibilities have certainly enhanced the losses of farmers, as they signed irrigation contracts with the Apele Moldovei concern for a 32,000-hectare area only, that means half of the irrigable land, given the available equipment.

About 50,000 hectares of land have been irrigated later, as the Government additionally allocated 5,000 lei to the initial amount of 7,000 lei foreseen for irrigation. Although irrigating about 120,000 hectares of land by 2015 (compared with 308,000 hectares in the 1990s) is the goal of the Ministry of Agriculture and this objective is also part of the national strategy on sustainable agriculture development for 2008-2020, it should be considered to which extent the financial power of farmers will allow them to sign irrigation contracts and how technical problems related to farm land irrigation will be solved. For this reason, granting cheap credits

⁸ Accordingly to data by the Ministry of Agriculture and Food Industry;



or using leasing schemes for purchase of modern and efficient irrigation systems would be a tool to stimulate the implementation of irrigation systems.

Although the Government gave green light to 16.5 million dollars (200 million lei) in early September to cover expenses of farmers for autumn land processing and sowing works (the 2008 crop), these allocations failed to remedy the effects of the drought. Following appeals by authorities to help the agriculture, Moldova has benefited by a humanitarian aid worth 30.83 million lei overall, including 26.63 million lei from donor countries (Romania, the Czech Republic, Lithuania, Turkey, Belarus, etc.), 4.2 million lei from USAID, and 209,000 litres of fuels from Lukoil Moldova. At the same time, the Food and Agriculture Organisation will release a 26-million-dollar grant to develop crop and irrigation systems.

As regards risk insurance in agriculture sector, the results are worse than expected on background of the 2007 drought for several reasons: short allocations from the state budget to subsidise risks in agriculture (15 million lei); only 0.46 percent (8,600 hectares) of the farm land was insured; lack of a healthy competition in this sector – there is only one insurance provider in agriculture, Moldasig Company; long-term effects of failure of private insurance companies to honour contractual commitments towards farmers in the droughty year 2003; frequent amendment of the legislation which empowers the state to provide initial subsidies of 80 percent of the cost of insurance premiums, then 60 percent, and then 80 percent again for the second half of 2007 is a symptom that the potential of the budgetary system is not known exactly.

Results of subsidising farmers are also modest. In February 2007 the Parliament adopted the regulation on use of the fund for subsidising farmers and reserved only 240 million lei to this fund, but this amount is too small as companies which acquire and harvest crops rather than farmers are the final beneficiaries of subsidies, while individual enterprises are discriminated. The fund could be enlarged and used better on

account of the state budget profit and by avoiding an unfair and corrupt selection of benefiting farms. Under amendments to the 2007 state budget law operated in June, only farmers who have insured their crops were granted subventions worth 22,400 lei per 100 hectares.

The decision of authorities to subsidise the planting of young vineyards on an area of 1,525 hectares (compared with the estimated surface of 30,000 hectares) is welcome, as the state compensates 230 economic agents via the state investment company MoldVinIpoteca,⁹ created in September under a Government decision. But the credit will be reimbursed depending on weather, given the lack of a mechanism to insure the risks of vine growers.

Authorities have paid an exaggerated attention to the farm land consolidation programme,¹⁰ with about 40,000 hectares of land being consolidated in the first round in 20 mayoralities in the districts of Donduseni, Telenesti, Stefan-Voda, Cahul, Comrat, Ciadir-Lunga, Vulcanesti, and a system of recording farm land accordingly to legal-organisational norms and property type was introduced. But this programme is not a priority, as the consolidation is a result of normal development and modernisation of agriculture (which is already achieved through economic tools). This is one more argument for authorities to prevent the concentration of farm land in hands of leaders, that means former heads or members of kolkhozes who hold agricultural equipment and do not pay rent taxes, so that they administrate wrongly the revenues of 1,883 new corporate farms which own 52.3 percent out of more than 100 hectares of farm land.¹¹ Even more, authorities acknowledged in August that some leaders have declared incorrect wheat crops and therefore, prime minister has instructed the Tax Service to re-estimate the quantity.

⁹ The first mortgage credit for planting young vineyards has a 8-year term and a 6-percent annual interest rate. According to data by the Agro-Industrial Agency Moldova-Vin, 71.9 million lei was paid from the fund for the sustenance of new young vineyards for spring planting works;

¹⁰ GD # 416 from 17.04.2007, GD # 1075 from 01.10.2007 approving the farm land consolidation regulation foresees allocations worth about 200 million lei both from the state budget and international donors;

¹¹ Agricultural activity, NBS, 2007, GD # 592 from May 29, 2007;

In this context, the world experience confirms that a high labour productivity per hectare may be achieved on small fields, too. For example, farm exploitations in Greece count for 4.3 hectares on average (75.7 percent of the total), Italy 6.4 hectares (77.5 percent), Portugal 9.2 hectares (78.1 percent), the Netherlands 16.3 hectares (34.1 percent), Belgium 20.6 hectares (35 percent), and EU 15–18.4 hectares (55.3 percent).¹² Also, the high intensification of production expressed in the value of raw production or per ear is a capacity of these family-type exploitations.

There are good practices in Moldova as well, as farmers achieved a high labour productivity on several hectares in the droughty year 2007. This was achieved due to high added value crops and modern agro-technical technologies, raising about 400,000-500,000 lei per hectare. Thus, the ability of farmers to elaborate viable business plans, find buyers for their crops, etc., rather than the surface of the field is important. For this purpose, authorities shall do their best for a qualified training of farmers in growing and selling crops.

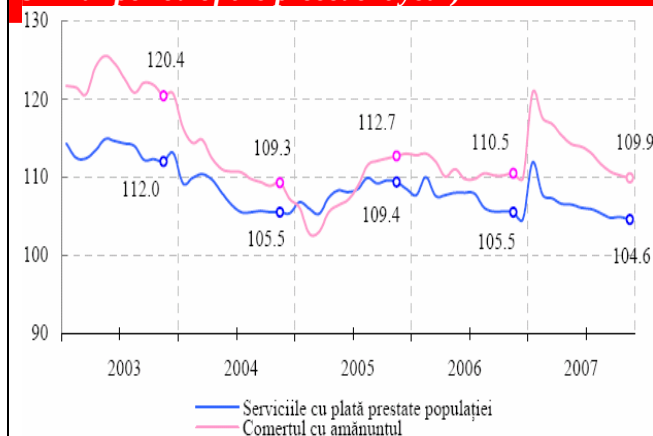
The problem of agriculture rests with the lack of a sustained culture of building business in this sector, a fact confirmed both by the number of medium and small-sized business (2,000) and profit per employee of these enterprises, which amounted to only 988 lei¹³ in January-September 2007. The profit per employee of medium-sized businesses accounted for 1,800.2 lei, small businesses 1,002.76 lei, and micro-enterprises 162.2 lei. Although data for the last quarter of 2007 are unavailable so far, optimistic profits in small and medium-sized businesses working in agriculture are not expected.

Services

The service sector continued achieving natural rises in 2007, following an increased consumption by population related to the growth of remittances up to a record of one billion dollars, on background of larger imports than in

2006. In particular, retail sales, pay-for services, telecommunication, insurance and advertising services have grown and the quality of passenger and commodity carriage services has improved.

Diagram 4 Dynamics of retailing and public services, % (from the beginning of the year, compared with the similar period of the precedent year)



Source: NBM

Thus, the retailing rose by 9.9 percent in January-November 2007, compared with the same period of 2006, while pay-for services provided to population increased by 4.6 percent (Diagram 4).

In particular, private commercial units have achieved 70.1 percent of all sales (the real growth was 11.8 percent), joint companies 24.5 percent (the real rise was 8.9 percent), while mixed enterprises reduced their retail sales by 16 percent compared with January-November 2006. At the same time, private facilities have achieved high rise paces of pay-for services for population (31.9 percent of all services), but services by public units covered 43.1 percent of all services.

The rise of retail sales was also linked to a stronger competition on retail segment on spring 2007, opening of 2 hypermarkets Fourchette in Chisinau and one in Balti, FoxMart, car saloons Lexus and KIA Motors, enlargement of the supermarket No 1, Green Hills Market, Xenon, new owner of Alina Electronic Company and its rebranding. The main pharmaceutical networks

¹² European Commission, FA and UNSO;

¹³ Calculated on basis of the NBS "Activity of small and medium businesses in Moldova in January-September 2007";



Felicia, Orient, Farmacia Familiei have also extended.

The telecommunication sector has also achieved a spectacular growth. Voxtel rebranded into Orange on April 25, Moldtelecom introduced the CDMA-2000 mobile telephony service Unite, and Eventis Mobile joined the GSM 900/1800 telecommunication market in late 2007, bringing the slogan "Everything Is Just Starting" and an initial investment of 35 million dollars.¹⁴

At the same time, the number of legal telecommunication companies has increased by 21.5 percent (1,214 units), compared with 2006. As much as 73.36 percent out of all licences awarded in 2007 were issued in informatics sector, 12.77 percent in telecommunication sector, and the rest to radio and television channels. The domination of informatics licences, in particular for elaboration and implementation of software, data transportation services (Internet access) and IP telephony, reveals the rise of demand for such services.¹⁵ Services of projecting and designing websites for companies, as well as Internet advertising are most demanded. The demand of entrepreneurs for licensed software has advanced due to the software legalisation campaign held by Business Software Alliance,¹⁶ though this legalisation is expensive for the small business sector. Also, the quality of wideband Internet access services has improved and the number of users has increased.

The wire television sector is becoming more dynamical, particularly after the EBRD invested 8 million dollars in SunCommunications Company in March, with the purpose to enlarge and improve the quality of services. Thus, on

October 14 the company introduced its services in the Balti municipality, proposing clients to get connected to favourite channels and enjoy free technical services. Such an investment will also make other important companies working in this sector look for investments to modernise and extend themselves, if they want to keep being competitive on a long term.

The insurance market was stimulated by concentration of assets after big foreign players have taken over some small companies. On August 1, the Austrian group Grawe bought 80 percent of shares in the insurance company Carat, with a further rise of the capital and participation in the capital of the acquired company. Thus, the demand for life insurance services with capital accumulation, car insurance, and insurance of commodity shipments has grown.

As regards the advertising market, it has extended and diversified. Both prices and number of corporate clients (particularly of foreign companies) of these services have increased. At the same time, two big companies (Bomba and SunCommunications) have been fined at the demand of NAPC on exaggerated advertising language charges, so that to make all competitors release a right advertising message.

Also, problems in the passenger and commodity carriage sector related to a summer 2007 interdiction by the European Commission against a number of domestic air companies to operate flights, as well as withdrawal of certificates of air operators from seven companies¹⁷ by SACA, have been remedied at the end of the year by improving the quality of air services and withdrawing old planes, increasing investments in professional training of all crews.

Prices

The major objective of the National Bank of Moldova in 2007 to maintain stability of prices was failed. Although the annual *inflation* in

¹⁴ On December 21, Eventis started exploiting the network which covers 40 percent of Moldova. Investments by this company shall exceed 100 million dollars the next years. In 2008 it has plans to achieve 95 percent coverage and to enhance its share on mobile telephony market up to 25 percent the next three years. Also, the company promised not to operate damping prices.

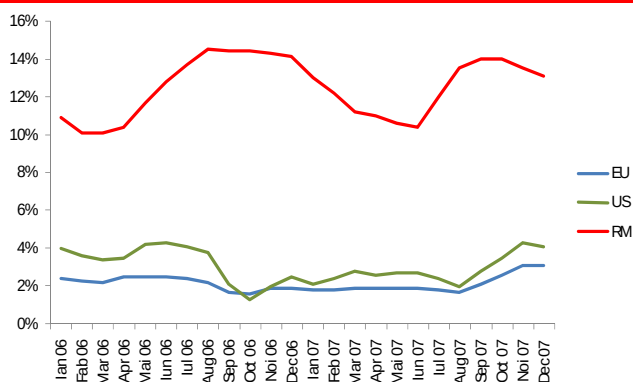
¹⁵ The number of licensed operators authorised to provide informatics services in public facilities has increased by 15.4 percent and exceeded 500, as of 31.12.2007;

¹⁶ The campaign was launched to combat the massive soft piracy in Moldova, which was estimated at over 90 percent in 2006;

¹⁷ Jet Stream, Grixona, Tiramavia, Jet Line International, Pecotox-Air, Valan, International Marculesti Airport and International Cargo Charter;

2007 was 13.1 percent and it was lower than in 2006, authorities have failed to maintain this rate in the limits set in the IMF Memorandum on economic and financial policies for 2007. There were great hopes in early 2007 to maintain the inflation in the limits of one figure, as the cumulated inflation for the first semester was only 3.9 percent, this being the lowest rate since 2001. However, developments at the beginning of the 2nd semester dashed this optimism and serious doubts regarding maintenance of the inflation targeted have been raised in July. But Moldova was not the only country to be hit by a fast price rise on autumn 2007. The European Union and the United States exceeded much the inflationist targets and many European countries have modified them. The inflation rate in the Eurozone was 3.1 percent in late 2007, after petrol prices have grown, while the annual inflation in the United States was 4.1 percent last year (Diagram 5). The rise of fuel price by about 13 percent was an essential factor to increase global prices.

Diagram 5 Annual inflation in Moldova, Eurozone, U.S.

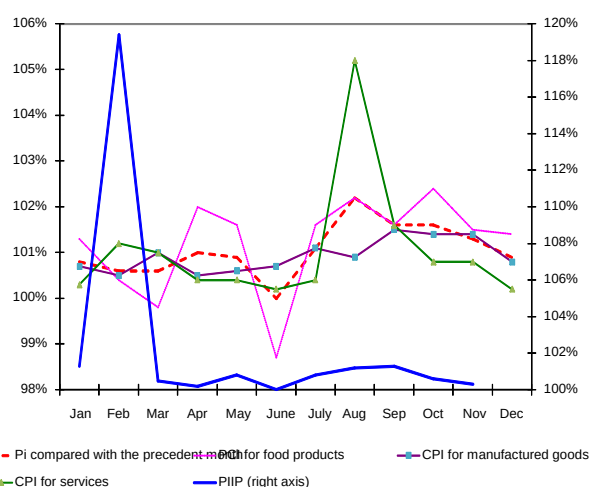


Sources: NBS, ECB, BLS

New tariffs introduced by ANRE for the natural gas supplied by SA Termocom to produce electricity and supply heating had the most significant impact on prices, as this increased the water and gas tariffs for consumers. Authorities underrated their intervention and

regulatory capacities and they did not envisage other risks. In particular, the National Bank reduced the basic interest rate by 1 percentage point in April. Nor it worried with the higher index about industrial production, which increased by 19.4 percent in February 2007 only and clearly signalled the intensification of inflationist pressures (Diagram 6).

Diagram 6 Price index of industrial producers and consumer price indexes, compared with the precedent month, 2007



Sources: NBS, NBM

The summer 2007 drought has seriously increased the prices of agricultural raw material and those depending on them, in particular of dairy and meat products. Such a significant price rise was not observed in the droughty year 2003. The inflation on food products reached the highest rate of 15.4 percent that year. The rise of electricity tariffs for final consumers in August, which suddenly increased the prices of services and then prices in general, was another impetus. Such a sudden price rise occurs after the energy tariff is changed through "shock interventions" by ANRE. In order to prevent such risks, the regulatory authority must change tariffs gradually and often.

Monetary elements have also fuelled prices, in particular, massive remittances that the central bank cannot control, rise of salaries and consumer credits up to 14.6 percent of all



credits in 2007. However, the influence of the monetary phenomenon on inflation is unknown, as the basic inflation is not calculated in Moldova to prevent changes of energy and food prices, which are usually volatile and may divert from general trend of inflation because of temporary price shocks, giving a wrong estimation to inflation.

Thus, both the National Bank and international financial institutions were deeply concerned with the inflation rate and persisting risks; therefore, the central bank resorted to radical actions. It increased the basic interest rate by 2.5 percentage points in September, up to 16 percent, this being the highest rise in the past seven years.

Further, the mandatory reserve norm was increased up to 15 percent for reserves in lei and freely convertible foreign currency. These actions aimed to influence credits by commercial banks and redirect available resources to savings. Apparently, this had an effect on inflation rate, which slowed down in November and December.

The failure to maintain the inflation target has made the NBM introduce a direct inflation targeting within 2-3 years. Although this is a welcome strategy aimed to maintain stable prices, as it implies a more transparent policy and a more frequent inflation monitoring, Moldova is not yet prepared to implement it. Firstly, the central bank needs a macroeconomic inflation forecasting model in the context of other macroeconomic indicators, in particular, growth of GDP on sources and use and indicators on foreign position of Moldova. Also, the Government will have to give up governmental policies which contravene to the basic objective of NBM to stabilise prices, and this will be hard in the pre-electoral period.

Labour market

The labour market encountered many challenges with a long-term effect in 2007, in particular, the insufficient rise of salaries in budgetary sector, the lack of qualified labour force faced by many companies, inappropriate professional education of young specialists who do not meet

requirements of companies, incoherent and faulty contribution by authorities to improve the quality of education, hitting the labour market directly, etc.

Table 1. Salaries on sectors, % of the national average

	2003	2004	2005	2006	2007
Agriculture	55	57	56	53	52
Industry	145	138	135	124	124
Constructions	139	152	152	144	147
Trade	84	91	90	88	98
Hotels and restaurants	96	92	90	88	88
Transportation and communications	164	163	163	151	147
Finances	328	295	262	228	219
Real estate	126	125	127	121	126
Public administration	118	109	103	127	116
Education	69	64	67	72	65
Healthcare and social assistance	64	76	74	78	82

Sources: Elaborated by EG on basis of NBS data

According to NBS accounts, the real salary increased by 8 percent in 2007, compared with 2006, up to 2,063 lei. Following collective negotiations between social partners, the minimum salary in budgetary sector is recalculated starting January 1, 2007 and it amounts to 400 lei per a full-time programme of 169 hours or 2.37 lei per hour, while in the real sector of economy it was increased from 700 lei up to 900 lei a month (5.33 lei per hour).¹⁸ Thus, the medium salary in budgetary sector amounted to 1,932 lei, while the real sector paid 3,054 lei.¹⁹ But salary rises on economic activities shall be compared with the precedent years (Table 1).

The highest salary is paid so far in financial sector (4,517 lei), and the lowest wage is paid in agriculture (1,074 lei), which covers about 35 percent of the employed population. Although

¹⁸ Under the GD from May 18, 2007;

¹⁹ The Government has promised to liberalise the salary system by following the world experience, so that to get rid of the annual indexation of the tariff coefficient for the 1st qualification category and apply the minimum salary on economy, which would foresee the necessary quantum for remuneration of labour force. For this purpose, the Ministry of Economy and Commerce recommended in August authorities to modify the labour remuneration law from 14.02.2002, which would allow employees to independently choose between tariff and joint systems and would enhance the interest of workers towards the final result. The tariff system is established after negotiations between companies and branch bodies, while the non-tariff system encourages workers, given their labour productivity, quality of products, works and services.

the merger of the two unionist confederations on summer 2007 remedied former divergences and created premises to increase salaries in education sector more, wages in this sector are very low so far, inclusively because the Parliament has postponed the rise of basic wages of teachers from January 1, 2007 to December 1 2007,²⁰ flagrantly breaching Article 53 (6) of the law on education, which says that “minimum salaries of teachers will not be lower than the medium wage of salary earners in national economy.” Following negotiations with trade unions, salaries have been gradually increased starting April 1. But the medium salary of a teacher amounted to 1,351 lei or about 80 Euros only in 2007, and this strongly undermined the motivation of teachers for a productive and efficient activity. This is also a result of the limited number of seats in colleges and universities introduced by the Ministry of Education and Youth, as well as an effect of the administrative postponement of salary rises. For comparison, the medium salary in education sector was 65 percent of the national average in 2007, which is by 4 percent lower than in 2003. At the same time, the state budget does not include supplementary allocations for a decent rise of teachers’ salaries, so that the best specialists of this sector decide to emigrate and this throws doubts on willingness of authorities to invest in education as a basic strategic priority to boost the international competitiveness of the country. Hence, promises of authorities that increasing salaries in public sector is a priority, in spite of the May 2007 disagreement of IMF, were common statements.

In this context, increasing the medium salary on economy up to 300 dollars by 2009 is irrelevant for salary earners, as this quantum will be equivalent or even lower than the purchase power in 2009, while prices of goods and tariffs of services keep growing.

Remuneration in rural areas has new trends, too. Workers in agriculture sector seek much higher salaries than the average on national

economy. Many leaders of agricultural farms cannot afford such a remuneration, so that employees are ready to immigrate to Baltic countries, Russia, etc., in order to earn twofold higher salaries than those they seek at home. For example, a tractor driver in Baltic countries earns 800-1,000 Euros a month. The shortage of labour force in agriculture is also linked to the exodus of rural population to cities, especially to Chisinau.

The industry, energy and building sectors are facing an acute shortage of labour force. This is also linked to the neighbourhood with the EU. Big companies are trying to promote various tools to make employees stay and keep working, such as corporate leisure, prizes, allocations needed by employees to buy housing.²¹ At the same time, small businesses continue facing the risk of losing employees, as they have an insignificant financial power. So, the modest economic growth in 2007 did not have an essential positive impact on employment and labour market. Therefore, a clear disequilibrium between number of jobs and effective demand including the potential demand by emigrant workers was maintained.

Although the ‘statistical’ unemployment has declined from 11.1 percent in 1999 down to 5 percent in 2007, it decreased in connection with the continued emigration of labour force, especially of youths. One should not forget that the unemployment was also encouraged by massive promotion of Work & Travel programmes in university centres²² starting September. So, the economic potential of the country is on the decline while considerable budgetary expenses go to training of labour force and formation of qualified human potential, but this is inefficient and unabsorbed at national level.

²¹ The branch association of light industry has decided to work out a national programme funded by state, companies and employees. Such plans are linked to the shortage of qualified labour force, while enterprises working in the light industry top the exports thanks to contracts with EU member states but face a deficit of qualified personnel.
²² According to data by the U.S. Embassy to Moldova, 20 percent of youths who left to the U.S. have never come back, while about 45 percent came back later than they should come.

²⁰ Law on modification and completion of the Law # 355-XVI from December 23, 2005 concerning salary system in budgetary sector, # 442 from 28.12.2006;



At the same time, the low number of those calling on employment agencies explains the limited job opportunities and material aid, as well as the reduction of confidence and prestige of these facilities in resolving employment matters. The unemployment is also encouraged by rigid regulations on labour market, which increase costs depending on dismissal and employment of personnel, as well as by redistribution of functions to employees inside organisations and enterprises.

A monitoring on execution of labour legislation by Labour Inspection in January-November 2007 noticed that 51.26 percent out of 56,878 violations were committed in the labour security and health area, and others were related to labour relations. At the same time, the number of work accidents has increased compared with 2006, particularly fatal accidents – 45. Although the Government approved last autumn a new draft law on labour security and health and the Parliament is due to adopt it, so far Moldova does not have a national programme on development of labour security and health system accordingly to European norms, an objective reiterated in December 2007 at a roundtable on analytical policy document “Problems of readjusting the labour security and health in Moldova to European norms”, with participation of social partners.

In conclusion, authorities shall carefully consider economic policy instruments at level of laws, decisions, programmes and strategies regulating the disequilibrium of labour market, and take into account existing complex problems and their resolution on a medium and long term.

Budget

Year 2007 was almost like the precedent years as regards the execution of the state budget and national public budget. Revenues to the state budget turned over 14,004.5 million lei, being executed 100.4 percent. Indirect taxes and notably the VAT had the highest share in revenues, as they covered 34.1 percent of overall incomes of the national public budget

and 40.3 percent together with excises (Table 2).

Table 2. National public budget in 2007

	Planned 2007	Executed 2007	Executed 2006
Overall revenues	21,997.6	22,219.6	17,827.2
Inclusively VAT collections, (million lei, % of overall revenues)	7,714.0	7,586.9 (34.1%)	6,193.7
Inclusively excises (million lei, % of overall revenues)	1,323.5	1,392.3 (6.2%)	1,070.9
Inclusively income tax on entrepreneurship (million lei, % of overall revenues)	1,332.7	1,388.4 (6.2%)	1,079.1
Overall expenses	23,074.1	22,353.3	17,973.9

Sources: Ministry of Finance of the Republic of Moldova

This occurs because the consumption is more inert than the production in Moldova, and thus revenues on consumption are more stable than those on economic results. The high share of indirect taxes in budgetary revenues ensures a certain budgetary stability and grants a respite to the Government to adapt the budget to realities in productive sector of economy.

At the same time, expenses to the state budget are by 1.7 percent lower than planned and amount to 14,211.5 million lei. The expense execution level has increased at the end of the year (Diagram 7). But the late execution of expenses reveals Moldova's small capacities of financial absorption and this may compromise the efficient use of foreign funds. This often happens because of the lack of human resources for an adequate financial management. This is observed both at local and central level. Large amounts have not been allocated to education, healthcare, insurance and social assistance.

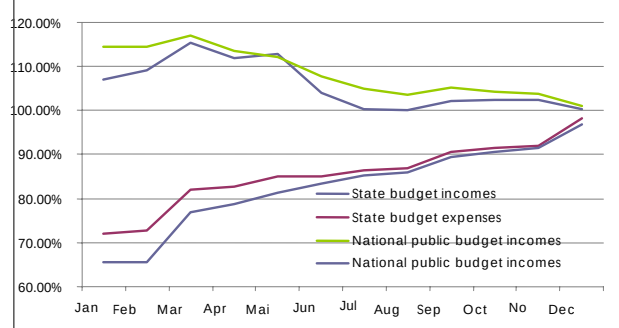
The state budget law was modified three times in 2007 because to low income planning capacities at central and local levels. By modifying the budget, the Government has allocated supplementary resources to partly cover the salary rise, for the gasification programme of the country, the Cahul-

Giurgiulesti railway portion, the road renovation programme, agriculture and subsidising of farmers affected by the summer 2007 drought, insurance and social assistance.

Revenues to the mandatory health insurance fund were executed over the plan, while expenses were executed 95.1 percent of the plan. However, the share of transfers is still very high in overall incomes of the fund. As regards the state social insurance budget, revenues have not been fulfilled because of unexecuted state social insurance contributions and transfers. The fiscal stability of the state social insurance budget is becoming problematical, as the number of taxpayers is on the decline and the number of retirees is on the rise, and therefore, the system shall be reformed.

Year 2007 brought developments in the area of fiscal stability and transparency. The liberalisation of economy, which did not have major effects on the 2007 budget, will influence budgetary revenues the next years. Although least questions concerned the zero tax on reinvested profit of economic agents, this will hit the budget, particularly local budgets, which depend 30 percent on this income. The 2008 state budget law estimates incomes of 2,328.1 million lei for administrative-territorial budgets, while transfers from the state budget for budgetary level will account for 2,721.1 million lei, which is by 55.3 percent less than in 2007, and this essentially reduces the financial autonomy of local authorities. Also, larger investments could not cover these losses, as the general business climate and macroeconomic condition of the country are unstable and this influences more the investment decision than the income tax rate, which was not very high in Moldova before 2008 as well. The period when the zero tax on reinvested profit will be applied was not announced yet.

Diagram 7 Execution of budgetary incomes and expenses, 2007



Sources: Ministry of Finance

The fiscal amnesty completed Government's actions which undermined the fiscal discipline in 2007, and thus debts in the amount of 4,337.6 million lei to the national public budget have been annulled, as of December 1, 2007. The fiscal amnesty did not affect the 2007 state budget, as the recovery of fiscal debts was not part of the incomes planned for last year. However, such a step could encourage hopes of subjects concerned by fiscal amnesty that the Parliament would repeat such actions, and could discourage disciplined taxpayers. Experience of other countries, particularly with regard to partial fiscal amnesties, did not restore fiscal discipline. Legalisation of capital is one of most doubtful components of economic liberalisation. As for data of December 2007, the legalised capital amounted to about 60 million lei. But this amount may grow by the legalisation deadline, as proved by experience of other countries, and budgetary incomes are insignificant so far. Taxes were distributed between the state budget and state social insurance budget.

The Medium-Term Expense Framework is being elaborated within the fiscal policy as an annual exercise. Accordingly to MTEF for 2008-2010, amendments to the Fiscal Code of Moldova have been operated and they entered into force on January 1, 2008. They envisage the tax on reinvested profit of legal entities; reimbursement of VAT afferent to material values, services



related to long-term capital investments, (expenses), (except for housing and transportation means) in localities of the republic except for Chisinau and Balti municipalities; introduction of a double taxation rate on incomes of individuals. The last amendment advantages wealthy people, while those earning low salaries are affected by the higher social insurance tax paid by employee and dearer mandatory health insurance premium.

Thus, expense priorities for 2008 are linked to the rise of salaries in budgetary sector and larger transfers to budgets of administrative territorial units, which is also stipulated by the 2008 state budget law.

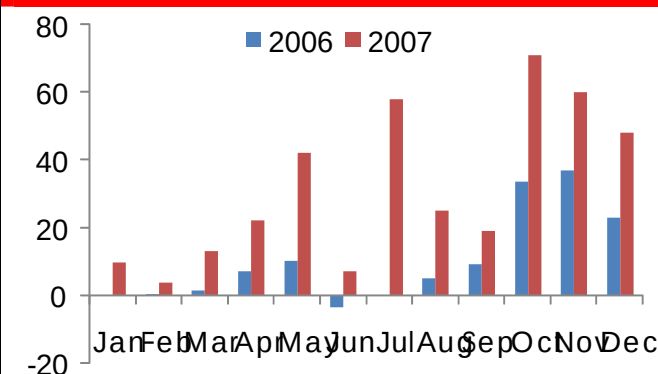
Currency

After being empowered to control the inflation in 2006, the National Bank of Moldova should intensify its presence on currency market and use available tools more efficiently in 2007. The first quarter of 2007 did not bring essential changes in the monetary-currency policy of NBM. The inflation of consumer prices fit favourable limits to aim at the 10-percent inflationist target established by NBM for 2007, and therefore it seemed that the monetary policy tools should not be modified.

But there were clear trends in February 2007 that inflationist tensions in economy will grow, as prices of industrial producers have increased much. In this context, the central bank was expected the least not to reduce the REPO rate from 14.5 percent down to 15.0-15.5 percent. Contrary to expectations, NBM reduced the REPO to 13.5 percent in April. Following inflationist developments in 2007, the NBM Board of Directors decided on September 26 to increase again the interest rate on securities transacted within REPO operations from 13.5 percent up to 16.0 percent a year.

It seems that the higher REPO rate had a certain effect. The annual inflation rate in October was 14 percent and it fell down to 13.5 percent in November and 13.1 percent in December.

Diagram 8 Net currency purchases on domestic market by NBM, million dollars



Sources: NBM

Although in 2006 the central bank was obliged to stabilise price rises as a basic goal, it intensified its presence on currency market in 2007 (Diagram 8). Foreign currency inflows into economy were very strong and they encouraged the appreciation of the national currency. Given the currency inflow, the task of the central bank to control inflationist risks in economy is seriously complicating, as the BNM should resist to pressures of exporters willing a competitive depreciation of Moldovan leu.

Banking system

In 2007 the banking system continued to raise the interest of foreign investors. Thus, the commercial bank Mobiasbanca was purchased and became part of the French bank group Societe Generale in January. The Austrian investment group Vienna Capital Partners purchased Unibank in September. A private Baltic investor has declared interest to purchase the majority package of Moldova-Agroindbank and to pay at least a 20-fold higher price per share than the nominal value. At the same time, the Romanian Bank Transilvania, the No.1 bank with Romanian capital, has plans to extend and considers the possibility to join the Moldovan market in 2008. The Romanian company Petromservice S.A. is willing to buy at least 40 percent of the capital of a Moldovan bank. Banca de Economii is expected to be privatised

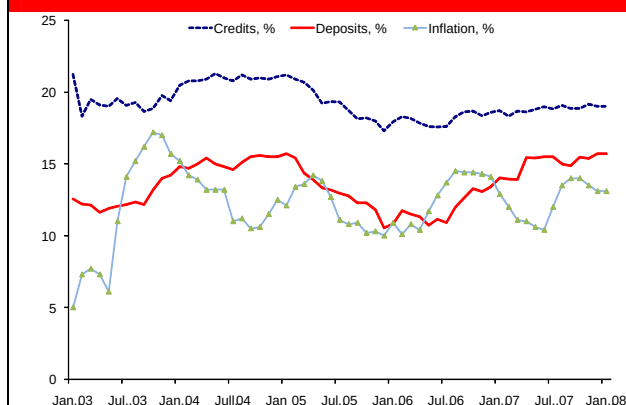
accordingly to the Memorandum between the National Bank and International Monetary Fund. The independent evaluation of the bank was stopped in 2007 because of the interest of the independent audit company in privatisation process. Local authorities described this action as a conflict of interest. The process of privatisation of Banca de Economii did not succeed negotiations between NBM and IMF. Other commercial banks contract foreign finances. Therefore, the banking sector continues to be a segment of growth of competition with an increasing foreign participation – from 50 percent in 2006 up to 65.72 percent this year.

Year 2007 was a continuous dynamics in the banking structure due to arrival of new foreign participants. By recapitalising, banks acquired by foreign financial institutions succeed in the top of banks ranked by size. The banking sector has generally achieved a growth of bank assets by over 39 percent. Eximbank has achieved the highest dynamics regarding growth of assets (more than 95 percent) due to instalments by totalitarian Italian shareholder Veneto Bank. Victoriabank and Investprivatbank assets rose by over 50 percent in 2007. The third group in terms of bank asset growth includes Moldindconbank, Mobiasbanca and Energbank (more than 40 percent). The group which achieved the lowest growth includes Eurocreditbank, Universalbank and Comertbank (less than 10 percent). Although some banks were more dynamical in increasing their assets, the structure of the banking sector in terms of size of institutions did not change. Moldova-Agroindbank (more than 6,600 million lei), Banca de Economii (more than 4,080 million lei) and Victoriabank (more than 3,900 million lei) are so far the largest three banks with nominative contribution to assets on the banking market. After having increased its assets by more than 95 percent, Eximbank succeeds from the 7th up to 5th place in the bank ranking on size, being preceded by Moldindconbank, which kept the place from last year and holds assets worth other 3,400 million lei.

Also, banks have intensified their operations by diversifying and increasing deposit and credit portfolios. The size of deposit portfolio is due to currency inflows and increasing interest of individuals for savings in banks. Therefore, banks achieved a significant rise of available currency and they directed these sources to a more intense crediting after a competitive intensification, with the view to conquer new segments of the real sector.

The credit portfolio of the banking sector has increased by 43 percent in real terms or by over 5,800 million lei in nominative terms in 2007. Eximbank demonstrated the highest crediting pace in 2007, increasing its portfolio by over 80 percent. Deposits in the banking system have grown by 34 percent or by over 6,000 million lei, with individuals holding more than 63 percent. Investprivatbank achieved the highest growth in real terms – 110 percent. But the three banks had the biggest contribution in nominative terms, both regarding crediting and attracted resources.

Diagram 9 Evolution of medium interest rate on credits and deposits in Moldovan lei, annual %



Sources: NBM

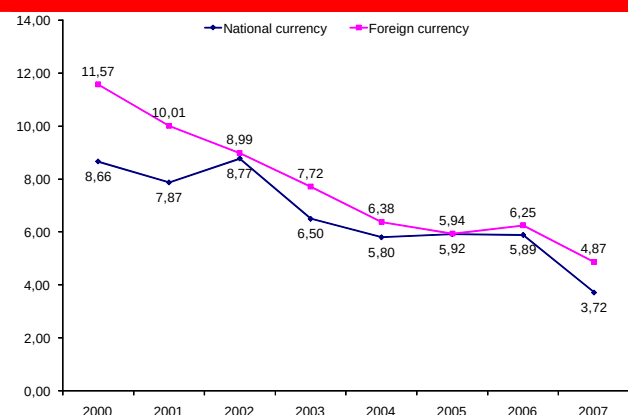
At the same time, banks have modified the interest rates on deposits and credits. Being probably influenced by an intensified competition, commercial banks focussed on promoting credits in early 2007. Hence, they reduced the interest rate on credits in lei from 18.7 percent down to 18.32 percent and from



11.12 percent down to 10.91 percent on credits in foreign currency for January-April 2007. Further, banks focussed on attracting sources by significantly raising the interest rate on deposits. Thus, in March-April 2007 they increased the interest rate on deposits in lei by 2.55 percentage points (from 13.9 percent up to 15.45 percent) and maintained these rates in April-July 2007. There are two explanations here. On one hand, new interest rates may be promoted by season or cyclic trends. For example, emigrants come back home on holidays and they bring much currency. On the other hand, banks focus on attracting deposits in lei, as population prefers savings in foreign currency despite the appreciation of the leu. Deposits in foreign currency covered between 45 and 60 percent of all deposits in 2007. Also, the fluctuation of interest rate may be supported by the new basic rate of NBM. The sudden rise of the basic rate for the last months of 2007 from 13.5 percent up to 16 percent may be explained by the effort to reduce the consumption of population and boost deposits, so that to reduce the inflation (Diagram 7).

Capital and liquidity sufficiency indicators met and even exceeded the NBM norms in 2007. Efficiency indicators reflected by interest rates indicate an increasing improvement. In particular, this has declined much compared with the precedent years, both for national currency and for foreign currency. (Diagram 8)

Diagram 10 Modification of margin of bank operations in national and foreign currencies, percentage points



Sources: NBM

According to estimates, the bank margin in 2007 was 5.07 for foreign currency and 3.84 for domestic currency. In comparison with 2006, it has decreased by 2.05 percentage points for domestic currency and 1.18 percentage points for foreign currency. It declined by 0.03 percentage points for lei and increased by 0.13 percent for foreign currency in 2006, compared with 2005. Thus, the deeper decline of the bank margin in 2007 compared with 2006 is a proof that the competition is intensifying on banking market and available currency is on the rise. Banks focus on promoting the placement of deposits via credits, as deposits are on the rise, especially by individuals.

Thus, the intensified competition imposed banks in 2007 to offer new and diversified products supported by promotional actions. Individuals enjoyed attractive products for consumer credit and mortgage credit. In particular, serving financial necessities via credit card was recently introduced. As for the real sector, the banking sector targets at small and medium business, especially farms and businesses in rural areas. This segment is a sector of interest with an increasing potential and competition for banks, being already served by non-financial institutions.

Insurance

Premiums collected by insurance companies in 2007 are worth over 690 million lei, which is a rise of about 25 percent compared with 2006. According to data of the National Commission of Financial Market, the highest rise of over 38 percent was achieved for the optional life insurance, followed by optional estate insurance – more than 32 percent. So far, premiums raised from mandatory insurance were the main source of activity for many insurance companies, as they increased by over 14.5 percent, compared with the precedent year.

Despite the high growth in relative terms, the life insurance covers only over 4 percent of all collected premiums. This indicator is very low

compared with other countries, especially western states, where the life insurance is the major investment source. Two main reasons of the passive participation of population could be noted here. First, it would be the non-confidence of people or the lack of insurance culture. And second, it would be the low percent offered by insurance companies, compared with bank interests. Insurance companies in Moldova offer percentage premiums for insurance below 2-4 percent unlike bank interests, compared with western countries, where insurance companies offer percentage premiums by 1-2 percent higher than bank interests. This situation indicates future possibilities to attract population in the insurance market more actively and there are two ways to do this. One way would be a more intensive work of companies by elaborating new and more attractive products and informing/educating population more actively. Another way would be to introduce private mandatory insurance, which is a recent practice in Romania.

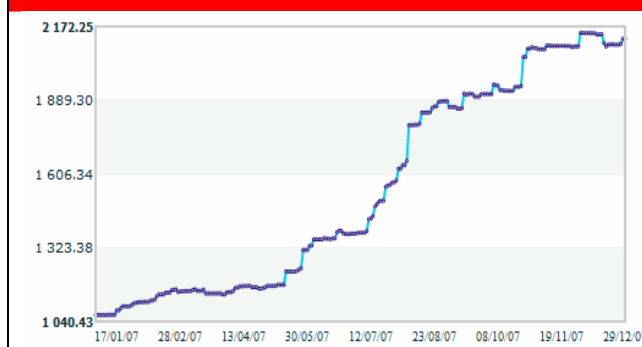
The Government has taken actions on insurance market to concentrate it. Under the new law, the statutory capital must be at least 4 million lei. Fourteen out of 33 certified companies respect this norm at present. The new law aims to enhance capacities of insurance companies to handle insurance-related risks.

Capital market

The securities market has undergone dynamic changes, both as quantity and quality indicators. Transactions on capital market were worth over 1.25 billion lei in 2007, and the Estimator-VM indicator has essentially grown (Diagram 9). The interactive market registered transactions worth over 627 million lei. But interactive operations and deals based on tender offers of bank shares had the greatest contribution to exchange transactions. In particular, the sale of shares in 3 banks, Mobiasbanca, Unibanc and Moldova-Agroindbanc, was the subject of exchange transactions worth over 937 million lei, which is 76 percent of all deals. Other stocks that raised interest on exchange market belong to the food and processing industry.

In general, the capital market achieved a threefold growth of transactions in 2007. According to data of Estimator-VM Agency, the exchange capitalisation volume reached 13.3 billion lei. However, it is too early to describe this growth as a strengthening of the exchange market. The exchange market must be nourished from open share issues, while issues on Moldovan market were rather closed. However, shares in 294 companies were purchased on the exchange market last year, compared with 180 companies listed in 2006. At the same time, more than half of shares were transacted for a higher price than the nominal one. In 2006, the number of such securities covered one forth of all transactions.

Diagram 11 EVM exchange indicator



Sources: Estimator VM, www.evm.md

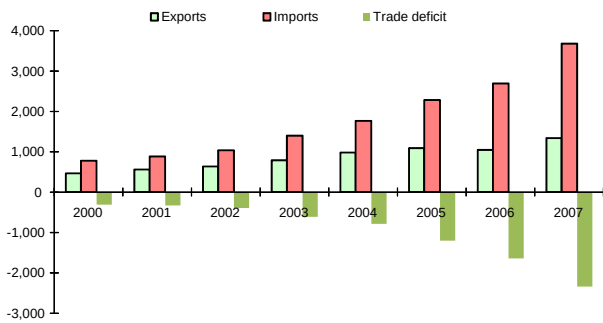
The last month of 2007 was advantageous enough for the Stock Exchange of Moldova (SEM), especially on interactive and auctioning segments. Sale of securities in stock societies in interactive regime and stagnation of exchange prices for shares in several banks were specific in the period concerned. However, a greater interest for non-bank corporate shares such as food industry, processing industry and especially building industry is expected in 2008.

Foreign trade

The foreign trade achieved important evolutions in 2007. Some of these evolutions continue the trends observed in the past years, others reflect latest changes.



Diagram 12 Evolution of exports, imports and trade deficit (commodities and services)



Sources: Estimator VM, www.evm.md

Firstly, the trade deficit continues to grow. It rose by 43 percent in 2007, compared with 2006, up to a record level of 2.348 billion dollars. Thus, exports have grown slower than imports, in particular, by 27.6 percent and 37 percent. This discrepancy is explained as follows:

- High internal demand for consumption and investments fuelled by remittances by Moldovan emigrants, foreign direct investments and bilateral and multilateral assistance. Besides direct effects on consumption, they influence the exchange rate, increasing much the supply of foreign currencies on domestic market and supporting the appreciation of leu. In addition, some of imports are made of energy resources, which price was permanently on the rise. Of course, this also boosted the value of imports.
- Low competitiveness of Moldovan exports and external commercial shocks/influences. Firstly, Moldovan exports would have been larger if Russian authorities did not restrict Moldovan wine exports in March 2006. However, the influence of this factor is not so important in annual comparison. Wine exports in particular would have been larger if the accession of Romania and Bulgaria to the EU did not cancel the free exchange and preferential trade regime with these countries.

In general, the introduction of GSP+, wine embargo and the new trade regime with

Romania and Bulgaria have geographically redistributed the Moldovan exports. Thus, the EU climbed to the 1st place and replaced the CIS as main destination of Moldovan exports in 2006-07, though this trend was not so obvious in late 2007,²³ and the resumption of wine supplies to Russia had probably an important influence. The structure of exports has also changed, with agro-food products, drinks and tobacco being defeated by textiles and items as main Moldovan export. At the same time, the share of common metals and animal and vegetal oil in all exports has advanced. But Moldovan exports are being restructured within the limits established in the precedent years, without any significant dynamics as regards competitiveness and diversification of these supplies. In this context, the asymmetrical trade regime between EU and Moldova expected to enter into force in March 2008 may bring maximum benefits unless the competitiveness of traditional exports (and higher shares for some products) grow, as well as will indirectly stimulate the development of other supplies.

Global markets

The **petrol** price has tended to grow and volatility on this market was high in 2007. Thus, prices have advanced from below 60 dollars per barrel in early January up to over 90 dollars per barrel, reaching a record level of 100 dollars per barrel in January 2008. The spectacular price rise was linked to fundamental and speculative factors. At the same time, the tight situation on global financial market conditioned a considerable volatility of prices, particularly starting summer 2007.

But unlike 2006, fundamental factors influenced the petrol prices in 2007, in particular, growth of global petroleum consumption and "weakening" of the U.S. dollar, the currency of most petrol deals. At the same time, higher prices were fuelled by factors such as geopolitical tensions around the Iranian nuclear file, internal conflicts in Nigeria, bad weather in the North Sea area and Mexico Gulf. In addition, OPEC has often hesitated to intervene on the global petro market

²³ Indeed, exports to the CIS grew faster in 2007 than in 2006.

and raise the petrol extraction quotas, and many experts signal risks related to concentration of petrol deposits in hands of state companies (about 80 percent of the global petrol extraction) because these businesses are less efficient and they are used as geopolitical tools.

Risks related to deceleration of the growth or economic recession in the United States reduced prices in late 2007. Moreover, many analysts anticipate a difficult deficit for the United States and Japan, which consume nearly 30 percent together. The weakening of economic growth paces of the two biggest global economies will affect the global economic growth and will directly reduce the growth of petrol for sure. In turn, the reduction of demand will reduce current pressures on petrol market.

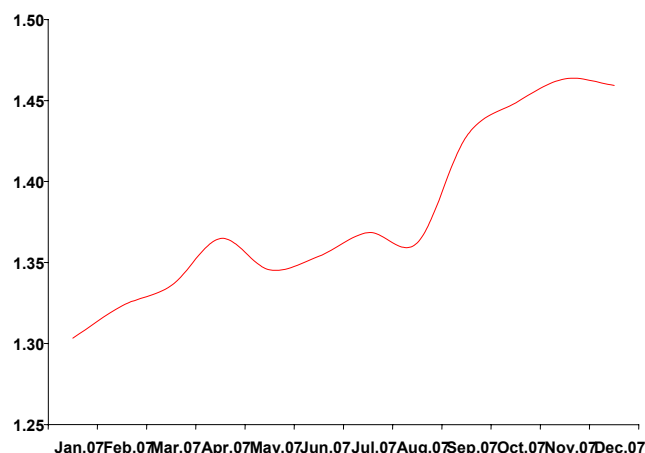
In general, the 'dear petrol' trend will maintain in 2008, but it will be more moderated than in late 2007. However, prices will be volatile and sensible in continuation, both for fundamental factors demand/supply and speculative and political factors.²⁴

Prices on the global **grain** market have doubled in 2007 because of a strong demand over the production level. The supply was adversely affected by bad weather in many producing countries and dearer carriage costs and depreciation of the dollar (the dollar is the currency of many grain transactions). The rise of production will be followed by augmentation of consumption in July 2008 (603 million tons vs. 611 million tons), thus smallest stocks in the past 25 years. Consequently, larger grains fields will be compensated by a higher food consumption and energy production. In these conditions, prices of grains and foodstuffs in general will be high in continuation. At the same time, World Economic Forum experts indicate the low food security as one of the four most serious risks in the world in 2008.²⁵

²⁴ Sources: The Economist, International Energy Agency, Reuters, RBC.

²⁵ Surse: USDA, World Agricultural Supply and Demand Estimates, Wheat Outlook; International Grains Council, Grain Market Report; The Financial Times; World Economic Forum „Global Risks 2008. A Global Risk Network Report”.

Diagram 13 Evolution of euro/dollar exchange rate in 2007



Sources: Rossbusinessconsulting

A clear trend of depreciation of **dollar** versus euro was observed in 2007 (Diagram 11). This evolution was particularly linked with the difficult condition of the U.S. market. Concerns with American economic prospects were on the rise in 2007, but starting autumn 2007 when the gravity of problems became clear, the confidence for the U.S. currency was apparently consumed and the dollar was almost in a freefall. Crisis on subprime market hit other sectors as well, challenging the so-called „liquidity” crisis that affected both American and European companies, etc. At the same time, economic evolutions in Eurozone were generally better than in the United States. Surprisingly, but European companies copped with a forte euro, with exports by main European economies especially Germany growing significantly. The mentioned differences were also observed in monetary policy. While the Fed was constrained between risks of a serious economic deceleration or even recession, the European Central Bank (ECB) was concerned above all with risks of an inflation which was about to get off control. Thus, Fed has reduced the financing rate while ECB decided not to touch the rates, but it was concerned with inflation paces. The dollar was unsurprisingly declining on this background while the last reduction of the financing rate by FED made many observers



think that American monetary authorities were in a slight panic.

Majority of analysts anticipate for the first half of 2008 that the dollar will continue depreciating versus euro, and some even forecast an exchange rate of 1.5 dollars per euro by late March. At the same time, many observers anticipate an eventual consolidation of the dollar by the end of this year.²⁶

Trade partners

Preliminary estimates indicate a spectacular economic growth of 8.1 percent in **Russia** in 2007. This growth rate is higher than expected and the economic growth accelerated in the 4th quarter, given the rise of 7.9 percent, 7.8 percent and 7.6 percent in the first three trimesters. The following sectors have grown the most in 2007: construction (+16.4 percent), internal trade (+12 percent) and manufacturing industry (+7.9 percent). Given the strong decline of net exports, the internal demand was the engine of economic growth in Russia. Thus, the demand for investments (+20.8 percent) and household consumption (+13.1 percent) were the pillars of this growth.

At the same time, the high internal demand supported by a strong rouble encouraged the considerable expansion of imports (+30.4 percent), while exports achieved a very modest rise (+7.4 percent). High rise paces are expected to continue in 2008 and they will be based on a high internal demand in continuation. Russian exports concentrated in gross and processed natural resources will play a minor role, should the global economic growth slow down, affecting the demand for these products.²⁷

The Ukrainian economy achieved an impressive growth of 7.3 percent in 2007. The economic growth was supported by expansion of industry (+10.2 percent) and constructions (+15.8 percent). The private consumption had a very important role, so that the available income has advanced by 12.5 percent in real terms (in

January-November 2007), raising in detail sales by 28.8 percent. The trade deficit is growing in continuation. The internal demand of consumption and investments will be the pillar of economic growth in 2008 and an eventual 'cooling' of the global economic will reduce the contribution of exports to the economic growth of Ukraine. The political life will be market by a stronger race of main politicians with possible risks for economic sector.²⁸

Table 3. Economic indicators of main trade partners of Moldova

	GDP		Industrial production	Inflation	Unemployment
	Updated data	2008, forecast			
Russia	8.1 2007	6.5	6.3 2007	11.9 2007	6.1 12/2007
Ukraine	7.3 2007	6.3	10.2 2007	16.6 2007	7.1 3rdT/2007
Romania	5.8 2ndT/07	5.5	5.6 01-11/07	6.7 12/07	7.0 12/07
Germany	2.5 3rdT/07	2.5	4.1 11/07	3.1 12/07	7.8 12/07
Italy	1.9 3rdT/07	1.5	-2.4 11/07	2.8 12/07	6.0 3rdT, 2007

Sources: The Economist, IMF, World Bank, Derjkomstat, Goskomstat, Eurostat, INS Romania, EXPERT-GRUP

Year 2007 was favourable for the **EU** economy. According to updated data, the economic condition is pretty favourable, with investments and big internal demands supporting relatively high rise paces of industry. Thus, industrial orders (an anticipative index) rose by 11.9 percent a year and 2.7 percent a month in the Eurozone in November 2007. From this point of view, the condition of the biggest European economy, Germany, is very optimistic, as this indicator has grown by 5.1 percent a month. According to statistics, European exporting companies coped with pressures of a forte euro. So, the Eurozone has registered a commercial surplus of 2.6 billion Euros. At the same time, analysts signal some risks concerning the economic growth in the Eurozone: dearer petrol,

²⁶ Reuters, RBC, Global Insight Inc., OECD, The Financial Times;

²⁷ Ministry of Commerce and Economic Development, Institute of Transition Economy;

²⁸ Інститут економічних досліджень (Institute for Economic Research and Policy Consulting), Міжнародний центр перспективних досліджень (International Centre for Policy Studies), Експерт-Україна (Expert-Ukraine).

forte euro and rise of refunding rates by ECB. Also, the 'cooling' of the U.S. economy, the main trade partner of the EU, may have a negative influence on European exports, while the 'liquidity' crisis will impose European companies to restrict the credit access.²⁹

The Romanian economy is on a continuous dynamical rise. According to data for January-November 2007, all sectors have expanded, and thus positive trends are observed in almost all sectors, in particular: constructions (+34.1 percent, January-November 2007), trade (+17.3 percent) and industry (+5.6 percent). At the same time, a trend of deceleration of the growth achieved the last months is observed in industry sector, with the industrial production index decreasing by 2.1 percent in November. Imports continue to grow faster than exports - 18.7 percent vs. 5.9 percent. Such an evolution is first of all explained by a high internal demand and reduction of oil exports and active processing operations, particularly textiles (which indirectly confirms the hypothesis that they leave Romania for Ukraine and Moldova). Forecasts by managers for January-March 2008 are generally positive. However, managers of enterprises anticipate the stagnation of the building sector (general situation, contracts and orders, new jobs) in connection with the approaching cold season and reduction of new jobs in industry sector.

Serious risks for 2008 concern the current deficit account (expected to be higher than 13 percent of GDP) and budgetary deficit. The budgetary deficit is related to the irresponsible macroeconomic policy of the Tariceanu Government and proliferation of 'electoral charity' prior to local and parliamentary elections.³⁰



²⁹ Eurostat, The Economist, RBC, Global Insight Inc.

³⁰ Sources: Saptamana Financiara, Capital, Curentul, The Economist, www.anpc.ro.