



STATE OF THE COUNTRY  
**REPORT**

Republic of Moldova **2016**

 **Expert-Grup**  
Independent Think-Tank

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# **Republic of Moldova 2016**

## **STATE OF THE COUNTRY REPORT**

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# Abbreviations

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<b>ATU</b>	Autonomous Territorial Unit
<b>BPP</b>	Barometer of Public Opinion
<b>CHIBID</b>	Chisinau Interbank Bid Rate
<b>CHIBOR</b>	Chisinau Interbank Offered Rate
<b>CPI</b>	Consumer Price Index
<b>CTEM</b>	Cuciurgan Power Station
<b>DCFTA</b>	Deep and Comprehensive Free Trade Area
<b>DPM</b>	Democratic Party of Moldova
<b>GDP</b>	Gross Domestic Product
<b>EG</b>	Expert-Grup
<b>EPPM</b>	European People's Party of Moldova
<b>EU</b>	European Union
<b>IPP</b>	Institute of Public Policies
<b>LDPM</b>	Liberal Democratic Party of Moldova
<b>LP</b>	Liberal Party
<b>NAC</b>	National Anticorruption Centre
<b>NBM</b>	National Bank of Moldova
<b>NBMI</b>	National Bureau of Motor Insurers
<b>NBS</b>	National Bureau of Statistics

# Key Messages

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**The Republic of Moldova is currently celebrating 25 years of independence, while at the same time it is entangled in one of the most acute crises in its short history.** The period of 2015-2016 was marked by a series of shocks manifested in the decapitalisation of the banking sector by about 12% of gross domestic product (GDP), bankruptcy of three banks that accounted for one third of the banking system assets, reduction by one third of foreign exchange reserves, depreciation by one fourth of the national currency, double-digit inflation and an increase in the state debt. In addition, development partners have either frozen or cancelled their financial support, which has fast-forwarded severe budget austerity. Nevertheless, in spite of the many pessimistic forecasts, the Republic of Moldova has stayed relatively stable and functional as a state: the most important social obligations have been met, and salaries in the budgetary sector have been paid, as have the state debt-related payments. In addition, inflation returned quite quickly back to the level targeted by the National Bank of Moldova (NBM), and the banking sector has remained, in general, relatively stable. Thus, despite the negative shocks, Moldova managed avoid a fully-fledged systemic catastrophe (e.g. state bankruptcy, collapse of the national currency, massive bank-run, or a long period of hyperinflation). The main reasons for this were the harsh monetary policy tightening, budgetary austerity, but most importantly the abundance of liquidity and high level of foreign exchange reserves before the crisis. Therefore, this crisis has showed, paradoxically, how rich Moldova was before, given the high levels of reserves, and how poor it has become, after these reserves drained out.

**After the economic, currency and banking shocks of 2015–2016, Moldova has become more vulnerable than ever.** Although the authorities have kept the

country afloat and managed to dodge a systemic catastrophe, the Republic of Moldova no longer has a safety airbag of the kind that cushioned the 2015–2016 shocks. Therefore, the case of the “stolen billion” is not related only to the decapitalisation and failure of three important banks, the meltdown by about one-third of foreign exchange reserves and an increase of the state debt, but also it significantly affected the country’s economic and financial security, which has made Moldova more vulnerable to a wide range of fiscal, currency and social shocks. In particular:

- the low level of foreign currency reserves limit considerably the NBM’s room for manoeuvre in the case of potential currency shocks;
- the large budget deficit limits the Government’s room for manoeuvre in mitigating potential fiscal shocks, whereas the recent increase in the state debt could even fuel a risk of default in the case of a severe economic recession or a massive migration of production to the informal sector;
- last but not least, the very low level of trust in the Government on the part of the population could stir up social anger to dangerous levels if the Government commits similar errors to those that fuelled the current crisis.

**Currently, Moldova’s economic growth is anaemic and this could last for at least five years.** This has mainly been caused by decreasing consumption, which has traditionally driven the country’s economic growth, whereas no alternative sustainable sources of growth (exports and investments) have been activated yet. The transition to a new economic growth model is even more cumbersome given that the country’s reputation will remain tarnished for

a long period in the eyes of foreign and local investors. The considerable increase in the out-migration of highly educated persons – a trend that has recently become more visible – will also harm even more the competitiveness of the Moldovan economy, depriving it not only of labour force, but also of human capital. Thus, in the context of weak domestic demand, investors' reticence, budgetary constraints and brain-drain (the draining of the driving force of innovation and progress), we expect GDP to grow only by an average of 1%–3% in the coming years. While this could be an acceptable level for developed countries, this is considered to be very low for Moldova, which needs to grow by about 7%–8% to catch up with the countries in the region within a reasonable period of time.

**The fundamental cause aggravating Moldova's economic condition is linked to major governance failures in the recent years.** The negative shocks caused by difficult economic conditions in the region and severe drought were aggravated by the Government's incapacity to prevent bank frauds, as well as by billing the cost of these frauds to its citizens. As a result, the perception of endemic corruption and state capture by obscure interests has become omnipresent in the civil society and private sector. This has also been fuelled by the perception of a democratic deficit, which impacts the current governance model. This has created the impression – which is well-founded as a matter of fact – that, in addition to the key decision-making powers in the state (Government, Parliament, Presidency), which are elected in a democratic fashion, an additional and much stronger decision-making power exists: the governing coalition. In this context, the democratic deficit is particularly related to the fact that the activity of this governing unit is not transparent, is unpredictable and is not subject to the principles of democratic accountability (the “checks-and-balances” principle). This has fostered a strong feeling of distrust among the population and among businesses, which has reduced investment and has caused a new migration outflow of the skilled workforce (the “brain-drain” phenomenon).

**The democratic deficit is mirrored by the growing distance between the Government and the society.** This is revealed by the increasing mismatch between the Government discourse and the perceptions of the population. For instance, the Government has reported that the first Millennium Development Goal (eradicate extreme poverty and hunger) has been achieved, but according to the perception of the population the level of poverty has increased over the last 10 years. At present, 42% of the population are worried about poverty, 37% of Moldovan

families regard themselves as poor, and 41% believe that their income is enough only to cover their basic needs<sup>1</sup>. The same disparity – which increased even more during 2015–2016 – can be observed between the dynamics of the GDP in constant prices and the perception of the population about Moldova's economic situation<sup>2</sup>. This undermines the efficiency of public policy and decreases even more people's trust in Government, which creates a vicious circle that can be broken only by changing fundamentally the operation of public institutions. As a result, the majority of the population does not trust the Government, which, amid the difficult economic conditions, fuels strong incentives for tax evasion – an issue that is especially acute nowadays, given the fact that it is planned for the budgetary deficit to exceed the threshold of 3% of GDP in 2016.

**On the positive side, the confidence crisis in public institutions can be turned into an opportunity for a Government that is willing to revolutionize the governing mechanism.** Under such circumstances, the population expects the Government to implement real reforms and revolutionary measures – no exaggeration is implied. This can present a real opportunity for the Government in regard to proving that it can be different than the previous governments (in a good sense). Thus, the crisis of trust in public institutions can be overcome only if the Government proves as clearly as possible its desire and capacity to promote systemic reforms. The reforms that need to be addressed as soon as possible are also those that have been most often talked about and the implementation of which has taken far too long during recent years. Given the constraints related to time, resources and capacities, we emphasize four areas of reform. The first one is about enabling the private sector, which is seen as the main energizer of the sustainable economic development of Moldova. The other three are considered to be the most vulnerable areas that need to be addressed by urgent policy measures and that could trigger other sectors.

- **Reform of the economic policy model.** The whole range of economic and fiscal policies must encourage investment, exports and innovation. For this purpose, it is necessary to strengthen the justice sector to ensure better protection of property rights (including intellectual property) – the key element without which it is impossible to imagine a modern and robust economy. In parallel, the authorities must pursue the objective of turning Moldova into the country with the most business-friendly environment in Central and Eastern Europe. This could be done by implementing on a

<sup>1</sup> Barometer of Public Opinion, April 2016, Institute for Public Policy.  
<sup>2</sup> Barometer of Public Opinion, Institute for Public Policy.



large scale customer-centred public services, using ICT solutions, optimizing and strictly regulating state inspections, reducing the number of permissive documents, developing a new tax code that leaves no room for abusive interpretation and that will encourage investment and innovation, increasing transparency of decision-making and involving the private sector in decision-making to a greater extent. These measures do not require significant financial costs and are relatively simple to implement, considering the support provided by development partners for this purpose and also the small size of Moldova. The main requirement is therefore merely a firm political will.

- **Reform of the public administration.** We cannot expect credible reforms from an unreformed Government. Accordingly, the reforms must begin within the civil service as the quality of public policy and services, and of the overall act of governance, depends on the quality of the civil service. The Government recently approved the Public Administration Reform Strategy, and the Prime Minister announced publicly several times a commitment to implement this reform. Such initiatives are welcome and it is worth mentioning that this reform is not only about optimizing public institutions or about the number of civil servants, it is also about increasing their performance, particularly by making the civil service more attractive for talented professionals, by implementing on a large scale information and communication technology (ICT) solutions, promoting meritocracy, minimizing political interference and by actually adopting the Open Government model.
- **Reform of the financial-banking system.** NBM – supported by the key development partners – has al-

ready started an ample reform in this regard. Still, for this reform to have any effect at all, it is important for both the NBM (in charge of regulating the banking sector) and the National Commission for Financial Markets (NCFM) (in charge of regulating the non-banking sector) to be reformed from within. First, both institutions must be more independent in managing human resources and salary policies, so as to develop a more attractive and incentivizing system for top-performing employees. Second, both institutions must enjoy greater political and institutional independence. Third, but not least, they have to communicate with one another and ensure a better coordination of their activity, with a view to strengthening and safeguarding Moldova's financial stability. At the next stage, it will be necessary to create an ample set of measures in the financial banking field, with a focus on improving corporate governance within banks and non-banking financial institutions, regulating with greater prudence excessive exposure to risks and their management, improving the legislation regarding the settlement of financial crises and developing a financial stability institutional framework where NBM would play the central role, while NCFM would play the role of the NBM's key partner.

- **Reform of the state-owned enterprises (SOE) sector.** The reform should be based on two strategic priorities: (i) downsizing the share of the SOE (privatization) in the case of SOEs that do not perform well and/or SOEs that compete with private enterprises and, in this way, undermine the competition framework and create entry barriers for private companies; and (ii) improving the transparency and corporate governance in the remaining SOEs.

# Executive Summary

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## Special Issue: Is the Financial Non-Banking Sector Exposed to Similar Crisis as the Banking one?

After the banking fraud that turned into the failure of three important banks, currency depreciation by about one quarter, monetary and budgetary austerity and economic recession, the policy-makers should focus on preventing similar shocks happening in the financial non-banking sector of Moldova.

The financial non-banking sector, in normal circumstances, is an essential component of a functional economy. On the one hand, it fulfils a series of important functions, such as ensuring firms sufficient working capital and long term investment finance (via both the banks and the capital market); ensuring an efficient payments mechanism; insuring against risks (the insurance sector) and providing credit and other financial services to those who cannot so easily be financed by banks (e.g. microfinancing). At the same time, this sector, normally, functions as an accumulator of households' and firms' savings (bank deposits; public placements securities, capital market transactions, investment and pension funds, life insurance etc.).

Unfortunately, in Moldova, the functionality of the financial non-banking sector is limited, while its component of savings' accumulation is almost non-existent. The key issues which the non-bank financial market struggles with are the following: a weak regulatory framework, slow implementation of the new legislation, issuers leaving the capital market and their low interest in registering with an orga-

nized market, the unclear statute of the central depository and of independent registrars, the use of non-bank financial market mechanisms when dealing with major frauds and risks related to the activity of the National Bureau of Motor Insurers (NBMI) and Moldova's right to issue green cards (international motor insurance certificates). All these issues pose a major threat to Moldova's financial stability and should be addressed by proper and urgent actions. Otherwise, the financial non-banking sector could easily find itself facing a similar crisis to that which has hit the banking sector.

## Economy

The key economic indicators for 2015–2016 confirm that the Republic of Moldova is going through a deep and complex economic crisis. This is manifested, first of all, in the form of an economic stagnation that is determined, for the most part, by the failure of the remittance-based model, by the effects of financial fraud, the gross errors of the economic policy and the difficult economic conditions in the region. The GDP growth went from plus 9 percent in 2013 to negative in 2015 and to moderately positive (1.8 percent) in the first half of 2016. The second element of the crisis is related to loans: banks have severely limited the access to investment resources and have taken measures to make sure they have enough cash funds available. Against the background of feeble consumption demand, this makes it even more difficult for companies to create productive capital. The major issues that the Government has to cope with in its attempt to meet its current financial obligations prove that the crisis includes an important fiscal component. The financial sector crisis is the last and the most toxic ingredient of the crisis that

has been encountered by Moldova. It affects both banks and insurance companies, and two of its key features are a lack of people's trust, on the one hand, and a lack of transparency in this sector, on the other hand. This crisis needs to be addressed by demanding the remediation of assets, restructuring of liabilities in banks under NBM supervision, an independent assessment of the NBM's activity during 2011–2015, exemplary budgetary discipline by the Government, as well as preventing the materialization of new risks to the public budget, particularly those triggered by state-owned enterprises and the Transnistrian energy debt.

## Labour Market and Social Well-being

The key labour market indicators – employment rate, unemployment rate, underemployment rate – improved during 2015–2016. However, this improvement was accompanied by a worsening quality of employment, with many employees migrating from salary-based jobs to jobs with uncertain remuneration and working conditions, self-employment and unremunerated agricultural work within their own household. To put it in other words, the labour market is getting more informal, which is bad news both for the well-being of the employed population and for the fiscal soundness of the state budget. In 2014–2016 we saw a dynamic improvement in the poverty indicators. In particular, the incidence of absolute poverty decreased to less than 10%, whereas extreme poverty (food poverty) was practically eradicated. However, these “objective” accomplishments cannot hide the general discontentment of the society with the current socio-economic situation, the ludicrously low level of people's income and the acute vulnerability of families exposed to possible shocks. This report shows that this ever increasing gap between the objectively measured degree of poverty and the day-to-day experience poses major risks. The rehabilitation of the socio-economic situation must include, thus, a conceptual review of the official poverty estimation methodology. Ideally, this review should provide for the transition from the estimation of poverty on the basis of “basic needs” to an estimation on the basis of economic and social integration and reduction of vulnerabilities.

## Human Capital

The state of the country's human capital has suffered throughout the entire transition period of the Republic of

Moldova, and the reforms launched in the past years are still not producing results. The gap between the supply of the educational system and the demand in regard to the labour force remains significant. In the World Economic Forum ranking, the Republic of Moldova scores 3.09 out of 7 points for the “Ease of finding skilled employees” indicator. Moreover, the share of overqualified employees has decreased over recent years, while the share of underemployed employees has increased. This reveals both the weaknesses of the educational system and the distortions in the labour market, which is unable to attract and retain human capital. According to the World Economic Forum index for “Country capacity to retain talent”, the Republic of Moldova scores only 1.88 out of 7.

The economic and political situation in the country has made this situation even worse. Meanwhile, the recent external developments, especially in European countries that are facing rising unemployment and the refugee crisis, represent additional risks and challenges for the Republic of Moldova. Nevertheless, on the positive side, the Republic of Moldova is in the close proximity of the European Union (EU) — a knowledge-based economy, which offers many opportunities for human capital development. This requires a higher degree of flexibility in the educational system, so as to respond promptly to the needs of the economy, connecting educational policies to the trends, opportunities and current risks affecting the economy of the Republic Moldova, promoting talented and competent people in civil service positions, increasing teachers' salaries and promoting creativity throughout the educational cycle.

## Energy Efficiency

Moldova imports a large part of its energy resources, and the unstable situation in the region is a risk for the domestic energy sector. Russia is the main gas supplier for Moldova, while Ukraine is both the transit country for Russian gas and an electricity supplier. Due to the tense relations between Russia and Ukraine, the electricity supply to Moldova is endangered. The Transnistrian authorities can always use “electricity blackmail” in their relations with Chisinau. Moreover, the rather unfriendly relations between Tiraspol and Chisinau could cause a blocking of the supply of electricity from the Moldovan Power Station on the right bank of Nistru River. In this context, the “energy case” cannot be ignored, and the Moldovan authorities should begin looking for a solution to this bundle of challenges.

## Domestic and Foreign Politics: The “Captured State” Getting Stronger, and its Implications for National Security

The monitored period was defined by a major collapse in public support for the Government and by the re-strengthening of the opposition that is supportive of the western development vector. The political changes within the country were triggered by the “captured state” phenomenon, which is growing ever stronger, and, consequently, by the society’s swelling spirit of protest. The Reform Agenda – relaunched by the Government and directed by the Democratic Party of Moldova (DPM) – was looked at with distrust by the civil society and by the foreign partners, even though progress was registered in certain areas. The implementation of the EU Association Agreement progressed, but there is a set of systemic issues that create obstacles to its effective implementation. The legitimacy crisis that the central authorities have been plunged into favoured a stronger rivalry between the regions (ATU Gagauzia) and the centre, and also the strengthening of Tiraspol’s positions within the “5+2”

negotiations. The initiatives that the Russian Federation launched during the monitored period (such as the “road-map” aimed at resuming trade relations) have targeted the strengthening of ATU Gagauzia’s and the Transnistrian region’s positions in their relations with the Chisinau authorities. The end of the “romantic” approach to the Chisinau–Brussels relationship, which was characteristic of the 2009–2014 period, helped increase the visibility of the EU. However, this has not brought about any radical changes in terms of people’s geopolitical preferences, with the Russian and Eurasian vector being more popular than the pro-European one.

The turbulence in the political field – both at the domestic and foreign levels – worsened the risks in regard to the security of democratic institutions and national security: (i) they eroded democracy and undermined statehood; (ii) they aggravated hotbeds of instability across the country; and they caused (iii) impediments to European integration. Several measures are recommended to prevent and/or minimize the impact of the identified risks. These include: (a) ending the “captured state” phenomenon; (b) resuming the dialogue between the central authorities and the regions; (c) strengthening the European agenda; and (d) intensifying the security policy.

# Special Issue: Is the Financial Non-Banking Sector Exposed to Similar Crisis as the Banking one?

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Compared to the banking sector the non-bank financial sector is fraught with even bigger systemic problems, including faulty oversight, poor transparency of the beneficial owners and flawed corporate governance in many institutions. This sector is thus vulnerable to fraud and crises similar to those that have hit the banking sector. Even though the non-bank financial sector is much smaller than the banking one, many banks are highly exposed to non-bank financial institutions, which may multiply any crisis in this sector. This chapter introduces the key vulnerabilities of the sector and identifies practical recommendations to increase its resiliency to negative shocks.

## How big is Moldova's non-bank financial sector? What structure does it have and why is it so important for Moldova?

**The Moldovan non-bank financial sector rests on three major pillars that are heterogeneous and whose trends are sometimes contradictory:** (i) the insurance sector, (ii) the microfinance sector (savings and loan associations and microfinance institutions), and (iii) the capital market<sup>3</sup>.

**The most important component of the non-bank financial market is the insurance sector.** As insurance

<sup>3</sup> At the same time, there are no significant life insurance products, pension programmes, or active pension funds.

services are widely spread and some of them are mandatory the participants in this market have constant and relatively stable revenues. Thus, the value of insurance premiums received by companies in 2013–2015 increased from Moldovan Leu (MDL) 1.19 billion up to MDL 1.23 billion. Although the value of the premiums was going up, they grew more slowly than GDP. As a result, the share of insurance premiums in GDP decreased from 1.19% in 2013 to 1.01% in 2015. Overall, the market penetration of insurance services is comparatively much smaller than in developed economies. Thus, the average rate of market penetration of insurance services in EU Member States was of 8.2% in 2014 (compared to 1.07% in Moldova).

**The microfinance sector consists of two categories of business entities:** (i) savings and loan associations, and (ii) microfinance institutions. They have both experienced robust growth during recent years. Their activity is particularly focused on small and micro loans – a segment where the competition with commercial banks has become strong (in 2015, loans granted by microfinance institutions represented 21.8% of total bank loans)<sup>4</sup>.

**The local capital market is affected by a set of negative factors that have not allowed it to turn into a real source of investment for business entities.** Unlike the insurance and microfinance sectors – which have grown every year – both the primary and the secondary security markets have experienced sporadic development. Thus, the primary securities market had a share of 1.12% of the GDP in 2014, but only 0.18% in 2015. The turnover on the secondary securities market registered its largest share in 2013, 1.7% of

<sup>4</sup> This indicator used to be even lower, as currently the lending is curtailed by high mandatory reserves ratio (35% in national currency) and macro-economic uncertainty.

GDP, and the smallest in 2015, 0.53%. Only 39 companies are listed on the stock exchange, and there were no initial public offerings in 2015. Hence, unlike the insurance and microfinance sectors, which could threaten the financial stability of Moldova due to their larger size and exposure to the banking sector, the capital market presents low direct risks.

## The key vulnerabilities of the non-bank financial sector that could jeopardize the country's macroeconomic stability?

The key issues, which the non-bank financial market struggles with, are the following:

### *Weak regulatory framework*

**The National Commission for Financial Markets (NCFM) – the regulatory authority of the financial non-banking sector – lacks the necessary independence and regulatory tools to ensure an efficient regulation of the non-bank financial market.** According to a Constitutional Court ruling of December 2012, any court in the Republic of Moldova can suspend the NCFM's decisions, pending a final court decision<sup>5</sup>. This is a serious violation of the basic principle of regulatory independence and is in contradiction with the best practices of financial market regulation.

**Another issue is related to the NCFM's financial stability.** This has always been a major constraint for the NCFM, given the poorly developed capital market, which represents one of the main sources of the NCFM's incomes (via taxes). The Commission's financial stability has always imposed significant pressure on the NCFM's efforts to reform its supervisory role, limiting its capacity to implement IT tools and fully transit to risk-based supervision. Additionally, the recent turnover decline in the securities market undermined even more the efficiency of its activities. Thus, in 2015 the NCFM's revenues shrank to MDL 12.7 million, from MDL 18.3 million in 2014 (and compared to the MDL 21.2 million initially planned).

**Poor communication and cooperation between the NCFM and the NBM.** Despite the fact that the financial banking and non-bank sectors are closely interlinked (e.g. many non-banking financial institutions finance their activi-

ties from bank loans), the communication and coordination between the institutions responsible for the regulation of each of these sectors is rather poor. This issue undermines the country's financial stability framework and became even more obvious during the banking crisis of 2015.

### *Too slow implementation of the new legislation*

After the Capital Market Law came into force fully (March 2015) radical changes were made to the capital market infrastructure and requirements. This had a significant impact on the capital market, giving rise to the following issues:

- **Issues related to the adjustment of the market participants and infrastructure to the new legal requirements.** The implementation of the new law and carrying out the required adjustment distorts the normal functioning of the market. For instance, during March–August 2015 stock exchange transactions were blocked because the stock exchange and the central depository did not meet the legal requirements. Hence, the law had to be adjusted in order to enable them to resume their activity. The volume of transactions on the regulated market in 2015 was thus the smallest over the entire 2011–2015 period.
- **A large body of secondary legislation has yet to be approved.** The Capital Market Law requires the implementation of a great number of subordinated regulatory acts. Thus, eight regulatory acts subordinated to this law were adopted in 2014 and 11 were adopted in 2015. However, this is not the end of this process. The need to draft such a large volume of regulations (some of which are fundamental for the market's operation) has placed a huge pressure on the law drafting team and has affected the quality of the respective regulations.
- **Some categories of market participants will not be able to meet the legal requirements.** Thus, as at the law enactment date, the central depository was required to increase its capital 31 times during the following 10 years, while the stock exchange is required to do so 44 times. It is obvious that it is impossible to do this with these entities' own resources only – considering the small capital market in Moldova. Therefore, it is necessary to attract additional investment.

In conclusion, besides a set of other general factors that led to the turnover decline in the market (the general economic situation in the country, the restrictive monetary policy, the pessimistic expectations and investors' lack of trust) the implementation of the Capital Market Law and the change

<sup>5</sup> Report of the Financial Stability Assessment for the Republic of Moldova, International Monetary Fund (IMF), released on February 2016.

in the capital market conditions has had a significant and direct impact on the capital market volume.

### ***Issuers leaving the capital market and their low interest in registering with an organized market***

**For many years in a row, the capital market has seen the withdrawal of free floating shares (that have been bought by large investors) and companies leaving the public market by changing their organizational and legal forms.** The Capital Market Law provides for a squeeze-out procedure, meaning that minority shareholders have to sell their shares to the owners of more than 90% of the company's shares. This procedure allows majority shareholders that have reached a particular degree of share consolidation to become the only owners of the company. Although this process is beneficial for the development of joint stock companies (after this process is fully implemented, we can expect a new wave of direct investments and optimization of the joint stock companies' activity), it is very dangerous for the capital market as it could potentially decrease the volume of activity on the market. After the final consolidation of shares, the companies either change their organizational-legal form or are no longer present on the market (because there are no free floating shares, stock exchange transactions are not conducted with small parcels of shares, but only transactions with the company as a whole).

**Another issue, which is somewhat related to the previous one, is that many companies are not interested in participating in the organized secondary market.** Thus, after the stock exchange was reorganized according to the new law, only 38 joint stock companies registered with the exchange. A total of 536 joint stock companies registered with the Multilateral Trading Facility (a transaction platform), compared to 905 companies before reorganization of the market infrastructure. Though this is a natural process, considering the very small volume of transactions in shares and the very few transactions on the secondary market, we could witness in the near future a dramatic decrease in the volume of stock exchange transactions, in the exchange's liquidity and in the possibility of the stock exchange market developing by creating new investment tools.

### ***The statute of the central depository and of independent registrars***

**Over recent years the legislation relating to the central depository has undergone several amendments.**

**Some of these were incoherent and missing a clear purpose.** Thus, a decision was taken to replace the existing depository with two others: one under the NBM, and the other under the Ministry of Justice. These were supposed to keep a record of the shares of banks and companies of public interest, respectively. Later on, it was decided to move the registers of all companies of public interest to one single depository, established under the NBM. Now it has been decided that a new additional law on the Single Securities Depository is necessary to regulate, univocally, its status.

**The situation of the central depository is now unclear because of these contradictory changes.** After the changes were implemented and the depository was established under the NBM the records of property rights on securities are now kept both by independent registrars and the central depository. This separation means that the revenue earned from record-keeping services will be shared among the depository and the independent registrars. After the record-keeping of public companies, which are the largest and, thus, generate the highest revenue from record-keeping and transactions, is transferred, we can expect independent registrars to go into the red. This could trigger the bankruptcy and merger of registrars, as well as companies' migration from one registrar to another, affecting the capital market's stability and predictability.

**These legal amendments failed to resolve the issue of a fragmented market of property rights recording** – there is no one-stop shop for shareholders and they still have to search through the 10 existing registrars and the depository to find out which entity keeps the records of their company. The establishment of a single company for securities record-keeping and depositing would have both resolved the issue of fragmented revenues and would have meant the existence of a one-stop shop for such services.

### ***Use of non-bank financial market mechanisms when dealing with major fraud***

**Several recent examples of major fraud cases prove the importance of a well-functioning non-bank financial market and its infrastructure.** As a rule, one of the key steps of a raider attack is to change the property rights of the targeted company. Sometimes this change occurs outside of the capital market (through court judgments), but in certain cases the market infrastructure and its weaknesses are used for this purpose. For instance, the current investigation of the 2010–2013 period shows that this method was used to change the ownership of sever-

**Table 1. Key Monitored Indicators Relating to the Financial Non-Bank Sector**

	2013	2014	2015
Earned insurance premiums, % of GDP	1,19%	1,07%	1,01%
Earned insurance premiums, % year on year (y-o-y)	10,06%	0,39%	2,07%
Capital adequacy in insurance sector, %	102,56%	98,85%	80,69%
Total assets in insurance sector, % of GDP	2,41%	2,31%	2,45%
Total assets in insurance sector, % y-o-y	2,11%	6,95%	15,24%
Total assets of savings and loan associations, % of GDP	0,40%	0,43%	0,42%
Total assets of savings and loan associations, % y-o-y	20,75%	19,81%	7,17%
Capital adequacy of savings and loan associations, %	36,91%	37,14%	40,40%
Total assets of microfinance institutions, % of GDP	2,50%	2,96%	3,01%
Total assets of microfinance institutions, % y-o-y	32,57%	32,26%	10,80%
Capital adequacy of microfinance institutions, %	53,80%	48,26%	46,41%
Volume of primary market of securities, % of GDP	0,95%	1,12%	0,18%
Volume of primary market of securities, % y-o-y	-14,10%	31,52%	-82,31%
Volume of secondary market of securities, % of GDP	1,70%	1,17%	0,53%
Volume of secondary market of securities, % y-o-y	36,76%	-23,59%	-50,41%

Source: NBS, NBM, Eurostat and authors' calculations

al parcels of shares of Moldova-Agroindbank bank. After gaining control over the bank registrar and access to all of the information about shareholders, several fraudulent transactions were conducted with respect to their shares. Another example of suspicious transactions in the non-bank financial market involves Asito company. A number of persons from this company's management have recently been detained on charges of embezzlement and money laundering (in a total amount of MDL 9.5 million). This came after the company carried out certain actions (alienation of its own immovable property and the immovable property of a subsidiary company) and used this money for purposes unrelated to the company's core activity.

### **Risks related to the activity of NBMI and Moldova's right to issue green cards**

Although the obvious issues of National Bureau of Motor Insurers (NBMI) have now been resolved<sup>6</sup>, the situation is still

<sup>6</sup> During January–February 2015, following a conflict among the shareholders of the NBMI, new management of the NBMI was appointed. Its activity was, however, blocked by a court judgement, at the request of

quite fragile. Therefore, if there are any bad faith participants in the motor insurers market there are many opportunities to sabotage the work of NBMI or to take control over it. For example, if one of the largest insurance companies, hypothetically, stops making payments on the issued insurance policies, the NBMI members will have to bear joint liability for its liabilities, which would force some of the smaller insurance market participants to leave the bureau within a short period of time. Also, during 2015 several newly registered insurance companies applied for NBMI membership. If any of these new companies has a hidden affiliation with some of the companies already existing on the market this would create potentially uncompetitive arrangements on the market.

an NBMI member. During this period, an alternative management of the NBMI concluded deposit contracts with several domestic banks under very unfavourable conditions for the pre-term withdrawal of deposits. In consequence, after the shareholder-appointed management assumed office, it found out that Moldova was not able to pay its tranche of the guarantee fund to the International Bureau of Motor Insurers. As a result, the International Bureau considered several times the possibility of withdrawing Moldova's right to issue green cards and demanded the settlement of the NBMI issues as soon as possible. Eventually, in April 2016, Moldovan insurers' right to issue green cards was suspended, but was then reinstated in May 2016.



## What are the key policy interventions that should be made to strengthen the non-bank financial sector?

**Finalize, as a matter of priority, the implementation of the Capital Market Law.** The drawing out of this process has a detrimental effect on the capital market, on its participants and on investors. It is necessary to accelerate the enforcement of the law and to make sure that the market operates on the basis of the principles of the law.

**Simplify the mechanisms for the IPO of securities, and incentivize their promotion.** The only way to avoid the “closure” of companies and their leaving the market is by ensuring an uninterrupted flow of public offering of securities on the primary market, which would sustain the stock exchange market. Finding ways to ensure this is one of the key challenges facing the capital market regulator.

**Develop a single concept to keep the records of property rights on securities.** As the central depository is still in transition and the relevant legislative process is not yet complete it would be good to reach a systemic agreement with regards to keeping the records of property rights on securities. It would also be appropriate to consider the opportunity of setting up one single entity that would serve as a central depository and registrar, and which would consolidate the registries of all joint stock companies in the country.

**Provide more intervention tools and mechanisms to oversight bodies, particularly to the NCFM.** The events that have occurred on the banking and non-bank financial markets over the past two years have revealed a lack of prevention and immediate response mechanisms for such situations. The needed tools have to be identified and implemented in law. In parallel, the decision-makers from the oversight bodies need to be assigned additional accountability.

**Assess the legislation on insurance and green card motor insurance, with a view to excluding any loopholes that could allow the system to be abused.** The assessment should focus on the legal loopholes previously used by a group of bad faith persons, which created an unprecedented situation, which jeopardized Moldova's capacity to issue international motor insurance certificates (green cards).

**Develop legislation relating to the financial stability of microfinance institutions.** Due to its rapid growth, the impact of microfinance organizations on macroeconomic stability is becoming more and more significant. Despite the fact that these organizations are not attracting deposits, they have accumulated large and permanently increasing exposures on the part of banks. This issue is especially acute in the case of banks with poor corporate governance. Taking into account the fact that many banks have close interlinkages with other banks (e.g. as showed the case of the failed three banks in 2015), a potential failure of some microfinance companies could have adverse implications for a large share of the banking sector. Also, microfinance institutions can be affiliated to banks and can be used by banks for indirect lending in cases where the bank cannot finance directly, which often contradicts the basic principles of risk management.

# Economy

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This chapter assesses the current economic situation in the Republic of Moldova and points out the most important recent trends. It argues that the country is facing a complex economic crisis, which will not be easy to get out of. The chapter ends with a series of strategic recommendations for how to overcome the crisis as soon as possible, and how to minimize its social impact.

## Current Economic Situation: Main Aspects

**Our predictions, stated in the previous State of the Country Report issue, came true:** 2015 was a rough year for the Moldovan economy – according to the preliminary data, GDP shrank by 0.5%. Agriculture, which suffered a heavy climatic shock that was reflected in a 14% decrease in its gross added value, contributed significantly to the GDP decline. The sectors that have a stronger immunity to the whims of the weather did not do much better either: construction and industry grew by only 0.6% each, trade by minus 0.4%, and transport by minus 0.2%. Against this bleak background, the expansion by almost 20% of the gross value added in the financial sector looks more than a little suspicious. Amid an acute credit crisis (see next section) the nature and content of the growth by one fifth of the added value created by Moldovan banks in 2015 remains a mystery, which is probably linked to the financial fraud that took place in the Moldovan banking sector. Thus, if growth in the banking sector – growth which is likely to have been more an accounting result rather than real growth – is omitted we can estimate that the GDP actually decreased by

about -0.8% in 2015. On the side of aggregate demand, the decrease by almost 2.3% of household final consumer expenditure amid accelerating inflation (Table 2), and the decrease by 1.2% of companies' demand for investment goods calls yet another time for a sober assessment of the officially reported growth rate in 2015.

**The GDP decrease in 2015 – even if corrected downwards – may look minor at first sight.** The decrease is indeed “only” around 1%. However, any assessment of this issue should not be so simplistic as to conclude that the situation is not so bad, because such economic shocks cost Moldova not only money, but also time. Considering the huge income gap with other countries in the region, Moldova cannot afford the luxury of a decline or stagnation in its economic growth, or even mediocre economic growth. The strategic goal of the country must be to reach and maintain, over the long term, economic growth rates closer to 7%–8%. Ensuring such a growth rate is the only way to gradually gain back citizens' trust and to slow down (though not stop) the outflow of workforce and human capital. Unfortunately, the indicators available for 2016 show that the country is far from reaching this target. According to our estimations, the GDP increased only by 1.2% in the first half of the year. Exports decreased by almost 9%, the volume of transported commodities decreased by about 12%, remittances decreased by almost 15%, while the volume of contracted construction work decreased by about 9%. The volume of industrial output stalled at the level reached during the first half of 2015. The increase by about 4% in agricultural production is one of the few positive trends in 2016.

**The short-term economic outlook remains uncertain.** An annual increase of 10% or even more in the agricultural sector seems to be already a fact, but this looks like it is

a recovery that is being achieved thanks to better weather conditions, rather than due to organic development of the sector. A helpful leading indicator, recently introduced by the NBS, is the number of construction permits issued by local authorities across the whole country. This indicator decreased by 15% compared to the first half of 2015, both for residential and non-residential buildings, which points to the fact that investors are very cautious. The balance of loans in the economy continued to shrink during the first half of the year (by almost MDL 1 billion during the first six months), while the interest rates went up, which is sign of unfavourable economic expectations on the part of the commercial banks and of more restricted access to loans. While in 2015 some big foreign-owned companies made quite large investments, this year – given the rather complex electoral context – foreign investors did not announce any major investment programmes (except for a merger and acquisition transaction in the telecommunica-

tions sector). Thus, our economic growth forecast is quite conservative for this year, with a target level ranging being between +1.0 and +2.0%.

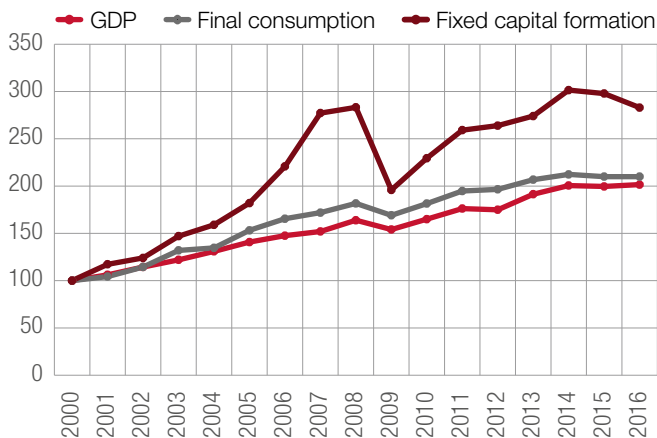
**The risks that might affect this forecast have a rather top-down orientation.** The internal risks originate mainly from the financial area – several banks are encountering financial troubles because of granting loans under fraudulent conditions, as well as the lack of trust from the population and from foreign lenders because of the lack of ownership transparency. The lack of external budgetary assistance could lead to tighter budgetary conditions for the Government and drastic rationalization of public procurement and public employment. At the same time, given the high stakes of the 2016 Presidential elections, for the Government, it is unlikely that any arrears will be accumulated for budgetary salaries or social benefits. One of the greatest external risk is related, of course, to the higher

**Table 2. Key Economic Indicators**

	2013	2014	2015
GDP, y-o-y change, %	9.4	4.8	-0.5
Agricultural production, y-o-y change, %	39.1	8.6	-13.8
Industrial production, y-o-y change, %	6.8	7.3	0.6
Volume of services provided, y-o-y change, %	6.0	3.6	1.2
Volume of construction work, y-o-y change, %	5.1	1.0	0.6
Household consumption, y-o-y change, %	6.5	2.9	-2.3
Gross fixed capital formation, y-o-y change, %	3.3	10.1	-1.2
Foreign direct investments, net inflow, % of GDP	2.7	2.6	3.5
Exports of goods and services, % of GDP	43.8	42.1	43.3
Imports of goods and services, % of GDP	81.5	79.8	74.2
Consumer Price Index (CPI), y-o-y change, %	4.6	5.1	9.7
Total bank loans, % of GDP	40.3	36.6	31.2
Unemployment rate, % of the economically active population	5.1	3.9	4.9
Employment rate, % of the population over 15 years of age	39.3	39.6	40.3
Current account/GDP, %	-6.6	-8.0	-5.7
Budget deficit/GDP, %	-1.8	-1.7	-2.2
Average interest rate on bank loans, %	12.3	10.6	14.1
Average interest rate on bank deposits, %	7.2	5.7	12.1

Source: NBS, NBM and authors' calculations;

**Chart 1. GDP, final consumption and fixed capital investment indices, 2000=100 percent**



Source: NBS and EG calculations;

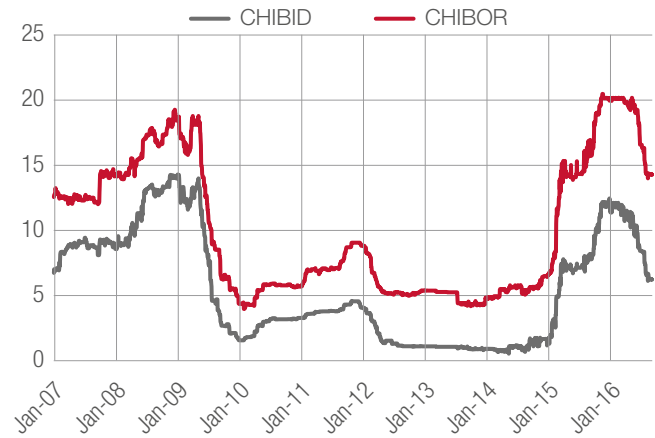
than expected decrease in remittances. The economic situation in Russia – the main country of destination for the Moldovan workforce – is far from simple, which directly impacts the migrants’ situation. In addition, Russia does not appear willing to withdraw the economic sanctions imposed on Chisinau over the recent years. Ukraine also does not offer promising conditions for Moldovan producers and exporters. On the contrary, the security situation in Ukraine could worsen further and make it more difficult to reach the Russian and Central Asian markets.

## Is There a Crisis? What Kind of Crisis?

**Moldova is going through a complex multi-dimensional economic crisis.** As shown below, this crisis includes a variety of interdependent elements. The blatant political mistakes and financial fraud in the period of 2013–2015 manifest most clearly in three major bank failures were arguably the first causes that triggered the crisis: they immediately materialized into a currency crisis, with a loss of about 30% of the national currency value between November 2014 and March 2015. An acute credit and fiscal crisis followed in 2015–2016. There are, however, deeper structural causes, including the fact that the remittance-based economic growth seems to have reached its natural limits, while an alternative model – a healthier and more sustainable one, based on innovation, imports and exports – has not yet taken root.

**Moldova is experiencing a long drawn-out period of economic stagnation.** This is the first and the most ob-

**Chart 2. Evolution of the CHIBOR and CHIBID Rates for Overnight Bank Placements**

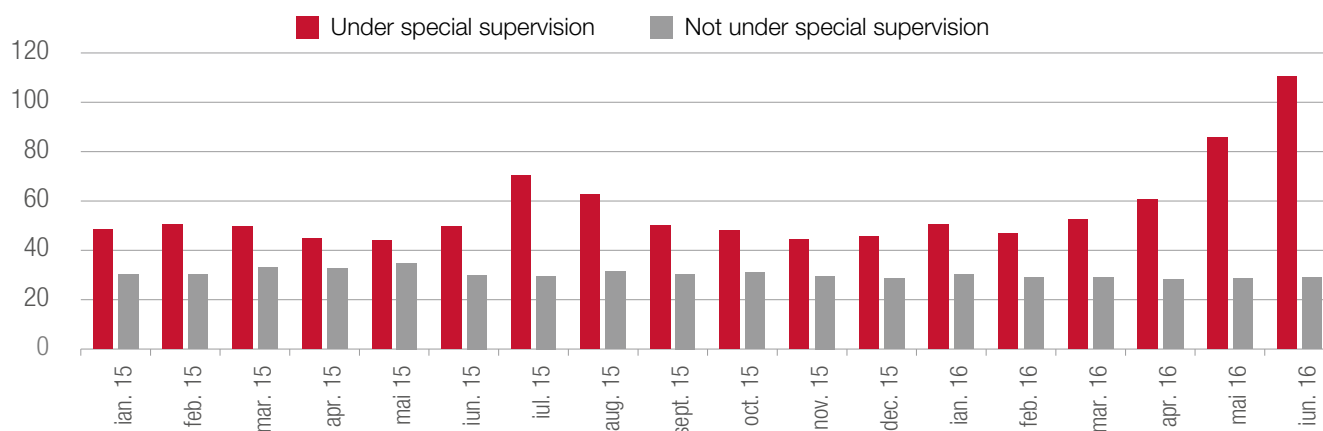


Source: NBM.

vious symptom of an economic crisis. The seasonally-adjusted quarterly GDP statistics series shows that the economy has practically come to a stall, a development that started in the third quarter of 2014. At a systemic level, this stagnation is partially caused by the vulnerability of the agricultural sector to weather conditions and the agricultural supply shock, which impacted the related branches of the economy. At the same time, the aggregate demand has declined. The public administration’s consumption and the demand for investment goods has continued to plummet since the second quarter of 2015. Final household consumption – after having plunged downwards during the second half of 2015 – showed signs of feeble growth in the first half of this year. Exports have continued on a downward trend since July 2015. Given the anaemic domestic and foreign demand, it is of no surprise that economic stagnation has affected a number of other important branches, including mining and quarrying, energy, construction, trade and transport.

**There is also a credit crisis.** During 2015, loans became more expensive and more restricted: the average weighted interest rates on loans granted to businesses increased from 10.6% to 14.1%, while the balance of loans granted to businesses decreased by almost MDL 2.6 billion. In 2016, the interest rate pressure decreased slightly. Nevertheless, they current level of interest rates is still suffocating the economy, while the credit crunch continued, with another decline of MDL 0.9 billion to the stock of loans granted to the economy during January–June 2016. Money became more expensive not only for companies and consumers, but also for banks. After the NBM tightened the monetary policy to protect the official reserve assets, stabilize the currency and abate inflation, the banks

**Chart 3. Evolution of Non-Performing Loans as % of the total Regulatory Capital, by Groups of Banks**



Source: NBM and authors' calculations.

became much more keen to maintain liquidity and much more vigilant, even when it came to mutual lending. The interbank interest rate for overnight placements (and even for longer maturities) skyrocketed, exceeding at times the level reached in 2009 (Chart 2). The spread between offer and bid interest rates increased twice. In June 2015, the interbank market plunged into an anaemic condition and has not yet recovered: there have been a total of nine monthly episodes in which no transactions were made at all. Worried about an eventual liquidity crisis, the banks engaged in a harsh competition to attract medium term and long term placements from the population, as the rates for bank deposits increased from 5.7% in 2014 to 12.1% in 2015.

**Since it is very difficult for the Government to service the state debt and to meet its current financial obligations, we can say that the economic crisis also involves a severe fiscal crisis.** The decision to liquidate the three problematic banks has been delayed for at least one year. That is why the financial guarantees that the Government gave to the NBM have caused a huge public finances gap, despite the fact that they made it possible to “save” almost entirely the bank deposits in the three affected banks, and to avoid a systemic banking crisis. The borrowing costs incurred by the Government increased from the highly favourable level of 4% in October 2014 to over 18% in April 2015, and to over 24% in February 2016. This shift in interest rates is one of the core factors causing banks to reorient their resources from crediting the economy to funding the state. By June 2016, the interest rate had declined to 11%, but this level is still too high, drastically constraining the Government’s capacity to fund public capital investments. If the rates go back to levels

exceeding 15%, and if the Government does not regain sustainable access to external funding to close the budget deficit, the Government may find it difficult to meet even its current expenses. Our estimates show that in 2016 interest expenditures will account for about 5-6 percent of the total budgetary expenditures. If in 2017 the financing conditions are similar to those of early 2016, the interest expenditures may take a total of 8-9 percent of total budgetary expenditures.

**Financial sector crisis.** This is the most threatening component of the current economic crisis, since the other components are more transient. The abuses and frauds committed by banks’ shareholders and managers, and the inappropriate response by the regulator, are the key factors behind the recent liquidation of the three commercial banks. Although the inappropriate oversight function may have been fixed by changing the NBM’s management, the issue of a non-transparent shareholder structure remains, having severe repercussions for the quality of bank management. The other three systemic banks are currently under the NBM’s special supervision. A key indicator of financial soundness, the ratio of non-performing loans to total regulatory capital (TRC)<sup>7</sup>, suggests that the group of commercial banks under special supervision has had much poorer performance and is currently in a much worse situation than the group of commercial banks that are not undergoing liquidation or that are not under special supervision (Chart 3).

<sup>7</sup> Obviously, using TRC as a basis for comparison has certain drawbacks, because the banks under special supervision have disproportionately smaller TRC, if reported to the size of their assets, compared to the rest of the banks. However, the situation does not look better even if we use alternative indicators, such as the balance of non-performing loans in the total loan liability.

## How Can The Economic Crisis Be Overcome?

Key strategic recommendations for overcoming the crisis are prioritized as follows:

- **Request the banks under special supervision increase their capital and restructure their assets.** It may also be necessary for the NBM to withdraw its acceptance of bank managers and/or to impose new limits for risky transactions in banks under special supervision that are at immediate risk.
- **Set up, if necessary, a special administration of the problematic banks that are under special supervision.** The delay in setting up a special administration, including due to electoral circumstances, could push some banks into a liquidity crisis or even into insolvency, followed by their forced liquidation, which would entail consequences for the rest of the banking system and for the economy as a whole.
- **Require independent external assessment of the financial regulators' activity during 2012–2015.** Major supervision and intervention mistakes were made during this period, and relevant lesson should be learnt.
- **Re-assess the shareholders and the management of all financial institutions.** This should be done both for bank and non-bank institutions. It is also necessary to assess the system for regulating and authorizing valuers of assets for the purposes of loan collateral.
- **Ensure budget surpluses or minimal deficits from now on.** The use of Government guarantees to save the deposits in the three banks undergoing liquidation increased the debt servicing costs, hence exemplary fiscal discipline will be required in order to repay the debt. It is true that a deficit of 2-3 percent of GDP may look minor in comparison to European countries. The key difference is that Moldovan government is seen as a risky borrower; therefore, even small deficits may be very costly.
- **Prevent the accrual of quasi-fiscal debts.** The Government should abstain from the political manipulation of tariffs in public entities and should professionalize state-owned enterprise management. It is also necessary for the Government to identify a legal strategy that would prevent in the future the transfer into the national budget of the debt for energy resources accumulated by Transnistria.

# Labour Market, Income and Social Well-being

This chapter indicates that employment indicators have somewhat improved, while the quality of occupations worsened in 2015–2016. Stemming from the ever-growing discrepancy between statistics and subjective perceptions, this chapter criticizes some aspects of the official methodology for poverty assessment.

## Analysis of Key Developments and Trends

**At first glance, employment does not match the economic activity in the recent period.** After a skyrocketing unemployment rate in the first quarter of 2015 (8.5%), which increased more drastically than seasonal factors and the economic “climate” would suggest, the indicator then returned to a normal level. In the first six months of 2016, it stood at an average of 4.9%–5.0%, compared to 6.3% in 2015. The employment rate has also experienced some improvement: in the first half of the current year its growth was significant, reaching the level of 43%, compared with 39% in the previous year. The data therefore suggest a continuous downward trend in unemployment and a reversal of the historically negative trend for the employment rate (Chart 4 and Table 3). At the same time, one can notice that the labour market is more fluid, as manifested by an increasing share of short-term unemployment. During 2014–2016, about one third of all unemployed were jobless for less than three months, compared to one fourth during 2010–2013. At first glance, these positive trends do not match with the stagnation in production. The dissonance is even more striking considering the fact that the labour

force emigration decreased to some extent in 2015–2016 (Chart 5), which means that the pressures on the labour market are increasing rather than decreasing.

**Although the employment rate is increasing, employment quality is actually decreasing.** The increase in the total employment is accompanied by important structural changes that have a negative effect. These changes involve a growing share of informal jobs and labour migration towards poorer paid jobs or even jobs without any cash payments. In fact, in the recent 12 months, total employment only grew because of the increase in informal jobs and according to our estimates the share of informal occupations will reach 40% by December 2016 – the same as it was

**Table 3. Key Labour Market and Social Protection Indicators**

Statistical Indicators	2013	2014	2015
Employment rate (%)	39.3	41.2	42.4
<i>Women</i>	37.0	38.6	39.9
<i>Men</i>	41.8	44.1	45.1
Unemployment rate (%)	5.1	3.9	4.9
<i>Women</i>	4.1	3.1	3.6
<i>Men</i>	6.0	4.6	6.2
Real wage growth rate (%)	3.5	5.4	0.7
External migration growth (%)	1.28	2.83	-4.8
Absolute poverty rate (%)	12.7	11.4	9.0 (est.)
Remittances growth rate (%)	35.9	5.2	-9.4
Gini coefficient (expenses)	0.2824	0.2754	0.2579
Nominal average wage RM/ CEE in USD (%)*	37.4	n/a	n/a

Source: NBM, NBS, Eurostat, EG estimates.

**Chart 4. Evolution of the Unemployment and Employment Rate, %**

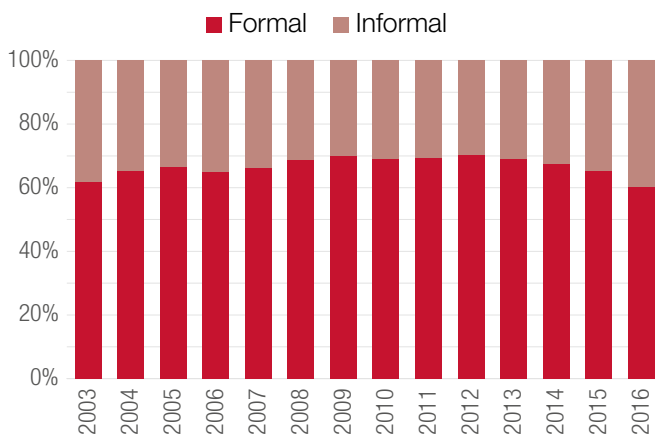


Source: NBS

back in 2003–2004 (Chart 6). The number of employees (as distinct from the self-employed and other categories) decreased constantly during recent years: our estimates show that in 2016 their number will be 10% lower than in 2008, before the global economic crisis. The number of self-employed persons will reach about 380,000 in 2016, while unpaid family workers, i.e. those involved in subsistence agricultural activities, will reach 50,000 in 2016 – an absolute record since 2002. We believe that this flow of the labour force from officially paid jobs to informal and poorly paid jobs is the main factor behind the better employment indicators in the context of a stagnating economy.

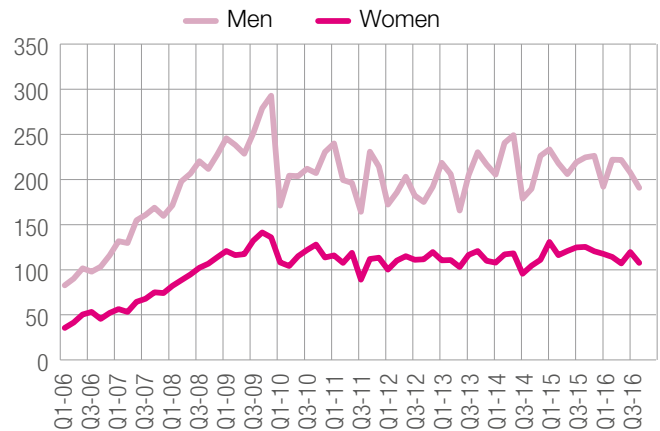
**Thus, the data on people’s income must be considered keeping in mind the worsening quality of employment.** On the one hand, it is good that despite the

**Chart 6. Structure of Employment by Type of Jobs: Formal or Informal, %**



Sources: NBS and EG calculations

**Chart 5. Evolution of the Number of Male and Female Emigrant Workers, thousand people**



Source: NBS

economic recession real salaries increased by about 0.7% in 2015 and by a further 0.1% in 2016. On the other hand, taking into account that the number of salary earners decreased and that the salary is the main revenue source for most families, we can infer that the social and economic impact of the economic crisis is very tangible. At the same time, according to the data available for the first quarter of the current year, the total households’ real income decreased by about 1.5% on average. The higher salaries could not offset the real decrease of income from other sources: income from individual agricultural activity and pensions decreased by 10%, while that from remittances shrank by 3%. At the same time, income from individual non-agricultural activity increased by more than 13%, which, to a certain extent, explains households’ preference for self-employment as a way to supplement the salary income with revenue from entrepreneurial activity. One cannot also overlook the fact that social aid had a major positive impact on poverty.

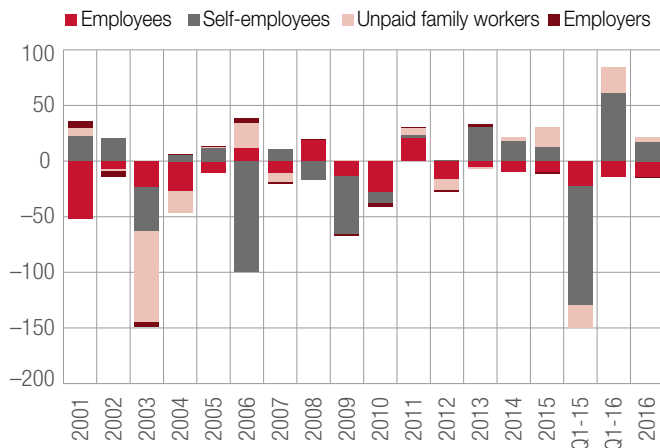
## Has Moldova Eradicated Poverty?

**The statistics reveal a dramatic decrease in poverty, estimated by reference to the national thresholds.**

According to official data, the share of people living under the absolute poverty threshold decreased from about 68% in 2000 to only 11% in 2014, while our estimates, based on the official methodology, suggest that this indicator decreased to about 8%–9% in 2015–2016. As regards extreme (food) poverty, the data show that it totally disappeared (Chart 8). The same goes with the inequality indicators: according to official data, the Gini coefficient of



**Chart 7. Dynamics of the Employed by Type of Occupations, Thousand People**



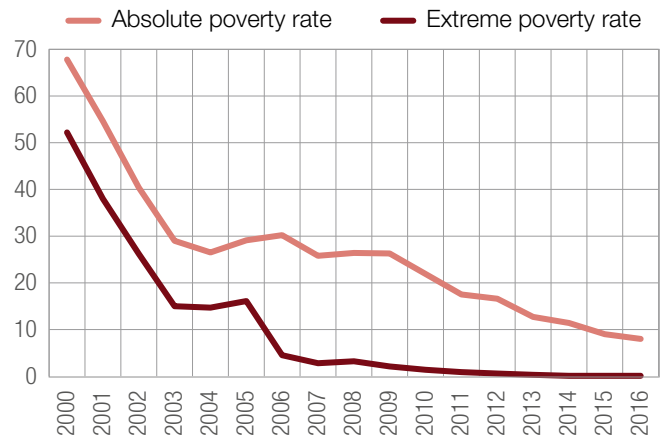
Source: NBS

households' consumption expenditures went from 0,315 in 2006 down to 0,256, thus suggesting a remarkable improvement in the inequality. At first glance, Moldova has achieved a remarkable and, in historical terms, very quick victory over poverty.

**However, the subjective reality contradicts the objective data.** Thus, if poverty is defined as the situation in which the reported income is not enough to meet basic needs then we find that 37% of Moldovan households perceive themselves as poor (Chart 9). We should add here that an even greater number (41% of the total population in April 2016) of those believe that their income is enough only for the basic needs: this is an extremely important indicator because it reveals a high vulnerability to poverty. Even though these two indicators do not compare directly (official indicators assess poverty based on expenditures, subjective indicators do so based on income), we nevertheless cannot neglect the fact that in people's perception during the last 10 years poverty has actually increased, not decreased.

**This gap between the official statistics and people's perceptions generates risks.** The dynamics of the official poverty data during 2000–2016 could foster a false feeling of social comfort and relaxation among politicians. Indeed, Moldova already reported to the UN that the first Millennium Development Goal — poverty reduction — had been successfully achieved (and even exceeded). However, such a decrease in the poverty rate should have been felt in the society, as well, but few Moldovans would confirm that they have such a sense. On the contrary, a number of alternative indicators characterize the Moldovan society as being an impoverished one, including the following:

**Chart 8. Incidence of Poverty at the National Threshold, % of total population**



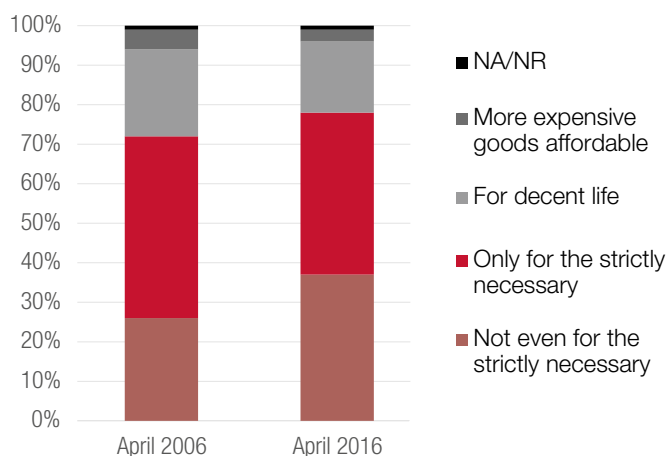
Sources: MoE. EG estimates and forecasts for 2015-2016

- the constantly high share of expenditures for food (about 40%) in the household budgets during the last decade (in Central and Eastern European countries it averages about 25%);
- a significant increase in the number of crimes committed against property: incidents of thefts increased by 33% in 2010–2016;
- the high number of abandoned houses: according to the preliminary data of the 2014 National Population and Housing Census, about 17% of houses are not inhabited in Moldova;
- the decreasing purchasing power of the national currency, which is expressed both in the dynamics of the market exchange rates compared to freely convertible currencies, and in the depreciation of the purchasing power parity. This depreciation limits, especially, wealth accumulation by procurement of financial assets and sustainable consumption goods – real estate, cars, furniture and household appliances.

**The disjunction between objectively and subjectively measured poverty reflects some methodological flaws in measuring poverty.** There are a number of issues that could significantly distort the poverty assessment, leading to its underestimation, as follows:

- Given the preliminary data of the 2014 National Population and Housing Census regarding the total number and structure of the population, and the number of abandoned houses, it is very likely that the sampling technique used by NBS no longer guarantees a representative sample for the Households Budget Survey. If the abandoned houses belong to wealthier households that have emigrated for good (for poor households, permanent emigration would be much more expen-

**Chart 9. Distribution of Answers to the Question “How Do You Assess the Actual Income Earned by your Family?”, %**



Sources: “Public Opinion Barometer” database, IPP

sive), then wealthier households are over-represented in the sample, while poor ones are under-represented.

- As reported by some field operators, the non-response rate among very poor households is much higher than among other households, which could be an additional source of bias and could lead to the improper representation of the poor in the final results.
- The extreme poverty threshold was set in 2006 by calculating the monetary value of the monthly food basket, which should ensure a minimum quantity of calories – 2282 Kcal/day (per adult equivalent). Afterwards, the value of the extreme poverty threshold was updated annually, by using the CPI. Although on aggregate the CPI has increased a bit quicker than the price of foodstuffs, we find that over time this method produces significant cumulative distortions in the picture of poverty. The explanation is that during 2007–2015 the CPI growth (184.5%) was exceeded by the growth of prices for those foodstuffs, which are fundamental for the poorest families, particularly in urban areas: pasta products (204%), rice (233%), milk (221%), butter (200%), eggs (247%), vegetables (202%), fruits (274%) and other foodstuffs (229%).
- Finally, one of the biggest gaps is that the methodology refers entirely to monetary poverty, and does not take into account such extremely important components as social inclusion, effective access to quality public services, etc. For example, how relevant is the estimation of purely monetary poverty rate in an isolated rural

area, where basic public services such as health centres, street lightening and cultural activities are completely lacking?

## Policy Recommendations

To reduce the impact of the economic crisis on people’s well-being, we recommend the following:

- Make efforts to regularize emigration to new destinations, where professionals in construction are in high demand (Israel, Qatar, Kuwait). This will help to redirect part of the migrants from their currently illegal or unregulated status in host countries to more legal statuses and to social protection, and to ensure remittances remain a source of income that stabilises the budgets of Moldovan families for a continued period of time.
- Increase the social aid coverage and targeting, and at the same time ensure a more sustainable transition from social aid to the labour market. Such a transition will help to address the public concerns regarding lack of transparency, integrity and social justice in attribution of the social aid.
- Facilitate the development of extension and rural development services, in order to replace the subsistence agriculture with market-oriented agriculture, thus moving people from the category of “unpaid” family workers to “paid” workers. With the same purpose, it is important to review the agricultural subsidies policy so that small farmers benefit from a higher share of the state aid.
- Conduct labour market forecasts on the basis of mid-term technological prospects and correlate properly the supply of formal, informal and lifelong education.
- Review the sampling and stratification methodology in the Households Budget Survey in order to enhance its representativeness and bring it into line with the results of the 2014 census.
- In the short run, set a poverty threshold that would ensure more robust poverty indicators. Indeed, our simulations show that the increase in the poverty threshold by 10% in 2014 (MDA 1,257) increased the poverty incidence from 11% to almost 16%.
- In the long run, switch from setting the poverty threshold based on “basic needs” to one based on social and economic inclusion, and include in official reports poverty indicators based on self-assessment.

# Education and Human Capital

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The state of the country's human capital is undetermined by the domestic political and economic situation and this is amplified by risks related to the external situation in the region, especially in the European countries. At the same time, the Republic of Moldova is close to a knowledge-based economy, and in the era of information, which sets appropriate preconditions for human capital development. However, such development requires a high quality education and a higher degree of flexibility in the educational system to respond more promptly to the needs of the economy, and to connect the educational policies to the trends, opportunities and current risks affecting the economy.

## Does the Human Capital Meet the Needs of Yesterday or of Tomorrow?

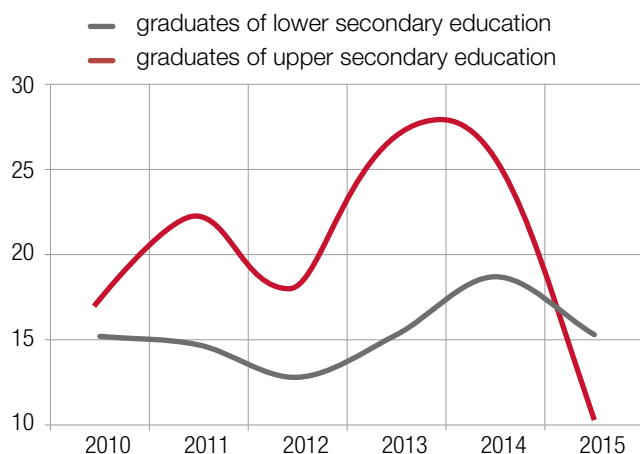
**During the past two decades the human capital of the Republic of Moldova has been affected both by migration and a rigid educational system, disconnected from the needs of the local labour market and of the regional and European economic trends.** Despite the negative impact of migration on human capital, it has provided important sources for private investment in education, which boosted significantly the enrolment in specialized education, in particular higher education. However, the educational system has failed to link this demand to the changing needs of the economy. The reforms in

education are too slow, lagging far behind the economic trends, which are continuously subject to new challenges and opportunities.

**For several years, the relatively high public investment in education ensured satisfactory enrolment rates at different levels of education.** Currently, the decreasing trend in enrolment rates seems to be misleading, due to the calculation of enrolment rates based on out-of-date population data. This has a negative impact on the financing of educational institutions and the rational use of budgetary funds. Moreover, it hampers the quantification of progress, which is very important in the context of the reforms that have been launched, such as school network optimization. Meanwhile, a relevant indicator – the share of lower and upper secondary education graduates who continue their studies in the same year at the following levels of education – reveals that about 14% of lower and upper secondary graduates do not continue their studies, thus remaining without a profession (Chart 9). These are mainly lower-secondary education graduates, where the share reaches 15.3% – mostly young people from socially vulnerable families, who cannot afford continuing their studies and most often engage in agricultural activities as self-employed workers or unpaid family workers.

**Thus, the agricultural sector rescues those who have no other economic opportunities.** In the long run, however, the agricultural sector remains problematic from several perspectives, including in terms of human capital. The Moldovan economy will change as a result of the economic trends in the region, including those due to closer relations with the EU and the signing of the Association Agreement with the EU, which will contribute to the restructuring of the agricultural sector: its modernization, wider use of

**Chart 10. Share of Lower and Upper Secondary Education Graduates, who do not Continue their Studies in the same Year, (%), 2010–2015**



Source: NBS.

agricultural technologies, and reduction in the number of workplaces. In this regard, the high number of people employed in this sector or engaged in agricultural activities represents a real challenge. In 2015, 381,900 people were employed in the agricultural sector, accounting for 31.7% of total employment and 63% of them have not graduated from specialized education.

**Moreover, even in other economic sectors employees' skills do not fully meet employers' expectations.**

Thus, in the latest World Bank Business Environment and Enterprise Performance Survey (BEEPS) survey of 2013, 31.2% of respondents stated that the inadequately educated labour force is a major constraint: a level significantly exceeding the global average and the average for the countries of Eastern Europe and Central Asia. The share is even higher for enterprises in the industrial sector. This indicates clearly the need for reforms in the education system aimed at ensuring high quality education and a higher degree of flexibility in the education system to respond more promptly to the needs of economy, and to connect the educational policies to the trends, opportunities and current risks affecting the economy of the Republic Moldova. These reforms must incorporate several important aspects, including the following:

- *The sectoral analysis indicates a faster growth of the added value in several economic sectors over the last few years, with high potential in the future:* (i) rental of machinery and equipment without operators, of personal household goods; (ii) computing and related activities; (iii) other activities and services provided mainly to enterprises; (iv) disposal of waste and

sewage; (v) civic activities; and (vi) private service activities. Although education policies tend to be based on the current economic structure, they do not provide the necessary correlation between the labour market needs and the already existing supply, in particular the need to retrain the people engaged in economic activities that are in decline. Thus, depending on the skills and knowledge needed for certain sectors, they can be included in the formal or non-formal and informal education programmes.

- *In a small country with limited resources, foreign direct investment is an important source of growth and potential employment.* Thus, the medium and long-term vision of the training needs should consider the areas of interest for potential investors. This refers not only to those sectors where investments already exist, but to the regional and even global trends, to provide as many advantages to investors as possible, including a skilled labour force. Seven priority sectors for attracting investment<sup>8</sup> have been identified in the Republic of Moldova: information and communications, machinery and equipment manufacturing, administrative services activities and support services activities, machinery and spare parts manufacturing, textiles manufacturing, clothes and footwear manufacturing, electrical equipment, the food industry and agriculture. Although the recent policies of the Ministry of Education cover these areas, these policies should be more flexible and should be implemented faster, in order to attract investors within the timeframe covered by the strategy.
- *The private sector is the main beneficiary of human capital and must be motivated to participate in its formation at different stages.* A dual system in vocational training programmes has been piloted recently. The results are expected to materialize in the future. However, the reluctance of many companies to be actively involved in human capital formation is due to the constraints outside the education system, such as low profitability, the cost of corruption and bureaucratic barriers. The removal of these barriers is essential in order to achieve an efficient collaboration between the private and educational sectors.
- *The EU Association Agreement provides opportunities to the Republic of Moldova, but the capitalization of these opportunities depends on the country's human capital.* Implementing the Agreement can qualitatively transform the Moldovan economy. However, this is not reflected in the educational policies so far.

<sup>8</sup> The National Strategy for Investment Attraction and Export Promotion for 2016–2020.

**Table 4. Main Indicators regarding Human Capital Development**

	2013	2014	2015
Share of overqualified employees, %	22.9	21.1	19.5
Share of public expenditures on education in GDP, %	7.0	7.0	6.9
Number of graduates of higher education	24,848	24,274	23,630
Number of graduates of post-secondary vocational education	10,380	9,664	9,220
Number of graduates of secondary vocational education	7,443	6,484	6,252
School dropout rate, %	21.1	21.1	--

Sources: NBS and authors' calculations.

**Thus, the discrepancy between the supply of the educational system and the demand for the labour force remains significant.**

In the ranking of the World Economic Forum, the Republic of Moldova scores only 3.09 out of 7 points for the indicator "Ease of finding skilled employees"<sup>9</sup>, despite the fact that 19.5% of the employed population in 2015 believed that they were overqualified for their jobs (Table 4). Moreover, the share of overqualified employees has decreased over recent years, while the share of underqualified employees has increased. This reveals both the weaknesses of the educational system and the distortions in the labour market, which is unable to attract and retain human capital. According to the World Economic Forum index for "Country capacity to retain talent", the Republic of Moldova scores only 1.88 out of 7<sup>10</sup>.

## Current Opportunities, Risks and Challenges

**The current state of human capital is undermined by the economic situation and by low trust in public institutions, which is encouraging the emigration of talented people.**

Meanwhile, the recent external developments, especially in the European countries facing rising unemployment and the refugee crisis, represent additional risks and challenges for the Republic of Moldova. Nevertheless, the Republic of Moldova is close to the EU – a knowledge-based economy, and is in the era of information, which sets appropriate preconditions for human capital development. The main risks, challenges and opportunities faced by the Republic of Moldova that need to be addressed as soon as possible in order to improve

<sup>9</sup> The Human Capital Report 2016, World Economic Forum. "Ease of finding skilled employees" index gives values from 1 to 7 (1=very difficult, 7=very easy).

<sup>10</sup> The Human Capital Report 2015, World Economic Forum. "Country capacity to retain talent" index gives values from 1 to 7 (1 = the best and most intelligent people leave to harness other countries' opportunities, 7 = the best and most intelligent people remain in their country and harness the domestic opportunities).

the state of human capital in the medium and long term are the following:

- **Teaching has become an unattractive profession.** Teachers are the key elements in preparing human capital at all levels, but this profession has lost its ability to attract professionals. Low salaries in the education system continue to cause the departure of the most talented specialists and a failure to attract new ones, as potential candidates choose other professions. Those who choose a teaching profession are less motivated to participate in training, which often does not meet the society's needs.
- **Unattractive public system for talented people.** The initiation of reforms and their implementation requires talented people with high knowledge levels and skills. In addition to low wages, which demotivates civil servants, civil servants also leave the profession because of excessive politicization of public institutions. Thus, the impossibility of advancing in a public institution and of promoting reforms that do not meet the priorities of the ruling party in a ministry amplifies the dissatisfaction of competent and experienced people, who thus leave the system.
- **Unattractiveness of technical vocational studies.** Despite the reforms that have been promoted for several years, technical vocational education remains unattractive. It offers neither the technical skills required by employers, nor other qualities that employers appreciate in university graduates, such as: flexibility, ability to learn, punctuality, etc. As long as the system fails to provide these skills and competencies, the demand for technical vocational studies will remain low.
- **High share of population without specialization.** The Moldovan economy is likely to evolve due to the Association Agreement with the EU, and the pressure from people with no specialization, who have low chances of employment, will increase. Thus, the need for non-formal and informal education will increase and must be anticipated in advance.

- **Fear to invest in human capital for the long term economic needs.** This fear is evident in educational policies, which are based on today's economic developments: by the time of their implementation these policies might meet only yesterday's economic needs. Investments in human capital must also anticipate the national, regional and sometimes global economic trends.
- **Intensification of intentions to emigrate.** Major governance failures over the last few years have generated a new wave of disappointment, intensifying people's desire to emigrate. Although there are no data confirming the extent of this phenomenon, various interviews show that a part of the educated population emigrates abroad. In the most recent Public Opinion Barometer, 51.7% of respondents indicated that if they had the opportunity they would leave the country forever or for a period, the share being higher for young people and those with a high education level<sup>11</sup>.
- **Correlating, in the medium and long term, educational policies with other economic policies.** Anticipation and the economic priorities in other sectors should underpin the educational policies, which must be very flexible and able to be modified quickly and efficiently.
- **Implementation of dual education and identification of all the leverages that could be used to attract the private sector into consortiums with educational institutions.** Employers' opinions must be taken into account at all stages: developing the curriculum, providing training and monitoring educational institutions.
- **Implementation and continuous improvement of legal framework for the recognition of qualifications obtained non-officially and informally in Moldovan or foreign companies.** This is particularly important in the context of economic transformation and the return of migrants.
- **Promotion of fields of study offering remote work.** Although this is interpreted as a risky step, as graduates may thus find it easier to leave the country, and even if they stay they might not formalize their activity, the long term risks are higher if the population remains untrained or completes irrelevant studies.
- **Re-model the educational system so that it meets the needs of an economy based on knowledge, innovation, and progress.** It seems that the educational system does not contribute to the identification of the skills and talents of participants in education, so that a large part of graduates do not know what they want to do in the future, despite the fact that they have already chosen a field of education based on other criteria<sup>12</sup>. These skills can be identified and developed through interventions (as early as in pre-school and primary education) which involve new ways of learning that stimulate creativity.
- **Openness to assimilating human capital from abroad.** Although this is a sensitive issue, both because of the economic risks and the low level of tolerance in Moldovan society, national policies must take into account this aspect, especially in areas where the lack of educated and skilled human capital is a major constraint for development and progress.

## Policy Recommendations

To address the key challenges and to create new opportunities for training, appealing to and retaining human capital in the country efforts are necessary in several areas, including:

- **Increased efforts to prepare, appeal to and retain teachers in the educational system.** The teaching profession still enjoys respect and prestige in the society, which by default serves as an important motivating factor. However, this may dissipate soon if necessary measures are not taken to ensure a sustainable motivational system for teachers. The logical policy response in this respect should be focused on monetary and non-monetary recognition of the teachers' performances. In the short and medium term, it is necessary to implement new performance appraisal systems and to strengthen the system of teachers' ongoing training. The long term sustainability of these actions can be ensured only by increasing teachers' salaries and developing a system of monetary remuneration for teachers' performance.

<sup>11</sup> Public Opinion Barometer, IPP, April 2016.

<sup>12</sup> "From Aspirations to Occupations: The Role of Information in Educational and Labor Market Decisions in Moldova", World Bank, 2016.

# Energy Efficiency

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Energy security in the Republic of Moldova is jeopardized by constant risks. The deterioration of the political situation in the region is already a real threat to Moldova's stable energy supply. Since the Republic of Moldova has no energy resources of its own, the possibilities for responding to these risks and development are limited. The economy could be seriously affected should energy imports stop. In this context, this chapter sets out the threats facing Moldova's energy security.

## The Energy Security Issue in Moldova

### *The natural gas sector*

**The Republic of Moldova does not have its own natural gas resources and, hence, is a net importer of this energy product.** Until 2015 all the gas was imported from Russian Gazprom. The procurement of gas from Russia has experienced a continuous decline in recent years: in 2015 22.8% less gas was imported compared to 2007. The import reduction was due to the decrease in gas consumption, which in 2015 decreased by 23.3% compared to 2007<sup>13</sup>. The decrease in gas consumption was mainly determined by the continuous increase in the average domestic tariff, caused predominantly by the increasing import price (Chart 11). In 2015, compared to 2007, the

<sup>13</sup> EG calculations based on data taken from <http://www.anre.md/ro/reports/8>.

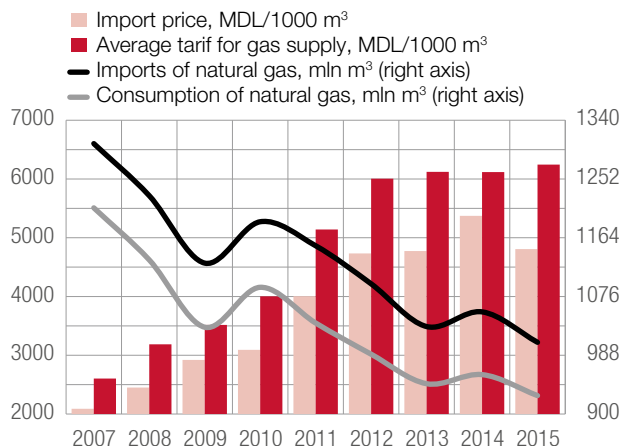
import price increased by 130.1% and the domestic tariff increased by 139.9%. The decrease in gas consumption was caused by the decreasing use of this energy product by business entities, by 40.8%, and by the energy sector itself by 20.9%<sup>14</sup>. These developments show that Moldovan companies are trying to carry out processes that are not energy-intensive, and thus need less gas. The procurement of gas from the Russian Federation occurs under a contract between Gazprom and Moldovagaz, where the Republic of Moldova holds 36.6% of the shares, and Gazprom holds the controlling interest. Under the contract, the import price of gas is linked to oil prices. In this context, lower oil prices are an advantage for the Republic of Moldova because they lead to a decrease in the gas import price.

**Given the fact that the gas supply from the Russian Federation passes through Ukraine, the worsening relations between Russia and Ukraine could trigger a new "gas conflict", similar to the one that took place in 2009.** Ukraine might refuse to allow the movement of energy originating in Russia across its territory. The gas supply to Moldova would be jeopardized, should this happen.

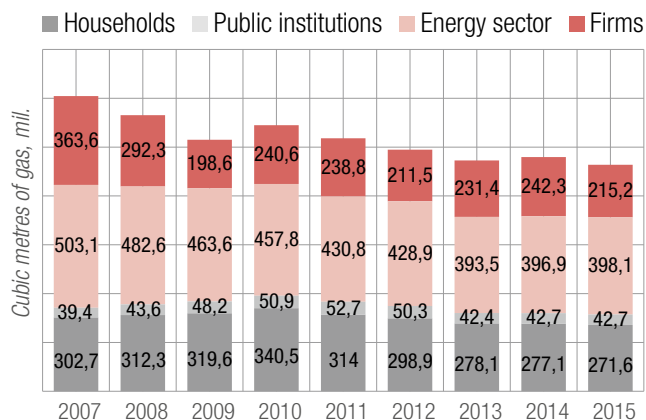
**Other risks stem from the fact that Russia often uses economic tools for geopolitical purposes.** In its relations with the Republic of Moldova, Russia shows no hesitation in using such approaches. Moscow looks unfavourably on the prospect of Moldova joining the EU, and it also looks unfavourably on the decisions of the Republic of Moldova to connect its gas infrastructure with the Romanian infrastructure and to join the European Energy Community.

<sup>14</sup> EG calculations based on data taken from <http://www.anre.md/ro/reports/8>.

**Chart 11. Gas Import Price, Average Tariff for Gas Supply, and Gas Imports and Consumption, Including by Consumer Categories (chart to the right), on the Right Bank of the Nistru River**



Source: NAER



In these circumstances Russia could use Moldovagaz's monopoly position, as the largest importer of gas, holding virtually the entire infrastructure of gas transit and distribution in the country, to block the attempts of the Republic of Moldova to strengthen its energy independence.

**In 2015 Gazprom ceased to be the sole source of imported gas in the Republic of Moldova, as gas was also purchased from Romania through the Iasi-Ungheni gas pipeline.** Although the planned transportation capacity of the gas pipeline is much bigger, currently the volume of gas imported from Romania is insignificant: of the total gas purchases in 2015, that purchased from Romania accounted for only 0.1%<sup>15</sup>. According to the plan, in the first phase the gas pipeline capacity will be about 500 million cubic metres of gas. In the future, however, after building a compressor plant in Romania, the gas pipeline will be expected to have the capacity to transport about 1.5 billion cubic metres<sup>16</sup>. Thus, in the future the Iasi-Ungheni section could in principle meet the entire gas demand of the Republic of Moldova. However, there are technical difficulties in exploiting the full transportation capacity of the Iasi-Ungheni pipeline that are related to the internal transportation network<sup>17</sup>. The Ungheni-Balti network section has a small capacity: it can transport around 550 million cubic metres of gas. To ensure that gas can be imported in large quantities from Romania, it is necessary to build

an additional pipeline between Ungheni and Chisinau, with a capacity equal to that of the Iasi-Ungheni gas pipeline<sup>18</sup>.

**An old, but still very acute issue, is related to the fact that Gazprom has the legal right to demand from the Moldovan authorities the payment of all debts, both those accrued by Chisinau and by Tiraspol**<sup>19</sup>. Transnistria also imports gas from the Russian Federation. Tiraspoltransgaz manages the gas network in the region and is responsible for the gas supply to the left bank of the Nistru River. The Transnistrian company is not a party to the gas procurement contract concluded between Gazprom and Moldovagaz, but it still has the obligation to pay directly to Gazprom for the energy supplied to the left bank of the Nistru River. Moreover, Tiraspoltransgaz is a co-owner of Moldovagaz and holds 13.4% of shares in the entity, but the shares of the Transnistrian company are also managed by Gazprom. The Tiraspol authorities cap the gas tariff, and the revenue collected for gas consumption by the households and firms from the region is used for social purposes. Since 2009, the payments to Tiraspoltransgaz

<sup>15</sup> EG calculations based on data taken from <http://www.anre.md/ro/reports/8>.

<sup>16</sup> *Ensuring Moldova's energy security: internal and external opportunities*, Association for Participatory Democracy (ADEPT), Chisinau, 2014, p. 6..

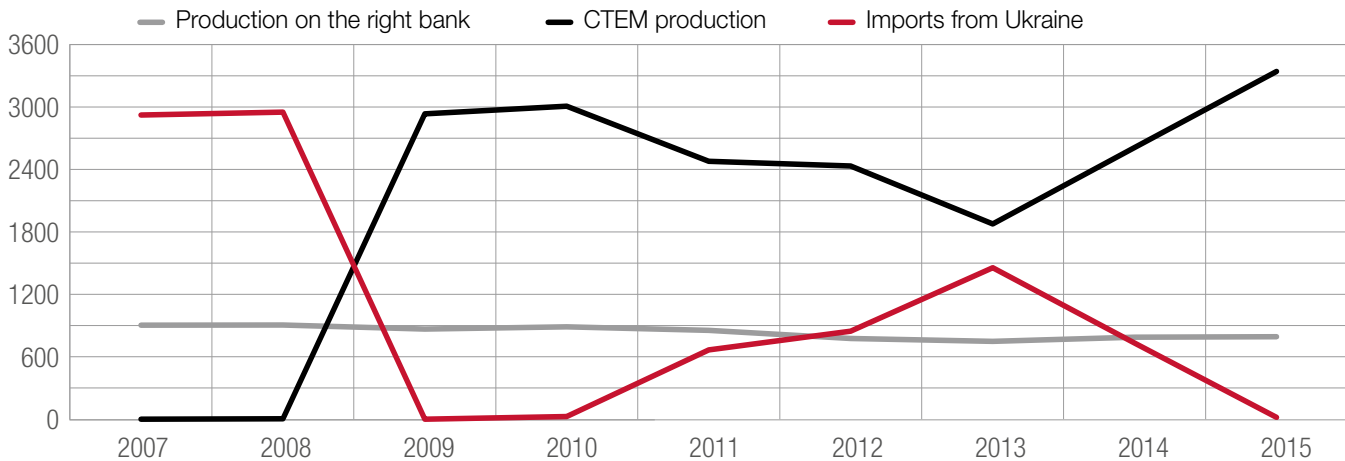
<sup>17</sup> Aparatu S., Cepoi M. *Opportunities for strengthening the energy security of the Republic of Moldova: Conventional gas vs shale gas*. Institute for Development and Social Initiatives IDIS-Viitorul, Chisinau, p. 19.

<sup>18</sup> The governments of Moldova and Romania backed the initiative of extending the pipeline and signed a Memorandum of Understanding on May 21, 2015. The document provides, in particular, the extension of the pipeline Iasi-Ungheni to Chisinau in Moldova and to Onesti in Romania. For the Republic of Moldova the extension of Ungheni-Chisinau gas pipeline costs about EUR 80-100 million (117 km). Also, possible further EUR 20 million for the installation of compressor stations, without which natural gas delivered to Romania cannot be pumped further from Ungheni to Chisinau if Romania does not ensure the pressure of 45 bars at the border as committed to in the Memorandum. Investments on the Romanian side mean the construction of two sections of pipeline of about 160 km and two compressor stations, a project estimated at least 110 million EUR (more details in Nuțu A. O., Cenușă D., *Interconnecting Moldova's gas market: the Iasi-Ungheni case*, Expert-Grup Independent Think Tank)

<sup>19</sup> *Ibidem*, p. 9.



**Chart 12. Electricity Production and Import, million kWh**



Source: ANRE

have been made only by offsetting the gas transit revenues<sup>20</sup>. Thus, given the low tariffs for consumers on the left bank of the Nistru River and the withdrawal of funds by the Tiraspol administration, the Transnistrian region's debt to Gazprom exceeds 5 billion USD.

## The Electricity and Energy Sector

**Although the Republic of Moldova has a large electricity generating capacity, of about 3000 MW, only about 346 MW can be used on the right bank of the Nistru River** (in cogeneration and hydro-based), and only about half of the capacity of the Cuciurgan Power Station (CTEM), which is located in Transnistria and has a capacity of 2520 MW, can be used<sup>21</sup>. Since 2007, around 20% of the country's electricity supply has been covered by the production from the right bank of the Nistru River. Most of the country's consumption is covered by CTEM-generated electricity and by imports from Ukraine, although the price of electricity from these sources is not stable<sup>22</sup>.

**Currently, the connection with Romania provides a low level of electricity supply, as well as a reduced security of supply.** The Republic of Moldova is interconnected with the Romanian power system by 400 kV overhead lines that go through Vulcanesti-Isaccea and three

110 kV aerial cables<sup>23</sup>. It is also acknowledged that there is a need for additional high voltage lines to meet the security criteria and to increase the energy supply capacity<sup>24</sup>. By 2020, the interconnection with the Romanian power system is expected to be expanded by: overhead lines from Suceava to Balti; and overhead lines from Straseneni to Ungheni to Iasi (alternatively Straseneni to Ungheni 330 or 400 kV and Ungheni to Iasi 400 kV)<sup>25</sup>.

**There are some issues around electricity supply from Ukraine.** The electricity in Ukraine is produced from a mix of raw materials and coal plays a major role. The conflict in Eastern Ukraine – a region abundant in coal deposits – led to a decrease in access to this fuel, and therefore resulted in less electricity being produced and exported. The expectation is that, starting with the third quarter of 2016, Ukraine could resume exporting electricity<sup>26</sup>. However, any escalation of military hostilities in Ukraine could lead again to the cessation of electricity imports from the country.

**The energy supply from CTEM is unpredictable.** Should the dialogue between Chisinau and Tiraspol be unproductive, the Transnistrian authorities could threaten to block the supply of electricity from CTEM to the right bank of the Nistru River. The possibility that Tiraspol could, under certain circumstances, actually block the supply of electricity cannot be excluded.

<sup>20</sup> *Ensuring Moldova's energy security: Internal and external opportunities*, Association for Participatory Democracy (ADEPT), Chisinau, 2014, p. 9.

<sup>21</sup> Energy Strategy of the Republic of Moldova until 2030, available at: <http://lex.justice.md/md/346670/>.

<sup>22</sup> *Ibidem*.

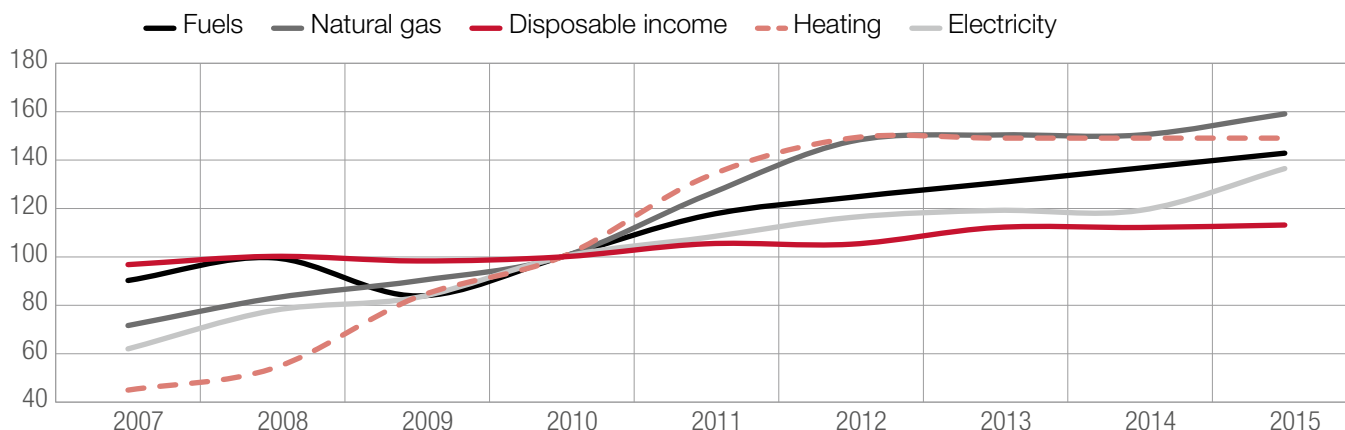
<sup>23</sup> *Ibidem*.

<sup>24</sup> *Ensuring Moldova's energy security: Internal and external opportunities*, Association for Participatory Democracy (ADEPT), Chisinau, 2014, p. 11.

<sup>25</sup> *Ibidem*, p. 11.

<sup>26</sup> <http://ria.ru/economy/20160714/1466280769.html>.

**Chart 13. The Evolution of Energy Prices vs Disposable Income Changes, %, 2010=100**



Source: EG calculations based on NBS data

**Until now the Moldovan authorities have not managed to identify sustainable domestic mechanisms for mitigating the risks related to energy supply.**

Even if gas supply to Moldova stops, CTEM can still produce electricity from fuel oil. Such a course of events could have implications for the electricity purchase price, but the supply would continue. The situation is similar in the case of the power stations on the right bank of the Nistru River. However, should the gas supply stop for an extended period of time, it would be necessary to settle the issue of supplying the power stations with fuel oil to ensure uninterrupted production of heat and electricity. Currently, the Republic of Moldova has reserves that would ensure autonomous functioning for only 15 days<sup>27</sup>.

## Energy Tariffs

**During 2007–2015, the energy price rose much faster than the population’s disposable income.** Thus, district heating became 3.3 times more expensive, the prices for network gas and electricity increased by 2.2 times, and the cost of other fuels increased by about 1.6 times. At the same time disposable income in real terms increased by 6.9% only. The accelerated increase in prices led to an increase in the share of payments for energy in the expenditure structures of households, from 9.4% in 2007 to 14.1% in 2014<sup>28</sup>. The increase in the share of expenditures for energy by more than 10% clearly shows that the

Republic of Moldova is experiencing an “energy poverty” phenomenon<sup>29</sup>.

There are several factors that have caused, and could cause in the future, the increase in energy prices:

- Gas and, partially, electricity are imported, with the domestic tariffs depending on the changes in import prices and in the MDL exchange rate. In 2015, compared to 2007, gas import prices rose by 2.3 times, and the purchase price for electricity in 2015 compared to 2005 increased by 3.8 times. In 2015, compared to 2007, the nominal exchange rate of MDL against the US dollar depreciated by 35.5%.
- Due to reduced thermal energy consumption in recent years (in 2015, compared to 2010, the supply to consumers decreased by 12.4%), the current operation regimes of electricity power plants are far from nominal, causing reduced efficiency<sup>30</sup>. Thermal energy generation in cogeneration mode cannot offset the high costs for electricity, and this causes increases in the tariffs demanded by electricity power plants.
- Other determinants of higher energy prices relate to: (i) the reorientation of consumers towards using alternative energy sources (gas, coal and wood), which are cheaper – which has a negative impact on the heat supply system and electricity production<sup>31</sup>; (ii) the pre-

<sup>27</sup> *Ensuring Moldova’s energy security: Internal and external opportunities*, Association for Participatory Democracy (ADEPT), Chisinau, 2014, p. 9.

<sup>28</sup> EG calculations based on data taken from <http://www.statistica.md/pageview.php?l=ro&idc=263&id=2206>.

<sup>29</sup> There is no universally accepted definition of energy poverty. Nevertheless, some European countries – such as France and the UK – define energy poverty as a situation where over 10% of the disposable income is used to pay for energy (Bouzarovski, S. *Social justice and climate change: Addressing energy poverty at the European scale*, p. 11).

<sup>30</sup> Energy Strategy of the Republic of Moldova until 2030, available on: <http://lex.justice.md/md/346670/>.

<sup>31</sup> Energy Strategy of the Republic of Moldova until 2030, available on: <http://lex.justice.md/md/346670/>.

**Table 5. Main Indicators Monitored with regards to Environment and Energy Sector**

Statistical indicators	2013	2014	2015
Energy productivity, GDP in MDL 2010/kg equivalent to coal	26.81	–	–
Natural gas import, million m <sup>3</sup>	1031.1	1053.1	1008.5
Price for natural gas import, USD/1000 m <sup>3</sup>	379.6	377.1	256
Procured electricity, million kWh	3959.7	4034.7	4050.4
Average procurement price of electricity, MDL/kWh	0.99	1.06	1.33
Energy consumption, % of household expenses	14.1	14.1	–
CO <sub>2</sub> emissions from stationary and mobile sources, tonnes per capita	2	–	–
Share of population with access to improved sewerage, %	60.2	63.2	–

carious conditions of the energy sector assets, which are outdated and worn out; and (iii) the accrual of debts for energy bills.

**Beside objective reasons, the uncompetitive practices and obscure transactions within the energy sector are other factors that determine the unjustified price increases for certain energy products.**

Despite the fact that there are normative acts that regulate the energy tariffs, the application of obscure schemes inflated the prices. An example in this regard relates to oil market products: the behaviour of business entities in this segment of the energy market often involves uncompetitive commitments. The prices are found to be inconsistent in terms of their level and adjustments to external variations, with most oil companies having a non-transparent pricing policy<sup>32</sup>. Along the same lines, Energocapital, a Transnistrian business entity that acts as an intermediary in the transactions of electricity supply on the right bank of the Nistru River, is worth mentioning: Energocapital allegedly applies schemes whereby it inexcusably inflates the electricity supply prices.

## Policy Recommendations

- **Moldova's energy security can only be strengthened if it cooperates with Ukraine, and especially with Romania, as both countries have a significant potential in the energy sector.** Ukraine seems to have solved the issues in the electricity sector and it could resume exporting electricity in a short while. By importing gas from the EU, Ukraine also proved that it can, at least partially, ensure its energy independence

<sup>32</sup> Lupusor, A., *Moldovan Fuels' Market: Assessment of the Regulatory Framework, Competition and Price Formation*, Expert-Grup Independent Think-Tank, Chisinau, 2011, p. 32.

from Russia. Romania is generally energy self-sufficient and able to ensure its energy independence in all segments. To strengthen their security both Romania and Ukraine intend to develop serious energy projects, such as the exploitation of shale gas or the construction of terminals for liquid petroleum gas storage. The Republic of Moldova should seize this opportunity and develop joint energy projects with both Ukraine and Romania.

- **Connecting to the Romanian power system should be a top-of-the-list task for the Republic of Moldova.** This would thus succeed in achieving two things in a single action. First, a stable supply of gas and electricity to Moldova could be ensured. Second, via Romania, the Republic of Moldova will be able to connect to the EU energy market, which is more secure and predictable. The connection between the power systems of the two countries requires time and resources, to build the necessary physical infrastructure. Provided that favourable circumstances are in place, particularly in relation to the political will in Chisinau, this objective can be achieved in the next couple of years<sup>33</sup>.
- **The Chisinau authorities must prepare carefully for negotiations with Moldovagaz and Gazprom.** Moldovagaz could use its dominant position in the gas market in Moldova to limit the supply of gas from Romania. For that matter, Russia may try to use Moldovagaz to block the implementation of the EU third energy package. Another matter at issue between Moldova and Gazprom is the Transnistrian region's debt. Gazprom has the legal right to demand from the Moldovan authorities payment of all debts, both those

<sup>33</sup> Lupusor, A., Fala, A., Popa, A., Cenusă, D., Morcotilo, I., Prohntitchii, V., Republic of Moldova 2015. State of the Country Report, Expert-Grup Independent Think Tank, Chisinau 2015, p. 39.

accrued by Chisinau and by Tiraspol and Moldovagaz. Connection to alternative gas import sources would ensure the security Chisinau needs, but this will require a lot of time. The debt generated by gas consumption on the right bank of the Nistru River should be paid soon. Solid legal arguments are needed for the talks with Gazprom.

- **Given the low oil prices, the Republic of Moldova can insist on extending the current contract with Gazprom.** As the cost of imported gas is linked to the oil price, lower prices for this fuel on the world market are an advantage for the Republic of Moldova.
- **The Republic of Moldova must conduct negotiations with Ukraine to be able to ensure the purchase of energy, should the gas and electricity supply be interrupted in the near future.** A new “gas war” between Ukraine and the Russian Federation in the near future could lead to the suspension of Russian gas transit across Ukraine’s territory. In this case, Moldova would only be able to import gas through Ukraine, which could import energy from the EU. The same approach should be used in the case of the electricity supply. If the energy supply to the right bank is suspended, the only possibility for
- ensuring access to electricity is by importing it from Ukraine.
- **The Republic of Moldova should increase its fuel oil reserves in the short term.** Should the supply of gas stop, a bigger fuel oil reserve would allow for the autonomous operation of the electro-thermal system.
- **The Republic of Moldova should make a huge investment in the energy sector.** The precarious state of the assets causes reduced efficiency of, and higher expenses for, infrastructure maintenance, and therefore the prices should be increased. Renovating the energy infrastructure and developing new projects (facilities for renewable energy sources or construction of an underground gas storage reservoir) will ensure a stable and efficient supply of energy and will reduce the maintenance costs, which will reduce the pace of price increases.
- **The competent institutions must direct their actions towards combating the implementation of fraudulent schemes in the energy sector to stop unjustified increases in prices.** The tariff methodology should be enhanced, which would make it impossible to introduce unjustified costs.

# Domestic and Foreign Politics

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The consolidation of new political forces had a significant influence on domestic politics during 2015–2016. In the area of foreign affairs, the EU's visibility increased, Moldovan–Romanian relations became more dynamic and the Russian factor was reactivated. The Reform Agenda was accelerated, but the opposition, civil society and foreign partners continued to have a mistrustful attitude towards governance. Political dependence and corruption in the justice system, systemic corruption, institutional politicization and the bank fraud case were at the top of the list of public concerns. Despite the many crises that affected the EU, low public trust in the government and the strong position of pro-Russian forces, the citizens' positive attitudes towards the EU were restored to a certain extent – although still to a lesser extent than their preference for the Euroasian initiatives.<sup>34</sup> The state institutional failures, mainly caused by actions meant to reinforce “state capture”, eroded the central authorities' legitimacy, thus heightening security risks related to the stability of democratic institutions and internal cohesion.

<sup>34</sup> Dionis Cenușa, *The Republic of Moldova between the European Union and the Eurasian Union: Polls and Trends*, Info-Prim Neo, 6 May 2016, <http://ipn.md/ro/integrare-europeana/76403t>

## Analysis of the Main Trends and Developments

### *Domestic Politics*

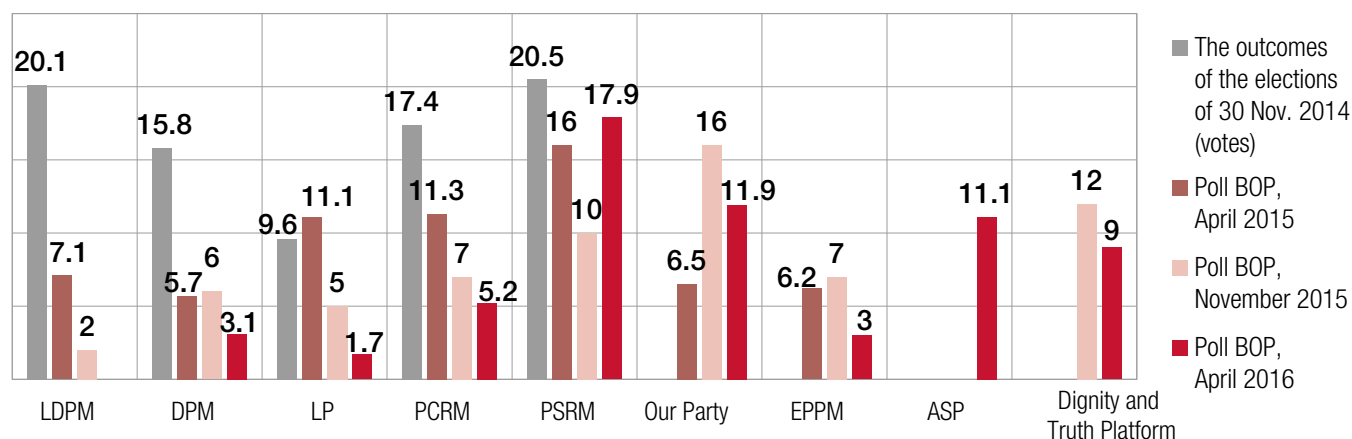
**Domestic politics experienced significant changes during the assessed period.** The public support for the political parties that governed during 2009–2016<sup>35</sup> literally collapsed.<sup>36</sup> In parallel, the oligarchic political duopoly LDPM–DPM fell apart after the former LDPM leader, Vlad Filat, was detained on 15 October 2015 and charged with passive corruption and influence peddling, for which he risks at least nine years' imprisonment. However, the coalition government continued to exist, but was now led by the DPM and LP – DPM's share being significantly large than LP's due to the control DPM has over the management body in the Parliament and Government (though not in the Presidency). Thus, DPM succeeded in attracting at least 57 MPs in the Parliament over to its side, including MPs from DPM and LP, former communists and liberal democrats. Besides the influence it already had on the General Prosecutor's Office, the National Anti-Corruption Centre and other state agencies and subordinate institutions, DPM also extended its control over 12 of the 16 ministries (four being conceded to LP<sup>37</sup>). Although it was found that DPM's control over institutions increased, particularly following the withdrawal of LDPM representatives,

<sup>35</sup> Governing parties during 2009–2015: Liberal Democratic Party (PLDM), Democratic Party (DPM), Liberal Party (LP).

<sup>36</sup> IPP, Public Opinion Barometer, page 44, April 2016, [http://ipp.md/public/files/Barometru/BOP\\_04.2016\\_prima\\_parte\\_finale-r.pdf](http://ipp.md/public/files/Barometru/BOP_04.2016_prima_parte_finale-r.pdf)

<sup>37</sup> Ministry of Defence, Ministry of Education, Ministry of the Environment, Ministry of Transport.

**Chart 14. Representation of Citizens' Political Options, %**



Source: Public Opinion Barometer, IPP

DPM waived the principle of institutional distribution that used to be largely applied during the 2009–2016 period, though only with regard to particular institutions. The NBM is subject to this exception, and, as a result, a new Governor was selected on an open and competitive basis (in March 2016). This isolated case was possible due to the huge domestic and foreign pressure, as well as to the unprecedented banking crisis, rather than to any radical change of attitude towards non-transparent and non-democratic distribution of institutions. This is confirmed by the Government's hesitation to replicate the NBM example in other important institutions believed to be politicized (NAC, the General Prosecutor's Office etc.).

**The newly created Western-oriented parties (The "Dignity and Truth Platform" Party and the Action and Solidarity Party and, to lesser extent, the European People's Party of Moldova (EPPM))<sup>38</sup>, as well as the pro-Russian opposition parties (Party of Socialists of Moldova (PSRM) and "Partidul Nostru" ("Our Party")), were the only political forces able to cross the electoral threshold of 6% required to enter Parliament (Chart 14).** However, except for PSRM, most new parties enjoy support in the capital city (Chisinau), but less in smaller towns and rural areas. The local elections of June 2015 showed that parties ruling during the current and former governments still have influence, due to the still strong local structures they have under their control (in particular, LDPM, DPM and PCRM).<sup>39</sup>

<sup>38</sup> EPPM – August 2015; Dignity and Truth Platform (DA) – December 2015; ASP – May 2016.

<sup>39</sup> The results of local elections in June 2015, ADEPT, <http://www.e-democracy.md/elections/local/2015/>.

**To break out of the internal and external isolation and to restore the previous foreign assistance flows, the Government relaunched the reform agenda, through the "roadmap for implementation of priority reforms" for March–July 2016,** containing measures for 13 sectors (82 actions), many of which are inspired by the Conclusions of the Council of the EU of February 2016. Although the authorities focused all institutional and political resources on achieving the objectives set out in the "road map", many of the actions carried out were ineffective.<sup>40</sup> The authorities also resumed the dialogue with civil society<sup>41</sup>, but the latter remained doubtful about the initiatives proposed by the Government, which is constantly accused of authoritarian trends and state capturing. Meanwhile, the EU Association Agreement was implemented at an accelerated pace, including as a result of the full enactment of the Association Agreement, which took place on 1 July 2016<sup>42</sup>, focusing more, however, on the technical aspects and on reporting to the EU. A mechanism of cooperation between the Government and the Parliament regarding the Association Agreement implementation was set up, in order to synchronize and speed up the reforms, which have often been delayed, particularly at the leg-

<sup>40</sup> According to Expert-Grup, LRCM and ADEPT 35 (51%) of the actions in the road map were carried out without any shortcomings; 24 (35%) actions were carried out defectively; whereas 10 actions (14%) were not implemented at all. <http://expert-grup.org/ro/activitate/item/1292-aplicatie-monitorizare-reforme-guvern>.

<sup>41</sup> The representatives of the Government decided to establish a permanent mechanism of cooperation between the NGO and executive sectors: the National Participation Council. It used to depend on the cycles of the Government formation.

<sup>42</sup> The technical procedures for ratifying the Association Agreement ended within the EU at the beginning of 2016. The Agreement became effective in the EU from 1 July 2016, while it has been effective in Moldova since July 2014.

islative stage. The aspects regarding the lack of political will, poor institutional capacity, scarce financial resources and the complexity of European standards (directives, regulations and technical regulations), etc. continued to impose constraints on the European agenda (in regard to the justice sector, banking sector, food safety, quality infrastructure, transport, etc.).

**To overcome the institutional deadlocks and to put an end to the ongoing political crises, the Constitutional Court adopted a decision with regards to the notification filed by 18 MPs from LDPM in November 2015.** The Court's decision ruled that the President of the country should be elected directly by the people<sup>43</sup>. The amendment made to the electoral legislation in order to allow for direct election of the President was criticised by NGOs due to the lack of transparency. As a result of these amendments the anti-government opposition broke apart again (temporarily, at least), while the Government (DPM and LP) managed to avoid new mass (including violent) protests, and to prevent a new political crisis that could be triggered by the possible failure of the Parliament to elect the President.

**Some efforts were invested by the Government in reviving the dialogue with the autonomous territorial unit of Gagauzia (via the establishment of an inter-parliamentary committee).** Also, mainly thanks to the German Chairmanship of the Organization for Security and Co-operation in Europe (OSCE), the "5+2" talks were resumed. Against the background of these negotiations, Chisinau made unilateral concessions to Tiraspol (regarding the region's registration of vehicles and their access to international traffic, recognition of certificates issued by educational institutions from the region, and phone interconnection)<sup>44</sup>. The central authorities' poor legitimacy was made use of by both the Gagauz authorities and the Tiraspol administration in order for them to strengthen their own positions.

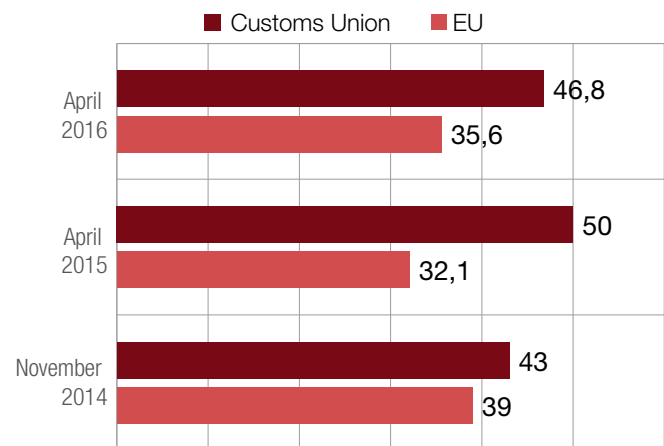
## Foreign Politics

**Regarding foreign politics, one can see that the EU has given up its romantic approach towards Moldova,**

<sup>43</sup> Decision of the Constitutional Court on the Constitutionality of Some Provisions of the Law No 1115-XIV of 5 July 2000, amending and supplementing the Constitution of the Republic of Moldova, on the election of the President, of 4 March 2016

<sup>44</sup> Protocol of the official meeting of the permanent conference for political questions in the framework of the negotiating process on the Transnistrian settlement, Berlin, 2–3 June 2016, <http://www.osce.org/moldova/244656?download=true>.

**Chart 15. Distribution of Geopolitical Sympathies of the Population, %**



Source: *Public Opinion Barometer, IPP*

which was confirmed by the very harsh conclusions of the Council of the EU in February 2016<sup>45</sup>. The Europeans' critical stance has become a permanent one, particularly as far as the rule of law is concerned.

**During 2016 the EU Delegation initiated actions to improve public communication – an objective included in the renewed European Neighbourhood Policy, scheduled for the end of 2016.** European assistance in relation to renewable energy, confidence-building measures in the context of the Transnistrian conflict, the support for agriculture and regional development in Gagauzia ATU and Taraclia have become increasingly popular. These measures created significant opportunities for the restoration of the EU's image, which is not yet strong enough to counterbalance the Russian–Eurasian vector (Chart 15). The pro-European mood in the society is vulnerable to the internal geopolitical rivalries, which may grow in intensity if the future President of the country is pro-Russian. The internal dissension in the EU with regards to the asylum and migration policy, the implications of the referendum in Great Britain (Brexit), the emergence of anti-European and anti-systemic political parties (Germany, France, the Netherlands, Sweden, etc.) and Russian anti-European propaganda all generate additional pressure.

**The relations with neighbouring countries remained relatively stable during the period.** In addition to

<sup>45</sup> EU Council's Conclusions on the Republic of Moldova, 15 February 2016, <http://www.consilium.europa.eu/en/press/press-releases/2016/02/15-fac-moldova-conclusions/>.

cross-border cooperation in the transportation, customs and energy sectors, the dialogue with Romania about obtaining a considerable loan (EUR 150 million) intensified<sup>46</sup>. This financial aid is crucial for the Government's political survival, taking into account the suspension of the EU's direct budgetary support in 2015, which could be lifted provided that a new memorandum with the IMF is initiated, which is scheduled for the end of 2016. The relations with Ukraine were marked by the developments in bilateral trade: the Moldovan authorities introduced temporary (non-)tariff restrictions (for cement, dairy products and meat) in order to moderate the effects of the more competitive Ukrainian exports because of the depreciation of the Ukrainian hryvnia.

**The Russian factor is back, through the “road map”, which aims to see a resumption of bilateral trade relations**, scheduled to be approved in November 2016, after the Presidential elections in Moldova (30 October 2016). At the same time, the tariff barriers and interdiction on exports from Moldova to the Russian Federation were kept up, while producers from Gagauzia ATU and the Transnistrian region continued to have access to the Russian market. The renewal of relations with the Russian Federation came at the same time as the strengthening of NATO's position in Romania (South-East and Eastern Europe) and the confirmation of NATO assistance to Moldova, obtained at the Warsaw NATO Summit (July 2016), and also at the same time as the intensification of military actions in Eastern Ukraine, following the support offered by the Russian Federation to the separatist forces.

During the period under review, the following **major trends** were visible in the domestic and foreign politics:

**Political class renewal.** After the fragmentation of the right-wing political pillar, which is made up of Western-oriented parties – two political forces with visible electoral potential – the “DA” Platform and ASP – appeared in the arena. Within a relatively short period of time they managed to draw in a great deal of the LDDM and LP electorate, including that of the new political force, the EPPM. At the same time, the left-wing political parties – “Partidul Nostru” (“Our Party”) and PSRM – continued to win to their side the electorate that used to be loyal to PCRM and DPM. The share of new parties grew also, due to the strengthening of the protesting spirit in the society (by

<sup>46</sup> The Government approved the first tranche of the EUR 150 million loan to Moldova, 8 August 2016, <http://revista22.ro/70255257/guvernul-aproba-prima-transa-a-imprumutului-de-150-milioane-de-euro-catre-republica-moldova.html>.

about 10%)<sup>47</sup> – a trend that is associated with making anti-government protests permanent (since September 2015) and with their radicalization (January 2016).

### **Intensification of the “state capture” phenomenon.**

This trend is assessed through three lenses: (1) access to the decision-making process; (2) degree of influence over the institutions; and (3) the implementation of policies that are convenient to certain vested interests. Regarding the first and second aspects, the decision-making power in the government was taken over by one single party (DPM), both in the Parliament and in the Government<sup>48</sup>. The third aspect relates to the adoption by the Government coalition of decisions that tend to serve the interests of the ruling party. This is the case, for instance, in the new draft Broadcasting Code adopted at its first reading (1 July 2016), when the recommendations of the civil society were ignored – a fact that was criticised by foreign partners. The new Code provides for an obligation for TV channels in the country to broadcast local productions each day (for at least eight hours) and to make sure that local productions are broadcast during prime time. Only a few media institutions can meet such demanding requirements. Most of these are owned by “General Media Group” (Publika TV, Prime TV, Canal 2 and Canal 3) – a company that is affiliated through intermediaries and off-shore companies with the prime deputy chairman of DPM.<sup>49</sup> Therefore, the requirements that the new Code provides for could put up barriers against the activities of TV channels that re-broadcast foreign TV channels and that do not have enough resources to create their own productions (TV7, N4 etc.)

### **New dissension between the local and central governments.**

After the precedent of February 2014 (the referendum regarding the foreign vector), Gagauzia ATU resumed the undertaking of unilateral actions. Its newly adopted decisions in the education and electoral fields are in conflict with the national legislation. Moreover, the Gagauz executive power threatened not to comply with the national legislation (contending that they would boycott the new Broadcasting Code if it limits Russian media sources). The dissension culminated in Comrat pronouncing a decision (August 2016) to declare unlawful the current administrative control mechanism for central authorities, which was set up in 2003. There are also tensions between the central authorities and Balti Munic-

<sup>47</sup> Comparative analysis of POB of April 2015 and POB of April 2016.

<sup>48</sup> The Pavel Filip Government – who is affiliated with Vladimir Plahotniuc – was established after Pavel Filip was voted into his position by a majority of MPs (57 votes) (DPM, LP, 14 former communists and former MPs from LDPM).

<sup>49</sup> RISE Moldova, May 2015, <https://www.rise.md/articol/plahotniucleaks/>.



ipality, where Renato Usatii – the Mayor of Balti Municipality and party leader of “Pardidul Nostru” (“Our Party”) – announced his idea of extending the municipality by comprising other northern districts of the country (about 10 districts). In another development, Tiraspol exploited the flexibility of the central authorities during negotiations only to strengthen the breakaway regime (recognition of graduation certificates, recognition of vehicle registration plates from the region, etc.). At the same time, the Tiraspol administration continues to be given support in strengthening its trade relations with Russian regions, just like Gagauzia ATU.

**The Russian factor is increasing its presence.** The Russian Federation proposed a “road map” to the Moldovan government at the end of June 2016, before the Russian Deputy Prime Minister – Dmitri Rogozin – came to Chisinau (July 2016), with the purpose of restoring trade relations. The aforementioned document, however, strengthens Russia’s position (in the energy, aircraft, military sectors), but also that of pro-Russian regions (Gagauzia ATU and the Transnistrian region), by requesting their inclusion in the Moldova–Russia intergovernmental dialogue. At the same time, in exchange for the rehabilitation of bilateral trade, the Russian Federation demanded that Moldova assumes again its Commonwealth of Independent States (CIS) commitments, which contradict the EU Association Agreement provisions (on metrology, standardization, technical regulations). The major objective of the Russian Federation is to unblock freight and soldier transportation to the Transnistrian region. During 2016, the Russian military carried out military exercises with military units from the Transnistrian region. In addition, the Russian authorities continue to encourage the Chisinau authorities to open a Russian Consulate in the Transnistrian region. The opening of the polling stations (22 stations) in the region for the Russian Parliamentary election in September 2016 – although slightly criticised by Chisinau – was used to endorse the idea of a Russian Consulate in Tiraspol. In parallel, the Russian Federation intensified the recruitment of soldiers from the region into the Russian Army. Also, it consolidated the support given to the separatists in Eastern Ukraine (Donbas) and caused tensions between Crimea and the territory that is under the control of Kiev.

**Harsher pressure from the EU.** The criticism of Chisinau launched by European and EU Delegation officials concerning the abuses and the lack of progress on reforms increased (e.g. the big brother law, the justice reform, the new Broadcasting Code, the case of the

Taraclia Mayor). The USA adopted the same stance as the Europeans, thus putting more pressure on the Government, in parallel with the pressure exerted by the anti-governmental protests and their radicalization.

## Greater Implications and Risks

The developments during 2015–2016 have serious impacts on several aspects of fundamental importance for the country’s stability and security:

**Efficient implementation of reforms and good operation of institutions.** The increased “state capture”, brought about by monopolization of political power, endangers the full implementation of reforms in sensitive sectors, where oligarchs are involved openly in decision-making (justice, the fight against corruption, regulatory infrastructure, anti-monopoly policy). At the same time, the political “colonisation” of institutions is an obstacle to the application of legislation that was supposed to guarantee the independence of the judiciary system, the good administration of public money, the promotion of a competition policy, etc.

**Stability of democratic institutions.** Cases of non-democratic and illegal practices became more frequent: (i) MPs bribed and intimidated (PCRM, LDPM) into forming a parliamentary majority and setting up the Government; (ii) strengthening of DPM’s top-down control of power, with the support of PL and about 20 other defecting MPs. These aspects affect the stability of democratic institutions. First, the balance of power (“check and balances”) in the state – which is crucial for a viable democracy – is undermined because of the stronger top-down control of the power. Second, the de facto subordination of the decision-making process directly to one single party diminishes the role of representative institutions that are elected by the people (Parliament). Third, the possibilities of altering the election results by bribing or intimidating MPs into agreeing to certain political decisions reduces citizens’ trust in public institutions even further (Parliament, Government, public authorities, agencies, etc.), including those that are not under the command of DPM (the Presidency) and, more generally, the democratic form of government. Finally, the concentration of decision-making power into the hands of a political and oligarchic groups means that institutions work for narrow interests (survival of the Government) – which inevitably drives attention away from the public interest (punishment of offenders who committed bank fraud and the subsequent return of money, reform of the justice sector, etc.).

**Consistency and irreversibility of the European integration process.** The authorities' approach towards the EU agenda is rather technical and superficial. From the political perspective, the alleged pro-European governing parties are compromised, whereas the new ones are either pro-Russian ("Partidul Nostru" ("Our Party")) or reticent about certain aspects of European integration (the "DA" Platform, the ASP – human rights)<sup>50</sup>, or worse – are related to the current oligarchic government (EPPM). Moreover, the European agenda faces difficulties caused by the complexity of the EU acquis, the regulatory framework failures, the poor institutional capacity and scarce human resources. In addition, the non-compliance of the quality infrastructure, the demanding European standards and the poor readiness of Moldovan producers to access the European market prevent an efficient use of the Deep and Comprehensive Free Trade Agreement (DCFTA), therefore generating a feeling of antipathy among certain categories of people.

**Keeping the country's territorial integrity.** The actions of Gagauzia ATU, aimed at extending its own powers, violate the national law and severely affect the country's territorial integrity. Several factors worsened the situation: legal gaps that have grown over time, erosion of the legitimacy of the central Government and the collapse of the pro-statehood political forces in the Gagauzian autonomy. Just like the Tiraspol administration, Gagauzia ATU is supported by the Russian Federation, which thereby seeks to extend its economic and political weight vis-à-vis the central authorities in Chisinau.

**Neutrality status.** The stronger military collaboration between the Russian Federation and the Transnistrian region (frequent organization of military manoeuvres) proves how inefficient the implementation of the neutrality status in Moldova is, with Russia ignoring the Moldovan–Russian bilateral agreements and the international law on sovereignty and territorial integrity. Driving the Russian military out of the region and replacing Russian peacekeepers with an international mission are indispensable for an actual adherence to the principle of neutrality.

The aspects analysed here reveal a series of major risks to national security and even to the fundamentals pillars of the state:

- **Eroded democracy and undermined statehood.** On the one hand, maintaining the current level of "economic and political state capturing", or allowing it to

<sup>50</sup> The "DA" Platform, ASP, but also PPEM, did not express any disapproval of the radical demonstrations conducted by religious groups against the participants in the "No Fear" march in May 2016.

grow worse, will generate new significant troubles within democratic institutions, directing even more of the population towards the autocratic model of governance (similar to the one in the Russian Federation). On the other hand, this undermines people's trust in public institutions, encouraging the dissociation from nationhood as other citizenships are sought (Romanian, Russian) –thus encouraging the migration of the active population (particularly of the young and economically active people) and harming the demographic and budgetary condition of the country. As a consequence, the radical political forces will enhance their influence ("radical unionists"), and conflicts with supporters of statehood will grow worse. If – over a short and medium term – state capture does not end, and if the political and economic situation worsens significantly, the Republic of Moldova risks turning from a "weak state" into a "failed state", permanently eroding the internal social and political cohesion.

- **Aggravation of outbreaks of instability across the country.** The replication of the unilateral steps, taken by the Gagauzia ATU, creates favourable conditions for animosity towards the central authorities. The low legitimacy of the central authorities encourages new steps by Gagauzia ATU to acquire more power, even if such measures violate the law. The political and economic support given by the Russian Federation to the Gagauz authorities and exporters, encourages the ATU to take more unilateral actions. After the 2015 local elections, another pro-Russian political figure – the leader of "Partidul Nostru" ("Our Party"), Renato Usatii – started investing efforts into transforming Balti Municipality into a (geo)political and administrative centre opposed to the central authorities in Chisinau. All of these dissensions, alongside the crumbling of the authority of the central authorities and the strengthening of the "state capture", only encourage the idea of the "federalization" of Moldova – an idea strongly supported by PSRM, which, besides the Transnistrian region, could well target (at the least) Gagauzia ATU. The federalization idea could gain a lot more visibility if the PSRM leader (Igor Dodon) wins the Presidential elections.
- **Emergence of some impediments to European integration.** The implementation of the European agenda is threatened by a set of internal risks, such as the complexity of the EU acquis, and the limited institutional and human resources, etc. In addition, certain complications of an internal nature may arise if the next President is anti-European and pro-Russian (e.g. the socialist Igor Dodon). There are also external threats.

These are triggered by the Russian Federation's initiatives to make Moldova resume its CIS commitments (on metrology, standards, etc.) by implementing the "road map", thus appealing to the Government's instinct for self-preservation. The Russian party has similar intentions in relation to the Transnistrian region, which should implement the DCFTA by the end of 2016. The European integration could also slow down because of the European governments' reluctance, due to the involvement of the Chisinau authorities in corruption and cross-border crimes (the banking system). Such a development might be triggered by the internationalization of the bank frauds case through the intervention of the US and EU investigative authorities.

## Recommendations

- **Fighting "state capture":** (i) support incorruptible stakeholders in the justice sector (judges, prosecutors, civil servants); (ii) democratize immediately the political parties and eliminate obscure interests (full transparency of internal funds use and sanctioning of non-compliant political parties, including by de-registering them); (iii) prioritize the fight against corruption; (iv) guarantee the independence of NAC, the National Integrity Committee and the General Prosecutor's Office, by conducting open recruitment contests for executive positions (like the best practices applied in the case of the NBM) and introduce new legal safeguards, based on the conditionality of development partners; (v) strengthen the anti-monopoly policy by consolidating the regulatory institutions (the Competition Council, ANRE,
- etc.), identifying and eradicating monopolist structures that pump resources into oligarchic groups; (vi) and limit the participation of companies affiliated with off-shore entities in major investment projects, in public property privatisation or in the strategic sectors of the economy (banking system, energy, transport, etc.).
- **Resume the dialogue between the central authorities and regions:** (i) establish and enhance the political dialogue with the regions that are conducting unilateral actions in violation of national legislation; (ii) improve the current legislation by removing the problematic provisions and eliminating the sources of tension between the centre and regions (e.g. review the 1994 Law on the Special Legal Status of Gagauzia ATU); (iii) create an objective and equidistant information environment (strengthen the financial efforts in relation to the development of independent media institutions in problematic regions); (iv) create some permanent civic platforms that would ensure a connection between the NGOs based in Chisinau and those from the regions.
- **Strengthen the European agenda:** (i) develop an official communication strategy and action plan for European integration (with measurable performance assessment criteria); (ii) strengthen and diversify the communication tools in the field of European integration, both within public institutions and among donors, particularly within the EU Delegation and EU countries' embassies; (iii) enhance the competence of civil servants at the central level in the field of European policy and ensure the transfer of knowledge to the local-level staff; (iv) strengthen communication about European integration among minorities and in the regions (Balti

**Table 6. Main Indicators Monitored with Regards to Political Situation**

	2013	2014	2015
Sentences in corruption cases <sup>51</sup>	61	143	493 <sup>52</sup>
Number of crimes investigated by NAC <sup>53</sup>	569	668	727
Value of the violations and offences in public funds management (MDL)	8.2 billion <sup>54</sup>	47.2 million <sup>55</sup>	4.7 billion <sup>56</sup>
World Economic Forum (ranking)	81	69	81
Transparency of government policies	123	123	126
Embezzlement of public funds (ranking)	(out of 148 countries)	(out of 144 countries)	(out of 140 countries)
Corruption Index, Transparency International (ranking)	102 (out of 177 countries)	103 (out of 175 countries)	103 (out of 168 countries)

<sup>51</sup> Sentences delivered by courts in corruption cases investigated by NAC.

<sup>52</sup> 83% of the 595 cases investigated by the Anti-corruption Prosecutor's Office and NAC during 2014–2015.

<sup>53</sup> The crimes investigated by NAC include corruption and corruption-related crimes, and money laundering.

<sup>54</sup> Public authorities (institutions, state-owned enterprises, etc. – 373 entities) were audited from October 2012 to September 2013.

<sup>55</sup> Public authorities (institutions, state-owned enterprises, etc. – 630 entities) were audited from November 2013 to September 2014. Only six of the 360 audited units were subject to a financial audit.

<sup>56</sup> Public authorities (institutions, state-owned enterprises, etc. – 373 entities) were audited from October 2014 to September 2015.

Municipality, Gagauzia ATU, Taraclia, the Transnistrian region); (v) prioritize the reform of strategic sectors (banking and financial, energy, quality infrastructure, entrepreneurship, local government sectors) and use (conditionality) European assistance to overcome the backlogs; (vi) establish a calendar and a well-targeted policy on DCFTA implementation in the Transnistrian region and in Gagauzia ATU; (vii) strengthen the relations with Romania and Ukraine to consolidate the policies in sensitive areas related to the European agenda (energy, transport, customs, settlement of the Transnistrian conflict); (viii) eliminate anti-DCFTA aspects from the initiatives developed together with the Russian Federation to re-establish the Moldovan–Russian trade relations; (ix) fight Russian propaganda by stimulating (mass-media, NGOs) the dissemination of correct information about the EU, the European agenda in Moldova and in the region, including about Russia’s Eurasian initiatives (strengthening media institutions); (x) accelerate the “Europeanization” of the new political forces (integration into the pan-European political community, enhancing the competencies in European integration, etc.).

- **Strengthen the security policy:** (i) finalize and strengthen the security policy strategic framework by fully capitalizing on the assistance provided by NATO, the EU and the USA; (ii) establish a strategic (bilateral and trilateral) dialogue on security with Romania and Ukraine to prevent hybrid threats launched by the Russian Federation in the region; (iii) ensure the transparency of negotiations about Transnistria between the central authorities in Chisinau and foreign stakeholders (OSCE, the EU, the USA) and necessarily condition each concession made to the Tiraspol administration (e.g. improvement of human rights situation in the region); (iv) establish a monitoring and reporting mechanism (quarterly public reports) for the Russian Federation’s actions in Gagauzia ATU, Balti Municipality and other regions prone to fall under Russian influence, including the Transnistrian region; (v) increase Moldova’s participation in regional initiatives dedicated to security risk assessment (e.g. StratCom Division of the European External Action Service).

# About EXPERT-GRUP

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## Who we are

EXPERT-GRUP is a Moldovan non-governmental and not-for-profit organization that specializes in economic and policy research. EXPERT-GRUP does not represent any economic, corporate or political interests. As an independent organization, EXPERT-GRUP reflects the ideals of the young Moldovan intellectuals who have created the institution with the purpose of contributing to Moldova's development. Among other types of organizations in Moldovan civil society, EXPERT-GRUP positions itself as a politically and ideologically neutral think-tank.

## Our activities

Our core activity is economic analysis, forecasting and policy research. In this area we offer a wide range of analytical products and services that help our beneficiaries to take decisions that support the development path of Moldova. Our key competence lies in the ability to provide professional, high quality and objective research in such broad fields as:

- Macroeconomic analysis and forecasting;
- Political economy;
- Public finance;
- Human development and poverty reduction;
- Labour market and consumer behaviour;

- Foreign trade;
- Financial markets;
- The economics of European integration;
- Sector-level economic analysis;
- Regional and local economic development; and
- Energy and environmental economics.

## Partners and donors

In the period 2006–2016 the EXPERT-GRUP has implemented more than 100 research and advocacy projects in different areas related to economic and policy research. More than 130 associated and non-associated experts from Moldova and other countries were involved in these projects. We have worked with such donors as Moldova Soros Foundation, Eastern European Foundation, Konrad Adenauer Stiftung, Balkan Trust for Democracy, Black Sea Trust, FES, the UN Development Programme (UNDP) Moldova, the UN Children's Fund (UNICEF), the European Commission, the Council of Europe, the Open Society Foundation, the Swiss Agency for International Cooperation, and the United Kingdom Department for International Development. In 2010 and 2012 the EXPERT-GRUP was elected as a member of the National Participatory Council of Moldova. Since 2008 the EXPERT-GRUP has been a member of the Policy Association for an Open Society – a network of policy centres uniting 56 think tanks from countries across Europe.

# About FES

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Friedrich-Ebert-Stiftung (FES) is a German political social democratic foundation which aims to promote democracy, peace, international understanding and cooperation. The FES fulfils its mandate in the spirit of social democracy and devotes itself to public debates about finding social democratic solutions to current and future issues in the society.

## FES in Moldova

In the Republic of Moldova the FES aims to foster European integration, democracy, peace and social justice through political dialogue, education and research. Our main areas of activity are the following:

### Democratization and Political Participation

Moldova faces the challenge of consolidating its democratic institutions and developing a democratic culture that brings the country fully in line with standards of the EU. The FES contributes to this process by promoting political participation in civil society organizations, political parties and local self-governing bodies. A particular focus of the FES's activities in this area is on empowering citizens in the regions. Citizens need to be empowered to be able to critically follow public debate, monitor political stakeholders, articulate their views, and act on behalf of their interests. Therefore, the FES engages in activities to promote participatory democracy and an enhanced citizens' civic and political culture at the local level.

### European Integration

Moldova is part of the European Neighbourhood Policy and the Eastern Partnership. The FES supports the European integration process in the country. Through a series of instruments, such as radio debates, news bulletins, policy papers, publications and conferences, the FES focuses on the main challenges related to the European integration process, facilitating the access of the public to up-to-date and reliable information on the topic, improving the dialogue between the civil society and decision-makers on the requirements for successful European integration, and contributing to strengthening the European integration efforts of the Moldovan authorities. Additionally, the FES supports non-governmental organizations in contributing to a peaceful resolution of the Transnistrian conflict as a prerequisite for successful European integration in the long run.

### Economic, Social and Environmental Policy

In this area the FES supports its partners in developing and implementing policies for a functioning market economy which is sustainable, socially balanced and able to address the needs of all citizens. Inputs and projects in the area focus on topics such as reforming social security systems, improving working conditions and labour market opportunities and fostering sustainable development. Additionally, the FES runs programmes which aim to promote social democratic values.



