

## I. SITUATION ANALYSIS<sup>2</sup>

### 1. Geographic Data

The Republic of Moldova is located in South-east Europe (to the North-east of the Black Sea, landlocked between Romania and Ukraine, between the river beds of Prut and Nistru). The land surface area of the country, which stretches some 350 km North to South and is 150 km-wide West to East, is 33,846 square km. The population of the Republic of Moldova totals 4.1 million people<sup>3</sup>, with a density of population accounting for 121 inhabitants per square km.

The Republic of Moldova is a geographic space with a very high degree of anthropogenic harnessing of natural space. Approximately 10% of the country's territory is occupied by human settlements.

The total surface of land resources is 3.385 million ha, of which 1.952 million ha are farming lands, including 1.659 million ha of arable lands, 242 thousand ha sown to perennial crops, 335 thousand ha of grasslands, and 9,807 thousand ha are pastures. Lands sown to forests and other areas covered by forest vegetations account for 433 thousand ha. The chernozem (humus) lands cover approximately 80% of the country's territory (2.5 mil. ha).

Administratively, the Republic of Moldova is made up of 1,679 communities, including five municipalities (Chisinau, Balti, Tighina (Bender), Comrat, and Tiraspol), 60 cities, 39 settlements within towns (municipalities), 917 residence villages (villages where village councils or communes are located), and 658 settlements within communes (except for the residence villages).

### 2. Demographic Situation<sup>4</sup>

The 2004 census data are indicative of depopulation trends in the country, mostly caused by a reduction in the birth rate and by people's migration. As of 1 January 2007, the stable population of the country consisted of 3.58 million inhabitants. Between 1997 and 2006, the number of population dropped by some 62.0 thousand people. The Republic of Moldova continues to be the country with the lowest level of urbanization within Europe, with 41.3% of people living in urban settlements and 58.7% – in rural settlements. Approximately half of the urban population is living in the municipality of Chisinau. In terms of gender balance, men account for 48%, and women make up 52% of the total number of population.

An analysis of population by age groups points to a growing demographic aging effect within the society. The average age of the country's population increased from 33.4 years in 2000 up to 35.6 years in 2007, putting Moldova in the group of countries with "adult" population. The decrease in the birth rate resulted in a reduction of the number of young people in absolute and relative terms. Compared to 2000, in 2007 there was a decline from 23.8% down to 18.2% in the share of 0-14 years-old population, with the share of people over 65 years going from 9.4% up to 10.3%. The adult population (15–64 years-old) accounts for 71.4% of all people – an upsurge of some 126.3

<sup>2</sup> The situation analysis, SWOT analysis and analysis of constraints conducted within the COMPACT assistance programme under the initiative of the Millennium Challenge Corporation, serve as tools for the identification of medium- and long-term priorities of the country. The analyses are inter alia substantiated in the Annual EGPRSP Evaluation Reports and in the EU-Moldova Action Plan Evaluation Reports.

<sup>3</sup> Including the population of Transnistria;

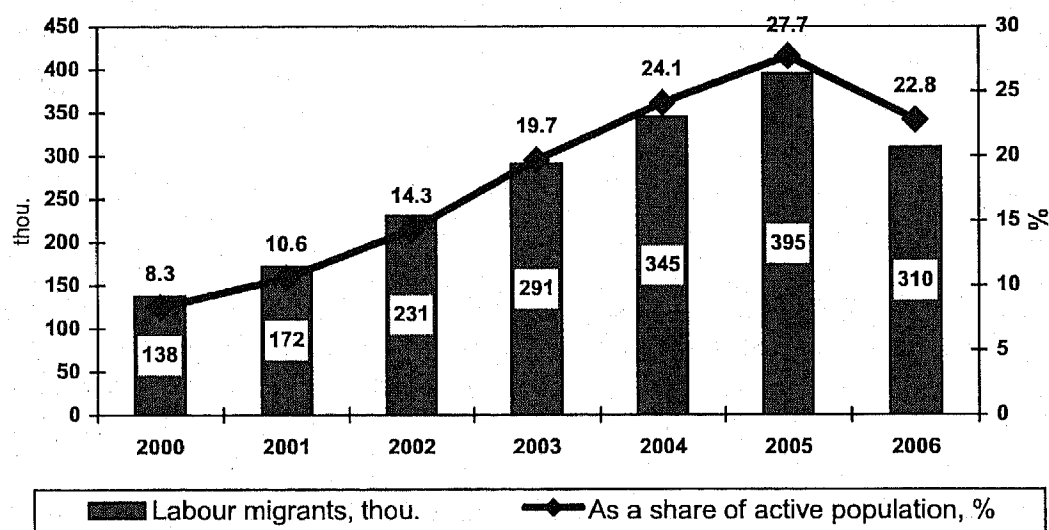
<sup>4</sup> The demographic review draws upon the data that excludes the left bank of the Nistru River and the municipality of Tighina (Bender).

thousand people versus the situation at the beginning of 2000. There was an increase in the proportion of age groups of 15-34 and 45-59 years within the adult population, alongside a decrease in the shares of age groups 35-44 and 60-64 years respectively.

The discrepancy in the age structure of population is more obvious when considered by regions, caused by territorial variations in the demographic phenomena and by the migration flow of population. The proportion of elderly is 1.4 times higher in rural areas than in urban settlements. Almost 12% of the rural population is over 65 years, and the elderly women account for 14% of the total number of women living in rural settlements. In urban settlements, the average age of the women is 2.9 years higher than the age of men, with the age gap reaching 3.3 years in rural areas.

Labour migration has a key role in changing the demographic situation, and is still a major problem for the medium and long term. According to the National Bureau for Statistics data, there have been approximately 310 thousand people reported to have left the country for a job or in search of a job abroad in 2006, that is 22.8% of the total active working population of 15 years and above. Two thirds of those reported to have left are men. The same proportion was noticed among people who have left from rural settlements. Outward migration is characterized by a massive outflow of people of reproductive age and economically active. People belonging to the 20-29 years-old age group account for the biggest share of those (40.3%), followed by 30-39 years-old people (22.1%).

**Figure 1: Labour migrants working abroad, 2000-2006 (%)**



*Source: National Bureau of Statistics, calculated by the Ministry of Economy and Trade*

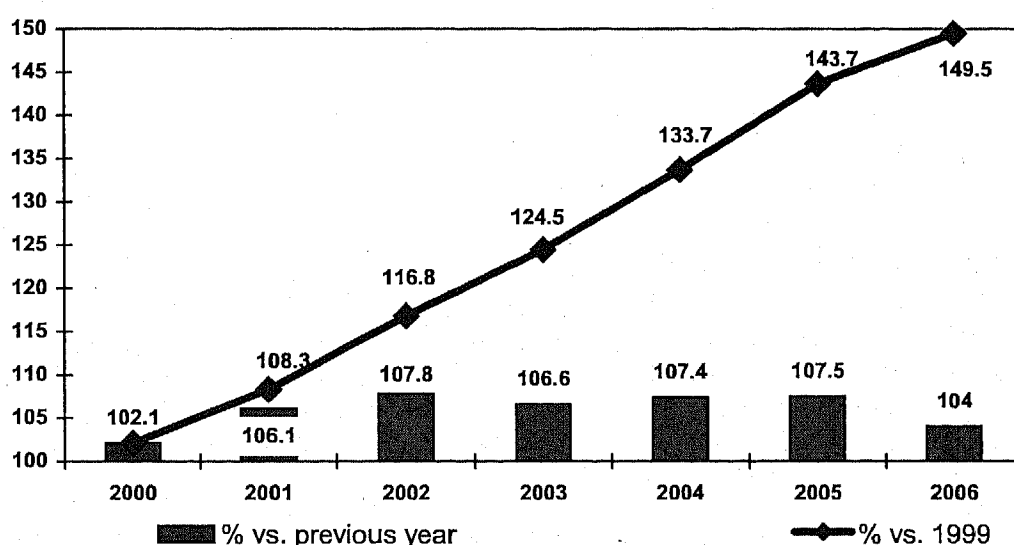
The reduction in the number of working population and the increase in the average age of employees in the national economy have resulted in complex consequences for the country's social and economic development, with a direct impact on the overall supply of labour force, investments, income distribution, public expenditure for social insurance, etc. The ongoing aging of population will result in serious shortages of human capital needed for a sustainable development of the country.

### 3. Economic and Social Situation

Beginning with 2000, Moldova's economy has resumed its growth track, reversing a decade of ongoing decline and deterioration of the living standards. The macroeconomic policy measures taken within the framework of internal and external growth contributed towards the halting of economic recession and ensured a steady growth in the gross domestic product (GDP). The real GDP grew on average by 5.9 per annually during 2000-2006, with a cumulative growth of 49.5% versus 1999.

The consumption of households was the main source of growth, funded mostly by increased domestic revenues (the real salary increased approximately 2.3 times during this period) and remittances sent home from abroad. Investments in fixed capital have had a lesser contribution to the economic growth, increasing by 81.5% versus 2000, accounting for 15.7% of GDP on average.

Figure 2: GDP growth between 2000 and 2006 (%)



Source: National Bureau of Statistics

Securing macroeconomic stability has played an important role in revitalizing and sustaining economic growth. The monetary policy provided for by the National Bank of Moldova (NBM) targeted several objectives, including a reduced level of inflation, maintaining a competitive exchange rate for the national currency, and accumulating international reserves. The huge flow of remittances put greater pressure on the national currency, which contributed to its deflation. Under these circumstances, the NBM stepped in the currency market in order to reach a balance between the demand and supply of foreign currency, thus pumping up the country's international reserves. The increased sterilization efforts and the slowing growth of monetary mass led to the offsetting of inflationary pressures.

The economic growth was accompanied by a significant improvement in the fiscal situation. There was a considerable growth of the national public budget revenues up to 40.5% of GDP in 2006, and the state budget reported an average surplus of 0.2% of GDP. Indirect taxation accounted for the largest part of the upsurge in revenues, and made up approximately 45.4% of all revenues in 2006. A drop in the rate of income taxes paid by natural persons and legal entities kept these revenues at 5% of GDP. The increase in revenues and decrease in costs for public and publicly guaranteed debt servicing allowed for an increase in public spending earmarked for other priorities. The social sectors benefited the most from this growth (almost

90%), expenditures for these sectors accounting for 63.2% of all national public budget expenditures in 2006. At the same time, the growth of consumption expenditures cut down the fiscal space for public investments, and the high share of public revenues and expenditures in GDP is generally indicative of a rapid expansion of the public sector – a situation that could limit the economic growth prospects.

The economic growth and the prudent debt management contributed to a significant improvement in foreign debt indicators. The total foreign debt to GDP ratio dropped from 133% in 2000 down to 74% in 2006. The public and publicly guaranteed debt was 26% of GDP at the end of 2006 (versus 79% of GDP in 2000). Also, there was a moderate growth in foreign direct investments (FDI) reported during the reference period. The total stock of FDI into the national economy represented USD1,300 million, or USD363 per capita, at the end of 2006 (versus USD123 in 2000). However, the amount of foreign investments is still much smaller than in South-east European countries, and is insufficient to ensure a sustainable development of economy. At the beginning of 2007, a more significant growth of FDI was observed, which increased by USD205 million, accounting for USD1,505.4 million on July 1.

The revitalization of economic growth was coupled with an increase in the external vulnerability of economy and higher emphasis on certain discrepancies both at macro and branch levels. The evolution of foreign trade featured a rapid growth of imports and a modest performance of exports during the given period – a situation that resulted in an ongoing increase of the trade balance deficit from 23% of GDP in 2000 up to 47% in 2006. The current account deficit was on a rise too, although at a lower pace than the trade balance deficit, due to massive inflows of remittances. The external vulnerability is exacerbated by the high concentration of exports to a limited number of countries and products. Despite a shift in the orientation of exports over the last years, specifically towards the European Union markets, most of the exports are still targeting the CIS countries, and the Russian Federation in particular. At the same time, approximately 45% (in 2006) of Moldovan exports are farming products (including from the processing industry), with alcoholic beverages dominating.

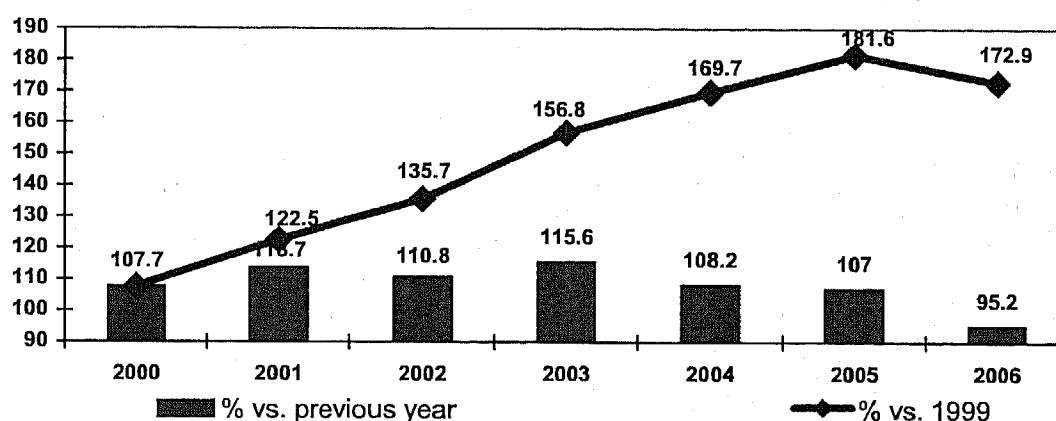
The true size of the country's economy external vulnerability was revealed by the 2006 trends. A doubling of natural gas prices and export restrictions on certain categories of products resulted in a number of negative trends – economic growth had slowed down (4%), inflation went up (14.1% at the end of the year), whereas the trade deficit and the current account deficit reported a considerable growth (by 34% and 65%, respectively). These trends pose threats to the sustainability of progress to date and are tokens of the low competitiveness of Moldovan companies on regional and world markets.

The economic recovery period is characterized by a poor development of domestic supply and low competitiveness on domestic and foreign markets. The development of the country's production sector during the given period drew mostly upon the growth in the use of existing capacity rather than building it up. Better productivity occurred against the background of a slump in the labour force, mostly due to migration. The wearing out of these resources, which are ensuring the growth of productivity, under the circumstance of few domestic and foreign investments to complement and replenish the stock of capital in the economy, is a paramount obstacle for the medium- and long-term development of the country's production sector.

To this effect, the evolution of the country's real sector corroborates the concerns set out above. The evolution of the industrial sector between 2000 and 2006 had been positive. The cumulative growth as compared to 1999 was of 73%. The growth of the industrial sector had varied (except for 2006), with the best results noted in 2003 (see Figure 3). The industrial output decreased by 4.8% in 2006 versus 2005 – something explained particularly by the

restrictions on the Moldovan wine imports to the Russian Federation and, as a result, a shrinking of the winemaking subsector. During the economic recovery period, a high proportion of enterprises (50%) operated in red, whereas there was only an insignificant growth in the number of enterprises reporting profits (by 4 percentage points (p.p.)).

**Figure 3: Trends in the industrial sector between 2000 and 2006 (%)**



*Source: National Bureau of Statistics*

The economic growth continues to display geographic polarity, exacerbating disparities in the social and economic development of the country. The municipality of Chisinau accounted for half of the industrial outputs in 2006 and for 56% of fixed capital investments. Companies registered in Chisinau contributed towards almost 91% of the net financial outcomes reported within the economy in 2006, whereas those registered in other districts – merely 2.7%. Hence, in 2006 the highest average monthly salary was reported in the municipality of Chisinau (MDL2,218) and municipality of Balti (MDL 1,854.3). The average monthly salary was as low as approximately MDL1,000 in some districts of the country.

Development continued to be low-profile in rural areas due to a modest progress accomplished in agriculture and below-par expansion of non-farming activities. Agriculture continued to report low productivity and low compensation for work. The marginal revenues of agricultural producers are dictated by the limited nature of economic trade in most farms (half of the revenues are in-kind), high prices of invested inputs, specifically for energy resources, as well as the extremely low sale prices on final outputs. The low performance in agriculture is also caused by the limited access to funds, scarce investments, deteriorated infrastructure, poor management of agricultural enterprises, and high vulnerability to natural disasters. Given the share of agriculture in the GDP (15% in 2006) and the number of people employed in this sector (33% of the total labour force in 2006), the low performance of this is cutting down on the growth prospects for the rest of the economy and is undermining the poverty reduction efforts.

The reduction in Moldova's vulnerability to the shocks caused by foreign prices for energy by diversifying energy import sources and by increasing the efficiency of its use is still a major challenge. Recent gradual increases of prices for energy resources has had a serious impact on the economy and the population alike. The direct impact of these resulted in increasing trade and budget deficits. The increase in the purchase prices contributed directly to the growth in costs of power, natural gas and oil products purchased by public institutions at all levels (bringing the budget spending up by 0.5% of GDP). The increased prices for energy, without a better social assistance system, have considerably added on to the needs for

public funding to support the system.

The prospects for development of the domestic supply are impeded by a severely deteriorated infrastructure. Infrastructure is one of the most critical constraints to economic growth in Moldova (see Box 2). The underdeveloped road infrastructure is generating an important impact on the mobility of assets and people, particularly in rural areas.

In 2007, with support from the Millennium Challenge Corporation, the Government conducted a constraints analysis to growth and development in the Republic of Moldova. According to this analysis, the following are extremely critical constraints in the Republic of Moldova: (i) physical infrastructure because of energy losses and poor quality of roads; (ii) investment climate with its burdensome license and permit issuance regime; (iii) rigidity on the labor market, and (iv) judiciary system performance. Less critical but as important for decisionmaking is the geographical location – a factor that we can't influence, and the macroeconomic risks shown through inflation and exogenous risks. Access to finance, human capital, innovations and competitiveness aren't considered critical constraints according to this analysis. Though these are preliminary conclusions, coupled with previous analyses conducted by the Government and the country's development partners, they served as a benchmark for the formulation of policies in the National Development Strategy.

This is also an obstacle for trade by imposing certain additional costs on both exporters and importers. The water supply and sanitation infrastructure has deteriorated all over the country, and most of these utilities face major financial issues caused by low collection rates, tariffs lower than the real production costs, and huge losses of water through leakages within the system. On top of that, almost 40% of the water pumped through the systems doesn't meet the health criteria. Although the level of public investments increased over the last years, it is still insufficient for the rehabilitation of infrastructure.

**Table 1: Fixed capital investments by source of funding (%)**

	2000	2001	2002	2003	2004	2005	2006
<b>Fixed capital investments - Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
Funded from:							
State budget	3.3	4.1	2.0	2.1	3.0	5.3	7.8
Budgets of territorial-administrative units	4.9	4.5	4.2	3.5	5.6	4.5	5.3
Economic agents' own funds	56.4	57.0	71.3	70.2	61.3	57.7	52.8
Population funds	3.8	4.0	3.8	3.6	2.4	2.2	1.8
Foreign investors' funds	25.3	19.4	11.9	14.8	20.6	18.5	19.0
Other sources	6.3	11.0	6.8	5.9	7.1	11.8	13.3

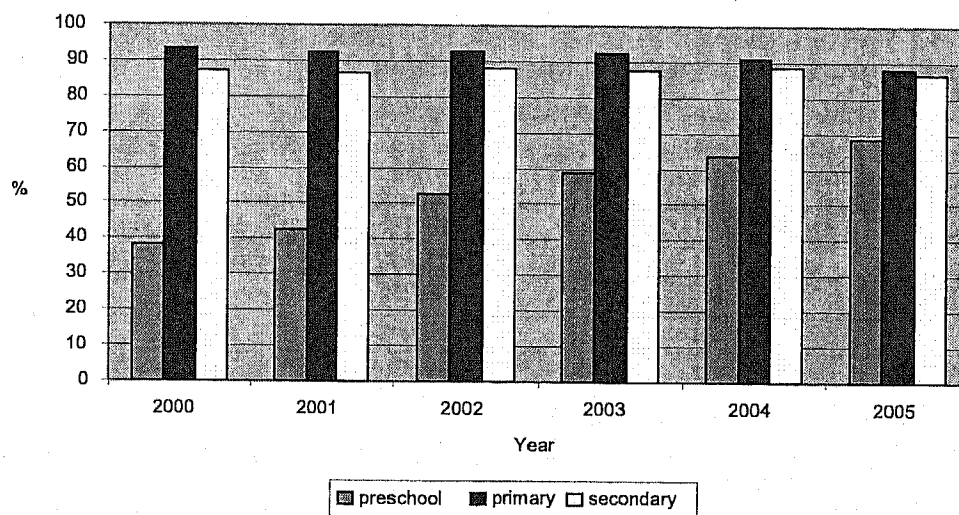
*Source: National Bureau of Statistics*

It's necessary to emphasize that the growth of economy hasn't achieved so far a new quality level. Even if the increased income of the population continues to support the robust growth of consumption in the short run, this model of growth will be used up given the lack of a strong response of domestic supply. The shift in the growth paradigm turned to be a far-reaching and enduring process, which is still a major challenge for the future development of the country.

As mentioned above, the economic growth and improvements in the fiscal area allowed increased public spending for the social sector. The growth of spending in this sector hasn't

been always accompanied by a similar improvement in the quality of rendered services. There were mixed feelings about the progress accomplished in improving the access and quality of education services over the last years. On the one hand, the enrolment rate in preschool education registered a significant growth from 38.5% in 2000 up to 68.6% in 2006. On the other hand, the net enrolment rate dropped from 93.5% in 2000 to 87.6% in 2006 for primary education, and from 87.0% in 2000 down to 86.1% in 2006 for lower secondary education (see Figure 4).

**Figure 4: Net enrolment rate by educational level between 2000 and 2006 (%)**



Source: National Bureau of Statistics

The quality of education is negatively affected by the method of funding in the education system, which doesn't provide the incentives required for an efficient use of resources. The reduced number of school-age children and the fact that in many communities the schools' projected capacity is already several times over the limits set for the number of students are conducive to unjustified costs. Furthermore, the optimization of the school network remains an obvious solution to improving the efficiency of resources by cutting down the proportion of non-teaching staff in the total number of staff, by lowering maintenance costs, and by bringing the student/teacher ratio in line with international norms. In this context, the mapping of pre-university education facilities was completed, and a school network optimization strategy will be developed on its basis.

The health sector has been subjected to important changes over the last years. The mandatory health insurance system was introduced in 2004, while the total expenditures in this sector increased from 4.2% to 4.8% of GDP in 2006. The health system reform strengthened in particular the primary health sector and launched the restructuring of the hospital sector. All these factors generated a reversal in the adverse trends from the previous decade, thus resulting in better health indicators. The introduction of health insurance improved the financial protection of the people, with almost 77.5% of population being covered by health insurance. Yet, there are still serious problems related to the general provision of health care services in rural communities and small towns. Even though the access to health services improved, there is still considerable room for improving the quality of health care services.

Despite some progress in improving the financial status of the pension system (by increasing the retirement age, improving collections), the reform initiated back in 1998 hasn't met its

long-term objectives. The payment of pensions continues to be based on declared salaries and not on individual contributions, thus undermining the financial sustainability of the pension system, leading to an inequitable redistribution of resources among various categories of insured people, and determines relatively low pensions. Moreover, there is no comprehensive solution to the issue of farmers participating in the pension system. The average retirement pension was MDL457.51 in 2006 – 5.3 times higher compared to 2000. This amount is very close to the poverty line. The replacement rate (average old-age pension as a share of the nominal average monthly salary in the economy) continued to drop, representing 26.9% at the end of 2006.

The current social assistance system is based on the nominal compensation system, which is still the most expensive social program, and amounted to 38% of social assistance expenditures in 2006. However, this system is known for not being efficiently targeted to the poor, its benefits equally covering all income quintiles (see Table 2).

**Table 2: Beneficiaries of nominal compensations by quintile**

Categories of beneficiaries	Quintile I	Quintile II	Quintile III	Quintile IV	Quintile V
Disabled, degr.I	12.5%	20.9%	21.6%	26.6%	18.5%
Disabled, degr.II from labour	29.7%	17.6%	19.2%	14.0%	19.5%
Disabled child	7.9%	14.3%	25.0%	29.7%	23.1%
Participants to the WWII	1.5%	3.4%	9.9%	41.2%	44.0%
Family suffered from Chernobyl	13.3%	4.4%	24.4%	23.3%	34.4%
Disabled from childhood, degr.I	5.9%	12.4%	19.1%	32.7%	29.9%
Family with 4 and more children	29.4%	26.6%	19.0%	19.2%	5.8%
Disabled, degr.II, unlimited period	34.1%	20.0%	13.1%	15.8%	17.1%
Lone pensioners	13.2%	46.4%	23.7%	11.8%	4.9%
Persons who worked on the home front	7.5%	29.0%	20.6%	30.4%	12.6%
Persons who stayed in Leningrad under blockade	0.0%	18.2%	27.3%	27.3%	27.3%
Disabled, degr.I Chernobyl	6.5%	2.2%	10.9%	41.3%	39.1%
Disabled from childhood, degr.III	24.5%	24.9%	16.1%	14.9%	19.6%
Disabled from WWII, degr.I	3.6%	3.6%	25.0%	17.9%	50.0%
Disabled from WWII, degr.II	2.3%	2.3%	6.0%	29.2%	60.2%
Disabled from WWII, degr.III	0.0%	11.8%	5.9%	23.5%	58.8%
Disabled, degr.II of related persons	19.5%	17.1%	7.3%	24.4%	31.7%

*Source: Ministry of Social Protection, Family and Child*

Other types of social assistance benefits are not targeted to the poorer quintiles either, and the public social protection expenditures (11.7% of GDP in 2006) don't always generate the expected impact. This situation limits the efficiency of poverty reduction efforts, and is a constraint for the implementation of reforms required for future economic development.



#### 4. Poverty and Inequality Trends

Poverty is a very complex phenomenon, determined by the evolution of several factors. A poverty line is used to estimate poverty, which is a benchmark to explain various aspects of this phenomenon. In the Republic of Moldova the poverty measurement indicators are calculated based on the Household Budget Survey (HBS) undertaken by the National Bureau of Statistics. The HBS is a selective study that aims at determining under different aspects the population welfare by looking at income, expenditures, consumption, living conditions, and other indicators.

Essential changes have been operated to the HBS starting in 2006: the sampling framework changed, the instruments (questionnaires) for data collection improved, and a single data collection network was established for research in the social area. Changes operated to the 2006 HBS contributed to an improvement in the quality of data and to the alignment of the poverty measurement methodology to international standards, but the disadvantage of these changes is that **the 2006 data are not compatible with the data from previous years.**

Due to data incompatibility, poverty in 2006 will be analyzed independently of its evolution in previous years. Below is the evolution of poverty before 2005 and poverty trends in 2006, as shown in the data generated by the new generation of HBS implemented by the National Bureau of Statistics.

##### *Poverty and inequality trends before 2005*

There is a close relation between poverty and economic growth. Economic growth is a prerequisite for poverty reduction and improvement of living standards. Thus, Moldova's economic performance throughout 2000-2004 contributed to achieving an economic growth that had an impact on poverty reduction. Between 2000 and 2004, the poverty rate had reduced significantly and constantly, and by 2004 only 26% of the country's population was below the absolute poverty line. Although in 2005 the economic growth trend of the previous years was maintained, it didn't produce an impact on poverty reduction in the country, specifically in rural areas, where poverty rates increased. Hence, in 2005 the absolute poverty rate increased by 3 percentage points (p.p.), meaning that 29% of Moldova's population lived in absolute poverty line, and 16% lived in extreme poverty (see Table 3).

**Table 3. Poverty indicators in 1998 – 2005<sup>5, 6</sup>**

Indicators and sources	2000	2001	2002	2003	2004	2005
<i>Absolute Poverty Line (MDL per adult equivalent per month)</i>	234.8	257.3	270.7	303.5	327.0	353.87
Poverty rate, %	67.8	54.6	40.4	29.0	26.5	29.1
Poverty gap, %	27.0	19.3	12.4	7.3	6.8	8.0
Poverty severity	13.7	9.1	5.2	2.7	2.5	3.2
<i>Extreme Poverty Line (MDL per adult equivalent per month)</i>	183.9	201.5	212.0	235.5	258.1	278.52
Extreme poverty rate, %	52.2	38.0	26.2	15.0	14.7	16.1
Extreme poverty gap	17.6	11.6	6.6	3.1	3.2	4.0
Extreme poverty severity	8.2	5.1	2.4	1.0	1.1	1.5
Gini coefficient by consumption expenditures per capita (weighted)	0.38	0.39	0.37	0.36	0.36	0.38
Distribution 90/10, mean consumption expenditures per equivalent <sup>7</sup>	10.45	10.85	9.40	8.39	9.10	10.28

Source: Ministry of Economy and Trade, based on HBS data

Other poverty measurement indicators showed similar trends. In 2005, the extreme and absolute poverty gap amounted to 4% and 8%, respectively. This means that the poor have an average consumption deficit of MDL11 to reach the extreme poverty line and MDL28 to reach the absolute poverty line.

In 2005, the inequality level slightly increased in the Republic of Moldova. This trend is reflected in the evolution of the Gini coefficient (see Table 3), which measures the level of inequality in household consumption at country level. The higher this coefficient, the greater inequality is. Thus, inequality in terms of the population's consumption maintained a relatively high level (the Gini coefficient was 0.38). Causes of inequality's growth are related to the increase in the income gap between the rich and the poor, in particular due to a faster development of urban areas, as compared to rural.

The poverty profile in Moldova is characterized by major differences between urban and rural areas. In 2005, rural poverty showed an upsurge of approximately 4.8 percentage points, reaching 36%, which has largely determined poverty growth at national level. In 2005, the poverty risk<sup>8</sup> for rural population was approximately 6 times higher than in large cities. However, poverty remained at the level of 2004 (see Figure 5) in small towns.

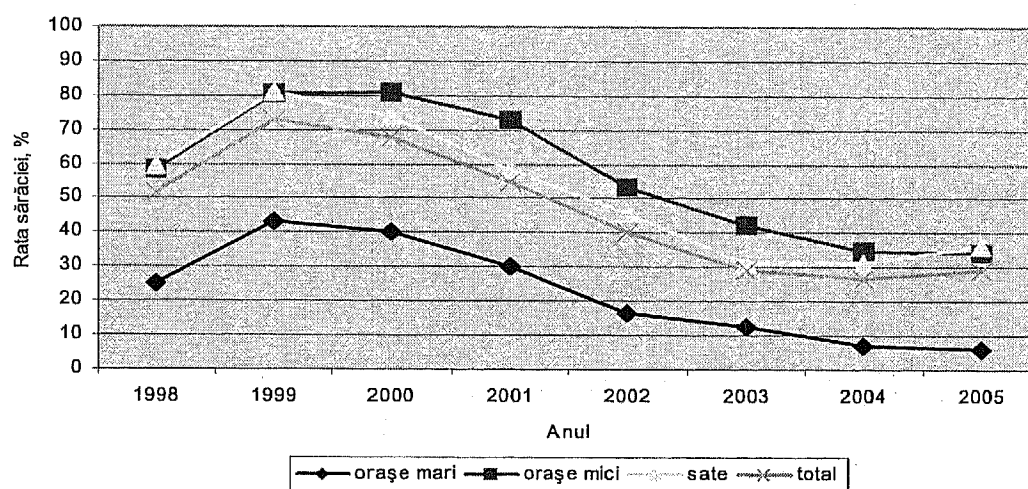
<sup>5</sup> Numbers are weighted and are nationally representative.

<sup>6</sup> Poverty lines are calculated per adult equivalent per month, unless otherwise noted.

<sup>7</sup> Adjusted for Purchasing Power Parity. Values per capita per month.

<sup>8</sup> Poverty risk is a relative concept, which indicates the probability of households/individuals with certain characteristics to fall under the poverty line.

**Figure 5: Poverty by area of residence (1998 – 2005)<sup>9</sup>**



(Poverty rate; Cities, towns, villages, total)

*Source: Ministry of Economy and Trade, based on HBS data*

In 2005, poverty risks were considered higher for big families, farmers, families with many children, and elderly. The level of education is another factor affecting household welfare. Individuals with primary education or incomplete secondary education are 7 times more likely to fall under poverty unlike people with higher education.

#### **Poverty and inequality trends in 2006**

2006 was a special year for Moldova, when the country's economy faced two economic shocks: increased prices for gas and introduction of restrictions on the export of alcoholic production. Certainly, these factors affected the population's wellbeing in that period. However, the full impact of these shocks cannot be assessed due to the incomparability of data and measures taken by the Government to alleviate these effects, such as compensation of expenditures for natural gas consumption.

According to statistical data, 30.2% of the population were under the absolute poverty line and 4.5% under the extreme poverty line in 2006 (see Table 4).

A rather low value can be noted for the extreme poverty rate, which proves that the problem of food poverty will no longer be relevant for the Republic of Moldova in the near future.

<sup>9</sup> Numbers are weighted and are nationally representative.

**Table 4. Poverty indicators in 2006<sup>10, 11</sup>**

<b>Extreme Poverty Line (MDL)</b>	<b>404.2</b>
Extreme poverty rate, %	4.5
Extreme poverty gap, %	1.0
Extreme poverty severity	0.4
<b>Absolute Poverty Line (MDL)</b>	<b>747.4</b>
Absolute poverty rate, %	30.2
Absolute poverty gap, %	7.9
Absolute poverty severity	3.0
Gini coefficient by consumption expenditures per capita (weighted)	0.315
Distribution 90/10, mean consumption expenditures per adult equivalent	7.01

Source: Ministry of Economy and Trade, based on HBS data

The difference between the absolute poverty line (MDL747.4) and the food poverty line (MDL404.2) is remarkable, and is considerably higher compared to previous years. This is explained by the change in the structure of household consumption in the 2006 HBS, as compared to the previous structure. Thus, food products have a lower share in the total household consumption, representing 46.3%.

In 2006, the poverty gap was 8% in relation to the absolute poverty line and 1% in relation to the extreme poverty line. This means that the monetary transfer needed by each poor person to get out of absolute poverty is MDL59 and approximately MDL4 for each person living in extreme poverty.

In 2006, the inequality of the consumption level overall for the population of Moldova, as measured by the Gini coefficient, was 0.315. While comparing the level of inequality in Moldova with the level of inequality in other countries, it is higher than in Ukraine, Bulgaria and Hungary, but lower than in the Russian Federation, Latvia, Lithuania, and Estonia.

#### *Poverty profile*

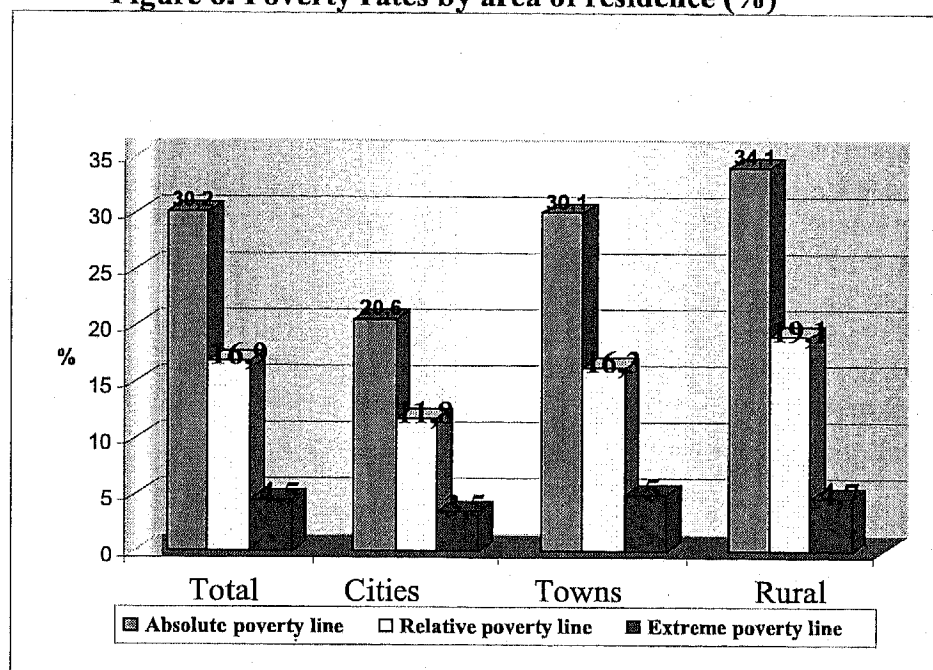
The area of residence is one of the factors with the strongest correlation to poverty. Rural population represents approximately 59% of the country's population and approximately 60% of all the poor live in village settlements.

The analysis of poverty rates by area of residence (see Figure 6) reflects the same overall profile of poverty as in the previous years, with significant differences between urban and rural areas. People living in cities still have the lowest risk of living in poverty, with a poverty rate of 20.6%. Poverty rates in rural areas are the highest (34.1%). Compared to large cities, absolute poverty in rural areas is by 13.5 p.p. higher, and compared to small towns – by 4 p.p. The high incidence of poverty in rural areas is due to low agricultural productivity and reduced employment opportunities for areas other than agriculture.

<sup>10</sup> Poverty lines are calculated per adult equivalent per month.

<sup>11</sup> Numbers are weighted and are nationally representative.

**Figure 6. Poverty rates by area of residence (%)**



*Source: Ministry of Economy and Trade, based on HBS data*

Poverty level increases with the number of household members, from less numerous households to those with 5 and more members. The share of persons living in large households (5 and more members) of the total population is approximately 22%, while their share of the total of poor households is 34%. At the same time, the poverty risk also prevails in households with one person (29.6%), while their share in the total population is only 7%. The highest absolute poverty rates were found in households with 4 members – 28.4%, 5 members – 38.5%, and 6 or more members – 55.9%.

Poverty trends in relation to the number of children are the same as in the previous years. The poverty risk increases with a higher number of children in a family. Almost 67% of the total households are households with one child and those without children. These households are the least poor, while the most affected are households with 4 or more children, with an absolute poverty rate of 65.4%. Extreme poverty is also higher in this type of households, representing 14.8%, or by 10 p.p. higher than the country average.

Data analysis according to socio-economic groups shows that poverty incidence is the highest among agricultural workers (42.8%). The high poverty risk among farmers and agricultural workers is closely related to the development of this sector. Agriculture in Moldova continues to be defined as the sector with the lowest level of productivity and compensation for work. Furthermore, the significant dependence of the level of income on the weather conditions determines its instability and is a specific and additional risk factor for poor rural households.

Another category affected by a high poverty risk are pensioners. Their share in the total population is 25%, and their share in the total number of poor households is 35%, with a poverty rate of 41.8%.

Education is another factor influencing the poverty rate. The evolution of the poverty rate is inversely proportional to the level of education of the household head and are strongly correlated. A household headed by a person without primary education is almost 5 times more likely to live under the poverty line than the household headed by a faculty graduate.

The share of households headed by persons without primary education and illiterate of the total population is not high (2.3%), although these households have the highest poverty level – 55.2%. The majority of the poor (89%) is made of households headed by persons with general secondary and special education (52.1%) and incomplete secondary and primary education (37.4%). The poverty rate for this group of households in 2006 was 27%; respectively 45% in relation to the absolute poverty line.

Poverty analysis by gender and area of residence confirms that both women and men have the same poverty rate of 30%. However, the situation differs by area of residence. People living in rural areas, both women and men, have a poverty risk by 9 p.p. higher than those living in cities. This trend is common for persons aged under 59 years. However, the situation changes in the case of elderly people. The absolute poverty rate for the elderly living in urban areas is by 2.3 p.p. higher than for rural residents, and represents 39%. The possibility of the elderly living in rural areas to earn their own living from what they produce reduces their poverty risk.

## II. SWOT ANALYSIS

**Key objective:** *Ensure a better quality of people's life by strengthening the foundation for a robust, sustainable and inclusive economic growth.*

<b>Strengths:</b>	<b>Weaknesses:</b>
<p>Maintain relative macroeconomic during profound reforms</p> <p>Relatively developed and stable banking sector</p> <p>Relatively cheap labour force in smaller towns and rural settlements</p> <p>Majority consensus on the European vector</p> <p>Customs duty free access to EU markets based on the GSP Plus system, to the countries of South-east Europe based on the CEFTA agreement, and to CIS countries based on free trade agreements</p> <p>Legal and fiscal frameworks conducive to investments</p> <p>Skilled human resources in certain sectors of economy</p> <p>Growing purchasing power of population and poverty reduction</p> <p>Opening the Giurgiulesti port and harnessing ensuing benefits</p> <p>Expanding the services sector</p> <p>Expanding the sector of information technologies and communications</p> <p>Cooperation between the Republic of Moldova and regional and international security structures</p>	<p>Skewed structure of production</p> <p>Relatively high cost of capital</p> <p>Growing deficit of skilled labour force, in particular due to outbound migration of manpower</p> <p>Utilization of energy-intensive, morally and physically outdated technologies</p> <p>Underdeveloped physical infrastructure</p> <p>Limited capacity of public administration</p> <p>Inefficient judiciary system and persevering corruption</p> <p>Administrative hurdles to businesses and attracting investments</p> <p>Poor targeting of social assistance</p> <p>Negative demographic trends</p> <p>Excessive social and economic gap between the municipalities of Chisinau and Balti, and other localities</p> <p>Some categories of natural resources are poorly explored and there is unused space</p> <p>Adverse impact of development on environment</p>
<b>Opportunities:</b>	<b>Threats:</b>
<p>Sustainable economic growth in trade partner countries</p> <p>Geographic proximity to EU and major trade markets</p> <p>Clear-cut prospects for better access to the EU markets based on ATP (autonomous trade preferences)</p>	<p>Delayed regulation of the Transnistrian conflict</p> <p>Reliance of the national economy on external factors</p> <p>Increasing prices for energy resources</p> <p>Protectionist measures on foreign markets</p>

Penetration of foreign banks on the domestic banking markets	Unfavorable image of the Republic of Moldova worldwide, and limited global visibility
Availability of international financial organizations and donor countries to provide financial and technical assistance for the country's development	

## 1. Strengths

**Maintain macroeconomic stability during profound reforms.** The performance of the economy made it possible to overcome a period of ongoing economic decline and poverty growth over the last seven years and reach economic growth and improvement in the living standards. Thus, the cumulative growth of GDP has been 49.5% during 2000-2006. The national currency exchange rate stayed stable, and the National Bank reserves grew significantly. The robust economic growth and prudent foreign lending limits led to a constant growth in public revenues and a reduction of foreign debt as a share of GDP from 60.4% in 2000 down to 21% in 2006.

**Relatively developed and stable banking sector.** Stability indicators of the financial sector are quite sustainable and, by and large, Moldova is meeting the criteria of the Basel Committee for an efficient banking supervision. Generally, the banking sector is characterized by growing revenues, capitalization and liquidity, as well as by few non-performing assets. In particular, between 2000 and 2006 the banking system's assets grew 5 times<sup>12</sup>, the credits provided by commercial banks to the economy doubled in relation to GDP, and the share of non-performing credits out of the total of credits provided by commercial banks in the Republic of Moldova reduced 4.7 times. Moreover, the growing interest on the part of foreign banks to invest in the banking sector of the Republic of Moldova is improving the internal and external credibility towards this sector.

**Relatively cheap labour force in smaller towns and rural settlements.** Labour force is relatively cheap in small towns and rural communities of the Republic of Moldova when compared to other countries in the region. Thus, the average monthly salary in Moldova was MDL1,700 (USD130) in 2006, while in Romania the average salary was over USD350 according to the National Institute of Statistics. The average monthly salary in Ukraine's public sector is approximately USD260. Also, the average salary in Baltic countries was slightly over USD650, being 5 times the one in Moldova. The relatively low cost of manpower is one of the incentives to attract investments and promote trade during a given period. However, one should take into account that our comparative advantage of lower costs will erode more and more as the time passes by, and the technological gap between Moldova and developed countries might widen.

**Majority consensus on the European vector.** There has been political and social consensus in the recent years regarding the country's domestic and foreign policy of European integration. According to the public opinion barometer conducted in November 2006 by the Institute of Public Policies, should there be a referendum on joining the European Union, as many as 68% of people would vote for it.

**Customs duty free access to EU markets based on the GSP plus system, to the countries of South-Eastern Europe based on the CEFTA agreement, and to CIS countries based on free trade agreements.** Moldova's access to the Generalized System of Preferences (GSP

<sup>12</sup> January 1, 2007 versus January 1, 2001.



Plus) as of January 1, 2006 allows free access to the EU markets for about 9,200 tariff items out of the 10,200 items existing in the country. Therefore, 2,000 items are made available to all third countries based on the EU customs tariff, and 7,200 items based on the GSP Plus, that only 15 countries benefit from. Getting the GSP Plus is a considerable improvement in the trade arrangements with the EU, thus making it possible to increase the exports to the EU markets by 20% in 2006. Moldova's adherence to the CEFTA (European Community Free Trade Agreement) is an excellent framework to prepare for the joining of EU and adherence to European values, by opening up economies and by developing regional trades. Similarly, the signing of free trade agreements with the CIS member states provides considerable opportunities to widen the spectrum and import markets for the domestic products.

**Legal and fiscal framework conducive to investments.** The legal and fiscal frameworks in the Republic of Moldova are not creating obstacles for investments. Once the Law No. 81-XV of March 18, 2004 on Business Investments was adopted in 2004, there were equal opportunities set up for local and foreign investors alike. Moreover, the rate of the corporate income tax was brought from 32% in 1998 down to 15% in 2006, and the tax legislation provides for incentives promoting investments in various areas, such as: information technologies, import of production equipment for operating SMEs, etc. Furthermore, three components of the medium-term fiscal reform were approved in 2007, which imply: fiscal amnesty (which is already completed), capital legalization, and enforcement of the "0"% rate for reinvested income of economic entities starting in 2008.

**Skilled human resources in certain sectors of economy.** By and large, considering the income levels reported by the population of the Republic of Moldova, the education they benefit from is quite substantial. The gross enrolment rates are 97% and 93% for the primary and lower secondary education, respectively. Although the education system in the Republic of Moldova is not fully meeting the demands of domestic and foreign markets, the country is benefiting from skilled and trained human resources in certain areas (specifically, in information technologies and communications, banking and financial services, health care etc.). Moreover, the majority of the country's population speaks two languages and are prone to easily assimilating foreign languages, providing the Republic of Moldova with additional opportunities for education, employment and retraining both inside and outside the country.

**Growing purchasing power of population and poverty reduction.** The purchasing power of population grew up in recent years. This is reflected in the increase of household consumption, particularly due to the inflow of remittances in Moldova, which accounted for 35% of GDP in 2006. At the same time, there was an increase in salaries, and the annual indexation of pensions made it possible to avoid the adverse impact of inflation. Furthermore, the number of population below the absolute poverty line dropped by 38.7 p.p. during 2000-2005. There was also a reduction in the number of people below the poverty food line by some 36.1 p.p.. This allowed to cut down on the social exclusion<sup>13</sup> and scale up the access of population to health care and education services, thus contributing to consolidating the human development in the Republic of Moldova.

**Opening the Giurgiulesti port and harnessing ensuing benefits.** The signing of an investment agreement for the Free International Port "Giurgiulesti" provides room for harnessing certain actions not taken previously, such as the construction and use of petroleum terminal objects, construction of a port for passengers and handling of goods (including a cereals terminal) on the Danube River. Additionally, the Government is looking into the

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<sup>13</sup> Social status that is peripheral, isolating individuals or groups, with limited drastic access to social living conditions: economic, residential, occupational, educational and learning-wise. It is shown through a deficit of self-affirmation opportunities and participation in the community's life.

possibility to connect the railway lines on the territory of the International Port with Moldova's railway. From an economic point of view, this will ensure for Moldovan economic entities and foreign entrepreneurs a safe and advantageous transportation through the International Port. Overall, the activities carried out in the Giurgiulesti port will open up space for investments both on this territory and in Moldova generally.

**Expanding the services sector.** The competitiveness of companies targeting domestic markets and those exporting goods on international markets depends on the availability, cost and quality of services on the domestic markets. During 2000-2006, the services sector showed an expansion, increasing as a share of GDP from 48.2% up to 56%, including the constructions sector from 2.7% up to 3.9%, and the transport and communications sector from 9.5% up to 12.1%. The transport services have been characterized by an increased traffick of goods and passengers by 2.4 and 1.5 times, respectively. The financial services sector has been marked in the last six years by an expansion of the supply to population in general and to economic entities in particular (expansion of electronic payments via Internet, development of factoring, establishment of 33 insurance companies, over 100 leasing companies, private pension funds, etc.). Hence, the sustained growth in the share of services within the GDP, alongside the quality of those, will facilitate the operation of enterprises and will favour economic growth.

**Expanding the sector of information technologies and communications.** Although at an embryonic stage of its development, the information technologies and communications sector reported a growth 6 times higher than the one of GDP starting in 2000. During 2000-2006, the number of fixed telephony lines and mobile telephony subscribers per 100 population increased approximately 1.7 and 6 times, respectively, and the number of personal computers and Internet users per 100 population increased 10 times. The expansion of the IT and communications sector will provide for an accelerated flow of information, assimilation of new technologies, which in turn will have an impact on Moldova's competitiveness.

**Cooperation between the Republic of Moldova and regional and international security structures.** The advancement of regional mechanisms for conciliation and development of cross-country relations, such as the Stability Pact for South-east Europe and the NATO Partnership for Peace, is the best way for the Republic of Moldova to join to the international efforts meant to create a single security system in the Euro-Atlantic region and consolidate stability in the world. In order to strengthen the border services of Moldova and Ukraine and consolidate the Transnistrian conflict resolution efforts, the EUBAM mission was established. At regional level, an opportunity would be to share information through the Regional Center to Fight Cross-Border Crimes (SECI Centre), which has national contact units in the member states, with a National Virtual Centre SECI/GUAM in the Republic of Moldova to fight terrorism, organized crime, illegal drug smuggling, and other kinds of serious violations.

## **2. Weaknesses**

**Skewed structure of production.** The economy of the Republic of Moldova did not manage to ensure a balanced operation of all sectors of the economy during transition. It was not possible to revitalize industry, improve the performance of agriculture and set up a sustainable tertiary sector. As a result, the spectrum of products that the Republic of Moldova is providing is very homogeneous and is not meeting the requirements imposed by foreign trade markets. Thus, because of the low competitiveness of Moldovan products, the export geography of the Republic of Moldova is poorly diversified, with about half of the exports heading for CIS markets. Although another half is heading for EU countries and South-

eastern Europe, the range of exported goods is poorly diversified, mostly made up of farming products, alcoholic beverages, and textiles.

**Relatively high cost of capital.** Although justified by the high inflation over the last couple of years, the high interest rates for loans (18% for loans in national currency and 11% for loans in USD) limit the access of companies, in particular SMEs, to these financial resources.

**Growing deficit of skilled labour force, in particular due to outbound migration of manpower.** The migration of labour force, which mostly scaled up during the second decade of transition, contributed to the outbound flow of skilled manpower. According to the annual labour force survey conducted by the NBS, approximately 330 thousand citizens of the Republic of Moldova emigrated abroad in 2006. According to some studies<sup>14</sup>, 25.7% of emigrants have higher education, 51% are graduates of vocational training institutions, and 23.2% have secondary education. The emigration of a significant part of people with vocational education shows an increased demand for emigrants with certain qualifications and professional skills. Although the unemployment rate is on a downward sloping trend in the Republic of Moldova, the growing number of unemployed youth raises concerns.

**Utilization of energy-intensive, morally and physically outdated technologies.** Because of the use of equipment and gear with substantial physical and moral wear-out, the energy consumption is intensive in the Republic of Moldova, totalling about 3 times the respective indicators reported in developed countries. Moreover, the heavy reliance of the economy (up to 96%) on imported energy resources and the up-surging price for those is an additional burden for the production sector of the country.

**Underdeveloped physical infrastructure.** In order to attract investments, it is required that an adequate physical infrastructure be put in place. This primarily refers to roads. 75% of national roads and 79% of local roads are currently dilapidated and in poor condition in the Republic of Moldova. At the same time, merely 34% and 30% of the households have water supply and sewerage, respectively; whereas the social infrastructure is to a great extent outdated and doesn't meet the current demands. This results in high maintenance costs and waste of resources to the detriment of the needs to develop the education, health care and social protection sectors for the population.

**Limited capacity of public administration.** The existing capacity of public administration is not adequate to provide good-quality public services. Despite quite a few people working in this sector, the low salaries contributed to low motivation and poor productivity. These, as well as the inadequate outlining of attributions and competencies of central and local public administration authorities, and the insufficient financial and economic independence of those, undermine the capacity of public administration to render good-quality public services.

**Inefficient judiciary system and persevering corruption.** Despite the efforts made to reform the justice system in the Republic of Moldova, it is characterized by judges having limited access to the tools needed to take well-poised decisions, to international law sources, as well as by the poor status of courts that would secure the access of the public to court rooms and trial procedures. Also, a problem characteristic to the current judicial system relates to courts, which examine an excessive amount of cases, also because of a limited use of alternative methods for litigations, such as mediation and probation. These issues, coupled with a large number of judge decisions left unexecuted, appeals to the European Court for Human Rights, and general appeals to justice (while the number of judges is constant over time) are another proof of the judiciary system's inefficiency. Moreover, the limited transparency of relations in certain

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<sup>14</sup> Gencea B., Gudumac I. Migration of Labor Force and Remittances in the Republic of Moldova. Moldova Microfinance Alliance and the Soros Foundation, 2004.

sectors, specifically in the health care system and education, result in corruption still being one of the most substantial hurdles to mount for the accomplishment of economic growth and poverty reduction objectives. Even if the Corruption Perception Index done by Transparency International improved, reaching 3.2 compared to 2.6 in 2000, Moldova continues to stay in the second part of the ranking, which includes 163 countries.

**Administrative hurdles to business and attracting investments.** Despite developing a legislative framework conducive to attracting investments and promoting regulation framework reforms, there are still administrative obstacles hindering the placement of investments in the Republic of Moldova. In this context, as part of the business regulation reform initiated by the Government in 2005, a number of normative acts issued by central authorities, which are burdensome for the operation of economic entities, were found. The reform process continues, and only once it is completed and the Regulatory Impact Assessment of proposed normative acts is fully introduced, these obstacles could be considered reduced.

**Poor targeting of social assistance.** Social assistance is the way to support the population to avoid poverty and improve its living standards. Although the benefits targeting families with children are reckoned to be one of the most important and efficient social assistance programs, the impact of those payments on the wellbeing of families with children is unsubstantial, because of the small amount payable. As to the nominal compensations paid on a category basis, which represented approximately 38% of social assistance and insurance spending in 2006, these have a number of drawbacks, including: i) nominal compensations are not always targeting the poorest groups of population; ii) the small amounts of nominal compensations don't provide solutions for beneficiaries' problems; iii) impossibility to evaluate the number of cash payments entering one or another family (there could be more two or more individuals within a family entitled to several compensations), thus posing an error threat to the system – over-inclusion and exclusion.

**Negative demographic trends.** At the beginning of 2007, there were 491 thousand people of 60 years and above in Moldova, two thirds of them located in rural areas. Out of the total number of those who are 60 years and above, every fourth person is aged between 60-64 years, and 12.8% of the total form the age group 80+. Furthermore, during the past 17 years there has been an increase in the population's ageing coefficient, from 12.8% in 1990 up to 13.6% in 2005 and 13.7% at the beginning of 2007. These numbers show a continuous process of ageing, which is more advanced in rural areas (15.2%). This demographic trend causes serious problems, as all the countries that go through population ageing and demographic decline face several issues, among which: adequate retirement age and health care for elderly, ratio of people working and those of retirement age, participation on the labor market.

**Social and economic gap between the municipalities of Chisinau and Balti, and other communities.** During the transition period, there was a sharp increase in the contrast between urban and rural settlements. The country's development is still polarized, the most developed in all terms being the municipalities of Chisinau and Balti. Because of certain more vulnerable communities, there is a considerable gap across regions including revenues, labour force employment, access to health care and education services, physical and social infrastructure. Thus, the municipality of Chisinau, which concentrates 22% of the country's population, had in 2006 half of the industrial production, 56% of the retail sales, and 58% of investments in fixed capital. The municipality of Balti, with a population of 4% of the country's total, generates 14% of the industrial production, 9% of retail sales, and accumulates 6% of investments in fixed capital. Regarding the pay level, the average salary

in the municipality of Chisinau exceed by approximately 23% the average salary in the country in 2006, and in Balti – by approximately 9%. At the same time, in the districts of Soldanesti, Stefan Voda and Cantemir, the average monthly salary was slightly under 60% of the average monthly salary in the economy.

**Certain categories of natural resources are poorly explored and there is unused space.** Moldova is holding a rich land patrimony and non-metal mineral reserves that are not used to full capacity. Although land areas sown to agriculture and forests may not be purchased by foreign citizens, there is a legal framework in place to ensure the long-term leasing of those, thus facilitating their use to full capacity.

**Adverse impact of development on environment.** Even if the impact of economy on the environment is smaller, because of the economic crisis during transition and deindustrialization of the country, the environmental status of the country could not be described as a favourable one. The quality of ground waters, drinking water and facilities for the biologic treatment of residual waters and sewerage systems is not satisfactory. Also, there are more emissions to the atmosphere from mobile sources, whereas the soils deteriorate due to intensive use of soils and utilization of obsolete farming techniques. As the climate change impact grows, the frequency and severity of natural disasters, such as droughts and hail, landslides and soil erosion may increase. The worsening of the environmental situation in the Republic of Moldova has a negative impact on both the health status of people and the agricultural production.

### **3. Opportunities**

**Sustainable economic growth in trade partner countries.** The Republic of Moldova and other countries are significantly relying on the economic development of partner countries. In 2006, the main trade partner countries in the region had GDP growth: Belarus – 13%, Romania – 7.7%, Ukraine – 7%, Russia – 6.9%. In the main EU trade partner countries (Germany, Italy, Austria, Hungary) economic growth varied between 1 and 3.8%, being smaller than in Moldova's trade partners countries in the region. Nonetheless, even if characterized by small numbers, the growth in developed European countries is sustainable and inclusive. The economic growth in partner countries, which is preceded by growth in the purchasing power and by prodigal development of various branches of economy, will make sure that there is a need for imported raw material and products, which could be supplied by the Republic of Moldova.

**Geographic proximity to EU and major trade markets.** The vicinity with EU – an important political pole and the biggest trade market in the world, is providing the Republic of Moldova with important advantages. Hence, within the framework of EU expansion to the borders of the Republic of Moldova, there is a possibility to request an EU-associated member state status, and become a plenipotentiary EU member state in the long run. By bordering the EU, the Republic of Moldova benefited from a new system, GSP Plus, which allows the access, at a zero per cent rate customs duty, for about 88% of Moldovan exports to the EU. Moreover, Moldova could benefit from the ATP (autonomous trade preferences) agreement, greater involvement of the EU in sorting out the Transnistrian conflict, an easier visa regime for the citizens of the Republic of Moldova travelling to the EU, as well as assistance provided within the framework of the New European Neighbourhood and Partnership Instrument. Besides, once Romania and Bulgaria joined the the EU, these countries accepted EU norms and standards that are less attractive to investors. The cost of labor force in those countries is growing up at a sustainable pace and is exceeding way off the cost of manpower in the Republic of Moldova. This situation is favourable to attracting investors from those countries to Moldova, specifically making allowance for the geographic

proximity and cultural and language similarities with those countries. At the same time, Moldova is geographically close to Russia, too – one of the most important emerging markets. Any eventual investments made into physical infrastructure, improvement of product competitiveness and better image of the country, could provide the Republic of Moldova with opportunities to turn into a “regional hub” between East and West.

**Clear-cut prospects for better access to the EU markets based on ATP.** Moldova has a big opportunity to get better access to the EU markets based on ATP (autonomous trade preferences) in 2008. The signing of the ATP agreement would augment the trade advantages that the Republic of Moldova is benefiting from based on the GSP Plus system, and would scale up the free trade facilities over some important products for the economy of Moldova, such as alcoholic beverages, sugar, etc.

**Penetration of foreign banks on the domestic banking market.** The entrance of several foreign banks on the banking market of the Republic of Moldova (such as *Banco Veneto* of Italy in 2006, *Raiffeisen* of Austria in 2006, *Societe Generale* of France in 2007) will enhance competitiveness within the given sector and will generate a drop in the cost of capital. Therefore, the presence of international banks on the domestic market minimizes the potential risks for foreign investors and stimulates direct foreign investments.

**Availability of international financial organizations and donor countries to provide financial and technical assistance for the country's development.** The decision taken by the Consultative Group for the Republic of Moldova to provide financial assistance worth USD1.2 billion for the next three years is an opportunity to support the country's balance of payments and make investments in physical and social infrastructure, run public administration reforms and regulatory framework reforms, as well as prevent and fight corruption.

#### 4. Threats

**Delayed regulation of the Transnistrian conflict.** The unsolved Transnistrian conflict is an obstacle to a sustainable and smooth socio-economic and socio-political development of the Republic of Moldova. This being said, smuggling and illegal trafficking are the main factors that influence economic growth and, as a result, the social sector. The barriers to the free movement of citizens, goods and services, as well as the administrative bans hinder trade development between the two banks of Nistru river. Another threat is the serious problem with human rights and operation of democratic institutions in the Transnistrian region. The violation of fundamental human rights by the region's administration affects not only those 500.000 people living in the region, but also the citizens living on the right bank and the foreign citizens. In terms of security, the main threat is the foreign military presence on the territory of Moldova (left bank) that undermines Moldova's neutrality status stipulated in the Constitution, as well as the existence of paramilitary groups in the region.

**Reliance of national economy on external factors.** The economic performance in 2006, going down due to the ban imposed by the Russian Federation on the imports of alcoholic beverages and meat, coupled with skyrocketing prices for energy resources, proved the negative consequences of a country's reliance on external factors. Any shift in the attitude towards the Republic of Moldova on the side of partner countries may result in severe impacts on the economic and social development of the country.

**Increasing prices for energy resources.** The recent consecutive increases in prices for imported energy resources have had a serious impact on the economy and the country's population. The increase in the purchase prices contributed directly to a higher cost of electricity, natural gas and oil products purchased by public institutions at all levels (increasing budget spending by 0.5% of GDP). The increased prices for energy and lack of an

improved social assistance system significantly increased public funding needs to support the system. Any eventual rise in prices of imported energy resources would be an extraordinary blow, both to domestic producers and to the entire population of the country.

**Protectionist measures existing on foreign markets.** Although the foreign markets to which the Republic of Moldova is exporting its products are liberalized, frequently there are certain protectionist measures imposed to protect the domestic producers. This is relevant specifically to Ukraine and Russia, which are not members of the WTO, and tend to impose certain protectionist measures affecting the foreign trade of the Republic of Moldova.

**Unfavorable image of the Republic of Moldova worldwide, and limited global visibility.** Being a small-size country, which declared its independence less than two decades ago, the Republic of Moldova is not well-known worldwide. On top of this, globally, information about Moldova has been dominated by negative news and labelling pertinent to certain issues faced by the country, such as poverty, corruption, Transnistrian conflict, and human trafficking. This information has not been consistently offset with positive images of the country. The unfavorable image of Moldova prevents the access of foreign investors to the local market, and sometimes contributes to a discriminatory treatment of Moldovan citizens staying abroad.

## **5. Conclusions**

The social, economic, SWOT, and constraints analyses reveal the existence of some internal and external factors that favour/threaten the development of the country. Hence, the country's development over the last seven years can be characterized by the resumption of economic growth, maintenance of macroeconomic stability, significant reduction of poverty, and initiation of a series of structural reforms in areas of strategic importance. However, these achievements have been attained on the background of a distorted production structure (based on such sectors as agriculture and industry, currently characterized by low productivity and use of outdated and energy-intensive technologies), a low level of internal and external investments, worsening of the trade balance deficit, and massive outflow of qualified labor force.

Generally, Moldova can be characterized as a country with a small sales market, limited capacity for manufacturing competitive products, extremely dependent on several partner countries with respect to both exports and imports, that now has the biggest share in the supply on the domestic market. In addition, the existence of a legal and fiscal framework favourable for the development of private sector and attraction of investments and qualified human potential in some economic areas are not enough if there are gaps in the operation of the public administration and judiciary system.

The positive development aspects in Moldova are conditioned by a combined impact of efforts made by the Government during the analyzed period, donors' assistance and increased purchasing power of population. These allowed to avoid great social disturbances, but were not sufficient to change the structure of economy and the paradigm of economic growth.

In this context, it will be necessary to ensure during 2008-2011 a development track, fully based on the existing peculiarities of the country, efficiently turn to benefit the entire range of indisputable opportunities, and prevent the appearance of any threats. Thus, the removal of drawbacks and achievement of the main objectives of the Republic of Moldova will rely on the capitalization of all existing opportunities, especially those related to the country's proximity to the EU and availability of international financial organizations to provide mid-term financial assistance to the country. Also, it is important to use the country's strengths in order to reduce the exposure to potential risks, particularly those related to the intensification

of state's vulnerability, continuation of labour force outflow, increasing poverty and population inequality.



### III. STRATEGIC VISION

#### 1. Overview of the Strategic Vision

The National Development Strategy starts from the *basic objective* derived from the Constitution of the Republic of Moldova and namely, *establishment of adequate conditions for improving the quality of life*. Moreover, the improvement of the quality of life is a polyvalent factor, consisting of a number of closely related dimensions. At a personal level, this means a healthy and educated person, able to exercise his/her fundamental rights and liberties, positive about a decent old age – a person who wishes that he/she and his/her children live in the Republic of Moldova. At country level, this implies a deep transformation and modernization of the country and an effective qualification for accession to the EU.

**In the context of the above-mentioned, the Government will make over medium term efforts to recover by 2011 at least 7 p.p. of the income gap in relation to the EU average<sup>15</sup> and reduce the absolute poverty rate down to 24%<sup>16</sup>. In the long run, the Government will make efforts to recover by 2015 at least 12 p.p. of the income gap in relation to the EU average and reduce the absolute poverty rate down to 20%.**

In the long run, the Strategy aims at changing the Republic of Moldova into:

- a) a reintegrated state that enjoys multilateral security guarantees (integrated into the European security architecture);
- b) a state where the political and election processes are carried out in accordance with the democratic procedures, and where the right to freedom of expression is enforced and accepted by all political forces;
- c) a state that by its modern judiciary system ensures all citizens' equality before the law, whereas corruption is considerably reduced and cannot endanger the development and modernization of the country;
- d) a country where economic growth ensures increased revenues for all social strata and promotes a productive contribution of vulnerable groups to the economic development of the country;
- e) a country free of poverty and vices characteristic to poor societies;
- f) a state that creates conditions for the establishment and attraction of international competitive companies that find niches on the global market, firstly because of the quality of their products;
- g) a country that shows a quick gap recovery in technological development compared to European countries;
- h) a country where the national economy is effectively integrated in the regional economic processes by modern and safe transport arteries;

<sup>15</sup> Estimates were based on the analysis of the GDP per capita to PPP. The simulation showed that a reduction of the income gap in relation to the EU average can be attained by 2011 at a 6% annual growth rate of GDP.

<sup>16</sup> While defining targets for poverty reduction, the relationship between economic growth and poverty reduction was taken into consideration, with a value of -1.4 of the poverty elasticity to economic growth, which is the regional average and is relevant in the context of the Republic of Moldova. Although at a GDP growth rate of 5% the simulations showed that the poverty rate may reach almost 21% by 2011, the target was adjusted by taking into consideration the non-linear correlation between economic growth and poverty reduction.

- i) a state that guarantees qualitative education, health care and social services for all citizens;
- j) a state where the education system ensures the employment of all young people through services adjusted to present-day labour force requirements;
- k) a state where the social insurance system is favourable for the demographic process (secured birth and old age);
- l) a country where economic growth is a process that covers all regions and communities;
- m) a country where the quality of life in rural areas comes close to that in urban areas, while also maintaining the cultural values and traditions;
- n) a country where the model of social and economic development does not endanger nature and environment and that contributes to the preservation of national and cross-border ecosystems;
- o) a country, whose international image improves dynamically and that turns into a welcomed member of the European family.

## **2. Millennium Development Goals on the Medium- and Long-Term Agenda of the Government**

In 2000, the Republic of Moldova along with other 191 countries of the world committed to achieving the Millennium Development Goals (MDGs) by 2015. The achievement of these goals is on the medium- and long-term agenda promoted by the Government through the National Development Strategy. The first adjustment of MDGs to the national context was done in 2004 and resulted in a number of specific targets and indicators. In the following years it was decided that some targets and indicators needed adjustment to the current situation. This is also relevant because of the evolution of MDG indicators over the last years and the results of 2006 intermediary target's accomplishment. The Government will continue to implement the MDG agenda, but to ensure the relevance of the established agenda and its full integration with national policies, the MDG targets and indicators underwent more rigorous adjustment to the specific nature of the country's development, as compared to the initial stage of adjustment.

The MDG targets for 2010 and 2015, revised under a process of consultations both with central public authorities and with a number of national and international organizations, which was conducted in parallel with the Strategy's participatory process, are presented below. The baseline year for establishing the medium- and long-term targets will be the same as in the initial MDG report (2002), except for cases when the estimation methodology was recently modified for some indicators:

### **Goal 1. Eradicate extreme poverty and hunger<sup>17</sup>**

- Reduce the proportion of people whose consumption is under \$4.3 a day/person (in PPP terms) from 34.5% in 2006 down to 29% in 2010 and 23% in 2015.

<sup>17</sup> The baseline year for establishing targets under this goal is 2006. This transition is inevitable because the NBS modified the HBS sample this year for the estimation of absolute and extreme poverty rates, and the numbers for 2006 are not comparable to previous years. If 2002 stayed as the baseline years, the series of data calculated according to the previous methodology would have stopped in 2005. Also, to avoid establishing different baseline years for indicators under this goal, for the third indicator "proportion of people whose consumption is under \$4.3 a day/person (in PPP terms)", the estimation of which was done for the first time in 2007, 2006 will also be taken as the baseline year.

- Reduce the proportion of people under the absolute poverty line from 30.2% in 2006 down to 25% in 2010 and 20% in 2015.
- Reduce the proportion of people under the extreme poverty line from 4.5% in 2006 down to 4% in 2010 and 3.5% in 2015.

## Goal 2. Achieve universal access to general secondary education

- Ensure opportunities for all children to attend general secondary education. Increase the gross enrollment rate for general secondary education from 94.1% in 2002 up to 95% in 2010 and 98% in 2015.
- Maintain the literacy rate for the 15-24 year-old population at the level of 99.5%.
- Increase the enrollment rate for pre-school programs for 3-6 year-old children from 41.3% in 2002 up to 75% in 2010 and 78% in 2015, and for 6-7 year-old children from 66.5% in 2002 up to 95% in 2010 and 98% in 2015, as well as reduce by less than 5% the discrepancies between rural and urban areas, between disadvantaged and middle-income groups.

## Goal 3. Promote gender equality and empower women<sup>18</sup>

- Increase women's representation in decisionmaking positions. Increase women's representation at the decisionmaking level from 26.5% in local councils in 2007 up to 40% in 2015, from 13.2% in raional councils in 2007 up to 25% in 2015, from 18% women-mayors in 2007 up to 25% in 2015, and from 22% women-Parliament members in 2005 up to 30% in 2015.
- Reduce gender inequality in employment. Reduce gender inequality on the labor market by reducing the discrepancy between salaries of women and men by at least 10% until 2015 (women's average salary representing 68.1% of men's salary in 2006).

## Goal 4. Reduce child mortality<sup>19</sup>

- Reduce infant mortality from 18.5 (per 1,000 live births) in 2006 down to 16.3 in 2010 and 13.2 in 2015.
- Reduce the under-5 mortality rate from 20.7 (per 1,000 live births) in 2006 down to 18.6 in 2010 and 15.3 in 2015.
- Maintain the proportion of under-2 children vaccinated against measles at least at 96% by 2010 and 2015.

## Goal 5. Improve maternal health

- Reduce the maternal mortality rate from 28.0 (per 100 thousand live births) in 2006 down to 15.5 in 2010 and 13.3 in 2015.

<sup>18</sup> The baseline year for establishing targets under this goal is 2006. This year, for the first time, quantifiable targets on gender equality were set in the context of MDG. To this effect, the data of the latest elections were used, which reflect the current gender situation in Moldova. At the same time, in relation to the difference between the salaries of men and women, the most recent data for this indicator are in place only for 2006.

<sup>19</sup> The baseline year for establishing targets under this goal is 2006. This transition is necessary because of the decision of the Ministry of Health to apply a new methodology for child mortality estimation, recommended by the WHO and established as an objective in the Moldova-EU Action Plan. Hence, starting with 2006, a live birth will be defined as a birth after 22 complete weeks of pregnancy and a child weight above 500 grams. Previously, this indicator was estimated based on a birth considered live after the 30<sup>th</sup> complete week of pregnancy and a child weight above 1,000 grams.

- Maintain the number of births assisted by qualified medical staff during 2010 and 2015 at 99%.

#### Goal 6. Combat HIV/AIDS, tuberculosis and other diseases

- Stabilize the spread of HIV/AIDS infection by 2015. Reduce HIV/AIDS incidence per 100,000 population from 10 cases in 2006 down to 9.6 by 2010 and 8 by 2015.
- Reduce HIV/AIDS incidence per 100 thousand population from 13.3 cases in 2006 down to 11.2 by 2010 and 11 by 2015 in the 15-24-year age group.
- Have halted by 2015 and begun to reduce tuberculosis. Reduce the rate of mortality associated with tuberculosis from 16.0 (per 100,000 population) in 2002 down to 15.0 in 2010 and 10.0 in 2015.

#### Goal 7. Ensure environmental sustainability

- Integrate the principles of sustainable development into country policies and programs and reduce degradation of natural resources. Increase afforestation from 10.3 % in 2002 up to 12.1% in 2010 and 13.2% in 2015.
- Increase the share of protected areas to preserve biological diversity from 1.96% in 2002 up to 4.65% in 2010 and 4.65% in 2015.
- Increase the share of people with permanent access to safe water sources from 38.5% in 2002 up to 59% in 2010 and 65% in 2015.
- Halve the number of people without access to improved sewage and sanitation systems. Increase the share of people with permanent access to safe water sources from 31.3% in 2002 up to 50.3% in 2010 and 65% in 2015. Increase the number of population with access to sanitation systems from 41.7% in 2002 up to 51.3% in 2010 and 71.8% in 2015.

#### Goal 8. Develop a global partnership for development

- Further develop a transparent, predictable and non-discriminatory trade and financial system based on rules through promoting exports and attracting investments.
- Settle the issues of land lock of the Republic of Moldova through upgrading the transport and customs infrastructure.
- Monitor the external debt issue.
- Develop and implement youth strategies.
- Ensure access of population to major drugs.
- Build an information society.

### **3. National Medium-Term Priorities as a Way to Meet the Long-Term Vision**

It is necessary to meet the MDG targets and indicators, but not sufficient to achieve the long-term vision. The achievement of MDGs and proposed long-term objectives can be accomplished by consolidating the foundation for a solid, sustainable, and inclusive economic growth. Starting with an analysis of the present growth model, the enhancement of local economic competitiveness and, respectively, its role in satisfying the domestic and external demand stays as a main task on the Government's agenda. At the same time, to ensure an inclusive nature of the growth it is necessary to eliminate the regional disparities by

promoting a development that would stimulate the creation of well-paid jobs countrywide, thus raising the incomes of the residents and offering an alternative for emigrants.

The identification of priorities is based on the analysis of socio-economic factors, SWOT analysis, and recognition of the fact that the financial resources, compared to the multitude of needs and opportunities, are scarce; so a high level of their concentration is needed.

In this respect, the Strategy proposes five national mid-term priorities in order to achieve general objectives:

- Strengthen democracy based on the rule of law and respect for human rights principles;
- Settle the Transnistrian conflict and re-integrate the country;
- Raise the national economy's competitiveness;
- Develop human resources, rise the employment level, and promote social inclusion<sup>20</sup>;
- Regional development.

**Ensuring macroeconomic stability and consolidating the capacity of local and central public administration are prerequisites for achieving the five established priorities.**

The prerequisites and national priorities identified in the Strategy cannot be approached separately – they are correlated and complement each other. Hence, good-quality human resources contribute to an increase in competitiveness and vice versa. Fighting corruption affects positively both the business environment and the quality of education. The separation by areas aims at rationally organizing the strategy paper, as well as simplifying the implementation, monitoring, and evaluation, and does not represent an essential division. The identified measures will be jointly implemented, and the achievement of an objective will contribute to the achievement of others.

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<sup>20</sup> Ensure access of vulnerable groups to jobs that can guarantee a decent living, access to social services and participation in the life of the community.

#### **IV. PREREQUISITES FOR ACHIEVING THE PRIORITIES OF THE NATIONAL DEVELOPMENT STRATEGY**

##### **1. Ensuring Macroeconomic Stability**

An essential prerequisite to sustainable and balanced economic growth is the assurance of a macroeconomic stability by means of steady and foreseeable monetary and fiscal policy. Macroeconomic stability provides for people's and economic entities' confidence in the sustainability of economic growth, thus stimulating them to augment their operation, increase the efficiency of production, make investments, etc. Moreover, macroeconomic stability is an important condition for an efficient implementation of social policies and improvement of people's living standards.

At the same time, the macroeconomic situation is also influenced by that of the real sector. An efficient operation of the real sector contributes to maintaining macroeconomic stability. On the contrary, an unbalanced and rigid structure of internal production, low level of competition in the economy and production can lead to macroeconomic instability.

Ensuring macroeconomic stability is not only about promoting balanced monetary and fiscal policies; it's also about stimulating the domestic supply and level of employment. Complex measures to stimulate the domestic supply and increase employment are described in the Strategy's mid-term priorities, and this chapter focuses narrowly on monetary and fiscal policies as factors contributing to a favorable environment for the achievement of other Strategy goals. To this effect, the Strategy will focus on achieving the following outputs:

- (i) ensure and maintain price stability;
- (ii) promote a flexible exchange rate policy;
- (iii) promote a balanced budgetary-fiscal policy, which would provide for the stability of public funds over medium and long term;
- (iv) reduce the tax burden on economy and prevent public sector expansion;
- (v) improve public financial management.

The provision and maintenance of price stability is the core objective of the National Bank of Moldova (NBM). In this context, the NBM will implement a prudent monetary policy and will use the entire range of tools available to ensure price stability. Over medium term, the implementation of a new monetary policy regime is planned, namely the introduction of the inflation targeting regime. During 2008-2011, measures will be taken to prepare and implement the new system.

The National Bank of Moldova will continue to maintain a floating regime of the exchange rate and will promote a prudent foreign exchange policy consistent with its core objective to ensure and maintain price stability.

Tax policy is another important instrument to ensure macroeconomic stability, economic growth and savings. In the years to come, the tax policy will further supervise support for economic activity and stimulation of investments from domestic and foreign sources. To this effect, starting in 2008, a 0% rate is introduced for reinvested income of legal entities. Also, starting in 2008, VAT reimbursement will be made for material assets, services related to long-term capital investments (spending), except for investments in housing and transportation means.

Increasing citizens' savings can be achieved as a result of modifying the structure and size of taxable annual income scales for natural persons, and gradually increasing the non-taxable income.

Furthering the fiscal administration improving efforts will contribute to a reduction in fiscal pressures by expanding the taxation base and ensuring stability in collecting budget revenues. The medium-term tax administration policy objectives result from the Tax Service Development Strategy for 2006-2010. The Strategy formulates the following major goals: (i) functional and structural strengthening of the State Tax Service; (ii) improving services provided to taxpayers and expanding the spectrum of services provided; (iii) improving fiscal procedures; and (iv) developing information technologies in data and information exchange.

The predictability of state revenues is to be achieved through the enforcement of public spending policies that would prevent a further increase of the public sector as a share of GDP. An important action in this regard is the initiation and implementation of a comprehensive medium-term public service reform, implying an optimization of the number and structure of civil servants. The accomplishment of this reform greatly depends on the advancement of structural reforms in sectors employing the majority of civil servants, and namely in education and health.

The resources needed to increase investment expenditures, other economic growth-related expenditures and reduce poverty are to be mobilized by improving the effectiveness and efficiency of current spending programs, as well as by redirecting allocations from programs having less priority towards programs generating a greater economic and poverty reduction impact, as identified in the Strategy. Generally, ensuring consistency between the priorities of the Strategy, the Medium-Term Expenditure Framework and the annual budget will be one of the major challenges of the medium-term fiscal and budget policies.

The qualitative improvement of public financial management is an inalienable condition for achieving the above-mentioned objectives. In public financial management, efforts will be focused on developing an efficient and sustainable financial management system, based on effective instruments and mechanisms, targeted towards and functional at the level of European standards. The main actions planned for the public financial management area refer to: (i) improving the public financial resource allocation process by applying modern budgeting and budget approval practices; (ii) strengthening of treasury system and improving budget execution procedures; (iii) optimizing fiscal administration and introducing a new system of financial control and internal audit in the public sector; (iv) optimizing budget management through developing an integrated public financial management information system.

Developing standardized, transparent and incorruptible decision making procedures for the use of budget resources, including through the use of public procurements, is one of the main conditions in the medium-term optimization of public financial management.

## **2. Strengthening Public Administration Capacity**

Improvement of central and local governments' performance is yet another important condition for a successful accomplishment of the ambitious agenda set forth in the National Development Strategy. Competitiveness of the national economy can not be ensured under an inefficient public administration, the structure of which is over-sized and the staff is under-skilled. On the contrary, the establishment of conditions to increase competitiveness in an economy, which is seriously unbalanced and has very limited domestic resources, under severe competition in the regional and global markets, is a serious challenge even for a well-trained and efficient public administration.