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COMMISSION STAFF WORKING DOCUMENT

Ex-ante evaluation statement

Accompanying the document

Proposal for a

DECISION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

providing macro-financial assistance to the Republic of Moldova

{COM(2017) 14 final}

Ex-ante evaluation statement

EU Macro-Financial Assistance to the Republic of Moldova

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1. PROBLEM ANALYSIS AND NEEDS ASSESSMENT

1.1 Introduction

The Republic of Moldova has faced a difficult period over the last two years on both the economic and political fronts. A major banking fraud scandal erupted in November 2014, exposing severe governance problems that have since been accompanied by political instability – including the formation of three different governments since the November 2014 elections and the replacement of the governor of the National Bank of Moldova (NBM) – and street protests. These developments have also led to a deceleration in economic growth, the suspension of budget support by Moldova's international partners, and a weakening of the fiscal and balance of payments position. Economic difficulties have been exacerbated by a recession or weak economic activity in some of Moldova´s key regional trading partners (notably Russia, but also Belarus and Ukraine), developments which reduced exports and remittances. This effect has only been partly offset by increased trade with the EU following the entry into force of the Association Agreement signed in 2014, which foresees the creation of a Deep and Comprehensive Free Trade Area (DCFTA).

In that context, Moldova requested support from the International Monetary Fund (IMF). After difficult and protracted negotiations, which reflected the existing political instability, in July 2016 the authorities finally reached agreement with the IMF on a programme to be supported by a three-year Extended Credit Facility and Extended Fund Facility (ECF/EFF) arrangement. The agreement was approved by the IMF Board on 7 November 2016. This agreement was made possible by a new determination on the part of the authorities, following the appointment of a new government led by Prime Minister Filip in January 2016 and of a new central bank governor in March 2016, to address governance problems in the financial sector and in public finance management (PFM). Access under the financial arrangement agreed with the IMF would represent 75% of Moldova's quota in the IMF (SDR 129.4 million, or about EUR 161 million). The aim of the ECF/EFF is to make swift improvements in financial sector governance and supervision, strengthen policies to ensure macroeconomic and financial stability, and foster sustainable and inclusive growth.

It should be noted that following the Foreign Affairs Council Conclusions of 15 February 2016, a Roadmap for Priority Reforms was agreed between the EU and the Moldovan authorities with the purpose of re-launching key structural reforms; the deadline was set for 31 July 2016. There has since been substantial progress with the implementation of this Roadmap, but as yet not all the EU concerns, expressed in the February Council conclusions, have been addressed.

The Moldovan government also requested Macro-Financial Assistance (MFA) from the EU in August 2015 and reiterated that request in March 2016. As a result of that request and in context of the political and economic developments since 2014, the European Commission is therefore submitting to the European Parliament and the Council a proposal for a Decision providing MFA to the Republic of Moldova of up to EUR 100 million. Of this amount, EUR 60 million would be in the form of loans and EUR 40 million in the form of grants. The proposed amount is justified based on an updated assessment of the country's external financing needs, the size of the IMF programme, burden-sharing considerations, and the room for manoeuvre available in the EU budget.

The proposed EU MFA would help Moldova cover part of its residual external financing needs over the period 2016-2018, which are estimated at USD 442 million (EUR 402 million), in the context of the new IMF programme. The operation would reduce the

economy's short-term balance of payments and fiscal vulnerabilities. It would be designed and implemented in coordination with the adjustment and reform programmes Moldova is agreeing with the IMF and the World Bank, as well as with the reforms agreed in the context of the EU's budgetary support operations and the DCFTA agreement.

Disbursement would take place in three tranches over 2017 and the first half of 2018, with the release of each tranche, including the first one, strictly linked to good progress with the implementation of both the IMF programme and a number of additional policy measures to be agreed between the Commission and the authorities and listed in the Memorandum of Understanding.

The implementation of the proposed operation is expected to go hand-in-hand with the resumption of disbursements under budgetary support operations financed by the European Neighbourhood Instrument (ENI). They have been frozen since early 2015 reflecting concerns over governance and the lack of a reliable macroeconomic policy strategy.

1.2 Moldova's macroeconomic situation

The **macroeconomic outlook** for Moldova remains vulnerable, but the combination of recent adjustment measures and the prospect of a resumption of foreign donor support have helped the country regain some stability.

After a marked deceleration of growth in 2014 (see Table 1 below), Moldova entered a recession last year, with its **GDP** decreasing by 0.5% in 2015 due to: (a) adverse weather conditions causing a 13.4% contraction in agricultural output; (b) an accelerating decrease in remittances and weak export performance reflecting the recession or weak economic activity in some of Moldova's main trading partners, notably Belarus, Russia and Ukraine; c) weak domestic credit expansion following the problems in the banking system and the tightening of monetary policy; and d) a fiscal squeeze partly caused by the suspension of international donors' support but also by the decline in tax revenues due to the recession, which significantly affected, inter alia, the public investment programme for 2015. After the adjustment in 2015, Moldova's economy is expected to recover only slowly in 2016 and the coming years. In 2016, GDP is expected to grow by about 2%. Growth in 2016 will continue to be constrained by budget cuts and tight credit conditions as well as by low remittance flows and higher local energy tariffs, which will keep private consumption subdued. Meanwhile, the reorientation towards EU markets will take time and require investment.

After accelerating from 4.7% in December 2014 to 13.5% in December 2015 (year-on-year), **CPI inflation** has been on a downward trend, reaching 3.0% in September 2016. The IMF projects average annual inflation at 6.9% for 2016 and at 4.9% for 2017.

In 2015, the **current account deficit** declined to EUR 293 million (by 40% year-on-year), due to a marked drop in prices of imported energy and the weakness of domestic demand, which depressed imports. As a percentage of GDP, however, the current account deficit declined from 6.7% in 2014 to 5.0% in 2015, due to the decrease of GDP in dollar terms in 2015 (itself a reflection of both the drop in real GDP and of the depreciation of the leu).

In 2015, exports decreased by 16% while imports declined by 24%. The **trade deficit** stood at USD 2 billion, down by 32% compared with 2014. In particular, exports to CIS countries decreased by 33% to USD 492 million, reflecting weak economic activity in several key CIS partners, as noted, but also import restrictions imposed by Russia. This led the share of CIS countries in total exports to decline from 31% to 25%. Exports to the EU countries decreased by 2% (although if calculated in euros they increased by 5%) over this period, while the EU share in Moldova's export structure increased from 53% to 62%. The decline in imports was mainly attributed to the fall in global energy prices and dampened import demand due to the leu depreciation.

Table 1: Moldova – Selected macroeconomic indicators, 2013-2018

	2013	2014	2015	2016 Proj.	2017 Proj.	2018 Proj.
National Accounts						
Real GDP growth	9.4	4.8	- 0.5	2.0	3.0	3.6
Population (million)	3.6	3.5	3.5	3.5	3.5	3.5
Consumer price index, period average	4.6	5.1	9.6	6.9	4.9	4.9
GDP per capita (USD)	2,222	2,286	1,857	1,914	2,000	2,114
Unemployment rate (in per cent)	5.1	3.9	4.9	4.7	4.5	4.4
Consolidated government operations						
Revenue and grants	36.7	37.9	35.7	34.9	35.3	35.4
Expenses	38.6	39.8	38.1	38.1	38.3	38.4
Overall fiscal balance	- 1.9	- 1.9	- 2.4	- 3.2	- 3.0	- 3.0
Overall fiscal balance excluding grants	- 3.8	- 5.4	- 4.0	- 4.9	- 4.7	- 4.3
General Government gross debt	29.6	36.0	45.0	45.7	46.8	47.7
o/w external debt	16.9	18.0	21.0	23.7	27.4	29.0
External sector						
Current account balance	- 5.8	- 6.5	- 5.0	- 3.5	- 5.0	- 5.4
Current account balance excluding grants	- 7.7	- 10.0	- 6.6	- 5.2	- 6.7	- 6.7
Gross international reserves, end of period (USD bn)	2.8	2.2	1.76	2.1	2.4	2.6
- In months of next year's imports of goods/services	5.4	5.4	4.7	5.1	5.5	5.6
Foreign direct investment, net (in per cent of GDP)	2.7	2.0	2.5	2.1	2.0	2.0
Nominal exchange rate (average - lei/USD)	12.6	14.0	18.8	20.0	20.4	21.0

Sources: IMF staff estimates, World Bank, MoF and Commission staff calculations

The Moldovan economy is highly dependent on **worker remittances** from abroad, which account for about 25% of GDP. In 2015, the total amount of net money transfers from abroad made in favour of individuals via authorized banks in Moldova amounted to USD 1.4 billion, down by 27% as against 2014, largely reflecting the decrease of transfers from Russia by 44%. Remittances from Russia accounted for 48% of the total, followed by Italy at 13%, USA at 10% and Israel at 9%.

Despite the turbulent economic and political developments in Moldova, **FDI inflows** in 2015 have not been affected. In 2015, FDI inflows reached USD 165 million, compared to USD 158 million for 2014. Moldova's free economic zones were important in attracting FDI.

As a result of the developing crisis in the financial sector, international reserves declined by 35% between September 2014 and February 2015, to USD 1.7 billion, or about 4.3 months of imports. More specifically, within that period the NBM sold from its **foreign exchange reserves**, both in special sales to the three State-controlled banks that went into liquidation and on the foreign exchange market, a total of USD 700 million. That decline partly reflected an increase in the rate of dollarization of savings as confidence in the leu weakened. Since then, reflecting the stabilisation and recovery in the foreign exchange market, the central bank accumulated USD 2.1 billion in foreign reserves by end September 2016, which represents an estimated 5.1 months of projected imports. However, resumption of disbursements from official donors will be essential to ensure future stability in the foreign exchange markets.

The government has been experiencing **substantial fiscal pressures** due to lower budget revenues resulting from weaker economic activity and the interruption of budget support from donors. These factors contributed to the increase of the **budget deficit** from 1.9% of GDP in 2014 to 2.3% of GDP in 2015. In July 2016, the parliament adopted a budget law fixing the budget deficit for 2016 at 3.2% of GDP (excluding one-off items). However, this was based on unrealistic revenues and expenditure forecasts. According to the IMF, without adjustment measures the deficit would in fact reach 3.5% of GDP. And if the one-off costs related to the bank resolution[1], which amount to about 10% of GDP, are included the deficit for 2016 would amount to -13.5% of GDP. According to the programme agreed with the IMF staff (prior action), a revised 2016 budget was adopted by the Government and signed by the President on 4 October 2016 based on more realistic macroeconomic and financial assumptions and foreseeing the necessary adjustment measures on both the expenditure and revenue sides so as to meet the 3.2% of GDP deficit target initially contained in the budget. Overall, savings made through both revenues and expenditure measures amounted to 2.2 billion lei, or 1.7% of GDP, in 2016[2]. They include measures to control the wage bill (also by cutting vacant positions) as well as various measures to improve tax collections and reform the tax administration and reduce the excessive number of tax exemptions).

Interest rates on T-bill auctions (3 to 12 months), which ranged between 23.5% and 26.4% in February, have sharply declined since mid-March. In the auction of 4 October, the 3-month T-bill was allocated at 7.85%. The cut in the base rate by the NBM from 19.5% in February to 9.0% in October 2016 has been instrumental as well as the prospect of an agreement on a programme with the IMF and the resumption of budgetary support from other donors.

The share of the general **government debt to GDP** increased from 36% at the end of 2014 to 45% at the end of 2015. These estimates take into account the emergency loans with State guarantees issued by the NBM to three banks under liquidation.

Last year's increase in government debt was largely driven by its domestic debt component. External government debt increased less (from 18% of GDP in 2014 to 21% of GDP at the end of 2015) and the increase was mainly attributable to the deprecation of the leu. External debt is mostly medium - and long- term debt owed to multilateral and bilateral creditors on concessional terms.

On 4 October 2016, the Law on the issuance of government bonds for execution by the Ministry of Finance of the payment obligations derived from state guarantees has entered into force and government bonds in the total amount of 13.34 billion lei have been issued and transferred to the central bank. The aforementioned amount was divided into 25 issuances of government bonds, with maturities from 1 to 25 years. Thus, the effective interest rate for the aforementioned issuances would allow keeping in real terms the value of debt at the time of bonds issuance.

As part of the medium-term **monetary policy strategy** adopted in December 2010, the NBM introduced an inflation targeting regime. The NMB aims to keep inflation (measured by the Consumer Price Index) at the level of 5% annually with a possible deviation of ± 1.5 percentage points, considered to be optimal for the growth and development of Moldova's economy over the medium-term.

In the aftermath of the banking crisis of November 2014, CPI inflation accelerated from 4.7% in December 2014 to 13.5% in December 2015 (on a year-on-year basis), thus amply

[1] In 2012-2014, Banca de Economii, Banca Sociala and Unibank conducted fraudulent lending activities, estimated at about MLD 14 billion (about USD 1 billion), which amounted to 12.5% of 2014 GDP. On 16 October 2015, the banking licenses of these banks were withdrawn by the NBM and they have been put in liquidation.

[2] The new assumptions include, inter alia, lower than previously expected imports and consequently lower than planned revenue from VAT as well as lower than assumed revenues from official transfers, mostly from the EU.

breaching the central bank's target. Reacting adequately, the NBM implemented restrictive monetary policies, increasing its leading interest rate from 6.5% in December 2014 to 19.5% in September 2015. This prevented inflationary expectations from becoming ingrained, curbed deposit outflows and supported the leu. As a result, CPI inflation has been on a downward trend, returning within the bands of the inflation target.

However, restrictive monetary policies also kept credit growth depressed, exacerbating the slowdown in economic activity. The closure of the three failed banks at the end of 2015 stopped the injection of liquidity in the system through these banks and, together with a stabilization of the foreign exchange market and a decline in inflation expectations, has allowed since February, as noted, a gradual reduction in the central bank's key policy interest rate, which was set at 9.0% on 27 October 2016.

Between September 2014 and February 2015 Moldova has been subject to increased **exchange rate volatility**, initially reflecting weak fundamentals (trade balance, growth forecasts) and the strengthening of the US dollar, but subsequently also as a result of speculation after the eruption of the banking crisis which caused an increase in dollarization (up to 54% by end March of 2015) and dwindling confidence in the financial system. The Moldovan currency depreciated by 21% against the US dollar and 12% against the EUR in 2015. However, following this period of turbulence, the situation in the foreign exchange market has stabilised, with the leu depreciating by just 3.4% against the euro and remaining stable against the USD between January and end September of this year.

1.3 Structural reform challenges

After several years of stalemate in the reform process, substantial progress has been achieved with the **implementation of the structural reform agenda** over the last six months, including those reforms that are part of the Priority Reform Action Roadmap agreed with the EU in February 2016. However, there have been delays in adoption of measures in some areas, such as public administration reform and the appointment of the president of the National Commission for Financial Markets (NCFM), as well as steps towards the liberalisation of the electricity and gas sectors. The short-term priorities identified in the Roadmap for key areas of structural reform in the economic field included:

1. **Financial sector**: in particular, improving banks' shareholder transparency and corporate governance, adopting a more advanced bank resolution framework, introducing a new prudential and risk management framework for banks based on Basle III and the EU's Capital Requirements Directive package (CRD IV/CRR), revamping the deposit insurance scheme and restoring the powers of the NCFM so that it can better regulate and supervise non-bank financial institutions, including the insurance sector, which, like the banking sector, also suffers from serious governance problems.
2. **PFM**: in particular, strengthening the public procurement framework (including the creation of a Complaints Settlement Agency), adopting the new legislative framework for the Court of Accounts, improving debt management and clearing expenditure arrears.
3. **Energy sector**: raising tariff rates for gas, heating and electricity to cost recovery level, improving the independence of the regulator and implementing the planned gas pipeline and electricity interconnection projects between Romania and Moldova.
4. **Social safety net**: taking measures to compensate the most vulnerable households for an increase in utility tariffs.
5. **Trade and investment**: implementing the DCFTA and improving the investment climate.

The EU has been increasingly involved in the provision of technical and policy advice to Moldova on structural reforms through the funding of a team of 25 so-called **High Level**

Advisors who work side by side with high level officials in different institutions. The latter include the Prime Minister, the Minister of Finance and the Governor of the NBM. This unprecedented exercise touches upon reform areas as important as financial sector reform, PFM, external audit and the implementation of the DCFTA. These advisers provide very valuable input that can help guide the design and implementation of reforms by the authorities, while supporting the convergence of Moldova's regulations with the *acquis communautaire*. Their expertise could prove very useful in the design of EU assistance programmes, in particular policy-based operations such as the envisaged new MFA.

Financial Sector Governance and Stability

Financial sector reform is one of the key challenges, if not the key challenge, Moldova faces as it tries to improve economic governance, ensure macroeconomic stability and restore the credibility of the authorities. The authorities' capacity and determination in tackling this challenge, in particular the governance problems in the banking and insurance sectors, are regarded by most donors as the litmus test of their commitment to reform the country's economic and political governance system.

The agenda of financial sector reform has a number of inter-connected but separate pillars. They include the following: i) completing the liquidation of the three banks involved in the 2014 bank fraud and pursuing the investigations with a view to recovering the diverted funds and bringing all those responsible to justice; ii) dealing with the governance or solvency problems in the three banks put under special supervision by the NBM in June 2015 (see below); iii) strengthening the regulatory and supervisory framework, taking into account the recommendations of the updated Financial Sector Assessment Programme (FSAP) jointly conducted by the IMF and the World Bank in April 2014, and as part of Moldova's regulatory convergence commitments under its Association Agreement with the EU; iv) strengthening the regulatory framework and oversight of non-financial institutions, notably of the insurance sector.

In order to achieve the objectives of improving financial sector governance and stability, it will be essential to strengthen the independence and bank resolution powers of the NBM; as well as to restore the powers of the NCFM, which were struck down by a Constitutional Court ruling in November 2012. A number of important initiatives in the banking sector have now been taken, including on laws on bank recovery and resolution, bridge banking, central depository. In the non-banking financial sector, more actions are called for, including the reinforcement of the regulatory and supervisory powers of the NCFM and the nomination of its president, the adoption of legislation related to non-banking credit organisations, and the creation of a State Register of shareholders.

Following the detection of problems related to the non-transparent shareholders structure of Victoriabank, Moldova-Agroindbank" (MAIB) and Moldindconbank" (MICB), and the engagement in high-risk related-party lending operations, the NBM decided in June 2015 to put these three banks under special supervision. Independent diagnostic studies of these three banks have been undertaken by audit firms, which have discovered serious deficiencies in the governance as well as significant solvency problems in one of them (MICB).

In the case of **MAIB,** 43% of the bank's capital shares were suspended in March 2016, and later cancelled, on suspicion that owners of these shares were acting in concert without the NBM's permission. In compliance with the NBM orders, MAIB announced a decision on 19 September 2016 to put up for sale, through the regulated market of the Moldovan Stock Exchange, two blocks of newly issued shares for the initial total price of all the new shares equal to approximately EUR 20.3 million. The tender period is set from end of September to 26 December 2016 and the shares can be purchased only by persons having the prior written permission of the NBM. In the case of **MICB**, which is in bad financial state due to a high

amount of related-party lending, the NBM has performed a thematic on-site inspection concentrating on the examination of the assets' quality, shareholders transparency, risks of related-party lending and anti-money laundry prevention. On 20 October 2016, the NBM has suspended 64% of the bank's shares on suspicion that owners were acting in concert without the central bank's permission. A procedure similar to the one employed in the case of MAIB will be also followed for MICB. In the case of **Victoriabank**, the Supervisory Board was finally elected, after a two-year delay, at the shareholders' meeting in July 2016 and with NBM's approval of another two supervisory board members of the Victoriabank in September 2016, the supervisory board of Victoriabank became legally functional. The first meeting of the Supervisory Board took place on 14 October 2016 and appointed a new management. The EBRD increased its total stake in the bank to 27.56% in June 2016 and has expressed possible interest in further increasing its ownership to up to 100% of the bank's capital.

The NBM is also in the process of developing, with technical assistance from the central banks of the Netherlands and Romania as part of an EU-financed Twinning project as well as the support of the EU's High Level Adviser posted at the NBM, a new regulatory and supervisory framework for banks based on the EU's Capital Requirements Directive package (CRD IV/CRR).

Moreover, the NBM has developed and intends to implement a new resolution framework that will allow it to act in due time so as to ensure the continuity of its critical functions, preservation of financial stability and minimize the costs of a bank's failure. The corresponding law was signed by the President on 4 October 2016. It reflects the recommendations of the IMF and the World Bank and uses as reference the new EU framework on bank recovery and resolution (Directive 2014/59/EU).

Moldova is also expected to revamp the deposit insurance scheme and to approximate its legislation to the EU Directive on Deposit Guarantee Schemes. This has been reflected in the government's action plan for the implementation of the Association Agreement. In this regard, a new draft Law on Bank Deposit Insurance is being prepared by the government.

Other Structural Reforms

Public administration reform (PAR)

PAR is one of the priority reform areas that had been identified in the Roadmap. It is also one chapter of the Association Agreement and one of the priorities of the 2014-2016 National Action Plan. A PAR Strategy for 2017-2020 has been developed by the State Chancellery with input from SIGMA[3] and in consultation with the civil society, World Bank and other development partners and was adopted by the government on 6 July 2016. An Action Programme for implementing the PAR Strategy is currently being developed.

Public financial management

In 2013, the government adopted a PFM Strategy for 2013-2020. A key challenge in the area of PFM is to restore the timeliness of the budget process. Another challenge is to strengthen the Treasury's debt and cash management. Public Internal Financial Control (PIFC) is being strengthened by increasing accountability for the use of public funds by establishing a sound Financial Management and Control system and Internal Audit Units. Mid-term priorities in the PIFC area include improving the national certification system and strengthening the professional development programme for internal auditors.

Public procurement

[3] In April 2015, the EU Delegation in Chisinau requested SIGMA to carry out an evaluation of Moldova's public administration system based on the "reference measurement" methodology recently developed by SIGMA for accession countries.

The new public procurement law adopted in July 2015 incorporates the fundamental principles of EU practice and the necessary secondary legislation is being adopted gradually. An agreement to adhere to the WTO's Government Procurement (GPA) was ratified by parliament in June 2016. A draft Public Procurement Strategy for 2016-2020 has been prepared by the ministry of finance. Some aspects of the 2015 law on public procurement still deviate, however, from the EU standards. In particular, it does not foresee the creation of an independent appeals and review body. Amendments to the law to address some of these shortcomings, in particular by creating a Complaint Settlement Agency, have been submitted to the parliament.

External audit – Court of Accounts

Reflecting the commitments made by Moldova under the Association Agenda, draft legislation, prepared with technical assistance from SIGMA experts and the Spanish and Finish supreme audit institutions, was submitted to parliament in February 2016. Two key objectives of the draft law are to ensure the financial and administrative independence of the Supreme Audit Institution, bringing it fully in line with INTOSAI standards, and to strengthen the parliamentary supervision of its audits. The parliament is expected to support the proposed legislative changes, including the amendment of the Constitution. The legislation is, however, unlikely to be adopted before the end of this year, as any proposed constitutional amendment requires at least a 6 months interval between the two readings by the parliament.

Fight against fraud

Anti-fraud provisions are an important element of the EU-Moldova Association Agreement. The majority of them relate to the practical cooperation between the European Anti-Fraud Office (OLAF) and the Moldovan agencies responsible for these matters. The draft law amending the Criminal Code on frauds detrimental to the financial interests of EU was adopted by parliament on 26 May 2016.

Tax policy

The bulk of Moldova's tax revenues are indirect taxes on consumption, most notably VAT and excises. The tax system is characterized by numerous tax exemptions that erode the tax base as well as weak tax compliance and substantial tax evasion.

In an effort to increase revenues to deal with the difficult budgetary situation, the authorities increased excises in early July 2016. Tax policy measures planned for 2017-2019 include: (a) to develop the new Tax Code, including harmonization with the EU with respect to VAT and excise duties; (b) to implement the new Customs Code that entered into force on 1 May 2016; and (c) to implement a Tax Administration Modernization Project financed by the World Bank.

Energy sector reform and the need to reinforce the social safety net

Another important area of structural reform relates to utility companies, as tariffs remain well below cost-recovery levels. Increasing them is necessary for preventing quasi-fiscal costs, promoting energy efficiency and ensuring the financial viability of energy companies. The energy regulator in Moldova has hardly adjusted the tariffs over the last few years, which has resulted in accumulated financial deviation and rising intercompany payment arrears. Since the beginning of 2016, there have been occasionally indications that the tariffs would be adjusted but this has not happened so far.

Adjusting tariff adjustments towards the cost-recovery levels will increase the need for social assistance. The most obvious option would be to strength the relevant social assistance programmes (Ajutor Social and Heating Allowance), which, according to the World Bank, are rather well targeted.

On 27 May 2016, the parliament adopted new laws on electricity and natural gas that are in line with the EU's 3rd Energy Package (Directives 2009/72/EC and 2009/73/EC). The new legislation corresponds to the commitments undertaken by Moldova as a member of the Energy Community and reflects the provisions of the Association Agreement. It allows for the liberalization of electricity and natural gas markets, which should attract new investments into these markets, streamlines the regulatory regime and creates the preconditions to facilitate interconnectivity with the European energy market.

DCFTA implementation and measures to improve the investment climate

In order to advance with the AA/DCFTA implementation process, a calendar has been agreed to liquidate the arrears, containing all actions not implemented as required by the end of 2015. According to the authorities, this calendar had been 90% implemented as of 31 July 2016. But while efforts are being made to liquidate arrears for the previous periods, new arrears have accumulated for the actions planned for 2016.

A number of laws aimed at improving the regulatory framework for investment have recently been adopted or are being considered by parliament. In March 2016, the government approved a National Strategy for 2016-2020 for attracting investments and promoting exports.

1.4 IMF and other donor support

Since 1993, Moldova has benefited from a number of arrangements with the IMF in support of the authorities' economic adjustment programmes. The last one was a three-year combined ECF/EFF, split equally between the two facilities, totalling SDR 370 million (300% of quota), which was approved by the IMF Executive Board in January 2010 and expired in January 2013, without the release of the final tranche of USD 76 million. Total Fund credits and loans outstanding at the end of July 2016 amounted to about USD 426 million.

The EU and the World Bank suspended in early 2015 their budgetary support over concerns as regards macro-financial stability following the banking fraud crisis. In this context, they called for an IMF programme to provide the guarantees that these concerns would be addressed. Meanwhile, the Moldovan authorities resumed discussions with the IMF, which had been ongoing since 2013, in view of a new financial arrangement.

After protracted and sometimes difficult negotiations, complicated by several changes in government and at the helm of the NBM, the Moldovan authorities finally reached in July 2016 an agreement with the IMF on an economic reform programme to be supported by a three-year (ECF/EFF) arrangement. The arrangement was approved by the IMF on 7 November 2016, following implementation by the Moldovan authorities of a number of prior actions. Access under this arrangement will be at 75% of Moldova's quota in the Fund (SDR 129.4 million, or about USD 178.7 million)[4]. This was made possible by a new determination of the authorities, following the appointment in January 2016 of the government led by Prime Minister Filip and of a new central bank governor in March 2016, to address governance problems in the financial sector and in PFM.

The new ECF/EFF arrangement aims at making swift upfront improvements in financial sector governance and supervision. It would play a catalytic role for unlocking donor support to sustain economic development and rests on two pillars:

- **Policies to ensure macroeconomic and financial stability**. The programme will tackle long-standing vulnerabilities rooted in a non-transparent shareholder structure

[4] In deciding on the size of the arrangement, the IMF has taken into account its already rather large exposure to Moldova, stemming from both the SDR 370 million ECF/EFF approved in 2010 and a SDR 111 million PRGF approved in 2006.

of the banks and weaknesses in the financial supervisory and regulatory framework. Monetary policy will continue to focus on maintaining price stability in the context of a flexible exchange rate regime. Fiscal policy will support fiscal consolidation while strengthening public investment and pursuing social and developmental objectives.

- **Structural reforms to promote sustainable and inclusive growth.** Structural reforms will aim to improve the business climate, attract investment and enhance Moldova's growth potential. Initial measures will support the authorities' anti-corruption efforts, a sustainable energy policy and the fiscal reform agenda, including reforms to mobilize revenue and enhance the efficiency of expenditure.

Economic activity is projected to gradually gain momentum during the programme period, with real GDP growth accelerating to 3% in 2017 and to 3.6-3.8% over the subsequent years of the programme. Inflation is expected to slow down to about 5% by the end of the programme (from 9.6% in 2015) on the back of a cautious monetary policy combined with moderate international fuel prices. Under the IMF programme, the budget deficit is expected to decrease from 3.2% of GDP in 2016 to 2.9% of GDP in 2019. Higher capital expenditure (in an effort to boost productivity growth) and higher debt service costs partly compensate for the restraint in public wages and other current expenditure. The current account deficit would return to the 5¼ - 5¾% of GDP range (reflecting the recovery of domestic demand and donor support), following a brief decline to 3.5% of GDP in 2016.

The **World Bank** made substantial progress during 2014 in negotiating with the authorities a policy matrix for a USD 45 million Development Policy Operation (DPO II), in the form of a loan, but discussions were interrupted after the large bank fraud was uncovered at the end of 2014. Like the EU, the World Bank is, as noted, expected to resume its budgetary support to Moldova following the agreement reached with the IMF on a programme. This will also include two new DPOs of USD 30 million each, being planned for 2017 and 2018, respectively.

Regarding assistance from the **EU,** and with the IMF's new programme confirmed, disbursements could be made of up to EUR 50 million in **budgetary support operations** in 2016, up to EUR 60 million in 2017 and up to EUR 40 million in 2018. These estimates include budget support disbursements currently on hold and take into account the fact that the lack of compliance with some of the measures foreseen in these operations could prevent their full disbursement even now that the IMF agreement has been confirmed. The total cooperation assistance funded by European Neighbourhood Instrument (ENI) for the period 2014-2020, including not only budgetary support but also technical assistance and policy advice, is set between EUR 610-746 million. The Single Support Framework (SSF) identifies the priority sectors of ENI-funded cooperation with Moldova for the 2014-2017 period. Internal discussions towards the new updated SSF for 2017-2020 have just started, and the preparatory work will progress in the coming months in close consultation with all relevant stakeholders.

On 7 October 2015, the **Romanian** and Moldovan governments signed an agreement to provide a EUR 150 million budget support loan to Moldova, once a number of conditions would be met, including reaching an agreement with the IMF on a new programme and appointing a new governor of the NBM. The loan is to be disbursed in three tranches of EUR 60 million, EUR 50 million and EUR 40 million. It has a five-year maturity and the interest rate is the same interest rate at which Romania borrows on the international capital markets. Following the announcement of the staff-level agreement with the IMF in late July, the Romanian government found that Moldova had fulfilled the conditions linked to the release of the first tranche of EUR 60 million, which was subsequently disbursed on 24 August 2016. The second tranche is expected to be disbursed following the IMF Board approval of the programme, while the last one is expected to be disbursed in 2017.

The EBRD has invested close to EUR 1.1 billion to Moldova since 1996. It currently has about fifty active operations at an investment value of EUR 470 million. It is actively pursuing a number of strategic projects. Key projects include, in addition to its equity participation in Victoriabank, its involvement in the construction of the Chisinau-Ungheni gas pipeline and the Moldova-Romania electricity interconnection, projects that involve also EIB co-financing and EU grants.

The **EIB** has been active in Moldova since 2007 and has provided to the country EUR 608 million covering the following: credit lines for the financing of SMEs and Midcaps and projects in the water, sewage, energy, transport and agricultural sectors.

1.5 Moldova's external financing needs

The projections produced by the IMF following their July mission point towards **significant external financing requirements for the 2016-2018,** the period covered by the proposed MFA operation, with the total external financing gap for this period estimated at **USD 439 million** (see Table 2). This financing gap can broadly be attributed to three factors: a relatively large **current account deficit**, the need to **build up foreign exchange reserves,** and **the large debt amortization requirements expected**.

The IMF foresees, as noted, that the **current account deficit** will remain sizeable, particularly if foreign grants are excluded. Indeed, after the reduction in the deficit seen in 2016, which was driven by the compression of imports in the context of the interruption of budgetary support from foreign donors and weak economic activity, the deficit is projected to hover in the 5¼ - 5¾% of GDP range in 2017-2018 (6¾ - 7% of GDP excluding grants). This deficit is expected to be covered by the surplus in the capital and financial account during the 2016-2018 period.

The second factor contributing to the estimated external financing gap are the significant **debt amortisations** foreseen, increasing from USD 326 million in 2015 to on average USD 582 million a year over the period of 2016 to 2018. Private debt is the main component of these repayments but public and publicly guaranteed debt amortisation is accelerating from USD 35 million in 2016 to USD 70 million in 2017 and to USD 97 million in 2018 (with the share in total debt amortisations going up from 6% in 2016 to 14% in 2018). Meanwhile, net FDI inflows are projected to remain moderate, averaging USD 142 million per year during the 2016-2018 period, compared to USD 165 million for 2015. While other components of the capital and financial account, led by foreign direct investment and loans, are enough to produce a surplus in the capital account, more than covering the deficit in the current account, this is not enough to finance the considerable need to rebuild the country´s foreign exchange reserves.

Indeed, the IMF programme foresees a build-up of reserves, with reserves expected to raise from USD 2.0 billion (or 5 months of imports) at the end of August 2016 to USD 2.4 billion at the end of 2017 and USD 2.6 billion at the end of 2018 (implying an increase of 30% compared to August 2016). This would allow Moldova to maintain an import cover ratio of more than 5 months over the programme period. All in all, the targeted build-up of reserves and the combined balance of the current account and the capital and financial account produce an overall external financing gap of USD 439 million for the period 2016-2018.

As already mentioned above, the ECF/EFF arrangement proposes the use of IMF funds in the amount of SDR 129.4 million, or about USD 178.7 million (EUR 161 million). However, the net use of the IMF funds will remain negative over the programme period, with net repayments at USD 108 million over 2016-2018, reflecting the significant repurchases stemming from previous IMF financial arrangements falling due during this period. For the MFA period (2016-2018), IMF net repayments would amount to USD 108 million. The

World Bank, for its part, is expected to disburse to Moldova a USD 45 million in 2016, and a further USD 30 million in 2017 and an additional USD 30 million in 2018.

Table 2: Moldova's External Financing Gap and Potential Financing Sources

USD million	2016	2017	2018	Total 2016-18
1. Current account balance*	-238	-358	-417	**-1.013**
2. Capital and financial account balance**	429	503	522	**1.454**
3. Overall balance (1+2)	191	146	105	**442**
4. Reserves ("-" indicates increase)	-318	-358	-205	**-881**
5. Overall External Financing Gap	**-127**	**-212**	**-100**	**-439**
6. Exceptional Financing by IMF and WB				
Net IMF Disbursements	-42	-45	-21	**-108**
Disbursements of World Bank's DPLs	45	30	30	**105**
7. Residual Financing Gap	**-124**	**-227**	**-91**	**-442**
Financing of the gap				
EU MFA	0	66	44	**110**
EU budget support grants	56	66	44	**166**
Romanian loan	66	100		**166**
Total identified sources	**122**	**232**	**88**	**442**
Total MFA as % of the residual gap for 2016-18				**24,9**

* Excludes official grants in the form of policy-based budgetary support.
** Includes exceptional financing.

Sources: IMF programme documentation (Board meeting of 7 November 2016) and Commission staff calculations.

In total, contributions from the Bretton Woods institutions are expected to be neutral towards closing the external financing gap and this would leave a **residual external financing gap of USD 442 million** for the period 2016-2018. Thus, the proposed MFA operation of EUR 100 million would cover **24.9%** of the estimated residual financing gap.

Other key contributions to covering the residual financing gap include the disbursement of EU budget support grants (estimated[5] at EUR 150 million for the period 2016-2018) and of the EUR 150 million budget support loan from Romania mentioned before.

2. OBJECTIVES AND MONITORING INDICATORS OF THE MACRO-FINANCIAL ASSISTANCE

2.1 Objectives

The objectives of the proposed MFA operation are to:

i) Contribute to covering the external financing needs of Moldova in the context of a sizeable external financing gap brought about by a relatively large current account deficit,

[5] For a budget support payment to be made, the Government of Moldova has to met two sorts of conditions **(i)** Eligibility Conditions (i.e. General Conditions) – their fulfilment qualifies the beneficiary for budget support disbursement or not and they relate to macro-economic stability-oriented policy, public finance management, budget transparency and sectorial policy progress; (ii) Specific Conditions – they are related to specific results to be achieved in each sector and how much will be disbursed reflects how much was achieved.

the need to build up foreign exchange reserves, and the large debt amortization requirements expected.

ii) Support the fiscal consolidation effort and external stabilisation in the context of expected the IMF programme.

iii) Support structural reform efforts aimed at improving the overall macroeconomic management, strenghening economic governance and transparency, and improving conditions for sustainable growth.

iv) Facilitate and encourage efforts by the Moldovan authorities to implement measures identified under the EU-Moldova Association Agreement and in the context of the bilateral cooperation programmes, support regulatory convergence and economic integration with the EU and strengthen the EU's economic policy dialogue with the authorities.

2.2 Monitoring indicators

The fulfilment of the objectives of the assistance will be assessed by the Commission, including in the context of the ex-post evaluation (see below), on the basis of the following indicators:

i) Progress with macroeconomic and financial stabilisation, notably by assessing the degree of adherence to the IMF-supported programme.

ii) Progress with the implementation of structural reforms, notably the specific policy actions identified as conditions for disbursement of the assistance, which will be included in a Memorandum of Understanding to be negotiated between the Commission and the Moldovan authorities.

3. DELIVERY MECHANISMS AND RISK ASSESSMENT

3.1 Delivery mechanisms

The MFA operation under consideration would **amount to a maximum of EUR 100 million.** The Commission proposes to provide the amount of the assistance in the form of a **medium-term loan of up to EUR 60 million and in grants of up to EUR 40 million**. Given the proposed size of the operation, the Commission is considering releasing the assistance in **three instalments**. The first two instalments would be disbursed in 2017 and the third one in the first half of 2018. The first two tranches will be composed of a grant element of EUR 10 million and a loan part of EUR 20 million, while the third tranche will be composed of a grant element of EUR 20 million and a loan part of EUR 20 million.

While the proposed amount is significant in terms of its share in the coverage of the residual financing 24.9% as noted above), it is important to ensure its value added, notably by providing the EU with sufficient leverage to promote progress with reforms[6]. At the same time, and as noted, strict conditions will be attached to the disbursements under the MFA, with each tranche, including the first one, conditional on good progress with both the IMF programme and the specific policy conditionality agreed with the EU in the Memorandum of Understanding attached to this operation.

[6] In this respect, the proposed size of the operation is close to that of the policy-based budgetary support operations being planned by other key donors (e.g. Romania or the World Bank) in complement of the IMF programme.

The inclusion of a grant element is consistent with the methodology for determining the use of grants and loans in EU MFA, as endorsed by the Economic and Financial Committee in January 2011 and as mentioned in the Joint Declaration by the European Parliament and the Council adopted together with the decision providing further macro-financial assistance to Georgia[7], which takes into account the following criteria[8].

Firstly, Moldova is a lower middle-income country with a **relatively low per capita income level**. Moldova's per capita Gross National Income (GNI) of USD 2,220 in 2015 is, indeed, the lowest in the Eastern neighbourhood[9].

Secondly, while Moldova`s public debt dynamics are judged to be sustainable by the IMF (based on its latest Debt Sustainability Analysis, produced in the context of the proposed programme), Moldova's public **debt ratios** have significantly increased following the banking crisis and the depreciation of the leu. The public debt-over-GDP ratio increased from 36% at the end of 2014 to 45% at the end of 2015 and is expected to further rise to about 48% in 2018 before gradually decreasing again. Total external debt, including public and private debt, has risen from 85% of GDP at the end of 2014 to 99% of GDP at the end of 2015 and is projected to continue increasing in the coming years, peaking at about 101% in 2017.

Thirdly, Moldova is **eligible for concessional financing** from both the IMF's Poverty Reduction and Growth Trust and the World Bank's International Development Association (IDA). In its assessment issued in July 2015[10], IMF staff considered Moldova's short-term vulnerabilities to be too elevated to merit graduation from PRGT eligibility. But Moldova is, as noted, obtaining blended finance (a mix of regular and concessional finance) from the IMF. Moldova is also a blended country at the World Bank, being considered as creditworthy for borrowing from the IBRD. IDA credits to Moldova currently represent 95.5% of the outstanding World Bank's IBRD/IDA lending to Moldova.

While Moldova meets, as noted, the criteria for receiving at least part of the proposed MFA in grants, the fact that it is not a PRGT-only/IDA-only country but a blended one, the constraints in the EU budget for MFA grants and lingering concerns about financial governance (despite the encouraging governance reforms being adopted and planned) argue in favour of using both loans and grants in the proposed operation. The Commission proposes to provide the bulk of the proposed MFA in the form of medium-term loans. As usual, these loans will carry very favourable conditions in terms of long maturities and grace periods (of up to 15 years) and a low interest rate (the rate at which the EU, benefiting from its triple A rating, borrows the funds in the international capital markets).

3.2 Risk assessment

There are fiduciary, credit, policy and political risks related to the proposed MFA operation.

There is a risk that the MFA, which is not dedicated to specific expenses (contrary to project financing, for example), could be *used in a fraudulent way*. In general terms, this risk is related to factors such as the quality of management systems in the central bank and the ministry of finance, administrative procedures, control and oversight functions, the security of IT systems and the appropriatedness of internal and external audit capabilities.

[7] OJ L 218, 14.8.2013, p. 18.
[8] "Criteria for Determining the Use of Grants in EU Macro-Financial Assistance", note of the European Commission to the EFC, January 2011.
[9] World Bank's Atlas 2015 figures. GNI per capita is the gross national income, converted to US dollars using the World Bank Atlas method, divided by the population.
[10] http://www.imf.org/external/np/pp/eng/2015/062415.pdf

To mitigate the risks of fraudulent use several measures will be taken. First, the Loan Agreement and the MFA Grant Agreement will comprise a set of provisions on inspection, fraud prevention, audits, and recovery of funds in case of fraud or corruption. Also, the assistance will be paid to a dedicated account of the National Bank of Moldova.

Moreover, in line with the requirements of the Financial Regulation, the Commission services have carried out an Operational Assessment of the financial and administrative circuits of Moldova to ascertain that the procedures in place for the management of programme assistance, including MFA, provide adequate guarantees. They received the final report of the Operational Assessment, prepared by a consultancy company, in February 2016. The report concludes that the current status of the administrative and financial circuits of Moldova is broadly adequate for managing a new MFA operation although important weaknesses remain. Developments in that area will continue to be closely monitored also through the regular progress reports on PFM reforms produced by the EU Delegation in Chisinau.

The Commission is also using budget support assistance to help the Moldovan authorities improve their PFM systems and these efforts are strongly supported by other donors.

Finally, the assistance will be liable to verification, control and auditing procedures under the responsibility of the Commission, including the European Antifraud Office (OLAF), and the European Court of Auditors.

A second risk stems from the possibility that Moldova will fail to service the financial liabilities towards the EU stemming from the proposed MFA loans (*default or credit risk*), which could be caused by a significant additional deterioration of the balance of payments and fiscal position of the country or/and by unforeseen events. This risk is mitigated, however, by the fact that the EU's MFA would be part of an international package of official assistance led by the IMF that is supporting an adjustment and reform programme aimed at restoring fiscal and balance of payments sustainability through the implementation of a series of policy measures, included those to be agreed in the MoU between the EU and the Moldovan authorities. Moreover, the risks for the EU budget are in a first instance covered by the EU's Guarantee Fund for external actions.

Another key risk to the operation stems from the *domestic political* situation, which could weaken the authorities' determination to implement the necessary economic reforms and fuel social unrest. A derailment of the reform process could put the objectives of the IMF-supported programme in jeopardy, endanger macroeconomic stability and prevent the effective disbursement of the EU's MFA. There are also risks from *regional instability*, notably the conflict in Ukraine, which is having a negative impact on Moldova's economic and social situation; a prolongation of weak economic conditions in Russia and/or possible new trade and economic sanctions by Russia.

Finally, there are risks stemming from a possible weakening of the European and global economic environment (taking into account Moldova's increasing dependence on the EU market) and an increase in international energy prices, which would have an important effect on Moldova's fiscal and balance of payments situation.

Having made a thorough assessment of the risks, the Commission services consider that there are sufficient grounds and guarantees to proceed with the proposed MFA to Moldova.

The Commission services will maintain close contacts with the authorities during the implementation of the macro-financial assistance in order to address quickly any concerns that may arise.

4. ADDED VALUE OF EU INVOLVEMENT

The Union's financial support to Moldova reflects the country's strategic importance to the EU in the context of the European Neighbourhood Policy. The MFA instrument is a policy-based instrument directed to alleviate short- and medium-term external financial needs. As a part of the overall EU package of assistance, it would contribute to support the European Union's objectives of economic stability and economic development in Moldova. By supporting the authorities' efforts to establish a stable macroeconomic framework and improve economic governance, the proposed assistance would help improve the effectiveness of other EU financial assistance to the country, including budgetary support operations.

The EU´s MFA would also complement the standard EU aid packages mobilised under the ENI. By supporting the adoption, by the Moldovan authorities, of an appropriate framework for macroeconomic policy and structural reforms, the EU's MFA would enhance the added value and effectiveness of the EU's involvement through other financial instruments. The proposed MFA would increase substantially the EU's leverage on policy making in Moldova, helping steer the country towards a reform trajectory that should help restore macroeconomic stability, address governance problems and boost potential growth in the longer run.

5. ASSESSMENT OF CRITERIA APPLICABLE TO MACRO-FINANCIAL ASSISTANCE[11]

5.1 Exceptional Character and Limited Time-frame

The MFA operation would be exceptional, aiming to support the restoration of a sustainable external finance situation for Moldova. It would run in parallel to the IMF ECF/EFF arrangement, approved by the IMF Board on 7 November 2016. The proposed MFA would only be implemented if the IMF arrangement on track, and only during a strict timeframe covering part of the IMF programme period. Against this background and given the expected time of approval of the programme, the assistance is expected to be implemented in 2017-2018. The disbursement of the first tranche could take place in the first half of 2017, the second tranche could be disbursed in the second half of 2017 and the third in the first half of 2018. All disbursements are conditional on the IMF programme remaining on track and on a number of policy measures, agreed with the EU and listed in the Memorandum of Understanding attached to the proposed MFA operation. While in the short-term the country faces substantial balance of payments financing needs, the macroeconomic and structural adjustment programme to be agreed with the IMF and supported by the proposed MFA is expected to produce a gradual strengthening of the balance of payments and fiscal positions.

5.2 Political preconditions and EU-Moldova relations

MFA is reserved to geographically close third countries that respect effective democratic mechanisms (including a multi-party parliamentary system) and the rule of law and that guarantee human rights, and with which the EU maintains close political and economic links. Countries that are covered by the ENP, like Republic of Moldova, are eligible for MFA.

Political preconditions: Countries that are covered by the European Neighbourhood Policy are eligible for MFA. A pre-condition for granting MFA is that the eligible country respects effective democratic mechanisms, including a multi-party parliamentary system and the rule of law, and guarantees respect for human rights. Despite concerns on human rights,

[11] Established Commission practice in line with the Joint Declaration by the European Parliament and the Council adopted together with Decision No 778/2013/EU of the European Parliament and of the Council of 12 August 2013 providing further macro-financial assistance to Georgia, OJ L 218, 14.8.2013, p. 15.

governance and the rule of law in the country[12], Moldova can be considered as a country with democratic mechanisms, including a multi-party parliamentary system, with a political and institutional system that broadly respects the rule of law and human rights but where vested interests are still very present. Between the parliamentary elections of November 2014 and early 2016, Moldova experienced significant political instability, partly reflecting governance problems. That said, following the appointment of a new government in January 2016, and of a new governor at the central bank, and the adoption in February and implementation of the Roadmap for Priority Reforms agreed with the EU, the authorities are now demonstrating a renewed commitment to addressing the country´s governance challenges and to moving forward with the necessary political reforms. In this context, the political preconditions for an MFA can be considered to be satisfied[13]. However, delivering on key reforms remains indispensable for a successful implementation of the MFA and will be monitored closely.

EU-Moldova relations: The EU and the Republic of Moldova have developed a close political and economic relationship over the years. It has led to the conclusion of an Association Agreement, including a DCFTA, which was signed on 27 June 2014 and entered fully into force on 1 July 2016. The Association Agreement replaced the previous Partnership and Cooperation Agreement and will allow for the political association and economic integration of Moldova with the EU. An Association Agenda - approved in 2014 - sets out a list of priorities for joint work in the 2014-16 period, based on the structure of the Association Agreement. It is currently under review in order to produce an updated version for 2017-2019. The Single Support Framework for 2014-2017 identifies the priority sectors of EU cooperation with Moldova under the European Neighbourhood Instrument. Work has also started to produce a new Single Support Framework for 2017-2020.

Moldova's economic ties with the EU are also well developed. In 2015, the EU was Moldova's largest trading partner, with a trading share of 53%, well in front of Russia with 13%. In 2016, that share has further risen to 62%.

In sum, Moldova has a democratic political system based on the rule of law and the respect of human rights and is taking steps to strengthen its democratic institutions and address the serious governance problems brought to the fore by the 2014 bank fraud and its aftermath. There is also a very close framework of bilateral relations between the EU and Moldova under the Association Agreement and the ENP.

5.3 Complementarity

The proposed MFA would complement the assistance provided by other multilateral and bilateral donors in the context of the new IMF-sponsored economic programme. The agreed IMF programme as described in the previous section, multilateral and bilateral donors other than the EU are expected to cover at least 50% of the estimated external financing gap for the period 2016-18, ensuring a reasonable burden-sharing. The proposed new MFA would represent 24.9% of the residual financing gap. This is consistent with the existing burdern-sharing guidelines applicable to MFA, while it ensures also the value added and significance of the EU's involvement.

The EU´s MFA would also complement the foreseen EU budget support operations, which could make up to EUR 50 million in 2016, up to EUR 60 million in 2017 and up to EUR 40 million in 2018. By supporting the adoption, by the Moldovan authorities, of an appropriate framework for macroeconomic policy and structural reforms, the EU's MFA would enhance the added value and effectiveness of the EU's involvement through other financial

[12] These include, in particular, the need to ensure freedom of the media, guarantee the independence of the judiciary, fight against corruption and enhance transparency of political party financing, as stressed in the Roadmap for Priority Reforms.

[13] A complete assessment of the fulfillment of the political preconditions for MFA, provided by the European External Action Service, can be seen in the Annex of this document.

instruments. The proposed MFA would increase substantially the EU's leverage on policy making in Moldova, helping steer the country towards a reform trajectory that should help restore macroeconomic stability, address governance problems and boost potential growth in the longer run.

5.4 Conditionality

Disbursements under the proposed MFA operation would be conditional on successful programme reviews under the IMF programme and on the effective use by Moldova of these IMF funds. In addition, the Commission and the Moldovan authorities would agree on a specific set of structural reform measures, to be defined in a Memorandum of Understanding. These reform measures would support the authorities' reform agenda and complement the programmes agreed with the IMF, the World Bank and other donors, as well as the policy programmes associated with the EU's budgetary support operations. They would be consistent with the main economic reform priorities agreed between the EU and Moldova in the context of the Association Agreement, including its DCFTA, the Association Agenda, Moldova's National Action Plan for the Implementation of the Association Agreement and other strategic documents.

The Commission will seek a broad consensus with the Moldovan authorities, so as to ensure a smooth implementation of the agreed conditionality. Strict conditions will be attached to the disbursements uner the MFA, with each tranche, including the first one, conditional on good progress with both the IMF programme and the specific policy conditionality agreed with the EU in the Memorandum of Understanding attached to this operation. These policy conditions should address some of the fundamental weaknesses shown over the years by the Moldovan economy and economic governance system. Possible areas of conditionality could, in principle, include reforms to strengthen governance in the financial sector, PFM, energy sector reform, and accompanying measures to strengthen the social safety net, improving the investment climate and supporting the implementation of the DCFTA agreement.

5.5 Financial Discipline

The planned assistance will be provided in the form of a loan and a grant. The loan will be financed through a borrowing operation that the Commission will conduct on behalf of the EU. The budgetary impact of the loan assistance will correspond to the provisioning of the EU's Guarantee Fund for external actions, at a rate of 9% of the amounts disbursed, from budget line 01 03 06 ("Provisioning of the Guarantee Fund"). Assuming that the first two loan disbursements (of EUR 20 million each) will be made in 2017 and the third loan disbursement (of EUR 20 million) in 2018 in accordance with the rules governing the guarantee fund mechanism the provisioning will take place in the 2019-20 budgets, for an amount of EUR 3.6 million and EUR 1.8 million, respectively. The grant element of the assistance (EUR 10 million each for the first two tranches and EUR 20 million for the third tranche) would be financed from commitment appropriations of the 2017 and 2018 budget, under the budget line 01 03 02 (Macro-financial assistance), with payments taking place in 2017 and 2018. Based on current projections on the utilisation of the budget line 01 03 02 and 01 03 06, the Commission assesses that the budgetary impact of the operation can be accommodated.

In line with the requirements of the Financial Regulation, the European Commission services have carried out, as noted, an Operational Assessment of the financial and administrative circuits of Moldova. Developments in this area will continue to be closely monitored also through the regular progress reports on PFM reforms produced by the EU Delegation in Chisinau.

6. EVALUATION AND COST-EFFECTIVENESS

This assistance is of exceptional and macroeconomic nature and its evaluation will be undertaken in line with the standard Commission procedures.

6.1 Evaluation

Ex-post evaluations of MFA operations are foreseen in the Multi-Annual Evaluation Programme of the Commission's Directorate-General for Economic and Financial Affairs. An ex-post evaluation of the proposed MFA to Moldova will be launched within a period of two years after the availability period has expired. A provision for the ex-post evaluation is included in the proposed Decision for the assistance, and will also be included in the Memorandum of Understanding. Budget appropriations from the macro-financial assistance grant budget line will be used for this evaluation.

6.2 Achieving cost-effectiveness

The proposed assistance would entail a high degree of cost effectiveness for several reasons:

i) Since the assistance would be leveraged by that provided by the international financial institutions, with which, as noted, it would be closely coordinated, its ultimate impact could be very significant compared to its cost. Moreover, in negotiating specific policy conditions, the Commission will be able to draw on the expertise of those institutions, including the IMF and the World Bank, and to influence their conditionality as well in ways that will take into account the EU's views.

ii) Providing a coordinated macroeconomic support to Moldova on behalf of the EU countries, the MFA would be more cost efficient than the provision of a similar total amount of financial support by EU Member States individually.

iii) A substantial part of the proposed assistance would be provided in the form of loans, the budgetary impact of which is more limited.

iv) Finally, the Commission will aim at achieving synergies with other EU policies and instruments used to support the implementation by the beneficiary of the relevant measures (notably in the area of PFM).

ANNEX

EUROPEAN EXTERNAL ACTION SERVICE

Head of Division

Brussels, 9 December 2016

ASSESSMENT ON DEMOCRACY, HUMAN RIGHTS, RULE OF LAW AND REFORMS IN MOLDOVA

Moldova's Constitution enshrines a parliamentary democracy for the country, based on the rule of law, a division of powers, the independence of the judiciary and respect for human rights; a constitutional court; an electoral law that allows for a multi-party pluralist democracy; an electoral commission; and legislations guaranteeing the freedom of press/media, speech, religion, association, assembly and civil society organisations.

Today, Moldovans generally enjoy all major fundamental rights and freedoms. However, the consolidation of democracy and rule of law need to continue.

On 27 June 2014, the EU and Moldova signed an ambitious and innovative Association Agreement, including a Deep and Comprehensive Free Trade Area. The Agreement had been provisionally applied from 1 September 2014 until completion of the ratification process, which allowed its full application since 1 July 2016.

Recent developments

Following parliamentary elections in November 2014, the then ruling coalition (Liberal-Democratic Party (PLDM), Democratic Party (PDM), Liberal Party (PL)), which defined itself as "pro-European", managed to form a minority government. However, the discovery of the fraudulent diversion of $1bn (equal to 12% of GDP) from three major Moldovan banks shook the political establishment and threw Moldova into a period of political instability and financial vulnerabilities.

Fragilised by internal fights for control over the state institutions and access to resources, the ruling coalition was unable to produce a stable government that would restore macro-financial stability, take the necessary steps to genuinely address the banking governance problems and the concerns and demands of an increasingly unsatisfied population.

This internal struggle took a turn in October 2015, with the arrest of one key figure of the coalition, former Prime Minister Filat, on corruption charges, in an investigation linked to the banking frauds. Eventually, this led to the creation of a new coalition, which, on 20 January 2016, voted in Pavel Filip as new the Prime Minister amid street protests. Since then, Moldova has re-gained a degree of political stability.

In an effort to address the EU's concerns, as expressed in the Council conclusions of February 2016, the authorities engaged rapidly in a reform process that led them to adopt several dozens of laws and measures related to justice, anti-corruption, banking, media, energy, business sectors and public administration.

In the same vein, the authorities addressed one of the protesters' main requests and restored the direct election of the President, yet through a ruling by the Constitutional court that declared that the modalities of the 2000 reform on the President's indirect election were unconstitutional.

The presidential election, which took place on 30 October and 13 November 2016, was competitive, with respect of fundamental freedoms, according to the report issued by the joint electoral observation of the OSCE, the Council of Europe and the European Parliament. Candidates could campaign freely without restrictions. Widespread abuse of administrative resources, lack of campaign finance transparency, and unbalanced media coverage were, however, also reported during the process.

The runoff led to a victory of Socialist Igor Dodon, by 52%, against PAS leader Maia Sandu. Against a background characterised by lack of independence of key institutions, the subsequent effects of this result on the partially stabilised but still fragile political situation will remain to be assessed at a later stage.

A strong political will and leadership will be necessary to engage the country in deep changes to address all the shortcomings in the democratic process, legal uncertainty and lack of inclusion of minorities.

Whereas the reform steps undertaken by the government in 2016 have undoubtedly contributed to stabilise the banking sector and have sent positive messages to international donors, they will require strong implementing measures to bring more tangible changes. This implementation phase will be a real test for Moldova's willingness to reform. The still significant influence of vested interests over state institutions and the so-far limited results of the investigation on the banking fraud of 2014 (also in terms of prosecution of all the persons responsible for it) suggest that there are still serious governance issues that need to be addressed.

The political developments throughout 2015 and 2016 have been accompanied by low transparency in the political and economic life and in the judiciary, as well as a worrying trend of criminal cases being brought against politicians, civic activists, representatives of national minorities, staff of the National Bank of Moldova, and even a human rights lawyer and a judge, often on legally dubious grounds, in particular when those individuals were engaged in undermining vested interests. Most of the people involved remain to date under house arrest, judicial control or threat to be arrested or sentenced. This underlines the importance of implementing reforms aimed at ensuring the full independence of the judiciary.

The reform process that started in early 2016, including as part of the commitments made under the Roadmap for Priority Reforms adopted by the government in March 2016, is intended to tackle these problems. International donors, above all the International Monetary Fund (IMF) and the EU, have positively embraced the new reform momentum in Moldova. On 7 November 2016, the IMF Board approved a three-year Extended Credit Facility and Extended Fund Facility (ECF/EFF) arrangement for an amount of EUR 161 million, and the EU intends to resume the disbursements of its budget support in due course and is considering a Macro-Financial Assistance operation. It will be, however, essential for the EU and other donors to continue to monitor closely developments and make disbursements of assistance

strongly conditional on good progress with the implementation of the authorities' reform commitments.

EU-Moldova relations

Relations between the EU and Moldova are deep and multifaceted, encompassing gradual economic integration and deeper political cooperation. Moldova participates in many EU agreements and programmes.

On 27 June 2014, the EU and Moldova signed an ambitious and innovative Association Agreement, including a Deep and Comprehensive Free Trade Area. The Agreement had been provisionally applied from 1 September 2014 until completion of the ratification process, which allowed its full application by 1 July 2016.

With a view to facilitating the implementation of the Association Agreement, the EU and Moldova agreed in 2014 on an Association Agenda, which provides a list of priorities for joint work through which the overarching objectives of political association and economic integration could be attained. This Agenda is currently being updated for the years 2017-2019.

The agreements on visa facilitation and readmission between the EU and Moldova took effect in January 2008, and a wider Mobility Partnership was signed in June 2008. Since 28 April 2014, over half a million Moldovan citizens with a biometric passport have been able to travel to the Schengen area without a visa following the successful completion of a VLAP.

Conclusions

Moldova's constitution and organic legislation enshrine the principle of a multi-party democracy, the rule of law and respect for law. Also, the EU and Moldova have developed close institutional and economic ties, and the Association Agreement signed in 2014 should help deepen them further. However, the political system continues to suffer from significant governance problems and from interference with the work of the judiciary. The authorities have recently engaged in a welcomed reform process, although the process still needs to deliver tangible results. At a time when the IMF has agreed with Moldova on an economic adjustment and reform programme, the EU remains fully committed to supporting Moldova in its reform efforts together with other international donors. The envisaged financial assistance should help keep the current reform momentum to the extent that its effective disbursement will be conditional on continued progress with key reforms. In this context, the European External Action Service stands ready to provide a further detailed assessment of the situation of democracy, human rights, rule of law and reforms in Moldova throughout the lifecycle of the proposed Macro-Financial Assistance operation, whose political preconditions may be considered as being fulfilled. Delivering on key reforms will be indispensable if the Macro-Financial Assistance operation is to be successfully completed.