Moldova – brief presentation

Area – 33,700 sq. km (including Transnistria)
Population – 3.6 million (including Transnistria – 4.4 million)
Climate – moderate winters, warm summers
Geography – rolling steppe, gradual slope south to Black Sea
Ethnic groups – Moldavian/Romanian 64.5%, Ukrainian 13.8%, Russian 13%, Gagauz 3.5%
Languages –Moldavian/Romanian(official), Russian, Gagauz (Turkish dialect)
Real GDP per capita (PPP) – 319 US$ (1999)

Background

Despite its small size, Moldova has emerged as a successful post-Soviet economy, and one of the most dedicated to reform. Since 1992, notwithstanding difficulties imposed by conflict in the Transnistria region and the collapse of the Soviet trading system, it has followed a broadly responsible fiscal and monetary policy. On November 29, 1993 Moldova introduced the Moldovan Leu (MDL), the country's new currency, which, thanks to prudent monetary policy, has broadly retained its value against leading western currencies.

During the last five years essential structural reforms have been completed. These have resulted in trade and price liberalization, the National Bank of Moldova's (NBM) development into an appropriate Central Bank, and a substantial **shift in ownership from the public to the private sector.**

Macroeconomic stabilization has created a general framework favorable for private initiatives, while small business is now an important aspect. The mass privatization program has been implemented, leading to considerable expansion of the private sector, which now contributes over 50% to GDP.

Until 1998 FDI in Moldova was on a steady rising trend accounting for US$ 210 million by the end of 1997. The US$ 86 million attracted over 1998 was considerably less then expected, due to an inability to privatize Moldtelecom and some other key enterprises. In 1999, FDI was lower than in the previous two years and largely reflected political difficulties, delay of large-scale privatization, of "Moldtelecom" and energy sector, and 1998 Russian crisis. During first half of year 2000 however, privatization of the electricity distribution companies was initiated, accounting for US$25,3 in privatization revenues and US$ 42 million in FDI.

	Unit of measure	**1995**	**1996**	**1997**	**1998**	**1999**
Nominal GDP	Ths. Lei	6480	7798	8917	9122	12204
% change of GDP, compare to 1990	%	39.4	37.1	37.7	35.3	33.7
GDP per capita	Lei	1763	2126	2437	2498	3348
	USD	393	462	527	464	319
General Government	% of	-8.0	-11.2	-6.3	-8.9	

Balance	GDP					
CPI, compare to the previous year	%	130	124	112	108	139
Current account	US$ million	-95	-198	-278	-332	-25
Trade Balance	US$ million	-70	-260	-348	-388	-127
Total FDI	US$ million	67	24	76	86	31
Average exchange rate of the national currency	Lei/USD	4.5	4.6	4.6	5.4	10.5

Russian crisis consequences

For Moldova, the lack of structural reforms translated into unsustainable internal and external positions at the end of 1997. Such a situation leads almost always to a financial crisis, unless rapid policy adjustments are undertaken. The turmoil that followed the Russian crisis in 1998 was for Moldova a catalyst that speeded up the collapse of its fragile monetary stabilization. The capital account losses (capital flight) brought the country to the verge of default. Unfortunately, the Russian crisis actually made a deeper impact on Moldovan economy, through the abrupt and probably persistent loss of major export markets, a situation that may affect the economic activity for a longer time period.

Moldova is a small open economy that is very sensitive to changes in its current account developments and international terms of trade. Unfortunately, the country's exposure increased in recent years, as one partner – Russia – intensified its domination of foreign trade. In 1997 exports to Russia accounted for more than 60% of total Moldovan exports, the direct consequence of a slow process of restructuring in the economy, resulting at the same time from the absence of any effort to diversify the export markets.

As a consequence of the Russian crisis, all countries in the region experienced dramatic outflow of private financing with rising interest rates on treasury bills. Private capital available to European emerging markets dropped significantly. In response to the crisis, foreign investors in Moldova withdrew their funds, converted them into dollars, and left the market. Domestic entrepreneurs were ready to fake external trade contracts, in order to buy dollars, while Moldovan commercial banks became involved in speculations against the national currency.

The deterioration of the balance of payments induced a serious financial instability in Moldova, forcing the authorities to adjust their policy accordingly. Fostering such adjustments, while avoiding social reactions, was the major objective of the 1999 agenda.

The deterioration of BOP has also determined a strong pressure on the national currency. The crucial dilemma the NBM faced was whether to defend the currency or to allow the market forces to determine a new exchange rate equilibrium. Two main reasons drove the NBM initial decision to maintain at any cost the stability of Leu in nominal terms until November 1998. Firstly, the already substantial external debt: the high cost of servicing this debt would have risen above the financial capabilities of the Government. Secondly, a stable national currency had been the only visible sign of successful economic reforms in Moldova: during 1994-1998 the NBM had managed to gain credibility through exchange rate stability.

Real wages were not initially affected as a result of the currency depreciation. The wage hike in the last quarter of 1998 more than offset the inflation effect and put further upward pressure on prices. Wages fell, however, both in nominal and real terms, in the first months of 1999 which significantly reduced the purchasing power of the population.

It is well known that between inflation and fiscal deficit there exists a strong relationship. The relatively high inconsistency between monetary and fiscal policies in case of Moldova induced significant imbalances in the field of public finance. The budget revenues decreased drastically – 54% of the whole year projections was collected during first 9 months of 1998. In August the Government introduced some expenditure cuts, together with the freeze of public wages and revocation of certain pension privileges. At the same time, the excise taxes were increased and several tax exemptions were removed. These measures significantly reduced expenditures. Despite the express priority given to the public debt service and payment of salaries, large arrears were accumulated.

According to the official forecast, 1998 was supposed to be the second year of economic growth in Moldova with real GDP increase more than 3%. However, negative tendencies started to appear in the economy from the beginning of 1998. The bad harvest in agriculture, combined with the crisis that hit the economy in the second half of the year, led to a decline of real GDP by 8.6% in 1998.

There are three main challenges that Moldova must confront as its transition continues: First, enterprise restructuring is being held back by dispersed ownership, low managerial turnover, and the lack of effective bankruptcy laws and procedures. The attraction of strategic investors would help to galvanize the restructuring process. Second, privatization of the energy, wine, tobacco and telecommunications sectors is an urgent priority. Third, challenges in agricultural reform include the break-up of remaining collective farms, land privatization, and development of the land market.

Introduction

Corporate governance is concerned with holding the balance between economic and social goals and individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interest of individuals, corporations and society. The incentive for corporations and for those who own and manage them to adopt internationally accepted governance standards is that these standards will help them to achieve their corporate objectives and to attract investment. The incentive for their adoption by the State is that these standards will strengthen the economy and discourage fraud and mismanagement.

Corporate governance systems have evolved over centuries. Moldova started its privatization and restructuring process 10 years ago, after the Soviet system had collapsed. Since then ownership has been shifting from public to private sector. This is not a period in which a corporate governance framework has been created and implemented. Moldova is now at the starting point of building the corporate system. Moldova has to pass through the process of continuous changes and creation of a complex of laws, regulations, institutions, and implementation capacity in the government and in the private sector. Corporate governance is as important in the private sector as overall governance is in the public sector.

Since its independence Moldova has experienced macroeconomic difficulties. It was demonstrated, by other countries' experiences, that these difficulties can be exacerbated by systematic failure of corporate governance stemming from weak legal and regulatory systems, inconsistent accounting and auditing standards, poor banking practices, thin and unregulated capital markets, and ineffective oversight by corporate boards of directors. Unhealthy and un-competitive corporate governance, or in some instances its non-existence, in Moldova, led to frequent economic shocks.

Corporate governance can be viewed, in its narrow sense, as a set of arrangements that define the relationships between managers and shareholders. In the center of this system is the board of directors. In Moldova the board is responsible for approving a company's strategy and major decisions and for hiring, monitoring and replacing management. The Board's task is to protect the interests of the company and its shareholders.

It can be said that in Moldova there are 2 kinds of ownership structure:

- publicly traded companies, with widely dispersed shareholdings, and;
- closely held companies with a controlling shareholder and a minority of outside shareholders.

The first type appeared out of the mass privatization program undertaken in 1993-1996, while the second resulted from privatization through investment tenders beginning in 1998.

Privatization and Corporate Governance in Moldova

The year 1993 can be considered a starting point for the privatization process in Moldova. At that time the Moldovan government took a strategic decision to launch the mass privatization program (MPP). The MPP relied upon the free distribution of the public property to the citizens of Moldova through National Patrimonial Bonds (NPBs). Privatization for NPBs was the main component of the State Privatization Programs for 1993-1994 and 1995-1996. As a result, at the end of 1996 more than 3 million Moldova citizens became shareholders and more than 2 thousand state enterprises were reorganized into Joint Stock Companies. Mass privatization has led to widely dispersed ownership, even in small and medium size enterprises. Significant blocks of shares are held largely by the State and investment funds only.

In Moldova, as in many transition economies, investment funds have been assigned an important role during both the implementation phase of mass privatization and the post-privatization development of financial institutions and the capital market. In the implementation phase, investment funds were expected to amass necessary data about companies and to develop the portfolio management expertise to make informed investment decisions. Moreover, endowed with a pool of voucher capital accumulated from citizens, investment funds could invest in a large number of companies and thereby diversify their own risk as well as that of their investors. Thus, investment funds were developed to help speed the process of mass privatization while ensuring that individual investors had equitable access to opportunities to invest in newly privatized companies.

Investment funds were also expected to contribute to the creation of private property rights and to capital market formation in the post-privatization environment.

Finally, the funds were expected to serve an important function as financial intermediaries in the newly emerging capital market. By forming a link between productive assets and small private shareholders, the funds would represent the initial experience of the investing population in the development of capitalism.

The analysis made on Investment Institutions' activity shows that lately the Investment Funds and Trust Companies are exercising activities which were not intended for them. Investment companies try to manage directly those companies in their portfolio in which their holdings are significant. These investment institutions are holding stakes in different sectors of the national economy (agriculture, processing industry, commerce, transportation, telecommunications etc.).

The degree of influence of investment institutions on a company's activity is highly dependent on its stake. If the stake is 0.01-5%, investment institutions have an insignificant influence if the package of shares is from 5% to 25% or higher (up to 100%), investment institutions have as an objective the direct influence of financial activity of the company. Based on a recent survey, in 2/3 of those companies surveyed investment funds and trust companies hold from 5% up to 100% of shares.

Citing different reasons, including an unstable national economy (inflation, unpaid debt etc.) and especially undeveloped capital market, companies' managers state that it is practically impossible to tap the capital market using classical methods. They are saying that under present conditions, investment funds and trust companies functions exercise the direct management of the companies included in their portfolios based on restructuring, attracting investments credits under funds' guarantees. In this connection there has been a tendency of redistribution of influence on enterprises through exchanging shares and stakes between Investment Institutions in order to concentrate the package of shares in few hands. This is done in order to obtain control and influence management. Thus, key positions in the company's management are taken by investment institutions' representatives. Usually these people are new in the field, have no management capabilities, no experience in company administration and little knowledge of the industry sector, which has led to negative results in a company's activity. Since Investment Funds and Trust Companies were created until now, the sales and profits of many companies have declined drastically. This shows that not only the crisis in the national economy influenced these indicators but also the changing of cash flow policy together with new managers. Presently investment funds and trust companies are limiting their activities to a few problems: sales of assets, including equipment, inventory and other assets; leasing of production areas and equipment; nominating the Investment Fund's and Trust Company's representatives as company's managers. This has led in many cases to reduction of the value of company assets managed by investment funds and trust companies.

These negative developments in investment institutions' activity result from violations of legislation on Investment Funds and Trust Companies activity, in particular those setting limitations regarding diversification of investment portfolios.

The Moldova MPP (following the Czech Republic and Russia model) succeeded in privatizing a large number of companies in a short period. But if we are to take the goals of mass privatization seriously, other criteria must also be considered in assessing the results. Did investment funds help to ensure equitable results in mass privatization? The record on this is discouraging. *The discount at which fund shares are being traded – if traded at all – reflects the market's perception that the funds either have been unable to enhance value of their holdings or have failed to share any gains with their investors. Dividends, if paid at all, have been extremely low. Have investment funds contributed to effective private property rights? The evidence suggests that establishing property rights is a longer and much more complicated process than nominal allocation of title.*

For a variety of reasons, including dispersed ownership and lack of corporate governance from investment funds, only limited restructuring has occurred in privatized companies. As a result, labor productivity in industry has declined continuously since 1992 and the underground economy had grown to an estimated 35-40% of GDP by 1998.

Apart from investment funds, pension funds and insurance companies can also serve an analogous role of owning shares on behalf of individual investors. To date, these kinds of institutions are not a significant factor in Moldova.

State role

The privatization process in Moldova is not finished yet, as there are still companies where the State is a significant shareholder, such as wineries, tobacco companies, Telecom Company, hotels etc.

During the process of privatization 1,384 companies were restructured into joint stock companies. Out of these 859 (62%) are now totally private, while in 505 enterprises the State has stakes from 5% up to 100%.

In a Joint Stock Company where the State is a shareholder it has nominated a representative, acting on behalf of the State, who defends the State's rights and legal interests. The State representative participates at the Board's meetings of the joint stock company and can be elected as a member of the board or executive body.

The main responsibilities of the State representative are providing methodological help in training corporate administration, participating at the elaboration of internal regulations, business plans, marketing plans, financial restructuring programs etc. Most State representatives are not well prepared for this and are still conducting themselves as if in a planned economy, not market economy. Some times their actions are negative toward the activity of the executive body of the company. Administration of the State property through its representatives have proved that during reorganization of enterprises into joint stock companies new methods of corporate administration have been implemented: general meeting of shareholders, meeting of the board of directors etc. The main objective of a joint stock company is to earn a profit and pay dividends. State representatives are assigned the task to achieve optimal balance between investments and dividends, which during recent years are increasing.

For example, dividends transferred to the state budget in 1996 accounted for 3,9 million Lei, in 1997 – 4,493 million Lei and in 1998 accounted for 13 million Lei, although in 1997 the number of joint stock companies was 761, in 1998 – 660 and in 1999 – 505 companies.

The role of the State should be re-oriented from directing and controlling economic activity towards transparently facilitating the growth and development of the private sector.

Foreign direct investments

Moldova's level of cumulative direct investment and FDI per capita is somewhat behind other countries in Central and Eastern Europe. However, on a per capita basis the country has fared reasonably well in comparison with other CIS countries, excluding Baltic States and those rich in mineral resources. The major sectors receiving foreign investment have been agro-processing and food products, telecommunications and the banking and energy sectors. Among the largest foreign investors are the Russian firms Gazprom and Lukoil; France Telecom Mobile International; the Western NIS Enterprise Fund, which has holdings in a glass bottling facility and a beverage company; Spain's Union Fenosa, which purchased three energy distribution companies; the German sugar producer Sudzucker, which purchased significant interests in 4 sugar companies; and Coca-Cola. The EBRD, the Commercial Bank of Greece, the Commercial Bank of Romania, the Bank of Turkey-Romania (BTR), the Bankcoop of Romania and Lukoil are the largest investors in Moldova's banking sectors.

Foreign Direct Investment in Moldova in 1999 was substantially lower then in the previous two years and largely reflected political difficulties and delays with large-scale privatization.

Moldova is keen to attract foreign direct investments and offers a liberal, non-discriminatory foreign investment regime including tax concessions. Foreign investors enjoy equal treatment with locals under the Law on Foreign Direct Investment, although some have found the registration process bureaucratic and lengthy. Foreign investment is allowed in all sectors, with high priority for investments in energy, agriculture, telecommunications and construction. There are no taxes, duties or other restrictions on the repatriation of funds associated with foreign investments. Other relevant legislation includes the Law on Property, the Law on Joint Stock Companies, the Law on Privatization, the Law on Financial Institution and the Tax Code.

As to World Bank and IFC the greatest potential for Moldova lay in three areas: agro-processing, metal industries and light manufacturing. Significant opportunities also exist in the financial sector. Specifically, the insurance industry is expanding rapidly and laws were changed in 1999 to allow 100 per cent foreign ownership. The banking sector is also expected to begin a period of consolidation offering opportunities to foreign investors. Both the insurance and banking sectors already have significant foreign investments.

Corporate governance arrangements when foreign investors are involved

Sales of large enterprises for cash formed part of the second wave of privatization, which started in 1997. Initial progress was slow, due in part to problems with the organization of tenders. In 1998 the government accelerated trade sales and adjusted tender procedures, in particular by lowering minimum prices.

A number of companies have been sold through investment tenders in spite of Moldova's low investment profile, due to a pragmatic attitude of government officials toward privatization.

After privatization of an enterprise, investors meet many difficulties. Managers are often reluctant to cede control, preferring to retain control of failing businesses rather then allow foreigners a chance to improve enterprise performance. Also, corruption and a general lack of transparency serve to deter investors.

If there is corporate governance then it is often unhealthy and not competitive. This can happen in case of closely held company with a controlling shareholder and a minority of outside shareholders. The foreign investors, if they purchase 51% of company's shares, have management control. To obtain total control of the company it has to buy 2/3 of company's shares. Major foreign investors here have management control; there is no case where a foreign investor is willing to be a minority shareholder.

Finally, it should be said that privatization of large enterprises to a foreign investor, although more time consuming, is clearly a better method than privatization to insiders. Privatization of strategic sectors including services (banking, insurance, and telecommunications) to foreign investors will help to establish an environment attracting FDI in other sectors and facilitating international trade.

Capital Markets

Corporate governance is important not only to attract long-term foreign capital, but also to broaden and deepen local capital markets by attracting local investors – both individual and institutional.

Capital markets in Moldova remain undeveloped. The government securities market suffered significantly due to the Russian crisis, as commercial banks switched funds from treasury bills to foreign currency. Demand for treasury bills fell throughout 1999, with the exception of one-week to one-month maturities. The volume trade on the stock exchange during 1999 was roughly one-third of the same period in 1998, which also reflects the Russia crisis.

The Moldovan Stock Exchange (MSE) is the youngest in Eastern Europe and is largely undeveloped, with most trades involving swaps of shares originally issued during mass privatization. The legislative framework broadly complies with international standards regarding investors' protection, information transparency, and fair competition among professional securities market participants. In total, almost 1000 privatized enterprises and commercial banks were registered at the end of 1999. There was a significant decline in both capitalization and total trade. This decline can be attributed largely to three factors: the Russian crisis of 1998, its fallout across CIS countries and the resultant Moldovan Leu devaluation. The MSE has also been competing with the over-the-counter share market, which has accounted up to 50 per cent of the country's stock transactions. In September 2000 the National Securities Commission took steps to curtail the OTC market. While no corporate bonds, futures, or commodities are currently traded, these may develop as the MSE continues to expand.

What is the relationship between investment funds and the capital market? While markets were supplied with a large amount of shares as a result of mass privatization, they remained under-supplied by capital. One reason that an efficient capital market failed to develop is the lack of institutional framework. Investment funds had the potential to play an intermediating role in the development of new capital market, but many have become holding companies rather than actively engaging in portfolio investment. The negative experience of a large part of population with NPBs (voucher) privatization has reduced confidence in the emerging capital markets.

Conclusions

The government is of the view that structural reforms are necessary in order to ensure the economy's growth and development in the medium term. It therefore remains committed to further progress in its structural reform program. With regard to the government's privatization program, future emphasis will be placed on the open and transparent privatization of the energy sector (with tenders already launched for the remaining two distribution companies and the three power generating companies), the telecommunications sector (with the privatization of "Moldtelecom"), and the wine sector. With regard to enterprise restructuring, the bankruptcy and liquidation of enterprises with significant debts will continue throughout the period, while the legislative framework for efficient corporate governance will be improved. The following are necessary to improve corporate governance:

- Improve the legal framework for corporate governance: (a) clarify land ownership rights of enterprises, (b) review regulations and operations of investment funds with the purpose of strengthening their corporate governance and efficiency, and (c) develop action plan(s) to improve corporate governance (including achievement of transparent accounting standards, protection of minority shareholder rights, establishment of transparency and clearly defined rules for stock market operations and improved market supervision).
- Initiate bankruptcy/restructuring procedures to be taken against loss-making firms
- Finalize bankruptcy/restructuring procedures of firms

Finally, a sustained effort will be made to create a better business climate. This includes the simplification of entry procedures (through the simplification of licensing and registration requirements) and the improvements in the legal framework required for the further growth and development of private sector activities in Moldova.

Banking system

In Moldova banking system and corporate sector are not interlinked.

Moldova’s banking system consists of 20 commercial banks, including subsidiaries of 3 foreign banks. The share of unfavorable loans decreased by 3.64 per cent, while there was an increase in the number of credits classified as standard and under supervision. At the same time, the share of loan portfolios as a percentage of total assets decreased by 12.55 per cent.

As of late 1998, around 10 per cent of loans in the banking sector were deemed to be “non-performing”.

Banks are still not completely fulfilling their role as financial intermediaries. Due to inexperience, many of the banks are hesitant in the core activities of making credits within a market economy in crisis.

According to the legislation in force all Joint Stock Companies are obliged to call for a General Meeting of Shareholders within 2 months since the financial body received the annual report on company’s activity. This request is abided by all investment funds which are opened Joint Stock Companies.

At the same time holding of the General Meetings of IF are and negative aspects. During 1999 the sufficient number of votes were only in 7 investment funds which is 20% of total IF. This number is reduced during 1997-1999 from 13 in 1997 to 7 in 1999.

Almost in all Investment Funs necessary quorum, according to the legislation in order to hold a General Meeting, was not achieved, and repeated GM had to be announced. Attendance was lower. It means that all-important issues on funds activity were voted by a small number of shareholders.

One of the distinctive features of Investment Funds is a large number of shareholders. It obvious that is impossible that all shareholders would be present at the General Meeting. In connection with that are doubtable achievements of necessary quorums at the general meetings, because the number of shareholders reaches 100 000 peoples and the meeting has to be held in a room of 60 000 seats which does not exist in Moldova. In order not to have such kind of problems the legislation permits to have mixed General Meeting, which means that shareholders can participate at the meeting in turn. Non of fund used this method and this led to an insufficient numbers of votes at General Meetings. Funds’ management explains this by high expenses.

However, such explanations are not taken into consideration firstly, because according to the legislation Funds are obliged to hold General Meeting having the necessary quorum and secondly, being J.S.C. with a large number of shareholders it has to be ensured high attendance of shareholders in order to ensure each shareholders’ right to participate at decisions taking.

At present time Investment Funds are publishing only annual reports, which is compulsory according to the legislation. However, there are some investment fund which have not published quarterly financial reports. Some IF *have published their financial reports changing some articles of the Balance Sheet, providing wrong information on calculated remuneration and paid salaries to managers. All these harm owner's rights, according to international standards, of having the information on its property, the right of being informed on fund's activity, shareholder of which he is, more then that the annual reports are not confidential.*