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Financial Crisis in Moldova - Causes and Consequences

192

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CONTENTS

MOLDOVA - BRIEF PRESENTATION

Area: 33,700 sq km (including Transnistria)
Length if boundaries: 1,389 km (Romania 450 km, Ukraine 939 km)
Geography: rolling steppe, gradual slope south to Black Sea
Climate: moderate winters, warm summers
Population: 3.6 million - including Transnistria 4.4 million (July 1997 est.)
Population growth rate: -0.02% (1997 est.)
Natural growth rate: 0.19% (1997 est.)
Net migration rate: -0.21% (1997 est.)
Infant mortality rate: 19.9 deaths/1,000 live births (1997 est.)
Life expectancy at birth: 66.7 years
Share of urban population: 46%
Adult literacy rate: 96.4%
Real GDP per capita (PPP): 2,122 US$ dollars (1996)
Ethnic groups: Moldavian/Romanian 64.5%, Ukrainian 13.8%, Russian 13%, Gagauz 3.5%
Languages: Moldovan/Romanian (official), Russian, Gagauz (a Turkish dialect)
(Source: Republic of Moldova, National Human Development Report (1998), CIA's 1997 Factbook)

Moldova, an independent state since 1991, was the second smallest republic of the former Soviet Union. The territorial integrity of the country, landlocked between Ukraine in the north, east and south and Romania in the west, is under the threat from the self-proclaimed secession of Transnistria, the Russian-speaking territory. Long-term settlement of the conflict is still to be accomplished.

Moldova is the most densely populated country in the CIS, but at the same time one of the least urbanised. Fertile soils and a moderate climate encourage agricultural production that accounts (together with agro industry) for 50% of GDP. Food products were traditionally supplied to the vast market of former Soviet Union. The collapse of trade links, deterioration of terms of trade that followed the dissolution of Soviet Union had very negative consequences on the Moldovan economy and the real GDP declined by 66% between 1989 and 1997. Moldova remains fully dependent on imports of energy resources. While the consequent IMF-guided policy of National Bank of Moldova allowed achieving fragile macroeconomic stabilisation before 1997, only very limited progress was made in structural reforms.

Table 1. Moldova in the process of reforms

		Enterprises			Markets and trade			Financial institutions	
Countries	Private sector share of GDP in %, mid-1997 (rough EBRD estimate)	Large-scale priva-tisation	Small-scale priva-tisation	Gover-nance & re-structu ring	Price liber-alisa-tion	Trade & foreign exchange system	Com-petition policy	Banking reform & interest rate liberali-sation	Securities markets & non-bank financial institutions
Belarus	20	1	2	1	3	1	2	1	2
Bulgaria	50	3	3	2+	3	4	2	3-	2
Latvia	60	3	4	3-	3	4	3-	3	2+
Moldova	**45**	**3**	**3**	**2**	**3**	**4**	**2**	**2**	**2**
Slovenia	50	3+	4+	3-	3	4+	2	3	3
Ukraine	50	3-	3+	2	3	3	2	2	2

Source: EBRD, Transition report 1997

Figure 1

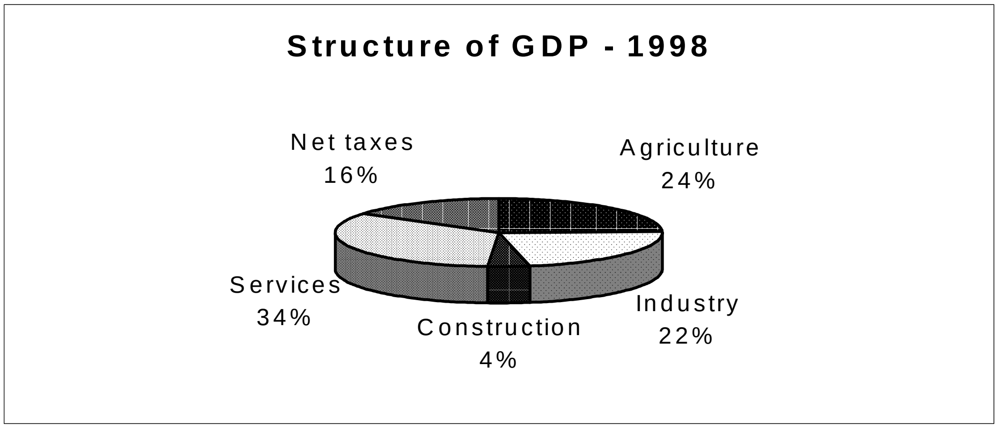


Figure 2

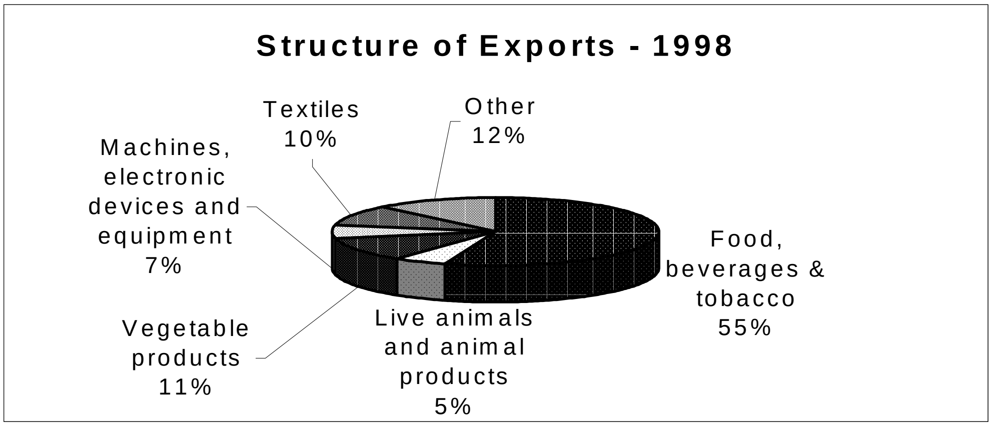


Figure 3

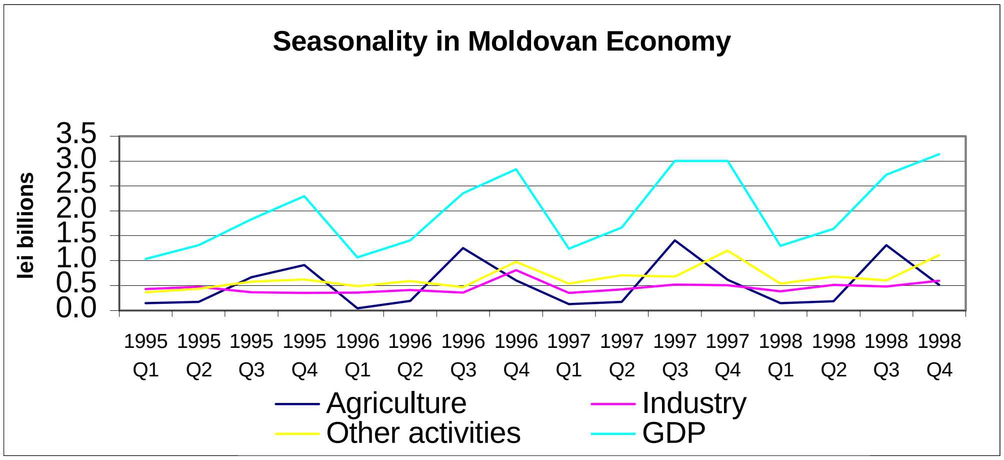
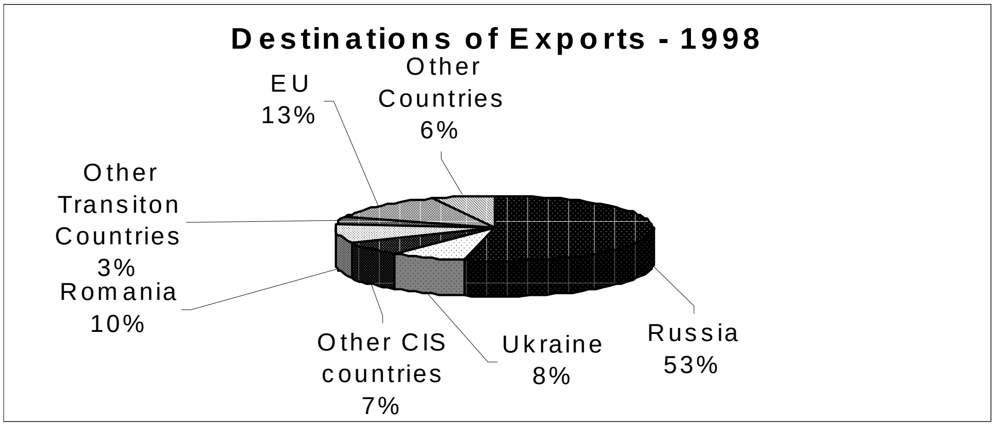


Figure 4



Source: Ministry of Economy and Reforms

Table 2. Main Macroeconomic Indicators

	1993	1994	1995	1996	1997	1998
Real GDP growth rate	-1.2%	-30.9%	-1.4%	-7.8%	1.6%	-8.6%
Nominal GDP (excl. Transnistria), lei million	1821	4737	6480	7658	8917	8804
Nominal GDP, USD million	1214	1164	1443	1665	1933	1630
GDP per capita, USD	337	322	400	463	538	454
Export (fob), USD million	395	618	739	822	851	644
Import (fob), USD million	530	672	794	1056	1235	1043
Trade balance, USD million	-135	-54	-55	-234	-384	-399
Current account, USD million	-155	-97	-115	-195	-308	-332
as % of GDP	-12.7%	-8.3%	-8.0%	-11.7%	-15.9%	-20.4%
Foreign direct investments, USD million	1	18	73	23	71	88
as % of GDP	0%	1.5%	5.1%	1.4%	3.7%	5.4%
Stock of foreign debt, USD million	255	633	840	1068	1228	1300
as % of GDP	21%	54.3%	58.2%	64.1%	63.6%	79.7%
NBM gross forex reserves, USD million	76	180	257	314	366	144
NBM reserves in months of imports of goods and services	1.73	2.85	3.03	3.00	3.07	1.38
Internal debt, million lei	105	270	477	737	940	1500
Budget balance as % of GDP	-7.5%	-5.9%	-6.7%	-7.6%	-7.8%	-3.6%
Annual inflation rate (end period)	2706.0%	104.6%	23.8%	15.1%	11.2%	18.3%
End-year exchange rate, lei/1USD	3.64	4.27	4.50	4.65	4.66	8.32
Average exchange rate, lei/1USD	1.5	4.1	4.5	4.6	4.6	5.4

Source: CISR calculations based on data from Ministry of Economy and Reforms, Ministry of Finance, National Bank of Moldova

I. MONETARY REFORM (1993-1997)

1. Introduction

Moldova, like other post-communist economies, joined the transition process having a high rate of inflation and massively decreasing production. After the surge in administered prices in early 1992, sharp price increases followed, leading to hyperinflation (in 1992 – 1280%). In such environment, the so needed budget deficit reduction, along with reforms in real sector, has not been started. Moreover, the deficit was financed by extensive money printing, as well as preferential centralized loans, which ultimately generated a non-productive consumption, since the loans were frequently absorbed by inefficient state enterprises which should have been either restructured or bankrupted.

The Government did not have the needed resolution (and experience) to perform the radical reforms, combining the transition to a market economy and the hyperinflationary environment. In these circumstances the country needed a stable monetary system, as well as a sound banking system. The currency stabilization environment had to be built up from scratch since in 1991, when Moldova became an independent state, the foreign exchange and gold reserves were zero, and there was neither a foreign exchange market, nor even a central bank of the state.

As in all other former Soviet republics, in Moldova the Soviet rouble banknote was in circulation. There was a republican central bank (branch of the former USSR Gosbank), plus several state specialized banks for savings accumulation, budget servicing, agriculture and industry financing. They were receiving financing from the central bank for granting directed credits. Hard currency flows were subject to a strict control and the circulation of hard currencies was banned.

2. Building-Up Institutional Framework

Banking Environment

In June 1991 the Parliament of Moldova approved the laws "On the National (State) Bank of Moldova" and "On Banks and Banking Activity", which established the basis of the actual banking system of the country. Later, in July 1995 Parliament adopted the new banking laws "On National Bank of Moldova" and "On Financial Institutions", elaborated by NBM in accordance with international standards. The laws set the legal basis for the 2-tier banking system in Moldova: the central bank - the National Bank of Moldova (NBM) - and commercial banks. The NBM is independent from the Government and reports only to the Parliament. It is the sole money issuance authority of the state, drawing up and implementing monetary, credit, and foreign exchange policies, setting the regulatory framework for commercial banks and supervising their activity.

When the inflation in neighbouring republics exceeded the inflation in Moldova, and some of them started issuing local currencies it became clear that in order to avoid the total chaos and invasion of Soviet roubles from the entire rouble zone, the domestic market must be somehow protected. Thus, in June 1992 the NBM put in circulation the Moldovan coupons, which were equivalent to Soviet type roubles, and circulated in parallel. After one year the coupons accounted for 80% of cash in circulation. At the beginning of August 1993 the NBM started an independent weekly quotation of the Moldovan rouble against main currencies, including other roubles of the FSU area, using the cross-rate through the Russian rouble. This greatly contributed to shrinkage of the currency black market. In the period January-November 1993, the exchange rate of Moldovan coupon against US dollar depreciated by more than nine times. The NBM supported this depreciation policy due to the negative trade balance between Moldova and Russia and import of inflation from the rouble zone.

In October 1993 the Moldovan Interbank Currency Exchange was founded by seven commercial banks as a closed joint stock company. The NBM had only a supervision role. Weekly trading auctions were held at this Bourse, and the exchange rate was set at the equilibrium between supply and demand, afterwards automatically becoming the NBM's reference rate for the next day. During the first several weeks of the Bourse's activity, the NBM was the only seller of hard currency in the market, but afterwards the situation became more balanced.

Introduction of the National Currency

Moldova introduced its national currency, the Moldovan leu, on November 29, 1993. The conversion rate was set to 1 leu for 1000 Moldovan roubles or coupons. The initial exchange rate of the leu was set at 3.85 lei per 1 US dollar. A floating currency regime was adopted, or more exactly – a managed floating regime, since the country had no gold or significant hard currency reserves and a fixed exchange rate or a pegged regime could at a larger extent expose the economy to shocks.

The program of financial stabilization and structural reforms, adopted along with the introduction of the leu, was supported by the IMF through stand-by arrangements (in fact if no IMF financial support followed, than it would have been impossible for Moldova to introduce its national currency, given the existing circumstances). The IMF program, which covered the period through March 1995, was designed to secure a stable leu through the adoption of tight financial policies. The program also sought to advance economic restructuring through the liberalization of domestic and international trade and payments systems and the introduction of key structural reforms. In addition to IMF support, the program was supported by other bilateral and multilateral donors, including the World Bank.

Thus, the long-term financial assistance received from the IMF and World Bank during 1993-1997 had a particular importance for Moldova. In total, IMF made available $242m, through CCFF, STF, Stand-by and EFF facilities - for balance of payments support, national currency support, and structural adjustment. The World Bank provided $265m, for financing critical imports, export promotion, financing budget deficit, private sector development and structural adjustment. Moldova also received considerable loans from donor countries, European Community, and private banks.

The Development of Commercial Banking System

At the end of 1991 fifteen commercial banks were operating in Moldova, and their number reached 22 by the end of 1993. Since then this figure did not vary too much. As of April 1999 out of the existing 23 commercial banks, 5 originated from the reorganization of the former state specialized banks, and 18 are new banks, including branches of some foreign banks.

There are 3 types of licenses granted by the NBM to commercial banks, subject to different capital requirements and granting different operating possibilities:

· type A license allows to perform basic banking operations, as well as cash foreign exchange transactions on the domestic market (minimal capital requirement, from 1 July 1999 set at 12 million lei);

· type B license alongside the above mentioned operations enables banks to perform international banking operations (capital requirement is 2 times minimal);

· type C license allows banks to perform all types of domestic and international banking operations, including dealing in foreign exchange and investment activities (capital requirement is 3 times minimal).

Aimed at regulating banking activity and insurance of banks' stable financial standing, as well as for protecting banking creditors and depositors, starting with 1992 the NBM put in place prudential regulations for all banks, subsequently revised in March 1995, which set standards for the Moldovan banking system compatible with Basle provisions. Among the most important norms there are: capital adequacy - raised from 4% in 1996 to 6 per cent in 1997, gradually moving to a level of 12 per cent by year 2000; classification of commercial banks' loan portfolio and compulsory risk provisions for covering losses in case of non-repayment of granted loans; monitoring of "big" loans, i.e. loans higher than 10% of total capital; daily monitoring of liquidity in the banking system, ultimately relying upon NBM as lender of last resort; limitation of loans to affiliated persons, as well as loans granted to one single client.

In May 1996 the banking system moved to an electronic settlement system which now covers most of current transactions. In addition to other significant operational advantages for the commercial banks and their customers, this system allows NBM to monitor more efficiently banks' liquidity and their financial standing. More than half of commercial banks became members of SWIFT, and the most advanced are connected to REUTERS Dealing. Some banks have issued VISA and other types of cards. In May 1997, Victoriabank became member of VISA International, and through its processing centre all VISA cards are now serviced in Moldova. However, so far this instrument has not gained a wide access in Moldova.

At the same time, commercial banking system has faced a number of difficulties, such as: insufficiency of qualified personnel with experience in modern banking operations, and capable of dealing with international counterparts, lack of experience of local bankers, as well as weak technical and material base. Significant efforts are made by most banks to overcome these constraints. Of course, proper training of a sufficient number of staff is a long process. The areas that appear to suffer most from this shortage are those of credit allocation, loan supervision and legal settlement of issues related to debt reimbursement.

Western bankers are unwilling to invest their capital in Moldova, and this proves the persistence of major factors that keep them away from our country. These are, apart from regulatory issues, the small size of the country's capital market, along with its underdeveloped productive sector – reasons discouraging investment decisions on the part of foreigners.

Overall, the situation in banking system of Moldova has been stable during 1993-1997 and did not suffer from any major shocks similar to those that occurred in Romania, Russia, Latvia or other European countries in transition. However, from the financial prospective, banking system cannot be considered a strong one because of lack of funds, and this imposes a firm prudential accent to banks' behaviour in the market, as well a need in competence and responsibility in taking decisions. Otherwise banks risk to go bankrupt, as it already happened with several commercial banks of Moldova. As in most cases of bankruptcy that happened in industrial countries, in transition countries, including Moldova, the main cause of this phenomenon is banks' mismanagement, as well as fraud and abuse in personal interest, that generated an unjustified concentration of risks in specific branches or economic entities, at the same time banks' management allowing crediting of insolvent clients.

3. Monetary Policy

Credit Allocation

Before 1993 the central bank was providing directed and centralized loans in the amounts requested by the Government. Since August 1993, when the first refinancing auction took place and till mid-June 1998, the main type of credit allocation was credit auctions held at the NBM. The approved policy guidelines for 1994 specified that 80% of the central bank's credit (and for 1995 – 90%) must go through credit auctions. And these conditions were fulfilled, though few believed back in 1992 that the economy could do well without preferential loans. Market method of granting loans to banks at the auctions proved to be substantially more efficient. The refinancing rate was equal to the interest rate set at the auctions according to the supply and demand.

In 1994 NBM's preferential credits (direct loans at low interest rate granted to some economic agents, mainly state enterprises) have been phased out. However, the Government itself continued to provide state guarantees for commercial banks' loans to some economic agents. Starting with the issuance of state T-Bills in 1995, NBM's direct credits for financing state budget were granted by the NBM against state's T-Bills. However, so far servicing of these loans by the Government has been continuously rescheduled.

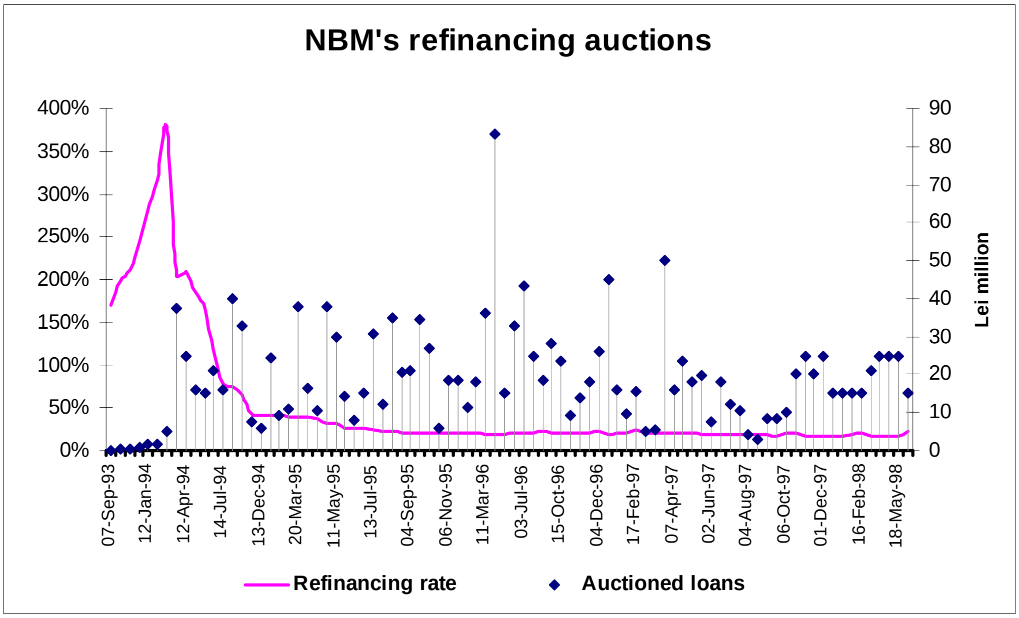
The refinancing rate set at the credit auctions has been the key reference rate of NBM. However, since August 1997 a new instrument started to be applied – the Lombard facility. The Lombard rate was determined at the level of interest rate on 28-day state securities plus a constant margin (5% or higher). Lombard facility is granted up to a maximum limit established for each bank, which can be: 3% of the total normative capital, or 8% of the attracted sources (deposits). Assets eligible for purchase and sale under Lombard facility are dematerialized treasury securities issued by the Ministry of Finance on the internal market and denominated in national currency.

In September 1997 NBM approved the regulations on open market operations – Repo agreements, i.e. selling of state securities with their further repurchase at a specific date at an agreed price. Commercial banks act as primary dealers in these operations. Open market operations take place at the actions held at the NBM.

Interest Rates

The annual refinancing rate established at credit auctions increased significantly through late 1993 reaching a peak of 377% in February 1994. Then, as inflation declined, the auction rate began to drop. The decrease of inflation rate has had a positive effect on NBM refinancing rate which became positive in real terms starting with January 1994. Real refinancing rate rose significantly in 1994 and peaked by mid-1994 (which brought the first symptoms of suffocating economy and urged NBM to start a decrease in interest rates).

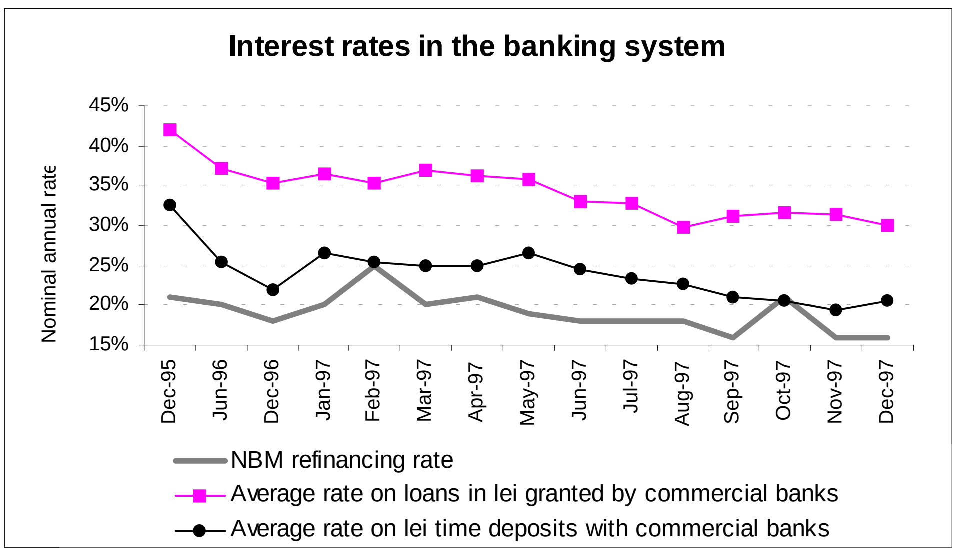
Figure 5



Source: National Bank of Moldova

By the end of 1997 the refinancing rate reached its lowest level of 16%. On the other hand, average interest rates in the banking system have declined continuously during 1997. The movement in interest rates shows that there has been a widening of spreads between rates on deposits and loans, indicating lack of a real competition between banks, as well as the fact that some banks tried to increase their profits granting risky loans.

Figure 6



Source: National Bank of Moldova

Real interest rates in the banking system always remained quite high as high borrowing requirements of the Government combined with low supply of domestic savings led to the high interest equilibrating the financial market. At the same time, international savings could be attracted only at the interest rate inclusive of significant risk premium (due to the high country risk rating of Moldova) so that domestic real interest rate remained high above the world level. High interest rates on T-bills caused an increase in the opportunity cost of lending, thus crowding out credit investments to the private sector and leading to a situation when a portfolio of major part of banks consisted mainly of profitable and relatively risk-free government securities. On the other hand, high systemic risk, driven by the weakness of court and legal environment for instance lack of legal basis for land collateral and mortgage loans) further reduced the incentives for search for profitable lending opportunities. As a result, the lack of serious competition between banks, as well as their undercapitalisation meant that private lenders had to bear the excessive cost of credits, at the same time not being allowed to borrow from foreign banks, due to a capital account restriction imposed by the central bank.

Analysing banks' crediting activity, it should be stressed out that there is a problem of availability and cost of credit, partly resulting from insufficient development and limited competition in the commercial banking sector, which continues to keep the real cost of credit at a quite high level. Generally speaking, the low share of long term loans in banks' portfolio is a typical problem in case of transition economies. One of the main functions of banks is efficient usage of credit resources. On the other hand, the main goal of banks is profit maximization, but at the same time the banks should be very cautious, especially in such environment. Because of big risks (economic instability and imperfection of collateral mechanisms), commercial banks refuse to make long term investments in national economy (that in fact could ensure the economic growth). And, on the other hand, they obviously can not provide long-term loans having a mainly short-term deposit base.

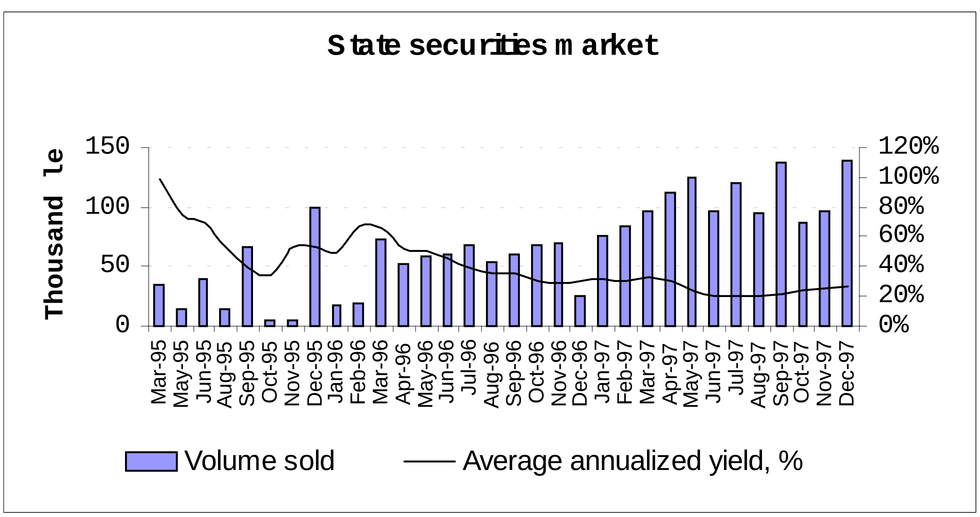
At the same time, one of the main causes of insufficient crediting of production sector is not just the acute lack of financial resources, but lack of efficient investment projects and small number of solvent economic entities, that could efficiently use the credits and reimburse them in due time.

State Securities

Starting with 1995, the budget deficit is covered mainly by issuance of state securities (Treasury bills and bonds) and not only by direct lending from the central bank. Thus, the needed budget funds are attracted from the financial market, avoiding additional money issuance by NBM. The volume of T-Bills to be issued annually is forecasted in the Budget Law which is approved by the Parliament. The NBM is the state's fiscal agent that puts state securities in circulation by organizing auctions and negotiating directly with commercial banks, which act as dealers in the primary market. Foreign investors may participate at auctions without any restrictions.

On March 14 1995, the NBM organized the first T-Bill auction (3-month maturity), where banks acted as buyers. Since August 1995, auctions started to be held once in two weeks according to the pre-published schedule. Initially the supply of state T-Bills was bigger than the demand, mainly due to the fact that the Ministry of Finance was trying to sell big amounts of securities, while these bills were not known in the financial market yet.

Figure 7



Source: MET

The volume of issued state securities had a continuous and fast increase until 1998 when the Government realized that this "pyramidal" practice can not continue any longer, since the budget deficit has not been reduced, and moreover, the proceeds from newly issued bills and bonds did not even cover the amounts needed for securities redemption. During 1995-1997 interest rates on state securities gradually decreased following the reduction of inflation, but they were often high enough (also comparing with deposit rates) to allow commercial banks to use available funds for buying T-Bills and getting easy and guaranteed profits instead of crediting the economy.

First Anchor - Control Over Monetary Supply

With the introduction of the Moldovan leu, a tight monetary policy was implemented, which proved to be one of the most successful (along with the one of the Baltic States) in the FSU. The following monetary instruments were used: reserve requirements, refinancing auctions, interventions in the foreign exchange market, and open market operations with securities. The last one is certainly most recommended, but it started to be utilized only after August 1997, when the securities market was sufficiently developed.

Referring to the reserve requirement, it should be noted that a more aggressive utilization of this instrument took place in 1994 and in 1998. Till February 1, 1994 mandatory reserves for sight deposits were equal to 20% of the total attracted funds, while for the time deposits the requirement was lower (15% and less). Then, in order to limit the money in circulation, NBM raised the reserve requirement up to 28%. And from June 1, 1994, seeing that the level of inflation has decreased, NBM lowered the reserve requirement back to 20%. From December 16, 1994 NBM set an unique reserve requirement for all deposits equal to 12%. From October 1, 1995 it was lowered to 8%. Then the situation changed dramatically in the last quarter of 1998.

Evolution of main monetary aggregates - cash in circulation, broad money and reserve money are shown in the table below.

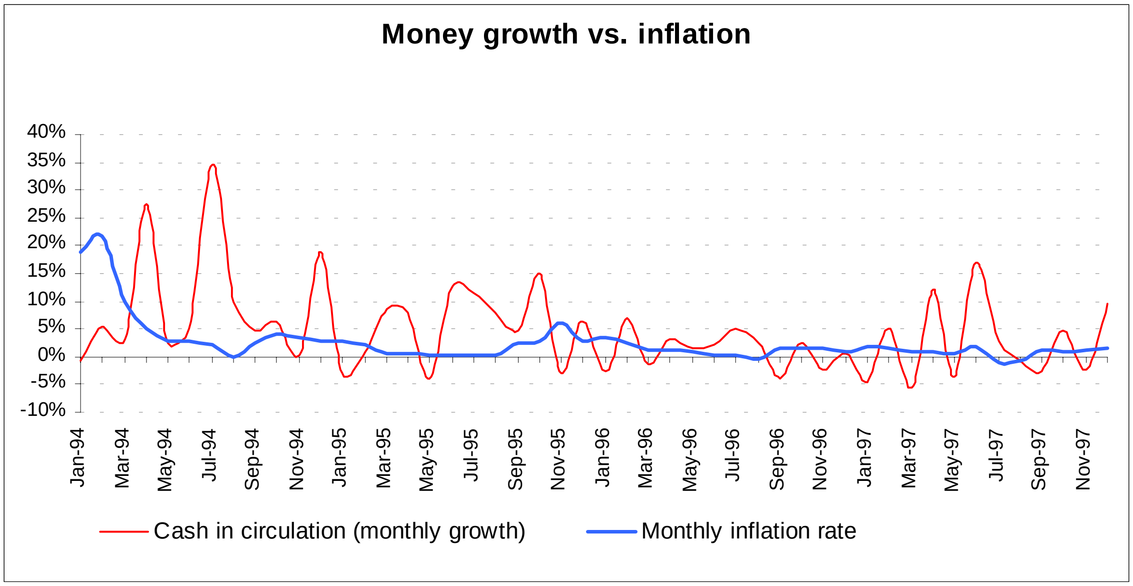
Table 3. Monetary aggregates

End-year:	Inflation	M0 growth	M3 growth	RM growth
1994	104.5%	191.9%	87.6%	136.1%
1995	23.8%	84.9%	65.1%	41.8%
1996	15.1%	14.5%	12.8%	8.4%
1997	11.2%	33.0%	37.0%	35.9%
1998	18.3%	-12.0%	-8.7%	-5.5%

Source: National Bank of Moldova

However, even having an adequate volume of broad money, or an adequate monetary policy of the central bank, does not implicitly mean the total control over the inflation, since the inflation rate could go up influenced by indirect, non-monetary factors, such as administrative increases in prices and tariffs (housing services, transport, energy etc.), or some seasonal tendencies.

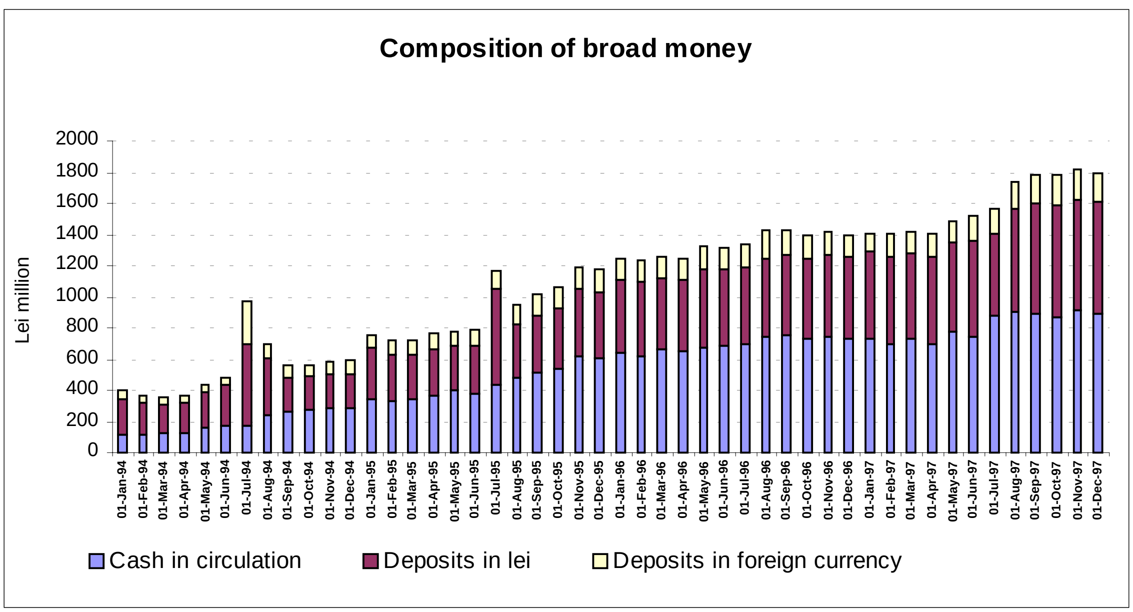
Figure 8



Source: National Bank of Moldova

Looking at the structure of broad money, one can notice that the volume of deposits in the banking system was increasing continuously (the biggest share being of those in lei), clearly showing the increase in confidence in the leu (supported by the stable exchange rate and the rapid decline in inflation) and the increasing reliance on foreign currency deposits to finance current transactions rather than as a store of value.

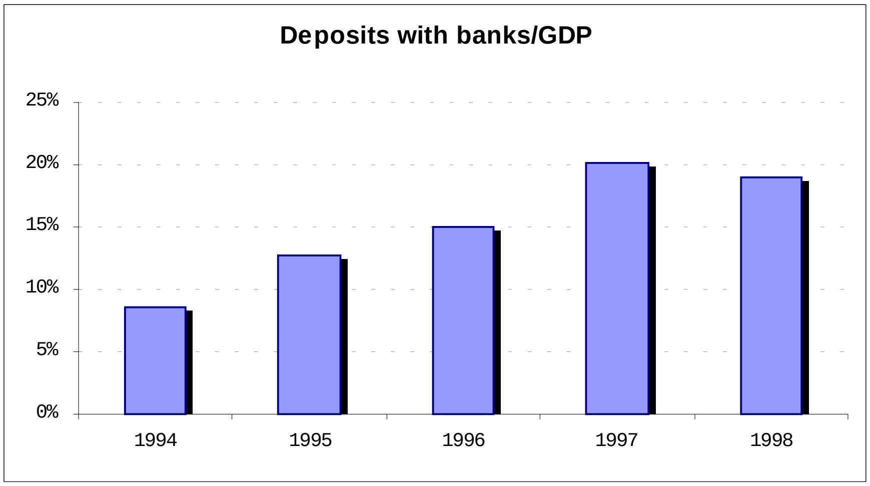
Figure 9



Source: National Bank of Moldova

During 1996 and 1997 the confidence of the population in banking system has grown, and this is reflected by the continuous increase of households' deposits with commercial banks.

Figure 10



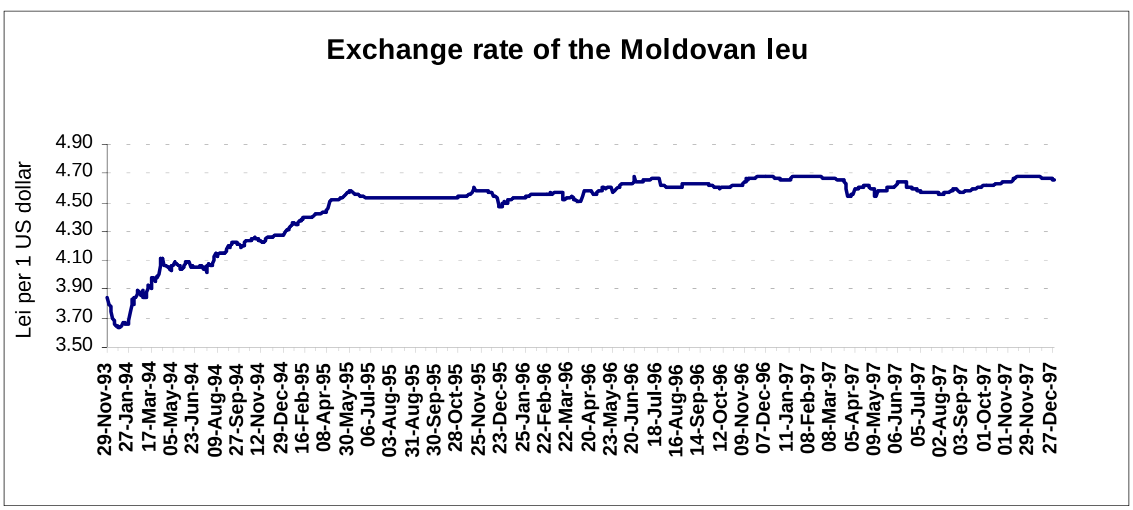
Source: CISR calculations based on data from National Bank of Moldova

Second Anchor - Exchange Rate

The official rate was fixed at the sessions of the Moldovan Interbank Currency Exchange. Due to the fact that the lag between exchange rates in the cash and non-cash markets was expanding, in December 1993 the NBM made several interventions at the exchange bureaus, buying US dollars and after a while selling them back. Thus, the nominal exchange rate was at first even appreciating, reaching 3.665 lei per USD during 20-25 January 1994. Afterwards the rate started to slowly depreciate. Relatively high interventions were made by the NBM in 1994, mainly in the cash market.

During 1993 the coupon depreciated by 900%, while already in 1994 the Moldovan leu depreciated against the US dollar only by 14%. Further on, leu showed a remarkable stability, and the yearly nominal depreciation index (USD/MDL) was: 5.1% in 1995, 3.2% in 1996, and 0.2% in 1997. The stable exchange rate was used as a second anchor (apart from control over money supply) for keeping the inflation in place. However, over a medium and long-term period, only one anchor, i.e. monetary policy, should be sufficient.

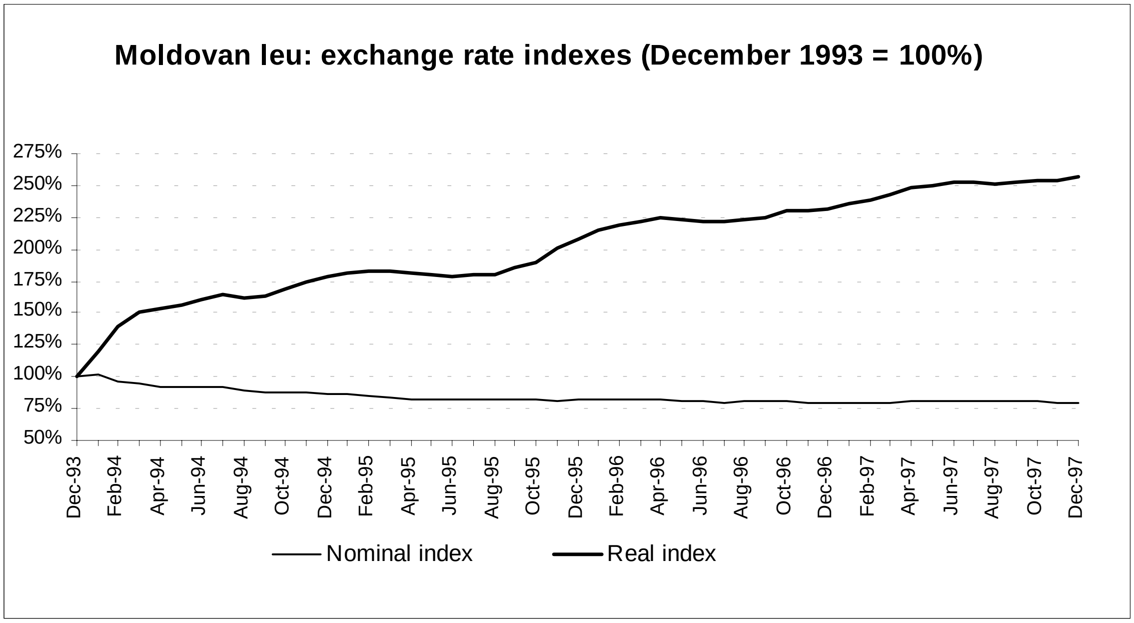
Figure 11



Source: National Bank of Moldova

Along with the reduction of inflation, the Moldovan leu started to appreciate in real terms against the Russian rouble, Ukrainian karbovanets, US dollar and other currencies. Thus, the real exchange rate index indicated an appreciation of leu against US dollar by about 74% in 1994, by 17.5% in 1995, 11.4% in 1996, and 10.9% in 1997.

Figure 12

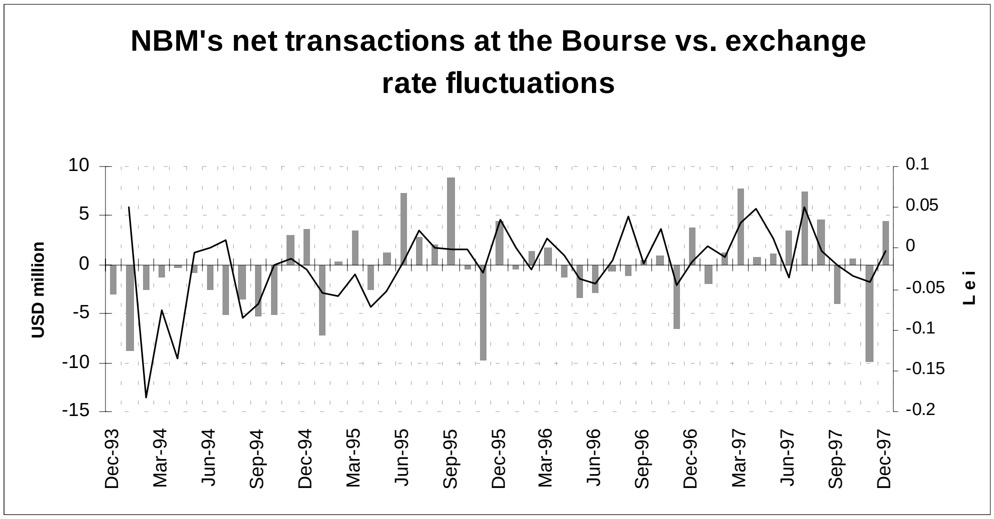


Source: CISR calculations based on data from National Bank of Moldova

This continuous appreciation of the leu, in the presence of huge and rising Balance of Payments disequilibrium (current account to GDP ratio was 15.8% in 1997), has generated many objections (especially in 1997) from the exporters' side, which claimed that an overvalued leu made Moldovan exported goods too expensive, thus deteriorating their competitiveness. At the same time, a devaluation of leu would cut the massive imports, especially of commodity goods. But, on the other hand, the devaluation would not solve the problem, since almost one third of imports were energy resources. Besides, a depreciation would have caused problems to the Government in terms of external debt service, and also would cause the reduction of households' real incomes.

Analysing the path of the exchange rate during 1994-1997, it may be seen that there were some common tendencies generated by seasonal fluctuations of the supply and demand for hard currency in the forex market. They are explained by the seasonal character of Moldova's economy, which is strongly relying on the agriculture sector. During 1994-1997 NBM has been intervening on the foreign exchange market for attenuating sharp exchange rate fluctuations, according to the goals of the monetary policy.

Figure 13



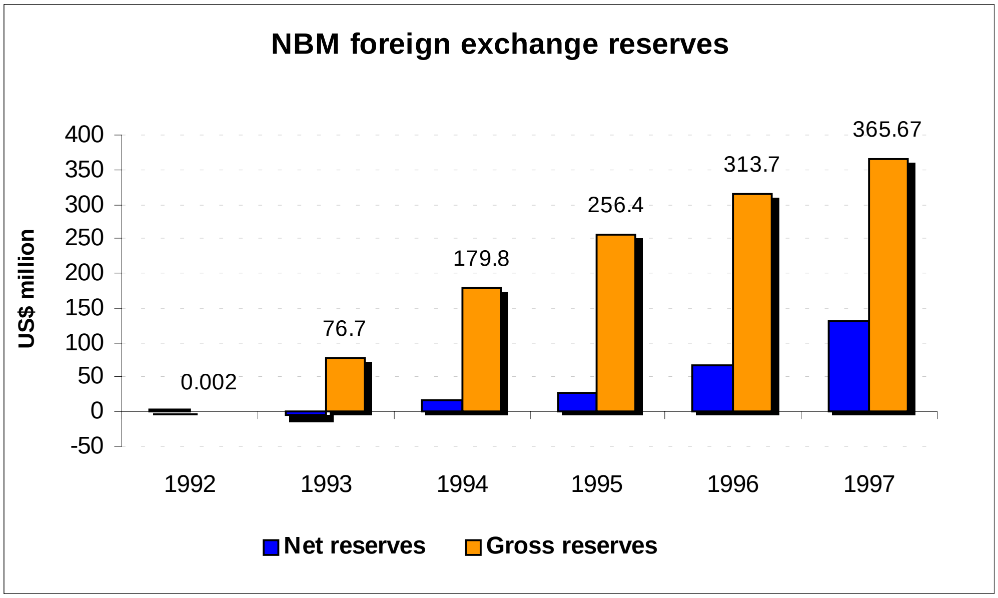
Source: National Bank of Moldova

Foreign Exchange Regime

The NBM has been gradually implementing a policy of foreign exchange market liberalization. Since 1992 positive changes in currency regulations emerged: till May 1992 mandatory sale of hard currency constituted 50% of the proceeds from production activity and 60% in case of intermediaries. Thereafter the surrender requirement has been gradually unified, accounting for 35% by end-1993. Moreover, while in 1993 exports proceeds have been sold to the NBM, starting January 1994 they are sold to commercial banks. NBM's foreign exchange reserves at the end of 1993 stood at $77m. On January 17, 1994 NBM approved the new Regulation on Currency Control, which authorized buying of hard currency for current account operations. From November 15, 1994 the surrender requirement was cancelled, thus economic agents being able to freely dispose of their export earnings, kept with banks. This was a strong evidence of leu's stability.

The building up of reserves evolved further. Thus, at the end of 1994 gross reserves already reached $180m, 1995 - $256m, 1996 - $314m. At end-1997 gross reserves reached - $366m (covering 3.1 months of imports of goods and services), out of which $132m represented net reserves.

Figure 14



Source: National Bank of Moldova

Increase in net reserves was mainly due to NBM's interventions in the foreign exchange market (where there was a higher supply of foreign exchange, resulted from exports, foreign investments, and foreign loans), and also due to a successful management of the reserve portfolio done by central bank's dealers.

Rules of export-import of hard currency in Moldova have been simplified, while quite liberal regulations have been set regarding keeping hard currency on deposits with Moldovan banks. These actions led to a growing confidence in leu from population and economic entities. Consequently, the exchange rate of leu has stabilized, the volume of lei deposits with banks increased, while the "street" activities and black currency market phenomena have practically wiped out.

The above mentioned measures and results obtained served as a good reason for the NBM to accept on June 30, 1995 the Article VIII, sections 2, 3, 4 of the IMF Articles of Agreement. This represented *de jure* the convertibility of Moldovan leu for current account operations, and for some capital account operations. As a result, any resident or non-resident individual or legal entity have been allowed to exchange with no limits lei into hard currencies (and some non-convertible currencies, for instance of FSU countries) and *vice-versa*. Foreign investors were granted the right to freely repatriate capital to their country of origin. Any economic agent of Moldova can buy hard currency amounts for import operations, without limitations, through Moldovan commercial banks. Economic entities have been allowed, in cases when they received loans from abroad, registered at the NBM, to buy hard currency in the local market for servicing these loans. Residents, working abroad, can freely transfer their earnings to relatives in Moldova. However, individuals residents of Moldova are not allowed to transfer abroad the money from their hard currency accounts with local banks, with a few exceptions such as for medical care, studies and other.

4. Concluding Remarks

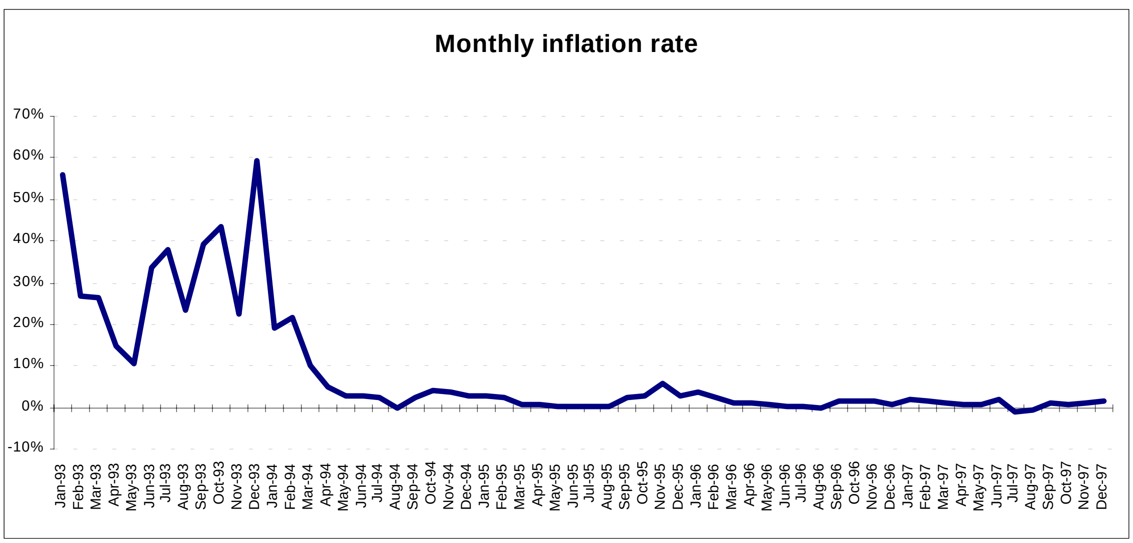
With the introduction of the Moldovan leu a tight monetary policy was implemented, which proved to be one of the most successful (along with the one of the Baltic States) in the FSU. But without the strong IMF financial support it would have been impossible for Moldova to introduce its national currency, given the existing circumstances.

The leu showed a remarkable stability, and the yearly nominal depreciation index was: 14.8% in 1994, 5.1% in 1995, 3.2% in 1996, and 0.2% in 1997. As a strong evidence of leu's stability from November 15, 1994 the hard currency surrender requirement was cancelled. After acceptance by NBM (30 June 1995) of the Article VIII of the IMF Articles of Agreement, Moldovan leu became *de jure* convertible for current account operations, and for some capital account operations.

Gross foreign exchange reserves of the NBM were increasing continuously: from almost zero at end-1992, they reached $366m at end-1997 (covering 3.1 months of imports of goods and services).

The rate of inflation decreased sharply in 1994. While in 1993 annual inflation was higher than 2000%, then at the end of in 1994 it came down to 105%, in 1995 it was already 23.8%, in 1996 – 15.1%, and in 1997 – 11.2%.

Figure 15



Source: Department of Statistics

The annual refinancing rate established at credit auctions decreased from 377% in February 1994 to 16% by end-1997. Beginning with January 1994 real refinancing rate became positive in real terms. In 1994 NBM's preferential credits to state enterprises have been phased out.

Starting from 1995 the budget deficit is being covered mainly by issuance of state securities, sold at auctions. The volume of issued state securities had a continuous and fast increase, but at the same time the budget deficit has not been reduced. Thus, in 1998 the Government realized that this practice can not continue any longer without budget adjustments - the proceeds from newly issued bills and bonds did not even cover the amounts needed for securities redemption.

Starting with 1992 the NBM put in place prudential regulations for all banks, subsequently revised in March 1995, which set standards for the Moldovan banking system compatible with Basle provisions.

Real interest rates in the banking system always remained quite high. Among reasons for this are: on one hand - high borrowing requirements of the Government, low supply of domestic savings, and on other hand - high systemic risk, driven by the weakness of court and legal environment, lack of serious competition between banks, their undercapitalisation.

Volume of deposits in the banking system was increasing continuously (the biggest share being of those in lei), clearly showing the increase in confidence in the leu (supported by the stable exchange rate and the rapid decline in inflation).

Generally speaking, the situation in banking system of Moldova is stable and did not suffer from any major shocks, however, from the financial prospective, banking system is still weak and undercapitalised.