COUNTRY PRIVATE SECTOR DIAGNOSTIC

# CREATING MARKETS IN MOLDOVA

## From a Remittances-Driven Economy to Private Sector-Led Sustainable Growth

*Executive Summary*

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# EXECUTIVE SUMMARY

**Moldova is at critical juncture: the economic growth drivers of the past decade are waning, further hindered by the lingering effects of COVID-19 shock and more recently by the ripple effects of the Russian invasion of Ukraine.**[1] This circumstance emphasizes the need of a more sustainable growth model propelled by private investment and productivity gains. Over the past decade, Moldova experienced relatively high, yet volatile, economic growth rates that supported a sustained decline in poverty rates. Yet, economic growth was mainly driven by remittances-led consumption, while productivity sharply declined owing to an unreformed economy, the pervasive presence of unproductive state-owned enterprises (SOEs) and controls in the economy, a concentrated and unsophisticated export basket, high dependence of imported energy, and sustained migration outflows. Further, despite the past decade's progress, Moldova remains one of the poorest European countries and labor informality is rampant. The COVID-19 shock has further weakened the growth drivers of the Moldovan economy by reducing remittance flows from the main migrant-destination countries. Moreover, Russia's invasion of Ukraine emphasizes the need to diversify the energy mix and boost private investment and productivity, while it makes more salient the challenge of export diversification for Moldova.

**Moldova is likely to be one of the economies most affected by the Russian invasion of Ukraine because of its physical proximity and close connections to Russia and Ukraine and the inherent vulnerabilities of being a small landlocked economy.** In particular, you list five the shock waves of the invasion on the Moldovan economy are moving through five main channels: (a) a massive influx of refugees, (b) heightened financial uncertainty and declining foreign direct investment (FDI) inflows, (c) disrupted trade and logistic links, (d) dwindling remittances from both Russia and Ukraine, and (e) soaring energy and food prices. As of April 2022, around 430,000 Ukrainian refugees (mostly women and children), or 13 percent of Moldova's population, have entered the country. With around 91,000 refugees remaining in Moldova, adults represent around 6 percent of the labor force, a massive shock for such a small economy. The invasion of Ukraine has also increased financial uncertainty, further curtailing access to finance for small and medium enterprises (SMEs) and putting a halt to FDI inflows. It has disrupted major trade and transport routes, with a large part of the country's logistic infrastructure relying on Ukrainian networks and gateway ports (Odessa) to connect with the rest of the world. Moldovan migrants in Russia and Ukraine account for one-quarter of total remittances flows, which have been completely disrupted by the invasion. Moreover, Moldova's entire energy supply, and most of the electricity generation (85 percent), depends on gas imported from Russia; thus Moldovans have already endured a 400 percentage increase in energy prices in 2021. Because around 40 percent of Moldova's food imports come from Ukraine and Russia, the invasion is also putting pressure on food prices, which had already increased by almost 20 percent over 2021. Overall, inflationary pressures are expected to persist owing to higher international prices—particularly for energy, food, and commodities—and the disruption of trade routes. Inflation increased to close to 30 percent year-over-year (YOY) in 2022. Finally, the fiscal space is projected to be further squeezed by the need to tackle the refugees crisis and to mitigate rising inflation through increased social spending. Because of these multiple shocks, GDP growth has been downgraded from 3.9 percent to -1.5 percent in 2022.[2]

**Besides this complex crisis, the Moldovan economy's potential is hindered by the structural challenges of poor governance and high vulnerability to climate change.** The country lags peer economies in the main governance indexes, riddled by corruption and weak institutions. This adverse business environment impinges negatively on entry of new firms and expansion of the most productive companies. The pervasive presence of SOEs and an unlevel competition playing field thwart private initiative, further hindering innovation, productivity, and formal job creation. Over the past decade, Moldova has also become one of the countries most affected by the negative consequences of climate change, with the occurrence and severity of extreme climate events increasing at a worrisome pace.

**Against this backdrop, there is an opportunity for the new government, elected in mid-2021, to mitigate the impact of the Russian invasion of Ukraine, while beginning to lay the foundations for a more inclusive, resilient, sustainable, and private sector–led growth model.** The economic recovery hinges on a more favorable external environment and on providing effective support to the private sector. Mitigating the impact of the Russian invasion of Ukraine will require additional social and financial assistance to refugees, SMEs, and the low-income population. Further, the aftermath of conflict in Ukraine will also demand intensified efforts to diversify the energy matrix and export market destinations. The Moldovan government has an important role to play in initiating long-awaited reforms to strengthen institutions, build resilience, and enhance competitiveness, which will help accelerate the convergence of incomes and living standards with the European Union (EU).

**The good news is that Moldova has clear opportunities that can be harnessed to unleash private sector growth.** The country has already shown it can produce differentiated products and services. Following the successful example of wine, agribusiness could become a driver of growth by investing in new technology and policy reforms. In agribusiness, with a proactive package of policy reforms, Moldova could double horticulture exports to its main markets, amounting to nearly US$500 million annually. Still incipient, Information and Technology Offshoring (ITO) services are also expanding rapidly, and Business Process Offshoring (BPO) and Shared Service Center (SSC) are showing promising growth potential along with exports doubling in the next decade with continued private investment. In response to the unfolding energy crisis and import dependence, Moldova can mobilize private investment toward its significant technical potential to generate renewable energy, estimated at nearly 25 gigawatts (GW)—21 GW in wind and 4GW in solar generation—or three times its current installed capacity. Similarly, improving roads and trade border-crossing logistics points alone could boost exports by an additional 0.4–1.8 percent. Finally, the financing gap for micro, small, and medium enterprises (MSMEs) stands at 14 percent of GDP, pointing to opportunities for banking and nonbanking financial institutions to expand access to finance for MSMEs with adequate regulatory and policy reforms.

**This CPSD explores how, in the postpandemic world and in response to the Russian invasion of Ukraine, Moldova can reignite economic growth and social inclusion by harnessing private investment in critical enabling activities and tradable sectors.** By boosting private investment in those activities, Moldova would be able to create new good jobs and thereby reduce outward migration, thus achieving more sustainable economic growth rates. As the relative importance of remittances wanes, Moldova will face the challenge of unleashing new and more sustainable sources of economic growth. FDI and exports can drive private sector–led growth, but they require scale. A small economy such as Moldova can sustain private sector–led growth by pursuing four development goals: (a) reach scale in firm-level characteristics and market size; (b) fully reap the benefits of a closer integration with the EU in knowledge transfers, business upgrading, and market access; (c) unleash the productivity potential of foreign and domestic firms by leveling the playing field considering the pervasive presence of SOEs and controls in the economy; and (d) boost connectivity investment in transport, logistics, and digital infrastructure.

**The CPSD focuses on three key cross-cutting constraints and two enabling sectors that hold back the development of a productive and competitive private sector in Moldova.**[3] They are (a) the need to accelerate the pace of reforms of the business environment, (b) an unlevel competition field dominated by SOEs, and (c) the unfinished trade facilitation and harmonization agenda with the EU. Other key cross-cutting issues (for example, regulatory uncertainty and high transaction costs and the availability of skilled labor and the gaps in the education system) were already explored in depth by the *Moldova 2021 SCD Update*.[4] The challenges and opportunities associated with improving transport and logistics and access to finance for MSMEs are covered as part of the assessment of enabling sectors.

**Improving governance in Moldova remains a cross-cutting priority to jump-start private sector–led growth.** As emphasized by the Moldova 2021 SCD Update, governance remains a cross-cutting priority. The country continues to be held back by corruption, poor governance, political pressures from vested interests, and the politicization of regulatory institutions, as well as the judiciary and the customs and tax services. A large state presence and relatively limited policy enforcement against the most harmful anticompetitive practices hinders market competition and private sector participation.[5] The cross-cutting and sectoral assessments presented in this report include an analysis of the governance aspects of the proposed reforms, with an emphasis on capture-resistant policy proposals, as well as international best practices and relevant country case studies on how to reform.[6]

**The three imperatives of tackling (a) energy dependence, (b) climate change and sustainable production, and (c) growth of higher-sophistication exports can be achieved by boosting the performance of the renewable energy, high value-added agribusiness, information technology offshoring (ITO), and BPO&SSC industries.** These three sectors were identified as areas of the economy in which the private sector can contribute to enhance productivity and economic diversification (and high-quality jobs as a result) and to foster a more open and inclusive society and a greener development path. Four selection criteria, reflecting these priorities, were used: (a) potential to support enhanced productivity and export diversification, (b) capacity to create high quality jobs, (c) contribution toward greater trade integration and contestable domestic markets, and (d) potential for sustainability and greening the economy.

**Strengthening resilience against climate change remains a priority for Moldova as a foundational element of a new growth model.** Moldova is highly vulnerable to climate change and scores poorly on the institutional readiness to adapt to the effects of climate change. Natural disasters, such as earthquakes, are a constant threat, and droughts and floods are expected to increase in frequency and intensity with climate change.[7] Whereas a full assessment of the challenges of climate change faced by Moldova goes beyond the scope of this CPSD, the report focuses on the green competitiveness aspects of the climate agenda by (a) analyzing the productive and export performance and opportunities of Moldova on green products, also in light of the EU Green Deal and Carbon Border Adjustment Mechanism (CBAM) (in chapter 2, section 2); (b) assessing the growth potential of renewable energy and the policy reforms to unleash private sector investments in the industry (in chapter 4, section 1); and (c) advocating for sustainable practices in prioritizing high-value agriculture (in chapter 4, section 2).

## STATE OF THE PRIVATE SECTOR

**The economy of Moldova is characterized by a large number of low-productivity micro and small enterprises and a shrinking share of medium and large firms.** Moldovan firms are smaller and have fewer exporters than the rest of Europe and Central Asia (ECA). Most firms gravitate toward the capital city, Chişinău, thus perpetuating geographic imbalances, whereas domestic low-productivity nontradable services (for example, wholesale and retail trade) show the highest enterprise density. Conversely, large, export-oriented, and foreign-owned firms are the most productive and, while accounting for the bulk of innovation and employment, remain poorly integrated with domestic suppliers. A more pervasive presence of SOEs, and controls across most enabling and traded sectors, than in other ECA countries hinders private investment, and the dual shocks of COVID-19 and of the Russian invasion of Ukraine have exacerbated the weaknesses of the private sector ecosystem.

## CROSS-CUTTING CONSTRAINTS TO PRIVATE SECTOR INVESTMENT

### Accelerating the pace of reforms to support the business environment in Moldova

**Whereas the business environment in Moldova has improved significantly over recent years, progress remains uneven.** Improvements have been made on business registration, permit and license reforms, inspections, and administrative simplifications across business operation. Yet, Moldova scores worse than regional peers and Organisation for Economic Co-operation and Development (OECD) in the green complexity index (GCI) (86th of 141). Corruption and political instability are identified as the top constraint by more than 27 percent and 20 percent of companies, respectively. Access to quality skills, although critical, is thoroughly analyzed in the *Moldova 2021 SCD Update*. The challenges posed by the business environment undermine the ability of firms to create new formal jobs: 41 percent of private firms report competing against informal enterprises. The fragmentation, duplication, and lack of clarity of legal norms governing the provision of public services for businesses contribute to the informality of firms. However, as witnessed during the COVID-19 pandemic, the digitalization of public services can increase accessibility, reduce the compliance burden, and encourage formalization, and the government of Moldova should build on the recent progress on the e-government agenda. At the other end of the spectrum, whereas Moldova has maintained a conducive investment regime, the recently adopted Law on the National Security-Related Investment Scrutiny Mechanism ("Law 174/2021" adopted in November 2021) risks undermining its openness and predictability. The law introduces an ex ante authorization system in wide-ranging areas, including mergers, concessions, public-private partnership (PPP) contracts, investment agreements, financial transactions, and minority shareholdings. Whereas this law could, in principle, support legitimate interests, it can give rise to unintended market and competition distortions. The objectives of the law could be achieved through less restrictive measures to competition (see appendix A3).

## Unfinished trade harmonization and facilitation agenda

**As a small open economy, Moldova's development path is inextricably linked with trade.** Over the years, it has liberalized trade policy and aligned with the World Trade Organization (WTO), but gaps remain in border administration, logistics services, and infrastructure. Moldova ranks 79th out of 136 countries on enabling trade in the World Bank's Logistic Performance Index (LPI). Trade policy has consistently focused on supporting the country's participation in the WTO and achieving closer integration with the EU. Whereas Moldovan exports to the EU grew, progress in the complementary trade harmonization and facilitation agenda remains limited. Critical gaps include food safety, quality infrastructure and standards, internationally recognized quality certifications, customs administration, and trade facilitation. Customs legislation and procedures in Moldova have undergone significant harmonization with EU and starting November 2022, Moldovan Authorized Economic Operators (AEOs) have been recognized by the 27 EU member states under the Mutual recognition of AEOs-Program.[8] Whereas separate risk corridors have been implemented at border crossings, risk assessment and inspection practices lag. Around 13.8 percent of firms in Moldova consider customs and regulations as a major constraint to trade (versus 8.5 percent in ECA, on average). Foreign-owned, large, and manufacturing firms are the most affected by customs procedures. Trucks spend 20 percent of transit time in custom clearance with a waiting time of two to three days at the border. Each day that companies must wait to clear customs is associated with a productivity decline of 0.5 percent.

**Moldova's trade with the EU is constrained by the country's inability to meet EU standards.** Inability to comply with international technical requirements, product quality standards, and food safety regulation, ranks among the top constraints to export, along with limited knowledge of international markets. Whereas Moldova has already adopted more than 25,000 EU technical standards, overall knowledge and adoption by firms of International Organization for Standardization (ISO), Hazard Analysis Critical Control Points (HACCP), Good Agricultural Practices (GAP), Global Risk Assessment on Social Practice (GRASP), and relevant food safety management and product quality standards remains low. Only 26 percent of food processors in Moldova adhere to international standards, which prevents their entry into new export markets. Whereas the National Agency for Food Safety has shown progress on harmonizing sanitary and phytosanitary standards, the capacity for laboratory diagnostics, traceability of products, and infrastructure of the production chain remain weak.[9]

**The EU green transition presents opportunities for further trade integration for Moldova.** The EU Green Deal and CBAM, which will essentially impose taxes on emissions-intensive imports, are likely to present some export opportunities and minimal adjustment challenges for the country because of the composition of its export basket. The relative importance of agricultural products in Moldova's export basket puts it in a good position to gain from the introduction of climate policies in the EU. Although not a global player, Moldova can accelerate its green transition by upgrading its offer of green products, building on its agricultural comparative advantage and focusing on renewables.

**Whereas the Russian invasion of Ukraine has disrupted trade, it also presents an unprecedented opportunity for an accelerated harmonization and integration process with the EU.** Trade is among the main transmission channels of the shocks caused by the conflict in Ukraine. Although the direct exposure of exports to Russia and Ukraine is just below 15 percent, imports are expected to be affected more directly. While the share of Russia's and Ukraine's total imports is about 25 percent, Moldova imports about 40 percent of its food from Ukraine and Russia and 100 percent of its gas from Russia.[10] At the same time, the invasion of Ukraine has galvanized the EU's commitment to accelerate the accession path of Moldova and has renewed the resolve of more than 30 international partners to support the international integration and harmonization agenda of the country through significant financial assistance. This situation represents a unique opportunity for Moldova to double down on its open trade, harmonization, and convergence to the EU policy agenda.

## Moldova's competition landscape: an unlevel playing field dominated by SOEs

**Competition in Moldova lags international comparators.** According to the OECD-WBG Product Market Regulation (PMR) indicators, Moldova's PMR scores are higher (worse) than the average of the PMR database (1.93 versus 1.56). Restrictions on competition are mostly driven by state involvement in the economy, notably through SOEs. Barriers to domestic and foreign entry are significant and are, primarily driven by barriers to competition in service and network sectors (for example, electricity, telecommunications, transport, or regulated professions). Limited competition in Moldovan markets can arise from a combination of three factors: (a) unequal treatment of certain operators, notably through state aid granted to SOEs; (b) restrictive regulations or discretionary application of the regulatory framework that may hinder market entry and competition on the merit; and (c) relatively limited competition policy enforcement issues against the most harmful anticompetitive practices.

**Despite past privatization efforts, SOEs continue to play an important role in Moldova's economy, including in sectors that could be efficiently supplied by the private sector.** SOEs account for about one-third of GDP, 50 percent of all fixed assets, 10 percent of corporate sector assets, and 24 percent of the labor force—and with a share in sales that is more than twice the average of other ECA countries.[11] Formal exclusions to private sector participation prevent entry in markets where competition may be feasible and even desirable (for example, human and animal medical research, manufacture of medals, or regular postal services). Lack of competitive neutrality constitutes an important entry barrier for private operators and presents the following challenges: (a) SOEs can cross-subsidize commercial activities where they face competition from private operators; (b) the presence of line ministries' in SOE boards may lead to regulatory capture and an unlevel the playing field; (c) SOEs benefit from state guarantees and other indirect financial and nonfinancial public advantages; and (d) SOEs receive some preferential treatment in applying commercial laws, despite that there is no formal exemption.

**Moldova has some of the most restrictive regulations on network industries**. In the energy sector, Moldova's PMR scores point to the persistence of barriers to entry in electricity and gas, mostly driven by barriers to entry and tariff regulations in electricity. In telecommunications, the regulatory framework contributes to an unleveled playing field among fixed and mobile operators. Moldova's PMR scores show the existence of restrictions to competition in both fixed and mobile markets. The telecommunications market is highly concentrated with few operators, which although relatively common among smaller countries, would require developing a well-designed regulatory framework to minimize risks of anticompetitive practices. In transport, restrictions relate to a lack of vertical separation between operators in different parts of the value chain and stringent licensing policies that limit market entry. Within ECA, Moldova has the largest percentage of firms that perceive transport as a major constraint (14.7 percent versus 11.9 percent ECA average).

**Price regulation in Moldova is more widespread than in comparator economies, including in sectors where most peers have already phased out price controls.** PMR subindicators for price controls are worse in Moldova than in most benchmark economies (see appendix D1), showing the existence of price regulation in a broad number of sectors (16 out of 29 sectors covered by the PMR database). Price controls limit competition, productivity gains, competitiveness, and innovation in sectors (for example, liquid petroleum gas [LPG], and dairy goods, among others) that are not generally subject to price regulation in peer countries. Although price regulation can be used to promote certain economic and social protection goals, it should be used only in cases where competition is not feasible.

**Overall, two policy priorities should be fast-tracked in response to the Russian invasion of Ukraine: (a) conducting a privatization triage (a government ownership strategy and road map for greater private sector ownership) and (b) promoting better SOE corporate governance practices to ensure competitive neutrality.** Whereas competition policy and SOE reforms usually require a sustained, medium- to long-term reform effort, because of their structural nature and long-term effects, the urgency of increasing the resiliency of the private sector in response to the shocks of the conflict in Ukraine call for swift policy action in facilitating private sector ownership and ensuring competitive neutrality of and by Moldovan SOEs. Specifically, short-term actions to kick-start more complex structural reforms in SOEs and competition policy entail (a) reviewing the rationale for state interventions through SOEs, considering the type and characteristics of the sectors and markets in line with the subsidiarity of the state, and ordering the sectors and markets from lower to higher private-led ownership and managerial transformation, and (b) promoting competitive neutrality between SOEs and private operators through internationally accepted corporate governance best practices in markets that warrant SOE presence.

## ENABLING SECTORS

### Enhancing transport and logistics to foster exports and investment

**Insufficient supply of quality transport and logistics services is a major drag on the Moldovan economy, particularly agricultural and food manufacturing.** The country ranks 76th out of 141 countries in the World Economic Forum (WEF)'s competitiveness index for infrastructure. The weakest score in the WEF's infrastructure index is the quality of road infrastructure (129). The poor state of roads generates additional costs for users amounting to approximately US$213 million annually. Firms report major delays in some of the main routes owing to lack of maintenance and insufficient rehabilitation work. Around 35 percent of large firms identify transportation as a major obstacle for investment. These conditions have a negative impact on the performance of other sectors, including health, especially in responding to public health emergencies, like COVID-19.

**An obsolete transport infrastructure further prevents Moldova from fully reaping the benefits of closer trade integration with the EU.** Road transportation is particularly time-consuming and deserves concerted efforts to build infrastructure and expand capacity, especially at the border with Romania. Railways need significant track maintenance and rehabilitation to speed access from the EU to the closest ports. With huge cargo capacity needs and poor operational efficiency at its two main airports (Chişinău and Mărculeşti), airfreight exports are almost nonexistent compared with regional peers. Compounded by the 48 hours required for documentation, compared with less than 2 hours in the EU, the median time an export transaction takes in Moldova is almost 12 times higher than in the EU and neighboring Romania and Ukraine. At the same time, the World Bank's LPI ranks Moldova behind Ukraine and Romania, and its worst scores are in infrastructure, tracking and tracing, and logistics competence.

**Logistics infrastructure in Moldova is among the least developed in post-Soviet countries.** Most facilities are old Soviet-style buildings that have been converted from production to warehouse facilities, and there are no A- or B-class temperature-controlled warehouses. Third-party logistics services (3PL) are also underdeveloped as retailers and distributors continue to keep logistics operations in-house and invest in their own vehicle fleets and warehouse facilities in spite of higher operational costs. Since 2009, cold storage capacity in Moldova has increased by 188 percent—633 cold facilities with a total capacity of 412,000 tons in 2019. However, only 250 of them are equipped with pre-cooling facilities that are particularly critical for the perishables with a short shelf life, and only 46 are equipped with sorting and grading equipment. Existing capacity is not enough to meet future demand. Currently, only about 35 percent of stone fruits and 40 percent of table grapes are distributed through the cold storages. While there is no issue with the supply of temperature-controlled trucks in the country, Moldova is underperforming against regional peer countries on non-temperature controlled transport.

**The Russian invasion of Ukraine has deeply affected Moldova's transport and logistics,** blocking not only access to key road freight transport routes via Ukraine, but also the main port gateway infrastructure—the port of Odessa. A large part of the country's logistic infrastructure relies on Ukrainian networks to connect with the rest of the world. The preferred route to and from Poland, Germany, Belarus, and the Baltic states currently transits through western Ukraine, whereas trade with the United States, the Middle East, and Asia is mainly shipped through the port of Odessa. The Russian invasion of Ukraine has resulted in the diversion of freight traffic from the Moldova-Ukraine transport corridor to the Moldova-Romanian corridor. It has caused congestion at border crossing points (BCPs) on the Moldovan-Romanian border. Although trade routes can be adjusted, an increase in transportation costs can be expected.

**The Russian invasion of Ukraine calls for reprioritizing policy interventions to mitigate the short-term impacts of the invasion on transport and logistics and to advance in parallel long-term sectoral reforms.** In the short term, policy priorities should aim at enabling a deeper integration of Moldova with the EU through Romania and at enhancing Moldova's transport resilience from security and trade perspectives. To ensure continuity in goods trade through the BCPs, improvement of border-crossing procedures and implementation of queue management systems are also urgent. Because of the port of Odessa closure, Moldova relies on the port of Constanța in Romania. Thus, connectivity of Moldova to Romania has the highest priority in order to ensure trade and secure supply chains, along with upgrading to the port of Giurgiulești.

**On structural reforms, Moldova is in urgent need of developing effective instruments and mechanisms to address long-lasting and chronic levels of underinvestment in transport infrastructure.** To achieve this goal, this CPSD recommends the following policy actions: (a) develop a road map of investments focused on integration of multimodal trade and logistics services and public-private coordination; (b) conduct a pilot test of output- and performance–based contracts for road maintenance and investment; (c) introduce public sector obligations to SOEs in charge of key road and railway infrastructure to increase investment in hinterland connectivity in the south to reap the benefits of proximity with the EU; and (d) resume the approval of the unbundling of Calea Ferată din Moldova (CFM), Moldova's railway operator, and undertake the reform of the railway service.

## Improving access to finance for MSMEs

**Improving access to finance for MSMEs while preserving financial stability has become a policy imperative for Moldova owing to the possible effects of the dual COVID-19 and Russian invasion of Ukraine shocks on liquidity and asset quality in the banking sector.** Whereas banks are well capitalized, the direct exposure to Russia and Ukraine is limited and the nonperforming loan (NPL) ratio is low, the invasion could have an effect on the banking sector through deteriorating asset quality and liquidity. Asset quality may suffer from the reverberating effect on the economy of the unfolding crisis in Ukraine, especially since households and firms are still recovering from the COVID-19 crisis. The high share of foreign currency loans (26.1 percent) also represents an indirect credit risk in the case of a significant depreciation of the domestic currency. Finally, high unofficial euroization ( i.e. the widespread use of euro for both transactional purposes and as a store of value) remains a tail risk for financial stability, given the uncertainty of the unfolding the invasion.

**Besides the effects of the Russian invasion of Ukraine and COVID-19 shocks, Moldova's financial sector remains constrained by its small size, low sophistication, and an unfinished reform agenda.** The ration of credit to GDP has been less than 30 percent over the past five years. After the banking crisis of 2014, risk management, anti money laundering efforts, and transparency of the banking sector have improved, but no similar improvements have occurred in the insurance sector and other non-bank financial institutions (NBFIs). Access to finance, particularly for MSMEs remains limited; more than 80 percent of firms report financing their working capital through reinvestment of their own profits, a much larger proportion than in other ECA countries and the international average, according to the Enterprise Survey 2019.[12]

**Financial intermediation for MSMEs has been limited on both the demand and supply sides.** Access to finance and the high cost of credit are the most often-mentioned key constraints to MSME development in Moldova. Financial service providers indicate an insufficient number of bankable firms and projects, in large part owing to a high degree of informality in firm operations. On the supply side, the banking sector provides 81 percent of all credit to the economy with limited products suited for MSME needs. Capital markets are underdeveloped and issuance of bonds or shares do not represent a viable alternative, yet there are no venture capital funds or similar vehicles to source the missing funding.

**Targeted reforms are required to improve access to finance to MSMEs and mitigate the effects of the dual COVID-19 and Russian invasion of Ukraine shocks.** The CPSD proposes the following priority policy reforms with a focus on improving access to finance for MSMEs: (a) modernize credit risk systems to reduce reliance on real state collateral (for example, effective data exchange among credit operators); (b) improve the movable collateral registry (for example, full digital processing and interconnection with other registries, use of alternative collaterals such as inventory, receipts, and crops); (c) promote open banking and regulatory sandboxes aligned with EU regulations to increase competition and foster innovation (for example, financial technology, noncard payments, paperless contracts, and digital onboarding); and (d) strengthen regulations in the nonbank credit organizations (NBCOs), especially in insurance to foster the creation of new products (for example, real estate, industrial accidents, third-party liability, transport and logistics, infrastructure investment, and agriculture).

## SECTORAL ASSESSMENTS

### Unleashing the potential of renewable energy to ensure a greener and safer energy supply

**Although the Russian invasion of Ukraine has exacerbated concerns over the security of energy supply, Moldova has the technical potential to generate nearly three times more renewable energy (RE) than its current installed capacity, with the potential to significantly diversify energy provision, meet climate change mitigation aspirations, and ensure an adequate supply-demand balance with domestic generation.** The synchronization of the Moldovan and Ukrainian transmission networks with the European Network of Transmission System Operators for Electricity (ENTSO-E) in March 2022 has partially addressed supply disruption concerns, and is supporting the balancing of the system through emergency interconnection to the EU network. However, the Moldovan domestic generation mix remains inadequate to ensure the supply-demand balance, a vulnerability that needs to be urgently addressed along with transmission and distribution bottlenecks, given the dependence of Moldova on gas-fired generation assets located in Transnistria. More than 80 percent of the country's generation capacity is also concentrated in the Transnistria region. As demand for electricity is expected to continue growing at a compound annual growth rate (CAGR) of 4.2 percent between 2020 and 2030, the capacity deficit could grow by 40 percent by 2033 unless new capacity is installed. To address this deficit, Moldova's National Energy Strategy 2030 proposes building up to 600 megawatts (MW) of RE sources by 2030.[13] Against this backdrop, and despite some limited success in developing small-scale RE projects, Moldova has only realized a negligible portion of its sizable RE potential to broaden its energy mix and ensure an adequate supply-demand balance.

**However, Moldova faces four main impediments to realizing its RE potential and attracting private investment to the development of utility-scale RE projects:** (a) major infrastructure bottlenecks related to limited capacity of the transmission grid (for example, the grid can only accommodate 200–400 MW of RE) and the need to invest significantly in the interconnection with ENTSO-E (for example, Moldova depends on Ukraine's system for balancing, and risks the curtailment of RE during peak hours); (b) the incomplete transition to a competitive wholesale energy market aligned with EU regulations, and an untested and incomplete regulatory framework for RE (for example, incipient implementation of competitive auctions and lack of track record of independent power producers [IPP]); (c) absence of a clear long-term strategy of priority investments to ensure resilient generation mix, transmission, and distribution through ENTSO-E; and (d) availability of land owing to the lack of economically viable solutions for coexistence of RE projects and agriculture production, especially for wind-generation projects.

**Moldova has an opportunity, in the short term, to pilot-test capacity auction mechanisms that enable price discovery and unlock cost-competitive sources of RE in the medium term.** This CPSD proposes an approach of scaling solar to attract investors to develop utility-scale RE projects that would be a cost-effective solution for the supply deficit and may help to achieve energy diversification. In parallel, Moldova should address fundamental bottlenecks that undermine the development of the electricity system and market, beginning with investments to modernize and expand the capacity of the grid. Moldova needs to reassess its energy strategy to tackle the evolving energy security situation and to prepare a package of risk-mitigation actions that would contribute to deploying RE projects as soon as possible.

## Agriculture: fostering higher value-added exports

**Moldova is characterized by good soil and agro-climatic conditions and proximity to important markets like the EU, Commonwealth of Independent States (CIS), and the Middle East.** The country shows strong promise in high-value crops (for example, specialty fruits, vegetables, and products such as honey), which can be produced in smaller plots, are more labor intensive, and can lead to higher profits, thanks to product differentiation, than traditional crops (wheat). By increasing production and exports of these items, Moldova can promote economic growth and formal job creation. Although participation in high-value horticulture international markets remains below potential, early successes in niche segments can be replicated and scaled up in a context of expanding global demand. With a proactive package of policy reforms and investments in EU-compliant quality and safety standards, Moldova could more than double horticulture exports to EU, CIS, and Gulf Cooperation Council (GCC) markets, from about to US$200 million to almost US$500 million annually.

**Whereas the Russian invasion of Ukraine will continue to disrupt agricultural trade, possibly heighten food security risks, and increase the price of agricultural inputs in the short term, it is not expected to alter the fundamental comparative advantage in high-value horticulture of Moldova.** Although the direct exposure of agricultural exports to Russia and Ukraine is just below 12 percent, agrifood imports from Russia and Ukraine account for 9 percent and 26 percent of all agrifood imports, respectively. Similarly, the invasion is affecting fertilizer trade, with 43 percent of Russia's chemical exports consisting of fertilizers, representing more than 13 percent of world exports. The invasion is expected to bring some readjustments in crop production in the short term in response to higher input costs and increased demand for cereal commodities. However, it is not likely to fundamentally change on-farm productivity, comparative advantage, higher sophistication and value added of exports, and overall competitiveness potential of Moldovan horticultural products as compared with cereal-based agricultural commodities, as illustrated in chapter 4, section 2,in appendices H1 and H2 and World Bank Group (forthcoming).[14]

**While Moldova's agriculture, especially horticulture, shows potential, it faces several constraints.** The five main constraints are: (a) the lack of adequate farming scale owing to fragmented and inefficient land markets and to limited land aggregation of producers; (b) deficient irrigation, postharvest, energy, and transportation infrastructure in rural areas, hampering agribusiness productivity and connectivity; (c) inadequate adoption of modern technologies, risk mitigation instruments, geographic denomination and organic agriculture techniques, and critical inputs (for example, certified seeds and fertilizer), especially by small-holders, owing to a lack of access to finance, insurance, and quality extension and advisory services (EAS); (d) limited adoption of EU and international food standards (for example, GLOBALG.A.P., HACCP/ISO 22000, and EU organic) to improve quality, safety, and access to the European market; and (e) limited dissemination of climate-smart agriculture (CSA) production methods and other mitigation measures to lessen the effects of climate change, especially among small landholders.

**Moldova can expand agriculture exports, especially of higher-value products, if it establishes a comprehensive, long-term strategy.** The CPSD proposes five priority reforms for the Moldovan agribusiness sector, with a particular focus on horticulture and other higher-value food products: (a) upgrade irrigation, postharvest, energy, and road infrastructure in rural areas to improve productivity and connectivity; (b) foster productive aggregation and land consolidation through an adequate functioning of land markets to support more efficient production systems; (c) promote adoption of modern technologies by facilitating smallholders' access to finance through better targeting of subsidies to support productivity growth and high-quality EAS; (d) support adoption of EU and international standards and investment in laboratories and digital infrastructure to improve product quality, traceability, and safety as well as access to the EU market for higher value-added agrifood products; and (e) promote CSA practices (for example, greenhouses, drip irrigation, antihail nets, antifrost systems, and windbreaks), climate finance instruments, and climate products (for example, drought-resistant varieties and water-efficient methods, among others) to improve climate change resilience.

## ITO and BPO&SSC: Supporting the next wave of ITO investments and fostering the nascent BPO industry

**Internet technology offshoring (ITO) is one of the most dynamic sectors in Moldova.** Although nascent, the country is also displaying some potential in BPO&SSC and e-commerce. In the past 15 years, ITO exports increased fourfold, from about US$60 million in 2005 to more than US$300 million in 2020, while BPO&SSC exports tripled over the same period. There are around 2,300 information technology (IT) companies employing nearly 15,000 IT professionals and accounting for around 11 percent of GDP and 7 percent of total exports. ITO expansion has been driven by the relative availability of low-cost specialized workers; Moldova ranks as the fourth best location for affordable talent in ECA. It is also well positioned in the quality and costs of its telecommunication infrastructure, with mobile penetration well over 100 percent, and Points of Presence (PoP) of fiber-optic backbone network at 98.2 percent. However, digitalization of SMEs is low because of limited infrastructure investment, regulatory barriers, and inadequate digital literacy. Finally, the government has nurtured the local ITO sector since 2006. The principal public initiative was the creation of the virtual IT park in 2018. The emergence of BPO&SSC has been related to a multilingual labor force, time zone compatibility with the EU and CIS, and adequate information and communication technology (ICT) infrastructure.

**The United States and the EU are the largest markets for Moldova's ITO exports.** About 40 percent of local firms export, mainly to the United States, and, to a lesser extent, to the EU market. Yet, Moldova is mostly specialized in providing low-sophistication ITO.[15] Gaps in market access, innovation, access to finance, and business environment represent the main constraints to the competitiveness of Moldovan offshore services (OS). Whereas Moldova's performance in OS is in line with comparators in Eastern Europe and the Western Balkans, it lags EU peers, especially in the conditions required for providing higher value-added OS.

**Whereas ITO and BPO&SSC exports could double over the next decade, seizing this potential will require a deliberate and proactive effort to increase the supply and quality of talent and improve access to finance within a more flexible labor market and enhanced regulatory environment.** Given the limited scale of its talent pool, Moldova's growth path lies in transitioning to higher-value-added OS activities (for example, engineering services, research and development [R&D], and other niche markets). Further expansion is restricted by four main constraints: (a) a limited supply of skilled workers and weak specialized technical education; (b) a dearth of early-stage financing; (c) the complexities and rigidities of labor regulations; and (d) the unlevel playing field between the ITO and the BPO&SSC regulatory frameworks.

## Summary of policy recommendations

**Tables ES.1 and ES.2 summarize the main policy recommendations to mitigate the effects of the dual crises of the Russian invasion of Ukraine and of the lingering effects of the pandemic in the short term.** They address the main structural challenges hampering private sector–led growth in the medium to long term. Whereas the analytical work presented in the CPSD predates the Russian invasion of Ukraine, the policy recommendations of the report have been reassessed and reprioritized considering the invasion and the lingering COVID-19 crisis. Recommendations have been reprioritized by adding the following filters: (a) short-term responses to the Russian invasion of Ukraine in support of the private sector and to COVID-19 aftershocks, and long-term actions on structural reforms; (b) preparedness for the unfolding the invasion-induced shocks on energy, inflationary, and supply chain, credit crunch, and slowdown of the global economy; and (c) presence of a reform champion. These filters supplemented the following the invasion prioritization criteria: economic impact, potential to open and create new domestic and international markets, opportunities to unlock private investment, and political economy feasibility.

**Six priorities have emerged to mitigate the effect of the Russian invasion of Ukraine and of COVID-19 aftershocks.** The economic shock waves of the invasion are spreading through the channels of trade and supply chains, commodity and energy markets, logistics networks, FDI, remittances, and refugees, with Moldova being particularly exposed owing to proximity and the large influx of refugees. Against this background, six broad policy priority goals can help mitigate the crisis and plant the seeds for a resilient private sector–led recovery (table ES.1):

(a) Accelerate trade policy harmonization and facilitation with the EU.

(b) Develop a clear strategy for SOE ownership (privatization triage).

(c) Ensure energy security in the short term while creating enabling conditions for private investment in renewable energy.

(d) Increase access to finance for MSMEs during this the double crisis.

(e) Upgrade BCPs, streamline customs procedures with Romania, and strengthen transport and logistics networks with the EU.

(f) Increase market access to the EU for agribusiness through Harmonized Food Safety and Quality Standards.

**At the same time, maintaining momentum on the long-term structural reform agenda for a sustainable private sector–led recovery remains an overarching priority.** At the current economic juncture, short-term recovery measures must be complemented by long-term structural cross-cutting and sector-specific reforms that will help steer the economy away from the current economic model, as presented in table ES.2. Tables ES.1 and ES.2 identify the top policy areas and constraints to be addressed, by cross-cutting constraint and sector, and further detail the main recommendations and present the time frame for implementation. The individual tables presented at the end of each chapter, however, provide a broader description of (a) the expected benefits, (b) the political economy feasibility, and (c) the lead implementing stakeholder for all recommendations identified.

**TABLE ES.1. PRIORITY POLICY RESPONSES TO MITIGATE IMPACT OF THE RUSSIAN INVASION OF UKRAINE AND OF LINGERING EFFECTS OF THE COVID-19 CRISIS**

| POLICY | SPECIFIC ACTIONS | TIMELINE |
|---|---|---|
| **Cross-cutting constraints** | | |
| Accelerate trade policy harmonization and facilitation with the EU. | • Implement provisions of the DCFTA in all sectors.<br>• Eliminate remaining tariff peaks.<br>• Eliminate restrictions to trade in services.<br>• Provide support to ANSA to align with EU regulations. | ST |
| Develop a clear strategy for SOEs ownership (privatization triage) and level the playing field for private and public operators. | • Develop a framework for SOE reform, including a government ownership strategy and road map for higher private sector ownership through SOE privatizations, PPPs, and concessions.<br>• Promote competition neutrality between SOEs and private companies.<br>• Adopt the Railway Transport Code and Action Plan to reorganize the railway sector and spur competition. | ST |
| **Enabling sectors** | | |
| Upgrade BCPs and streamline customs procedures with Romania, and strengthen transport and logistics networks with the EU. | • Prepare blueprint for the NSW for Trade.<br>• Upgrade BCPs with Romania and develop a one stop-shop customs clearance zone in Chișinău.<br>• Modernize railway rolling stock and assets, in light of the increased importance of railway infrastructure to facilitate connection with EU as a consequence of the invasion.<br>• Improve hinterland connectivity of available gateway ports of Giurguilești and Constanța that are not affected by the invasion. | ST |
| Increase access to finance for MSMEs to weather the double shocks of the Russian invasion of Ukraine and the lingering COVID-19 crisis. | • Develop and announce a regulatory strategy for financial markets beyond 2022 given the transfer of supervision of the nonbank financial sector from NCFM to NBM.<br>• Enforce data exchanges between credit information operators and access of private sector credit information operators to relevant data held by government entities.<br>• Scale up and increase attractiveness of credit guarantee schemes for MSMEs (coverage and pay out practice), focusing on women entrepreneurs.<br>• Review legislation to enable modern instruments like crop and warehouse receipts. | ST |

Note: ANSA = National Agency for Food Safety; BCP = border crossing point; DCFTA = Deep and Comprehensive Free Trade Area; EU = European Union; MSMEs = micro, small, and medium enterprises; NBM = National Bank of Moldova ; NCFM = National Commission on the Financial Market; NSW = National Single Window; PPP = public-private partnership; SOE = state-owned enterprise; ST = short term.

| POLICY | SPECIFIC ACTIONS | TIMELINE |
|---|---|---|
| **Tradable sectors** | | |
| Ensure energy security in the short term, while creating enabling conditions of private investment in RE. | • Prioritize the security of supply. Invest in 400 kV connection to ENTSO-E (via Romania). Consider new interconnections considering security of supply and availability of interconnections to Ukraine.<br>• Prepare a least-cost generation plan that provides a road map of investments in RE and substantiates an update of RE targets. | ST |
| Increase market access to the EU for agribusiness through Harmonized Food Safety and Quality Standards. | • Align food safety regulations and implementation with EU standards focusing on horticulture, and facilitate adoption of food safety and quality certifications (e.g., GLOBALG.A.P., HACCP/ISO 22000, and EU organic).<br>• Invest in developing laboratories and digital infrastructure to support traceability systems. | ST |

Note: ENTSO = European Network of Transmission System Operators for Electricity; EU = European Union; GLOBALG.A.P. = Global Good Agricultural Practices ; HACCP = hazard analysis critical control points; kV = kilovolt; RE = renewable energy; ST = short term.

### TABLE ES.2. STRUCTURAL PRIORITY POLICY REFORMS

| POLICY | SPECIFIC ACTIONS | TIMELINE |
|---|---|---|
| **Cross-cutting constraints** | | |
| Accelerate reforms of the business environment on investment policy and e-government for MSMEs. | • Revise the Law on National Security Related Investment Scrutiny Mechanism to minimize unintended FDI distortionary and anticompetitive effects.<br>• Advance the digitalization of public services for MSMEs by introducing e-government, e-notary, and public depository of financial statements. | MT |
| Accelerate trade policy reform. | • Fast-track negotiations of additional FTAs to enhance Moldova's market diversification away from CIS. | MT |
| Level the playing field for private and public operators. | • Rationalize the use of state aid in the economy, prioritizing horizontal aid plans instead of individual state aid, notably for SOEs. | MT |
| Allow competition in key sectors and provide enforcement. | • Complete the unbundling of the electricity transmission market.<br>• Implement an effective deregulation of electric tariffs for final consumers.<br>• Ensure fair and nondiscriminatory third-party access to the gas transmission network.<br>• Complete the revision and adopt the new draft law on competition. | ST-MT |

Note: CIS = Commonwealth of Independent States; FTA = free trade agreement; MSMEs = micro, small, and medium enterprises; SOE = state-owned enterprise; ST = short term.

| POLICY | SPECIFIC ACTIONS | TIMELINE |
|---|---|---|
| **Enabling sectors** | | |
| Reform transport and logistics services and infrastructure. | • Pilot test standard OPBCs for maintenance of key road corridors and private sector PSOs for ASD.<br>• Reform the road fund to allow adequate and multiyear payment mechanisms for rehabilitation and maintenance of roads.<br>• Undertake CFM reforms (as a follow up to the adopting the Railway Transport Code) of unbundling of key activities, and develop business plans.<br>• Develop a strategy and plan for multimodal transport integration and logistics that provide a road map of investments and cross-institutional coordination. | MT-LT |
| Improve access to finance for MSMEs. | • Modernize the movable collateral registry and create a regulatory and technological environment that is trusted by creditors.<br>• Enact governance reforms to clean up the insurance industry and consolidate regulation and supervision to boost trust and new service development.<br>• Develop start-up finance programs for early-stage innovative businesses, focusing on women entrepreneurs. | MT |
| **Tradable sectors** | | |
| Encourage private investment in RE. | • Pilot utility scale projects (wind and solar) through sealed-bid auctions, and set benchmark of a bankable project structure.<br>• As part of the pilot, develop standardized package (tender and PPA documentation) for RE procurement to use in subsequent auctions.<br>• Undertake investments in grid development and modernization to reduce losses.<br>• Finish transposing European Commission's acquis provisions for tendering of new assets, establishment of operation of generation assets and IPPs, including licensing and certification process, and market exchange for electricity.<br>• Improve terms of the PPA following best international practices to mitigate key off-taker risks and address other bankability gaps. | MT |
| Enhance quality and organic certification and geobranding for horticulture and agribusiness exports. | • Promote wider adoption of regulation and implement programs for geographic identification and organic certification to support product differentiation and allow producers to compete in high-value niche markets, aligned with EU standards. | MT |
| Encourage productive aggregation and scale in agriculture. | • Promote commercial aggregation models.<br>• Promote long-term leasing of agricultural land (10+ years) to facilitate investments in infrastructure and equipment.<br>• Support land leasing mediation to encourage transfer of use rights between farmers to promote land aggregation.<br>• Introduce mechanisms for promoting the use of abandoned agricultural lands (+10 years). | MT-LT |
| Encourage agricultural sustainability and climate resilience. | • Promote CSA practices and climate finance instruments for small and large farmers.<br>• Invest in technologies and infrastructure that mitigate climate risks. | MT-LT |

Note: ASD = state administration of roads; CFM = Calea Ferată din Moldova; CSA = climate-smart agriculture; EU = European Union; PPA = power purchase agreement; PSO = public service obligation; RE = renewable energy.

| POLICY | SPECIFIC ACTIONS | TIMELINE |
|---|---|---|
| Attract returning skilled migrants and refugees for ITO and BPO&SSC. | • Simplify IT visa requirements.<br>• Extend IT visa to companies located outside the IT park.<br>• Extend long-term entry and right to work to Ukrainian refugees with their national IDs, which were granted in March 2022.<br>• Provide evidence-based tax benefits and explore opportunities to establish some facilities for digital nomads. | ST-MT |
| Level the playing field between ITO and BPO&SSC. | • Pass new legislation or adapt Law 77 to tailor it to the BPO&SSC.<br>• Foster formalization of BPO&SSC companies.<br>• Include BPO&SSC representation in the formal stakeholder consultation process of the government. | ST-MT |

Note: BPO = business process outsourcing; IT = information technology; ITO =information technology offshoring; SSC = shared service center; ST = short term.

**NOTES**

1 The analytical work underpinning this Country Private Sector Diagnosis (CPSD) was completed in January 2022. A summary assessment of the expected impact of Russian invasion of Ukraine on Moldova is presented in section 1 of the Country Context. Policy recommendations have been reprioritized, and individual chapters have been updated, to account for the impact of the Russian invasion of Ukraine on Moldova using information and data available as of September, 2022.

2 World Bank. 2023. Global Economic Prospects, January 2023. Washington, DC, January 2023.

3 This CPSD presents the most binding constraints holding back private investment in Moldova. It also identifies areas where private sector solutions could contribute to ease these constraints. Based on consultations with private and public sector stakeholders, the main cross-cutting obstacles were identified that both disincentivize investment and, as a result, limit growth opportunities in promising sectors.

4 World Bank, Moldova 2021 SCD Update. Building Resilience and Enhancing Competitiveness (Washington, DC: World Bank, 2022).

5 The CPSD analysis shows that the limiting role for competition of SOEs is especially due to them competing for resource allocation with private sector firms. In addition, SOEs are shown to induce market distortions in various industries in the country..

6 World Bank, "How to Identify Capture and Design Privilege-Resistant Policies," EFI Note–Governance, World Bank, Washington, DC, 2021, https://documents1.worldbank.org/curated/en/537291636611822955/pdf/How-to-Identify-Capture-and-Design-Privilege-Resistant-Policies.pdf.

7 World Bank, "How to Identify Capture and Design Privilege-Resistant Policies," EFI Note–Governance, World Bank, Washington, DC, 2021, https://documents1.worldbank.org/curated/en/537291636611822955/pdf/How-to-Identify-Capture-and-Design-Privilege-Resistant-Policies.pdf.

8 Moldova has 135 Authorized Economic Operators (AEOs) for which simplified border crossing procedures are applied upon importing to Moldova from the EU and the Central European Free Trade Agreement (CEFTA) member countries.

9 Organisation for Economic Co-operation and Development (OECD), Promoting Exports and Supply-Chain Linkages in the Food Industry in the Republic of Moldova (Paris: OECD Publishing, 2021).

10 On March 9, 2022, the Ukrainian government imposed a ban on exports of key agriculture products, including wheat, corn, grains, salt, and meat.

11 World Bank Group, "Moldova: Rekindling Economic Dynamism," Country Economic Memorandum, (World Bank Group, Washington, DC, August 2019)

12 World Bank, Enterprise Surveys, electronic dataset (World Bank, Washington, DC, 2019), https://www.enterprisesurveys.org/..

13 World Bank, "Moldova Electric Power Market Options: Sector Study," Report No. ACS12721, Energy Sector Management Assistance Program, World Bank, Washington, DC, July 11, 2015.

14 For further information see World Bank Group "Moldova CPSD Deep Dives", Washington DC, forthcoming.

15 International Data Corporation (IDC). 2019. Moldovan IT players priming for worldwide presence.

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