NEWSLETTER

GET MOLDOVA

Issue No. 39 | January - February 2017

# IMF programme ensures long overdue banking sector clean-up

**In November 2016 the IMF approved a new programme for Moldova worth USD 175.7 m over a 3 year period. To secure the programme the government had to fulfil an unusually large number of upfront conditions ("prior actions"). Unsurprisingly, almost all of them relate to the banking sector as fraudulent lending was the main cause of Moldova's recent financial and subsequent fiscal crisis. A key requirement of the IMF is to implement measures to increase bank shareholder transparency and strengthen the supervisory powers of the National Bank. Furthermore, energy tariffs for households have to be raised to cost recovery level and lending to state companies has to be made transparent.**

**In addition to much needed financial assistance, the IMF programme offers the realistic chance to reform a dysfunctional banking sector which has been the source of several banking scandals since independence. If successful, the emerging clean-up of the banking sector will promote economic growth in the medium term. The signing of the IMF programme also highlights that strong upfront conditionality is an effective way to secure meaningful reforms in areas with vested interest.**

### IMF programme: Volume and lending conditions

The total sum which will be disbursed in the 3-years course amounts to USD 175.7 m using up 75% of the financing volume available to Moldova from the IMF. The sum is provided as a loan under two financial credit facilities of the IMF – the Extended Fund Facility (EFF) and the Extended Credit Facility (ECF), which differ in their lending conditions. The interest rate for loans under the EFF currently amounts to 1.3%. Lending conditions for assistance from the ECF are more favourable with no interest payments and a 5 ½ years grace period.

**Planned disbursement schedule**

| Available on/after | Total | ECF | EFF |
|---|---|---|---|
| | in USD m | | |
| 7 Nov 2016 | 35.3 | 11.8 | 23.5 |
| 20 March 2017 | 21.3 | 7.0 | 14.3 |
| 20 Sept 2017 | 21.3 | 7.0 | 14.3 |
| 20 March 2018 | 32.6 | 10.9 | 21.7 |
| 20 Sept 2018 | 32.6 | 10.9 | 21.7 |
| 20 March 2018 | 32.6 | 10.9 | 21.7 |

*Source: IMF*

A sum of USD 35.2 m was made available in December shortly after IMF Board approval. Disbursement of the remaining amount is subject to five semi-annual reviews every July and December during which the authorities have to prove that they are on track with fulfilling the remaining conditions of the programme.

While the IMF funding is significant, even more important is that the agreement unlocks an additional USD 390 m from other donors which had frozen their financial assistance in the wake of the bank fraud scandal and made a continuation dependent on a new IMF programme.

### Large number of prior actions

An unusually large number of 16 so-called prior actions had to be completed upfront by the Moldovan authorities in order to secure the approval of the programme. Most of the upfront conditions related to the reform of the dysfunctional banking sector supervision, which led to the massive bank fraud scandal that rocked Moldova in 2014. A particular focus of the IMF's conditions in that area was on increasing bank shareholder transparency in an effort to reduce the chance that the owners of a bank lend themselves or related parties money ("related party lending") without an intention to pay it back. Among other things the National Bank of Moldova (NBM) introduced the principle of reverse burden of proof for bank owners who now have to show that they are not acting in concert. The IMF also requested that the two largest remaining banks (Moldova-Agroindbank and Moldindconbank) were put under special supervision of the NBM in order to identify dodgy ownership structures, audit the loan book and unwind related party lending. Furthermore, the NBM forced a third bank (Victoriabank) to convene its board of directors in order to get a long overdue audit done and to appoint new executive directors. In parallel the supervising role of the NBM was strengthened for example by protecting the NBM staff from dubious law suits and elevating the legal status of NBM regulatory orders. In the past NBM staff was frequently threatened by law suits and regulatory decisions were overturned sometimes by corrupt judges of low ranking regional courts.

Additional prior actions required the government to adjust energy tariffs for households which are lower than their production costs causing financial losses of public utilities.

### Programme conditions for the financial sector

In order to receive further tranches of the IMF loan, the government will have to continue the reform of the banking sector supervision throughout the programme. The government has agreed that all other banks (not only the three largest ones) will have to undergo the same process of identifying the real owners and auditing their loan books in order to uncover dodgy lending practices. Moreover, coverage of the Deposit Guarantee Fund will be increased to avoid that the government has to provide costly state guarantees or recapitalise banks as was the case during the recent bank fraud, when the deposit protection turned out to be insufficient.

**Programme conditions in the fiscal policy field**

In comparison to the banking sector conditionality, the requirements of the IMF regarding public expenditures and public revenues are less strict. In fact, the funding provided by the IMF and other donors will allow the government to increase public spending which was cut back to a bare minimum during 2015 and 2016. Indeed, while the IMF requires the government to limit the deficit to 2.9% of GDP by 2019, this is more generous than the deficit the government was able to afford in 2016. Additional revenues can then be spent in important fields like social policy and capital investment.

Instead the main focus of the IMF programme is made on containing future fiscal risks. For example, the IMF programme requires that lending to state-owned enterprises and government guarantees will have to be reported and monitored more closely. The IMF also expects the government to refrain from moving public sector bank accounts to specific banks in an arbitrary manner as this was one of the sources for fraudulent lending during the bank scandal.

To avoid that the state has to cover deficits at public utility companies, the IMF requires that energy tariffs for households are raised to a cost-covering level. While the IMF requested an increase of the retirement age, it also asked that pension entitlements are increased in line with inflation, which will lead to a rise of the average pension level.

**Impact of the programme**

The government and the National Bank deserve credit for implementing the banking regulation requirements of the IMF which subsequently led to the signing of the programme. The measures implemented in the second half of 2016 represent the most radical reform of the banking sector since the independence. The reform, if continued, may actually put an end to a long-lasting series of bank frauds, which were used to steal money from the banking sector since the early 1990s. While bank lending will be constrained in the short and medium term until the banks have cleaned up their balance sheets, the evolving banking sector may be much stronger and able to attract much needed capital from foreign banking investors, which could bring healthy lending practices, fresh capital and new banking products to Moldova.

The successful signing of the IMF programme shows that strong upfront conditionality is a good means to achieve meaningful reforms against vested interest in the Moldovan banking sector.

Indeed, the dire fiscal situation and the unified stance of the donor community were the main reasons for the government to commit itself to the strict prior actions prescribed by the IMF. Moldova's international partners should continue this approach and review carefully the reform progress before disbursing new funds.

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GET Moldova maintains a dialogue on economic policy with decision-makers of the Moldovan government since 2010. It is funded by the Federal Ministry of Economic Affairs and Energy.

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