WHAT DRIVES HIGH COST OF FINANCE IN MOLDOVA?

Alexandru Stratan,
Ph.D., Director, Institute of Economy, Finance and Statistics, Republic of Moldova
Marcel Chistruga,
PH. D., Institute of Economy, Finance and Statistics, Republic of Moldova

Abstract: Why there are high costs to finance in Republic of Moldova? Is it a problem for business environment? These are the questions discussed in this paper. Following the well know Growth Diagnostics approach by Hausmann, Rodrik and Velasco, authors assess the barriers and impediments to access to finance in Republic of Moldova. Guided by international and national statistics we found evidence of poor intermediation, poor institutions, high level of inflation, and high collateral as major causes of high cost of financial resources in Republic of Moldova. At the end of the study authors give policy recommendations identifying other related fields to be addressed.

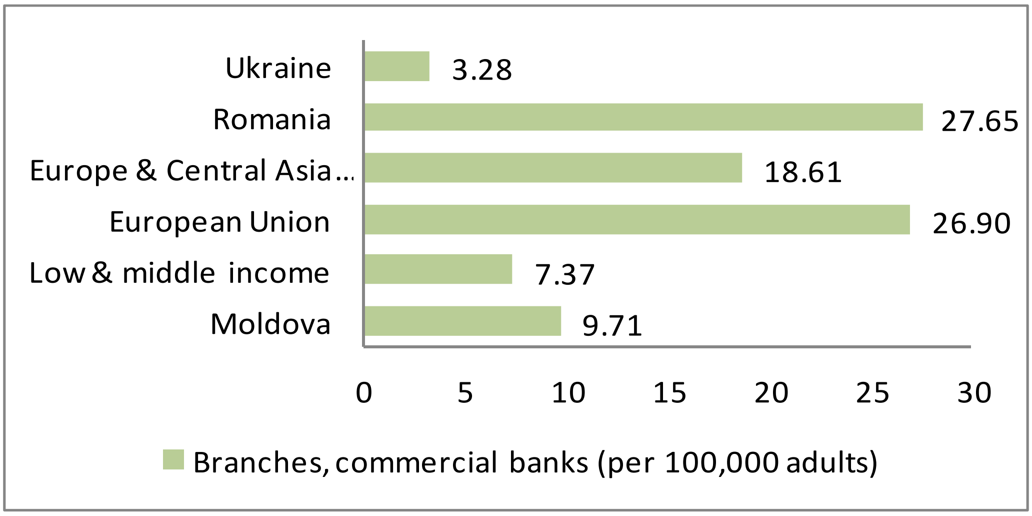
Key words: access to finance, constraints, growth diagnostics

In general, according to Growth Diagnostics[1] approach, the problem should be seen both in terms of access to domestic finance and to international financial markets. In turn, the poor access to domestic financing is associated with the following two reasons: lack of competition and high money costs. At the same time, the access to external financial markets is subject to country risks, investment climate and exchange rate risk.

If we talk about sustainable economic growth, Moldova needs to boost the investment rank to a level at least higher than in countries of the region. To achieve this, first we should understand what the problem is and then what should be done?

Access to domestic finance. Currently, there are 15 finance and banking institutions operating in Moldova, of which 9 were foreign-owned in 2010. The total number of banking institutions (branches, representative offices) increased from 388 in 1999 to 1160 in 2010. The banking sector is growing continuously and is largely adequate in comparison with countries in the region, but weak compared to EU countries.

Figure 1. Bank branches per 100,000 adults

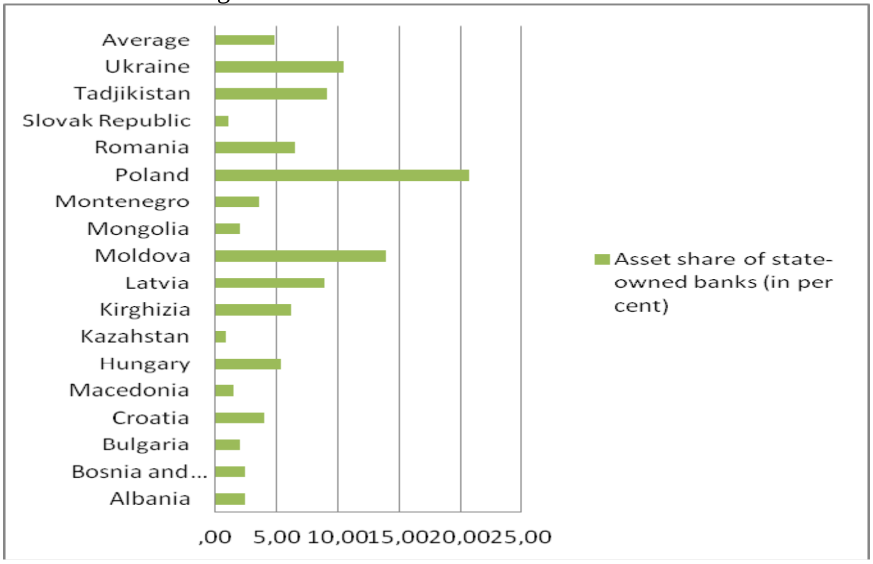


Source: according to World Bank Database

The banking system in Moldova has a relatively large share of state-owned banks. The state currently has a relatively small presence in the region; if we exclude Belarus, the average for countries in the region is 6.1 per cent of total assets, while in Moldova the figure is 13.4 per cent.

[1] Hausmann, Ricardo, Dani Rodrik, and Andres Velasco. 2004. Growth Diagnostic, mimeo, September. R. Hausmann, D. Rodrik, and A. Velasco, "Growth Diagnostics," John F. Kennedy School of Government, Harvard University, September, 2004 –http://ksghome.harvard.edu/~drodrik/barcelonasep20.pdf.

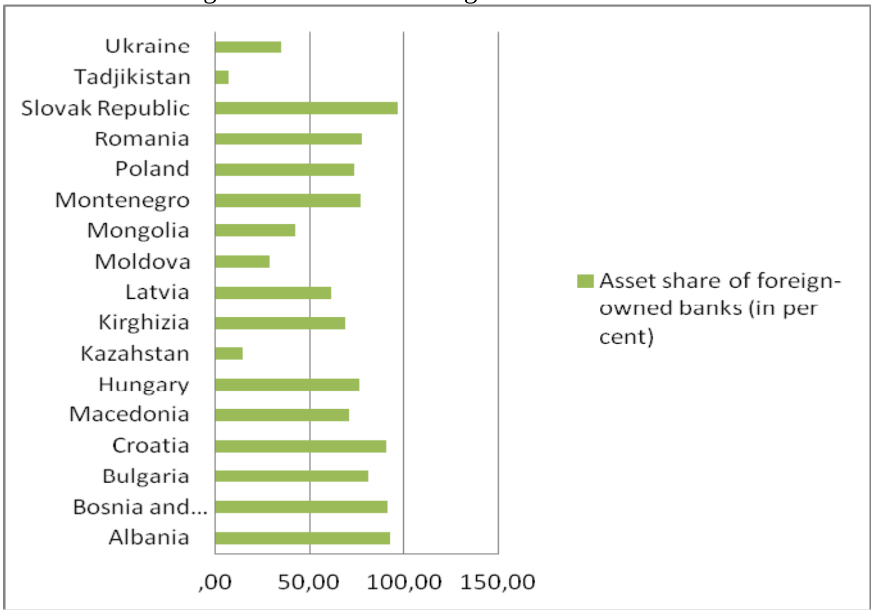
Figure 2. The share of state-owned bank assets



Source: According to International Financial Statistics database

At the same time, the share of foreign-owned banks in the total banking assets was of 28 per cent in average in 2004-2009, increasing to 31.6 per cent in 2010. This deficiency is confirmed by the OECD study "Competitiveness and Private Sector Development in the Republic of Moldova"; with the exception of Belarus and Azerbaijan, all CEE countries have an average of 88 per cent.

Figure 3. The share of foreign-owned bank assets

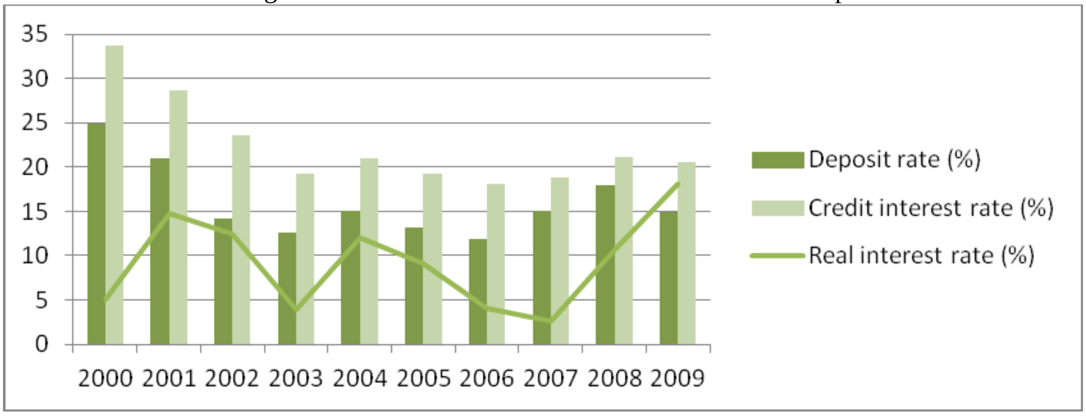


Source: According to International Financial Statistics database

The first six banks in Moldova hold about 70 per cent of bank assets and total loans to the economy. Although, corresponding to the region average, the concentration index (CR-4-Herfindahl-HirschmanIndex HHI) of the market shows a relative degree of banking market concentration in Moldova. The calculation of the concentration indicators of this segment of the market (CR-4 and HHI-Herfindahl-Hirschmann) shows that in 2010 a level of 1210 points was recorded, so the banking market is characterized by a moderate degree of concentration, which implies a satisfactory level of competition.

High cost of finance. The real interest rates on loans and deposits have shown declining trends during the years. Thus, the balanced developments of the interests would mean a constant supply of finance to the real sector, that would support a uniform growth of the economy, gradually and without major fluctuations. However, some businesses and business people consider that interest rates in Moldova are high.

Figure 4. Evolution of real interest rates on loans and deposits.

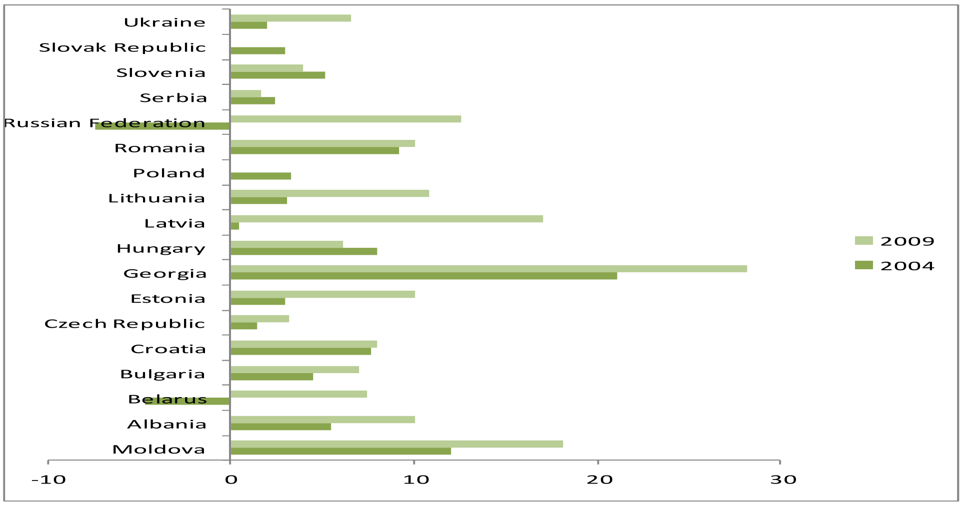


Source: according to World Bank database.

The need for and insufficiency of access of the real sector to finance is captured by the Global Competitiveness Report 2010-2011, where most respondents mentioned the access to finance as a particularly acute problem for business development in Moldova. The same situation is found in the Doing Business Report 2011, the section Access to credit in the Republic of Moldova of which shows a 2-step drop in ranking to the 89th position of all countries analyzed. A similar situation is presented in BEEPS survey, where issues related to access to finance have been identified by the interviewed businesses.

The high costs of access to credits are associated with inflation. The crediting of the economy is made on higher interest rates than the cost of funds and not less than the inflation rate. Compared with the level in the region, the interest rate on loans in Moldova, both in nominal and in real terms is at a high level. Partly due to a high inflation rate, Moldova has one of the highest rates of interest in the region. With the financial sector development, a negative consequence of high interest rates may be the stimulation of speculative pressures, with consequences for exchange rate stability.

Figure 5. Regional rates of interest, nominal values

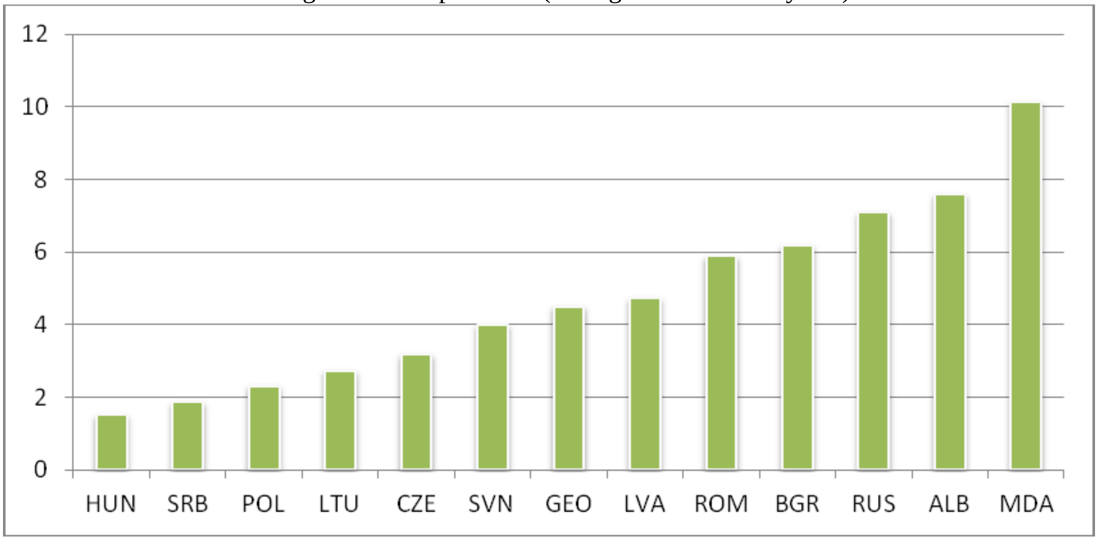


Source: According to International Financial Statistics database

Excluding the inflation rate, thus a part of the macroeconomic policies, the reasons for high real interest rates derive from the structure and particularities of the financial market. On the one hand, causes associated with corporate management and administration on the financial market, on the other hand, elements that are not related to administration within the system, such as regulatory framework, market structure, diversity of financial products, access to foreign markets, etc.

In this respect, the high interest rates are the result of risk premiums and the amount of collateral. Compared with countries in the region, both the risk premium and the size of collateral are some of the largest in the region. The risk premium is the difference between interest rates on loans provided to best customers and the interest rates on state securities and bonds. Basically, this difference highlights the share retained by the bank to ensure the risk of default. The insecurity, uncertainty and the quality of business environment is reflected in the size of the risk premium. It should be noted that there are other factors that influence the size of the risk premium, these factors are related to risk assessment and the level of competition in the banking system.

Figure 6. Risk premium (average of the last 10 years)

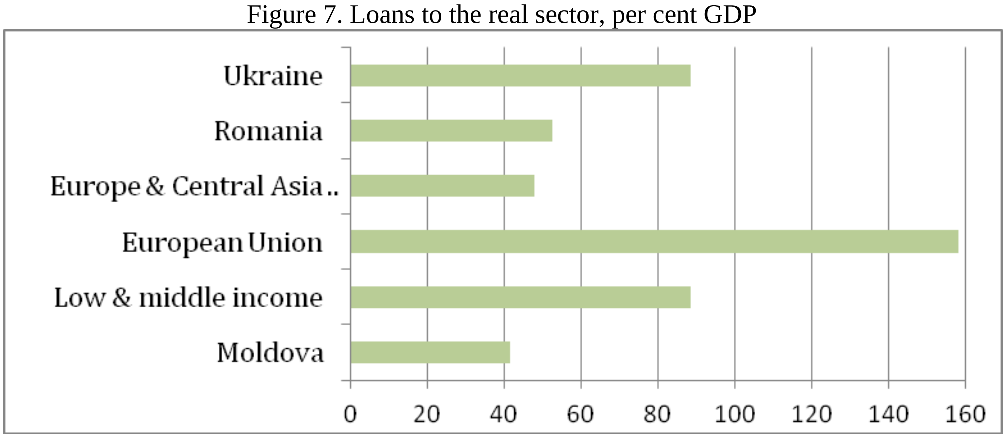


Source: according to World Bank database

Volatility and uncertainty in the local business environment is offset by the banking system by increased requirements towards the collateral procedures. The size of the collateral is identified by BEEPS as a problem of the business environment in receiving a loan. In Moldova the size of collateral is over 130 per cent of the loan amount.

Credit dynamics. In the last five years the banking system recorded a positive performance in terms of bank profits and level of capitalization. This performance is partly due to increase in provision of loans. For instance, in 2008 the balance of loans taken increased by over 20 per cent compared to 2007, the consumption credits also recording an increase. While before 2004, there was a reluctance of banks to grant consumption credits, the situation has clearly recovered since 2005. The share of this type of credit increased from 3.6 per cent in 2008-2009 to over 10 per cent of bank loan portfolio, this upward trend materialized in the coming years with growth rates of over 12 per cent. In fact, the average credit growth in the economy over the last five years was 17 per cent. Compared with countries in the region, the increase recorded in Moldova is a performance. However, national credits are below average credit against GDP among the countries in the region. While the EU countries credit the real sector of the economy with a share of over 100 per cent of the GDP, Moldova has a share of loans to the same sector of only 23 per cent (average of the last 10 years).

Figure 7. Loans to the real sector, per cent GDP

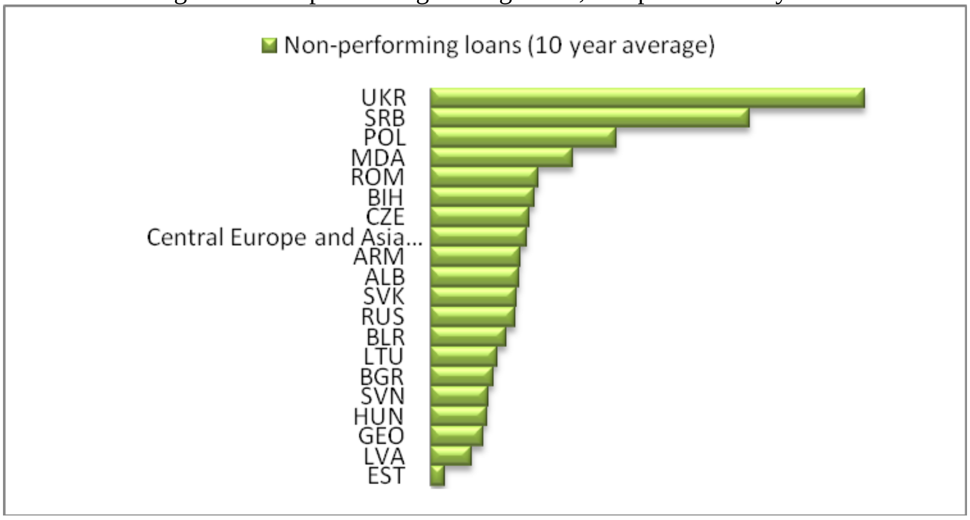


Source: According to International Financial Statistics database

Although expensive, the statistics for the recent years have shown a rapid increase in loans, but at the moment, insufficient to cover the needs of the economy. The rate of loans to economy against GDP in other countries in the region per total is higher than in the Republic of Moldova. Countries like Slovakia, Hungary and Estonia are leading the ranking, even Ukraine outranked Moldova.

Characteristic of the banking sector, compared with countries in the region, is a **high degree of non-performing loans.** Although in 2011 this indicator decreased from 17.8 per cent to 9.3 per cent, the national banking system is constrained in lending operations. This situation is partly explained by external shocks in recent years, especially those associated with export operations, which led to a decrease in the reliability in the economy. In the last 10 years the average non-performing loans in the economy have reached extremely high levels. Therefore, the causes can be reflected by the quality and volatility of the local business environment, but also by the practices of credit banking system (mostly without providing risk management measures, but also corporate governance practices).

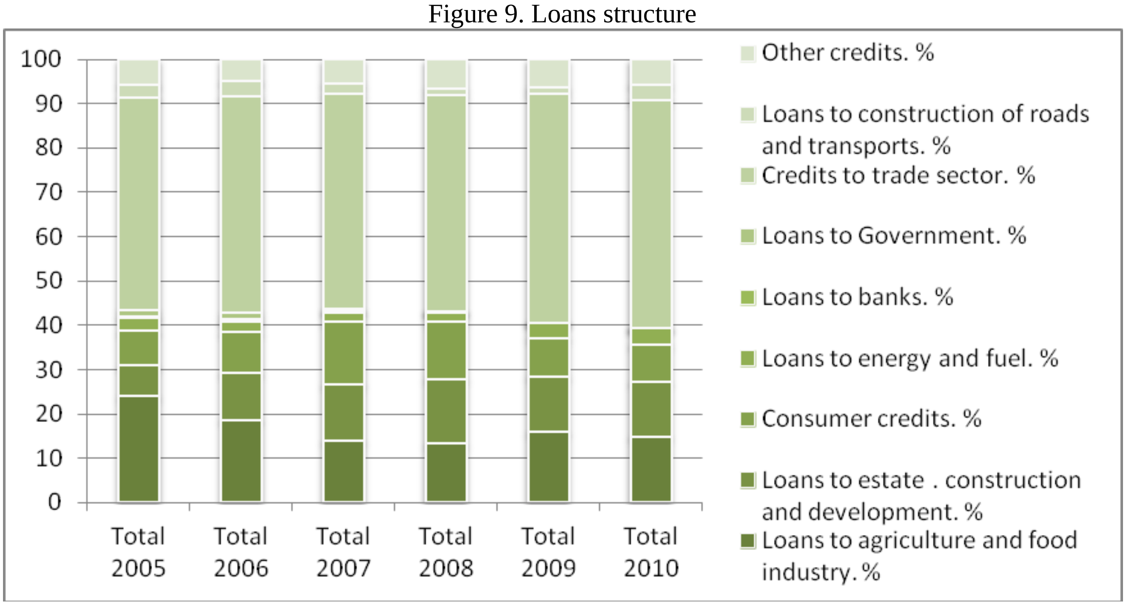
Figure 8. Non-performing loans granted, comparative analysis



Source: According to International Financial Statistics database

The structure of loans shows that most loans are issued to industry and trade. Given the weight of these two sectors, both in GDP and in the VAB, we consider that most loans were channeled to trade. A small fraction of the total loans go for the development of productive capacity of the economy. Under these conditions the SME are particularly disadvantaged, facing an acute lack of funding. Loans issued to households represent 20 per cent of total loans, which is below the regional average achievement.

Figure 9. Loans structure

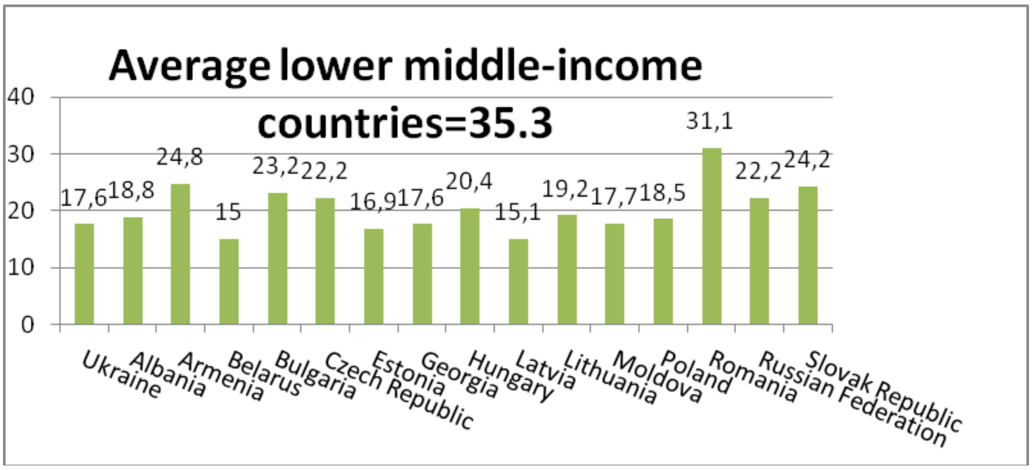


Source: According to annual data of the National Bank of Moldova.

Savings Rate; The high volume of transfers from Moldovans who work abroad and the wage growth resulted in increased household savings, and thus an increased savings rate. However, because of the slow pace of structural reforms and the lack of remittances' targeting policies, the channeling of these massive inflows of currency for productive purposes failed. The positive effects of remittances have been superimposed over the negative. These led to Moldovan leu's appreciation which in turn stimulated consumption of imported goods, but has damaged the external competitiveness of local products.

Increase in savings in recent years compared with countries in the region and worldwide is insufficient. According to World Bank classification, there are 56 medium and small income countries, average savings in these countries accounted for 35.3 per cent of GDP, while in Moldova only 17.7 per cent of GDP.

Figure 10. Savings against GDP, n per cent of GDP



Source: World Development Database, http://data.worldbank.org

Another feature of the structure of loans and deposits in the Republic of Moldova is a disproportionate **degree of maturity.** Most deposits are short-term deposits and most loans are long- and medium-term. The largest share of deposits, about 55 per cent belongs to deposits in local currency and about 45 per cent in foreign currency.

Table 2. Structure of loans and deposits

Deposits' structure by maturity (per cent)	2007	2008	2009	2010
Bank deposits in foreign currency with a term less than one year	96.5	96.5	96.5	92.5
Bank deposits in foreign currency with a term more than one year	3.5	3.5	3.5	7.5
Bank deposits in national currency with a term less than one year	89.4	95.0	95.9	92.4
Bank deposits in national currency with a term more than one year	10.6	5.0	4.1	7.6

Loans' structure by maturity (per cent)	2007	2008	2009	2010
Bank loans in foreign currency with a term less than one year	26.7	31.1	28.1	26.7
Bank loans in foreign currency with a term more than one year	73.3	68.9	71.9	73.3
Bank loans in national currency with a term less than one year	41.5	39.2	40.6	32.3
Bank loans in national currency with a term more than one year	59.4	60.8	59.4	67.7

Source: according to NBM data

In consequence, the gap between the maturity of loans and deposits is a factor influencing the possibility of lending long-term investment projects. Thus, besides the fact that the financial system and especially local banks do not have internal capabilities to manage long-term investment projects (10-20 years), the structure of deposits does not allow long-term lending. Most deposits are placed for a period shorter than one year and in national currency.

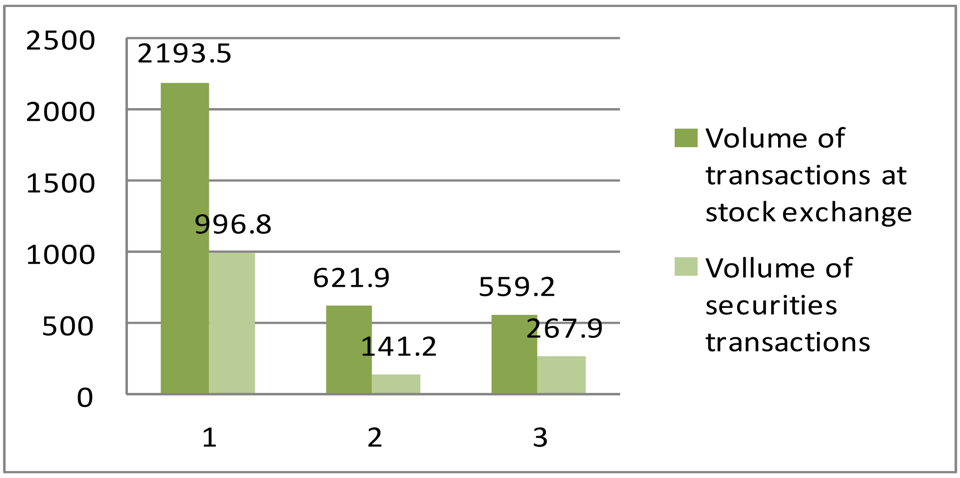
An alternative to the banking sector is **the microfinance sector**. The analysis of the microfinance sector shows that, although it accounts for about 2.0 percent of GDP, the rate of penetration of microfinance services remains a poor indicator at national level. The microfinance loans provide lending services which are accessible and affordable for small and medium enterprises and socially vulnerable groups throughout the country, as a priority in rural areas. In 2010 5.1 per cent of economically active population of Moldova has benefited from microfinance loans, its value decreasing by 12.1 per cent compared to 2009 and less than 2.6 times compared to the similar indicator for Bosnia and Herzegovina, the microfinance sector of which is representative of Central and Eastern Europe. Thus, the share of microfinance sector in total loans and credits to economy is too small, the empirical data show that the banking system is some kind of monopoly; there are no alternative funding sources in Moldova.

Securities market in Moldova has the characteristics of an emerging market: small number of issuing entities, low liquidity, lack of public investments, low number of investors, and reduced integration in international financial markets. The range of financial instruments issued and traded on domestic securities market is limited to ordinary shares, and there is no interest in attracting investment through placement of corporate bonds.

During 2010 there was a similar trend to that of 2009, investors having a reserved behavior towards the securities market opportunities.

In 2010 the secondary securities market recorded a decrease of 10.1 percent compared to 2009 due to lower volume of extra stock market transactions.

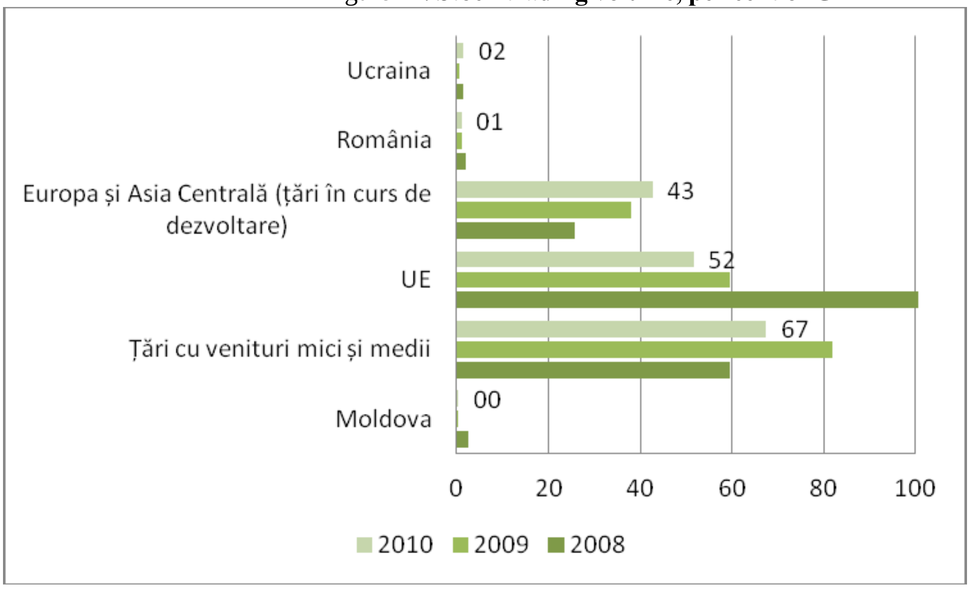
Figure 11. V**olume of securities transactions**



Source: according to NCFM data

The development of key segments of the nonbank financial sector in Moldova, the capital market, participation of **pension funds and of insurance companies in the financial market** remain far behind countries in the region and countries in Southeast Europe. The low liquidity and high degree of fragmentation of market infrastructure resulted in insufficient determining of the cost of financial instruments and their underdevelopment. The mentioned weaknesses limit the activity of institutional investors, creating significant risks for their development. The experience of economic crisis highlighted serious shortcomings and it is obvious that necessary reforms are needed both to provide immediate funding to support economic growth and to ensure the stability of the nonbank financial system.

Figure 12. **Stock trading volume, per cent of GDP**



Source: According to International Financial Statistics database

An indicative feature of the level of stock market transactions is the volume of stock transactions. Compared to other countries, it is virtually nonexistent. Most stock market transactions are not intended for acquisition of funds. The nature of these transactions is associated with the change of ownership of traded companies.

Access to domestic finance is a major constraint for the economy and economic growth in Moldova. The Banks are guided by the establishment of interest rates based on macroeconomic indicators, especially inflation, by the saving rates and the economic and financial situation of each banking institution. Thus, one of the causes of high costs of capital is the low financial intermediation, reflecting the level of development of the banking system and of financial market as a whole.

A special aspect is the lack of competition[2] and of alternative economy financing instruments, and on the other hand, structural inefficiency of the banking system. The most obvious symptoms are the large volume of non-performing loans[3] and the high level of risk premiums. Last issues, combined with gaps and deficiencies of state institutions, influence the size of the collateral, which is considered to be an impediment in accessing the finance.

There are virtually no alternatives to the banking system. The non-banking sector is largely underdeveloped, providing credits mainly to rural sector and individuals; the share of loans to GDP does not exceed 1-2 per cent. Purchase of financial resources through capital markets and microfinance sector is not a relevant option at the moment.

Access to international financial resources. Moldova's net external debt against GDP has tended to decline over the past five years. Both public sector and compared with other states, the real sector of national economy is practically absent from the international financial markets, for which it is assigned a low financial maturity and high interest rates. Country risk rating is high. International financial assessment agencies such as Moody's Investors Services and Fitch IBCA designed to provide country risk ratings according to the evolution of key macroeconomic indicators still assign low ratings for Moldova. For instance, Moldova has the lowest financial ranking in the region as assessed by Moody's Investors. However, the country ratings assigned by different agencies vary. Fitch IBCA has changed the rating of the Republic of Moldova in terms of credits from "stable" to "positive", as result of economic growth and stability and adopted fiscal discipline. At the same time, Fitch reaffirmed the rating given to Moldova for long-term external liabilities in foreign currency and local currency at 'B-"and "B".

Moldova is not financially integrated at the international level Domestic companies are not listed on international stock exchanges. The most dynamic in relations with the international financial market are banks and microfinance companies, but also some subsidiaries of the foreign companies. The volume of these transactions is negligible in comparison with countries that benefit from financial integration. Under the conditions of a more pronounced development of international financial markets and low interest rates in these markets, it is essential for Moldova to accesses these resources.

Domestic companies listed on international stock exchanges.

Low and middle income countries	**17506**
EU	11865
Europe and Central Asia (developing countries)	3233
Romania	1663
Ukraine	236

CONCLUSIONS AND RECOMMENDATIONS

We believe that the most important constraints of access to finance can be grouped as follows:

- ***poor financial intermediation,***
- ***high costs of financial resources,***
- ***relatively high requirements for collateral,***
- ***weaknesses in state institutions.***

Poor financial intermediation can be addressed through several measures. First, since it is the only option for the procurement of financial resources in the domestic banking system. It is necessary to enhance the competition. This sector is currently represented by more than 10 institutions and thus has characteristics of an oligopolistic market/monopoly.

Increasing diversification of financial instruments and financial market would help increase financial intermediation. New products and structures would boost the absorption of excess liquidity and create financial instruments that would meet the needs of the economy. Support of the non-banking sector would create additional competitive pressure on the banking system.

Given the high financial costs and underdeveloped financial markets, the access to international markets would also become a mobile for domestic investment. The financial opening would bring cheap and varied resources, but also the practices and knowledge transfer.

Measures:

- Streamlining the activity of credit bureau.

---

[2] Moldovan Economic Trends no. 1, Republic of Moldova July 2011, Publishing. www.iefs.md

[3] OECD (2011), *Competitiveness and Private Sector Development, Republic of Moldova 2011: Fostering SME Development*, Competitiveness and Private Sector Development, OECD Publishing. *http://dx.doi.org/10.1787/9789264112285-en*

- Improving corporate governance.
- Stimulating the creation of new financial instruments and financial market development
- (Creation of venture capital, cooperation with insurance companies and stimulation of capital market transactions, etc.).
- Development of collective investment institutions, private pension funds and life insurance funds.

Another constraint is the **cost of financial resources.** The most important reason for this constraint is related to macroeconomic stability, especially inflation. To ensure a low interest rate there must be a budget, foreign balance and the inflation must be decreased. The problem of inflation is widely debated in society, and the actions of the NBM are directed to its reduction.

The savings rate and risk premium are two other causes of high costs of financial resources. The stimulation of savings and deposits rate by creating tools for maintaining these resources on the long term would enable a more effective and balanced management of risk, thus reducing the risk premium.

The effects of high interest rates have an influence on the structure of lending as well. The process of credit rationing. It is safer to credit the trade because of lower lending costs and safety associated with this type of activity.

Another implication is associated with "credit rationing" or the rationing process by financial intermediaries to streamline the funding resources. Given the high cost of credits, the safer loans with a high probability of returning the loan do not accept a higher interest rate because of profit implications. Usually less risky investment projects have lower profit rates compared with the riskiest. In this respect, high interest rates restrict the access to less risky business. This phenomenon has implications for non-performing loans, but also on collateral requirements applied by financial intermediaries.

Measures:

- Achieving and maintaining price stability.
- Stimulating securities transactions
- Increasing guarantees for deposits;
- Increasing the competition in the financial market
- Developing alternative payment instruments (for example - credit cards).

Exaggerated collateral r**equirements and** procedures for the sector. The uncertainty and quality of business environment results in exaggerated measures applied by the banks to ensure themselves. At the same time, when most of the collateral is land and real estate values, the markets are underdeveloped. Therefore we believe that actions must be directed to:

- Land market and real estate market development,
- Mortgage market development;
- Stimulation of the activity of credit bureau.
- Implementation of alternative methods of risk assessment (e.g. audit);
- Stimulation of non-banking sectors.

The last constraint which has been highlighted refers to **state institutions deficiencies.** No matter how well organized and diversified financial market will be or what are the country's macroeconomic results, without catalysts that ensure cohesion of all these elements, the financial system will not work. Clearly, the role of the catalyst has to be taken over by state institutions, which have a duty to create and maintain an environment beneficial to sustainable economic growth. Of the range of problems that must be addressed in the restructuring of state institutions, we refer to the most important for access to finance. Guaranteeing property rights, insolvency and general procedures, the quality of the legal constraints are key issues that generate access to finance for local business environment.

Measures:

- Developing a functioning market economy and its institutions.
- Improving income reporting and tax compliance.
- Measures to improve the quality of legal acts.

BIBLIOGRAPHY:

1. Hausmann, Ricardo, Dani Rodrik, and Andres Velasco. 2004. Growth Diagnostic, mimeo, September. R. Hausmann, D. Rodrik, and A. Velasco, "Growth Diagnostics," John F. Kennedy School of Government, Harvard University, September, 2004 – http://ksghome.harvard.edu/~drodrik/barcelonasep20.pdf.
2. Moldovan Economic Trends no. 1, Republic of Moldova July 2011, Publishing. www.iefs.md
3. OECD (2011), *Competitiveness and Private Sector Development, Republic of Moldova 2011: Fostering SME Development*, Competitiveness and Private Sector Development, OECD Publishing.
4. World Development Database, http://data.worldbank.org
5. National Bank of Moldova, www.bnm.md