ACCESS TO FINANCE - CONSTRAINT ON ECONOMIC GROWTH IN MOLDOVA

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One of the inherent constraints revealed by further analysis is poor access to finance. One of the seven pillars on which the National Development Strategy 2012-2020 is going to be based addresses this problem. The analysis complements existing studies, highlighting other issues identifying the constraints and causes associated with access to finance in Moldova. The findings of the study were discussed and presented at the Working Group "Accessible and Inexpensive Finance", held by the Ministry of Economy.

In general, 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: a lack of competition and the high costs of financial resources. At the same time, access to external financial markets is subject to country risks, investment climate and exchange rate risk.

If we are seeking sustainable economic growth, Moldova needs to boost the **investment performance** to a level that is at least higher than in other countries of the region. To achieve this, several actions that would allow the development of the financial system are needed.

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.

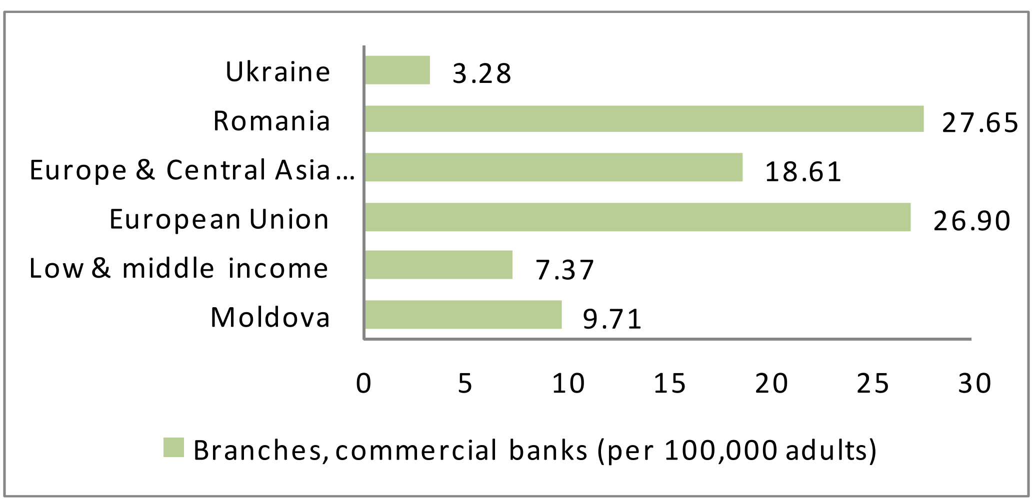

Figure 1. Bank branches per 100,000 adults
Source: according to World Bank Database

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.

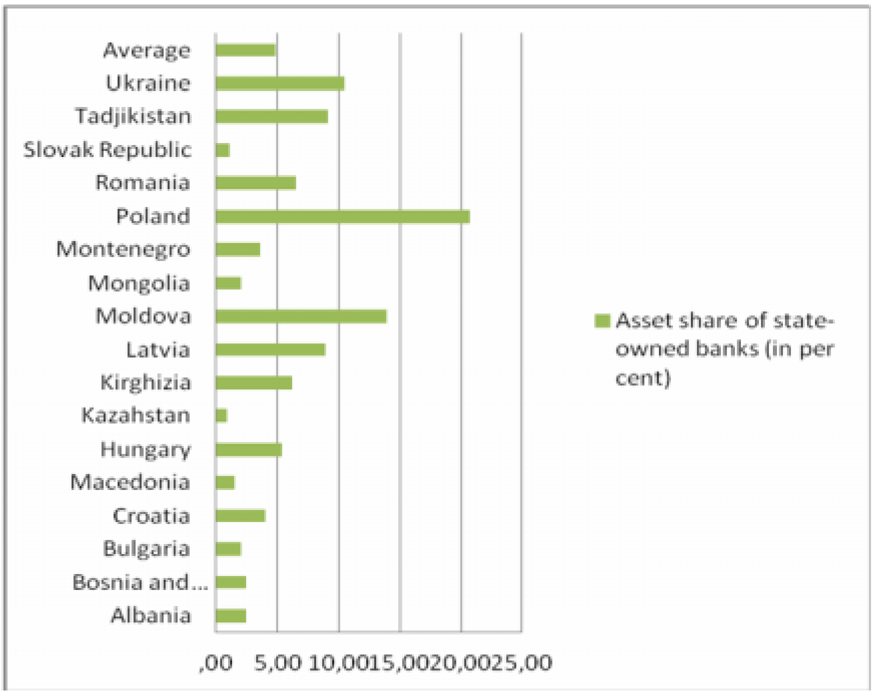

Figure 2. The share of state-owned bank assets
Source: According to International Financial Statistics database

At the same time, the share of foreign-owned banks by total banking assets was 28 per cent on average in 2004-2009, rising 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.

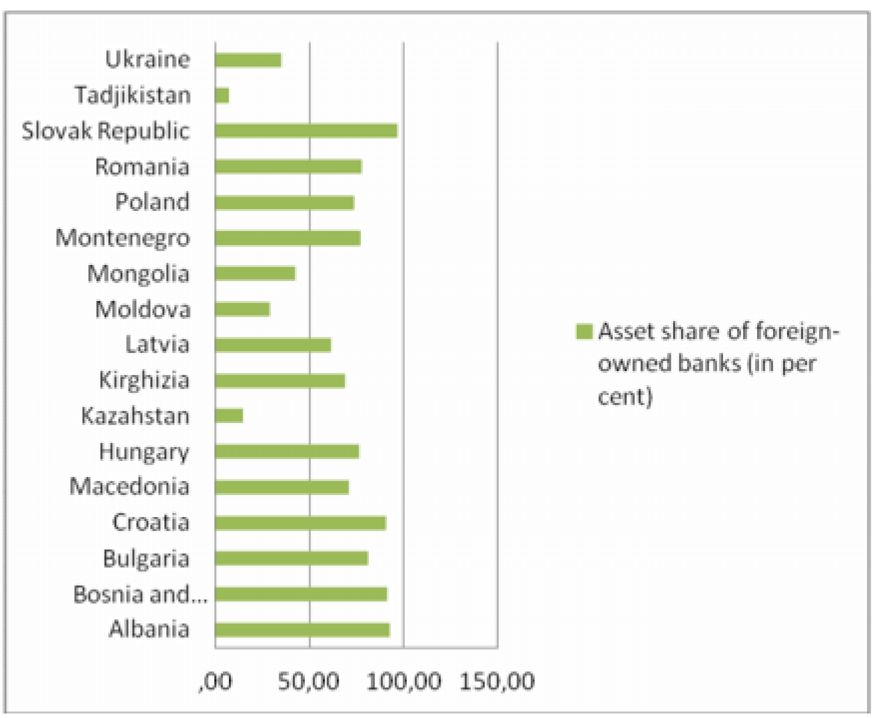

Figure 3. The share of foreign-owned bank assets
Source: According to International Financial Statistics database

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-Hirschman Index HHI)of the market shows a high relative degree of banking market concentration in Moldova

Table 1. Banking sector concentration indexes 2009-2010

No.	Indexes	2009	2010
1	**CR-4, per cent**	***59***	***60***
2	**HHI, points**	***1172***	***1210***

Source: Calculations based on data provided by the National Bank of Moldova.

The *concentration indicators* of this segment of the market (CR-4 and HHI-Herfindahl-Hirschmann) show that in 2010 a level of 1210 points was recorded, so the banking market is characterized by a *moderate degree of concentration,* which potentially allows a satisfactory level of competition.

High cost of finance. 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.

Considering all of the above, one can have a wrong impression.

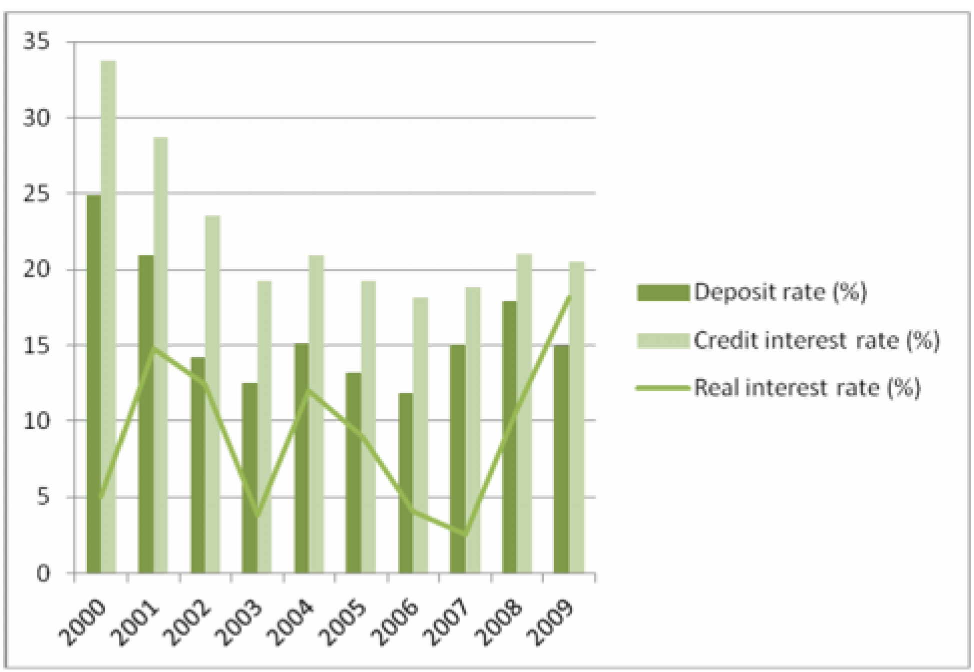

Figure 4. Evolution of real interest rates on loans and deposits
Source: according to World Bank database.

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.

High cost of access to credits is associated with inflation. Loans to the economy are made at higher interest rates than the cost of funds and at levels that are not below 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.

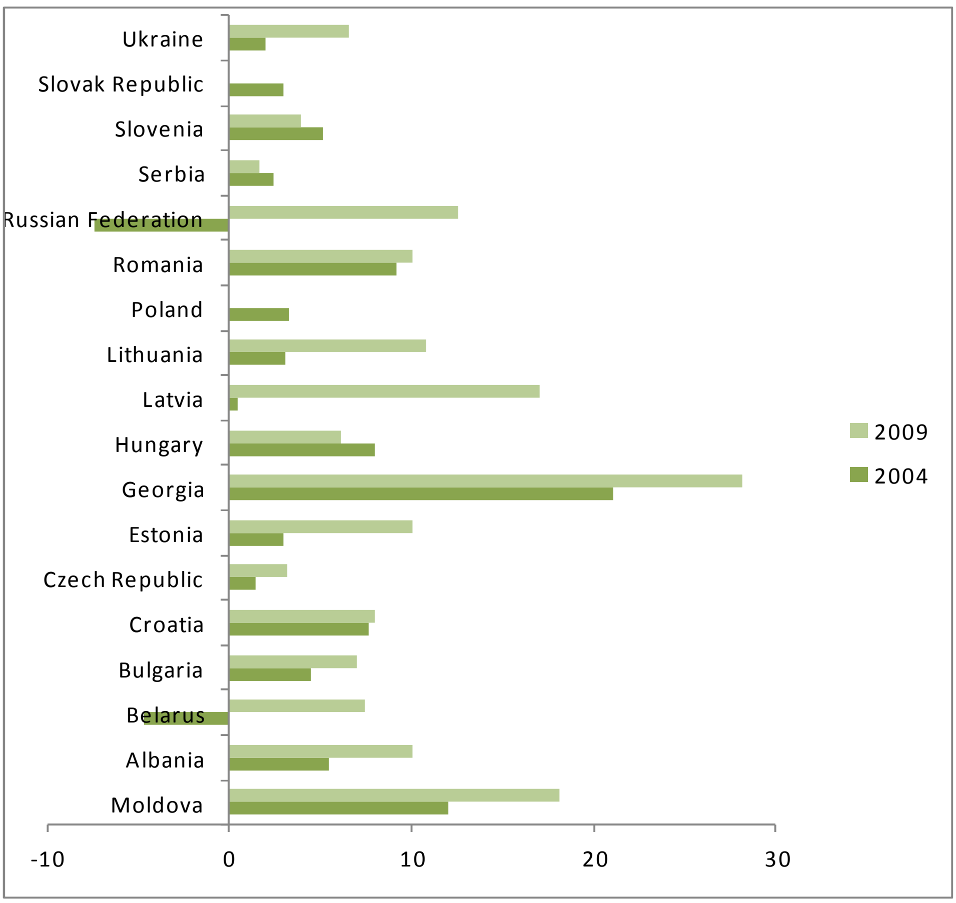

Figure 5. Regional interest rates, nominal values
Source: According to International Financial Statistics database

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, the causes are associated with corporate management and administration on the financial market, and, on the other, with elements that are not related to administration within the system, such as the 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 insure against the risk of default. The insecurity, uncertainty and the quality of the 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, and these factors are related to risk assessment and the level of competition in the banking system. In this regard we associate the causes of high risk premium with microeconomic risks identified through a growth constraints analysis and discussed in the two previous policy notes of this publication. Implicitly, we support the idea that microeconomic risks are the major problem for the Republic of Moldova. Elimination of this constraint should have an impact on the cost of financial resources as well.

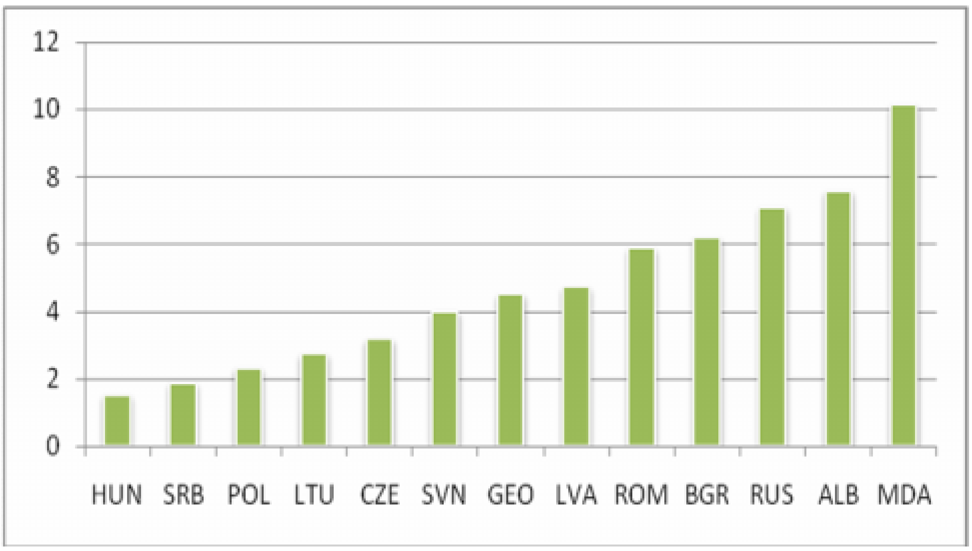

Figure 6. Risk premium (average of the last 10 years)

Source: according to World Bank database

Volatility and uncertainty in the local business environment is offset in the banking system by increased collateral requirements. The size of the collateral is identified by BEEPS as a problem for business in seeking credit. 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 an 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 reluctance on the part 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 portfolios, this upward trend materialized in the coming years with growth rates of over 12 per cent. In fact, average credit growth in the economy over the last five years has been 17 per cent. Compared with countries in the region, the increase recorded in Moldova is a strong performance. However, national credits are below average credit to 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).

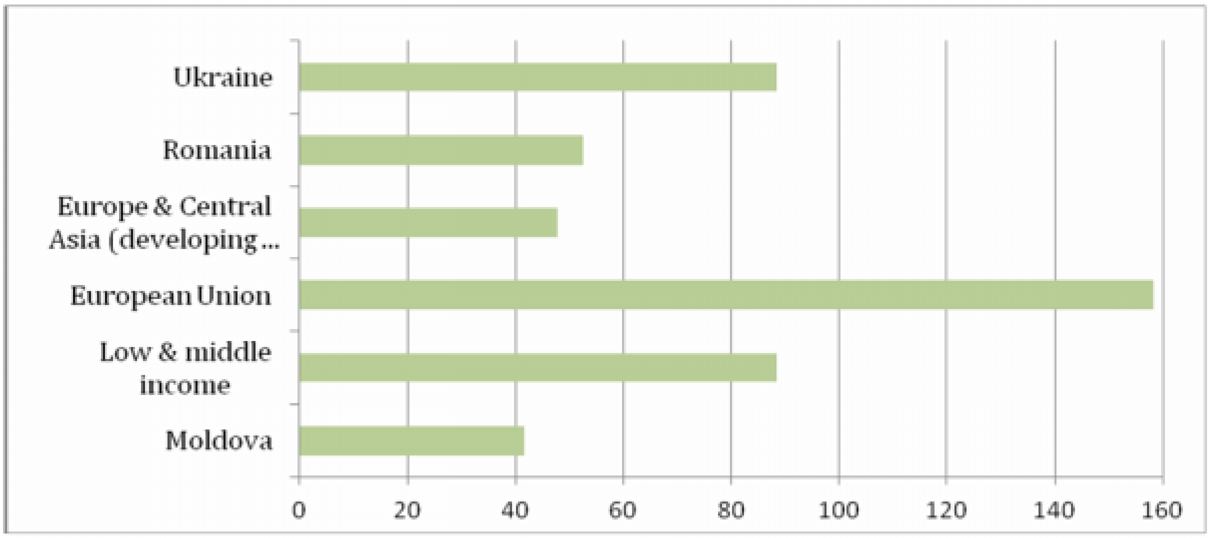

Figure 7. Loans to the real sector, per cent GDP
Source: According to International Financial Statistics database

Although expensive, the statistics for recent years have shown a rapid increase in lending, but at the moment volumes are insufficient to cover the needs of the economy. The rate of loans against GDP in other countries in the region 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 fell from 17.8 per cent to 9.3 per cent, the national banking system is constrained in its lending operations. This situation is partly explained by external shocks it has suffered in recent years, especially those associated with export operations, which led to a decrease in reliability in the economy. In the last 10 years average non-performing loan levels 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).

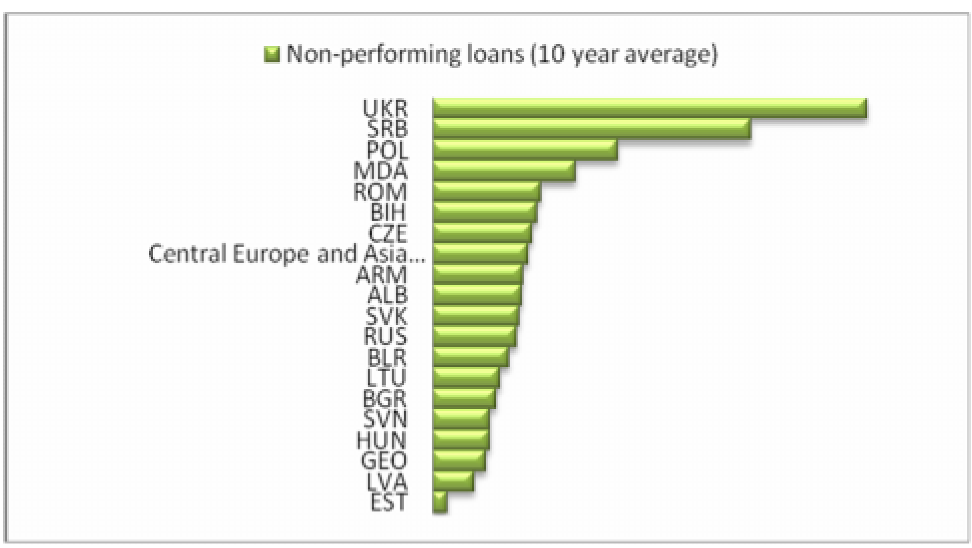

Figure 8. Non-performing loans granted, comparative analysis
Source: According to International Financial Statistics database

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 channelled 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. Under such conditions, it is particularly SMEs that are affected. According to the BEEPS questionnaire they are in acute need of financing. The prevailing trends in the structure of loans reveals a major problem, as it disproportionately finances trade, and little capital is available for the start or development of new business ventures or for investment enhancing their productivity; this issue, of course, must be seen together with the maturity structure, discussed below, which has partly coincident causes and similar effects. Can, in other words, any kind of economic growth be internally generated in the absence of financial resources to either open or develop an SME?

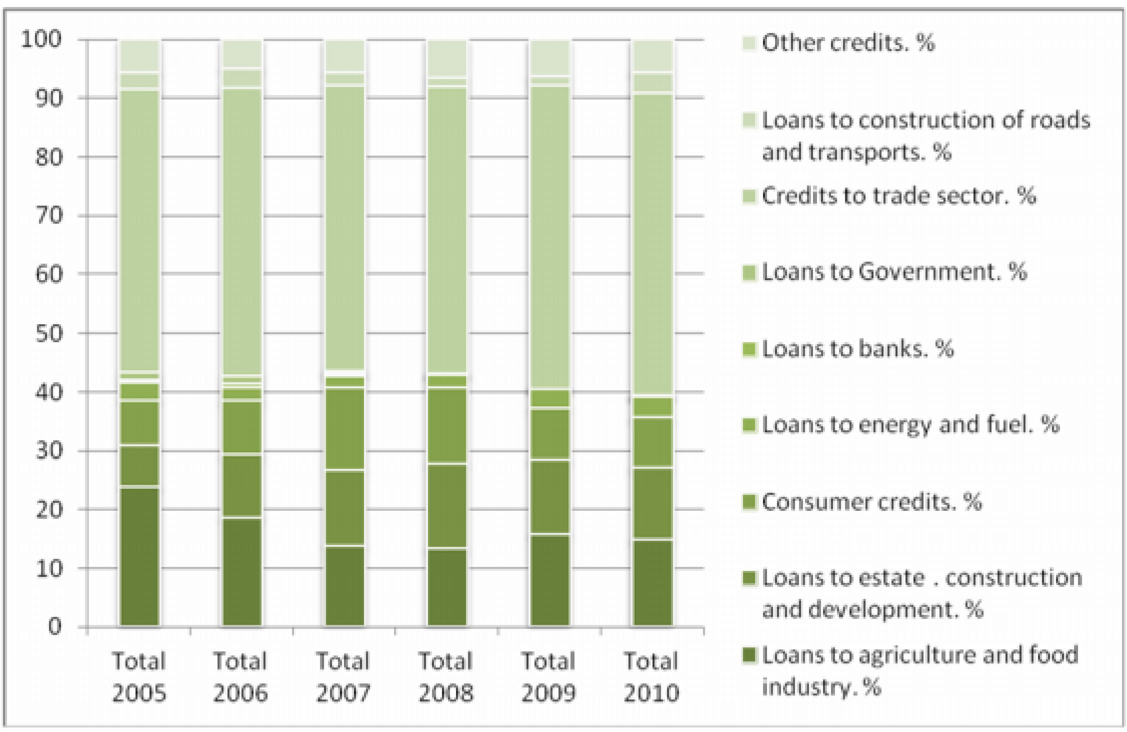

Figure 9. Loans structure

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

Savings Rate. The high volume of transfers from Moldovans who work abroad and 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 appreciation of the Moldovan MDL which in turn has stimulated consumption of imported goods, but has damaged the external competitiveness of local products.

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

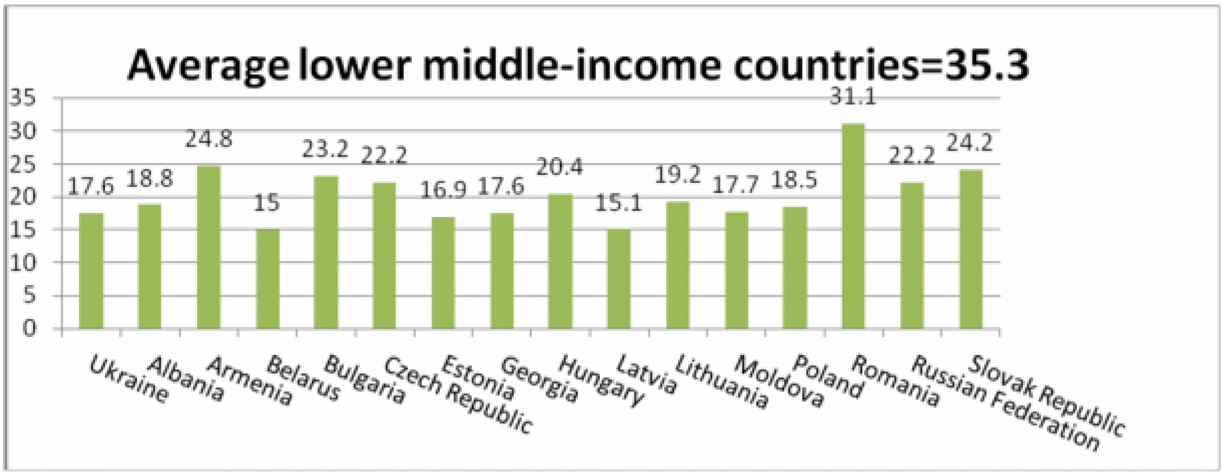

Figure 10. Savings to GDP, % of GDP

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 to 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**. Analysis of the microfinance sector shows that, although it accounts for about 2.0 per cent of GDP, the rate of penetration of microfinance services remains a poor indicator at the 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 the economically active population of Moldova has benefited from microfinance loans, down from 12.1 per cent compared to 2009 and less than 2.6 times the similar indicator for Bosnia and Herzegovina, the microfinance sector of which is representative of Central and Eastern Europe. However, on account of its high interest rates and low coverage, the microfinance sector has marginal relevance; its share in total loans and credits to economy is very small, and empirical data shows that the banking system retains a monopoly on the provision of loan finance: currently, there are no alternative funding sources in Moldova.

The securities market in Moldova has the characteristics of an emerging market: a small number of issuing entities, low liquidity, a lack of public investments, a low number of investors, and reduced integration into international financial markets. The range of financial instruments issued and traded on the 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, with investors taking a cautious approach towards securities market opportunities.

In 2010 the secondary securities market recorded a decline of 10.1 per cent compared to 2009 due to a lower volume of non-stock market transactions.

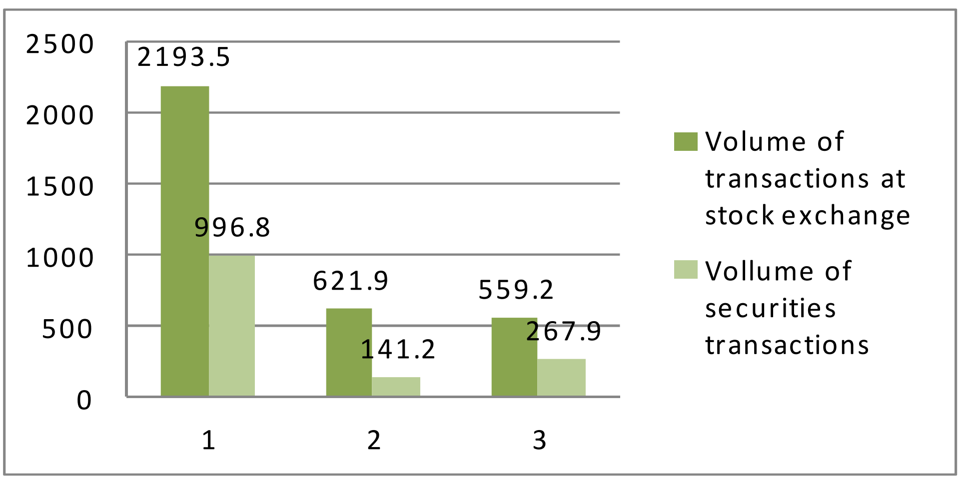

Figure 11. Volume of securities transactions

Source: according to NCFM data

The development of key segments of the nonbank financial sector in Moldova, the capital market, the 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. In this respect, a timely opportunity could be offered by a possible future reform of the pension system, which might prove necessary in the relatively near term for reasons of fiscal sustainability: in this context, the possible creation of new institutional investors (the pension funds, on which any reform is likely to rely upon) could both open a new source of financing for domestic companies and favour Moldova's integration in the international financial markets.

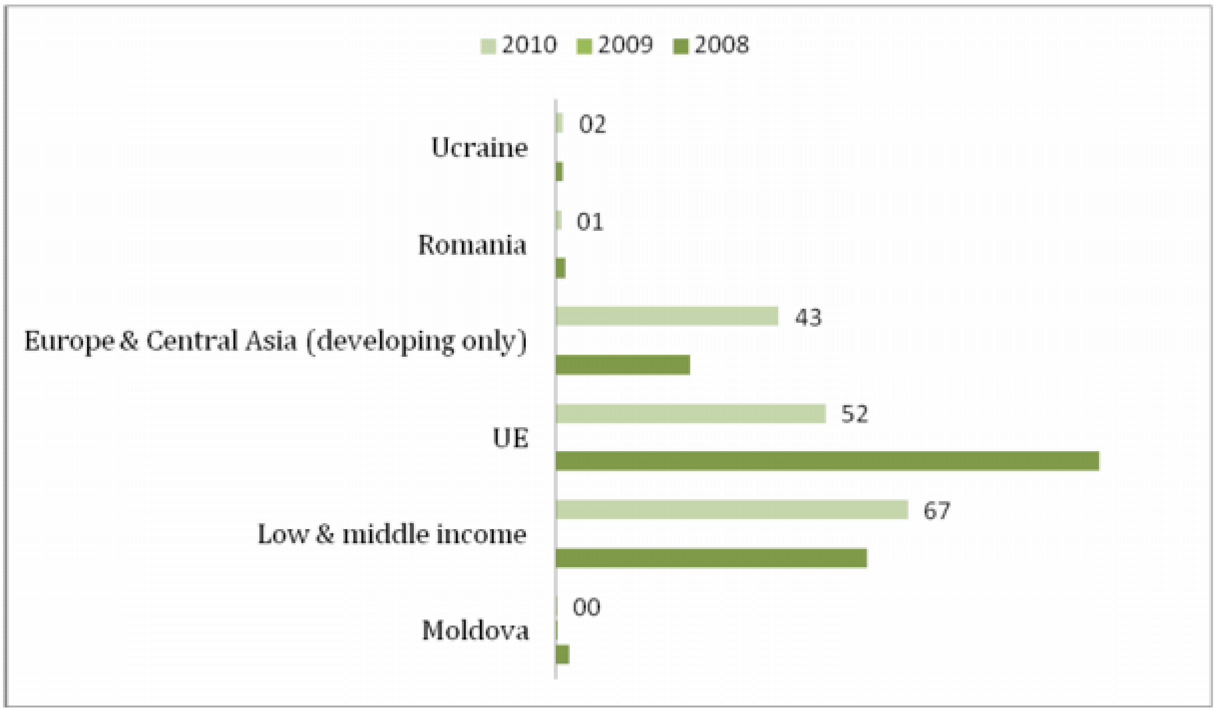

Figure 12. Stock trading volume, per cent of GDP
Source: According to International Financial Statistics database

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 the 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[24], 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 degree of 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[25] 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 delinquent loans[26] and the high level of risk premiums. These last issues, combined with the gaps and deficiencies of state institutions, influence the size of the collateral, which is considered to be an impediment to accessing finance.

There are virtually no alternatives to the banking system. The non-banking sector is largely underdeveloped, providing credits mainly to the rural sector and individuals; the share of loans to GDP does not exceed 1-2 per cent[27]. Purchase of financial resources through capital markets and microfinance sector is not a relevant option at the moment.

[24]NBM Material for GL "Accessible and Non-expensive Finance."
[25]Relatively high concentration of the banking system, oligopolistic market. MET no. 1, www.iefs.md
[26] OECD Report "Competitiveness and Private Sector Development in the Republic of Moldova"
[27] See details in NCFM materials for the WG "Accessible and Non-expensive Finance."

Access to international financial resources

Moldova's net external debt against GDP has tended to decline over the past five years. Both in the public sector and compared with other states, the real sector of the national economy is practically absent from the international financial markets, for which it is assigned a low financial maturity and high interest rates. The country risk rating is high. International financial assessment agencies such as Moody's Investors Services and Fitch IBCA which 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 both within the banking sector and between the banks and other financial intermediaries. 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.
- 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, and the foreign balance and inflation must be decreased. The problem of inflation is widely debated in society, and the actions of the NBM are directed towards its reduction.

The savings rate and risk premium (which we associated with microeconomic risks, as highlighted in the previous policy note) are two other causes of the high costs of financial resources. The stimulation of the savings and deposits rates 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 via a process of credit rationing. It is safer to credit the trade because of lower lending costs and the safety associated with this type of activity.

Another implication is associated with "credit rationing" or the rationing process by financial intermediaries to streamlining 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 access to less risky business. This phenomenon has implications for non-performing loans, but also for the collateral requirements imposed by financial intermediaries.

Measures:

- Achieving and maintaining price stability;
- Stimulating securities transactions;
- Increasing guarantees for deposits;
- Increasing competition in the financial market;
- Developing alternative payment instruments (for example - credit cards).
- Measures to improve the quality of the legal system (on both regulation and enforcement);
- Measures to increase the intensity of competition in the real sector.

Exaggerated collateral r**equirements and** procedures for obtaining a credit. The uncertainty and quality of the business environment result in exaggerated measures being applied by the banks to protect themselves. At the same time, when most of the collateral is land and real estate, 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 bureaus;
- 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 the financial market will be or what the country's macroeconomic results are, 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, and the quality of the legal constraints are key issues that generate access to finance for the 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.