

Chapter V

FINANCIAL FRAMEWORK

Introduction

Though the Republic of Moldova is still in the initial stages of its transition to a market economy, the Government is trying to keep the general direction of development in line with that of other economies in transition. As a part of its ambitious reform efforts, Moldova introduced a stable convertible local currency, liberalized prices, stopped issuing preferential credits to State enterprises, backed steady land privatization, removed export controls and freed interest rates. Yet these efforts could not prevent the housing-sector crisis - house prices are falling and there are few buyers. One of the features of the deep housing crisis is a lack of adequate financial mechanisms.

This chapter covers the following issues: financial principles, housing investment, national and local authority budgets, house construction financing, savings, incomes and purchasing power, financial institutions and mortgage market infrastructure, mortgage products, housing taxes and allowances, and the maintenance and improvement of the existing housing stock (including homeowners' associations). Special emphasis is placed on the development of the financial sector and mortgage infrastructure, as well as on mortgage products that facilitate the operation of the housing market. In addition, the chapter explores changes in housing demand, focusing on housing costs, affordability, housing subsidies and allowances.

Financial principles

The financial framework for any housing sector must promote:

- The economic and efficient use of physical and financial resources;
- Equity between households in similar circumstances and between housing sectors/tenures;
- Transparency.

The experience of other countries in transition indicates that these principles are easier to implement in financial frameworks which favour:

- A stronger general-purpose commercial banking system rather than special, closed circuits for housing capital;
- Continuing revenue subsidies (where they are required) through personal, household and means-tested allowances rather than credit subsidies or supply-side subsidies. Where capital subsidies (including land price subsidies) are used they should seek to lever in private-sector contributions;
- A clear enabling role for the State (including the provision of seed funding for the innovation, development and strengthening of financial institutions) rather than a direct State supply-side role.

In short, the Moldovan housing finance system should seek to:

- Reduce to a minimum the direct intervention of the State;
- Provide sustainable, market-based finance;
- Integrate the housing finance system into national and international capital markets;
- Channel more household savings into housing investment and seek additional extrabudgetary sources to support housing.

A. Housing investment in the macroeconomic context

The dissolution of the Soviet Union had a very negative effect on the Moldovan economy and real GDP declined by 66% between 1989 and 1997. At the same time the Government and the National Bank of Moldova succeeded in achieving a modicum of fragile macroeconomic stabilization, although only very limited progress was made in structural reforms.

Major indicators characterizing the economic situation of Moldova and trends for 1993-2000, as outlined in chapter I (table 2) describe the environment which influenced and defined the main changes in housing investments during this period.

Investment in housing

Although nominal GDP steadily increased from 1993 to 2000 its real value continued to fall and, consequently, housing investment decreased dramatically both in absolute terms and as a percentage of GDP. It fell to almost one fifteenth of what it had been before 1993. In 2000 real GDP grew slightly and investment in 2000 totalled 1,511.1 million lei, with investment in construction reaching 558.1 million lei (37% of total investment). During the same period housing investment as a share in total investment in Moldova also decreased, as was the case in most countries in transition, mainly due to the collapse of public investment in housing (table 16).

Table 16. Housing investment

Year	Housing investment	
	As a percentage of GDP	As a percentage of total investment
1991	2.7	21.2
1992	5.05	34.3
1993	2.75	35.5
1994	5.2	34.9
1995	4.0	30.0
1996	2.6	19.2
1997	0.35	2.6
1998	0.39	..

Source: Department of Statistical and Sociological Analysis.

Investment by type of investor

The overall reduction in the volume of housing sector investment was accompanied by significant changes in its structure (table 17). The economic crisis resulted in a drastic reduction in government subsidies to the construction sector. In 1991, government investment in housing construction was 2,017 million lei, by 1999 it had fallen to 2.8 million lei.

Table 17. Sources of funding for housing construction, 1970-2000 (In per cent)

Source of funding	'70	'75	'80	'85	'90	'91	'92	'93	'94	'95
State and municipal budgets and State companies	65	61	59	53	55	60	54	17	14.1	6.8
Collective farms	4	8	6	6	5	1	7		6.1	0.1
Cooperatives	31	31	35	41	40	39	39	9.2	6.3	5.2
Individual developers								73.8	73.5	87.9
Total	100	100	100	100	100	100	100	100	100	100

Source: Department of Statistical and Sociological Analysis; NAHRES and PADCO Europe Ltd., Construction Industry and Building Materials Study: Final Report (1997).

Similarly, investment by cooperatives dropped sharply from 39% in 1992 to only 5.17% in 1995. In many respects, such a marked reduction in cooperative construction was caused by the phasing-out of concessionary finance to cooperatives, which used to be subsidized by the State.

At the same time, private investment in new housing units in 1995 increased to 87.8% from almost zero in 1992. It is worth mentioning that, because of the extensive privatization of industry, State enterprises have largely become either wholly private or joint-stock companies with mixed ownership, which obviously has had an impact on the distribution of investment in housing construction, i.e. a large share of enterprise investment that was previously considered government funding was classified as private investment in 1996. The sharp increase in private investment can be also explained by the lifting of the ban on the construction of single-family units in large cities.

Under the former system, the State effectively assumed all risks associated with the construction sector. In the new market economy, new mechanisms are needed to facilitate private investment in the sector, such as insurance services and private guarantees.

Housing investments trends

It is worth mentioning that profitable enterprises have adapted a rather cautious policy of profit distribution; almost half of them plough back into production more than 35% of net profit. Table 18 presents the data on the distribution of net profit (after tax) in 1995 and 1996.

Table 18. Use of companies' net earnings (In per cent)

Uses	1995	1996
1. Reserve fund	1.8	1.4
2. Production development	21.2	23.3
3. Social development	34.4	15.8
4. Employee bonuses	20.3	7.8
5. Dividends to outside shareholders	1.0	2.4
6. Charity contributions	2.0	0.9
7. Others (including fines and penalties)	19.3	48.4
Total	100.0	100.0

Source: INMACOM trade association; NAHRES and PADCO Europe Ltd., *Construction Industry...*

The data lead to the conclusion that positive changes have recently occurred in corporation taxation. Thus, in 1995, 44.1% of a company's profits were taken in taxes; in 1996 this figure was only 17%. The surveyed companies clearly capitalized on some tax deductions.

Payments into the production development fund accounted for only 17-20% of companies' internally generated financial resources. Amortization is another important source of financing production and new assets. In 1996, the internally generated financial resources of building materials enterprises (amortization plus a share of profit allocated to production development) allowed a 5-6% renewal of fixed assets, which is not sufficient. A rapid depreciation of fixed industrial assets demands recourse to external sources of funding such as bank loans and equity investments.

Comparison with other economies in transition

Although the crisis in the apartment construction sector is not yet over, some positive changes have been observed over the past two or three years. They can be interpreted as encouraging results of the reform process. Investment is starting to stabilize and, in 1997, for the first time in many years, the total area of habitable apartments increased by 8% as against 1996, giving hope for the future.

The State has almost completely ceased to be involved in housing construction, its share in this activity now varying between 2 and 5%. All investments in housing are now private; banks do not accept land as collateral and will accept an apartment as collateral only after all tenants have been evicted.

B. Financing new housing construction

Significant changes in the structure of sources of housing finance and an overall shortage in volume mean that it is very important to focus on the development of new financial mechanisms which will help meet the demand for various financial services in the restructured housing sector. Financial services for contractors and the development of commercial construction and mortgage finance lending systems should become the central elements of a market-based housing industry. At the moment the Republic of Moldova is still very far from having such a financial system but, nonetheless, the Government has taken some significant initial steps towards creating it.

In the National Housing Concept approved in 1994, the Government adopted the following general principles:

- The Government would no longer be involved in direct housing construction financing;
- It would focus on creating better conditions for the development of the real-estate and housing market in order to stimulate financing of the housing sector, it would continue the privatization of apartments, and use market-economy mechanisms in the construction and the construction materials industry;
- It would abandon the huge general State housing support and move towards strictly targeted housing subsidies for very limited categories of vulnerable people.

As a result, budget resources for residential construction shrank. At the same time, the Government was not successful in creating adequate conditions for attracting significant extra funds to the housing sector, particularly from institutional investors.

The housing market is still not considered to be an attractive capital investment, so there are very few market-oriented financial instruments available for housing construction:

- Housing finance is still predominantly cash payments by individuals – owner-occupiers using their personal savings (table 20).
- There is the equity of new shareholders of privatized former State enterprises. It was very common for completed dwellings to be allocated to employees, frequently free of charge. Rarely was the housing completed for the purpose of future sales.
- Housing cooperatives organized to obtain State-subsidized construction loans to complete already existing buildings.
- Finance for condominium construction is not yet developed and there is no regulation for such loans.

Table 20. New housing construction according to type of developer (Percentage)

Year	Public	Cooperative	Private
1993	23.3	12.2	64.5
1994	21.1	15.3	63.6
1995	12.5	20.7	66.2
1996	7.2	13.4	78.3
1997	7.2	8.2	82.3

Source: Department of Statistical and Sociological Analysis.

In general, free capital resources are not being channelled into the housing sector. As a result, the largest constraint on housing-sector development is currently a shortage of capital.

The fact that the main resources are in the hands of owner-occupiers makes it very difficult to raise the capital needed to increase housing production, especially when average household income is still very low (see below). Increases in individual housing investment have been unable to compensate for reductions from other sources. Consequently a decline in government funding and a lack of working capital in housing construction companies has led to deferred investment in the housing construction industry with the result that much equipment, with an average remaining service life of three to five years, is rapidly ageing. A high proportion of equipment is imported, and much equipment is under-utilized. The leasing of equipment is very unusual.

Leasing is a highly recommended way to finance the acquisition of construction equipment and machinery. The key advantage of leasing is that it enables a construction company to have access to specialized construction equipment when needed on a short-term basis without freezing its capital for the long term. Leasing also offers innovative ways to make small construction firms highly competitive regardless of the size of their fixed working assets. It is highly recommended that the Government encourage the development of construction leasing firms by providing legislative and tax incentives for leasing operators and the users of such services.

Construction loans

Before 1993, it was not uncommon for cooperative housing loans to carry an interest rate of 1 or 2%. Now, with the high cost of construction, inflation and high interest rates, and scarce domestic savings, loans for residential construction have become risky and very expensive. The result is that, in cases where banks are willing to provide such loans, they are well beyond the means of cooperative members.

Often the new institutional developers emerging after privatization do not consider themselves as effective commercial organizations. Many are not willing to borrow for construction and are not interested in more effective financial resources management. On the other hand, many banks do not offer construction loans to legal entities due to the lack of a developed market infrastructure, experience and adequate funding.

A similar situation exists with construction loans to individuals. Most people do not know how to deal with the loan and do not apply to banks because their income is very low. At the same time few banks offer such a product on the market.

Although the official statistics on housing construction and purchasing loans were not available, according to the National Agency for Housing and Real Estate Services (NAHRES), until 1997 commercial bank activities in the sector were very limited, typically involving two- to five-year loans at a 30-40% interest rate. Loans are usually financed in local currency. Currently lenders are very cautious about extending credit for construction projects. Among other reasons they do not yet see sufficient developers capable of meeting lenders' underwriting criteria. The lack of a secure legal framework, economic uncertainty and the lack of experience result in underwriting procedures with typical loan-to-value ratios of 30%-70%. Currently lending is limited to households with an affordability gap of 30-40% and incomes that can meet payments of \$200-250 per month.

At the same time the survey carried out by NAHRES shows (table 20) that many households firmly expect to solve their housing problems by borrowing from banks, employers or friends. There is a clear demand for bank loans as the most popular form of housing finance for individuals after cash payments.

Table 20. Expected forms of payment for housing

City	Number				Per cent			
	Chisinau	Balti	Orhei	Total	Chisinau	Balti	Orhei	Total
Using cash/ savings	217	24	6	247	25.6	30.4	17.6	25.7
Loan from a bank	172	19	8	199	20.3	24.1	23.5	20.7
Loan from employer	49	5	1	55	5.8	6.3	2.9	5.7
Sale of personal household assets	12	3		15	1.4	3.8	0.0	1.6
Sale of land (other housing unit)	22	3	4	29	2.6	3.8	11.8	3.0
Credit from friends	49	4		53	5.8	5.1	0.0	5.5
Combination of the above	98	7	8	113	11.6	8.9	23.5	11.8
Others	66	10	1	77	7.8	12.7	2.9	8.0
N/a	163	4	6	173	19.2	5.1	17.6	18.0
Total	848	79	34	961	100.0	100.0	100.0	100.0

Source: National Agency for Housing and Real Estate Services (NAHRES).

In spite of the current situation, all banks see large potential in construction lending particularly for completion of unfinished buildings in Chisinau.

In general, the economic environment is becoming more conducive to competition in housing construction. Some contracts are now procured through competitive tendering. Housing construction depends more and more on market demand and less and less on State or economic enterprise capacity. The local market has become more open to foreign construction firms as well; construction firms from Romania, Bulgaria and Greece have been involved in local residential construction thus attracting some element of foreign investment.

Land acquisition and development financing

Chapter II discusses the market for housing land. There remain a number of barriers to land purchase and development financing and local experts confirm that the existing legislation still does not meet emerging land market demand, especially as concerns land-use regulations, independent valuation and registration. Land was only recently included in the Government's efforts to gear the economy towards market conditions. For example, land plots underneath residential buildings were previously allocated free of charge to households or homeowners' associations – now a nominal price is charged.

Local experts stress that the first land auctions were quite successful but that later they slowed down owing to the lack of financing available to buy land. There are no banking loan instruments for land purchase or development and land is considered to be unsafe and illiquid collateral by the banks. That is why, for example, in Chisinau land is reserved for housing construction but it cannot be used to this end because there is not enough finance to pay for the land and its infrastructure development.

Infrastructure development financing

Good quality infrastructure plays a vital role in the country's progress and is a precondition for housing-sector development. Currently, this infrastructure is in a critical condition in Moldova because finance is lacking for infrastructure development and modernization. According to the law, every legal enterprise undertaking construction has to pay an infrastructure development tax to the local authority. It

is evident that the present system is very inefficient, and the creation of a market-oriented infrastructure financing mechanism is well behind.

At present the local authorities are responsible for infrastructure development, but in fact they are not pro-active. They prefer to allocate land plots for residential construction free of charge or for nominal prices instead of dealing with the issue of infrastructure development in a commercial way. There are no private institutional developers who can raise the money for building infrastructure for future residential land.

Although responsible for infrastructure development, the local authorities very often devote less than half of one per cent of the local budget to infrastructure development. They have no strong incentives to get involved in this activity and have very limited revenues. In addition, the amount of money obtained by the Government from privatization (table 21) was very limited and was not used to develop a system to attracting extrabudgetary money into the housing sector.

Table 21. Privatization revenue

Year	1993	1994	1995	1996	1997	1998
Thousands of lei	1,090	2,110	6,018	1,153	13,883	15,067

Source: Department for Privatization and State Property Administration of the Ministry of Economy and Reforms.

The Law on the Budget System and Budgetary Process was adopted on 24 May 1996. The budgetary system comprises the State budget, local budgets, the social security budget and extrabudgetary funds. Of these, the combined State budget and the local budgets constitute the consolidated budget. The Law on Administrative and Territorial Reform is currently implemented, with the number of local administrations cut from 38 to 11. Every year a budget law is approved by parliament, setting the relations between budgets of different levels defining how much of overall governmental expenditures is to be transferred to county and local authorities. At the moment local government pilot projects on fiscal, property tax, land reform matters are being implemented by USAID in a few Moldovan cities. The aim of the proposed reform is to make local government autonomous, so that it will take responsibility for the needs of the people and provide them with adequate services. Local government should have some degree of fiscal autonomy and be accountable to local people. Under the current system there are no local taxes to compensate for the absence of subsidies provided previously by the State budget.

Beside the budget reform encouraging their financial independence, the initiatives of the local authorities in looking for and using non-budgeted finance for housing and infrastructure construction should be supported and strengthened. The Law on Public Administration and Law on Local Public Finances allow local authorities to borrow funds from the State budget and the banking system, but only where they can guarantee their repayment and do not already have out-of-schedule loans. Borrowing with a life of under a year should not exceed 5% of the forecast revenues for the year. Long-term borrowing by local authorities is also a possibility for financing capital investments. According to the Law on the Securities Market, local authorities can issue publicly traded securities denominated in local currency and they have the right to sell these securities to legal entities and individuals.

None of these instruments, except for loans from the State budget, has been used to attract funding to the housing sector.

Unfinished construction financing

The decline in the government share of funding left many apartment buildings unfinished. In 1997, there were 170 multi-storey buildings (around 10,000 apartments) with a total area of more than 500,000 m² at an average state of completion of 35%. Capital investment to the tune of 700 million lei, or \$152.1 million, is needed to complete them. There is also a lot of uncompleted individual housing due to difficulties in financing construction based on personal income stream only and a lack of cash-flow management tools.

To facilitate the completion of unfinished units previously financed from the budget or by governmental enterprises, the Government has passed special regulations authorizing the auctioning of unfinished construction projects to private entrepreneurs so that they can finish and sell them (see chap. II, sect. C).

The options for developers to become involved are limited. Sometimes it is better to demolish existing buildings and redevelop sites with a more efficient and economic design. For buildings more than half complete, it is better to execute investment agreements with potential apartment owners (legal entities or individuals). Banks should also provide loans to investors using incomplete constructions as collateral.

In 1998 the Government adopted a resolution adding a new form of housing subsidy for incomplete construction. This allows people on the waiting list and willing to solve their housing problem by personally investing a part of the required capital to receive a share of an uncompleted construction free of charge. After completion of the building, the individual who financed the completion becomes the owner of the unit. During the completion process the individual can sell his/her share according to a set procedure. Two residential buildings have been completed using this mechanism, four others are ready to follow suit.

There are also limited loans provided by the banks and subsidized by the National Bank of Moldova for cooperatives to finish construction (see below).

C. Purchasing power and housing expenditure patterns

Incomes

Wages have been rising even in real terms over the past years but remain extremely low and have not reached even the pre-1998-crisis level (see table 22). The population's disposable income has also increased in nominal terms but the difference between urban and rural areas has become even more pronounced. Income from employment is still low in rural areas. Table 23 shows that the main source of disposable income is still non-salaried activity, especially in rural areas. Social security benefits are the third most important source of income. Estimates of real income ignore the unencumbered equity value of privatized housing stock (table 24).

Table 22. Monthly wages

(Annual averages, year-on-year change in per cent in parentheses)

	1995	1996	1997	1998	1999	2000*
Nominal monthly wage	143.2 (32.1)	187.9 (31.2)	218.5 (16.3)	252.0 (15.3)	303.4 (20.4)	418.6 (Aug) (20.8)
Real monthly wage (Jan 1994=100)	75.8 (1.7)	80.5 (6.2)	83.8 (4.0)	89.7 (7.1)	77.5 (-13.5)	80.8 (est.) (4.3) (est.)

Sources: Moldovan Economic Trends; Economist Intelligence Unit, Country Profile (London, 2000).

* TACIS; Moldovan Economic Trends; Economist Intelligence Unit, Country Profile (London, February 2001).

Table 23. Breakdown of disposable income (In per cent)

	Total		Urban		Rural	
	1998	2000	1998	2000	1998	2000
Disposable income, lei per month per person	114.8	167.7	145.5	203.0	97.3	145.8
Share of disposable income						
From employment	35.8	39.3	59.3	64.3	15.9	17.9
Non-wage	44.0	41.8	11.1	12.1	71.9	67.4
From property	0.6	0.3	1.2	0.6	0.0	0.1
Social security benefits	8.3	9.1	10.3	9.3	6.6	9.1
Remittances	11.4	9.4	18.1	13.7	5.6	5.6

Source: Household Budget Survey, Department of Statistical and Sociological Analysis; *Economic Trends Quarterly Issue: Moldova* (July-September 2000).

Table 24. Value of privatized housing stock

Year	1993	1994	1995	1996	1997	1998
Thousands of lei	12,981	80,480	175,746	300,980	314,661	322,351

Source: Department for Privatization and State Property Administration of the Ministry of Economy and Reforms.

Usually official statistics do not reflect one typical phenomenon of countries in transition; there is a significant black economy, which allows some social groups to increase their income, thus further increasing social polarization. Some local experts estimate that about \$300 million per year enter Moldova from abroad in the form of unaccountable personal income. This factor may be important for the development of the real-estate market.

Savings

Special mechanisms to facilitate personal and other private savings and channel them into the housing sector are not effective. There are no housing-related saving schemes, no securities as instruments to raise money for housing, and no specialized institutions for accumulating housing-related savings. Nevertheless, by 2000 national savings accounted for 22.3% (1999, 22.9%) of GDP, higher, for example, than in Lithuania, but less than in more successful countries (30%).

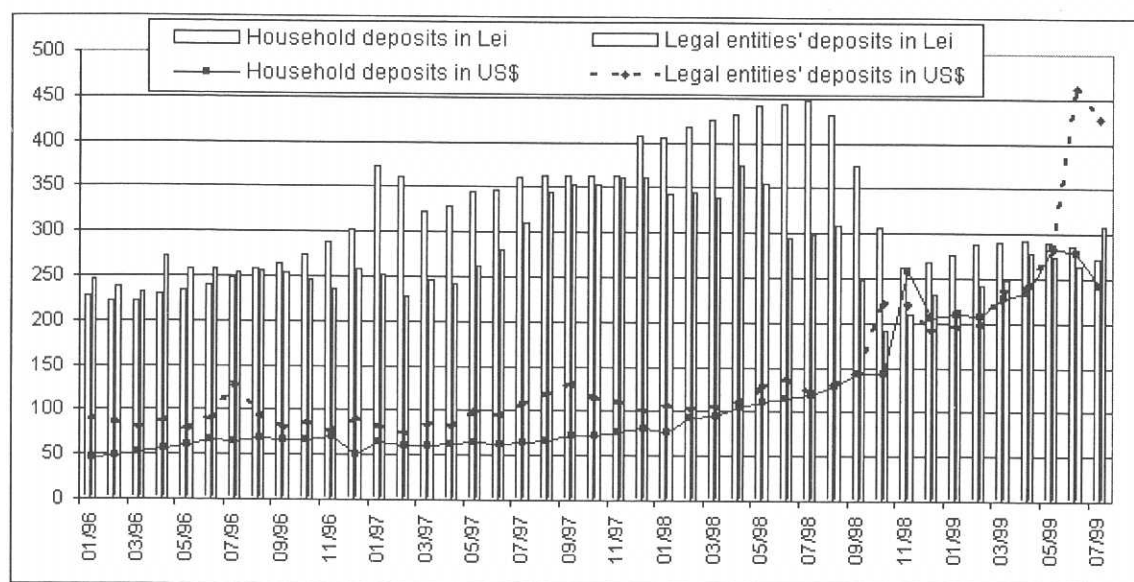
Despite an overall decrease in the savings share of GDP, due to the comparable strengthening of the banking sector, an inflow of private savings into banks proved possible. The volume of deposits in banks has been increasing continuously (the biggest share being of those in lei). During 1996 and 1997 confidence in the banking system grew, and this was reflected in a continuous increase of household deposits with commercial banks. Figure XVII shows deposits with commercial banks (in lei) in 1997-1999 and figure XVIII deposits in foreign currency as a percentage of total deposits in 1994-1999.

A rapid increase in the rate of inflation in the first two years of transition undermined household savings, most of which evaporated through inflation. Since then, however, the Government has made substantial progress in macroeconomic stabilization efforts, bringing the rate of inflation down to 11.2% in 1996 compared to 2,700% in 1992.

Foreign deposits in the commercial banks started growing sharply in the last quarter of 1998, although they had gradually increased throughout the first three quarters of 1998. However, this increase was mainly due to changes in the exchange rate; in dollar terms foreign deposits were relatively stable throughout the first five months of 1999, at \$48 million. A sharp growth, even in dollar terms, was registered in June to \$64.5 million. The volume of foreign deposits, expressed in lei, increased by 68% in July 1999 compared with the beginning of 1999. In dollar terms, the increase was only 27%.

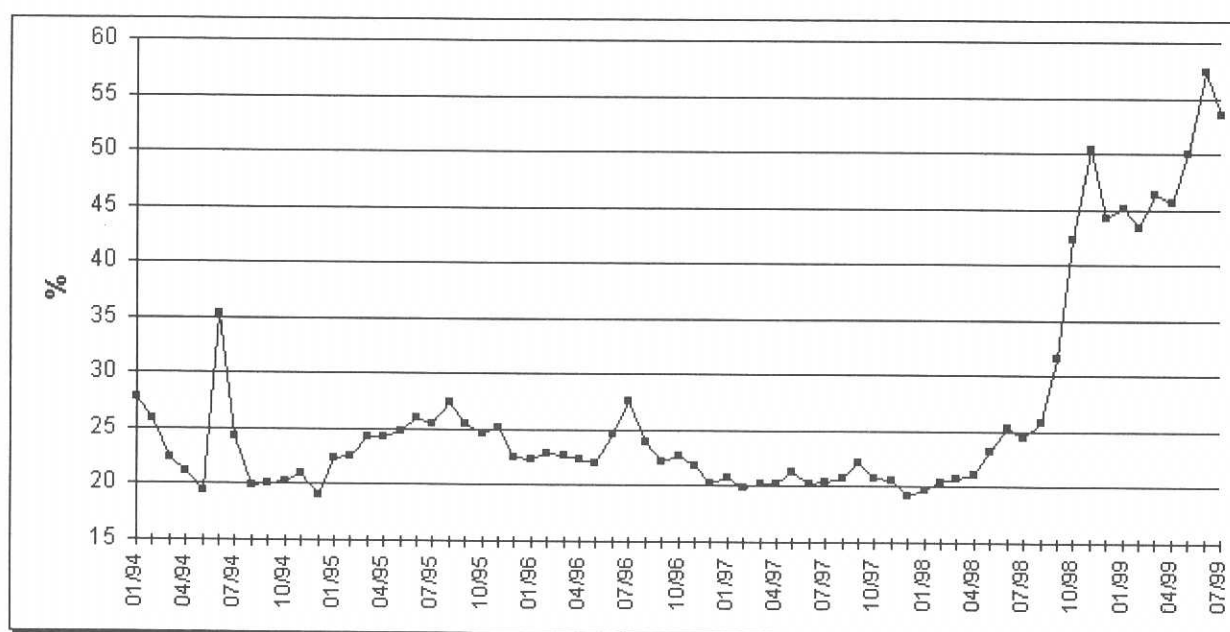
Figure XXI. Deposits with commercial banks, 1997-1999

(In millions of lei)



Source: National Bank of Moldova.

Total household deposits, after dropping in December 1998, followed a persistent upward trend, reaching 564.3 million lei in July 1999. The proportions of foreign deposits held by physical persons increased from 43% in January 1999 to 47% in July 1999. The same trend was observed for deposits held by legal entities, which increased by 32.6% while dollar deposits rose by 122.1%. An unexpected sharp growth in foreign deposits held by legal entities took place in June 1999, when they increased by 63% or by \$16 million compared with May. This growth was due to the \$16 million credit received by Voxtel, the mobile telephone operator, from abroad and put in one of the commercial banks. Thus, the dollarization of legal entities' deposits reached 63.6% in June and 58% in July 1999.

Figure XXII. Deposits in foreign currency as a percentage of total deposits, 1994-1999

Source: National Bank of Moldova.

It is clear that even limited personal and other private savings may be a sound basis for the development of new financial instruments to encourage an increase in the volume of savings in general, and allow available funds to be channelled into the housing sector.

An analysis of statistical data on the housing market for the period 1995 to 1999 shows that:

- Annually only 5% of families needing to improve their housing conditions were able to use their income to buy dwellings requiring more than \$200 per person per month;
- A quarter of families with incomes of between \$75 and 200 per person per month improved their housing by using their own savings and borrowing from relatives, friends and very seldom either from banks or from specialized organizations. Because the interest rate was 30-42% per year with a very short repayment period, the role played by financial organizations in improving housing conditions was minimal;
- Three quarters of families with incomes of \$35 or less per person per month had no hope of improving their housing conditions. They either endured poor housing conditions or rented a dwelling.

An analysis of housing preferences obtained in the Housing Preferences and Affordability Survey (HPAS) shows that while people are very willing to pay for new housing, not many have the money to do so. At present, new housing is affordable by the top 1 or 2% of household incomes. This range might extend to the top 5 to 10%, depending on the extent to which the people who say that they can mobilize equity actually do so, and on the availability of long-term credit. The only significant demand for housing at present is in the secondary market, where, currently, prices are below those for new housing.

The ability of Moldovans to purchase or build new housing has declined. The indicator of access to housing in Chisinau, calculated as a ratio of the price of urban housing to income generated by a family from all sources, is 13.0. This means that a family living in Chisinau will need 13 years to save for an apartment, completely excluding other necessary expenses.

The HPAS shows the extent of the existing housing affordability problem in various ways. The median value of the ratio of housing expenditure to household income in the three surveyed towns, Chisinau, Balti and Orhei, is 0.19, (0.13 at the 25th income percentile and 0.29 at the 75th percentile). Thus it would appear that a quarter of Moldovan families spend more than the Western affordability standard of 30% of income on housing. However, it should be borne in mind that most of this expenditure is on utility bills and very little on maintenance. The ratio deteriorated further in 1997 with the introduction of further increases in utility charges, and this highlights the fact that the primary housing affordability issue in both the Republic of Moldova and other countries in transition is the rapid rise in housing utility expenditures as a proportion of income.

Table 25. Breakdown of household consumption expenditure

	Total		Urban		Rural	
	1998	2000	1998	2000	1998	2000
Consumption expenditure, lei per month per person	123.9	173.1	154.4	205.3	106.6	153.3
Share of disposable income (in per cent)						
Housing rent and utilities	6.5	8.5	10.6	10.9	3.1	6.5
Housing furnishings and equipment	2.0	2.6	2.6	2.1	1.7	3.0

Source: Household Budget Survey, Department of Statistical and Sociological Analysis; *Economic Trends Quarterly Issue: Moldova* (July-September 2000).

An analysis of the population's purchasing power by the structure of overall consumption expenditures shows that the expenditure on housing (11%) occupies second place in total expenditures.

Unlike in most other countries with a more developed housing market, there is no correlation in Moldova between family income and apartment size. There is an affordability mismatch between household income and housing conditions, mainly because of the inertia of the former housing allocation system. However, when analysing the situation of households who have moved recently, there is evidence of a positive link between income and housing consumption, which may reflect the beginning of an allocation of housing by market principles. While families who have moved recently are somewhat

younger and smaller than the wider population, they are, in fact, buying about the same quantity of housing per person, a result of the very limited choice of housing types at present, although the quality may be somewhat better.

At present, families who are unable to maintain their dwellings from their own earnings, rent out surplus living space as explained in chapter I.

In order to assess affordability it is necessary to study the structure of consumption expenditures per dwelling obtained from the household budget survey. The study offers the opportunity to trace tendencies and phenomena and their impact on standards of living. (See chap. I, figs. III and IV.)

From standards of living and affordability, it is possible to define three main population groups by their ability to enter the real-estate market:

- People with high cash incomes (holding circa 50% of total income) that are able to enter the market directly;
- People with average incomes that can enter the real-estate market with long-term and medium-term housing loans given acceptable interest rates;
- People who, due to their low incomes, will never enter the real-estate market.

Specific population groups suffer disproportionate housing problems. For example, the elderly find it hard to maintain their apartments and a minimum level of comfort, which they so need at their age, and there are other disadvantaged groups, for example, young families and people with disabilities, who live in very difficult conditions.

D. Housing subsidies and taxes

Capital subsidies

During the reform process, the Government was not able to use the resources obtained from housing privatization for a system of targeted housing subsidies. So far the subsidy system is very costly, obscure and not very efficient. However, some positive changes have been already introduced. Over the past few years, traditional capital subsidies have almost disappeared.

Most of the remaining capital subsidies are used to finish uncompleted construction. At the moment there are two major schemes.

- Highly subsidized long-term loans provided by the National Bank of Moldova to housing cooperatives to finish the construction of incomplete buildings.
- Subsidies to individuals on the waiting list in the form of dwellings in uncompleted constructions.

Under the first scheme the Government decided to support thousands of families who invested their savings in construction cooperatives and who, because of the changed economic situation, can neither continue the construction work nor get their money back.

The National Bank of Moldova provided designated commercial banks with long-term funding at below-market interest rates. These funds were passed on by commercial banks to housing cooperatives to finish construction. Local authorities acted as guarantors for such loans. During 1992-1998 the loans totalled 100 million lei. All of the buildings have now been completed or are in the final stage of construction.

The other type of capital subsidy takes the form of an unfinished apartment, free of charge, transferred to an applicant on the housing waiting list. Some participation by people with personal finance allows the completion of these dwellings. The mechanism applies only to the houses previously funded from the State budget, local funds or State enterprise funds.

There are only very limited opportunities for people with low incomes to benefit from dwellings built with public funds. For example in 1999, 3.9 million lei (\$325,000) was planned for the construction of 11 houses. Capital investments are mostly directed toward the construction of houses for vulnerable categories of the population and the reconstruction and strengthening of emergency constructions.

Revenue subsidies

The legislative framework for benefits and subsidies comprises more than 100 legislative acts and is not adequate for present needs. Until 1998 the subsidies for electricity, thermal energy and natural gas were based on family income. Although the system operated for more than one year it did not work well. The procedure for estimating household income was too bureaucratic and rigid, and the subsidies too small. Social benefits were not focused on the most vulnerable groups but rather on a wide sector of the population through numerous privileges, subsidies and benefits linked to energy consumption, which led to huge over-consumption. For example, policemen, firemen, teachers, doctors, etc. all benefited from this subsidy system.

The most important reform in this area was the elimination of large numbers of non-targeted privileges and the rationalization of energy subsidies. In 1999 measures were taken to reduce subsidies for heating and energy. More fundamental reform was introduced in 2000, when a new law annulled various privileges, such as public service, energy and transport privileges that cost about 600 million lei annually (about 20% of 1999 budget revenues). Instead of these general privileges, parliament passed a separate law on targeted cash benefits available only to the most vulnerable groups: disabled adults and children, Second World War veterans, pensioners, the victims of Soviet-era political repression and families of victims of the Chernobyl disaster. The aggregate cost of these benefits represents just one fifth of that of the previous privileges and will be available to some 225,000 people (while there are more than 700,000 pensioners living in Moldova). The reform supports the strategy to tackle poverty through targeted social benefits and at the same time reduce the extent of the non-payment culture.

Even so, the social benefit schemes need to be thoroughly reviewed, and future spending should be determined on the basis of explicitly assumed priorities and not be a renewal of appropriations from previous budgets. The State should stop any kind of implicit subsidies to households and enterprises. Such subsidies tend to impede real restructuring. Restructuring prices for utilities and public services will reduce the waste of energy and resources. The remaining subsidies should be made explicit and transparent. At the same time, social benefits should be channelled directly to the poorest in order to offset the negative impact of higher prices.

Designing a social benefit system that is transparent, fully funded, fiscally sustainable, and well targeted will be the focus of the next phase of social security policy development. The modification and establishment of various policy parameters (e.g. minimum wage and subsistence minimum) need to be based on the financial and economic analysis of their link to and impact on social benefit programmes. The lack of a reliable income certification process means that a future social benefit system would need to rely on a combination of targeting mechanisms and would consist of a mixture of national and local programmes.

In its reform of the pension system the Government remains committed to strengthening the link between contributions and benefits, eliminating privileged pensions and tightening eligibility criteria, making the system more transparent, with a clearly specified benefit formula and establishing an individual pension record for everybody.

Taxes

Moldova's taxation system is currently being restructured. Parliament has already approved three sections of the new fiscal code: general provisions, income tax and value-added tax. The remaining three sections, excise tax, tax administration and property tax, are being prepared. In 1998 value-added tax was introduced in Moldova. The rate for construction is 38%. At the moment there is a VAT exemption for the construction of specially selected buildings (those 40% financed from the budget or with charity funds), which finally reduces the level of VAT to 3%.

In general, heavy taxation hinders economic development and drives many economic actors into the black economy. By the end of 2001, bills on local taxes and fees as well as the valuation of real estate property will have been considered by parliament. At the moment property taxes depend on location and on the Bureau of Technical Inventory's valuation (the maximum rate is 0.3%; the minimum is 0.1% for 100 m²; for more than 100 m², the rate doubles; for more than 200 m² the rate increases sixfold). Real-estate sales tax is equal to personal income tax, namely 28%. Capital gains tax is 50% of income tax.

A comprehensive collection enforcement programme and a reporting system by which the State Tax Inspection can monitor the collection of arrears at all levels of the tax administration will be developed with the assistance of USAID. An audit strategy for the State Tax Inspection that includes improved coverage of taxpayers, automation and audit selection techniques, as well as more comprehensive audit methods, will be also designed.

Under the current system municipalities have no incentives to raise more local tax revenue since it results in a reduction of the money transferred from the central budget. The strict limitation of tax exemptions, unifying tax rates across various tax categories and the elimination of sectoral differences in tax treatment are needed. More transparency should be introduced into the tax system, which is currently too complicated and provides opportunities for serious misconduct. A sound, clear, uniform and predictable taxation system for the construction industry is another prerequisite for a successful construction sector.

E. Mortgage-lending system

The core element of any developed housing finance system is residential mortgage lending. The national strategy for such a system in Moldova has not been put into practice. There are still only the odd case of residential lending and some examples of the use of instalment payment instruments. The main reasons for the failure to develop a mortgage system were low effective demand and high interest rates. In addition there are still numerous infrastructure drawbacks to the development of mortgage lending, including: the absence of a mortgage law, inadequate collateral procedures, inadequate remedies available to lenders in cases of default, and the difficulties experienced by banks in matching longer-term assets with short-term liabilities. The institutional and legal barriers to mortgage lending are dealt with in chapters III and IV, respectively.

The first apartment building financed through a mortgage arrangement was completed in December 1999. Individuals make an initial payment of 45% of the planned cost of housing to the Chisinau Municipal Mortgage Agency (Amic S.A.), while the remaining 55% is paid on a pro rata basis for a period of up to ten years. The interest rate for the unpaid amount is 8%. The second apartment building financed through this novel arrangement was completed in April 2000. The mechanism is being further developed, for example, by taking property as an initial deposit, and opening special savings accounts. In two years, more than 1000 people have registered for this scheme.

The banks will be interested in the larger housing-finance sector if longer-term funds become available and legal changes are made in the form of a mortgage law, improved procedures for foreclosure, etc. It means that the Government should focus on developing an adequate infrastructure for

residential mortgage lending. Although some significant achievements have been already made in Moldova's financial sector, more reforms and strengthening are still required.

Banking system

The domestic banking system was created in the early 1990s as a two-level system: the National Bank of Moldova (NBM) and the commercial banks. The National Bank of Moldova was established in 1991, and modelled on the Central Bank of Romania. It is an autonomous legal entity, answerable only to the country's parliament. The Bank's functions are as follows:

- To establish monetary and foreign exchange policy, as guided by the Bank's own economic analysis;
- To act as banker and fiscal agent to the Republic of Moldova;
- To license, supervise and regulate the activity of financial institutions. Banking supervision is completely in line with Basle Committee standards;
- To act as banker to the banks, providing them with credit facilities;
- To supervise and facilitate the payments system;
- To be the sole issuer of currency;
- To hold and manage foreign-exchange reserves;
- To settle the country's balance of payments.

The NBM supervises the commercial banks and acts independently of the Government. The banks' regulatory system was developed with technical assistance from the International Monetary Fund (IMF) and USAID. Its main norms are in line with, or – as far as capital adequacy and loan provisions are concerned – even stricter than Basle prudential norms. The combined capital of all the commercial banks in Moldova amounted to about \$104 million at the end of 2000.

The largest members of the banking system are the four former State banks, privatized in 1994-95, which account for about 54% of total banking assets. All four belong to the group of banks with assets of over 100 million lei (about \$8 million.) Except for Agroindbank, the largest bank in Moldova, which is in a relatively stable financial position, banks in this group were facing problems even before the Russian crisis.

There are also four or five private banks, established in 1993-94, which have become significant members of the banking sector and have foreign investors among their shareholders. This group is likely to lead the future growth of Moldova's banking sector.

In July 1998 the National Bank of Moldova stopped setting the refinance rate for credit to commercial banks, making the interest rate subject to supply and demand in the credit market and hence the Bank no longer controls money supply and monetary aggregates.

The World Bank considers the consolidation of the banking sector in a smaller number of stronger banks and the presence of foreign banks that will increase competition and provide a beneficial influence on banking markets to be steps in the right direction. However, the current situation in Moldova's banking market would suggest the opposite. Today the banks are holding \$70 million, which are not being used effectively. That is why the majority of commercial banks do not find it profitable to increase their own capital. Moreover, small and medium-sized banks tend to be more aggressive, more lenient on qualifications, much friendlier and more personalized in the service they offer. The competition that they face forces them to be more flexible.

Banking opportunities are scarce, which prompts most banks to avoid specialization. Corporate banking is the main source of revenues, whereas retail banking plays primarily a funding role. The involvement of banks in financial services such as capital markets, leasing, factoring, or insurance is low. Weak IT systems hinder the development of the range and the quality of services available. The top-tier private banks have been able to gain some advantage over the ex-State banks in this area.

Moldova's commercial banks are still not used as much as they could be. As in other countries in transition, tax evasion and a lack of trust in the banking system are partly to blame. Loan risk in Moldova, exacerbated by the continued poor financial situation of many enterprises and a still vague legal framework, for example for bankruptcy, adds a significant premium to lending rates charged by commercial banks.

The outlook for personal banking looks more promising, although many potential investors continue to mistrust Moldova's banking institutions. Because of the financial crisis starting August 1998, people began converting their lei deposits into hard currency ones and some withdrew all their funds from the banking system.

In general, the Republic of Moldova's banking sector is very stable. However, most of the leading banks face similar problems:

- A continuous struggle with insufficient capitalization;
- Overdue credit;
- Rules and regulations that limit competition;
- A lack of adequate strategic plans;
- A lack of experience in credit-risk evaluation;
- Poor management;
- A lack of cheap credit resources.

At present, nearly all licensed banks in the Republic of Moldova are involved in some form of housing finance activity, including housing loans typically for two to five years at interest rates of 20-40%, and construction and building materials loans. Such activities constitute only a very small proportion of their lending portfolios. According to the National Agency for Housing and Real Estate Services (NAHRES), up to 1997 commercial bank activity in the housing sector was very limited, usually involving two- to five-year loans at rates of 30-40%.

There are no training programmes for residential mortgage lending based on mortgage industry standards and commercial banks involved in some housing lending neither have nor use approved underwriting standards.

It should be stressed that there is the problem of the availability and cost of credit, partly resulting from insufficient development and limited competition in the commercial banking sector. This continues to keep the real cost of credit high. Generally speaking, the low share of long-term loans in bank portfolios is a typical problem in economies in transition.

Other elements of the financial system

Non-bank financial institutions remain underdeveloped. The **government securities market** suffered significantly due to the Russian crisis, as commercial banks switched funds from treasury bills to foreign currency. Demand for treasury bills fell short of supply throughout 1999 with the exception of one-week to one-month paper. The volume traded on the stock exchange during 1999 was roughly one third of that in 1998.

The **Moldova Stock Exchange** (MSE) was established in December 1994 as an electronic, screen-base, order-driven system. The MSE is one of the youngest in Eastern Europe and is largely undeveloped with most trades involving swaps of shares issued during privatization. Nevertheless, through USAID support, the MSE has a modern technological infrastructure and enjoys favourable legislation. The legislative framework broadly complies with international standards for investor protection, information transparency and fair competition among professional securities market

participants. The shares of more than 1000 privatized enterprises and commercial banks, including 840 registered joint-stock companies, are registered at the MSE.

The **insurance industry** is at a very early stage of its development in terms of the range and quality of its products, its legal framework and its size. In June 1999 the Law on Insurance was changed to allow 100% foreign-owned companies to sell insurance in Moldova (previously restricted to companies with no more than 49% foreign ownership). Despite the increased importance of insurance services in the new market economy, the sector remains small and fragmented.

Not much has been done in developing the mortgage insurance system including obligatory real estate and title insurance.

F. Financing maintenance and reconstruction

Chapter II analysed the condition of Moldova's housing stock, a considerable part of which is seriously dilapidated. This is largely owing to the lack of adequate maintenance and renovation finance, bearing in mind the low income of the majority of the population. The difficult financial situation of most households is the main cause of the deterioration of the housing stock. The maintenance and renovation of existing housing stock, including the introduction of energy-conservation measures, is needed. There is also a need to look further ahead to the more comprehensive reconstruction and modernization of apartment housing, as was recommended by the Programme for Maintenance, Renovation and Energy Conservation in the Housing Market Report prepared by NAHRES.

Unfortunately, none of recommended steps for improving the maintenance system has been fulfilled up till now. The failure during the transition to create the necessary conditions for the financial support of housing maintenance and reconstruction had a significant negative impact. The existing housing maintenance and reconstruction finance system was not changed and is still based on State-regulated tariffs (fixed in the end by the local authorities), which do not reflect the real cost of the necessary maintenance and reconstruction improvements. It is evident that housing maintenance is significantly underfunded. Experts estimate that it would cost 1.04 lei/m² to ensure a normal quality of maintenance. The standard tariff is only 0.19 lei.

At the same time no specific financial instruments for housing maintenance and reconstruction have been developed. The banking system was neither able nor willing to offer any financial means or instruments to finance housing maintenance or reconstruction. No specific regulation has been developed to allow the banks to finance new homeowners' associations (PHOAs) or other private companies.

The lack of maintenance and renovation of the housing stock is perhaps the most serious weakness facing the housing market today. The reasons are complex, involving problems of institutional responsibility for the upkeep of apartment buildings, the financial problems of municipal maintenance companies and local governments and a lack of resources on the part of residents. The problem will get worse as buildings continue to depreciate.

The housing maintenance and servicing system should receive sufficient fees to cover the cost of its services. On the other hand, it should ensure that the money meant for maintenance is used to that end, and its income and expenses should be transparent.

Housing stock maintenance and servicing can be an attractive proposition with an adequate tariff policy and the reorganization and privatization of maintenance companies. However, it is necessary to develop special instruments for housing maintenance and reconstruction finance, including the creation of special reserve funds for future repairs, commercial home-improvement equity loans and targeted home-improvement and repair subsidies.

Without an integrated and consistent reform of relations within the sector, both administrative and economic, the efficiency of funds spent on upgrading will be insignificant and the sector will fail to attract more investments. Unlike the previous situation (three to four years ago), most people (owners of dwellings, residents) are now more aware of the need for large-scale changes. In many cases people are taking the initiative by associating and finding highly effective solutions for dwelling maintenance, the metering of water and energy consumption, etc. There are private maintenance companies interested in maintenance or refurbishment services. However, their services are non-complex and fragmented.

A major problem for heating, water and natural-gas supply systems is the absence of any integral record of production and consumption. This fact encourages defalcation, one of the causes of the exaggerated service costs. The general state of the economy and the delay in institutional reforms in the dwelling sector only exacerbate the situation. The high cost of services together with the mentality of most people who are used to paying only symbolic prices for services have generated huge consumer debts.