

Real Economy is a quarterly economic review, tracking the most important economic evolutions and policy developments. Its readers are economic journalists, policy-makers, representatives of local and foreign companies and commercial banks, as well as international institutions, embassies and political parties.

Acronyms and abbreviations used:

y-o-y - year on year; q-o-q - quarter on quarter; m-o-m - month on month; e-l-y - versus end of last year, e-o-p - end of period; Q1:18 - first quarter 2018; Jan:18 - January 2018; NBS - National Bureau of Statistics; NEA - National Employment Agency; NBM - National Bank of Moldova; MDL - Moldovan leu (national currency); FDI - foreign direct investments; p.p. - percentage points.

EXPERT-GRUP is an independent think-tank specialized in economic and public policy research. We are positioning ourselves as a politically and ideologically neutral think-tank, and we do not represent any economic, corporate or political interests. The mission of the organization is to promote the public interest and to develop efficient and innovative solutions for the development of the Republic of Moldova. In order to fulfill this noble wish, Expert-Grup provides the necessary creative and institutional environment, encouraging expression of free and non-trivial thinking, which makes us a leading source of unbiased economic analysis.

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Early Warning Index (EWI)

The EWI is formed by aggregating six macroeconomic indicators: exports, transfers to individuals, new loans, weight of allowances for loan losses, money in circulation (M0), and bank margin. The indicators were selected depending on their relevance for the economic trends. For more details about the calculation methodology see the website of EXPERT-GRUP.

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Financed by the Government
of Sweden



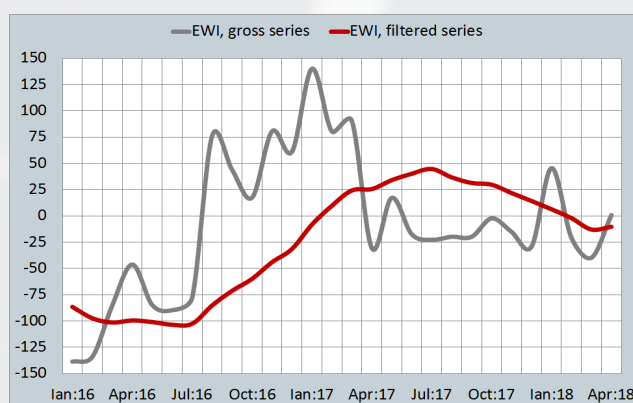
Evolution of the Early Warning Index (EWI)

Despite the positive economic dynamics, the trends that could endanger the economic growth are getting stronger. The Early

Warning Index (EWI), calculated quarterly by Expert-Grup, posted a downward trend and remained below 0 in Apr:18. This reveals preconditions for a slower economic growth in the near future, which corroborated the Expert-Grup forecast of economic growth. While we expect a GDP growth of 3.8% (pessimistic scenario) or 5.6% (optimistic scenario) for 2018, the growth rates

will slowdown in the second half of the year. The EWI components that pulled the indicator down were the remittances and exports expressed in MDL and adjusted for inflation. The negative change in remittances and exports is determined by the strengthened position of MDL on the foreign exchange market.

Early Warning Index, gross and filtered series (12-month moving average)



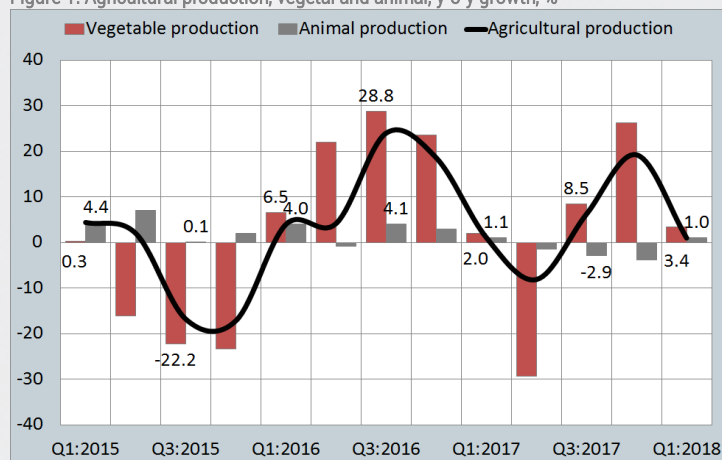
Source: NBM, NBS, EG calculations

The economic dynamics is supported by public investments, while the MDL appreciation limits the growth prospects. Namely, as a result of the strengthening of MDL, the purchasing power of remittances declined. In Jan-Apr:18 the real value of money transfers decreased by 5.6% y-o-y. At the same time, the strengthening of MDL had a negative impact on the exporters' revenues. Thus, in Feb-Apr:18 the real value of exports decreased by -1.4% y-o-y.

The main factors that risk to undermine the economic growth until the end of the year can be grouped into three categories: (i) structural; (ii) electoral; and (iii) weather-related. The structural factors are related to competitiveness shortfalls, manifested by increasing trade deficit (especially in the context of national currency appreciation), low productivity and growth at a rate below real wage growth. The electoral factors are related to the reluctance of private companies to invest, which results in stagnation of private investment and decreasing stock of bank loans. In addition, a series of initiatives with electoral flavor have been already launched (e.g. 'Good Roads for Moldova' program or 'Chisinau Arena' complex), but which lack clear budget coverage and risk to affect the public finance stability. These risks are fueled by the proximity of the Parliamentary elections, scheduled for this autumn, when the public policies could be anchored predominantly in electoral interests to the detriment of reforms that target at sustainable economic growth (even if such electoral actions can have beneficial economic effects in the short run, after the elections they need to be offset against medium- and long-term economic growth). An example is the increasing budget deficit, which could reach 3% of GDP in 2018, which will have to be offset in the coming years. The third set of constraints for economic growth is related to the weather conditions of this year. In particular, the insufficient rainfall could damage a number of agricultural crops, which could impact negatively the income of both farmers and the agricultural processing industry, with low-income rural households and small farmers being affected the most.

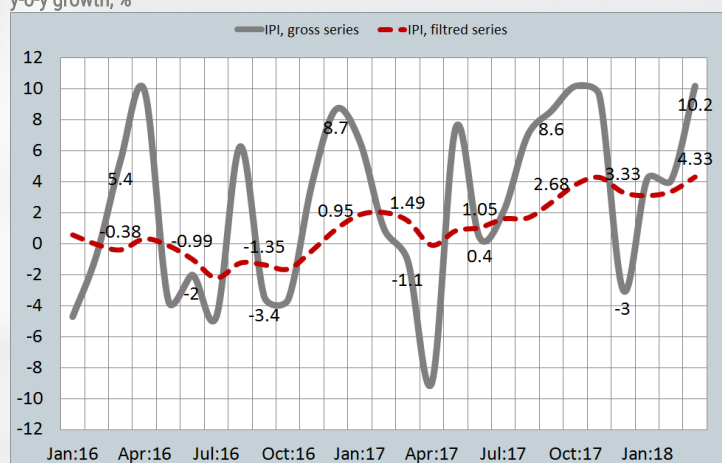
MAIN ECONOMIC TRENDS IN Q1-Q2:18

Figure 1. Agricultural production, vegetal and animal, y-o-y growth, %



Source: NBS, EG calculations

Figure 2. Industrial Production Index (IPI), gross and filtered series (12-month moving average), y-o-y growth, %



Source: NBS, EG calculations

Figure 3. Domestic trade turnover in Q1:18, y-o-y growth, %



Source: NBS, EG calculations

AGRICULTURE

After a spectacular growth in Q4:17, in Q1:18 the agricultural production posted a moderate dynamics. Usually, in the first quarter of the year the agricultural production consists of animal products only. In Q1:18 the livestock sector grew at a slow pace, being fueled by higher meat and milk production. However, the egg production decreased. The vegetable production also grew slowly in Q1:18. The insufficient rainfall poses risks for 2018.

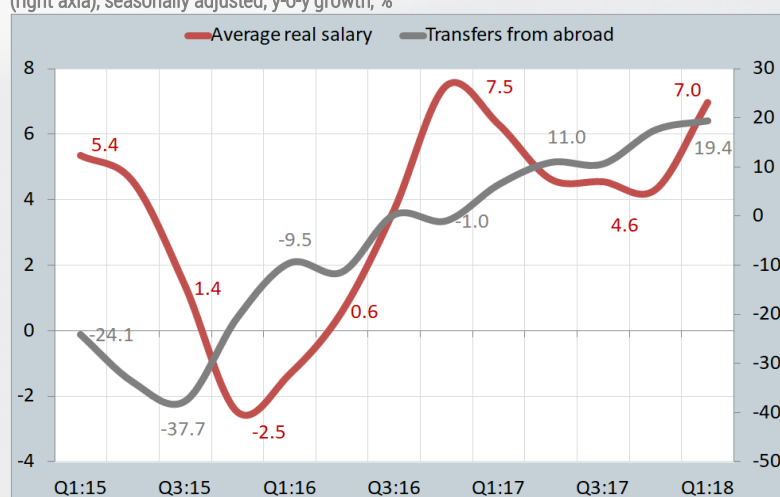
INDUSTRY

In the industrial sector, the positive trends are strengthening. From May:17 to Mar:18, except for Dec:17, the industry witnessed positive growth rates. This dynamics was favored by the rise in the manufacturing industry. In Q1:18 the processing industry grew by 6.4% y-o-y. The energy sector is anemic and grew by less than one percent in Q1:18. The mining industry continues to shrink, although the negative trend slowed down.

DOMESTIC TRADE IN GOODS AND SERVICES

Except for wholesale, all domestic trade components have an upward trend. In Q1:18, the largest increases in turnover were registered for retail trade and services provided to the population. Two worrying signs are spotted: the volume of services provided to enterprises increased more slowly and the wholesale trade declined during the same period. It points on high uncertainty in the Moldovan economy and in the private sector in particular.

Figure 4. Average real salary (left axis) and transfers from abroad in favour of physical persons (right axis), seasonally adjusted, y-o-y growth, %

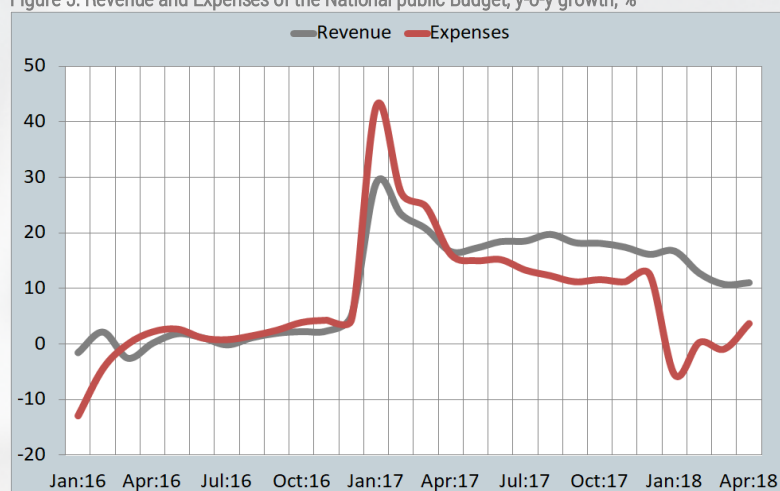


Source: NBS, NBM, EG calculations

INCOME AND EXPENSES OF THE POPULATION

Households' incomes are on a pronounced upward trend and display growth rates. In Q1:18 the average monthly real salary increased its growth rates thanks to higher economic growth and lower inflation rate. Remittances show impressive growth rates, due to the low basis of comparison of the previous period. However, the appreciation of the national currency in 2018 eroded the purchasing power of remittance beneficiaries.

Figure 5. Revenue and Expenses of the National public Budget, y-o-y growth, %

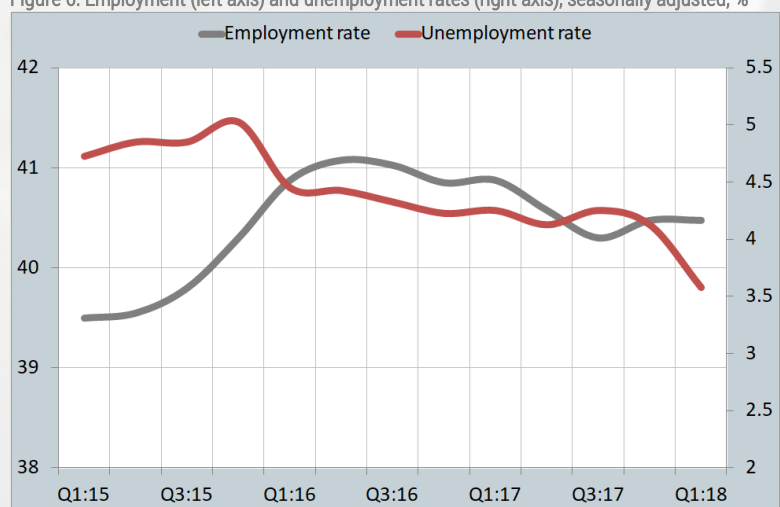


Source: Ministry of Finance

PUBLIC FINANCE

The pace of budget revenue accumulation and expense execution slowed down significantly in the early 2018. The budget revenue growth rates halved in the first four months of this year y-o-y, including due to higher basis of comparison. Also, the effect of comparison basis largely explains the sharp fall in growth rates of budget expenses, while another explanation could be related to the uncertainty of EU external assistance.

Figure 6. Employment (left axis) and unemployment rates (right axis), seasonally adjusted, %

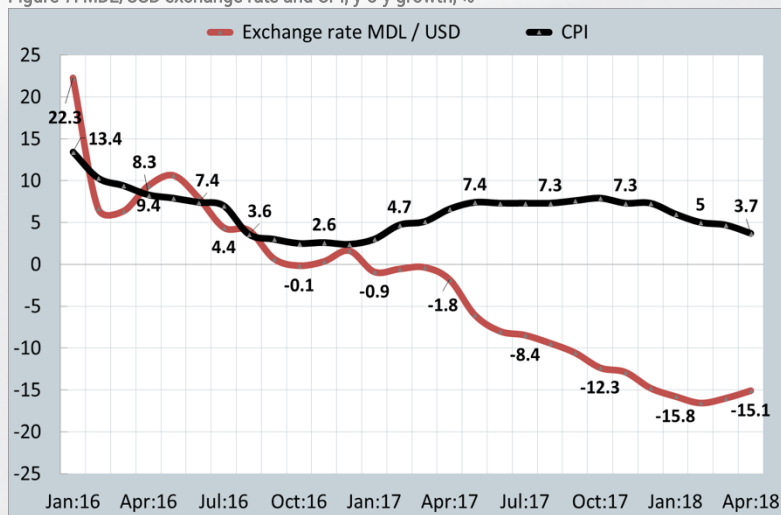


Source: NBS, EG calculations

LABOUR MARKET

The labour market is characterized by a return to a lower level of economic activity of the population. In Q1:18, the employment and unemployment rates were lower compared to previous year's figures. The unemployment decreased thanks to the economic growth. Re-launching of the emigration process is an important factor that contributed to diminishing of both unemployment and employment levels.

Figure 7. MDL/USD exchange rate and CPI, y-o-y growth, %

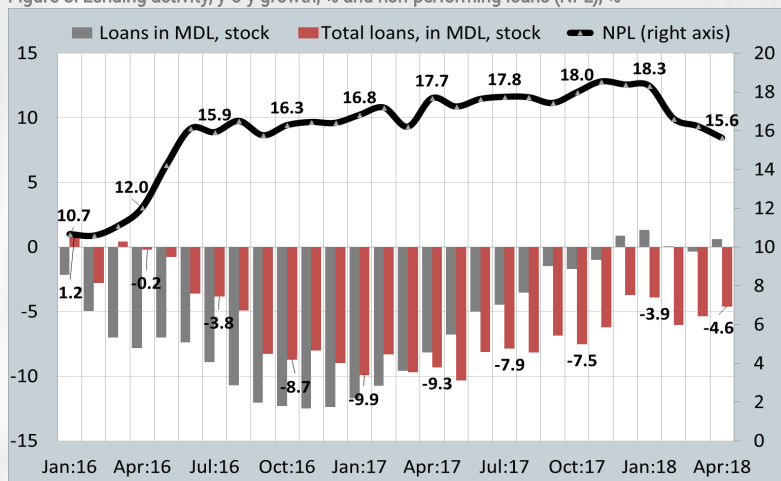


Source: NBM, NBS, EG calculations

PRICES AND MONETARY POLICY

If 2017 was marked by more intense inflationary dynamics, the price growth rate slowed down in the first months of 2018. This allowed NBM to decrease the base rate to 6.5%, with some beneficial effects on lending. The national currency continues to appreciate, with the average MDL/USD exchange rate reaching in Apr:18 the lowest level over the past three years. At the same time, NBM is intervening constantly on the foreign exchange market as a buyer of foreign currency.

Figure 8. Lending activity, y-o-y growth, % and non-performing loans (NPL), %

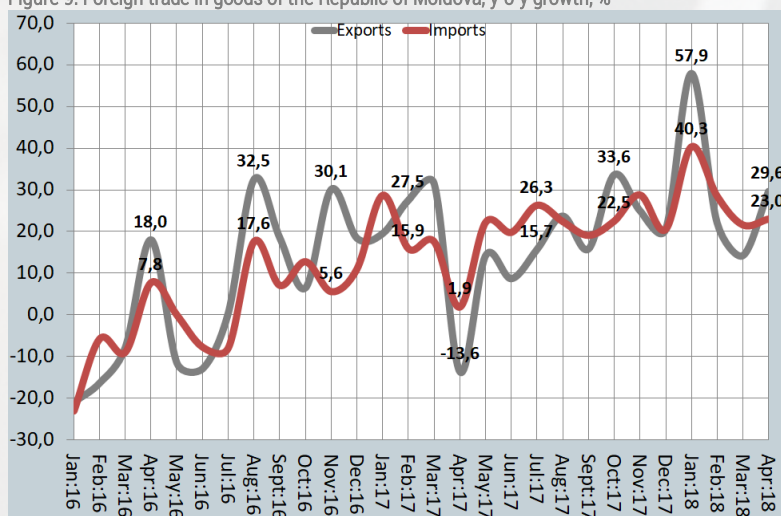


Source: NBM, EG calculations

BANKING SYSTEM

Lending activity became slightly more dynamic, but still insufficient to improve the banks' intermediation function. Even if the volume of new loans is increasing, the outstanding loans are repaid at a much faster pace, which leads to a lower loan stock. At the same time, the quality of bank assets tends to improve, emphasizing the measures taken by banks in order to diminish the portfolios of non-performing loans.

Figure 9. Foreign trade in goods of the Republic of Moldova, y-o-y growth, %

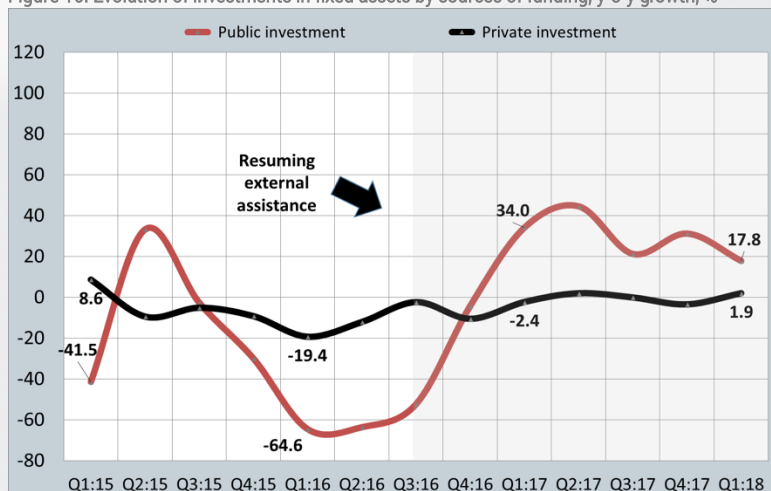


Source: NBS

FOREIGN TRADE

The foreign trade expansion can be explained by the low basis of comparison and the more dynamic trade with the EU, which reveals a better use of the DCFTA. Another important factor is the partial resumption of exports to Russia as a result of the selective abolition of trade restrictions on imports. At the same time, from a structural point of view, exports reveal competitiveness shortcomings, which have led to an excessive concentration on low value-added products.

Figure 10. Evolution of investments in fixed assets by sources of funding, y-o-y growth, %



Source: NBS, EG calculations

INVESTMENT ACTIVITY

Investment dynamics is further supported by the increasing public investment. Unblocking the external assistance and resuming the funding for infrastructure projects started by the Government, contributes significantly to a higher investment activity. On the other hand, private investors remain reluctant to the economic environment due to the upcoming elections, as well as limited access to bank credits.

Figure 11. EU and Russia, y-o-y economic growth, %

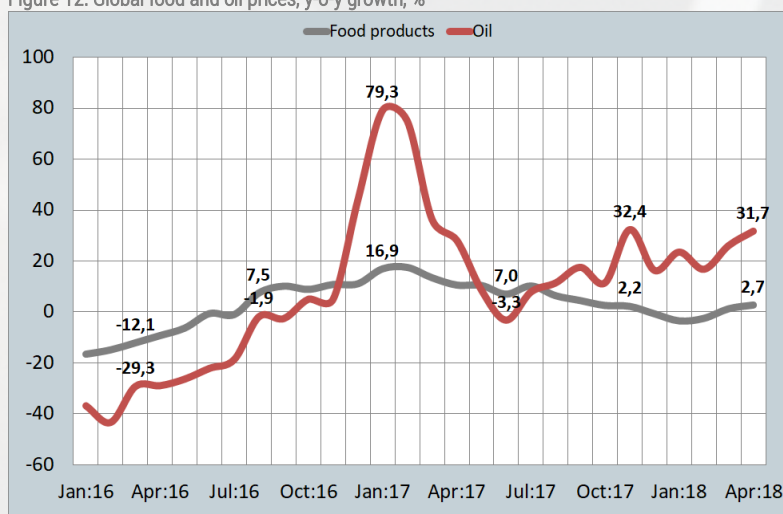


Source: EUROSTAT, Federal State Statistics Service of Russia

EXTERNAL ENVIRONMENT

The external economic environment is relatively favorable. Supported by a certain degree of macroeconomic stability and monetary easing, the Russian economy continued its recovery, largely thanks to the non-tradable goods sector. At the same time, the European economy continues to expand in the context of increasing world trade and higher domestic demand driven by improved consumer confidence and labour markets.

Figure 12. Global food and oil prices, y-o-y growth, %



Source: FAO, IMF

GLOBAL MARKETS

The oil price continues to rise against the background of decreasing stocks, but also in the context of the agreement between Saudi Arabia and Russia to maintain the production limits set back in 2017. Prices for cereals and dairy products increased slightly due to unfavorable weather conditions and higher demand. On the other hand, prices for sugar and vegetable oils decreased due to the large quantities available for export.

Key policy developments in Q1-Q2:18

POLICY DEVELOPMENTS	EXPERT-GRUP COMMENT
27 February. The Democratic Party of Moldova announced the launching and the political support for 'Good Roads for Moldova' program. This program involves financing the construction and repair of 1200 km of roads in the country's localities.	The legal framework approved by the Government on financing the 'Good Roads for Moldova' program has neither proper justification nor clear financial coverage. This program is planned to be partially funded from the Road Fund (about 51% of the total Fund volume). Sources to fund the remaining part of the program were not indicated, stating that investments will be made 'when the necessary financial resources are accumulated'. Thus, at least MDL 366 million of the program budget are not covered. In order to ensure the necessary financial coverage, a budget amendment was made on 10.05.2018. Despite this amendment, 'Good Roads for Moldova' program has not been yet discussed with the local authorities.¹ Thus, the program of building and repairing local roads has rather an electoral flavour.
5 - 6 March. The Ministry of Economy and Infrastructure (MoEI) held the first round of negotiations for drafting and signing of the Free Trade Agreement between the Republic of Moldova and the People's Republic of China.	According to MoEI, this agreement will strengthen the trade and economic relations between both countries, will facilitate the access of Moldovan products to the Chinese market, and will also attract investments in the country's main economic sectors. Moreover, according to MoEI estimates, Moldova's exports to China could increase by 39.85% and the Gross Domestic Product could increase by 0.42% (without indicating the timeframe for these effects). Note that this initiative is taking place in a context where, in 2017, our country's imports from China were 27 times higher than the exports to this destination (USD 505 million vs. USD 19 million), and the trade balance with this country has been worsening continuously over the last few years. Moreover, the usefulness of this Agreement is unclear, as China's tariff policy is already liberalized for many products exported by the Republic of Moldova (e.g. the customs duty on fruit is around 10% and for wine about 14%). Therefore, the Agreement benefits will be rather insignificant for Moldovan exporters. Thus, the optimistic scenarios presented by the MoEI and the forecasts of higher exports and economic growth are not supported by empirical calculations (at least the ones made public), and the negotiation of the agreement is rather faulty. In this context, the major challenge for the authorities stems from the ambiguous economic justification of the need for this agreement and the objective quantification of its impact on the

¹ <https://www.expert-grup.org/ro/comentarii/item/1590-comentariu-la-ini%C8%9Biativa-guvernului-privind-drumurile-locale&category=5>

POLICY DEVELOPMENTS	EXPERT-GRUP COMMENT
21 March. During a press conference, Minister of Finance, Octavian Armasu, announced the launch of 'Prima Casa' ('First Home') State Program. Starting with this date eligible persons can apply for funding to banks that have signed collaboration agreements with the Ministry of Finance and ODIMM. The program aims to offer young people access to mortgages and envisages a state guarantee of 50% of the loan balance. 15 May. The ruling party announced the extension of 'Prima Casa' program with 'Prima Casa - 2' subprogram for public officials. It stipulates that the Government will compensate 50% of the loan payments to attract as many young people as possible to public/budgetary positions.	national economy, while ensuring the transparency of the negotiation processes. Although the program aims at helping young people to buy the first dwelling, note that the group of eligible persons is rather large: people up to 45 years of age, who did not own, either exclusively or jointly with the spouse, any dwelling in the past 12 months. This implies that for some beneficiaries this would not be the 'first home'. Hence, this makes us wonder to what extent this program has a social character and who would be the main beneficiary. Real estate companies have already updated their offers and are targeting partnerships with banks in order to find customers for their apartments. On the other side, the banks might neglect the standard real estate loans, paying more attention to and favoring applications secured by State guarantees. At the same time, in mid-May 2018, policymakers announced the program extension and compensation by the Ministry of Finance of 50% of mortgage payments for the employees of public institutions. Like the other recently launched projects, 'Prima Casa - 2' has a strong electoral flavour and discriminates employees from other economic sectors, who will not benefit from the same compensations as budget sector employees. Even if we support the need for stronger motivation schemes for public officials, this must be done primarily by rethinking the wage mechanism in the public sector, which should be more transparent and based on performance indicators, so that officials with higher performances are paid better. Other motivational mechanisms for public officials, such as 'Prima Casa - 2', are neither efficient nor sustainable.
14 May. Presidents of the five member countries of the Eurasian Economic Union met in Sochi at the organization's Supreme Economic Council and decided by consensus to grant Moldova the status of observer.	Although strengthening of foreign economic relations is an objective of Moldova's foreign policy, obtaining the status of observer in the Eurasian Economic Union generated a number of controversies. This situation can have at least two explanations. First, the status of observer was requested by the President of the Republic of Moldova, without any prior consultations with the legislature or the executive. Although the national law contains confusing provisions regarding the foreign policy responsibilities of the countries' President, it clearly indicates the role of Parliament as the authority in charge of ratifying international treaties. In this regard, should be mentioned the message of the Parliament's Speaker, who said that country's status of observer has null effects because it was neither initiated, nor validated by the legislature. Another explanation is that the status of observer does not provide any economic benefit to the Republic of Moldova. Problems related to the Moldovan-Russian economic relations (the elimination of tariff and non-tariff barriers for the

POLICY DEVELOPMENTS	EXPERT-GROUP COMMENT
12 June. The National Agency for Energy Regulation (NAER) announced new higher reference prices for fuels for the period 13-26 June. The reason for this increase in prices is related to the increase in prices on international markets and currency depreciation – the key elements of the methodology for calculation of fuels' prices adopted by NAER in March 2016. It stirred a lot of anger in the society, while the Ministry of Economy and Infrastructure, together with the Competition Council, attacked the NAER's decision in Court. As a result, the Court of Chisinau suspended this decision until a final decision will be made by the Court.	sale of Moldovan products on the Russian market, the situation of Moldovan migrants working in Russia and the supply of gas to the Republic of Moldova) can be solved by bilateral intergovernmental negotiations or on multilateral platforms, for example the CIS Free Trade Area. However, note that individual political negotiations between the heads of the two states could result in certain concessions, but they will not be sustainable and can be withdrawn at any time. This issue should be analysed by answering two key questions: (i) how justified is the decision of the energy regulator to increase the reference prices for fuels? (ii) how justified is the level of prices of fuels in general, given the level of incomes of the population? How justified is the decision of the energy regulator to increase the reference prices for fuels? The NAER made its decision based on the methodology approved in March 2016. According to it, the price of fuels is formed based on four key components: (i) prices on the international markets (Platts and Argus); (ii) level of excise duties; (iii) level of the Value Added Tax; and (iv) commercial margin. In order to assess the level of justification of NAER decision to increase the reference prices it is sufficient to compare the dynamics of prices on the domestic market with the one from Romania, which is the key source of imports of fuels. The estimations reveal an almost perfect correlation between the reference fuel prices in Moldova and the market prices in Romania (the correlation coefficient for the period Jan:17 – Jun:18 is 0,96). Although, we do not have access to the full set of data that would allow us to conduct an alternative calculation of the reference prices for fuels, such a high correlation between the prices of Moldova and Romania seems reveal that NAER's decision to increase the reference prices is justified. Hence, the main concerns should not be related to NAER decisions on <u>adjusting</u> the fuel prices, but rather their <u>level</u>. How justified is the level of fuel prices, given the economic realities in Moldova? In order to answer this question, we have to analyze the key components that form the fuel prices. The first one is related to the prices on international prices, which can not be influenced by domestic decision makers. The level of excise duties and VAT (second and third components) can be influenced, but their level is lower compared to other countries from the region. For example, in Romania, Bulgaria, Hungary and other countries from

POLICY DEVELOPMENTS	EXPERT-GRUP COMMENT
	Central and Eastern Europe, excises represent about one third (or even more) from the final price, while in Moldova their share is around one quarter. The level of VAT is similar to the one applied in other countries from the region. So, the core problem is related to the forth (last) component of fuel prices – commercial margin of wholesalers and retailers. According to the NAER methodology is it 3,25 MDL/l, which is a rather generous one, given the fact that it has been established based on one single year, 2015, when the companies managed to expand their margins due to declining prices on international markets and currency depreciations (in other years, the margins have been about twice lower). In March 2016, Expert-Grup flagged this issue, pointing the risks that are being currently materialized². Another problem is that the final prices are very homogeneous among the companies, which, along with high margins, are classical symptoms of anti-competitive arrangements on the market. Hence, the Competition Council has to get involved more actively in depicting, penalizing preventing anti-competitive arrangements on the market. Also, the Ministry of Economy and Infrastructure has to examine the current legal barriers that hinder the entrance of new players on the market and think of easing the conditions to enter. Both interventions will spur the competition that would turn into lower final prices for fuels. At the same time, cutting excise duties and/or VAT, although seems an attractive solution due to its immediate effects, would have a clear electoral flavor, with temporary effect on prices and losses for the state budget.

² <https://www.expert-grup.org/ro/comentarii/item/1245-recomandari-metologie-calculare-preturi-benzina>

Tabel 1. Key Monthly Indicators

Indicator	May:17	Jun:17	JuL:17	Aug:17	Sep:17	Oct:17	NoV:17	Dec:17	Jan:18	Feb:18	Mar:18	Apr:18	MaY:18
Industrial production, y-o-y growth, %	7,5	0,4	2,1	7	8,6	10,2	9,6	-3	4,2	4,1	10,2	n.a.	n.a.
Retail trade, y-o-y growth, %	-4,5	-0,8	-6,3	-1,7	-2,4	-4,2	-2,7	-10,9	9,1	6,5	0,1	n.a.	n.a.
Services provided to the population, y-o-y growth, %	8,4	8,4	2,3	-1	-13,1	-5,4	-2,7	4,6	6,6	10,7	2,2	n.a.	n.a.
Export of goods, y-o-y growth, %	14,2	8,7	15,7	23,7	15,8	33,6	25,0	20,5	57,9	22,1	14,2	n.a.	n.a.
Import of goods, y-o-y growth, %	22,2	19,8	26,3	22,4	19,1	22,5	28,8	20,5	40,3	28,5	21,6	n.a.	n.a.
Official reserve assets, million USD	2335,6	2388,7	2474,8	2508,4	2629,4	2696,8	2726,1	2803,3	2903,5	2841,2	2875,2	2869,3	2846,5
Budget revenue, y-o-y growth, %*	17,3	18,5	18,6	19,8	18,3	18,2	17,5	16,2	16,8	12,8	10,8	11,1	n.a.
CPI, y-o-y growth, %	7,4	7,3	7,3	7,3	7,6	7,9	7,3	7,3	6,0	5,0	4,7	3,7	n.a.
IPPI, y-o-y growth, %	3,6	3,7	3,8	4,0	3,9	3,4	3,1	2,3	1,9	1,7	1,0	1,0	n.a.
Nominal exchange rate MDL/USD (e-o-p)	18,22	18,15	18,10	17,85	17,61	17,32	17,18	17,10	16,72	16,69	16,47	16,53	16,85
Money transferred from abroad, y-o-y growth, %	19,2	10,4	8,4	9,4	9,5	19,2	15,7	13,0	26,1	18,4	12,0	14,6	n.a.
Monetary aggregate M2, y-o-y growth, %	13,2	13,4	12,7	9,7	9,0	9,8	11,3	14,2	14,1	14,5	14,1	13,0	n.a.
NBM base interest rate, %	9,0	9,0	8,0	8,0	7,5	7,5	7,0	6,5	6,5	6,5	6,5	6,5	6,5
Bank deposits interest rate, %	5,33	5,67	5,24	5,78	5,82	5,72	5,57	5,19	5,17	4,54	4,66	4,46	n.a.
Bank loans interest rate, %	10,26	10,03	10,00	9,76	9,96	10,00	9,88	9,58	9,80	9,47	9,35	9,00	n.a.
Share of non-performing loans in total loans, %	17,3	17,6	17,8	17,7	17,4	18,0	18,5	18,4	18,3	16,6	16,2	15,6	n.a.

Sursa: NBS, NBM, EG estimates

Tabel 2. Key Quarterly Indicators

Indicator	T4:15	T1:16	T2:16	T3:16	T4:16	T1:17	T2:17	T3:17	T4:17	T1:18
Real GDP growth rate, y-o-y*, %	-3,2	1	2	6,7	7	3,1	2,5	5,4	6,4	n.a.
Agricultural production, y-o-y growth, %*	-17,2	4,0	4,2	24,0	18,6	1,1	-8,1	6,2	19,2	1,0
Construction, y-o-y growth, %*	-19,6	-7,0	-23,4	-8,7	-5,9	1,7	3,3	1,4	2,5	n.a.
Investments in long-term assets, y-o-y growth, %*	-14,5	-22,6	-20,0	-12,9	-9,8	-1,2	4,8	2,3	0,2	2,9
Net inflow of FDI, USD million	24,12	35,04	-13,04	66,62	-13,94	41,97	31,65	66,13	66,02	n.a.
Real salary, y-o-y growth, %	-6,0	-1,9	0,4	5,2	10,5	6,8	5,8	3,5	4,7	7,7
Unemployment rate, %	3,3	4,2	6,2	4,0	2,9	3,8	6,3	3,5	3,4	3,3
Employment rate, %	43,7	39,2	37,6	43,8	43,5	38,5	37,7	42,6	42,4	39,2

Note: * - cumulative; (e) – estimate;

Source: NBS, NBM, EG estimates