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Moldova Economic Growth Analysis

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Key policy messages

Major achievements in 2010: from crisis to growth

Since its inception, the Alliance for European Integration (AEI) faced a tall order of multiple and often competing goals. Despite the short-term political horizon, the AEI can boast significant achievements in the past year:

- Stabilising the state budget is among key successes, which helped averting a disastrous macroeconomic scenario involving rocketing prices and collapsing national currency.
- Downbeat economic evolutions smoothed in early 2010, with the economy likely to put a 7% end-of-year economic growth, a rate to be among the highest in Eastern Europe and CIS.
- On the monetary front, the National Bank of Moldova adopted necessary measures to stabilize banking sector and prevent escalation of the non-performing loans.
- The year 2010 has seen unprecedented inflow of foreign aid which helped both stabilize the public budget and start important infrastructure projects.
- Regulatory reform advanced in some key aspects: reduction of number of activities subject to licensing and streamlining of the procedure; streamlined VAT reimbursement; downsizing of the list of goods subject to compulsory state authorization for internal market; reducing the number, simplification and speed-up of constructions-related administrative procedures.
- Significant progress has been registered in relations between Moldova and EU, with the plan of actions for negotiations of a DCFTA to start being implemented in 2011.

Failures in 2010: defeated in the 'royal court', clueless on the 'Eastern front'

Despite the overall positive balance of governance act, the AEI government failed to deliver on several key aspects:

- Despite progress in regulatory reform, a thorny issue remain: the competition promotion. The AEI government failed to achieve any meaningful progresses in this area, which reflected onto the consumers' (voters') dissatisfaction. Apart from this, many other problematic aspects of the business climate have not been addressed.
- While at high level the government engaged in dialogue with civil society, most of the ministries and governmental agencies remained plagued by a weak capacity to engage in consistent dialogue with social partners. Often the dialogue was missing at the high level too, especially on some socially sensitive issues. As result of poor consultations and inefficient policy communications, a number of decisions have been contested by civil society.
- The economic growth in 2010 has been a job-less recovery which will only made the population more willing to migrate. And this is with Moldova already displaying a record low rate of employment: less than 40% in 2010; at the same time the unemployment rate reached 7.4%, while 10% of those employed lament of actually being under-employed.
- While achieving a spectacular rapprochement with Western partners, Moldova failed to put in place a meaningful policy with Russia which, among others, resulted in trade disruptions.

Constraints

The governance act was significantly hindered by a number of constraints originating in the economic, institutional, political and geopolitical spheres. Looking into 2011, some of these constraints may appear as less binding: for instance, the economic growth will remain positive in 2011 and thus state's coffers will continue replenishing. However, this would be only a superficial and misleading conclusion. In fact, most of the constraints surfacing in 2009-2010 will persist.

- Economic growth in 2010 has represented a job-less post-crisis recovery with no signs that the consumption-based model will be shortly replaced by an investment-led one. Also, this growth will remain highly sensitive to how quickly improves financial landscape in Europe.
- The geopolitical setting next year will remain as complex as in 2010, to say the least: Russia continues to reassert itself in its near abroad, while the EU readiness to counteract is subject to domestic instability and sovereign debt crises. US are preoccupied with other parts of the world, being tied for at least a couple of years in Iraq and Afghanistan, while its ability to engage in the far-away Eastern Europe is constrained by limited resources, state of domestic economy, weakened presidency and continuous need for 'reset' in relations with Russia.
- On the domestic front, the next government will have to reconcile political agendas of different parties at the background of fierce opposition and unclear prospects for overcoming the 'presidential' stalemate, hence political turbulences are still ahead.
- Due to lack of progress over the last 5 years in effectively reforming the public administration, capacity to formulate and implement reforms remain weak across all levels and sectors of administration, and fear of taking responsibility for decisions – overwhelming.

Short- to medium-term priorities: get rid of barriers to growth

A number of policy issues will have to be addressed quickly by the next government:

- Consolidating an independent and pro-active agency for competition promotion is probably the most not-to-be-postponed decision that the future government will have to take if it is serious about creating an enabling business environment.
- Consumers' protection remains an issue yet to be tackled by next Government, possibly by mandating this task to a brand-new governmental agency.
- Better strategic coordination of policy is necessary to make best use of the foreign credits and loans; the Court of Accounts has to be entitled to audit foreign-financed projects.
- It is necessary to revamp the current policy of state authorization of the economic activities; despite the on-going regulatory reform, the number of business-hindering regulatory acts adopted by various state authorities followed a trend of 'natural' growth.
- The same recommendation goes for the policy of state control over businesses; controlling agencies have to be functionally reviewed and brought in line with the pro-growth rhetoric.
- The administrative reporting procedures have to be streamlined, through a more active introduction of the fiscal reports' electronic submission procedures.
- Despite the progress achieved in regulatory reform, there is a lengthy list of overdue tasks: effectively steer the companies' registration procedure in one-stop-shop; simplification of the business liquidation procedure; enforcing protection of the minority shareholders' rights.
- It is necessary to ease the access of private companies to natural resources and to put in place a functional system of monitoring the practices of resources' exploitation.
- Simplifying the cumbersome and sprawling framework for attribution, changing destination and exchange of the land plots is necessary in order to enable dispersal of economic growth from the capital area towards rural regions.
- It is highly necessary to start privatise or reforming the state-owned enterprises in order to annihilate anti-competitive structures and to increase the economic efficiency; restructure of the state-owned rail-road company and the telecom remain top priorities.
- Reform of pensions system cannot be delayed anymore; the social insurance budget register skyrocketing deficit which will weigh heavily on state budget if not collapsing it; reforms in this area should start with abolition of unwarranted benefits, increasing the pensions age for women up to men's and gradually bringing agricultural sector into the universal pensions system. Equally important, in mid-term it is necessary to develop a multi-pillar pensions system by adopting the accumulation principle.

Long-term issues: enable a new model of economic development

The AEI government has declared that changing the model of economic growth is an over-arching strategic priority for the country. More specifically, the government declared of not being satisfied of the consumption-based economic growth model (towards which Moldovan economy is currently reverting). The governmental preferred model has been described as an investment-based, innovation-driven and export-oriented model. However, replacing the current consumption based model implies many ingredients from which the government seems to be shy so far. Let's take them one by one:

- Private investment will not grow sustainably as long as transport infrastructure remains prohibitively poor. The government has relied so far on foreign resources for infrastructure recovery. However, channelling significantly more domestic resources into infrastructure rehabilitation may turn inescapable considering the sheer size of the long-term needs of Moldova and the financial crises affecting Moldova's European partners. More capital investment funded from the state budget requires in first instance a significant reshuffle of spending policy. Bound by social commitments, the government has to start by downsizing itself and by looking for intra-sectors' potential savings. In any case, an investment-driven growth means less budgetary revenue from taxed consumption. Is the government serious about the new model?
- To stir up the innovation-based component of the pursued economic growth model the government has to review its current R&D policy. Actually the government has to formulate a meaningful policy in this sense. Presently the public resources are wholesale offered by the government to the National Academy of Science entrusted with 'producing innovation'. As result of this, there is limited if any connection between the research taking place within the Academy's labs and the real needs of the Moldovan SMEs. Moldova needs a research-development-innovation program which would provide access to public resources to support implementation of its innovative ideas to any non-state and non-academic innovative entity.
- Increasing export potential requires further streamlining the behind-the-border and customs administrative procedures, as well as promoting access to existing and new markets. Companies have their part of job if they really need these markets: meet the quality standards. However, the government has to adopt a more cautious approach in designing country's foreign policy ensuring that both capital and trade flows are not disrupted by futile declarations and gestures. Also, the country needs a more pro-active diplomacy and competent business friendly agencies, keen to advance country's image abroad and match Moldovan producers with potential partners across the world. Under no conditions should the government delay the modernization of key infrastructure enabling exports of goods and services (such as in the recent case of digital tachographs).
- The education system has to be reinvented in order to respond to the needs of its customers: students and companies. The quality of human capital in Moldova was ignored for the last two decades of transition, the few implemented reforms giving poor results, and thus, it became a serious constraint for growth. While eating away 9% of GDP, the educational institutions of all levels have little connections with the real world. The increased financial and academic autonomy has to be coupled with higher public responsiveness and harder budget constraints, with increased competition among universities, including from the part of extensions of foreign universities. At the same time, provisions of the fiscal code should be amended so that companies are not discouraged to invest in the training of their staff. Although the impact of investment will be visible only in long-run, it is necessary in order to attract investments in high value added sectors and to increase labour productivity, which is the essential factor for long-term enhancements in international competitiveness.
- Keeping inflation at bay will remain a challenge for the open Moldovan economy. In order to consolidate the monetary policy transmission mechanisms, the National Bank of Moldova

should acquire competences of monitoring of the leasing and micro-finance, as well as of insurance activity involving banks. Taming inflation is indeed a key pre-requisite for Moldova to get more attractive as destination for foreign investments. Obviously, a lower inflation also means a healthier economy, with positive externalities across all sectors. However, without structural and institutional reforms targeting the anti-competitive market arrangements, the monetarist tools will remain of limited use.

- Ultimately, the new model that the government desires requires a complete change in philosophy of economic regulation. Big corporate and political interests should be kept at bay, while SMEs economic creativity and potential unleashed. Ultimately, this implies a transparent framework of political parties financing. Considering this, how quick and far is the political elite ready to go with changing the country's economic development model?

Statistical indicators

Table 1. Moldova: key long-term economic and socio-economic indicators

	2006	2007	2008	2009	2010 estimate	2011 forecast
Population, million (excludes Transnistria), beginning of the year	3.590	3.581	3.573	3.568	3.564	3.562
GDP, billion MDL, current prices	44.754	53.430	62.840	60.043	70.549	78.885
GDP, billion USD, current prices	3.408	4.395	6.047	5.409	5.689	6.413
GDP per capita, USD at PPP	2561	2715	2986	2843	n.a.	n.a.
Real GDP, y-o-y % change	4.8	3.0	7.2	-6.5	7.0	4.0-5.0
GDP deflator, y-o-y % change	13.4	15.9	9.7	2.0	9.9	7.0
Private consumption, y-o-y % change	7.0	3.6	4.5	-7.9	5.0	4.0
Gross fixed capital formation, y-o-y % change	2.8	10.5	-7.8	-37.2	14.0	10.0
Industrial production, y-o-y % change	-4.8	-1.3	0.7	-22.2	8.0	3.3
Agricultural, y-o-y % change	-1.1	-23.1	32.1	-9.9	20.0	3.0
Share of industry in GDP, %	18.0	19.1	13.9	13.0	13.0	12.8
Share of agriculture in GDP, %	14.8	10.0	8.8	8.5	9.1	8.9
Merchandise FOB exports, million USD	1060.8	1373.3	1646.0	1331.6	1558.0	n.a.
Merchandise CIF imports, million USD	2644.4	3676.4	4866.3	3275.8	3820.0	n.a.
Service exports, million USD	465.66	625.08	837.2	668.9	674.0	n.a.
Service imports, million USD	487.64	631.16	824.72	701.8	714.0	n.a.
Net foreign direct investment, million USD	234.16	522.04	691.49	112.0	193.7	n.a.
Net work remittances, million USD	1119.0	1419.4	1795.8	1124.4	1170.0	1321.0
Current account/GDP, %	-11.7	-15.2	-16.7	-8.6	-10.0	n.a.
Official reserve assets, end-year, million USD	775.3	1333.7	1672.4	1480.3	1655.0	1826
Total external debt stock, million USD	2522.7	3345.5	4093.8	4364.1	4350.0	4133
External debt/GDP, %	74.3	76.3	67.9	80.8	76.5	n.a.
External debt/exports of goods and services, %	164.8	167.4	164.6	215.1	194.9	n.a.
Employment rate, % of population aged above 15	42.9	42.5	42.5	40.0	39.1	n.a.
Unemployment rate, % of economically active population	7.4	5.1	4.0	6.4	7.4	n.a.
Real wage growth rate, y-o-y % change	14.2	8.0	10.2	9.0	0.8	3.5
Consumer prices index, year average on year average % change	12.7	12.3	12.7	0.0	7.1	6.5
Consumer prices index, end-of-year % change	14.1	13.1	7.3	0.4	7.8	7.3
General government balance, % of GDP	-0.3	-0.3	-1.0	-6.8	-4.5	-3.0
General government expenditure, % of GDP	40.1	41.8	41.6	43.5	38.0	37.0
Exchange rate, year average, MDL per USD	13.1	12.1	10.4	11.1	12.3	12.1
Broad money (M2), y-o-y % change	12.2	47.3	18.3	-3.8	25.0	15.0
Central bank refinancing rate, end-year, %	14.5	16.0	14.0	5.0	7.0	n.a.
Total commercial bank loans, % of GDP	29.3	37.2	37.5	35.0	35.2	n.a.
Bank deposit rate, %, average per year	11.9	15.1	18.1	14.7	9.3	9.1
Bank lending rate, %, average per year	18.2	18.9	21.0	20.3	17.2	16.1

Source: NBS, IMF, NBM and Expert-Grup calculations, estimates and forecast;

Summary

Governance

The AEI government led by Vlad Filat faced a tall order in steering the country under severe economic, financial, institutional, political and geopolitical constraints. There were several sound achievements up-to-date such as macro-economic stabilization, consolidation of the European integration process and improved ties with the Western bilateral and multilateral partners. Indeed, the budget deficit was slashed, and (recovery) economic growth resumed. Moreover, the West and donor community pledged significant financial support for implementation of the 'Re-think Moldova' program, while negotiations on the Association agreement with the EU started and Action Plan for negotiations on DCFTA agreed. The progress on structural reforms proceeded much slower than expected. Business climate is still frosty, public service often either incompetent or unmotivated at best, market fair competition enforcement - low, and prices – high. Furthermore, while on the Western front the ruling coalition was charming, on the Eastern front it was often clumsy, irrational and at odds with itself when the geopolitical context required perseverance, coordination and diplomatic dexterity.

There will be no easy time for future coalition. The constraints under which operated the Government of Vlad Filat will haunt the next government too. The latter will have to build on the achievements of the AEI, repair the blunders of the former and perform there where the former failed to deliver.

GDP

Economic recovery in Moldova set on in early 2010 and in the third quarter of the year beat even the most optimistic expectations of the Government and international organizations. In January – September 2010, Moldovan economy posted 6.5% growth, with all economic sectors being on rise in the third quarter. For the whole year 2010 we expect 7% annual growth, above IMF, EBRD and NBM forecasts, and this is likely to be one of the most paced recoveries in the CIS. At the same time, some evolutions throughout the year show the Moldovan economy reverting to the pre-crisis consumption-driven growth model, defying the Government's dreams of an investment-driven, innovation-based and exports-oriented growth model. Indeed, putting in place such a growth model requires something more than upbeat public statements. It ultimately demands a complete overhaul of the way how Government thinks and acts in the policy sphere and well beyond this down through the economy.

Despite the unexpectedly high growth in 2010, the pre-crisis level of output will not be achieved. The recovery will last longer as the speed of growth in agricultural and industrial sectors will slow down in 2011, with the expected growth in these sectors being twice lower than current year. At the same time, construction sector, which is only at the onset of growth path, and services sector, which is following the pattern of increasing income, may achieve better outcomes next year. The conservative forecast we adopt for the GDP growth in 2011 is around 4-5%.

Agriculture

2010 has brought about good news for the Moldovan agriculture. The sector has grown at healthy pace of 20%, driven by the 17% growth in production of crops and 24% expansion in the livestock sector. Prices for many crops have risen dramatically, while in case of animal products the farm-gate prices have not been buoyant at all, and some have even declined. In 2010 the agricultural subsidies policy has been reviewed, establishing socially fairer criteria for distribution of the state support among agricultural enterprises. Because it is new, the scheme suffers due to some organizational challenges, but the net social outcome seems superior as compared with the policy of the previous Government biased against small farmers. Despite this, the labor outflow from the sector continued, with a 5% contraction of jobs, and we expect to see this trend to hold in the long run.

We expect that domestic demand for food and agricultural products will continue growing fast in 2011. This is an opportunity that Moldovan farmers should not miss; we believe that consolidation of the international competitiveness of the Moldovan agriculture should be accompanied by a better use of domestic opportunities. However, there is a high probability that Moldovan farmers will be misguided by evolution of the prices in 2010 and again will give preference to the low value added products. For instance, we estimate that the total area under cereals in 2011 may increase up to 8.5%. Production of crops will register a negative growth, -4%, while that of livestock will go up 13%. All in all, the expected economic growth of the agricultural sector in 2011 is about 3%.

Industry

Following a dramatic 22% contraction of the industrial output in 2009, the year 2010 has been a turning point for the Moldovan industry. We estimate an 8.0% annual growth of the industrial production, driven by the recovery of such sectors as sugar, wine, dairy, apparel and furs, tobacco products, leather processing and shoes making. However, this is a far cry from the pre-crisis level of production, which in case of industry goes back to 2005. The tiny mining industry has put an 8.0% growth rate, following the feeble recovery in constructions sector. The demand for electricity grew more than 3%, but this growth has been entirely covered by imports. Constant under-investment in domestic generation capacities has made local producers less efficient, while their production uncompetitive. Because importing 100% of the consumed energy is not an option for Moldova, further delays in industrial restructuring of the energy sector creates great risks for the Moldovan economy in general.

After a relatively moderate recovery in 2010, we expect in 2011 the industrial growth rate to flatten. Our models render a 3.3% growth as the most likely scenario next year. As constructions sector is expected to gather more steam next year, we expect a further acceleration of the growth in the mining industry, with the output up by 15%. But the main industrial sector – the manufacture – is expected to put a rather modest 5% growth next year, mainly originating from the same two clusters that enabled the growth in 2010: the food and the textiles. Yet in the energy sub-sector we expect to see a further decline at estimated 7% rate.

Constructions

In 2010 a moderate 2.5% growth is expected by the Expert-Grup, however, ironically, this growth at least partially is due to the construction works initiated by Moldovan Government in result of the summer floods in the Hancesti district. Residential real estate market fared below expectations in 2010, with most of the market orders concentrated on current repairs rather on new construction works.

We expect a somewhat half-hearted economic growth to be put by the construction sector next year. According to our estimates, a 5% growth is the most likely one. The real estate prices will remain stable in the first half of the year, and will start moderately growing in the second part.

Services

With a share of 2/3 of the GDP and an estimated growth rate of 3% in 2010, the services sector has been the main engine of economic growth in 2010. The growth has been particularly strong in the retail trade and services rendered to the population, but in the second half of the year some of the business-oriented services (such as transport) began growing stronger. The tourism sector was severely hit by the financial crisis in 2009, but started recovering in the second half of the year 2010. The telecommunications sector has been only marginally affected by the financial turmoil; for instance, due to high market growth potential and fierce competition, the number of mobile telecommunications subscribers grew 15% in 2009 and about 9% in 2010. Internet market has been another bright spot, with number of broad-band subscribers growing almost 50% in 2010 and yet the whole market potential not being tapped.

For 2011 we expect a 5.6% growth of the value added generated by the services sector. This growth will come in result of market services expanding more, while the size of the public services will remain roughly at the same value. We believe that the retail trade will expand by 9.3% in real terms in 2011, while services rendered to the population will increase by 7.3%. The telecommunications market perspectives are bright for the next years, with mobile telecommunications and Internet services remaining cheerful leaders. A key risk for the international transport sector may arise from delayed implementation of the digital tachographs system, which can hamper Moldovan carriers entering EU.

Labour market

Labour market has been slow in responding to the ongoing economic recovery. During 2010 the employment rate continued to decline, while under-employment and unemployment rates – to rise (even though the decline moderated throughout the year, due to slight improvement in construction and service sectors). At the same time, employment in agricultural and industrial sector fell without contraction of production that can be explained by over-employment prior to the crisis (especially in agriculture) and by a crisis-imposed staff optimization (by downsizing the auxiliary personnel in the industrial sector). The economic crisis leaves its footprints on the labour market; some of them, such as increase in informal employment, are particularly harmful for the economy and population welfare. The jobless economic growth left no choice to many Moldovan citizens but to migrate looking for a job. Indeed, the number of individuals working abroad increased by 6.5% in 2010.

In 2011 we expect a stabilization on the labour market, with increasing employment in constructions and services sectors, but a further decline of employment in agriculture in the process of transition from labour-intensive to capital-intensive agriculture.

Households' income and consumption

The first weak signs of recovery were visible in the fourth quarter of 2009, when disposable income of the population returned to its growth path. The trend persisted during 2010, however, with major differences in the evolution of the most important sources of income. Only income from agricultural individual activity and from social payments rose throughout the year, while remittances displayed a significant y-o-y growth only in the third quarter. Growing income of the population had an immediate impact on the recovery of consumption. Households' consumption increased faster than households' income – 5.6% compared to 4.1%.

In 2011 we expect a recovery in all private economic sectors that will allow the increase in wages in the real sector on average by 3-4%. There might be large differences across the economic sectors, with wages in agricultural sector still advancing slowly, and higher rates of growth in service sectors: transport and communication, trade. Although we expect migration to increase in 2011, the earnings of migrants will not be as high as before the crisis and consequently the amount of remittances will not reach the 2008 level, increasing around 12-14%.

Prices

Moldova presently tends to have one of the highest price increases among Central and Eastern European countries. In 2010 foodstuffs had the main contribution to the price increase, followed by services and non-foodstuffs. Despite the NBM statements about lack of inflationary pressures of monetary origins, our models suggest that up to 1/3 of the price hikes can be explained by growth of money in circulation. Thus, relaxed monetary policy leads to the decrease in interest rates stimulating population's propensity to consume and creating disincentives to save. Other 27-29% of inflationary pressures are determined by cost-push factors. These are mainly explained by increase in prices for energy resources, increase in storage costs for foodstuff products, poorer harvest of some agricultural products and increase in several indirect taxes. Given the strong reliance of economy on imports, the CPI level in 2010 was also influenced by the leu's depreciation in late 2009.

We expect that until the end-2010 the annual CPI level will remain around 8%, with the average inflation for the year being roughly 7.1%. However during 2011 the annual average inflation rate will gradually decrease to 6%-7% on the grounds of absorbing cost-push factors associated with increase in aggregate output.

Monetary policy

Despite the inflation direct targeting regime adopted by NBM in 2010, it continued with a quite lax monetary policy amid relatively high inflationary pressures. NBM supported this position with the argument of spurring banks' lending and claiming that most of inflationary pressures are related to production costs and cannot be influenced by the monetary policy. Contrary to this argument, our model shows that a significant share of inflation is led by strong increase in money in circulation and by recovery of domestic demand. Using the standard Taylor rule we conclude that in order to effectively address the inflation, the NBM should increase its REPO rate by 2-3 p.p. During the 2010 year the central bank significantly decreased its interventions on the foreign exchange market, which made the national currency follow an almost free-floating trend. Nevertheless, the currency has been less volatile in comparison with the previous years, registering a moderate appreciating trend.

Probably in 2011 the NBM will continue balancing between the objectives of propping up the economic growth and decreasing inflation. However, the central bank's ability to steer inflation into the targeted interval will remain pretty limited due the slow transmission mechanisms.

Budgetary and fiscal policy

In 2010 clear signs of stabilization of public finances appeared, as revealed by the deceleration of growth of public expenditures and acceleration of public revenues. The increase in budgetary revenues was mainly driven by the recovery of domestic demand and national currency depreciation in early 2010, while the aggregate supply had negligible contribution to the budgetary balancing. The deceleration of public expenditures was determined some cuts in the low-priority projects. The driving forces behind the public expenditures remained the high governmental commitments in the health, education and social protection sectors, which continue weighing heavily on the state budget.

Given the economic recovery, we expect the budgetary deficit to be slashed from 6.8% in 2009 to 4.0%-4.5% in 2010 and around 3% in 2011, which is just in line with the IMF-agreed terms. Given the current economic growth model, indirect taxes will remain chief source of the budgetary revenues, and the main driving force of public expenditures – social projects. Despite these constraints, the government should aim at rebalancing in long term the structure of budgetary formation and utilization. A key priority should be restructuring of the pensions system, which risks bending under the heavy deficit that has grown at accelerated pace since 2008.

Banking sector

As economic recovery gained ground in 2010 and NBM relaxed the monetary policy, banks managed to improve their loan portfolios. In March 2010 a robust increase in lending activity started, with an average annual rate of new loans around 70%. According to our estimates, the decrease in interest rates was the main driver of increased lending. Additionally, we see domestic demand to have a much stronger impact on the revival of the lending activity than the foreign one. This development points again to the fact that the economy returns to the consumption-based growth path. Despite this, the share of non-performing loans remains high in comparison with the pre-crisis period, while banks continue to keep their loss-covering reserve funds quite large. This suggests banks are not yet 100% certain about economic growth prospects.

With economic recovery anticipated to continue in 2011 the lending activity will carry on. However, in 2011 it will grow slower (about 20%-25%), due to higher comparison base of 2010. The problem of loan affordability will persist, as banks will rationalize the loans, especially those demanded by the SMEs.

Foreign trade

Throughout 2010 the trade growth has been gaining momentum as reflected by the 23% pick-up in the global merchandise trade in January-September 2010. Moldovan foreign trade followed the suit with 15% growth in the same period, with both exports and imports on the upwards trend. On the quarterly basis the recovery appears somewhat erratic. Imports rebounded in steadier manner only to see its growth rate to level off into the second half of 2010. The growth of exports seems to be much more uneven since the recovery set in. The foreign trade data also show an interesting twist: return to the yawning trade deficit, which was in retreat for much of the recession and beginning of the post-recession period. The data also show a much stronger exports' rebound on the Eastern front ushering way for some rebalancing in foreign trade which saw much more robust exports' drive towards the EU in pre-recession period. The attractiveness of Eastern markets is supported by well-built economic recovery throughout the region, while the EU economies seem to be mired in sovereign-debt saga. Furthermore, exports to Romania were disproportionately hit by adverse climate conditions critical for some Moldovan exports to Romania.

The outlook for foreign trade remains moderately sanguine. The risks will mostly stem from low demand on the main partner markets (mostly the EU), and depend on political and administrative vagaries (the future of relations with Russia). At the same time start of the implementation of the Action Plan for the DCFTA negotiations can bring about sorely needed institutional reforms and provide the necessary boost for the competitiveness of Moldovan goods and services.

Global markets

The global economic recovery seems to have been gaining momentum throughout 2010, supported by far and large by fiscal and monetary stimuli worldwide. The recovery is not evenly spread across the world, being more and more tilted towards emerging economies, mostly in South-East Asia and Latin America. The prospects are dimmer for advanced economies, crippled by combination of the sovereign debt and budget deficit in advanced economies, as well as risk exposure of the banking sector coupled in many countries with structural rigidity and low growth potential. All this drives high volatility on commodity and Forex markets. So far recovery on the commodity market mirrored to certain extent recovery of the global economy, being mostly supported by demand of fast-growing emerging economies and monetary easing of the main currencies, mostly of the greenback.

Although the global recovery now appears on solid footing, challenges ahead abound. The advanced economies appear poised to sluggish growth, global imbalances look daunting, while markets inherently volatile. This uncertainty, relatively high energy prices and sluggish growth in the EU offer lacklustre prospects for mid-term growth in Moldova which will have to get serious about its new economic growth model and about international competitiveness.

1. Economic governance

This chapter looks at main achievements and failings of the governance act throughout 2010. While the analysis mainly tries to track progress on some essential areas varying from outreach to donor community to domestic economic governance reform, it also takes into the disheartening domestic policy context. The chapter concludes with outlook for the next half a year or so.

Intentions meeting reality: missions accomplished and lost opportunities

Upon the very beginning the Government led by Vlad Filat was invested not only with power, but with great hope and responsibility. After the first stint at power of the Alliance for European Integration (AEI) Government drew to a close we think it is reasonable for public to learn some lessons, to take some positives from this period and, alas, regret some so far missed opportunities. But before this we take an impartial look at the web of constraints the Government has had to deal with since its investment. The character and magnitude of these constraints varied throughout the period but broadly resume to the following:

- *Financial and economic.* In the fall of 2009 the new AEI Government inherited the plummeting economy and a burning 16% of budget income hole in the public budget aggravated by the pre-electoral public salary hikes pledges and reckless spending made by the ousted Communist Government. Furthermore, economic growth plummeted 6.5% at the background of falling remittances and shrinking external demand.
- *Institutional.* The administrative apparatus left from the previous administration has been over-bloated, often poorly trained and underpaid, and reform-averse, with planted 'pockets' of resistance to change in some instances. Furthermore, Vlad Filat government has had to follow to what appears to be not necessarily complementing objectives: to fill the positions with loyal nominees respecting the 'alliance' principles as well as to bring fresh blood of professionals and technocrats to the Government.
- *Domestic and party politics.* Firstly, alliance patchwork has often impeded decision-making process. Secondly, the communication and coordination within the Government (and fully reflecting lack of proper coordination within the ruling coalition) left much to be desired, and political bickering resulted in open bust-ups between cabinet members which further on degenerated in conflicting stances during parliamentary elections of 2010. Thirdly, the out-of-power Communists' Party after initial shock and severe blood-shedding managed to regroup and as parliamentary elections showed retained considerable, although declining, share of votes.
- *Foreign policy context.* The foreign entourage has not been particularly better. The EU has been struggling with recession and sovereign debt malaise, while Russia has become especially assertive in what it sees as its geopolitical courtyard. Although, the Western community demonstrated an increased degree of openness and support for the AEI Government, the relations with Russia after initial entente have degenerated considerably. Some of this degeneration was of Moldovan making.

Re-think it: 'charm offensive' vs. 'reform timidity'...

As mentioned above the AEI faced a tall order of achieving multiple objectives related to the keeping Moldovan economy afloat and avoiding budgetary bust, securing that Moldova remains on the euro-integration track without scuttling the bridge-the-gap process with Russia, and no less important, pursuing much-awaited political and economic reforms. The progress across these areas has been uneven and there are certain areas where the Alliance excelled and where not much progress was accomplished.

The brighter side for the starters. In 2009 the newly invested Government has proved itself astonishingly deft in winning and securing Western support. Already in the fall of 2009 the dialogue with the IMF was re-established and new policy memorandum agreed. The next milestone in 'charm offensive' was the visit made by an impressive Moldovan delegation headed by the country's Prime-minister in January 2010 to Brussels, ushering the way for the grand donor package agreed in March 2010: Re-think Moldova. In parallel, the negotiations on the Association agreement between the EU and Moldova have been puffing ahead, while Action Plan on negotiation on the Deep and Comprehensive FTA (DCFTA) was approved by the end of 2010. Thus, the Western community decided to support Moldova (and implicitly the AEI Government) in the times of heightened political instability in Moldova and amidst sovereign debt crisis at home.

It also appears that economic growth prospects brightened considerably throughout 2010. The Government of Vlad Filat with the support of the international financial institutions (IFIs) managed to stabilize the economy, reduce budget deficit (from 6.8% in 2009 to expected 4-4.5% in 2010) and respect its 'social' obligations to the population. Both the IFIs and Government are much more upbeat about Moldova's economic prospects, but at the same time the downside risks should not be overlooked. They range from the tepid character of global economic recovery and eventual slack in demand in commercial partner economies to dangers of complacency with respect to the domestic structural reforms which are long overdue.

Relations with business community and investment climate remind us about another very serious issue – the cartel arrangements on both services' and goods' markets. Overall, it should be mentioned that Moldovan competition legal framework as well as monitoring and enforcement mechanisms are seen as largely inadequate, and the whole competition system is begging for overhaul in order to comply with the EU standards in the field¹. Electoral period was full of talk on monopolies and 'royal court businesses', but how much the AEI Government progressed in dismantling them? After initial progress with fish imports and some other areas (such as broadband internet connection, etc.) the monopoly fighting has been apparently put to the back banner. The attempt to eliminate the 'meat' monopoly schemes not only failed but also turned into farce as at one moment the Government intended to raise meat import tariffs (already at the highest WTO-agreed level). This move not only exposed lack of coordination within the government, but also the carefree attitude to the external commitments, tendency to bow to sectors' interests and penchant for the protectionist instincts. Furthermore, this measure if passed would fly in the face of the interest of commons in the country where the meat prices are the highest by the regional standards while consumption is at the lowest level. Overall, one of the most important expectations towards the AEI Government was investigation of the current value chains of price formation for many products (especially foodstuffs and medicines), which seem to be quite dear by regional standards. The respective legislative act was passed, alas, with no practical effects. The issue resurfaced during electoral campaign, but more as a tool to foster electoral support.

On the Eastern front the AEI government faced a much taller order both due to the less welcoming terrain as well as conflicting views of different factions of the ruling coalition (doves vs. hawks) on the relationship with Russia. After initial entente, the relations soured at the background of intensifying geopolitical struggle and careless declarations and decrees by the acting President of Moldova. The tensions between both countries culminated in import restrictions imposed by Russian authorities on wines and agri-food products for which Russia is the main export destination. Besides foreign policy issues, the wine restrictions also brought back on the table the issue of efficiency of a series of sector and export-promoting governmental agencies (such as Moldova-Vin, MIEPO, Chamber of Trade and Industry, etc.) and the need to reform them. With all the pro-business talk and

¹ Eugene Stuart, Abel Mateus, "Competition Law and Policy. Law approximation to EU standards in the Republic of Moldova", December 2009.

initial efforts to cut red-tape the gap between local business community and the government is still wide². Here comes another snag: the business climate overall. Indeed, the latest Doing Business Survey³ (for period June 2009 - May 2010) shows Moldova to lose 3 positions in its rankings as the result of small number of reforms implemented (only one, captured by the Survey) and more reforms implemented by competing economies. At the same time, despite some progress made in previous period Moldova remains one of the most unattractive countries for the entrepreneurship. Needless to say, negative impact of the business climate over investment attraction is only more heightened by the dire regional investment environment overall, as majority of the countries and investors are still reeling from the effects of the global financial turmoil. The poor results of the privatizations auctions conducted in 2010 seem to point in the same direction.

To sum up, the AEI Government managed to ensure macro-economic stabilization and win at least Western hearts, if not minds, via its 'charm offensive'. To win the minds the new Moldovan government will have to focus on proper democratic conduct as well as on enhancing its absorption capacity and demonstrating its ability to employ these funds efficiently. At the same time, normalization of relations with Russia will be another priority.

Forecast for 2011

- As can be seen from the positive sectors' dynamics the Moldovan economy has returned to the growth path abandoned in the aftermath of the global economic crisis and political turmoil that marked 2009 for the country. The economic growth should not be taken for granted though. The economic crisis effects can still be widely seen in various sector of the economy, while unpredictability related to the political instability and need for structural reforms have not gone anywhere.
- Indeed, the shape and sustainability of the future ruling coalition will impact heavily on the robustness of the reform process and cooperation with the EU and development partners, as a whole, throughout 2011. This refers to the conclusion of the Association agreement, implementation of the Action Plan on the DCFTA, but also to the projects supported by the aid package that underpin the *Re-think Moldova* implementation, etc.
- On the foreign policy front, the geopolitical struggle will become more acute, with both East and West exercising increasing pressure on Moldova. This is why the future ruling coalition should be based on clear principles and distribution of competencies, as well as be underpinned by the respective institutional arrangement (including permanent Staff to smooth daily functioning of the coalition government and coalition as a whole).
- Otherwise, this year would be favourable for the Government to start laying foundations of the new export-led economic growth that would gradually substitute the current one based on the consumption propped up by the remittances. The support of donor community and institutional reforms foreseen by the negotiation of the DCFTA will be very helpful in this respect. This will not however change the nature of growth in the short-term as it appears that domestic consumption remains the fundamental engine for economic recovery.

Policy challenges and recommendations⁴

- The constraints in which the AEI has had to operate since fall 2009 will stay put and will haunt the 'initiation' of the new ruling coalition as well. After all, geopolitical context will remain as complex (if not even more so) as it has been since 2009; the turbulences of

² Logos Press, *Бизнес заявил позицию*, April 23, 2010.

³ Doing Business Survey 2011: *Making a Difference for Entrepreneurs*, 2010. On Government's response and some reforms since then see: <http://mec.gov.md/node/2403>

⁴ This section partly draws from: Alex Oprunenco, Valeriu Prohntitchi, "Priorities for the Government: the Future Moldova Should not Lose", <http://expert-grup.org/index.php?go=news&n=167&nt=4>

domestic politics will perpetuate with party(ies) left out of coalition seeking revenge; the new ruling coalition will still have to learn lesson of the AEI and build effective communication and coordination mechanisms (after bitterly contested electoral campaign); and even after the macro-economic stabilization achieved the new Government will have to laid foundation for financial stability in the mid-term, maintain the economy on growth track and help this growth to become less sclerotic and more inclusive.

- To bring Moldovan economy on sustainable growth path and shed dependence on the development aid the new Government will have to start by more efficiently employing the country's most valuable resources (people and land), provide proper support for their development (reform and investments in education and training, capitalization of the land market, and streamlining value chains within the agri-food markets) as well as overcome the hurdles that appear as critical constraints to growth, i.e. improve quality of human capital, rehabilitate road infrastructure and make business climate attractive for local and foreign businesspeople.
- The fact that many future parliament members have business background may be seen as both opportunity and risk. Opportunity is that they will use their experience to ensure open dialogue between business community and the Government. The risk is that they will use the political position to further their private interests. Thus one of the challenges for the government will be to ensure proper institutional set-up that would help avoiding conflict of interests, provide for efficient platform for Government-Business dialogue and maintain different business representatives in equidistant positions in this dialogue.
- The Government will have also to deal with geopolitical challenges that will not go anywhere. Therefore, Moldovan foreign policy should be further streamlined and developed to include clear objectives (East-West dimension) and means to achieve the set goals. The goal of the foreign policy should not be limited to European integration, which if Moldova is serious about its euro-ambitions should become priorities for domestic reforms agenda. Moldova should have clearly stated goals and strategies for relations with its partners that should complement its European integration strategy. At the same time, Moldovan rulers should understand that European integration coupled with the country's reintegration will increasingly become a balancing act matched by hard work both inside the country and abroad, freed of useless and distractive decrees and declarations. Furthermore, while improvement of relations with Russia should be pursued, the demagogic declarations on accession to the customs union between Russia, Kazakhstan and Belarus (remember promise of accession to Russia-Belarus Union?) should be put to rest. Such an accession would bring little for Moldova's effort to modernize and develop economy (and not simply parasite on remnants of post-Soviet endowments), would be problematic due to institutional issues (the members of this Union still have a series of issues to sort out among them) and mere geography (there is still Ukraine between Moldova and Russia, after all), would effectively block negotiations on DCFTA with the EU (you simply cannot have it both ways), and would contravene Moldova's international commitments (WTO membership).
- The upmost challenge for the Government will remain the promotion of competition policy in services sector that would spur stronger competition, higher quality and lower prices. Undeniably, this would entrench support for the Government from different quarters: most of the business community, ordinary citizens and foreign community. It is crucially important to understand that this liberalization and competition enforcement will be also at heart of the negotiations of the DCFTA between the EU and Moldova. The inability to start such comprehensive reforms and to withstand 'special' interests in different economic sectors would mean an utter failure for the new Government. Furthermore, with prices flying high, the Government will have to follow a two-pronged strategy: on the one hand, to streamline, to implement and to communicate an efficient social protection policy; and on the other to

ensure that prices trends reflect market developments and not manipulative anti-competitive arrangements.

- The sheer size of foreign aid to Moldova implies enhancement of absorption capacity, better monitoring and transparency of the aid use, as well as better donor coordination. Exactly the issues on which Moldova has never excelled. Furthermore, as EU-Moldova Association agreement negotiations are gathering steam the negotiation skills and technical strength of the relevant personnel should be consolidated, while issues related to the various areas of DCFTA should become subject of public debates, which should involve the affected stakeholders. All in all the faith of EU and donor community should be repaid by competent negotiating process and genuine and comprehensive reforms on the ground.
- The last but not the least, year 2011 may well become existential test for Moldovan political class. This year exposed significant weaknesses in the political governance of the country. The opposing political elites have consistently failed in their attempts (have they been genuine after all?) to reach consensus on several key issues, while manipulating with much aplomb the dividing lines in society. While political processes in the fully-fledged democracies may also often end up in impasse, given the particularly tricky background in Moldova (divided society, public dissatisfaction with political elites and 'transition' fatigue), such protracted stalemates can undermine the national development and modernization plans. Furthermore, continuous appeals to the foreign actors to intervene and 'baby-sit' the conflicting factions of Moldovan political class (it is another matter whether Moldovan class is ready to heed the foreign advice) in finding solutions to various existential issues gives a black eye to Moldovan political class and shows at best limited ability to grow up to responsibility implied by the national sovereignty. The unwillingness or failure to pursue *real* development priorities does not bode well for the 'much-nurtured' Moldovan statehood.

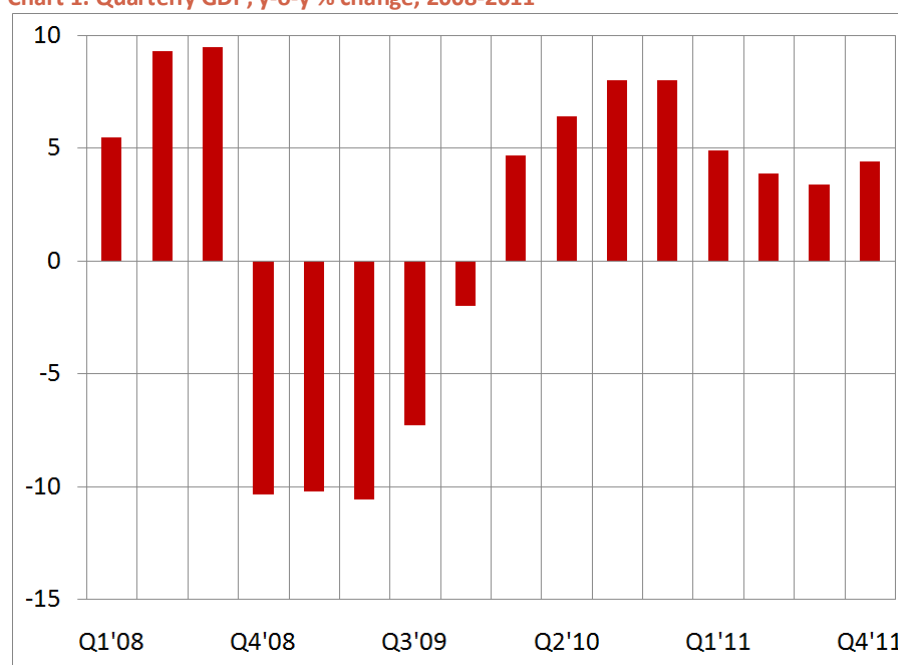
2. Gross Domestic Product

This part analyzes the evolution of GDP in 2010 and the factors that determined Moldova re-entering the growth path. It presents the quantitative and qualitative changes in the structure of GDP and detects the patterns similar to the pre-crisis growth model. The chapter contains forecasts for growth in 2011 and challenges the Government will face in during economic recovery.

GDP evolution in 2010

The economic decline in Moldova slowed down in the second semester of 2009 and by the end of the year reached 6.5% thus surpassing Government's, IMF's and experts' more pessimistic forecasts and being also less acute than in many countries in the region. In early 2010, Moldovan economy already stepped on the recovery path, and posted a 6.5% growth in January-September (Chart 1). Even more, the significant growth in output in the third quarter placed Moldova well above the growth reached by the CIS and EU new-member states. This performance has continued into the fourth quarter due to increase in both final consumption and capital formation. On the production side, a significant advance in agricultural and industrial GVA is expected in the last quarter of the year. For the whole year we estimate a 7% economic growth, which is significantly higher than expectations of the IMF (3.2%), EBRD (4.5%) and NBM (5%).

Chart 1. Quarterly GDP, y-o-y % change, 2008-2011



Source: NBS, Expert-Grup estimates for Q4'2010 and forecast for 2011;

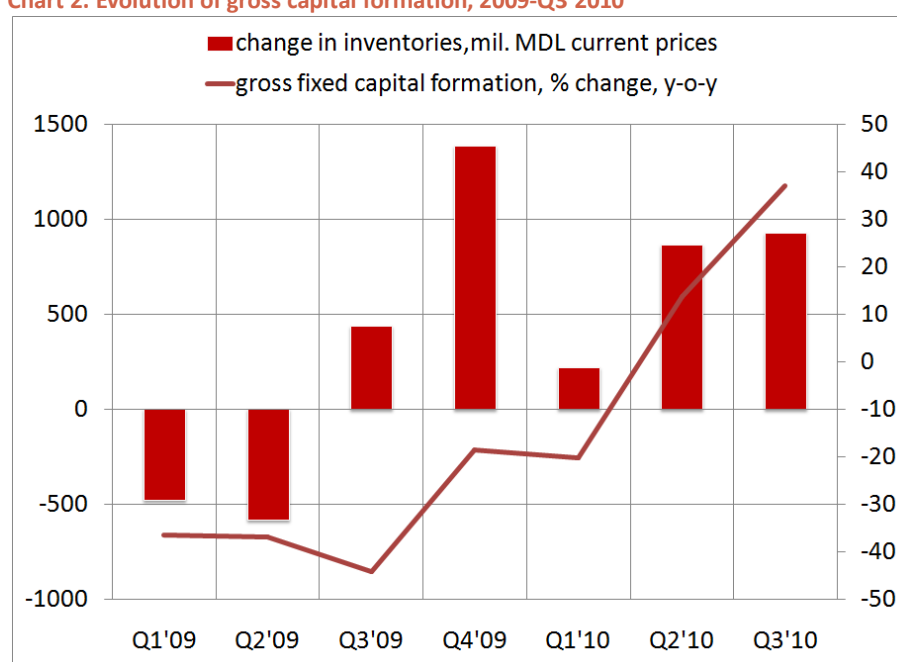
However, the evolution of the GDP by expenditure elements points to the return to the pre-crisis consumption-driven growth model. Increasing households' disposable income, mainly due to stabilization of remittances (see more in chapter **HOUSEHOLDS' INCOME AND CONSUMPTION**), almost immediately reflected in the households' consumption that advanced 5% in the first half of 2010 and 9.4 % in the third quarter, accounting for 95% of total GDP (the highest share in the region). As before the global economic crisis, local producers are not able to satisfy growing domestic demand, consequently imports growing at a rate as high as 12.2%, almost half above the growth of exports (7.9%). Therefore, negative net exports continue to somewhat dent the economic growth (see Table 2).

Table 2. GDP by main expenditure components in January – September 2010

	Y-o-y growth rate, %	Share in GDP, % of total	Contribution to the GDP growth, percentage points
Final consumption	4.2	118.2	5
Gross capital formation	42.5	20.6	7.1
Exports	7.9	36.6	2.8
Imports	12.2	-75.4	-8.4

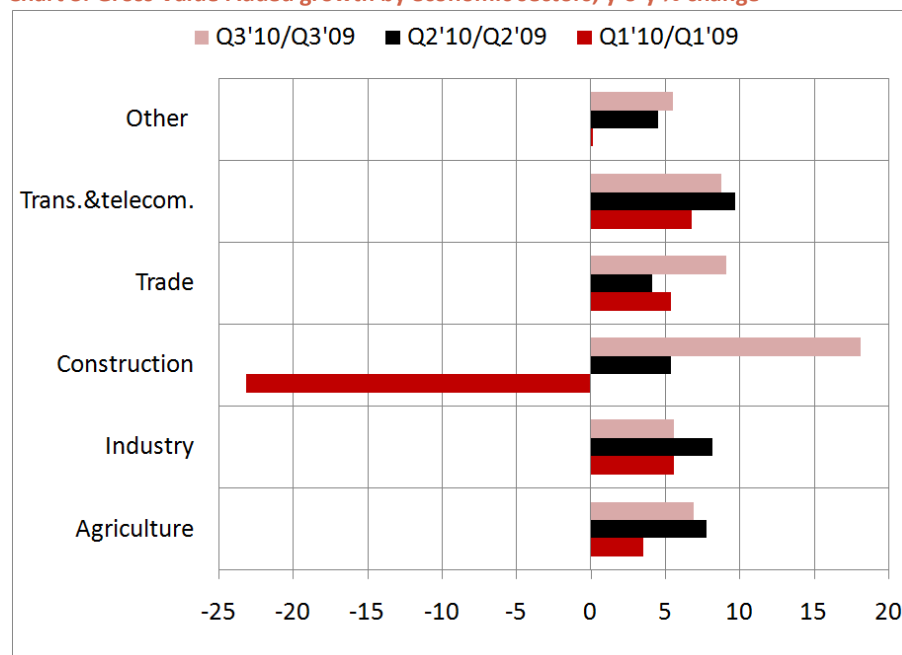
Source: NBS;

Worthwhile to mention, the destocking process that started in late 2008, at the first signs of the global crisis, stopped in the second half of 2009. The positive change in the aggregate demand and upbeat expectations of the companies caused an increase in inventories already in the third quarter of 2009 (Chart 1), but only recently the growth stabilized. Another very important evolution in the third quarter of 2010 is the increase in gross fixed capital formation, mainly determined by maintenance and repair works (37% y-o-y growth in January-September 2010). An increase in capital repair works and new buildings was registered only in the third quarter; however, this has been partly generated by construction of new houses for individuals affected by the floods in the Hancesti district.

Chart 2. Evolution of gross capital formation, 2009-Q3'2010

Source: NBS;

Another positive qualitative change in growth can be detected on the production side. The GDP growth in the first quarter of the year was mainly a consequence of rising net taxes on goods and imports; however, in the second and third quarters the gross value added (GVA) component had the main role, contributing 4 p.p. to the economic growth. In the quarters two and three the GVA increased across all economic sectors, with a significant improvement compared to the first quarter in agricultural, industrial, trade and communications and especially in the constructions sector (Chart 3). With all pitfalls, the recession in the construction sector seems to be over: after the 23% decline in the first quarter, the GVA in the sector increased by 5.4% in the second quarter and added another 18.1% in the third quarter.

Chart 3. Gross Value-Added growth by economic sectors, y-o-y % change

Source: NBS;

Forecast for 2011

- Despite the unexpectedly high growth in 2010, this growth is not sufficient to get Moldova back to the pre-crisis level of output. The complete recovery will last longer as the growth in industry and agriculture will slow down in 2011, with the expected growth in these sectors being twice lower compared to the current year. At the same time, construction sector, which is at the onset of growth path, and services, propped up by rising incomes, may achieve better outcomes next year. The conservative forecast we adopt for the GDP growth in 2011 is around 4-5%.

Policy recommendations

- Moldovan economy is returning to the pre-crisis consumption-driven growth model, contrary to the Government's desire of shifting to an investment-driven, innovation-based and export-oriented growth. We maintain our view that in the short term such a shift is merely impossible. The long-term pre-condition for this model is making the infrastructure investment the top-priority for the Government in the forthcoming years. In addition to public investment, the Government should encourage private investments through a much friendlier business environment.
- For the innovation-based component of the economic growth the Government has to review its current R&D policy. Presently the scarce public resources are wholly channelled to the National Academy of Science and there is limited connection between the R&D activity taking place within the Academy's labs and the real needs of the Moldovan SMEs. Moldova needs a research-development-innovation program by which any non-state and non-academic innovative entity would have access to public resources to support implementation of its innovative ideas.
- Increasing export potential requires further streamlining of the behind-the-border and customs administrative procedures, as well as increasing/preserving market access. Aside

from investments in productive technologies and management to meet the European and international quality standards, this implies a more cautious approach in designing country's foreign policy: annoying Russia with imprudent declarations is certainly not in line with protecting the 25%-share of the Moldovan exports going to this market.

3. Agriculture

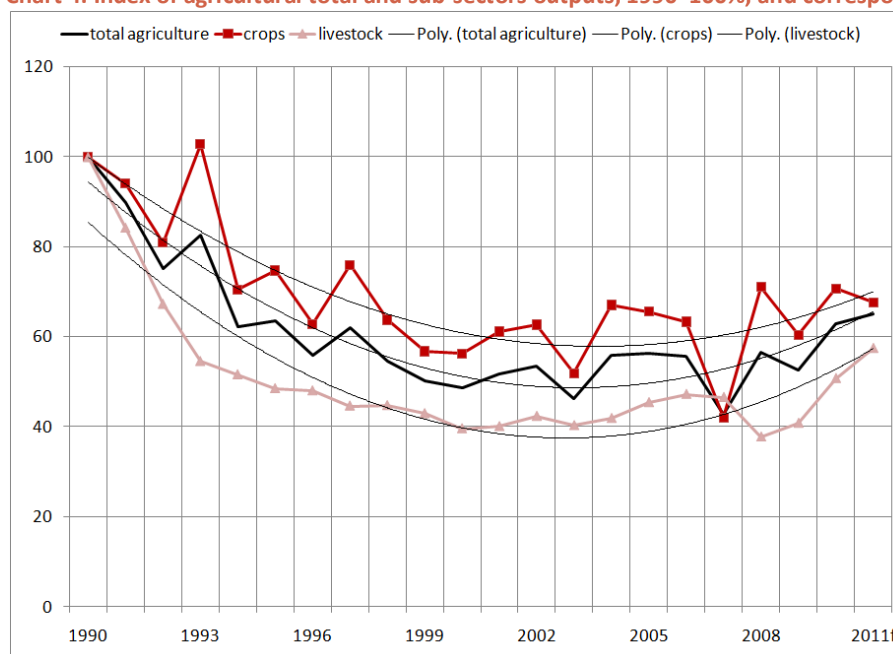
This chapter analyzes the recent trends in crops and livestock sectors of the agriculture in 2009-2010. The forecast for 2010-2011 is made based on a simple model incorporating projections of the areas sown, livestock headcount and potential productivity indicators. The final part of this chapter identifies main challenges that the government will have to address through efficient policy.

General evolutions

By and large, the year 2010 has been a positive episode in the see-saw development of the Moldovan agriculture. Despite the weather extremes in January-February 2010 impacting heavily production of grapes and some fruits, the overall growth remained strongly positive. According to our estimates, the total value of agricultural output will reach MDL 18.5 billion, which is 20% more than in 2009 and is significantly pulling up the historical trend (Chart 4). In 2010 the agricultural subsidies policy has been reviewed, establishing socially fairer criteria for distribution of the state support among agricultural enterprises. Because it is new, the scheme suffers due to some organizational challenges, but the net social outcome seems superior as compared with the policy of the previous Government biased against small farmers.

Yet another telling evolution has been the continuing labor outflow from the agricultural sector: according to our estimates, the number of employed declined by 5% in 2010, a continuation of the long-term trend: the number of employed in agriculture more than halved in only one decade, from 770 thousand in 2000 to 334 thousand in 2009 and 317 in 2010. Against this drop in the number of employed the main factors of growth remained the productive capital and total factor productivity, both of which improved sizably in the recent years. The farmers are investing particularly much in agricultural machinery and equipment: its share in total productive capital in the sector grew from 26.9% in 2006 to 29% in 2009, and according to our estimates, it reached 30.5% in 2010.

Chart 4. Index of agricultural total and sub-sectors outputs, 1990=100%, and corresponding trends



Note: the trend in evolution of agricultural output in the recent decade is best described by a second-order polynomial;

Source: NBS and Expert-Grup estimates and forecast;

Dynamics in the crops subsector in 2010

After a significant 13% plunge of crops output previous year, in 2010 the sub-sector rebounded with a strong 17% growth rate. This has been the outcome of both structural and technological factors. On the one hand, with the total surface of annual and multiannual plantations remaining roughly the same, the share of low-value added cereals in total sown areas has declined by 3% to the benefit of technical crops (+6%), as well as, vegetables (+2%) and fodder plants (+8%). On the other hand, yields have improved across the board, except tobacco (-25%), vegetables (-23%) and grapes (-40%). Farmers producing sugar beet registered a spectacular 250% hike of their yields, mainly due to low comparator base. Cereals' yields have been on the upbeat mood too, with improvements ranging between 24% in case of wheat and 42% in case of corn. The harsh winter in 2010 undermined the production of some fruits (such as peaches); however, the average yield and total production of the fruits sector put a growing rate of about 55%. Farmers specialised in production of crops benefited plenty from the buoyantly growing prices for their products in 2010 (except sugar beet, whose farm-gate price declined by about 8%): cereals were sold at prices 55% higher than in 2009, vegetables farm-gate prices increase by 20%, fruits' price – on average by 56%, grapes' – by 32%, with prices for table grapes growing particularly fast. According to our estimates, production for most of the crops remained profitable in 2010 and thus farmers have more resources to invest next year. But these investment decisions may not be necessarily optimal, as shown below in the Forecast section.

Livestock subsector trends in 2009-2010

On the first sight, the situation in the livestock sector in 2010 was even better than in case of crops: indeed, according to our estimates, the total production in this sub-sector increased 24.3% in 2010, as compared with 17% in the crops sector. However, this burly growth was largely due to the meat production (+40%), which is not likely to be as impressive next year. Production of milk put a modest increase of 3%, while production of eggs perked up by almost 12%. The production of wool increased as well significantly (+10%), but this product has a negligible share in total production of the sub-sector. However, speaking about the farm-gate prices, the farms specialized in production of the animal products have not been this year as lucky as those deriving their income from production of crops. After a moderate growth in 2009, we estimated that in 2010 the farm-gate price for bovine fell by almost 35% (even though not for consumers). Producers of poultry have been hit less, by a 10% decline in the price they received. Wholesale prices remained constant for those breeding pigs (+5%), but the dynamic was very much positive for those specialised in production of sheep and goat meat (+25%). Production costs in the livestock sector grew more than in case of crops' growers, and this reflected in the worsening profitability indicators, especially for the farms producing bovine meat and wool.

Forecast for 2011

- The reassertion of the Moldovan agricultural potential should start with the domestic market. There is presently a very favourable situation on the domestic market which is much simpler for the Moldovan producers to exploit as compared with accessing foreign markets. The consumption demand for food is growing and there is a high potential for this growth to persist in the future: we expect that the domestic consumption will converge to the higher levels of consumption in neighbouring countries and thus will recover to Moldova's own traditionally higher levels of consumption. As shown in Table 3, the consumption of all important products is expected to continue growing in 2011. However, there is a high probability that Moldovan farmers will be misguided by evolution of the prices in 2010 and again will give preference to the low value added products.
- Because of the growing prices for cereals in 2010, we believe that many farmers, especially those from the poorest strata, will increase the areas sown with wheat, corn, barley and

other cereals. While allocation of the land for different cereals can vary, the total area under cereals in 2011 is likely to increase by 8.5%, to slightly exceed 1 million ha. The areas under technical cultures will increase as well (+6.1%), mainly due to enlargement of plots with sunflower, rapeseed and an expected doubling of areas under tobacco, while areas under vegetables will continue declining. No significant areas of vines and orchards are expected to enter the maturity phase in 2011. Based on the projected trend of yields for specific crops, we forecast a negative growth of agricultural output in 2010 of about -4%, a forecast supported by the cyclical evolution pattern in the Moldovan agricultural sector.

- We expect that in 2011 the headcount of cows will increase by 1.8%, while the productivity of milk per cow will improve 1%, leading to a 1.9% growth in produced milk. Headcount of pigs will increase by 25%, poultry – by 5%, and that of sheep and goat will decrease by 4%. Overall, this will result in a 21% growth of meat produced for the market. The quantity of eggs will increase only 2%, while the wool will register a negative growth of 6%. All in all, the production per livestock sub-sector will go up by about 13%. Coupled with the moderate decline in crops production, this will result in 3% growth of the agricultural output next year.

Table 3. Consumption of main food staples, kg/per capita if not otherwise indicated

Products	Average 1981-1990	Average 1991-2000	Average 2001-2007	2009	2010e	2011f
Meat and meat products	52	32	32	30	38	39
Milk and dairy	280	173	167	169	173	175
Eggs, pieces/capita	201	132	160	162	171	174
Potatoes	75	70	72	59	77	78
Vegetables	123	90	101	106	104	105
Fruits	66	59	37	35	37	37
Bread, bakery & pasta	175	145	135	119	119	119

Source: NBS and Expert-Grup estimates and forecast;

Policy recommendations

- While relatively limited data are available for analysis, the interviews with farmers suggest that the new scheme of agricultural subsidies has brought about positive effects for the farmers, by allowing them to upgrade the livestock breeds and procure more advanced machinery and equipment for crops harvesting. However, the access of all potential beneficiaries to the new scheme remains somewhat limited because the Agency for Agricultural Interventions and Payments is under-staffed and overwhelmed with the huge number of applications. The AAIP should have functional regional extensions and the work to be decentralised, while assessment procedures streamlined.
- Moldova's agriculture is becoming less labour-intensive and more capital-intensive. This is a significant long-term structural shift which will continue in the long run and which should not be discouraged, because it is accompanied by a growing labour productivity in the sector. At the same time, the Government should devote more resources to adequately monitoring the quality of soils and their rehabilitation, promote new technological standards, implementation of the European sanitary and phytosanitary standards and effectively enforce the good training of farmers as precondition for receiving state subsidies. So far, the latter was often formally required and not effectively enforced.
- Several key recommendations formulated in the previous editions of the MEGA remain relevant. Among these, the most important are promoting access of the farmers to market information, putting in place necessary infrastructure to simplify payments to suppliers/from customers, allowing wider access of foreign/donors capital to the agricultural sector, adopting realistic strategy for mitigation of the impact of natural hazards, updating the agriculture insurance system to the most disastrous hazards affecting Moldovan agriculture (drought and frost) and promoting the insurance 'culture' among the Moldova farmers.

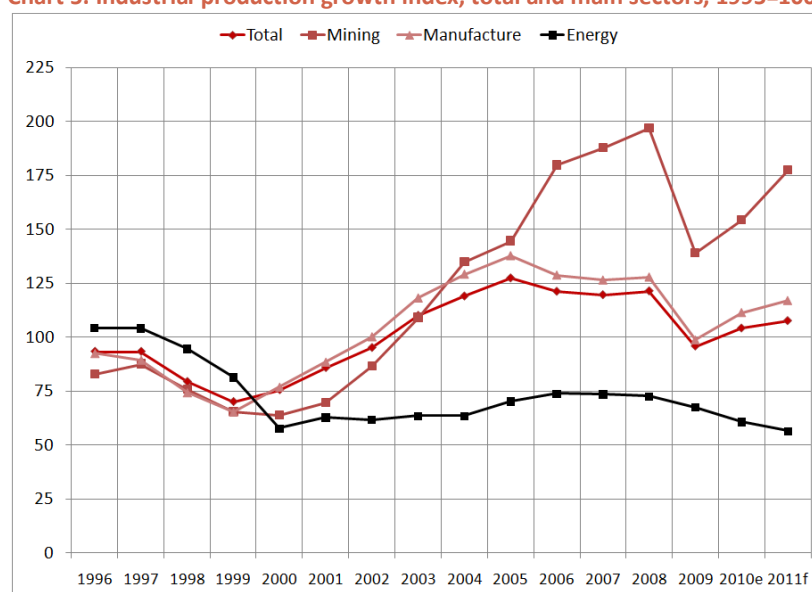
4. Industry

This chapter examines the evolution of the Moldovan industry in 2010. It deciphers the general and sectors-level trends and highlights the most significant barriers and opportunities for growth. A brief section forecasting the industrial growth for 2011 follows. The chapter ends with key policy recommendations addressing the short-term challenges that Moldovan industry faces.

General trends: recovery slow in a regional perspective

Following a dramatic 22% contraction of the industrial output in 2009, the year 2010 has seen a turning point for the Moldovan industrial sector (Chart 5). We estimate a 8.7% annual growth of the industrial production in 2010, which has been mainly driven by the recovery of some food and beverages producing sectors (sugar, wine, dairy) and non-food sectors (apparel and furs, tobacco products, leather processing and shoes making). This growth, obviously, is a far cry from what is necessary to get the production volumes back to the 2006 level, when the crisis hit the Moldovan industry (i.e. more than two years before the outbreak of the global financial crisis). With such a modest growth in production, it will take 6-7 years for the industry to recover completely.

Chart 5. Industrial production growth index, total and main sectors, 1995=100%



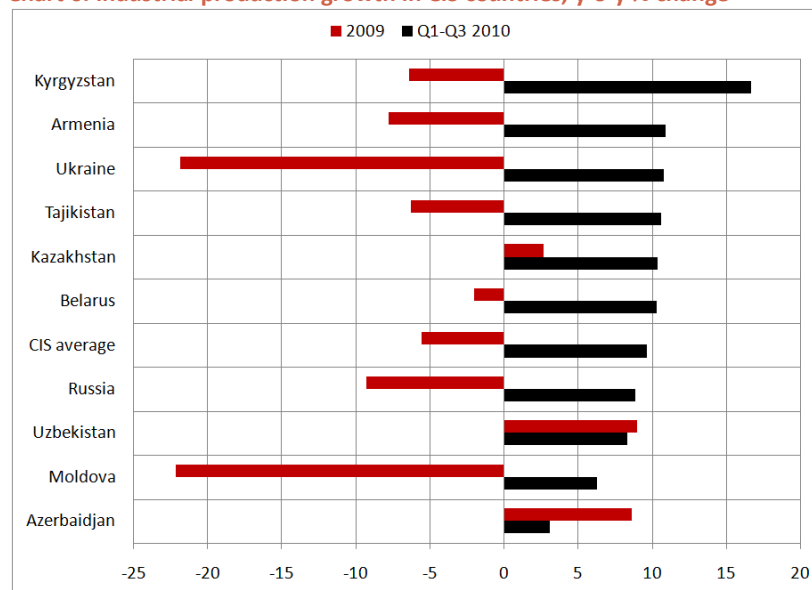
Source: NBS and Expert-Grup estimates and forecast;

The industrial growth looks quite bleak not only from the domestic perspective; the picture is even gloomier when adopting a regional comparison. Indeed, among the CIS countries, Moldovan industry has suffered *the* deepest decline in 2009, and at the same time, one of the slowest recoveries to date (Chart 6). This slow growth underlines two core intertwined problems of the Moldovan industry: the low labour productivity and the low international competitiveness. The former is particularly a problem in the sectors where the state maintains a high level of ownership. For instance, in the energy sector the labour productivity has increased only by 65% in 2001-2009, while the real wage in this sector grew 2.7 times.

There has been a moderate on-going industrial restructure, as suggested by a 3.5% decrease in number of labour force employed by industrial companies in 2010. What is particularly interesting, in 2010 the companies shed only the labour from the superior age cohorts, preferring to preserve or even increase the number of young employed. We expect that this trend will only get stronger with the privatisation of state-owned enterprises. However, it is clear that productivity gains achieved

through shedding labour is an arithmetical rather than an economic growth. Industrial labour productivity needs to improve through both upgraded technological endowment and through better training of the staff employed. The latter is a significant challenge, as it requires a genuine reform of the Moldovan educational sector, and also removal of regulatory barriers impeding companies to invest more in staff training.

Chart 6. Industrial production growth in CIS countries, y-o-y % change



Source: CIS statistical office;

Mining industry: hostage of the constructions sector

The bell rang for the extractive industry in October 2008, when the first significant year-on-year drop in production was registered after a five-year long period of growth. A disastrous 30% decline in production followed in 2009, the deepest as compared with other industrial sectors. Only in April 2010 a positive y-o-y growth episode was registered, with a more stable growth to start in September 2010. According to our estimates, in 2010 the mining industry has put an 8.0-8.2% growth rate. In the last quarter of the year, the quarried physical quantity of sand, gravel and stone even exceeded the pre-crisis levels. The on-going economic rebound in the constructions sector has somewhat reflected in the extractive industry supplying more than 40% of its entire production to the constructions sector directly and another 20% indirectly through the building materials industry. However, the latter trails four-five months behind the extractive industry per se, with an only minor positive growth to be registered in 2010. This rather feeble demand from the side of building materials industry is a significant risk for the extractive industry in the short term, but we expect it to recover as growth in the constructions sector itself gets a bit stronger in 2011.

Recovery growth in processing industry

The processing industry has been the main engine of the industrial recovery in 2010. We estimate that the manufactured output increased 9.1% this year. Main sources of this industrial growth originate in two clusters: food and textiles. Sugar production has recorded a spectacular three-fold growth in 2010 due to higher harvest of the sugar beet, but also because of the very low comparator base. Then the apparel & fur production sector comes, where the growth is estimated to have reached 13%. Interesting enough, the textiles sector was not as vibrant as production of higher value-added apparel & fur products, with the total amount of production only reaching the level of the previous year. After a decade-long crisis, the tobacco processing industry has posted a significant

38% growth rate. The alcoholic beverages industry has lost the momentum over the year, partly due to the uncertainties in the trade relations with Russian Federation. Opposite to this, the dairy industry has only get strength throughout the year: it posted a negative a 3.5% growth in the first quarter, reported a total 4% for the first half of the year and, based on our estimates, ended the year with a strong 12% rebound of annual production.

Energy sector: out of steam

The domestic energy sector was not able to adequately respond to the general economic recovery in 2010. Contrary to the general growth of the industry and other economic sectors, the domestic power production declined 1.0-1.5% in the current year, going hand-in-hand with the production of thermal energy at the cogeneration power plants in cities of Chisinau and Balti. The 3% growth in demand in the electricity was therefore satisfied by imported energy. These evolutions only confirm the historical trend of the domestic energy sector shrinking comparing to other sectors. Lack of investment in cogeneration power plants will exponentially make these producers less efficient, while their production uncompetitive. Importing 100% of the consumed energy is not a good option for Moldova. Therefore, postponing the industrial restructuring of the energy sector creates great risks for the Moldovan economy in general, not only for the energy sector per se.

Forecast for 2011

- After a relatively moderate recovery in 2010, we expect in 2011 the industrial growth rate to reduce even further. Our models render a 3.3% growth as the most likely scenario next year.
- As constructions sector is expected to gather more steam next year, we expect a further acceleration of the growth in the mining industry, with the figure to rise as high as 15%.
- The main sub-sector – the manufacturing – is expected to put a 5% growth next year, mainly originating from the same two clusters that enabled the growth in 2010: the food industry (with production of beverages very much depending on future trade relations with Russia) and the textiles, apparel and fur cluster. The latter very much depend on how strongly recovers the demand on the EU markets.
- Yet in the energy sub-sector it is expected that production will further decline, with an estimated figure of -7%. This will be entirely due to further decline in production of electricity, with the cogeneration power plants being unable to invest at least for the maintenance of the existing production capacity.

Policy recommendations

- In 2010 several important legislative progresses regarding industrial policy have been made. The law on public-private partnership and the law on concessions were amended to streamline the procedure of establishing such partnerships. A new law on industrial parks was passed in 2010 replacing the law with similar title adopted in 2007. However, nothing changed in the real world: no industrial parks have been created and no PPPs established. While some by-laws are necessary to be adopted in order to get the new industrial policies working, equally, if not more important, is to reform the business support institutions, such as Moldovan Investment and Export Promotion Organisation, Organization for SMEs Development and the Commerce and Industry Chamber.
- A clear political decision has to be taken on the privatisation/restructuring of the cogeneration power plants. Few years more and these power plants will generate more financial losses than energy. Without private capital it will not be possible to upgrade technologically these facilities. However, entrance of the private capital, potentially through PPPs requires significant changes in the management practices. There is no much time left,

because shortage of energy may turn a significant constraint limiting economic growth in general.

- It is necessary to urgently review the fiscal and labour codes in parts regulating the fiscal and civic implications of the labour training. Currently companies are not motivated to invest in their staff for a number of fiscal reasons, and also because they are afraid of losing investment in case the employed decides to leave. The provision of the training services by non-state providers has also to be more deregulated so that the number of training providers is allowed to rise, including via arrival of foreign companies.

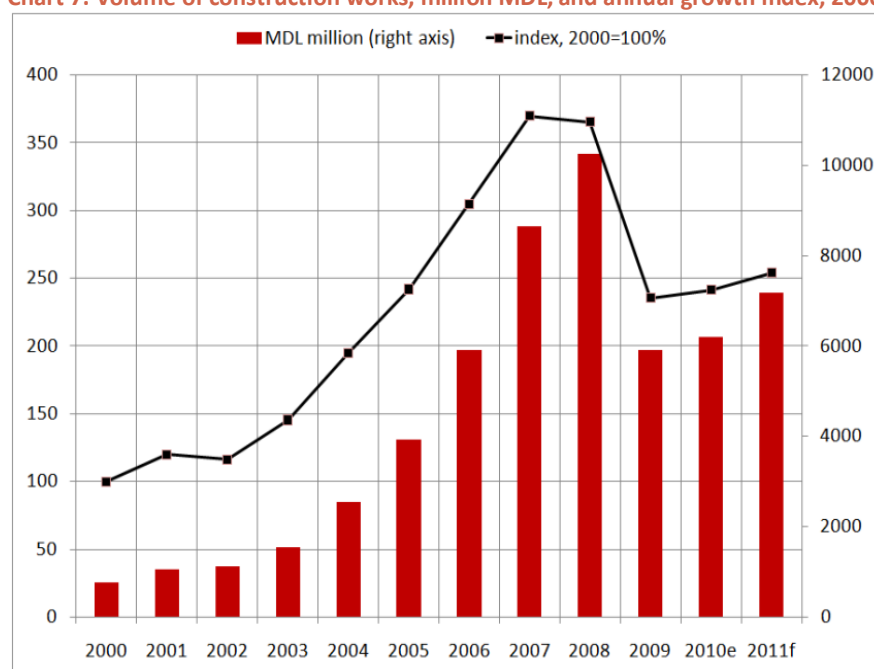
5. Constructions

This short chapter sheds light on the difficulties that companies from the constructions sector meet as they try to recover from a shocking recession in 2009. The 2011 forecast is based on a simple auto-regressive model of the sector. Policy recommendations are provided to ease the process of constructions post-crisis recovery.

Constructions sector in 2010

The constructions sector lost the momentum in the final quarter 2008, so that the year-on-year growth of the volume of constructions works turned a negative figure of -1.4% (Chart 7). In 2009 the sector collapsed more than 30% because of the fading demand and also because of the banks cutting finance. In 2010 a moderate 2.5% growth is expected by the Expert-Grup, however, ironically, this growth at least partially is due to the construction works initiated by Moldovan Government in result of the summer floods in the Hancesti district. The “Prima Casa” program announced by the local public authorities of Chisinau also promises to underpin somewhat the sector’s growth, but only starting next year and obviously with limited impact.

Chart 7. Volume of construction works, million MDL, and annual growth index, 2000=100%



Source: NBS and Expert-Grup estimates and forecast;

Apart from the government, some foreign-owned and mixed joint ventures ordered construction works, but these are limited to a small number of relatively large projects (such as construction of the cargo terminal in the Giurgiulesti Port ordered by the port’s operator, the Danube Logistics). Private domestic companies have been very unenthusiastic regarding the purchases of construction services in 2010. The residential sector received some fresher impulse in second half 2010 in result of Moldovan migrants starting again sending more money back home. However, most of the money is spent for current repairs rather than for capital constructions; actually the residential constructions sector remains deeply in crisis, with prices exhibiting a generally declining trend in 2010.

Forecast for 2011

- We expect a somewhat half-hearted economic growth to be put by the construction sector next year. According to our estimates, a 5% growth is the most likely to materialize. The real estate prices will remain stable in the first half of the year, and will start moderately growing in the second part.

Policy recommendations

- Despite some more lukewarm evolutions in 2010, the constructions sector remains in deep crisis, owing basically to the greed of the developers and banks that before the crisis have over-invested in doubtful construction projects. Therefore, it would be not either economic efficient or socially fair for the Government to bail out the construction companies. However, the Government should do its part of job to streamline the administrative procedures that a residential or non-residential project involves. These procedures include change of land destination. While the administrative burden is not limited to this aspect, it is critical point where the cost of construction rises due to cumbersome procedures and high level of unofficial payments.
- It is vital for the Government to enforce fair competition in the constructions sector, so that legally-operating companies are not outcompeted by those operating 'wild'. This refers to both big capital constructions and to petty interior repair services. In this respect, it is essential for the local public authorities to fight illegal residential constructions. Fighting illegal constructions obviously involves more public control over the State Inspections for Constructions, but also some legal amendments allowing the local authorities to stop illegal works (including demolishing the illegal buildings). In long term these measures will bring the law into the construction sector and more orders to the legally-working companies.
- The demand for construction works is significantly hindered by the lack of access by the median citizen to mortgage programs of the commercial banks. Aside from the fact that only a few commercial banks are actually offering mortgage loans, the costs of these loans are prohibitively high. For a typical 20-year mortgage loan, the commercial bank would ask the customer to prove a monthly income 5 times exceeding the average wage per economy while the total cost of credit would be twice the value of the credit itself. There are no easy solutions for streamlining access of the population to the mortgage. It is obviously necessary to reduce the barriers arising from the insufficient competition among the banks in this niche. But in long term the mortgage crediting will depend on public's confidence in the banking sector and national currency, macroeconomic and political stability and development of the capital market.

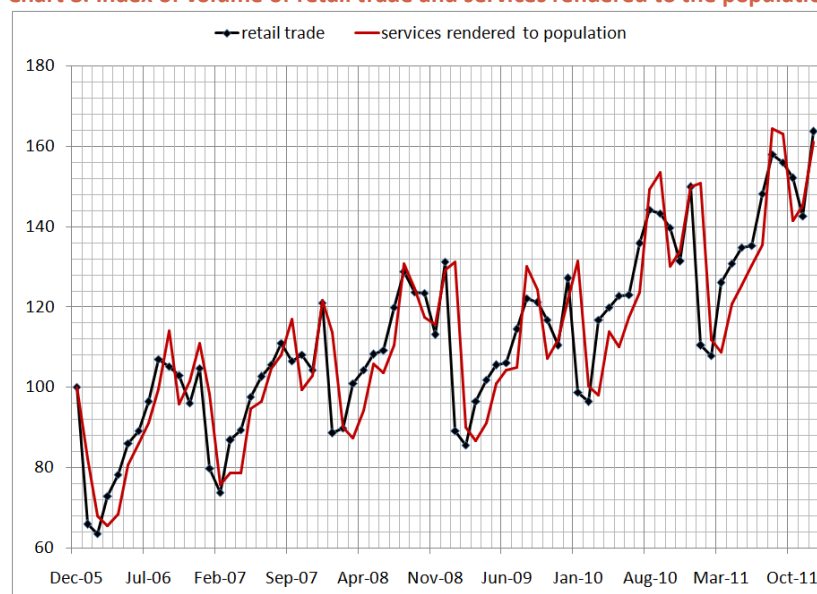
6. Services

This chapter highlights chief evolutions in the services sector in the recent year. It shows that services rendered to population grew faster than those provided to companies, which only emphasizes the argument of a consumption-driven economic growth remaining in place in near future. It ends with some key policy recommendations addressing the market failures and under-regulated aspects.

Main evolutions in the services sector in 2010

With a share of 2/3 of the GDP and an estimated growth rate of 3% in 2010, the services sector has been the main pillar of the domestic economic recovery. While growth in the services sector benefited of a relatively wide base, it has been particularly strong in the retail trade and services rendered to the population (Chart 8). We estimate a total growth of 9% in retail trade volume and 6% in the volume of services rendered to the population in 2010. It is worthwhile noting a forward-looking structural shift of the trade: while in 2009 the trade with non-food articles shrank much more than the trade with food items, in 2010 the situation was opposite - the trade with non-food items posted a faster growth (11%) as compared with that in food (4%). This is a statistical reflection of the geographically-biased economic growth, which is led by the rapidly growing consumption of the urban dwellers, while consumption in rural areas has remained depressed. Indeed, in 2010 the share of the Chisinau-based supermarkets in total retail sales increased more than 2 p.p. (55.8 in 2009 to almost 60% in 2010). Share of services rendered to the Chisinau population equally grew, from 48% in 2009 to almost 50% in 2010.

Chart 8. Index of volume of retail trade and services rendered to the population, December 2005=100%

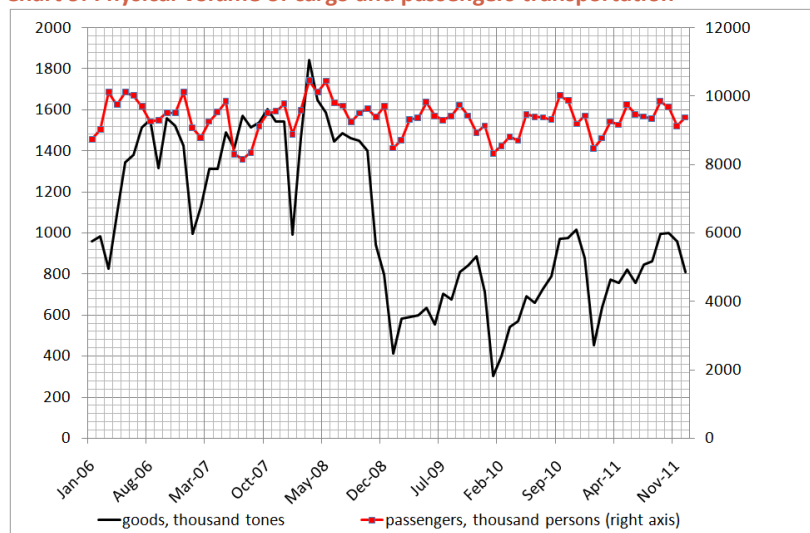


Source: NBS, and Expert-Grup estimates for 2010 and forecast for 2011;

At the same time, the business-oriented services sub-sector trailed a bit behind, as suggested by the relatively sluggish evolution of the cargo transportation sector (Chart 9). According to our estimates, the volume of transported cargo increased in 2010 about 6.5%, especially in the fourth quarter, while number of transported passengers remained roughly the same as in 2009. The road transport has been the main source of growth in this sector, with rail-road only starting to recover in September 2010. As we predicted in the MEGA no.2, the rail-road carrier has lost to the automobile transportation the dominant share on the cargo transport market. An eventual solution to the railroad conflict with the Transnistrian breakaway region will only provide a short-term relief. In long

term the fortunes of the railroad transportation will entirely depend on the effective restructure of the national carrier 'Caile Ferate ale Moldovei'. The accounts of the company represent a financial quagmire while the management practices are extremely inefficient and outdated. (To quote only one example, the tickets bought in advance at 'Caile Ferate ale Moldovei' are more (!) expensive than those bought the day of travel, which is completely against the modern marketing approach).

Chart 9. Physical volume of cargo and passengers transportation



Source: NBS, and Expert-Grup estimates for 2010 and forecast for 2011;

In 2009 the tourism and hotel sector in Moldova was severely hit by the financial crisis. The number of tourists accommodated in hotels declined almost 20%, both for Moldovan and foreign tourists. The downward trend continued in the first quarter 2010, but starting with April the business received a moderate boost. Our estimates show that in the recent year, the total number of guests accommodated in the Moldovan hotels increased 6%, including due to a 25% rise in number of foreign visitors. All sub-sectors have developed at more or less similar pace, suggesting that 'old' structures (such as sanatoriums, and visitors' campuses) faced the crisis' impact equally well as the more 'innovative' structures (such as rural guesthouses, and hotels).

The telecommunications sector has weathered out the crisis lots better than others (except one tiny new-entrant company which ceased its activity two years after being created). Due to the fierce competition between the two big players, the number of mobile telecommunications subscribers grew 15% in 2009 and about 9% in 2010. The average revenue per user declined across all operators in 2009, but started growing again in 2010. Mobile telecommunications penetration rate has reached a remarkable level of 83%, to be compared with 78.1% in Q3'2009. The Internet market has undergone significant structural shifts, while at the same time total market sales increased more than 25% in real terms in 2010. One private company has spectacularly doubled its market quota, thus dissolving the monopoly of the state-owned telecommunications company. The number of broad-band subscribers has grown almost 50% in only one year, while the Internet penetration rate reached 14%, as compared with 10.2% end of 2009. From this perspective, Moldova has been one of the fastest growing countries in Europe.

Forecast for 2011

- For 2011 we expect a 5.6% of the value added generated by the services sector. This growth will come in result of market services expanding more, while the size of the public services will remain roughly at the same value.

- Due to continuing migration and associated rise in remittances, but also due to expected growth in salaries, we believe that the retail trade volume will grow 9.3% in real terms in 2011, while services rendered to the population will expand 7.3%.
- Positive changes are expected to continue in the transport sector, but this will represent mainly the contribution of the automobile transportation, whereas the stagnation of the railroad sector is expected to go on. All in all, we expect that the number of transported passengers will rise about 1%, while volume of transported cargo – about 13%. The latter is subject to effective implementation of the digital tachographs, without which Moldovan carriers will simply not be allowed to cross the EU border.
- The telecommunications sector will remain as buoyant as it was in 2010, with the volume of sales of mobile telecommunications to put a 7-8% growth in real terms. The fixed telecommunications market will stagnate under best case scenario in 2011. As for the Internet market, this will be the most rapidly growing sub-sector. With intensified competition among the main players and a very high growth potential, we believe that the market volume will increase at least 23-25% in 2011, entirely due to wider use of broadband.

Policy recommendations

- The year 2010 has revealed how persistent are some key horizontal constraints limiting the growth in the services sector. High market entry costs (mainly due to unofficial payments) remain as prohibitive as in the past, especially in such sectors as retail trade and services rendered to the population. After the entry point, corruption and pervasive state controls remain significant barriers with the impact on SMEs being particularly high. It is necessary to conduct a comprehensive assessment and functional review of all controlling/authorizing bodies in Republic of Moldova in order to bring these institutions in line with the governmental policy of streamlining the business regulatory framework.
- As mentioned in the previous issues of the MEGA, it is imperative for Moldova to put in place a strong, independent, pro-active and transparently-functioning anti-trust agency. The existing National Agency for Competition Promotion has not proved so far to be able to effectively enforce the fair competition and dismantle the anti-competitive market agreements. At the same time, the competences of this Agency should be clearly delineated so that there is no overlapping with other regulatory agencies operating at sectors' level.
- Despite the financial crisis, the telecommunications sector has remained dynamic in 2009 and 2010. The market perspectives are bright for the next years, with mobile telecommunications and Internet services remaining the leaders. The mobile telecommunications market is specific in the sense that it is represented by a small number of big players that have enough capacity to address the problems related to market functioning in direct dialogue with the government. It is important for Moldova not to lose the momentum of the Internet market. This market is represented by a bigger number of players, most of them small, with no power to effectively engage in dialogue with the government. As internet penetration is growing, the government should capitalise on the progress achieved and further enable the growth through improved access of private providers to key infrastructure.
- The Government should pay attention to solving a number of issues that are critical for access of the national service providers to the foreign markets. A relevant negative example in this respect is the lack of any meaningful progress in implementation of the digital tachographs on the basis of which national transport companies will be allowed entering EU. While Moldova was provided an extension of the deadline for implementation of the system until the end of 2010, according to available information there was no progress done in selecting a company to implement the system. Quick actions are necessary in order to avoid the detrimental impact that a potential ban will have on the national carriers.

7. Labour market

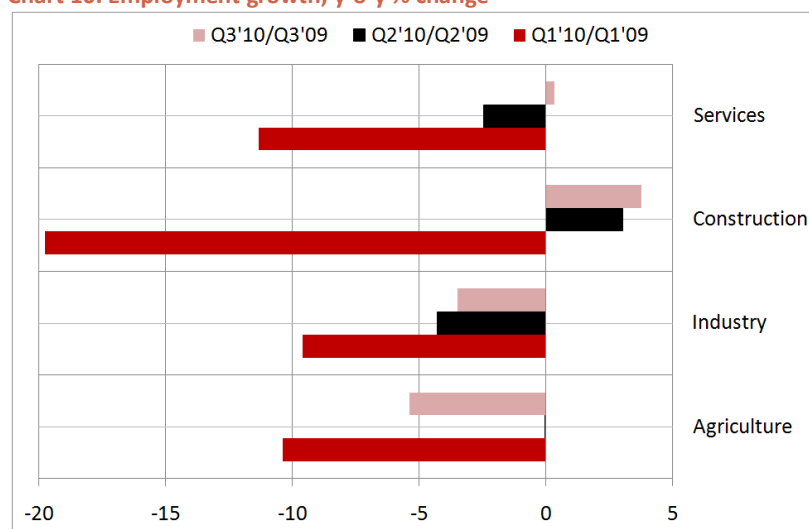
This chapter analyses the situation on the labour market in 2010, which kept worsening despite the resumption of economic growth in all sectors. It looks at how different groups of population were affected by the economic crisis and identifies main trends of 2010 and possible developments in 2011. The chapter finalizes with some policy recommendations that in mid- and long-term should have a positive effect on the situation on the labour market and the competitiveness of Moldovan economy.

General evolutions

Despite the good start of the year 2010, with recovery taking ground in most of the economic sectors, labour market failed to react to these positive evolutions. For three quarters in row labour market indicators continued to worsen. Employment dropped during the first three quarters of year, however, with remarkable differences across economic sectors. In construction sector the decline in employment was the most significant during 2009 and early 2010, but so has been the recovery. However, in the constructions sector the recovery of employment was due mainly to some episodic factors (such as governmental demand for construction works in the floods-affected areas in Hancesti district, this project leading to creation of 2000 jobs) rather than to systemic changes. Services sector as a whole resisted the pressures until the third quarter of 2009, when the employment went on a descending path. One year later it grew moderately due to the recovery of some sub-sectors, including transportation.

On the other hand, employment in agricultural and industrial sector continues to decline despite the earlier growth of production in the sector (Chart 10). Although the impact on the population is negative, it reflects also some qualitative changes in the economy, e.g. the increasing productivity. As for the construction sector, it is more labour-intensive, and an increase in production is necessarily associated with an increase in employment. All in all, we estimate that employment rate in Moldova in 2010 retreated even more, reaching 39.1% as compared with 40.0% in 2009 and 42.5% in 2008.

Chart 10. Employment growth, y-o-y % change



Source: Expert-Grup calculations based on NBS data;

Lack of jobs in the country and limited opportunities to migrate abroad in the post-crisis period pushed unemployment in 2010 to its highest historical values (9.1% in the first quarter). According to our estimates the average unemployment rate for 2010 has been 7.4%, i.e. 1 percentage point up as compared with 2009. Registered unemployment also increased, currently around 50% of

unemployed individuals being registered at National Employment Agency, which is significantly higher compared to pre-crisis level (around 38%). The early increase in registered unemployment was partly explained by the compensation scheme for heating in winter season. However, this was valid only for Chisinau municipality, while registered unemployment increased throughout the country driven by lack of opportunities (inside the country and abroad) and decrease of disposable income of the households. Therefore, the total amount of unemployment benefits increased by 73% in 2010 compared to previous year, but still, only 12% of the unemployed individuals (registered!) receive unemployment benefits.

At the same time, having a job does not guarantee full employment and decent income. Most enterprises are just starting to recover and do not work at their full capacity, which explains high underemployment rate. In the second and third quarter of 2010 the latter increased on average by 37%. Currently, around 10% of employed population are underemployed.

Some other interesting trends can be identified in 2010 on labour market:

- The crisis affected differently men and women. In early 2010 men were more exposed to the negative impact of the crisis due to being dominant among employed in the sectors that declined the most (construction and agriculture). Only after the economic growth resumed in the 2nd quarter in the construction sector that employ mostly men, the situation has changed.
- A quite new phenomenon was registered in Moldova, where young individuals were less affected by the crisis. Thus, the number of employed decreased the most in the age group of 35-49 years, and the least in the age group of 15-34 years. Therefore, the flexibility of young employees was certainly seen as an advantage by the employers.
- Migration to informal economy has been a widespread method to deal with the economic problems during the crisis and post-crisis period. In three quarters of 2010 the number of individuals with informal occupations increased by 3.4%, while the population in formal activities decreased by 4.3%. The situation is similar for both self-employment sector and employees. The informal employment in formal sector takes significant size, in the third quarter it increased by 6.4% y-o-y.

Despite negative trend of labour market indicators in 2010, the rate of decline has moderated somewhat in the quarters two and three. At the same time, we can observe migration coming back as important factor influencing the labour market, despite the formal determination of previous governments to change it. Migration abroad comes again as the main solution for many individuals unable to find a job or unable to earn decent salaries within the country. The number of individuals working abroad or looking for a job abroad has increased in 2010 by 6.5%.

As mentioned before, increasing demand and supply does not necessarily result in the creation of new jobs, when qualitative changes in the economy happen, such as increasing labour productivity. Therefore, for the whole 2010 we do not estimate a rise in employment. Employers seem to have tried to better use under-employed individuals (representing a high share in employment) rather than hiring new employees to meet the increasing demand.

Forecast for 2011

- In 2011 we expect a stabilization on the labour market, with increasing employment in constructions and services sectors, but a further decline of employment in agriculture in the process of transition from labour-intensive to capital-intensive agriculture.
- The recovery on the labour market will have two phases. During the first one, expected already in early 2011, the employment will stabilize, with more significant evolutions in informal sector. The second stage, of migration from informal to formal sector and creation

of new jobs, is expected in the second part of 2011, linked to the more certain and stable recovery of the private sector. However, the strength of this employment growth depends on the business climate, political and macroeconomic stability in the country.

- In short- and mid- term migration will remain a feasible option for those unable to find a job and to earn decent salaries inside the country. Therefore, an increase in the number of migrants, up to the 2008 level, is expected. This means that we expect a 5% increase in migration in 2011. Long-term developments of migration will depend on the negotiation of visa-free regime with EU, which may rise the number of migrants (although not significantly), but certainly, may redirect migration from CIS to EU countries due to significant decrease of migration costs.
- Unemployment rate is expected to stabilize at current level, with slight decrease in the second semester of 2011 as migration will advance.

Policy recommendations

- The Government cannot 'create' jobs through direct intervention, but rather through the improvement of business climate. Only private sector can offer new jobs and the efforts of the Government should be oriented towards creating an enabling business environment for attracting new investors and reducing administrative burden that would trigger the enlargement of existing businesses.
- The quality of human capital in Moldova was ignored for the last two decades of transition, the few implemented reforms giving poor results, and thus, it became a serious constraint for growth. Investment in human capital is vital and cannot be postponed anymore. Although the impact of investment will be visible only in long-run, it is necessary in order to attract investments in high value added sectors (almost missing in Moldovan economy, except IT sector). This will increase labour productivity, an essential factor for growth.
- As in short- and mid- term migration is going to be a widespread phenomenon, the Government should put more effort into protection of its citizens' rights abroad. This refers especially to social protection: bilateral agreements on the social protection and insurance should be signed with countries where Moldovan citizens work and Moldovan Government should be the one launching the negotiations.

8. Households' income and consumption

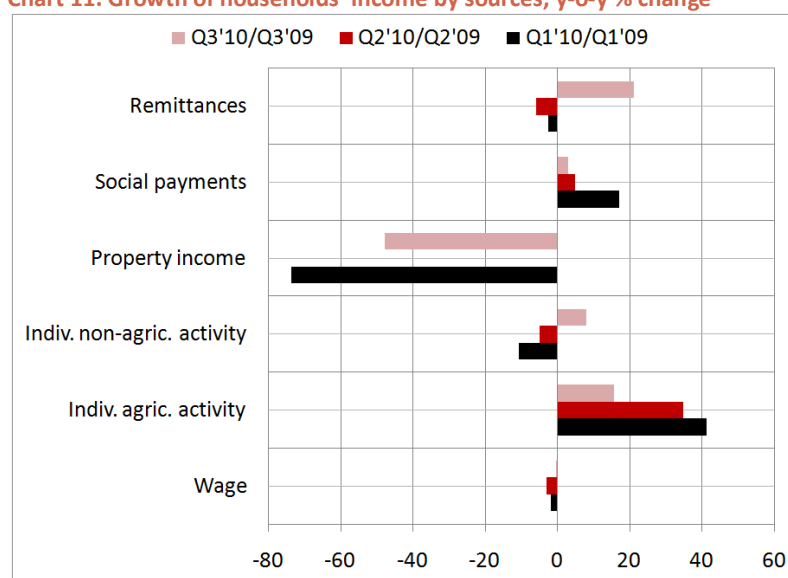
This chapter presents the situation of the households in a post-crisis year: the evolution of different sources of income, the impact on the population welfare, the adjustment of consumption to the changes in income and the dynamics of households' savings. The end of the chapter comprises some projections for 2011, based on the positive expectations on global growth, and policy recommendations to increase the population' welfare and stimulate consumption.

Evolution of households' income

The most significant negative impact of the economic crisis on population welfare was registered in 2009 with the deepest decline of households' income, on average by 2.7% in the first three quarters of the year. The first weak signs of recovery were visible in the fourth quarter of 2009, when disposable income of the population returned to its growth path. The trend persisted during 2010, however, with major differences in the evolution of the most important sources of income (Chart 11). Only income from agricultural individual activity and from social payments rose during the whole year, while remittances displayed a significant y-o-y growth only in the third quarter.

Higher agricultural production, due to better weather conditions, but also the increase in prices for agricultural production in 2010 for cereals, vegetables, fruits and grapes pushed agricultural income up by about 30% in three quarters. This contributed essentially to the contraction of the gap in the income between rural and urban households, which reduced from 57% on 2009 to 36.8% in 2010. Social payments to population rose mainly due to the revision of the value of social benefits for children at the beginning of 2010.

Chart 11. Growth of households' income by sources, y-o-y % change



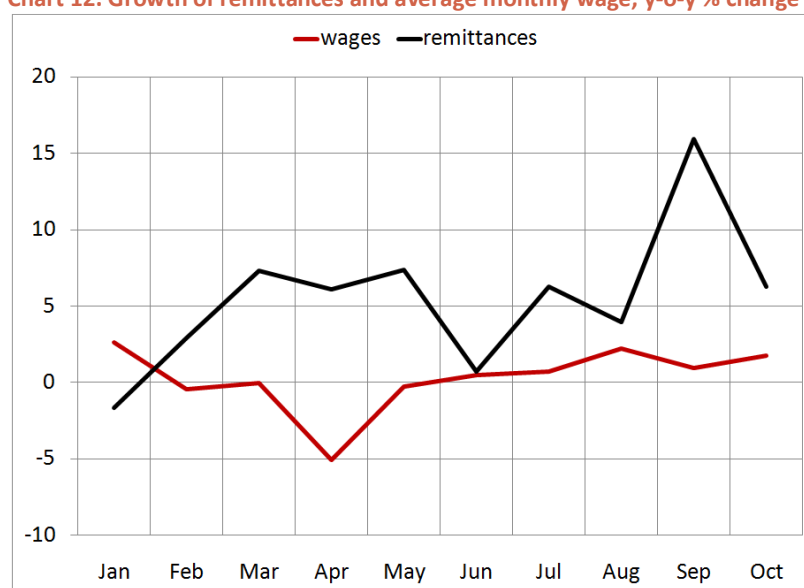
Source: Expert-Grup calculations based on NBS data;

At the same time, the recovery of the other two very important sources of income - wages and remittances – is slow, their share in the total income of the households declining. Average real wage started to decrease in 2010 (Chart 12), after a year of resistance to the economic pressures due to administrative rise of wages in the budgetary sector. Together with the decrease in employment this contributed to the reduction of wage income share in households' income. Starting from June, the wages in real sector returned to moderate growth pattern. By October 2010, the wages increased in almost all sectors of private economy, except quarrying and mining, transport and communication

and construction (where wages remained stable during the last few months). This development points at the optimism of the employers who are able to increase the wages based on their expectation on growing demand. Initially, this cannot influence strongly the share of income wage in the households' budgets, due to still declining employment rate; however, some groups of the population will definitely benefit from it.

According to HBS data, remittances started to grow only in the third quarter of 2010, while in the first half they declined by 4.1% and their share in total households' income fell (from 21% in 2007 to 15% in 2010). On the other hand, NBM data (balance of payments and international transactions by natural persons via the banking system) show an increase in the amount of remittances throughout the year by 5.9% (Chart 12). The two diverging trends were identified also in the beginning of the economic crisis, when the remittances reported in the BoP dropped faster than remittances reported in HBS. The explanation might be the same, some of the remittances reported in the BoP are actually payments for goods and services delivered from Moldova or even investments transfers paid as remittances due to lower administrative and transactional costs. These were the first who decreased and currently they are the growing. However, the increasing number of migrants seems to influence 'the actual' remittances that registered a higher recovery in fall.

Chart 12. Growth of remittances and average monthly wage, y-o-y % change



Source: Expert-Grup calculations based on NBS and NBM data;

Evolution of household consumption

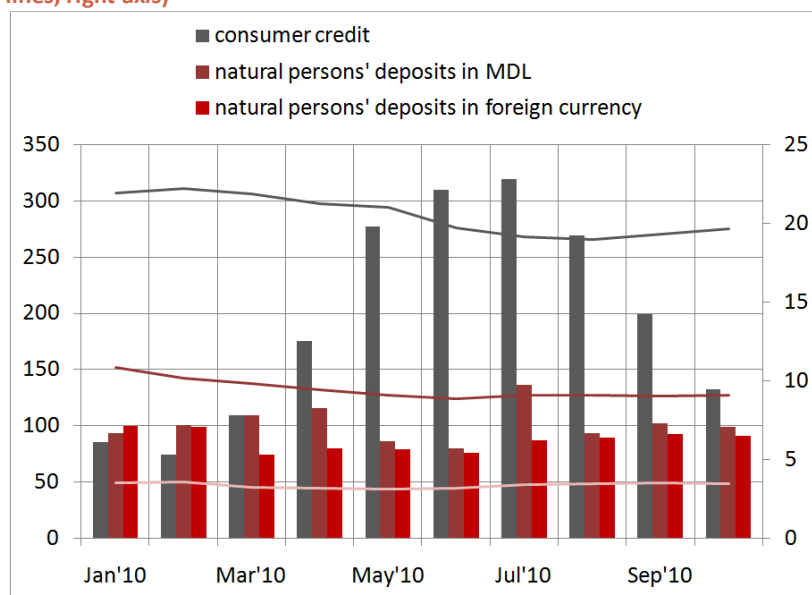
Growing income of the population had an immediate impact on the recovery of consumption. According to HBS data, households' consumption increased faster than households' income – 5.6% compared to 4.1%. National accounts data show a slightly lower advance in consumption of 5% in January – September 2010. The rise in consumption preceded the increase in wages, but rather has followed the pattern of remittances. Thus, Moldovan economy is getting back to the pre-crisis consumption-based growth model, underpinned by remittances.

Both retail trade and the amount of services rendered to the population have grown since the beginning of 2010 by 8.3% and 5% respectively. While the amount of services rendered to the population reached and even surpassed the level of growth before the economic crisis, the retail trade is growing almost twice slower compared to pre-crisis level. The rebound of retail trade depends mostly on the evolution of trade with non-food goods that shrank during 2009, when trade

with food stuff was still growing. The growth of consumption was unevenly distributed in the first part of 2010, more concentrated in Chisinau municipality; but in the third quarter of the year the regions already registered a higher increase in services rendered to the population compared to Chisinau.

Although remittances explain to a significant extent the growth of consumption, there are also other sources to it. In 2010, consumption was partly financed by consumer credit. After a year of decline, consumer credit resumed in spring of 2010 during few months registering a two-/threefold y-o-y growth. This pattern moderated in the fall, but the increase is still significant. At the same time, deposits of natural persons were mostly falling during 2010, partly explained by lower savings of the population, but also by decreasing interest rates set by commercial banks for deposits, especially in foreign currency (Chart 13).

Chart 13. Consumer credit and deposits of natural persons (y-o-y % change, columns) and interest rates (% , lines, right axis)



Source: Expert-Grup calculations based on NBM data;

Forecast for 2010-2011

- In 2011 we expect a recovery in all private economic sectors that will allow the increase in wages in real sector on average by 3-4%. There might be large differences across the economic sectors, with wages in agricultural sector still advancing slowly, and higher rates of growth in service sectors: transport and communication, trade. The budgetary revenues are expected to grow in 2011, raising the chances of amending the wages for public employees. However it is difficult to predict how the new Government will use money: for hikes in wages, other social payments or investment; and in the case of a potential increase in wage – who will benefit from it? One possible scenario is the revision of salaries in non-educational sectors, as educational sector already benefited twice from upward revisions in 2009.
- Migration re-emerges as a viable option for many Moldovan citizens without a job or a well-paid job in the context of recovery of some European and Russian economies. Already for two quarters we observed an increase in number of migrants, but this has not been accompanied by a proportional increase in remittances. Thus, despite the recovery in most of the countries where Moldovan citizens leave for work, remittances are still below the pre-crisis level. Therefore, although we expect migration to increase in 2011, the earnings of

migrants will not be as high as before the crisis and consequently the amount of remittances will not reach the 2008 level, increasing around 12-14%.

- Based on the projections on wages and remittances we expect an increase of 8% in retail trade and around 5-6% increase in overall consumption for 2011.

Policy recommendations

- The Government should more actively promote investments. In light of this necessity, we believe it is necessary to revise some of its recent contentious policies, such as PARE 1+1 program. Firstly, the role of the Government is to promote investments in some priority sectors rather than for some groups of population. Secondly, there are no good tools to implement such programs as PARE 1+1 as most of Moldovan citizens have a relative abroad and the temptation to speculate on this will be high, while the methods to check the source of invested money are not sound.
- The Government should implement performance monitoring mechanisms in the public sector in order to ensure that evolution of public wages corresponds to the quality of provided services.
- The Government should revise its social expenditure policies. Currently, the social expenditures hold excessively big share in the national public budget and they also represent a large share in the households' income. Means-tested social allowance should be the only method used for the targeting of social vulnerable categories of population. Government should work on the elaboration of a well-designed means-tested mechanism and update it gradually in the context of changing economic conditions.
- Fiscal legislation should allow the natural persons to deduct the investments in durable goods from the revenues declared for taxation. This will increase the demand for the deductible from taxation goods, but also for the complementary products and services.

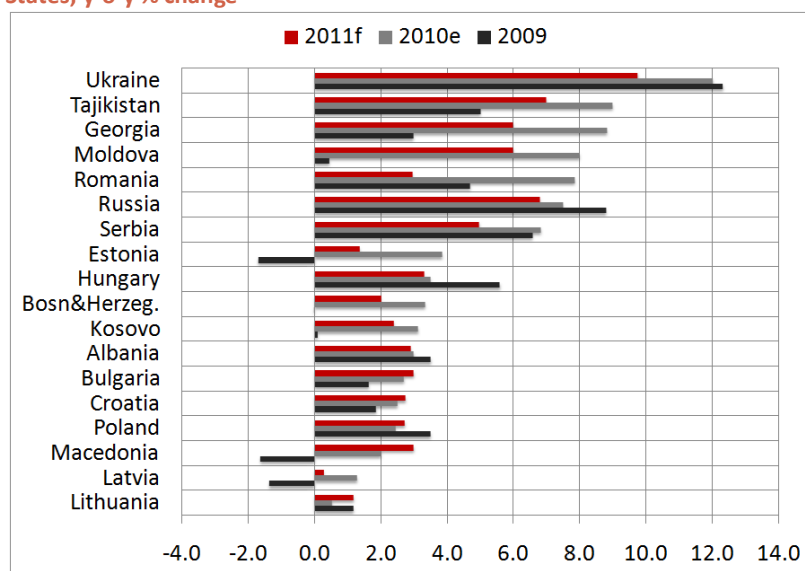
9. Prices

This chapter analyzes the inflation trend during 2010, as well as the main factors driving the prices up. Based on empirical estimations we prove the persistence of monetary inflationary pressures which should not be ignored by the central bank. We also discuss in brief the main contagion channels of inflation, as well as the challenges faced by the policy makers while trying tackling rising prices.

Evolution of prices in 2010

After a long period of deflation in 2009, when the prices for foodstuffs and non-foodstuffs products dipped well below the historical trends, the inflationary pressure began mounting again in 2010. Thus, after registering one of the lowest inflation rates in CEE region, Moldova presently tends to have one of the highest price increases (Chart 14). In October 2010 the y-o-y inflation rate reached the level of 8.2%, significantly exceeding the corridor targeted by the central bank ($5\% \pm 1$ p.p.).

Chart 14. CPI index in some countries in Central and Eastern Europe and Commonwealth of Independent States, y-o-y % change



Note: the data for 2010 and 2011 were estimated by the IMF staff;

Source: International Monetary Fund, World Economic Outlook Database, October 2010;

The prices for foodstuffs (+2.9 p.p.) brought about the main contribution to the Consumers Price Index (CPI), followed by services (+2.8 p.p.) and non-food items (+2.6 p.p.). The prices for foodstuffs were primarily driven by vegetables, sugar, oil, milk and dairy products whose prices increased from 10% up to 25% in y-o-y terms. Similar price hikes were registered for electricity, centralized heating and natural gas which inflated the utilities' bills for households and firms. Among non-food items, the highest price increase was registered for fuels (+18.8%) which also served as a contagion channel for other products. As one can see, the highest price hikes were registered mostly for socially important products, with few or no substitutes, composing the biggest share of households' expenditures. Hence, it served as the main culprit for jeopardizing the social-economic situation, the most affected categories of population being the pensioners and other socially vulnerable groups of population.

Main inflationary factors and contagion channels

According to our empirical estimations, in 2009-2010 the most important inflationary factors were the increase in production costs (IPPI), expanding money in circulation (M0) and national currency

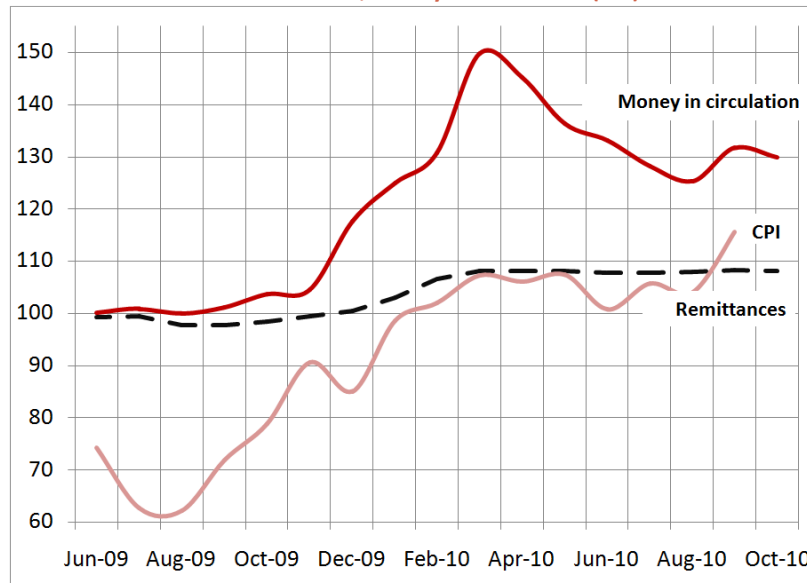
depreciation⁵. Thus, our model showed that besides the costs-related inflationary factors, the price level was influenced also by monetary factors. These findings are somewhat contradicting the central bank's assertion about the fact that prices are purely determined by production costs and that the inflationary pressures cannot be addressed by the monetary policy. Let us analyze the most important inflationary contagion channels of 2010 in more details:

Cost-push inflationary factors:

- *Inflation of energy resources costs* was mainly determined by the increase in prices for imported natural gas and fuels. This caused higher production costs for firms employing these production factors, which eventually reflected in prices for final products.
- *The increase in indirect taxes*. The inflationary factors mentioned above were fueled by the increase in excises for several products (fuels, cosmetics, alcoholic beverages etc.) and in VAT for imported natural gas from 5% to 6%. This inflated production costs and CPI.
- *Inflation of storage costs*. It started in October and was conditioned by the increase in storage costs for agricultural products which fueled the prices for fruits and vegetables.

According to our estimations, the above mentioned cost-push inflationary factors contributed to about 27%-29% to the y-o-y inflation level registered in October 2010. However, these were hardly the main culprits for driving the consumer prices up. We argue that the recent price hikes had a substantial monetary component, which could be influenced by the central bank. Our model suggests that the sharp increase in money in circulation by 30.6% y-o-y in October contributed about 33%-35% to the y-o-y inflation level.

Chart 15. Correlation between CPI, money in circulation (M0) and remittances, y-o-y % change



Source: NBS, NBM and Expert-Grup calculations;

The Chart 15 illustrates clearly the robust annual growth rates of money in circulation, significantly exceeding the CPI level. It was mainly due to the quite lax monetary policy promoted by the central bank, who seems to have temporarily sacrificed its inflation targeting objective in favor of economic growth (see chapter **MONETARY POLICY**). Thus, the low interest rates stimulated the population's

⁵ We ran a Generalized Least Squares (GLS) model: $CPI_t - \rho CPI_{t-1} = \beta_0 - \rho \beta_0 + \beta_1(M0_{t-1} - \rho M0_{t-2}) + \beta_2(IPPI_{t-1} - \rho IPPI_{t-2}) + \beta_3(MDL_t - \rho MDL_{t-1}) + \beta_4(MDL_t^2 - \rho MDL_{t-1}^2) + \varepsilon_t - \rho \varepsilon_{t-1}$

propensity to consume, which together with increase in inflows of remittances and economic recovery fueled the domestic demand and monetary inflationary pressures.

Besides the monetary and cost-push inflationary factors, the CPI level was also influenced by the *national currency depreciation*. Given the strong reliance of Moldovan economy on imports of both final and intermediate goods, the depreciation of Moldovan leu in late 2009 – early 2010 fueled the consumer prices. However, its impact was less significant in comparison with monetary and cost-push factors.

Forecast for 2011

- The average annual CPI in 2010 is likely to be around 7.1%, however during 2011 it will gradually decrease to 6%-7% on the ground of absorbing cost-push factors, increase in industrial production, as well as due to arithmetic factors (high comparison base of 2010). Nevertheless, it will strongly depend on the monetary policy promoted by the central bank, the weather conditions and harvest from 2011, as well as the economic situation in Moldova's main trading partners.

Challenges ahead

- The fact that monetary inflationary pressures exceeded the cost-push factors should determine the central bank to reevaluate its monetary policy. Hence, it should stick directly to its inflation targeting regime, while the economic growth for the sake of growth is not the best objective to be followed by the monetary authority. Furthermore, mounting inflationary pressures and deviation from the central bank's objective undermines the credibility of the central bank's strategy of direct inflation targeting.
- Besides the inflationary factors mentioned above, the inflation nests deeply into the systemic failures of Moldovan economic system. It is imperative to shorten the over-extended value-chains in commercialization of agro-food products (meat, vegetables, fruits etc), by shortening its non-value-added components, referring mainly to the intermediaries which monopolized the outlets and keep the prices high or even drive them up. In this respect, it is necessary to consolidate the capacity of the National Agency for Competition Protection for identifying and punishing the existing cartels or companies abusing of their market positions.
- Another fundamental inflationary cause is the anemic demand for national currency. As a result, the monetary authority in a way has to interfere by creating artificial demand through sterilization of excessive liquidities. This issue can be addressed only in long-term by the liberalization of domestic capital markets and development of new attractive financial instruments which could efficiently mediate savings and investments.
- The inflation could be tackled in long-term only by a better synergy between monetary and economic policies promoted by the central bank together with the Ministries in charge (Ministry of Economy and Trade, Ministry of Finances, Ministry of Agriculture and Food Industry) and relevant regulatory agencies.

10. Monetary policy

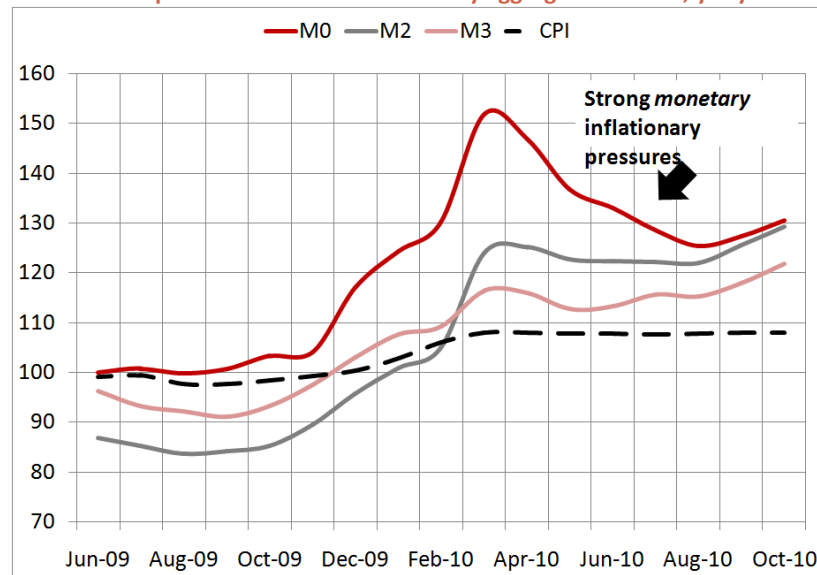
This chapter deals with the main challenges that Moldova had to face in 2010 on the monetary policy front. It analyzes how the views of the central bank evolved and how the bank reacted to new economic conditions. Policy challenges arising in 2011 are discussed at the end of this chapter.

Is current monetary policy targeting inflation directly?

Since 2010 NBM has formally switched to inflation targeting strategy, meaning that its entire activity should be concentrated on ensuring a given CPI level (5%±1 p.p. set for 2010). Despite this change in strategy and despite the inflationary pressures looming ahead, the central bank still keeps a monetary policy of negative interest rates, with a REPO rate of 7%, which is below the annual CPI of 7.6% for October 2010. NBM argues that such an ultra-relaxed monetary policy is necessary to spur the lending activity of commercial banks and stimulate economic growth, while the above-the-target CPI is a temporary phenomenon caused by high share of cost-push factors, which cannot be influenced by the central bank. To support this position, its proponents point to the large gap between CPI and core inflation.

However, our empirical estimates prove that about 1/3 of inflationary factors are of monetary origin (see more in **PRICES**). This suggests that the NBM's monetary policy may be biased in favor of economic growth objective and may not be appropriate for an inflation targeting strategy. Moreover, if the central bank would follow the Taylor rule⁶ the current policy rate should be around 10%-12% which is well above the 7% REPO rate currently set by BNM. This reveals that an excessively relaxed monetary policy undermines the efficiency of inflation targeting strategy. The Chart 16 illustrates the mounting monetary inflationary pressures determined by much higher y-o-y growth rates of money in circulation amount (M0) in comparison with the inflation level and other, less liquid, monetary aggregates (M2 and M3).

Chart 16. Comparative evolution of monetary aggregates and CPI, y-o-y % change



Source: NBM, NBS and Expert-Grup calculations;

⁶ Taylor rule is a basic monetary policy rule which approximates the optimal policy rate set by the central banks depending on the output gap and the difference between current and expected inflation: $i_t = \pi_t + r_t^* + a_\pi(\pi_t - \pi_t^*) + a_y(y_t - y_t^*)$

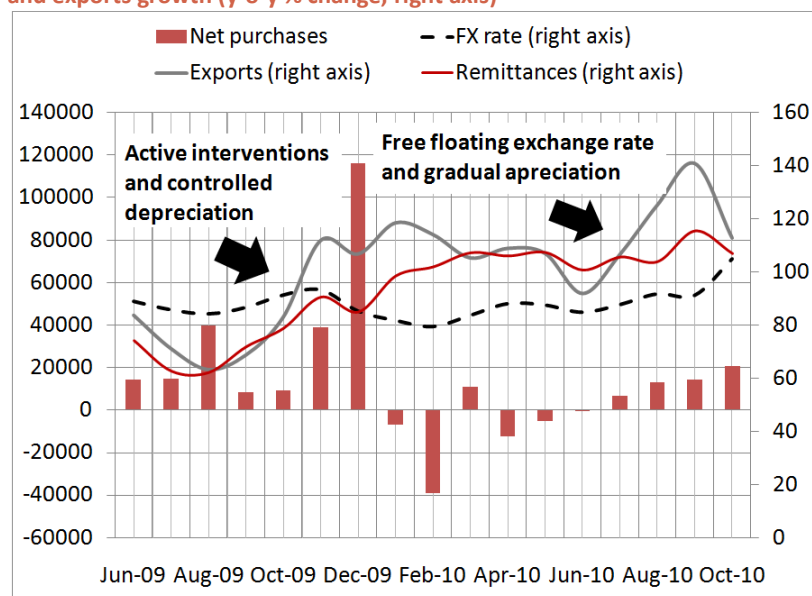
This phenomenon is determined by the increased demand for liquidities on the grounds of economic uncertainty and poor confidence in commercial banks. Additionally, it was fueled by the increase in remittances inflows and domestic demand recovery (see chapter **HOUSEHOLDS CONSUMPTION**). However, a major contribution to fueling monetary inflationary pressures belongs to the over-relaxed NBM monetary policy. Thus, keeping its policy rate at historically low levels increases the opportunity costs to save (due to a higher discount factor) and motivates economic agents to substitute future consumption with the present one.

It is interesting to note that despite NBM public assertions that CPI is mostly driven by cost-push factors, the bank actually intensified over the recent months its liquidity sterilization operations. Implicitly, these moves show that the Bank is aware of the previously mentioned monetary-induced inflationary pressures. At the same time, the Bank acts as a lender of last resort for the banking sector, by supplying a credit line at an interest rate equivalent with REPO rate (although over the recent months this monetary policy instrument was used less intensively, given the abundant liquidities in the banking sector and economic take off, see chapter **BANKING SECTOR**). Such an 'eclectic' approach to monetary policy reveals that the central bank continues the difficult balancing between the necessity to support the economic recovery by keeping its policy rate at the low levels and its strategic objective of steering inflation under the targeted level.

A moderate appreciation of the national currency

During the 2010 year the NBM significantly decreased its interventions on the Forex market, which made the national currency to follow an almost free-floating trend. In this respect, the NBM currency policy differs substantially from 2009, when the central bank made large purchases of foreign currency in order to amass its international reserves, resulting in depreciating national currency. However, during 2010 the NBM interventions on the Forex were almost invisible (Chart 17). Nevertheless, the national currency behaved much more smoothly in comparison with the previous years: the standard deviation of MDL/USD parity for the first 10 months of 2010 was 33.3%, while for the same period of 2009 it was 37.8% and 51.2% in 2008. Throughout most of the year, the national currency registered a moderate appreciation, due to the increase in remittances inflows and continued on the grounds of accelerating growth of exports and remittances.

Chart 17. NBM foreign currency net purchases (USD equivalent) and MDL/USD exchange rate, remittances and exports growth (y-o-y % change, right axis)



Source: NBM and Expert-Grup calculations;

Thus, at the end of October, the Moldovan leu appreciated 4.9% in comparison with January 2010 and 8.8% in comparison with June when the parity USD/MDL reached a maximum level. Obviously, besides the internal factors, the exchange rate was highly influenced by the situation on foreign markets and EURO/USD parity. By the end to 2010 the national currency slightly depreciated given the increased demand for foreign currency of importers (mainly of energy resources).

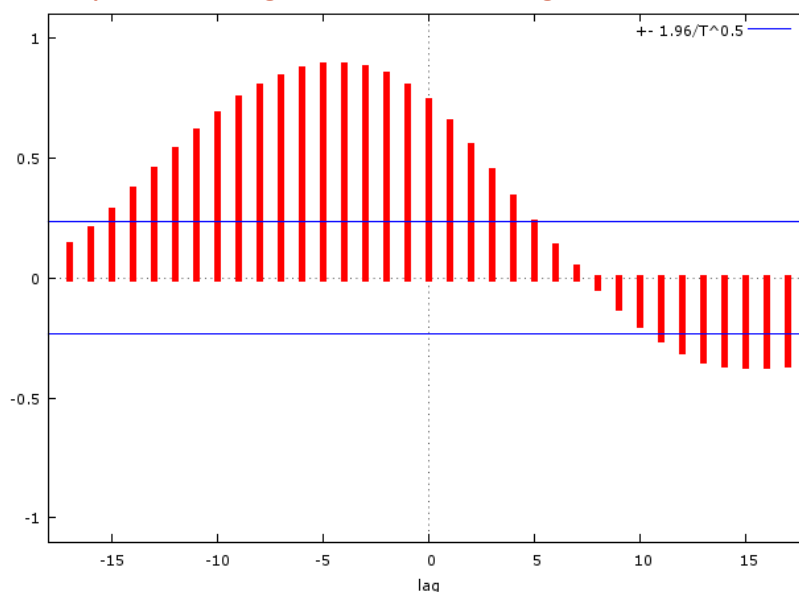
Forecast for 2011

- During 2011 the Moldovan leu will register a slight appreciation of 3%-4% due to higher inflows of foreign currency through exports, remittances and FDIs.
- Unless the demand for foreign currency essentially exceeds the supply as a result of some external or internal shocks on the foreign exchange market the official reserve assets will remain sufficient enough for ensuring the macroeconomic stability, by covering about 4 months of imports.

Policy recommendations

- The main challenge faced by the central bank is to efficiently start inflation targeting strategy. Despite intentions set in early 2010, NBM temporarily sacrificed its own objective, for the sake of broader economic growth objective. One of the possible implications of such an ambiguous policy could be the dented credibility of the central bank's actions in the eyes of the public, which is one of the main ingredients for ensuring a successful inflation targeting.
- In promoting its monetary policy, the central bank will have to find a better optimum between steering the inflation rate into the targeted corridor and ensuring the necessary conditions for the recovery in commercial bank's crediting activity. We believe that the current monetary policy stance makes the NBM biased in favor of economic growth objective and the negative interest rate policy is not appropriate given the direct inflation targeting strategy. Therefore, the NBM has to address more decisively the inflationary pressures by gradually increasing its REPO rate, so that it remains 1-2 p.p. above the CPI level. The main arguments in favor of monetary policy tightening are the looming monetary inflationary pressures and the currently robust economic recovery.

Chart 18. Cross-correlogram of CPI and lagged NBM policy rate: high positive correlation on the left-hand side and poor and late negative correlation on the right-hand side



Note: blue line indicates the minimum benchmark for statistical significance;

Source: NBM, NBS and Expert-Grup calculations;

- The slow transmission mechanisms of NBM monetary policy will limit the central bank's ability to steer the inflation rate to the targeted corridor in due time and may undermine the credibility of the central bank's monetary policy. Chart 15 includes a cross-correlogram revealing that in 2005-2010 NBM responded quite adequately to rising inflationary pressures, with about 5 months before the increase in CPI, as suggests the high positive correlation of lagged NBM policy rate. However, the monetary policy was quite inefficient since its effects are observed with a lag of three or more quarters, and the correlation is less significant.
- The efficiency of NBM monetary policy is undermined by the fact that it does not regulate the activity of other segments of financial sector, except the banking system (e.g. leasing, insurance, micro-financing companies etc). Most of these financial non-banking institutions are highly interconnected with the banking system, which limit the transmission effect of central bank's monetary policy. Thus, we believe that some of the functions and responsibilities of the National Commission of Financial Market should be actually undertaken by the National Bank of Moldova which would enhance the regulatory and monetary policy efficiency.

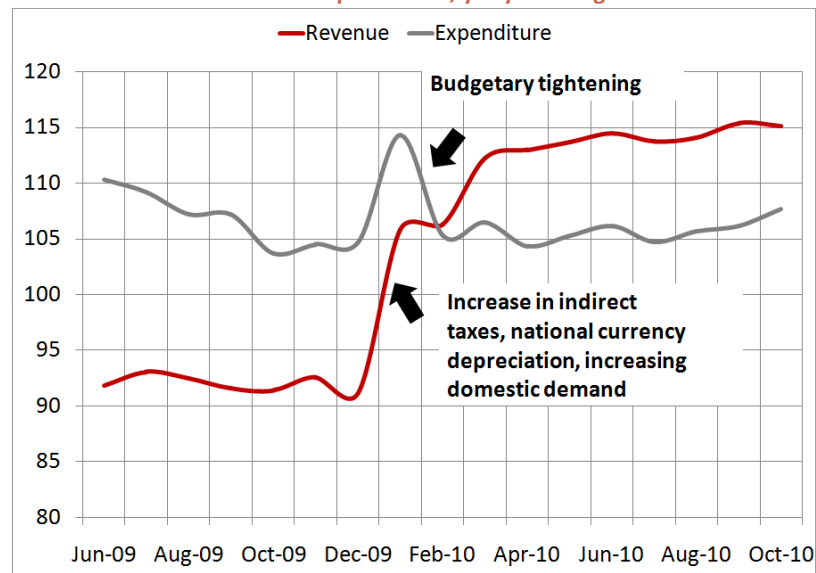
11. Budgetary policy

During 2010 clear signs about consolidation of the budgetary equilibrium emerged. This result is due to a series of unpopular actions undertaken by the Government, as well as by the economic recovery gathering steam. The main driving force of budgetary rebalancing has been the domestic demand which, through indirect taxes, provided for the biggest share of public revenues. At the same time, social expenditures continue creating major pressures on the budget. Thus, we emphasize that despite this stabilization, the paradigm of public finances system remains erroneous, and in long-term should be addressed by a series of structural reforms discussed at the end of this chapter.

Evolution of the public budget

The year 2010 has been a period of remarkable fiscal stabilization, with accelerated growth of public revenues paralleled by a sober growth in public expenditures (Chart 19). The increase in budgetary revenues was determined by inflows of indirect taxes which registered two-times higher y-o-y growth rates in comparison with the direct taxes. As a result, the share of VAT, excises and customs duties in total public revenues, increased continuously from 42.9% in March up to 46.3% October. This figure is also higher in comparison with the same period of 2009 (43.4%⁷) which reveals the stronger dependence of the state budget on domestic consumption, as well as the fact that the Moldovan economy returns to its previous economic growth model (see chapter GDP).

Chart 19. Public revenue and expenditures, y-o-y % change



Source: Ministry of Finance and Expert-Grup calculations;

Our econometric model of budgetary revenue suggests that the state budget relies to a high extent on domestic demand which is mainly covered by imports⁸. This dependence on imports makes the public finances relatively vulnerable to foreign exchange rate fluctuations. Thus, the national currency depreciation in late 2009 – early 2010 had a positive impact on public revenues since it inflated the value of imports and, respectively, the amount of indirect taxes inflows. However, the most important financing sources of the state budget are domestic trade (a 1 p.p. increase in the growth rate results in a 0.5 p.p. increase in public revenues) and imports (1 p.p. growth rate generates a 0.2 p.p. growth in public revenues). At the same time, the domestic supply (with

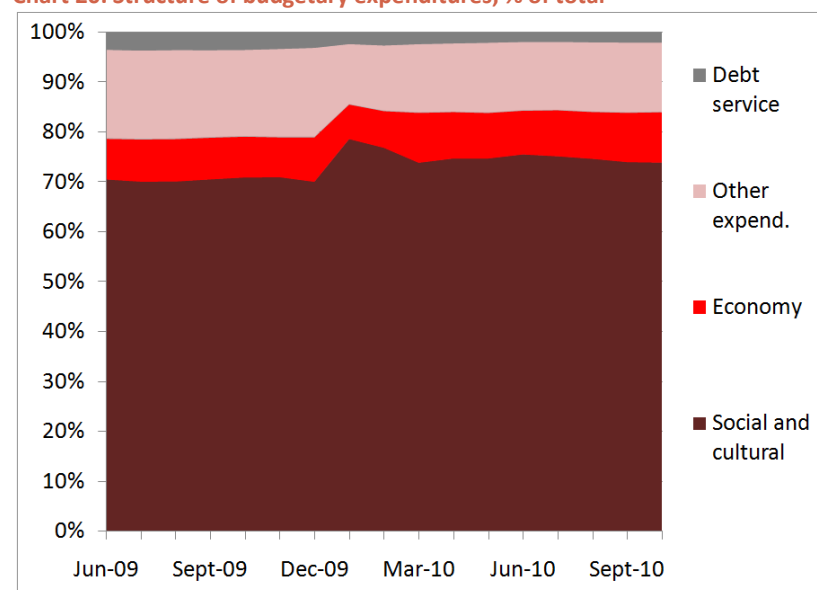
⁷ The total budgetary revenues imply social and medical insurance contributions.

⁸ $Revenues_t = \beta_0 + \beta_1 Imports_{t-1} + \beta_2 MDL_FX_rate_{t-1} + \beta_3 Domestic\ trade_{t-2} + \beta_4 Industry_{t-1}$

industrial production index used as a proxy) has no influence on the budgetary revenues. This is a telling fact which reveals that the current consolidation of the public finances equilibrium was made on the consumers' account, while firms remain excluded from the budgetary revenues formation.

Given the signed memorandum with IMF and the imperative of scaling down the budget deficit, the Government promoted an austere expenditures policy, by cutting the low-priority programs and postponing some social or investment programs. Additionally, several unpopular reforms were started in agricultural and educational sectors. The driving forces of the increases in public expenditures remained the health, education and social spheres which continue to take away 74% of the state budget (Chart 20) – lower than earlier in 2010, but higher in comparison with the same period of 2009 (71%).

Chart 20. Structure of budgetary expenditures, % of total



Source: Ministry of Finances and Expert-Grup calculations;

The budget deficit continues to be financed mostly from external sources given the scarcity of cheap domestic resources in the long-term and the increased openness of international financial community for Moldova. As a result, in ten months of the year the stock of public foreign debt increased by 42.6% in USD (from USD 775.1 mil. up to MDL 1103 mil.). However, the current level of external indebtedness remains sustainable due to the fair share of state foreign debt in GDP (14.3% in 2009 which is likely to increase up to 20%-21% in 2010 and 25% in 2011). In our opinion, a much more significant threat is posed by the increase in domestic state debt by issuance of T-bills, which bear higher interest rates, have a shorter financial maturity and crowd out private investments.

Forecast for 2011

- We expect the budgetary deficit to scale down from 6.8% in 2009 to 4.0%-4.5% in 2010 and around 3% in 2011, which is in line with the IMF-agreed terms.
- The driving force of the increase in budgetary revenues will continue to be, at least in the short- and mid-run, the indirect taxes, as the economy returns to the growth model based on consumption which does not seem to change soon.
- The further path of budgetary stabilization will highly depend on the political situation, as the structural reforms which are necessary to be implemented require a stable Government and Parliament with a 4-year mandate. Otherwise, the political elites will be guided by short-term political horizon forcing them to adopt populist fiscal decisions.

Policy challenges and recommendations

- Moldova registers one of the highest levels of total public expenditures in GDP among CEE countries (about 45%). The state's active implication into the economy leads to sub-optimal allocation of resources, crowding out of private investment, inflationary pressures and chronic budgetary deficits. The Government must gradually scale down its extensive public expenditures policy. The most urgent reforms should be implemented in the social protection and health care sectors which consume about 50% of overall public expenditures despite the existence of separate budgets for social and medical insurance.
- The reform of social protection system should encompass two pillars. Social assistance should be better targeted and based entirely on the means-tested mechanism. Social insurance should switch from the current redistributive one-pillar pension system to a multi-pillar one based on accumulation. Decreasing employment rate and aging population create significant pressures on the current pensions system. It is worthwhile mentioning that in 2010 from the state budget about 2.276 billion MDL were planned to be transferred for covering the deficit of the state social insurance budget (SSIB), as compared with 1.968 billion transferred in 2009 and 902 million in 2008! This means that the SSIB effective deficit grew dramatically from 14% of total expenditures in 2008 up to 26% in 2009 and further up to 31% in 2010. Besides the fact that it implies a rocketing fiscal pressure on taxpayers, it also reveals the deficiencies of the social insurance system which could get bankrupt in few years unless structural reforms are implemented.
- Besides scaling down the budgetary expenditures as a share of GDP, the Government should aim at rebalancing the structure of budgetary formation. The current situation, where most of budgetary revenues are formed from taxing consumption and, at the same time, over 70% of budgetary expenditures are redistributed into the social sector, creates significant distortions and inefficient allocation of public resources. Thus, on the one hand the Government stimulates domestic demand through its expenditures policy and, on the other hand, it taxes the same domestic demand through its fiscal policy. Therefore, reforms should be implemented in order to increase the role of private sector and decrease the role of consumption in the budget formation.
- The Government has to scale down its borrowings from commercial banks through T-bills. According to our estimates⁹, this practice crowds out private investments as there is a negative relationship between the growth rates of new banking loans and T-bills issued. The 29.4% y-o-y increase in average volume of T-bills sold in October 2010 subtracted 7.5% from the growth of new banking loans. These are resources which could have been directed into private investments and creating new jobs. Instead, they were used by the Government for covering cash-deficits: due to short financial maturity they cannot finance public investment.
- If the internal debt continues to build up, an eventual monetary policy tightening (see chapter **MONETARY POLICY**) could inflate a bubble on the T-bills markets posing new pressures on the state budget. The logic behind this is that currently, a significant amount of new T-bills are issued in order to repay the maturing ones. During two years of relaxed monetary policy (the REPO rate has continuously decreased from 18% in May 2008 to 7% in late 2010), this pyramidal financing was sustainable and even profitable for the Government since there was permanently the opportunity to refinance the debt with a lower rate. If the central bank policy rate increases, it will generate a higher cost of servicing domestic state debt, because an increase in REPO rate by 1 p.p. leads to a T-bills interest rate 0.7 p.p. higher.

⁹ The estimation was made using an ordinary OLS with robust standard errors: $CR = \beta_0 + \beta_1 VMS_t + \beta_1 IR_{t-1} + \beta_1 DT_{t-1} + EXP_t$

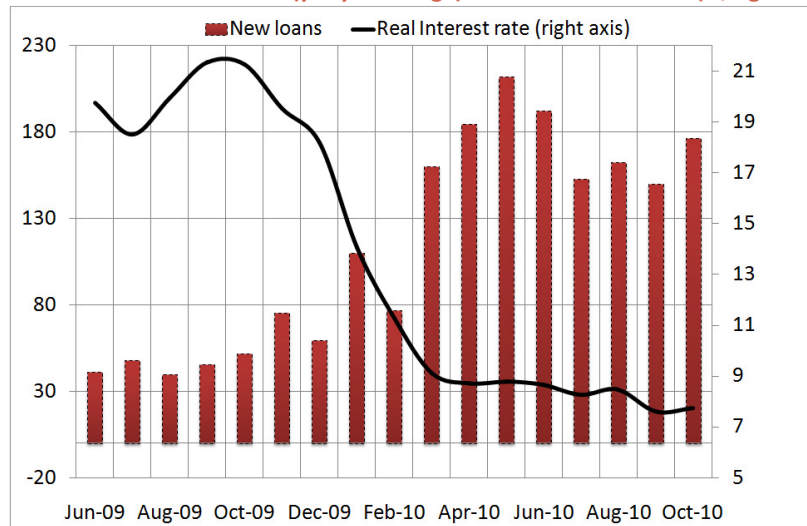
12. Banking sector

In this chapter we discuss the main trends of the banking sector during the economic recovery in 2010. The banks managed to slightly improve their loan portfolios which had a positive impact on the profitability indicators. However, we point out that despite these positive trends, the level of risk premiums included in the interest rates, as well as the share of non-performing loans in total banking credits remained well-above the levels registered before the crisis. Additionally, we mention the main systemic deficiencies which negatively affect the loan affordability.

Key evolutions in the banking sector

The recovery of the foreign and domestic demand significantly improved the financial situation of some Moldovan companies. This led to an increase in demand for banking loans paralleled with a lower reluctance from the part of the commercial banks to provide loans. As a result, the volumes of new loans started to increase in March 2010: in the period March–October 2010 the average y-o-y monthly growth rate was around 70%. Such a strong growth was determined primarily by the sharp fall in real interest rate (Chart 21) on the ground of economic recovery and NBM monetary policy.

Chart 21. Banks' new loans (y-o-y % change) and real interest rate (% , right axis)



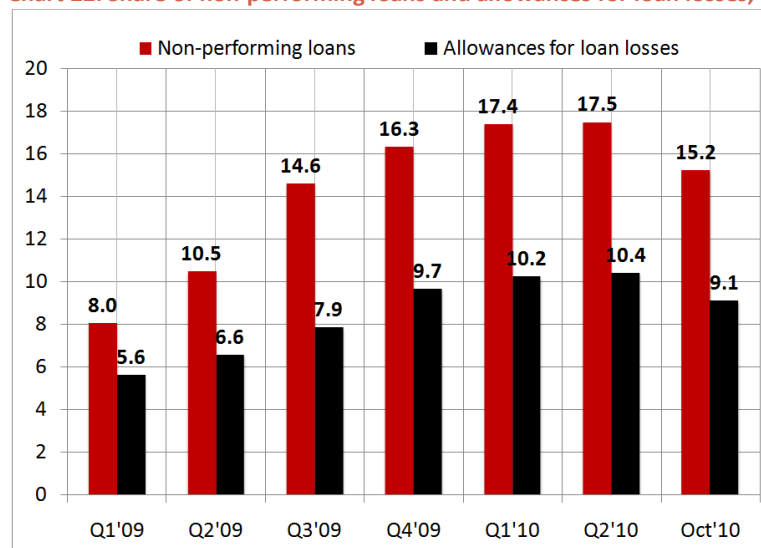
Source: NBM, NBS and Expert-Grup calculations;

Our empirical assessments confirm that decreasing interest rates that reached historical lows in nominal terms has been the main driving factor of the surging demand for banking loans¹⁰. The cut in interest rate from 19.63% in October 2009 to 15.88% in October 2010 explains about 2/3 of growth rate on new loans in the given period. At the same time, other 1/3 of variations are explained by the recovery in domestic and foreign demand, as revealed by the evolution of domestic trade and exports. According to the results of our regression, the domestic demand had a much stronger contribution (26%-28% of total credit growth) than the foreign one (8%-10%). Equally important, the regression reveals the effect of investments crowding out due to Government borrowings on domestic market through T-bills (see chapter **BUDGETARY POLICY**).

¹⁰ The estimation was made using an ordinary OLS model with robust standard errors: $CR = \beta_0 + \beta_1 T - bills_t + \beta_1 Interest\ rate_{t-1} + \beta_1 Domestic\ trade_{t-1} + Exports_t$

Since March 2010 the revival in crediting activity has contributed to the improvement of banks' loan portfolios: the share of non-performing loans in total credits dropped from 17.37% at the beginning of 2010 to 15.23% in October 2010 and continued till the end of the year. Although it remains at quite high levels, the bad loans appear to be concentrated in wine and construction sectors, which currently face major indebtedness and structural problems due to past systemic deficiencies and economic crisis repercussions. Relative improvement in loans portfolio allowed banks reducing their provisions for loan losses which augurs well for further increase in lending activity (Chart 22).

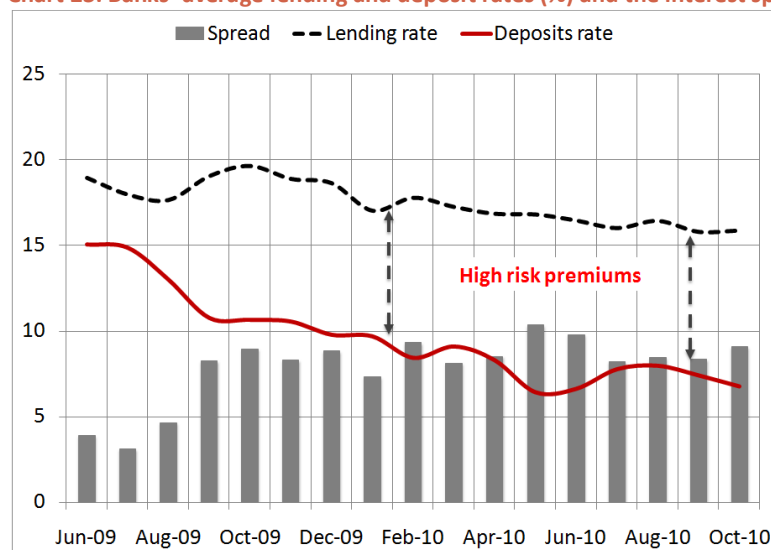
Chart 22. Share of non-performing loans and allowances for loan losses, % of total loans



Source: NBM;

Despite these positive trends, the level of bank's risk aversion remained quite high as the risk premiums included in the commercial interest rates remains at high levels in comparison with the pre-crisis periods. This is revealed by the large spread between interest rates for credits and deposits (Chart 23): during January-October 2010 it ranged between 8-9 p.p., two-times higher in comparison with the period before the crisis.

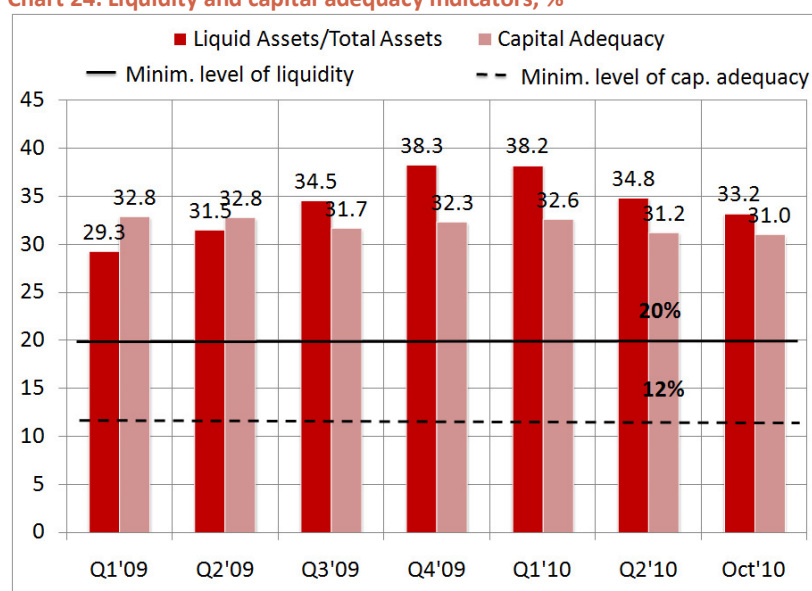
Chart 23. Banks' average lending and deposit rates (%) and the interest spread (p.p.)



Source: NBM and Expert-Grup calculations;

The increase in lending activity paralleled with declining deposit rates contributed to a slight decrease in liquidity and capital adequacy indicators (Chart 24). However, we interpret this trend as a positive one since these indicators remain well-above the minimum requirements and contribute to increasing banks' profitability. The latter is revealed by the Return on Average Equity (ROAE) and Return on Average Assets (ROAA) indicators, which in October 2010 constituted 7.76% and 1.4% respectively. Although, these indicators remain low in comparison with the periods before the crisis, they are above the levels registered in 2009 (-2.12% and -0.39%) which is a promising sign for further consolidation of banking activity.

Chart 24. Liquidity and capital adequacy indicators, %



Source: NBM;

Forecast for 2011

- In 2011 the lending rates are expected to slightly rise (up to 16-16.5%) as NBM tightens its monetary policy given the persisting inflationary pressures. Additionally, banks could increase the demand for additional liquidities and thus could increase the interest rates on deposits.
- As a result, the crediting activity in 2011 will increase with a lower but still robust pace (20%-25%), being driven primarily by domestic demand and to a lower extent by the foreign demand.
- Given the economic recovery and increase in volume of new banking credits, the quality of loan portfolios of commercial banks will continue improving during 2011. Thus, the share of non-performing loans in total loans could decrease to 10%-12%. However, it will remain well above the levels registered before the crisis due to the problems incurred by the wine and construction industries.

Policy challenges and recommendations

- The recent crisis made the commercial banks to analyze more carefully the quality of their loan portfolios and to hedge more actively against any potential losses. Therefore, it is likely that banks will keep the credit risk premiums and allowances funds for loan losses at much higher levels than before the crisis. Consequently, it will keep the level of lending interest rates relatively high with obvious negative effects on loan affordability for firms and

households. This issue could become even more vexing if the central bank tightens its monetary policy given the mounting inflationary pressures.

- In order to overcome this issue, policy makers will have to address the main culprits which keep the loans interest rates high. These are, primarily, systemic factors related to *high market concentration* (Herfindahl-Hirschman Index computed for the market of banking credits at the end of the 3rd quarter 2010 was 0.196 revealing an increased market concentration of the 5 largest banks), *shortage of long-term liquidities* (the share of long-term deposits was only 7.2% of total deposits stock), *poor protection of lenders' rights*, *low efficiency of the banking system* (the ratio between operating expenses and operating income is one of the highest in CEE) and *insufficient substitutes for banking credits*.
- The banking sector needs urgent structural reforms, the main guidelines for policymakers being:
 - Ensuring a well-functioning credit-bureau system which would serve as the primary sources of information about credit histories of borrowers;
 - Easing and speeding up the collateral execution by banks and development of extra-judicial approaches through licensed private collection agents, following the best practices of Georgia, Romania, France and UK.
 - Development of capital markets, as an alternative source of financing for economic agents.
 - Development of private pension funds which would ensure a strong inflow of liquidities into the capital markets and increase the demand for financial instruments.
 - Recapitalization of the Fund for Loan Guarantees for small and medium enterprises.

13. Foreign trade

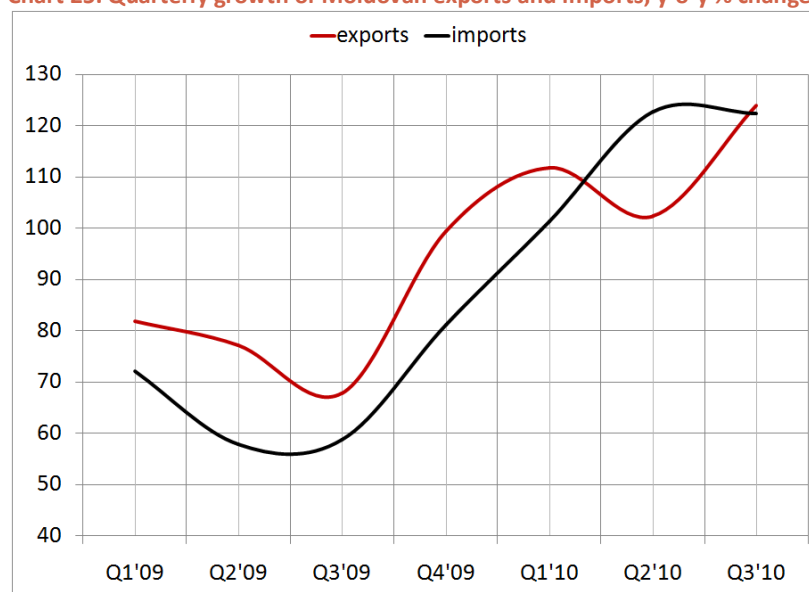
This chapter looks at main developments in the Moldova's foreign trade in the aftermath of the 2009 slump. The analysis shows that the recovery that followed has significantly varied across different categories of goods and geographical destinations and sources, for exports and imports respectively. At the same time return to the pre-crisis trade deficit pattern is likely. The chapter concludes that, though on a firmer ground, the foreign trade is set for a rather sluggish and uneven recovery highly dependent on the anaemic economic growth prospects in the major partner economies.

The twinkling light in the end of tunnel...

The same channels that ushered the global economic crisis in Moldova seem now pulling Moldovan economy the other way round. Thus, by the end of the third quarter of 2010 both exports and imports (supported by stronger remittances) showed clear signs of recovery. These positive trends were perfectly in line with the global trade dynamics: the world merchandise trade increased in January-September 2010 by 23% on yearly basis¹¹. In Moldova the foreign trade expanded by almost 15% on yearly basis in the same period. In more detail exports rose by almost 13%, while imports gained 15.5%. Overall, trade data shows exports and imports to be hovering around 2007 levels (the trade peaked throughout the first three quarters of 2008 before the crisis struck).

A look on quarterly data offers a more nuanced outlook (Chart 25). Although the imports experienced a steeper decline in the wake of the financial crisis, their rebound was much more robust and consistent up to Q3'2010 when trends reversed a bit. On the contrary, exports weathered the global crisis better; however their growth has been much more erratic since then. The erratic growth of exports and robust rebound of imports offer us simple evidence: yawning trade deficits are back even if in a somewhat muted fashion. Indeed, in the January-September 2010 trade deficit widened by 17.2% y-o-y. So much about new economic growth model so far.

Chart 25. Quarterly growth of Moldovan exports and imports, y-o-y % change



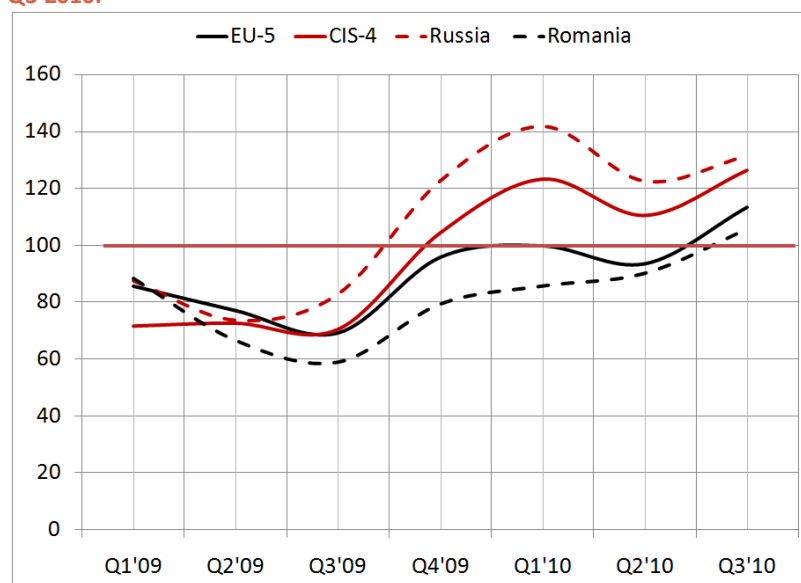
Source: NBS and Expert-Grup calculations;

¹¹ WTO, short-term merchandise trade statistics, December 2010.

No love lost...

Moldova may well be euro-bound, but its trade exposes some growing penchant for eastern markets. Indeed, already in the second quarter of 2009 Russia overtook Romania as the top country-destination for Moldovan exports; it has entrenched its position since then. Indeed, if by the end of 2009 Russia held 22.3% of the total of exports (19.7% a year before) its share reached 24.5% in the Q3 of 2010. For instance, exports to Romania spiralled downwards to 16.6% in Q3 of 2010, compare it to 19.9% in Q3'09 and 21.1% in Q1'09. Given the important share of both countries in the larger export destination entities, the EU and CIS, the broader regional export trends follow to a significant extent their path. This points to the geographical rebalancing act in the exports developments as well.

Chart 26. Growth of Moldovan exports to selected countries and country groupings*, y-o-y % change, 2009–Q3'2010.



*Note: EU5 includes Romania, Germany, Italy, UK and Poland; CIS4 includes Russia, Ukraine, Belarus and Kazakhstan;
Source: NBS, Expert-Grup calculations;*

There are various explanations to these developments: some of the common and some of them specific. A common culprit is the global financial crisis. Apparently, its impact was more swift and deep in the CIS economies and this affected much more dramatically the exports to these markets. Since recovery there appeared to be more robust and pronounced hence the turnaround looks more V-shape-like. The economic recovery in the EU is somewhat tepid, resulting in a rather U-shape trend in exports to the respective countries.

There are also some peculiar features to this too. These refer mostly to the diverging paths followed by the exports to the leading trade partners from both economic areas. In the last year we witnessed a stunning comeback of Russia as the main destination for Moldovan exports and no less precipitous decline of Romania from that position. As it now appears these two developments are quite different and nature, but also have dissimilar lasting effects.

The decline of Moldovan exports to Romania has proved to be more profound and protracted than expected due to the effects of global economic crisis, poor climatic conditions (sugar exports are central to Moldovan exports to Romania and the sugar-beet crops were dismal in 2009). Indeed, with the crisis receding, exports to Romania posted 5% growth in the Q3'10 (and strengthened further in October) and will grow further thanks to 'sweetened' crop outlook. Quite opposite, exports to Russia rebounded faster and stronger than expected thanks to relatively robust recovery of Russian

economy and some liberalization in wine trade done in the end of 2009. The latter is in reverse now. The beverages exports together grew throughout the first half of the year by 17.3%¹², however, the third quarter saw these export falling by 4.2%, which can be seen as indication that effects of import restrictions imposed by Rospotrebnadzor have started to kick in.

Forecast for 2011

- The recovery of foreign trade appears to gain momentum as both global and regional trade flows recover. Up to the end of 2010 both brightening external outlook (world merchandise trade is expected to grow by 13.5% this year)¹³ and low comparative base will help improving trade indicators. Nonetheless, further in 2011 we expect trade recovery to slow down as effects of a lower comparative base will be withdrawn while the economic growth in the major trade partner economies is expected to be either sluggish (EU) or much less robust (CIS).
- Furthermore trade relations with Russia (major trade partner at the country level) will be quite a wild card in the aftermath of the general elections in November 2010. Still we expect the new coalition government to put relations with Russia on the mend and foster trade connections.
- Further on the upside, the much improved climatic conditions in summer-fall 2010 will help exports to Romania rebound by the end of 2010 which will probably go into 2011 as Romania will be shrugging off recession and return to growth.
- The relations with the EU are set to consolidate in the mid-term as negotiations on the conclusion of DCFTA will puff ahead. The implementation of the respective Action Plan by the government will require some sustained reform efforts which can provide positive spill-over effects over the competitiveness of Moldovan exports and trade infrastructure. As Moldova is set to conclude FTA agreement with Turkey prior agreement with the EU, the opening of the borders for the Turkish goods will provide a stern test for the preparedness and competitiveness of Moldovan economy¹⁴.
- The EU also decided to increase by 80% quotas for wine imports from Moldova starting next year. We however do not expect the decision to have crucial impact over Moldovan wine exports to the EU. Both our simulations¹⁵ and interviews with wine exporters show that Moldovan wine companies already use maximum of their export potential and realistically can increase these exports by 10%, at most.
- After robust rebound the growth of imports may well level off as its main driver, remittances, will show a sluggish growth as recovery in the EU will remain tepid and construction sector still in doldrums around much of the region.

Policy challenges and recommendations

- Outlook for global economy has improved somewhat in recent months; however, there are still important risks to the economic recovery. At the same time, as growth prospects are significantly brighter for the emerging economies, especially Asia, the time has come for Moldovan exporters to pay more attention to the Asian markets. This is where the most future growth in consumer demand lies, at least in short and mid-term. At the same time this task if put only on the companies looks a tall order and efforts on behalf of the government are needed. However, this leads us to the question about *efficiency of the Moldovan*

¹² Given unavailability of wine exports stats for the three quarters of 2010 we use beverages exports data as a proxy.

¹³ WTO estimates.

¹⁴ Logos Press, Турецкий тест для Молдовы, Dmitri Kalak, December 3, 2010.

¹⁵ Results of the research to be published by the end of January, 2011.

economic diplomacy and the relevant public agencies and their role in export promotion. Is the time ripe for overhaul reform? The structure and mandate of these agencies should be reviewed and streamlined. They should work in close connection with the business and be responsive to it. The state may look into making these agencies public-private bodies to allow more say and expertise from the private sector. Moreover, companies and state should work together on the country's image promotion campaign which should go hand in hand with exports promotion. This campaign should be consistent as substance and extensive as time and be conducted by professional PR agencies in order to accomplish desired effects. The result of the sector promotion campaigns supported by the state should be judged by the objective results and formalistic reports.

- In the short-term the role of the CIS markets is set to increase. While it will bring about some positive effects, such as helping Moldovan exports weather out better lethargic demand from the EU markets, it still leaves Moldovan exports vulnerable to political or regulatory whims of the respective market. In order to maintain the benefits Moldovan foreign policy should be cautious and pragmatic, while business infrastructure, including quality control, should be improved. The role of the relevant state institutions should become more tailored to the interests of businesses and consumers, without compromising key issues such as quality and food safety. In the longer perspective, more focus should be put on geographical diversification of exports for reaching out for the places outside of the EU and former Soviet Union. Wine-sector may serve as a litmus test in this regards. The industry, which heydays seem long gone, was severely affected by Russian embargo, global economic crisis and harmful government policies. While increasing the wine quotas by the EU is a welcome development, its impact will be limited. As wine-makers contemplate a tall order of modernization, market and product diversification at the background of mounting corporate debts it becomes clear that wine companies cannot do it alone. This task needs strategic vision supported by combined efforts of the companies themselves, financial sector (including IFI support) and effective (not pervasive or amateurish) government policies and actions.
- As implementation of the Action Plan on negotiations on the DCFTA between the EU and Moldova will start soon a series of thorny issues will come to fore. It is crucially important for the Government and the companies to come prepared and well-documented for discussing these issues. Otherwise there is a risk of overlooking some legitimate interests and planting seeds of discord in the future or slowing down the negotiations process due to the late 'discovery' of the respective issues.

14. Global markets

This chapter looks at the main developments in the world economy and main global commodity markets. Although global recovery seems to be puffing ahead a series of concerns remain. This analysis looks at these main risks as well as effects for the main commodity markets.

Global economy: an unevenly brighter outlook

The global economic recovery seems to have been gaining momentum in the last months, supported by far and large by fiscal and monetary stimuli worldwide. So far global growth rate has reached 5.25% which is significantly higher than anticipated. The better than expected growth has been vastly supported by government-driven stimulus spending of varying degrees across major world economies. Indeed, an important policy conundrum for now is how to withdraw the government support for the economy and to entrench fiscal consolidation (most of advanced economies sorely need) without jeopardizing the prospects of economic recovery.

The recovery is not evenly spread across the world, though (Table 4). The core of the recovery apparently becomes more and more tilted towards emerging economies, especially in South-East Asia and Latin America. The growth in advanced economies, especially in Europe, is much more anaemic.

Table 4. Selected World Economic Outlook projections, y-o-y % change

Economic grouping / Geographic area	2009	2010	2011
World output	-0.6	4.8	4.2
Advanced Economies	-3.2	2.7	2.2
United States	-2.6	2.6	2.3
Euro area	-4.1	1.7	1.5
Germany	-4.7	3.3	2.0
Italy	-5.0	1.0	1.0
Emerging and developing economies	2.5	7.1	6.4
Central and Eastern Europe	-3.7	3.6	3.1
Romania	-7.1	-1.9	1.5
CIS	-6.5	4.3	4.6
Russia	-7.9	4.0	4.3
Developing Asia	6.6	9.4	8.4

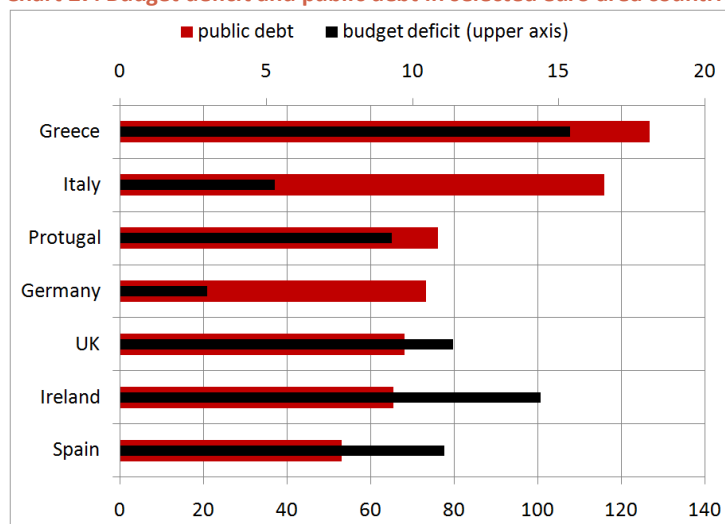
Source: WEO, October 2010, IMF;

Euro-crisis: from the Olympus and beyond

The Greek crisis has undoubtedly been in the spotlight since the first quarter of 2010. It has been so not as much because of the sheer size of the financial trouble in Greece, but rather since it has put in light several alarming trends on global and regional levels.

In the nutshell, it is the combination of the sovereign debt and budget deficit in advanced economies, as well as risk exposure of the banking sector coupled in many countries with structural rigidity and low growth potential. Although it has been chiefly euro-PIIGS¹⁶ in the limelight (Chart 27), the problem is not limited to these countries. Indeed, Japan had a staggering 192% of GDP public debt by the end of 2009, the US is expected to see its public debt to climb over the actual Greek levels by the end of 2011. Of course not all countries have suffered from the same amalgamation of economic frailties as Greece, but considerable risks as well as investors' jitters persist, especially as Ireland already followed the suit and asked for bail-out. The fears are that Portugal and, then, Spain might fold in. The last may be both too big to fail, but also too big to save.

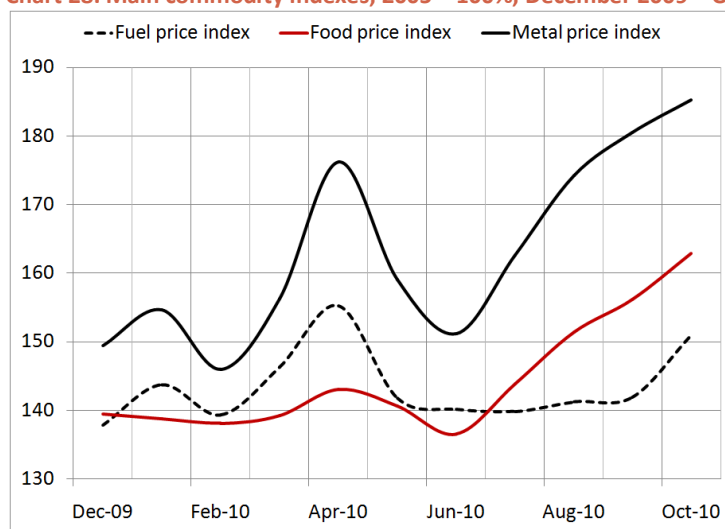
¹⁶ This country grouping includes: Portugal, Ireland, Italy, Greece, and Spain.

Chart 27. Budget deficit and public debt in selected euro area countries, % of GDP, 2009

Source: Eurostat, Provision of deficit and debt data for 2009 - Second notification, November 2010;

Commodity markets: a volatile recovery

The trends on the main commodity markets remained closely entwined with the outlook and pace of recovery of the global economy: brighter recovery prospects sending commodity markets upwards with the latter when excessive susceptible of hampering and jeopardizing the former. Overall, the recovery in commodity markets was stronger and swifter than in the previous recessions (Chart 28), mostly due to stronger than expected demand from the developing and emerging economies, smaller increases in excess inventories relation to average stock-use ratios, high currency volatility throughout most of the period as well as low real interest rates in the United States. However, the recovery has slowed down somewhat in the second half of the year. Still, prices for wheat remained strongly on the upward trend as adverse weather conditions led to downgrade in harvest expectations¹⁷.

Chart 28. Main commodity indexes, 2005 = 100%, December 2009 – October 2010

¹⁷ IMF, WEO, October 2010.

Description: *Commodity Metals Price Index includes Copper, Aluminium, Iron Ore, Tin, Nickel, Zinc, Lead, and Uranium Price Indices; Commodity Fuel (energy) Index includes Crude oil (petroleum), Natural Gas, and Coal Price Indices; Commodity Food Price Index includes Cereals, Vegetable Oils, Meat, Seafood, Sugar, Bananas, and Oranges Price Indices;;*
 Source: IMF;

Forecast for 2011

- Although global economic recovery seems to be on solid footing by now, the daunting downside risks remain. One serious risk is plight of the sovereign debt in the advanced economies. Although, currently the European economies appear to be at the frontline, the other advanced economies seem to be also exposed to varying degrees. At the same time the need to cover these gaps will require thorough fiscal austerity measures that will ultimately undercut the short-term growth prospects in these countries. Weak real estate markets, high unemployment and structural rigidities (in some economies) are also reasons for concern. In the near run the euro-zone economies will be particularly exposed, while the euro may find itself under continuous pressure in the forthcoming months. Overall, the world economy is expected to post a 4.2% growth, while advance economies are expected to grow by 2.2% in 2011. Specifically, forecast for euro area economies puts growth rate at 1.5% (Table 4).
- The dim outlook for the advanced economies is partly offset by buoyant growth prospects in the emerging Asia and Latin America which are expected to grow by 8.4% and 4% in 2011¹⁸. The growth in many Asian economies has been export-led and these countries have amassed huge current account surpluses. Given shrinking demand in advanced economies and their staggering public debt the global economy imbalances are set for correction. There is and will be pressure on export-led economies to spur local demand, and in some case, such as China, revalue their currencies;
- The situation on the commodity markets will be to a large extent dependent on the global demand prospects closer intertwined with the pace of global economic recovery. Given the existent slack productive capacity the prices for most of the commodities will stay on the current levels despite expected rise in demand for some commodities¹⁹. The oil prices are expected to remain volatile somewhere in 75-85 USD per barrel range, however, and highly dependent on the global economy path of recovery.

Policy challenges and recommendations

- The slow recovery of the main European economies will continue affecting adversely growth prospects in Moldova. Firstly, shrinking domestic demand in EU, as the respective national government embark on austerity programs, will further on darken somewhat prospects for growth of Moldovan exports to the EU. Secondly, besides jobless and tepid recovery in the EU economies, the freeze or cuts in wages and public payments will reduce demand for migrant workers, including in the services sector. Furthermore, any eventual public backlash against the migrant workers as well as stricter enactment of the residence rules can also have negative repercussions over the Moldovan labour migrants. In this context, Moldovan government should vigorously pursue social protection policy agreements with the EU countries, support legal labour migration schemes, as well as visa-free travel arrangements despite the fact that overall environment for such agreements may not be very inviting now.
- The risks of competitive devaluations and currency wars remain a high probability, with the world still lacking institutions and arrangements to deal effectively with such dire prospects

¹⁸ Ibidem.

¹⁹ International Energy Agency, Oil Market Report, November 2010.

(see for instance inconclusive G20 in this respect)²⁰. It remains whether multilateral solution can be found or something akin to Plaza Accord is on cards. Obviously, as a little state and economy Moldova lacks clout to influence this situation, however it will need to try to adapt eventually. What Moldova sorely needs is a strategic vision for development in the global economy that is so much different to the one only five years ago. Furthermore, this vision should be at the core of the switch to the new export-led development model trumpeted some time ago.

- Barring apocalyptic disentanglement of the current financial architecture in Europe, i.e. demise of euro, that would put on hold the nascent recovery of the world economy, to say the least, the commodity markets are set to remain tight. The means that high prices do not pass into history and Moldovan economy and households will have to deal with high energy prices throughout the current year. The higher energy prices have already translated in higher energy bills for businesses (competitiveness) and households (income and poverty) alike. Furthermore, higher prices will put additional strain on vital social infrastructure in a time of already yawning holes in public finance. In reality, the time for a comprehensive nation-wide energy efficiency and saving program has come a long time ago. The protracted lack of adequate, not only-on-paper response could be fatal.

²⁰ Kishore Mahbubani, The World is Adrift as Nations Skirmish, Yale Global, 23 November, 2010.

About the Expert-Grup

Who we are

EXPERT-GRUP is a leading economic think-tank in Republic of Moldova. It is member of the PASOS (Policy Association for an Open Society) network comprising 39 policy think-tanks in 27 countries from Central and Eastern Europe and Central Asia.

Our mission

The institutional mission of the Expert-Grup is to contribute to the economic, democratic and social development of Republic of Moldova, as well as to promote its international competitiveness. We tend to accomplish this mission by delivering top quality services and promoting efficient, transparent and innovative policy models.

Main activities

- Provide the public with relevant and most up-to-date analysis on economic trends;
- Offer assistance and consultancy in the decision-making and policy-making processes;
- Promote innovative development solutions and policy models.

Areas of expertise

- Development strategies;
- Macroeconomics and economic systems;
- Global economy and international economic relations;
- Economy of the European integration;
- Monetary and fiscal policies;
- Labour economy, management and business culture;
- Consumer behaviour;
- Industrial and agricultural economics;
- Economy of health and education.

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