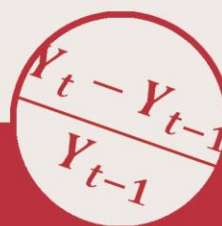


MEGA

2nd Quarter, 2017, #16



Moldovan Economic Growth Analysis

Mysteries of economic growth after the storm

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This document is published by the Independent Think-Tank EXPERT-GRUP with the financial support of the Global Partnership for Social Accountability, World Bank. Opinions expressed in this document belong to the authors and are not necessarily the opinions of the Global Partnership for Social Accountability or the World Bank.

About MEGA

*MEGA is the English acronym for **Moldova Economic Growth Analysis**. MEGA is a biannual publication issued by EXPERT-GRUP since 2009 and has the main purposes of explaining the fundamentals of recent economic trends in Moldova, analyzing economic policies and coming up with strategic solutions for the economic development of the country.*



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Abbreviations

AA	Association Agreement
CIS	Community of Independent States
CPI	Consumer Price Index
DCFTA	Deep and Comprehensive Free Trade Agreement
EUR	Euro currency
GVA	Gross Value Added
GS	Government Securities
IMF	International Monetary Fund
Jan:16 – Dec:16	January, 2016 – December, 2016
NBC	National Bank Certificates
NBS	National Bureau of Statistics
NBM	National Bank of Moldova
NCFM	National Committee for Financial Stability
NPB	National Public Budget
PEM	PanEuroMed
Q1:16 – Q4:16	Quarter 1, 2016 – Quarter 4, 2016
USD	US dollar
VAT	Value Added Tax
WTO	World Trade Organization
y-o-y	Year on year

Key policy messages

The economic growth of 2016 was higher than forecasted, but lower than the optimal level. The Gross Domestic Product of the Republic of Moldova increased by 4.1% in 2016, exceeding the forecasts from the previous MEGA publication (3.4% according to the baseline scenario). This evolution was determined by the higher-than-expected increase in consumption and exports of goods and services, which grew quicker than imports. These developments led to higher-than-expected increases in services and industry. At the same time, the slumps in investment activity and constructions were milder than expected. Also, the recovery of agriculture after the 2015 drought gave impetus for the economic growth in 2016. However, the GDP growth of 4.1% is much lower than the optimal level (~7%), especially given the low comparison base (in 2015 the GDP decreased by 0.5%). Moreover, this level was not much higher than in other countries from Central and Eastern Europe that have a GDP per capita several times bigger than Moldova: Romania grew quicker (+4.8%) with a GDP per capita of almost 5 times higher, Bulgaria grew by 3.4% with a GDP per capita 4 times higher, and Slovakia - by 3.3% with a GDP per capita 9 times higher.

Our GDP growth forecast for 2017 is 6% according to the baseline scenario and around 4% according to the pessimistic scenario. Though at the first glance this forecast seems to be counterintuitive and higher than the forecasts made by the Government, IMF and World Bank, it is justified by three growth factors that were inhibited in 2015-2016 and will be unleashed in 2017:

- *Revival of lending.* The volume of new loans is expected to grow by about 15-16% in 2017, after banks had accumulated significant liquidities during the last two years, which were translated into lower interest rates on deposits and loans. This will foster consumption, as well as investments.
- *Growth of remittances* by about 5% in 2017, which will also contribute to consumption growth at higher rates than in 2016.
- *Resumption of funding for public investments* will foster the fixed capital formation due to the investment projects that were blocked in 2015-2016. The IMF Memorandum is the catalyst factor in this regard that helped relaunch the dialogue with other development partners of the country.

The economic growth remains rather unsustainable in the long-run. The aforementioned factors that will boost the economy in 2017 are short-term factors: revival of lending and remittances will happen after two years of decline, while the public investments will grow on the account of the projects that were postponed in the past. In addition, the economic growth model will remain consumption-based and will be accompanied by a worsening balance of payments, which in 2017 could exceed 5% of GDP.

The increasing current account deficit, on the background of a high short-term foreign debt and lack of access to foreign capital markets are the main sources of macrofinancial vulnerabilities for the following years. Signing of IMF Memorandum is helpful in this regard, as besides the reforms-based conditionalities, it also helps supplement the level of official reserve assets. As present, despite the fact that the official reserve assets exceed 5 consecutive months of imports, they do not cover fully the short-term foreign debt. For a state with an open economy, without access to foreign capital markets, with a relatively high current account deficit and foreign debt of almost the same level as the annual GDP, the current level of international reserves is not enough to ensure comfortable immunity against external shocks.

The low competitiveness is a fundamental drawback that has affected the economic growth in Moldova during the past years. Traditionally, in Moldova wages grow at a higher pace than labour productivity: a trend that most probably will be maintained in 2017, as well. This puts major pressures on the private sector and generates strong stimuli for informal employment, especially in the agricultural sector, which accounts for about one third of total employment.



The labour market trends reflect the unsustainable and non-qualitative nature of economic growth. Though the quantitative indicators of labour market (higher employment rate) improved in 2016, the informal employment increased on account of the formal one. Thus, the increase in employment was accompanied by a decrease in the number of formal jobs. This trend will most probably persist, with severe consequences for the productivity and wage growth rate. As a result, the forecasted economic growth will not translate into a similar growth of people's wellbeing.

Policy recommendations: Theory of change for the Moldovan Economy

The entire set of economic policies should target at enhancing the labour productivity and competitiveness of the Moldovan economy. These are the main underpinning pillars for the growth of wages, formal employment, people's welfare, financial sustainability of businesses and revenue to the national public budget. Investments are the main trigger for higher competitiveness and productivity. Hence, the Government policies should give top priority to facilitating investments in the economic and human capital. This will augment exports, bring into equilibrium the trade balance and current account, increase the level of international reserves, decrease pressures on the national currency, increase people's welfare and enhance the country's resilience to external shocks.

In order to increase the investments in fixed capital it is crucial to improve the institutional framework and business environment. According to the Global Competitiveness Report 2016-2017, the following are the top-3 obstacles to businesses: corruption, policy and Government instability and inefficient bureaucracy. These results suggest that the Government needs to strengthen the rule of law in order to fight corruption more efficiently, and to implement the Public Administration Reform Strategy and the Regulatory Reform Strategy in order to strengthen the institutions and cut bureaucracy. It is also important for the accomplishment of these objectives that the civil society and development partners ensure permanent and rigorous monitoring in order to enhance the decision makers' accountability in these areas.

The Government needs to streamline the public investments and encourage private investments in human capital. The public investments in human capital may be streamlined by moving all educational institutions to student-based funding (self-financing) in tandem with enhancing the accountability of educational institutions' managers (Managing Boards, with representatives of students among its members - mechanism piloted in 80 schools under My School Project - is a universal mechanism of enhancing the managers' accountability). Special attention needs to be paid to the reform of vocational education system, by increasing its relevance and prestige. At the same time, in order to increase the private investments in human capital, the Government needs to recognise largely the informal and non-formal education, facilitate the access of private educational institutions (including foreign) and provide more tax facilities for investments in human capital.



Forecasts for 2017–2018

Table 1. Forecast of the key macroeconomic indicators

	2017		2018	
	<i>Baseline forecast</i>	<i>Pessimistic scenario</i>	<i>Baseline forecast</i>	<i>Pessimistic scenario</i>
Gross Domestic Product, %	6	3.8	5.9	3.6
Agriculture, GVA, %	3.1	0.4	5.3	2.7
Industry, GVA, %	4.2	2.6	4.2	1.8
Constructions, GVA, %	6.9	6.4	7.5	6.1
Domestic trade, GVA, %	7.3	6.8	7.4	6.6
Transport, GVA, %	10	6.5	10	5
Net taxes, %	3.7	3.2	2.2	1.4
Final consumption, %	5.2	4.9	5.2	4.7
Gross fixed capital formation, %	6.8	4.2	10.2	8.3
Exports of goods and services, %	12.2	8.5	10	5.7
Imports of goods and services, %	8.9	8.5	8.7	7.9
Remittances, %	5	0	5	0
Investments, %	4.4	3.3	5	2.9
Bank loans in MDL, %	15.7	12.1	12.2	10
Fiscal revenues, %	15.5	15.2	6.2	5.9
Real wages, %	7.9	7.8	8.2	7.6
Inflation, %	7	7.5	5.5	6

Source: EXPERT-GRUP estimates and forecast



Executive summary

Domestic Supply. The economy is still adjusting to the post-crisis environment. Agriculture became the flagman of economic growth in 2016, with a contribution of 2.2 p.p. to the overall growth of 4.1%, in spite of the embargo imposed by Russia. As this was due to the recovery after the 2015 drought, we cannot expect similar performances in 2017. Trade and services, stimulated by the higher household demand, increased by 6.4%, ranking the second biggest contributor to the GDP growth. Signing the IMF Memorandum and resumption of external support to Moldova had an important role for the second half of the year. Thus, the Government expenses rose the end of 2016 and beginning of 2017, and the fixed capital will increase in 2017 on the account of Government investments.

Domestic Demand. The evolution of aggregate demand confirms that the economy is adjusting to the post-crisis environment. Thus, in 2016 the trend of net exports reversed into a negative contributor comparing to the year 2015, while the household consumption became the main contributor to the aggregate demand growth. The adjustment to the new post-crisis realities will continue in 2017. Thus, once the IMF Agreement was signed and the financing was resumed, the Government will become the leader in terms of investment growth. It will also foster the increase in consumption. Due to the small size of Moldova and its low economic development, the expansion of investors in the car industry in Moldova became visible in the country's macroeconomic indicators. Thus, we expect that GDP will grow by about 6% in 2017.

Public Finance. The memorandum with IMF had a positive impact on public finance. It contributed to the unfreezing of external financing, which is important mainly for capital investments. Furthermore, the economic growth above the official forecasts and the non-execution of all planned expenses resulted in an improved budgetary balance in 2016. The National Public Budget registered a deficit of only 1.8% of GDP, in spite of the initial forecasts of 3.2%. The positive evolutions from late last year continued in 2017 as well, with the budget revenue increasing by over 20% y-o-y during the first 3 months of the current year. In spite of these positive trends, the authorities amended the 2017 State Budget Law by introducing a new mechanism for the management of budgetary risks - establishment of a cash buffer. Unfortunately, this innovation was not accompanied by a (public) analysis of the usefulness of this mechanism in existing circumstances. In addition, the expected risks were not stated expressly and the existing legal framework was not adjusted. There are also risks for other structural reforms related to public finance, mainly for the public procurement area. The recent initiative to switch all public procurements into an electronic format may encounter resistance of different interest groups.

Labour market. The labour market is characterized by a continuation of the trends engendered in previous years - improvement of quantitative employment indicators and worsening of qualitative ones. The employment rate rose up to 40.8% for the first time in the last 7 years, and the unemployment fell to 4.2%. However, the higher general employment was generated by the informal economy, while the number of formal employees continued to decrease. The share of employment in formal enterprises reached a new low in 2016 - about 68% of total employment, which is by 10 p.p. less than in 2010. Structurally, there was a continuing concentration of employment in agriculture, which again was coupled with an increase in informal forms of employment. These trends have a major impact on the aggregate level of labour productivity. The labour productivity in the formal sector has grown continuously during the last decade, even during periods of economic shocks, but the lower number of employees in this sector contributes less and less to the overall labour productivity. Besides, the labour force concentration in the informal sector is accompanied by the stagnation and decrease of labour productivity in this sector, which in the end leads to slower rates of aggregate productivity.

Prices and Monetary Policy. The inflationary trends are getting stronger. The banking sector has a significant surplus of liquidities. This is a precondition for a monetary expansion and for a possible growth of the inflation rate. In these conditions, the NBM tightened the monetary policy and increased the reserve requirements from 35% to 40%. The developments on the international markets could also generate additional inflationary pressures. At the same time, the



appreciation of the national currency has a disinflationary effect. It is likely that the inflation rate could be not maintained within the limits monitored by NBM, ranging from 3.5% to 6.5%, and the price will grow above the upper level of the corridor.

Banking Sector. The previously started reforms will continue and new laws and regulations of vital importance for the recovery of the financial and banking environment are proposed to be adopted in 2017. Passing the new law on the activity of banks and the new framework for the maintenance of financial stability are just some of the most important actions proposed for the near future. The purpose is to implement new fundamental rules for the activity and supervision of banking institutions and to enforce the necessary legal framework in order to achieve financial stability. Though after the IMF Agreement was signed the implementation of reforms became more dynamic, they still need more active support by politicians, especially by the Parliament, which should find the necessary consensus and adopt draft laws in due time. Although significant progress was made, the recovery and financial development of the sector is slow and not flawless. The worsening quality of assets and the modest results of the lending activity reveal the existence of a series of structural bottlenecks, besides the crisis of trust between banks and the economic sector, which affect the financial intermediation. Thus, to guarantee the positive effect of reforms, special attention needs to be paid to mechanisms that could enhance the banking sector capacity to finance the economy in a sustainable manner.

Foreign Trade. After the dramatic drop in 2015, this negative trend slowed down in 2016, but it did continue in the first two months of 2017. However, these trends should be interpreted through the lens of the very small comparison base of 2015. Thus, in 2016, the value of exports was by 4.0% higher than in the previous year, and in the first quarter it grew by 26.8% y-o-y. Geographically, the European Union is still the main destination of Moldovan exports, with a share of 65% in total exports, offsetting thus the lower exports to the CIS countries, which account for 20% of all Moldovan exports. At the same time, the quantitative indicators show a very different picture than the value indicators, with increases in the main groups of exported commodities, despite the falling unit price, as a result of the decrease in international prices for these commodities. On the other hand, the imports of goods dropped by 0.8% in 2016 mainly due to cheaper oil products and well gas, as well as due to the import restrictions imposed by the Russian Federation for EU, which decreased the re-exports to Russian Federation. The total exports of goods and services are expected to grow in 2017 by about 12% and the imports - by about 9%.

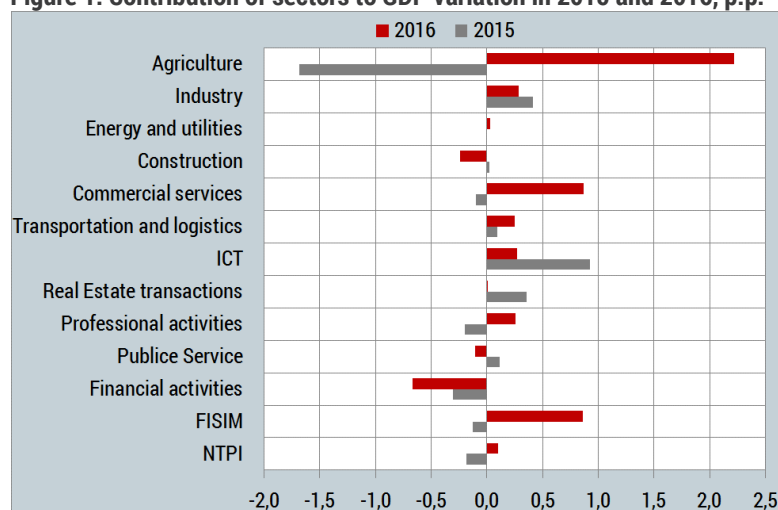
Chapter 1. Domestic supply

If during 2015 the financial and insurance sector was the leader in terms of economic growth, managing to use to its advantage the crisis of late 2014 and registering a 20% growth in 2015, the agricultural sector – having recovered from the 2015 drought – became the leader in 2016, registering a growth of about 18.2%. Thus, in 2016 the agricultural sector contributed to over 50% of the GDP growth. Worst performance in 2016 was recorded by the construction sector, as it went down by 6.7%. This sector is in a strong need of massive financing, being affected by the difficult recovery of the lending activity.

Recent Trends

GDP based on production approach increased in the second half of the year, largely due to agriculture and trade. These two sectors contributed to the GDP growth by more than 3 p.p. As illustrated in Figure 1, the main obstacles for GDP growth were the construction and financial sectors, as they both contracted by around 6-7%. The severe budget constraints of 2015 worsened in 2016 and caused a stagnation of public services.

Figure 1. Contribution of sectors to GDP variation in 2015 and 2016, p.p.



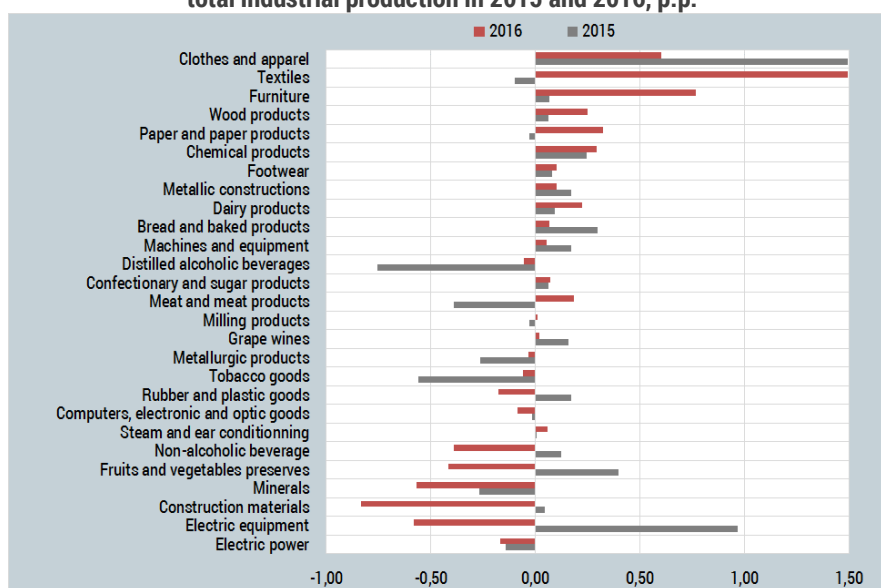
Source: NBS

Agriculture resumed its position, lost because of the 2015 drought, with an 18.2% growth. The crop production sector contributed with a growth of 26%. Livestock production was more modest, with a growth of 3.1%, being traditionally less volatile. The crops of wheat (+40%), sunflower (+39%), fruits and berries (+19%), vegetables (+12%) and grapes (+3%) saw a significant increase compared with 2015. While the production of grain crops, fruits and grapes recovered and exceeded the 2014 production volume, sugar beet production did not recover even half of the 2014 production volume (590 thousand tones in 2016 versus 1356 thousand tones in 2014), and the potato harvest decreased by 20% compared against the 2014 harvest. The livestock sub-sector grew insignificantly (+3%), but traditionally, the smaller increase in livestock production are offset by a stronger stability compared to crop production. The unusually strong growth in egg production (almost 7%) occurred prevalently due to the increase in the number of laying hens. Milk production remained at the 2015 level, one of the causes being the shortage of fodder in households.

The industry showed major structural changes. The industry grew modestly by 2.8% in 2016 and underwent significant structural changes. Thus, the production of textiles, clothing, leather goods and footwear was affected by the crisis insignificantly and during 2016, these sectors recorded a two-digit production volume growth. Furniture production also

increased significantly. These two sectors played an important role in the 2016 gross value growth. Tobacco production – the volume of which decreased more than 2 times in comparison with 2014 and which, most likely, will not recover soon because of the anti-tobacco policy and because of the more efficient fight against cigarette smuggling – is on the other end of the spectrum. The production of beverages, canned fruits and vegetables, electric equipment, construction materials are also among the sectors that contributed to the gross value decrease. Contrary to the dominant opinion of the mass-media, the trade embargo imposed by the Russian Federation is neither the only, nor the main cause of the current decrease in industrial production. Structural and conjectural factors are at issue. Thus, the unfavorable evolutions in the construction sector caused a reduction in the production of construction materials and, as consequence – a contraction of the mining activity. It is beyond any doubt that the 2015 drought affected fruit and vegetable canning, but this trend will turn the other way around in 2017. At the same time, the risks related to the poor diversification of this sector and the dependence upon the eastern market are not fully mitigated.

Figure 2. Contribution of industrial branches (by main products) to the variation of total industrial production in 2015 and 2016, p.p.



Source: EG, on the basis of NBS data

Constructions. The year of 2016 was a complicated one for the construction sector, which experienced a 6.7% drop in the physical volume index. The volume of installation works decreased by 8.4%, while as few as 3947 construction permits were issued – by 8.5% less than in 2015. Only engineering facilities construction kept the level of installation works volume levels, whereas residential and non-residential building works decreased by 16% and 14%, respectively. The fact that fewer construction permits were issued makes one believe there won't be any spectacular growth in 2017 in the private sector. At the same time, the greater number of funding programs made available to the Government and the reform of the road funding mechanisms will offset and will have a positive effect on this sector.

Commercial services experienced a 6.4% growth. Regardless of the fact that car trade represents only 6% of the trade sector, this subsector contributed with almost 1/3 to the growth of the trade volumes in current prices. Thus, the car trade recorded a volume increase of 40% compared to the year 2015. This effect is due to the facilitations granted by the government during the year 2016. The results of retail trade registering a growth of 7.1%, while wholesale trade experienced a 3.2% growth. The services provided to the population recorded 6.1% growth of volumes. Along the expansion of some sub-sectors, it is observed and increase in the gross value created in the sector. Due to remittances growth as well as governmental expenditures growth, both volumes and gross value of the sector will keep a growing trend during 2017.



Challenges and Forecasts

- Despite the natural calamities of April 2017, there are no catastrophic losses for agriculture. Still, on the background of the good year of 2016, achieving better results in 2017 will be difficult. Therefore, we expect the agricultural sector to register a modest growth of about 3%.
- The positive trend in the textile, clothing, leather goods sectors will most probably continue. The fact that new large companies like Sumitomo and Fujikura started their operations in Moldova, and that Draexlmaier and other investors in the automobile field expanded their activity, will have visible effects in 2017. Therefore, we expect a positive growth by about 4%.
- The construction activities in the private sector may reduce the negative trends and in the optimistic scenario may record even a light growth, but the main driving force in 2017 will be ensured by the public sector due to the funding programs and investments made by the Government on the basis of external funding.
- The domestic trade with goods and services will tend to speed up to about 7%, on the grounds of consumption growth.
- In 2017, despite the fact that certain sectors will continue to experience decreases in production volumes as a result of rationalizing intermediate consumption, GDP growth will be positive – around 3.8% in a negative scenario, and around 6.0% in a positive scenario. The positive 2017 forecast is possible only if agroclimatic condition will not register additional negative impacts.



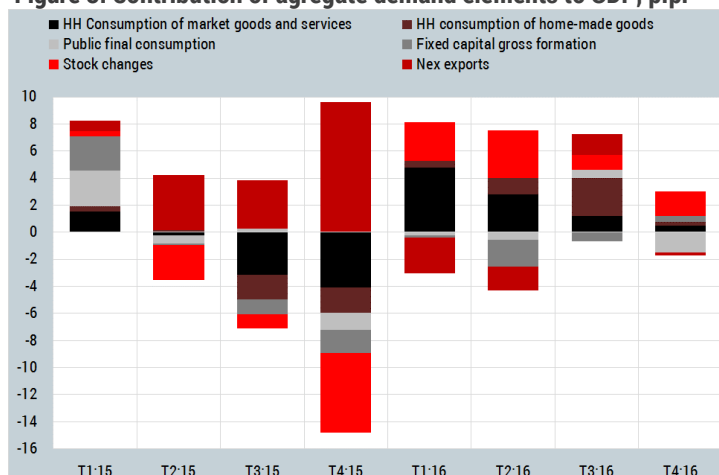
Chapter 2. Domestic demand

The aggregate demand changed at a higher pace in 2016 once the IMF Agreement was signed and the external funding was resumed. Despite the fact that in 2016 the GDP grew mainly on the account of higher household consumption, an increase in the Government investments was noticed in early 2017 able to reverse the negative trend of investments in fixed assets, registered in 2015 and 2016.

Recent Trends

Due to the crisis effects and structural adjustments, the years of 2015, 2016 and 2017 had different structural configurations in terms of “driving forces” of the aggregate demand. The positive contribution of net exports was a life buoy in 2015. Household consumption and services, in particular the services to population, were the growth engine in 2016 (Figure 3). However, this growth model was not stable, and underwent significant changes at the end of the previous year, which will affect the entire 2017. After the IMF Agreement was signed and the external financing was unlocked, the Government resumed its investments in Q4:16, which smoothed out the negative developments and will become one of the main driving forces of the aggregate demand in 2017. The variation of stocks is another characteristic that had a massive positive contribution in 2016, but this factor most probably will not have any growth contribution in 2017.

Figure 3. Contribution of aggregate demand elements to GDP, p.p.

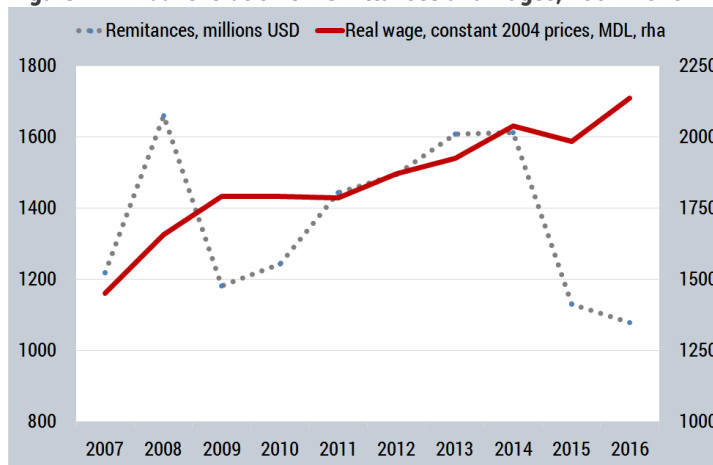


Notes: HH – households, PA – public administration. The market consumption of HH also includes the consumption of non-profit institutions for the benefit of households.

Source: NBS

During 2016, the household consumption increased by 3.6% and was the main factors of GDP growth, generating a contribution of 3.2 percentage points. The favorable conditions for agriculture in 2016 secured a higher income, which fostered consumption, in particular the in-kind consumption. The higher real wages (+7.7%) is another significant factor that supported household consumption. The real wages have increased constantly for a long period of time, in spite of the economic crises. (Figure 4) As for remittances, during the first half of this year they were under the level of 2015, a significant part of decrease was recovered in the second half of the year. The data for early 2017 confirm the upward trends of remittances, which is a good sign for consumption acceleration - traditionally the main driver of economic growth in Moldova.

Figure 4. Annual evolution of remittances and wages, 2007-2016



Source: NBM, NBS

The final consumption of public administration decreased by about 0.5% y-o-y in real terms, depriving the GDP growth by about 0.2 percentage points. This is a natural consequence of the severe budgetary constraints of 2016, which limited the central and local authorities' expenditures. The lower final consumption of public administration was also caused by the uncertainties regarding the resumption of financial support from development partners of Moldova. Once the IMF Agreement was signed and the external funding was resumed by foreign partners, the negative trend was reversed.

The lower investment activity had a negative contribution to the GDP formation in 2016. The capital investments decreased for seven consecutive quarters, from Q2:15 to Q4:16. The annual negative impact on GDP reached 0.7 percentage points of GDP growth. The main component in the gross fixed capital formation - constructions - shrank by over 5% last year, while the other components were rather stable.

The net exports had a negative impact on GDP during the first half of the year, but it was later recovered limiting thus the negative effect on the annual GDP growth to -0.5 p.p. This is caused by the modest growth of exports of goods (+2.3%), mainly due to agriculture and related sectors that obtained good results in the second half of the year. The modest external demand for goods is mainly caused by the Russian crisis and the economic barriers imposed by Russia for political purposes. As a result, the country's reliance on the Russian market declined to a relatively comfortable corridor of 10-15% share of the export markets, so that the future economic shock of Russia will have a minimum transmission effect on Moldova. The services sector recovered quicker: the exports increased visibly (by about 8.8%), while the imports stagnated.

Challenges and Forecasts

- During 2017 we expect that the final consumption will increase by about 4.9-5.2% almost exclusively on the account of higher household consumption. The component of in-kind consumption will have an important role in this regard. The positive trends from the beginning of this year suggest that remittances will increase by about 5%.
- As a result of resumed external financing, the consumption of public administration will increase in 2017. A two-digit increase is expected.
- The gross fixed capital formation will have a positive trend (+4.2-6.8%), driven by public authorities.
- The external demand will remain quite weak, taking into account the unsolved issues of quality and certification for the Western markets.



Chapter 3. Public finance

The quality of public finance has improved lately, and the memorandum with IMF played a decisive role in this regard. As a result, the foreign financing was resumed and the dynamics of all macro-fiscal indicators improved. Concurrently, a cash buffer was established without changing the existing legal and institutional framework. This manoeuvre can however generate moral hazards in the future. There are also risks for other structural reforms in public finance, such as in public procurements.

Recent Trends

The memorandum with IMF, signed in November 2016, had a stabilizing impact on public finance. First, this document acted as an anchor for national authorities to adopt the 2017 State Budget Law in a reasonable term, and unlike the last two years, this Law was approved before the beginning of the fiscal year. Second, the memorandum contributed to the resuming of external financing by key donors. In immediate aftermath of memorandum's signature, the IMF disbursed the first tranche of USD 24.1 million as a loan to finance the budgetary deficit. Next, by the end of the year, the European Commission and World Bank disbursed EUR 45.3 million and EUR 48.5 million respectively, which improved the cash balance of the State budget by MDL 992.1 million compared to the beginning of the year, reaching MDL 3,298.5 million.¹

The key budgetary parameters have significantly improved compared to the initial forecasts. The deficit of the National Public Budget (NPB) was the key indicator that registered a positive evolution. In 2016, the deficit accounted for only 1.8% of GDP, rather than the 3.2% deficit planned by the national authorities and stated in the memorandum with IMF. Two factors underpinned this lower-than-expected budgetary deficit. First factor was the underexecution of planned budget expenditures. By the end of 2016, the expenditures reached only 95.4% of the planned amount, whereas the revenue reached about 98.9%. A second factor was the growth of GDP with 1.5 p.p. higher in comparison with the initial forecasts, up to 4.1% y-o-y in 2016. In addition, during the first three months of 2017, the budgetary revenue had a positive dynamics, increasing by 20.8% y-o-y. The positive evolution of the revenue, combined with a potential GDP growth above the official forecasts, will keep the deficit under 3% of GDP in 2017, as forecasted by the Ministry of Finance and agreed with the IMF for the current year.²

Despite the positive forecasts for most of the macro-fiscal indicators and the lower budgetary risks, the Government has introduced some innovations in this area, establishing a cash buffer. The amendments to the 2017 State Budget Law, which included proposals in this regard, were submitted as early as in February and were adopted by the Parliament in March 2017. Thus, it was planned a cash buffer of MDL 2 billion to be established through the issuance of state securities (SS) and the placement of respective amounts in a term deposit account with the National Bank of Moldova (BNM). The declared aim of this buffer was to avoid seasonal pressures on budgetary deficit financing and to mitigate the refinancing risks of the domestic Government debt.

The current mechanism and aim of the cash buffer imply some contradictions and inconsistencies from the viewpoint of economic logic and the current legal framework. Such an instrument of budget management is neither envisaged in the Law on Public Finance and Budgetary-Fiscal Accountability, nor in the State Budget Law for the current year.³ At least, the mentioned legal framework should have been amended in order to create such a mechanism. Hence, this is an ad-hoc, rather than a long-term instrument. Additionally, the Law amending the State Budget and its Analytical Note does not

¹http://mf.gov.md/files/reports/Raport%20BPN%2031.12.2016_0.pdf

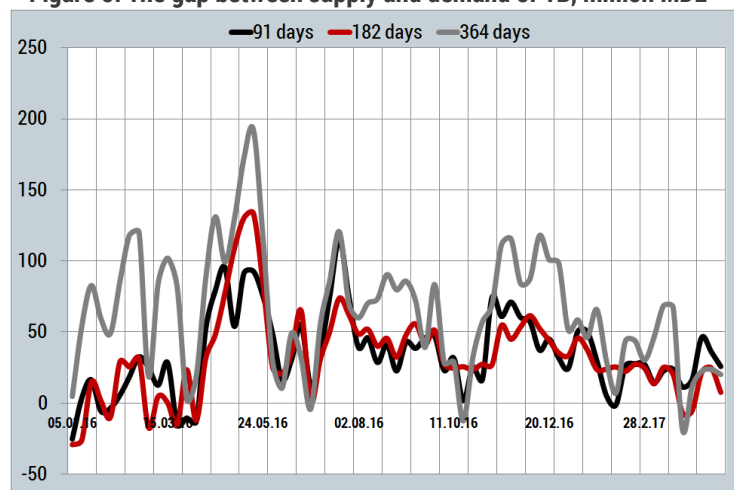
²Expert-Grup forecasts an economic growth of 6% y-o-y and an increase of tax collections by 15.5% y-o-y.

³<https://vnegruta.wordpress.com/2017/02/09/credite-impuse-statului-cash-buffer/>



stipulate clearly for what period of time this buffer was created, which creates the impression that this is a conjectural and discretionary mechanism. Moreover, it is not clear to what extent the cash buffer can reduce the debt refinancing risks, given that even during the most stressful situations, the Government did not have any problems to sell its Treasury Bills (TB) (Figure 5). Indeed, the commercial banks' demand for such financial instruments of the Government is volatile, but this is also caused by the lack of real competition for these securities, since the market is not liquid and a limited number of entities (commercial banks) can buy them. So, this initiative should have been more ample and should have included the amending of the entire fiscal-budgetary architecture. Still, a most optimal solution would be including the cash buffer into the existing budgetary rules.

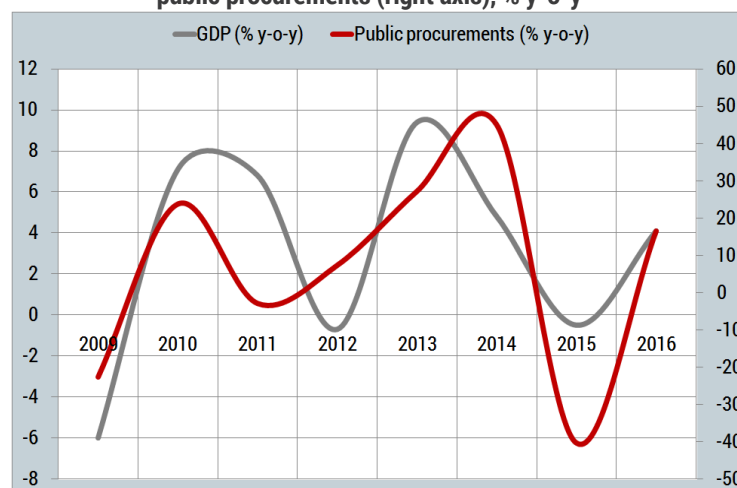
Figure 5. The gap between supply and demand of TB, million MDL



Source: Authors' calculations on the basis of NBM data

The existing budgetary rules neither decrease the budgetary risks, nor smooth out the cyclical fluctuations of the economy. Currently, the Law on Public Finance and Budgetary-Fiscal Accountability stipulates quite vaguely, in Article 15, the macro-fiscal indicators and principles of public finance management. The main rule is to establish a threshold for the deficit at 2.5% of GDP by 2018, excluding the grants, with a derogation allowing to exceed this threshold only if there are actual external funds to finance capital investments. This formulation does not state clearly the maximum allowed deficit or the budget indicators for periods of economic expansion and economic contraction. Besides the described quantitative indicators, it is necessary to specify all long-term instruments for the management of the budget (either in the Law, or in regulatory acts), i.e. of the cash buffer. In general, the fiscal-budgetary policy is clearly pro-cyclical, which can be noticed by comparing the dynamics of public expenditures and GDP growth, with a correlation coefficient of 0.7 (Figure 6).

Figure 6. Relationship between the dynamics of GDP (left axis) and the volume of public procurements (right axis), % y-o-y



Source: Authors' calculations based on NBS and PPA data

Another structural reform of public finance, launched this year, aims at upgrading the public procurement electronic system. The implementation of an electronic public procurement system started with the financial and technical support of the European Bank for Reconstruction and Development (EBRD). It was tested during the first half of 2017, and it is planned that all contracting authorities from the Republic of Moldova will start using only electronic procurement since early 2018.⁴ The e-procurement platform will increase significantly the transparency in this area, enhance the efficiency of procurement procedures and improve the relevant statistical data. All mentioned advantages are important, but the improved statistical data have a primary importance, because currently there is no information available about low-value procurements. The Public Procurement Agency (PPA) does not publish any data about the value of this category of procurements, but they could have a significant share in total public procurements.⁵

Challenges and forecasts

In spite of the quantitative and qualitative progresses in public finance, this area is still subject to some major risks. There are three major short and long-term systemic risks that, unless mitigated, could destabilize the public finance in the long-run:

- **Lack of detailed budgetary-fiscal rules and of an institutional framework for their monitoring.** The current rules from the Law on Public Finance and Budgetary-Fiscal Accountability are quite vague. It provides a wide space for discretionary decisions and leads to an extremely pro-cyclic budgetary-fiscal policy, which keeps the Government in a continuous state of unpreparedness for potential negative shocks and economic crises. In addition, there isn't any independent Fiscal Council that could prepare forecasts and reports on the compliance of the budgetary-fiscal policy to the agreed rules. Though some discussions started last year on the possible structure and role of a Fiscal Council, no more visible steps have been yet taken in this direction. In the light of these developments, there is a risk that a final decision to set up a Council and review of the fiscal rules will be postponed for as long as possible.
- **Institutionalizing some ad-hoc mechanisms for public finance management that are not integrated well in the existing budgetary architecture.** This mechanism refers to the establishment of the cash buffer, without making any changes in the existing legal and institutional framework. The established cash buffer shall be for the medium term at least, and not for the 2017 budgetary year only. This fact is proven by the the first issuance, on 28 March, of

⁴<http://mf.gov.md/newsitem/10762>

⁵ http://tender.gov.md/sites/default/files/document/attachments/raport_anual_2016.pdf



Government bonds with a maturity of 365 days and 2 years, with an estimated value of MDL 1 billion.⁶ Such decisions only reinforce the discretionary nature of the budgetary-fiscal policy and create moral hazards for the future.

- **Undermining the public procurement reform.** In spite of the centralized effort of the Ministry of Finance and of EBRD support, the new e-procurement platform may be obstructed by some contracting authorities and by the legislative. In the first case, the officials from some public authorities may invoke different difficulties related to the use of this platform and lack of experience in electronic procurement. This risk can be mitigated by producing detailed guidelines and amplifying the trainings. An important role in this regard can play the technical and financial support of external donors for the Public Procurement Agency in order to increase both the number and the quality of such guidelines and trainings. Concerning the legislative, it could manifest the resistance by making objections to the number of documents from the public procurement file to be uploaded on the e-procurement platform and to be accessible for large public. There is a risk that will be invoked the commercial secret of participating companies or the claim that evaluation report of tender committee, which should be publically available in accordance with the Law on Public Procurement, is enough to ensure transparency in this area. It will not be possible to decrease this risk without pressure from the civil society and foreign partners.

⁶http://www.bnm.org/files/auctions_results/ofx_pm_results_28.03.2017_3008_md.pdf



Chapter 4. Labor market

The realities of labour market are rather ambiguous. On one hand, most of the quantitative indicators, such as unemployment and total employment, improved in 2016. On the other hand, there was a continuing deterioration of qualitative indicators that began in previous years. Creation of informal jobs speeded up, with an excessive concentration on agriculture. However, the worst aspect is the rise of the informal jobs at the expense of formal ones. All these trends will have a negative impact on sustainable economic growth.

Recent Trends

In 2016, the key labour market indicators recorded an improvement in quantitative terms. The employment increased in both absolute and relative terms. The number of employed increased by 1.3% y-o-y, up to 1,219.5 thousand people, which constitutes an employment rate of 40.8%. A similar employment rate was recorded last time during the crisis year of 2009, when the employment rate reached the 40% threshold. Thus, it took national economy about seven years to recover the employment rate reached in the period of global crisis, but still not reaching the values attained prior to this economic shock. In addition, the employment growth in 2016 led to the decrease in unemployment by 0.7 p.p. down to 4.2%, after an increase in the previous year.

The quantitative improvement on the labour market was, however, accompanied by a worsening quality of employment. As mentioned in the previous editions of MEGA, the total employment growth in the recent years is driven mainly by informal jobs. This trend continued in 2016, amid the informal employment growth in less productive production units, i.e. households producing for their own consumption. Obviously, the informal employment has also been increasing in enterprises from the informal sector, but the household employment speeded up during the last three years and in 2016 it almost caught up with the number of those employed in informal enterprises (Figure 7).⁷ It is most likely that the returning Moldovan migrants from the Russian Federation is the main labour source for this type of employment, who were affected by tightening economic conditions and anti-migratory policy regulations.⁸

The informal employment has increased over the last years on account of formal employment. This is an additional factor that worsens the problem of informal employment. Over the last 6-7 years, the employment rate in enterprises from formal sector decreased by about 10 p.p.: from about 79% of the labour force employed in 2009 (the year when this indicator registered the maximum value during last decade) to 69% in 2016. The decrease was recorded not only in relative terms, as it might have been explained by the stagnation of employed labor force in the formal sector and increase in the number of those informally employed, but also in absolute terms. Thus, the number of those formally employed shrank from 937.4 thousand people in 2009 to 839.1 thousand in 2016, while the number of informally employed people in the same period increased from 355.4 thousand to 443.3 thousand people (Figure 7). Hence, there is a deeply rooted process of migration of jobs from the formal sector to the informal one. This decrease has equally affected both formal and informal jobs from the formal economy sector. During 2009 – 2016, about 98.3 thousand jobs from the formal sector were reduced, and about 46% of them were informal jobs. On one hand, it is promising that companies from the formal sector reduce the number of informal jobs, which constitutes about 7.5% of the total number of people employed in the formal sector in 2016

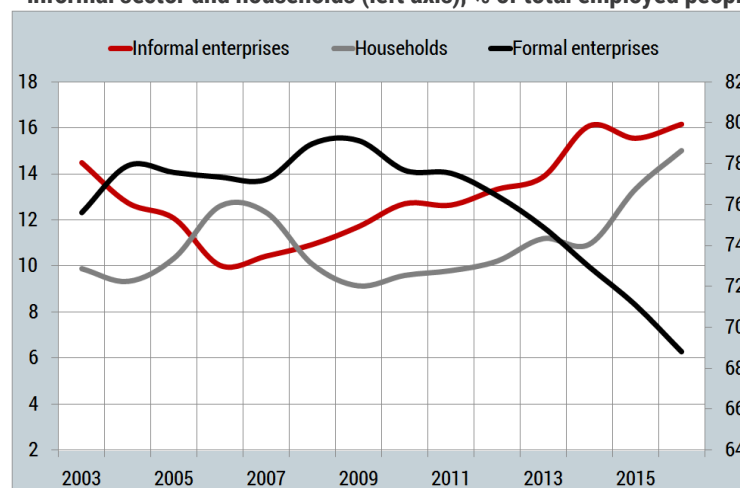
⁷According to the Labour Force Survey, the **household employment** indicator includes persons engaged in production of agricultural goods exclusively for their own consumption, if they practice this activity for 20 hours and more per reference week, as well as paid domestic workers employed by the household. Thus, if the persons employed in households for less than 20 hours per week were factored in, their total number, most likely, would have exceed the number of employees in the enterprises of the informal sector in 2016.

⁸A. Lupusor, A. Fala, I. Morcotilo, D. Cenuşa 'MEGA XII: The year of a looming crisis, Q1-2015'.



compared to 11.6% in 2009. However, the greatest risk is that informal employment from the formal economy sector decreases because the informally employed migrate to the informal sector, and not legalize their contractual relations in the formal sector of the economy. In addition, the fact that almost 50 thousand formal jobs were lost during 2009 – 2016 in the favor of informal ones is also of high concern.

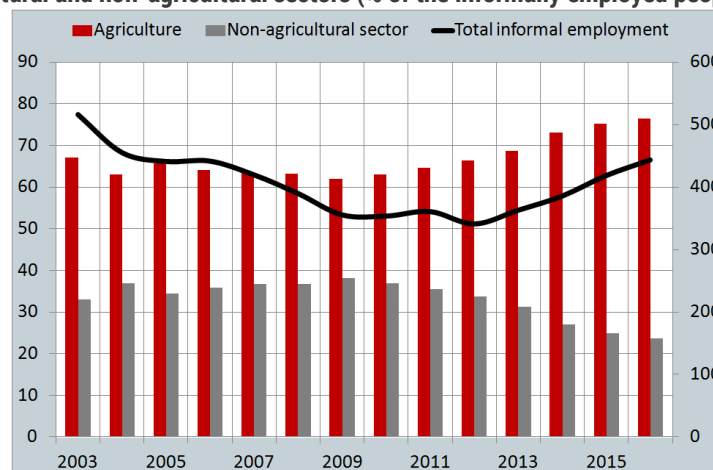
Figure 7. Evolution of employment in enterprises of the formal sector (right axis), informal sector and households (left axis), % of total employed people



Source: authors' calculations based on NBS data

In 2016, similarly to the last years, agriculture was the driving force of the informal employment. In sectoral terms, since 2010 the informal employment started to concentrate more and more in the agricultural sector. The share of this sector increased in 2016 by about 13 p.p. as compared to 2010, up to 76.4% of the total informally employed people. The change has occurred not only in relative, but also in absolute terms, increasing during the same period from 223 thousand to 338.6 thousand people employed informally in the agriculture. This sharp rise, though occurred with a decrease in informal employment in the rest non-agricultural sectors, has led to the increase in the total informal employment up to 36.6% of the total employed population (Figure 8). Both figures of 76.4% and 36.6% reached record values for these indicators, at least for the last 14 years. Additionally, it should be specified that the increase in the total agricultural employment does not take place only because of the inflow of people from other economic sectors or emigrants, but also because of the movement of jobs from the formal agricultural sector. During 2010–2016, the ongoing increase in agricultural employment was accompanied by a decline of those employed formally in this sector in amount of 20 thousand people.

Figure 8. Evolution of informal employed (thousand people, right axis), employment in agricultural and non-agricultural sectors (% of the informally employed people, left axis)

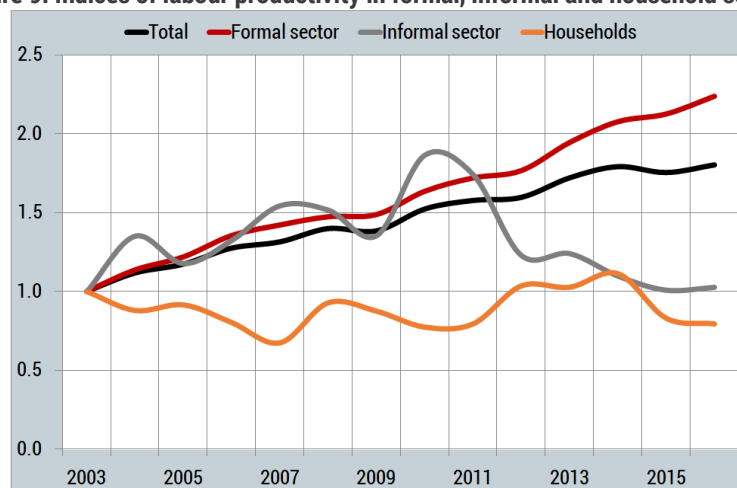


Source: authors' calculations based on NBS data



Expansion of informal employment has a negative and an ample impact on labour productivity. In 2016, labour productivity increased by about 2.8% y-o-y in real terms. This growth was caused almost exclusively by the positive dynamics of this indicator in the formal sector of the economy.⁹ Generally, the productivity in this sector constantly grew in real terms over 2003 – 2016, without registering negative growth rates, even in the years with the most severe economic shocks¹⁰. However, the evolution of the productivity in informal enterprises and households sectors was opposite. The dynamics of productivity in the informal sector was very volatile during the analysed period, registering involutive movements right in the period when employment in this sector started to grow, namely after 2010 (Figure 9).

Figure 9. Indices of labour productivity in formal, informal and household sectors



Source: authors' calculations based on NBS data

In 2016, the wages continued to grow faster than productivity. The difference between the growth of wages and labour productivity in real terms was about 1 p.p. As mentioned above, an important factor in the slow growth of labour productivity is the higher employment in the informal sector, in which the productivity stagnates or decreases. This trend has persisted for several years already and constitutes a significant challenge for the national economy's competitiveness.

Challenges and forecasts

One of the main challenges for the labour market is the extension of the informal employment over the recent years. The problem lies not so much in the rise of those employed informally, but in the structure of this employment and its impact on the formal sector. Few recent trends in informal sector of the national economy can generate major risks for the sustainable economic growth, of which the main risks are the following:

- **Extension of the informal employment in the production units with the lowest economic development capabilities**, i.e. in households. People employed in these units are merely concerned about surviving, and are not necessarily striving to integrate in a functioning market economy. As a result, the households' labour productivity during last decade almost did not change in real terms, slightly decreasing in 2016 in comparison with 2003.
- **Increased concentration of informal employment in one sector – agriculture.** This evolution, besides the fact that it reached record values, indicates on the structural problems of the national economy. First, the higher employment in agriculture is mostly caused by informal jobs, which is far from contributing to modernization

⁹Labour productivity was calculated as the ratio between GVA in prices of 2003 and number of employed people.

¹⁰ The year 2003 was selected as a reference one due to statistical constraints. NBS has begun to publish disaggregated data on informal employment only starting with this year.



efforts in this sector. Second, other economic sectors does not generate enough formal jobs, but on the contrary are reducing them.

- **Extension of total employment on account of informal employment.** The employment growth of recent years was accompanied by the decrease in the number of formal jobs. This trend, if continued, will have dire consequences on the productivity and wage growth rates, because the labour productivity has been constantly increasing over the last decade only in the formal sector. Accordingly, the less labour force in formal sector implies slower labour productivity rates at macroeconomic level.
- **Faster growth of salaries over productivity will most likely persist.** According to forecasts, in 2017 the salaries will grow in real terms by about 7.9%. Given that the recent employment and productivity trends in formal sector will, most likely, not change significantly, the gap between labour productivity and wage growth rates at macroeconomic level will persist for the current year as well, further undermining the competitiveness of the country.

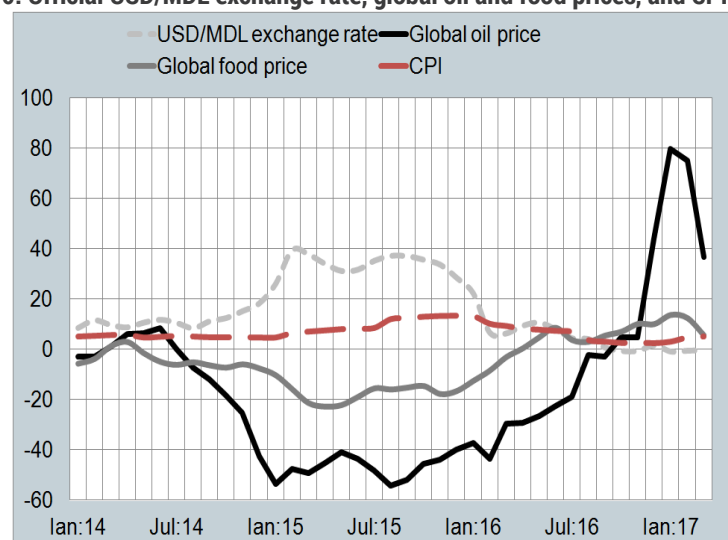
Chapter 5. Prices and monetary policy

The beginning of 2017 was marked by more intense inflationary risks. The significant augmentation of liquidities in the banking sector poses the risk of a strong monetary expansion, which could aggravate the inflationary pressures. In these conditions, the NBM had to tighten the monetary policy and increase the rate of mandatory reserve requirements from 35% to 40%. Besides, there are also external risks, related to the dynamics of international prices. However, some factors have a disinflationary effect, including the evolution of the exchange rate of the national currency.

Recent Trends

The inflationary trend reversed at the beginning of 2017. Thus, the disinflationary trend of 2016 was replaced by a quicker price growth in Q1:17. The significant decline in inflation in 2016, when the CPI dropped from 13.4% y-o-y in Jan:16 to 2.4% y-o-y in Dec:16, was followed by an inflation growth from 3% y-o-y in Jan:17 to 6.6% y-o-y in Apr:17. Broadly speaking, the CPI components had a rather homonegious evolution: the prices for food products increased from 3.8% y-o-y in Jan:17 to 7% y-o-y in Apr:16, the prices for non-food products - from 3.9% to 5.5%, and for services - from 0.3% to 7.5%. The dynamics of inflation was influenced by the evolution of commodity prices on global markets (Figure 10). After a long period of declining global prices, a new trend of increasing prices on the global markets started in Oct:16. This evolution was caused by the increasing prices for oil and food. The period of negative rates of oil prices ended in Sep:16, and since Q4:16 the price for fuel has started to grow. As for food, the first 4 months of 2017 prices have risen more than 10%, and then the growth has tempered. On the other hand, the appreciation of the national currency had a disinflationary effect. Thus, in Sep:16 the depreciation of the national currency stopped, and since Oct:16 the Moldovan leu has been appreciated, except for Dec:16, with the MDL/USD exchange rate recording negative annual rates.

Figure 10. Official USD/MDL exchange rate, global oil and food prices, and CPI, growth y-o-y, %



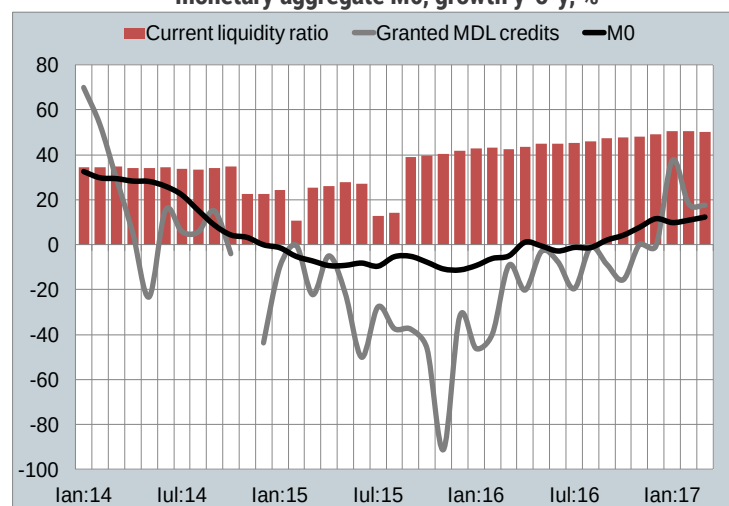
Source: Author's calculations based on IMF, NBM and NBS data

Banks have excessive liquidities, which is a precondition for a more intense crediting activity and, implicitly, for a monetary expansion. The banking sector has been recently characterised by higher levels of savings: in Mar:17 the MDL deposits increased by 25.2% y-o-y. At the same time, the MDL loans are shrinking: in Mar:17 they dropped by 9.7% y-o-y. In this context, the current liquidity indicator reached high levels, exceeding 50% in the first three months of 2017. The



excessive liquidity forces banks to intensify their lending activity, which could relaunch the crediting process. The first signs have been already noticed in this respect: in Q1:17 the value of new MDL loans increased by 22.2% y-o-y. In its turn, expanded crediting increases the volume of money in circulation (Figure 11). Monetary aggregate M0 has been increasing since Sep:16, and in Q1:16 this dynamics became more intensive.

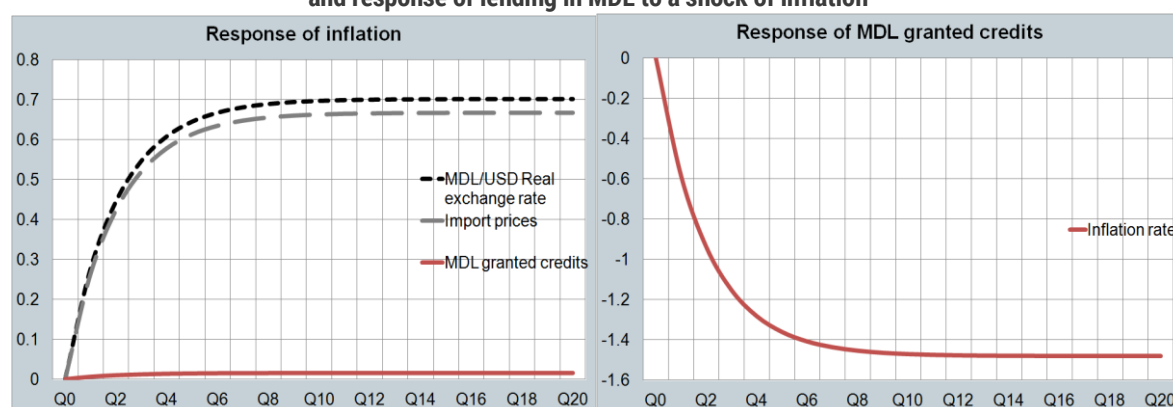
Figure 11. Current liquidity, % and dynamics of granted MDL loans and of monetary aggregate M0, growth y-o-y, %



Source: Authors' calculations on the basis of NBM data

The banking sector developments could create a vicious circle: a possible rapid extension of banking loans could generate inflationary pressures, and a rapid price increase could curb the crediting. In the Republic of Moldova the import prices and exchange rate impact significantly the inflation. Crediting, which is a factor of monetary nature, also has a positive impact on price increase, but it is smaller compared with the effects of import prices and exchange rate. At the same time, inflation shrinks the crediting process (Figure 12). The rise in interest rates at high rates make loans more expensive (higher nominal interest rates), which leads to less granted loans.

Figure 12. Response of inflation to a shock of import prices, MDL/USD real exchange rate and lending in MDL, and response of lending in MDL to a shock of inflation



Source: Authors' calculations on the basis of NBM and NBS data

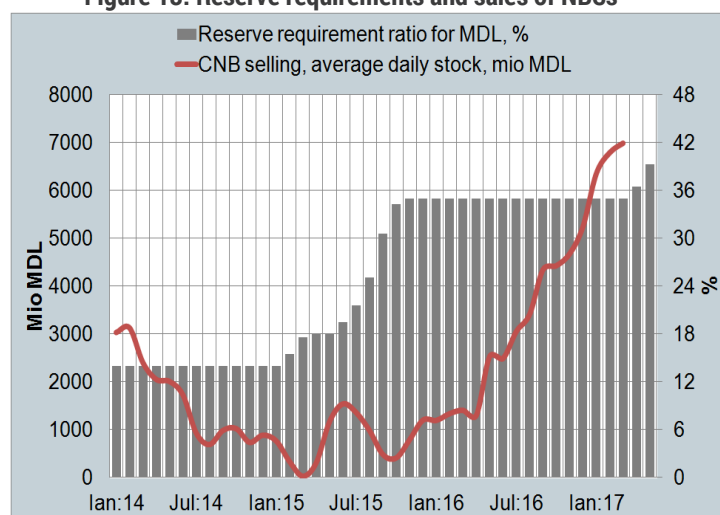
Note: estimates on the basis of the vector error correction model of rank 1. The calculations were made on the basis of quarterly observations covering the period of Q1:11-Q1:17, which reflect the annual increases of variables included in the model.

The abundance of liquidity in banks fuels inflationary risks. To diminish the monetary pressures, the NBM has to act tougher. In Q1:17 the NBM managed liquidities both via sterilisation operations and reserve requirements (Figure 13). The explosive growth in liquidities led to a significant increase of sterilisation operation by the NBM. In Mar:17 the average



daily balance of NBCs sold by the central bank reached about MDL 7 billion - the peak level recorded ever in the history of such transactions. Besides, during the first 5 months of 2017, NBM increased successively the reserve requirements from 35% to 40%. Establishment of a liquidity buffer by the Ministry of Finance, despite its shortcomings described in Chapter 3, is another measure that will diminish the pressures on the monetary market. The institution will issue and sell state securities worth MDL 2 billion to the banking sector, and the money obtained from this transaction will be placed on a deposit account with the NBM. The interest rate and maturity of sources placed with the Central Bank will be the same as for the Government securities issued on the primary market.

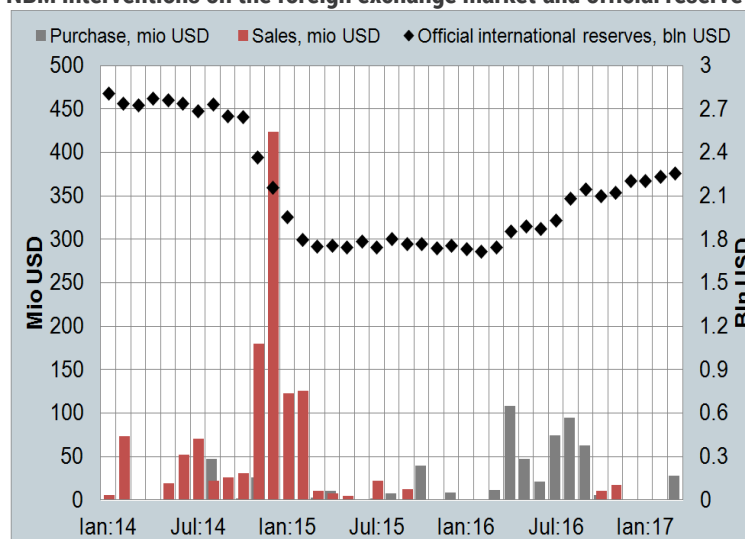
Figure 13. Reserve requirements and sales of NBCs



Source: Authors' calculations on the basis of NBM data

The NBM buys less foreign currency and practically does not sell any foreign currency. The more passive behaviour of the monetary authority on the foreign exchange market helps avoid additional monetary pressures. Since Oct:15 the NBM has only procured foreign currency on the market (except for only Oct:16 and Nov:16, when the monetary authority bought foreign currency). At the same time, the volume of procurements is decreasing (Figure 14). Thus, if in Q2:16 and Q3:16 it bought foreign currency in the amount of USD 176.2 million and USD 231.7 million, then in Q4:16 and Q1:17 it only bought USD 6.6 million and USD 28.1 million. If the NBM bought more foreign currency, the liquidities of MDL would increase in the banking sector, which would generate additional inflationary risks. In this context, the Central Bank intervenes prudently on the foreign exchange market. The procured foreign currency increased the foreign-exchange reserves and in Apr:17 the official reserve assets reached the level of USD 2.3 billion, but which are still not enough to fully cover the short-term foreign debt.

Figure 14. NBM interventions on the foreign exchange market and official reserve assets



Source: Authors' calculations on the basis of NBM data

Forecasts and Challenges

- **In 2017 as a consequence of higher risks inflation rate could reach 7-7.5%.** In 2018 prices will grow at lower pace, and inflation rate will be in 5.5-6% range.
- **There is a significant risk because of price dynamics on the international commodity markets.** In general, an increase in international prices could lead to higher prices for imported goods. Still, regarding oil, there are threats that could emerge because of both an increase and a decrease in prices for this product on international markets. A decrease in oil prices would affect economic growth in Russia, which would cause a decrease in the remittances from Moldovans working there. This would put pressure on the exchange rate and cause, indirectly, inflationary risks.
- **Internally, there are risks of monetary nature.** The excess liquidity in the banking sector could lead to a strong expansion of crediting. Such circumstances allow for the appearance of inflationary risks of monetary nature. Excess liquidity also makes the promotion of the monetary policy difficult. Banks that have excess liquidities do not contract the loans either from other banks or from the monetary authority, therefore the transmission mechanism is much slower.
- **Higher reserve requirements might relieve the inflationary pressures, but the lending activity could be severely affected, which could, in its turn, harm the short-term growth prospects.** Still, considering the current situation characterised by massive excess liquidity, increasing the reserve requirements could remove the 'symptoms' denoting strong lending activity and could secure a 'smoother' growth. Also, the lower inflationary risks could lead to better conditions for the lending activity, favouring thus the long-term growth. It seems that, in fact, the inflation rates below 6.5% do not create obstacles – on the contrary, they foster economic growth¹¹. On the other hand, because of the excess liquidity, relaxing the monetary policy could cause a rapid monetary expansion, which would favour short-term growth, but lead to higher inflation. In this context, long-term growth prospects would be jeopardised.
- **The issue of excess liquidity in the banking sector must be considered from the point of view of the business climate.** One of the reasons for banks' accumulation of money is related to lower level of crediting. In its turn, one of the causes for the credits decline is related to decreasing of private sector appetite for investments. Thus, the investments

¹¹ Fala A., Septelici V., Stratan A., Aspecte cantitative în trioul: variabile monetare, inflație, creștere economică (cazul Republicii Moldova) [Quantitative aspects in the trio: monetary variables, inflation, economic growth (the case of the Republic of Moldova)], Institute of Economy, Finance and Statistics, Chisinau, 2011, p. 18



form non-budgetary sources decreased by about 16.7% in the period between 2011 and 2016. The unfavourable investment climate –a fundamental problem for the Republic of Moldova – influences the performance of the banking sector. As long as the private sector does not find investing in Moldova attractive, the issue of excess liquidity might even worsen, while the efforts of the NBM would become futile.



Chapter 6. The banking sector

The 2014-2015 banking crisis was followed by a crisis of confidence that hit the relationship between banks and the real economy. The collateral damage caused by the bank frauds becomes more and more visible – businesses and the population have less trust in the national economy prospects, and banks have less trust in the quality and viability of investment projects. The latest results show that the main activity of commercial banks – financial intermediation (financing economic and consumer activity on the basis of attracted savings) – is affected by a number of major deficiencies. Therefore, although banks accumulate surplus of liquidities, they continue to be relatively expensive, with short maturities and finally, unattractive for the real sector.

Recent Trends

The continuation of reforms in the banking sector is still a matter that draws the attention of foreign partners, as this is also the key element for maintaining the dialogue with national authorities. To this end, the 2017 agenda provides for the continuation of initiated reforms and for the adoption of certain laws and regulations of vital importance for the recovery of the domestic financial and banking environment. Passing the new law on the activity of banking institutions, the law on money laundering and terrorism financing or adopting the framework for the maintenance of financial stability are just some of the most important actions proposed for the near future. Thus, the draft Law on the Activity of Banks and Investment Firms¹² aims to replace completely the Law on Financial Institutions¹³ and to create a new legal framework for the activity of banks in Moldova. The purpose is to implement new fundamental rules to regulate the activity and supervision of the banking system and to align the domestic law to the best international standards and practices in terms of licensing, regulation and supervision. Drafting and passing the law on the national macroprudential authority also aims to establish the necessary legal framework that would help maintain financial stability, which ultimately will ensure a sustainable contribution of the financial sector to the economic growth.

Although significant progress was made, the recovery and development of the financial system, especially the banking sector, is slow and not flawless. Although the intensive supervision of the three largest banks in the sector can be regarded as a safety measure, the fact that it is so long-lasting raises some concerns about these banks' capacity to manage their activity independently. At the same time, the issues with the level of risky exposures, including the exposures to affiliated persons/groups, and the weaknesses of shareholding structure were not fully solved yet. The slower banking intermediation process, particularly in these banks, shows that concrete action need to be taken to identify and minimize factors that hamper the bank credit expansion. Accordingly, the initiated reforms should target and create some modern lending mechanisms and instruments that would be based on long-maturity funds. It is particularly the lack of this type of tools that prevents long-term investments and the launching of complex infrastructure projects – key elements of a sustainable economic growth.

Because of excess liquidity in most commercial banks, the aggregate indicators for the banking sector prove its capacity to manage possible unfavorable developments. The measures taken by the NBM regarding the reassessment of extended loans generated an important increase of provisions in some banks. Still, after using the gained profits to establish

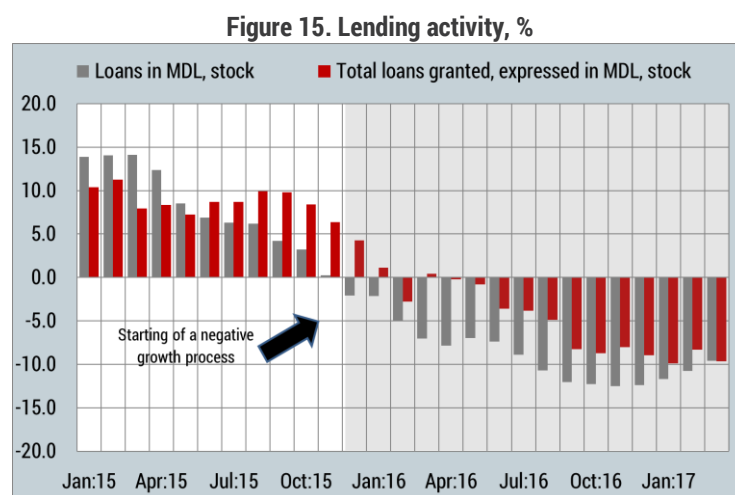
¹²Draft Law on Banking Activity and Investment Firms (transposition of Directive 2013/36/EU of 26 June 2013 and Regulation 575/2013 of 26 June 2013); <http://bnm.md/ro/content/proiectul-legii-privind-activitatea-bancilor-si-societatilor-de-investitii-transpunerea>

¹³Law on Financial Institutions No 550 of 21 July 1995.



reserves, the level of the capital and of the solvency indicator improved and has appropriate values, providing a consistent reserve of resources that can absorb possible losses. At the same time, the level of liquidity – both short-term and long-term – continues to stay above the limits provided by NBM rules, which proves that banks have significant resources to finance the national economy. The bank assets keep their moderate growth pace, supported by the resumed trust in national currency deposits, so that the deposit dollarization indicator decreased in Mar:17 by 6 p.p. y-o-y, to 46%. Still, this growth continues to be in contradiction with the typical trend of the main component of bank assets – gross loans. Their share amounts to only 46% in Mar:17, by over 8 p.p. less y-o-y, or by MDL 3.5 billion less. The smaller stock of loans is largely the result of constraints that characterize banking intermediation, such as lack of trust in the future of the national economy, high interest rates or other harsher credit requirements.

The modest results of the lending activity denote, in particular, the lack of trust between banks and businesses, as well as the uncertainty about the prospects of the national economy. On the one hand, as there is no certain information about the improvement of the macroeconomic situation, some businesses blocked the new investment projects or froze the expansion of the existing ones. On the other hand, inspired by the attractive interest rates on state securities at the end of 2015, banks focused their attention on less risky placements. This way, the identification of new potential viable clients supporting a healthy lending activity was somewhat pushed into the background. At the same time, on the background of the lack of lending tools and products adapted to the demand, some banks continue to have a business model oriented to large companies, resources being allotted mainly to support the working capital. In such conditions, the results of the lending activity are far below the potential of the liquidity accumulated in this sector, and the statistics confirm the idea that we are witnessing a bank disintermediation process. Thus, at the end of Mar:17, the total stock of loans granted through banks registered a value of only MDL 34.2 billion – by 9.7% (i.e. MDL 3.7 billion) less y-o-y (Figure 15). Correlated with the GDP size, the figures show that 2016 has the lowest financial intermediation rate over the past 10 years, with bank loans accounting for only around 27% of GDP.



Source: Author's calculations based on NBM data

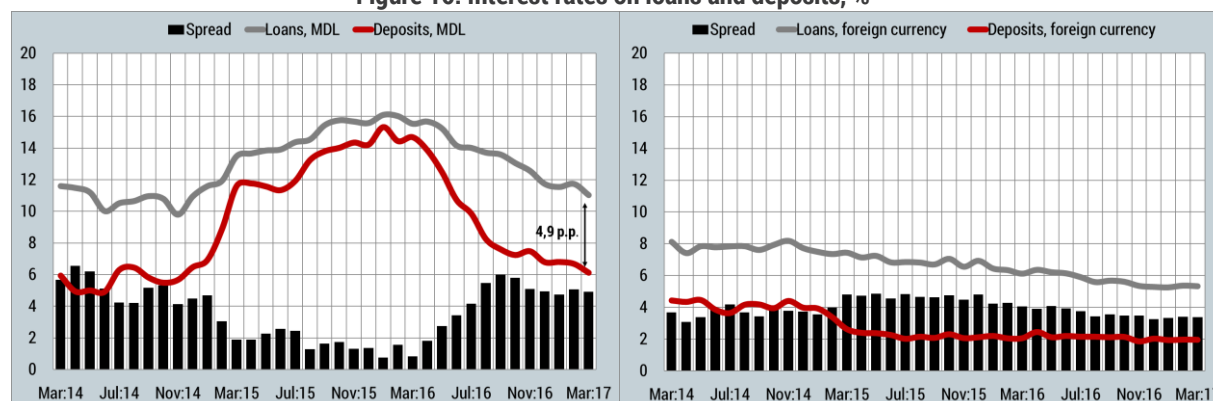
The diminishing bank intermediation generates, to some extent, the migration of loan demand to other less regulated sectors of the financial market, especially the microfinance and leasing companies'. Minimum prudential requirements and the lack of specific *know-your-customer* procedures put these companies at an advantage, as they need less time to process the loan applications. Still, with the view of maintaining financial stability, it is important to strengthen the supervisory powers over this sector as well, especially in terms of exposures of the microfinance and leasing companies to the banking sector.

Against a background of low loan demand and excess liquidity in the sector, interest rates on deposits continue to decline at a much quicker pace than the rates on loans. The average interest rate on new deposits in MDL is close to 6%, only 1



p.p. away from the annual inflation level (5.1% in Mar:17). At the same time, although there are still circumstances that would allow for decline, the average rate on new granted loans stays above 11%, which further hinders lending. As a result of this lending policy, the bank margin for operations in MDL stays at around 5%, which provides banks with a consistent source of income. On the other hand, the margin for foreign currency operations stays relatively stable at 3.4%, by 0.7 p.p. less y-o-y (Figure 16). Thus, taking into account the latest monetary policy interventions and the abundance of liquidities, rates on new deposits fall much faster than those on new loans.

Figure 16. Interest rates on loans and deposits, %

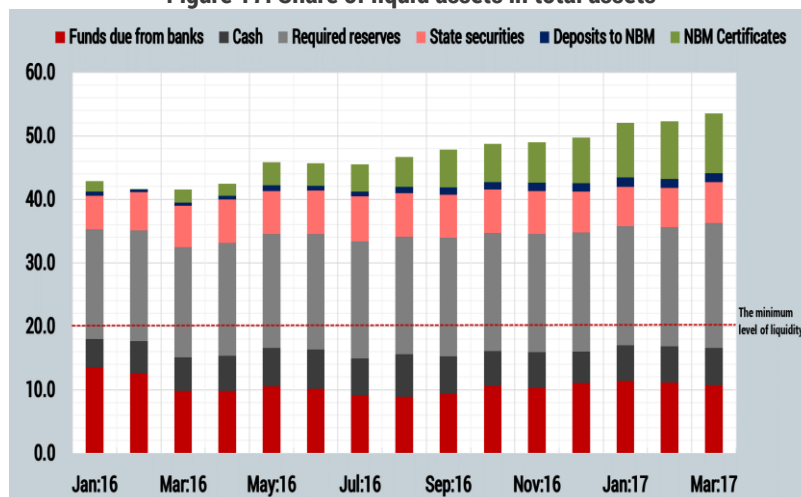


Source: Author's calculations based on NBM data

Reducing the stock of loans and reassessing the quality of existing ones bring the share of non-performing loans at a record level for the recent years. At the end of Mar:17, the share of substandard, doubtful, and loss categories of loans was at 16.2%, or about MDL 5.7 billion. The persistence of a high volume of non-performing loans in banks' balance sheets is an element, which hampers, to some extent, efforts to lower the interest rate on new loans and, implicitly, to revive the lending activity. To obtain the expected profit from operational activity, banks are practically forced to apply a higher net interest margin to cover the foregone revenue due to non-performing loans. However, it should be noted that a large part of the overdue loan portfolio was granted in periods when banks had less stringent lending requirements, i.e. before the crisis. Therefore, some banks have to consolidate their provisions in order to maintain an adequate financial situation.

The liquidities in the banking sector remain high, which increases the costs for sterilization and for monetary policy support. These trends are emphasized by the intense use of NBM facilities, namely – bank certificates (NBC) and overnight deposits, which currently account for about 22% of liquid assets compared with just 6% in the same period of the last year (Figure 17). At the same time, the cost of liquidity sterilization operations via NBCs is much higher compared with the other instruments, since the remuneration rate is set at 9%. As a result of these interventions, the current liquidity indicator aggregated for the entire banking system reached, in Mar:17, the level of 50.3%, having increased by 8 p.p. y-o-y. Moreover, excess liquidity creates inflationary pressures, with the NBM motivating in this way the increase up to 40% in the reserve requirements for the funds attracted in MDL. So, as the norm of reserve requirements is not characterized by the same trend as the base rate, this instrument continues to be used to stabilize the banking sector.

Figure 17. Share of liquid assets in total assets



Source: Author's calculations based on NBM data

Despite the latest negative developments in the sector, banks continue to obtain constantly profit. Even amid the 2016 macroeconomic uncertainties, the key profitability indicators of the banking sector – return on assets (ROA) and return on equity (ROE) – saw positive developments, reaching, at the end of 2016, 1.97% and 11.95%, respectively. At the same time, in nominal terms, the profit amounted to MDL 1.5 billion, this being the highest level reached in recent years. Also, as in the previous years, net revenues stemming from exchange rate differences and related activities remain fairly consistent, amounting to around MDL 1.8 billion. However, most of the earned profit was or is to be funneled into reserves to the detriment of paying dividends to shareholders, as most banks maintain an austere dividend policy.

Challenges and Forecasts

- **The fact that relatively high interest rates (as compared against the level of inflation) on new loans are maintained, confirms the slow transmission of the monetary policy via the base rate, as well as the prudent stance of the central bank.** The NBM continues to use reserve requirements as an element stabilizing the banking sector and as a measure to mitigate the inflationary risks generated by excess liquidity in the sector. According to forecasts, the lending activity will expand over the next 2 years, but it is unlikely for it to reach the pre-crisis level. Having as a benchmark a low basis of comparison, we expect the lending process (new granted loans) to recover in 2017 by about 16% – in an optimistic scenario, or by 12% – in a pessimistic one. At the same time, forecasts do not take into account the other components of the financial system that contribute directly to the financing of the economy, as some of the loans could be granted by microfinance or leasing companies.
- **A greater stock of non-performing loans and the difficult recovery process signal that the banking sector has a number of weaknesses.** Keeping them in the balance sheets leads to higher monitoring costs, lower operational profitability and higher requirements regarding the provisions, which might ultimately affect the ability of some banks to grant loans. To reduce the stock of problematic loans and improve the overall quality of bank assets, banks must follow-up in good time the restructuring and/or refinancing of loans, and in the case of compromised loans – they should be acknowledged as losses, removed from the balance sheet, followed by the enforcement of the pledge.
- **Although we witness a bank disintermediation process, its effects on the need to finance the real economy are diminished by non-bank loans from the microfinance and leasing companies.** It suggests that a large part of the loan demand is reoriented to non-bank financial market, most of the determinant factors being of procedural nature. Minimum prudential requirements and the lack of *know-your-customer* procedures put these companies at an advantage, as they need less time to process the loan applications. Still, with the view of maintaining financial



stability, it is important to strengthen the supervisory powers over this sector as well, especially in terms of exposures of the microfinance and leasing companies to the banking sector.

- **The fact that the thorough monitoring of the three largest banks in the sector takes so long and that early interventions are made with regards to one of them, raises questions about the strengthening of corporate governance and about the improvement of the financial situation.** Even though the processes taking place at the level of these banks' shareholders show some positive signs regarding the transparency and the quality of the shareholders – so far, no qualified investor has shown any interest in the equity stake for sale. At the same time, several shareholders pushed Moldova in international arbitration litigations.
- **Despite all measures taken by authorities so far, the national framework regarding the maintenance of financial stability remains rather problematic.** Thus, the mandate of the National Committee for Financial Stability (NCFS) remains unclear, focusing more on solving, rather than preventing crises. Another issue is that one of the duties of NCFS is to define the systemic crises, which may serve as a trigger for NBM's subsequent activities targeting the stabilization of the situation. Under these circumstances, one of the most important actions in reforming the financial and banking system is to pass and implement the law establishing the national macroprudential authority, as prescribed by the Bank Recovery and Resolution Law¹⁴.
- **The deposit guarantee system is still vulnerable.** According to a draft law that passed its final reading in the Parliament¹⁵, the deposit guarantee ceiling will go up from MDL 6 thousand to MDL 20 thousand, since 2018. Still, raising the ceiling without a substantial reform of the Deposit Guarantee Fund will not change the situation fundamentally. The fund should not serve as a simple 'cash box' in case a bank goes bankrupt, it should play a more active role in the entire infrastructure ensuring financial stability (especially in terms of preventing bank crises). In this respect, the fund requires technical support and internal reforms.

¹⁴Law No 232 of 13 October 2016 on Bank Recovery and Resolution.

¹⁵Law No 39 of 24 March 2017 amending Article 6 of the Law No 575/2003 on Guaranteeing Deposits of Individuals in the Banking System.

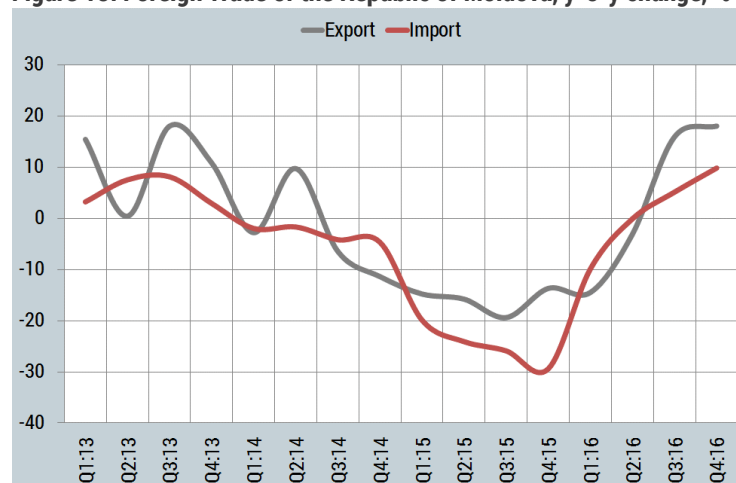
Chapter 7. Foreign trade

The negative trends of the previous years slowed down during 2016. Trade with the EU registered positive dynamics, especially in quantitative terms, as it managed to offset, to a certain extent, the loss of the eastern markets. Also, the implementation of the commitments made under the DCFTA remains a priority for the authorities, although backlogs and delays are inherent to this process. Although DCFTA expanded in the Transnistrian region too, the degree of implementation continues to be uncertain, as there are no instruments to monitor and report the compliance efforts made in the region. At the same time, new trade opportunities appeared once the Free Trade Agreement between the Republic of Moldova and Turkey entered into force on 1 November 2016.

Recent Trends

After the dramatic drop in foreign trade in 2015, this negative trend slowed down in 2016, but it did continue in the first two months of 2017. Thus, in 2016, the value of exports was by 4.0% higher than in the previous year and amounted to USD 2045 million. At the same time, the value of imports in 2016 amounted to USD 4020 million, i.e. by 0.8% more y-o-y. However, these trends should be interpreted through the lens of the very small basis of comparison of 2015 (Figure 18). We have to point that this positive dynamics in foreign trade continued during the first two months of 2017, where exports increased by 23.9% and imports – by 21.3%.

Figure 18. Foreign Trade of the Republic of Moldova, y-o-y change, %



Source: Expert-Grup calculations based on NBS data

The exports to EU continue to offset the decrease in exports to CIS markets. Geographically, the European Union consolidated its position as the main destination of Moldovan exports, with a total value of USD 1332 million in 2016, up by 9.4% y-o-y and with a share of 65.1% in total exports (61.9% in 2015). The most significant increases to this market were noticed in Romania (by 14.9% more y-o-y, as a result of an increase in sugar and wheat exports), Bulgaria (2.7 times more y-o-y, as a result of an increase in exports of sugar and sunflower seeds), but also in Germany (by 8.0% more y-o-y, due to increased exports of chairs and their parts). At the same time, exports to the United Kingdom of Great Britain and Northern Ireland declined by 17.2% y-o-y because of smaller exports in sunflower seeds and soybeans, to Latvia - by 49.8% y-o-y, because of smaller exports in electricity meters, but also to Cyprus - by 46.7% y-o-y, because of smaller exports in air vehicles. For some groups of commodities, the dynamics were determined by the reduction in the export potential (as



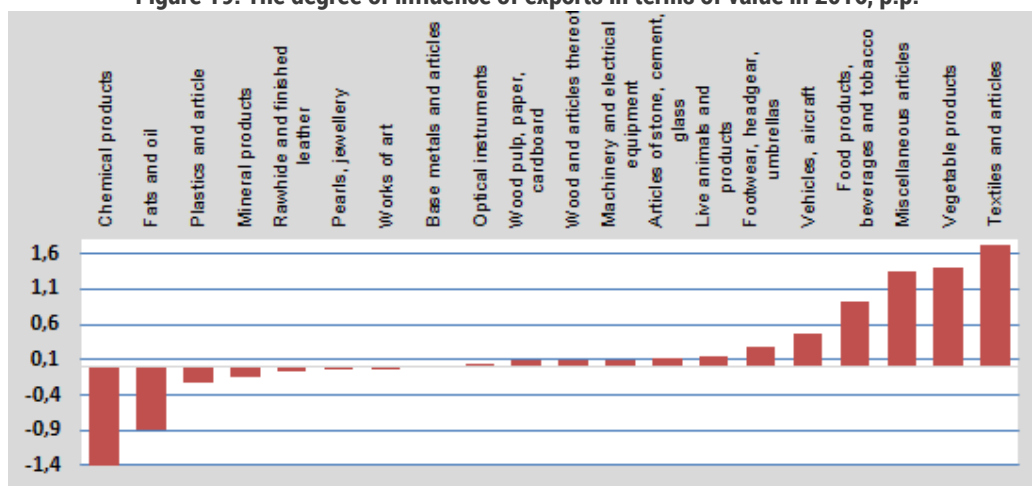
in the case of soybeans), while for others – by their redistribution to more attractive export destinations (such as in the case of the electricity meters or sunflower seeds). At the same time, exports in air vehicles are not typical of the country, these being single transactions.

The use of export tariff quotas in the EU looks promising. Two categories of products subject to annual exemption from customs duties were exported in 2016: the quotas on table grapes were filled to the full extent of 100%, while those on plums – to the extent of 75%. The tariff quotas for apples was not used at all. At the same time, the products subject to anti-circumvention mechanism¹⁶, eligible for exports (i.e. except for products of animal origin) saw impressive dynamics. Thus, in 2016, export quotas for processed cereals (to be more precise – for ethyl alcohol) were exceeded almost 7 times, and sugar – 1.8 times. While the quotas for other categories were used differently – from 63% for sweet corn, up to 111% and 154% for barley and corn, respectively.

Exports to the CIS have been declining because of a reduced demand for Moldovan products on the markets of Kazakhstan and Belarus. In 2016, 20.3% of exports went to CIS countries (in 2015 – 25.0%), which is equal to a value of USD 414 million, i.e. by 15.9% less y-o-y. The biggest drop in exports was registered for Kazakhstan (-77.5% y-o-y), as a result of lower exports of sugar, apples and wine, but also for Belarus (-21.3% y-o-y), as a result of lower exports of fruits (some of them being re-exports) and sugar. At the same time, taking into account that during the baseline period (2015) the Russian Federation also applied restrictive tariff and non-tariff measures, Moldovan exports to this destination did not change significantly and declined by only 3.1%, largely on the account of lower re-exports of pharmaceuticals. At the same time, since the armed conflict in East Ukraine is settling down, exports to Ukraine increased by about 8.4%, thanks to greater exports of wine and corn.

Exports to other countries of the world slightly diversified. In 2016, exports to other countries of the world (beyond the EU and CIS), amounted to about USD 299 million – an increase by 16.2% y-o-y, accounting for a share of 14.6% (in 2015 – 13.1%). This spectacular development was possible thanks to a 53.8%-increase y-o-y in exports to Iraq, as a result of the increase in exports of sunflower seed oil, and also thanks to greater exports to Malaysia – 3.3 times greater, as exports of wheat to this destination increased.

Figure 19. The degree of influence of exports in terms of value in 2016, p.p.



Source: Expert-Grup calculations based on NBS data

Re-exports of pharmaceuticals undermined the export dynamics. In 2016, the most negative impact on exports was caused by the chemical industry, as these exports decreased by about 24%, amounting to only USD 90 million, which is by

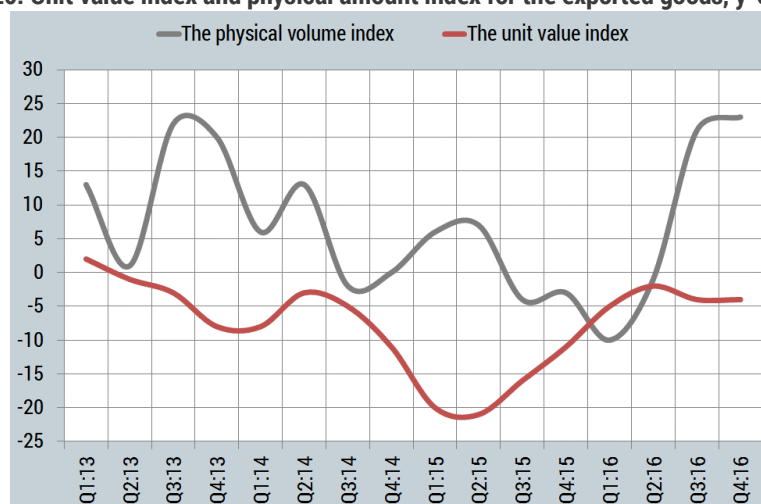
¹⁶Mechanism that provides for export quotas, but providing the possibility to exceed the maximum levels in the case of increased exports (such as better harvest or increase of the production potential of local businesses).

USD 28 million less y-o-y (Figure 19). However, the negative dynamics of exports in this group was determined by the steady decrease of re-exports of pharmaceuticals to the CIS countries, predominantly to the market of the Russian Federation.

The export of vegetable products increased due to deliveries of grains and oil seeds. So, in 2016, the export of vegetable products of plant origin increased by 5.5%, or by USD 28 million y-o-y (a development due exclusively to grains and oilseeds, not to fruits). On the other hand, the indirect impact of the increase in the export of sunflower seeds was the decrease in the export of vegetable fats (namely, sunflower oil), which shrank by 24.6% in 2016, total value being of USD 54 million, i.e. by USD 17 million less y-o-y (Figure 19).

The dynamics of exports expressed in quantities was much more impressive than that expressed in values. In 2016, exports recorded a modest overall result of + 4.0% y-o-y, despite the quite low basis of comparison of 2015. However, in terms of quantity, foreign trade does not look the same as when illustrated according to values. Thus, there were quantitative increases in the main groups of exported commodities, despite the decrease in the unit price, as a result of the decrease in international prices for these commodities (Figure 20).

Figure 20. Unit value index and physical amount index for the exported goods, y-o-y change, %

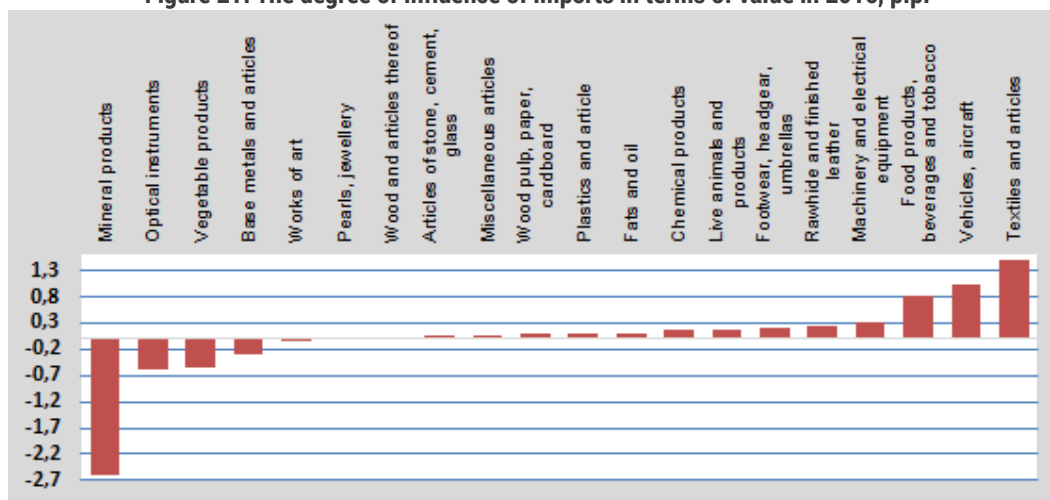


Source: Expert-Grup calculations based on NBS data

The evolution of imports from the EU was determined by the needs of the national industry. The European Union is still the main source of imports, with a total value of USD 1974 million in 2016, up by 1% y-o-y and with a share of 49.1% in total imports (49.0% in 2015). Imports from the following countries decreased the most: Austria (by 17.6% less y-o-y, due to decreases in imports of wires and cables, copper wire), Bulgaria (by 15.8% less y-o-y due to decreases in imports of oil) and Germany (1.5% less y-o-y due to decreases in imports of medical devices, cars and other vehicles). However, imports from the following countries increased: Hungary (by 15.6% more y-o-y, due to increased imports of leather and toiletries), Poland (by 8.1% more y-o-y, due to increased imports of sugar and agricultural equipment) and France (by 11.0% more y-o-y, due to increased imports of sunflower seeds and insecticides) (Figure 21).

Imports from the CIS stagnated because of cheaper gas. In 2016, 25.6% of the imports came from CIS countries (in 2015 – 25.5%), which is equal to a value of USD 1027 million (about 30% of which are mineral products), having increased by 0.9% y-o-y. More was imported from Belarus (by 20.4% more y-o-y, due to greater imports of sugar and tractors) and from Ukraine (by 3.4% more y-o-y, due to greater imports of mineral water and margarine). At the same time, looking at the CIS countries, least imports came from Uzbekistan (-76% y-o-y), as the source for importing mineral fertilizers changed, but also from Kazakhstan (-71% y-o-y), because imports of gas dropped.

Figure 21. The degree of influence of imports in terms of value in 2016, p.p.

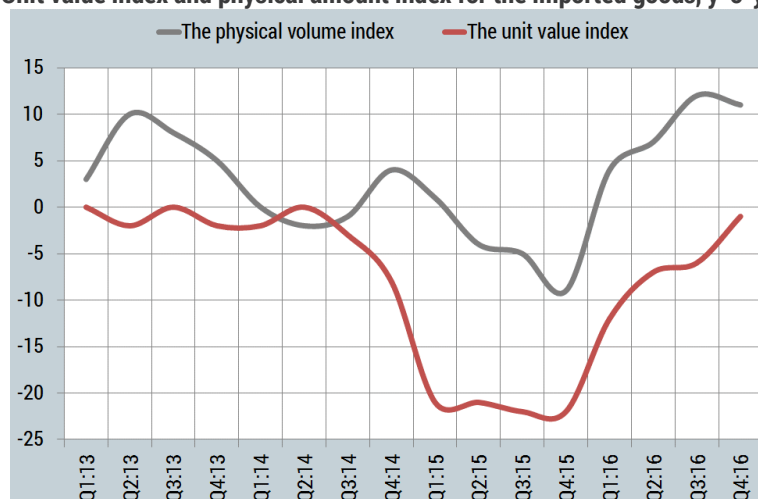


Source: Expert-Grup calculations based on NBS data

Cheaper fuel influenced negatively the dynamics of imports. In 2016, the most negative impact on imports was caused by the mineral products (to be more precise – mineral fuels), as the decrease was of about 14%, registering only USD 630 million, which is by USD 104 million less y-o-y (Figure 21). This development is valid in terms of values, but not in terms of quantities, as there were increases for these categories of goods.

The import restrictions imposed by the Russian Federation on the EU, reflected upon Moldova's imports from the EU. Thus, a number of products originating in the EU and that are usually re-exported to the Russian Federation decreased as the latter established import restrictions, which affected the volume of Moldova's imports from the EU.

Figure 22. Unit value index and physical amount index for the imported goods, y-o-y change, %



Source: Expert-Grup calculations based on NBS data

Although in terms of values imports remained practically at the level of 2015, their quantitative evolution shows increases in 2016 for the main commodity groups, especially for mineral products (Figure 22).

Challenges and Forecasts

- The total exports of goods and services are expected to grow in 2017 by about 12%, expressed in MDL and in real terms. At the same time, imports are expected to increase at a lower pace – by about 9%.



- The delays and backlogs as regards the implementation of DCFTA commitments indicate that there are some institutional weaknesses, and failure to strengthen institutional capacity will still maintain the **risk the commitments will not be implemented appropriately.**
- Considering the fact that the DCFTA is not completely tapped on (the results are still modest), **not including the Republic of Moldova in the group of third countries that have the right to export animal products on the EU market** will fuel multiple speculations on the economic opportunity of this agreement.
- Since the preferential trade regime extended in the Transnistrian region too and there is no reliable mechanism to monitor the implementation of the agreement in the Transnistrian region – **guaranteeing European partners that the commitments under this agreement will be implemented correctly all across the country is uncertain.**
- **The main instrument of trade pressure used by the Russian Federation in relation to the Republic of Moldova** (trade restrictions on imports) will most likely continue to be used without providing any coherent economic reasons, and the major challenge is using the WTO dispute settlement mechanism.
- If the Russian Federation maintains the restrictions imposed on the imports of EU products (especially for those directly competing with Moldovan products), this will **expose national producers to additional pressures on EU markets** that are over-saturated with similar products.
- Although the Republic of Moldova is part of the PEM Convention on Rules of Origin, it cannot benefit from the diagonal cumulation of origin, and the delay in this process **will not allow it to fully tap the opportunities provided by the DCFTA and by the Free Trade Agreement with Turkey.**
- Considering authorities' intentions to initiate trade negotiations on new free trade agreements (with countries like China, Egypt, etc.), the major challenge is **to provide and economic reasoning and to quantify the impact on national economy.**



About EXPERT-GRUP

WHO WE ARE

EXPERT-GRUP is a Moldovan non-governmental and not-for-profit organization that specializes in economic and policy research. EXPERT-GRUP does not represent any economic, corporate or political interests. As an independent organization, EXPERT-GRUP reflects the ideals of the young Moldovan intellectuals who have created the institution with the purpose of contributing to Moldova's development. Among other types of organizations in Moldovan civil society, EXPERT-GRUP positions itself as a politically and ideologically neutral think-tank.

OUR ACTIVITIES

Our core activity is economic analysis, forecasting and policy research. In this area we offer a wide range of analytical products and services that help our beneficiaries to take decisions that support the development path of Moldova. Our key competence lies in the ability to provide professional, high quality and objective research in such broad fields as:

- Macroeconomic analysis and forecasting;
- Political economy;
- Public finance;
- Human development and poverty reduction;
- Labor market and consumer behavior;
- Foreign trade;
- Financial markets;
- The economics of European integration;
- Sector-level economic analysis;
- Regional and local economic development; and
- Energy and environmental economics.

PARTNERS AND DONORS

In the period 2006 –2016, the EXPERT-GRUP has implemented more than 100 research and advocacy projects in different areas related to economic and policy research. More than 130 associated and non-associated experts from Moldova and other countries were involved in these projects. We have worked with such donors as Moldova Soros Foundation, Eastern European Foundation, Konrad Adenauer Stiftung, Balkan Trust for Democracy, Black Sea Trust, FES, the UN Development Programme Moldova, the UN Children's Fund (UNICEF), the European Commission, the Council of Europe, the Open Society Foundation, the Swiss Agency for International Cooperation, and the United Kingdom Department for International Development. In 2010 and 2012 the EXPERT-GRUP was elected as a member of the National Participatory Council of Moldova. Since 2008 the EXPERT-GRUP has been a member of the Policy Association for an Open Society – a network of policy centres uniting 56 think tanks from countries across Europe.