

Economic Reality is a quarterly economic publication that outlines the major economic and political developments. Its readers are economic journalists, policy makers, representatives of local and foreign companies and commercial banks, as well as international institutions, embassies and political parties.

Acronyms and abbreviations:

YOY – year-over-year; QOQ – quarter-over-quarter; MOM – month-over-month; EOY/EOY – end of year to end of year; EOP – end of period; Q1:18 – quarter 1 2018; Jan:18 – January 2018; NBS – National Bureau of Statistics; NEA – National Employment Agency; NBM – National Bank of Moldova; MDL – Moldovan leu; FDI – foreign direct investment; pp – percentage points.

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Early Warning Index (EWI)

EWI is calculated by aggregating eight indicators: average air temperature, amount of precipitation, export of goods, remittances to individuals, new loans granted to legal entities, transport of goods, revenues from the personal income tax, budget expenditures. For more details about the calculation methodology, please see the website of EXPERT-GUP.

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Top 10 economic events in 2019 and top 10 challenges for 2020

During 2019, economic trends stabilized and did not show any prerequisite for acceleration.

The Early Warning Index, calculated quarterly by Expert-Grup, shows some rather timid signs of growing economic trends, which seem rather uncertain against the background of

worrying trends in

private investment activity, remittances and exports. However, the expansionary budgetary policy is expected to boost the government's investment activity for the second consecutive year, although with certain risks for the economic growth in the next years.

The current special edition of *Economic Reality* outlines the 10 major economic events in 2019, as well as the 10 major challenges for 2020 (and not only), according to Expert-Grup.

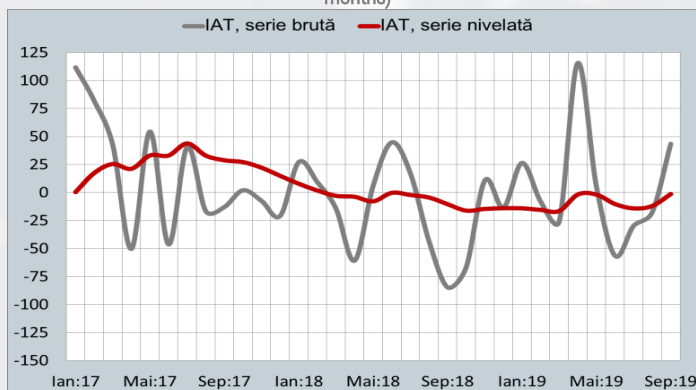
Top 10 economic events in 2019:

1. Stabilization of economic growth
2. Monetary policy easing
3. Investors' reluctance
4. Adoption of the state budget for 2020
5. Closing the process of shareholders' restructuring of systemically important banks
6. Enforcement of the law on salaries in the public sector
7. Decline in remittances
8. Deceleration of exports
9. Higher population's indebtedness and regulation of the micro-lending sector
10. Integration of results of the 2014 population census in official statistics.

Top 10 economic challenges for 2020:

1. Financing of the budget deficit
2. Under-execution of public investment projects funded from external sources
3. Security of supply of natural gas
4. Decrease in the population's income growth rates
5. More severe labour market conditions
6. Climate risks
7. Ensuring the legal and decision-making independence of the NBM
8. Investigation of frauds in the banking sector
9. Cooling of the world economy
10. Pressures on the current account.

Early Warning Index, gross series and filtered series (moving average over the last 12 months)



Source: NBM, NBS, EG calculations

1. Stabilization of economic growth

Although the GDP growth will stabilize at seemingly healthy 5% rate in 2019, the economic dynamics will have the same pattern and model as in the last years. Thus, after a decline in 2015, the GDP growth became more steady and ranged from 4 to 5%, which was close to the natural rate of growth. However, in the long run, the potential GDP growth has stabilized around 4%. This is rather a sign of concern. Thus, as long as such fundamental factors as capital and labour force, which ensure a sustainable basis for economic growth, are constantly undermined, the phase of stable evolution could be followed by a slowdown of the dynamics of the effective GDP and, implicitly, of the potential GDP. The new capital formation in the private sector has virtually stagnating over the last 6 years. From 2014 to 2017, private investments decreased by more than 20%, and growths in 2018 and 2019 only compensated for the decrease. At the same time, although in the last years there was a boom of public investments, there are concerns about their efficiency and sustainability. Another constraint is human capital due to the acute shortage of skilled labour force, while the huge emigration of Moldovan citizens only exacerbates this problem.

The favorable economic dynamics was driven largely by the active role of the state, especially in the electoral context, while the private sector remains vulnerable and uncertain. Stabilization of economic growth is confirmed by the evolution of the Early Warning Index (EWI), calculated quarterly by Expert-Grup. Thus, after EWI underwent a stagnation phase in the second half of 2018 and in the first months of 2019, the index has increased from Q2:19, although this growth was "uncertain". It should be noted that the active role of the state was one of the factors that boosted the economic activity. In particular, this fact refers to Q1-Q2:19, a period when the state increased public spending by 17.4% y-o-y. This boom was determined by the fact that 2019 was an intense election year, with parliamentary and local elections. This led to an expansionary budgetary policy, characterized by the launch of extensive infrastructure programs, increase in wages in the public sector and other social payments. However, in the second half of the year, the growth of budgetary expenditures slowed down. Likewise, the investment activity in the private sector increased in the first half of the year due to decrease in social contributions paid by the employer. However, these effects tend to dissipate rapidly: in the second part there was a visible slowdown in investment activity, and this trend could continue in 2020 due to uncertainties related to the election period.

2. Monetary policy easing

During 2019, the NBM shifted from a more severe to a more relaxed monetary policy. In the summer of 2019, the policy rate was increased 2 times: in June from 6.5 to 7% and at the end of the month from 7 to 7.5%. Some of the factors that caused monetary policy tightening were the higher aggregate demand driven by the promotion of an expansionary fiscal-budgetary policy, higher regulated prices (electricity tariffs) and the sharp increase of prices for some agri-food products (potatoes and vegetables). The rise of inflationary pressures led to an accelerating increase in the Consumer Price Index (CPI) from 2.2% in Jan:19 to 7.1% y-o-y in Nov:19. At the same time, the NBM forecasts a disinflationary trend in 2020, when inflation will enter the NBM target corridor of 5% (± 1.5 pp). In this context, in Dec:19 the NBM decided to relax its monetary policy by reducing the policy rate from 7.5 to 5.5% and the rate of required reserves for resources attracted in MDL in 2 stages to 41%. At the same time, in Jul:19 the NBM decided to increase the rate of required reserves for foreign currency resources from 14 to 17%, and in Dec:19 NBM decided to increase it from 17% to 20%, which will come into effect in Q1:20. This decision was taken after 8 consecutive years (2011-2019), when the rate of required reserves for resources attracted in foreign currency was kept constant at 14% and is, to some extent, an unusual action. This approach adopted by the NBM will demotivate to some extent financial intermediation in foreign currency and will encourage financial intermediation in the national currency. However, such a conspicuous relaxation of the monetary policy, both in terms of the base rate and the norm of required reserves in MDL, raises some concerns regarding the independence of NBM, as this decision is taken in the context of an expansionary budget adopted on the eve of elections, while its deficit will be covered largely by loans from commercial banks through state securities. Thus, the relaxation of the monetary policy will allow the Government to take loans from banks under much more favourable terms as a result of reducing the reference rate and making available a higher amount of liquidity in the banking system. At the same time, the analytical basis for such a visible relaxation of monetary policy is not sufficiently clear, as the problem of excess liquidity that has previously driven the increase of the required reserves was not solved, and their recent decrease seems to be a procyclical action taken by the NBM, in the electoral context, fueling inflationary and credibility risks in 2020.

3. Adoption of the state budget for 2020

Adoption of the state budget for 2020 raised many controversies and concerns, against the backdrop of expansionary investment programmes and the higher budget deficit in the electoral context, as well as in the context of the relaxation of monetary policy.

However, a closer look at the 2020 Budget Proposal reveals that only 10% of the fiscal space is devoted to new policy measures, while 90% contribute to the implementation of policy measures committed to in previous years. The main policy measures in the Budget Proposal for 2020 relate to: the widening of local financial autonomy by increasing the revenues from personal income tax and accruals to the Fund for financial support of territories of 10% of the income tax from entrepreneurial activity; 6-10% increase of wages for most public sector employees; implementation of social assistance programmes providing for higher social benefits to support low income people. In addition, the macroeconomic indicators set out in the budget law are based on a forecast of slightly worsening economic conditions in 2020. Compared to forecasts approved in the Medium-Term Budget Framework (MTBF) for 2020-2022, the main macroeconomic indicators were revised: the real growth of the Gross Domestic Product (GDP) changed from 4.0% to 3.8%, inflation from 5.0% to 5.7%, and the MDL is expected to depreciate in terms of the average annual MDL/USD exchange rate, from 18.47 MDL/USD to 19.63 MDL/USD as compared to the forecast of 18.97 MDL/USD.

4. Investors' reluctance

The political and economic uncertainty in the Republic of Moldova over the last period lead to a reluctant investment behavior. Even though in Q2: 2019 the direct investment inflows into the national economy tripled y-o-y, from these benefited a limited number of companies, mainly in the field of cultivation and distribution of agricultural products and the banking sector, but less in other sectors of the economy. Moreover, the investors' cautious behaviour is also proved by the negative dynamics of reinvested income (dividends paid to investors exceeded the profits obtained in Q2:19). All of these testify to the fact that the competitive advantages associated with the first years of openness to the market economy are eroding very quickly. Furthermore, in a regional perspective, the Republic of Moldova is losing in the investment attractiveness race, which indicates that deficiencies in the country's business climate were not addressed in a systemic way over time. The same issue is confirmed by the modest scores gained by the Republic of Moldova in international rankings that reflect the country's economic situation and its attractiveness for investors.

5. Deceleration of exports

The exports of the Republic of Moldova were affected by cooling down of the external demand, showing a mediocre growth of only 3.4% y-o-y during the period Jan-Oct:19. It should be noted that total exports are kept afloat only due to exports to Turkey, while exports to the EU decreased, and those to the CIS registered positive values as a result of increased re-exports. In addition to these worrying developments, there is also a number of shortcomings related to the concentration of exports, both geographically and in terms of the structure of exported products. This is exacerbated by the fact that these exports entail a rather low added value (either primary agricultural products or industrial products processed under loan), thus highlighting the low level of competitiveness of domestic producers, which undermines the sustainability of exports as a whole. Under these conditions, it is necessary to promote an active policy aimed at enhancing the competitiveness and value-added of exports.

6. Decline in remittances

During 2019 remittances to individuals from the Republic of Moldova have steadily decreased. The statistics on the seasonally adjusted net remittances, which is published by the National Bank of Moldova, shows a decline in almost every month, except for the months of April and September, compared to the same period of the previous year. Cumulatively, in the first ten months of 2019, the amount of seasonally adjusted net remittances decreased by 5% y-o-y. This decrease is sensitive for households in the Republic of Moldova, as the share of remittances is around 15% in the total budget of an average family and 20% in rural areas. However, the decrease in remittances was offset by the considerable increase in wages in real terms of approximately 10% y-o-y in the first half of 2019. At the same time, the net impact of the decrease of remittances on the total income of the population is not known due to delays in publishing the income statistics by the National Bureau of Statistics.

7. Enforcement of the law on salaries in the public sector

The new law on the unitary pay system approved at the end of 2018 continued to be implemented in 2019 with some positive effects. However, the issue of fairness and sustainability of the remuneration in the public sector remains valid. The law allows for the second consecutive year to increase salaries for all public sector employees (by 10% in 2020), which will increase the gross average monthly salary from 6524 MDL (7953 MDL in the real sector) to 7437.4 MDL (9328 MDL in the real sector, forecast). This was possible due to the increase of the amount of the reference value - from 1500 to 1650 MDL, which contributed to the increase of personnel expenses by 1 212.9 million MDL, and the approval of the additional allocations at the proposal of the authorities of 85.2 million MDL. At the same time, maintaining a large number of reference values of the unitary wage system in the public sector is not in line with the originally intended principle of equity and sustainability. We must mention that the increase in personnel costs in 2020, by 1.03 billion MDL, constitutes one of the categories of economic expenses with the highest degree of growth, similar to the one dedicated to social benefits and subsidies. Although, independently, it does not constitute an electoral measure, on the basis of the "delayed" adoption of certain measures from the law (the change of the number of reference values, and their value for certain categories of budget), there are premises that these increases and subsequent changes will be used as a political instrument. In this case, only budgetary discipline and respect for budgetary transparency will allow for the Government and Parliament to be held accountable, and efficient in managing the public resources.

8. Closing the process of shareholders' restructuring of systemically important banks

The sale of the majority shareholding of BC Moldindconbank to the Bulgarian company "DOVERIE UNITED-HOLDING AD" virtually completed the process of increasing transparency of shareholders of systemically important banks. The transaction made at the beginning of 2019 was followed by the election of new members in the Bank's Board, which allows the NBM to lift the intensive supervision regime introduced in 2016. Along with the other 3 large banks, BC Moldindconbank completes the list of systemically important banks (BC Moldova Agroindbank, BC Victoriabank and BC MobiasBanca) that are owned and managed by foreign financial groups. As a result, foreign institutional investors are currently in control of about 90% of the assets of the banking sector, as well as most of the profit generated by the sector. Even so, other investors are leaving, as is the case of Societe Generale that decided to sell its stake in BC Mobiasbanca to the Hungarian OTP Bank. Although the departure of the French group is part of the strategy of withdrawal from several countries, it shows that the Republic of Moldova cannot be attractive to large investors, as long as the economy continues to be affected by fundamental issues related to justice, corruption or competition.

9. Increasing population's indebtedness and tightening the regulation of the micro-lending sector

The year 2019 witnessed a significant increase in the lending to individuals in terms of real estate loans and consumer loans. At the same time, in addition to bank lending, non-bank loans also made a significant progress. Higher population incomes, lower interest rates, easier lending requirements or even the "Prima Casa" state program introduced a new habit among the population – paying the monthly rate. Given that many lending institutions do not have an honest business conduct, sometimes using abusive lending practices, some groups of people wishing to live above the standards they can afford get exposed to the risk of over-indebtedness. In order to mitigate such risks and to exclude exaggerated costs related to loans, the legal procedure for capping the costs related to a loan was recently initiated so that their value does not exceed the amount of the originally contracted loan.

10. Integration of results of the 2014 population census in official statistics

Since September 2019, the National Bureau of Statistics has begun publishing the population and labour market indicators in line with the 2014 census results.. The adjustment of these indicators led to the revision of the methodology of calculation of labour market indicators and to the per se review of the number of employed population. Thus, according to the revised statistics, the number of employed population in the Republic of Moldova varied between 829 thousand in Q1:19 and 910 thousand in Q3:19. According to the new statistics, the number of employed population decreased by about 30% YOY, when the number of the employed population was over 1.2 million people according to official data. Also, the adjustment of the labour market methodology led to the fact that some indicators are no longer comparable. For example, according to new statistics, the share of informal employment decreased to 25% of the total employed population from 35% according to the previous methodology. Thus, the adjustment of the population statistics highlights the significant reduction of the labour force in the Republic of Moldova.

Top 10 economic challenges for 2020

1. Financing the budget deficit planned

The deficit of the national public budget (NPB) is planned at 3.3% of GDP, which raises concerns about its electoral flavour, with repercussions on the stability of public finance and economic growth in the medium and long term. If we exclude the impact on the deficit of the projects financed from external sources, then the planned deficit falls within the budgetary and fiscal rule set out in the law of public finance at 2.5% of GDP calculated without grants. From this amount, the deficit related to investment projects financed from external loans will constitute 4.8 billion MDL, i.e. 65.3%. Respectively, the budget deficit in terms of the basic component will be 2.6 billion MDL i.e. 34.7% of the total deficit of the state budget, which represents 1.1% of the GDP expected for 2020. If we exclude grants from the state budget revenues, the deficit will amount to 3.5 billion MDL, which is 1.6% of GDP. The main sources of financing of the state budget deficit are external sources, net inflows from external loans for budget support and implementation of projects financed from external sources (IMF, EU, WB, Romania). Internal sources include state securities and funds from privatization of the public property. At the same time, if we consider that the rule allows to exceed the limit of the deficit of the national public budget, only upon availability of real sources of financing of capital investment projects financed from external sources, there are real risks that the Government forecasts will not materialize. Firstly, the IMF assistance programme ends in March 2020, while the general practice of this institution is not to negotiate/approve agreements in election years, and 2020 is an election year. Secondly, the financial assistance provided by the European Union is conditional upon implementation of anti-corruption measures, ensuring the rule of law, continuing structural reforms, in particular the justice reform. These conditionalities are also supported by the World Bank in Moldova, while the current government programme does not include clear commitments to any of these components. Another source of risk is the growth of government loans from commercial banks by issuing state securities, which could undermine private sector lending (banks will prefer to channel their liquidity to virtually risk-free investments to the detriment of the real sector, which under the conditions of the economic downturn of 2020 could show more risks).

2. Under-execution of externally funded public investment projects

In 2020, investment projects planned to be financed from external sources could be under-executed. For example, the level of execution of fixed assets in 2018 was 70% compared to the forecasted level and only 50% compared to the level of execution of financial resources for capital investments, and this trend continued in 2019 (as of 11 October 2019, 70% compared to the forecasted level and only 40% compared to the level of execution of financial resources for capital investments). The situation is largely due to the poor planning of projects (including capital investment projects) and, consequently, low capacity to implement them. Under these conditions, there is a risk of inefficient use and immobilization of public resources in projects that may lose their relevance and importance for the country's economic development and increase of the people's living standards. At the same time, as long as fiscal space is allocated to existing capital investment projects, new projects that could generate significant changes cannot be started.

3. Supply of natural gas to the country

Although the existing contract signed between "Moldova-Gaz" and "Gazprom" is expected to be extended, a potential interruption of the transit of Russian gas through the Ukrainian gas transmission network poses a risk for the Republic of Moldova. In this context, efforts are made to identify alternative scenarios for the supply of natural gas from 1 January 2020. Thus, in the event that Russia and Ukraine do not reach an agreement on gas transit, preparations are made for the supply of gas to the Republic of Moldova by reverse flow through the Trans-Balkan corridor. In this context, "Moldovagaz" SA announced that the company will sign, by the end of the year, contracts for the provision of natural gas transportation services on the territory of Ukraine. At the same time, other important measures are implemented to ensure the reverse gas transport: the capital repair and commissioning of the RI (Razdelnaya - Izmail) pipeline section and the completion of the reconstruction of the SDKRI (Sebelinka-Dnepropetrovsk-Krivoy Rog-Izmail) pipeline and the gas metering station "SMG Causeni". In addition, in the event that the reverse flow will not be sufficient to cover the demand for gas in the coldest winter days, a complementary instrument is provided that will allow Energocom to purchase gas from Naftogaz (Ukraine) using a EBRD loan. Under these circumstances, the risk of a potential "gas crisis" is rather low. However, the very fact that in 2020, for the first time, alternative solutions to the traditional one (the purchase of natural gas transiting Ukraine) will be implemented, involves risks, because the mechanisms have not been tested previously, and preparations were made very fast.

4. Decrease in the population's income growth rates

In the coming years, the population's well-being can be adversely affected by both the stagnation of the sources of external income (remittances) and the internal ones (salaries). The reduction in remittances in 2019 may indicate that a growth limit was reached for this source of income, which is caused by the depletion of human resources involved in migration processes. Another factor that may adversely affect remittances in the coming year is the slowdown of economies where Moldovan migrants work. At the same time, the record growth rates of wages in 2018 and 2019 may decrease due to budget constraints and slower increase in labour productivity. At the same time, this risk for wages is rather valid in the medium term, because in 2020 additional budgetary sources can be used to stimulate wage growth.

5. More severe labour market conditions

The adjusted statistics on employed population published by the National Bureau of Statistics in 2019 reveals a higher labour deficit. The decrease in population is expressed by a lower supply on the labour market, which is accompanied by a higher demand from companies in recent years. The gap between the supply and demand of the labour force is also observed in the vacancy statistics. In recent years, the number of vacancies registered by the National Employment Agency increased from 6 thousand in 2016 to 12-14 thousand this year. The major consequences of the labour deficit are the faster increase of wages than labour productivity, which is already happening in the Republic of Moldova, as well as the decrease of the country's attractiveness for foreign investors.

6. Climate risks

The developments for 2020 are uncertain, but the probability of an extreme climate events is very high. In 2019, the climatic conditions showed a worrying dynamic. Thus, there is an increasing trend of higher temperatures, while extreme weather phenomena become normal in the last years. Thus, over the last 20 years, there were several droughts of various intensity, and the most severe ones were in 2003, 2007, 2012 and 2015. Also, there were floods, and three of the strongest floods occurred in 2006, 2008 and 2010. In the context of extreme weather phenomena, the severe frosts and heavy snowfall from April 2017 should also be mentioned. At the same time, it should be noted that climate change and, associated extreme climate events, negatively affect economic growth and has become an imminent constraint for the Republic of Moldova.

7. Ensuring the legal and decision-making independence of the NBM

In the context of new political arrangements, ensuring the independence of the central bank becomes a major challenge for 2020. On the one hand, the NBM should demonstrate its decision-making independence by keeping the monetary policy away from the interests of the government. On the other hand, the Parliament should ensure the appointment of non-political persons in the management of the NBM, taking into account the fact that the mandate of two deputy governors will expire in the middle of next year. In addition, maintaining the legal independence of the central bank is another test for the government. Whatever action will be taken, either finding a solution in relation to interest rates that the Ministry of Finance should pay to the NBM for guarantees granted previously by the government to the bankrupt banks, the monetary policy easing in the context of a higher budget deficit or even the intention to simplify the procedure of dismissing the Governor, it should be based strictly on the international principles of independence of central banks, and namely: (i) sufficient capital for the implementation of the monetary policy; (ii) legal protection of members of the governing bodies; and (iii) prohibition of direct government lending.

8. Investigation of frauds in the banking sector

More than 5 years after the frauds in the banking sector, public opinion still does not have clear results on what happened and, in particular, who is really guilty. Even if several investigations were started, recovery strategies were adopted and parliamentary investigation committees were established, the result is the same - there are more questions than answers. One thing, however, becomes clear. Both the frauds and the investigation process had and still have a strong political influence, and are a very difficult test for the justice system. As a result, the investigation of the "one billion theft" is still a case of high interest for the society and a major challenge for the authorities, especially taking into account that the Agreement with the IMF that kept this commitment alive, expires in March 2020. Over time, the chances of recovering the money decrease, while the burden on the Ministry of Finance increases, as it is forced to use the money of taxpayers to repay the debt to the NBM.

9. Cooling of the world economy

The world economy shows clear signs of "cooling", and this phenomenon is accompanied by economic and even geopolitical tensions among the world's largest players, which further undermines commercial performance and investment prospects for the coming periods. Moreover, the anticipation of stagnation in food prices internationally, dictated by increased export availability, as well as the slowdown of the EU automotive industry will boost the negative effects on the growth of Moldovan exports to this direction. At the same time, the commercial conditions on the CIS market (in this case, the Russian Federation) remain uncertain, while the prospects for their changes are currently anchored only in the pre-election promises. From the same perspective, the investment plans of foreign companies in the Republic of Moldova could be reconsidered, while the flow of remittances to individuals will certainly be affected, which will have negative repercussions on consumption.

10. Pressure on the current account

Both the internal and external objective economic factors testify to a potential increase in the current account deficit of the balance of payments in 2020. This perspective is determined by the reduction in the aggregate demand of the main trading partners, which will negatively affect the dynamics of the Moldovan exports (although the reduction of the domestic consumption coupled with the decrease of imports could positively affect the trade balance). However, reduction of remittances, stagnation of foreign investment and anticipated decline in foreign assistance will no longer be able to balance the components of the current account deficit, which could put pressure on the currency and external debt.