

# MEGA

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**Economic recovery of 2023:  
forecasts, risks and ways  
forward**

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### **About MEGA**

MEGA is an English acronym standing for Moldova Economic Growth Analysis. MEGA is a biannual review published by EXPERT-GRUP since 2009 with the purpose of explaining the fundamentals of the recent economic trends in Moldova, analysing economic policies and proposing solutions for the economic development strategies of the country.

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## Abbreviations

|       |                                           |
|-------|-------------------------------------------|
| BOP   | Balance of payments                       |
| CPI   | Consumer Price Index                      |
| EU    | European Union                            |
| EUR   | Euro                                      |
| GDP   | Gross Domestic Product                    |
| GVA   | Gross Value Added                         |
| MDL   | Moldavan leu                              |
| NBC   | National Bank Certificate                 |
| NBM   | National Bank of Moldova                  |
| NCFM  | National Commission for Financial Markets |
| NPB   | National Public Budget                    |
| NPL   | Non-performing loan                       |
| ROA   | Return on assets                          |
| ROE   | Return on equity                          |
| SME   | Small and Medium Enterprise               |
| SS    | State Securities                          |
| VAT   | Value added tax                           |
| y-o-y | Year on year                              |

## Key messages of the publication

**The Moldovan economy faced an unprecedented mix of crises in 2022, but thanks to proper crisis management and external support it entered 2023 stronger and with good prospects for a speedy recovery.** Stagflation, on the background of the energy crisis, draught and war in Ukraine, called for unprecedented and rapid policy responses. Thus, within months, the Government adopted a series of bold policy measures that contained the shocks. In order to support the demand amid the unprecedented increase in energy tariffs, it was introduced the mechanism of compensation to cover part of the energy tariffs for households; in order to support the businesses, it was increased the capitalization of the programs implemented by the Organization for Entrepreneurship Development; in order to address the energy crisis, for the first time in the history of Moldova, alternative sources of natural gas and electricity were used and natural gas has been stored as measures to increase energy security; in order to support the budget stability, the government switched to financing the budgetary deficit, primarily, from external sources, which were available due to the generous support from development partners. At the same time, the macro-financial stability was preserved, due to a prudential monetary, foreign exchange and regulatory policy, which kept the national currency stable, the banking sector well capitalized and robust and that allowed inflation to start decelerating by the end of 2022.

**The effects of Russian aggression in Ukraine, the energy crisis, persistent inflation and drought have put firms under severe cost and competitiveness pressures.** As a result, 2022 brought an economic downturn of 5.9%, with the economic sectors most affected being agriculture, construction, real estate and industry. The main challenges for firms were related to: (i) the loss of markets and suppliers in Russia, Ukraine and Belarus, (ii) the need to rebuild many logistics routes with the loss of access to the port of Odessa, (iii) the substantial increase in transport and logistics costs as Moldova became a major transit point for goods to and from Ukraine, (iv) higher costs for energy resources, (v) more expensive financing because of monetary policy tightening, and (vi) lower sales on the domestic market because of erosion of the purchasing power of the population.

**The economic outlook for the coming years is marked by historic opportunities, but also risks.** The baseline scenario of the current forecast horizon is based on an economic recovery in 2023 of 4.7% and economic growth in the following years (5.4% in 2024 and a growth corridor of 4-5% in 2025-2027). For the coming years, the main assumptions considered for economic growth are the stabilization of the security situation in the region, the improvement of energy and mobility connectivity with Romania and the start of EU accession negotiations. The materialization of these opportunities can create an enormous synergy effect for attracting investment and modernizing the country. At the same time, risks remain an important variable and these include the risk of escalation of the war in Ukraine, volatility in the energy market, a global recession, hybrid threats from the Russian Federation, but also the behavior of policy makers and currently limited administrative capacities.

**In the structure of the population's income, the share of labour earnings is increasing, while the role of remittances is decreasing, although they continue to play an important role.** Between 2012 and 2022, the ratio of remittance inflows to GDP decreased from 21% to 13.8%. Additionally, the share of remittances in disposable income has fallen from 16% to 12%. During the same period, the share of labour earnings increased by 8 p.p., from 42.7% to 50.7%. In the medium term, income growth will be supported by an increase in labour earnings. In addition to economic growth, the increase in salaries will be driven by the mismatch between labour supply and demand. In order to attract qualified employees, firms will be forced to increase labour costs.

**The mismatch between labour demand and supply may favor labour earnings' growth for a certain period, but in the long term, it is necessary to increase labour productivity.** The labour supply in Moldova is largely provided by unskilled workers. In this context, increases in labour earnings in the Republic of Moldova will lead businesses to shift towards other markets where unskilled labour is cheaper or to automate their activities. To ensure decent wages and salaries in the long term, it is necessary to increase labour productivity, by reforming the tertiary education and the research sector, and improving the investment climate.



**For 2023, maintaining fiscal sustainability will continue to be challenged by the regional context that still fuels uncertainty.** The Government has already committed a substantial deficit for 2023 (6% of the GDP), resulting from a budget construction aiming to sustain critical social and economic priorities. The higher planned expenditures are not accompanied by commensurate revenue increases, therefore further war spillovers or other shocks could pose additional risks to the budget. For the next period, the fiscal policy tends, on the one side to ensure sufficient liquidity for SMEs and stimulate private investments, while on another, focuses on strengthening fiscal discipline in a manner that will boost revenue mobilization and reduce the shadow economy.

**Moldova should seize the opportunity offered by its EU candidate status and capitalize on the openness shown by the development partners.** In the short and medium term, the fiscal space remains limited, being estimated at around 1.5% of GDP. Securing additional grants and concessional financing from donors and creditors will remain an important requisite for funding new policy initiatives and new public investment projects. The credibility and predictability that the EU candidate country status offers to the Republic, will further mobilize financial assistance. However, this background also sheds light on the current problems related to the limited capacity of authorities to assimilate foreign assistance. Thus, issues related to strategic planning, correlation of foreign assistance with development needs, management, and implementation of capital investment projects should be eliminated.

**The Moldovan banks entered the crisis of 2022 well capitalized and prepared to bear such shocks, given the strengthening of the regulatory framework and improving banks' governance after the banking crisis of 2015.** As a result, the banking sector proved to be robust to the shocks of 2022, emerging more resilient from the crisis, with improved liquidity and capital adequacy indicators. The credit risk, which significantly increased in 2022 given the economic recession, inflation and uncertainty around the war in Ukraine, has been adequately managed by banks. The share of non-performing loans (NPL) remained relatively low (lower compared to the pre-pandemic period), suggesting an adequate quality of the banks' loan portfolios. This is reinforced by comfortable liquidity and capital adequacy indicators, which, despite the shocks, remained at comfortable levels. Also, all liquidity indicators remained in the safe zone, in much better situation compared to the regulatory requirements. These indicators suggest that the banking system not only overcame well the crisis of 2022, but emerged even stronger from it, being well-capitalized, with sufficient liquidities, which can support the economic recovery of 2023-2024.

**The banks remained profitable during the crisis, despite shrinking interest margin.** The monetary policy tightening had a much stronger effect on the interest rates of deposits compared to credits, leading to a shrinking interest margin. However, it did not undermine the profitability indicators of banks because, while the average interest rate on deposits increased, the share of long-term deposits in total bank deposits, which bear the highest interest rates, decreased. It complicated the historical structural issue of maturity mismatch of liquidities of Moldovan banks, because of high uncertainty around the economic and security situation of the country that the owners of deposits to increase their liquidity by switching to shorter-term deposits. Another important factor was the increase in interest rates on state securities and NBM certificates after the monetary policy tightening that supported the profitability of banks.

**The high liquidity and capitalization of the banking sector, along with monetary policy easing and improving inflationary dynamics will lay the ground for a robust economic recovery in 2023-2024.** Assuming that in 2023 the security situation in the region will marginally stabilize, the inflation will continue decelerating with continued monetary policy easing, the agricultural year will be better than in 2022 and the economic situation in the region will also marginally improve, the banks' balance sheets will continue expanding at a high pace. Namely, the volume of new loans is forecasted to increase by 28% and 18% in 2023 and 2024 respectively. The growth rate will be much higher in the case of consumer loans (+51% and +21% for 2023-2024) compared to firms (+22% and 17% for 2023-2024), especially taking into account the low comparison basis: in 2022, the volume of new loans to population decreased by 35%, while in the case of firms they grew by 26%. As a result, the total stock of loans will expand by +24% in 2023 and 14% in 2024, which will stabilize around 13%-14% during 2025-2027.

**Overall, the central bank promotes a conservative and cautious monetary policy, responding adequately to the inflationary dynamics and the balance of risks, but promoting a more forward-looking monetary policy should be considered in the future.** During 2022, given the second-round effects of external inflation shocks (mainly, the



inflationary expectations and the second-round effects of energy price hikes), the central bank significantly tightened its monetary policy, both by raising the policy rate and mandatory reserves rate. The main reasons for this monetary policy tightening were to address the second-round inflationary effects of the cost-push inflation shocks of 2022, by mitigating the raising inflationary expectations, limiting lending and withdrawing idle liquidity from the banking sector. As long as it became clear that the inflation upward trend reversed, the central bank started to gradually ease the monetary policy by cutting the policy rate, but being more cautious in cutting its mandatory reserves rate. The reason is that, on the one hand, the central bank intends to stimulate lending in national currency, by cutting the mandatory reserves rate in MDL and keeping unchanged the rate in foreign currency; on the other hand, the high level of idle liquidities in the banking sector does not allow the NBM to cut the mandatory reserves rates further.

**Despite the major shocks of 2022, the central bank managed to maintain a relative stability of the national currency and overall resiliency of the macro-financial situation.** The national currency remained stable despite the multiple shocks and difficult economic conditions. It was possible due to the central bank's timely interventions on the domestic currency market. Namely, in order to avoid excessive depreciation of the Moldovan leu during the harshest times of the crisis (e.g. after the war in Ukraine started or when the import prices for energy increased), the NBM sold from its international reserves sufficient foreign currency in order to contain the increased demand for foreign currency and mitigate the pressure on MDL. However, during the following months, the level of reserves consolidated thanks to the international financial support from development partners.

**2023-2024 will mark a period of "return to normality" of the inflationary dynamics.** The inflation shocks started to dissipate at the end of 2022 and the beginning of 2023, with the annual CPI posting a downward trend. The deceleration of inflation will last throughout the entire 2023-2024 period, on the grounds of a high comparison base, better agricultural year, stabilization of inflationary trends in the region, and limited demand-side inflationary pressures at the domestic level. Hence, assuming that there will not be any major cost-push inflationary shocks, the CPI will continue declining down to 13-14% average for 2023 and 5.5% in 2024. **The inflationary deceleration will allow the central bank to ease its monetary policy further during 2023-2024.**

**Fears of capital flight from Moldova and depletion of reserve assets, which were circulating at the beginning of the war in Ukraine, did not materialize.** In fact, net capital inflows recorded in the balance of payments financial account were 37% higher than in 2021. Non-residents have not withdrawn their deposits from the Moldovan banking system, on the contrary, foreigners' deposits have increased and foreign investors have significantly expanded their direct investments in Moldova. The NBM intervened in the foreign exchange market at the beginning of the year to meet the sudden surge in demand for foreign currency, but this situation did not last long. During 2022, on the background of large inflows of foreign capital, the state's reserve assets increased and reached a record level.

**However, action is needed to correct the exaggerated current account deficit, caused by the persistence of competitiveness issues of Moldovan exports as well as by the price dynamics of imported energy resources.** Chronic deficits lead to the accumulation of external debt over time which, although not currently exceeding sustainability limits, may result in a debt crisis in the future. In this respect, it is crucial that Moldova seizes the opportunities offered by its status as a candidate country for EU membership by implementing the necessary reforms and promoting structural policies to boost supply.



## Executive summary

**Private sector.** The overlapping of several crises in the last 3 years has made the Moldovan economy oscillate at extreme values. However, 2022 has brought an accumulation of new crises materialized by the effects of Russian aggression on Ukraine, the energy crisis and persistent inflation. As a result, in 2022 Moldova recorded an economic contraction of 5.9% y-o-y. Sociological data reveal that most business activity in the last 2 years has been affected by rising costs and other expenses, along with the war in Ukraine. At the same time, the last two years have also brought a positive change of trend by registering a positive increase between the number of newly registered enterprises and the number of closed enterprises. Investment data show a contraction, both from public and private sources. After 5 consecutive years of real annual increases in gross fixed capital formation, 2022 brought a reduction in real terms of 6.8%. Amid drought conditions, agriculture reached its lowest share in GDP since independence (7.8%), after a 29.8% y-o-y decline in agricultural output. Manufacturing recorded a decline of 4.5% y-o-y, dragged down by the automotive, energy and construction-related industries. The decline was mitigated by positive developments in the food and beverage industry. The erosion of the purchasing power of the population led retail trade to decrease by 1.8%. After 5 consecutive years of growth, the volume of construction works fell by 13.9%, while the IT sector continued its expansion with a 33% jump in exports. After 3 years marked by multiple crises in which the economy went from one extreme to the other, we anticipate an economic recovery of 4.7% this year, followed by an economic growth of 5.4% in 2024. This year's economic recovery is underpinned by rapid growth in agricultural production, continued economic growth in the main economic partners and monetary policy easing. For the coming years, the main assumptions for growth are the stabilization of the security situation in the region, improved energy and mobility connectivity with Romania and the start of EU accession negotiations.

**Households and Labour Force.** In 2022, in the context of stagflation, real disposable income decreased by 5.9%. Real labour earnings diminished by 10.2%, and the influx of remittances declined by 3.4%. To reduce the adverse effects of the inflationary shock on households, the authorities significantly increased social spending (social benefits rose, in nominal terms, by 33.9%). Thanks to these measures, it was possible to increase the real pensions by 1.1%. However, even though the government provided a certain level of protection for people's incomes against inflation, household consumption decreased by 4%. Furthermore, paradoxically, the decline in GDP did not affect the labour market, and the employed population increased by 2.2%. The increase in employment was recorded in most sectors of the economy, and a decrease of 1% was only observed in agriculture. We anticipate that the growth rate of disposable income will double, increasing from 1.6% in 2023 to 3.1% in 2025. After 2025, the growth rate of disposable income will vary around 3%. The main factor that will determine the increase in income will be the growth of salaries. Real pensions will decrease in 2023, but will then be on the rise, and will also contribute positively to the increase in the population's incomes. The increase in disposable income will stimulate household consumption. The growth rate of consumption will increase from 2.4% in 2023 to 2.9% in 2024. After 2025, household consumption will increase by 2.3-2.5%. Due to the delay in transmitting the effects of the 2022 economic decline on employment indicators, the labour market will contract slightly in 2023. Employment will decrease by 1.5% in 2023, while the unemployment rate will reach 5.1%. In 2024, the labour market will be growing: employment will increase by 1.4%, and the unemployment rate will decrease to 2.6%. At the same time, for the period 2023-2027, the employment rate will remain close to 40%, while the unemployment rate will not exceed 4%. The risks to the forecast are related to the occurrence of new shocks that could diminish economic growth prospects.

**Public finances.** The overlapping crises have brought pressure on public finance, as the Government had to quickly react with supportive measures directed at individuals and firms. The execution of the general government budget ended in 2022 with a deficit of about MDL 9 billion (3.2% of GDP), significantly below the planned level (MDL 17.6 billion or 6.2% of GDP). This dynamic was on one side determined by higher higher-than-expected revenues and external grants, and on another by underperformance in capital and current expenditures. Overall, the general government revenues recorded a growth of 18% y-o-y, boosted by the robust increase in income tax and VAT. The expenditures growth rate was 22% y-o-y, with almost half of the increase being generated by social protection spending. Despite the fact that the government was forced to intervene with crisis-related current spending, the capital expenses also increased. Specifically, the investment capital spending went up by 47%, however, their level



still remains modest and insufficient for achieving developmental goals. To finance the deficit, the government relied mainly on external sources, as the domestic borrowing cost significantly increased. Consequently, the external state debt grew by 25%, representing 22% of GDP. Nevertheless, the risk of state indebtedness is assessed as low. For 2023, a deficit of MDL 18.3 billion (6% of the GDP) was approved, still higher than the allowed threshold in normal conditions. The deficit is to be mostly financed from external concessional loans; however, domestic borrowing will also resurge due to decreasing costs for state securities. Fiscal policy for 2023 aims to support SMEs' liquidity and stimulate private investments but also is focusing on strengthening fiscal discipline.

**Financial institutions.** The Moldovan banks entered the crisis of 2022 well capitalized and prepared to bear such shocks, given the strengthening of the regulatory framework and improving banks' governance after the banking crisis of 2015. As a result, the banking sector proved to be robust to the shocks of 2022, emerging more resilient from the crisis, with improved liquidity and capital adequacy indicators. Total banking assets increased, while the exposure to risks decreased, revealing the NBM's efforts to consolidate the macro-financial stability. The monetary policy tightening through raising the mandatory reserves rate led to a visible expansion of the share of banks' funds held at NBM, becoming the largest component of banks' assets. The improved robustness on the assets' side was mirrored by improvements on the liabilities' side of banks, reinforcing the trust in banks and the stability of the banking system overall. Banks emerged from the crisis of 2022 not just more resilient, but also more profitable. The structural changes in banks' balance sheets reflected on the evolution of revenues, expenditures and profitability indicators in the banking system, amid decreasing interest margin. The paradox of banks' profitability increasing amid decreasing interest margin is explained by the changing structure of bank deposits. The high liquidity and capitalization of the banking sector, along with monetary policy easing and improving economic and inflationary dynamics will lay the ground for a robust economic recovery in 2023-2024. This economic recovery, along with prudent monetary policy and robust credit growth, will turn into a rapid growth in bank deposits. The forecast is sensitive to two main risks: lower-than-expected economic recovery and additional inflationary pressures.

**Prices and Monetary Policy.** The rapid growth in inflation during 2022 was primarily driven by cost-push external shock factors that were temporary in nature: the drought of 2022, adjustment of energy tariffs and imported inflation. The fact that CPI from Moldova correlated almost perfectly with CPI from the EU, as well as the visible increase in the contribution of services to CPI (mainly, because of adjustment of tariffs for gas, electricity and heating), confirms the dominance of the external shocks on the inflationary dynamics at the domestic level. At the same time, the relatively even contribution of all key components of CPI point on to the strong domestic inflationary factors as well, associated mainly with the increase in the cost of production (industrial production prices index also peaked at 35% (y-o-y growth) in Oct-22) and inflationary expectations. Hence, the central bank cautiously tightened its monetary policy in order to contain the second-round effects of cost-push inflationary factors and limit lending in order to stabilize the core inflation. The inflation growth stabilized and since Oct-22 is rapidly decelerating. The inflation deceleration is likely to continue during 2023-2024, down to the NBM target of 5%. Taking into account the reversal in inflationary dynamics and low demand-side inflationary factors, the central bank started to ease its monetary policy. At the same time, given the abundance of idle liquidities in the banking sector, the NBM continues to be a net borrower to banks, aiming at sterilizing the liquidity excess. Nevertheless, few months after the war in Ukraine started, the NBM had to inject additional liquidities into the system in order to contain the bank run and the effects on increasing the mandatory reserve rate. Another important achievement is that despite the major shocks of 2022, the central bank managed to maintain a relative stability of the national currency and overall resiliency of the macro-financial situation. The 2023-2024 will mark a period of "return to normality" of the inflationary dynamics. The inflation shocks started to dissipate at the end of 2022 and beginning of 2023, with the annual CPI posting a downward trend. The inflationary deceleration will allow the central bank to ease its monetary policy further during 2023-2024.

**External sector.** The developments in Moldova's external sector in 2022 were mainly shaped by spillovers from the war in Ukraine and the dynamics of regional prices. The exports of goods recorded a remarkable growth (+44% y-o-y) due to the rich crop of oilseeds harvested in 2021 and to the reexport of fuel to Ukraine. Services exports went up 39%, with largest increases in travel, attributable to refugees admission, and in transport as Moldova became a transit area for Ukrainian trade and travelers. The export of computer services also continued to rise at a fast pace.



However, the growth in imports was even larger, caused by an unfavorable price dynamic, particularly for energy resources. Although Moldova received large amounts of external grants and other support, the receipts of remittances from abroad recorded a slight decrease, while remittances sent abroad grew considerably. Investment income payable to foreign investors increased by 34% as against 2021, mainly because of exceptionally high profits recorded by banks. The confluence of these factors gave the largest current account deficit in the last decade that amounted to 16% as a ratio to GDP. Fears of a sudden stop and capital flows reversal that arose at the beginning of war did not materialize, thus the financial account of Moldova's BOP recorded a net capital inflow worth US\$ 2.4 billion in 2022, 37% larger as compared to 2021. Capital inflows mainly consisted of currency and deposits, external loans, and FDI (both reinvested earnings and new investment). Because of large inflows of foreign currency, the NBM's reserve assets increased and are today record high. Substantial borrowing from abroad caused the gross external debt of Moldova to grow by 8% during the year, reaching 66% as a ratio to GDP. Nevertheless, public indebtedness indicators are far below critical sustainability ceilings. In 2023, the CAB is projected to mildly improve and reach -14% as a ratio to GDP and then enhance gradually to -9% in 2027. Downside risks include the persistence of energy prices crisis and the contingency of another drop in agricultural output in uncertain climate conditions. Positive events are also possible, such as a strong recovery of growth in trading partners and more support from the EU, particularly in connection with Moldova's candidate status.



## Forecasts of the key macroeconomic indicators for 2023-2027

| Indicator                                     | 2023     | 2024     | 2025     | 2026     | 2027     |
|-----------------------------------------------|----------|----------|----------|----------|----------|
| GDP, growth, %                                | 4,7      | 5,4      | 5        | 4,5      | 4,5      |
| Agricultural production, growth, %            | 30,6     | 1,6      | 3,9      | 3,5      | 3,5      |
| Industrial production, growth, %              | 9,4      | 1,6      | 2,4      | 2,1      | 2,1      |
| Retail trade in goods and services, growth, % | 3,3      | 8,0      | 5,5      | 4,9      | 4,9      |
| Private consumption, growth, %                | 2,4      | 2,9      | 2,5      | 2,3      | 2,3      |
| Gross fixed capital formation, growth, %      | 9,3      | 13,9     | 6,3      | 5,7      | 5,7      |
| Disposable income, growth, %                  | 1,6      | 2,2      | 3,1      | 2,8      | 2,8      |
| Consumer Price Index, average, %              | 13,5     | 5,5      | 5        | 5        | 5        |
| Monetary policy rate, end of the year, %      | 10       | 5        | 5        | 5        | 5        |
| MDL/USD exchange rate                         | 19,3     | 19,1     | 19       | 19       | 19       |
| Unemployment rate, average, %                 | 5,1      | 2,6      | 3,8      | 3,8      | 3,8      |
| Exports of goods and services, growth, %      | -0,2     | 7,0      | 6,9      | 6,3      | 6,3      |
| Imports of goods and services, growth, %      | 0,9      | 11,7     | 7,2      | 6,5      | 6,5      |
| New loans, nominal growth, %                  | 28,2     | 18,0     | 18,0     | 17,0     | 17,0     |
| - Business                                    | 21,8     | 16,9     | 19,0     | 18,0     | 18,0     |
| - Households                                  | 50,9     | 21,2     | 15,2     | 14,1     | 14,0     |
| Outstanding loan balance, thousand MDL        | 76532,2  | 87234,9  | 99447,8  | 112376,0 | 126984,8 |
| Share of total loans in GDP, %                | 21,7     | 25,0     | 27,7     | 30,6     | 33,9     |
| New deposits, nominal growth, %               | 30,2     | 14,2     | 18,0     | 17,0     | 17,0     |
| - Business                                    | 19,9     | 14,2     | 19,0     | 18,0     | 18,0     |
| - Households                                  | 34,5     | 14,2     | 15,2     | 14,1     | 14,0     |
| Outstanding deposit balance, thousand MDL     | 123668,4 | 141250,2 | 164556,5 | 190062,8 | 219522,5 |

Source: Expert-Grup estimates and forecasts.

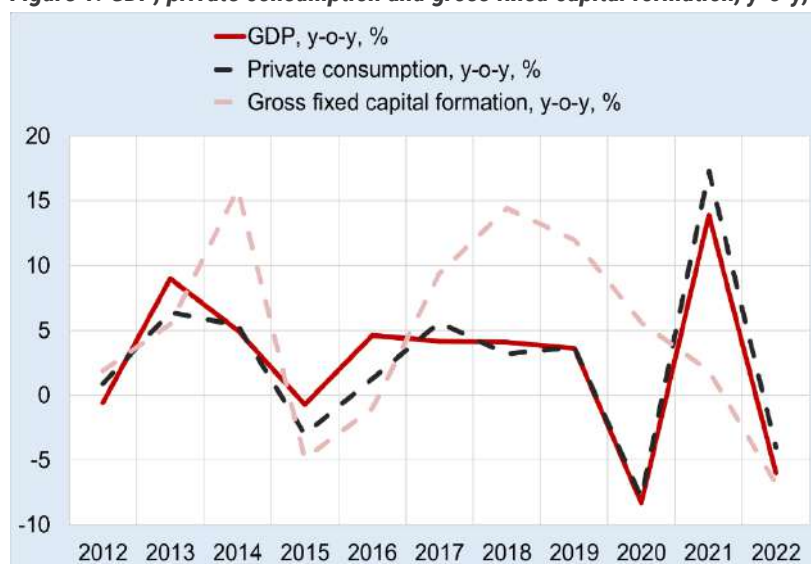
## Private sector

*This chapter presents how the Moldovan economy, mainly the private sector, has evolved and reconfigured amidst the multiple shocks it has been subjected to in 2022. In this respect, developments in the main sectors are presented, considering their level of resilience and the factors that influenced them. In addition to the sectoral approach based on statistical data, the chapter also presents the latest data from business surveys to assess the impact of crises through the perception of entrepreneurs. The forecasts for 2023-2024 are also outlined and explained, detailing the factors that will contribute to or detract from economic growth, as well as the main challenges resulting primarily from uncertainties regarding regional and energy security.*

### Long-term trends

***In the last decade, the evolution of the Moldovan economy has been increasingly influenced by the effects of climate change, while the investment component of GDP has grown faster than consumption.*** On the resource side, the evolution of GDP has been increasingly influenced by the situation in agriculture. Thus, after years of drought (2012, 2015, 2020, 2022), the economy has seen strong compensatory recoveries. In terms of reconfiguration of the economy, the last 10 years are characterized by the trend of decreasing share of GDP of some sectors - agriculture, real estate transactions, industry, while increasing the share of trade, transport, storage, and IT. On the expenditure side, over the period 2012-2022, gross fixed capital formation had a higher average annual growth rate (4.9%) compared to the dynamics of private consumption (2.6%). The given trend also reveals a lower dependence of the economy on remittances in relative terms and a slightly better exploitation of domestic growth resources. At the same time, being a small open economy, external shocks and crises spread rapidly through the economy. This trend has become even more pronounced in recent years as Moldova has become even more integrated into the international economic circuit through agricultural products and some branches of industry (e.g. automotive, textiles).

**Figure 1. GDP, private consumption and gross fixed capital formation, y-o-y, %.**



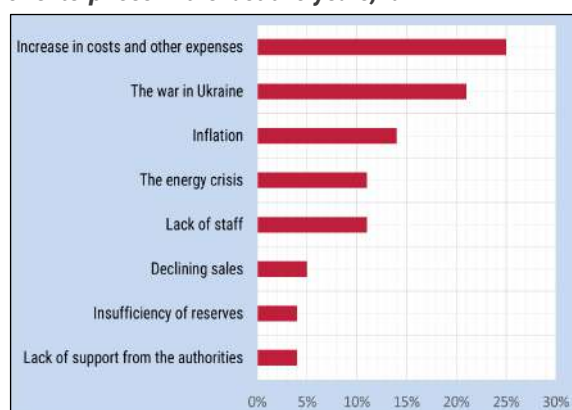
Source: NBS data

## Recent trends

### **The overlapping of several crises in the last 3 years has made the Moldovan economy oscillate at extreme values.**

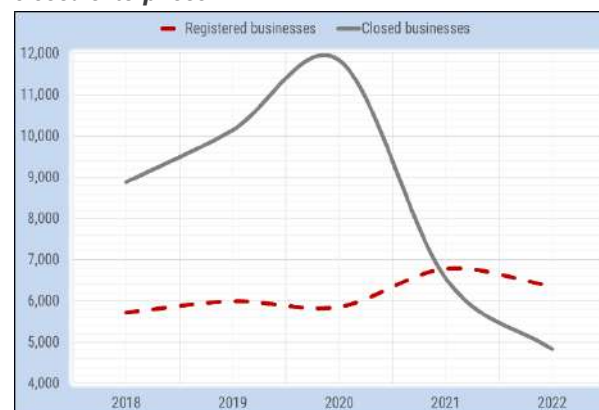
After the effects of the Covid-19 pandemic and severe drought from 2020 led to a contraction of the Moldovan economy by -8.3% y-o-y, 2021 saw a strong rebound of the economy with a 13.9% y-o-y growth, due to record agricultural production, post-pandemic recovery in consumption and low comparison base. However, 2022 brought a mix of new crises materialized by the effects of Russian aggression on Ukraine, the energy crisis and persistent inflation. As a result, in 2022 Moldova recorded an economic contraction of -5.9% y-o-y. According to data from a recent survey<sup>1</sup>, the most significant impact on business activity over the last 2 years has been the rise in costs and other expenses (25%) and the war in Ukraine (21%). Inflation (14%), the energy crisis (11%) and the lack of staff (11%) have also had a strong negative impact on business activity. Broadly speaking, these challenges have put pressure on the costs and competitiveness of businesses, manifested by: (i) the loss of markets and suppliers in Russia, Ukraine and Belarus (before the war these countries accounted for 13% of Moldova's exports and 26% of imports), (ii) the need to rebuild many logistical routes after the loss of access to the port of Odessa, iii) the substantial increase in transport and logistics costs as Moldova became an important transit point for goods to and from Ukraine, iv) the increase in the cost of energy resources, v) the cost of financing as monetary policy tightened, and vi) the more difficult local market sales as the purchasing power of the population eroded. On the other hand, the last two years have also brought a positive change in the trend with a positive increase between the number of new businesses registered and the number of businesses closed. Thus, the number of new businesses created in 2021 (6.8 thousand) and 2022 (6.4 thousand) exceeds pre-pandemic levels, while the number of businesses closed in 2022 (4.8 thousand) is 2.5 times lower than in 2020 (11.8 thousand). These figures may suggest both higher adaptability to crises and higher business confidence.

**Figure 2. The challenges that most affected the activity of enterprises in the last two years, %**



Source: [Magenta Consulting](#), Survey of business representatives (survey of 392 companies), February 2023

**Figure 3. Dynamics of the number of newly created and closed enterprises**



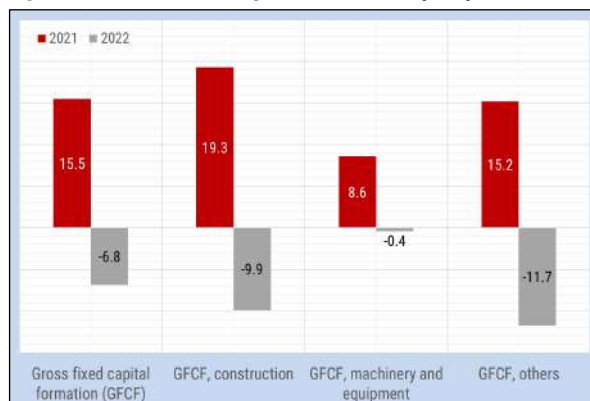
Source: Public Service Agency

**The crises and uncertainty undermined the investment activity, both from public and private sources.** After 5 consecutive years of real annual increases in gross fixed capital formation, 2022 brought a reduction in real terms of -6.8%. The reduction in gross capital formation was mainly on account of the construction component: -9.9% y-o-y, due to the decrease in the volume of works in the residential sector, as well as engineering construction (roads, railways, aqueducts, etc.). At the same time, the machinery and equipment component of gross fixed capital formation was close to the parameters recorded in 2021 (-0.4% y-o-y). The reduction in infrastructure and residential works was conditioned by the inflationary context and the tightening of monetary policy. This was reflected in the increase in prices of construction materials which substantially complicated both the conduct of public procurement procedures and the investment plans of real estate developers. At the same time, on the supply side, higher credit prices have led to a reduction in demand for mortgage loans. The investment in fixed assets followed the trend of

<sup>1</sup> Magenta Consulting, Survey of business representatives (survey of 392 companies), February 2023, <https://www.youtube.com/watch?v=sw5YqbMjAzo&t=5s>

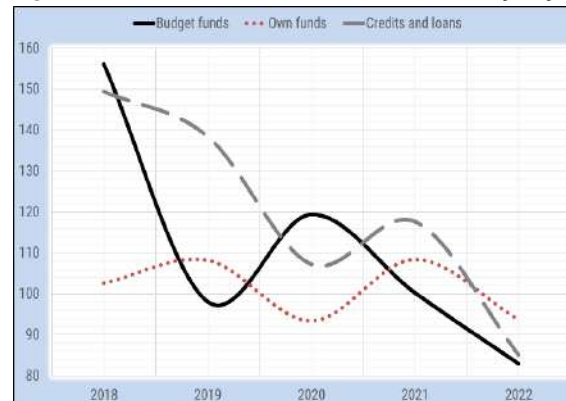
gross capital formation, recording in 2022 a decrease of -11.6% y-o-y (in comparable prices), after an increase of 4.8% recorded a year earlier. By source of finance, investment from budgetary resources was most affected: -17.1% y-o-y, followed by investment from credits and loans: -14.9% y-o-y, while investment from firms' own sources declined at a slower pace of -6.3% y-o-y.

**Figure 4. Gross fixed capital formation, y-o-y, %**



Source: NBS data

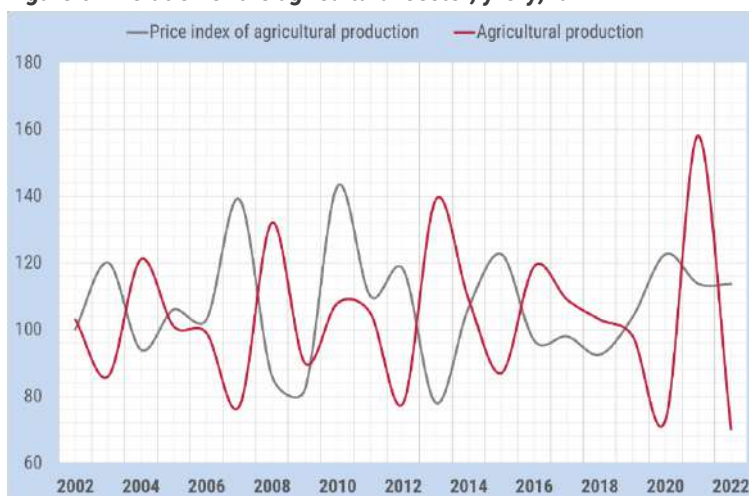
**Figure 5. Index of investments in fixed assets, y-o-y, %**



NBS, Expert-Grup calculations

**Because of the severe drought of 2022, agriculture has reached its lowest share of GDP since independence.** The results for 2022 show a decline in agricultural output of -29.8% y-o-y (in comparable prices), driven by a sharp drop in crop production of -36.8% and mitigated by a slower decline in livestock production of -2.6%. As a result, the share of agriculture in GDP reached a historical low of 7.9%. The decrease in crop production was mainly accounted for by cereals and grain legumes: -63.1% y-o-y, sunflowers: -35.3% y-o-y, fruit, nuts and berries: -26.1% y-o-y. Positive developments were noted for grapes (7.6% y-o-y) and vegetables (10.3% y-o-y). At the same time, the livestock sector continues to become smaller in size. This phenomenon is explained by the accelerated decrease in the number of livestock in households and the slow increase in the number of livestock in enterprises. For example, the number of cattle, sheep and pigs on 1 January 2023 in households was 40-50% lower compared to 5 years ago, with the decrease also stimulated by the droughts in 2020 and 2022. From a market conjuncture perspective, the last 3 years can be considered rather favorable for farmers. Thus, in the period 2020-2022, the price index of agricultural production increased by 22.5%, 13.7% and 13.6% respectively.

**Figure 6. Evolution of the agricultural sector, y-o-y, %.**

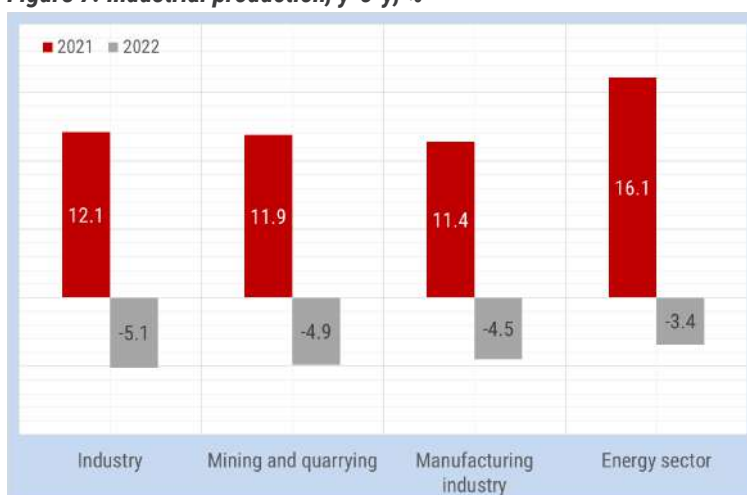


Source: NBS data

**Manufacturing was dragged down by automotive, energy and construction-related industries.** The 2022 results reflect a 4.5% y-o-y decline in manufacturing after robust growth a year earlier. Developments within the sector are uneven. Thus, the largest declines in production volume are reflected in sectors that are largely identified with

automotive<sup>2</sup> - motor vehicle, trailer and semi-trailer manufacturing: -34.1% y-o-y and electrical equipment manufacturing: -59.4% y-o-y. The given result is explicable stemming from reduced external demand amidst the war in Ukraine, but also disruption of supply chains due to the prolonged lockdown in China and the semiconductor crisis. The decline in production in the metalworking industry (-27.3% y-o-y), the metal construction industry (-14.8% y-o-y), repair, maintenance and installation of machinery and equipment (-23.2%) is associated with reduced investment in fixed assets, as well as rising energy tariffs. Another pole of decline was furniture manufacturing: -29.8%, the result of the high comparison base but also the decline in the construction sector. These negative developments were partially offset by increases in production volumes in the food industry: 12.1% y-o-y and beverages: 9.3% y-o-y, these 2 sectors having a cumulative share of around 44% of the value of the manufacturing industry. The positive increase in the agri-food industry was possible due to the valorization of raw material stocks related to the 2021 agricultural year, which covered the deficit resulting from the modest harvest of 2022. Significant positive developments were also recorded in wood processing: 21.4% y-o-y, pharmaceutical manufacturing: 19.7% y-o-y, and clothing: 4.0% y-o-y. At the same time, the production index in the energy sector was negative (3.4% y-o-y), conditioned by energy saving measures undertaken by the population, following the substantial increase in tariffs, but also by higher average weather temperatures.

**Figure 7. Industrial production, y-o-y, %**



Source: NBS data

**The erosion of the purchasing power of the population has led to a decline in retail trade, while export-oriented services have performed remarkably well.** The year 2022 ended with a -1.8% y-o-y decrease in retail turnover and a 10.4% increase in services provided to the population (in comparable prices). In the retail segment, trade in non-specialized stores, where the activity of most supermarket chains and convenience stores is reflected, turnover fell by around 9% y-o-y, correlating with the fall in real average wages in 2022 of -10.3% y-o-y. A 2-digit decline was also recorded by stores specializing in IT equipment, as well as those based on beverages and tobacco. The decline in retail turnover was partly offset by a 44% increase in fuel sales, as the territory of Moldova was heavily transited after the aggression of the Russian Federation in Ukraine. At the same time, the expansion of trade through formal trade channels (retail networks, specialized shops) to the detriment of informal trade in markets continues to be observed. For example, during 2022 the number of patents in retail trade decreased by 13.1% to 4 706. In the same period of time, turnover in HoReCa increased by 39%, sales of travel agencies and tour-operators increased by 29%, as well as recreation and leisure activities increased by a high rate of 30% y-o-y. The given sectors, which were among those most affected by the pandemic, continued their recovery to pre-pandemic levels. Turnover in wholesale trade grew by a nominal 25.9% in 2022, while sales in services mainly provided to businesses grew by 28.2% in the same period, with the increase in transport and warehousing services being the most notable, at around 47% growth y-o-y. After 5 consecutive years of growth, the volume of works executed in construction decreased by 13.9% (in comparable prices), mainly due to the decrease of works in residential projects (-23% y-o-y). On the other hand, the year 2022 also stands out with a strong increase in services exports of 39.2%. In this context, it is worth noting the continued

<sup>2</sup> in 2021 these 2 sectors accounted for 9.8% of the value of manufacturing output



rise of the IT sector, which is capitalizing on the business environment and the favorable external demand, including a 33% increase in IT services exports. Thus, in 2022 the value of IT exports exceeded USD 468 million or 4.5 times more than 5 years ago.

## Forecasts and challenges

**The baseline scenario of the current forecast horizon is based on an economic recovery in 2023 and economic growth in subsequent years.** The economic recovery in 2023 is underpinned by rapid growth in agricultural production, continued economic growth in the main economic partner countries and monetary policy easing. Thus, lower monetary policy rates and receding inflation will increase access to finance and encourage investment. At the same time, the prospects for strengthening and facilitating global trade put small and open economies such as Moldova's in a good position to benefit from stronger external demand. For the coming years, the main assumptions for economic growth are the stabilization of the security situation in the region, the improvement of energy and mobility connectivity with Romania and the start of EU accession negotiations. These factors can create a huge synergy effect for attracting investment and modernizing the country.

**Moldova's EU candidate status obtained in 2022 and the prospect of starting accession negotiations by the end of 2023 create significant growth opportunities.** It is supposed to anchor Moldova more deeply into the European civilizational area being no longer treated as part of the grey zone that previously separated Russia from the EU. As previously mentioned in Expert-Grup publications, the benefits of advancing with the status of EU candidate country will manifest themselves through<sup>3</sup>: i) tightening of the "rules of the game" - with the inclusion in the EU enlargement package, Moldova will be subject to comprehensive, intrusive and ad hoc monitoring by the EU. Therefore, the room for political maneuver in the decision-making process will be considerably reduced. In addition, it increases the accountability of political actors in Moldova for mimicking, postponing or interrupting reforms, as well as for undemocratic deviations; ii) Increasing resources for the national reform process - candidate country status integrates Moldova's needs into the EU multi-annual financial planning process, which will involve a series of national and European political negotiations and decisions. As a result, the Republic of Moldova could receive access to additional financial resources, which it has not had available throughout the post-Soviet period.

**The year 2023 shows prospects for a recovery in investment activity from both public and private sources.** After a fall in real terms of -6.8% in gross fixed capital formation in 2022, the forecast for 2023-2024 is based on an increase in gross fixed capital formation of 9.3% and 13.9% respectively. The assumptions underlying this forecast consider the further reduction in inflation, the availability of lower-cost financing and the application of incentives from fiscal policy. With prices stabilizing and several infrastructure projects entering the operational phase, a better take-up of public investment is expected. The state budget law for 2023 provides for capital expenditure of 6.8 billion Lei. On the other hand, private investments will be supported by the reduction of financing costs as well as the entry into the active phase of the Fund for Entrepreneurship and Economic Growth of Moldova (FACEM), which will provide investment loans to SMEs below market costs. At the same time, in the period 2023-2025, SME profits that are not distributed to dividends will not be taxed, while large enterprises can use accelerated depreciation for purchased fixed assets by expensing up to 50% of the input cost of fixed assets in the first year of use. In addition, the energy crisis seems to have substantially increased firms' interest in equipment modernization and efficiency. For example, already in the first two months of this year, the number of electricity prosumers through the net metering mechanism has increased by 40%<sup>4</sup>. At the same time, the Energy Efficiency and Retrofit Program for Small and Medium Enterprises<sup>5</sup> implemented by the Entrepreneurship Development Organization (ODA) is the most popular program among SMEs since its launch.

<sup>3</sup><https://www.expert-grup.org/en/biblioteca/item/2436-raportul-de-stare-a-%C8%9B%C4%83rii-2022/2436-raportul-de-stare-a-%C8%9B%C4%83rii-2022?category=182>

<sup>4</sup> In January and February, 721 connection permits were issued for 12.8 MW of electricity from photovoltaic panels

<sup>5</sup> <https://www.oda.md/ro/granturi/retehnologizare>



**After 3 years marked by multiple crises in which the economy has gone from one extreme to another, we expect an economic recovery of 4.7% this year, followed by economic growth of 5.4% in 2024. For the next 3 years (2025-2027) we forecast an economic growth of around 4-5%.** Such a development is conditioned by:

- **Anticipating a very good agricultural year with an increase in production volume of about 30.6% f-y-p in 2023.** The prerequisites for this are the low base of comparison and the climatic conditions, which for the current year look to be favorable. A current challenge for farmers is the trend of slowing price growth<sup>6</sup> amid persistently high production costs.
- **In 2023, the industry will recover, boosted by the good agricultural year, external demand, as well as lower pressure from production costs.** After a decline of -5.1% f-a-p in 2022, the industry will record a 9.3% increase in production volume this year. This will be mainly due to the food and beverage industry, but also to the recovery of external demand for some industries (light industry, furniture manufacturing). In the risk zone remain the energy-intensive industries, reflecting the volatility of energy prices, and the automotive industry, reflecting the rather stagnant forecasts for this industry at the European level this year<sup>7</sup>.
- **Retail trade in goods and services will see a more modest 3.3% recovery in 2023 and 8% growth in 2024.** Real wages will only return to positive growth in the second half of this year, with the trend expected to continue next year. As the purchasing power of the population improves, trade will pick up.
- **The transport and logistics sector will remain on an upward trend** as Moldova continues to be an important transit point after the Russian aggression in Ukraine. At the same time, the EU's decision to extend the Moldova-EU Agreement on the liberalization of road freight transport<sup>8</sup> is a key factor that will allow the sector to grow.
- **Maintaining the business facilitation regime for the IT sector with the application of the single tax for residents of the IT park** will further make the sector regionally competitive, leading to increasing exports. Digitization reserves within the country are another source of growth. However, the main risks in this sector are associated with human capital and the excessive reliance on a man-day rather than product-centric business model, which may be affected including by the progress offered by artificial intelligence.
- **The presence of several sources of risk means that the forecast is accompanied by a high degree of uncertainty.** Further developments remain influenced by a number of significant risks, the most important being: (i) the possibility of an escalation of the war in Ukraine, including with the consequence for the Republic of Moldova to manage an additional flow of refugees, (ii) the volatile situation on the energy market - a further increase in prices may put additional pressure on the external balance of payments, but also test the social cohesion in the country, (iii) the worsening of economic situation in the main trading partners in the context of increasingly frequent discussions about a global recession - the Republic of Moldova is a small open economy, and external shocks are spreading rapidly, iv) the Kremlin's hybrid warfare and hijacking of the European integration agenda - over the last year, the Russian Federation has launched several destabilizing actions against Moldova (temporary fruit embargo, reduction of gas deliveries, propaganda actions, support for fugitive oligarchs). We can assume that such actions will continue, and this poses a danger also for the European course of the country, v) the behavior of policy makers who are faced with a growing spectrum of multidimensional challenges, and the possibility of making mistakes is high. Added to this is the limited administrative capacity, especially in terms of human resources, to develop and implement public policies correctly and coherently.

<sup>6</sup> <https://www.fao.org/newsroom/detail/fao-food-price-index-declines-for-the-11th-consecutive-month/en>

<sup>7</sup> <https://www.eiu.com/n/campaigns/automotive-in-2023/>

<sup>8</sup> <https://anta.gov.md/content/decizia-referitor-la-prelungirea-acordului-rm-ue-privind-liberalizarea-transportului-rutier>

## Households and labour force

*This chapter analyses the developments in household wealth and the labour market. In the conditions of deep recession in the 1990s and poor economic progress that followed after 2000, emigration became a solution for improving the standard of living for Moldovan citizens. Despite its negative effects, emigration contributed to the stabilization of the Moldovan labour market, and remittances boosted the population's consumption, thus stimulating economic growth. After 2010, the pattern of economic development underwent some changes. Private consumption remained the main contributor, accounting for more than 80 percent of GDP, but the share of remittances decreased while the importance of labour earnings increased. Thus, labour earnings represented more than half of disposable income, and remittances constituted only 12 percent in 2022. The recent shocks such as the war in Ukraine, drought, and high inflation had negative effects on household income, resulting in a decrease in labour earnings, remittances, and private consumption in 2022. However, due to an increase in public expenses oriented toward the social sector, it was possible to ensure a marginal increase in real terms of pensions. The labour market was resilient to economic shocks, with employment increasing by 2.2 percent. The chapter ends with forecasts that suggest an improvement in household wealth in the mid-term due to labour earnings growth.*

### Long-term trends

**After sharp economic decline in 1990 the emigration became one of the main factors shaping the socio-economic life in the Republic of Moldova.** In the 1990s, because of recession the labour earnings and pensions collapsed. Although the economic recovery after 2000 has led to an increase in household incomes, a full recovery has not been achieved<sup>9</sup>. Due to low income, emigration has become one of the main strategies by which the population can improve their standard of living. The main factor that determined emigration was the opportunity to gain higher earnings abroad, along with obtaining a better education (especially university or postgraduate studies) or benefiting from a higher quality of social infrastructure.

**The Moldovan labour market was directly affected by emigration, but since 2010, the employment indicator has shown insignificant changes.** Due to emigration, an important part of the qualified labour force has been lost, resulting in a decrease in the employment rate. In 2000, the employment rate was 54.8 percent, and after the 2009 economic crisis, it stabilized and fluctuated around 40 percent. However, the reduction in the labour supply balanced the internal labour market and led to a decrease in unemployment. This reduction began after 2000 when the unemployment rate was 8.5 percent, and since 2013, it has ranged between 3-5%.

**Although remittances continue to be an important source of income for Moldovan citizens, their role is declining as wages increase their share of disposable income.** The current model of economic growth is based on household consumption, which represented 84.2% of GDP in 2022. Remittances remain an important source of financing consumption, although their share of income has reduced. Disposable income increased in real terms by 35.7% between 2012 and 2022. The main driver of this change was salaries, whose share in disposable income increased from 42.7 to 50.7% (Figure 8)**Error! Reference source not found.** The share of pensions remained relatively stable (with a marginal decrease from 15.9 to 15.8%), while the share of remittances reduced from 16 to 12%. The share of other incomes also diminished by 3.9%.

<sup>9</sup> A., Lupușor, A., Fala, D., Cenușă, S., Madan, V., Prohnițchi, Republic Moldova 2021. State of the country Report, Independent Think-Tank "Expert-Grup"/ Friedrich-Ebert-Stiftung, Chisinau, 2021, p. 38, [https://www.expert-grup.org/media/k2/attachments/RAPORT\\_2021\\_EN.pdf](https://www.expert-grup.org/media/k2/attachments/RAPORT_2021_EN.pdf)

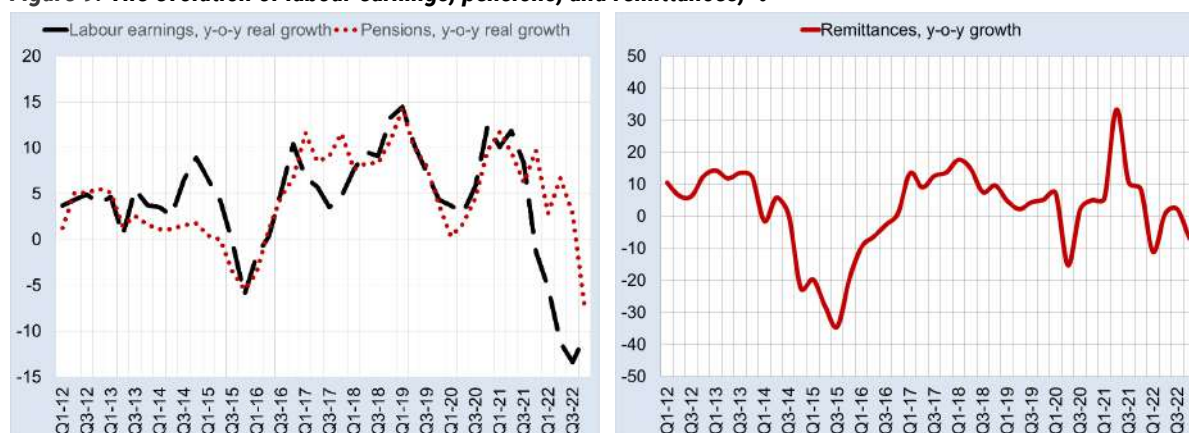
**Figure 8. The structure of disposable income, %**

Source: Expert-Grup calculations based on NBM data

## Recent trends

**In 2022, household income in Moldova was affected by a series of shocks, including a security crisis in the region, a rapid increase in prices, and adverse weather conditions.** The biggest challenge facing the Moldovan economy remains the security risks in the region, resulting from the Russian invasion of Ukraine. This has compromised trade with Russia, Belorussia and Ukraine, and reduced the investment of Moldovan firms. Inflation has increased, eroding the purchasing power of household income and hampering private consumption. The drought affected agricultural production. As a result, the Moldovan economy experienced stagflation in 2022, with an average annual inflation rate close to 29 percent and a reduction in GDP of 5.9%.

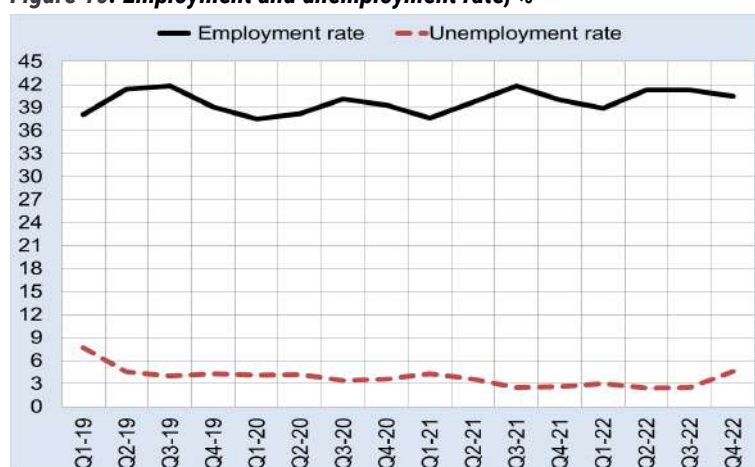
**The adverse effects of inflation translate into a diminishing of real disposable income by 5.9 percent in 2022. However, despite the reduction of the purchasing power of labour earnings, real pensions have increased.** The rapid increase in prices has undermined household wealth. Thus, while real labour earnings increased by 6.9% in 2021, there was a decrease of 10.2% in 2022. The real sector saw a slower decline in real earnings compared to the public sector: 9.8% versus 11.6%. There was an increase in remittances in nominal terms (+13.8%) in 2021, but a reduction in the inflow of remittances by 3.4% was registered in 2022. In the case of pensions, a relatively positive evolution was recorded. The 9.4% increase in 2021 was followed by a marginal growth of 1.1% in 2022, despite the real decrease by 7.3% y-o-y in Q4-22. However, there is also "inequality" in the distributional effects of inflation on households. The most affected were people with low and medium incomes from urban areas. In rural areas, consumption of food and energy could be covered by incomes in nature, being less sensitive to the rise of prices.

**Figure 9. The evolution of labour earnings, pensions, and remittances, %**

Source: Expert-Grup calculations based on NBM data

**Despite the government's actions to support households, private consumption declined by 4% in 2022.** To reduce the adverse effects of shocks on households, the authorities significantly increased social spending. Thus, social benefits increased by 12.7% in nominal terms in 2021 and by 33.9% in 2022. Thanks to these measures, it was possible to increase the minimum pension. The pension indexation formula was changed in 2022, abandoning the annual average inflation and including the year-on-year price increase in December. This made it possible to index the pension by 13.9% in 2022. These measures increased pensioners' real income in 2022. The government also increased the guaranteed minimum wage in the public sector from MDL 2935.1 to MDL 3500. A new mechanism for energy bill compensation was applied based on the energy vulnerability of households in the cold season from 2021 to 2022. Although these measures did not stop the decline in private consumption, they offered some protection for household income against price fluctuations.

**Despite stagflation, the labor market experienced positive evolution in 2022.** In general, over the past few years, even during economic recessions, the labor market has been growing (Figure 10). The employment rate increased from 40.3% in 2020 to 41.8% in 2022, and the unemployment rate decreased from 5.1% in 2019 to 3.1% in 2022. The evolution pattern in 2022 was similar, with a 5.9% decrease in GDP accompanied by a 2.2% growth in employment. Employment growth was recorded in the majority of sectors of the economy, with only a 1% decline in agriculture. This counter-intuitive development can be explained by (1) the delay between the evolution of the real sector of the economy and that of the labor market, and (2) by mismatch between labor supply and demand. Companies may not resort to personnel dismissal or may even try to increase their staff because labor demand is not covered by supply.

**Figure 10. Employment and unemployment rate, %**

Source: NBS data

**The developments in recent years have indicated the vulnerability of informal employment to economic shocks.** During the 2020 crisis, informal employment decreased by 7.5%, while formal employment decreased by only 3.5%.



The positive developments in the labor market were ensured by the expansion of formal employment during the stagflation of 2022. Formal employment increased by 3.3%, while informal employment shrank by 1.4%. These developments can be explained by the fact that, in weak economic conditions, companies in the formal sector have access to more opportunities than firms operating informally. Formal sector companies can contract bank loans or access different financing instruments offered by the government.

## Forecasts and challenges

**We anticipate that the growth rate of the population's disposable income will double, increasing from 1.6% in 2023 to 3.1% in 2025.** We forecast that real labour earnings will grow by 4.9% in 2023 and 3.6% in 2024. The growth in earnings will be determined by economic recovery and the needs of firms to attract new employees. The real pension will drop by 5.6% in 2023, but will increase by 2.3% in 2024. One of the factors that will cause the average pension to diminish is under-indexation in 2023. According to the law, the indexation coefficient should have been equal to 30% (year-on-year CPI growth in December 2022), while the de facto indexation was only 15% because of budgetary constraints. As a result, disposable income will rise by 1.6% in 2023 and by 2.2% in 2024. The growth rate of disposable income will vary around 3% after 2025.

**Disposable income growth will stimulate household consumption, but the growth rate will not exceed 3%.** After a 4% decrease in 2022, consumption will slightly accelerate its growth from 2.4% in 2023 to 2.9% in 2024. Private consumption will increase by 2.3-2.5% after 2025.

**We presume that the labor market will feel some effects of the 2022 recession in 2023, but will recover in 2024.** Due to the lag in the transmission of economic decline into employment indicators, the labor market will contract slightly in 2023. Employment will fall by 1.5% in 2023, while the unemployment rate will reach 5.1%. The decline in unemployment will be recovered by a growth of 1.4% in 2024, and the employment rate will fall to 2.6%. However, the employment rate will not change significantly and will remain close to the 40% level for the 2023-2027 period, while the unemployment rate will not exceed 4%.

**The risk to the forecast is related to the occurrence of new shocks that could hamper growth prospects.** The uncertainty is caused by (i) the chronic inefficiency of public institutions, which makes it difficult to deliver qualitative public services; (ii) vulnerability to climate change, which manifests itself through an increased frequency of severe droughts<sup>10</sup>; and (iii) sensitivity to external factors due to the high degree of economy openness. These risks are amplified by political developments, as the Republic of Moldova is entering a three-year electoral "marathon" (local elections in 2023, presidential election in 2024, and parliamentary elections in 2025) amid increased dissatisfaction among the population with the pro-European Government.

<sup>10</sup> A., Lupușor, A., Fala, D., Cenușă, S., Madan, V., Prohnițchi, Republic Moldova 2021. State of the country Report, Independent Think-Tank "Expert-Grup"/ Friedrich-Ebert-Stiftung, Chisinau, 2021, p. 36, [https://www.expert-grup.org/media/k2/attachments/RAPORT\\_2021\\_EN.pdf](https://www.expert-grup.org/media/k2/attachments/RAPORT_2021_EN.pdf)

## Public Finance

*The overlapping crises have brought pressure on the government to respond quickly to the increasing needs of households and businesses, being challenging to carefully prioritize the spending programs in the context of budgetary constraints. In 2022 the budget posted a deficit of almost MDL 9 billion, twice higher than a year before in nominal terms, but only with a 1.6 p.p. more if reported to GDP. The main source of financing fiscal deficit was external loans. The government relied less on state securities, as the internal financing cost significantly grew. Even if the external state debt has increased, reaching 22% of GDP at the end of the year, the risk of external debt distress remains low. This chapter will describe in more detail the dynamics of budget indicators, sources of financing budget deficit, and recent measures of fiscal policy while focusing at the same time on debt sustainability aspects.*

### Long-term trends

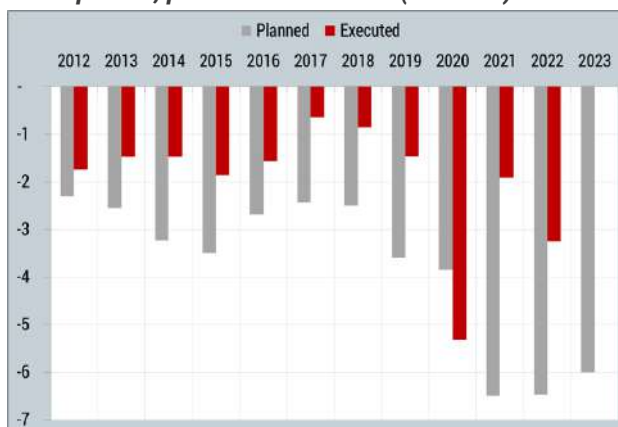
***In the long term, the budget framework is focused to ensure a balance between development spending needs and fiscal consolidation, while keeping in the loop debt sustainability.*** The budget deficit to GDP will narrow and meet the threshold of 2.5% as established by the Public Finance Law. The increase in recurring expenditures, while safeguarding proper social assistance and benefits and augmentation of public sector wages, should not come at the cost of cutting capital expenditure. Furthermore, the focus will be on gradually increasing the levels and execution of pro-growth development spending. Trends in budgeted capital spending have to be consistent with Moldova's strategic objectives, as defined in national strategies, particularly National Development Strategy European Moldova 2030, which underlines the need for increased capital spending in the energy, roads, water, and sanitation sectors. Moreover, the authorities are committed to addressing climate change vulnerabilities, and in this regard are considering requesting assistance under the IMF's Resilience and Sustainability Facility in order to support a range of green investments.

### Recent trends

***Despite the complicated year marked by a set of crises that required concrete measures meant to alleviate their impact, the budget ended with a deficit twice lower than planned.*** Even if for the National Public Budget (NPB) a deficit of MDL 17.6 billion (6.2% of GDP) was estimated after the last correction of budget parameters, the end of the 2022 effective data shows a significantly lower-than-expected deficit or MDL 8.8 billion (3.2% of GDP). The situation was determined on the one side by the higher-than-expected revenues and external grants, and on another, by the underperformance both in capital and current expenditures. The external loans served as the main source to cover the budget deficit. The government relied less on state securities as their cost increased due to inflation and tighter monetary policy.

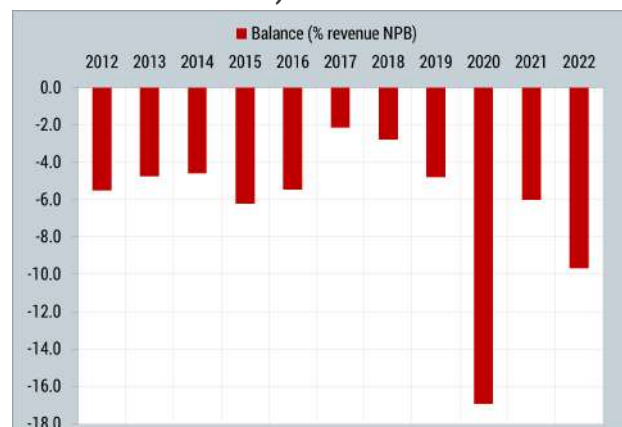
***In 2022, despite the challenging economic context, revenue collection slightly over-performed compared to initial plans.*** The total revenue of NPB amounted to MDL 91.5 billion in 2022, which was 18% higher y-o-y. Overall, the share of general government revenues in GDP increased by 2 p.p. up to 33.6%. Tax revenues showed positive dynamics, boosted by the robust increase in income tax and VAT. The income tax reached MDL 14.7 billion (+32.2% y-o-y), with the corporate income taxes increase of 45.3% (MDL +2.7 billion) and personal income tax of 16.8% (MDL +0.9 billion). The receipts from VAT, taking into account the VAT refunds, constituted MDL 29.1 billion (50.5% of the overall tax revenues), up by 13.9% (MDL +3.5 billion) relative to 2021, which was determined inclusively by the inflationary effects. Around 80% of the collected VAT comes from imported goods. The revenues collected from excise taxes, taking into account the refunds, amounted to MDL 8.01 billion, recording a growth of 5.3% y-o-y. Roughly 90% of collected excise taxes were generated from imported goods.

**Figure 11. The National Public Budget Deficit developments, planned and achieved (% of GDP)**



Source: Expert-Grup calculations based on the Ministry of Finance data

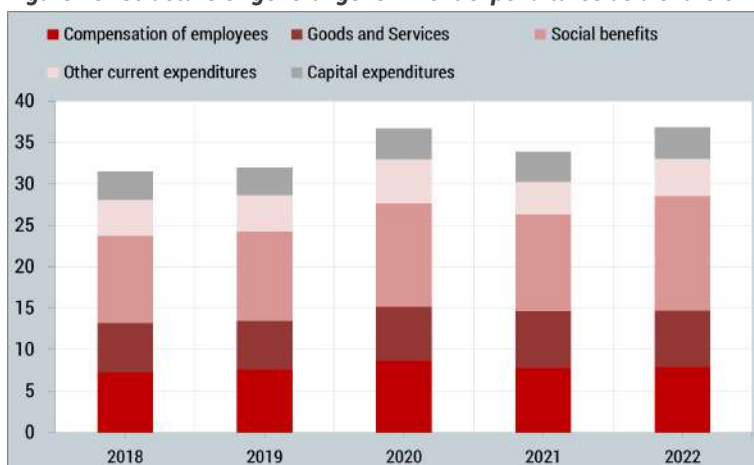
**Figure 12. Comparative analysis of the NPB Balance (% of the NPB overall revenues)**



Source: Expert-Grup calculations based on the Ministry of Finance data

**At the same time, the expenditures for 2022 grew by 22% y-o-y, up to MDL 100.3 billion, jumping from 34% to 37% of GDP.** Almost half of the increase in public expenditures was generated by the social protection spending that grew by +30% or about MDL 9 billion in nominal terms. This evolution was determined, both by the newly adopted measure aiming to support the vulnerable categories of people in the context of rising costs of energy resources (e.g. financing the Energy Vulnerability Reduction Fund, increase the aid for the cold season, etc.), but also as a result of adjustment of pension payments, introduction of new childcare allowance and other. However, despite a considerable effort to cover the necessary current expenses, the government also focused its attention to capital expenses too. During 2022, the general government spend on capital expenditures roughly MDL 10 billion (+20% y-o-y), of which MDL 3.2 billion on capital investments (+47% y-o-y). At the same time, in order to further accelerate the implementation of capital expenditures at the regional and local level, last year was restructured the National Fund for Regional and Local Development that will ensure a clearer framework for planning and financing regional and local development programs.

**Figure 13. Structure of general government expenditures as a share of GDP (%)**

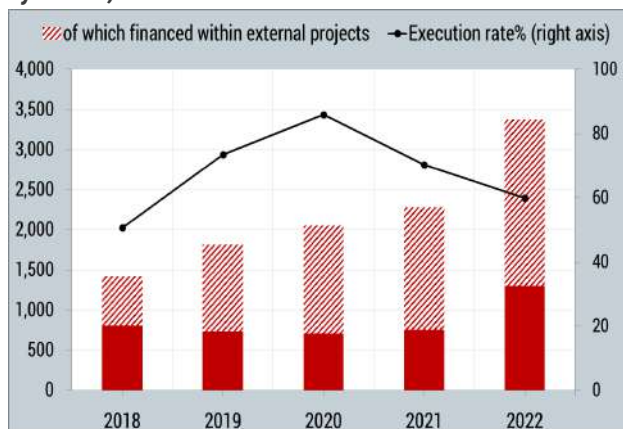


Source: Expert-Grup calculations based on the Ministry of Finance data

**The gap between executed and approved expenditures for capital investment is suggesting implementation issues.** Similar to the previous years, the spending target on capital investment for 2022 was not fully met, being executed only 60% of the planned expenditures. This is explained by the limited capabilities in planning and project management of central authorities, but also the low potential of economic agents to implement large projects, which finally undermines and causes delays in the implementation of scheduled investments. In 2022 more than 60% of expenditures on capital investment were financed within external assistance projects. Thus, as the medium-term budget framework foresees a gradual transition of external financial assistance from budgetary support to specific

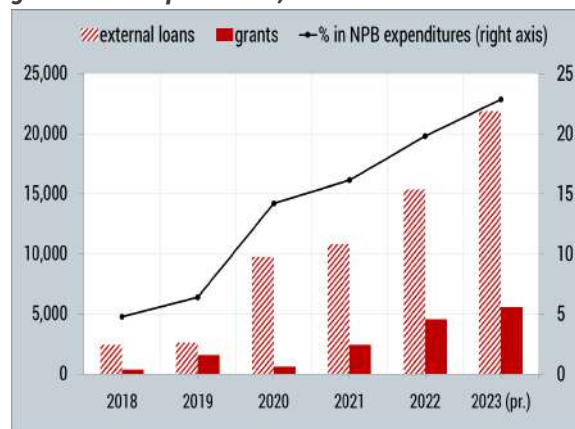
capital investment projects, the need to overcome the current barriers that undermine achieving the spending outcomes becomes imperative.

**Figure 14. General government capital investments in dynamics, million MDL**



Source: Expert-Grup calculations based on the Ministry of Finance data

**Figure 15. External sources of financing general government expenditures, million MDL**

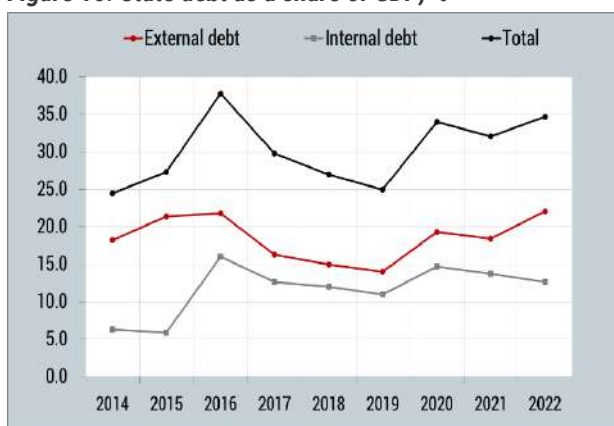


Source: Expert-Grup calculations based on the Ministry of Finance data

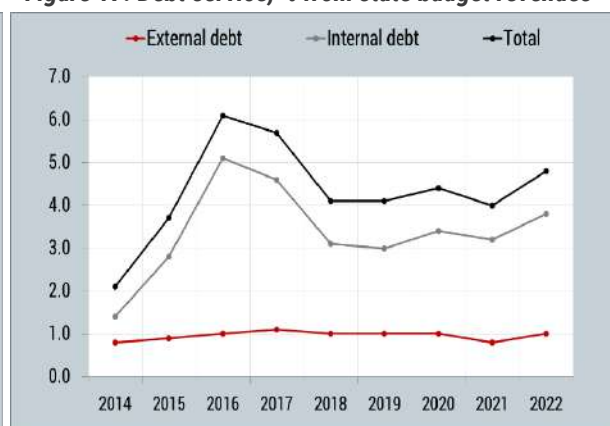
**The Government relies increasingly on external loans and grants to finance public expenditures.** In 2022 the external sources (grants and external loans) covered around 20% of total general government expenditures. Specifically, in 2022 were assimilated MDL 15.3 billion of external loans, of which MDL 8.9 billion went directly for budget support, while MDL 6.4 billion was for financing specific projects. Related to grants, even if initially the external grants have been planned as a more modest source of revenues (1.6%), the actual results show a higher contribution than anticipated. In 2022, the volume of assimilated grants reached MDL 4.5 billion (5% of total revenues), almost double that of 2021. This outcome was obtained due to the solidarity of the external community to the difficult situation Moldova faces and also in the response to the strong commitment government shows to overcome longstanding vulnerabilities and advance on the reform pathway.

**The fiscal pressure generated by the overlapping crises has translated into the need to borrow more in order to address urgent issues.** In 2022 the public debt has increased by 20% y-o-y, reaching MDL 98.5 billion, or 36% of GDP (+2.3 p.p compared to 2021). Public debt is mainly formed by state debt (96%). The Ministry of Finance focused on covering the fiscal deficit by contracting loans mainly from external sources in order to reduce reliance on expensive, short-term domestic financing. As a result, external debt has increased by 25%, reaching an equivalent of MDL 60 billion and representing 63.5% of the total state debt. The internal debt recorded a more modest growth of +3.4%, up to MDL 36 billion. State external debt reported to GDP reached 22.1%, up by 3.7 p.p. compared to 2021, while internal debt as a share of GDP slightly decreased, representing 12.6%.

**Servicing external debt costs less than the internal debt.** In 2022, the service of external state debt (interest payments and fees related to the debt) cost MDL 560 million, representing 1% of state budget revenues, while the cost for internal debt was about MDL 2.1 billion, equaling 3.8% of state budget revenues. Servicing internal debt became more expensive considering that the weighted average nominal interest rate on state securities traded in 2022 was 17.8%, increasing by 12.1 p.p. compared to 2021. Nevertheless, the overall state debt service-to-income ratio remains within sustainable limits, constituting 4.8%, below the ceiling of 10.0% established in the Program of Mid-Term Management the State Debt for 2023-2025, and respectively currently it does not produce additional risks on the macroeconomic stability of the country.

**Figure 16. State debt as a share of GDP, %**

Source: Expert-Grup calculations based on the Ministry of Finance data

**Figure 17. Debt service, % from state budget revenues**

Source: Expert-Grup calculations based on the Ministry of Finance data

## Forecasts and challenges

**Maintaining fiscal sustainability will be challenged by the regional context that continues to fuel uncertainty.** In order to realize the important social and economic priorities committed by the government, for 2023 was approved a NPB deficit of MDL 18.3 billion or about 6% of the GDP. According to the State Budget Law, the authorities plan to continue measures aiming at increasing allocations for existing social assistance programs, supporting the development of SMEs, investment in transport infrastructure and gradually increasing public sector wages to mitigate the purchasing power erosion and to attract and retain qualified staff. The deficit is to be financed both from external grants and concessional loans and domestic borrowing. Specifically, it is estimated that MDL 21 billion in foreign loans will be disbursed, of which around two-thirds will be designated for budgetary support, while the rest will be channeled for the implementation of concrete projects. At the same time, it is estimated that the budget revenues will be supplemented by external grants, which are expected to amount to MDL 5.5 billion. Also, as the cost of domestic borrowing is decreasing, the issue of governing bonds will tend to resurge. In addition, to make the government securities market more attractive for retail investors, a trading platform is planned to be launched by the end of the year.

**The fiscal policy for 2023 does not foresee additional fiscal burden, on contrary, it came with some measures favourable for the business environment.** Thus, aiming to support SMEs' liquidity and stimulate private investments was decided to apply a zero rate on undistributed income (subject to a sunset clause). At the same time, starting from January 2023 the VAT accumulated in the account can be refunded, when the VAT paid by companies on the procurement of raw materials, fixed assets, etc., exceeds the VAT collected on sales. For strengthening fiscal discipline, the government is committed to improving tax and customs administration in order to boost revenue mobilization, reduce the shadow economy, while reducing, at the same time, the interaction between the taxpayer and the tax official. For this, according to the new structural benchmarks agreed upon with the IMF, the government committed to introducing, by the end of September 2023, in the Tax Code a general anti-avoidance rule provision to counter tax evasion and abusive tax practices. Also, an automated tax filing compliance program is to be introduced.

**Over the medium term, the deficit is forecast to moderate gradually but will remain well above the 2.5% of GDP ceiling.** In 2023, the NPB overall expenditure are expected to rise by 18% y-o-y in nominal terms compared to the executed volume in 2022, while the revenues by 10%. We forecast that the budget execution will result in a deficit of 5% of GDP in 2023, while in 2024 it will narrow to 4% of GDP. Considering the forecasted GDP growth, the public debt to GDP will stay around 33%. Overall, the mid-term budgetary framework shows that in the expenditure structure, the social protection share will slightly consolidate, increasing to around 41% of the total general government expenditures by 2025 (38% in 2022). At the same time, in the context of the security crisis, national defence spending will be strengthened. The fiscal space for the next years remains limited, with the funding available for new policy initiatives and new public investment projects for the period 2024-2025 being estimated at around 1.5% of GDP. Thus with limited flexibility, the focus will be on reprioritizing expenditures, and transitioning from emergency measures



to boosting public investment, while ensuring a sustainable medium-term trajectory for wage and pension spending. Securing additional grants and concessional financing from donors will remain an important task for the government in order to cover financing needs. The candidate status for the EU granted to Moldova in 2022, and the accession negotiations planned to start this year will be a strong sign of EU support for the ongoing reforms, catalysing more international financial assistance in the upcoming years.

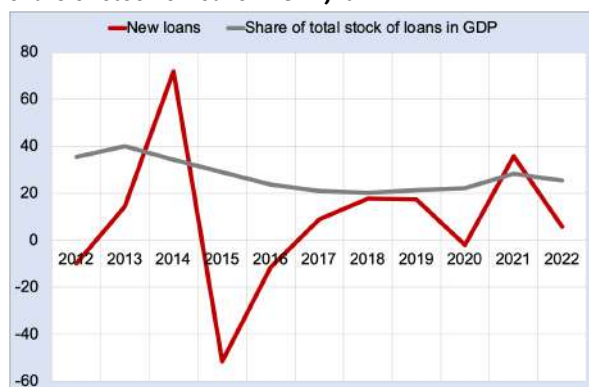
## Financial Institutions

This chapter outlines the evolution of the banking sector through the unprecedented mix of crises of 2022 and provides forecasts for 2023-2024. The analysis covers the financial situation of banks, the impact of the war in Ukraine, the effects of the restrictive monetary policy of 2022, as well as the evolution of lending and deposits during the crisis of 2022 and the expected dynamics for 2023-2024.

### Long-term trends

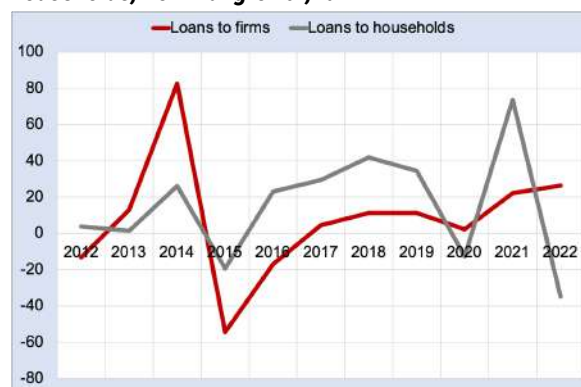
**The banking sector of Moldova follows a prudent/conservative lending policy, taking into account the high volatility of the macroeconomic and policy environment.** After the banking crisis of 2015, the regulatory supervision was tightened, which allowed for a relative stabilization of credit growth around 10%-20%, except for the shocks of 2020 (Covid pandemics, coupled with severe drought) and 2022 (stagflation and security crisis in the region). Overall, given the high volatility of the macroeconomic and policy context, the Moldovan banks have always had a rather limited appetite for risk (except the abnormal increase in lending in 2014 that were frauds leading to the banking crisis in 2015), the lending policies oscillating around tight collateral requirements and high reluctance to lend to firms and households without or with improper credit history. As a result, the bank credit did not expand over the last years. In fact, it constantly declined from 35.4% in 2012 to 20.1% in 2018, before marking a modest trend reversal during 2019-2022, when it recovered to 28.2% in 2021, but in 2022 it dropped to 25.5% because of the recession. Over the last years, the loans to households grew at higher pace compared to firms, except for the crises of 2020 and 2022 when the volumes of new loans to households decreased, while the loans to firms remained on a positive growth.

**Figure 18. Evolution of new loans (nominal growth) and share of stock of loans in GDP, %**



Source: Expert-Grup calculations based on NBM data

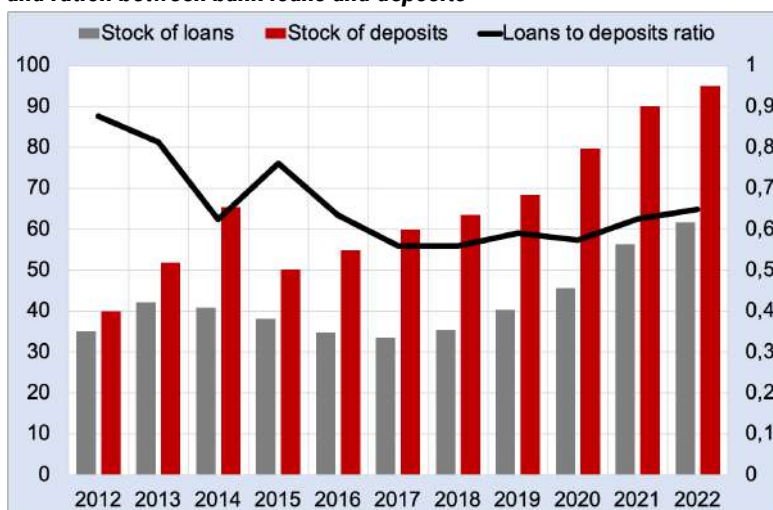
**Figure 19. Evolution of new loans to firms and households, nominal growth, %**



Source: Expert-Grup calculations based on NBM data

**The traditional conservative approach of Moldovan banks regarding their lending policy is also reflected in the low capital leverage and high liquidity indicators.** Over the last years, the stock of loans and deposits constantly increased (except for the banking crisis of 2015), building up resiliency of the banking sector. Moreover, the stock of deposits grew faster, revealing the increased trust in the banking sector among the population and businesses. During 2012-2022, the stock of loans expanded about twice (from 35 billion MDL to 61.6 billion MDL), while the stock of deposits increased almost 2.5 times, from 40 billion MDL to 95 billion MDL. Thus, the ratio between loans and deposits decreased from 0.88 in 2012 to 0.65 in 2022, pointing, on the one hand on low credit penetration, and, on the other hand, on high liquidity and, hence, resiliency of the Moldovan banking system.

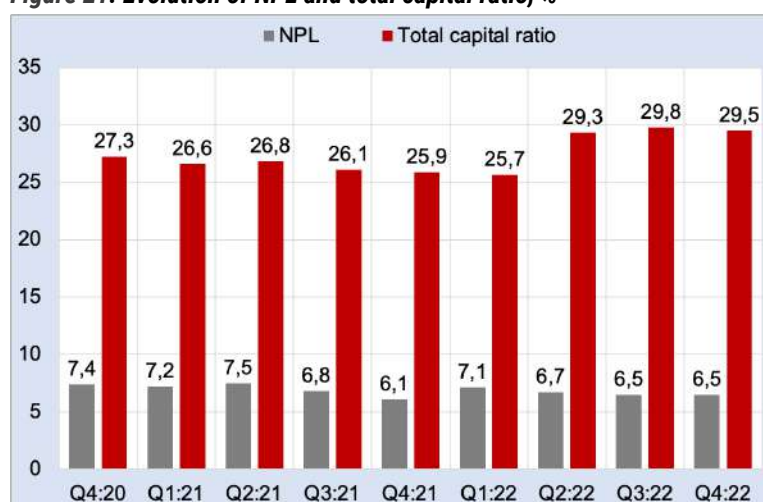
**Figure 20. Evolution of stock of bank loans and deposits (billion MDL) and ration between bank loans and deposits**



Source: Expert-Grup calculations based on NBM data

## Recent trends

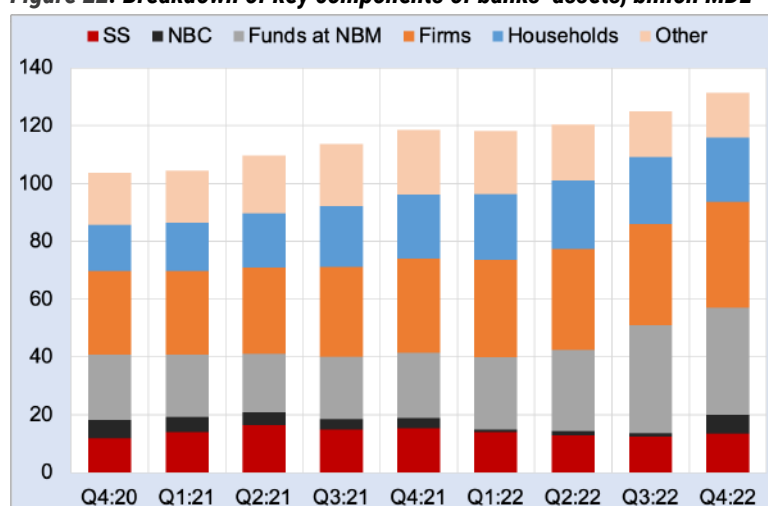
**The banking sector proved to be robust to the shocks of 2022, emerging more resilient from the crisis, with improved liquidity and capital adequacy indicators.** The credit risk, which significantly increased in 2022 given the economic recession (-5.9% drop in GDP), inflation (average CPI of 28.7%) and increased uncertainty around the war in Ukraine, has been adequately managed by banks. The share of non-performing loans (NPL) in total loans' portfolios of banks slightly increased, by 0.3 p.p. compared to 2021, reaching the level of 6.4% at the end of 2022 (still, immediately after the war started, the share of NPL rose a bit more rapidly: from 6.1% at the end of 2022 to 7.1% in Q1:22, which gradually shrank throughout 2022). Nevertheless, the overall share of NPL remained relatively low (lower compared to the pre-pandemic period), suggesting an adequate quality of the banks' loan portfolios. This is reinforced by comfortable liquidity and capital adequacy indicators, which, despite the shocks, remained at comfortable levels. Thus, the leverage ratio (the ratio between bank debts and capital) decreased from 5.1 in 2021 to 4.64 in 2022, suggesting banks' conservative behavior aimed to minimize the exposure to credit risks. Also, all liquidity indicators remained in the safe zone, in a much better situation compared to the regulatory requirements (e.g. long-term liquidity indicator improved from 0.74 in 2021 to 0.67 in 2022, the maximum admissible threshold being 1.0). Also, all regulatory requirements with regard to the own funds were well respected by all banks (e.g. the total ratio of own funds remained well above the minimum threshold of 10%, improving from 25.89% in 2021 to 29.49% in 2022). These indicators suggest that the banking system not only overcame well the crisis of 2022, but emerged even stronger from it, being well-capitalized, with sufficient liquidities, which can support the economic recovery of 2023-2024.

**Figure 21. Evolution of NPL and total capital ratio, %**

Source: NBM

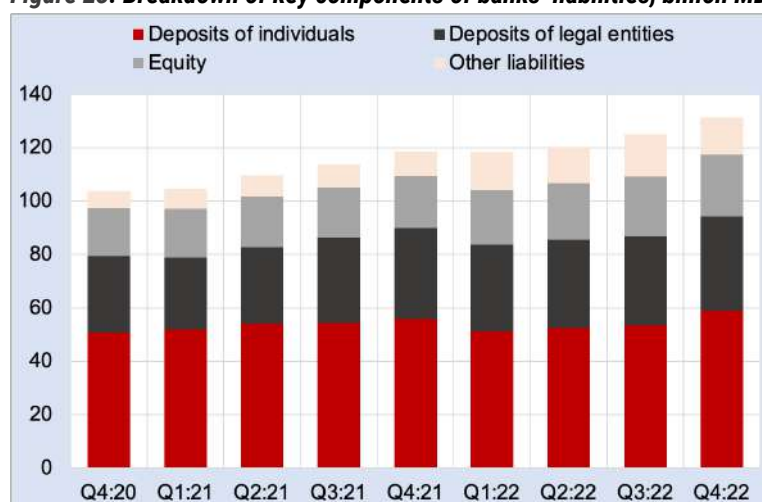
**Total banking assets increased, while the exposure to risks decreased, revealing the NBM efforts to consolidate the macro-financial stability.** During 2022, the total assets of the banking sector increased by 10.9%, while their share in GDP increased from 49.01% in 2021 to 49.69% in 2022. It was primarily caused by the expansion in lending to firms, which traditionally represents the largest share in total banks' assets. Thus, in 2022, new loans to businesses increased by 26.2%, while the total stock of loans expanded by 9.3%, mainly on the account of loans to retail (+14.4%), food industry (+26.6%), real estate/constructions (+7.6%) and financial non-banking sector (+36.9%). At the same time, it was registered a decline in consumer loans issued by banks (-4.5% in stock and -34.9% in new loans, in 2022), revealing the increased reluctance of banks about consumer lending in the context of high inflation and uncertainty, as well as because of enforcement of responsible lending requirements established by the central bank.

**The monetary policy tightening through raising the mandatory reserves rate led to a visible expansion of the share of banks' funds held at NBM, from a share of 22.8% in Q4:21 up to 37.1% in Q4:22, becoming the largest component of banks' assets.** Two other structural evolutions are related to the share of NBM certificates and state securities in total banks' assets. Thus, during the monetary policy tightening of 2022, the shares of both decreased, because banks had less idle liquidities. In the case of state securities, an additional trigger was the position of the Ministry of Finance to not issue additional state securities because of high interest rates after the NBM lifted its policy rate (the state securities were issued only to cover the payment obligations on securities issues before), the budgetary deficit being financed almost entirely based on the international financial support. However, in Q4:22, this tendency started to change, as the share of both NBM certificates and state securities started to increase. It was the result of the monetary policy easing, which had two immediate consequences: (i) it freed up additional liquidities in the banking sector that had to be sterilized through NBM certificates, and (ii) it decreased the costs for contracting domestic debt through state securities, making the Ministry of Finance to resort more to this source of financing budgetary deficit.

**Figure 22. Breakdown of key components of banks' assets, billion MDL**

Source: Expert-Grup calculations based on NBM data

**The improved robustness on the assets' side was mirrored with improvements on the liabilities' side of banks, reinforcing the trust in banks and the stability of the banking system overall.** In 2022, the total stock of deposits expanded by 5.4%, while the new deposits increased by 57.5% (new deposits of firms increased by 73.7% and by 51.5% in case of households). This discrepancy between the slow growth of stock and high growth of new deposits is explained by the fact that many long-term deposits were closed and transferred into short-term new deposits, amid high uncertainty. The main contribution to the expansion of bank deposits had the deposits opened by households, which traditionally account for about two thirds of total deposits and which increased by 5.5% (stock of deposits of firms increased by 3.4%). These evolutions, in parallel with the cautious lending policies of banks amid the difficult economic conditions of 2022, allowed for increasing liquidity indicators and fostering the stability of the banking system (as mentioned above). Another important and encouraging evolution was the increase in the share of the stock of deposits denominated in national currency from 57.4% in 2021 to 60% in 2022. Thus, the stock of deposits in national currency increased 10.3%, while the stock of foreign currency denominated deposits shrank by 1.1%. Last, but not least, the increase in the share of equity capital in total liabilities of the banking sector from 16.4% in Q4:21 to 17.7% in Q4:22 also reveals the consolidation of the resilience and stability of Moldovan banks, which will lay the ground for the economic recovery of 2023-2024.

**Figure 23. Breakdown of key components of banks' liabilities, billion MDL**

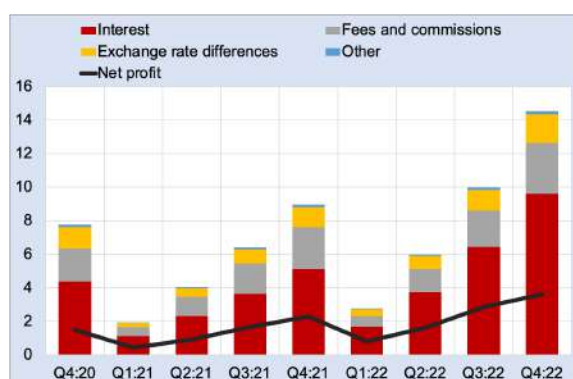
Source: Expert-Grup calculations based on NBM data

**Banks emerged from the crisis of 2022 not just more resilient, but also more profitable.** The structural changes in banks' balance sheets reflected on the evolution of revenues, expenditures and profitability indicators in the banking system. Overall, in 2022, the total revenues of banks increased significantly (+58.6%), mainly due to the increase in

revenues from interests (+88.5%), exchange rate differences (+46.7%) and revenues from fees and commissions (+19.1%). Besides increased revenues, the profitability also increased. The return on assets (ROA) in 2022 was 2.9%, higher by 0.9% compared to the previous year. The return on equity (ROE) also increased, from 12.2% in 2021 to 16.9% in 2022. It was mainly due to the fact that expenditures on interests and fees and commissions increased at a much lower rate, as shown in figure 25.

**The paradox of banks' profitability increasing amid decreasing interest margin is explained by the changing structure of bank deposits and monetary policy tightening.** The figure 26 reveals that the inflation and monetary policy tightening had a visible impact on average interest rates, but interest rates of deposits grew faster. It was due to the fact that the monetary policy tightening implied a strong increase in mandatory reserves rate, which limited the access of banks to idle liquidities, forcing them to put more emphasis on attracting additional deposits. At the same time, the adjustments on loan interest rates were at a lower pace because of regulatory limitations on banks; also, because raising the interest rates too much could fuel the credit risk, amid the difficult economic conditions of 2022. As a result, the interest margin (difference between the average interest rate on bank loans and deposits) significantly shrank. However, it did not undermine the profitability indicators of banks because, while the average interest rate on deposits increased, the share of long-term deposits in total bank deposits, which bear the highest interest rates, decreased (figure 27). Thus, the share of deposits with maturity of more than 1 year decreased from 44.9% in Q4:21 to 36% in Q4:22. It complicated the historical structural issue of maturity mismatch of liquidities of Moldovan banks, because of high uncertainty around the economic and security situation of the country that motivated the owners of deposits to increase their liquidity by switching to shorter-term deposits. Another important factor was the monetary policy tightening that increased the interest rates on state securities and NBM certificates.

**Figure 24. Banks' revenues by main components, billion MDL**



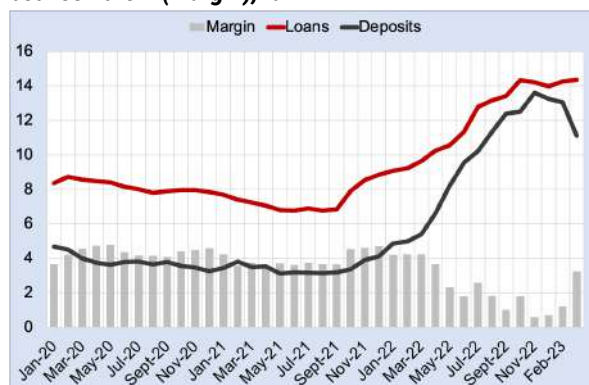
Source: Expert-Grup calculations based on NBM data

**Figure 25. Revenues and expenditures on interests, fees and commissions, and other activities of banks, billion MDL**



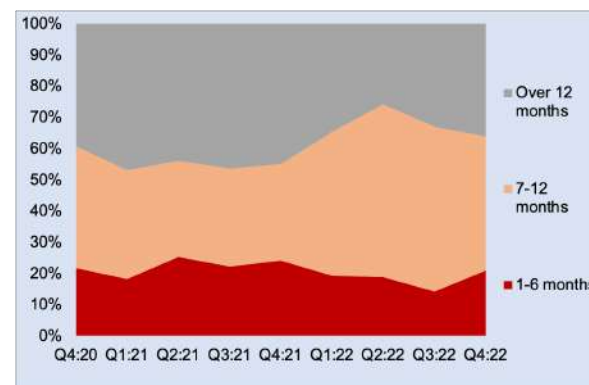
Source: Expert-Grup calculations based on NBM data

**Figure 26. Average interest rate on bank loans and deposits in national currency, and the difference between them (margin), %**



Source: Expert-Grup calculations based on NBM data

**Figure 27. Evolution of the structure of bank deposits by key types of maturities, %**



Source: Expert-Grup calculations based on NBM data

## Forecasts and challenges

**The high liquidity and capitalization of the banking sector, along with monetary policy easing and improving economic and inflationary dynamics will lay the ground for a robust economic recovery in 2023-2024.** Assuming that in 2023 the security situation in the region will marginally stabilize, the inflation will continue decelerating with continued monetary policy easing, the agricultural year will be better than in 2022 and the economic situation in the region will also marginally improve, the banks' balance sheets will continue expanding at a high pace. Namely, the volume of new loans is forecasted to increase by 28% and 18% in 2023 and 2024 respectively. The growth rate will be much higher in the case of consumer loans (+51% and +21% for 2023-2024) compared to firms (+22% and 17% for 2023-2024), especially taking into account the low comparison basis: in 2022, the volume of new loans to population decreased by 35%, while in the case of firms they grew by 26%. As a result, the total stock of loans will expand by +24% in 2023 and 14% in 2024, which will stabilize around 13%-14% during 2025-2027.

**Economic recovery forecasted for 2023-2024, along with prudent monetary policy and robust credit growth, will turn into a rapid growth in bank deposits.** One of the key objectives of the central bank for this period is to ensure that the banking system remains abundant in liquidities in order to build up resiliency for other potential shocks. It means that, most likely, the mandatory reserves rate will not be cut at the same pace with the policy rate. This fact, coupled with the expected rapid revival in lending, will make banks focused on deposit attraction. Thus, for 2023-2024, the new deposits are forecasted to grow by 30% and 14%, before stabilizing at 17-18% during 2025-2027. Deposits opened by the population will have the biggest contribution to this growth (+35% and +14% in 2023-2024), while deposits of firms will grow at a bit lower pace (+20% and +14% in 2023-2024). The total stock of deposits will grow by 30% in 2023 and 14% in 2024, and will stabilize at around 16%-17% during 2025-2027.

**The forecast is sensitive to two main risks: lower-than-expected economic recovery and additional inflationary pressures.** Any shock that could undermine the economic growth could inflate credit risk, cool down the demand for loans and cut banks' appetite for risk, which will negatively reflect on the dynamics of deposits and loans. Also, a potential cost-push inflationary shock, with consequent adaptation of the monetary policy could reverse the downward dynamics of interest rates, undermining the expansion of loans' portfolios.

## Prices and Monetary Policy

*This chapter analyses the inflationary dynamics, its implications, as well as the adequacy and timeliness of the monetary policy reactions of the central bank. It discusses the main driving factors of inflationary trends during 2022-2023 and their decomposition by key elements. Also, the chapter provides the forecast for the short and medium-term perspective, key risks and challenges, as well as the expected monetary policy stance for this period of time.*

### Long-term trends

**Over the last years, the central bank of Moldova follows an adequate inflation targeting regime, managing to anchor the long-term inflation dynamics around its policy target of 5% (+/- 1.5 p.p.).** If we exclude two major inflation shocks from the last 10 years that were outside the control of the monetary policy (the banking crisis that resulted in the depreciation of the national currency in 2015 and the stagflation induced by cost-push factors in 2022), the average Consumer Price Index is 4.9%. It is the direct result of the inflation targeting strategy of the NBM that anchors the monetary policy objectives around the inflation target of 5% (+/- 1.5 p.p.). Because the inflation dynamics over the last years was marked by a large spectrum of factors (e.g. currency depreciation in 2015, draughts in 2012, 2015, 2020 and 2022, Covid pandemics in 2020, energy crisis and global inflation in 2022), there is no clear policy rule. Usually, the monetary policy rate tends to be higher than the annual CPI in order to contain inflationary pressures and anchor the inflationary expectations more effectively given the slow pass through of monetary policy decisions on the economy. However, during difficult economic conditions, with limited demand-side inflationary pressures, the monetary policy tends to be lower than annual CPI, in order to contain the economic shocks and their implications on the macro-financial stability. This was clearly visible during 2022, when despite the strong increase in inflation (+28.7% average CPI), the monetary policy rate remained negative in real terms, because of the prevalence of cost-push inflationary factors and the focus of the NBM to mitigate the second-round effects of cost-push inflationary shocks.

**Figure 28. Evolution of the monetary policy rate and average CPI, %**



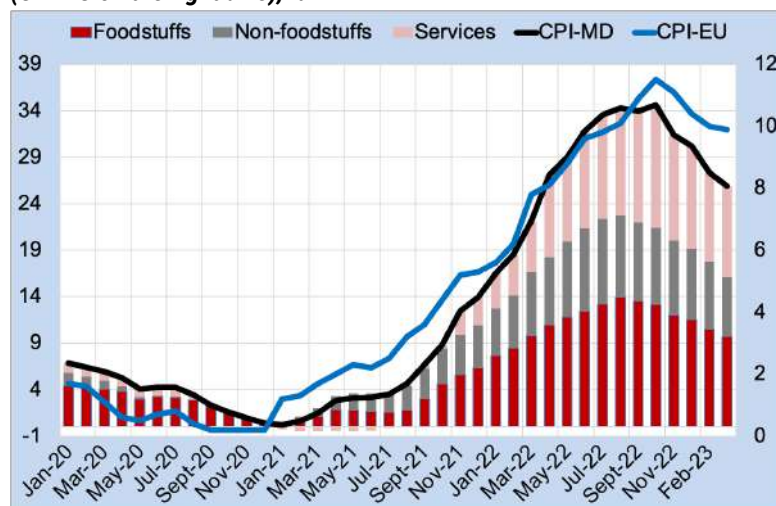
Source: NBM

### Recent trends

**The rapid growth in inflation during 2022 was primarily driven by cost-push external shock factors that were temporary in nature: drought of 2022, adjustment of energy tariffs and imported inflation.** The 2022 was a year with one of the most rapid inflation growths in the history of Moldova, with CPI reaching the maximum of 35% in Oct-22. It was driven by a mix of domestic and external factors. At the domestic level, the drought of 2022 shrank the supply

of agrifood driving up the domestic consumer prices, coupled with a strong increase in lending before the war in Ukraine along with strong inflationary expectations that also pushed the CPI up. Still, the strongest inflationary factors came from abroad. Namely, from three major shocks: (i) the war in Ukraine increased the import prices for many products because of higher logistics costs (e.g. the prices of agricultural fertilizers that Moldova was importing from Russia); (ii) the energy crisis that drove up the global prices for all types of energy, Moldova being extremely vulnerable because of its limited domestic generation capacities and almost full dependence on imports of energy; (iii) global inflation, driven by the shocks mentioned above along with the inflationary effect of the post-pandemic stimulative monetary policies promoted at the global level (e.g. the Harmonized CPI (y-o-y growth) in the EU increased constantly from only 1.2% in Jan-21 up to 10.4% in Dec-22 and 9.9% in Feb-23). The fact that CPI from Moldova correlated almost perfectly with CPI from the EU (figure 29), as well as the visible increase in the contribution of services to CPI (mainly, because of adjustment of tariffs for gas, electricity and heating), confirms the dominance of the external shocks on the inflationary dynamics at the domestic level. At the same time, the relatively even contribution of all key components of CPI point on the strong domestic inflationary factors as well, associated mainly with the increase in the cost of production (industrial production prices index also peaked at 35% (y-o-y growth) in Oct-22) and inflationary expectations. Nevertheless, the inflation growth stabilized and since Oct-22 is rapidly decelerating.

**Figure 29. Consumer Price Index and contribution of its key components (CPI-EU on the right axis), %**



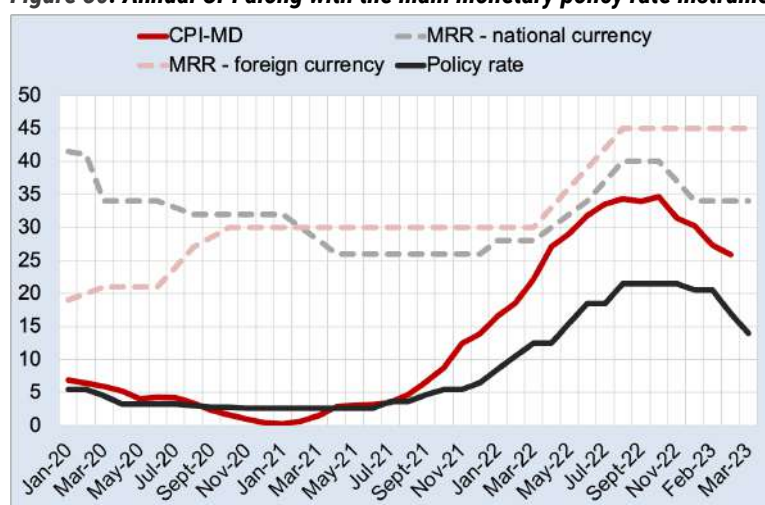
Source: Expert-Grup calculations based on NBM data

**The inflation deceleration is likely to continue during 2023-2024, down to the NBM target of 5%.** On the one hand, this tendency will be driven by the dissipation of effects of cost-push inflationary factors of 2022, along with high a comparison base. Thus, 2023 is likely to be a much better agricultural year compared to 2022, the global prices for natural gas are likely to stabilize and the global inflation also is estimated to decelerate during this period of time. On the other hand, the high uncertainty, mainly around the war in Ukraine and the security situation in the region will induce a rather moderate recovery in demand, meaning that there will not be any major demand-side inflationary pressures during 2023-2024.

**Taking into account the reversal in inflationary dynamics and low demand-side inflationary factors, the central bank started to ease its monetary policy.** During the 2022, given the second-round effects of external inflation shocks (mainly, the inflationary expectations and the second-round effects of energy price hikes), the central bank significantly tightened its monetary policy, both by raising the policy rate from 2.65% at the end of 2020 to 6.5% at the end of 2021 up to the peak of 21.5% in Aug-21. Also, the NBM resorted to another monetary policy instrument with a much stronger and rapid impact – mandatory reserves rate. It increased from 26% for the reserves in national currency and 30% for reserved in foreign currency from the end of 2021 up to the peak of 40% and, respectively, 45% in Aug-2022. The main reasons for this monetary policy tightening were to address the second-round inflationary effects of the cost-push inflation shocks of 2022, by mitigating the raising inflationary expectations, limiting lending

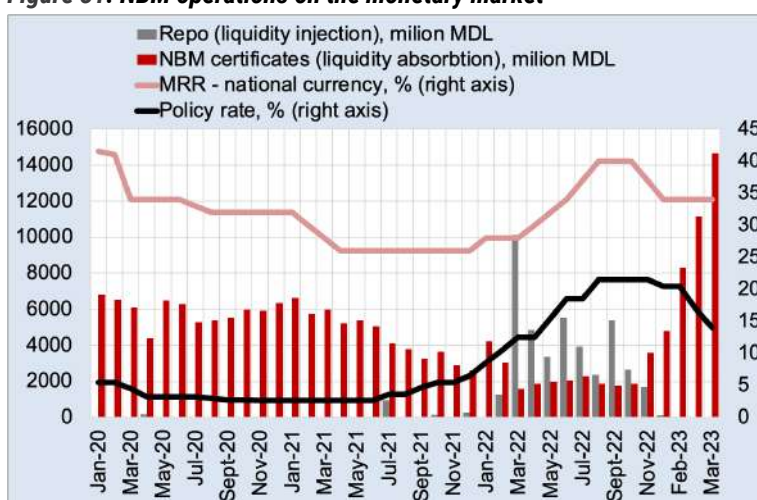
and withdrawing idle liquidity from the banking sector. As long as it became clear that the inflation upward trend reversed, the central bank started to gradually ease the monetary policy. Namely, the policy rate was cut from its peak of 21.5% in Nov-22 to 14% in Mar-23, with the purpose to anchor the inflation expectations and support the consumer demand by stimulating the lending activity. At the same time, the central bank is cutting its mandatory reserves rates more cautiously: the rate for reserves in national currency was cut twice, in Nov-22 from 40% to 37% and in Dec-22 to 34%, while the rate for reserves in foreign currency remained unchanged at 45%. The reason is that, on the one hand, the central bank intends to stimulate lending in national currency, by cutting the mandatory reserves rate in MDL and keeping unchanged the rate in foreign currency; on the other hand, the high level of idle liquidities in the banking sector does not allow the NBM to cut the mandatory reserves rates further. Overall, the central bank promotes a conservative and cautious monetary policy, responding adequately to the inflationary dynamics and the balance of risks, but promoting a more forward-looking monetary policy should be considered in the future.

**Figure 30. Annual CPI along with the main monetary policy rate instruments, %**



Source: NBM

**Given the abundance of idle liquidities in the banking sector, the NBM continues to be a net borrower to banks, aiming at sterilizing the liquidity excess.** The excess liquidity in the banking sector is a structural peculiarity of the Moldovan economy, the NBM being forced to permanently sterilize this monetary mass by issuing central bank certificates. However, during the monetary policy tightening of 2022, the situation temporarily changed. Because of a major increase in the mandatory reserves rates, some banks felt the need to supplement their liquidity levels and resorted to Repo operations with NBM through which the central bank injected liquidities in the banking sector. This phenomenon became evident especially in Mar-22, as a result of the bank run after the Russian military invasion in Ukraine, when the central bank pumped over 10 billion MDL in order to stabilize the market. While the psychological factor of the war was contained relatively fast, the need for other liquidity injections, although at lower scales, appeared in the coming months as a result of NBM tightening the monetary policy by raising the mandatory reserves rates. Thus, during Apr-Dec-23, the central bank injected about 30 billion MDL (besides 10 billion MDL) in the form of Repo operations. These operations were winded down after the mandatory reserves rate for deposits in MDL started to decrease and, thus, more liquidities started to be available on the banks' accounts. Hence, no liquidity infusions were made so far during Q1:23. Despite the liquidity injections during 2022, the central bank continued to sterilize the liquidities by selling NBM certificates. Thus, in 2022, NBM sold about 31 billion MDL of certificates. During Mar-Oct:22, the NBM was in the position of net lender to the banking sector, in order to contain the effects of the war in Ukraine and monetary policy tightening. However, starting from Nov:22 until now, the situation returned to "normal" of NBM being the net borrower in relation to the banking sector. Moreover, since the beginning of 2023, the volumes of liquidity sterilizations increased significantly: during the Q1:23 the volume of sold NBM certificates (34 billion MDL) was comparable to the volume sold during the entire 2022.

**Figure 31. NBM operations on the monetary market**

Source: NBM

**Despite the major shocks of 2022, the central bank managed to maintain a relative stability of the national currency and overall resiliency of the macro-financial situation.** As of Mar-23, the average official exchange rate of the national currency with USD depreciated by only 1.7% compared to Mar-22 and appreciated by 1.4% with EUR. In 2022, in the same month, the volatility of the Moldovan leu was a bit higher, with the depreciation against the USD being of 3.5% and the appreciation against the EUR of 4.3%, because of the effects of the war in Ukraine. Nevertheless, the national currency remained stable despite the multiple shocks and difficult economic conditions. It was possible due to the central bank timely interventions on the domestic currency market. Namely, in order to avoid excessive depreciation of the Moldovan leu during the harshest times of the crisis (e.g. after the war in Ukraine started or when the import prices for energy increased), the NBM sold from its international reserves sufficient foreign currency in order to contain the increased demand for foreign currency and mitigate the pressure on MDL. Thus, during Nov:21 – Mar:22, a period when there was a growing demand for foreign currency because of the major increase in import prices for natural gas and, later, when the war in Ukraine started, NBM sold about USD 760 million from its reserves. However, during the following months, the level of reserves consolidated thanks to the international financial support from development partners. As a result, as of Mar:23, the level of international reserves of the central bank was higher by 35% compared to Mar:22 or by USD 1.2 billion, reaching USD 4.6 billion or equivalent to about 4.8 months of imports of goods and services.

**Figure 32. International reserves and NBM interventions on the currency market, mil. USD**

Source: NBM



## Forecasts and challenges

**2023-2024 will mark a period of “return to normality” of the inflationary dynamics.** The inflation shocks started to dissipate at the end of 2022 and the beginning of 2023, with the annual CPI posting a downward trend. The deceleration of inflation will last throughout the entire 2023-2024 period, on the grounds of a high comparison base, better agricultural year, stabilization of inflationary trends in the region, and limited demand-side inflationary pressures at the domestic level. Hence, assuming that there will not be any major cost-push inflationary shocks, the CPI will continue declining down to 13-14% average for 2023 and 5.5% in 2024.

**The inflationary deceleration will allow the central bank to ease its monetary policy further during 2023-2024.** The objectives of the monetary policy for 2023 will most likely be to support the aggregate demand, by stimulating the revival in lending (primarily in national currency) and, avoiding in this way the other extreme – deflationary pressures. Hence, the NBM will continue cautiously easing its monetary policy, by cutting the policy rate down to 10% by the end of 2023 and to 5% till the end of 2024. Given the abundance of liquidities in the banking sector, the central bank will cut its mandatory reserves rates at a much lower pace, in order to preserve macro-financial stability and avoid a too rapid growth in lending. This will be especially the case of mandatory reserves rate in foreign currency, which could be kept stable (or could be insignificantly cut) in order to stimulate lending in national currency.

**The main risks to the baseline inflationary forecast are stemming from the energy prices.** The forecast is based on the assumption that the Gazprom “gas deal” with Moldovagaz and the Energocom “electricity deal” with Cuciurgan powerplant from the Transnistrian region will remain in place. However, this assumption is exposed to the risk of the unpredictable behavior of Gazprom/Kremlin decision-makers in relation to the Moldovan counterparts, especially amid the current tensed geopolitical situation. In the event of Gazprom cutting its natural gas supplies to Moldovagas, it will immediately undermine the “electricity deal” Cuciurgan powerplant and Energocom. Cuciurgan could start purchasing natural gas from Energocom in exchange for electricity it produces, which will be at much higher prices compared to the status quo (currently, the Transnistrian counterparts are not paying for the Gazprom natural gas, being able to produce electricity at relatively convenient prices that is sold to Energocom). Also, Energocom could increase its purchases of electricity from other sources (e.g. OPCOM) at much higher prices. These events will call for upward adjustment of electricity tariffs for the final consumers in Moldova, directly impacting the CPI through direct and second-round effects. Another cost-push inflationary risk is stemming from the potential increase in global prices for natural gas, especially ahead of the next cold season, as there will be limited supply from Gazprom and the high probability that the next winter could be colder than the previous one. These risks could reverse the deceleration trend of the CPI and the monetary policy easing process forecasted based on the baseline scenario.

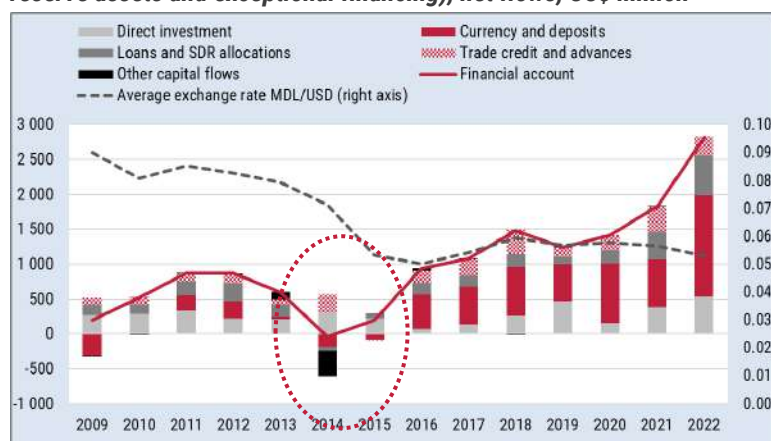
## External Sector

*This chapter provides insights into the dynamics and driving forces of Moldova's external economic activity. It touches upon current account balance and its main components: external trade in goods, services, remittances, investment income and foreign aid. It also shows how the current account deficit is financed and analyses the main cross-border capital flows, including foreign direct investment and debt instruments. Finally, a forecast for the short and medium-term perspective is provided with an outline of major downside and upside risks.*

### Long-term trends

**Historically, Moldova records current account deficits each year, driven solely by the goods balance, while other components (services, primary and secondary income) show surpluses.** Current account deficits are financed by capital inflows, mainly currency and deposits, FDI, external loans, trade credit and, occasionally, by the NBM's interventions from reserve assets. Following the banking crisis of 2014, Moldova experienced an episode of 'sudden stop', after the banking fraud triggered a loss of confidence, causing international organizations and private investors to withhold credit and investment to Moldova (Figure x). Combined with a reduction in exports and remittances associated with low economic growth in partner countries in 2014-2015, the interruption of external financing led to a sharp depreciation of domestic currency. Since then, regulations regarding capital adequacy, reporting and transparency of banks have been improved significantly so that the banking system has become more resilient and accountable. Capital inflows rebounded and reserve assets are record high. However, competitiveness issues persist, putting protracted pressure on the current account.

**Figure 33. BOP financial account in analytic presentation (excluding reserve assets and exceptional financing), net flows, US\$ million**



Source: Calculations by Expert-Grup based on NBM data

Note: The + sign in this presentation means capital inflow.

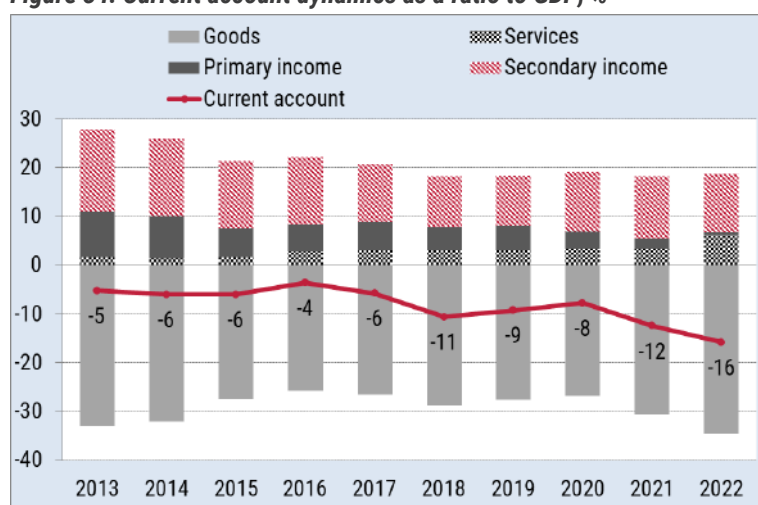
### Recent trends

Despite a significant growth in the exports of goods and services, in 2022 the current account deficit of Moldova's balance of payments reached the highest level in the last decade. Due to the rich crop of oilseeds harvested in 2021 and to the reexport of fuel to Ukraine, Moldova's export of goods recorded a remarkable growth (+44% as against 2021), particularly in the first half of the year. The almost two-fold increase in services surplus (+91%) primarily reflected spillovers from the war in Ukraine: the 77% growth in travel services exports was mainly attributable to refugees admission, while transport services exports (both passenger and freight) went up by 54% as Moldova became a transit area for Ukrainian trade and travelers. The export of computer services also continued to rise at a fast pace (+33%). However, the growth in imports was even larger, despite the contraction of consumption and



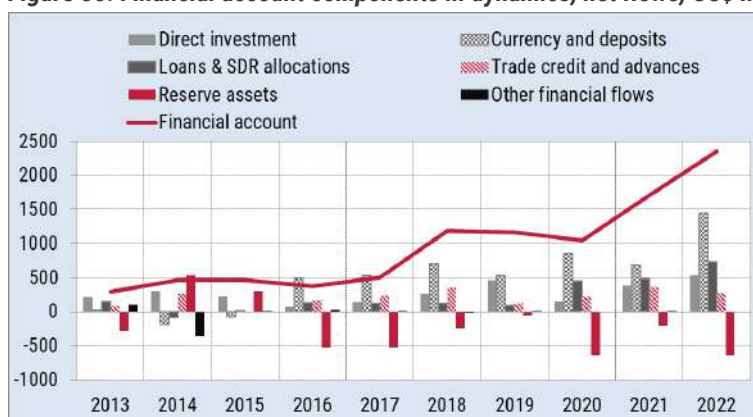
investment, so that the trade balance deteriorated. This was caused by an unfavorable terms of trade dynamics: the growth in the prices for exported goods was slower (+9%, +8%, +14%, +6% in Q1-Q4:22, respectively) than in the prices for imported goods (particularly energy resources): +27%, +18%, +17%, +10%. The amount of grants, humanitarian aid, and technical assistance received from abroad within international cooperation also grew significantly (+61%), reaching US\$ 563 million. However, notwithstanding the large amounts of foreign aid received by Moldova, the contribution of changes in both primary and secondary income to the total change in CAB was negative. On the inflow side, personal remittances received by Moldovan residents from abroad recorded a slight decrease (-4%), while on the outflow side personal remittances paid to non-residents grew by 32% (this may reflect support provided by Moldovan households to relatives in Ukraine, as well as transfers of personal capital abroad at the onset of war in late winter - early spring 2022). Investment income payable to foreign investors also increased by 34% as against 2021. The confluence of these factors gave the largest current account deficit in the last decade, both in absolute terms and as a ratio to GDP (figure 34). The current account deficit in 2022 increased by 34% as against 2021 and amounted to US\$ 2.3 billion or 15.8% to GDP.

**Figure 34. Current account dynamics as a ratio to GDP, %**



Source: Calculations by Expert-Grup based on NBM and NBS data

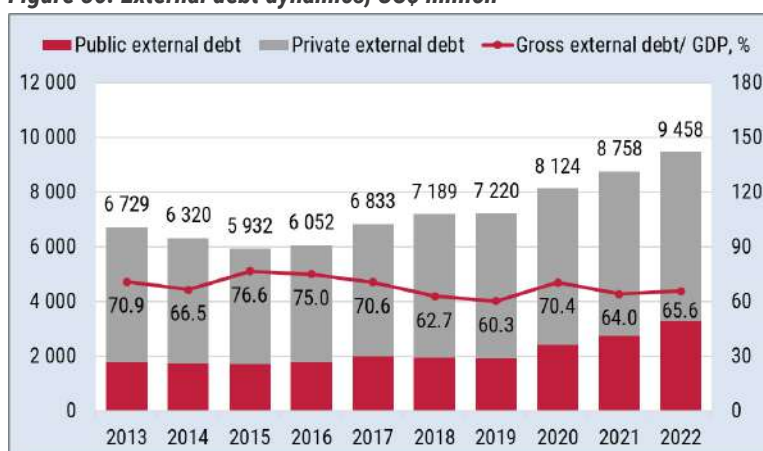
**Fears of a sudden stop and capital flows reversal that arose at the beginning of war in Ukraine did not materialize, thus the financial account of Moldova's BOP recorded a net capital inflow worth US\$ 2.4 billion in 2022, 37% larger as compared to 2021.** Capital inflows came mostly from the net decline in currency and deposits assets of resident non-financial corporations and households (US\$ -959 million), but also from a significant increase in liabilities in the form of deposits of foreign nationals (presumably Russian and Ukrainian) with Moldovan banks (US\$ +69 million) (figure 35). The second major source of financing were loans received from abroad (not including intercompany lending within FDI): US\$ 799 million borrowed by general government (including local public administration), US\$ 167 million – by banks, US\$ 124 million – by other financial corporations, and US\$ 114 million – by non-financial corporations and households. The largest lender to general government in 2022 was the EBRD with US\$ 244 million provided in loans, followed by the World Bank (US\$ 183 million), IMF (US\$ 171 million), French Development Agency (US\$ 79 million), EIB (US\$ 55 million), and other creditors. Despite the risk of FDI withdrawals expected initially, the net FDI inflow to Moldova actually increased and amounted to US\$ 592 million. These mainly consisted of reinvested earnings (US\$ 468 million), particularly on the back of exceptionally large profits made by banks, but new investment in equity was also recorded (US\$ 103 million), while debt to foreign affiliates grew by US\$ 21 million. It should be noted, on the other hand, that direct investment made by Moldovan residents in foreign companies also showed quite a remarkable net growth (US\$ +55 million). Given the above-mentioned large inflows of foreign currency, the NBM's reserve assets increased by US\$ 637 million during the year (recorded as capital outflow in the BOP).

**Figure 35. Financial account components in dynamics, net flows, US\$ million**

Source: Calculations by Expert-Grup based on NBM data

Note: The + sign in this presentation means capital inflow.

**Because of substantial borrowing from non-residents, the gross external debt of Moldova grew by 8% during the year and reached US\$ 9.5 billion at the end of 2022, or 66% as a ratio to GDP** (figure 36). Public sector was the main contributor to the growth in the external debt: during 2022, public external debt went up by 20% (US\$ +533 million) and amounted to US\$ 3.3 billion at year-end, which is 23% to GDP (+3 p.p. as against 2021). Nevertheless, public indebtedness indicators are far below the sustainability ceilings recommended by the IMF and World Bank (55% for the public external debt to GDP ratio). The cost of external borrowing increased somewhat: while in the first half of 2022 the average implicit yearly interest rate on foreign loans was 1.2%, in the second half it reached 1.6%, though still way below domestic rates.

**Figure 36. External debt dynamics, US\$ million**

Source: Calculations by Expert-Grup based on NBM and NBS data

## Forecasts and challenges

**The actual current account deficit in 2022 (16% to GDP) was larger than forecasted (12%) because of the protracted energy crisis with high prices for imported fuels and electricity, and a poorer-than-expected agricultural output that affected exports in the second half of the year.** In 2023, the CAB is projected to mildly improve and reach -14% as a ratio to GDP and then enhance gradually to -9% in 2027, assuming no additional shocks. No major changes are expected for exports and imports in 2023. Although a significant increase in agricultural output is forecasted in 2023 (+30%), this will be a growth from a small base recorded in 2022, and it will contribute to exports mainly in the second half of the year. The outlook for agricultural prices is negative, as the FAO Food Price Index continues to drop, especially for vegetable oil, one of Moldova's major exports. Imports are expected to grow slightly due to the projected recovery of consumption and investment but are unlikely to considerably worsen the CAB. In every



instance, the NBM's reserve assets are enough to suppress the effects of any sharp fluctuation in foreign exchange demand.

***The same downside risks for external sector projections remain as in 2022: a persistent energy prices crisis (particularly in connection with the recent decision taken by OPEC countries to cut oil production) and the contingency of another drop in agricultural output in uncertain climate conditions.*** Should these risks materialize, the CAB can deteriorate, putting pressure on the exchange rate. Additionally, in order to continue alleviating the cost-of-living crisis, the Government will need to rely on more external and domestic borrowing, which can eventually drive the public debt beyond sustainable levels, if repeated for several years.

***On the other hand, upside risks include a strong recovery in trading partners' economic growth and thus in demand for Moldovan exports, and more support from external partners in the form of grants rather than lending.*** Apart from that, the European Union may decide to further increase quotas on agricultural products that can be exported from Moldova duty-free or to cancel the quotas downright. In a longer run, the recently obtained authorization to export poultry meat and eggs to the EU might boost Moldovan exports, provided that constraints related to limited production capacities are overcome. The upcoming signing of the agreement on conformity assessment and acceptance of industrial products with the EU should also contribute to an increase in manufactured goods exports. In terms of financial flows, Moldova's candidate status to accession to the EU will make it a more attractive destination for investment.