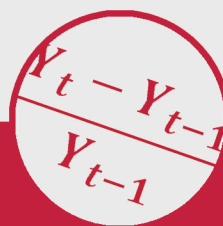
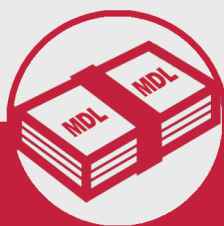


MEGA

First Quarter, 2015. #12



Moldovan Economic Growth Analysis

The year of a looming crisis
Are we well prepared?

Authors:

Adrian Lupușor

Alexandru Fala

Iurie Morcotîlo

Denis Cenușă



Disclaimer

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

About MEGA

*MEGA is the English acronym for **Moldovan Economic Growth Analysis**. MEGA is a bi-annual publication issued by EXPERT-GRUP since 2009 and has the main purpose to explain the fundamentals of the recent economic trends in Moldova, to analyse the economic policies and to come up with strategic solutions for the economic development of the country.*



Content

List of figures	4
List of tables.....	4
Key Policy Messages	5
Forecasts for 2015-2016	8
Executive Summary	9
Chapter 1. Domestic Supply	11
Key trends in domestic supply	11
Forecasts and Challenges	13
Policy Recommendations	14
Chapter 2. Domestic Demand	15
Key trends in Domestic Demand	15
Forecasts and challenges	16
Policy Recommendations	17
Chapter 3. Public Finances.....	18
Key trends in public finances	18
Forecasts and challenges	20
Policy Recommendations	20
Chapter 4. Labour Market.....	22
Key trends in the labour market.....	22
Forecasts and Challenges	24
Policy recommendations.....	24
Chapter 5. Prices and Monetary Policy.....	26
Key trends in prices and monetary policy	26
Forecasts and Challenges	28
Policy recommendations.....	29
Chapter 6. Banking System	30
Key trends in banking sector	30
Challenges and short term forecasts	33
Policy recommendations.....	34
Chapter 7. Foreign Sector	35
Key trends in foreign trade	35
Forecasts and Challenges	37
Policy recommendations.....	38
■ About EXPERT-GRUP	39



List of figures:

Figure 1. Real GDP growth in the region, 2014, %	11
Figure 2. Contribution of main economic activities to GDP, %.....	12
Figure 3. Composite Leading Indicator (ELI) of the Moldovan economy, points	13
Figure 4. Contribution of the main GDP components, expenditure approach, %	15
Figure 5. Different types of trade, average growth per quarter, % y-o-y	16
Figure 6. The dynamics of NBM domestic lending (left axis) and foreign reserves (right axis), million lei	18
Figure 7. Public debt-to-GDP ratio (right axis) and public debt service ratio (left axis)	19
Figure 8. Fiscal adjustment scenarios to reach the current level of public debt	20
Figure 9. Relationship between the employment dynamics and the external migration (% y-o-y).....	22
Figure 10. The evolution of the unemployment rate (%) depending on annual migration inflows	23
Figure 11. Contribution of the main components to the formation of the Consumer Price Index, growth, % yoy.....	26
Figure 12. Nominal and real effective exchange rates of the Moldavian currency (MDL), %	27
Figure 13. Official reserve assets and NBM net purchases of foreign currency (purchases minus sales of foreign currency), USD million	28
Figure 14. Balance of bank deposits, million MDL.....	31
Figure 15. Interest rates on loans and deposits, %.....	31
Figure 16. The total volume of newly granted loans, changes (%yoy) and the effect of loans in MDL and in foreign currency on growth, %	32
Figure 17. The amount calculated for loss in assets and conditional commitments, million MDL	32
Figure 18. Current liquidity (%) and the stock of NBM Certificates (million MDL)	33

List of tables:

Table 1. Forecast of the key macroeconomic indicators	8
Table 2. Public debt disaggregation into main influence factors (% of GDP)	19
Table 3. The relationship between economic growth and the inflow of migrants per year (forecasts).....	24
Table 4. The impact of trade embargoes imposed by the Russian Federation, million USD	35



Key Policy Messages

The 2015 is going to be a difficult economic year, the Gross Domestic Product being expected to decline by about 0.2% according to the baseline scenario and by 1.8% according to the pessimistic scenario. The repercussions of external constraints to economic growth will be amplified by the domestic ones. Particularly, the economic recession in the Russian Federation and Ukraine will cause the reduction in remittances (-7%) and exports of goods and services (-0.5%). Moreover, the level of uncertainty will be fuelled by the high probability of worsening of the security crisis in Ukraine, whereas the maintenance of Russian trade restrictions and the slow recovery of the EU economies will continue putting pressures on the Moldovan economy. External factors will be amplified by domestic constraints. Thus, the worsening situation in the banking sector and the volatility of the national currency - which has increased the level of uncertainty and has eroded the confidence of consumers and enterprises - is bound to reduce lending in lei (-30%), investments (-4%), tax revenues (-3%) and the final consumption (-1.2%). Overall, most economic sectors are going to decline: industry (-2%), construction (-1.5%), domestic trade of goods and services (-0.2%) and transportation (-0.2%). Assuming relatively favorable climate conditions this year, agriculture will maintain its positive trend, although the growth will be much slower than in previous years (+1.5%). Despite this fact, farmers will remain in a difficult economic situation due to lower prices on agricultural products that are subject to trade restrictions imposed by the Russia.

Moldova's economy is approaching a recession mostly unprepared. Although the worsening economic situation could have been predicted timely, public authorities have not taken the appropriate prevention measures. Thus, they have not found a feasible mechanism to compensate for farmers' losses as a result of the Russian trade restrictions, the labour market is not ready for an eventual return of large number of migrants from the Russian Federation and the budget deficit remained at the same level of 1.7%, despite the impressive economic growth of 2013 and 2014. In addition, the relevant institutions (especially the National Bank of Moldova (NBM), the Ministry of Finance and the National Council for Financial Stability) did not react quickly and decisively enough to prevent the emerging crisis in the banking system. Moreover, the NBM played the role of rather a firefighter in alleviating the foreign currency fluctuations and was therefore less effective in preventing them. The passive reaction of authorities occurred despite the fact that major economic and financial shocks could have been foreseen. The banking sector problems, especially those related to Banca de Economii, have been expected at least since 2012, the risk of implementing the Russian restrictions - since 2013, Expert Grup highlighted the risk of maintaining a highly-relaxed monetary policy in 2013, and the Russian and Ukrainian economic downturn risks have been noted since 2014. Therefore, the Republic of Moldova enters the economic crisis with a weakened banking sector, very low population confidence in banks and national currency, a budget deficit that does not leave much room for intervention and a foreign exchange reserves approaching the minimum allowable level. In addition, the lack of a clear Parliamentary back up for the Government feeds the level of uncertainty and undermines the capacity to quickly and efficiently implement structural reforms. All these factors greatly expose the Moldovan economy to external shocks, which is a major risk to the macroeconomic stability of the country.

Tightening monetary policy pose major risks for further worsening of the economic situation. Although the economy is approaching a recession, the NBM is promoting a pro-cyclical monetary policy. It has tightened the monetary policy stance, following its inflation targeting strategy, in order to alleviate inflationary pressures and to stimulate savings in national currency. In this context, it is necessary to review the analytical framework and the main approach to monetary policy decisions. Thus, NBM should target the fundamental causes of the growing inflationary pressures, which, this time, are not related to the increase in demand and household incomes, but are on the contrary related to the worsening economic situation in the country, which has led to national currency depreciation, and upwards price adjustments. Therefore, in order to mitigate inflationary pressures, monetary policy should rather encourage and not inhibit economic activity. It does not imply winding down the inflation targeting strategy, but rather adopting



a broader and long-term vision by NBM: stimulating lending, investments and the economy, amid growing risks of recession, on the one hand will mitigate the pressures on the national currency (the main inflationary factor) and, on the one hand, will help the economy to overcome the crisis faster. In addition, the liquidity problems in the banking system are valid only for banks under special administration of the NBM, the rest of the banks being sufficiently liquid and capitalized. Therefore, in order to channel the liquidity surplus from the banking system, the economy needs to unwind rather than tighten the monetary policy, while the problem of the 3 banks should be resolved through levers other than monetary policy ones.

In the context of the worsening economic situation, the fiscal policy should stimulate and not restrict the entrepreneurial activity. The fiscal and budgetary policies for 2015 clearly aim at hedging fiscal gaps at the expense of taxpayers. In fact, the budgetary deficit problem should be approached by adjusting public spending, which should be better targeted and more transparent. At the same time, it is necessary to extend tax incentives to companies that invest in the modernization of production, implementation of EU standards and create employment, at least for 2015-2016. In general, the approach towards the fiscal policy should be changed drastically: instead of being focused on the collection of taxes at any cost, it should pursue long-term goals such as increasing tax collection based on the stimulation rather than the inhibition of the economic activity.

The crisis in the banking system is, currently, the main threat to the national security of the country, and the way in which the authorities intervened in finding a solution was rather disappointing. The actions of relevant state institutions were limited to warning the administration of the troubled three banks about the risks related to transactions made, as well as to resultless discussions within the National Commission for Financial Security or Security Council. The establishment of a special administration at Banca de Economii, Banca Socială and Unibank, the financial support to these banks or the activity of the parliamentary committee were delayed actions that were able to mitigate only the effects, and not the fundamental causes, of the fraudulent transactions. Although public institutions had the necessary tools, they have not used them at full extend in order to counter the obscure operations. For example, the Law on Financial Institutions expressly provides that the NBM may limit the activity of commercial banks (Article 38, paragraph 1, item f) and may restrict, suspend or prohibit certain transactions or operations (Article 38, paragraph 2, item 3 e) in cases the interests of the depositors are in jeopardy or the bank has engaged in risky or suspicious operations. The presidency and the government could use the platform of the Security Council or the National Commission for Financial Security to elicit the involvement of other institutions, such as the Prosecution or the National Anti-Corruption Center, in order to counter such operations. In its turn, the Prosecution or the National Anti-Corruption Center could take initiative and commence a serious investigation on the suspicious transactions made by the three banks. The Parliament could have had a decisive role, having the ability to reshuffle the inefficient managers of public and legislative institutions and to use the legal tools in combating doubtful transactions.

The main causes that triggered the banking system crisis have not been eliminated. Therefore, there is a risk of experiencing similar shocks in the future. Thus, the issue of shareholders' transparency and weak corporate governance within most banks has not been resolved yet, the responsibility of bank managers has not been fortified, and the activity of the investigating authority regarding the suspicious transactions made by the three banks under special administration is slow and unreliable. Thereby, the appointed people from the respective banks, the central bank, the government and other relevant institutions have not been sanctioned. In addition, the NBM and the National Commission of Financial Markets (NCFM) do not possess sufficient legal guarantees in order to enforce more efficiently the regulations of the banking and non-banking financial systems. Removing these deficiencies should be an immediate priority on the government agenda.

In order to ensure a more effective intervention of the NBM, a substantial strengthening of its independence is required. At the moment, most of the measures adopted by the monetary authority could be suspended as a result of the court's referral, whereas the implementation of the central bank's legal acts is conditioned by the legal expertise of the Ministry of Justice. Therefore, the NBM activity can be easily



blocked by various outer interest groups, which undermines the efficiency of the bank's regulating activity. Thus, it is necessary to strengthen the NBM independence by providing more legal safeguards and eliminating interference levers from other institutions or political forces. Clearly, the strengthening of the NBM independence should be complemented by enhancing its transparency and accountability, as well as by the creation of an external performance monitoring and evaluation mechanism.

The Republic of Moldova needs a consolidated vision on the economic, financial and social security of the country. A fundamental factor of Moldova's high macroeconomic volatility and economic vulnerability to domestic and foreign shocks resides in government's lack of a comprehensive vision about country's security, as well as the lack of tools necessary to anticipate and prevent crises. Therefore, the government, along with the NBM and other relevant institutions, should urgently adopt and implement an action plan focused on strengthening the economic, financial and social security of the country. *The economic security* is related to putting forth a dynamic effort in diversifying the markets, reducing dependency on the Russian market, encouraging directly and indirectly companies which adopt EU standards and invest in international marketing and communication activities, as well as identifying a feasible mechanism for integrating the Transnistrian economy into the DCFTA with EU. A fundamental component of the economic security is the energy security in terms of gas and electricity supply, the latter being more feasible to implement. Another essential aspect of the economic security should also be the reduction of the informal economy by reducing the cost of formal one (improving the business climate) and the substantial increase in costs of informal activity (raising fines, strengthening capacities of the State Tax Service and State Labour Inspectorate). Strengthening the *financial security* is aimed directly at solving the problem of the troubled three banks under special NBM administration, the consolidation of the official reserve assets, strengthening of the NBM and NCFM independence, the increase in transparency and accountability of financial institutions' managers and the improvement of competition within the financial sector. Finally, the *social security* is related to the mitigation of social effects caused by increased prices on basic goods and services, easier integration of unemployed and returned migrants (mainly from the Russian Federation) into the labour market, the pension system reform and the increase in the efficiency of the social assistance policy.

Strengthening of the economic, financial and social security is impossible without a memorandum with the IMF. Given the fact that the Moldovan economy is entering a crisis completely unprepared, from a macroeconomic and political point of view, a new memorandum with the IMF could strengthen the country's immunity to potential negative shocks. The importance of the memorandum is derived from several key considerations: (i) the completion of official reserve assets, in order to enhance the NBM's ability to mitigate the foreign exchange market fluctuations; (ii) unlocking of other funds from development partners, which could boost the supply of foreign currency and stabilize the exchange rate, modernize the infrastructure and increase in labour demand; (iii) technical support for the government and NBM in terms of creating tools that will strengthen the analytical and forecasting capacity, banking regulations, tax administration capacity, and other vulnerable fields of the Moldovan economy; (iv) creation of an external motivation anchor and pressure on Moldovan politicians to implement the necessary reforms needed to repair the financial system, improve the business climate and increase economic competitiveness. However, the government must be very careful in the negotiation process with the IMF, in terms of the conditionalities on a potential memorandum. Namely, they should focus on structural reforms (modernizing tax administration, diminishing the informal economy, improving public and energy sector efficiency), rather than on parametric adjustments that might be painful amid a difficult economic and social context (raising taxes or tariffs on utilities, decreasing wages in the public sector etc.).



Forecasts for 2015-2016

Table 1. Forecast of the key macroeconomic indicators

	2015		2016	
	Scenariu de bază	Scenariu pesimist	Scenariu de bază	Scenariu pesimist
Gross Domestic Product, %	-0,2	-1,8	+3,7	+3,2
Agriculture, VBA, %	+1,6	-3,8	+1,1	+0,1
Industry, VBA, %	-1,6	-2,2	+4,0	+3,7
Constructions, VBA, %	-1,3	-1,7	+2,4	+2,3
Domestic trade with goods and services, VBA, %	-0,2	-0,8	+3,1	+3,0
Transportation, VBA, %	-0,2	-1,6	+3,6	+3,4
Net taxes, %	-0,3	-1,5	+4,7	+4,0
Final consumption, %	-1,2	-1,3	+3,0	+2,7
Gross capital formation, %	-1,0	-6,7	+2,2	+1,2
Exports of goods and services, %	-0,5	-2,5	+3,5	+2,7
Imports of goods and services, %	-2,8	-3,1	+1,7	+1,6
Remittances, %	-7,0	-10,0	+1,0	+0,6
Foreign Direct Investments, %	-0,7	-0,7	+1,7	+1,7
Bank loans în MDL, %	-30,0	-34,0	+13	+10
Fiscal revenues, %	-3,0	-4,7	+2,7	+2,0
Real wages, %	+1,3	+0,2	+3,4	+2,5
Consumer Price Index, %	+9,0%	+12,0%	+6,5%	+7,5%

Note: GVA – Gross Value Added

Source: EXPERT-GRUP estimates and forecast;



Executive Summary

Domestic Supply. In 2014, the economy of the Republic of Moldova recorded a surprisingly high growth rate, being one of the highest from the region. Agriculture, industry and domestic trade were the main sectors, which contributed to the economic growth in 2014. The production in the agricultural sector exceeded all expectations, a considerable growth being recorded as a result of a favorable climate conditions. However, Russian trade restrictions contributed to the decrease of average prices for fruits, grapes and bovine meat, affecting the financial situation of many farmers. On the other hand, some industrial branches benefited of the opportunity to access cheaper raw materials for agricultural and food products, this being reflected in the dynamics of the industrial production price index. At the same time, the industrial output increased, especially due to branches, which are mainly oriented towards the EU market: textiles and electrical equipment manufacturing. The growth in domestic trade was determined by retail trade and it was a reflection of the inflation expectations amid the depreciation of the national currency. In the last months of 2014 there were recorded both a noticeable deceleration in wholesale trade and services delivered to people. For 2015, GDP is anticipated to remain almost unchanged and with a slight downward trend (-0.2%). Nevertheless, there is a high probability of a more pessimistic scenario according to which the economy will decline by 1.8%. In order to face these challenges, the authorities should increase the economic security of the country, properly adjust fiscal and monetary policies and explore to a larger extent the opportunities offered by the Deep and Comprehensive Free Trade Area with the EU.

Domestic demand. In 2014, a structural change in the components of economic growth occurred: if in the first half of the year the growth was based on exports, in the second half of the year the main components were the private consumption and public investment. However, the growth of private consumption of 2014 was a temporary one and it is going to be compromised in 2015 because of decreasing remittances and increasing uncertainty among consumers and companies. Moreover, the growth of the investment activity in 2014 is also temporary since it has been determined exclusively by state financed infrastructural projects, which may be affected by the austerity of fiscal and budgetary policies in 2015. The problem of economic growth in 2015 is that the factors that generated growth in 2014, most likely, will not be relevant anymore: both the consumption and the investment are expected to decrease due to worsening expectations among people and due to monetary and budgetary constraints. In the short term, the authorities should find appropriate policy tools to stimulate private consumption, while in the long-term comprehensive reforms are needed to stimulate exports and investment.

Public Finances. The macro-financial and budgetary framework worsened significantly in 2015 because of the banking crisis and in consequence of parliamentary elections of 2014. Thus, the populist decisions on amending the budget in 2014 led to increased expenditures in 2015 and along with tax collection slowdown resulted into a growth of budget deficit up to the forecasted level of 3.8% of GDP in 2015. At the same time, the electoral factor influenced at a big extent the timing of the state budget law elaboration, which was approved with a half a year delay. Another disruptive factor for the quality of public finance was the banking crisis, which most likely can lead to further increase of budget deficit and public debt. This is due to the possible conversion of loans offered by NBM to troubled commercial banks into a state debt. These actions might challenge the balance of the macro-financial framework amid a deficit growth of about 10% and public debt growth up to about 42% of GDP, while the consequences will be felt in the long run.

Labour market. The economic growth in the last 2 years positively influenced the main labour market indicators. Yet, the decelerating growth rates registered by the end of 2014 have reversed these trends. At the same time, labour market performance that reached in 2014 the minimum unemployment rate of 3.9% is explained mainly by labour migration. Geopolitical tension and the economic recession in the Russian Federation, a country that has received two thirds of Moldovan work migrants, increased the probability of substantial return of our co-nationals to Moldova. The labour market is also unable to absorb the returnees, although in the last years there has been a real increase in employment in the national economy. Therefore,



it is extremely important to continue the reforms for the improvement of market flexibility and to stimulate private sector demand for labour.

Prices and Monetary Policy. After a long period of stability, the inflationary pressures again challenged seriously the National Bank of Moldova. Thus, currency depreciation in late 2014 and early 2015 fuelled strong inflationary pressures. Hence, 2015 is likely to be a year of stagflation: rising inflationary pressures amid economic recession. Following its inflation targeting strategy, NBM had to tighten the monetary policy. In the context of anticipated economic recession for 2015, it turns up a classic contradiction between the monetary policy objective on price stability and the economic policy objective on increasing the Gross Domestic Product. Solving this contradiction requires an effective visionary and anticipatory approach, both from NBM and the Government. The main challenge of the current year for NBM is not related only to increasing inflationary pressures (that are fuelled by supply side and not demand side factors), but also to the context of anticipated economic recession, decreasing public confidence in the currency and banking system and decreasing international reserves to the minimum level allowable. Therefore, it is necessary to unwind monetary policy to 10% throughout 2015 - a level that is considered optimal between the objective of price stability and the one based on the stimulation of economic activity.

The banking sector is passing through a difficult period. As a result of a series of suspicious transactions which resulted in the disappearance of a large amount of capital from the system, NBM has established a special administration regime on three troubled banks: Banca de Economii, Banca Sociala and Unibank. Furthermore, in the context of economic uncertainty and monetary policy tightening, lending activity has decreased. In addition, the worsening of economic situation and national currency depreciation undermined the quality of bank assets. In the current situation, the uncertain economic outlook and national currency instability pose risks to the banking sector development in 2015. The identification of a solution regarding those three problematic banks placed under special administration should be a top priority. However, the task is difficult since it is caused by the complexity of the problems, which reside both in the financial and social aspects. Therefore, the banking sector will have a negative influence on the development of national economy in 2015.

Foreign trade. The reorientation of the Moldovan economy towards the EU market continued in 2014 as well. Thus, in spite of the decrease of total exports by 3.7%, those oriented towards the EU market increased by 9.6% and represented 53.3% of the total exports. At the same time, because of Russian trade restrictions the Moldovan exports to this country decreased by 32.9%. Despite the constraints imposed by the Russian side, embargoes on Moldovan exports were not taken over by other countries from the Customs Union – Belarus and Kazakhstan. On the contrary, the supplies to CIS countries increased (by 49.1% and 15.4% accordingly). In addition to the indispensable need for depoliticizing trade relations with the Russian Federation in order to unlock exports, it is extremely important to explore more actively the opportunities of the liberalized trade regime with the EU. Thus, the authorities must focus on the following priorities: 1) the fulfilment of European sanitary and phyto-sanitary requirements, including the acceleration of the dialogue with DG SANCO, in order to obtain access of animal products to the EU market; 2) competitiveness development among local producers and exporters by implementing European and international quality standards, empowering entrepreneurs in promoting local products and connecting them to EU supply chains; 3) strengthening institutional and monitoring capacity of the quality infrastructure institutions (standardization, metrology and accreditation ones).

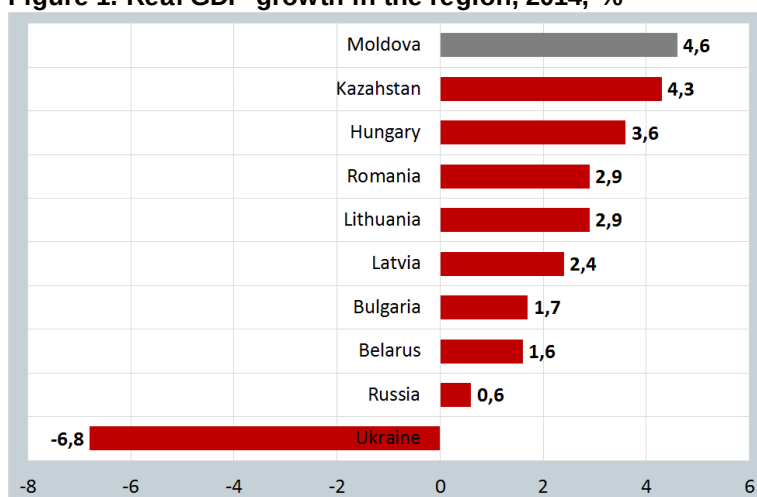
Chapter 1. Domestic Supply

Although the economic growth in 2014 was surprisingly high, the year 2015 comes with several challenges and risks that could drag Moldova into an economic recession. The main pressures are of external origin: worsening of economic conditions in Ukraine and Russia, maintenance and even extension of the Russian trade restrictions and aggravating security crisis in Ukraine. The public authorities proved to be unprepared to effectively face these economic shocks, which have caught the country in a context of fragile fiscal position, inefficient public sector, minority government and foreign exchange reserves pushed to the limit. In addition, the decapitalisation of three troubled banks created vulnerabilities in the banking system, amplifying the domestic effect of foreign shocks. To face these challenges, the authorities should enhance the economic security of the country, properly adjust fiscal and monetary policies and explore the opportunities offered by the Deep and Comprehensive Free Trade Area with the EU.

Key trends in domestic supply

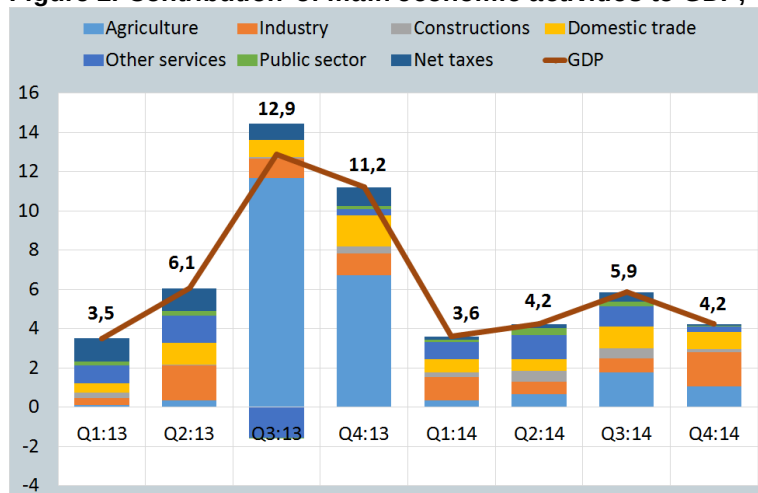
In 2014, the economic growth of the Republic of Moldova was surprisingly high, one of the most significant in the region. According to preliminary estimates, the real growth of the Gross Domestic Product in 2014 was +4.6%. Although this level is almost two times lower than the one recorded in 2013 (+9.4%), the performance has substantially exceeded the expectations of the expert community and of some international organizations. The growth rate proved to be higher compared to neighbouring countries (Figure 1) and it happened in the context of a difficult domestic political climate, an uncertain economic situation in the country and in the region, security turbulence in Ukraine, difficult economic situation in Ukraine, Russia and EU, and trade restrictions imposed by the Russian Federation on the most important agricultural products imported from Moldova.

Figure 1. Real GDP growth in the region, 2014, %



Source: National Statistical Offices of the countries examined

The main sectors that contributed to the economic growth in 2014 were the agriculture, industry and domestic trade. If in 2013, the robust economic growth was determined 60% by the agricultural production resulted from a favourable agricultural year and low comparison base (in 2012 there was recorded a drought which had reduced the agricultural production by about a quarter), the increase in 2014 was more balanced. Thus, about 60% of the 4.6% GDP growth was due to three sectors: industry, agriculture and domestic trade (figure 2).

**Figure 2. Contribution of main economic activities to GDP, %**

Source: Authors' calculations based on NBS data

Agricultural sector. In 2014, the agricultural sector has exceeded all expectations: it has recorded an increase of 8.2% in total production, having a high basis of comparison (in 2013, the sector had a spectacular growth of 39.1%). Thanks to a relatively favourable agricultural year, the main contribution to the growth was brought by crop production. The growth was mainly determined by cereals and grain legumes (+8.9%), corn (+7.8%) and soybeans (+70.2%). However, most of farmers could not benefit of the rich harvest due to trade restrictions imposed by the Russian Federation on the most important agricultural products exported by the Republic of Moldova (wine, apples, peaches, pork, canned vegetables etc.). Thus, while the volume of agricultural production increased, farmers' incomes for sold production were affected by Russian trade restrictions. For example, in 2014 the average price for fruit decreased by 24.1%, for grapes - by 10.7% and for bovine meat - by 5.4%. Therefore, the agricultural year 2014 can be considered favourable in terms of climate and at the same time extremely unfavourable from the political point of view.

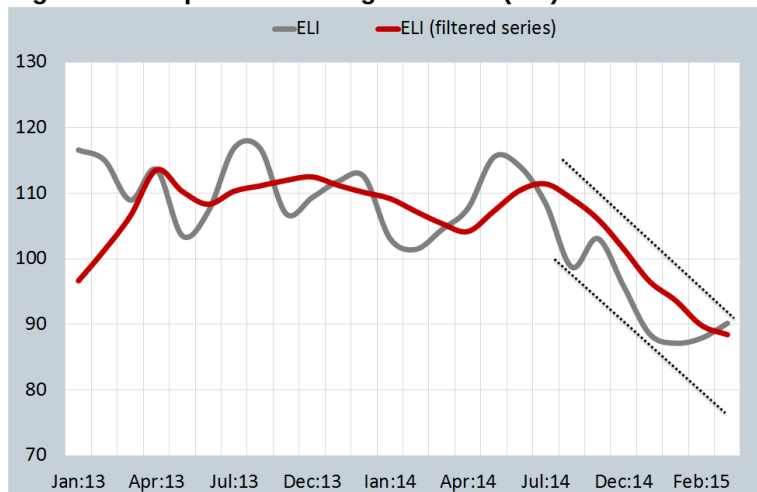
Industrial sector. Apparently, due to Russian trade restrictions, the benefits of the rich agricultural harvest were distributed from farmers to some food industry companies, especially those which do not depend much on the Russian market. Thus, lowering prices for products subject to embargoes has facilitated the access of processing enterprises to cheaper local raw materials, reducing their production costs. For example, if in Feb:15 the industrial production prices index increased on average by 6.2% y-o-y compared to 4.6% increase in Jan:15, the index has decreased by 4.3% for fruits and vegetables in processing and preservation industry. Overall, the volume of industrial production recorded in 2014 a significant growth of 7.3%, the main contributor being the food industry (+12.3%). At the same time, a considerable growth was recorded in the Electrical Equipment Manufacturing sector (+54.3%) and in Textile Manufacturing (+20.4%), both being mainly oriented towards the EU market.

Domestic trade. The Index of physical volume of domestic trade with goods and services recorded a growth of 6.1% in 2014, as a reflection of the important role the household final consumption has played in the economic growth throughout the period examined. This evolution was mainly due to retail, which in 2014 increased on average by 7.5% and in Dec:14 - by 18.4%. However, there is a less optimistic aspect of this development. Thus, the wholesale trade volume has constantly recorded a decline in the second half of 2014: if by Sept:14 the growth rates ranged around 20%, towards the end of this year it fell down to just 2.1%. At the same time, an alarming dynamics was also observed for paid services rendered to the population: the value of which has declined in Dec:14 by 2.2%, although the average growth rate for the whole year was +7.4%. These developments show that the domestic retail trade growth is not a result of increased consumer confidence (which could have been an optimistic sign for the economy), but it is rather a result of inflationary expectations in the context of national currency depreciation that started in the last quarter of 2014.

Forecasts and Challenges

- The year 2015 tends to be much more difficult from an economic point of view compared to 2013 and 2014. The economic growth is continuously slowing down under the pressure of both internal and external factors. The Composite Leading Indicator of the Moldovan economy, calculated monthly by Expert-Grup, has recorded a noticeable decline since Jul:14 (figure 3), which shows less encouraging perspectives for this year.

Figure 3. Composite Leading Indicator (ELI) of the Moldovan economy, points



Source: Authors' calculations

- According to the baseline forecast of Expert Grup, in 2015 the Moldovan economy will enter recession: GDP is supposed to register a slight decline (-0.2%). At the same time, there is a high probability of a more pessimistic scenario, according to which the economy could shrink by about 1.8%. In the context of high openness of the Moldovan economy and its low immunity to negative shocks, the main pressure will stem from external factors: worsening economic situation in Ukraine and Russia, aggravating security instability in Ukraine, the maintenance or even extension of Russian trade restrictions, depreciation of the Russian ruble and of the Ukrainian hryvnia. Additionally, domestic constraints will remain relevant: vulnerabilities in the banking system, political uncertainty due to the minority Government, tightening of the monetary policy in the context of inflationary pressures along with tightening of the budgetary policy amid a very fragile fiscal position.
- The Gross Value Added in the industrial sector is expected to record a decline of about -1.6% amid the slump in exports. The construction sector will fall by -1.3% due to diminished loans and household income as well as due to negative expectations of companies and households. The fall of international trade will also affect the transportation sector, which is going to drop by about -0.2% in 2015. At the same time, the domestic trade will decrease by about -0.2% as a result of shrinking consumption. The agricultural sector might remain on a positive path, with a modest growth (+1.6%). However, if the climate conditions this year were less favourable, the agricultural sector could decline by about 4-5%.
- A fundamental challenge for the Moldovan economy is the lack of effective leverages in preventing and mitigating external shocks. The fiscal position is fragile, foreign exchange reserves fell down almost to the minimum acceptable level, the public sector is inefficient and the private one is not competitive. Consequently, public authorities have a very narrow margin of manoeuvres and public institutions often lack sufficient technical skills, which facilitates the exposure to external risks. In such conditions, in addition to the fact that the Moldovan economy is projected to grow in the medium and long term twice slower than the optimal level, it will be very volatile, which requires more attention from the relevant institutions (National Bank of Moldova, Ministry of Economy, Ministry of Finance).



Policy Recommendations

- The authorities should pay more attention and allocate more resources to the immunization, at least partially, of the Moldavian economy against external shocks. Conventional measures in this regard are related to the implementation of countercyclical fiscal and monetary policies: during the economic growth the government should reduce the budget deficit (or even create a fiscal surplus) and the National Bank should tighten the monetary policy; during the economic crises, the government could use the resources accumulated during the years of growth by increasing the budget deficit and NBM can ease the monetary policy. In this respect, it is important to allocate more human and financial resources at NBM and Governmental levels for activities of forecasting the economic cycles in order to implement efficiently the counter-cyclical fiscal and monetary policies.
- A universal immunization measure against risks is diversification. In this respect, the Republic of Moldova strongly needs to diversify its trade relations in the context of hostile and unpredictable behaviour of the Russian Federation, one of the most important trading partner of our country. In addition, the devaluation of the Russian and Ukrainian currency also generates the need to diversify markets towards more stable ones from the macroeconomic and political perspective. In this sense, the implementation of the Association Agreement with the EU provides the necessary opportunities to diversify the exports.
- The implementation of the Association Agreement with the EU and the capitalization on the opportunities offered by the Deep and Comprehensive Free Trade Area between the EU and the Republic of Moldova will be top challenge for the Government in the near future. In this regard, 3 main priorities to focus on are: (i) the elimination of internal non-tariff trade barriers: the adoption and implementation of EU quality standards, simplified procedures in issuing documentation on export-import operations; (ii) the elimination of external non-tariff barriers: extending the applicability of the provisions of the Association Agreement on animal products; (iii) the capacity building of public institution: implementing meritocratic principles, implementing criteria for assessing individual and collective performance, diminishing political exposure of civil servants.
- The Government should develop mechanisms to support small and medium enterprises (eventually by partial subsidies, guarantees or fiscal facilities), which make efforts in implementing EU quality standards and international marketing and communication activities. The ultimate aim is to ensure an advanced integration of domestic producers into the regional and global value chains.

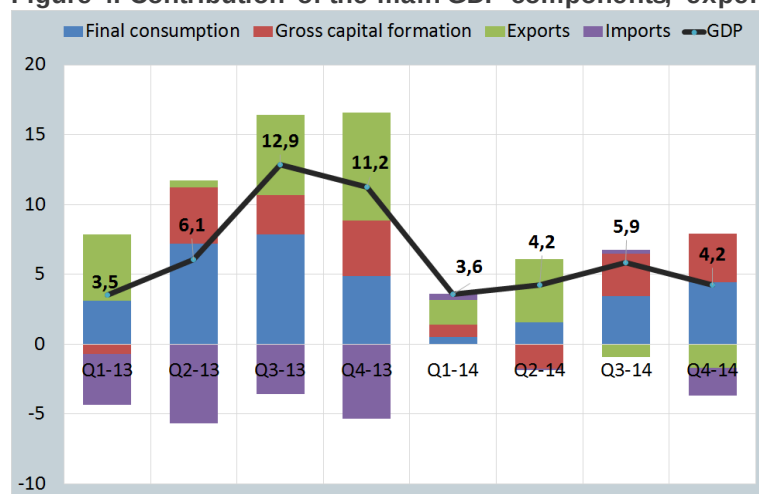
Chapter 2. Domestic Demand

The economic growth in the second half of 2014 was based, at a large extend, on private consumption and public investment. However, these factors are temporary and, most probably, they are going to dissipate in 2015 when both the consumption and the investment will shrink, as a result of worsening consumers' confidence and monetary and fiscal-budgetary tightening. In the short term, the authorities should find the appropriate policy tools to stimulate household consumption, while in the long term comprehensive reforms are necessary in order to encourage exports and investment.

Key trends in Domestic Demand

In 2014, there was a structural change in the components of economic growth: if in the first half of the year, the growth was based on exports, in the second semester the main components were the household consumption and the public investment. In 2014, the final consumption increased by 2.9%, the growth rate continuously rising from 0.4% in Q1:14 up to +4.5% in Q4:14. The main contribution corresponds to the final household consumption which accelerated from 0.6% in Q1:14 up to 4.5% in Q4:14, while the final consumption of public administration decreased by 0.6% during 2014, reflecting the budgetary constraints. Yet, the increase in consumption, amid weak domestic supply, had also negative effects on the economic growth, as it stimulated the imports of goods and services. Along with decreasing exports and widening trade deficit, these factors caused increasing pressures on the Moldovan GDP, mainly in the second half of 2014.

Figure 4. Contribution of the main GDP components, expenditure approach, %

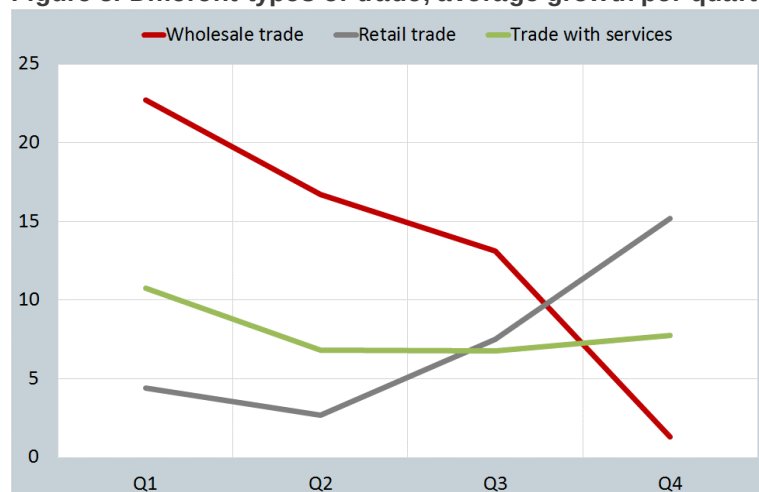


Source: Authors' calculations based on NBS data

The increase in private consumption in 2014 was temporary and it will dissipate in 2015. Most likely, it reflected the inflation expectations for 2015, as a result of currency depreciation in Q4:2014. Thus, the increased consumption was reflected mostly just in the growth of the retail trade, which in Q4:14 recorded an average increase of 15.2% y-o-y, which was accelerating compared to previous quarters, while the wholesale trade cooled down and the growth rate in trade in services remained constant. Taking into consideration these contradictory evolutions, we can ascertain that the increase in consumption is temporary because it is based on inflationary expectations, which accelerated retail growth, while the decline of wholesale trade indicates negative expectations regarding the future economic evolutions. At the same time, it could be noticed the increase of private consumption, despite the decline in remittances: in 2014, the volume of remittances decreased by 5%. Moreover, the biggest losses were reported in Q4:14 (-21% y-o-y), when households' final consumption, on the contrary, grew by 4.5% y-o-y. Thus, the expected

decline in remittances coupled with the high level of uncertainty and the low consumers' confidence will negatively affect the consumption in 2015.

Figure 5. Different types of trade, average growth per quarter, % y-o-y



Source: Authors' calculations based on NBS data

The growth in investment activity in 2014, as in the case of the growth of consumption, is temporary.

The reason is that it wasn't determined by the improvement of companies' expectations, but exclusively by infrastructural projects financed from public money. Thus, in 2014, the growth by 1.8% of capital investments was determined only by the increase in investments financed from the state budget (+94.2%) and from the local budgets (+52.2%). At the same time, the investments financed by firms and households decreased by 5.5%, and those financed from foreign sources decreased by 40.3%. Budgetary constraints along with tightening monetary policy and increasing uncertainty will undermine investment growth in 2015.

Forecasts and challenges

- The problem of economic growth in 2015 resides in the fact that the factors, which contributed to the growth in 2014, most likely, will not be relevant anymore. Thus, the final consumption will decrease by about -1.2% taking into account both the worsening of consumer confidence and the expected decrease in remittances by 7%.
- The increasing cost of credit and economic uncertainty along with worsening financial conditions of the private sector and decreasing domestic and foreign demand are going to further undermine the investment activity. Thus, in 2015, the gross capital formation is expected to decrease by -3.7%.
- Due to the maintenance of trade restrictions imposed by the Russian Federation and also due to the decline in foreign demand (especially from Ukraine and Russia amid the economic recession and currency depreciation in these countries), the volume of exports will decrease by -0.5% in 2015. At the same time, the pressures on the economic growth will be mitigated by fact that the imports are going to shrink even more (by -2.8%) and, hence, the trade deficit will decline, because of decreasing domestic demand, but also due to the MDL depreciation. Hence, the floating exchange rate is one of the few mechanisms of the Moldovan economy that allows accommodating to negative economic shocks.
- In 2015, the decreasing investments, remittances and exports will put under pressure the national currency given the decline in foreign currency supply. This will remain a major challenge in the future, in the context of already high inflationary pressure and limited area of intervention of the central bank.
- Another source of risks is related to decreasing consumption and imports that will affect the stability of public finances even more, thus increasing the budget deficit. In this context, due to increased budgetary constraints, the Government will not be able to use the budgetary policy to boost public



demand as a tool for mitigating the repercussions of the economic crisis and declining private consumption.

Policy Recommendations

- Consumption stimulation could be the short-term measure to mitigate the economic crisis in 2015. As the remittance inflows are going to decrease and the budget deficit will narrow the Government area of intervention, a measure that can be implemented immediately is to unwind the monetary policy. In chapter 5 we show that the tightening of monetary policy from the last months is not justified since the inflationary pressures were caused by the national currency depreciation amid worsening economic conditions and not by the growth in demand. Thus, in order to stabilize the national currency, the authorities should boost the economy, not inhibit it. Therefore, a gradual relaxation of the monetary policy (decreasing the base rate down to 10%) could stimulate lending and consumption, which will have positive effects on the economic growth.
- If stimulating private consumption is important in the short term, boosting investment and exports is crucial to ensure a robust long-term economic growth. In this respect, the authorities have to simplify the rules of doing business (facilitating the issuance of permissive documents, implementing broadly the principle of one-stop shop, depoliticizing public-private dialogue), to ensure a more effective protection of property rights and access to fair justice, to enhance the competition and enforce the anti-trust legislation. A top policy priority in order to unchain the exports is to remove non-tariff barriers to trade: the adoption and implementation of EU quality standards, especially in the agribusiness sector.
- Consumption, investment and export cannot be boosted without a greater access to banking and non-banking financing. Thus, in addition to monetary policy relaxation, systemic reforms are needed in order to: (i) reduce entry barriers to the financial sector and improve competition framework; (ii) improve financial regulation and managers' accountability towards financial institutions for their performance; (iii) increase the system transparency; (iv) develop credit bureaus (v) simplify the procedures of restructuring non-performing loans and (vi) strengthen corporative governance and risk management of banks and other financial institutions.

Chapter 3. Public Finances

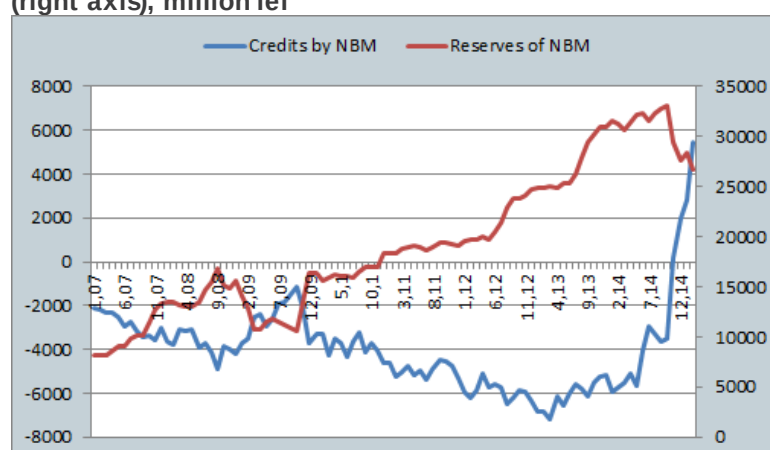
Over the last year, the quality of budgetary and fiscal policies has decreased substantially. Practically, all efforts to stabilize and balance the budget over the last years have failed because of the electoral factor and banking crisis. If parliamentary elections have a short-term influence on public finance, a potential bailout of the problematic banks might have more long-lasting consequences. Therefore, the possible conversion of NBM loans into state debt could substantially increase public debt and could reduce the fiscal space of the government in the future.

Key trends in public finances

The key document for budgetary and fiscal policies (the state budget for 2015) was approved by the government with a half year delay. The document elaboration process was non-transparent for the public and its content reflects the impact of the 2014 elections. Thus, increases in salaries and pensions, that were adopted last year and were not covered by reliable funding sources, doubled the budgetary deficit, from 1.8% in 2014 to 3,8% of GDP, as forecasted for 2015. The deficit was influenced by the difference in growth rates of revenues and expenditures, given the forecast growth of revenues by 6.3% and of expenditures by 11.7%. One of the main funding sources for increased deficit is the public debt, which is expected to grow by about 8.5%, up to 33.5% of GDP.

The public debt position is rather uncertain due to the lack of transparency in the NBM and government reporting process. This uncertainty on final figures of public debt derives from secret bailout applied by NBM for the troubled commercial banks. It is very likely that loans of about 10 billion lei provided by NBM to the troubled banks were not covered by the central bank's reserves, but were offered under government guarantee and in case of default on repayment to NBM by the due date they will be converted into state debt. This situation is clearly seen in Figure 6, which for the first time since 2002 shows a sudden increase in the last four months of loans offered by NBM to commercial banks, equivalent to 10.5 billion lei.

Figure 6. The dynamics of NBM domestic lending (left axis) and foreign reserves (right axis), million lei



Source: NBM

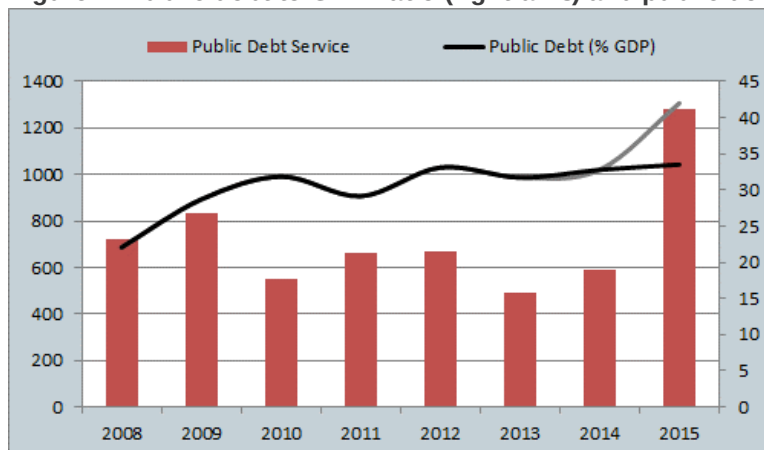
An eventual conversion of loans granted by NBM into state debt will have a major long lasting impact on public debt. By this year, the public debt has gradually increased and it is expected to reach 33.5% of GDP in 2015, well below the critical threshold of 60%.¹ As shown in Figure 7, in case of potential

¹ Public debt is composed of internal and foreign debt of the state, NBM, public enterprises and local authorities.



growth of domestic debt by 10 billion lei, the public debt rate will increase by about 8.5 p.p. compared to the baseline forecast, reaching 42% of GDP. For the state budget the problem is going to be even worse in 2015, since this year comes with the highest public debt service ratio, which almost doubled compared to 2014, reaching 1.3 billion lei.

Figure 7. Public debt-to-GDP ratio (right axis) and public debt service ratio (left axis)



Source: Ministry of Finance

Until now, the stability of public debt has been provided by the balanced influence of several factors. Table 2 shows that one of the main factors that have alleviated the debt pressure was the inflation and the economic growth in real terms, at this end the most obvious being the year 2013. Yet, the factors which contributed to increased public debt were mainly the national currency depreciation (in the case of external public debt) and the budget deficit growth, which unexpectedly increased in 2015. At the same time, it can be mentioned that any increase in debt ratio by 9.18 p.p. and not by 0.73 p.p. (according to the planned level), as a result of the conversion of NBM loans into state debt, can be explained by the change of sign of other factors. Though, if this process occurs this year, it will migrate next year to the core fiscal deficit, which might increase from the current level of -2.7% to -11.2% of GDP.

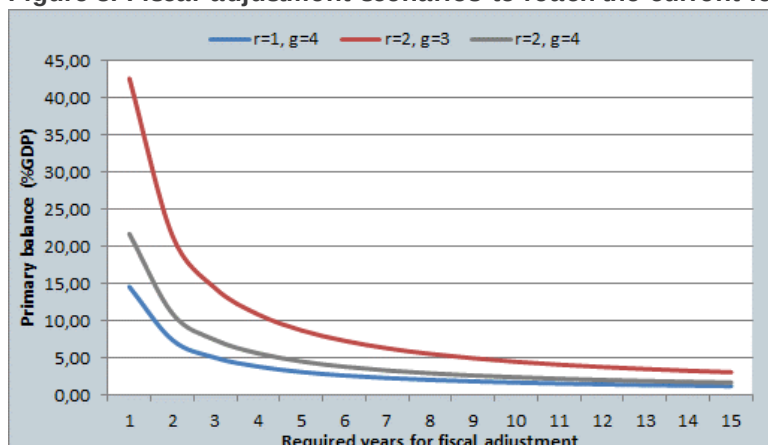
Table 2. Public debt disaggregation into main influence factors (% of GDP)

	2012	2013	2014	2015
Change in public debt (y-o-y)	3,96	-1,38	1,06	0,73/9,18
Primary fiscal balance	0,24	1,27	1,22	2,71
Real economic growth	1,33	-2,99	-1,46	0,35
Inflation	-1,15	-1,64	-1,42	-1,97
Nominal interest rates	0,84	0,73	0,49	0,57
Exchange rate dynamics	0,63	1,78	3,83	1,46
Other factors	2,06	-0,52	-1,58	-2,39/6,05

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

The possible fiscal shock will last in time, and the return to the current parameters of deficit and current public debt ratio will be stretched over several years. If the budget deficit can be modified by optimizing expenditures which depends on the dynamics of tax collection, the public debt adjustment will take much longer and will directly depend on the budgetary balance. As of Figure 8 it is obvious that, regardless of real interest rates and economic growth, which will directly influence debt service and will facilitate budget collection, the recurrence to the current level of public debt will last for more than 15 years. It can be mentioned that a combination of slow economic growth and higher interest rates significantly prolong the adjustment period. In fact the adjustment may take even longer since lowering public debt will require a budgetary surplus every year, which is unlikely in short term.

Figure 8. Fiscal adjustment scenarios to reach the current level of public debt



Note: r - real interest rates, g - real economic growth rates

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

Although the public debt is still below critical levels, its significant increase will reduce the fiscal space of the government. Thus, a public debt, primarily the domestic one, will be more costly to service. Amid increased inflationary trends and tightening monetary policy, there will be upward pressure on interest rates of domestic debt, which is already more expensive than external debt service. Therefore, debt amplification and its service will not only diminish the investment availability in more productive areas of the national economy, but also will reduce intervention areas in combating economic crisis.

Forecasts and challenges

- A key challenge for the public finance remains the dominant political factor. This, as mentioned in 2014, in the medium-term, undermines all efforts in balancing and improving the fiscal-budgetary framework. Also, the fiscal discipline and the transparency of authorities remain extremely low, resulting into delayed approvals on the Law on state budget for several years, and in the current year being adopted with a half-year delay.
- The considerable increase of budget deficit and the most probable increase of public debt will directly influence the budgetary parameters in the medium-term. Thus, the budget deficit of 2.5% of GDP, excluding the grants of 2018, will be attainable only by reaching impressive levels of economic growth and maintaining public debt at the new level of over 40% of GDP. On the contrary, the limits set in the new Law on public finance and fiscal-budgetary responsibility will be difficult to achieve.
- A medium-term challenge is to lower the external funding ratio and to develop the domestic market of state bonds. Dependence on external sources of funding from external development partners, primarily on those with extremely favourable rates and grace periods, diminished the motivation of the authorities to fundamentally reform the domestic market and work with potential commercial foreign creditors.
- The economic growth slowdown and the persistence of political risks related to minority government raises the probability of failure of collection plans to the state budget this year. In these circumstances, it is very likely the adjustment of expenditure plans or the increase in the budgetary deficit over the initially forecasted 3.8%.

Policy Recommendations

- As the experience of other countries shows, applying fiscal rules and independent monitoring institutions of fiscal-budgetary policy within the national legislation did not have a radical influence



on authorities' discipline. Therefore, the approval of fiscal rules in Law on Public Finance and Fiscal Responsibility, as well as the possible establishment of the Fiscal Council in the Republic of Moldova, could increase the fiscal-budgetary discipline only if combined with monitoring and constant pressure from the population and development partners. In this regard, the new institutional structure will enhance the public finance transparency and the responsibility of relevant institutions. At the same time, increasing the discipline and flexibility of the fiscal-budgetary policy requires the introduction of additional fiscal rules into the Public Finance Law, which will take into account economic cycles and adjust budget deficits to economic fluctuations.²

- To reduce the dependence on external funding sources, it is important to develop the domestic capital market, both from the quantitative and qualitative point of view. Thus, in order to mitigate the refinancing risks, the Ministry of Finance should focus on issuing long term bonds. Furthermore, broadening the range and sophistication of financial tools, which remain rather limited at the moment, will allow more flexibility to the government in attracting funds and will help develop the domestic capital market. At the same time, in the long-term, it is necessary to diversify external funding sources, with additional emphasis on the commercial ones. It is very important to work on the credibility of the Republic of Moldova on foreign capital markets, to improve the rating of the country and to attract funding at more convenient conditions.
- In order to reduce the budget deficit in medium term it is important to broaden the tax base and to reduce the tax discrepancy by enhancing the efforts in combating tax evasion. In this field, a lot depends on reforming and improving the Fiscal Service institutional framework. At the same time, the coercion mechanisms should be combined with an improved business environment and a relationship based on trust between public authorities and the private sector, focusing on the optimization of the tax framework, including the predictability and transparency of the fiscal policy.

² A. Lupusor, A. Fala, I. Morcotilo "MEGA XI: From political economy to economic policies", Expert-Grup, 2014.

Chapter 4. Labour Market

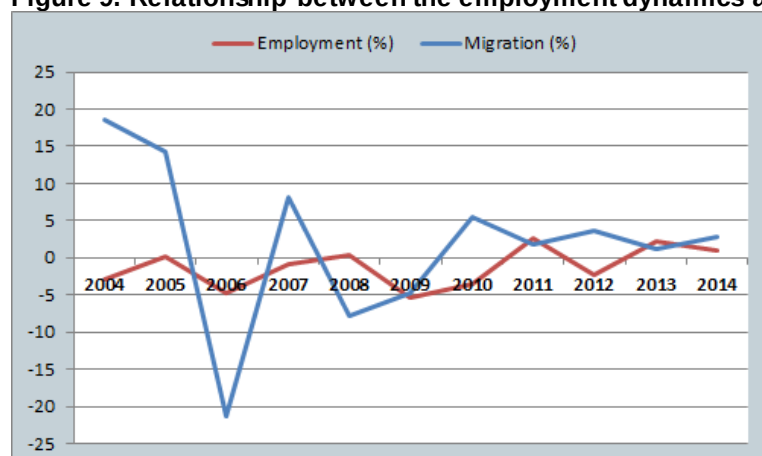
In the second half of 2014, the situation on the labour market started to worsen, after the positive trends registered at the beginning of the year. Moreover, the probability that a significant number of Moldovan migrants will return from Russia, which is passing through a period of economic recession, heighten the risk of external shock for domestic labour market and economic stability of the country. From this perspective, the problem of the reintegration of Moldavian migrantworkers who may potentially return from Russia should become a priority on the development agenda of the government.

Key trends in the labour market

The Moldovan labour market registered contradictory evolutions throughout the year 2014. As a positive dynamic we can note the decrease in unemployment to a historical low of 3.9%, reaching the level of the period before the crisis of 2009. Also, in the first two quarters of 2014 the employment rate increased and it only started diminishing toward the end of the year as a result of the economy slowdown. At the same time, the external migration has accelerated and increased by 2.8% compared to the previous year, totalling 347,000 people, which alleviated the pressures on the domestic labour market. Moreover, the number of migrants has increased despite complicated economic situation in the main destination countries, primarily in the Russian Federation.³ In the near future, the amplification of the Russian crisis will have a direct impact on the migration process in Moldova.

The role of external migration for the national economy and the labour market has significantly changed lately. Namely, employment growth has begun to directly influence the emigration dynamics, the latter decreasing during the economic boom and accelerating during national economic slowdown. This is clearly seen in figure 9, which represents the dynamics of employment and external migration, clearly showing that until 2009 the economic growth had almost no influence on migration. This fact represents a negative elasticity between economic growth and employment, which was negative until 2009.⁴ Thus, the correlation coefficient between the employment growth dynamics and external migration was positive before 2010 (0.42), changed to negative (-0.94) after 2010. This fact suggests that ensuring economic growth may stop the exodus of labour in the country.

Figure 9. Relationship between the employment dynamics and the external migration (% y-o-y)



Source: National Bureau of Statistics

³ Data on geographical distribution of migration by country for the year 2014 are not available yet. Thus it is difficult to assess whether there was a decrease in migration to Russia and if so, which other destinations have absorbed this increase.

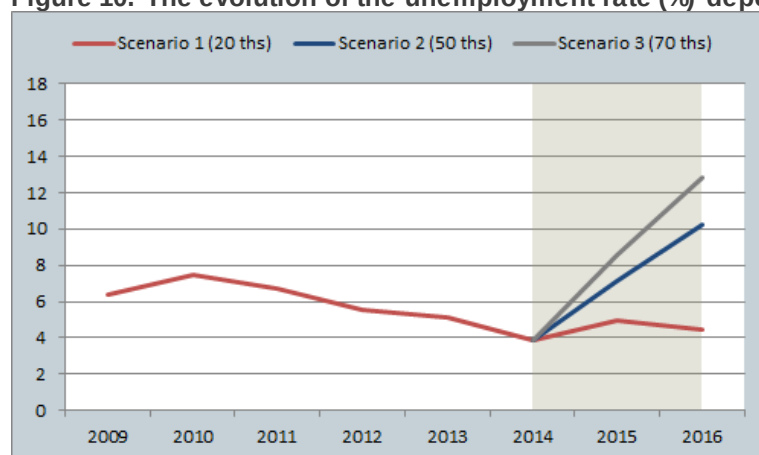
⁴ A. Lupusor, A. Fala, D. Cenusă, I. Morcoteș "State of Country Report 2014", Expert-Grup.



Despite the changing relationship between economic growth and migration, the significant amount of people working abroad poses risks for the local labour market, given the probability of their fast return. Thus, as mentioned above, the worsening socio-economic situation in the Russian Federation will stimulate the return of Moldovan migrants from this country, creating additional pressure on the domestic market. The number of returnees is hard to predict, but it can be significant if the Russian ruble devaluation and recession continue in the coming years.⁵ In this context, it is important to predict how the Moldovan labour market will react to such a shock, taking into account the long-term trends in labour elasticity and economic growth.⁶ Based on the forecast, there have been designed three scenarios of returning 20, 50 and 70 thousand migrants per year during 2015-2016.

Generally, the Moldovan economy remains unprepared for the effective integration of migrant returnees. This can be clearly seen in Figure 2, where there are shown forecasts on the three return scenarios and their impact on unemployment (the average growth for the period 2015-2016 being 1.75%). Namely, it can be observed that the labour market can absorb only the minimal inflows of 20,000 people per year, thus the unemployment will increase by about 1 p.p. to 5% in 2015, then will decrease by about 0.5 pp to 4.5% in 2016. If the inflow increases to 50 and 70 thousand people per year, unemployment will increase in the first case up to 7.2% in 2015 and up to 8.6% in the second case, and will further increase in 2016 over 10% in both cases. In case of economic recession in 2015 (the average growth for the period 2015-2016 being 0.7%), the forecasted unemployment rates will worsen by about 0.5 p.p. for each scenario.

Figure 10. The evolution of the unemployment rate (%) depending on annual migration inflows



Source: Calculations of Expert-Grup based on NBS data

In the short term, the policies related to improving the labour market flexibility will not play a vital role in mitigating external shock on the labour market, arising from massive return of Moldovan migrants. Namely, the measures which enhance the elasticity coefficient between GDP and employment growth from the current 0.26 to 0.5, as a result of reforms implemented to improve the labour market, can shrink the unemployment rate, from the simulations above, only by 0.2 to 0.3 p.p. a year.⁷ At this end, there comes the crucial need to maintain the economic growth as a measure to downsize unemployment. Thus, as shown in Table 1, in order to absorb the surplus labour and maintain the current unemployment rate there is a need for economic growth of over 10% in the scenarios on 50 and 70 thousand returnees. And only in the scenario 20 thousand returnees, the required economic growth for a successful integration of

⁵ Most economic forecasts of the IMF, World Bank, Ministry of Economic Development and the Central Bank of the Russian Federation confirm the recession and ruble depreciation for the period of 2015-2016 years, and economic recovery only in 2017.

⁶ The forecasts on the labour market were based on the methodology and model drawn up by R. Chami, Y. Abdi, A. Behar, S. Cevik, L. Dougherty-Choux, D. Furceri, N. Janus, P. Zimand "A Template for Analyzing and Projecting Labour Market Indicators", Technical Notes and Manuals, IMF, 2012.

⁷ The elasticity coefficient between GDP and employment dynamics show how economic growth influences employment generation. A positive coefficient indicates that economic growth leads to an increased employment and in case of a negative coefficient it shows the contrary.

these ones is 6.3%. Therefore, maintaining and fuelling the economic growth is important in mitigating possible shocks on the labour market in the short term.

Table 3. The relationship between economic growth and the inflow of migrants per year (forecasts)

	Scenario 1 (20 ths/year)	Scenario 2 (50 ths/year)	Scenario 3 (70 ths/year)
Annual economic growth (2015-2016) required to reach 5% unemployment rate	3.7	12.7	18.5
Annual economic growth (2015-2016) required to absorb surplus labour and maintain current unemployment rate	6.3	15.6	21.7
Annual economic growth (2015-2016) required to decrease the forecast unemployment rate by 50%	10	19.2	25.3

Source: Calculations of Expert-Grup based on NBS data

In the long term, in order to ensure a sustainable economic growth, it is important to implement policies which would increase labour market flexibility. Thus, improving the functional framework of the labour market will facilitate the consolidation of the relationship between the economic growth and employment, amplifying the elasticity index closer to the European average, which is about 40-50% higher.

Forecasts and Challenges

- In the short term, the main challenge for the labour market stability is the possible mass return of Moldovan migrants from the Russian Federation. Thus, migration policy restrictions in this country amid the economic recession, which will reach its peak in 2015 and the Russian ruble depreciation, will determine many of Moldovan co-nationals to leave Russian Federation. The exact number of returnees is hard to forecast, but it can be quite significant in the upcoming two years, coming up to a cumulative figure of 70 thousand people.
- Amid worsening external risks of the Moldovan labour market, this issue still remains outside the public authorities' interest. Basically, the current occupational policy framework as well as other mentioned factors will hardly face a possible mass return of Moldavian migrants.

Policy recommendations

- Unfortunately, the Republic of Moldova enters the recession with a budget deficit, which does not allow increasing significantly public investments - a conventional measure to mitigate the effects of the economic crisis on employment. Therefore, the best solution in the short and medium terms resides in stimulating the demand for labour in the private sector. In this regard, in addition to conventional measures, which remain valid (simplifying business regulations, decreasing the costs of credits, enhancing competition), there is a need of complementary measures in supporting companies that generate employment. In this sense, various short-term fiscal facilities could be used, at least for the next 2 years, and generally the government should rethink its fiscal policy approach: it should be stimulating and not inhibiting the investment activity.
- In case of a potentially large number of Moldovan migrants returning from the Russian Federation, the risk of informal employment increases as a result of relatively reduced professional qualifications and low educational profile. Therefore, authorities have to boost their efforts in preventing and reducing informal employment. In this respect, it is necessary to consolidate the institutional and technical capacities of the State Labour Inspectorate, to improve the Inspectorate's control effectiveness, to facilitate operative exchange of information between institutions involved in preventing and combating informal employment (State Labour Inspectorate, State Tax Authority, Ministry of Internal Affairs, Prosecution etc.), to discourage by all possible means cash use and to encourage electronic payments, to increase fines for informal employment (which should make both the employer and the employee responsible) and to increase the Inspectorate's capabilities in



gathering evidence and demonstrating breaches in legislation. Obviously, these measures have to be complemented with increased motivation from the companies and employees to act formally (to improve the business climate, facilitate technology transfer, and enhance the competition and the quality of public goods and services). However, these measures will have long run effects.

- The sudden increase in external risks for the labour market is due to the perpetuation of the current migration model, followed by the Republic of Moldova. Thus, in the context of a 60% dependency rate on remittances and migration to a single destination, it is important to geographically diversify the migration flows in order to diminish such risks in the future. The temporary migration agreements concluded with Israel and currently negotiated with Qatar can serve as an alternative model. At the same time, these should be applied only as medium term measures and serve in decreasing external risks, not in replacing efforts done to reform the labour market in order to achieve sustainable internal growth.
- In the context of increasing discrepancies between the qualification levels of the workforce and the demand in the real sector, besides reforming the educational system it is crucial to develop and reform the educational and lifetime learning framework.⁸ This aspect becomes even more important given the possible mass requalification of the returnees. In addition to increasing the funding system, it is also appropriate to broaden the range of related services provided by the state in this sector. An example might serve the implementation of vouchers for requalification programs as well as some wage subsidies to certain qualified employees.

⁸ A. Lupusor, A. Fala, I. Morcotilo "MEGA XI: From political economy to economic policies", Expert-Grup, 2014.

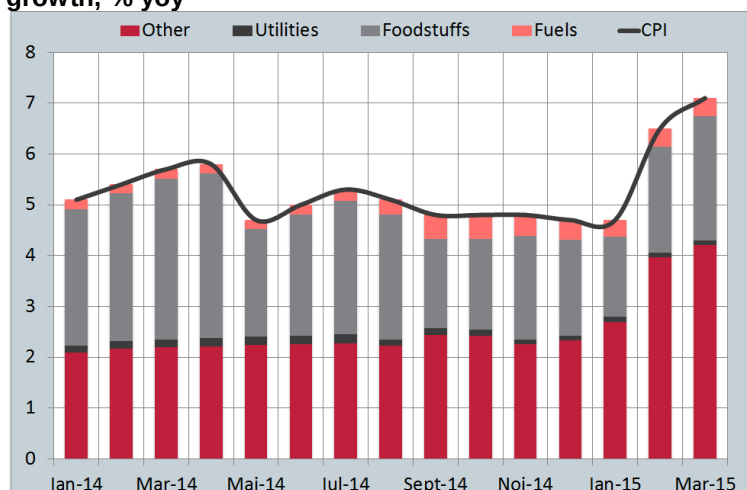
Chapter 5. Prices and Monetary Policy

The 2015 year brings many challenges to the monetary policy. The recent depreciation of the national currency has become the main inflationary source in the current year. To moderate the depreciation, the NBM performed active interventions on the foreign exchange market, which generated a decrease in the official reserve assets. The main challenges relate to taming the inflationary pressures and anchoring the inflationary expectations without undermining the economic situation in the country (in the context of a forecasted recession for 2015). In this respect, the NBM should rethink its analytical framework, which so far generated essential tightening of monetary policy in the last months and should strengthen its tools for forecasting macroeconomic shocks. At this end, a memorandum with the IMF on consolidating the foreign exchange reserves as well as creating a strong anchor for structural reforms would be timely. However, the authorities should be very cautious in the negotiation process, given the difficult economic situation in the country.

Key trends in Prices and Monetary Policy

After a long period of stability, inflationary pressures pose difficult challenges for the National Bank of Moldova. In Mar:15, the y-o-y CPI was 7.1% and for the first time in the last 3 years, it exceeded the upper limit targeted by NBM (+6.5% y-o-y). The increase by 2.4 p.p. in just two month (4.7% in Jan:15) was determined by the first effects of national currency depreciation in late 2014 and early 2015. Thus, the prices for imported products - mainly non-food items (medication, footwear, clothing, building materials) – rose, leading to the overall price increase (Figure 11). As a result, the core inflation (CPI excluding food and beverages, fuel, products and services subject to price control) exceeded the 2 digits limit for the first time since 2011 (when the indicator was first published), recording 10.6% y-o-y in Mar-15.

Figure 11. Contribution of the main components to the formation of the Consumer Price Index, growth, % yoy



Source: Author's calculations based on NBS data

The 2015 is likely to be a year of stagflation (inflationary pressures amid economic recession). The strong increase in the headline inflation starting with Feb:15 could be just the beginning of serious pro-inflationary trends that will continue throughout the year. The main reasons for this relate to the effects of the national currency depreciation on products subject to price control (especially tariffs for natural gas and



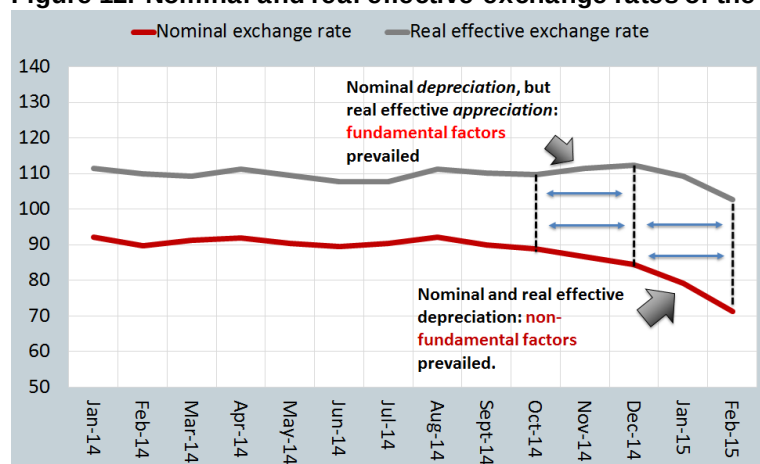
electricity), a fact which will generate the second round of inflationary effects. Additionally, the further reduction of exports and remittances from abroad could put additional pressure on the national currency, thus boosting inflationary pressure.

The monetary policy became contradictory with the economic policy, at least on the short term. In order to alleviate inflationary pressure and expectations, as well as to stabilize the national currency exchange rate (the main source of price increase), the NBM implemented a substantial tightening of the monetary policy. Thus, from Dec:14 to Feb:15, the NBM base rate increased from 3.5% (historical minimum) to 13.5%, the deposit and overnight interest rates increased from 0.5% and 6.5% to 10.5% and 16.5% accordingly. The purpose of these actions was to stimulate national currency savings, to stabilize the exchange rate and ultimately to alleviate inflationary pressure.

The first effects of monetary policy tightening can already be noticed. The average interest rate on deposits in national currency increased from 5.7% in Nov:14 to 8.9% in Feb:15, and the respective growth will continue in the coming months as well. However, the tightened monetary policy while stimulating savings, it undermines loans. In the same period, the average loan rate granted to companies for a period over 12 months increased from 9.7% in Nov:14 to 12.3% in Feb:15. Therefore, while in late Feb:15 the stock of deposits increased by 10%, that of loans decreased by 0.4% y-o-y. In the context of the forecasted stagnation in economic activity for the current year, a classical contradiction arises between the monetary policy objective focused on price stability and the economic policy objective of increasing the Gross Domestic Product. Resolving this contradiction requires a visionary and effective anticipatory approach, both from the NBM and the government.

The depreciation of the national currency was caused mainly by fundamental factors in 2014, while in 2015 non-fundamental factors prevailed (panic, speculative attacks, capital outflow). The national currency started to prominently depreciate in Sept:14, a process that particularly accelerated in the first two months of the current year. Thus, from Sept:14 to Feb:15, the Moldovan leu (MDL) lost approximately a quarter of its value (-24%) against the US dollar, the largest fluctuation occurring in Feb:15, when during the first 3 weeks of the month, the MDL lost about 14% of its value against the US dollar. If by the end of 2014 fundamental factors prevailed (exports and remittances were decreasing), the accelerating depreciation in 2015 was based on non-fundamental factors (panic, speculative attacks and capital migration). According to Figure 12, during Oct-Dec:14, the MDL depreciation occurred while the foreign currencies of major trading partners depreciated more in real terms compared to the MDL. This was caused by the economic problems in the region, which had undermined the exports and remittances inflows (fundamental factors of MDL depreciation). In 2015, additional non-fundamental factors appeared, which made the MDL weaken at least twice as fast than if solely driven by the economic situation, the depreciation being stronger compared to the fluctuations in the region.

Figure 12. Nominal and real effective exchange rates of the Moldavian currency (MDL), %

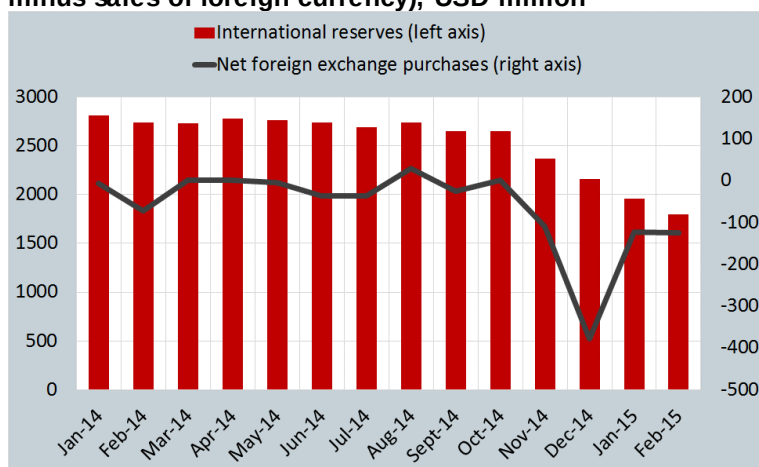


Source: Author's calculation based on NBM and NBS data



NBM acted rather as a firefighter in moderating pressure on the national currency by actively intervening on the foreign currency market. The most consistent interventions were performed during Nov:14 and Feb:15, when approximately 740 million USD were sold. As a result, the NBM official reserves fell to the level of early 2011 and in Mar:15 there were about 975 million less than in the same month of the previous year. Although the NBM intervention was justified and prevented a more rapid depreciation of the MDL, it appeared to be too late. Given that the pressure on the national currency gradually turned up in 2014, some risks being imminent (e.g. Russian embargoes, the economic crisis in Russia and Ukraine), the NBM interventions could have been more preventive in order to timely compensate the diminishing currency supply. At the moment, the foreign exchange reserves level is approaching the minimum allowable (3.5 months of consecutive imports), which limits the NBM possibilities of intervening in the future, and respectively it exposes the economy to potential pressures on the national currency and to negative macroeconomic shocks.

Figure 13. Official reserve assets and NBM net purchases of foreign currency (purchases minus sales of foreign currency), USD million



Source: Authors' calculations based on NBM and NBS data

Forecasts and Challenges

- The main challenge of the current year for the NBM does not only reside in taming the inflationary pressure, but in the fact that it should be done amid worsening economic conditions, lowered public confidence in the national currency and banking system, as well as the decrease in foreign reserves close to the minimum allowable level. Thus, the inflation rate could reach the 2-digit level for several months, while the average forecast for 2015 is of 9%. In this context, it is necessary to strike an optimal balance between the need to consolidate the economic growth and stabilize the national currency and inflationary pressures.
- The decreasing level of official reserve assets down to its 2011 level narrows the NBM area of intervention in case a new wave of pressure on the national currency occurs. Therefore, compared to previous years, the Republic of Moldova has become more exposed to risks of MDL depreciation and macroeconomic destabilization in 2015.
- Tightening monetary policy in response to inflationary pressure and currency depreciation is pro-cyclical, being implemented amid an economic recession: in 2015 the country's GDP is going to decrease by 0.5% according to the base scenario and by 2% according to the pessimistic scenario. Under these conditions, the increase of loan interest rates, with adverse effects on consumption, investment and exports, could create additional pressure on the economic activity of the current year.



Policy recommendations

- It is necessary to review the analytical framework and the motivations, which guided so far the NBM in its process of monetary policy tightening. The restrictive monetary policy stance could be justified if and only if the main sources of inflationary pressures reside in increasing demand as a result of increasing wages, loans, investment and economic growth in general. In fact, the current inflationary pressures are generated by the MDL depreciation, which is caused by non-monetary factors: reducing foreign currency supply (declining remittances, exports and direct foreign investments) and increasing foreign currency demand amid capital outflow abroad, panic or possible speculative attacks. Therefore, it is necessary to alleviate the pressures on the domestic currency and on the price level through boosting economic activity instead of inhibiting it, given that by the end of Feb:15 the stock of deposits increased by 10%, while that of loans shrank by 0.4% y-o-y. In addition, the level of liquidity and the ratio of loans and deposits in the banking system (excluding three banks under special administration by the NBM) shows the potential of the banking system to increase lending to the economy. In these circumstances, it is necessary to relax monetary policy to 10% base rate during 2015 - a level considered optimal between the objective of stabilizing price and that of stimulating economic activity.
- Increasing exposure to potential negative effects on the domestic currency and on macro-financial and macroeconomic stability reveals the need to agree on a memorandum with the International Monetary Fund. This is important for at least two reasons: one purely monetary and the other non-monetary. First, the memorandum would complement the level of official reserve assets, which from Aug:14 to Mar:15 fell by over a third (about 980 million USD). This will allow the NBM to cope with future potential excessive fluctuations in exchange rates. In addition, the memorandum acts as a trigger for other funds from development partners. Secondly, the IMF's role is even more important as an additional accountability factor for politicians in their motivation to implement structural reforms, which could enhance the competitiveness and sustainability of the national economy, but which might be unpopular in the short term (e.g. reforming the central and local public administration, increasing the efficiency in public and energy sectors, reforming the pension system and the entire social protection system, etc.). However, the authorities have to negotiate carefully the memorandum conditions, given the unfavourable economic situation. In this respect, it is necessary to insist on structural reforms which contribute to the strengthening of the growth potential (decreasing informal economy, increasing public and energy sector efficiency) rather than on adjusting the parameters (e.g. tax and rate hikes, decreasing wages) that the IMF often insists on in other states.
- It is necessary to improve forecasting and shock prevention tools available to the NBM, particularly in terms of exchange rate fluctuations and inflationary pressures. The effectiveness of the monetary and foreign currency policy depends directly on the central bank's ability to intervene before the shock occurs. In fact, the NBM has acted as a firefighter in stabilizing the exchange rate and the monetary policy tightening was delayed by a year (in mid-2013, Expert Grup recommended a gradual tightening of monetary policy and increasing the base rate by about 1-1.5 percentage points compared to the forecast inflation rate⁹).

¹ MEGA - Moldova Economic Growth Analysis, no. 9, Expert-Grup, August 2013

Chapter 6. Banking System

In the period under review, the situation in the banking sector has worsened. Banks involved in the suspicious transactions from 2014 have reached a dramatic situation and are currently under special administration of the NBM. The worsening economic situation will affect the banking assets' quality and generate new challenges for the banking sector. Also, exchange rate volatility and low confidence in public authorities and banks pose a risk to the financial stability of the entire banking sector.

Key trends in banking sector

The banking sector was disturbed by a series of dubious “mega-transactions” at the end of 2014. As a result, three involved banks have been drawn into a critical situation. During 2014, Banca de Economii, Banca Sociala and Unibank have significantly increased their balances on investments abroad. Thus, in Oct:14 the three banks held external investments of about MDL 9.4 billion, which represented 63.9% of the outstanding debts of foreign banks to financial institutions in Moldova. In Nov:14, the three banks withdrew their overseas investments (at least such operations have been reflected in the banks' activity reports). Also, in Nov:14 Banca de Economii obtained funds from the interbank market and reallocated resources amounting approximately 11.1 billion MDL to Banca Sociala. Based on the information on banks' economic and financial activity, it may be presumed that the amount offered by Banca de Economii was covered by the money withdrawn from abroad. Based on the same sources of information, it may be stated that the following operations were performed at the Banca Sociala: it withdrew its investments from abroad, received funds from Banca de Economii, and used these sources in a suspicious way. The suspicious use of the funds has been reflected in the accounting records of Banca Sociala as an excessive “thickening” of about 17.8 billion MDL in the category of “other assets”. Additionally, Unibank has also granted a transfer of funds in favour of Banca Sociala.

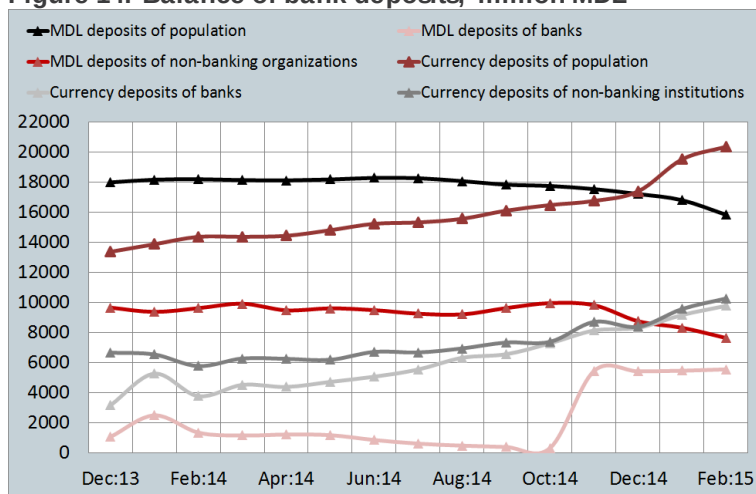
As a result of dubious transactions in the banking sector, a large capital gap has been created. Thus, whereas the minimum limit for principle 2 on current liquidity is 20%, in Feb:15 this indicator was much lower in all 3 banks: Banca de Economii (-3.6%), Banca Sociala (-69.2%) and Unibank (8.2%). At the same time, due to the enormous volume of toxic assets held by the 3 problematic banks, these financial institutions did not meet the criteria concerning the risk weighted capital adequacy, which is regulated to a minimum of 16%. By the end of February, the three banks had the following capital adequacy ratios: Banca de Economii (2.4%), Banca Sociala (2.9%) and Unibank (15.8%). The alarming situation at these banks motivated the NBM to establish a special administration over these institutions. Additionally, the operations performed by the three banks, along with other factors, such as decrease of exports and remittances and depreciation of the Russian ruble, have fuelled the depreciation of the MDL.

As a result of the suspicious transactions from the banking sector, large amounts of foreign currency have “vanished”. This fact is also supported by the foreign currency interventions made directly by NBM in favour of the 3 banks, operations that have been performed during Dec:14-Feb:15. Thus, the NBM performed special interventions by selling foreign currency to the Banca de Economii, Unibank and Banca Sociala in Dec:14 (USD 221 million, of which USD 167.1 million were designated to close the previously opened foreign currency swaps), in Jan:15 (USD 4.1 million) and in Feb:15 (USD 6.8 million).

National currency depreciation has caused a redistribution of deposits in favour of foreign currency deposits. During Dec:13-Feb:15, the depreciation of MDL led to increased foreign currency deposits, while the balance of deposits in MDL has decreased. In order to protect from the purchasing power downturn caused by the depreciation of the national currency, the population and economic agents have oriented

their savings to foreign currency deposits. Thus, the decrease of MDL deposits was due to withdrawals made by the population and legal entities (excluding banks). At the same time, the balance of deposits in foreign currency increased continuously for all categories of depositors.

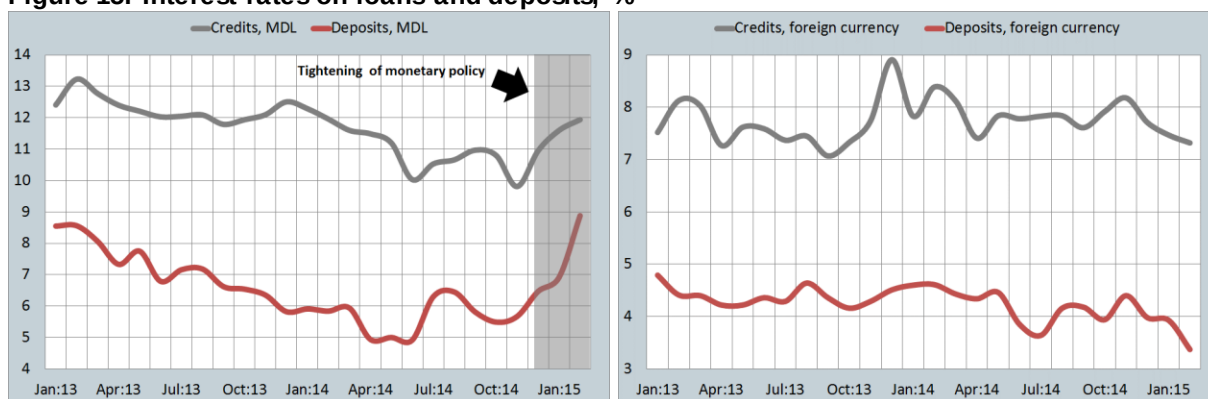
Figure 14. Balance of bank deposits, million MDL



Source: the NBM data

Monetary policy tightening, that started in Dec:14, caused the growth of interest rates. The increasing rates of monetary policy instruments influenced the rising costs for loans in MDL. The interest rates on deposits grew faster compared to the rising costs of credit. Thus, in Feb:15 compared to Nov:14, interest rates on deposits in MDL increased by 3.2 p.p., while bank rates for loans in MDL increased by 2.1 p.p. The faster growth of deposit interest rates could have also been influenced by the banks' intention to increase liquidity in MDL. In this context, while striving to make placements of household savings in MDL more attractive, banks increased interest rates on deposits. On the other hand, increasing foreign exchange resources allowed banks to decrease interest rates associated to deposits and loans in foreign currency. In Feb:15 compared to Nov:14, interest rates on currency deposits decreased by 1 p.p., while rates on foreign currency loans decreased by about 0.9 p.p.

Figure 15. Interest rates on loans and deposits, %

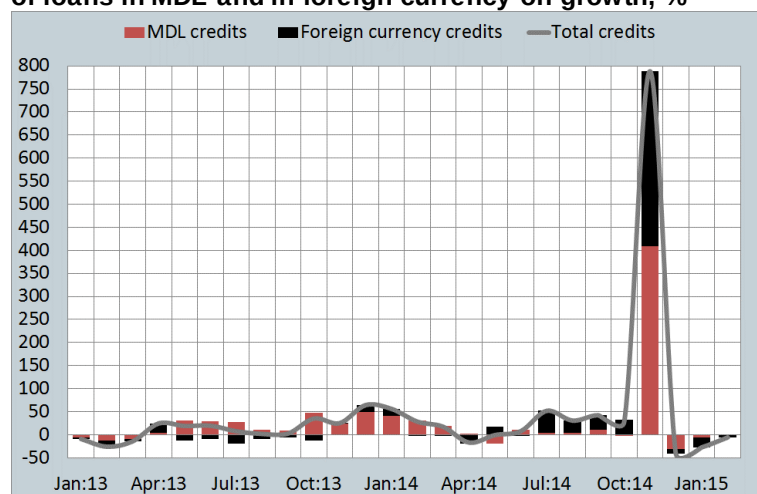


Source: the NBM data

In the context of economic uncertainty, increasing rates of monetary policy and the decrease of banks' activity under special administration, the banks' lending activity has decreased. After the „anomalous explosion” of loan granting as of Nov:14, within Dec:14-Feb:15, the volume of new bank loans decreased by 16.2% y-o-y, although this decrease has slowed down: in Nov:14 the slump was of -40.9% y-o-y, while in Feb:15 it was of -5.6% y-o-y. Decreases were recorded for both loans granted in MDL and foreign currency. One factor behind this development was the monetary policy tightening that led to more expensive bank loans, which consequently made the population and economic agents be reluctant to

access loans. Additionally, the significant depreciation of MDL also generated increased costs related to servicing the loans in foreign currency. In these circumstances, companies are more reluctant to take foreign currency loans and attempt to identify other solutions to finance their economic activities. Also, given the worsening economic perspectives, banks became more cautious in granting loans. Another obvious factor is the reduction in the lending activity of the three banks placed under special administration.

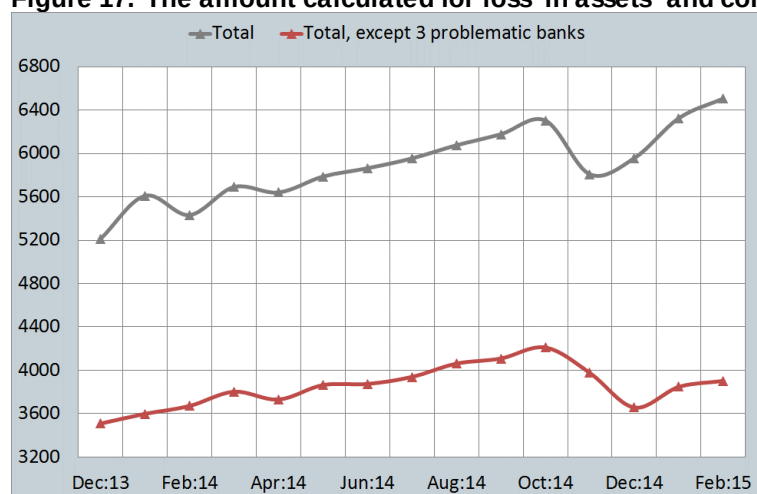
Figure 16. The total volume of newly granted loans, changes (%yoy) and the effect of loans in MDL and in foreign currency on growth, %



Source: Expert-Grup calculations based on NBM data

The worsening trend of the loan quality portfolio was resumed from Dec:14. The worsening of the loan portfolio is specific to the entire banking sector. Although this development is more critical for the three problematic banks: Banca de Economii, Banca Sociala and Unibank, the rest of the banking sector also registered an increase of the amount calculated for loss in assets and conditional commitments. Thus, in Feb:15 the amount calculated for loss in assets and conditional commitments decreased by 19.8% y-o-y for the entire banking sector, and, if to exclude the 3 problematic banks, the decrease was of 6.3% y-o-y. The deterioration of loan quality should be related to the worsening economic situation, which makes it more difficult to repay loans, but also to the tightening of monetary policy, which leads to restrictions in loan granting activity.

Figure 17. The amount calculated for loss in assets and conditional commitments, million MDL



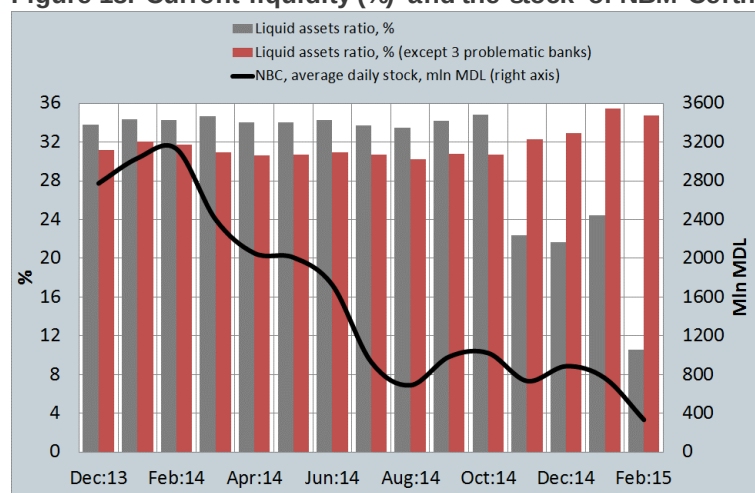
Source: Expert-Grup calculations based on NBM data

In the banking sector (excluding the three problematic banks) an accumulation of liquid assets is recorded. In the banking sector, except for Banca de Economii, Banca Sociala and Unibank, in Feb:15,



the current liquidity level increased by about 3 p.p. y-o-y and then in Jan:14 the growth was of 3.4 p.p. This development is a result of the diminished volume of granted loans. Another cause of the increase in liquid assets is the fact that banks have significantly decreased the supply of liquidity by purchasing NBM Certificates, despite the fact that the increasing rates of monetary policy made this instrument more attractive.

Figure 18. Current liquidity (%) and the stock of NBM Certificates (million MDL)



Source: Expert-Grup calculations based on NBM data

Challenges and short term forecasts

- The Increase in non-performing loans is an imminent risk to the banking sector. The worsening of economic perspectives for 2015 will reduce the revenues of households and firms and cause serious difficulties in loan repayment. On the other hand, MDL depreciation already generates additional costs upon payments for borrowers in foreign currency.
- A potentially stronger oscillation on the foreign exchange market along with the pessimistic expectations of the population could result into significant withdrawals of bank deposits. Such evolution could hamper the liquidity of banks, and this risk will remain persistent throughout 2015. However, the Moldovan banks, over the last years, have accumulated reserves of liquid assets, which could mitigate to certain extent the negative impact of funds withdrawals from bank deposits.
- Another issue is the population's lack of confidence in public institutions. All institutions responsible for economic security have tacitly "green lighted" the fraudulent transactions in the financial sector. Lamentable performance of the state authorities caused drastic reduction of public confidence in these institutions. Additionally, permanent disruption of the financial sector also diminished public confidence in banks. The economic uncertainty and distrust in public authorities and financial institutions are prerequisites that may intensify certain harmful behaviour among the population. Thus, in the context of unfavourable financial oscillations, the population may be irritated by the messages delivered by representatives of public authorities and act in a manner opposite to the recommendations given by public officials.
- The public institutions responsible for ensuring the state's economic security are also liable for the deteriorating situation in the banking sector. Generally, the actions undertaken by these institutions were limited to filing warnings to the governing bodies of the 3 banks on the risks related to the operated transactions, including discussions within the National Commission for Financial Security or the Security Council. The appointment of a special administration over the Banca de Economii, Banca Sociala and Unibank, granting loans to these banks or measures taken by the Parliamentary Committee were delayed actions which merely had the role to mitigate the consequences caused by the fraudulent transactions. Although the public authorities had all the necessary instruments at hand, the latter have not make use of them in order to counter the obscure operations. The Law on



Financial Institutions expressly provides that the NBM may limit the bank's activities (Article 38, paragraph 1, item f)) and may restrict, suspend or prohibit certain transactions or operations (Article 38, paragraph 2, item 3 e) if the interests of depositors are jeopardized or if the bank is engaged in risky or suspicious operations. The Presidency and the Government could use the platform of the Security Council or of the National Commission for Financial Security in order to raise the involvement of other institutions such as the Prosecutor's Office or the National Anti-corruption Centre to counter the transactions. In turn, the Prosecutor's Office or the National Anti-corruption Centre could commence serious investigations on their own on the suspicious transactions made by the 3 banks. The Parliament could have had a decisive role, being entitled to remove the inefficient leaders from the public authorities and use legislative tools in order to combat the obscure operations.

Policy recommendations

- Whichever solution shall be taken for the 3 banks: rescue or bankruptcy - a huge capital injection will be needed. Upon choice of the rescue option, recapitalization funds and supply of liquidity to the troubled banks will be needed, whereas if opting for liquidation of the banks, monetary resources will be necessary to repay the amounts deposited. It is possible that the solution of liquidating the banks might be much more expensive, as it may result in numerous undesired consequences. Liquidation of a bank might alarm the population, which could wrongly predict a collapse of the entire financial sector and would soar to a massive withdrawal of deposits. This would lead to a sharp drop in the amount of cash held by banks and to additional financing of the financial institutions by the NBM. It is possible that the final solution could be a combination of both rescue and liquidation measures. And in this context, in order to mitigate risks, the bank which has the lowest social importance should be liquidated.
- It is absolutely necessary to ensure a stable development of the foreign exchange market, without causing large volatility. To have the required amount of resources that would allow the market stabilization, the NBM should urgently identify sources to increase the foreign exchange reserves. One solution at this end is an immediate negotiation and signing of a new agreement with the IMF. At the same time, the status of the banking sector could become the "apple of discord" in the negotiations. Certainly, the IMF will insist on this point: the Moldavian side will be required to offer real guarantees on sector rehabilitation and detailed information on the suspicious transactions. On the other hand, political-oligarchic groups do not wish any disclosure of information about their interests in the financial sector and their possible involvement in certain suspicious transactions. In these circumstances the discretion of the Moldovan negotiators will be stimulated, and this will affect the dialogue with the IMF.
- It is absolutely necessary to change the approach on financial sector supervision and increase the efficiency of investigating the shadow transactions from the banking system. It takes a responsible and severe attitude on behalf of the relevant public authorities towards the banks that ventured into suspicious transactions and the individuals who performed or were accomplices in fraudulent operations. Currently some success in this regard may be achieved only under pressure from development partners, particularly the IMF and the EU.

Chapter 7. Foreign Sector

During 2014, the EU has strengthened its position as the main trading partner of the Republic of Moldova. The emerging European market attractiveness is also determined by the maintenance of Russian market restrictions and by other economic disturbances in the CIS region. As a result of the Russian involvement in the military conflict in Eastern Ukraine and the annexation of Crimea, the trade relations between the EU and the Russian Federation are worsening and generating adverse effects on imports from third party countries, including the Republic of Moldova. Thus, the main challenges for Moldavian exports are going to be the deficiencies in the quality of the national infrastructure, the domestic barriers to trade and the economic downturn Russia and Ukraine.

Key trends in foreign trade

The foreign trade was affected by both tariff and non-tariff trade embargoes, applied by the Russian Federation during 2013-2014. Therefore, in 2014 exports to the Russian market decreased by 32.9% y-o-y (or by 208.2 million USD), which represents 18.1% of total exports. Noticeable losses have been recorded in exports of the following products: apples, plums, quinces, wine; distilled wine products and fresh bovine meat (Table 4). On the other hand, although embargoes generated a restricted access to the Russian market, they partially protected in advance the Moldovan exporters from the negative effects of the strong devaluation of the Russian ruble and the economic slowdown in this country that started in Q4:2014 and is going to continue in 2015.

Table 4. The impact of trade embargoes imposed by the Russian Federation, million USD

Product category	Value in million USD
Apples, plums and fresh quinces	33.9
Wine	24.1
Distilled wine products	10.4
Fresh bovine meat	7.1
Canned vegetables	6.2
Total loss	81.7

Source: NBS

The attempts of the Moldavian authorities to resume the animal and vegetable product exports to the Russian market have failed. Partly, this was determined by the reluctance on the Russian side, which believes that Moldavian products do not meet the sanitary, veterinary and phyto-sanitary safety norms imposed by the Customs Union (CU) and the Russian Federation. The main objections expressed by Russian authorities regarding the meat products are related to the inefficiency in controlling the products conformity with the requirements of the Russian market, failure to ensure the tracking mechanism within enterprises and deficiencies in the certification of origin of products exported to the Customs Union¹⁰. Although some objections could be dismissed, the politicized trade relations continue blocking the communication between the institutions responsible for food safety from both countries. Thus, the Russian Federation has a negative impact on the political dialogue and its aggressive rhetoric towards the CIS states that have liberalized trade with the EU, maintains an unfavorable climate for the resumption of

¹⁰ Rosselkhoznadzor, FINAL REPORT on the business trip of specialists in veterinary services from the Member States of the Customs Union to the Republic of Moldova 13.10.2014 - 17.10.2014, 2015, http://www.fsvps.ru/fsvps-docs/ru/importExport/moldova/files/report_moldova_final_201410_13.pdf



bilateral trade. This aspect could worsen in time as a result of normative and technical discrepancies between the food safety systems, as determined by the increasingly apparent differences between the two geopolitical and economic systems – the EU and the CU / the Eurasian Economic Union.

The crisis in Ukraine had a strong negative impact on bilateral trade. The destabilization of the Eastern Ukraine regions had negative effects on the economy of this country, accelerating the devaluation of the hryvnia and shrinking the purchasing power of the population. Therefore, exports of Moldova to Ukraine country have been significantly affected, decreasing in 2014 by 22%. Also, in order to adjust the payment balance and the foreign exchange reserves of the country, the Ukrainian authorities have decided to implement non-discriminatory taxes for one year: 5% on industrial products and 10% on food products. Accordingly, the exports will have to face additional constraints in trade with Ukraine, currently by means of tariffs. The prolongation and/or the aggravation of the crisis in Ukraine will lead to the deceleration of the Ukrainian economy, which will continue having a negative impact on the demand for Moldovan exports.

The situation in Ukraine also had indirect significant consequences on Moldavian exports to some European countries. Due to the unstable situation in Ukraine and the adoption of economic sanctions by the EU against Russia in July 2014¹¹, Russia imposed an embargo on many EU products in Aug:14. For example, the demand for Moldovan juice in Poland has decreased by about 6 million USD. Maintaining or increasing sanctions due to the failure of concerned parties to implement the ceasefire ("Minsk 2"), namely the Russian Federation, will increase the competition on the European retail market, thus limiting the demand for supplies from third party countries, including the Republic of Moldova.

The trade acceleration with the EU Member States partly compensated the sales decline in CIS countries. The share of exports to the European market reached 53.3% in 2014, while the total volume of exports to EU increased by 9.6% compared to 2013. This growth was mainly generated by increasing exports to Italy (+31.4%), Germany (+21.6%) and Romania (+5.6%). At the same time, supplies to CIS countries continued to decline, reaching a decline of 20.3% compared to 2013, as a result of the crisis in Ukraine, trade embargoes imposed by the Russian side, and the depreciation of the Russian ruble and the Ukrainian hryvnia. Overall, the share of exports to CIS countries was 31.4% in 2014. Despite the Russian Federation's efforts to extend the area under trade restrictions on Moldovan products within the Custom Union, the supplies to Belarus and Kazakhstan increased by 49.1% y-o-y and 15.4% y-o-y. Although supplies to the EU had a positive impact on foreign trade, the total exports decreased in 2014 by 3.7% y-o-y due to the slow recovery of the European economy, the difficult economic situation in the region and the obstacles generated by the Russian Federation.

While the export of food, live animals, fats and manufactured goods have increased significantly, sales of other categories of goods have decreased. The exports of agricultural products increased considerably: corn by 192.1% y-o-y, sunflower oil by 77.9% y-o-y, cane sugar by 112.9% y-o-y, wheat and olive by 23.4% y-o-y. These products are being exported to EU countries and other non-traditional markets (Egypt, Libya, etc.). At the same time, the supply of other products decreased, e.g. wine and grape by -25.2% y-o-y; wine distillates by -25.3%; fresh apples, pears and quinces by -47.4% y-o-y. The main reasons for this contracted outcome are the trade embargoes imposed by the Russian Federation.

The imports from CIS countries continue to diminish amid the decreasing overall import volume by 3.2% compared to 2013. The negative trend of imports from CIS countries continued throughout 2014, recording a compression of 13.3% y-o-y. A completely opposite situation was observed for EU imports, where the growth was of 3.9% y-o-y. The major decline was noted on imports of sugar, sugar based products, honey and electricity, representing -53.1% y-o-y and respectively 50.3% y-o-y, which remains low in early 2015.

¹¹ EU sanctions against Russia over Ukraine crisis, http://europa.eu/newsroom/highlights/special-coverage/eu_sanctions/index_en.htm



Forecasts and Challenges

- The economy of the Russian Federation will shrink significantly. Keeping oil prices low, maintaining Western sanctions and the outflow of the capital from the country, are the main sources of current economic stagnation, and of the forecasted economic recession of this country and important trading partner of Moldova. The worsening of economic parameters was also caused by the depreciation of the ruble against the dollar by about 50% in 2014, which affected the public finances and domestic consumption in Russia. All of these factors will cause a drop of the Russian economy by 3% and respectively by 1% in 2015-2016. Thus, it will influence the demand for Moldavian exports, which is already low due to restrictions imposed by the Russian Federation in 2013-2014. At the same time, the pressure on Moldovan migrants will increase due to the devaluation of the ruble, eventual tensions on the labour market of the Russian Federation, but also due to tighter policies for immigrants. The economic situation in Ukraine remains difficult because of the military conflict in the Eastern part of the country. For 2015, there is a forecast drop of Ukraine's GDP by 5.5%¹² and an estimated inflation rate of at least 14%, based on the drop of the economy by 6.5% in 2014¹³, pointing on the unfavourable environment for Moldavian exports.
- The EU economy recovery, although slow, is getting more visible, which can generate new opportunities for the Republic of Moldova, in terms of deepening the trade liberalization process with the EU. The EU economic growth is estimated to 1.7% in 2015, and 2.1% in 2016¹⁴. At the same time, the main economic partners within the EU will record positive economic trends. Thus, the EU estimates for 2015-2016 show that Romania will achieve an economic growth of 2.7-2.9%, while Italy will continue to recover from the recession with a GDP growth of 0.6 to 1.3%¹⁵. A positive trend is expected in Germany, where the economy is expected to grow by 1.5-2%¹⁶. Nevertheless, maintaining the Russian embargo on food products of EU origin could partially limit the demand on the EU market for imported products. The reorientation and diversification of European exports to markets other than the Russian one will decrease the created surplus and will also encourage imports from third party countries.
- The involvement of the Transnistrian region in the trade liberalization process with the EU will become crucial to the economic convergence of both sides of the Dniester. The estimates show that the region's economy could shrink by 3.5% in 2015¹⁷, particularly due to decreasing foreign investments and economic slowdown. Therefore, the implementation of economic measures foreseen by the Association Agreement with EU is essential to the short and long-term economic development. In order to benefit from the advantages of trade liberalization with the EU, the Transnistrian side should meet at least three fundamental conditions: 1) the harmonization of quality infrastructure; 2) conformity to the requirements concerning rules of origin; 3) state aid transparency¹⁸.

¹² <http://www.reuters.com/article/2015/03/11/ukraine-crisis-imf-economy-idUSL1N0WD2KZ20150311>

¹³ www.imf.org

¹⁴ http://ec.europa.eu/economy_finance/publications/european_economy/2015/pdf/ee1_en.pdf

¹⁵ According to IMF, during 2015-2016, the expected GDP growth will be 0.4-0.8% in Italy, 2.4-2.5% in Romania and 1.3-1.5% in Germany, www.imf.org

¹⁶ http://ec.europa.eu/economy_finance/publications/european_economy/2015/pdf/ee1_en.pdf

¹⁷ <http://expert-grup.org/ro/biblioteca/realitatea-economica-transnistreana/item/1062-ret-q4-2014&category=7>

¹⁸ Idem.



Policy recommendations

The external economic risks can be mitigated through the following actions:

- Exploring the benefits of the DCFTA with EU is an emergent objective, despite the transitional periods negotiated with the EU. The efforts of the authorities should be focused on the following aspects: 1) fulfilment of sanitary and phyto-sanitary requirements, including the acceleration of the dialogue with DG SANCO, in order to obtain the access of animal origin products to the EU market; 2) enhancing the competitiveness of the domestic producers and exporters, by implementing the European and international quality standards, empowerment in promoting local products and adhesion to supply chains in the EU; 3) strengthening the organizational and monitoring capacities of quality infrastructure institutions (standardization, metrology and accreditation ones). At the same time, in order to diversify foreign markets and penetrate the EU market more easily, it is vital to have an efficient application of EU assistance provided in the framework of COSME and ENPARD.
- Unless trade relations with Russia are depoliticized, Moldavian exports to the Russian market will be impossible. However, it is necessary to focus efforts on unblocking the export items on which Russian authorities have clear objections (e.g. meat products). But removing embargoes will completely depend on the political decisions made by Russian authorities. Thus, creating a robust quality infrastructure could discredit the Russian objections. Likewise, this will stimulate exports to other CIS markets (Belarus, Kazakhstan). Moreover, the trade liberalization with the EU should be used as an opportunity to enhance local product quality and penetrate other foreign markets, thus reducing dependence on the Russian market. Also, tripartite negotiations (between the EU, Moldova and the Russian Federation) would be proper for addressing the discrepancies between European and CU legislation on food safety and quality standards.
- The authorities, together with European partners should examine the enforcement of a transitional period for the Transnistrian region, which would facilitate the transition from preferential trade regime (ATP) to the DCFTA conditions. Taking into consideration that the ATP regime will be cancelled for the Transnistrian region by the end of 2015, it is necessary to define a mechanism in a short period of time, in order to gradually extend the AA economic provisions on the region, starting with economic agents that already export to the European market. A realistic, flexible and inclusive approach should prevail in the negotiations with the Transnistrian region, in order to increase the interest for a greater economical convergence between the two sides and prevent new tensions in 2016.



■ About Expert-Grup

WHO WE ARE

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

OUR ACTIVITIES

Our core activity is economic analysis, forecast and policy research. In this area, we offer a wide range of analytical products and services helping our beneficiaries to take decisions that will support Moldova's development path. Our key competence consists in the ability to provide professional, high-quality and objective research in such broad areas as:

- Macroeconomic analysis and forecasts;
- Political economy;
- Public finance;
- Human development and poverty reduction;
- Labour market and consumer behavior;
- Foreign trade;
- Financial markets;
- The economy of European integration;
- Economic analysis by sectors;
- Regional and local economic development;
- Energy and the economy of the environment.

PARTNERS AND DONORS

During 2006–2014 Expert-Grup implemented over 60 research and advocacy projects in various areas related to economic research and public policy. Over 100 experts, both affiliated and not affiliated to our institution, from Moldova and abroad, were involved in these projects. We have worked with such donors as World Bank, Soros Foundation Moldova, East Europe Foundation, Konrad Adenauer Stiftung, Balkan Trust for Democracy, Black Sea Trust, Friedrich-Ebert-Stiftung, UNDP Moldova, UNICEF, European Commission, Council of Europe, Open Society Foundation, Swiss Agency for International Cooperation, and United Kingdom Department for International Development. In 2010 and 2012 Expert-Grup was selected as member of the National Participation Council. Since 2008, Expert-Grup has been a member of the Policy Association for an Open Society – an international network consisting of 56 think-tanks from various European countries.