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Post-COVID-19 crisis: what will the Moldovan economy look like?

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COVID-19 left a rather deep footprint on the Moldovan economy, although the 7% GDP reduction suffered in 2020 was partly due to the impact of the drought. The vulnerability of the Moldovan economy to such complex and intertwined crises is one of the most important lessons to be drawn from the economic year 2020. To some extent, this double source of fiscal vulnerability may explain the modest response from the part of government to COVID-19. However, the lack of vision of the Moldovan policymakers left the society and economy bearing the full brunt of the crisis, with potentially damaging political consequences for the future. The crisis revealed how timely the purge of the banking sector has been and how important it is to consolidate its progress. In the short-term, Moldovan companies will continue responding to the crisis by adopting new technologies and new modes of using labor, whereas consumers are likely to become a bit more frugal, at least for some time. In the longer-run, structural responses are necessary to enhance the resilience of the economy, including a policy for rebuilding domestic industrial capabilities, the creation of more solid budgetary reserves and development of capacities for evidence-based policy, from design to impact evaluation.

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Analytic framework

As the COVID-19 crisis is still unfolding, making projections involves a triple risk. First, how and when the pandemic crisis ends are still far from clear; and the longer it lasts, the more disastrous the economic consequences. Secondly, due to slow and shallow availability of official statistics, we still do not have a satisfactory understanding of how Moldovan companies and workers are adapting to the new reality. Third, it is not clear what policy adjustments are considered by Moldovan government for the medium-term and how they will interact with company-level strategies.

‘General equilibrium’ is one of the consistent frameworks for assessing the economic impacts, even if applied only qualitatively rather than quantitatively². We begin by examining the main economic impacts of the coronavirus in Moldova. Next the analysis undertakes a brief overview of the main lessons offered by the crisis regarding the Moldovan economy. We then turn to the most likely changes that one can observe as economic agents adjust their economic behavior. Finally, we discuss a number of policy adjustments that are required in the long-term for reducing the costs of future crises, be they epidemiological or of other kinds.

Economic impact of COVID-19 in Moldova

How exactly did COVID-19 crisis affect Moldovan economy? As for most of the Central and Eastern European (ECA) countries, Moldova has suffered a double hit: one related to domestic restrictions and another one caused by the adverse external environment.

What made Moldova a particular case is the very strong dependence of its real economic sector on external conditions. This is dramatically different to the 2008-2009 financial crisis, when the Moldovan financial sector was quite insulated from the global financial havoc. Our own economic simulations suggest that domestic and external shocks contributed more or less equally to the overall economic impact of the coronavirus. A part of the external shock came via falling domestic exports (-5 percent year-on-year decline in 2020). In addition, due to reduced output in automobile, apparel and fashion industries in European countries, to which many Moldovan firms provide processing services, the re-export of processed goods fell even more heavily than exports of domestic origin, by around -25 percent. Suspension of international travel and economic restrictions in countries hosting large groups of Moldovan workers (including Italy, Spain, Israel and Russia) created more adverse conditions for short-term labor migration and thus worsened the livelihood of many Moldovan households. In mid-2020 the number of persons temporarily working abroad was about 1/3rd smaller compared with the year 2019. As for the long-term migrant remittances, they behaved counter-cyclically, rather than in the expected pro-cyclical fashion: after a dramatic 15% decline in the second quarter of 2020, the flow of remittances stabilized somewhat in the third quarter, and apparently resumed

² By ‘general equilibrium’ we understand the process whereby an economic shock hits different sectors of the economy in different ways, with successive rounds of interaction between the impacted variables, before a new equilibrium state is established.

their growth in final quarter of 2020. This intriguing dynamic of the remittances compensated, in late 2020 and early 2021, the loss in domestic incomes.

All in all, the Moldovan economy suffered a 7% recession in 2020. The figure stands out as the most dramatic economic dip among the Central and Eastern European countries. Because of the resurgence of the coronavirus cases and associated mortality rates in early 2021, the economic decline is likely to continue in the first months of 2021 and the overall growth in 2021 to be rather modest. Around 2.0-2.5 percent points of the 2020 negative growth are due to the impact of the drought that has undermined the agricultural sector and related industries, rather than the coronavirus itself. However, once considering the counterfactual scenario – i.e., the assumption that under normal conditions the expected growth in 2020 could have been around 4.5 percent - it is clear that overall, the COVID-19 crisis caused a net economic loss equivalent to about 8-10 percent of the GDP.

What COVID-19 revealed about Moldovan economy?

The very fact that Moldovan economy has been doubly hit by the coronavirus crisis and by the drought, is in itself a very telling account of the exposure of Moldova to multiple crises. It is clear that once the COVID-19 crisis is over, Moldova will continue suffering the impact of the climate calamities. In the long-run, the cumulated economic, environmental and social impact of climate change is by far more detrimental than that of coronavirus – this is something Moldovan policymakers should be aware of. Addressing the climate change-related crisis requires more complex responses going much beyond the provision of adequate infrastructure for irrigation. However, a part of the policy response required by COVID-19 crisis may help Moldova adapt itself better to the current and future climate challenges.

Early in 2020 the IMF assessed the pre-Covid economic performance of Moldova as relatively positive, with decent fiscal and external buffers³. Subsequently, only the external reserves held by the National Bank of Moldova proved adequate, whereas the governmental fiscal space turned out to be rather narrow, and has been poorly managed. The declared fiscal response to coronavirus was only around 1% of the GDP (compare to 3.4% in Ukraine and 5.5% in Romania)⁴, but the effectively provided support is estimated to be even smaller, due to poor design of the measures, poor communication, prohibitive administrative conditionalities and lack of any impact evaluation during the implementation⁵. The manner in which the Government tried to rationalize and renegotiate the initially committed financial support to medical doctors who suffered coronavirus infection as part of performing their professional duties is one of the most illustrative failures of policy design and communication.

³ IMF, "Republic of Moldova. Staff Report", IMF Country Report No. 20/129, April 2020.

⁴ German Economic Team, "Economic Outlook in Eastern Partnership Countries", Policy Briefing, 02/2021, https://www.german-economic-team.com/moldau/wp-content/uploads/sites/4/GET_MDA_PB_02_2021.pdf

⁵ Stas Madan, "How can the economy be relaunched in 2021?", Expert-Grup Independent Think-Tank and Friedrich Ebert Stiftung, December 2020, https://www.expert-grup.org/media/k2/attachments/FES-Masuri_anti-criz_2020-ENG.pdf

The Moldovan financial sector withstood the pressure of the crisis in an orderly fashion. The National Bank of Moldova adopted a number of regulatory measures for the financial institutions in a swift manner, which contrasted the anemic and slow fiscal response. This may be something to consider for potential future crises – leaving aside considerations related to institutional independence; why not imagine the National Bank of Moldova playing the role of integrator and coordinator of the economic response? In addition, the speed of subsidiary response from the part of the commercial banks who efficiently provided options for renegotiations of loans, and their end-of-year financial results showed that structural and regulatory reforms undertaken in the recent 3-4 years have clearly paid off. It is not difficult to imagine the extent of the damage the COVID-19 crisis would have left on the balance sheets of the Moldovan banks had the banks been caught in a financial distress resembling that of 2013-14, when a financial embezzlement depleted the Moldovan financial sector of resources worth 15% of the GDP. The recent gains in financial soundness should be preserved and further consolidated, especially against the background of some actors attempting new attacks on domestic financial institutions.

Another lesson taught by COVID-19 crisis is that Moldovan households are desperately short of lifelong savings. With very small current incomes, around half of the Moldovan families do not have savings beyond 1-2 months of consumption. In the third quarter of the year 2020, only 15% of the households surveyed by the National Bureau of Statistics reported that they did not encounter any financial difficulties due to COVID-19 pandemic and associated restrictive measures⁶. At the same time, 12% of households mentioned they had to reduce their food expenditures, while another 14% reported they were consuming their savings. These figures suggest that many households probably had to increase their financial debt: consumer loans provided by Moldovan banks to physical persons increased by 18 percent between October 2019 and October 2020. In addition, the loans taken from non-bank organizations, usually at draconian interest rates and arrear-related penalties, increased by almost 9 percent.

It is quite likely that a number of companies in the most exposed sectors (including HORECA, transport, personal services) have already gone bankrupt or are going to go in the near future. Many of them operate in the “grey” economy. These companies, mostly of micro- or small size, do not have enough own liquidity, nor are they ‘bankable’ to borrow working capital from the banks. While end-of-year figures are missing, our own estimates suggest that in these sectors up to 10 percent of the companies may be forced to exit. This would be a tragic loss of entrepreneurship skills and jobs. Giving them a second chance should be a priority of first order for a wise government.

Finally, the COVID-19 crisis has undeniably proved that relying too much on foreign aid and support amid crises of magnitude and extent of a pandemic may be a very risky strategy; more exactly, it is not even a strategy. As of late of March 2021, Moldova is still severely short of any vaccine, with the number of infected persons per capita and

⁶ National Bureau of Statistics of the Republic of Moldova, “The main results of the survey “The influence of the COVID-19 pandemic on the household ” in the third quarter of 2020”, available in Romanian language at <https://statistica.gov.md/newsview.php?l=en&id=6859&idc=168>

associated mortality rates hitting global records. Taking more responsibility for our own lives is a very important lesson of this crisis, a lesson coming at huge human and economic costs.

Post-Covid: what to expect for the Moldovan economy?

As demonstrated by the coronavirus economic fallout, Moldova is already deeply integrated with the global economy. Some of these links, however, may suffer significant changes, thus influencing the economic trajectory of Moldova in the decade to come.

- ***Slowing down the globalization process.*** The economic globalization process suffered a heavy blow, although it is not yet clear if it is going to reverse or rather to halt for a period. However, the coronavirus crisis has demonstrated that international companies have to attach importance not only to the minimization of costs of every link in their supply chains but also to resilience of the chain in its entirety. European manufacturing companies who have their suppliers scattered globally, will probably consider bringing their production capacities closer to Europe. This may bode well for Moldova, provided that it develops technical and human capacities, offers a more predictable and fairer business environment for Foreign Direct Investment (FDI) and nudges FDI spillover effects to the benefit of the wider domestic economy.
- ***Shifting center of the global economy.*** With their strong growth China and other countries in Asia have seen their shares in global demand rising in recent decades. With a relatively milder economic and health impact on these countries, the coronavirus has accelerated this global mutation. For Moldova, this is an opportunity to further diversify and balance its foreign trade, especially in respect to the export of food and beverages, with many products still excessively dependent on the Russian market.
- ***A more rationalized official development assistance.*** Growing public debt of the developed countries, who are also the main global development donors, has been an inevitable consequence of their massive fiscal response to the COVID-19 crisis. Increased indebtedness will put more pressure on their budgetary expenditures and one should expect the electorates to hold these governments more accountable for the official development agendas of their countries. As the cost of servicing the public debt rises, so will the cost of the official development assistance. Moldova should expect the composition of its ODA to tilt towards more loans, fewer grants, and more conditionalities.

Besides these global post-coronavirus mutations, a number of domestic economic changes are likely to take place. These include:

- ***Consumers may become temporarily more precautionary.*** The crisis took most Moldovan families unprepared, without meaningful financial savings. They suffered heavy losses in their current incomes which were only partially compensated by the social assistance schemes and remittances. Quite likely, households will remain cautious regarding additional spending and notably regarding consumer durables, particularly the younger ones, dependent on labor income. Uncertainty always makes consumers more frugal and the pandemic perspectives remain highly uncertain.
- ***An increase in governmental debt is quite likely.*** The COVID-19 crisis opened a large public budget deficit (around 6% in 2020) and may cause additional budgetary distress in 2021. This will increase the borrowing needs of the government, which will turn to Moldovan banks for additional financing. Even though the level of public debt may remain manageable, financing it will put additional pressure on private financial institutions, and will potentially crowd out public and private investment and consumers' loans.
- ***A temporary reduction in investment demand.*** With so many unknowns regarding the short- to medium-term economic perspective, many companies will prefer to postpone their investment plans. This is especially the case of the micro- to small enterprises usually financing investment from their own resources that the COVID-19 crisis has depleted.
- ***Technological changes adopted by the companies may have systemic implications.*** The previously sluggish transition of Moldovan companies to online business processes has accelerated dramatically during the COVID-19 crisis. While not all elements of the production process can be put online, digitization is certainly the new trend. Companies want to enhance their productivity and to protect themselves in the face of similar crises in the future. This may have a number of undesirable implications, including reduced demand for some types of office-related labor and for administrative real estate.
- ***Emigration will probably intensify.*** There certainly will be an increased "demand" for emigration from the part of the workers losing temporarily or permanently their jobs, especially the younger ones, urban-based, working in services sectors. In addition, there may be an enhanced appetite for migration even from the part of those not having problems with their jobs, but who lost trust in the capacities of the Moldovan state to deliver critical services related to human capital formation, including education and health.

- ***A number of economic sectors will likely increase their output in short and medium term.*** The COVID-19 crisis has been an opportunity for the development of the Moldovan IT sector, which has seen dramatic increases in sales, both domestically and abroad. The demand is expected to remain strong as companies and state continue the digitization processes. Other economic niches may also experience positive impact due to coronavirus. For instance, we expect that the demand for domestically-grown organic food will rise strongly, as households attach greater importance and resources to health. With international tourism broken for an uncertain period of time, domestic niches, such as rural tourism and agri-tourism, may also see a better outlook, even though this may not last.

Post-Covid: the required long-term structural response

In order to respond to COVID-19 crisis economic fallout and to near-term uncertain epidemiological conditions, Moldovan companies already started adopting many technological, marketing and organizational innovations. Some of these may result in undesirable systemic changes, such as reduced labor demand and under-investment in crisis-exposed economic sectors. A more pro-active policy is required to address or countervail the expected negative trends.

- ***Industrial policy should ensure a gradual shift of the FDI attraction policy from providing assembly services towards development of effective manufacturing capacity.*** Providing assembly services within Free Economic Zones isolated from the rest of the economy does not offer the country a significant value added, or create lasting productive capacities and human capital. Instead, Moldova should adopt policies that would ensure that FDI are more evenly distributed territorially, and effectively contribute to the development of local suppliers and the emergence of local industrial clusters.
- ***It is necessary to rebuild domestic capacities in the pharmaceutical industry.*** Of course, the COVID-19 crisis has been a high-impact low-probability event. However, it may not be unique, and in the future health-related crises will probably proliferate. The Moldovan health protection system depends too much on provision of supplies from abroad, not only those technologically advanced, but also even for the most basic (masks, gowns, gloves, sterilizers, tests etc.). Moldova used to have a rather strong and diversified domestic pharmaceutical industry, whose capacities and technology degraded a bit over time. This industry needs state support for a technological boost. Moldova meets all the preconditions for a rather strong pharmaceutical cluster – including a top-level medical university, a number of medical schools, traditions of medical and biological research, strong connections with medical doctors from diaspora and multilingual staff.

- ***The food industry may turn into a sector enhancing economic resilience.*** Despite the sanitary crisis and drought, Moldova's food industry resisted rather well, with output declining only 3% and with exports remaining at the previous year level. Disregarding all technological revolutions and critical situations, the world permanently needs food, and the willingness to pay for decent quality food is very high. The importance of the sector goes much beyond this – it may provide an anchor stabilizing agricultural output and reducing rural poverty in long-term.
- ***Build stronger budgetary buffers.*** Moldovan government has practically no reserves for meaningful interventions during difficult times. Such reserves are crucially necessary and can be built gradually, but steadily. COVID-19 crisis is a type of disastrous but rare event; however, smaller-scale but more frequent crises in Moldova abound, especially related to weather conditions and extreme climate events. Reserves may take the form of a small National Investment Fund managed by some professional (foreign) asset management company or by the National Bank of Moldova. Creation of such a fund requires a strategic re-evaluation and optimization of current and capital expenditures, a predictable and fair fiscal policy, professionalization of the management of state-owned enterprises and a sound long-term plan of public capital investment. At least, a robust assessment of the cost-benefits of such a fund is fully warranted.
- ***Develop capacities required for effective policy design and delivery.*** Moldovan government lacks the most essential ingredients for evidence-based policy – real-time or short lead-time data, quantitative tools for continuous policy assessment, trained human resources and a tradition of honest assessment of policy impacts. These are core elements of the policy function and they cannot be 'contracted out', but rather have to be. Easy to say, difficult to do, but any journey requires a first step.