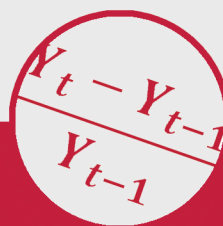


MEGA

4th Quarter, 2015. #13



Moldovan Economic Growth Analysis

**2015 - the year when
everything in our economy
turned bad**

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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.*



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Key Policy Messages

- The year 2015 can be considered as the year of materialized risks.** Practically all the risks that we identified in the previous MEGA issue in April 2015 did occur: the banking crisis, perpetuation of political uncertainty, stagnation of reform process, worsening relations with the development partners, reduction of exports and remittances due to the economic crisis in Russia, 2-digit inflation etc. In addition to these constraints, Moldova has faced a year with unfavorable weather conditions, which affected the agricultural production. Because of this overlapping of external and, especially, internal shocks, the economic growth rate has decelerated continuously. For 2015 we expect an economic recession of about 0.8% and a slow recovery of +2.9% in 2016. In fact, this year's economic recession could have been much more severe if our national currency would not depreciate, since this phenomenon ensured a better performance for exports compared to imports. Therefore, when analyzing GDP creation according to the expenditure approach, we can assess that the only reason why, after three quarters, the economic growth remained positive is the net export effect (increase of exports coupled with reduction of imports).
- The main challenge for the Moldovan economy is not necessarily its recession, but rather the low level of resilience towards negative shocks and the weak capacity of authorities to face the crisis.** In particular, the national economy was utterly unprepared for this crisis: a rising budget deficit (estimated at 3% of GDP in 2015, while the optimal level is approx. 1% of GDP), low level of currency reserves (they currently can cover 3,5 months of imports – at the dead-end of acceptable levels) and a struggling banking sector weakened by the bankruptcy of the three banks, representing one third of the system's assets. These problems are worsened by the fact that the key-institutions that are supposed to urgently intervene to stabilize the economy are either paralyzed by the political crisis or lack technical and financial resources. Thus, due to the absence of a functional government, the reform process is blocked, the next year's budget is not approved and because of the management crisis at the National Bank of Moldova (NBM), there is an impossibility to negotiate a new memorandum with IMF and respectively, to unlock funding from the development partners.
- The political uncertainty has strongly affected the investment activity in 2015.** The weakening internal demand, the reduced level of credit and a low confidence of entrepreneurs have all determined the decline of private investment in Moldova, which will likely keep this downward trend in 2016. Additionally, current budget constraints not only hamper the public investments, but also represent a barrier for urgent and strictly necessary investments. Moreover, political instability has also led to a reduction of external funds for stimulating investment. In this respect, it is necessary to agree on a new memorandum with IMF, which will not only enable the increase of official reserve assets and the stabilization of public finance, but will also unlock funding from other development partners that could contribute to modernizing the infrastructure and increase the labor demand. In addition, it is necessary to improve Moldova's reputation abroad and particularly that of the banking system, in order to attract new investments and to create the necessary conditions for businesses to expand.
- The banking sector, which has always been a key pillar of stability for the Moldovan economy, has suddenly become one of its Achilles' heel.** Although most of the banks remain sufficiently capitalized, the bankruptcy of three important banks has eroded the trust of population in the entire banking system and highlighted the major flaws in terms of banks' corporate governance and the efficiency of banking supervision. One of the immediate measures that should be undertaken by the authorities is adopting a Law on stabilization and reform of the banking system. This law should focus on seven key elements that shall strengthen the confidence in the system, increase the efficiency of banking supervision and improve corporate governance in banks:

 1. Ensure transparency of the final beneficiaries of banks' shares;



2. Accelerate the investigation of causes that led to the bankruptcy of BEM, BS and UB and prosecuting those responsible;
 3. Prohibit by law any interaction between Moldovan banks and entities that operate in jurisdictions which do not implement international principles of accounting and financial evidence;
 4. Increase the capacity of banks, especially the systemic ones, to absorb losses;
 5. Strengthen the corporate governance within banks according to BASEL III principles;
 6. Strengthen corporate governance of NBM and increase its capacity in the area of bank supervision;
 7. Facilitate competition in the banking industry by streamlining the efforts from NBM and Council of Competition in preventing and countering eventual anti-competition arrangements between the industry participants;
- **The fiscal year of 2015 has proven to be extremely difficult, but the major risks in public finance will persist for the next year.** The future risks relate more to the political aspect rather than the economic one. In fact, the main economic risks have already happened this year, with the budget execution affected by the internal shocks in the banking system and the external shocks channeled through the economic crises in Russia and Ukraine. In addition, the political risks are transferring from this year to the next one, without any sign of them fading out. These risks relate to both the political instability, which affects the schedule of Budget drafting and adoption, and how the authorities are managing the current banking crisis, which caused a backlash in foreign financial assistance. Along these transferable risks, it will be challenging to adopt a viable budget without an agreement with IMF.
 - **It appears that the consumption-based economic growth model is fading away, leaving the economy without alternative growth engines.** An internal consumption that is heavily dependent on remittances cannot ensure a balanced economic growth. Given that resources were not used efficiently in more stable economic times, to ensure a transition to a more sustainable growth model, it is necessary in the short-term to undertake major efforts in maintaining the private consumption in times of tough budgetary constraints. Therefore, it is necessary to coordinate policies in all fields: (i) relevant fiscal and social policies that will enable a healthy model of internal demand; (ii) industrial policies that will promote private investment and will facilitate economy's structural transformation; (iii) a monetary policy that will ensure a monetary stability without major repercussion on consumption and investment; (iv) trade policies focused on development, albeit difficult to accomplish under current budgetary constraints. On the long run, a stable growth of private consumption can be ensured primarily through creating well-paid jobs. Therefore, the main efforts shall be directed to improving the business climate, which despite some small achievements in the last year remains uncertain for investors, because of the rampant corruption and the inequitable justice system.



Forecasts for 2015-2016

Table 1. Forecast of the key macroeconomic indicators

	2015		2016	
	Baseline forecast	Pessimistic scenario	Baseline forecast	Pessimistic scenario
Gross Domestic Product, %	-0.8	-2.5	+2.9	+1.0
Agriculture, VBA, %	-12.6	-20.4	+6.8	+4.3
Industry, VBA, %	+3.1	+1.2	+4.8	+1.7
Constructions, VBA, %	-0.5	-1.2	+3.0	+0.1
Domestic trade with goods and services, VBA, %	+2.3	+0.8	+3.3	+0.7
Transportation, VBA, %	-1.6	-2.6	+1.0	0.0
Net taxes, %	+1.0	+0.7	+3.3	+1.1
Final consumption, %	-1.5	-2.0	+2.0	+1.0
Gross capital formation, %	-6.8	-13.4	+3.8	-1.5
Exports of goods and services, %	+2.1	+1.5	+4.7	+4.2
Imports of goods and services, %	-2.2	-3.3	+3.0	+2.1
Remittances, %	-8.3	-10.4	+0.6	-10.0
Foreign Direct Investments, %	-5.4	-6.2	+0.8	-5.2
Bank loans in MDL, %	-42.5	-42.5	-6.6	-25.2
Fiscal revenues, %	-4.4	-6.1	+4.0	+3.8
Real wages, %	+2.5	+2.2	+3.0	+2.5
Consumer Price Index, %	+9.6%	+9.6%	+11.0%	+12.0%

Note: GVA – Gross Value Added

Source: EXPERT-GRUP estimates and forecast;



Executive Summary

Domestic supply. Despite many domestic and external challenges, in Q1-Q3:15 the Moldovan economy managed to grow by 0.5% y-o-y. The GDP growth was driven primarily by the financial sector (+1.0 p.p.), industry (+0.6 p.p.) and domestic trade (+0.2 p.p.). At the same time, the agricultural sector stagnated, due to bad weather conditions and difficulties created by the embargo imposed by the Russian Federation. Moreover, economic growth has been mostly caused by the national currency depreciation against the main benchmark currencies. Nevertheless, in the second quarter, the gross value added is clearly going through a slowdown, which is a worrying sign unless this trend is stopped and reversed swiftly during the next quarters. It is a difficult goal, not only in the context of the latest developments in the main economic domains, but also because of the basic effect the political instability amid regional tensions / challenges. Furthermore, the current political situation diminishes the confidence of economic actors in the domestic business climate and it discourages behaviors that generate added value to the economy. At the same time, the lack of predictability in the decision making process further erodes the confidence within the business environment, and the poor implementation of legislative / regulatory measures (which are often subjective and not transparent) contribute to the further instability of the business climate and to the erosion of investment incentives. In these circumstances we expect an average annual GDP growth of about -0.8% in 2015, with a modest recovery in 2016 of about 2.5%.

Domestic demand. The structure of economic growth by expenditure components reflects its low quality and, finally, shows that the Moldovan economy is on a recession trend. Given that remittances have been declining, the final household consumption stagnated as well and might diminish by 0.9-1.2% in 2015 y-o-y. Additionally, low confidence of entrepreneurs and budgetary constraints have caused the decline of private and public investment, which will sharpen by the end of the year. We anticipate a 6.8% fall in gross capital formation in 2015. Thus, only the decline in the trade deficit could ensure the economic growth in the first half of the year, but this was also due to factors not related to increased the competitiveness of the national economy. Moreover, by the end of this year it will not be able anymore to offset the decreased consumption and investment, so that we forecast a GDP decrease of 0.5% in the baseline scenario, up to 2.5% in the pessimistic scenario. Therefore, a major effort is needed for coordination of all policies that would help emerge from recession, immunize against external shocks and, subsequently, build a balanced growth model. This is extremely difficult in the context of rigorous budgetary constraints and certainly cannot be achieved without a Memorandum with IMF that would also unlock funds of other development partners and wider access to finance by restoring the confidence in the banking system.

Public finances have been affected both by economic factors and by the country's political crisis. In the first case, two economic shocks related to the deterioration of the external economic situation and the banking system crisis from the Republic of Moldova, have created a chain reaction on all macroeconomic indicators. There was noted a decrease in remittances, a depreciation of MDL, an acceleration in inflation, a decrease in internal demand, imports and exports. All these factors have led to a level of budgetary revenue below the initially planned one, and the tightened monetary policy has caused a rapid growth of the interest rates on public securities (PS), raising the financing cost of the budget deficit. Moreover, the opportunity to use public securities in order to finance the growing budget deficit was also undermined by the decrease in the commercial banks demand for these instruments, as a result of the increased required reserves ratio. At the same time, the political crisis had a negative impact on following the budgetary calendar. Since there was no functional government at the beginning and the end of the year, the budget for 2015 was adopted with delay and at the end of this year, the budget for 2016 will not be adopted and published according to the budgetary calendar. Additionally, the poor management of the banking crisis made the main external donors freeze their financial assistance. In general, the budgetary system has turned out to be flexible enough to economic shocks and the immediate priorities should focus on solving the current political crisis and negotiating an agreement with the IMF.



Labor Market. In the context deteriorating economic conditions of the current year, the main indicators of the labor market have surprisingly demonstrated a quite positive dynamic. Despite the fact that in Q1:2015 there was noted an unexpected increase in the unemployment rate of 8.5%, by 3.4 p.p. y-o-y, it decreased in Q3:2015 by 3.3%. If we exclude the seasonal element of unemployment, then the growth was not that impressive, oscillating around 4.8%, during the all three quarters. The employment rate had a dynamic similar to the unemployment one, reaching about 39.6%, except seasonal oscillations. During this year, the number of monthly available job vacancies oscillated between 6 and 8 thousand, this being a new equilibrium point for the last three years, unlike the 2009-2012 period, when the number of monthly available vacancies was of only 2 to 4 thousand. At the same time, there is a negative side of this process, and that is the constant growth of the employed population in the agricultural sector and its reduction in other sectors of the economy. This will have a negative impact as long as the ratio of informal jobs created in agriculture remains at the current level of over 70% and the labor productivity remains lower than in other sectors.

Prices and monetary policy. During the analyzed period, the consumer price index has returned to the double-digits level from the pre-crisis period of 2009, as a direct consequence of the visible depreciation of the national currency and the decrease in the supply of agricultural products due to a climatically unfavorable year. In order to counter the negative effects caused by the depreciation of the exchange rate and to stabilize the imminent rise in prices, the National Bank of Moldova has undertaken a series of measures in order to tighten the monetary policy. During 2016, the inflation will remain at the double-digit level, due to rising prices for electricity, heating, utilities, as well as due to the reduction in the supply of agricultural products caused by an unfavorable agricultural year. A major challenge for the monetary policy is ensuring price stability amid an economic recession. Therefore, we reiterate the recommendation from the previous MEGA edition, namely to ensure a gradual easing of the monetary policy through the reduction of the interest rate to 10%, which could be done throughout 2016. At the same time, it is necessary to continue modernizing the toolkit meant to identify and predict inflationary shocks, in order to boost the NBM capacity in promoting a prevention monetary policy instead of one countering post-factum the excessive inflationary growth.

The Banking Sector is going through difficult times. Thus, after almost a year of „convulsions”, in October 2015 the National Bank of Moldova decided to liquidate the 3 banks involved in the fraudulent mega-transactions of 2014, and put other 3 major banks under special supervision. Moreover, at the end of the year, the NBM Governor decided to quit. Additionally, the economic uncertainty and the tightened monetary policy have negatively affected the activity of the banks. The worsening economic situation and the depreciation of the national currency caused a reduction in the lending activity and resuscitated the tendency of banking assets to deteriorate. The mistrust of the population in financial institutions has led to a reduction in the deposits level, and the perpetuation of this development could become an important risk for the banking sector. In this context, the uncertain economic and political perspectives will present risks for the evolution of the banking sector in 2016. Most likely, in the short run, the evolution of the banking sector will continue to negatively impact the dynamics of the national economy.

Foreign trade. The last year evolution of the trade policy has been marked by the stagnation of exports to the Russian market due to tariff and non-tariff restrictive measures applied by the Russian Federation. Statistically, the negative evolution of the external trade has been significantly slowed down by the appreciation of the US dollar against the Euro, but also by quantitative increases in exports of several groups of goods. During Q1-Q3:2015 the exports of goods decreased by 16.6% y-o-y. Geographically, the main destination of Moldovan exports continues to be the European Union, which has a rate of 62.1% of the total exports, followed by the CIS countries, which represent 25.3% of Moldovan exports and which decreased by 35.6% y-o-y. In 2016, the total exports of goods and services will rise by 3.4%, while imports are about to rise by only 1.7%. We forecast a faster increase in exports compared to imports due to the depreciation of the national currency and the perpetuation of the macroeconomic uncertainty in the country. At the same time, in order to boost the external trade, it is necessary to continue the discussion with Russian authorities in order to reevaluate the restrictive measures applied on Moldovan goods, while consolidating institutional efforts meant to deliver on the advantages offered by the new trade regime with the EU.

Chapter 1. Domestic Supply

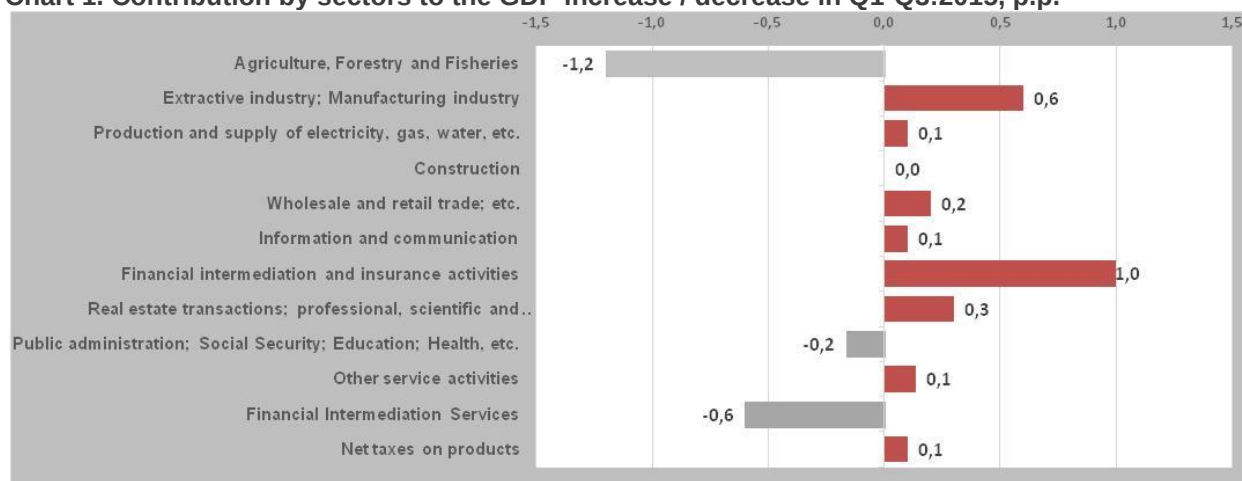
Since the beginning of 2015, the economic activity has been continuously cooling and by the end of this year, it might enter into recession. Although the modest prospects for agriculture decelerate the dynamics of economic growth, it is likely that the depreciation of the national currency will partially compensate these deficiencies. Nevertheless, given the less favorable prospects in the region and the lower external demand, the cyclical recovery will be below expectations and the negative GDP deviation from its potential level will persist relatively more. We anticipate an average annual GDP growth of about -0.8% in 2015, with a modest recovery of about 2.5% in 2016.

Recent trends

Despite many domestic and external challenges, in Q1-Q3:15 the Moldovan economy managed to grow by 0.5% y-o-y. This result is mostly due to a domestic currency depreciation of about 25% against the US dollar, which, on the one hand, has helped the exporters to face the recession easier, and, on the other hand, discouraged imports, leading to a positive contribution of net exports to GDP formation.

In Q1-Q3:2015, the economic growth was driven by 3 sectors. GDP growth was driven primarily by the financial sector (+1.0 p.p.), industry (+0.6 p.p.) and domestic trade (+0.2 p.p.). Nevertheless, these growth factors seem to be temporary, given the difficulties in the banking sector, the cooling domestic consumption (see Chapter 2), and export reduction (see Chapter 7). At the same time, the construction has been mostly stagnating and agriculture registered negative growths (Chart 1). Thus, the absence of evidence-based incentives, which would ensure at least an increase in accounts, we expect a slowdown or even a reduction of the economic activity in the second half of the current year, which will affect largely the GDP evolution throughout 2015.

Chart 1. Contribution by sectors to the GDP increase / decrease in Q1-Q3:2015, p.p.



Source: National Bureau of Statistics

Agriculture. Adverse weather conditions and the difficulties resulted from the embargo imposed by the Russian Federation, have affected the performance of this sector. Thus, in Q1-Q3: 2015 the agricultural production recorded a dramatic decrease of 17.8% y-o-y. First, the decrease in global agricultural production was determined by the reduction of vegetal production by 21.8% y-o-y. It should be mentioned that due to the current year drought, the average harvest per hectare has declined by about 26% y-o-y for agricultural crops, and has increased only for stone fruit and wine grapes by 8% and 37% respectively. Despite the poor harvest recorded, the prices for



most crop production increased by about 24.4% y-o-y, which compensated to some extent the incurred losses resulted from the current year drought and the loss of certain outlet markets.

At the same time, despite the fall in milk and eggs production by 0.1% and 13.4% y-o-y respectively, during Q1-Q3:2015 the animal production recorded a slight increase of 3.3% y-o-y due to an increase of 7.6% y-o-y in cattle and poultry production. Also, despite the progress recorded, the prices for animal products decreased by 10% y-o-y, especially for pork.

Industry. During Q1-Q3:2015, the industrial production increased by about 4.0 % y-o-y, with a slight decrease in September compared to previous months, and this trend will continue until the end of the year. By far, the manufacturing industry has generated the highest country growth index. But we cannot say that the food industry has fully recovered from the last year shock, since it recorded an increase of only 0.9% y-o-y (the most dramatic situation being noted for spirits distillation) and the tobacco production recorded a peak decrease of 56.1% y-o-y. At the other end, the electrical equipment production recorded an increase of 43% y-o-y, thus contributing to the increase of the country growth index by 1.8 p.p. Also, the pharmaceutical production and the garments industry increased by 20.7% y-o-y and 12.4% respectively. This highlights the increased external demand for these products after the reanimation of the EU economy, stimulated by the depreciation of the real effective exchange rate, which had a positive impact on Moldovan exporters (see Chapter 5). The current situation in Moldovan industries shows that the highest value-added activities are not initiated and perpetuated by local companies, but they are performed or provided in other countries. Also, the activities of Moldovan companies usually have a low value-added, they are fragmented and unstable in the long run. Currently, the most significant contribution to export is brought by goods placed under outsourced inward processing procedure. Especially wearing apparel and footwear, followed by cables and chairs etc. have an enormous potential for such operations, although they actually do not represent a proper export since the value-added and the respective revenues are lower than in case of "classical" exports. Such competitive advantages can be easily eroded and lost (they represent temporary competitiveness conditions and cannot be sustained), especially in the context of an excessive dependence on the EU demand.

Construction. During Q1-Q3:2015, the construction sector registered a significant decrease of 7.4% y-o-y. Although the volume of residential and nonresidential constructions increased by 12.8% and 4.2% y-o-y, the engineering construction volume decreased by 21.3% y-o-y. Most of the works were performed by private economic agents. They executed construction works of 77.6% from the total performed works. In the mentioned period, the price index for the construction and assembly works increased by 7.8% y-o-y. It should be also noted that the development partners hesitated to initiate major projects with social facilities and canceled them for an indefinite period.

Domestic Trade. During Q1-Q3:2015 the dynamics of domestic trade and delivered services recorded a sporadic character in all components. Thus, the retail trade volume decreased by 4.5% y-o-y, which shows a decline of household consumption due to reduced purchasing power, in the context of higher prices or consumption slowdown after the panic from the beginning of the year. At the same time, the wholesale trade volume increased by 7.5% y-o-y. The volume of market services provided to the population increased by 1.0% y-o-y, while the volume of market services provided to enterprises increased by 6.0% y-o-y. This trend has continued throughout the year in the context of reduced household incomes (see Chapter 2).

Challenges and forecasts

- According to our baseline forecast, in 2015 the country's economy will register a decline of -0.8% in the context of noted difficulties in agriculture and construction, and given the stagnation of the main sectors of the national economy. Also, the dissipation of the stimulatory effect of MDL depreciation in the first semester and its transformation into inflationary effect, is going to put an additional pressure on the real GDP growth. For 2016, we forecast a slow recovery of the national economy, with an increase of about 2.5%.
- The agriculture is going to remain in recession (-15%) until the beginning of the new agricultural season,



given the modest results caused by the current year drought. Nevertheless, for 2016 it is foreseen a revitalization of the sector and an increase of 6.8% of the gross value-added. Furthermore, the most optimistic scenario would require a better integration of this sector in the community flows in case of a hypothetical advancement in the implementation of the provisions of the Association Agreement with the EU.

- The average increase of the GVA generated by the industrial sector in 2015 is estimated at about 3%, and it is forecasted to grow by about 4.3% in 2016 amid the revival of the external demand.
- The construction industry will record an average decrease of the GVA of about 1.5% in 2015 due to the tight investment activity, the limited access to bank loans, the suspension of several infrastructure projects due to budgetary constraints and the suspension of financial assistance from development partners. For 2016, we forecast a very slow recovery of the sector, with an increase of only 3.5% of the GVA, amid constraints perpetuating from 2015.
- The domestic trade is going to grow by 2% in 2015 and 3% in 2016, driven by consumption of goods and services for which the demand is less sensitive to economic cycles. Nevertheless, the cooling of the consumption is going to put major pressures on the economic growth (see Chapter 2).

Policy recommendations

- For the moment, the domestic economy has a relatively low level of competitiveness in the European context and less investments attracted per capita compared to other countries from the region, due to both the lack of a transparent legal framework and the enhanced regional competition. For that reason, there appears the stringent need of strengthening confidence of the economic actors in market quality and encouraging the behaviors generating economic value-added. Thus, the end of political crisis, along with the establishment of a functioning government, requires a higher degree of predictability in the business environment, which would be transposed into an economic activity stimulating the private sector.
- Also, the authorities should get more concerned about increasing the gross value-added and business productivity by focusing on sectors that could have a competitive advantage. Furthermore, there is a need for structural adjustment of the economy, which can be done through increasing the ratio of products, processes and activities that use a smaller amount of resources, but generate a high value-added. In this regard, the most efficient could be the services sector. Nevertheless, the development, specialization and improved service quality should be rather a tool than a goal for increasing the efficiency and competitiveness of all other economic sectors.
- We also mention that currently the country's biggest competitive advantage is the cheap and relatively skilled labor. But a sustainable economic development based only on this competitive advantage is not sustainable, taking into account the mobility of this factor in the context of an increasing globalization. Furthermore, we risk to encourage temporary investments, which have no contribution to the development of any industrial sectors and has investors who at any time could migrate to other destinations given the exhaustion of this benefit. Thus, for a sustainable development, the current public policy should focus on the successful example of economies that continuously create and recreate competitive advantages.
- In the current difficult economic conjuncture, it is obviously necessary to negotiate a new Memorandum with the IMF, this being not only a precondition for ensuring macroeconomic stability, but also a clear signal on strengthening the country's credibility abroad, which will have a stimulatory effect on investment activities. Thus, we reiterate the crucial importance of this exercise for the economic recovery in the next year and for ensuring the forecasted economic growth.

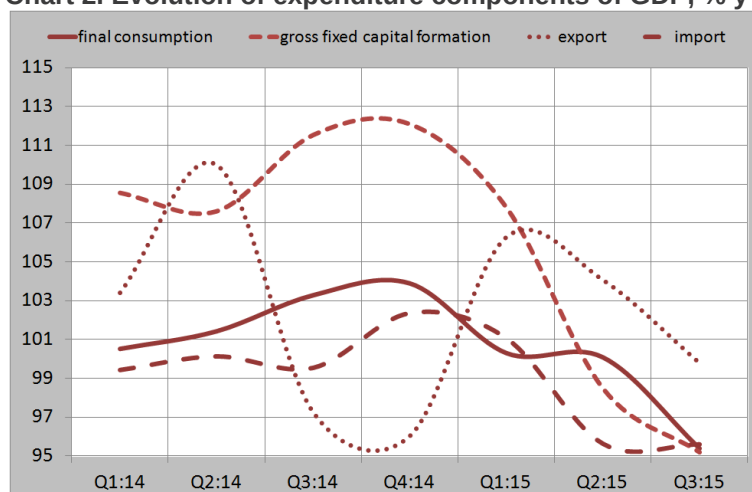
Chapter 2. Domestic Demand

The structure of economic growth by expenditure components reflects its low quality and, finally, reveals that the Moldovan economy is on a recession trend. The final consumption stagnated, the gross fixed capital formation got on a negative trend, and the economic growth was kept up almost entirely by lower trade deficit. Thus, under strict budgetary constraints, a major effort is needed in coordinating all policies that would help Moldova emerge from the recession, get less sensible to external shocks and, subsequently, build a balanced-growth economic model.

Recent trends

The growth structure by expenditure components reflects its low quality and, finally, shows that the Moldovan economy is on a recession trend, confirmed by significantly worsening indicators in Q2-Q3:2015. Thus, in this period, the final consumption and the gross fixed capital formation started a negative trend, and the economic growth was kept up entirely by a decreasing trade deficit (Chart 2). Even this last development was supported by factors not directly related to the increase of domestic products competitiveness, as the sharp depreciation of the national currency, that makes the economic reality of Moldova even more gloomy.

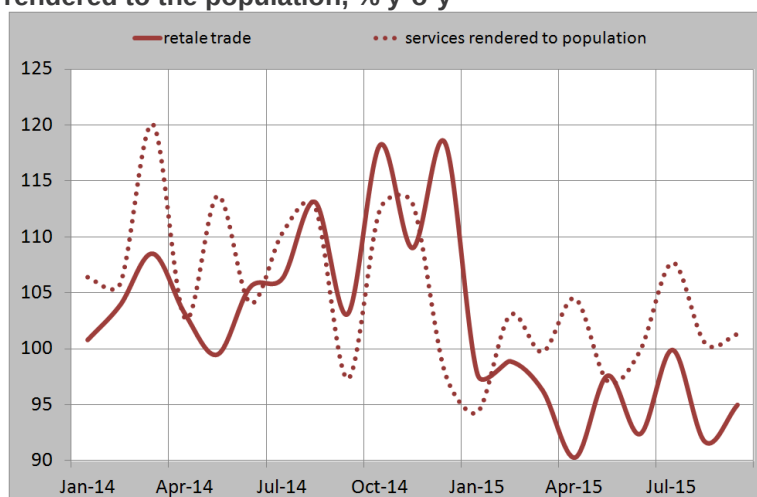
Chart 2. Evolution of expenditure components of GDP, % y-o-y



Source: NBS;

As anticipated, the more consistent increase in final consumption of late 2014 has quickly dissipated in 2015. Even though inflation pressures remained high, the uncertainty and the decline in some important sources of population revenues have caused a stagnation in private consumption in Q2:15 and its decline in Q3:15. Thus, in three quarters of 2015 private consumption reduced by 1.9%. Such a low performance of final household consumption during three consecutive quarters has not been recorded over the past five years. Data on retail trade and services rendered to population also indicate over low trade activity during this period. The retail trade has been declining throughout the year, the turnover decreased by 4.5% y-o-y in Q1-Q3:2014 and the volume of services rendered to population almost stagnated, the growth being of 1% in the same period (Chart 3). These evolutions overlap the reduction in remittances in 2015. Remittances recorded a decrease by 33% y-o-y in ten months of 2015, which has sharpened in recent months. Moreover, current budgetary constraints led to a reduced government consumption too, which declined by 0.7% in the first half of the year.

Chart 3. Turnover evolution in retail trade and services rendered to the population, % y-o-y



Source: NBS;

Economic and political uncertainty have also affected the investment activity, which was rather modest in 2015. Thus, the gross fixed capital formation has declined since Q2:2015, decreasing by 0.5% in nine months of 2015 y-o-y. This evolution was driven both by the low confidence of entrepreneurs in economic conditions and by more pronounced budgetary constraints throughout the year, which sharpened during the third quarter. Thus, the decline of investments in long-term tangible assets was more pronounced, reaching 3.4% y-o-y in Q1-Q3:2015. Investments from budgetary sources reduced by 0.2% and the situation on investment projects became more uncertain after the interruption of external funding and the inability to negotiate a memorandum with the IMF. Investments funded by local businesses and the population decreased by 3.6% and only the investments financed from foreign sources increased by 63%. Still, their share is relatively low and it is rather a recovery after foreign investment inactivity. FDI also almost doubled y-o-y in the first half of 2015 due to the reinvestment of incomes which were largely withdrawn in 2014 and decline in commitments to foreign investors.

Challenges and forecasts

- The recent events on the Eurasian continent can have a major impact on the future policy of the Moldovan partners and their economic situation. Thus, besides internal problems, Moldova has to face new potential external shocks. Most of the time Moldova was not ready to face such shocks even under conditions of political stability. It will be even more difficult to respond to these shocks in the context of political instability: the lack of a parliamentary coalition majority, of a functioning government and a NBM leadership that may take responsibility and manage potential external shocks promptly and efficiently.
- The year 2015 was less beneficial both for Moldova and its Eastern and Western partners, as revealed by the evolution of remittances. By the end of the year we forecast a decrease of remittances by 8.3% to 10%. Thus, this year the final household consumption, which lacks other sources for growth, might shrink by 0.9% according to the optimistic scenario or even by 1.2% according to the pessimistic scenario. Given that the final consumption of public administration is on a downward trend due to budgetary constraints this year, the total final consumption could fall by 1.5 - 2% in 2015, with a negative impact on economic growth. For the year 2016, due to increased international uncertainty, we forecast a low increase in remittances by 0.5%, which will contribute to a moderate recovery of final consumption by 1-2%.
- Modest domestic demand, low lending activity and low confidence of entrepreneurs will maintain investment on a downward trend until 2016. Thus, we anticipate a decrease of investment of 5.4%



in 2015 and a moderate growth of 0.5% for 2016. The gross capital formation is going to reduce by 6.9% in 2015, and in 2016 we expect a recovery of 3.8%.

- Trade deficit will continue to decrease in 2016. Thus, the slowdown in domestic demand and more expensive imports as a result of national currency depreciation in 2015, will lead to a decrease of imports by 2.2% on the one hand, and an increase in exports, which value more, by 2.1% on the other hand. Thus, net exports could positively impact the economic growth by 3.1 - 3.5% in 2015. Although developments in 2016 depend on the geopolitical situation as well, we forecast a moderate increase in imports, so that the net export contribution to GDP growth will still be positive, but weaker (0.2-0.8%).

Policy recommendations

- It seems that the consumption-based growth model has dissipated completely. Even if it is often criticized, this model has provided over several years the necessary resources for a gradual shift to a balanced growth model. This has not happened due to the slow and very deviated implementation of necessary reforms, some of which were even missing on the government agenda. The current situation requires to find necessary solutions to emerge from recession, to ensure balanced growth and make Moldova less sensitive against external shocks. This involves coordination of policies in several areas: (i) fiscal and social policy that would support healthily the domestic demand, (ii) industrial policy to promote private investment and structural transformation of the economy, (iii) monetary policy that would ensure monetary stability without severe repercussions on consumption and investment and (iv) development-oriented trade policies.
- Domestic consumption heavily dependent on external developments (i.e. remittances) cannot ensure the balanced growth we should aim to. In order to make it less dependent on remittances, it is necessary to have a healthy demand that can be primarily ensured through the creation of well-paid jobs. Thus, the main efforts in this regard should be directed towards improving the business climate, which, despite some small achievements in recent years, remains uncertain for investors and is dominated by corruption and unfair justice system. Moreover, in order to attract foreign investors, the image of Moldova has to be generally rebuilt since it was badly damaged in the last year.

Chapter 3. Public Finances

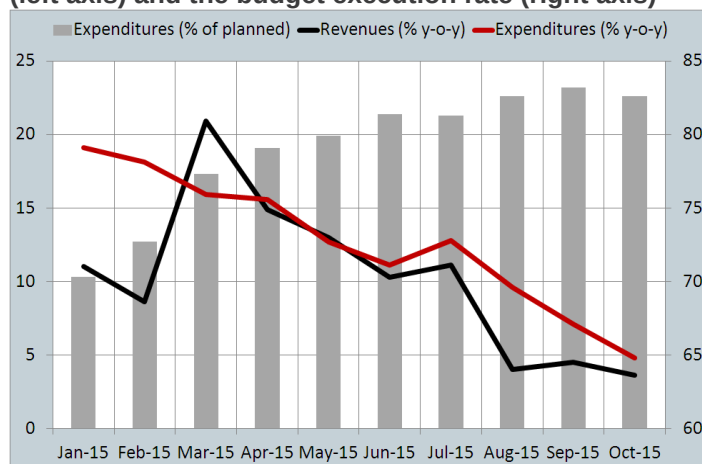
The macro-financial stability of the Republic of Moldova was affected by two crises, the political and the economic ones. While the economic shocks have affected primarily the dynamics of budget formation, the political factor had a complex influence on the budgetary and fiscal discipline. The lack of a functioning government both at the beginning and at the end of the year led to the non-compliance with the budget calendar, and issues related to the quality of governance caused the freezing of foreign assistance. Next year, the risks for the public finance framework remain closely connected to the political factor, mainly on the adoption of a realistic budget in a reasonable period of time and on unlocking external financing.

Recent trends

The public finances in 2015 were affected by two basic disruptive factors - the economic slowdown and the political crisis. The political factor resides in non-respecting the budget calendar both at beginning and the end of the year. In the first case, procrastination with enactment of new government after the parliamentary elections in 2014, led to the fact that the National Public Budget (NPB) was approved with a delay in April 2015, by assumption of responsibility. In the second case, the lack of a functional executive and of any clear perspective for its creation resulted into no publicly presented NBP draft, violating all the provisions of the budget calendar. Another aspect of the political factor is related to the poor governance and settlement of the banking crisis, which caused suspension of external financing by the World Bank and the European Commission.

The economic slowdown was a result of economic shocks of both external and domestic origins. In the first case, it was due to worsening economic situation in the CIS countries (the Russian Federation, Ukraine) and the slow growth in the EU countries. In the second case, it was due to the crisis in the banking system. Both shocks have overlapped in time. They have significantly undermined the revenue base of NPB through such transmission channels like currency depreciation, export, import and remittance cuts, and tight monetary policy.¹ Thus, the budget revenues continued to decrease throughout the year and the government had to react by temporarily stopping the public procurement. So, the budget execution rate did not exceed 83% of the planned volume for each period (Chart 4).

Chart 4. Public revenues and expenditures dynamics (left axis) and the budget execution rate (right axis)



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

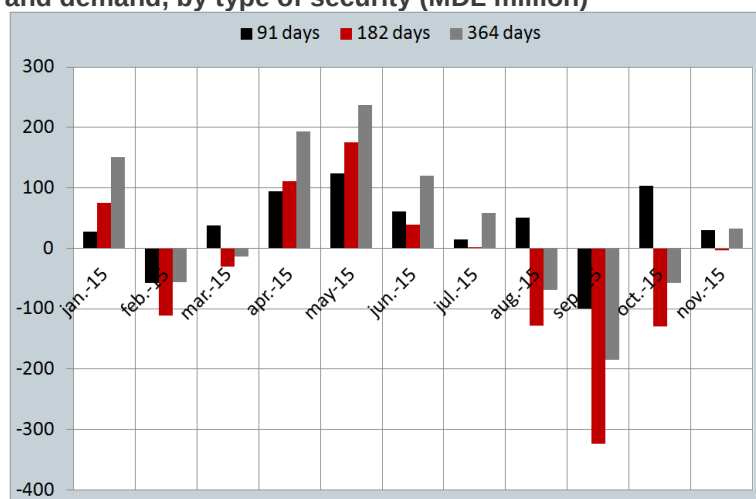
¹ I. Morcotilo "Budget rectification for 2015", Expert-Grup, 2015.



The financial sources meant to cover the budget deficit and the differences between the planned and real revenues have been also undermined. Grants and loans are an important source of revenues, but as mentioned above - they have been lost in the current year. Cumulatively, as a result of external assistance suspension, the budget has not received about 2 billion lei. A part of this amount had to be compensated by the EUR 60 million loan offered by Romania, but there is still a risk that the loan will not be received, due to the political instability in our country.

Another important source of financing the budget deficit, namely the issuance of Government Securities (GS), was not fully capitalized. The result of tightening monetary policy, by increasing the base rate and bank reserve requirements, was drastic decline of demand from commercial banks for GS. This resulted into an increasing discrepancy between the GS supply and demand, and of skyrocketing interest rates on these instruments from 7-12% at the beginning of the year up to 24-26% in November (Chart 5). Thus, since August, the Ministry of Finance has been in a quite difficult situation to tap additional financial resources to finance the budget deficit.

Chart 5. Evolution of the discrepancy between GS supply and demand, by type of security (MDL million)



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

In the context of macro-financial constraints, the budgetary resources have been directed primarily towards the social sphere. This field was basically financed at the planned level, and in October the execution rate of expenditures in the functional group of Social Security and Assistance was 97.2%. In the other fields, the spending rate was below 90% of the planned level, being equivalent with 7.7 billion lei of unexecuted payments at the level of NPB, or about 6.4% of GDP.

Thus, the issues with the execution of public expenditures and revenues resulted in a necessity to adjust main parameters of the budget to the new economic realities. This was done by approving the Law on **AMENDING AND SUPPLEMENTING** the LAW on State Budget for 2015. According to this document, the revenues were to decrease by 1126.0 million lei (1.42% of GDP), the expenditures by 1642.8 million lei (1.9% of GDP) and the budget deficit by 516.8 million lei (0.48% of GDP). At the same time, the spending adjustment was not done symmetrically in various fields. A priority was given to the social field, where according to the plan, expenditures had to decrease only by 1.4% compared to the initially approved level, while the economic field was going to receive 9.2% less financial resources (Table 2). Thus, the budget focus was on social stability at the expense of reducing the budget investment component, transforming it into a pro-cyclical budget.



Table 2. NBP adjustments by main expenditure groups

	Approved (million lei)	Rectified (million lei)	Change (+/-, million lei)	Change (+/-, %)
National economy	8426,6	7653,5	-773,1	-9,2
Social sphere	32818,8	32355,3	-463,5	-1,4
State debt service	1260,5	1064,5	-196,0	-15,5
Other expenditures	7675,2	7471,2	-204,0	-2,7
Net lending	-120,6	-126,8	-6,2	5,1

Source: Expert-Grup calculations based on Table no. 1 to the explanatory note to the draft law amending and supplementing the Law on State Budget for 2015

The public finances will overcome the current year relatively well (taking into account overlapping negative shocks). However, major risks for the next year are still looming. These risks are related to two fundamental factors. One factor depends on the settlement of the problem related to transforming into a public debt the state guarantees provided by government to the National Bank of Moldova (NBM) for lending commercial banks, and namely what would be the final amount of the debt and resulting interest rates. Also, signing or not accepting an agreement with this institution will influence the final decision of external donors to reopen the frozen financial assistance in the current year.

Challenges and short-term forecasts

- The duration and unpredictability of the current political crisis create major risks for the NPB approval in a reasonable period of time and with reasonable parameters. Unless the new NPB is approved by the end of the year, the parameters of public revenues and expenditures for the current year will be extended. Nevertheless, the lack of budget and of fiscal policy draft for the next year, not only will perpetuate the current level of investments, but also will heighten the level of uncertainty for the private sector. This uncertainty is related to the fact that the operational and investment plans for the next year are drafted by economic agents, taking into account the proposed amendments to the fiscal and budgetary policy and the published macro-economic forecasts.
- Another major risk related to the current political crisis and the creation of a viable government, is the negotiation time-scale of an agreement with the IMF. This agreement is vital to unlocking and increasing the external assistance. In a situation, when the budget deficit constitutes 3% of GDP, and the grants cover around 7% of the NPB revenues, most of them being oriented towards investments, the access to such funding is critical for the Republic of Moldova, at least in the medium term.
- A significant challenge for the macro-financial framework is the transformation into public debt of state guarantees issued by the government to the National Bank of Moldova for crediting the problem banks. The final cost of servicing the state internal debt will depend on the final amount of state guarantee to be repaid and the interest rate parameters negotiated with the IMF. Certainly, both the share of debt and the annual interest payments will increase by a few p. p. of GDP.

Policy recommendations

- One of the main conditions to minimize the risks for public finances in 2016 is negotiating an agreement with the IMF. This agreement will not only reopen the external assistance, but will also stimulate a set of reforms promoted by this institution, including accelerating reforms related to the budgetary-fiscal system.
- The publication and approval of the drafts for NPB and for the fiscal policy have to be one of the first measures of the new government. In the context of extending the period of political uncertainty,



the Ministry of Finance should publish at least the budgetary and fiscal policy draft in order to inform the business with the most important changes planned for 2016 in this field.

- The dependence on the external financial assistance, which is expected to diminish in the medium term, shows that it is important to develop the domestic sources of budget revenues. This can be achieved by quantitatively broadening the tax base, which presumes the improvement of business environment and boost of new business openings. Another important factor would be reducing the fiscal gap, which is estimated at around 8% of GDP.
- One of the main reasons for reduction in financial coverage of budget deficit from the issuance of GS under a restrictive monetary policy is the fall in demand of the commercial banks for these securities, even at extremely high interest rates. In order to change this situation, it is necessary to broaden the range of potential investors in GS, along with commercial banks. These buyers can be both of domestic and external origins, including non-bank financial institutions. The population might also play an important role in purchasing GS. But, an additional informational campaign is required in order to inform the population about the possibilities and opportunities of investment in the GS.

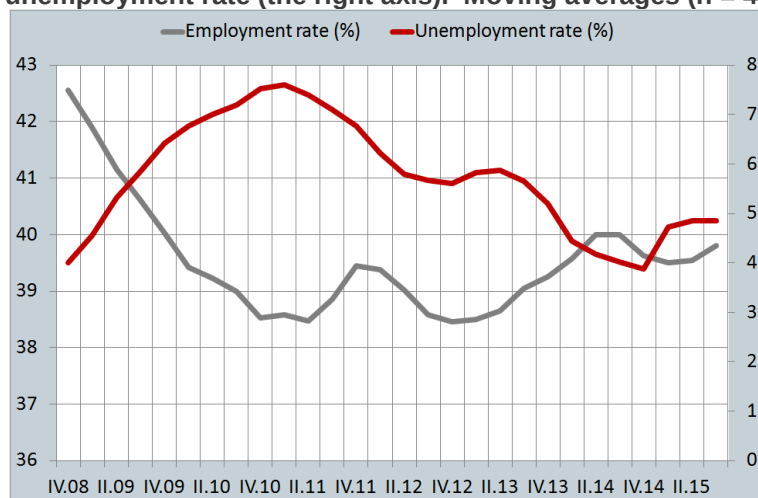
Chapter 4. Labour Market

The labor market of the Republic of Moldova proved to be flexible enough to the worsening macroeconomic framework. Despite the economic deceleration, there has not been recorded any drastic deterioration in the employment and unemployment rates. Nevertheless, this flexibility has a significant cost for the economic growth in the medium and long terms, due to the rise of agricultural employment at the expense of other sectors of the national economy. The downside is the fact, that agriculture, predominantly, generates informal employment and has a lower productivity compared to other sectors.

Main trends

The internal and external shocks to the national economy did not have a major negative impact on the labor market. Although in Q1:2015, the employment rate fell to 35.3% and the unemployment rate rose sharply to 8.5%, the situation has improved in the next two quarters. Due to the seasonal nature of the labor market, by Q3:2015 the employment rate increased to 43.7% and the unemployment rate fell to 3.3%. Even excluding the seasonal component from both these indicators, we note that this year the employment rate has stabilized at around 39.5% and the unemployment rate around 4.9% (Chart 6). In general, the dynamics of these indicators is influenced by the interaction of two important factors - labor migration and the capacity of national economy to generate new jobs, the contribution of each of them being analyzed below.

Chart 6. Dynamics of employment rate (the left axis) and unemployment rate (the right axis). Moving averages (n = 4).



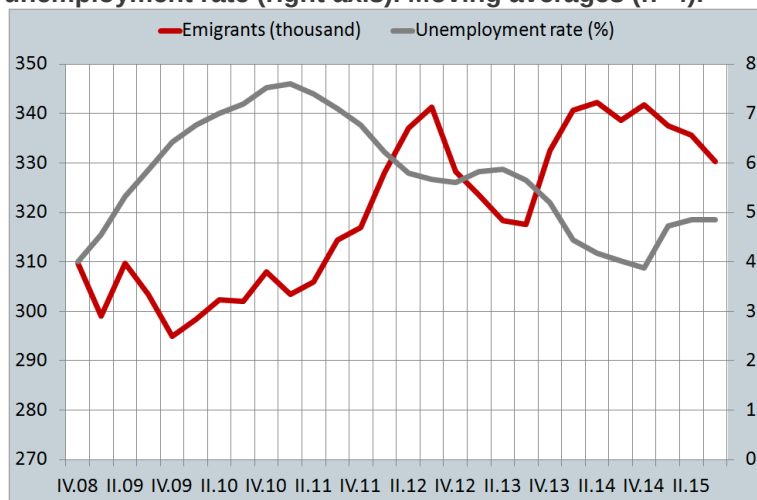
Source: Expert-Grup calculations based on the NBS data

This year, the decline in labor migration contributed to the increase of labor supply on the domestic market. The number of migrant workers decreased during the three quarters of the current year, reaching the rate of 6% y-o-y in Q3:2015. Most likely, the main cause of this process is the economic crisis in the Russian Federation, where about 2/3 of Moldovan migrants are employed.² The majority of those who have returned back or could not emigrate reoriented to domestic labor market, contributing to the increase of both the unemployment and employment rates. At the same time, this relation between migration outflows and the domestic labor market is characteristic not only for this year, but to previous years as well. Chart 7 shows a negative relation between the emigration level and the unemployment rate, the correlation

² The extent of the outflow from the Russian Federation will be estimated only after the publication by the NBS of the final data on the labour emigration in geographical perspective. These data are not available for this year yet.

coefficient between these two indicators being -0.63 over the last years. But the absolute level of unemployment is caused not only by the emigration dynamics, but also by the capacity of the economy to generate jobs.

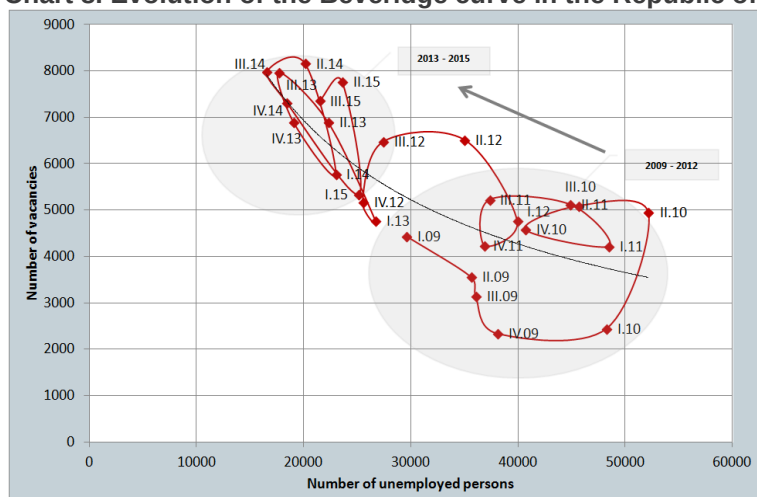
Chart 7. Dynamics of the migrant labor (left axis) and unemployment rate (right axis). Moving averages (n=4).



Source: Expert-Grup calculations based on the NBS data

In recent years, the national economy has increased its capacity to generate new jobs. The positive evolution can be noted by the increased number of available vacancies and the decreased number of unemployed people (the Beveridge curve). Lately, the economy of the Republic of Moldova advanced on the Beveridge curve towards a new equilibrium point (Chart 8). Thus, during 2013-2015 the average number of vacancies available quarterly was at around 6000-8000 jobs, while the same indicator in 2009-2012 was of only 3000-5000 jobs. Although in Q1:2015 the number of vacancies decreased, by Q3:2015 it grew to the average level of 7500 jobs specific to the period 2013-2015. At the same time, the increasing number of new jobs created is not always accompanied by a proportional increase in qualitative jobs, in the Republic of Moldova de facto being realized the quantitative, but not the qualitative scenario.

Chart 8. Evolution of the Beveridge curve in the Republic of Moldova

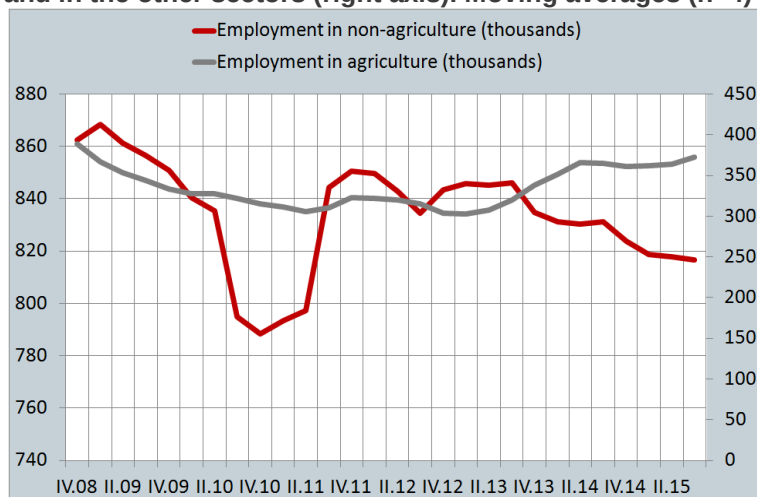


Source: Expert-Grup calculations based on the National Employment Agency data

The increase in the number of employed people is provided mostly by agriculture. Thus, by the end of 2012, the number of employees in this sector ceased to decline, when it reached a historical low of 26.5% of the total employed population. But, since 2013 this trend has reversed and has been constantly growing up to 31.3% of total employed population in Q3:2015 (seasonally adjusted data). The increasing

employment in agriculture is not accompanied by an increase of employment in other sectors of the economy, the labor factor being reallocated at the expense of these ones. These evolutions on the distribution of employment by sector can be mainly explained by two factors. The first one is the return of Moldovan migrants to their rural areas of origin (about 70% of total emigrants), under the pressure of external factors such as the crisis in the Russian Federation. The second one is related to the incapacity of public authorities to stimulate the development of industry and services sectors, able to absorb the labor force from agriculture.

Chart 9. Evolution of employment in agriculture (left axis) and in the other sectors (right axis). Moving averages (n=4)



Source: Expert-Grup calculations based on the NBS data

The increasing role of agriculture in national economy will have negative consequences for the economic growth in the medium and long terms. The main risk for the economic growth is the informal employment in agriculture, in the absolute majority of existing and newly created jobs. Thus, in 2014, out of the total number of informal jobs, about 73% were concentrated in agriculture. It should also be mentioned that labor productivity in agriculture is substantially lower than in the industry and services sectors. Thus, at the economy level we achieve a permanent increase of employed population in the sector that offers the fewest and the least productive qualitative jobs.

Challenges and forecasts

- The increased risks of a continuous stagnation in the Russian Federation or a possible deterioration in bilateral relations raise the probability of return of a higher number of Moldovan emigrants. Depending on the scenario, the number of unemployed can grow quite significantly.³
- One of the main challenges for the national economy, stemming from the labor factor use, relates to its sectoral distribution. Thus, the increased share of employment in agriculture is a sign of failure of structural reforms and diminishes the economic growth prospects in the medium term. Unless the approach in terms of structural reforms is changed, this trend of labor concentration in agriculture will persist. The evolution risks will consist of the intensification of the economic growth rates volatility and the decline of their average in the coming years.

³ A.Lupusor, A. Fala, I.Morcotilo, D.Cenusa "MEGA XII: The year of major economic risks, Q1: 2015", Expert-Grup, 2015.



Policy recommendations

- When the number of employed population decreases and the labor migration rate is significant in the economically active population, it is important to find an approach not only to diminish the negative consequences, but also to obtain positive contributions to the economic growth. One of the few opportunities in this regard is to increase labor productivity. Labor productivity growth has to be a key objective in the employment policies and it may be obtained by stimulating economic agents to create formal and decent jobs. In the first case, it is known that in informal companies the labor productivity is much lower than in the formal ones due to many financial and technological constraints they are facing in their business activity. Also, the employees in informal jobs do not have incentives that would motivate them to work efficiently. The decent that can generate a high added value, have to be a priority for granting fiscal facilities and in attracting foreign and domestic investors.
- The provisions of the Association Agreement should be implemented completely and on time, since they can serve as incentives for productive investments, capable to boost labor productivity. The opportunities generated by this agreement do not imply only adjusting the national legislation to the EU standards, but also offering the economic agents the possibility to use the scale effect, to access the enlarged market on a par with other economic agents from the EU. The access to a huge market by means of potential, through standardizing the rules of the game, is one of the few opportunities to stimulate investments in the context of shrinking domestic market.
- The qualitative workforce is the one which plays an important role in stimulating productive investments for qualitative jobs. Without an educated population able to learn new technologies and without a high work culture, it will be difficult to achieve the mentioned objective. In this respect, it is important to continue the process of adapting all levels of education system to the current market conditions, especially the vocational and higher education. It should be done by revision of the curricula, modernization of the technical basis and more intense cooperation with the economic agents.

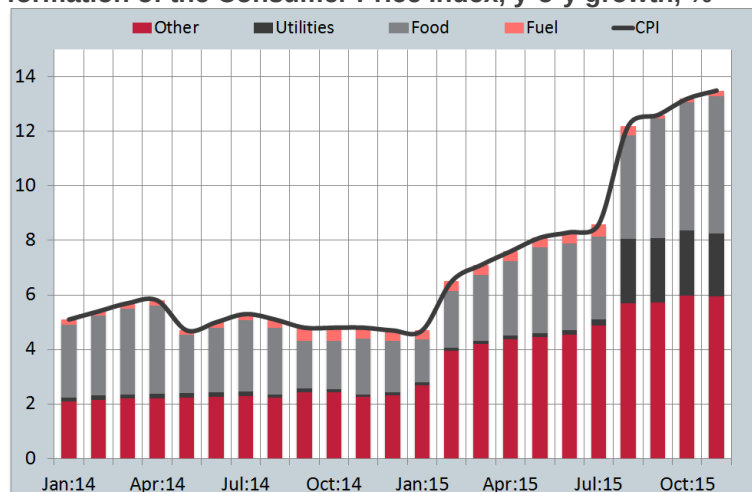
Chapter 5. Prices and Monetary Policy

The main risks in terms of prices and monetary policy, identified in the previous MEGA edition, have partially materialized: the annual inflation hit a double-digit level and the monetary policy remained pro-cyclical and got tightened given the economic recession. Although the fundamental objective of the NBM is strictly to maintain price stability, we reiterate the fact that the main challenge for the monetary authority is not related to the increasing inflation, but rather to identifying the balance between stabilizing prices and ensuring a favorable macro-financial framework for economic recovery. In this regard, the monetary policy stance has to focus on anchoring inflationary pressures in the long run while tolerating the temporary overcome of the inflation target in favor of a moderate monetary easing.

Recent trends

The inflation gets back to its rate registered in the period before the crisis of 2009. In November 2015, the Consumer Price Index was 13.5% y-o-y, and has continued to grow constantly since the beginning of the current year (in Jan:2015 the CPI was of only 4.7% y-o-y). The inflationary pressures increased mostly due to all CPI components and developed in two major waves: (1) the increase in core inflation (the increase of the contribution of “other” CPI components, which does not include utilities, food and fuels), along with the increase in food prices over the first half of 2015; (2) the adjustment of prices for services with regulated prices (mainly for utilities, since Aug: 2015) (Chart 10).

Chart 10. Contribution of the main components to the formation of the Consumer Price Index, y-o-y growth, %



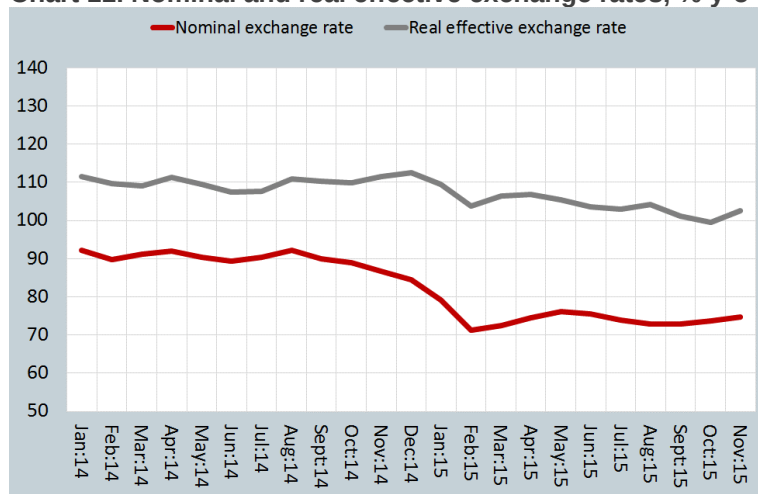
Source: Authors' calculations based on the NBS data

The main factor behind the increase in inflationary pressures was the noticeable depreciation of the national currency. The average nominal exchange rate of the Moldovan currency (MDL) against the US dollar depreciated during 2015 by 25% y-o-y. While at the beginning of the year, this phenomenon was caused mainly by the increasing demand for foreign currency (in the first 2 months of this year, the NBM sold USD 237.3 million and EUR 10.8 million), over the last months the depreciation was rather due to decreasing currency supply given the reduced remittances, exports and external assistance. At the same time, it had a certain effect on Moldovan exporters who had to adapt to the economic constraints, since the real effective exchange rate fell as well. This fact has supported in a certain way the competitiveness of domestic producers (over the first 10 months, the imports of goods declined faster than the exports of



goods: -24.1% compared to -16.1% y-o-y). Nevertheless, this positive factor was not strong enough: the nominal depreciation was faster than the real effective one, thus showing that the inflationary effect exceeded the stimulatory effect on exporters (Chart 11).

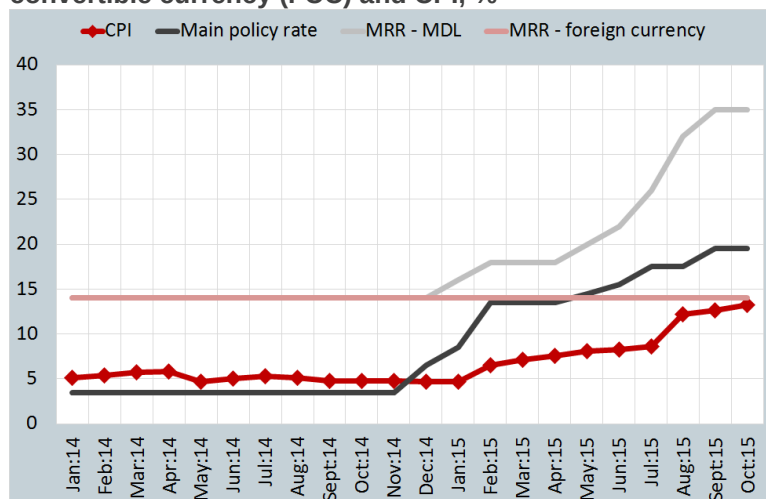
Chart 11. Nominal and real effective exchange rates, % y-o-y



Source: www.bruegel.org

In order to counter the negative effects caused by the exchange rate depreciation and stabilize the imminent increase in prices, the National Bank of Moldova has taken a number of measures for tightening the monetary policy. In this context, the base rate was increased gradually from 4.5% in Dec: 2014 to 19.5% in Aug: 2015, which led to an increase of the overnight lending rate (22.5 % in Oct: 2015) and the overnight deposit rate (16.5% in Oct: 2015). Another measure taken to freeze the banks liquidity excess was the decision to gradually raise the reserve requirement up to 35% from the attracted resources in MDL and in a non-convertible currency (Chart 12).

Chart 12. Base rate, reserve requirement in MDL and in freely convertible currency (FCC) and CPI, %



Source: NBM

Forecasts and challenges

- For 2016, the inflation is expected to remain at the double-digit level due to adjustments to electricity, heating and utilities' tariffs, and a decreased supply of agricultural products amid an unfavorable agricultural year of 2015. Nevertheless, the annual inflation rate will begin to gradually decline from early 2016, given the increased basis of comparison and the dissipation of the cost-push inflationary factors. For 2016, we anticipate an average annual inflation rate of about 11%.



- At the moment, the exchange rate of the national currency seems to have got stable at a new equilibrium, without any clear premises of significant depreciation. Nevertheless, a major challenge is related to a relatively low level of official reserve assets, which will essentially limit the room for manoeuvre of the NBM in case of possible currency shocks.
- A major challenge for monetary policy is to ensure price stability given the economic recession and the fact that in crisis conditions the channels of monetary transmission are much slower than during an economic growth.

Recommendations

- The current monetary policy framework seems to be too restrictive, given the fact that inflationary pressures are not caused by overheated economy (e.g. the increased incomes or lending), but rather by factors that are outside the intervention field of the monetary policy (e.g. higher energy and utility tariffs, reduced agricultural crop, increased demand for foreign currency or / and decreased supply of foreign currency). Therefore, we reiterate the recommendation from the previous MEGA edition to provide a gradual easing of monetary policy by reducing the base rate to 10%, which is to be done in 2016.
- It is necessary to continue upgrading the tool-kit for identifying and forecasting the inflationary shocks in order to enhance the capacity of the NBM to promote a monetary policy of preventing and not countering post-factum the excessive inflation growth.
- The negative developments in the banking sector, correlated with the rapid depreciation of the national currency (MDL) and the inflationary pressure growth, inevitably and essentially undermined the image and credibility of the NBM. Thus, the institution urgently needs to regain the confidence of the real sector and the society in general. In this respect, it is necessary to solve immediately the management crisis of the institution while strengthening the NBM corporate governance in accordance with the Basel principles.
- It is necessary to sign a new memorandum with the International Monetary Fund in order to complete the official reserve assets, increase the economic resilience to possible negative shocks, strengthen the confidence of development partners in government, and therefore to unlock external funding.

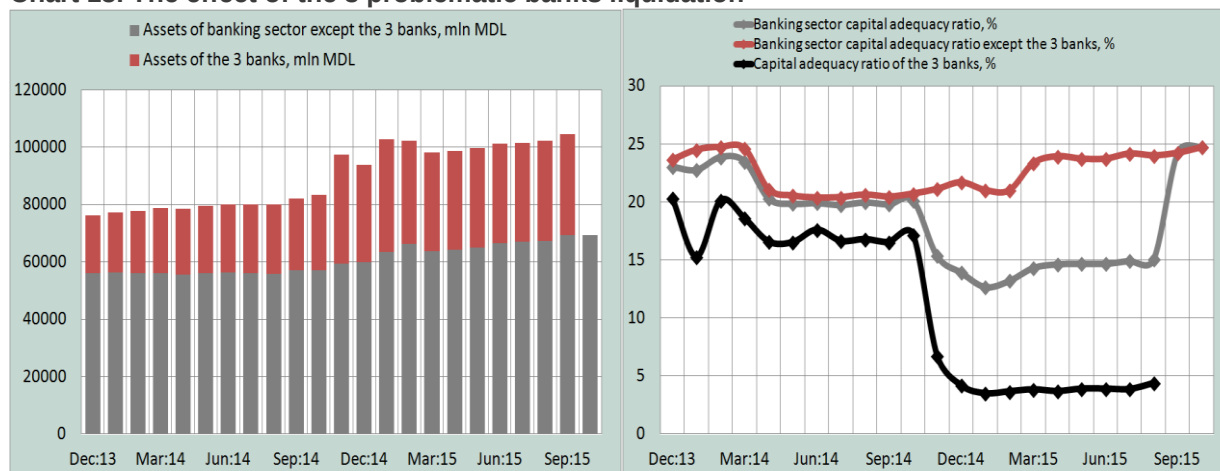
Chapter 6. Banking System

During the analyzed period, the banking sector had a weak evolution. The banks involved in the dubious transactions of 2014 have got into a catastrophic situation, and in October 2015, the NBM has withdrawn the license from these institutions. The deteriorating economic environment affects the quality of assets and generates new challenges for financial institutions. At the same time, the volatility of the stock market and the low confidence in the financial institutions lead to the reduction of deposits and in case this trend continues, it will create a high risk for the stability of the banking sector in the Republic of Moldova. The mentioned risks overlap with additional costs caused by the tight monetary policy.

Recent trends

The most important event that marked the evolution of the banking sector in 2015 refers to the liquidation of the 3 problematic banks: the Savings Bank, the Social Bank and Unibank. The banking sector assets decreased due to the elimination of the balance sheet items related to the 3 financial institutions under liquidation. Thus, in October 2015, the banking sector assets totaled MDL 69.3 billion, which is 33.7% lower compared to the amount recorded in September 2015. At the same time, there was noted an improvement in the aggregated prudential indicators, a fact revealed by the increased Capital to Risk Weighted Assets Ratio of over 16%, which is an acceptable level.

Chart 13. The effect of the 3 problematic banks liquidation

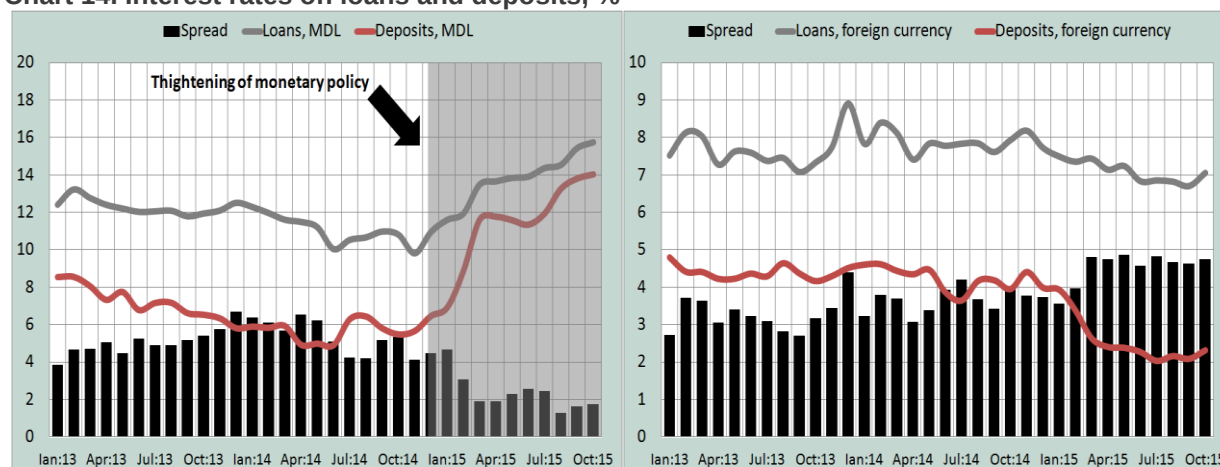


Source: Expert-Grup calculations based on NBM data

Tightening monetary policy has generated to a certain extent the increase of interest rates. For transactions in MDL, the interest rate margin decreased, but for foreign exchange transactions it increased. Increasing rates of monetary policy tools has led to higher prices for loans in MDL. The increase of interest rates on deposits was higher compared to the increase of the bank loans cost. Thus, the interest rate on deposits in MDL increased by 8.5 p.p. y-o-y in October 2015, while the costs related to loans in MDL increased by 4.9 p.p. As a result, the bank margin decreased from 5.3 to 1.7 p.p. A cause of slower increase of credit cost refers to the banks desire to preserve the attractiveness of bank lending among the population and economic agents. Most likely, the sharp increase of rates might have had a significant negative impact on lending activity. On the other hand, although the interest rate for foreign currency loans recorded a certain decline, the decrease of interest rates on deposits in foreign currency was much faster, and therefore the margin on foreign currency transactions increased. Thus, in October 2015 the margin on foreign currency transactions increased by 0.8 p.p. y-o-y. In the context of acute MDL depreciation,

servicing foreign currency deposits has become more expensive, and this could make banks reduce their interest rates.

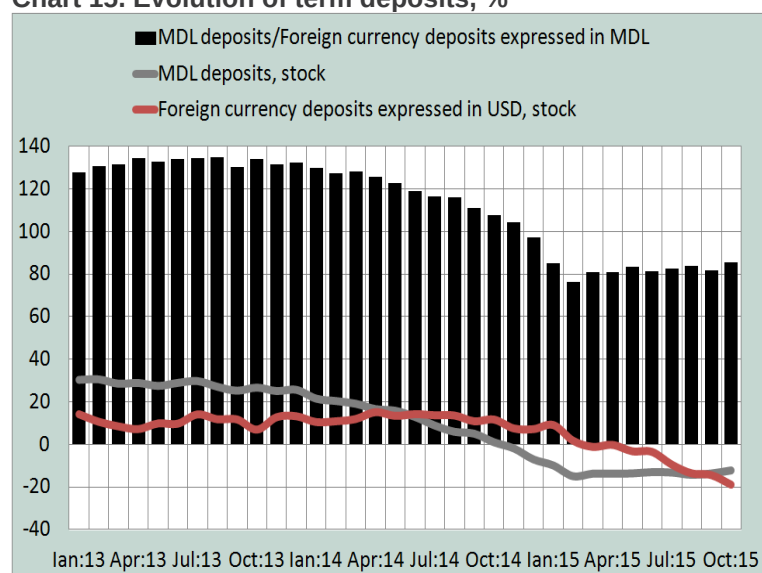
Chart 14. Interest rates on loans and deposits, %



Source: Expert-Grup calculations based on NBM data

It can be noticed a downturn trend in stock deposits along with deposit dollarization. The MDL depreciation has increased the population reticence towards deposits in MDL, and therefore the balance of deposits in MDL has been continuously decreasing since November 2014, and since January 2015 the monthly decrease has exceeded 10% y-o-y. The term foreign currency stock deposits expressed in MDL recorded an increase, but that is in a slowdown phase. As a result, the ratio between MDL and foreign currency deposits is decreasing, while deposits in USD are growing. Thus, in October 2014, deposits in MDL exceeded the foreign currency deposits by 7.7%, but in October 2015 deposits in MDL were by 14.7% lower than those in foreign currency. However, the foreign currency deposits in USD have gone on a downward trend since March 2015. For instance, in October 2015 the balance on term deposits in foreign currency expressed in MDL increased by 10.6%, and the same parameter expressed in USD decreased by 19%.

Chart 15. Evolution of term deposits, %



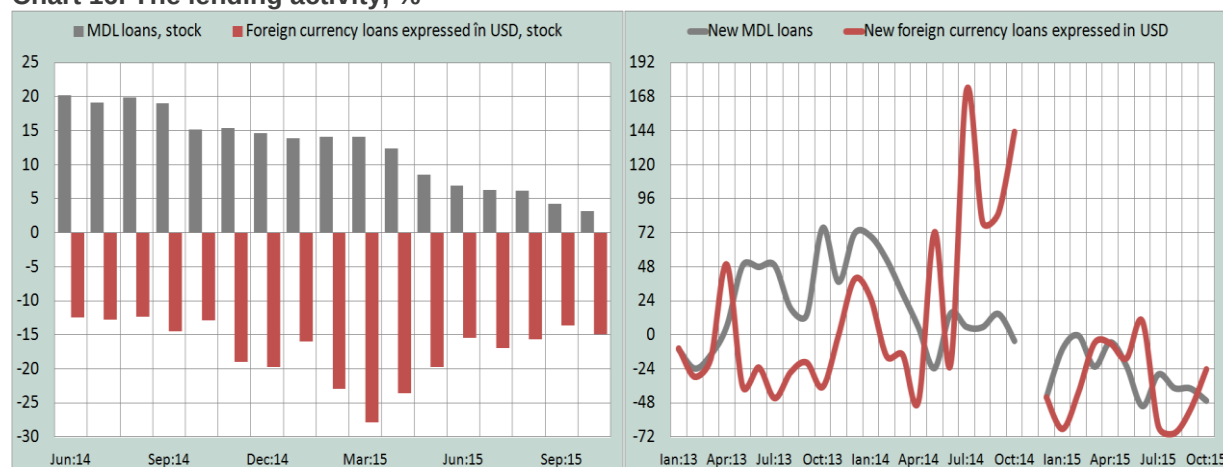
Source: Expert-Grup calculations based on NBM data

The economic uncertainty and tightening monetary policy have negatively affected the lending activity. The balance on MDL loans slowed down its growth. In the first ten months of the year the increase fell from 13.9% y-o-y in January 2015 to 3.2% y-o-y in October 2015. Moreover, the balance on foreign currency loans expressed in MDL slowed down its growth due to substantial decreases recorded at the



beginning of the year. However, the stock of foreign currency loans expressed in USD is shrinking and monthly decrease exceeds 10%. The negative evolution of banks' loans balance was generated by the decrease in new lending, both in MDL and in foreign currency. In fact, since November 2014 the lending dynamics has been constantly getting negative.

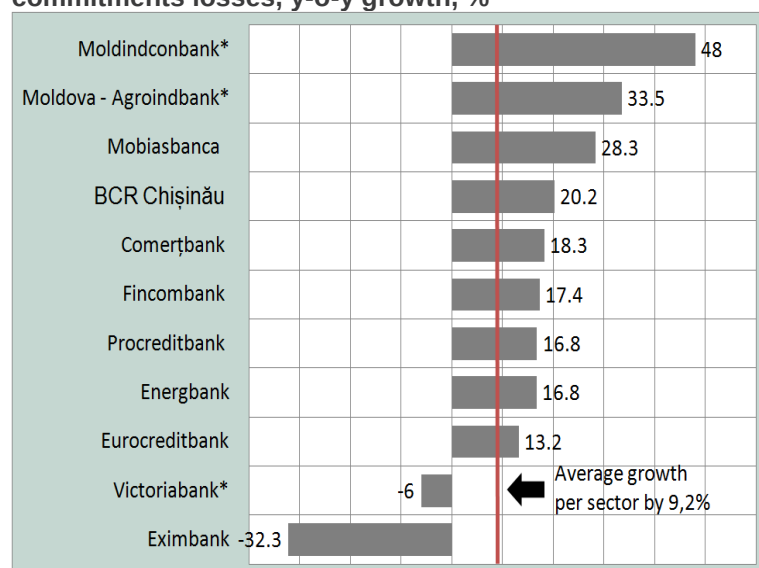
Chart 16. The lending activity, %



Source: Expert-Grup calculations based on NBM data

The worsening loans portfolio is characteristic to the entire banking sector. Thus, the assets and conditional commitments losses increased in several banks. In October 2015 the amount calculated for assets and conditional commitments losses in the banking sector, increased by 9.2% y-o-y for the whole banking sector. The worsening lending quality was caused by the worsening economic situation, which made it more difficult to refund loans.

Chart 17. Amount calculated on assets and conditional commitments losses, y-o-y growth, %



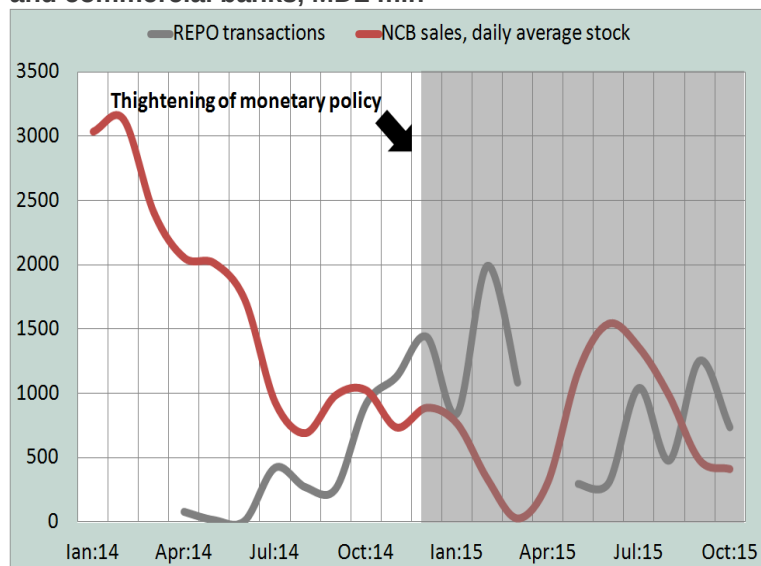
Source: Expert-Grup calculations based on NBM data

Note: * - bank under special surveillance

Although the banks have an adequate capital ratio, there are risks that might affect the liquid assets. At the same time, the high required reserves ratio leads to banks impossibility to use about a third of the provided funds. While, the current liquidity is quite high and reached 39.7% in October 2015, the transactions on the stock market of the banks involved, show a contrary picture, namely increasing liquidity procurement from the NBM, made through REPO transactions. Although this development was curved in

Q2:2015, the upward trend restarted in Q3:2015. The increased liquidity procurement was achieved in the context of tight monetary policy. Similarly, there was noted a continuous decline in the liquidity provisions to the Central Bank, operated through the procurement of NBM certificates (NBC). Although in Q2:2015 the trend has reversed, since Q3:2015 the funds provision to the National Bank decreased again. Also, as in the case of REPO transactions, the transactions with NBC were conducted in the context of increased interest rates.

Chart 18. Liquidity provision and procurement between NBM and commercial banks, MDL mln



Source: NBM data

Although the increase of monetary policy rates should stimulate banks to purchase less money from the Central Bank and, simultaneously, to increase the liquidity provided to the NBM, the situation is opposite. Banks are forced to purchase financial resources at higher costs from NBM and to give up providing funds at more advantageous rates. Thus, during January-October 2015, NBM operated mainly as a net creditor for commercial banks, and this situation is different from the last years' developments when the Central Bank was acting as a net debtor of the banking sector. A factor behind this development relates to the significant increase in the required reserve ratio for funds attracted in MDL. Since late 2014, the required reserve ratio has been increased in several successive stages, from 14% in December 2014 to 35% September 2015. It is obvious that in the context of reduced balance on deposits, in order to conserve more than a third of the raised funds, banks need liquidity to perform transactions. In this context the banks resort to additional lending from the NBM, despite the higher costs for liquidity procurement. Similarly, the continuation of diminishing deposits trend and the deterioration of the asset quality could have adverse effects on the banks liquidity level.

Challenges and forecasts

- The pessimistic outlook on economic growth will negatively affect the quality of banks' loan portfolios. The need to maintain public finances balanced will cause more pressure on bank resources and will decrease the financial resources oriented towards lending the real sector. The further promotion of the restrictive monetary policy will cause as well a reduction in the lending activity. Growing non-performing loans are an imminent risk for the financial sector although the banks have accumulated certain reserves to absorb possible losses (there was increased the required reserves ratio and the rate applied on calculating the necessary amount of funds for asset and conditional commitments losses).
- In case of negative developments, the reduction of stock deposits could accelerate, the population could begin to withdraw significant savings, and such a development could generate a liquidity



deficit in the banking sector.

- The declining trend in deposits, the deterioration of the quality of the loan portfolio along with the mandatory maintenance of reserves from attracted sources, will only generate additional costs for banks. Not being able to attract additional resources from the population and economic agents, the banks will have to purchase funds from the NBM. Given the high rates of the monetary policy for banks, it will be too expensive to borrow from the Central Bank, and therefore there could appear some difficulties for the banks.
- Concentration of the banking sector is an imminent challenge. Currently, the first 3 banks hold two-thirds of total assets. At the same time, these banks hold 70% of total deposits, which makes the whole sector highly sensitive in case of financial shocks. Furthermore, this implies risks for the quality of the competitive environment in the sector, because of increasing probability of certain anticompetitive agreements among market actors.

Policy recommendations

- The banking sector, which has always been a key pillar of stability for the Moldovan economy, has suddenly become one of its Achilles' heel. Although most of the banks remain sufficiently capitalized, the bankruptcy of three important banks has eroded the trust of population in the entire banking system and highlighted the major flaws in terms of banks' corporate governance and the efficiency of banking supervision. One of the immediate measures that should be undertaken by the authorities is adopting a Law on stabilization and reform of the banking system. This law should focus on seven key elements that shall strengthen the confidence in the system, increase the efficiency of banking supervision and improve corporate governance in banks:
 1. Ensure transparency of the final beneficiaries of banks' shares;
 2. Accelerate the investigation of causes that led to the bankruptcy of BEM, BS and UB and prosecuting those responsible;
 3. Prohibit by law any interaction between Moldovan banks and entities that operate in jurisdictions which do not implement international principles of accounting and financial evidence;
 4. Increase the capacity of banks, especially the systemic ones, to absorb losses;
 5. Strengthen the corporate governance within banks according to BASEL III principles;
 6. Strengthen corporate governance of NBM and increase its capacity in the area of bank supervision;
 7. Facilitate competition in the banking industry by streamlining the efforts from NBM and Council of Competition in preventing and countering eventual anti-competition arrangements between the industry participants
- It is urgently needed to resolve the management crisis within the NBM, by appointing a new Governor and a team of Deputy Governors. The perpetuation of this crisis will increase the banking sector uncertainty and will undermine the resilience of the institution and of the entire economy to potential negative shocks.

Chapter 7. Foreign Sector

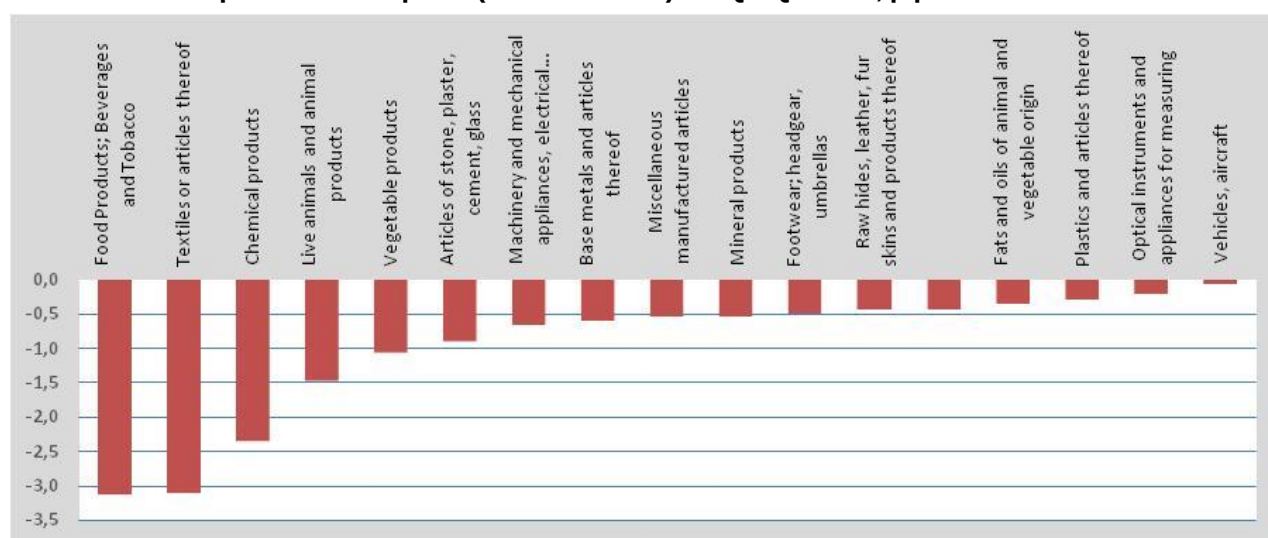
The last year developments in trade policy were marked by stagnating exports to the Russian market amid tariff and non-tariff restrictive measures applied by the Russian Federation (with partial exceptions for some economic agents). Simultaneously, the implementation of the DCFTA commitments continued in order to fully benefit from the opportunities given by this preferential trade regime. Nevertheless, the permanent political instability in the country has negatively influenced the implementation dynamics of the mentioned commitments. In statistical terms, the negative evolution of the foreign trade was tempered to some extent by the appreciation of the US dollar against the Euro and by a quantitative increase in exports of several commodity groups.

Recent trends

The rate of exports to the EU remained at the last year level, since the EU continued to be the main destination for Moldovan exports. Exports of goods during Q1-Q3:2015 amounted to USD 1448 million, being 16.6% less y-o-y. In terms of geography, the main destination for Moldovan exports remains the European Union, totaling USD 899 million, 0.5% less y-o-y and 62.1% of total exports (52.1% in 2014). The most important downturn was noted for the following destinations: Italy - 18.8% less y-o-y, due to decreased export of sunflower oil, and clothing; Germany - 17.1% less y-o-y, due to the contraction of export of juice, chairs and clothing; and Bulgaria - 27.9% less y-o-y, due to reduced export of gas meters.

Exports to the CIS decreased due to restrictions imposed by the Russian Federation and due to the Ukrainian conflict. Meanwhile, during Q1-Q3:2015, CIS countries had a rate of 25.3% in Moldovan exports (and 32.8% in 2014), which is USD 367 million. Exports to these countries decreased by 35.6% y-o-y. The most important downturn was obviously noted for the Russian Federation - 49.4% less y-o-y, due to imposed tariff and non-tariff measures, and for Ukraine - 62.2% less y-o-y, in the context of armed conflict in the Eastern part of the country. It was also recorded a significant decrease in exports to Turkey, which totaled only USD 44 million, or 45.7% less y-o-y, due to severely decreased exports of sunflower seeds.

Chart 19. The impact rate of exports (in value terms) for Q1-Q3:2015, p.p.



Source: Expert-Grup calculations based on NBS data

The appreciation of the US dollar against the Euro and the quantitative increases in exports offset the loss of markets. In Q1-Q3:2015, the exports decreased in value terms for all HS sections (Chart 19). But in



quantitative terms, the foreign trade shows a different picture than the one in value terms (mainly in USD). There was recorded a growth in the main groups of exported goods, despite the reduction of the unit price. Moreover, given that 62% of the total exports have the EU market as an ultimate destination (49% of total import), the transactions are made in EUR, although official statistics are conducted in US dollars. The depreciation of the Euro against the US dollar (from 1.36 in 2014 to 1.11 in 2015) contributed to the distortion of data related to foreign trade.

Re-exports are distorting the export performance of the country. The exports evolution (and indirectly of imports) should be assessed according to existing statistical deficiencies. During Q1-Q3:2015, about 34.5% of total exports were actually re-exports, amounting to 21.1% or USD 134 million less than the same period last year. However, it should be mentioned that in these circumstances, any statistical data presented above do not fully reflect the real situation in the field, since in terms of customs procedures the notion of re-export is a very general one and it includes several suspensive customs procedures. Therefore, by the characteristics of the exported goods, we can define the following categories:

- Goods which have undergone processing operations (especially clothing and footwear items, followed by cables and furniture, etc.), were produced under outsourcing contracts and obtained Moldovan origin prior to being exported to ordering companies. It should be mentioned that almost all the EU re-export category consists of those goods. (Naturally this category of goods may be excluded from re-exports).
- Goods which were totally exported to other destinations and which obviously did not obtain Moldovan origin prior to re-export. It is to be noted that namely this "typical" re-export is characteristic to export transactions towards the Russian Federation (and recently to Belarus), thus distorting the export performance of the country.

Exports to the Russian Federation decreased dramatically after it had applied trade restrictions. We mention that during Q1-Q3:2015, after the continuation of unilateral tariff measures (customs duties on more than 20 domestic products exported mainly to the Russian Federation) and non-tariff measures (embargo on wine, apples, peaches, pork, canned vegetables and other products), the Russian Federation has lost its leading rank in the main export destinations, and according to NBS data, the exports of Moldovan products to this market decreased by 50% yoy, or by USD 171 million, at the same time having a significant impact of -9.8% on exports as a whole.

At the same time, most Moldovan exports to the Russian market are actually re-exports involving low added value. Goods which represent the so-called "typical" re-export and which have been totally exported to the Russian Federation using the Republic of Moldova as a runway for final transactions as of some partial/impartial reasons (geographical or cultural proximity), amounted to USD 101 million during Q1-Q3:2015 (from USD 338 million in 2013 and USD 205 million in 2014), which constitutes about 58% of total exports to the Russian Federation.

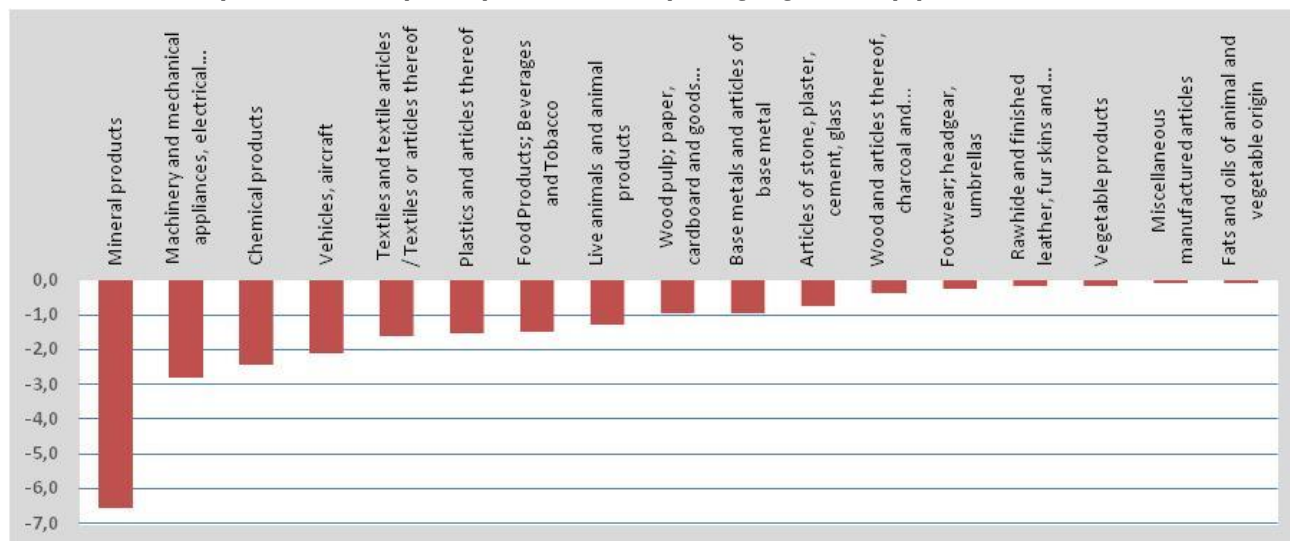
Exports to Ukraine were disrupted by the armed conflict, but also by the imposed import duties. We mention that since 2015, Ukraine has applied import duties for a 1 year period. This measure is justified by the need to adjust the balance of payments and the foreign exchange reserves of the country. The surcharges applied in a non-discriminatory manner, were of 10% for food products and 5% for industrial products, which further eroded the capacity of Moldovan products to penetrate the Ukrainian market. Therefore, the total volume of exports to Ukraine during Q1-Q3:2015 amounted to USD 31 mil., by over 62% less y-o-y. Nevertheless, the main factor of decreased exports is the security crisis in Eastern Ukraine, which has generally caused a quite significant contraction of the Ukrainian economy.

Imports in Q1-Q3:2015 accounted USD 2962 million, which is 23.4% less y-o-y. The main source of imports remains the European Union, with a total of USD 1 461 million, which is 23.6% less y-o-y, with a 49.3% rate in total imports (49.5% in 2014). The most significant decrease was recorded for: Romania - 27.7% less y-o-y, due to reduced imports of petroleum oils, pipes and tubes, plastic materials, and hair care products; Germany - 25.5% less y-o-y, due to the contraction of imports of machinery and agricultural equipment, cars and medicines;

and Italy - 22.7% less y-o-y due to reduced import of medicines and different machinery and equipment. It should be noted that most imports of medicines from these countries are destined for re-export to the CIS market.

The import value decreased due to cheaper petroleum gas and the change in energy source. At the same time, in Q1-Q3:2015 CIS countries had a rate of 25.1% in Moldovan imports (26.9% in 2014) accounting USD 743 million. Imports of goods from these countries decreased by 28.5% compared to 2014. The most significant reductions were noted for the following destinations: for Ukraine -34.0% less y-o-y, due to the cancellation of electricity import and the drastic reduction in pork and poultry imports; and for the Russian Federation - 20.6% less y-o-y due to cheaper petroleum gas.

Chart 20. The impact rate of imports (in value terms) for Q1-Q3:2015, p.p.



Source: Expert-Grup calculations based on NBS data

Similar to exports, the figure above shows decreasing imports in value terms for all HS sections (Chart 20). While the depreciation of national currency generated a significant decrease of imports (in value terms) of certain categories of goods, the **quantitative evolution of imports, on the contrary, shows an increase in most commodity groups.**

Challenges and forecasts

- In 2016, the total exports of goods and services would rise by about 3.4% both in MDL and in real terms. At the same time, imports are expected to increase by only 1.7%. Export growth is expected to have a higher rate than imports amid the ongoing currency depreciation and perpetuate domestic macroeconomic uncertainty.
- The asymmetric preferential trade regime granted by the EU to the Republic of Moldova in 2008 (Autonomous Trade Preferences) will expire on the 1st of January 2016. This is de facto a regime the Transnistrian economic agents were benefiting from, while exporting to the EU. The further denunciation of the Association Agreement by the Transnistrian authorities might get complaints from the exporters who will no longer be able to export duty free to the Community market. As well, it would further undermine the competitiveness of the producers in the region, thus contributing to a recession of 4-5% in 2016.
- Since the implementation of the Association Agreement with the EU has just begun, and the main effects are not obvious yet, the authorities will have to cope with accelerating critics and manipulation on political interests, related to the implementation of this agreement and the lobbying for joining the Customs Union Russia-Belarus-Kazakhstan.
- With the entry into force of the WTO Agreement on Trade Facilitation, the authorities should input substantial efforts to assure a complete outreach of the multilateral commitments undertaken, including the ones in institutional capacity building with the involvement of development partners.



Policy recommendations

In order to redeem the negative influence of exogenous and endogenous factors, public policy efforts should be channeled towards the following areas:

- Continuous discussions with the Russian authorities for the reassessment of restrictive measures applied on goods of Moldovan origin, including the presentation of arguments related to the alleged invasion of the goods of poor quality on the Russian market, and the elimination of the subjective character in exports admission for only some Moldovan companies.
- If appropriate, initiation of disputes within the WTO in response to unjustified discriminatory measures applied by the Russian Federation to the Republic of Moldova.
- Ratification of the Free Trade Agreement between Moldova and Turkey, signed on 14 September 2014 and disseminating at the same time the information to the private sector about the new opportunities offered by this trade regime.
- Strengthening institutional efforts towards harnessing the benefits of the new trade regime with the EU.
- Attracting gradually the Transnistrian side in commitments undertaken by Moldova within DCFTA.
- Promote and implement the new WTO Agreement on trade facilitation, which will lead to streamlining regional and international trade by reducing transaction costs, and to optimizing cross-border flow.
- Also, initiating the process of establishing a National Committee on Trade Facilitation, which will coordinate the implementation of the mentioned Agreement, involving all stakeholders.
- Complete the accession to the PEM Convention that will create economic benefits, especially in terms of attracting additional investment opportunities in the industrial sector and in processing raw materials.



■ 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.