

Real Economy is a quarterly economic review, tracking the most important economic evolutions and policy developments. Its readers are economic journalists, policy-makers, representatives of local and foreign companies and commercial banks, as well as international institutions, embassies and political parties.

Acronyms and abbreviations used:

y-o-y – year on year; q-o-q – quarter on quarter; m-o-m – month on month; e-l-y – versus end of last year, e-o-p – end of period; Q1:18 – first quarter 2018; Jan:18 – January 2018; NBS – National Bureau of Statistics; NEA – National Employment Agency; NBM – National Bank of Moldova; MDL – Moldovan leu (national currency); FDI – foreign direct investments; p.p. – percentage points.

EXPERT-GUP is an independent think-tank specialized in economic and public policy research. We are positioning ourselves as a politically and ideologically neutral think-tank, and we do not represent any economic, corporate or political interests. The mission of the organization is to promote the public interest and to develop efficient and innovative solutions for the development of the Republic of Moldova. In order to fulfill this noble wish, Expert-Grup provides the necessary creative and institutional environment, encouraging expression of free and non-trivial thinking, which makes us a leading source of unbiased economic analysis.

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Early Warning Index (EWI)

The EWI is formed by aggregating six macroeconomic indicators: exports, transfers to individuals, new loans, weight of allowances for loan losses, money in circulation (M0), and bank margin. The indicators were selected depending on their relevance for the economic trends. For more details about the calculation methodology see the website of EXPERT-GUP.

Authors:

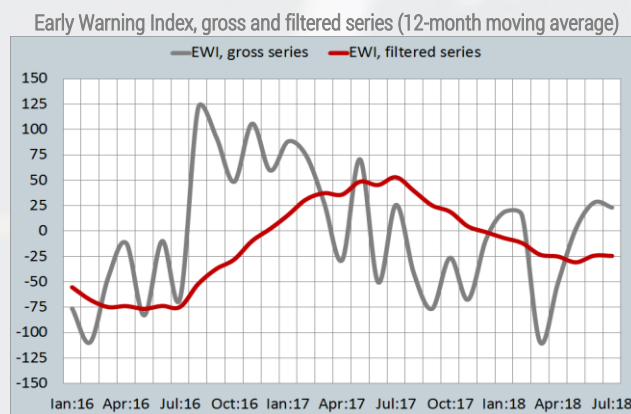
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Evolution of the Early Warning Index (EWI)

Economic dynamics remains positive, but many risks persist. The Early Warning Index (EWI), calculated quarterly by Expert-Grup, after a downward trend, in Q2:18 reached the resistance level and stabilized. EWI negative growth during Q2-Q4:17 signaled the possible slowdown in growth, which was reflected in the GDP evolution from the beginning of 2018: in Q1:18 compared to Q4:17 the GDP growth decreased from 6.4% to 3.7% y-o-y. EWI trajectory in Jan-Jul:18 points to the current year's growth limits. Thus, the growth is likely to stabilize at around 5% in 2018 and 4% in 2019.



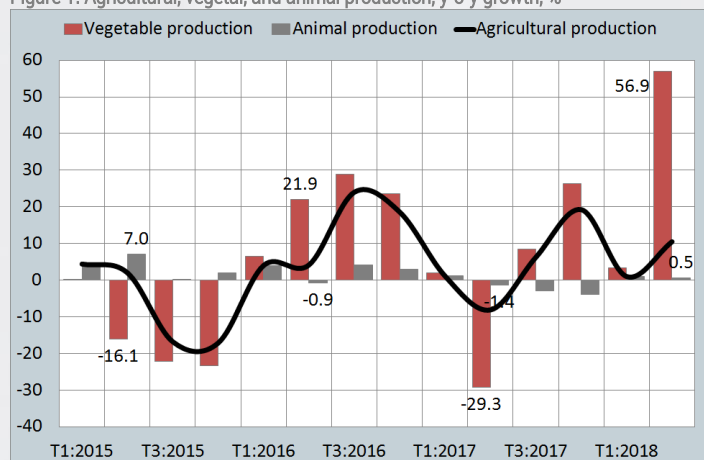
Source: NBM, NBS, EG calculations

Weather conditions and MDL strengthening will constrain the economic developments. In Jan-Aug:18 the amount of precipitation decreased by 19.3% y-o-y. This evolution was due to the declines in Apr:18 (-92.1% y-o-y), May:18 (-65.5% y-o-y) and Aug:18 (-54.5% y-o-y). The low volume of precipitation will have a negative effect on the vegetable and autumn crops, thus affecting the dynamics of the agricultural sector. Due to the strengthening of MDL, the purchasing power of remittances declined, and this fact negatively influences the consumption of the population, in particular of the households receiving remittances: in Jan-Jul:18 the real value of money transfers from abroad decreased by 3.6% y-o-y, despite a growth in USD terms.

Economic policies with electoral flavor create imminent risks for economic growth. In addition to major infrastructure projects ('Good Roads for Moldova' program or 'Chisinau Arena' complex), the Government launched other electoral initiatives: extending the 'Prima Casa' program for public officials and families with children and tax break by implementing the flat tax rate of 12% for individual income and the reduction of the state social insurance contribution paid by the employer from 23% to 18%. Both initiatives have important budgetary implications: the 'Prima Casa' program involves the allocation of budgetary resources to guarantee mortgages, while the tax break only in 2018-2019 implies costs of initiatives were promoted in a period when a large proportion of foreign financial assistance was about MDL 1.8 billion for the state social insurance budget and MDL 600 million for the state budget. These suspended and the budget deficit could exceed 3% of GDP. Therefore, after the elections we can expect measures that would offset these losses, including budget austerity, more severe fiscal controls and/or a rise in taxes, with adverse effects on the medium-term economic growth. In addition, to cover the budget deficit, the Government will most likely increase the issue of Government securities through which it will borrow from banks. As a result, the competition with the private sector for bank resources will be tightened, which will further undermine the private investment activity (phenomenon of crowding out of private investments).

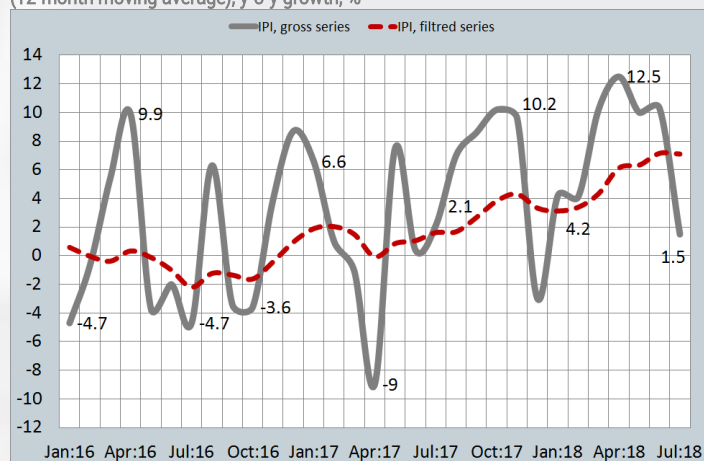
Main Economic Trends in Q1-Q2:18

Figure 1. Agricultural, vegetal, and animal production, y-o-y growth, %



Source: NBS, EG calculations

Figure 2. Industrial Production Index (IPI), gross and filtered series (12-month moving average), y-o-y growth, %



Source: NBS, EG calculations

Figure 3. Turnover of trade in Q1:18, y-o-y growth, %



Source: NBS, EG calculations

AGRICULTURE

In Jan-Jul:18, agricultural production grew by 7.2% y-o-y, due to the rise in crop production. The intensification of harvesting determined the increase in vegetal production. However, insufficient rainfall will adversely affect vegetal production. At the same time, the livestock sector grew at a slow pace. Thus, only cattle and poultry production expanded, while milk and egg production decreased.

INDUSTRY

All industrial branches witnessed positive growth rates. In Jan-Jun:18, the industry grew by 7.5% y-o-y. The mining industry is recovering, with an increase of 8% y-o-y in Jan-Jun:18. The production volume of the processing industry increased by 6.4% y-o-y, while the manufacture of motor vehicles and electrical equipment experienced the fastest growths. Similarly, the energy sector witnessed a 5.8% y-o-y rise.

DOMESTIC TRADE IN GOODS AND SERVICES

There is a positive dynamics in domestic trade. Both delivery of goods and services rose. In Jan-Jun:18, the largest increase in turnover were registered for services provided to the population. In retail and wholesale, smaller growth was recorded. At the same time, the financial result related to services offered to enterprises increased marginally.

Figure 4. Average real salary (left axis) and transfers from abroad in favour of individuals (right axis), seasonally adjusted, y-o-y growth, %

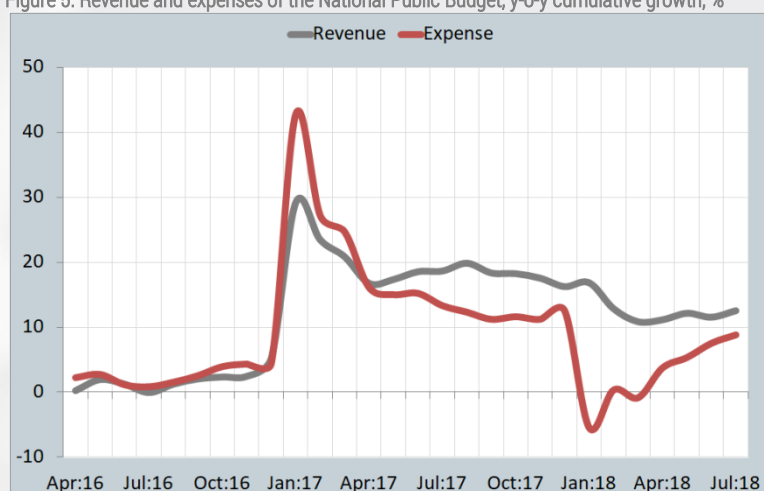


Source: NBS, EG calculations

INCOME AND EXPENSES OF THE POPULATION

The real income of the population keeps rising with impressive growth rates. By Q2:18, the growth rates of the average real salary have reached the maximum values from the recent years. This leap is due to higher economic growth and lower inflation rate. The remittances moderated their growth rates, but remain at double-digit values. However, the appreciation of the national currency continues to undermine the purchasing power of remittance beneficiaries.

Figure 5. Revenue and expenses of the National Public Budget, y-o-y cumulative growth, %

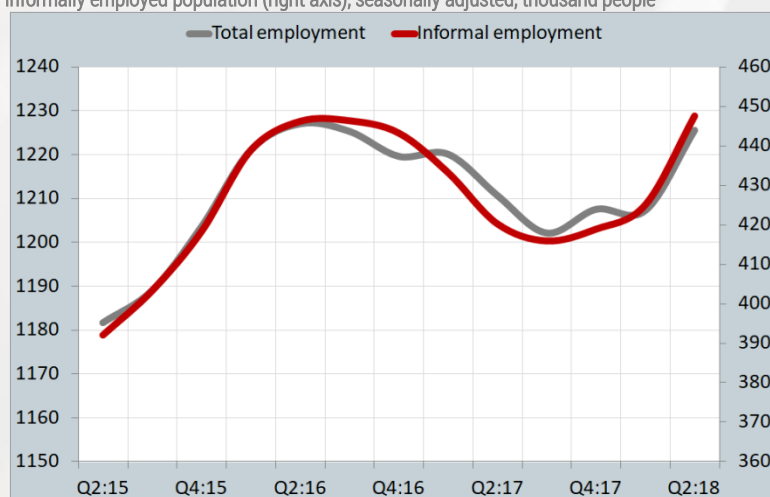


Source: Ministry of Finance

PUBLIC FINANCE

By the middle of 2018, public finances continue to be in a favorable state. The budget revenue growth rates although have moderated, remain higher than the expense ones. The positive dynamics of budget revenue accumulation is due to both economic growth and improved tax collection policy. Still, there are risks of increased electoral expenses and negative impact of electoral policies.

Figure 6. Dynamics of the total formally employed (left axis) and informally employed population (right axis), seasonally adjusted, thousand people

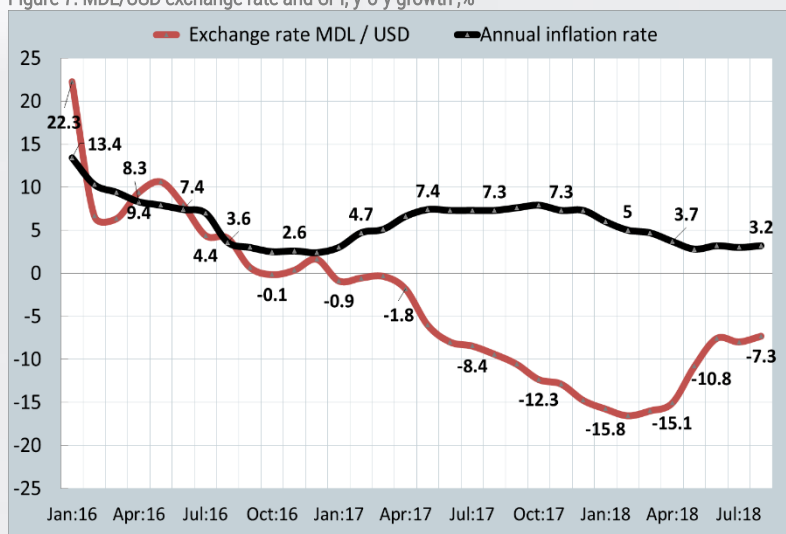


Source: NBS, EG calculations

LABOUR MARKET

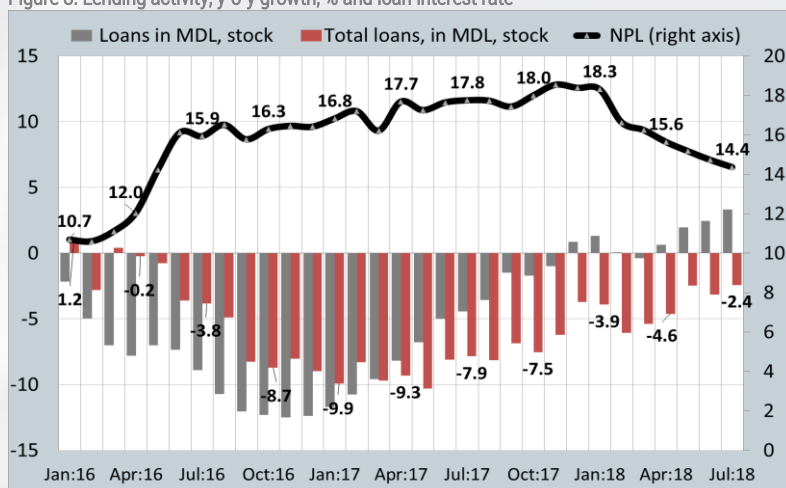
The quantitative indicators of the labour market are improving continuously, but at the expense of quality. By Q2:18, the seasonally adjusted employment has steadily increased over the last four quarters. However, the labor market dynamics is caused almost totally by the informal employment, which increases its importance. By Q2:18, the share of informal employment increased by 3.5 p.p. compared to Q2:15, to 36.5% of the employed population.

Figure 7. MDL/USD exchange rate and CPI, y-o-y growth, %



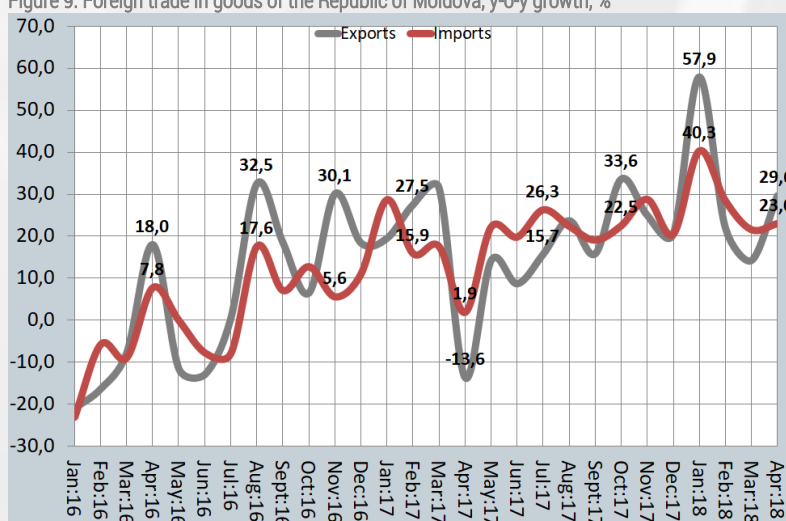
Source: NBM, NBS, EG calculations

Figure 8. Lending activity, y-o-y growth, % and loan interest rate



Source: NBM, EG calculations

Figure 9. Foreign trade in goods of the Republic of Moldova, y-o-y growth, %



Source: NBS

PRICES AND MONETARY POLICY

After a period of continuous decrease, the annual inflation rate witnesses a slightly upward trend. However, inflation remains below the targeted band of 5% (+/- 1.5 p.p.). During the summer, the national currency continued to appreciate against the major reference currencies, but at a much lower rate than the one at the beginning of the year. NBM continued to intervene constantly on the foreign exchange market as a buyer of foreign currency. The autumn season comes with the traditional exchange rate correction as the demand for foreign currency increases.

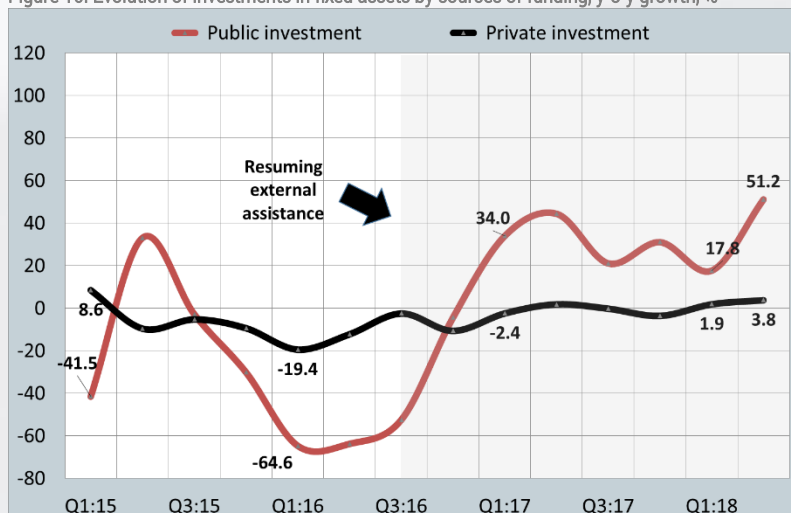
BANKING SYSTEM

The bank lending became slightly more dynamic mainly supported by loans to individuals. However, despite the fall in interest rates, business entities appear to be attracted by non-bank financing. The tightened credit requirements of banks narrow the group of eligible clients, even opting for more expensive financing rather than complying with the requirements of transparency and quality of the financial information.

FOREIGN TRADE

The low base of comparisons and increased production capacities of the industries operating on the basis of inward processing regime (related to components for the automotive industry) have boosted the foreign trade. At the same time, the exports of agri-food products (fruit, oil seeds, cereals) supported the export growth, especially to EU. In spite of these developments, from a structural point of view, exports reveal competitiveness shortcomings, which have led to an excessive concentration on low value-added products.

Figure 10. Evolution of investments in fixed assets by sources of funding, y-o-y growth, %

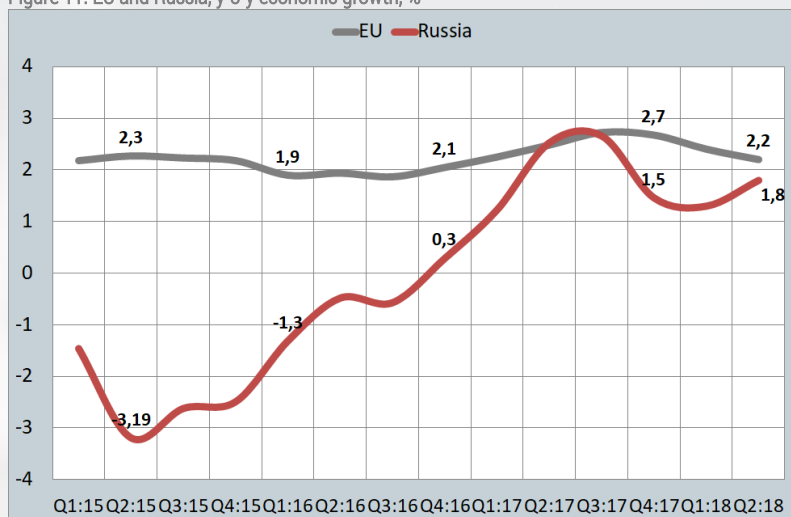


Source: NBS, EG calculations

INVESTMENT ACTIVITY

Since the electoral campaign is close, the investment activity witnesses the acceleration of public investments. The Government's launch of certain projects with a clear electoral flavour, alongside with foreign assistance projects, contributes to a record rise in public investments. On the other hand, private investments show modest growth (practically stagnating), fueled by political uncertainty and investors' low confidence.

Figure 11. EU and Russia, y-o-y economic growth, %

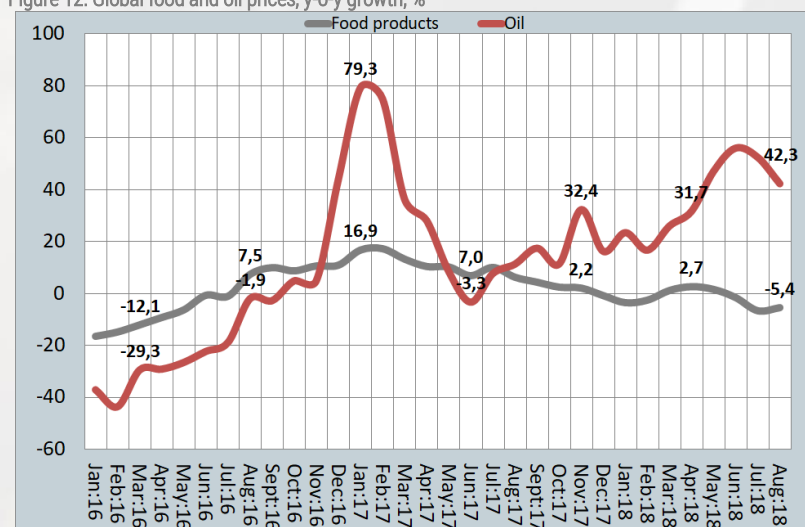


Source: EUROSTAT, Federal State Statistics Service of Russia

EXTERNAL ENVIRONMENT

The external environment saw a positive development. The Russian economy was triggered by the hotel, transport and restaurant sectors thanks to both the World Football Championship and the relatively high oil prices that supported this development. On the other hand, the European economy, although expanding in the context of increasing world trade, experienced a certain slowdown, being affected by the inflation that influenced the consumption patterns.

Figure 12. Global food and oil prices, y-o-y growth, %



Source: FAO, IMF

GLOBAL MARKETS

The oil price rose to the highest level in the last year due to the maintaining of the production limits and the escalating violence in certain OPEC countries. Prices for wheat and dairy products increased due to unfavorable weather conditions, resulting in poor harvests in the EU and Russia. At the same time, prices for sugar and vegetable oils decreased due to both the depreciation of the national currency in Brazil and India, and the favorable prospects for crop harvest in the current year.

Key policy developments in Q1-Q2:18

POLICY DEVELOPMENTS	EXPERT-GROUP COMMENT
20 June. The Government approved the '2018-2021 Professional Army' program to implement the ruling party's initiative to reform the National Army.	In March 2018, the ruling party came up with the political initiative to reform the National Army. Following this initiative, the Government developed and approved the '2018-2021 Professional Army' program. The main purpose of the initiative and of the approved program is to enhance the National Army until 2021, i.e. the shift to staff employment only on a contractual basis. Although a professional army has a number of advantages, this initiative is rather an electoral one since it is not well-planned and reasoned. Here are some reasons: • <i>Inconsistency between strategic planning documents in the defense area.</i> The political initiative to reform the National Army came just a few months after the approval of the National Defense Strategy (approved by the Government on 1 November 2017), which stated that the mixed system for completing the armed forces would be maintained until 2021. This inconsistency points to the fact that the political initiative was not built on a comprehensive analysis of the sector and of the existing reform plans in this area and that it was an electoral one; • <i>Lack of a comprehensive analysis of the need for military reform.</i> Although a comprehensive analysis of the sector and of the need for a reform was mentioned when the reform initiative was announced, the '2018-2021 Professional Army' program has no reference to a feasibility study on this issue. There are only references to some feasibility studies on secondary issues; The approved program does not take into account all reform-related problems. The approved document does not clearly state the problems the National Army will collide with while moving to a contract-based completion. For instance, the problems and solutions for the National Army as an employer on the labor market are not formulated, taking into account that it will compete with the rest of the employers for human resources after becoming a professional army. Thus, the transition to a professional army in the economic realities of the Republic of Moldova was not analysed in terms of feasibility and budget costs.
17 July. The ruling party announced a new extension of 'Prima Casa' program, i.e. a sub-program with the generic name 'Prima Casa - 3' for families with many children. It stipulates that the Government will compensate 10% of the loan for families with a child, 20% for the families with two children and 50% for the families with three children. At the same time, for families with four or more children, the Government could fully pay	Following the model of other countries, the Government of the Republic of Moldova launched in the spring of this year the 'Prima Casa' program. Although initially the program aimed at helping young people to buy the first dwelling, it gradually extended its applicability to certain groups of people, such as budget employees or families with many children. Thus, in addition to those presented in the previous edition of Realitatea Economică regarding 'Prima Casa - 1' and 'Prima Casa - 2' components, note that the Government continues to promote some electoral initiatives creating prerequisites for the discrimination of different groups of people. Hence, the compensation of loan payments for families with many

POLICY DEVELOPMENTS	EXPERT-GRUP COMMENT
off the amount of the loan, excluding the interests.	children, even up to 100%, tends to have a real limited effect given that vulnerable families lack the capacity to comply with the established eligibility requirements. Therefore, we believe that social issues, regardless of their stringent nature, should be solved through the social protection system and not through the banking system. First, the political environment should focus on economic development policies that would generate additional revenue, including for the social protection system. Second, policy-makers should carefully calibrate the program terms, considering that housing loans could become a risk factor for both the banking sector and the state budget in the event of macroeconomic imbalances. Last but not least, policy-makers in the financial system should avoid targeting the loan resources to the non-productive sectors of the economy, such as consumer loans accessed by individuals or housing loans secured by mortgages. The over indebtedness of certain groups of persons would, on the contrary, cause them to leave the country in search of higher incomes to cope with the monthly financial burden.
27 July. The Parliament of the Republic of Moldova adopted in final reading the 'Draft Law Amending and Supplementing Certain Legal Acts (Tax Code – Articles 3, 14, 19, etc., Law Implementing Titles I and II of the Tax Code – Articles 24, 42, 43' (registration number 282) and the 'Draft Law on Voluntary Reporting and Tax Incentives' (registration number 284).	The Government promoted the two draft laws (282 and 284) as a package and introduced them as a 'small tax reform' aimed at boosting the economic activity. The draft Law No 282 involves a fiscal relaxation by restructuring of the tax system, and the draft Law No 284 provides for tax and capital amnesties. The key elements of the tax break refer to the transition from the progressive taxation by 2 rates (7% and 8%) to the implementation of the 12% flat tax rate for income of individuals and the reduction of the compulsory state social insurance contributions paid by the employer from 23% to 18%. It must be mentioned the non-transparency and the 'cosmic speed' these drafts were promoted with. Thus, on 24 July the so-called 'tax reform' initiative was launched publicly without consulting the civil society, local public authorities or development partners. During its meeting on 25 July, the Government approved the draft laws, followed by their adaptation by the Parliament in 2 readings, on 26 and 27 July. If we strictly refer to the restructuring of the tax system, then there are no grounds for substantial objections. Fiscal relaxation can have positive effects on the economy, e.g. boosting the investment activity, increasing the employment and reducing the informal employment. At the same time, there are risks of increased social inequality due to the implementation of flat tax rate for individual income (the Gini coefficient is estimated to reach 31% if the reform takes place, compared to 24% without the reform) and the loss of important revenues for the national public budget in the first years of the 'reform' implementation (in 2018-2019, the losses are estimated at about MDL 1.8 billion for the state social insurance budget and about MDL 600 million for the state budget). Tax and capital amnesties are a counterproductive measure that encourages unofficial revenue recipients and discourages honest taxpayers. The capital amnesty was also promoted in 2016. The initiative was then criticized by the civil society and international bodies. The insistent return to the amnesty of the undeclared capital indicates clearly

POLICY DEVELOPMENTS	EXPERT-GRUP COMMENT
	the promotion of group interests infiltrated in the political environment. Given the weak framework on fighting corruption and money laundering, these measures could favor criminals and expose the banking system and the entire economy to the increased risk of money laundering.
27 July. Amendments to the Tax Code of the Republic of Moldova were approved, allowing the sale of duty-free fuels at state border crossing points.	The Amendments to the Tax Code will allow for the sale of duty-free oil products, which means that the imports and the subsequent sale of oil products within the customs control area for the fuelling at the exit from the country will be exempted from VAT and excise duties (with the provision that the fuelling can only be made within the capacity of the tank of the means of transport). Despite the major implications in tax/customs policy, this initiative is not accompanied by any analysis of its future impact, at least at the level of budget revenues. It is worth mentioning that VAT and excise duties are important weightings in the prices of the retail sale of fuels (about 36% for gasoline and about 27% for diesel). Therefore, taking into account the current ceiling prices set by ANRE for the rest of the country, these components would amount to about MDL 7 for gasoline and MDL 4.6 for diesel (which actually represent the amounts non-collected in the budget). It will automatically offer these companies an indisputable advantage: lower prices compared to their competitors, on the one hand, and huge profits, on the other. At the same time, the damage to the state budget (which was not even estimated by the authors of the draft) should also not be neglected.
31 July. NBM published the data on the value of official reserve assets. Thus, the reserve assets reached a record level in the history of the Republic of Moldova – USD 2.97 billion.	The increase in foreign-exchange reserves is due to the increase in foreign exchange inflows in the Republic of Moldova. Although the accumulation of official assets is an advantage for the Republic of Moldova and increases the country resilience to financial crises, the massive influx of foreign currency generates significant risks. Thus, NBM has to buy massively foreign currency to moderate MDL's appreciation and reduce the negative effects on the foreign trade balance. By purchasing the foreign currency, additional MDL are issued, and the excess of liquidity amplifies. As a result, the Central Bank has to intensify its operations to sterilize the liquidities and tighten the monetary policy.
1 September. Four years have passed since the provisional implementation of the Agreement establishing the Deep and Comprehensive Free Trade Area between the Republic of Moldova and the European Union (DCFTA).	The first four years of DCFTA implementation were marked by serious internal and external economic and political issues that affected the country's trade performances and generated some speculations about the benefits and opportunities of this agreement. However, despite these constraints, Moldova's exports to the EU increased by 22% in the first three years of DCFTA implementation. This trend also continues in 2018: after the first half of the year, exports to the EU increased by 38.1% compared to the same period last year. In addition, EU has strengthened its position as the most important sales market for Moldovan exporters: the EU share in the total Moldovan exports increased from 53.3% in 2014 to 65.8% in 2017,

POLICY DEVELOPMENTS	EXPERT-GRUP COMMENT
	reaching 68.5% after the first half of 2018. Moreover, the agri-food sector was DCFTA's main beneficiary: exports grew by 44% if compared with the industrial sector – 11%. Thus, one of the main concerns before signing the DCFTA – that trade liberalization would adversely affect the agri-food sector due to its low competitiveness – was dispersed. The fears and speculations about the invasion of goods imported from the EU were also dispersed. Thus, agri-food imports decreased by 4%, while industrial imports – by 15%. This determined the reduction of the trade balance deficit almost by 45%. Therefore, domestic products have become more competitive on the EU market during the implementation of DCFTA. The positive impact of the DCFTA on the trade flows registered by the Republic of Moldova in relation to the EU, shows the viability of assumptions supporting the opportunity to negotiate such a document. It is however a fact that its potential continues to be untapped, which shows the need to strengthen the institutional efforts in implementing all the assumed commitments.
4 September. During its meeting held on 4 September 2018, NBM's Executive Board on Monetary Policy decided to increase the mandatory reserves' rate for the funds attracted in MDL to a record of 42.5% from the calculation base.	The mandatory reserves' rate is the most tough monetary policy instrument, the effects of which can be observed most quickly (relatively short transmission period compared to the base rate). NBM has taken such a measure to prevent the inflationary risks caused by the excess of liquidities in the banking sector. Considered directly, this measure comes following the increased excess of liquidities present in the banking system. However, considered in a much wider way, i.e. taking into account where this excess of liquidities comes from, we can see that the measure tries to counter the deficiencies recorded in the financial intermediation mechanism. On the one hand, the large stock of deposits in MDL confirms the reluctance of the population and companies to implement and develop entrepreneurial ideas (otherwise a behavior characteristic for the periods of uncertainty). Moreover, the rudimentary development of the national financial system does not offer another saving alternative, such as the private pensions or the investment funds. On the other hand, once accumulated, the deposits of the population are hardly converted into loans for the real economy. This is due both to the existence of constraints at the level of loan demand and offer. Hence, in the context of the new banking regulatory requirements, Basel III, the banks need transparent, sustainable and quality financial records businesses in order to be able to lend. At the same time, a large number of business entities can hardly comply with these rules, opting for even more expensive non-bank loans, with less complex procedures.

Statistical Annexes

Table 1. Key Monthly Indicators

Indicator	Aug:17	Sep:17	Oct:17	Nov:17	Dec:17	Jan:18	Feb:18	Mar:18	Apr:18	May:18	Jun:18	Jul:18	Aug:18
Industrial production, y-o-y growth, %	7	8.6	10.2	9.6	-3	4.2	4.2	10	12.5	10	10.3	1.5	n.a.
Retail trade, y-o-y growth, %	-1.7	-2.4	-4.2	-2.7	-10.9	9.1	6.5	3.4	12	5.7	3.3	n.a.	n.a.
Services provided to the population, y-o-y growth, %	7.4	7.3	8.4	9.8	15.6	8.1	2	0.4	5	4.5	9.3	n.a.	n.a.
Export of goods, y-o-y growth, %	23.7	15.8	33.6	25.0	20.5	57.9	22.1	14.2	29.6	27.6	25.2	14.2	n.a.
Import of goods, y-o-y growth, %	22.4	19.1	22.5	28.8	20.5	40.3	28.5	21.6	23.0	26.2	18.0	23.1	n.a.
Official reserve assets, million USD	2,508.4	2,629.4	2,696.8	2,726.1	2,803.3	2,903.5	2,841.2	2,875.2	2,869.3	2,846.5	2,899.8	2,970.4	2,963.2
Budget revenue, y-o-y growth, %*	19.8	18.3	18.2	17.5	16.2	16.8	12.8	10.8	11.1	12.1	11.5	12.5	n.a.
CPI, y-o-y growth, %	7.3	7.6	7.9	7.3	7.3	6.0	5.0	4.7	3.7	2.8	3.2	3.0	n.a.
IPPI, y-o-y growth, %	4.0	3.9	3.4	3.1	2.3	1.9	1.7	1.0	1.0	0.3	0.2	-0.1	n.a.
Nominal exchange rate MDL/USD (e-o-p)	17.85	17.61	17.32	17.18	17.10	16.72	16.69	16.47	16.53	16.85	16.84	16.58	16.71
Money transferred from abroad, y-o-y growth, %	9.4	9.5	19.2	15.7	13.0	26.1	18.5	12.1	14.6	19.8	8.5	9.9	n.a.
Monetary aggregate M2, y-o-y growth, %	9.7	9.0	9.8	11.3	14.2	14.1	14.5	14.1	13.0	13.6	13.1	11.9	n.a.
NBM base interest rate, %	8.0	7.5	7.5	7.0	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5	6.5
Bank deposits interest rate, %	5.78	5.82	5.72	5.57	5.19	5.17	4.54	4.66	4.46	4.20	4.58	4.44	n.a.
Bank loans interest rate, %	9.76	9.96	10.00	9.88	9.58	9.80	9.47	9.35	9.00	8.63	8.72	8.67	n.a.
Share of non-performing loans in total loans, %	17.7	17.4	18.0	18.5	18.4	18.3	16.6	16.2	15.6	15.2	14.7	14.4	n.a.

Source: NBS, NBM, EG estimates

Table 2. Main quarterly indicators

Indicator	Q1:16	Q2:16	Q3:16	Q4:16	Q1:17	Q2:17	Q3:17	Q4:17	Q1:18	T2:18
Real GDP growth rate, y-o-y*, %	0.8	1.9	6.5	6.7	3.2	2.6	5.3	6.4	3.7	n.a.
Agricultural production, y-o-y growth, %*	4	4.1	18.9	18.8	1.1	-5	3.7	8.6	1	n.a.
Construction work, y-o-y growth, %*	1.7	2.7	2.1	2.3	1.7	2.7	2.1	3.6	-1.7	n.a.
Investments in long-term assets, y-o-y growth, %*	-1.2	2.5	2.4	1.3	-1.2	2.5	2.4	1.3	2.9	n.a.
Net inflow of FDI, USD million	35.04	-13.04	66.62	-13.94	41.97	31.65	66.13	66.02	82.31	n.a.
Real salary, y-o-y growth, %	-1.9	0.4	5.2	10.5	6.8	5.8	3.5	4.7	7.7	9.5
Unemployment rate, %	4.2	6.2	4.0	2.9	3.8	6.3	3.5	3.4	3.3	3.0
Employment rate, %	39.2	37.6	43.8	43.5	38.5	37.7	42.6	42.4	39.2	45.0

Note: * – cumulative; (e) – estimate;

Source: NBS, NBM, EG estimates