

MEGA

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Economy in seatbelts - elections are coming

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About MEGA

MEGA is the English acronym for Moldova Economic Growth Analysis. MEGA is a biannual publication issued by EXPERT-GRUP since 2009 and has the main purposes of explaining the fundamentals of recent economic trends in Moldova, analyzing economic policies and coming up with strategic solutions for the economic development of the country.

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Contents:

Key indicators	5
Major Economic Evolutions in 2018.....	5
Forecast for 2019	7
Risks and uncertainties	9
Policy Recommendations.....	10
Households	11
Recent Trends.....	11
Short- and Medium-Term Forecasts.....	15
Main Risks to the Forecast.....	16
Firms	17
Recent Trends.....	17
Short- and Medium-Term Forecasts.....	19
Main Risks to the Forecast.....	20
Financial institutions	21
Main Evolutions in the Financial Sector	21
Short- and Medium-Term Forecasts.....	24
Main Risks to the Forecast.....	24
Fiscal Policy	26
Main Evolutions in the Budgetary Sector	26
Short- and Medium-Term Forecasts.....	28
Main Risks to the Forecast.....	29
Prices and Monetary Policy	31
Inflation and Exchange Rate.....	31
Monetary Policy and Interest Rates Market	32
Short- and Medium-Term Forecasts.....	33
Main Risks to the Forecast.....	33
Foreign Sector	35
Evolution of External Environment	35
Balance of Payments Current Account	37
Capital and Financial Account of the Balance of Payments	40
Short- and Medium-Term Forecasts and Risks	41

**List of figures:**

Figure 1. Households income and expenses, seasonally adjusted series, real growth y-o-y, %	12
Figure 2. Evolution of new loans granted to individuals, growth y-o-y, %	12
Figure 3. Dynamics of banks deposits by maturity, growth y-o-y, %	13
Figure 4. Employment in the industrial sector during 2010-2017, thousand persons	14
Figure 5. Population employed in agriculture in Q2 during 2008-2018, thousand people	14
Figure 6. The evolution of investments in fixed assets, growth y-o-y, %	17
Figure 7. The evolution of production from agricultural sector, y-o-y growth, %	18
Figure 8. Industry dynamics in Jan-Sep:18, y-o-y growth, %	19
Figure 9. Structure of assets and liabilities, %	22
Figure 10. Development of interest rates on main financial instruments and inflation rate, %	23
Figure 11. Lending activity, %, non-bank loans, MDL billion	24
Figure 12. Foreign grants and loans, planned vs. realized, MDL millions	27
Figure 13. Nominal budget deficit, over revenues and GDP	27
Figure 14. Evolution of consumer prices, y-o-y growth, %	31
Figure 15. NBM interventions on the foreign exchange market and nominal exchange rate (right hand axis)	32
Figure 16. Monetary aggregates, MDL billion and increase in money stock and base, % (right axis)	33
Figure 17. GDP growth in Russia and EU, % growth y-o-y	35
Figure 18. Evolution of prices for food products and oil, % growth y-o-y	36
Figure 19. Evolution of current account by main components, net values, USD million	37
Figure 20. Export of goods by regions (USD million) and structure of goods export (% of total)	38
Figure 21. Import of goods by regions (USD million) and structure of goods import (% of total)	38
Figure 22. Export and import of services, USD million	39
Figure 23. Structure of export and import of services in Q2:2018, % of total	39
Figure 24. Evolution of primary (left) and secondary (right) incomes, USD million	40
Figure 25. Personal remittances received by residents, by country of origin, USD million	40
Figure 26. Evolution of capital account, USD million	41
Figure 27. Evolution of the financial account, net values, USD million	41

List of tables:

Table 1. Forecast of the key macroeconomic indicators of the Republic of Moldova for 2018-2019, percentage growth y-o-y, unless indicated otherwise	7
Table 2. Deviations of debt categories contracted by Government of the Republic of Moldova, MDL million	28



Key indicators

Major Economic Evolutions in 2018

In 2018 the Moldovan economy generally developed as forecast, but new risks emerged. Our estimates show that GDP increased by 4.2% - 4.6%, on a broad basis which included almost all key sectors. The domestic supply was mainly driven by gross fixed capital formation (but there are major issues regarding growth quality and sustainability) and by increase in household final consumption. Households benefited from increase in salary income and social benefits and more tempered growth of prices. The foreign sector, however, had a much bigger impact on domestic economic dynamics.

Concerning macroeconomic indicators as a whole, worsening of the current account is the most worrying evolution. Its dynamics is persistently negative: from -4.2% of GDP in Q1-Q2:16 to -8.7% in Q1-Q2:17 and -10.6% of GDP in Q1-Q2:18. In the first half of the year, exports of goods and services increased by about 23.5%, but imports grew even more dynamically (24.5%), and from a much higher initial level than exports. The higher deficit of the trade in goods as accompanied by a better balance of services. The defining structural and geographic trends consolidated by augmenting the role of EU and the share of automotive industry exports. Remittances from emigrants, expressed in USD, increased more slowly. It is worthwhile noting that in 2018 the EU area exceeded for the first time the CIS states in the geographical structure of the personal transfers made by emigrants living abroad (40% compared to 33%). Altogether, in 2018 the current account was financed less from foreign direct investments and mostly through reducing external assets and contracting new commercial loans.

As a reflection of the current account dynamics, the domestic demand components developed robustly in the first half of 2018. The main component of the demand - households' consumption - increased by about 4.2%, financed by higher incomes from almost all sources. In particular, the income from the salaries increased by about 3.8% in real terms. The higher salary income is explained to a certain extent by the increase in men employment (+2.6% of the employed population) and, especially, women's employment (9.2%), as well as by the recession of the unemployment rate to historical lows (3.0% for women and 3.9% for men, both seasonally adjusted). But the level of employment continued to increase especially through the informal employment in agriculture. Generally, the agricultural employment has grown steadily over the recent 5 years, which is a phenomenon with dual economic implications. The involution of remittances expressed in Moldovan lei is equally notable and worrying, which decreased by about 3% in real terms of the domestic currency. Revenues from social protection programs increased by 10%. This administrative increase in revenue - both welcome and necessary - is something to be expected in the current political context making the Government to offer more generous electoral alms. In the long run, however, it makes households more vulnerable to potential problems affecting the revenue side of the public budget.

After a stagnation period of several years, in 2018 we also saw a more tepid investment process. Gross Fixed Capital Formation (GFCF) increased substantially by about 9%, but, in terms of quality, this increase is not unequivocal. On the one hand, there is a feeble increase in private investments (+1.5%), mainly to replace some of the depreciated productive capacities. On the other hand, the GFCF growth is determined mainly by public investment programs. Some of them, such as 'Good Roads for Moldova' Program, were implemented without proper preparation and gave the impression that the Government is more interested in the process rather than in the outcome. Without questioning the need for good roads at local level, more and more field evidences reveal big problems with the relevance of the rehabilitated sections and quality of the performed works. In other words, a large part of the public investments program implemented in 2018 could eventually turn out to be nothing more than a waste of resources. It will not increase productive capacity of the economy and, in the medium run, will put even greater pressure on public finances and, ultimately, on taxpayers.



The domestic production capacity covered less than a half of the aggregate demand growth. The 4.5% GDP growth in the first half of the year consisted of the real increase in gross value added (4.1 p.p.) and of net taxes on products amounting to 0.4 p.p. The market services generated the largest share of total gross added value. In particular, there has been an increase in retail sales (+4% in Q1-Q3:18) and if services provided to population (+12%). The dynamics of the transport services provided to enterprises (+9%) coincided with the evolution of domestic and foreign trade. The industry has shown impressive growth rates (+6% in the first nine months), the most dynamic were the automotive, construction, packaging, and shoe production sectors. The volume of agricultural production did not increase significantly, albeit without negative impact on incomes of the rural population. The exceptions are farms which were directly affected by the overproduction of fruits and related price reduction. Construction sector has also shown certain revitalization (+6%), possibly due to mortgage lending.

The banking sector continued to reduce its presence on the credit market, while the non-banking lending companies advanced impressively. Their aggressive marketing strategies in the last three years allowed them double their share on the lending market, even if the terms of loans are draconian (effective interest rates exceed 25% in most cases). Total financial intermediation reached historical lows. The Government is still the preferred customer of the commercial banks. Despite very low interest rates, private companies do not hurry to finance their investments through bank loans. On the contrary, there is evidence that companies instead of investing, increase their medium-term bank deposits - a symptom of the investment skepticism before the elections. Thus, loan resources increasingly migrate to finance spending priorities with a modest impact on the economy's productive capacity - including mortgage or consumer loans - and escalate the risk of growth in the indebtedness level of some households, and, in the mid-term, the risk of a possible negative adjustment of the final consumption.

The developments in the agricultural sector led to minor increases in prices or even to decline in prices of some foodstuffs. At the same time, the political context and the appreciation of the national currency resulted in downward revision of tariffs and prices for some regulated goods and services. As a result, the annualised consumer price index decelerated, from 4.7% in March to 1.2% in October 2018. Reduction of inflationary pressures, coupled with growing supply of foreign currency, allowed the NBM to increase its official reserve assets to more than USD 3 billion, thus ensuring comfortable financing of more than 5 months of imports and exceeding the short-term foreign debt by 60%. The NBM base rate remained at 6.5% over the whole year. In Aug:18 the NBM increased the rate of minimum reserve requirements. After a steady decrease over the recent period, the yield curve of government T-bills increased slightly in Q2-Q3:18, on the background of increased volume of issued T-bills and growing domestic debt. This is due also to the increased level of creditors' skepticism regarding the budget revenues in 2019, given that EU cancelled macro-financial assistance, while the fiscal reform will probably produce positive results with a certain delay. At the same time, these changes could also reveal slightly worsening inflationary expectations in the banking community.

In 2018, the Government had strong fiscal positions which were weakened for next year due to changes in tax policy and new budgetary commitments. Total NPB revenues increased by 11.0% y-o-y in the first 9 months of 2018, and full year revenues are expected to exceed by 2.3% those approved in the initial version of the budget. The foregone foreign grants and loans were offset by the higher tax and non-tax revenues. However, revenues to the budgets of administrative-territorial units evolved at a much slower pace, reflecting poor economic and demographic situation at level of territorial communities, especially of the small rural ones. Expenditures in the first three quarters were executed at 65% of the planned level, but we expect that situation will change significantly in the last quarter of the year, both for technical reasons (traditionally, many public procurements are made closer to the end of the year, when there is higher certainty about the execution of revenues) and political ones, determined by the elections calendar. Overall, expenditures estimated for the whole 2018 will exceed the approved amount by about 1%, resulting in budget deficit lower than previously expected. Corroborated with the change in calculation methodology for GDP, co-evolution of budget revenues and expenditures may result in a small budget deficit (below 1% of GDP, according to our estimations). In 2018, the Government adopted a



package of tax and institutional reforms with a negative impact on short-term revenues (even if net impact is positive in the medium and long term), undertaking new financial commitments with immediate effect. They will not have a major negative impact in 2018, but the situation could be different in 2019. Increasing fiscal disequilibrium, combined with a reduction in foreign assistance, could lead to surge in government debt level. Evidence in this sense represents the increase in Government's forecasts regarding internal debt: at the end of 2017, authorities were expecting total internal debt not to exceed MDL 27 billion towards the end of 2020; only one year later, the expected level was raised by MDL 1.5 billion to a total balance of MDL 28.5 billion at the end of 2020.

Forecast for 2019

Traditionally, we developed our forecast for 2019 along an optimistic and pessimistic scenario. In the optimistic scenario, we expect that GDP will grow by 5.2% and the pessimistic one counts on a 3.5% increase (Table 1). Sources and uses of GDP are virtually the same in both scenarios. Only the magnitude of contributions varies. Regardless of scenario, income of population will increase in real terms, both thanks to real wage growth and revenues obtained from more generous social protection programs. The growth in revenues will fuel household consumption expenditures (+5.6% in the optimistic scenario and +4.3% in the pessimistic one). On the demand side the consumption expenditures will remain the essential driver of economic growth. Lending expansion will support households' consumption, but signs of over-indebtedness of some categories of households may appear in 2019. Exports will increase by 8.7% in an optimistic case and by 7.7% in a pessimistic one. Imports will grow robustly, on a higher basis, thus making a negative contribution of the net exports to GDP.

Table 1. Forecast of the key macroeconomic indicators of the Republic of Moldova for 2018-2019, percentage growth y-o-y, unless indicated otherwise

Indicator	2018	2019	
		optimistic scenario	pessimistic scenario
Household disposable income	5.3	6.3	4.5
Household consumption expenditures	3.8	5.6	4.3
Investments in fixed assets, total	6.8	8.5	6.5
Public investments in fixed assets	31.9	11.5	4.3
Private investments in fixed assets	3.3	8.0	6.9
Gross fixed capital formation	9.2	8.4	6.0
Export of goods and services	9.7	8.7	7.7
Import of goods and services	8.6	6.8	4.4
Gross Domestic Product	4.4	5.2	3.5
Net taxes on product	5.7	5.6	4.4
Gross value added, total	4.8	4.7	2.9
Gross value added, industrial sector	6.1	4.9	4.3
Gross value added, agricultural sector	0.6	7.2	4.1
Gross value added, transport services sector	5.4	5.2	4.3
Gross value added, trade sector	7.6	6.8	5.4
Gross value added, construction sector	7.0	7.8	6.8
Consumer Price Index	3.5	5.1	5.7
Deficit (-) / surplus (+) of the National Public Budget, % of GDP	-1.0	-1.5	-3.0
Deficit (-) / surplus (+) of the current account of Balance of Payments, % of GDP	-12.0	-10.8	-11.6
Women employment rate, % of the working age women population	40.2	40.3	39.7
Men employment rate, % of the working age men population	43.9	44.0	43.5

Source: Expert-Grup estimates and forecasts.



Acceleration of the investment process is quite likely, even though great uncertainties threaten the growth magnitude.

In a pessimistic scenario, we anticipate 6.5% growth in investments in fixed assets, with the private growth higher than public one. In a positive scenario, we expect increase of about 8.5%, driven mainly by the public investments (+11.5%), but also by the more active expansion of private ones (+8%). Gross fixed capital formation reflects this dynamic of fixed assets. However, after a long period of decline in investment activity, these growth rates should be viewed as unsatisfactorily low, under the potential of the sources accumulated by the financial institutions and firms themselves and below the investment needs of the economy in general.

On the resource side, in 2019 GDP will benefit from a broad growth base. The industry will grow robustly, forecasts for both scenarios are quite close (4.9% versus 4.3%). Due to climatic uncertainty, confidence interval of the forecast is much broader in case of the value added generated by agriculture (+4.1% in a negative scenario and +7.2% in a positive one). In case of transport, trade and construction services, increase in gross value added generated in each sector will be positive in both scenarios, with a difference of one percentage point only. Taxes on products (VAT, excise duties, customs tariffs) will have a positive net contribution to GDP. Their growth to a large extent reflects materialization of the effects of a more relaxed tax policy.

In 2019, lending will advance due to interest rates at historical lows. The consumer lending will continue its upward trend due to decrease in interest rates and due to banks' focus on loans to individuals. Activity of microfinance, leasing companies and savings and loans associations will expand as well, their resources will be directed mainly to household consumers. We also forecast increase in corporate loans, especially in the second half of the next year, thanks to the more upbeat investment appetite of the firms and due to alleviation of constraints imposed by intensive supervision by the NBM of some commercial banks. MDL loans will increase by about 3% in a pessimistic scenario and 15-16% in optimistic one. The growth rate of foreign currency loans will also remain on an upward trend: +10% in case of a pessimistic scenario and +17% under conditions of an optimistic one.

The inflation is forecast to grow in both scenarios. Consumer price index will increase by 5.7% in a negative scenario and by 5.1% in a positive one, which is within the variation interval pursued by the NBM. After moderate increase in prices in 2018, there are signs that inflation expectations may again grow slightly. The increase in prices for some agricultural products that stagnated in 2018 is possible due to cyclical factors. Global oil prices may require substantial increases in the domestic prices for fuel and for some public utility services. Government will do its best to postpone these adjustments for the post-election period - and the longer it postpones, the harder the final adjustment will be.

The first impressions on the proposed 2019 budget is that it is balanced, but only at the level of the draft. The draft is based on growth rates that look too optimistic for some categories of revenues, and the political context (at least two election exercises are to be conducted – at national and local levels) could lead to new liabilities. Both the optimistic and the pessimistic forecast scenarios hint to smaller revenues for the national public budget than forecast by authorities: by MDL 700 million in the optimistic scenario and by MDL 3,100 million in the pessimistic one. It is rather risky to forecast the deficit because it is unclear how budget expenditures will behave in 2019, while the sources for covering the deficit possess a high-risk level. Missing the foreign assistance and incurring tax revenues smaller than expected will force the Government to increase internal borrowing, or might even require hiking certain taxes (such as the VAT). According to our projections, in 2019 the budget deficit will amount to a level between MDL 3,200 million (1.5% of GDP in the optimistic scenario) and MDL 6,300 million (3% of GDP in the pessimistic scenario). These projections are based on the spending model for the period 2012-2018. Building on these tendencies, we expect that the control of the budget deficit will take place through reduction of capital expenditures: in recent years, on a regular basis, services related to the economy had recorded the lowest execution levels. Categories of expenditures that have consistently been realized refer to social spending such as: health, education, social protection etc. We do not eliminate the possibility that political objectives may cause essential corrections to our model, with deficits levels closer to 4.0-5.0% of GDP being fairly possible.



Risks and uncertainties

Risks to the economic forecast for abound, both from the internal and external sources. It is impossible to uniquely assess the balance of risks, but this appears to give better chances to the pessimistic forecast scenario.

Concerning external risks, most sources of global economic forecast agree that in 2018 the global economic growth reached a maximum. Currently, the prospects for 2019 are less optimistic than at the beginning of 2018. Although fiscal and monetary policies in the main global economies still favor the growth, the resources of governments and central banks have their limit. New geopolitical and geoeconomic risks undermining both global demand and supply are taking shape. Worsening of Chinese-American relationships disbalanced the whole multilateral trade relations system and cast a shadow over the perspectives of global trade in 2019. The lack of clarity regarding the Brexit scenario and the increasingly tense relationships between the European Commission and Italian Government concerning Italian draft budget - which does not comply with convergence conditions of the European Monetary Union – adds even more uncertainty in Europe. In Russia, the fever of sport events is naturally dwindling down, and Western economic sanctions have neither limit nor end. Instability in the Middle East, tensioning of Iranian-American relationship, implosion of Venezuela risk to skyrocket oil prices, while prices for cereal products and basic foodstuffs are likely to decrease. This negative correlation between global oil and food prices may act as a pair of price scissors for Moldovan farmers, which will cut even more from the profitability which is already quite small.

The political climate in 2019 is a big unknown, with implications on the real economy and on the balance of the national public budget. If parliamentary elections run inconclusively, it might make the general sociopolitical situation more tense, making enterprises more caution to invest and limiting the households' consumption appetite. At the same time, high political stakes – linked both to national and local elections - could determine the Government and local public authorities to take on new budgetary commitments which are hard to guess at the time of writing this edition. This could further exacerbate the deficit we expect even for the pessimistic scenario. Financing this deficit could be costlier amid a more turbulent sociopolitical and economic climate. Concurrently, if at the early stages of forecast we approached the resumption of macro-financial assistance by EU as an uncertain development, there is more and more clarity that it will not be resumed in the first half of 2019. For technical reasons, there are high risks that assistance will not be resumed by the end of the year, even if the elections are conducted in impeccable manner. Cumulation of all factors and risks may force the next Government to adopt unpopular budgetary stabilization measures. These measures may include reduction of current and capital spending, increase of some taxes and fees, and issuing a larger domestic debt, with negative consequences for banks' capacities to finance the real economy.

The surprising resignation of Mr. Sergiu Cioclea, the NBM Governor, on 20 November, adds a new dose of uncertainty. This uncertainty arises due to questions regarding the real causes of resignation and political position to be adopted by the new Governor and, implicitly, due to extent to which NBM will remain an independent institution as compared to the Government. In particular, it shall be seen to what extent the NBM will adhere to strategy of direct inflation targeting and to what extent ensuring and maintaining price stability in the mid-term remains the central objective of monetary policy. Mr. Octavian Armașu will play an important role in the finalization of the existing IMF program and potential negotiation of a new one. Next year, IMF is expected to release a tranche of MDL 700 million for budgetary support.

Traditionally, weather conditions remain a major source of risks. During the whole period for which statistic data are available, agriculture was the sector demonstrating the most erratic evolution, caused mainly by the combination of humidity conditions and temperature regime in the active vegetation period. The national meteorological service does not make forecasts for the 2019. Current climatic conditions and those of past decades show that such forecasts would be risky anyway. Weather conditions will also have an impact on the prices of agricultural products, as the optimal level of



prices reflects a fragile balance between the objective to raise farmers' revenues and that of providing food security for entire population.

Policy Recommendations

- Even though it may sound as totally contradicting the current behavior of the Government, a key recommendation regarding the fiscal policy is caution and moderation. The Government already undertook a vast amount of immediate financial commitments, which can create middle- and long-term risks for the stability of the fiscal system. This spending tendencies have to be brought under control if the Government puts any value on the long-term public interest.
- Moderation is important not only for the sake of the fiscal discipline, but also for not undermining the tepid resumption of the investment process which took shape in 2018 and which we expect will continue in 2019. Financing the budget deficit through T-bills purchased by commercial banks comes in stark contradiction with the goal of stimulating banks' lending to the real economy.
- In the realm of financial regulation, a number of technical measures are required for a better evaluation of risks associated to the financing of physical persons by non-bank credit organizations. At the same, it is important to better assess the risk undertaken by these organizations, particularly as there are signs that they attract deposits in hidden forms and thus expose third parties to credit risks.
- It is imperative to speed up the investigation of the bank fraud and recovery of the stolen assets. The lack, for the time being, of any palpable progress in this regard, can further dent the trust of the external partners, maintain high levels of Moldova's country risks and perpetuate the ballast of domestic debt and the risks of public finance. From the moment of activating the state guarantee and turning it into public debt, the state incurred total service costs amounting to MDL 1.5 billion. Over this period, only MDL 430 million have been recovered from liquidation of banks assets.
- After the recent reduction in the employer's contribution to mandatory social insurance, a more effective package of measures is essential to reduce the phenomenon of informal employment. Inter alia, the package should aim a better financial education of the population which must be aware of the risks associated to informal work arrangements – such as lack of social protection, lack of medical insurance and small size of future pension. Without a sizable reduction in the informal employment, the economic boost expected from the recent relaxation of the fiscal policy may turn well below expectations.
- A number of political developments and declarations made us get back to the subject of capital amnesty and reiterate our previous opinion that the only correct decision is the abolishment of this part of the package – even though its implementation period has just been extended until 31 of March 2019. Capital amnesty risk to engender a number of negative consequences which will undermine the recent years' gains from the efforts of cleaning the financial sector.



Households

In 2018, the disposable income of population could increase by more than 5%, which will stimulate household consumption and increase it by 3.8%. During the year, the employed population grew thanks to higher employment in the informal sector and households, while the unemployment rate reached historical lows. Also, with the very loose fiscal-budgetary policy, the Government boosted population's income and consumption. For example, in Jan-Jun:18, the pension income increased by 9.8% y-o-y and covered about half of the disposable income growth. In Q4:18, the shift to a flat tax rate on individuals' income will raise the net wage. We assume that the 2018 fiscal reforms will have a positive impact on population income and employment in 2019. At the same time, we forecast that in 2019 the social budget expenditures, such as social benefits or public-sector wages, will grow moderately compared to 2018. This will slow down the growth pace of household income. In general, for 2019, we expect the household income and spending, as well as the formally employed population to grow.

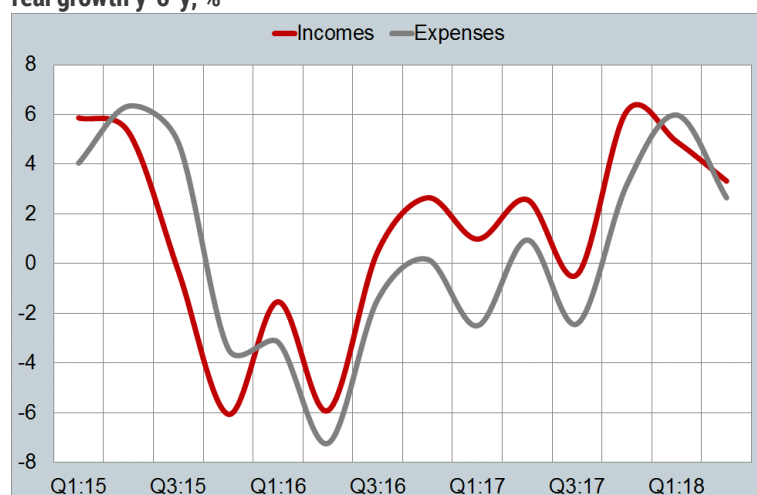
Recent Trends

The rise in wages and pensions contributed with more than 86% to the increase in household disposable income. The Government played an important role in augmenting the household income by increasing significantly the pensions and budgetary wages. In Jan-Jun:18 the available household disposable income grew by 4% in real terms. Net wage income rose by 3.8% and contributed to the increase in disposable income by about 1.6%. The dynamics of net wages was influenced by the evolution of gross average salary, which increased by 8.5% y-o-y. High growth rates of the gross wage were recorded both in the budgetary sector (9.2% increase y-o-y) and in the private sector (8.1% increase y-o-y). The pension income grew by 9.8% y-o-y and had the largest contribution to the growth of disposable income – by 1.9%. Due to appreciation of the Moldovan leu, remittance income stagnated. A stagnation is also noticed in the income from agricultural activity. At the same time, in Jan-Jun:18 in rural areas disposable income increased by 5.4%, while in cities – by only 2.6%. As a result, the ratio of the rural population's income to those in the urban area increased from 70.1% to 72.4% in the first half of 2018 compared to the similar period of 2017. The rapid growth of net wages in the rural area is worth mentioning. Thus, in villages they grew by 7% y-o-y, while in cities by 1.8% y-o-y only.

The evolution of household expenses correlates with the dynamics of household income in the first half of 2018, while the expenditure structure did not change significantly. In Jan-Jun:18 household expenses grew by 4.2% y-o-y in real terms, which is close to the increase in household income (by 4% y-o-y). Historically, there is a high correlation between the evolution of household income and expenses (Figure 1). In Jan-Jun:17 and Jan-Jun:18 the cumulative share of spending for foodstuffs, clothing and footwear, and housekeeping remained constant and accounted for 72% of total spending. Insignificant changes occurred for the most important categories of expenses: share of spending for foodstuffs grew from 44.2% to 44.4%, the share of expenses for clothing and footwear increased from 10.0% to 10.4%, while housekeeping costs dropped from 18.5% to 18.0%. The share of other categories of expenses also changed insignificantly. At the same time, household expenses grew faster in the rural area than in the urban one. Thus, a 4.4% increase y-o-y was registered in villages, while in cities – a 3.8% increase y-o-y. As a result, the ratio of rural to urban spending increased from 72.7% to 73.1%.



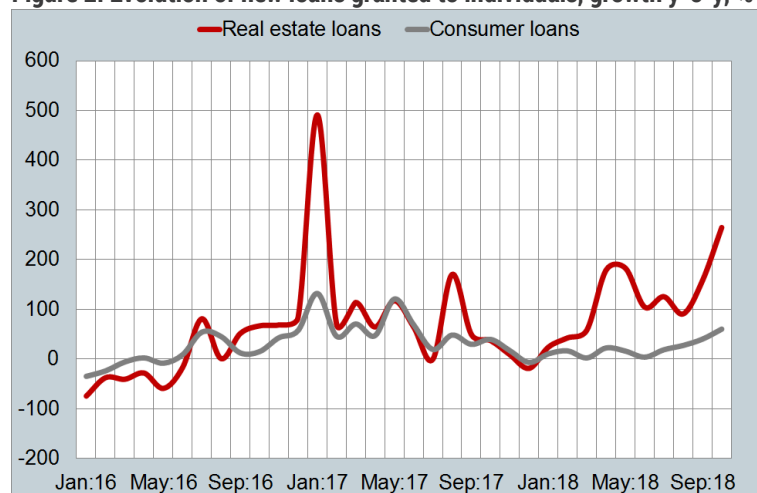
Figure 1. Households income and expenses, seasonally adjusted series, real growth y-o-y, %



Source: NBS, EG calculations

Lending to individuals is on an upward trend. The growth of real estate loans is particularly strong, which was also influenced by the implementation of the “Prima Casa” program. In Jan-Oct:18 the volume of loans granted to individuals grew by 33.4% y-o-y. Consumer loans grew by 20.6% y-o-y. In the case of real estate loans, we witness a new ‘boom’, with an increase of 118.6% (Figure 2). At the same time, we assume that the increase in consumer loans, of which a large part is used to purchase long-term goods, benefits mainly the high-income groups, who can afford to repay the principle and the interest. Such a hypothesis is also supported by disaggregated data on consumption. Thus, in the rural area, where households have lower income, in Jan-Jun:18 the housing expenses¹ decreased in real terms by 9.9% y-o-y. In the urban area, where residents have higher income, housing expenses increased by 5.6% y-o-y.

Figure 2. Evolution of new loans granted to individuals, growth y-o-y, %



Source: NBM, EG calculations.

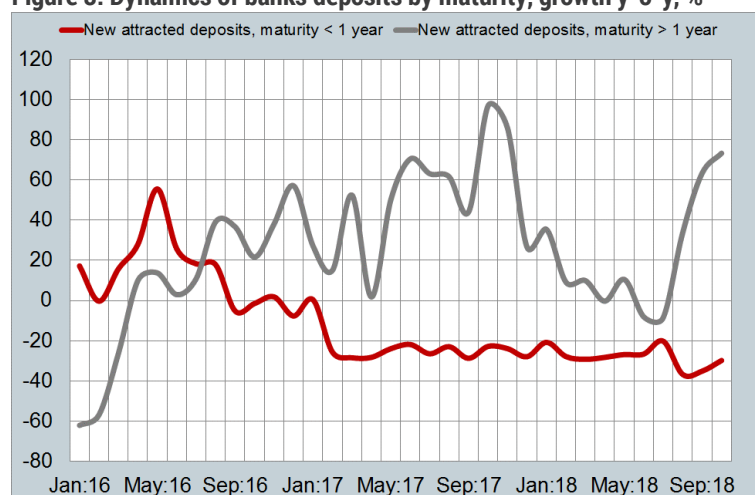
People reorient their savings from short-term to long-term deposits. In Jan-Oct:18 short-term deposits in MDL and foreign currency decreased by 31% and 24% respectively, while long-term deposits in MDL and foreign currency increased by 27.9% and 23.6%, respectively. The decrease in MDL deposits with a maturity under one year can be explained by the lower nominal interest rates, although the real interest rate went up. In Jan-Oct:18 the nominal interest rate on deposits under

¹Housing expenses, covering the procurement of durable goods, can reflect to a certain extent the use of consumer credits.



one year fell from 5.18% to 4.45% and the real interest rate rose from -2.07% to 3.25%. This can be explained by the fact that when placing their savings, people compare the interest paid by the deposit with the future inflation rather than with the current price growth. Thus, although a disinflationary process is currently in place, there are negative expectations about the future price dynamics, which make short-term MDL deposits unattractive. At the same time, the MDL appreciation to a certain extent determines use of the savings for short-term deposits. Historically, there is a predominance of the periods when term deposits grow at a quicker pace than deposits with a maturity under one year (Figure 3). The more attractive interest rates on term deposits are one of the causes that explains these evolutions.

Figure 3. Dynamics of banks deposits by maturity, growth y-o-y, %



Source: NBM, EG calculations.

During the year the employed population grew, which is due entirely to the higher employment in the informal and household sectors, and the unemployment rate reached 18 years minimum. Seasonally adjusted activity and employment rates in Q2:18 grew by 0.25 p.p. and 0.5 p.p. y-o-y, respectively. Against this backdrop, the seasonally adjusted unemployment rate fell to 3.45% at the end of Q2:18, the lowest level recorded since 2000. These indicators improved thanks to the higher employment in the informal sector. Although informal employment is a source of income and social security for a large group of population, it affects negatively the budget revenue, resulting in Government's inability to deliver qualitative social services, at the same time distorting the tax system. At the same time, this income is uncertain and volatile, and the areas with predominant informal employment have a low productivity.

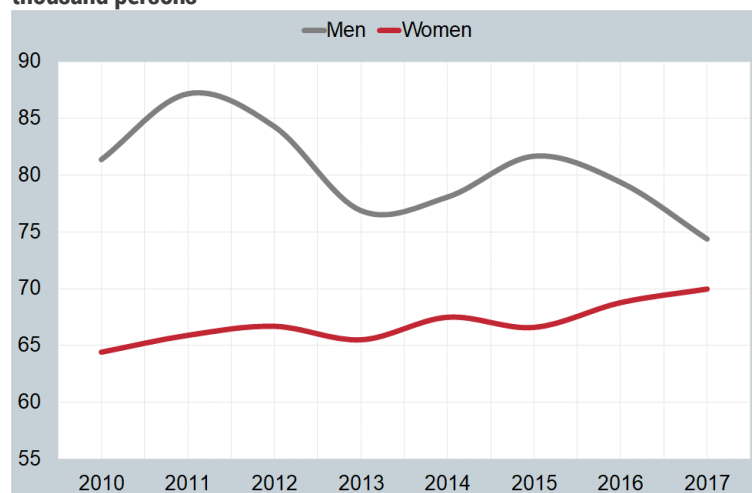
The unemployment reached its low and the employment reached its peak mainly thanks to the employment of women. At the end of Q2:18, the number of active and employed women registered peak levels in the last decade (696 thousand and 677 thousand, respectively) and a seasonally-adjusted unemployment rate of only 3.03%. The growing number of women employed in the industrial sector is a curious development. The number of women in the industrial sector increased by 8.7% as of the end of 2017 compared to 2010, indirectly offsetting at least a part of the decrease in the number of men by 8.6% over the same period (Figure 4). The newly created stable jobs offered some opportunities in the country, discouraging partially women's emigration for work. Thus, in 2017, compared with 2010, the number of women working or looking for a job abroad fell by 5.1% (almost 6000 women), while for men this indicator has increased throughout the period.

The formal employment shrank by 3.3% and 2.1% in Q1 and Q2:18 y-o-y, oscillating below the average level of the last decade. In Q2:18, the seasonally adjusted number of people employed in the formal sector was 778 thousand, the average



of the last decade being 805 thousand². The share of formal employees dropped to 58.9%, by 4.7 p.p. less y-o-y, with the number of informal employees increasing by 20% y-o-y.

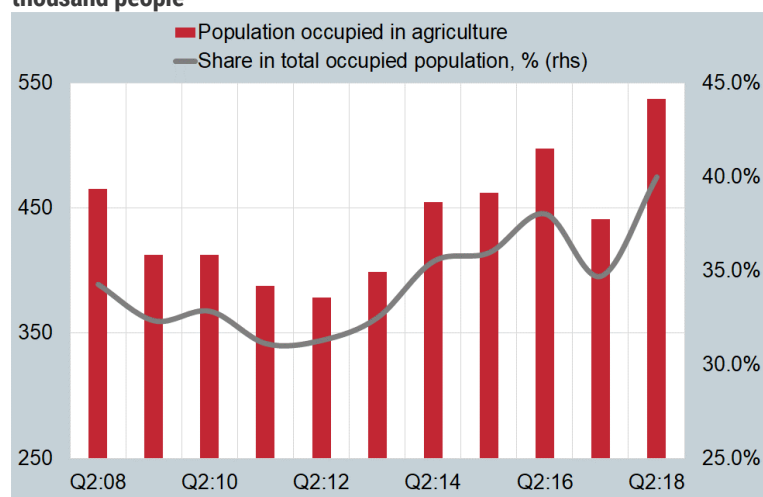
Figure 4. Employment in the industrial sector during 2010-2017, thousand persons



Source: National Bureau of Statistics.

Most of the active people are employed in the agricultural sector. The share of people working in the agricultural sector has reached the highest share in the past 10 years. A number of 537 thousand people were employed in agriculture at the end of Q2:18, which had a determinant impact on the growth in informal employment (Figure 5). Around 40% of the active population are employed in agriculture (and 20.4% of them produce only for their own consumption). Employment in agriculture experienced the highest growth of all economic sectors, by 22% y-o-y. The average nominal wage in agriculture increased by 16.9% y-o-y, which is faster than the average growth of 13% in the economy in general. Despite this, the employment of so many people in the agricultural sector remains a problem in many aspects. This sector cannot provide stable and sufficient income to provide for the families, and people are not covered by any social protection schemes, with the sector being characterized by relatively low labor productivity.

Figure 5. Population employed in agriculture in Q2 during 2008-2018, thousand people



Source: National Bureau of Statistics

²Annual average 2008-2017.



Modernizing the sector that involves 40% of the country's employed people is both a major challenge and an imperative.

The upward trend of increasing number of people involved in agriculture is atypical for a fast-growing economy. This phenomenon could be explained by the return of migrants from abroad, especially from the Russian Federation. The number of people working in the Russian Federation dropped by 30% compared to the peak registered in 2014, that year marking the beginning of a seven-quarter period of economic contraction in Russia. At least some of these people are supposed to having returned home, with the total number of people working abroad falling in 2017 compared to 2014. Regardless of this, with the increasing regional competition, the use of agricultural technologies becomes imperative in order to enhance the efficiency of this economic segment. This will inevitably reduce the number of agricultural jobs. In this regard, the large number of people employed in agriculture is a real challenge, their placement in other economic sectors being difficult because of their low level of education. In 2017, out of 390 thousand people employed in the agricultural, hunting and fish farming sectors, over 63% did not have specialized studies.

Short- and Medium-Term Forecasts

In 2018, due to the increase in household incomes by 5.3%, household consumption will grow by 3.8%. The Government payments made under social protection programs will play an important role in raising the income. Thus, the main factor contributing to the increase in disposable income is pension income, which will augment by 8.3%. Net wage income will grow more slowly, and the growth rate will not exceed 2%. Also, an important contribution will come from other income, which will increase by 5.7%.

The effect of shifting to flat tax for individual income will be felt in 2019 and will have a positive impact on wages and formal employment. Due to the transition to flat rate taxation, net wages will rise at higher rates than gross wages. In the pessimistic scenario, the gross average wage will increase by 0.4%, and the net wage – by 1.5% in real terms. In the optimistic scenario, the gross average wage will increase by 4.8%, and the net wage – by 5.9%. At the same time, informal employment will drop by 0.4% in the pessimistic scenario, and by 5.9% in the optimistic scenario. Introduction of flat tax will also increase inequality, as higher-wage employees will benefit from higher earnings. The Gini coefficient³, calculated on the basis of employees' distribution according to the earned wages, is 31% for a flat rate taxation system and 25% for progressive taxation.

Reducing the share of social contribution paid by employers will foster more employment and could result in higher property income. A lower pressure on companies will boost the investment process, which will lead to increase of employment by 1.4-1.5% in 2019. However, some of the savings obtained by the firms due to the lower social contributions could be distributed as dividends, which will be reflected in the higher property income. Most likely, this phenomenon can already be seen in Q4:18.

In 2019, on the background of diminishing rates of public revenue growth, the Government will slow down the social spending growth. As a result, the Government's role in generating household incomes will reduce. According to the negative scenario in 2019, due to the decline of the budget revenue in real terms, public sector wages will only be maintained in nominal terms, and the pension will increase in real terms by 3.5%. In the optimistic scenario, real wages in the public sector will increase by more than 6%, but from Q3:19 onwards the growth rates will slow down, while pensions will increase by 4.9%.

Despite the risks associated with a possible tightening of the budgetary policy in 2019, we anticipate developments that will lead to increases in standards of living. According to the negative scenario, the disposable income of the population

³The Gini coefficient is an indicator of inequality and shows the disproportionate distribution of income. The indicator ranges from 0 to 100%. The lower the coefficient, the lower the inequality level.



will increase by 4.5% and the consumption will grow by 4.3%. In the positive scenario, the disposable income will grow by 6.3%, and household consumption will increase by 5.6%.

The number of the employed population will continue to increase, with a growing formal employment expected after a period of stagnation. According to the optimistic scenario, the number of formally employed persons will grow significantly up to 830 thousand. In the pessimistic scenario, the number of formally employed persons will be about 800 thousand. The relatively large number of informally employed people, especially those employed in agriculture, points to an opportunity for investors and companies, as evidenced by the availability of labor force.

Main Risks to the Forecast

After a period of tax cuts, and increasing public-sector wages and social benefits, the budgetary policy might need to be adjusted. The Government will have to use its resources more economically. In addition to cutting budget spending, a more austere approach to budgetary policies could involve raising taxes. Although the negative scenario envisages lower real wages in the budget sector and lower growth rates of pensions, there may also be an increase in taxes, such as VAT. Higher indirect taxes could negatively affect household consumption so that growth will be lower than predicted according to the pessimistic scenario.

The uncertain investment process might impact negatively the employment. Due to the political agitation, in 2019 businesses could take an expectative position, and the investment dynamics will be slow and could fall below the pessimistic forecasts. In such a situation, we may witness negative trends in employment.

If formal employment does not grow as forecasted, the Social State Insurance Budget (SSIB) will face considerable difficulties. Lowering the contributions to the SSIB and income tax on individuals also aimed at bringing some of the informally employed people into legality. If the tax base is not broadened enough, the SSIB's revenue will be even lower than planned, and the deficit will need to be offset by larger transfers from the state budget to the detriment of other programs.



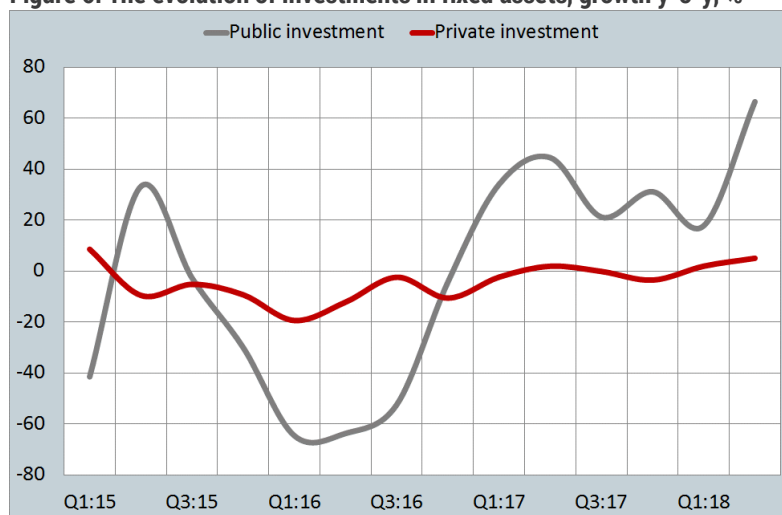
Firms

In 2018 all key economic sectors witnessed positive growth rates. Agriculture is an exception to this trend, as in Jan-Sep:18 the sector stagnated due to unfavorable weather conditions. Also, private investments increased in Jan-Jun:18, after 4 years of decrease. In this context, we forecast that positive trends will persist till the end of 2018, and, as a result, Gross Value-Added (GVA) will increase by 4.8%. In 2019 the business environment will be marked by the implementation of tax reform. The decrease of social contributions rate paid by the employer will boost investment process to some extent. At the same time, business confidence will remain low due to preservation of fundamental constraints such as corruption or the non-independent justice system. Investments will be also affected by political uncertainty. Despite these risks, we anticipate expansion of the investment activity. Thanks to higher domestic and foreign demand, companies will increase production in 2019, and GVA could increase by about 4.7%.

Recent Trends

After a long period of decline, private investments increased in the first half of 2018. Private investments decreased between 2014 and 2017 due to financial crisis and low business confidence (Figure 6). Both private and public investments decreased in 2015 and 2016. In 2017, Government intensified significantly its investment activity, while investment appetite of private sector remained low. In 2018, capital formation financed from budgetary sources continued to grow. Thanks to higher domestic and foreign demand, companies' revenues also increased, resulting in a growth of private investments. Thus, in Q1:18 private investments increased by 1.9% y-o-y, and in Q2:18 – by 5% y-o-y.

Figure 6. The evolution of investments in fixed assets, growth y-o-y, %



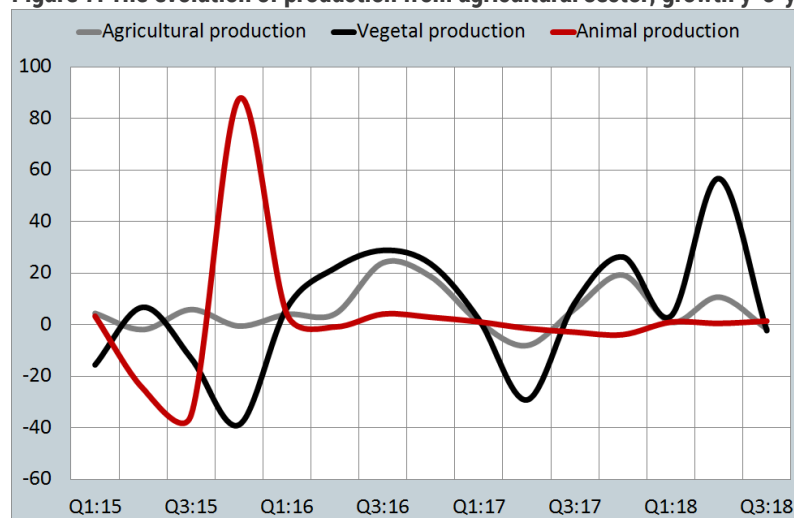
Source: NBS, EG calculations.

Unfavorable weather conditions affected crop production, as a result, agriculture practically stagnated in Jan-Sep:18, with growth rates of only 0.2%. The livestock sector evolved constantly during the first three quarters of 2018, and registered marginal growth rates, resulting in 1% growth during Jan-Sep:18. In Jan-Aug:18 the amount of precipitation decreased by 19.3% y-o-y. Decrease in amount of precipitation had a negative effect on many crops. In Jan-Sep:18, agricultural enterprises and farms witnessed a decrease in yields of cereals and legumes (-16.1% y-o-y), potatoes (-7.6%) and vegetables (-23.2% y-o-y). However, there were high yields of pome fruits (+46.3% y-o-y), stone fruits (+26.1% y-o-y)



and grapes (+14.9% y-o-y). Despite growing harvest of some crops, in Jan-Sep:18 total crop production decreased by 0.2% y-o-y. The contraction of the output in the plant-growing sector was almost entirely determined by a 2.8% decline in Q3:18, while increases in the first two quarters amounted to +3.3% y-o-y in Q1:18 and, respectively, +56.7% y-o-y in Q2:18 (Figure 7). Overall, evolution of the whole agricultural sector correlated with the dynamics of plant production. Thus, a decrease by 1.6% y-o-y was registered in Q3:18 after positive evolutions in the first half of the year (+1% in Q1:18 and +10.7% in Q2:18).

Figure 7. The evolution of production from agricultural sector, growth y-o-y, %



Source: NBS, EG calculations

Industry is ascending this year, an evolution that has been driven by higher external demand and revived growth of other economic sectors. In Jan-Sep:18 production increased by 11.9% y-o-y, and gross value added reported in the first half of the year increased by 7.3% y-o-y. In Jan-Jun:18 all industrial branches witnessed positive growth rates. Mining industry increased by 10.3% y-o-y. Growth of construction sector fosters the mining industry dynamics. Processing industry grew by 11.2%. In Sep:18, however, a 3.6% decrease was registered, a significant deviation from continuous growth of processing industry noticed in Jan-Aug:18. The decrease was determined by food industry contraction (-23.2% y-o-y in Sep:18), which was most likely affected by negative evolutions in the agricultural sector. Despite this episodic decrease, in Q1-Q3:18 food industry grew by 6.9% y-o-y. Also, in Jan-Sep:18, the sectors operating under the external processing agreements (toll manufacturing) grew thanks to the rise of external orders: manufacture of motor vehicles, trailers and semi-trailers (+40.6% y-o-y), electrical equipment (+32% y-o-y), furniture (+6.1% y-o-y), textile products (+8.6% y-o-y). Energy sector increased notably by 5.9% y-o-y.

Figure 8. Industry dynamics in Jan-Sep:18, growth y-o-y, %

Source: calculations based on NBS data.

Expanding domestic demand favored the increase in domestic trade, construction and transport. Increase in households' consumption and investment expenditures, both from public and private sector, stimulated domestic trade. In Jan-Jun:18 retail trade revenues increased by 7.2% y-o-y, and turnover for the market services provided to the population increased by 10.7% y-o-y. Turnover in wholesale trade increased by 4.6% y-o-y, and revenues related to the market services provided to enterprises grew by 0.9%. Also, the turnover of trade in vehicles and motorcycles grew (2.7% y-o-y). Growth in domestic trade, is also reflected by evolution of value added which increased by 7.9% y-o-y in Jan-Jun:18. At the same time, boosting of investment activity fostered the construction sector. In Jan-Sep:18 the volume of contracted construction works increased by 15.6% and value added in construction increased by 6.5% y-o-y in Q1-Q2:18. In turn, positive evolutions in trade and construction contributed to the transport sector growth. In Jan-Oct:18 the volume of transported goods grew by 9.9% y-o-y.

Short- and Medium-Term Forecasts

The year 2018 will be characterized by growth of all economic sectors, except for agriculture. Higher aggregate demand will determine growth of investments and production. Private investments are estimated to grow by 3.3%. Aggregate GVA will increase by 4.8% and value added growth in the economic sectors will be as follows: +6.1% in industry, +7.6 in trade, +7% in construction and +5.4% in transport. In agriculture, a marginal increase of only 0.6% will be noticed due to weather conditions.

Investments in 2019 will be marked by the implementation of tax reform. The lower social contributions paid by employer should stimulate the investment process. Nonetheless, fiscal reform does not address the fundamental issues that affect investment process, such as corruption or inefficient justice. Along with political uncertainty generated by the election process, these factors will constrain the investment activity. In this context, the impact of the fiscal reform most likely will be limited, and some sources saved by companies will not be invested, but deposited in banks or distributed as dividends. Despite these constraints, in 2019 we anticipate an increase in private investment activity. Thus, according to a negative scenario, private investments will grow by 6.9%, and gross fixed capital formation will increase by 6%. In a positive scenario, investments will grow by 8%, and gross fixed capital formation will increase by 8.4%.

Although there are some risks, in 2019 we anticipate an expansion of economic activity which will increase GVA from 2.9% (negative scenario) to 4.7% (positive scenario). Significant positive evolutions of value added will be registered in the key economic sectors:



- in agriculture, depending on weather conditions, growth will range from 4.1% in a pessimistic scenario to 7.2% in an optimistic one;
- in industry, growth would be 4.3% according to a pessimistic scenario and 4.9% according to an optimistic one; the sector growth will be supported by increase in external demand;
- construction may grow by 6.8% (negative scenario) and 7.8% (positive one); its evolution will be driven by dynamization of investment process;
- in trade, thanks to higher domestic demand, we anticipate a 5.8% increase according to a pessimistic scenario and 6.4% according to an optimistic one;
- in transport, we forecast a 4.3% increase according to a pessimistic scenario and 5.2 according to an optimistic one; the growth will be influenced by increased trade and construction sectors activity.

Main Risks to the Forecast

Intensification of anti-EU rhetoric will confuse business entities and will negatively affect investment dynamics. Strengthening the anti-EU discourse both during elections and after formation of the new Parliament could discourage business representatives. Companies that have economic operations with EU countries pay particular attention to these messages. In this context, companies may refrain from new investment projects. As a result, investment dynamics could be slower than growth forecast in a negative scenario.

There are very high uncertainties regarding how companies will use the resources saved thanks to the tax reform. While we anticipate that not all saved resources will be invested, we can have even weaker evolutions than in a pessimistic scenario. As we mentioned, a number of fundamental constraints continue to affect the economic activity. Confidence of the business community remains low, which slows down the investment appetite. Investment dynamics of the recent years supports this hypothesis. Private investments decreased between 2014 and 2017 and only in the first half of 2018 there has been an increase. Unfortunately, in 2019 political evolutions will only strengthen the doubts of the private sector.

Weather conditions are traditionally a factor of risk and uncertainty. Year 2018 was drier than 2017 and, as a result, the agricultural production was affected. Our forecast is based on a set of "normal" weather conditions, although this normality seems to change more and more each year and the aridity tends to become part of this normality. If weather conditions in 2019 will be comparable to those of the current year, it could lead to an evolution of agriculture even below the pessimistic forecast.



Financial institutions

Following the banking crisis of 2014/2015, banking sector continues to dominate the national financial system, but its role in increasing access to finance is continuously shrinking compared to previous years. Amid the persistence of some constraints that characterize demand and supply of bank loans, non-bank financing expands quickly, being ensured by microfinance companies, savings and loan associations or leasing companies. During the last three years, they practically doubled their market share, reaching a portfolio of about MDL 8 billion. Still, they failed to prevent the decreasing of total financial intermediation, which reached 27%, about 10 p.p. less than five years ago. At the same time, there is a tendency of loans reaching mostly non-productive sectors of the economy, such as consumer or housing loans secured by mortgages. In these conditions, new risks are noticed, including the possibility of over-indebtedness of some categories of population, application of the abusive lending practices or migration of the depositors' savings to the less supervised sectors. Lack of complete information on chain of clients' indebtedness can amplify the deterioration of financial situation of debtors, of individual financial institutions or even entire sectors of the economy. On the other hand, attracting deposits from individuals in various form (quasi-deposits) by non-banking financial institutions could undermine individual financial stability in the context of reduced investment education and weak protection mechanisms.

Main Evolutions in the Financial Sector

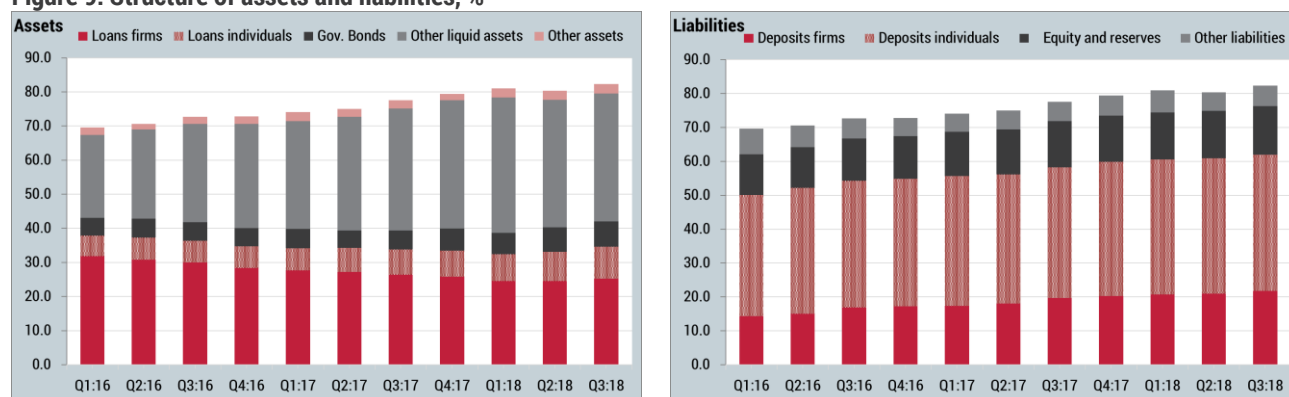
Risks at the level of commercial banks tend to improve amid the increased transparency of shareholding structure and strengthened mechanism of corporate governance. This improvement is also reflected by the withdrawal of special supervision regime in one of the systemic banks, with the increase in transparency of shareholders and full functionality of the governing bodies ensured. Also, quite likely, this regime will be soon withdrawn from another major bank, which recently finished the procedure of attracting a good quality strategic investor. Evolution of prudential and financial indicators that are on a positive trajectory also confirm the good developments. Nonetheless, the surprising resignation of former NBM's Governor raises some questions on the reasons that determined this decision. Along with this event, the lack of clear results four years after the banking fraud, the authorities' attempts to legalize suspicious funds, and the involutions in other areas may lead to a regress of partners and foreign investors' confidence in the perspectives of the Moldovan financial system.

The banks' business model tends to focus on a category of clients who were somehow neglected so far, namely, the segment of population. Consumer and real estate loans are the proposed financial product. A wider diversification of portfolio of banks' clients and a high-quality risk management are imposed on banks by the new regulatory framework based on Basel III regulatory standards. New regime also requires increased accountability of persons in management positions regarding the compliance with lending standards, which, under current circumstances, enhances banks' risk aversion. Even though the need to reform the banking activity cannot be questioned, especially in the light of the facts revealed by the banking fraud, however, the non-uniform regulation and supervision of the segments of financial market results in significant differences in the supply of loans. Banks' attention is focused on funding of Government and state guaranteed programs, and thus may result in neglecting the classic function of financial intermediation and risk diversification. At the same time, non-banking lending generates asymmetrical competition for banks on the lending market, as well as wide competition for financial resources, given the increase in loans attracted from legal entities or even hidden deposits attracted from the population.



The balance sheet structure of assets still indicates the increased interest of banks in Government securities and instruments of central bank' monetary policy (Figure 9). As a result, the share of total loans stock in total assets is only 43%, more than 10 p.p. less than 10 years ago. Thus, although there are excessive liquidities that can be channeled to economic development, the low risk appetite of banks and extended prudential limits forced by the NBM make bank loan less accessible for certain economic groups. On the one hand, there is the need to address the vulnerabilities identified by the banking crisis, such as limitation of large exposures or exposures to the affiliated persons. On the other hand, relatively small size and excessive concentration of the national economy reduce banks' capacity to diversify their risks and, implicitly, to meet the demand for loans. Sources of funding of bank assets continue to be seemingly robust, being dominated by deposits attracted from individuals. These account for about 50% of total liabilities, slightly decreasing, amid the expansion of savings made by legal entities. However, the short maturity of deposits is still an important issue. More than a half of the savings of population and companies are represented by demand deposits or those with up to one-year maturity. Moreover, once interest rates decrease, there is a risk of savings' migration to current consumption or alternative instruments such as the real estate sector, the one which continues to ensure higher returns.

Figure 9. Structure of assets and liabilities, %



Source: Author's calculations based on NBM data.

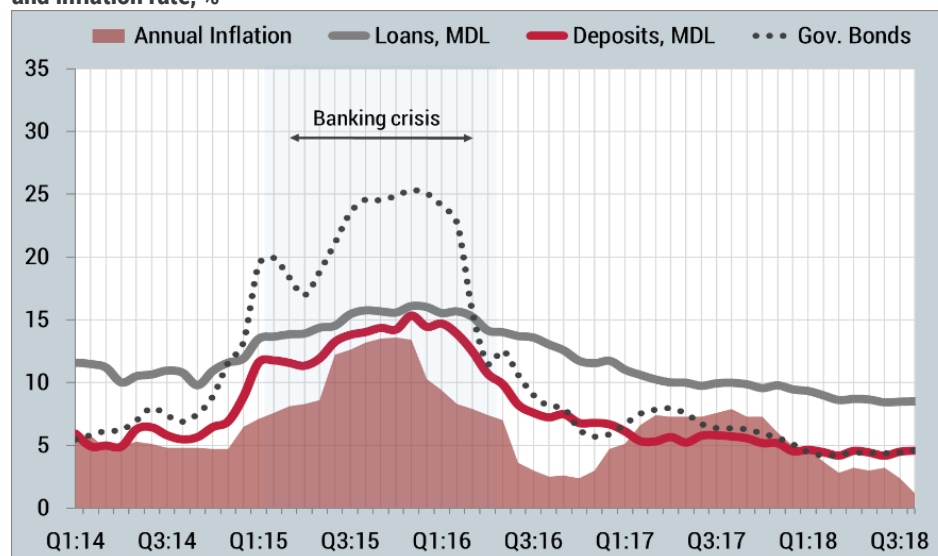
The main financial and prudential indicators of banks remain appropriate. The capital reserves accumulated during the past years facilitated the transition to a new assessment regime of capital sufficiency. Starting with Q3:18, the limit set for this indicator is 10%, plus additional requirements of own funds, added by capital buffers. Nonetheless, even after these changes, the solvency level for the entire banking sector is still high (about 28%), with fluctuations from one bank to bank in the range of 20-66%. The liquidity of banks is much above the regulated limits, reaching about 55% in the short term – i.e., more than half of banks' exposures are liquid assets (state securities, NBM certificates or compulsory reserves). Indicators of assets quality continue to improve thanks to efforts to resolve the issue of non-performing loans granted in the period prior to the banking crisis. Thus, at the end of Q3:18, rate of non-performing loans is approximately 13.5%, ranging from 5% to 33% depending on bank. Currently, banks continue to earn profit, but their ability to sustain such a pace in the long run seems to be limited, since their profit is not the result of lending activity but rather a marginal effect of the monetary policy that may only be taken into account on a short run.

Favorable monetary conditions and more than expected decrease in inflation rate resulted in a reduction of the interest rates on the financial market. The interest rates on bank deposits in MDL and on Government securities decreased continuously during the last months, due to excess of liquidities in the banking sector and surplus to the state budget. As a result, at the end of Q3:18, the average interest rate on new deposits attracted in MDL is around 4.5% and yields for the Government securities with one-year maturity are about 4.6% (Figure 10). The average rates on new loans also decrease, but remain within margin of about 5 p.p., compared to banks' funding costs. At the same time, the level of interest rates for the consumer loans granted to the population is higher, about 14%. With a small amount of non-performing loans (below 5%), this results in higher margin of profit for this segment. As regards real estate loans accessed through 'Prima



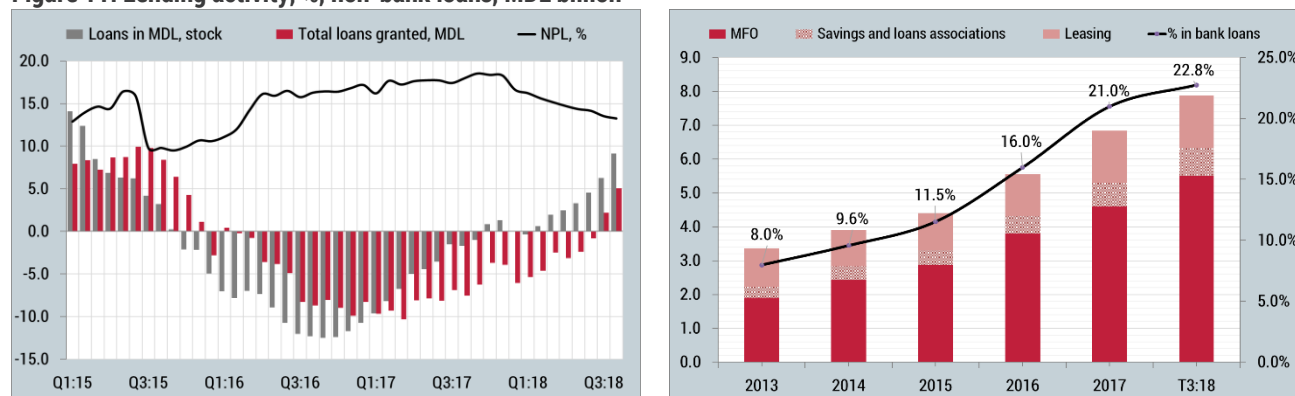
Casa' Program, the effective interest rates are around 6.4%. It is the reference rate for new deposits attracted in national currency, with the term from 6 to 12 months, which is currently 4.5%, plus a maximum margin of 3% from banks.

Figure 10. Development of interest rates on main financial instruments and inflation rate, %



Source: Author's calculations based on NBM data.

After three years of anemic developments, the bank's intermediation function sees the first positive signs of growth. On the background of decreasing interest rates, the demand for new loans increases both from individuals and business entities. As a result, the average monthly amount of new loans this year has been around MDL 2.3 billion, MDL 360 million more as compared to the similar period of the previous year. The financing of population needs grows on the background of the extension of the categories of persons benefiting from the 'Prima Casa' State Program and from the increase in demand for consumer loans. This fact also results in the expansion of maturity of the total loan portfolio, especially those over 5 years maturity at the expense of loans below one-year maturity. Amid these evolutions, for the first time since the 2014/2015 banking crisis, the speed of granting new loans tends to be higher than speed of reimbursement of previously granted loans, which is also reflected in loans stock dynamics. Thus, at the end of Q3:18, the stock of loans granted by commercial banks increased by about 2.2% y-o-y, up to MDL 34.6 billion. Nonetheless, lending growth is not ensured by productive sectors of the economy, the key benefiting sectors being the real estate (+37%) and consumer sectors (+23%). Other traditional sectors, such as agriculture, trade or the food industry, increase insignificantly or even decreased. With demand and supply of bank loans constrained by a number of factors, the non-bank funding sees a quick expansion, driven by microfinance companies, savings and loan associations or leasing companies. Only during the last three years, they practically doubled their market share, with the total financing amount reaching about MDL 8 billion (Figure 11).

**Figure 11. Lending activity, %, non-bank loans, MDL billion**

Source: Author's calculations based on NBM data.

Short- and Medium-Term Forecasts

For the first time since 2014/2015 crisis, the segment of individuals will witness a positive growth rate of bank loan in 2018. This trend will increase, given that budget for the next year guarantees the continuation of 'Prima Casa' State Program⁴. At the same time, the demand for consumer loans will be on an upward trend amid the improving interest rates and significant banks' attention to category of clients - individuals. Moreover, a perspective of much higher general increase is determined by the expanding activity of microfinance and leasing companies, of savings and loans associations, whose resources are directed mainly to household consumers. In these conditions, we expect an advance of about 30% y-o-y in the new loans granted for 2018, and if we take into account non-bank loans, it could even exceed 40%.

In the context of interest rates at their lows, lending of legal entities will continue to advance in Q4:18. This trend will continue next year, particularly in the second half of the year, supported by increasing investment appetite of companies, as well as by alleviation of some constraints generated by the intensive supervision of a number of large banks. In 2018 we expect an increase by about 5.7% in new loans granted in national currency and about 18% in foreign currency loans. MDL appreciation against USD and EUR and the low base of comparison from the previous year will generate a significant effect for the latter category. At the same time, for 2019 we forecast further increase for loans in MDL denominated up to 3% in case of a pessimistic scenario, and 15.8% in case of an optimistic one. The growth rate of foreign currency loans will also remain on an upward trend, about 10% in case of a pessimistic scenario and 17% under the optimistic conditions.

Main Risks to the Forecast

Risks to the forecast are diverse - some stem from the financial system itself, others are related to general political and economic evolutions. Migration of the credit demand to the non-bank financial sector, in the context of more simple lending standards, generates an increased competition for the banks. In this respect, financial system needs more uniform regulations both at level of risk management (investment function) and at the level of depositors' protection (savings function). Currently, the non-bank lending sector continues to register a number of shortcomings in the activity, such as poor governance, low supervision or attraction of the camouflaged deposits from individuals. Moreover, lack of complete

⁴ For 2019, Government provides for allowances amounting to MDL 80 million, including MDL 50 million to pay state guarantees under the Program and MDL 30 million to pay the compensations under 'Prima Casa 2' and 'Prima Casa 3' Subprograms.



information on the chain of customers' indebtedness can amplify the degree of individual debtors' over-indebtedness, of individual financial institutions or even entire sectors of the economy.

The election scheduled for the beginning of the next year and possible degradation of the dialogue with foreign financial partners could augment the volatility and uncertainty on the financial market. In the first instance, this could increase the interest rates on loans and Government securities. Subsequently, as revealed by the history of financial crises, the higher interest rates growth decreases the demand for loans, with a direct effect on economic activity. At the same time, with the single-rate income tax and lower state social insurance contributions, the companies will have more funds available, and hence will be able to invest more own funds and need less bank funding. Last but not least, the lack of clear results in investigation of the bank fraud will increase distrust of foreign financial partners regarding authorities' real intention to shed light on this case. As shown in Box 1, four years after the bank fraud, the results of investigations are more than modest.

Box 1. Special Subject: Four years from the bank fraud and have we found out since that time

Four years after the bank fraud we know that it was not a separate event, but a number of well-defined actions that were taken in several directions, covering a large part of the financial and banking environment, involving high-level officials from Government institutions and having strong support in the political environment. At the same time, fraud reveals several distinct stages and elements. If these are viewed individually, they do not necessarily involve any fraudulent violations or intentions but viewing them as a whole provides a clear picture of the phenomenon we know as 'theft of the billion'. Ensuring ownership and control of the three bankrupt banks, concentrating lending activity to a single group, using money laundering mechanisms to hide cash route - these are the most important elements that allowed stealing MDL billions from the banking sector.

Even if the Government tried to invoke an unfavorable regional economic environment, national financial crisis of 2014-2015 was the result of an intentional huge bank fraud, when money was literally stolen from banks. By late 2014, several domestic banks were brought on the verge of collapse. A series of banks were involved, some were completely decapitalised, others had significant exposures to those from the first group. This interconnection between several banks has all characteristics of a systemic crisis, and if we take into account that the banking sector accounts for about 90% of the whole national financial system, then it is obvious that the banking crisis was in fact a crisis of the financial system.

A number of bank fraud events remain unclear and still raise a lot of questions. Lack of real information will continue to undermine people's confidence regarding authorities' intention to hold the guilty ones accountable. Thus, at least the decisions and actions taken by the persons responsible for maintaining financial stability until November 2014 need to be clarified, including:

- *The time gap between deciding to grant the emergency loans (13 November 2014) and establishing the special administration (27 November 2014);*
- *The actions taken after 27 November to repay depositors and creditors of the three banks are very suspicious;*
- *Role of Banca de Economii management before the administrative and shareholding changes that started in 2012.*

Sources: Expert-Grup Independent Think Tank, 'The Financial Monitor' No 8, special edition, https://www.expert-grup.org/media/k2/attachments/Monitorul_Financiar_8_en.pdf



Fiscal Policy

Reduced access to external resources forced authorities to focus on increasing the revenues from taxes and duties, and to raise internal debt. For 2017 and 2018, foreign grants and loans were executed in proportion of 40% of the planned level. A similar risk persists for 2019. However, due to a faster growth in total revenues than expenditures the budget deficit will be lower than previously expected. Expenditures in Q4:18 will significantly exceed the revenues, so that budget surplus of MDL 1,770 million existing in Sep:18 will turn into a deficit up to MDL 1,800 million or about 1% of GDP in the last quarter. The draft budget for 2019 is balanced; however, reliance of the budget on external funding, in an uncertain domestic and regional environment, and too optimistic growth rates forecasts for some categories of revenues are the highest risks. At the same time, at least two election campaigns will take place in 2019. Personal income tax and social insurance contribution will decrease in real terms as a result of the tax reform. These losses will be offset by an increase in indirect taxes and expansion of the tax base through job creation. In the optimistic scenario, deficit forecast for 2019 is 1.5% of GDP. This forecast, however, is very fragile due to many volatile factors, such as increase in some categories of revenues and access to external resources. Changes in these factors may quickly increase the deficit to over 3% of GDP or even more.

Main Evolutions in the Budgetary Sector

In the first 9 months of 2018, budget revenues grew faster than expenditures. Total revenues of the national public budget (NPB) amounted to MDL 42.6 billion, a 11.0% y-o-y growth. The estimated revenue for 2018 is expected to exceed by 2.3% the level approved in initial the version of the budget. On the other hand, based on the experience of recent years, the expenses will not be executed fully in 2018, which will result in a lower budget deficit than previously expected. The expenses will decrease, mainly due to reduction in foreign grants and loans by MDL 5.2 billion as compared to draft budget for 2018.

The growth rate of budget revenue from corporate income tax considerably exceeds growth rate of other components as a result of the more efficient operation of the fiscal and customs services. The collected taxes and duties amount to MDL 27,7 billion, i.e. by 9.4% more y-o-y, while the collected corporate income tax increased by 37.5% y-o-y⁵. This category of revenue grew at a high rate during the whole year. Additionally, the legislative initiative on voluntary compliance and tax incentives entered into force on 17 August 2018. The tax incentive component refers to the cancellation of the fines and penalties for delayed payments to the State Tax Service, Customs Service and National Social Insurance House. If companies use the provisions of this law, more corporate income tax could be collected by the end of this year (provisions on tax incentive are in force until 20 December 2018).

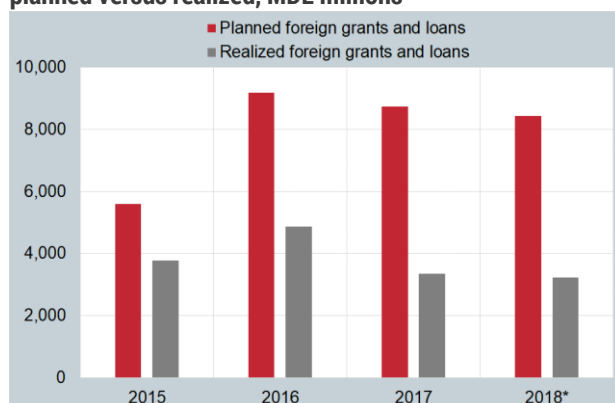
The receipts from grants continued the downward trend of recent years, and three components of NPB are still dependent on transfers from the State Budget. So far, due to the postponement of macro-financial assistance at least until after the 2019 elections, only MDL 209.6 million were obtained from external grants, which is less than 8% of the amount expected when the draft budget for 2018 was adopted. For the fourth consecutive year a smaller volume of foreign grants and loans

⁵ In the first 9 months of this year, receipts to the State budget from income tax of legal entities reached 89% of the adjusted amount set for the whole year.



are received than planned at the beginning of the period (Figure 12), with a decreasing executed/planned ratio. The total revenue of the State Social Insurance Budget (SSIB) and Compulsory Health Insurance Funds (CHIF) increased by 9.3% and 9.5% y-o-y respectively. The share of transfers received from the state budget is maintained – 33% of total SSIF revenue and 40% of CHIF revenue. In case of CHIF, the downward trend of last two years maintains, as the share decreased from 43.4% in 2016. Revenues of budgets of the administrative-territorial units (ATUB) grew at a slower pace – by only 5.6% y-o-y. The weak capacity to generate revenues from local taxes, as well as presence of structural problems such as economic specialization and constraints related to economic growth at local level, keep local authorities dependent on transfers from the state budget.

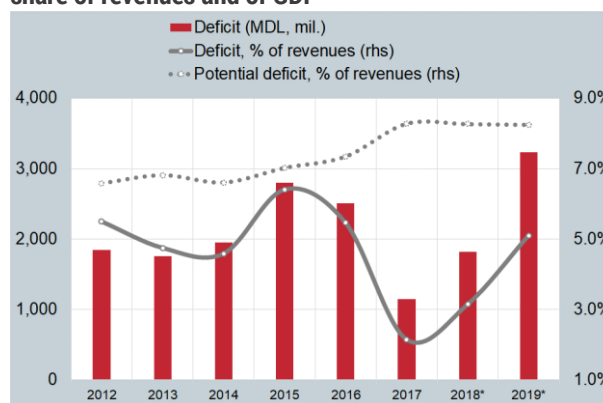
Figure 12. Foreign grants and loans, planned versus realized, MDL millions



Note: *expected by the authorities

Source: Data of the Ministry of Finance

Figure 13. Nominal budget deficit, share of revenues and of GDP



Note: *forecast of Expert-Grup Independent Think Tank

Source: Author's calculations based on Ministry of Finance data

The expenses were executed slower than revenues in the first three quarters of the year, leading to a significant cash surplus. By the end of September 2018, NPB expenses were executed in proportion of 65% of the expenses planned for the whole year. Thus, budget surplus amounted to MDL 1.77 billion, much over the initially approved budget deficit. This trend was also noticed in 2017, when the budget had a surplus of MDL 1.16 billion after 9 months, but the year ended with a deficit of 0.8% of GDP. In the last quarter, expenses will grow at a much faster pace than during the previous quarters, significantly exceeding the revenues. The trend of larger expenses towards the end of the year is not new and is explained by the higher level of authorities' confidence regarding the amounts collected into the budget. Also, large public procurements are usually planned for the second half of the year. Setting the date of general elections for early 2019 may be another reason why most of the expenses were planned for Q4:18, i.e. in period immediately before the elections.

The robust increase in revenue without a similar increase in expenses will result in a lower budget deficit than expected at the beginning of the year – MDL 1.8 billion, which represents almost 1% of GDP. The recent trend shows that expenses are realized in proportion of 95% of the expenses planned in NPB. With this trend in mind, against the backdrop of growing revenues, the budget deficit by the end of the year will not exceed 1% of GDP (Figure 13). The drop in the received grants and foreign loans will be offset by over-execution in other categories of revenue and also by reducing some expenses. The new system of individuals' taxation entering into force on 1 October will have a negative impact on the growth rate of collections on this category in the last quarter of 2018, but also during 2019. The decrease of contributions to SSIB, in real terms, due to fiscal reform will increase the SSIB's dependence on state budget transfers, against the backdrop of gloomy prospects resulting from population ageing and growing social spending.

Modification of the methodology for calculating GDP by the National Bureau of Statistics provides room for maneuver due to higher potential ceiling for the budget deficit. Although in 2017 the GDP increased by 4.5% in real terms, the



increase in current prices was 31%. Modification of the methodology for calculating GDP also increased the potential ceiling for the budget deficit in nominal terms. Analyzing budget deficit over NBP income ratio, we can observe a considerable growth of potential ceiling after 2017 (Figure 13). This potential has not been tapped into yet, however the risk for excessive indebtedness will become real if future revenues decrease.

Diminishing foreign loans forced the Government to increase borrowing on the internal market, while reducing bond issuance norm for topping up of liquidity cushion. As of 31 October 2018, internal debt was MDL 23 billion, which is MDL 413.8 higher as compared to the beginning of the year. The draft budget for 2018 envisaged the net issuance of governmental securities (GS) on the primary market amounting to MDL zero (Table 2)⁶. Despite this fact, internal debt has recorded a constant increase over the course of the year, by approximately MDL 60 million per month. This took place due to a decrease in external funding by about MDL 5.2 billion.

Table 2. Deviations of debt categories contracted by Government of the Republic of Moldova, MDL million

	<i>Draft budget 2018</i>	<i>Adjusted 2018</i>	<i>Expected 2018</i>	<i>Expected deviation compared the draft (+/-)</i>
Foreign loans	5,598	3,789	2,581	-3,017
Grants	2,830	1,927	642	-2,188
GS issued on the domestic market	0	600	600	+600
GS issued for liquidities reserve	0	1491	300	+300

Author's calculations based on Ministry of Finance data.

So far, the budget was amended only once, providing for a decrease in the projects funded from external sources and reallocation of resources between categories of expenses funded from local sources. Amendment of the Budget Law included new commitment amounting to MDL 800 million for the National Public Roads Repair Program at the expense of the general collections. At the same time, the appropriation for capital investments by central public authorities was reduced by MDL 962 million. Approving the reform on the unified salary system in the budgetary sector, coming into force on 1 December 2018, will be an additional cost that was not previously included in the budget, which will require one more budgetary amendment to enter into force.

Short- and Medium-Term Forecasts

The draft Budget Law for 2019 is balanced, but it includes too optimistic growth rates on some categories of revenues, especially considering the two election campaigns that will take place. Both optimistic and pessimistic scenarios of our forecast show smaller revenues collected into the NBP compared to what authorities forecast. The gap is MDL 700 million in the optimistic forecast and MDL 3,100 million in the pessimistic one. Taxes on corporate revenue and external grants are the categories where there is a high risk of under-execution. Authorities expect perpetuation of the growth rate of income from taxes on corporate revenue – 28.7%, compared to 2018, compared to an already very high base of this category of revenues in 2018. At the same time, the draft budget is based on grants amounting to almost MDL 2 billion, of which 63% are expected to provide direct support for the budget. The report on the implementation of the EU Association Agreement with Moldova, adopted by European Parliament⁷, recommends the European Commission to resume macro-financial assistance for Government of Moldova only after 2019 elections, on condition that they are conducted in line with internationally recognized standards and are well assessed by specialized international bodies. There is a high risk

⁶ Despite the fact that briefing note envisaged net issuance of GS amounting to MDL 0, according to the same note, for the end of 2018, the GS issued on the primary market would exceed the balance of the end of 2017 by MDL 1,491 million. Most probably, GS balance growth was foreseen to replenish the liquidity reserve.

⁷ Report on the implementation of the EU Association Agreement with Moldova (2017/2281 (INI)), Committee on Foreign Affairs, Rapporteur Petras Austrevicius, 15 October 2018, <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A8-2018-0322+0+DOC+PDF+V0//EN>.



that external assistance installments will not be disbursed in the first half of the year or even in 2019, depending on how elections are held.

The deficit forecast for 2019 will be covered by sources with a high degree of uncertainty. Thus, according to draft budget for 2019, the national public budget deficit, excluding grants, will constitute MDL 7.7 billion or 3.7% of GDP, applying the derogation clause of 1.2% of GDP for capital expenses funded from external sources. Under these circumstances, the budget balance will reach 2.5% of GDP, excluding grants, ensuring compliance with the budgetary-fiscal rule. According to the draft budget for 2019, domestic Government debt will not exceed MDL 25.8 billion, and the external one – MDL 37 billion (equivalent of USD 2.1 billion). Compared to the situation of late Sep:18, domestic Government debt will increase by 11.4% and the external debt by 30.1%, total debt increasing by 21.7%. The major challenge is the uncertainty of the obtaining of external assistance – grants and loans for budget support – the total envelope being estimated at MDL 3,670 million. Disbursements from the European Commission amounting to about MDL 1,200 million (400 million – grants, 800 million – loans) and the next tranche of MDL 700 million loan from the International Monetary Fund will depend on how parliamentary and local elections will be held, as well as how new Governor of NBM will be elected. According to Expert-Grup forecasts, in 2019 budget deficit will amount to MDL 3,200 million (1.5% of GDP in an optimistic scenario) and MDL 6,300 million (3% of GDP in a pessimistic scenario). The forecasts do not include potential changes in expenditures that political context of 2019 may require.

In real terms, the fiscal reform will affect the collected individual income taxes and will increase the existing deficit of SSIB. According to the draft budget, fiscal reform implemented since 1 October 2018 will result in losses on taxes on wages – almost MDL 200 million, and state social insurance contributions – MDL 70 million. The decrease in social insurance contributions paid by private sector employers from 23% to 18% will affect SSIB revenue in real terms. These losses will be covered by transfers from the state budget funded from other revenues: corporate income tax, VAT, voluntary compliance of taxpayers. Some individuals receiving salaries ‘under the table’ might be brought into legality as a result of the tax relief. This will ensure a wider basis for taxation.

The fiscal reform will increase the dependence of SSIB and ATUB revenues on transfers from the state budget. The SSIB problem, directly related to population ageing, could be solved by the radical reform of the pension system and gradual transition to a pension system based on individual saving accounts. Despite the reform that will reduce the amounts collected into SSIB in real terms, transfers from the state budget are planned to increase by MDL 2,100 million in 2019. Additionally, aggregate ATUB deficit will increase in 2019. Own revenues and transfers from the individuals’ income tax in local budgets, according to the limits set by the law, will decrease by almost 200 million MDL. To this end, it is planned to offset the foregone revenues from transfers from the state budget amounting to over MDL 300 million, with overall transfers increasing by MDL 950 million. Due to political connections and clientelism, mayors affiliated to the governing alliance will have better chances to obtain funds for investment projects than mayors in opposition and the independent ones. This phenomenon could consolidate due to local elections next year.

Main Risks to the Forecast

The main vulnerability of the draft budget for 2019 refers to accessing external funding. The executed/planned ratio of foreign grants and loans has been falling since 2015, dropping to under 40% in 2017 and 2018. Failure to access MDL 3,670 million from foreign grants and loans for budget support next year could force authorities increase domestic borrowing or use the available cash. Issuing more GS on the domestic market involves two challenges: on the one hand, there will be an increase in cost of domestic debt servicing on the background of reversing downward trend in interest rates; on the other hand – banks will be even more discouraged to credit the real sector of the economy. Failure to secure budgetary support will reduce the funding of investment projects, with long-term economic impact.



There is a risk of under collecting the planned amounts of income for some categories of revenues. Both, the optimistic and pessimistic scenarios of Expert-Grup foresee smaller amounts collected into the budget than planned in the draft budget. The growth rate of corporate income taxes does not seem to be sustainable. In the first 9 months of the year, receipts from corporate income tax increase by 37.5% y-o-y. For 2019, the Government expects a growth over 28%, compared to the amount adjusted for 2018. Growth perpetuation at these rates is questionable on the background of a high comparison base. At the same time, the lower SSIB and ATUB revenues due to the fiscal reform will result in higher deficits of these budgets, emphasizing their dependence on the state budget.

Increasing fiscal imbalances, against the backdrop of diminishing foreign assistance, could increase the level of indebtedness of the state. Evidence in this sense is the increase in the authorities' domestic debt forecast: at the end of 2017, the authorities estimated that the domestic state debt balance would not exceed MDL 27 billion towards the end 2020. Currently, they already estimate that the domestic state debt balance will not exceed MDL 28.5 billion. Excessive indebtedness of the state will imply the need to stabilize public finances through measures such as: budget optimization, strong investment and social spending cuts, tax increases (including VAT) on the background of competition between the state and the private sector for limited resources in the economy.

Given that at least two election campaigns will take place in 2019, there is a danger of implementing some projects without analyzing the timeliness of these projects and without sound financial coverage. The country's economy undoubtedly needs infrastructure programs, which help accelerate the economic growth rate. But the failure to take into account the evidences when analyzing the timeliness of some projects implemented by the authorities raises questions regarding their relevance. It is hence crucially important to launch projects on the basis of analyses and consultations, and with a reliable financial coverage.

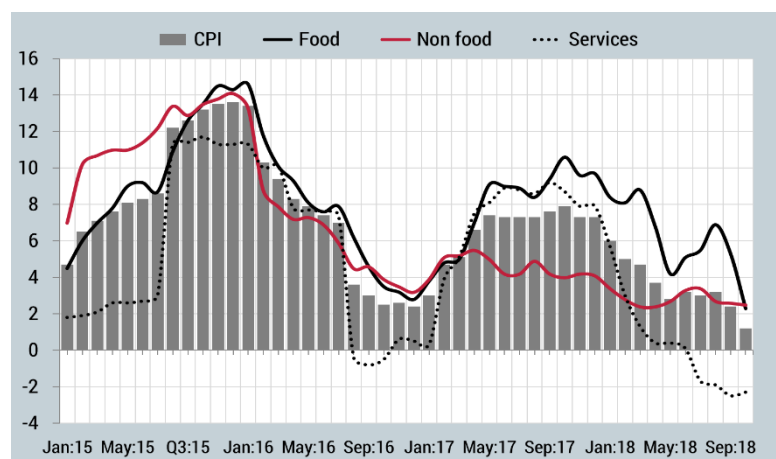
Prices and Monetary Policy

A series of disinflationary trends supported the descending trend of the annual CPI rate. Appreciation of the national currency, lower electricity and gas tariffs, as well the cheaper foodstuffs resulted in a lower price growth rate (down to 1.2%) in Oct:18. In order to diminish the negative effects associated with the fast appreciation of MDL, the central bank continued to purchase currency in huge amounts, which lead to the supplementary monetary emission and an even higher excess of liquidity. In order to manage the excess of cash, reserve requirements grew from 40 to 42.5%. At the same time, the base rate on the main monetary policy operations stayed at the level of 6.5% Even so, banks still have sufficient liquidities to expand their lending activity.

Inflation and Exchange Rate

The inflationary dynamics of the first half of 2018 persisted in Q3:18. Price growth rates decreased from 4.7% at the end of Mar:18 to 1.2% in Oct:18. This dynamic was determined mainly by internal factors: decreasing prices for foodstuffs and tariffs for services, while prices for non-foods recorded the same dynamics, just as during the same period of the previous year (Figure 14). The prices decreased in the first category mainly due to the dropping prices for some categories of goods, such as meat or sugar, as well as some vegetables and fruits - garlic, grapes or citrus fruits. The decrease of prices in the food industry was also caused by the surplus in international supply, while in the country, the cheaper energy resources increased the volume of domestic production. Moreover, due to weather conditions at the end of summer, the grape harvest started earlier, causing an earlier decrease in prices. At the same time, low prices for services were driven by administrative decisions, such as decrease in tariffs for gas by 20% from the beginning of the year and for electricity by about 10% starting from July this year. As for the prices for non-food goods, prices for home appliances and cars decreased amid the appreciation of the exchange rate. Deflationary trends, however, were hampered by growing global prices for fuels and the planned increase in the excises of some goods.

Figure 14. Evolution of consumer prices, y-o-y growth, %



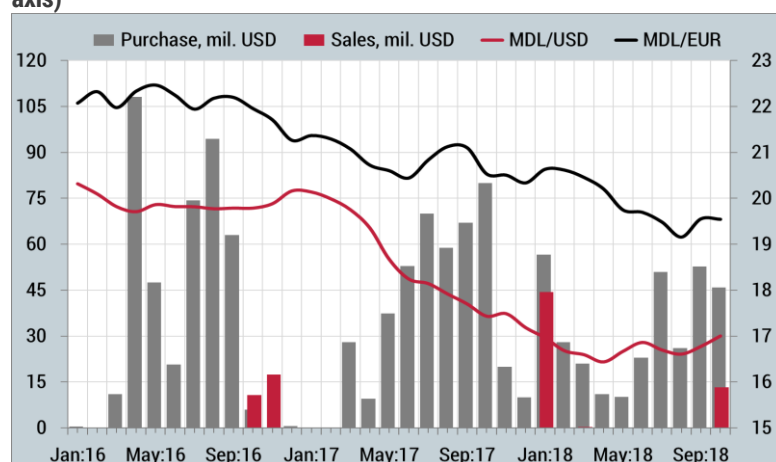
Source: Author's calculations based on NBS data

National currency strengthening in relation to major currencies played an important role in reducing inflation. After a major strengthening of national currency at the beginning of the year, appreciation rate slowed down in Q3:18, so that at the end of Oct:18 MDL/USD exchange rate was 17.0 and MDL/EUR - 19.5 (Figure 15). These figures describe an MDL appreciation by about 3.3% y-o-y in relation to USD and by 4.8% in relation to EUR. Even so, the foreign exchange market



has a surplus of currency due to physical persons' net supply of about USD 193 million during September this year. On the other hand, the net demand for currency from legal entities amounts to about USD 169.3 million, finally resulting in demand covered by supply in proportion of 114%. These conditions required permanent NBM's presence on the foreign exchange market as foreign currency buyer. During this year, interventions amounted to about USD 300 million, slightly decreasing compared to the same period last year. On the one hand, the procurement of currency strengthened the official reserve assets up to the peak of USD 3 billion by the end of Oct:18, which turns to be a comfortable level when compared to amount of imports financing (over 5 months of import). On the other hand, these operations translated into more currency held by the banking sector. Thus, in the first 9 months of 2018, NBM's interventions in the foreign exchange market resulted in monetary emission amounting to about MDL 4.5 billion, which required additional effort to sterilize the created excess of liquidities.

Figure 15. NBM interventions on the foreign exchange market and nominal exchange rate (right hand axis)



Source: Author's calculations based on NBM data.

Monetary Policy and Interest Rates Market

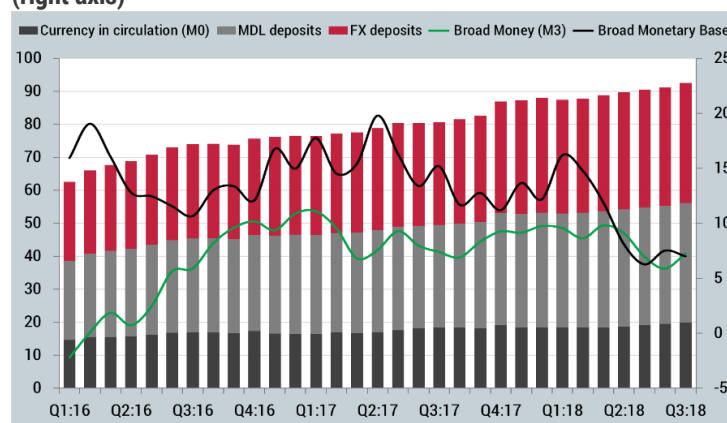
With the stabilization of the banking sector, one of the NBM objectives is to boost lending activity. However, the main objective to maintain the level of inflation and the need to adjust it within the limits of tolerance bands as provided by the agreement with IMF, requires additional efforts from NBM. On the one hand, base rate on the main monetary policy operations is still 6.5%, which stabilizes to a certain extent the interest rates on newly granted loans. On the other hand, the NBM increased the reserve requirements by other 2.5 p.p. to 42.5% in Q3:18 in order to mitigate the monetary pressures on inflation. For the time being, this adjustment allows to reduce sterilization operations through NBC (National Bank Certificates) by about MDL 1 billion to daily average level of MDL 7.6 billion. At the same time, the interest rates registered on the interbank currency market (CHIBOR) continued to decline during the first 9 months of this year, in line with the level of interest rates offered by NBM standing facilities (loans/overnight deposits). Nonetheless, the interest rates increased quicker by the end of Q3:18, in the context of increasing uncertainty due to the elections scheduled for the beginning of the next year. After a recent steady decrease, the yield curve of Government securities increased slightly. This is determined by the creditors' considerable skepticism about the level of budget revenues for the next year, given that EU officially cancelled macro-financial assistance, and the fiscal reform could probably produce positive results with a certain delay.

Supported by expanding investments in the national currency, monetary mass has increased continuously during the last three quarters (Figure 16). Deposits in national currency still contribute the most to both on demand deposits (+11.8% y-o-y in Sep:18) and term deposits component (+19.2% y-o-y). At the same time, the deposits attracted from the legal entities, especially term deposits, demonstrate significant growth. This can be explained by the reluctance to invest in the



context of forthcoming election period. Furthermore, the fiscal reform entered in force on October 1 generates a large amount of resources for companies. Currently, the resources do not yet seem to be used for investments or salary increases. On the other hand, negative growth rates are registered only for deposits attracted in foreign currency, which can be explained by the quite low remuneration level of about 0.5-1.5%. In this context, the growth rate of money stock (M3) reaches an average of about 8.5% quarterly with identical prospects for the next period. At the same time, the monetary base growth rate slowed down in Q3, roughly in line with the monetary mass growth rate (+7% y-o-y), after the dissipation of effect created by the increase in required reserves ratio on funds attracted in MDL up to the ceiling of 42.5%. Last but not least, given the positive trend of lending activity, including stock of bank loans, the indicator of current liquidity tends to decrease without a significant impact on registered excess of liquidity.

Figure 16. Monetary aggregates, MDL billion and increase in monetary mass and monetary base, % (right axis)



Source: Author's calculations based on NBM data

Short- and Medium-Term Forecasts

According to an optimistic scenario, annual inflation rate will reach 3.4% for the whole 2018, and will be on upward trend during the next year. The inflationary contribution during 2019 will increase notably after the end of the election campaign, as a result of the adjustments of regulated prices. This will determine annual increase in prices up to 5.1% in case of a optimistic scenario, and 5.7% for pessimistic one. The tightening of external conditions that might materialize in growing import prices and financing costs, or internal uncertainties regarding election period and results of fiscal reforms are among the main risks of the forecast.

Main Risks to the Forecast

Most sources of forecast expect the global economic activity to shrink amid increasing trade protectionism in a number of areas of the globe. Tensions regarding USA - China or USA - European Union relationships, as well as the inconclusive scenario proposed for *Brexit*, add even more uncertainty. At the same time, tightening of monetary conditions in several advanced economies, but also in some emerging economies (for example, Turkey, Argentina) implies higher financing costs for debtor states, including the Republic of Moldova. Moreover, after a lull period, oil prices on the international market tend to enter a period of pronounced uncertainty. Even if there are no fears in the short run, they may be increased by international sanctions imposed on Iran, further isolation of Venezuela, unfavorable attitude in relationships with Saudi Arabia, and other disagreements at level of OPEC states.

Internally, inflationary pressures will be generated by adjustments in the regulated tariffs, planned increases in excises or growth of aggregate demand on the basis of expanding disposable income. For NBM, managing the excess liquidity in the banking sector and leveling out the national currency will remain major monetary policy challenges. Moreover, through



fiscal reform the Government releases more liquidity that will increase population and companies' deposits. This suggests that it is necessary to correlate the monetary and fiscal policy to maintain macroeconomic balance at least at the current level. NBM believes that banks have too much liquidity and would like them to be placed in the economy. Procurement of hard currency in large amounts will involve additional money supply which NBM will have to sterilize, making relaxation of reserve requirements less likely.

The surprising resignation of the Governor of the NBM, Mr. Sergiu Cioclea in late November adds a new dose of uncertainty in the financial market. This stems both from questions about the real causes of the resignation, as well as from the political position to be adopted by the new governor, respectively to what extent the NBM will remain an independent institution in relation to the Government. Following the wave of reforms aimed at strengthening the banking sector, the government comes up with a series of legislative initiatives that can undermine banks' ability to prevent dubious money entering the financial circuit. The capital amnesty or the Citizenship by investment Program does not appear to be in line with the development of the financial system as supported by the NBM, taking into account the commitments on prevention and combating money laundering. Under these circumstances, it remains to be seen to what extent the NBM will ensure the irreversibility of the reforms and monetary policy objectives.



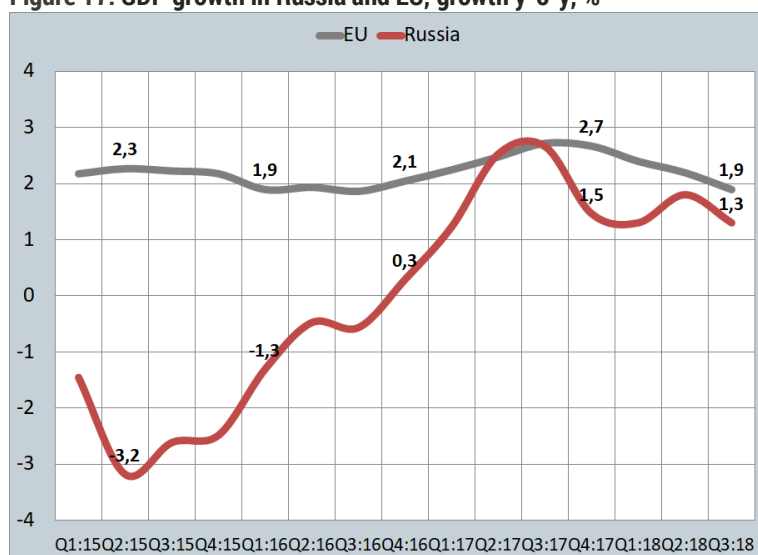
Foreign Sector

World economy shows clear signs of cooling, accompanied by growing global trading and geopolitical tensions. This undermines trading and investment prospects for the next periods. Although exports increased in 2018, prospects of maintaining these dynamics in 2019 remain vague despite the EU consolidation as the main trading partner of the Republic of Moldova. In fact, anticipating international stagnation in food prices, dictated by increase in stocks and a slowdown of the EU automotive industry might have negative effects on exports in this direction. Trade conditions in the CIS (in this case of Russian Federation) do not allow agrifood products to use all opportunities. So far, prospects to change these conditions are fueled only by pre-election promises. On the other hand, imports in current period increased steadily, last but not least due to households' consumption, accompanied by the appreciation of the national currency. High prices on oil products amid lower supply, resulted from OPEC cartel' decisions, will further make the imports more costly and, implicitly, increase the current account deficit.

Evolution of External Environment

Global economic growth reached its peak in 2018, a more tepid growth is expected next years. Overall, the recent global economic and financial evolutions, as well as increased risks of their damage, indicate worse prospects for global economic growth. Robust increase in jobs and supporting fiscal and monetary policy should support domestic demand in advanced economies. But rising trade tensions and geopolitical uncertainty could mitigate trade outcomes, investments and, implicitly, growth prospects in the next period (Figure 17).

Figure 17. GDP growth in Russia and EU, growth y-o-y, %



Source: Author's calculations based on IMF data.

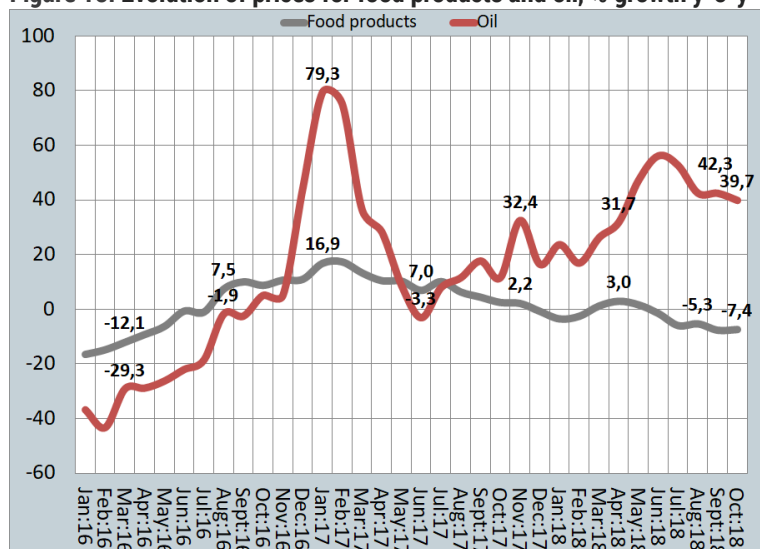
In the context of increasing trade tensions, as well as uncertainty of trade policies evolution, world trade growth slowed down. The global trade expansion decreased from 5% in 2017 to around 3% in the first half of 2018. Recently introduced restrictive trade policy measures already resulted in significant changes in trade flows and distorted the balance of prices in target sectors. Besides, political statements by US, EU, Russian and Chinese leaders affected expansion plans and business investments, reflecting uncertainty regarding potential disruption of supply chains as risk of restrictions intensifies.

Under these conditions, contribution of net exports to EU economic growth - only 1.9% in Q3:2018 - seems to decrease as EU exporters begin to feel negative impact of global economy slowdown, aggravated by Brexit and appreciation of the euro against other currencies. This could hamper investment prospects in the Republic of Moldova. Besides, in the next few years EU economic growth will be driven mainly by domestic demand.

There is similar situation in the Russian Federation where an economic slowdown of 1.3% was registered in Q3:2018, after the end of the World Cup which fueled the economic growth in the previous period. The announced intentions to increase taxes will further affect real wages and will boost inflation in the next period. Moreover, possible economic sanctions could affect even more the economy of the Russian Federation, and forecast increase in international oil and gas prices is the only favorable scenario for Russian economy.

Oil price continued to grow, reaching maximum of the last 4 years of USD 76.73/barrel in Oct:2018, 39.7% more y-o-y. This development was mainly due to new sanctions imposed by USA on Iran and substantial decrease in oil production in Venezuela and Libya. Evolution of oil prices remains uncertain until the next OPEC meeting, but it is possible that the production will remain limited, especially in the context global economy slowdown and demand reduction (Figure 18).

Figure 18. Evolution of prices for food products and oil, % growth y-o-y



Source: Author's calculations based on FAO data

Overall, the international food prices dropped by 7.4% in Oct:2018 y-o-y, in the context of growing supply for export. The October decline resulted from decrease in prices for dairy, meat and vegetable oil, that could not be offset by higher prices for sugar and cereals. The latest evolutions for product groups that are of higher interest for Moldova exports are as follows:

- International prices for cereals increased by about 8.9% in Oct:2018 y-o-y, corn and wheat prices increased mostly due to bad harvest in EU and Russia, and deteriorating prospects of good harvest in Australia;
- International prices for vegetable oil continue to decrease, about -21.8% in Oct:2018 y-o-y, reaching the minimum of the last 10 years. These evolutions are due to increase in palm and sunflower oil stocks held by the main exporting countries on the background of a low demand. At the same time, soya bean oil prices increased slightly, supported by strong demand of biodiesel sector, while rape seeds oil prices are supported by reduced stocks in EU;
- Prices for sugar suddenly began to recover during the last 2 months, but they still remain below the level of the previous year (-13.8%). This dynamic is explained by the negative production prospects resulting from weather effects in the main sugar producing regions - India and Indonesia. At the same time, in Brazil (the world's largest

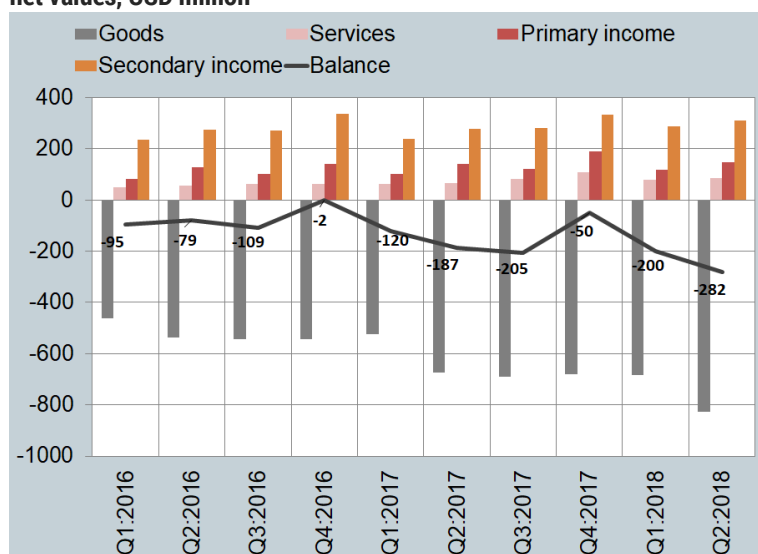


producer and exporter of sugar), there is an increasing share of production of sugar cane, used in ethanol production, which provided a support to the international sugar prices.

Balance of Payments Current Account

Amid the deterioration of the balance of goods, the current account deficit of the Moldova's balance of payments increased by 50.6% y-o-y in Q2:2018, thus amounting to 10.6% as a share of GDP (+1.8 p.p. y-o-y) (Figure 19). Thus, the volume of foreign trade of goods in Q2:2018 increased by 22.2% y-o-y, amounting to about USD 1,726 million. But trade balance deteriorated even more (+22.7% y-o-y), with a deficit of USD 828 million or 31.2% of GDP.

Figure 19. Evolution of current account by main components, net values, USD million



Source: Author's calculations based on NBM data

In Q2:2018 the value of goods⁸ exports was 21.8% higher than the previous year and amounted to USD 449.3 million (reaching the maximum season value registered in Q2:2014). The value of goods shipped after the processing (mainly related to textile and automotive industries) increased by 39.2% y-o-y, while the 'classic' re-export of goods (except for goods after processing) decreased by 51.9% y-o-y, amounting to 6.0% in the total export of goods (15.2% in Q2:2017) resulting from reduction of this phenomenon compared to CIS countries.

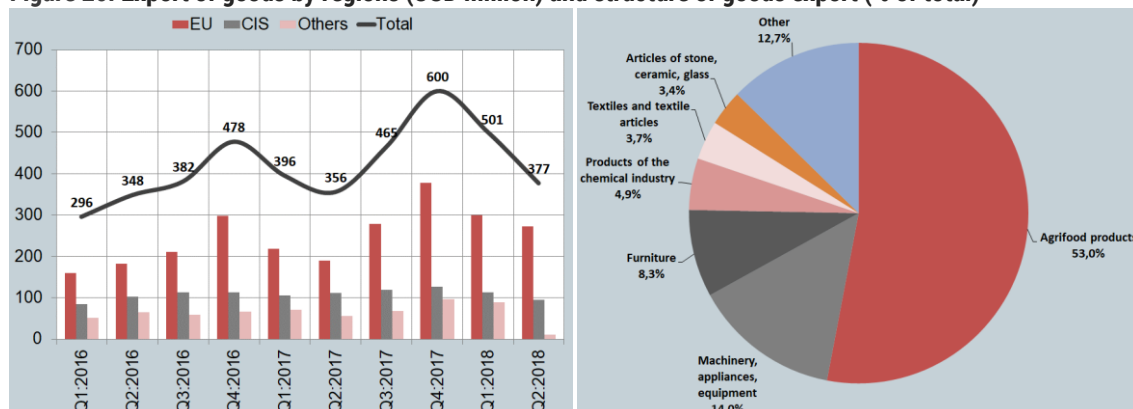
Geographically, the European Union is still the main destination of exported goods, with a total amount of USD 1,597 million in Q2:2017, reaching a new historic maximum, up by 43.3% y-o-y and with a share of 62.2% in total exports of goods (53.3% in Q2:2017). The most significant growths were registered in Romania - by 38.7%, Germany - by 62.9%, and, particularly, Italy - 2.7 times y-o-y. Export to CIS countries during this period decreased by 14.7% y-o-y, amounting to USD 94.6 million, as a result of decrease in supplies to Russia - 15.2% and Belarus by 27.8%. At the same time, export to other countries increased by 27.4% y-o-y, an evolution determined by 4.2-fold increase in exports to Serbia, Switzerland - 2.1 times, Lebanon - 3.5 times (Figure 20).

The positive evolution of exports was conditioned mainly by dynamics of agrifood products, especially growing supply of walnuts (3.0 times), vegetable oil (2.1 times), corn (by 94.5%) y-o-y. Unfortunately, export of sunflower seeds decreased

⁸ Data on foreign trade, presented by the NBM, differ from those presented by the NBS. NBM data are based on the customs declarations database, without goods for/after the processing that do not change the ownership and without sales of duty-free shops, import choices (CIF prices) according to country of delivery. NBS presents the import by the country of origin and includes the goods for processing/after processing and the sales of duty-free shops.

by 8.4% y-o-y. At the same time, export of machinery and equipment continued the upward trend, increasing by 35.4% y-o-y, and export of furniture and parts of furniture increased by 32.2% y-o-y. At the same time, the export of chemicals products exports of textiles and textile materials and products decreased by 2.7% and 16.9% y-o-y respectively (Figure 20).

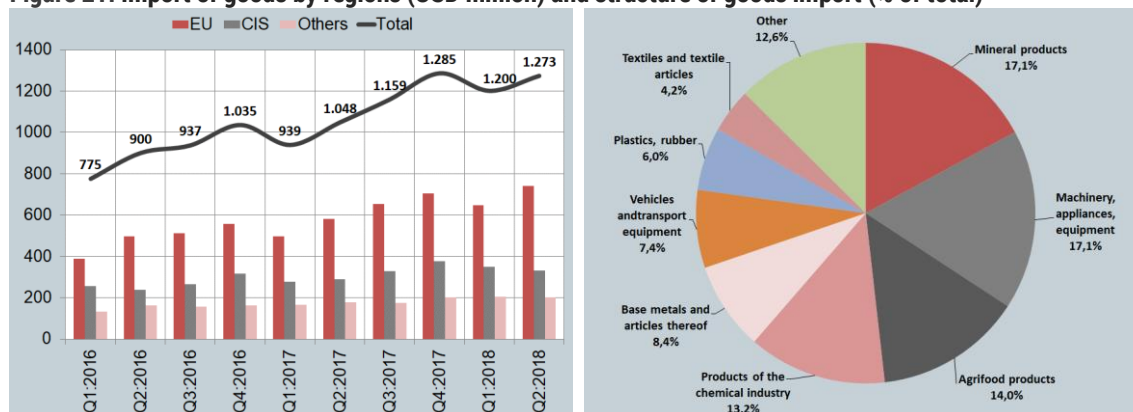
Figure 20. Export of goods by regions (USD million) and structure of goods export (% of total)



Source: Author's calculations based on NBM data

Import of goods in Q2:2018 amounted to USD 1,277.9 million, by about 22.4% more y-o-y. EU holds the majority share of 58.2% in the imports' geographical structure by 27.3% more y-o-y, followed by CIS with 26% (+14.6%) and other countries, with a 15.8% share (+13.7%). The main categories of imported goods were mineral products, with a 17.1% share (by 24.0% more), machinery and equipment (by 39.0% more), agrifood products (by 11.6% more) chemical products (by 16.5% more), base metals and articles thereof (by 30.8% more), transport means and equipment (by 34.7% more).

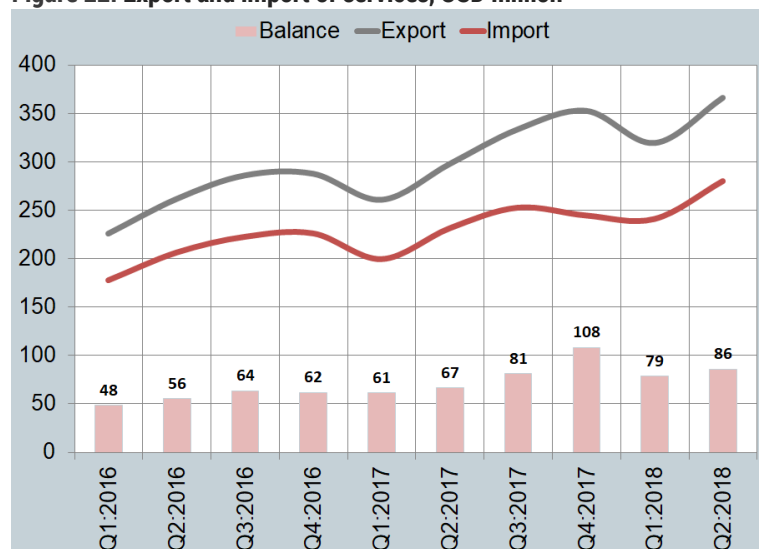
Figure 21. Import of goods by regions (USD million) and structure of goods import (% of total)



Source: Author's calculations based on NBM data

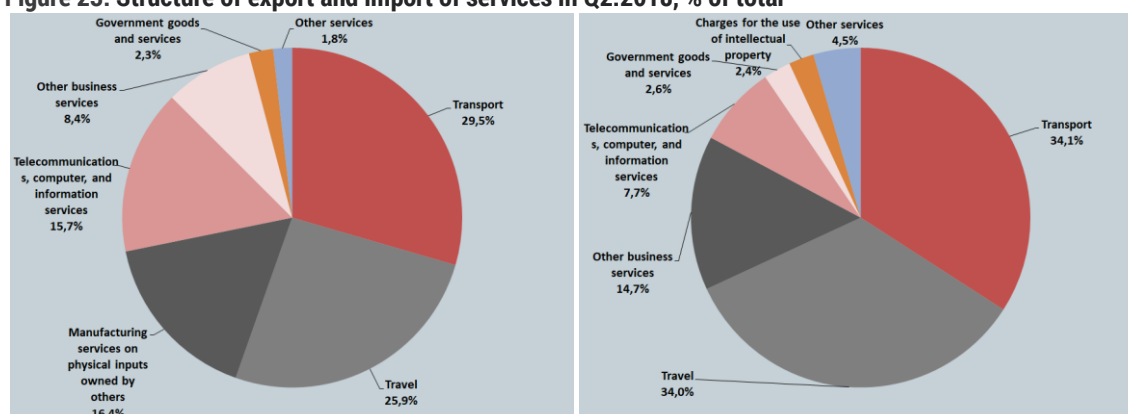
The import of energy and electricity amounted to USD 203.5 million in Q2:2018, increasing by 20.1% y-o-y as a result of growing international oil prices. This is mainly related to higher diesel import by 57.5%, gasoline (+21.6%) and natural gas (+22.4%). Concurrently, import of electricity decreased by 56.9%, with the resumption of supplies from the Transnistrian region.

The surplus of the balance of trade in services amounted to USD 86.0 million, increasing by 29.4% y-o-y as a result of the higher value of the services provided to non-residents (+22.9%), compared to services received from non-residents (+21.1%, Figure 22).

Figure 22. Export and import of services, USD million

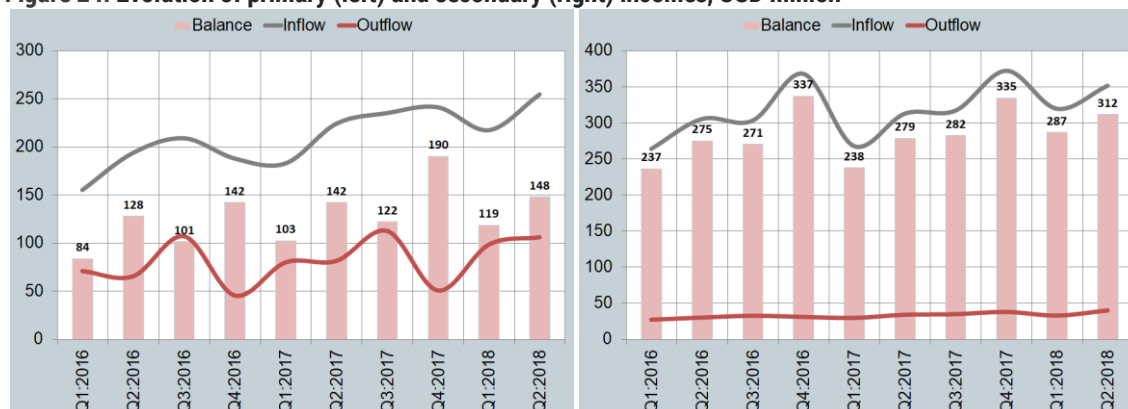
Source: Author's calculations based on NBM data

Transport services held the largest share in the export of services in Q2:2018 - 29.5%, (+7.9% y-o-y), followed by export of travel services of 25.9% (+28.2% y-o-y). The services of processing raw materials owned by third parties hold a significant share of 16.4% (+51.0% y-o-y) (a feature of the automotive and textile industries), but also telecommunications, computer and information services with a share of 15.7% (+32.3 y-o-y). Imports of services in Q2:2018 reflect a similar structure, with the majority share being held by transport services with 34.1% (+16.4% y-o-y) and travel services with 34% (+24.4% y-o-y). At the same time, import of other business services constituted 14.7% (+46.3 y-o-y), and telecommunications, computer and information services amounted to 7.7% (falling 1.5% y-o-y, Figure 23).

Figure 23. Structure of export and import of services in Q2:2018, % of total

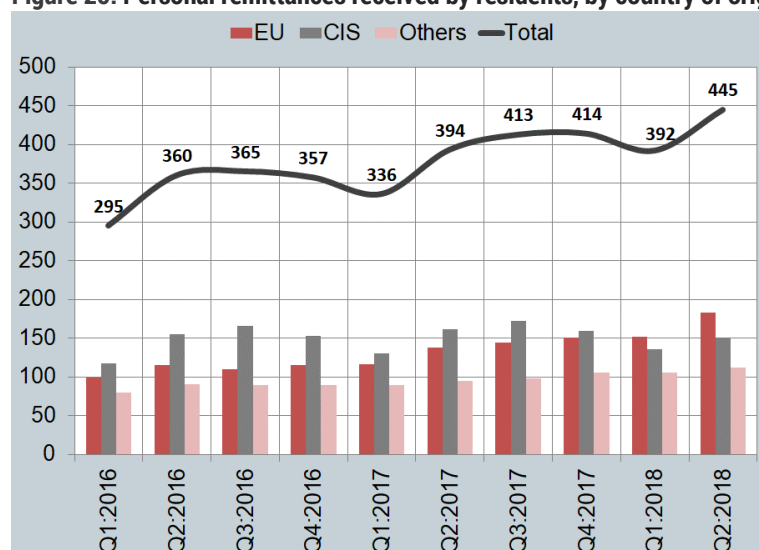
Source: Author's calculations based on NBM data

In Q2:2018, the balance of primary incomes registered a surplus amounting to USD 147.9 million (+4.0% y-o-y). Primary income inflows increased by 13.6% y-o-y and their outflows - by 30.1% y-o-y. Structure of inflows shows that 94% was generated by resident employees' remuneration for work done for non-resident employers, amounting to USD 239.1 million (+11.1% y-o-y). The effect of this increase, however, was mitigated by associated growth of outflows from investments incomes amounting to USD 85.9 million (+39.5%) and especially by dividends owed to foreign investors. The reinvested profits also decreased to negative value (USD 16.76 million in Q2:2017), although overall situation did not change dramatically in the first half of the year comparing to 2017 (Figure 24).

Figure 24. Evolution of primary (left) and secondary (right) incomes, USD million

Source: Author's calculations based on NBM data

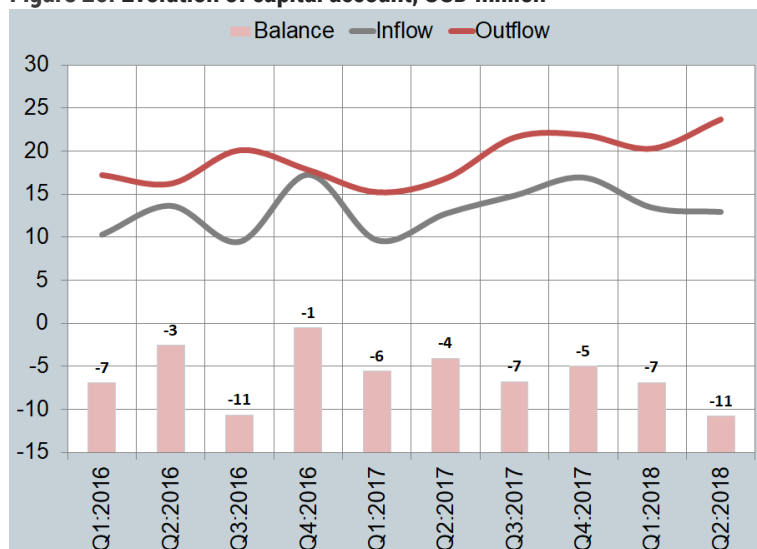
In Q2:2018, the balance of secondary incomes registered a surplus of USD 311.7 million (+11.8% y-o-y). Inflows of secondary incomes totaled USD 351.6 million (+12.4 y-o-y), and outflows – USD 39.9 million (+16.9% y-o-y) (Figure 24). Inflows of personal transfers were estimated at USD 231.4 million (+15.6 y-o-y), and outflows – at USD 20.3 million (+17.5% y-o-y). At the same time, the balance of secondary incomes of public administration ended with a surplus of USD 23.5 million (-1.6% y-o-y). Note that 51.3% of inflows received by public administration were grants and foreign technical assistance provided to the Republic of Moldova. Personal remittances received by residents of the Republic of Moldova in Q2:2018 amounted to USD 445.24 million (+13.1 y-o-y), and in 2018 the EU became the main source (Figure 25).

Figure 25. Personal remittances received by residents, by country of origin, USD million

Source: Author's calculations based on NBM data

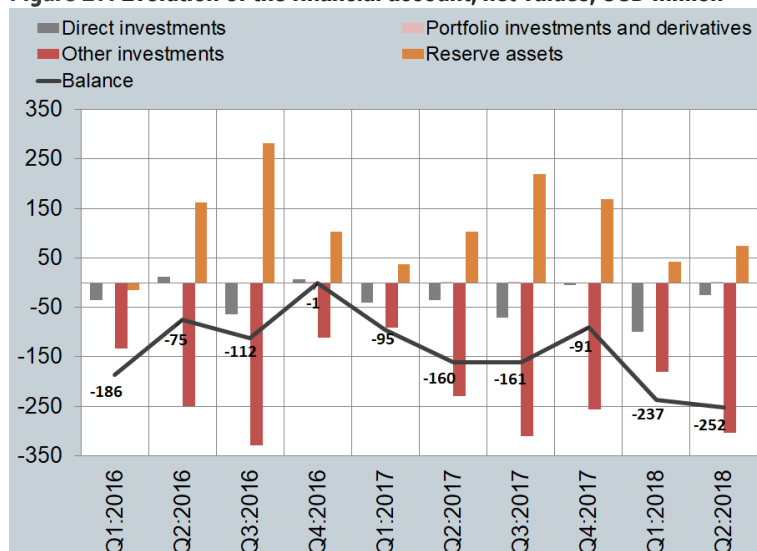
Capital and Financial Account of the Balance of Payments

In Q2:2018, capital account registered a negative balance amounting to USD 10.9 million. The flows reflected by capital account of Moldova's payments balance are traditionally insignificant. The public administration received external grants for investment projects amounting to USD 3.5 million (+6.8% y-o-y), while net outflows from other sectors amounted to USD 14.3 million (+95.0% y-o-y). The balance of current and capital account during the reporting period reveals a net borrowing of USD 292.9 million (+53.0% y-o-y, Figure 26).

Figure 26. Evolution of capital account, USD million

Source: Author's calculations based on NBM data

In Q2:2018, net capital inflows in the financial account amounted to USD 252.4 million, resulting from net decrease in foreign financial assets of USD 209.1 million and from net accumulation of the liabilities amounting to USD 43.3 million. Note that decrease of net capital inflows was influenced mainly by the decrease of direct investments and accelerated accumulation of reserve assets by the central bank. Thus, direct investments flow as a share of GDP amounted to only 0.9%, and reserve assets - 2.8%. At the same time, net inflows of funds related to 'other investment' component increase in Q2:2018, which held a share in GDP of 11.4%. This dynamic was supported mainly by 'cash and deposits' and 'loans' groups evolution (Figure 27).

Figure 27. Evolution of the financial account, net values, USD million

Source: Author's calculations based on NBM data

Short- and Medium-Term Forecasts and Risks

Forecast related to foreign trade of the Republic of Moldova corroborates with slowdown trends of global economic growth. The forecasts for 2019 is influenced by aggregate demand of major trading partners. Thus, we estimate an increase in exports of goods and services of about 8.7% according to an optimistic scenario or 7.7% according to a pessimistic one. A 6.8% increase in imports of goods is forecast in case of an optimistic scenario for 2019 and 4.4% in



case of a pessimistic one. These forecasts reflect the growth prospects of major trading partners of the Republic of Moldova due to new global and regional circumstances. Thus, the EU revised the economic growth downwards to 1.8% due to uncertainty resulted from the protectionist policy of USA and controversies inside the EU (Brexit, budget approval in Italy, or dialogue with the Government of Romania). On the one side, the growth of Russian economy will be fueled by the increasing oil prices. On the other side, it will be affected by the possible sanctions applied in this respect, and by subsequent RUB depreciation, with an expected increase in Russian economy of about 1.6% in 2019.

The growth rate of personal transfers may also be affected under these economic conditions. Thus, we expect an increase of 5.0% in 2019 in case of an optimistic scenario and of 3.0% in case of a pessimistic one. At the same time, in geographic terms, EU may further strengthen its role of main source.

The investment plans of foreign companies in the Republic of Moldova (especially for toll manufacturing) could be revised from the same perspective. It could directly influence the resident employees' remuneration for the work done to non-resident employers. In 2019, the remuneration is estimated to modestly increase by 4.0% under the optimistic scenario and by just 1-2% for a pessimistic scenario. At the same time, an inertial increase in investments revenues of about 7.0% in case of both scenarios should be expected. However, it is expected that most of them (if not entirely) will not be reinvested, due to aforementioned objective reasons. Note that exports of industrial products of the Republic of Moldova (mostly automotive components) could be severely affected in the next years, due to loss of dynamism of this sector in the EU, after a strong increase in demand for cars in recent years. The market became increasingly saturated in terms of number of vehicles, but also affected by uncertainties generated by the protectionist policy of USA and prospects of supplying chains after the Brexit.

Forecast of international oil price increases after reaching the maximum of USD 85/barrel in the last 4 years. Thus, by the end of the year, it is expected to increase up to the average of USD 75/barrel for the whole 2018. The same trend will continue next year, when an average price of about USD 85/barrel is forecast. However, the volatility of price correlates with both economic evolutions in the major producing countries (including through the lens of new USA sanctions on Iran) and OPEC cartel' intentions to balance the supply against the backdrop of moderation of global economic growth.

After a slight increase of 3% estimated in 2018, the food prices will stagnate in 2019. Thus, the forecast stagnation of international prices is based on high level of inventories for the most product groups. Last but not least, existing and potential trade conflicts could decrease international trade and, implicitly, food prices. Nevertheless, evolution of the agrifood sector in the Republic of Moldova is still the great uncertainty for forecasts, especially taking into account its vulnerability to weather conditions.



About EXPERT-GRUP

Who we are

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

Our activities

Our core activity is economic analysis, forecasting and policy research. In this area we offer a wide range of analytical products and services that help our beneficiaries to take decisions that support the development path of Moldova. Our key competence lies in the ability to provide professional, high quality and objective research in such broad fields as:

- Macroeconomic analysis and forecasting;
- Political economy;
- Public finance;
- Human development and poverty reduction;
- Labor market and consumer behavior;
- Foreign trade;
- Financial markets;
- The economics of European integration;
- Sector-level economic analysis;
- Regional and local economic development; and
- Energy and environmental economics.

Partners and donors

In the period 2006 –2017, the EXPERT-GRUP has implemented more than 100 research and advocacy projects in different areas related to economic and policy research. More than 130 associated and non-associated experts from Moldova and other countries were involved in these projects. We have worked with such donors as Moldova Soros Foundation, Eastern European Foundation, Konrad Adenauer Stiftung, Balkan Trust for Democracy, Black Sea Trust, FES, the UN Development Programme Moldova, the UN Children's Fund (UNICEF), the European Commission, the Council of Europe, the Open Society Foundation, the Swiss Agency for International Cooperation, and the United Kingdom Department for International Development. In 2010 and 2012 the EXPERT-GRUP was elected as a member of the National Participatory Council of Moldova. Since 2008 the EXPERT-GRUP has been a member of the Policy Association for an Open Society – a network of policy centres uniting 56 think tanks from countries across Europe.