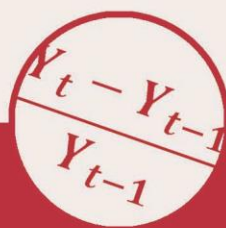


MEGA

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Moldovan Economic Growth Analysis

From political economy to economic policies: policy priorities for the new government

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About MEGA

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



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Key Policy Messages

- The Republic of Moldova embarks on a new political cycle and the challenges that the new Government will have to deal with will be greater than ever.*** Contrary to the widespread opinion, the parliamentary elections in 2014 were not geopolitical. In fact, they were based on purely domestic considerations and reflected the division of the society into people who gave their vote of protest against the government and those who offered it one last chance. The next government will have to cope with a series of crucial challenges. This is because the current domestic political ground is not strong enough to promote some systemic reforms of outmost importance, without which, however, neither the modernization of the country, nor its convergence to the UE is possible. The main challenges of political nature are related to the fragmentation of the political “elites” that determines the fragility of the parliamentary majority with a pro-European visions (at least as stated by them) and the proximity of the local elections in 2015 and of the presidential elections in 2016. Hence, the government will have to deal with two overlapping electoral cycles: the post-electoral period for the central public authorities, when the most unpopular reforms are being promoted, and the pre-electoral period for the local public authorities, when, on the contrary, such reforms are usually suspended and preference is given the populist measures. In this context, for formation as soon as possible of the new government is of utmost importance.
- The main policy priorities that should receive strong political support from the legislative body and be compulsorily present in the next Government Program are the following:*** to continue the education system reform, enhance the transparency and resilience of the banking system, simplify the issuance of permissive documents for companies, increase labor market flexibility (in depth revision of the Labor Code), reform the pension system, implement the EU quality standards, upgrade the overall quality system, increase the transparency of the financial and banking sector, and last but not least - reform the legal system.
- In the second half of 2014, the economic growth is expected to slow down significantly to only 0.5% - 0.8% y-o-y (during the first semester it progressed by 3.9% y-o-y), while for the whole year the GDP could grow by only 2.0%.*** Still, the result is not that bad if we consider the troubled economic, political and security environment in the region, as well as the trade embargoes imposed by the Russian Federation on certain agrifood products. We expect a 4.0% growth in 2015, while the main challenges shall reside in harnessing the opportunities provided by trade liberalization with the EU, return to the Russian market, and orientation towards alternative export markets. These challenges are especially relevant for the agrifood sector, which depends the most on the Eastern market and is encountering the greatest competitiveness issues.
- A major medium and long term challenge for the Moldovan economy is to ensure a robust and sustainable growth of the non-agricultural Gross Domestic Product (by 5%-7%)*** The favorable economic performance over the recent years occurred due to certain temporary factors (rich harvest and the substitution - to a certain extent - of the imported products with the domestic ones because of the national currency depreciation). In order to harness the economic potential and minimize the exposure to climate shocks, it is necessary to encourage the development of the SME sector, along with the consolidation of the competitive framework. The subsidy policy in the agricultural sector must be refocused from subsidizing large capital investments to the infrastructure of protection and “small” niche technologies, which can be easily implemented by Moldovan farmers. As for the industrial sector, the policy priority should be to support enterprises, especially the ones operating in the food industry, in terms of advertising and marketing, as well as the integration of Moldovan companies in the European distribution networks and supply chains. In this regard, the Industry and Trade Chamber, MIEPO and other business support institutions must play a more active role. Last but not least, the Moldovan economy needs more credit resources to fund both the working capital and capital investments, but, in order to reduce



the producers' vulnerability to all kind of shocks - insurance services must be developed. In this respect, higher transparency and improvement of the country's financial sector should become an immediate priority of the next Government.

- The tepid consumption, in tandem with no alternative factors for economic growth, represents another challenge for the coming years.*** The moderate consumption in 2014 was especially determined by the conjuncture and psychological factors (MDL depreciation in Q4:14, stressful international background, rumors about the shaky conditions of the financial sector), which might remain valid in 2015, as well. Additionally, the private investors - the main engine of the investment activity - are very cautious in this period, and investments financed from abroad are decreasing dramatically.
- The consumption is expected to remain moderate throughout 2015, which will undermine correspondingly the economic growth.*** Besides the high uncertainty which, as a rule, fosters the population's propensity to save rather than to consume, there will remain active a series of additional factors that will keep the consumers more cautious. Thus, the population's consumption will be also affected by the trade restrictions enforced by the Russian Federation in tandem with the worsening of the economic and financial situation in Russia and the depreciation of the Russian ruble. This will affect the foreign currency inflows into the Republic of Moldova through at least two channels: remittances from and exports to the Russian Federation. Additionally, given that we are now at the beginning of the electoral cycle, 2015 will be accompanied by a relative budgetary austerity: according to our estimates, the budgetary expenditures will not grow by more than 2-3%, which will actually have a negative contribution to GDP of about -0.5-0.7%.
- Although the revitalization of consumption is important, the authorities should primarily focus on bringing the consumption within the formal economy, while the informal economy should be discouraged by all possible means.*** This will ensure the sustainability of the economic growth and will strengthen the public finance system in the country. The key-ingredients for making a larger part of consumption official include: development of electronic payments and discouraging the use of cash, stimulation of trade through organized commercial units, making sure that the e-invoice system is used and digitalization of anti-fraud and investigative tools used by the tax service
- Despite the nominal depreciation of MDL against the main reference currencies, the real effective exchange rate of the national currency, in fact, has appreciated.*** This phenomenon occurred due to the depreciation of the national currencies of the main trade partners of the Republic of Moldova (especially the Russian Ruble, the Ukrainian Hryvna and the Romanian Leu) at faster rates than those of the Moldovan Leu). Although this cheapened certain products imported from these countries, the appreciation of the actual effective exchange rate of the national currency affects the competitiveness of local producers on the respective markets. Still, this phenomenon does not have to be the reason for the national currency to depreciate to the level of the ones in the Russian Federation and Ukraine. It rather points out to: (i) the need to increase the presence on other foreign sales markets that are more stable and provide more opportunities; (ii) the need to strengthen the domestic producers' competitiveness through quality (development of niche agriculture and industry, greater efforts investment into product packaging and in marketing activities).
- Although the main indicators of the labor market marginally improved, employment increased only thanks to the agricultural sector.*** At the same time, in other branches that have higher productivity, such as industry, transport and communication, the number of the employed population decreased considerably. This inter-sectorial distribution of labor force affects the external competitiveness of the country, suggesting that the labor market progressed quantitatively, but regressed qualitatively. Moreover, the higher employment in the agricultural sector is due to two very favorable years for this sector, but this effect is expected to vanish in the



near future. We cannot expect the employment rate to go up in the coming years if the business environment is not improved essentially and if the labor code does not go through a cardinal reform.

- ***The problem of correlating the educational system with the economic needs grew worse.*** The discrepancy index between labor demand and supply increased, the problem growing more acute especially with regards to higher education. Thus, the share of the unemployed who graduated from a higher education institution continues to increase. This is why it is critically important to continue the reforms in the education system (quality, quantity and adjustment to the economic requirements). The labor market risks to turn into a market with “overqualified” unemployed if the situation doesn’t change.
- ***The “corporate wars”, in tandem with the slowdown in economic growth and the depreciation of the national currency contributed to the worsening of the credit portfolio quality and endanger the stability of the banking system.*** Additionally, the trade restrictions enforced by the Russian Federation could augment the pressures on commercial banks’ assets in the near future. In this context, the stabilization and strengthening of the resilience of the banking system should become the top priority of the new Government. In particular, it is necessary to increase the transparency of the banking system, foster competition in the sector, strengthen the corporate governance and the efficiency of processes carried out within banks (especially as regards loan granting procedures and mechanisms of non-performing loans management), as well as to ensure a stronger protection of property rights.
- ***The European orientation contributed the most to the general increase of exports, which allowed to compensate the losses on the Russian markets.*** The first effects of DCFTA that entered into force on 1 September are already taking shape. An important growth of “sensible” goods exports is noticed, against most of which the Russian embargo was enforced. Particularly, for the period Sept-Oct:14, we may notice the y-o-y growth of exports of wine (+26%), apples (2.7 times more), plums (8.1 times more), table grapes (5.8 times more), sweet frozen corn (more than 3 times) and cereals (+77%). Nevertheless, to take full advantage of the EU Association Agreement provisions, Moldova should invest more in eliminating the non-tariff barriers to trade. In this respect, it is necessary to: (i) extend DCFTA coverage over animal products by implementing the recommendations of DG SANCO; (ii) improve the quality system in order to enhance the products’ competitiveness on foreign sales markets; and (iii) implement and ensure a sustainable system in the area of standardization, metrology and conformity assessment.



Key Statistical Indicators

Table 1. Moldova: key long-term economic and socio-economic indicators

	2010	2011	2012	2013	2014 estimări	2015 proгноză
Population, million (excludes Transnistria), beginning of the year	3,564	3,560	3,559	3,559	3,558	3,558
GDP per capita, USD at PPP	3829,4	4178,7	4223,6	4666,0	4829,6	5091,0
Real GDP, y-o-y % change	7,1	6,8	-0,7	8,9	2,0	4,0
GDP deflator, y-o-y % change	11,1	7,2	7,9	4,5	5,8	5,4
Private consumption, y-o-y % change	9,2	8,5	1,0	6,5	1,4	3,6
Gross fixed capital formation, y-o-y % change	18,1	12,5	0,4	3,3	3,8	5,0
Industrial production, y-o-y % change	8,9	7,1	0,5	7,4	2,8	4,2
Agricultural production, y-o-y % change	7,4	5,5	-23,3	41,0	7,0	1,5
Share of industry in GDP, %	13,3	14	13,9	13,8	14,0	14,2
Share of agriculture in GDP, %	11,0	12,2	11,2	12,2	12,5	12,5
Net foreign direct investment, million USD	193,9	242,6	155,4	236,3	140,0	n.a.
Net work remittances, million USD	1243,7	1511,8	1712,1	1868,5	1995,56	n.a.
Current account/GDP, %	-7,8	-11,2	-6,8	-4,8	-6,2	-7,3
Official reserve assets, end-year, million USD	1717,7	1965,3	2515	2820,6	2594,0	2720,0
Total external debt stock, million USD	4711,1	5358,9	5983,8	6300,0	6770,0	n.a.
External debt/GDP, %	81,0	76,4	82,5	79,4	77,0	n.a.
Employment rate, % of population aged above 15	38,5	39,4	38,4	39,3	40,1	n.a.
Unemployment rate, % of economically active population	7,4	6,7	5,6	5,1	4,5	n.a.
Real wage growth rate, y-o-y % change	0,7	-0,1	4,1	3,5	7,3	5,5
Consumer prices index, year end, y-o-y % change	8,1	7,8	4,1	5,2	4,8	5,2
General government balance, % of GDP	-2,5	-2,4	-2,1	-1,8	-2,7	-1,5
General government expenditure, % of GDP	40,8	39	40,3	38,7	41,0	39,0
Exchange rate, year average, MDL per USD	12,4	11,7	12,1	12,6	14,0	n.a.
Central bank refinancing rate, end-year, %	7,0	9,5	4,5	3,5	3,5	n.a.
Total commercial bank loans, % of GDP	35,4	36,2	39,6	42,2	43,5	44
Bank deposit rate, %, average per year	7,6	7,5	7,6	7,2	7	7,2
Bank lending rate, %, average per year	16,3	14,4	13,3	12,3	12	12,0

Source: NBS, NBM, Ministry of Finance and EXPERT-GRUP calculations, estimates and forecast;



Executive Summary

Domestic Supply. Despite the unfavorable security and economic context on the regional level, the Moldovan economy registered a respectable progress in 2014, estimated by us at about 2%. Two consecutive years of almost excellent weather conditions ensured a fulminatory growth of the agricultural production, although some agricultural producers were not happy with the lower prices for agricultural products. In some cases, the dynamics of prices was determined by market factors, in other cases - by the trade shocks caused by the embargoes imposed by the Russian Federation. The industrial sector also registered a good increase in the gross value added, mainly thanks to the industries located in free economic zones and industrial parks. The constructions sector remained in a rather bad shape, the sector being virtually frozen as a result of investors and population growing more cautious, but also due to the dynamics of prices in the real estate sector. The services sector continued to be the engine of economy in 2014 as well, even if it was characterized by a contradictory progress, and also by a quite strong volatility. We expect that the economic growth will accelerate in 2015, and according to the main scenario, it will reach 4.0% (+/- 0.5 p.p.). Services will remain the main source for growth, being followed by the industry, and especially by the export-oriented branches. The complicated geopolitical situation in the region that can worsen more due to the degeneration of the conflict in Eastern Ukraine, is the main risk threatening this forecast. After two years of favorable weather, the risk of worse climate conditions that could threaten the expected growth in the agricultural sector is increasing. Furthermore, the banking sector may generate some risks as well, as the Government may be compelled to apply drastic measures aimed at stabilizing and rehabilitating the sector after a long period of hesitation and considerations.

The domestic demand continued its positive trend in 2014, although at a much more moderate pace. Household consumers spent only a little more than in 2013, while the household consumption increased more due to the good weather conditions that favored natural consumption of products, obtained in the "household" economy. Public administration's consumption was characterized by negative values and we expect the same trend in 2015. In 2014 investments in fixed capital contributed significantly to the GDP progress, but a great deal of the growth occurred thanks to the investments in road rehabilitation projects, made from the state budget and local budgets. Private investors were very cautious during this difficult period, and the foreign investments decreased dramatically. The dynamics of net exports influenced favorably the economic growth in 2014 and we believe that in 2015, when the opportunities provided by the Deep and Comprehensive Free Trade Area are harnessed fully, the contribution of exports to economic growth will increase significantly. The performance on foreign markets will influence to a great extent the funding sources of households' consumption and corporate investments. The Russian Federation might go through an economic recession in 2015. Not even Europe is in a better economic shape. In such conditions, the main risk that undermines our forecasts regarding the progress of demand components in 2015 is a less powerful growth or even a stagnation in terms of amount of money sent by Moldovan migrants.

Public Finance. The tax and budgetary policy in the Republic of Moldova maintained its pro-cyclic nature throughout 2014, being influenced to a great extent by the electoral period. The consequence of such policies is the volatility of the economic growth rates, undermining thus the efforts invested to stabilize public finances in the medium and long term. In order to avoid such risks, a set of measures were carried out with the view to adjust the public finance framework, the most significant one being the adoption of the Law on Public Finance and Tax and Budgetary Discipline. This law enforces a set of tax rules aiming at disciplining the line authorities and at stabilizing the budget. At the same time, the perpetuation of the current institutional framework for the development and implementation of the tax and budgetary policy generates risks of non-compliance with the stipulated rules. Thus, besides the legal adjustments, it is also important to modify the institutional framework by assigning the analysis and advisory role to an independent Tax Council. Furthermore, the quality of medium and long term public finance could be improved by applying certain new disciplinary tax rules drawn up by the Tax Council.



The **labor market** registered progresses in the first half of the year thanks to the decreasing number of unemployed and increasing employment rate. However, alarming trends were present, as well. In particular, the job creation rate has been decreasing for several consecutive quarters, coupled with the convergence of the current rate to the natural rate of unemployment, which signals worsening conditions on the labor market. Another negative occurrence was the inter-sectorial redistribution of labor force towards agriculture, this process continuing for the second consecutive year as a result of the inefficient structural reforms implemented recently. Finally, the gap between labor demand and supply increased, mainly for the highly-educated graduates. In the light of the presented information, it is important to accelerate the education system reform at all levels, in order to adjust it better to the economic, social and demographic realities.

Prices and Monetary Policy. In spite of the national currency depreciation, disinflationary pressures prevailed in 2014, and by the end of the current year, the annual Consumer Price Index will remain close to the lower threshold of the NBM target of 5% (+/- 1.5 p.p.). The main disinflationary factors were the increasing propensity to save rather than consume, the rich harvest, the trade restrictions imposed by the Russian Federation and the decreasing world prices for certain foodstuffs. At the same time, although the national currency depreciated against the main reference currencies, the real effective exchange rate appreciated. This happened due to a stronger depreciation of the national currencies of certain important trade partners of Moldova (the Russian Federation and Ukraine). The domestic and regional economic context allowed the NBM to keep up the simulative nature of the monetary policy and to allow a certain depreciation of the national currency (although, had the central bank not intervened on the internal currency market, the MDL would have depreciated to a much greater extent). In 2015 the inflation will stay within the NBM target of 5% (+/- 1.5 p.p.), while the depreciation pressures exerted on the national currency will become more moderate given the higher economic growth, investments and exports. On the other hand, the trade restrictions imposed by the Russian Federation, the economic difficulties in the EU, and especially in the CIS, as well the depreciation of the Russian rouble and Ukrainian hryvna, in tandem with the establishment of the Moldovan economy below its potential will fuel further the disinflationary pressures in 2015.

There are clear signs of weaknesses in the **banking sector**. On the one hand, the economic developments affect the activity of banks. The restrictions imposed by Russia will damage the financial situation of agri-food exporters, and as a result, these business entities will encounter difficulties when paying back their loans. The depreciation of the national currency also creates difficulties when it comes to paying back bank loans in foreign currency. On the other hand, continuation of the “corporate wars” coupled with inefficient management influence negatively the stability of the Moldovan banks. In this context, the public institutions are quite passive, and their interventions come too late, which favors the augmentation of negative trends.

Foreign Sector. The foreign trade of the Republic of Moldova was affected by the barriers imposed by the Russian Federation. Dishonesty and disregard of the Free Trade Agreement within the CIS are aspects that characterized Russia’s behavior in its economic relations with the Republic of Moldova. The restrictions imposed by the Russian authorities on the import of certain categories of products from Moldova caused the stagnation of exports. Russia’s hostile attitude could be in 2015 an important factor that would jeopardize Moldova’s economic stability. Another factor that influenced the foreign trade was the depreciation of the national currency, which led to the substitution of imported goods by the domestically produced ones. For 2015-2016, the Government’s priorities should focus on eliminating the technical barriers to trade and on upgrading the quality infrastructure - which are crucial conditions that need to be met in order to be able to harness the benefits provided by the EU Association Agreement and to decrease exposure to the Russian market.

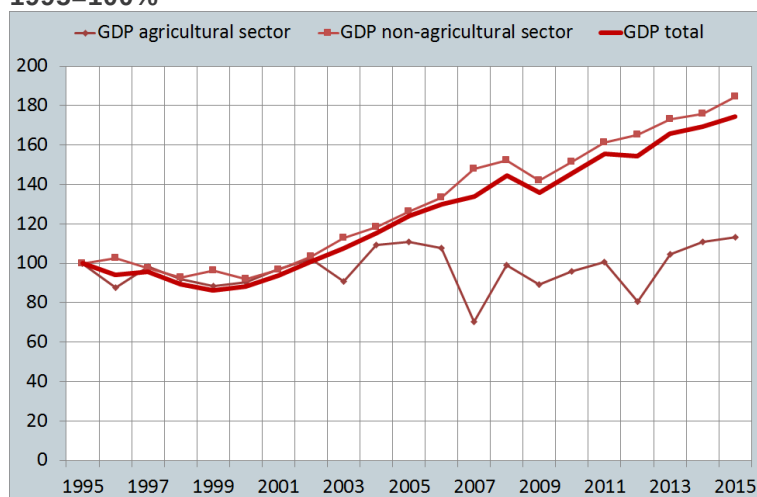
Chapter 1. Domestic Supply

The current year (2014) can be considered as a rather good one for Moldovan economy, taking into account difficult domestic and regional economic and political context. However, as shown in this chapter, it owed mainly to a set of temporary factors - including the depreciation of the Moldovan leu, as well as the “electoral bonuses” provided by the Government to certain producers and consumers. As soon as their effect vanishes in 2015, the economy will have to cope with new challenges, including those related to the liberalization of trade with EU, to the return to the Eastern markets and to the climate conditions that could be less favourable than during 2013-2014. We keep our previous forecast of GDP growth for 2014 at around 2% and expect for the next year a slightly higher economic growth of about 4.0% (+/- 0.5 p.p.). The main risks which might affect this forecast are related to the political, geopolitical and financial instability.

Recent Developments and Trends in Domestic Supply

The GDP growth by 3.9% in the first half of the year, as well as the accelerated economic growth that was noticed in Q3:14, should be regarded as good news, given the unfavourable geopolitical and security background on regional scale and the high comparison base in 2013 against which the current year's growth is compared. The currently available international statistics show that the growth rate registered in the Republic of Moldova in the first half of 2014 seems to be one of the highest across Europe. A deeper analysis, however, suggests that falling into a state of euphoria would be a great mistake because the registered economic progress was determined by a series of temporary factors. An essential factor which supported exports and discouraged imports in Q2:14 (both of them having positive arithmetic effects on GDP) was the depreciation of the MDL (by more than 10% against the US dollar and by 16% against Euro). This positive impact cannot, obviously, last too long especially since the alignment of the Moldovan Leu to the regional currencies and the depreciation of the real effective exchange rate in the second quarter was balanced out by a comparable appreciation in Q3:14. In the second half of the year the effect of the very high comparison base from Q3:13 was strongly felt. According to our estimates, the GDP grew by about 0.5-0.8% in the second half of the year, reducing, thus, the annual growth rate down to about 2.0% (figure 1).

Figure 1. GDP Evolution, by Agricultural and Non-Agricultural Sector, 1995=100%



Source: NBS, Expert-Grup forecasts for 2014-2015



Agriculture. The agricultural sector surprised the analysts again as it showed an essential production increase, estimated officially at around 8.6% during Q1-Q3:14, while we estimated an increase by 7.5% for the entire 2014. Thanks to favourable weather, crops per hectare increased in the case of most of the important crops, providing a growth indicator of about 12% of the phytotechnical production value. In the case of certain crops, however, production growth did not mean higher incomes for farmers. This is, for instance, the case of plum producers, and especially of apple producers who ended up being the main victims of the Russian embargo and of the frost in October, who sold their crops to processing plants and supermarkets at ridiculously low prices. As for the corn, the delivery prices dropped down by almost 40%, this time due to objective market factors. The Government paid the producers of early fruits (apples and plums) compensations for losing access to the Russian market. In practice, however, the provision of support was neither transparent nor fair in terms of access - the large producers were again more favoured than the small ones. The livestock sector registered a less impressive growth of 2.5% in Q1-Q3:14, which was also the growth rate throughout the whole year. Although the volume of livestock production did not grow too much, the producers were much more advantaged by the ascending dynamics of prices for animal products. Overall, the gross value-added generated by the agricultural sector in 2014 increased, according to our estimates, by about 8%.

Industry. During Q1-Q3:14 the industrial production grew by 4.7% y-o-y, registering a slight increase in Sept:14 (7.4% compared with Sep:13). After a disappointing performance in 2013, oil production showed an impressive return in 2014, when it registered more than a twofold growth. At the same time, production, procession and canning of meat and meat products increased by 25.3%, dairy products preparation increased by 8.0%, fruits and vegetables procession and canning - by 6.1%, while the preparation of products made of cocoa, chocolate and sugar products - by 5.8%. On the other hand, the industries affected by the Russian trade sanctions reduced their production level. In particular, the production of distilled alcoholic beverages decreased by 28%, while wine production decreased by 23%. In non-food industries, progress was mixed as well. Thus, while the chemical industry increased its production volume by 46%, tobacco processing and manufacture of tobacco products decreased by almost 40%. It is worth mentioning that the latter has decreased significantly during the past five years. In general, the industrial production rate slowed down in the second half of the year, which will result in an annual index of gross value-added growth of the industrial sector of 3.6% to 3.8%. As a mega-trend, an accelerated production growth and increase in the share of industries in free economic zones and industrial parks is noticed. In November another big European cable producing company announced its decision to come to Moldova, and was going to settle in the Straseni subsidiary of the Balti Free Economic Zone. At the same time, the less favoured producers working under "normal regime" go through harder times. Among the great lot of problems that small producers have to deal with there are the bureaucratic and financial barriers that prevent connection to the electricity grid. Although the problem did catch the attention of the Government in 2014, a sustainable solution has not been found yet.

Constructions. The construction sector looks very bad in 2014. In the first half of the year the volume of construction works remained at the level reached in 2013, with a great deal of investors and banks giving up or putting off the funding of new constructions, especially of the residential ones. The negative dynamics of prices on the real estate market is one of the factors determining investors' vigilance. If it were not for the big infrastructure projects, funded from the budget (as a matter of fact, they were funded by European donors and creditors), the construction sector would have been now sliding down and registering negative results. This sector did not show any ascending signs in the second half of the year, either. Still, as the intermediary consumption decreased more than the volume of construction works, the gross value added within the sector grew by approximately 6.8-7.0%. Generally, the construction sector tends to reduce its share in the gross value added, going from the 6% in 2008 down to an estimated share of about 4% in 2014.

Services. Overall, the services sector was characterised in 2014 by contradictory progress, and also by an atypical volatility. Wholesale trade registered a strong growth while the retail trade was rather hesitant. The share of services provided to the population stayed high from January to August, but dropped down



during September - October, and its condition stays unclear. The sector of services provided to enterprises, on the other hand, is going through a rather steady growth. The amount of transported commodities increased by 13% in Q1:14, by 10% in Q2:14, and by 1% only in Q3:14. All together, the key-indicators are rather pointing to a small domestic demand - especially for final consumption - and a small external consumption demand in the last quarter of the current year and the same is expected in 2015.

Short and Medium Term Forecasts

- According to the estimations of EXPERT-GRUP, the Moldovan economy shall increase in 2015 by 4.0% (+/- 0.5 p.p.). As showed below, we are expecting all sectors to contribute positively to this economic progress, even if some of them will bring a quite modest contribution. The risks that might affect this forecast have a top-down orientation. From the perspective of domestic supply, a major risk for this forecast is the result of the Parliamentary elections on 30 November 2014 and the potential political instability following the elections. The complicated geopolitical situation in the region can worsen more due to the degeneration of the conflict in Eastern Ukraine, which is inevitable and will affect the Moldovan economy. Furthermore, the banking sector may pose some risks as well, as the Government may be compelled to apply drastic measures for the stabilization and rehabilitation of the sector after a long period of hesitation and options weighting.
- As far as the agricultural sector is concerned, the access of agricultural producers to new foreign markets is the biggest long and medium-term challenge. In 2014, even though exports of agricultural products to the EU increased impressively immediately after the entry into force of the new trade regime, the opportunities provided by the Deep and Comprehensive Free Trade Area (DCFTA) could not be exploited entirely, while the Russian market denied access to many Moldovan producers. Another major challenge is the need to cope with eventually less favourable weather conditions for the agricultural sector. Probabilistically speaking, after two consecutive years of excellent conditions for the sector, there is an increased risk of worse conditions in 2015. We stick to a conservative scenario as far as the agricultural sector's progress in 2015 is concerned, believing the growth indicator would be about 2.0% (+/- 0.5 p.p.).
- The industrial sector shall also have to deal with some new challenges determined by the liberalization of trade with EU. In particular, the private producers operating in the food industry will have to invest in the technologic modernization and improvement of products' quality and safety control systems in order to be able to deliver goods to the European market. Meat processing and meat products fabrication, and dairy production are industries where these conditions are of critical importance. At the same time, against a background of a more vigilant attitude on behalf of the consumers, the competition on domestic market shall grow harsher. The industry shall be pushed forward by the branches that have already proved their competitiveness on domestic and external levels - i.e. food industry, textile and clothing sector, footwear manufacture, chemical industry, building materials. The industry of wine and distilled beverages, on the other hand, shall continue to experience the impact of the Russian embargo. Some particular producers, though, shall be able to redirect their products to other markets. We expect and overall growth of about 4.0%-4.5% of the gross value added generated by this sector in 2015.
- There are no clear perspectives for 2015 as far as the construction sector in concerned. On the one hand, investors and banks shall still be cautious when investing money in residential projects. On the other hand, as a series of large projects was already announced in 2014, the non-residential constructions sector might experience some progress in 2015. Furthermore, the infrastructure projects funded by European banks and other donors will play a more important role. An increase of this sector by 4.5 - 5.0% seems to be, in this regard, a realistic forecast for 2015.
- Concerning the domestic trade with goods and services, we foresee a relatively conservative increase in the gross value added of about 3.0% - 3.5%. The relatively modest growth of the sector is determined by the quite reserved expectations as regards the progress of domestic



consumer demand, as well as by a more austere budgetary policy expected in 2015. The latter shall have as a consequence a smaller volume of public services provided to the population.

Policy Recommendations

- As it was mentioned in the previous issues of MEGA, a major medium-term challenge for the Republic of Moldova will consist in keeping up a rather good growth rate of at least 5-7% of the non-agricultural components of the GDP. Two very good years for the agricultural sector did very well to the economy, but the good luck cannot last forever and this sector might go back to its sinusoidal regression pattern, affecting macroeconomic and macrofinancial predictability. The process of issuing subsidies to agricultural producers became the subject of debates within the Government, given that the request for subsidies in 2014 (about MDL 800 million) went beyond the allotted financial resources (MDL 560 million), which poses serious challenges for policy planning. The major problems are not only about correct planning on macro level of the amount of necessary resources, but also about their distribution in a judicious and fair manner. In order to avoid market distortions and ensure fair access to subsidies, the subsidy policy must be refocused from subsidizing large equity investments to protection infrastructure and “small” niche technologies, which could be easily implemented by the Moldovan farmers.
- The producers working in the food industry must receive the necessary support from the state within the subsidy programs, and from the banks as well, in the form of loans granted under reasonable conditions in order to exploit the opportunities provided by the Deep and Comprehensive Free Trade Area and the EU. One of the options that are worthy of serious consideration is the aid granted in order to support the advertising and marketing efforts. At the same time, the Chamber of Commerce and Industry, MIEPO and other business support institutions must play more active roles in ensuring the integrity of Moldovan companies in the distribution networks and European supply chains.
- As it was anticipated in MEGA #10, the trade embargo enforced by the Russian Federation occurred in the summer and autumn of this year. Unfortunately, the Government and the exporters did not manage to identify other sales markets for their foodstuffs, agricultural production and alcoholic beverages besides the European ones. Some efforts were invested in opening the markets in China and in some countries in the Near East, but they were not very substantial. In order to make more substantial efforts, it is necessary to identify new sales markets, to be based on attracting professional companies in the field of international marketing and communication.
- Moldovan economy needs more crediting resources both for funding working capital and equity investments. It is also necessary to develop insurance services in the agricultural sector in order to reduce producers’ vulnerability to different shocks. However, the development neither of the banking sector, nor of the insurance one is possible if they become victims of anticompetitive arrangements, while the real owners do not want the general public to know who they are. As 2015 will be the first year of the mandate of the new Government, it provides a brief window of opportunity to make the financial sector of the country transparent and to improve it. This opportunity should not be missed.

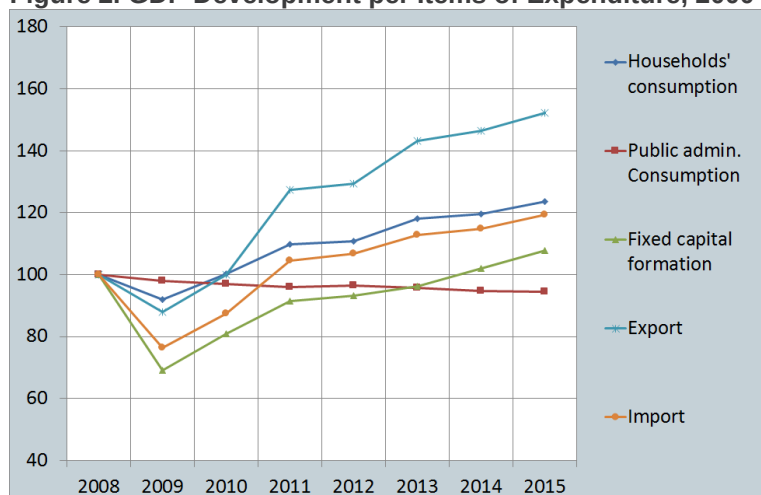


Chapter 2. Domestic Demand

Moldovan consumers were very cautious during the first half of the year, with their consumption expenses increasing by little over 1% y-o-y in the first half of the year and by even less than that during Q3-Q4:14 according to our estimates. Public administration consumption gave little reasons for enthusiasm in 2014. Investments in fixed capital were not impressive as well in the context of greater cautiousness on behalf of the large investors, as they await the results of the elections. The accelerated growth of exports as compared to imports of goods and services played the main role in GDP growth, calculated based on the expenditure approach, over the entire year. All in all, the Moldovan economy expended (by about 2% in 2014) despite several new trade shocks after the Russian Federation enforced embargoes on some agricultural products important from Moldova. As for 2015, we generally anticipate more or less the same structural contribution of items of expenditure. Households will be cautious with their consumption, because of the slow increase of the income from wages, remittances and social transfers. The tighter budget for 2015 will cause the public administration to be more modest, as well. Depending on elections results, a strong inflow of foreign and local investments may be possible, but exports will remain the main source for GDP growth.

Recent Developments and Trends in Domestic Demand

Households' consumption registered a very modest growth of about 1.3% during the first half of the year (Figure 2), which was also due to better weather conditions that boosted natural consumption of "household" farming crops (+4.1%). According to our preliminary estimates - households' consumption increased by about 1.2% in 2014. As for the procurement of the goods on the market - consumers became more cautious in Q2:14 (+1.4%) compared to Q1:14 (+2.6%). The fact that expenses for service procurement went back to positive trends in Q2:14 (+1.6%) is interesting, after the decrease in Q1:14 (-2.2%) while goods and services procurement by Moldovan residents from abroad increased by 11.5% after the 4% decrease in Q1:14. Corroborated with the balance of payments data, these trends may hint to the first economic effects of the liberalized visa regime by the European Union for Moldovan citizens. We estimate, nevertheless, that during the second half of the year households' consumption expenses increased even slower (by approximately 0.5 - 0.8%). This moderate consumption was especially determined by the temporary and psychological factors (MDL depreciation in Q4:14, stressing international background, rumours regarding the shaky financial sector).

Figure 2. GDP Development per Items of Expenditure, 2000=100%

Source: NBS, EXPERT-GRUP calculations, estimates and forecasts

Final consumption of the public administration. If in the first quarter the contribution of this component of demand was moderately negative (registering a 0.6% decrease), the situation aggravated even more in Q2:14 (-1.2%). Judging by the dynamics of the public budget - the consumer demand on behalf of the public administration decreased by 1% in the second half of the year as compared to 2013.

The increase **fixed capital investments** (+7.6% in the first half of the year and +5.9% during the entire year, y-o-y) made an essential contribution to the progress of GDP. However, a great deal of the growth is due to the investments financed from the state and local budgets (especially in road rehabilitation and certain utilities-related projects). Private investors - who are the main engine of the investment activity - proved to be very cautious in this period, and investments financed from abroad are decreasing dramatically. The slowdown in investment rates in Q2:14 as compared to Q1:14 is particularly relevant for investments in constructions (from +11.3% down to +9.4%) and for investments in machines and equipment (from +10.2% down to +6.5%).

The **foreign demand** supported very much the economy in the first half of the year. It was especially the almost 11% increase of exports in Q2:14 that played a major role in speeding up GDP growth as compared to Q1:14. The European orientation contributed the most to the general increase in exports. Nonetheless, this effect went down to almost zero in Q3:14, especially in the last quarter of the year. At the same time, in Q3-Q4:14 the first effects of DCFTA that entered into force on 1 September were already taking shape. An important growth of "sensible" goods exports is noticed - on most of these goods the Russian embargo was enforced. Thus, in the period Sept-Oct:14, we may see a y-o-y growth in Moldovan exports to EU of wine (+26%), apples (2.7 times more), plums (8.1 times more), table grapes (5.8 times more), sweet frozen corn (more than 3 times) and cereals (+77%). We can see an encouraging development, and precisely the acceleration of exports as compared to imports in the first half of the year and it appears that it is the same in the second half of this year as well. One of the key factors is the depreciation of the MDL in 2014, which also allowed to correct, at some extend, the current account deficit.

Short and Medium Term Forecasts

- The performance on foreign markets will influence to a great extent the funding sources of households' consumption and of the investments made by companies. The Russian Federation is in a very difficult financial and economic shape (recession in the construction sector, registered particularly in the second half of year). The recession of the entire Russian economy is possible in 2015. Not even Italy (the second major destination for Moldovan migrants) is in a better economic condition. Hence, we should expect a slower growth or even stagnation of remittances in 2015 (+0.8%-1.0%, based on a conservative scenario).



- Currently, the population's consumption is cooling down due to the impact of Russian trade embargo, which was the highest in the second half of 2014. Hence, it diminished the revenues from exports and put negative pressure on GDP. However, we expect a slight improvement in 2015 with regard to households' consumption indicators, registering a growth of 3.4 - 3.6%.
- Though the 2015 Budget Law was not passed yet, our main hypothesis is that it will be an austere year and that budget expenditure will not grow by more than 2-3%, which will actually have a negative contribution to GDP of about -0.5 - 0.7%.
- According to our main scenario, the phase of political uncertainty due to the parliamentary elections will be overcome relatively quickly and in 2015, we can expect the investment activity to keep a growth pace of about 5.6 - 6.0%.
- The opportunities provided by the DCFTA between the Republic of Moldova and the EU could be harnessed at a larger scale in 2015. However, it will imply a harsher competition with the European producers. Nevertheless, we generally anticipate that exports in 2015 will grow faster than imports (4.0% against 3.8%), which will have a positive impact on GDP.

Policy Recommendations

- How could the consumer demand on behalf of the population be harnessed better in order to stimulate sustainable economic growth? This is an essential question, which is taken seriously only by a small number of Moldovan economic policy makers. At the first sight, consumer demand stimulation may seem to contradict the Government's intention to change the economic growth paradigm with a paradigm focused more on investments, less consumption and more exports. However, this contradiction is not that obvious. Population's consumption is one of the most important stimulating signals for economic growth, but it is also important for this consumption to be brought within the formal economy, while the informal economy should be strongly discouraged. Besides ensuring a higher sustainability of the economic growth, it will also simplify the collection of indirect taxes generated from consumption taxation. At present, population's consumption should generate about MDL 18-20 billion of net revenue from VAT per year, but in reality the amount is about MDL 12.5 billion. The key-ingredients for making a larger share of consumption official include: development of electronic payment tools and discouraging the use of cash, stimulation of trade through organized commercial units, making sure that the e-invoice system is used and digitalization of anti-fraud and investigative tools used by the tax service.
- The investments made during 2014 and 2015 will be lower compared to the potential offered by the trade liberalisation with the EU. Besides the economic uncertainty, caused by the political and geopolitical instability in the East, one of the essential causes is the unfriendly investment climate, which perpetuates over the past 20 years, despite some marginal progress achieved over the last years. The Government analysed and even approved over the years various active industrial policy instruments in order to attract investors (free economic zones, industrial parks, technological parks). Recently, the policy discussions started to focus on the idea of providing direct subsidies from the state budget to jobs created by investors as a method to attract investors. This method deserves serious consideration only when all other conventional instruments had been implemented. This is not precisely the case of the Republic of Moldova, where none of the necessary key-reforms for the improvement of the investment environment brought the expected results. An in-depth analysis of the implementation of Government's roadmap aimed at eliminating the critical constraints to the business environment for 2013-2014 will show that half of the actions were not implemented or were implemented on paper only, without having real impact on companies. More than that, the analysis of the opportunities provided by the policy of direct subsidies for the jobs created must compulsorily take into account the adverse economic effects of such subsidies - market distortions, high opportunity costs, discouragement of small producers.

Chapter 3. Public Finances

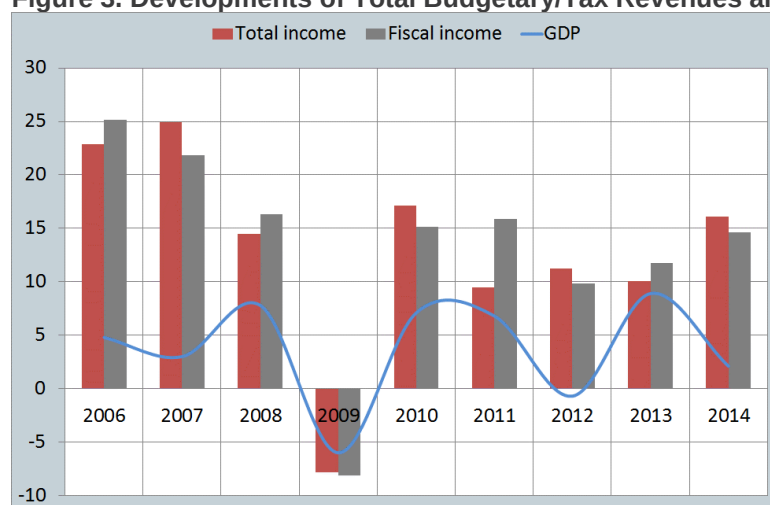
During 2014, the Moldovan tax and budgetary policy was influenced by the electoral period and remain pro-cyclical. The approved new Law on Public Finance and Tax and Budgetary Accountability was an important step made to change this situation. Nevertheless, considering the nature of the new tax rules, the previous behaviour of competent authorities in managing the public finances, as well as the international experience with adherence to such rules, we can anticipate that the new fiscal rules could be hardly respected.

Tax and Budgetary Policy - Looking for a New Target

The Republic of Moldova started the year 2014 with a budget that was largely influenced by the parliamentary elections of November. During the year, the electoral factor became even more obvious, owing to the amendment of the National Public Budget (NPB) in the middle of 2014, with the upward adjustments of the planned revenues and expenses. In fact, compared to the estimates from the beginning of the current year, the expenses were increased higher than the revenues, which led to a larger budgetary deficit. Thus, following these amendments, the expenditure growth rate increased from 10% to 21.6% y-o-y, while the total revenue rate - from 10.3% to only 16% y-o-y, and the tax revenue trend increased only by 1 p.p to 14.6%. As a result, the budget deficit could increase to about 3.8% of GDP, compared to the 2.64% initially forecast. But, considering the expenditure execution rates in the previous years of about 97%, the budget deficit by the end of the year may return to the initially forecast parameters.

Besides the influence of electoral factors, the country's tax and budgetary policy is characterized by a pro-cyclical trend. Figure 3 reveals that the GDP trend has a significant impact on the budgetary revenue growth rates. With regard to tax revenues, this trend is even more significant. Thus, the correlation between tax revenue and GDP revenue during 2005-2014 constituted 0.69, while the correlation between expenses in the same period constituted 0.23. Whereas the dynamics of the tax revenue largely reflect the activation of the automatic stabilizers, then the budgetary expenditures reveal the pro-cyclical trend.

Figure 3. Developments of Total Budgetary/Tax Revenues and GDP (% y-o-y)



Source: Expert-Grup calculations based on data from NBS, Ministry of Finance

The approval by the Legislative of some guiding tax norms for the Executive was a qualitative step to minimize the pro-cyclical fluctuations and to achieve macroeconomic stability in the long



run. Such fiscal rules were also stipulated in the Law No. 181 of 25.07.2014 on Public Finance and Tax and Budgetary Accountability, which was recently approved by the Government, which will establish the general legal framework in the public finance area. The main fiscal rules stipulated in the draft law were related to the maintenance of growth rates of total budgetary expenditures under / or equal to the nominal growth rates of GDP, as well as the establishment of a ceiling for the budget deficit of 3% of GDP, with the option to derogate the possible exception provided by the law. In the final version, these rules were changed to achieve the budget deficit target of 2.5% of GDP in 2018, excluding grants.¹

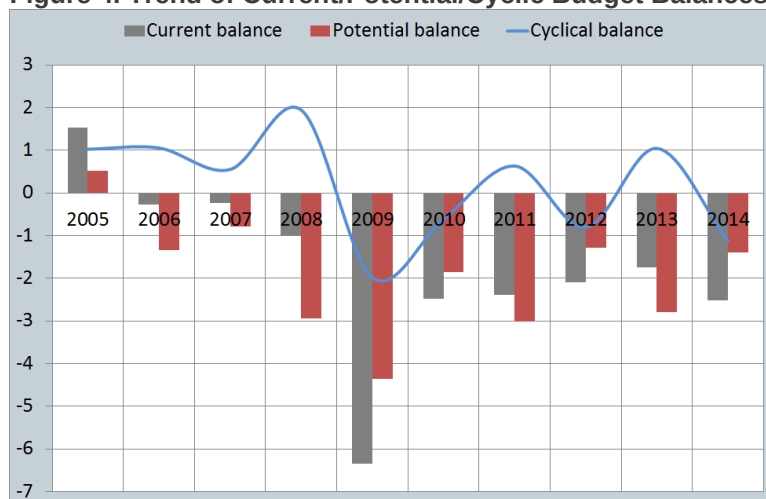
The fiscal rules, while being necessary, do not fully guarantee the budgetary discipline, as confirmed by the international practice. To make these rules efficient, they should meet some criteria, and namely they should be credible and transparent, and not too rigid. Also, an important role assigned to the tax policy and guiding rules is the balancing of the cyclical fluctuations, through automatic stabilizers and discretionary component. As the discretionary measures play a critical role, it is important to distinguish between the permanent/structural and cyclical factors that influence the current budget balance. Ignoring these factors creates the risk of incorrect adjustment of the tax policy to business cycles. Thus, a key indicator that meets the above-mentioned criteria is the potential budget balance, that shows the difference between the possible revenue and budgetary expenses when the economy operates at its potential level.

The potential budget balance, as a tool for the analysis of the tax and budgetary policy, can highlight links between the economic potential and tax base of a country. For the Republic of Moldova, as shown in Figure 4, the potential budget balance has always been negative and had a significant amplitude in the recent years.² Also, it is symptomatic that in the years with a positive cyclical component, the potential fiscal balance is always higher than the one registered de facto. It reveals the narrow tax base of the national economy and the persistence of negative balances in the medium term, due to the fact that only the GDP growth above its potential level, equivalent to the increase of collected taxes above the norms, could reduce the budget deficit. At the same time, perpetuation of the potential budgetary deficit in the medium term, indicates both the low level of tax discipline, with the Government failing to adjust the expenses to business cycles and realities, and the inability to mobilize domestic revenues.

¹This objective was mentioned in the IMF report. „Republic of Moldova: 2014 Article IV Consultation and First Post-Program Monitoring Discussions-Staff Report”, 8th July 2014, Country Report No. 14/190

² Current budget balance is spread in the cyclical component, when the economy deviates from its long-standing level, and in the potential component, which reflects the influence of fundamental factors on the tax balance. To calculate the potential balance it is necessary to estimate the potential GDP and the elasticity of revenue and expenses compared to GDP. In the case of the Republic of Moldova, the potential GDP was calculated in real terms, using the Hodrick-Prescott filter with $\lambda = 100$. Also, the main method to estimate the balance was the aggregate method and, respectively, elasticities for revenue/expenditures were chosen as 1/0, according to:

Fabian Bornhorst, Gabriela Dobrescu, Annalisa Fedelino, Jan Gottschalk, Taisuke Nakata „When and How to Adjust Beyond the Business Cycle? A Guide to Structural Fiscal Balances”, IMF Technical Notes and Manuals, April 2011.

Figure 4. Trend of Current/Potential/Cyclic Budget Balances (% of GDP)

Source: Expert-Grup calculations based on data from NBS, Ministry of Finance

The usefulness of potential budget balance as a tool for analysis, planning and implementation of the tax and budgetary policy is also revealed by the international experience. Thus, since 2001, Chile has voluntarily implemented the tax rule with an objective for potential budget balance of 1% of annual GDP, and legislated this rule in 2006.³ The implementation of this framework resulted in a countercyclical tax policy, lower economic growth rates and interest rates on external debt, as well as a transparent institutional framework.⁴ Also, the potential budget balances have replaced the real ones and in EU key documents related to prudence and sustainability of public finance, being introduced and the Stability and Growth Pact, revised in 2005.⁵ Finally, this rule allows maintaining a stable financing for some important economic area, regardless of its place in the business cycle (education, capital investments, social expenses, etc.).

Education Sector Financing - Performance through Efficiency

The education sector plays an important role for the sustainable economic growth and is still a priority area in terms of state budget financing. Thus, in 2014, about 18% of the total budgetary expenditures were allocated to education, which is 7.8% of GDP and this percentage is almost the same as in the previous years.⁶ In this context, it is reasonable to compare the efficiency of this sector with the ones from other countries, from the perspective of the achieved results. As an input indicator we use expenses per student, because the share of GDP does not highlight the gap in population and the absolute amounts allocated to the education systems in various countries. With regard to output indicator, for purposes of international comparison, PISA scores from 2009 can be used.⁷ The figure 5 clearly shows that there is a positive link between the level of allocations per student and the final PISA scores, with a positive impact achieved with the increase of financing up to about USD 1000 per student (constant prices of 2005), and maintaining the efficiency of the education sector constant once this threshold is exceeded (we refer here primarily to pre-university education).

³ Jorge Rodriguez C., Carla Tokman R., Alejandra Vega C., „Structural Balance Policy in Chile”, OECD Journal on Budgeting, Volume 7 – No.2, 2007.

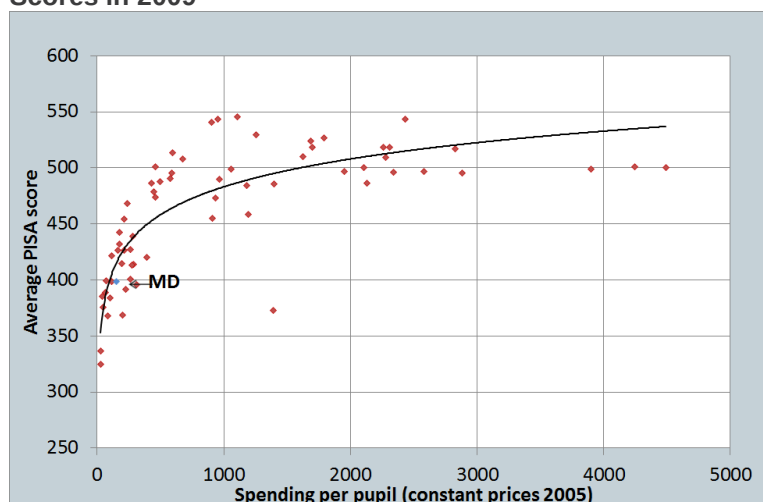
⁴ In Chile the entire methodology of calculating the structural balance is performed by independent experts, and the methodology is published for the wide public.

⁵ Martin Larch, Alessandro Turrini „The cyclically-adjusted budget balance in EU fiscal policy making: A love at first sight turned into a mature relationship”, EC – Directorate General for Economic and Financial Affairs, Economic Papers 374, March 2009.

⁶ The share of expenses in the educational sector is calculated based on a corrected GDP forecast of MDL 109.2 billion for 2014, from the Information Note to the draft Law on Amendments and Addenda to the 2014 State Budget Law and the amount of MDL 8545.4 million planned for education.

⁷ PISA score, with all its shortcomings, is currently the only tool available to compare the performance of students from different countries, based on a single methodology. Here we used the PISA score 2009, as the Republic of Moldova participated only in 2010 and 2014, the last test data are not yet available. Also, the ratio between PISA/expenses was used in several studies to analyze the expenses' efficiency in the educational sector. See: Adam Wagstaff, L. Choon Wang, „A Hybrid Approach to Efficiency Measurement with Empirical Illustrations from Education and Health”, World Bank, Policy Research Working Paper 5751.

Figure 5. Relation between Level of Expenses per Student and Average PISA Scores in 2009



Source: OECD, World Bank - World Development Indicators

Besides analysing the gap in absolute numbers between the expenses/student in the Republic of Moldova and the best-performing countries, as a result of the difference in the economic potential, it is worth analysing the efficiency of the current allocations. Due to the fact that the financing gap per student is not expected to narrow in the near future, the Republic of Moldova should maximize the efficiency of each leu allocated to the education sector. Therefore, the comparative analysis based on the DEA method for 15 countries from the East Europe and Central Asia shows that efficiency level of public money allocated in the educational sector on the Republic of Moldova is about 70%.⁸ Thus, if the expense efficiency increased, then the 2010 score might have been achieved with only USD 51.6 per student, rather than the actual USD 73.2 per student. The results show the opportunities of a more qualitative use of public money in the education sector, in order to achieve an efficiency level equivalent with the countries in the region.

Public Finance from the Perspective of Political Economy

One of the main public finance problems in Moldova is the perpetuation of the discretionary and pro-cyclical tax policy. The adjustment of the regulatory framework initiated in recent years, at the insistence of foreign donors, has not changed radically the situation. The adoption of the new Law, with certain tax rules that are not so optimal for disciplining public authorities, as well as perpetuation of the responsibilities of public institutions already involved in the public finance management, obviously will not help to change the current model of tax policy. The quality of public finance in Moldova will increase only if the institutional framework is reformatted, by establishing the Tax Council, reformulating the tax rules and increasing the transparency of the decision-making.

Short-Term Challenges and Forecasts

- Most likely, the 2015 budget will be drawn based on more austere principles, as a measure to offset the more relaxed tax policy of 2014. Thus, the oscillation of tax policy depending on electoral cycles undermines the stabilization of public finance in the medium-term and the credibility of tax rules.
- The dynamics of tax collection reflected by structural budget balance shows a narrow tax base, which is susceptible to economic fluctuations. Thus, the economic slowdown in the near future will worsen the situation, leading to lower growth rates of tax revenues. This problem is aggravated by the high share of the informal economy: the most conservative estimates suggest

⁸ DEA (Data Envelopment Analysis) is a nonparametric method used to establish the efficiency frontier, in our case it is established based on only one input (financing) and one output (PISA).



that about 30% of the Moldovan economy is informal, which implies direct opportunity costs of about MDL 9.0-10.0 million as uncollected taxes⁹.

- The budgetary stabilisation will continue largely to depend on the availability of the external financing sources. In the medium-term, with the expected decrease in financing sources, the government will have to follow new tax rules and to search for new financing sources.

Policy Recommendations

- Budgetary discipline will depend on the implementation of new Law on Public Finance and Tax and Budgetary Accountability. At the same time, a set of measures to enhance the institutional and regulatory framework is necessary. Thus, considering the positive and negative experience with adherence to tax rules, for the Republic of Moldova it is crucial to set a flexible and transparent mechanism at the macroeconomic level. The establishment of a Tax Council, in charge of calculating the main macroeconomic and financing indicators, including the potential budget balance - as an optimal indicator of tax discipline, will contribute significantly to the achievement of a sustainable and effective budgetary system, able to minimize the economic fluctuation and to increase the efficiency of public money use.
- Considering that the eventual budget balance during 2005-2014 constituted about -2% of GDP, a new tax rule can be recommended for the Republic of Moldova (amendment to the Law on Public Finance and Tax and Budgetary Accountability). It can consist of an annual structural balance of $-2\% \pm 0.25\%$ of GDP for the next two budgetary cycles, with a subsequent reduction by 0.5 p.p. during each next cycle, until the long-term objective of $0\% \pm 0.25\%$ of GDP is achieved. Implementation of this rule will require a reformatting of the tax and budgetary institutional framework, according to the recommendation from the previous section.
- Public finance sustainability will depend largely on decreasing the dependence of external financing sources and the negative budget balances. In this regard, it is very important to work on the enlargement of the tax base and narrowing of the tax gap, by optimizing the institutional and policy framework (mainly the tax framework). Improvement of the business environment will play a crucial role and will increase the number of taxpayers, both newly established and those who legalized their previously shadow activity. A major progress in several areas is needed, ranging from the reform of the judiciary system to the financial-banking system.

⁹ „Fiscal Discrepancy – An Invisible Reality”, EXPERT-GRUP, 2014

Chapter 4. Labour Market

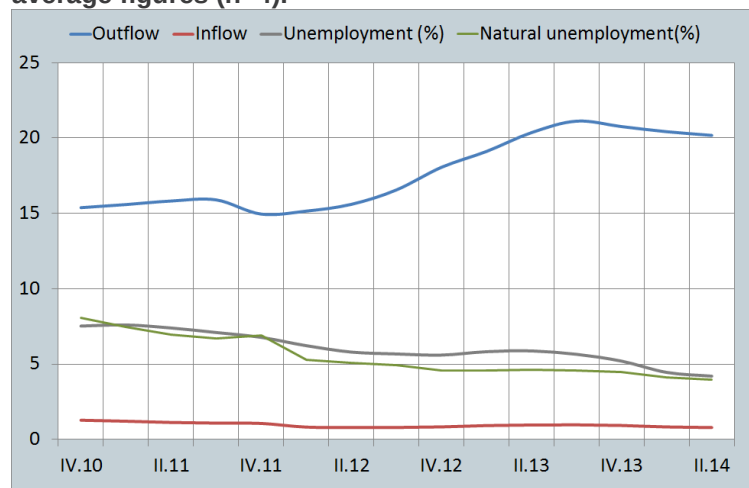
The labour market in Moldova continued its positive dynamics. At the same time, a more in-depth analysis of flows, as well as of the inter-sectorial distribution of the labour force underlines the issues that discourage the qualitative growth in the medium and long term. This result is mainly due to the increasing vulnerability of the current economic growth model and of the slow structural adjustment in the past decade.

Labour Market - Progress at the Cost of Quality?

In Q2:14 the situation on the labour market continued to improve, as compared to the same period of the previous year. It was precisely unemployment that reached 3.7% versus 4.7% y-o-y, while the employment rate increased by 1.7 p.p. during the same period up to 42.8%. The share of economically active population increased by 3.1%, while that of the inactive one decreased by 1.4%. Thus, the relatively robust economic growth in the recent period contributed to a wider use of the labour factor in the national economy.

In terms of flows, the unemployment in the national economy is influenced mainly by the outflow from unemployment, i.e. by the number of newly created jobs¹⁰. Figure 6 reveals that the job creation rate and the probability to be employed began to grow from mid- 2012 and reached maximal values in Q3:13. As of Q4:13, however, the outflow rate started to decrease and accelerated in the first 2 quarters of the current year. Hence, the national economy stopped generating enough jobs. At the same time, we can notice the convergence of the unemployment rate to its equilibrium level. Thus, in the recent years the difference between these two rates has oscillated between 0.5% and 1%, and in Q2:14 it decreased down to 0.2% and registered a convergence of five consecutive quarters.

Figure 6. Dynamics of inflows into and outflows from unemployment, of the equilibrium unemployment rate and of the actually registered one (%), mobile average figures (n=4).



Source: Expert-Grup calculations based on NBS and NEA data

Besides the quantitative aspect of labour use, it is also critical to analyse the qualitative part. Using the Shapley methodology on the breakdown of the y-o-y GVA growth from the labour market perspective, we identify the impact of labour productivity growth, dynamics of the economically active

¹⁰ The monthly data on the number of registered unemployed and the newly created jobs were taken from NEA, this agency being the only source of centralized statistical data in the Republic of Moldova. These data were adjusted by taking into account the ratio between the number of registered unemployed by NEA and by NBS, the unemployment data delivered by the latter being regarded as more relevant.



population and inter-sector distribution of the employed population.¹¹ Thus, this approach allows identifying the basic drivers for economic growth from the perspective of use of labour.

Cumulatively, the use of labour during the current year had a positive contribution to the economic growth. However, according to some efficiency indicators, there were certain contradictory trends. Table 2 shows clearly that the gross value added (GVA) per capita increased in Q2:14 y-o-y by MDL 490.63 (i.e. by 4.7%) in real terms, of which the demographic component and the increase in the number of economically active population contributed with MDL 10.03. Labour productivity and the increase in the number of employed population contributed positively to the economic growth, while the effect of inter-sectorial redistribution was negative. This is primarily due to the significant increase in the number of population employed in the agricultural sector and the decrease in other sectors with higher productivity, such as industry, transport and communication. Thus, the labour force was redistributed from the efficient sectors to the less efficient ones, causing a total loss of MDL -385.35 per capita (had the structure of employment per sectors not changed as compared to the one in 2013, or had the share of employment in the agricultural sector not diminished, the aforementioned figure would have been positive).

The sectorial analysis of the labour contribution to the economic growth reveals the strong influence of the extensive growth factor, this process being the most visible in the agricultural sector. Thus, the agricultural sector developed due to the increasing number of the population employed in this sector, while labour productivity decreased and opportunity costs for using labour force increased. However, thanks to the share of agricultural sector in GVA and employment, the final effect was positive - about MDL 170 per capita. Public sector was another sector with negative trends, as the effect of the increasing number of people employed in this sector could not offset the decrease of labour productivity. Thus, the cumulative result of the use of labour in the public sector was of MDL -11.88 per capita. At the same time, the branches showing the highest labour productivity - such as industry, transport and communication (these are the two most productive ones in 2014, reaching about MDL 47 thousand/employee in the first one and about MDL 74 thousand/employee in the other) registered losses in the number of employees.

Table 2. Contribution to GVA growth per capita in Q2:14 y-o-y (MDL).

Sectorial contributions	Contribution of inter-sectorial dynamics of labour productivity	Contribution of the dynamics of persons employed per sector	Contribution of labour force inter-sectorial distribution	Total
Agriculture	-45.74	460.86	-245.12	170.00
Industry	103.31	-3.03	-28.58	71.70
Construction	39.29	8.94	0.92	49.15
Trade, hotels, restaurants	133.89	-48.34	-2.68	82.87
Transport and communications	85.31	-9.43	-46.80	29.08
Public services	-43.09	28.35	2.86	-11.88
Others	159.33	-3.71	-65.94	89.68
Subtotals	432.29	433.65	-385.35	480.59
The demographic component				10.03
GVA growth per capita				490.63

Source: Expert-Grup calculations based on NBS data

The current economic growth model of the Republic of Moldova is based on extensive and suboptimal use of the labour force, which can not be sustainable in the long run. The recent trends

¹¹ The Shapley methodology was used based on the tool developed by the World Bank. Job Generation and Growth Decomposition Tool, PREM Poverty Reduction Group, WB.



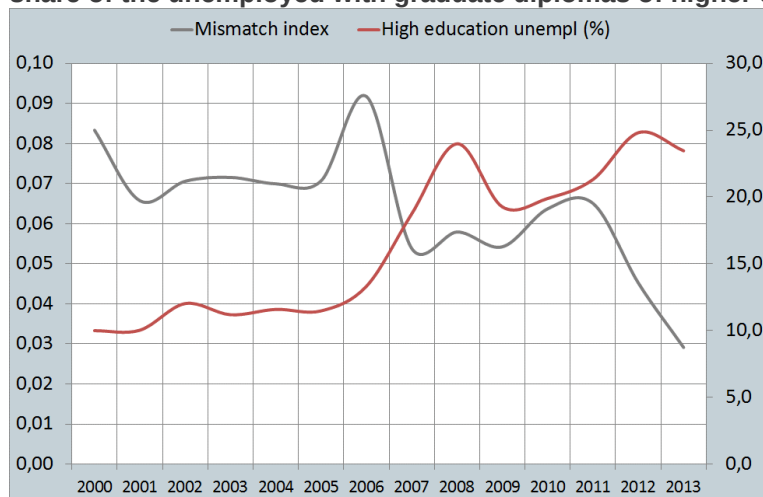
on the labour market underline the inefficiency of structural reforms, which leads to human capital waste and undermine the economic growth. Unless the current economic growth pattern changes - the Republic of Moldova cannot achieve sustainable and high growth rates as well as the convergence to GDP levels in the region.

The Role of the Educational Sector in the Labour Market

The educational system can play an important role in the reconfiguration of the current economic growth pattern starting from the extensive use and ending with the intensive use of the human factor. The situation on the labour market, however, is not favourable from this standpoint either. A major problem resides precisely in the underuse of labour due to the increasing gap between the level of education and the jobs held by a growing number of employees. This qualification gap between labour demand and supply can be quantified using the discrepancy index¹². This index reveals the differences between the groups with different levels of education, receiving the maximum value of 1, when there is a significant asymmetry in the distribution of unemployment per these groups (lack of unemployment for graduates from higher education institutions and highest unemployment for graduates from vocational education). At the same time, the minimum value of the index (zero) indicates that there is no difference in unemployment among different groups of population.

The evolution of the discrepancy index in the Republic of Moldova, shown in Figure 7, reveals that over the last decade the labour market was characterized by an increasing discrepancy between labour demand and supply. To be more precise, the minimal values and the continuous decreasing trend of the given index imply a more uniform distribution of unemployment per levels of education. However, it is alarming that the higher education group was the main group that underwent redistribution. Thus, the share of the university-educated unemployed continued to increase and since 2012 it registers the highest share of unemployed: about 24-25% of the unemployed have diplomas of higher education.

Figure 7. The discrepancy coefficient dynamics (left axis) and the dynamics of the share of the unemployed with graduate diplomas of higher education (right axis).



Source: Expert-Grup calculations based on NBS data

The discrepancy index is distributed unevenly among different segments of the labour market as far as the level of education is concerned. Thus, the tertiary education system, along with the impressive increase in the share of enrolled students turns into the greatest supplier of unemployed on the labour market. This is why it is critically important to continue the reforms in the education system (quality, quantity and adjustment to the economic requirements) and to change the focus from lower

¹² The discrepancy index is defined by the formula: $IN = \frac{1}{2} \sum_{i=1}^6 ABS(\frac{E_i}{E} - \frac{U_i}{U})$, where i stands for the level of education (in the case of the Republic of Moldova, the following different levels were considered - high, specialized secondary, vocational secondary, high school/upper secondary, lower secondary, primary/no education), ABS is the term designating the absolute difference, E_i/E is the share of the employed who have the level of education i , while U_i/U is the share of the unemployed having the levels of education i .



levels to higher education institutions. The labour market risks to turn into a market with “overqualified” unemployed if the situation doesn’t change.

Short-term Challenges and Forecasts

- Deceleration of the national economy will contribute to the decrease of the job creation rate, which could undermine the positive trends in unemployment rate from the recent years. This trend became visible since Q3:13 and gained velocity during the first quarters of the current year, which, most probably, will last until the end of the year.
- A challenge for the labour market in particular and for the economic growth in general, is the perpetuation of the current pattern of the use of labour. To be more precise, the growth based on the extensive use of labour rather than on a higher labour productivity and/or inter-sectorial redistribution towards higher productivity sectors cannot be sustainable by definition.
- In terms of the optimal use of labour, another constraint for the Moldovan economy is the increase in the discrepancy between qualification demand and supply. The lack of investments in the sectors that require qualified labour and the discrepancy between the knowledge acquired and the knowledge effectively demanded by employers will contribute to the maintenance of the current trends of human capital underutilization.

Policy Recommendations

The efficiency of human capital utilization plays a crucial role for increasing the competitiveness of the Moldovan economy. The economic progress depends to a great extent on how and where the labour force is used on the national scale. Thus, we need a set of measures and policies which could generate structural changes in this field:

- In terms of labour demand, it is important to prioritize and attract investments (foreign and domestic) in the economic sectors that are characterized by the best performance, as well as to strengthen the creation of decent jobs, which are able to generate higher added value. The country’s business environment plays a crucial role in this respect, affecting the investors’ decisions to come to Moldova.
- The same business environment, as well as the institutional quality influences the informal employment level in the national economy. It is virtually impossible to talk about progress in this area unless a relation based on trust is established between the public authorities and the business environment and unless the tax and normative burden is optimized.
- The increasing qualification gap on the labour market can be overcome by changing the structure of labour supply. The education sector plays the main role in this respect, which could be aligned to the market demand by changing the curriculum and establishing a closer cooperation with business entities. Considering the above-mentioned trends, it is of critical importance to accelerate the implementation of reforms in the tertiary education system. At the same time, progress in this area depends also on the results obtained after the reformation of other education levels, as this issue requires a systemic approach.

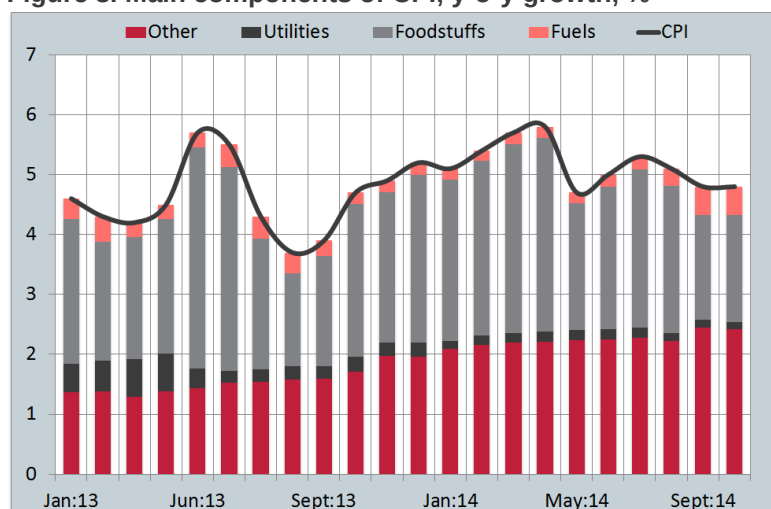
Chapter 5. Prices and Monetary Policy

The inflationary environment remained stable, while the inflationary pressures generated by the depreciation of the national currency were offset by other trends with disinflationary impact (slowdown in domestic consumption and overall economic growth, trade restrictions imposed by the Russian Federation, higher supply of agricultural production etc.). As a result, the inflation level remained close to NBM target of 5% (+/- 1.5 p.p.). This allowed the central bank to maintain an accommodative monetary policy in order to stimulate lending and respectively, consumption, investments and economic growth. At the same time, to avoid excessive exchange rate fluctuations, the central bank intervened periodically on the foreign exchange market.

Overlapping Inflationary and Disinflationary Factors

Inflationary pressures outlined in the first 4 months of 2014 generated by the foodstuffs' prices, decreased significantly in the following months. Moreover, since Aug:14 some disinflationary trends have taken shape, while in Oct:14 the Consumer Price Index (CPI) constituted 4.8% y-o-y, decreasing for the fourth consecutive month. The lower annual inflation was mainly determined by the decreasing growth rates of prices for foodstuffs from 7.3% in Jan:14 or even 8.7% in Apr:14 to 4.8% in Oct:14, y-o-y. This trend is explained by rich crop harvested this year, coupled with trade restrictions imposed by the Russian Federation, which increased the domestic supply of fruit and vegetables. The reduction of global prices for agrifood products also contributed to the deceleration of the growth rates of the domestic prices for these products: since Apr:14, FAO Food Price Index¹³ constantly decreased from 211.5 points to 192.3 points in Oct:14. Thus, compared with the beginning of the year, the prices for onion, potatoes, cucumbers, carrots, eggs, grapes, tomatoes and sugar decreased on an annual basis (the prices for these products were much lower in Oct:14, than in the same period last year).

Figure 8. Main components of CPI, y-o-y growth, %



Source: EXPERT-GRUP calculations based on NBS data

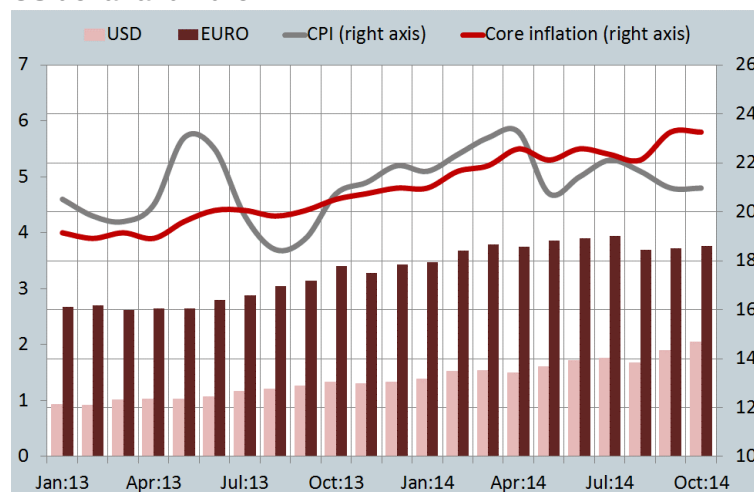
Figure 8 also reflects the growing importance of other CPI components (except for utilities, foodstuffs and fuels). This trend can be corroborated with the upward trend of core inflation¹⁴ (Figure 9). Thus, **in the last months the gap between the standard CPI and core inflation has grown**: while the first indicator

¹³ Food and Agriculture Organization of the United Nations

¹⁴ Total CPI, exclusive of foodstuffs and beverages, fuels, regulated goods and services

is much more volatile and is decreasing, the core inflation registered a continuous upward trend during 2013 and 2014. On the background of decreasing domestic demand and economic growth slowdown, this phenomenon can be explained mainly by the depreciation of the national currency (if the correlation index between CPI and the USD/MDL exchange rate is only 0.14 points, then the correlation index¹⁵ between the core inflation and USD/MDL exchange rate is 0.59 points).

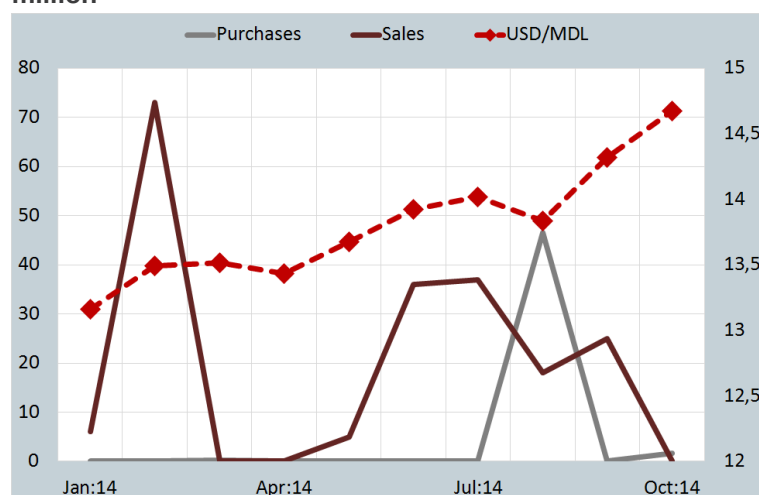
Figure 9. Developments of the Consumer Price Index (CPI) and Core Inflation, %, compared to the official average exchange rates of the national currency against US dollar and Euro



Source: NBM

Thus, *the inflationary environment was influenced by some diametrically opposed factors, as reflected by the increasing gap between standard CPI and core inflation*. The disinflationary trends in 2014 were fostered by the rich harvest, trade restrictions imposed by the Russian Federation, reduction of the global prices for foodstuffs, depreciation of the currency of Moldova's major trade partners, lower domestic demand and economic growth slowdown. These trends enabled the National Bank of Moldova (NBM) to allow a controlled depreciation of the national currency (Figure 10).

Figure 10. Sales and Procurements of Foreign Currency by NBM, equivalent in USD million



Source: NBM

During 2014, NBM intervened periodically on the foreign exchange market through net sales of foreign currency in order to mitigate the depreciation pressures on the national currency and to

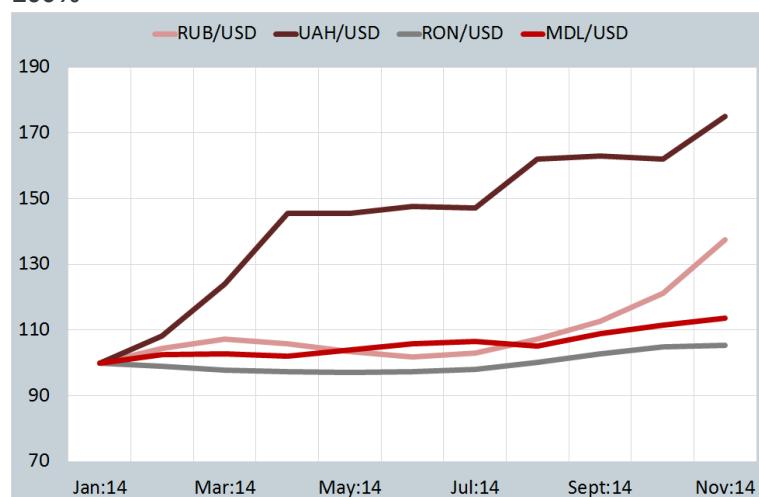
¹⁵ The correlation index was calculated for a time series with monthly frequency, for 2013-2014 (October).



avoid excessive exchange rate fluctuations. Thus, during Jan-Oct:14, the Central Bank sold on the interbank market the equivalent of USD 200 million, while purchased only USD 48.8 million. However, besides avoiding excessive exchange rate fluctuations, the foreign exchange policy applied by NBM, apparently, pursued monetary policy objectives as well, given that the traditional monetary policy tools (e.g. base rate) are less efficient amid crises. Thus, the disinflationary trends, along with the decreasing exports and consumption, determined central bank to allow a sharper depreciation of the national currency. Therefore, in the second half of this year, NBM gradually reduced the sales of foreign currency, and in Aug:14 NBM even purchased foreign currency, which allowed a more pronounced depreciation of the Moldovan leu against the US dollar.

During Jan-Oct:14, the exchange rate of the national currency against the US dollar depreciated by 14%. Although worrying, this trend followed the regional trends: in the same period, the Ukrainian hryvna depreciated by 75%, the Russian rouble - by 38%, the Belarus rouble - by 12.5%, and the Romanian leu - by 5.4%. This served as an additional ground to allow a gradual depreciation of the Moldovan leu during this period of time (Figure 11). Moreover, despite this depreciation, the real effective exchange rate of the Moldovan leu, in fact, appreciated by 2,3% in Q3:14 compared to Q2:14.

Figure 11. Developments of the Average Monthly Rate of the National Currencies of the Republic of Moldova, Romania, Ukraine, and the Russian Federation, Jan:14 = 100%



Source: authors' calculations based on the data from Central Banks of the analyzed countries

Short and Medium Term Challenges and Forecasts

- By the end of 2014 and 2015, the inflation will remain within the NBM target of 5% (+/- 1.5 p.p.) due to the mild domestic and foreign demand and the fact that the economy will remain below its potential level. Disinflationary pressures will be also determined by additional factors: lower prices for fuels and foodstuffs in the region, maintenance of trade restrictions on exports to the Russian Federation, depreciation of the Russian rouble, and, respectively, lower purchasing power for families who have relatives working in Russia.
- However, additional inflationary pressures are emerging, which are fuelled by the national currency depreciation and, as a result, the possible upwards adjustment of prices for utilities. In the next 6-12 months, the depreciation pressures on the national currency will persist given the trade restrictions imposed by the Russian Federation, easy monetary and foreign exchange policy, and the depreciation of the national currencies in the region (especially, of the Russian rouble and the Ukrainian hryvna). In medium and long run, the exchange rate stabilisation will depend on local producers' capacity to harness the export and investment opportunities of the EU Association Agreement, as well as to reorient towards alternative export markets.



Policy Recommendations

- The use of foreign exchange policy for the purposes of monetary policy is motivated in cases of economic growth slowdown and uncertainty, when the traditional tools of monetary policy have very slow transmission effects. Hence, the controlled depreciation of the national currency in the context of disinflationary pressures and exports reduction is justified in the short run. Nevertheless, the central must focus on the strategic objective of increasing the efficiency of the basic monetary policy tools (notably, the refinancing rate).
- The key measures aimed at increasing the efficiency of the basic monetary policy tools must be the following: (i) strengthening the institutional independence of the central bank by reducing the possibilities for the Parliament or Government to interfere; (ii) enhancing the internal governance of the institution; (iii) improving the banking oversight; and (iv) intensifying the communication between NBM and business environment and civil society. This will increase the companies' and society' confidence in the institution, which should be the top priority for NBM.
- While being influenced by the economic growth slowdown, decreasing inflows of foreign currency and fluctuations on foreign markets, the excessive volatility of the national currency during 2014 posed serious reasons for concern. Taking into account the limited market size amid a number of large companies that could easily influence the exchange rate, the central bank should interfere much more actively in preventing and penalizing the speculative attacks on the national currency. Particularly, it should: (i) coordinate with the largest exporters and importers about their plans to sell and purchase significant amounts of foreign currency; (ii) intensify its prevention measures against the potential speculative attacks, including with the support of other relevant institutions (ex: the Security and Information Service, Competition Council, National Commission of the Financial Market etc.); (iii) strong penalization of the speculative attacks against the national currency.
- Taking into account the fact that the economic growth in 2015 is expected to be slightly better compared to 2014, as well as the inflationary expectations fuelled by the national currency depreciation, the central bank should consider a gradual withdrawal of the acomodative stance of its monetary policy. It could involve an upward adjustment of the policy rate from 3.5% to 5.0%, which is the central bank's inflationary target. This would ensure a more efficient anchoring of inflationary expectations and, at the same time, would create additional room for policy manoeuvre for NBM in case of any negative shock.

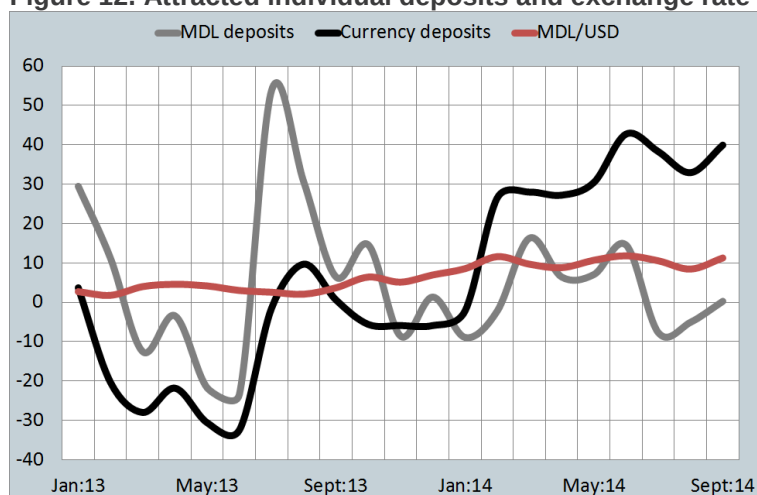
Chapter 6. Banking System

The banking sector registered a contradictory evolution in 2014. Moderation of economic growth and depreciation of the national currency affected the quality of credit portfolio and generated new challenges for the financial institutions. The “corporate wars”, that overlapped with these worrisome trends created significant risks for the stability of the banking sector in the Republic of Moldova.

Recent Developments and Trends in The Banking Sector

Depreciation of the national currency influenced negatively the banking activity. Depreciation of the Moldovan leu has considerably increased the public appetite for keeping savings in foreign currency, the deposits in MDL witnessing a downward trend. Since May:14, the attracted individual term deposits in foreign currency increased by monthly rates higher than 30% y-o-y. On the other hand, the individual term deposits in MDL registered negative growth rates in Q3:14. In this way, in order to protect themselves against the losses caused by the decreasing of the national currency, the population increased the demand for savings in foreign currency.

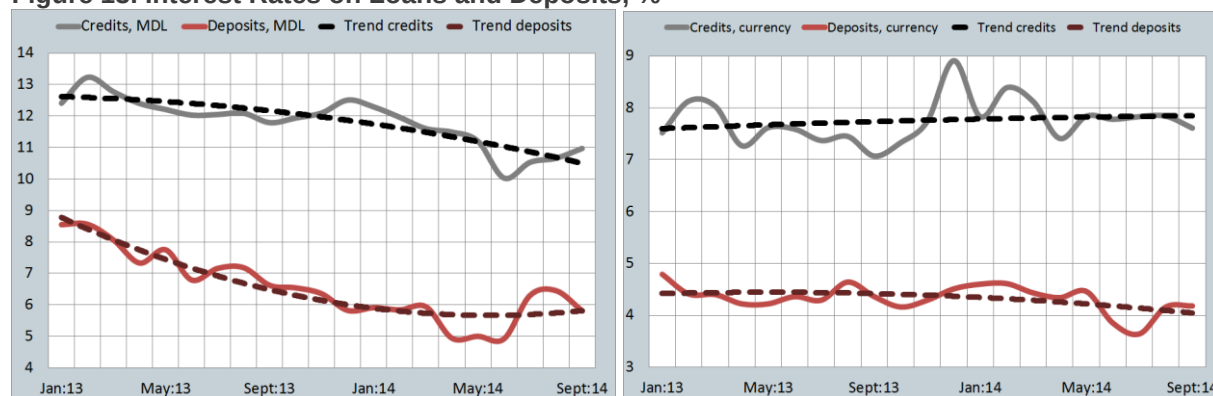
Figure 12. Attracted individual deposits and exchange rate MDL/USD, change y-o-y, %



Source: Expert-Grup calculations based on NBM data

Redistribution of people's savings in favor of foreign currency deposits influenced the interest rates. The poor attractiveness of the deposits in MDL determined banks to adjust their interest rates. Thus, in order to encourage people to keep their savings in domestic currency, the banks have stopped reducing interest rates on deposits in MDL, and from Q2:14 they started to slightly increase. On the other hand, the interest rates on loans in MDL continue to diminish amid a relatively stable inflationary environment. At the same time, increase of resources, due to the growth of individual deposits in foreign currencies, allows the banks to reduce the interest rates on foreign currency deposits. Although, a slight upward trend has been registered, the interest rates on foreign currency loans have seen an oscillatory development and generally, this parameter's values varied between 7-8%.

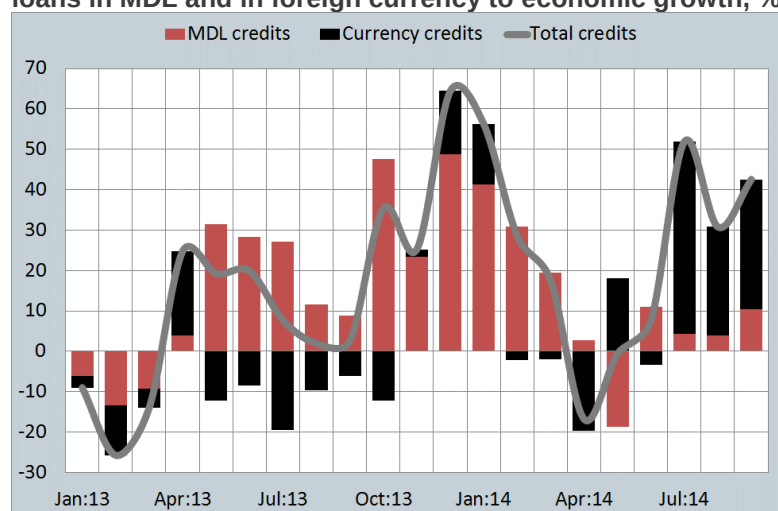
Figure 13. Interest Rates on Loans and Deposits, %



Source: NBM, calculations by Expert-Grup

The growing foreign currency deposits motivated the banks to use more actively these type of resources. Thus, in Q3:14 the loans in foreign currency had the largest contribution to the increase banks' lending activity. On the other hand, the credits granted in MDL after a significant increase in Q1:14, have tempered their growing trends in the next quarters.

Figure 14. The total volume of new loans, change y-o-y, % and, contribution of loans in MDL and in foreign currency to economic growth, %



Source: Expert-Grup calculations based on NBM data

The deterioration in the quality of banks' credit portfolios has been noted due to the slowdown in economic growth and depreciation of the national currency. The non-performing loans accounted for 12.3% of total loans in Sept:14 and increased by about 3.4 p.p. compared to Dec:13. In the case of the Republic of Moldova, changes in the quality of credit portfolio can be generally explained by GDP growth and the exchange rate. Our estimations show that during one quarter the economic growth leads to the decrease of share of loan allowances in total credits¹⁶ by 0.04 p.p., and the previous GDP growth recorded 2 quarters before has a similar influence¹⁷. In Q1-Q3'14, due to the slowdown in GDP growth, the role of economic growth has decreased as a factor influencing the quality of credit portfolio. In Q1:14 the contribution of the economic growth to the formation of the share of loan allowances was -7.2%, and

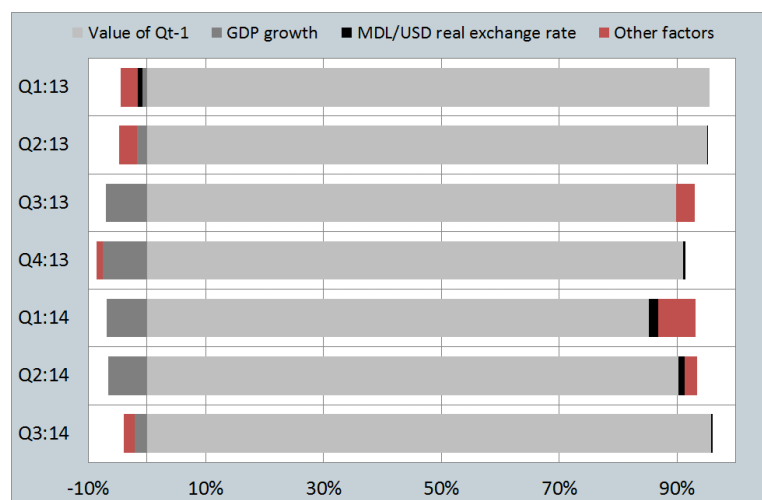
¹⁶ The share of non-performing loans in the stock of loans and loan allowances divided to the loan balance reflects the quality of the loan portfolio. The share of non-performing loans denotes the size of toxic loans. The share of loan allowances is a wider indicator that reflects both the size and the depth of loan portfolio degradation, as it takes into account the loan classification by their exposure to credit risk. Therefore, in the estimations the quality of the loan portfolio was represented by the share of loan allowances.

¹⁷ $X = 1,07^* + 0,92 \cdot X_{t-1}^* - 0,04 \cdot Y^* - 0,04 \cdot Y_{t-2}^* + 0,05 \cdot E^* - 0,04 \cdot E_{t-1}^{**}$, where: X - share of loan allowances; Y - GDP changes, E - changes in the real exchange rate MDL/USD. The statistical criteria characterizing this relation are the following: $R^2 = 0,94$; $DW = 1,98$, where * and ** denote the statistical relevance of the variable for $p < 0,05$ and $p < 0,1$.



in Q3:14 the role of GDP growth dropped to -2%. The depreciation of MDL against USD has lowered the quality of credit portfolio, but this effect diminished over time. In Q1:14 the contribution of the depreciation of MDL to the formation of the share of loan allowances was 1.6%, and in Q3:14 this influence constituted 0.4%. The formation of the share of loan allowances is impacted mainly by the previous evolution of this variable, in particular its level in the previous quarter.

Figure 15. The percentage contribution of the determinants to the formation of the share of loan allowances in total loans



Source: Expert-Grup calculations based on data from NBM, NBS <http://www.bls.gov/cpi/>

Besides the slowdown in economic growth and national currency depreciation, worsening of credit portfolio quality was determined by a set of non-trivial factors, whose role has increased in 2014. The contribution of these factors to the increase in the share of loan allowances was 6.5% in Q1:14 and 2.2% in Q2:14. These factors include various variables, which could not be quantified in the our model. Most likely, the shadow movements and “corporate wars” in the banking sector were the basic component associated with the effect produced by these factors on lowering the quality of bank assets. This assumption is supported by at least two findings. The banks that were and are subject to “hostile takeovers” are currently registering a more rapid deterioration of assets. The purpose of hostile takeovers is related to gaining control over the property and its use for purposes often inconsistent with financial stability. Besides, the “corporate wars” create blockages in the activity of banks, affecting thus the institutions’ performance. Certain banks, even after receiving clear signs of situation worsening, did not take remedial action or acted too late. This induces the idea of “intended disinterest” of the financial institutions’ management to normalize the situation of the banks.

The worsening of loan portfolios decreased the level of banks’ capitalization and poses risks for the sector stability. The increase in the balance of non-performing loans by 19% in Sept:14 compared to Dec:13 led to higher accrued allowances of assets losses and conditional commitments by 18.5% in the same reference period. Due to the rapid increase in the allowances for loan losses and conditional commitments, the level of calculated, but non-reserved allowances for loan losses and conditional commitments increased by 26.2%. It negatively affected the total regulatory capital, which increased by only 3.1% in Sept:14 against Dec:13. At the same time, the risk weighted assets increased by 19.8%. As a result, the risk weighted capital adequacy was 19.8% in Sept:14 and dropped by 3.3 p.p. compared to Dec:13.

Short-term Challenges and Forecasts

- Further fast-paced depreciation of the national currency can have negative effects on the banking sector. Although, in the long-run the depreciation has both positive and negative effects on non-performing loans, the net effect of MDL depreciation is unfavorable to the quality of banks’



assets¹⁸. Given that 40% of loans are in foreign currency, a faster depreciation of the national currency could impact significantly the quality of bank loans and would challenge the sector's stability. The reason is that the significant depreciation of MDL already creates and will continue to generate difficulties for many debtors in the repayment of their foreign currency loans. On the other hand, further weakening of the national currency will make people reorient their savings in foreign currency deposits and, as a result, the dollarization of banking resources will increase. Such an evolution significantly undermines the monetary policy efficiency and, hence, makes much more difficult for the central bank to ensure a long-term inflation stability. Moreover, the fact that people give up on placing their savings in domestic currency deposits will increase the cost of national currency resources. Under such circumstances, the banks will have to provide loans at higher interest rates to the Government and this could affect even the budgetary balance.

- The difficulties generated by the ban on the exports to the Russian Federation market, which affects the agrifood sector, will have a negative impact on the commercial banks, as the affected companies will face difficulties in repaying the bank loans.
- Though legislative changes have been introduced to diminish the exposure of the banking system to risks associated with fraudulent transaction, this sector continues to be the "fighting arena" for corporate riders. At the same time, a number of banks are using their assets in an inefficient and even non-prudential manner, impacting thus the sector's stability. IMF clearly states that three banks, whose joint assets account for about 28% of the banking sector's total assets could be affiliated and have a high exposure among themselves and to some financial institutions from Russia.¹⁹

Policy Recommendations

- Depreciation has complex and multilateral effects. Therefore, with the depreciation of the foreign currency of relevant trading partners, the weakening of national currency was a timely evolution that protected the competitiveness of domestic products. However, a quicker depreciation could have negative effects on the quality of banking property, considering that 40% of total loans are in foreign currency. In this context, the NBM should pay greater attention to this aspect when deciding on the promoted foreign exchange policy.
- The fight for influence in the banking system and the shadow transactions have become the chronic diseases of the national financial sector. This is followed by the intentional inefficient use of financial assets, which damages the banking stability. Passive public institutions and corrupt justice represent a favorable environment for fraudulent operations and non-prudential use of assets. In this context, it is necessary to change the approach to monitoring and supervision of the financial sector. The reluctance of public institutions might turn into large social costs. The relevant institutions need to have a more severe attitude towards the banks which adventure themselves into economically unjustified transactions and towards persons who perform or are accomplice to fraudulent operations. Also, a genuine reform of the justice sector and public institutions is crucially important and this process should be achieved as soon as possible.

¹⁸The increase in the share of loan allowances by 0.05 p.p. caused by the current depreciation, is higher than the decrease by 0.04 p.p. of the share of loan allowances, driven by the MDL cheapening in the previous quarter.

¹⁹ Republic of Moldova - IMF Staff Reports, IMF Country Report No. 14/190, July 2014, p. 8

Chapter 7. Foreign Sector

Signature and ratification of the Association Agreement (AA) with the EU, which involves the establishment of a Deep and Comprehensive Free Trade Area between Moldova and EU, was the main achievement of Moldova, in the foreign sector. At the same time, in order to penalize the Republic of Moldova for the ratification of AA with EU, Kremlin imposed tariff barriers and restricted the import of some product categories from the Republic of Moldova. This was complemented by the volatile economic context (especially in CIS region), which affected negatively the foreign demand for Moldovan products. In the medium-term, the main external risks for the Republic of Moldova will still come from the Eastern market.

Recent Developments and Trends in the Foreign Sector

The foreign trade was disrupted by a series of trade barriers imposed by the Russian Federation.

The restrictions for the import of Moldovan products were imposed in several stages. The import of wine was banned in autumn 2013; in summer 2014 the Russian Federation decided to impose customs duties for some of the Moldovan products and prohibited the import of fruits, and in autumn 2014 the import of pork products was banned. The prohibitions on the exports of wine, fruit and pork products were motivated by the non-compliance with the Russian standards. Due to the lack of a modern quality control system in the Republic of Moldova, it is not excluded that the exported products did not meet the Russian phytosanitary standards. However, the imposition of these restrictions on the eve of Parliamentary elections and in the context of EU Association Agreement points on a clear political origin of these measures.

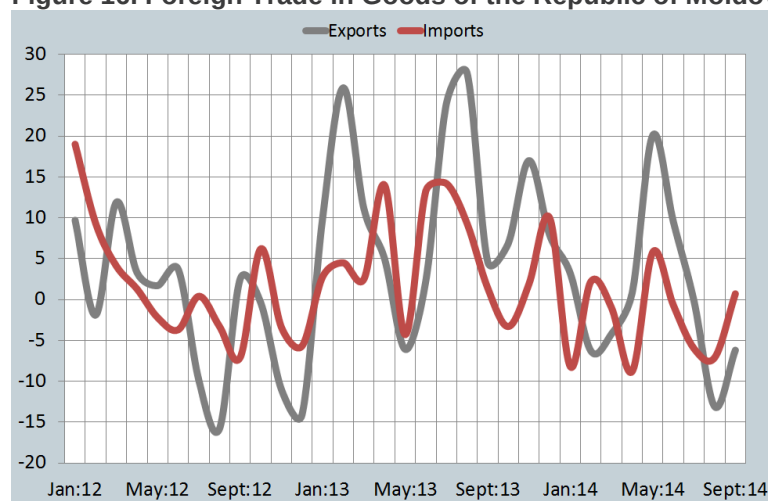
The custom duties imposed by the Russian Federation for some products exported by the Republic of Moldova is explained by the Russian side by 2 arguments, which, however, are unfounded. The first argument is referring to the need to protect the Russian market from a potential „explosion” of imports. The increase of imports would be determined by the increase of re-export from Republic of Moldova of the products from the EU or could be caused by market “invasion” with Moldovan products, which could not withstand the competition with the EU goods on the domestic market. The second argument invoked by Moscow authorities is referring to the so-called Russian “response”: after signing the AA, the Republic of Moldova created a non-tariff barrier in the interstate trade by taking over and implementing some higher quality standards, specific for EU. However, both sets of arguments are unfounded and the customs duties were imposed in contradiction with the Free Trade Agreement with CIS, which the Republic of Moldova and Russia are parties to. This agreement lays down the procedures for protection measures implementation and dispute settlement. According to the Agreement, in case of a product, protective customs duties may be imposed if 3 conditions are met simultaneously: the country from which the products are imported has been among the five largest suppliers during the last three years, the import from the country of origin have grown faster than the imports from other countries during the last three years and the import price is lower than the domestic prices from the importing country. None of the products originating from the Republic of Moldova met simultaneously these three conditions. In case of re-exported products, customs duties are imposed in accordance with trade regime established between the importing country and the products’ country of origin. Thus, in case of EU goods reaching the Russian market through export or re-export, Russia applies the trade regime, including customs duties, established with EU. Concurrently, the Republic of Moldova did not implement any crucial reforms for quality infrastructure modernization and did not implement standards specific for EU.

Thus, so far the establishment of DCFTA between the Republic of Moldova and EU has not affected any country. Moreover, the Agreement provides that the problems that affect significantly the economy of a member state of the CIS free trade area, which appeared as a result of another member

state joining another integration structure, shall be settled through consultations. Respectively, the restrictions imposed unilaterally by the Russian Federation contradict these provisions and confirm their political nature.

Unfavorable external conditions caused stagnation of exports and reduction of imports. During Q1-Q3'14 the value of exports did not exceed the level recorded in the same period of 2013; on the contrary, the dynamic was negative (-0.2%). This was caused by the decrease recorded in Q3'14, when the Russian Federation restricted the imports of Moldovan fruits. On the other hand, the import had a clear downward trend, with some deviations in Q1-Q3'14 it decreased by 2.6% y-o-y.

Figure 16. Foreign Trade in Goods of the Republic of Moldova, y-o-y change, %

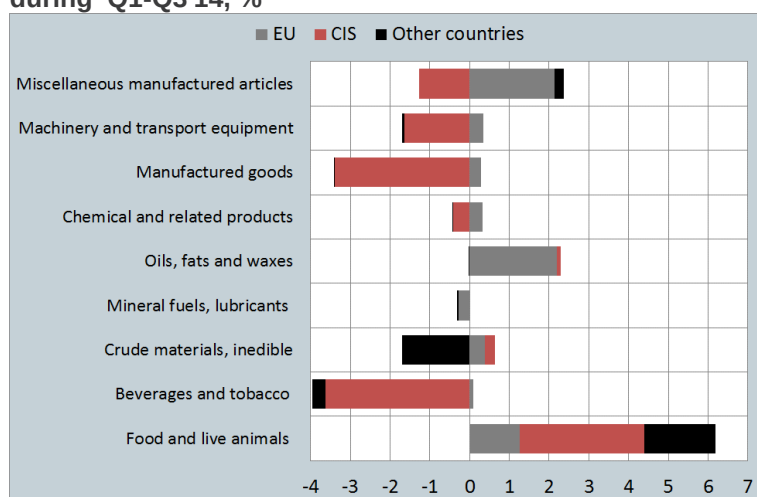


Source: EXPERT-GRUP calculations based on NBS data

The supplies to the CIS region had a negative contribution to total exports, while the sales on the EU market have counterbalanced these losses. Due to Ukraine recession and trade restrictions imposed by Russia, the exports to CIS region had a negative contribution to the export growth rate. Thus, during Q1-Q3'14 the export to CIS decreased by 17.3%, contributing with -6.9% to export modification. At the same time, the export to EU increased by 14.9% y-o-y, contributing with 6.8% to the export evolution. The export to other states decreased by 0.7% y-o-y, with a contribution of -0.1% to export modification.

Exports of food and live animals, oils and fats and different manufactured items increased, while the deliveries of other categories of goods to the foreign markets decreased. Despite of the lower exports of fruit and vegetables (by 4.1% y-o-y), in Q1-Q3'14 the exports of foodstuff increased by 32.3 y-o-y. Note that during Q1-Q3'14 the export of this product category increased by 15.3% in the EU and by 45.4% in the CIS. Moreover, namely the exports of food and live animals contributed mostly to the export growth in the first 9 months of 2014, with a contribution of 6.2%. The export of beverage and tobacco was impacted by the embargo and decreased by 31.7% y-o-y, contributing with 3.9% to the overall export decline. The manufactured goods was another product category that negatively influenced the exports. This product category decreased by 28.1% y-o-y and the level of influence on the evolution of the export was of -3.1%.

Figure 17. Influence of Various Group of Exported Products to Export Modification during Q1-Q3'14, %



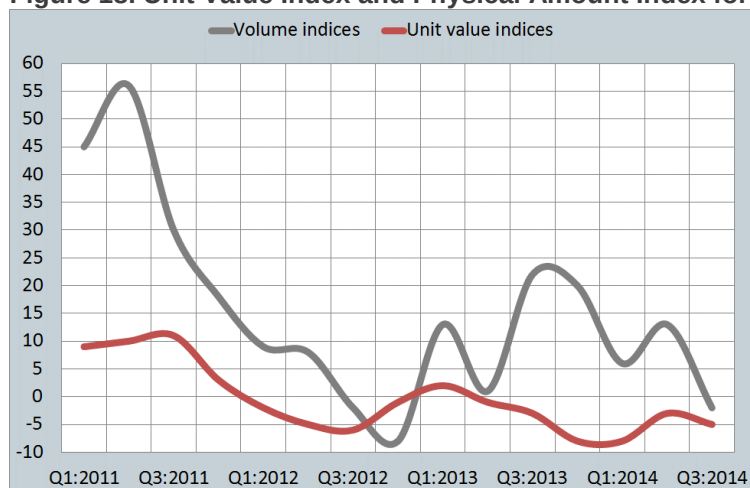
Source: EXPERT-GRUP calculations based on NBS data

In the recent years, including in Q1-Q3'14, the exports grew due to the increase in the physical amount of exported goods, while the prices of the exported products are decreasing. During the first three quarters of 2014, the physical amount of the exported goods increased by 5.5% y-o-y, while the unit value of the exported products (an indicator that to a certain extent reflects the prices of products supplied abroad) decreased by 5.4% y-o-y. This trend reflects a deficiency of the national economy. Due to the weak storage infrastructure, exporters of agricultural products are forced to sell their goods in a short period of time in order not to spoil them. Often these transactions occur when international prices are low. In this context, the agricultural exporters are constrained, have no spaces for storage and cannot sell goods in the period when prices are more attractive.

The imports also decreased due to the reduction of imports from the CIS region. During Q1-Q3'14 the import from CIS decreased by 14% y-o-y, while the import for other countries shrank by 7.4% y-o-y. At the same time, the import from EU increased by 7.7% y-o-y, but this increase could not offset the lower imports from the CIS region and other countries. Fuels had the largest contribution to the decrease of imports. The import of this product group decreased by 8.2% y-o-y during Q1-Q3'14, influencing the import evolution by -1.8%. Vehicles and transport equipment had the secondary contribution to the import reduction. The import of this product category decreased by 3.3% y-o-y, influencing the modification of import by -0.7%.

Depreciation of the national currency was a major cause for imports reduction. The real depreciation of the national currency against USD by 1% led to the reduction of imported goods by 0.3%²⁰. Since the beginning of the year, the real depreciation of the national currency contributed to the reduction of import by about one per-cent.

²⁰ $\ln(M - \ln M_{t-4}) = -0.37^{**} + 0.59 \cdot (\ln R - \ln R_{t-4}) - 0.3 \cdot (\ln E - \ln E_{t-4}) + 0.36 \cdot D(Q4:04) - 0.21 \cdot D(Q1:11)^*$, where: M - import of goods expressed in MDL, R - remittances expressed in MDL, E - real exchange rate, D - dummy variable, and the base year is 2005. The statistical criteria characterizing this regression are the following: $R^2=0.61$, $DW=1.36$, where * and ** denote the statistical relevance of the variable for $p < 0.05$ and $p < 0.1$.

Figure 18. Unit Value Index and Physical Amount Index for the Exported Goods, y-o-y change, %

Source: Expert-Grup calculations based on NBS data

Short-Term Challenges and Forecasts

- The economic growth slowdown leads Russia to a stagnation phase or even recession. Thus, for 2014 it is expected that the Russia's GDP will grow insignificantly by only 0.2²¹%. Besides the imposed sanctions, the capital outflow and low prices of oil, the economic slowdown is caused also by structural factors. The Russian economy is close to its potential, while the extensive factors that used to contribute to the economic growth have been exhausted. It is foreseeable that in the near future the external environment for Russia will be unfavorable: it is anticipated that oil prices will remain low, while sanctions, most likely, will not be canceled. The foreign investments' inflow will be minimal. In this context, the Russian economy development prospects are bleak. The economic slowdown will shrink the labor market and could affect the Moldovan people who work in Russia. In addition, a rougher behavior towards migrant workers cannot be excluded. As a result, we cannot exclude that more migrant workers will return, and the inflow of remittances from Russia will decrease. At the same time, due to the slow recovery of Ukraine, the exports to that destination will not be fostered.
- The EU economic dynamics are positive and could offer real advantages to the Republic of Moldova, above the costs associated with the Russian economic slowdown. Thus, the positive trends will strengthen in EU, and after a 1.4% economic growth forecasted for 2014, the economy could grow by 1.8% in 2015²². The economies of some important partners from EU will grow: in 2014 and 2015 the Romania's GDP will grow at rates close to 2.4% - 2.5%, and in Germany the growth will be the same, with approximately equal rates of 1.4 - 1.5%²³. At the same time, Italy will overcome the economic recession: in 2014, the economy will shrink by 0.2%, and for 2015, a growth of 0.8% is expected²⁴.
- The denunciation of the EU Association Agreement is still an important political theme in the Republic of Moldova. A potential denunciation of the AA could lead to a range of major risks for Republic of Moldova, and the damage could be irreparable. The Republic of Moldova would automatically lose all the trade facilities provided by the EU. Thus, EU would treat the goods from Republic of Moldova as products from third countries and would impose customs duties according to the Most Favored Nation (MFN) clause. In this case, the agricultural and food products would be the most affected items. The MFN tariff in EU is 5.5%, while the MFN tariff for agricultural and food products is 13.2%²⁵. Besides, Moldova could lose all financial support from the EU. However, the biggest concern will be the discontinuation of the country's modernization,

²¹ <http://www.imf.org/>

²² <http://www.imf.org/>

²³ <http://www.imf.org/>

²⁴ <http://www.imf.org/>

²⁵ World Trade Organisation, International Trade Center. [UN Conference on Trade and Development](#), World Tariff Profiles 2014, p.75



as EU is the main anchor of systematic reforms in the country. At the same time, the alternative of the Republic of Moldova joining the Customs Union, proposed by some political parties of the country, is difficult to implement and does not provide any significant advantages. First, adjustment of the customs duties of the Republic of Moldova to the CU would involve a long process of negotiations, both in the WTO and with third countries. On the other hand, the Russian Federation is the locomotive for Customs Union and if its economy is not strong enough, then there is a possibility that the adherence to this union will not allow at least covering the costs generated by AA denunciation. Moreover, even under a favorable external environment for Russia, for Moldova joining the UV would create costs that would outweigh the benefits induced by this process. The economic dimension should be complemented by the political risks that affect negatively the relations with EU and Ukraine and, respectively, political self-isolation of the Republic of Moldova.

Policy Recommendations

In order to minimize the external economic risks, the Republic of Moldova should take the following actions:

- In order to rip the benefits of the AA with EU, Moldova should invest more efforts in the elimination of the non-tariff barriers to trade. In this respect, the following actions are needed: (i) to extend DCFTA coverage over animal products by implementing the recommendations of DG SANCO; (ii) to improve the quality system in order to enhance the products' competitiveness on foreign sales markets; and (iii) to implement and ensure a sustainable system in the area of standardization, metrology and conformity assessment.
- It is necessary to rethink the format of economic relations with the Russian Federation. In this context, the government must provide reliable information to the domestic business environment and support the companies' efforts to diversify their sales markets. The difficulties encountered by the Moldovan companies with their transactions, which are caused by some restrictions imposed by the Russian authorities, cannot be solved by Chisinau authorities. At the same time, the Republic of Moldova must negotiate with the Russian Federation in order to identify some solutions and stabilize the trade relations. The starting point for negotiations is the fact that AA is juridical document which already active, and the attempts to denounce or even to remodel it do not make any sense. A strong argument that Chisinau authorities could use is the one related to the Russia's attempt to align to European quality standards, as well as the crucial interest of Moscow authorities to enhance trade relations with the EU. In this context, the economic cooperation with the Republic of Moldova or with Ukraine, countries that signed AA with EU, can be advantageous for Moscow. Russia could use the Moldovan market as a "bridgehead" that will bring it closer to the EU. A key component of the Moldovan-Russian dialogue must be depoliticization of the economic relations.
- Considering the difficult nature of the relations with the Russian Federation, Chisinau should change its economic orientation in the post-Soviet region. Ukraine and Georgia should become more important economic partners of the Republic of Moldova. The economic characteristics of these countries are identical, so are their development agendas. In this respect, it is appropriate to revitalize the GUAM, or to create another format that will favor the economic cooperation between Georgia, Ukraine and Republic of Moldova.



■ About EXPERT-GRUP

WHO WE ARE

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

OUR ACTIVITIES

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

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

PARTNERS AND DONORS

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