

MEGA: Moldova Economic Growth Analysis

ISSUE NO.8, WINTER 2013

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Chisinau, February 2013

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This publication is produced by the Independent Think-Tank EXPERT-GRUP with the financial support from the Think Tanks Fund of the Open Society Foundations and Konrad Adenauer Foundation. Only authors alone are responsible for the views expressed in this document, which may not be necessarily shared by other organizations, including the donors. EXPERT-GRUP does not take collective positions.

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■ Key policy messages

- External and weather shocks are to be blamed for the economic downturn Moldova suffered in 2012. At the same time, as we warned repeatedly in previous editions of the MEGA, the vulnerability of Moldovan economy to the exogenous factors is magnified many times by domestic weaknesses resulting from unaccomplished structural reforms, immature institutions and policy failures. To mention just one aspect, the fact that in 2012 Moldova lost the competition with other countries in the region in attracting foreign direct investment - and, to put it honestly, was actually on the verge of losing some of the large foreign companies already in the country - has no linkages with economic crisis in Europe and with the severe drought affecting the country. This stands to prove that, by and large, the Government has not been able to address the shortcomings of the national business climate in a systematic way.
- In the recent years, many good reform initiatives have been stalemated in result of not coming from the 'right' political actors, while others hurting the economy are being 'consensually' implemented. The dialogue with private sector - mainly with representatives of the big companies, foreign investors and more organized sectors - is ensured only when it comes to formally defining the policies, but it is almost missing at the more critical stages of policy monitoring and evaluation. As for the small firms, they are not part of a meaningful policy dialogue. It is very important for the Ministry of Economy to initiate a national system of permanent communication and dialogue with private sector, including through district-level and municipal Economic Units, so that the system gives chances to all firms to be part of dialogue, irrespective of their size, location, economic sector and political connections. It is equally important for the Ministry of Economy, Ministry of Finance and Ministry of Agriculture and Food Industry to adopt more advanced tools of consulting public opinion on their policy initiatives, including by a more visible presence in the Internet, creating Facebook accounts, creating discussion forums on their websites etc.
- Suddenly, Moldovan public rediscovers how vulnerable are private companies, especially those conducting 'attractive' businesses, to the high-level political pressures and administrative harassments promoting obscure private interests. While only one such high-profile case emerged recently in the public sphere, there are a higher number of unreported incidents in which Members of Parliament, municipal and local councillors, policemen, prosecutors and other high-ranking officials are using their positions to exert pressure on private entities. At the same time, parallel institutions are competing - instead of collaborating - to attract foreign companies to Moldova.
- The situation of the "Banca de Economii" clearly shows that the state, and especially the Moldovan state, is a bad owner, unable to enforce efficient and transparent management procedures in the public entities. The Bank was - deliberately or by criminal inaction - brought on the brink of failure, which can send shocks across national financial system and create a much worse economic environment scarring national and foreign investors away from Moldova. It is imperative to address the problem of the "Banca de Economii" and of other state-owned companies in the strategically most correct way – by privatising them.
- Poor oversight over spending of public money remains a key cause of Moldovan budgetary problems. An analysis of the Court of Accounts' decisions on regularity of using public resources in 2013 reveals systematic breaches of the financial discipline, dilapidations of public property and even large-scale embezzlements of public money. While this problem is common for many transition countries lacking strong civil society and having weak tools of democratic control, this problem in Moldova seems to be much more significant. The Government and the Parliament – two key institutions called to ensure control on the public money – so far have taken only half-hearted measures in this respect. Ensuring effective fiscal responsibility and harder budgetary constraints across public sector is a key precondition for the country in achieving a more sustainable budget and in using its scarce resources for socially more useful ends.
- A recommendation which we kept mentioning in our publications is of adopting a hands-on rather than theoretical or declarative approach in addressing the behind-the-border barriers to trade. It is particularly important for the Customs Service to take on an institutional mission more in line with trade facilitation and depart from the 'tax collector' philosophy. This is especially important

considering the little chances for a rapid upturn in economic situation in the EU serving as destination for more than half of Moldova's exports. Considering the pressures that will build up again on the current account starting 2014, it would be strategically right for the Government to concentrate on improving as much as possible Moldova's terms of trade. Informal payments and administrative hurdles are only further deepening sufferings of Moldovan companies.

- We do not expect a breakthrough in Moldova's stalemate with Gazprom in 2013. Sorting out all problems, particularly the historical debt of Transnistria, will be difficult. At the same time, considering the technological advancements and the energy trends in the wider region, it is highly advisable for Moldovan government to pursue decoupling of the price of gas imported from Russia from the global prices for oil, while at the same time to ensure investment in the cross-border gas and electricity connections.
- The year 2012 has revealed a new challenge for Moldovan economy, that of losing competitive edge on the Russian market. After Russia joined the WTO Moldovan producers and exporters of fruits and vegetables face more direct competition with third-countries producers (Poland, Turkey), which significantly reduces their margins. Addressing this emerging risk will require measures from both producers and the Government. While the former have to address existing technological and marketing weaknesses undermining their competitiveness, the latter needs to adopt a state program of developing domestic post-harvesting and processing capacities, to provide alternative outlets for the Moldovan producers of vegetables and fruits.
- The year 2012 has been a defining one in terms of change in attitudes regarding the fiscal evasion, informal economy and smuggling. The Government seems more determined in reducing the magnitude of these phenomena. However, it is a strategic fault to aim fighting these vices by using predominantly administrative measures and more frequent and more severe controls. The key emphasis should be on using financial and economic intelligence tools, rather on 'carpet bombing'. Understanding and adopting this perspective requires investing more in human resources and IT technologies and ensuring more transparent and fair court procedures. The former is conditional on the effective reform of the public administration employing better paid human staff, while the second - on the reformed justice sector. As long as the two preconditions are missing, promoting forcefully the reduction of informal economy sounds more like a politically correct statement which is not really binding for the Government.

■ Statistical indicators

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

	2009	2010	2011	2012 estimate	2013 forecast	2014 forecast
Population, million (excludes Transnistria), beginning of the year	3,568	3,564	3,560	3,559	3,558	3,557
GDP, billion MDL, current prices	60,429	71,849	82,174	87,088	94,643	102,356
GDP, billion USD, current prices	5,409	5,810	7,003	6,967	7,571	8,188
GDP per capita, USD at PPP	2,843	3,088	3,373	3,534	3,761	4,006
Real GDP, y-o-y % change	-6.5	6.9	6.4	-0.7	3.5	3.0
GDP deflator, y-o-y % change	2.0	11.2	7.4	6.5	5.0	5.0
Private consumption, y-o-y % change	-7.9	9.0	8.5	1.0	3.0	6.0
Gross fixed capital formation, y-o-y % change	-30.9	17.2	10.7	0.0	5.5	7.0
Industrial production, y-o-y % change	-22.2	7.0	7.4	2.0	4.0	5.0
Agricultural production, y-o-y % change	-9.9	7.9	5.8	-20.0	30.0	1.0
Share of industry in GDP, %	13.0	13.3	13.7	13.5	13.6	13.7
Share of agriculture in GDP, %	8.5	12.0	12.3	9.4	11.9	10.0
Merchandise FOB exports, million USD	1,331.6	1,541.5	2,221.6	2,181.5	2,345.1	2,544.4
Merchandise CIF imports, million USD	3,275.8	3,855.3	5,191.6	5,232.7	5,494.3	5,989.9
Service exports, million USD	673.1	701.2	868.8	896	963.2	1,045.1
Service imports, million USD	712.9	770.9	894.7	979	1028.0	1,120.5
Net foreign direct investment, million USD	138.6	193.9	253.4	n.a.	n.a.	n.a.
Net work remittances, million USD	1,198.6	1,351.4	1,600.4	1,648.0	1,746.9	1,921.6
Current account/GDP, %	-8.6	-7.9	-11.5	-7.6	-7.0	-8.0
Official reserve assets, end-year, million USD	1,480.3	1,717.7	1,965.3	2,515.0	2,892.3	3,326.1
Total external debt stock, million USD	4364.1	4778.7	5,442.61	5,850.0	6,435.0	6,917.0
External debt/GDP, %	80.8	82.2	77.9	84.0	85.0	84.5
Employment rate, % of population aged above 15	40.0	38.5	39.4	38.0-39.0	38.0-39.0	39.0-40.0
Unemployment rate, % of economically active population	6.4	7.4	6.2	5.0	5.5	5.5
Real wage growth rate, y-o-y % change	9.0	0.7	3.7	5.3	5.0	n.a.
Consumer prices index, year end, y-o-y % change	0.4	8.1	7.8	4.1	5.0	4.5
General government balance, % of GDP	-6.8	-2.5	-2.4	-2.0	-1.5	-1.0
General government expenditure, % of GDP	45.3	40.8	39.1	40.6	40.0	39.0
Exchange rate, year average, MDL per USD	11.1	12.4	11.7	12.2	12.5	12.5
Broad money (M2), y-o-y % change	-3.8	18.3	14.4	23.5	15.0	12.0
Central bank refinancing rate, end-year, %	5.0	7.0	9.5	4.5	n.a.	n.a.
New bank loans, % of GDP	35.0	32.6	36	30.7	32.0	35.0
Bank deposit rate, %, average per year	14.7	7.6	7.54	7.6	7.7	7.5
Bank lending rate, %, average per year	20.3	16.3	14.4	13.3	13.5	13.0

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

■ Executive summary

Domestic Supply

Worsening economic conditions in Europe and extremely hot and dry weather sent Moldovan economy into recession in 2012. However, the two external shocks have been magnified by the domestic vulnerabilities and policy failures. The annual GDP is estimated to have fallen 0.7%, and the main brunt came in the third and, especially, the fourth quarter, when the GDP is estimated to have contracted about 2% y-o-y. Agriculture has been the key source of decline, taking almost 3 percentage points away from the GDP annual growth rate. In 2013 we expect a 3.5% economic growth, largely driven by the one-off recovery growth in the agriculture. Sluggish growth expected in agriculture in 2014 is, again, the main reason for the grimmer outlook we expect for 2014, with the GDP expected to gain 3.0%. No significant improvements are expected in the other sectors and in the consumption patterns to compensate fully the agricultural sinusoid.

Domestic Demand

While in the first half of 2012 the domestic demand was negatively influenced by external factors, in the second half of the year internal factors corroborated with the external ones. Households' consumption went back on a positive growth path in Q3:12, but it is still volatile and does not inspire optimism to the companies that remain conservative in investment and marketing decisions. Thus, private investment continued to fall in late 2012, with the most prominent decline taking place in the foreign investment. Moldova not only lost the international competition for FDI, but risks to lose the investors already settled in the country. In this context, public investment might be considered a 'saviour' of the Moldovan economy in 2012. The increase in overall public capital investment, and, in particular, investment in roads infrastructure, determined a more sustainable structure of the state budget, compensating for the steep decline in private demand for construction works and creating the necessary conditions for attracting in long term investments in the regions. The following two years will be more favourable and the domestic demand is expected to increase, but the magnitude of growth will depend on several aspects related to investment attractiveness of the country, transparency of public spending and the monetary policy promoted.

Public Finance

The economic downturn took a heavy toll on the budgetary revenues in the second half of 2012. Despite a series of tax hikes, reintroduction of the corporate income tax and removal of some legislative loopholes, the annual growth rate of revenues declined. The economic crisis' repercussions, coupled with excessive optimism in revenue planning and lower than expected foreign grants, caused the public revenues to underperform as compared to the planned level. The budgetary deficit reached the level of 2% as of end 2012 (well above the initial target of 1%), two thirds of which is financed from foreign sources. During 2013, the Government will have to continue walking a tightrope between the need of fiscal stabilization and that of spurring economic growth. Given the currently weak economy and high risk of fiscal evasion, the most optimal strategy would be that of downsizing the state's intervention in the economy and of enhancing the management of public money. Additionally, the state budget law for 2013 should be amended in order to adjust the planned revenues and expenditures to the new economic constraints. The need of redressing the financial situation by capitalizing the "Banca de Economii" will make the budgetary amendment exercise more challenging.

Labor Market

While the decline in employment aggravated in Q3:12, this evolution cannot be entirely assigned to the drought's impact, as it does not differ greatly from previous years with normal weather conditions. Nevertheless, further drought's repercussions on the labor market might be still visible 2-3 quarters from now. The main determinant of the overall employment decrease was the decline in employment in services sector, which accounted for over 50% of job losses in Q3:12, mostly taking place in market services

branches. While agricultural and service sectors are highly concentrated in informal sector, the employment decreased more significantly in the formal sector. As for the number of salaried workers, this indicator dropped more in informal occupations, partly due to more coercive measures adopted by the Government worried of the undeclared work. We believe that a better system of tracking tax evasion and creation of incentives to pay taxes would work better in reducing informal employment than administrative measures. The employment rate is estimated to have hit a new low of about 38.3% in 2012. As the years 2013 and 2014 will be slightly more favorable on the external front, the employment rate will not register significant growth if the barriers to business activity are not eliminated.

Prices and Monetary Policy

The evolution of headline inflation in 2012 was mainly influenced by the drought repercussion and the dissipation of the effects of last winter's price hikes for gas and heating. At the same time, the demand-side inflationary pressures remained low, given the weak economic conditions. The prevalence of cost-push factors amid negative economic growth has served as major challenge for the monetary authority, which kept an accommodative stance of the monetary policy. While keeping its policy rate untouched, NBM used the foreign exchange purchases on the domestic market and liquidity sterilization in the banking system as main tools for inflation stabilization. In 2013 a new round of inflationary pressures will emerge as a result of a series of tax hikes and recovery, though moderate, of domestic demand. Nevertheless, in medium-term perspective, the consumer price index is likely to fit into the central bank's target corridor (5% $\pm$ 1.5 p.p.).

Banking Sector

During the second half of 2012 the banks remained reluctant about lending, which caused a prolonged credit squeeze. It was primarily driven by foreign currency lending, as banks continued to minimize their exposure to risks associated with the economic crisis in EU. At the same time, the weakening domestic economy caused the lending in domestic currency to decrease as well, though at a much lower rate. Another culprit for the crediting activity cooling down was the decreasing inflow of new deposits, as a result of shrinking households' disposable income and lower firms' turnovers. Despite this turbulence, banking sector remained stable, liquid and well capitalized. The biggest challenge is related to the unsolved issues at "Banca de Economii", which is a bank of systemic importance struggling with huge amounts of bad loans. Hence, the main policy actions in the near future should be aimed at solving these issues and avoiding any negative spillovers across the entire banking system.

Foreign Sector

Last year, the adverse economic conditions in the Euro area spilled over the wider region, touching upon other key trade partners of Moldova, including Russia, Ukraine, and Romania. Combined with a particularly severe and extended drought, this resulted in Moldova's exports of goods and services receding 0.4%, with services partially compensating the more dramatic decline in trade with goods. Total imports registered a minor 1% growth y-o-y, reflecting weaker domestic demand, both for consumption and investment goods. The Euro area will continue experiencing economic troubles in 2013, and will start recovering only in 2014. This will slow down the recovery of the Moldovan exports to the EU and weaken chances of attracting direct investments and technologies from EU. A key policy recommendation is for Moldovan Government to address more effectively the behind-the-border barriers to trade and to enforce upon the Customs Service an institutional mission more in line with trade facilitation. Considering the pressures that will build up again on the current account starting 2014, it would be strategically right for the Government to concentrate on improving as much as possible Moldova's terms of trade, including by decoupling the price of gas imported from Russia from the global prices for oil.

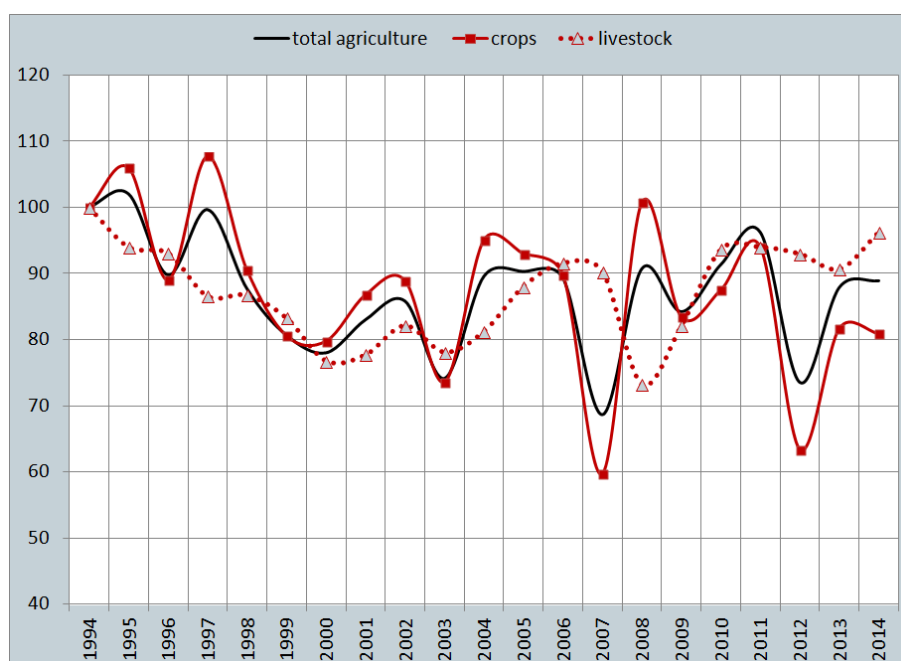
■ Chapter 1. Domestic supply

Domestic weaknesses magnifying external shocks

In 2012 Moldovan economy entered recession, due to worsening economic conditions in Europe and extremely hot and dry weather. The two external shocks have been magnified by the domestic vulnerabilities and policy failures. The year started with already rather disappointing GDP growth figures (+1.0% y-o-y in Q1:12) and has cooled down rapidly, with +0.7% in GDP in Q2:12 and -1.5% in Q3:12. The annual GDP is estimated to have fallen 1%, and the main brunt came in the fourth quarter, when the GDP is estimated to have contracted about 2% y-o-y. Agriculture has been the key source of decline, taking almost 3 percentage points away from the GDP annual growth rate.

Agriculture. As seen from the Chart 1, in 2012 Moldovan agriculture continued its 20 years-long sinuous evolution. Losing one quarter of the previous year's output, in 2012 the agricultural sector has been the key deterrent of the Moldovan economy, both in arithmetic terms (i.e. as direct impact on the GDP) and by weakening the supply basis of the food industry. With total sown areas about 5% up y-o-y, the losses have been determined entirely by extremely dry period of 2011-2012 and extremely hot summer 2012, with resulting significant drops in soils' humidity. We know many cases of individual farmers mitigating the impact of the drought by appropriate crops selection, rotation and processing techniques in 2012. However, such cases are exceptions rather than norm; this is why the crops growing sector has been hit particularly badly, with volume of harvest contracting one third against 2011. The key factor behind the crashing harvest was the production of cereals declining 50%. The technical crops, vegetables and fruits have suffered as well, albeit not as much as the cereals. Aside from the weather factor, the farms started meeting new problems related to competitiveness of fruits and vegetables exported to Russia, after the latter joined the WTO. This will have much higher impact on exports and income in 2013 and beyond. The livestock sector was firmer than crops sub-sector (-1% in annual production), but we expect more difficult times to come in first half of 2013, due to fodder shortages. This problem will affect particularly small farms and peasant households, where the beef and dairy cattle declined significantly already in late 2012, by 4% and 7% accordingly.

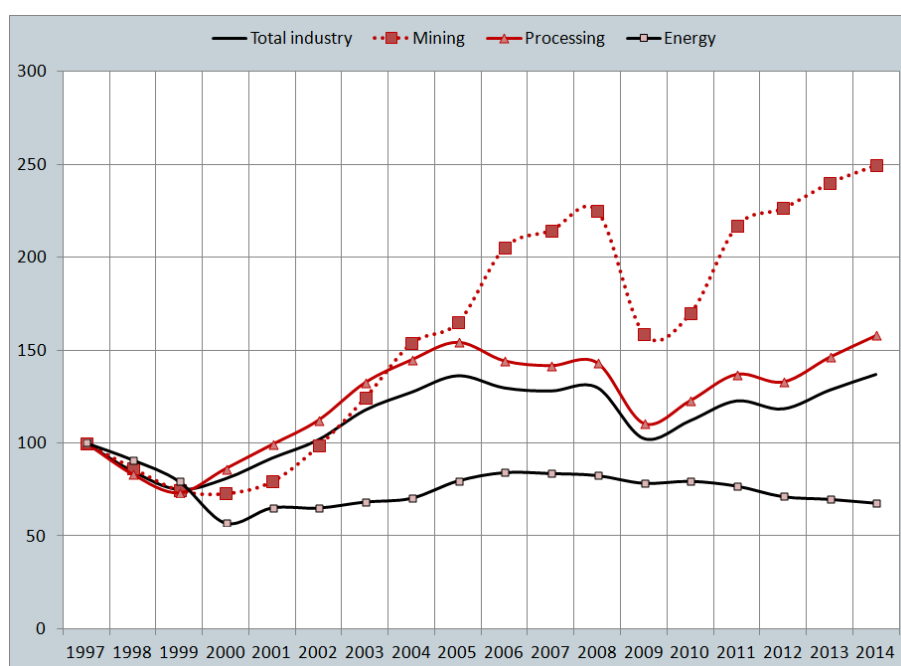
Chart 1. Evolution and forecast of agricultural output for the period 1994-2014, 1994=100%



Source: NBS, forecast for 2012-2014 by EXPERT-GRUP;

Industry. Two important factors shaped Moldovan industry in 2012: the extreme drought and the receding external demand for Moldovan products, mainly in EU, but also in the CIS. Available data on industrial production for 2012 reflect a significant slowdown of activity taking place in the second half of the year. After an already modest, but still rejoicing - considering the harsh economic conditions domestically and externally - growth of +1.1% in Jan-Jun:12, industrial production went down by 10% y-o-y in Sep:12, 6% in Oct:12 and 7.9% in Nov:12. We estimate that in December the situation worsened further, with an estimated decline in output of 10-12% y-o-y (Chart 2). Lasting two quarters and affecting almost all industrial sectors, this reduction in economic activity fully qualifies as recession. As we expected in previous MEGA no. 7, two key industries - vegetables and fruits processing and preserving, and milling and flour industry - suffered particularly large losses in output (30% and 25% accordingly), thus responding to the lower quality and quantity of the supplied agricultural raw materials. In the sectors responsible for intra-industrial trade with the EU countries – apparel, clothes, furs, shoes, leather products – situation in late 2012 was, in general, worse than earlier on.

Chart 2. Evolution and forecast of output by main industrial sectors and total industry for the period 1994-2014, 1994=100%



Source: NBS, forecast for 2012-2014 by EXPERT-GRUP;

On the bright side, there are several important sectors registering positive developments. Despite smaller grapes' harvest in 2012, the alcoholic beverages sector maintained the previous year's production level. Similarly, despite declining domestic production of milk, the dairy industry is almost 9% up, reflecting the successfully established international supply chains allowing producers to substitute the domestic raw materials with imported ones. We expected previously that one of the 'rediscovered' Moldovan industry – electrical equipment, machines, medical tools and equipment, that doubled the level of production in first half of 2012 - would slow down by the end of the year. In fact, even this technologically more advanced industry entered recession in late 2012, posting a level of production of only 40% y-o-y in Oct-Dec:12. As this industry is mainly oriented to Russia, this reduction in production reflects growing economic strains on the Eastern markets. Activity sped up healthier in the mining industry (+17% y-o-y in Nov:12) and in production of construction materials (+10%), which predicts a more tepid activity in the constructions sector in short-term (mainly related to public infrastructure), but also the short-to-live external demand emanating from places like Sochi construction sites. Production of electric machines and equipments (+36% y-o-y in Jan-Nov:12) has been among those few manufacturing sectors that were more resilient against the declining domestic and foreign demand, with biggest share of the production coming from Transnistrian companies. The domestic

production of electricity continued its years-long decline in 2012, with a 18% contraction y-o-y in Nov.12. Unabated, this problem may turn into a significant deterrent of the industrial growth.

Services. Evolution of services' sector in 2012 reflects the worsening confidence of the Moldovan consumers which showed more spending restraint, but businesses are apparently even less confident than final consumers. The retail trade and the wholesale trade began the year with upbeat moods, however lost the steam by the end of the year. We estimate that the retail trade volume grew 1.1-1.2% in 2012, while the wholesale trade lost 0.8-0.9% in volume. Services rendered to population have also grown (estimate +3.4-3.5% annually), while services rendered to businesses lost 0.3-0.4% in their annual volume. Transporters have been hit particularly hard, losing both domestic and foreign orders and registering a parallel reduction in the volume of transported goods (-2.9%) and in the routes' total length (-3.6%, including -20% for railroads). The latter comes as mixed outcome of the drought impact (with lower quantities of cereals transported to the East) and of the lower consumers' mood in Russia, Ukraine and other CIS countries.

Constructions. Like services sector, the construction sector in 2012 also fully internalized the less confident businesses' and investors' attitudes. While the construction companies continued works that began earlier, with even some tepid increase in the residential sector works (+3% compared to 2011), the new construction works' orders declined both in residential sector (estimated -10% against 2011) and in non-residential one (estimated -15%). As we expected earlier on in 2012, public infrastructure projects (mainly roads) remained the main driver of the constructions sector last year, even though with a less prominent role than in early 2012.

Short-term forecast and challenges

- To begin with agriculture, we expect that 2013 and 2014 will be climacterically more 'normal' years, even though, as the recent two decades have proven, the meaning of 'clime normality' is changing dramatically in Moldova. Based on assumed normal aridity and expected reaction of the farms to changes in relative prices, in 2013 we expect that the crops sector will see a 28-30% recovery growth, mainly due to higher quantities of harvested cereals. However, in result of higher comparison base we predict that agriculture will register a decline of 1-2% in 2014. Opposite to that, the livestock sector will continue experiencing woes in 2013 (-2.5%) mainly due to the problems with feeding animals in the peasants households, but will recover in 2014 with a 6% growth in output. All in all, the total agricultural output will rise 18-20% in 2013 and will recede again, by 1-1.5%, in 2014. As we expect the global and domestic prices for fuel and fertilizers to decline a bit, the value-added generated by the agricultural sector is expected to rise by 30% in 2013, and only 1% in 2014.
- Industrial sector will benefit, to some extent, of the higher agricultural output, with food industry production forecasted to grow 15% this year. However, other industries will remain flat in best case (such as clothes, apparel and footwear) or continue declining (such as tobacco production). For the year 2013 we expect that both industrial production and the generate value added will register a timid 4% growth, and slightly more upbeat in 2014, +5%.
- Considering the expected evolution of the remittances, wages and bank loans, the services sector will stagnate in 2013, with expected growth in value-added from 0 to 0.5%, with more positive outlook for 2014, +2%. The constructions sector will continue experiencing difficult times in 2013, and the expected change in activity is negative, from -2.5% to -10% (depending on the magnitude of public roads rehabilitation projects), with slightly more positive prospects in 2014 (+5%).
- Based on the above, the total GDP in 2013 is expected to grow 3.5%. The downside risks to this forecast come mainly from the part of the weather conditions, which may undermine growth in agriculture for the second year in a row. Another risk stems from the yet unsettled financial and political crises in Europe, which resulted in an economic recession expected to extend until mid-2013 at least. For the year 2014, the outlook for Moldovan economy is gloomier, with an expected 2.0-2.5% growth, mainly reflecting the effect of the higher-comparison basis in agriculture.

Policy recommendations

- Considering how the business regulatory policy was implemented in 2012 and the current challenges, it is inappropriate to come out with revolutionary policy recommendations. All the issues we previously raised in our publications, unfortunately, remain relevant, and some even more relevant. To begin with the most important aspect, evolutions in 2012 have revealed, yet again, the high degree of Moldova's vulnerability to the climate conditions. Despite all policy initiatives and the agricultural subsidies provided in the recent years, the farmers did not yet learn the lesson and did not invest massively in new equipment and conservative technologies. The rural area continues to be abandoned by the youth and unless effective policy measures are adopted to stimulate the use of innovative technologies in the sector, its long-term outlook is negative, with long-lasting political and social impact.
- In one of its interviews in early 2013, the Prime-Minister Vlad Filat stated that continuation of the privatization is key priority, but he suggested that a higher-level control system will be put in place in order to ensure transparency of the process. While ensuring transparency is key, it is equally important to ensure that higher-level control does not stalemate the process. As the "Banca de Economii" unfolding story compellingly prove, the state, and especially the Moldovan state, is the worst-possible manager of commercial companies and banks.
- Constructions sector will remain under pressure in 2013 and probably in 2014. The real-estate investors appetite is weak, while production costs continue to grow. We said in the previous MEGA no. 7 that, as the World Bank's Ease of Doing Business 2013 rating suggests, dealing with constructions permit remains a key problem dragging Moldova down. The reforms attempted so far brought little or no result. Red-tape, corruption, improper regulation and complex legislative framework – these are the key constraints to growth in the sector, calling, by their complexity, for a radical and comprehensive political intervention. Leaving these issues unsolved, the construction sector will lose its unique window of opportunity opened for the next 5-10 years by demographic shifts. Thus, the baby-boomers from 1970-80s (25-35 years old now) which currently form the biggest cohort of the population enter the age of consumers with the highest demand for residential real-estate.
- We continue pleading for a stronger political will which is necessary for the justice sector reform to take shape. In early 2013 we have already seen how uneasy is the policy dialogue on this matter between the Ministry of Justice and Supreme Council of Magistrates. We suspect that the latter is not full-heartedly 'in' the reform, because the proposed measures – polygraph testing of candidate judges, greater use of recording equipment during trials - will undermine the deeply entrenched vested interests having a high stake in preserving the current situation. These and other initiatives (like separation of investigative and prosecutorial functions) will require, again, exceptional political will and the reform can even put under threat the very existence of the Alliance for European Integration. Getting on board the young representatives of the judicial profession is key for its effective implementation, considering that the reform is also conditional on the outcomes of next general elections.

■ Chapter 2. Domestic demand

How does Moldovan economy look like with slack consumption?

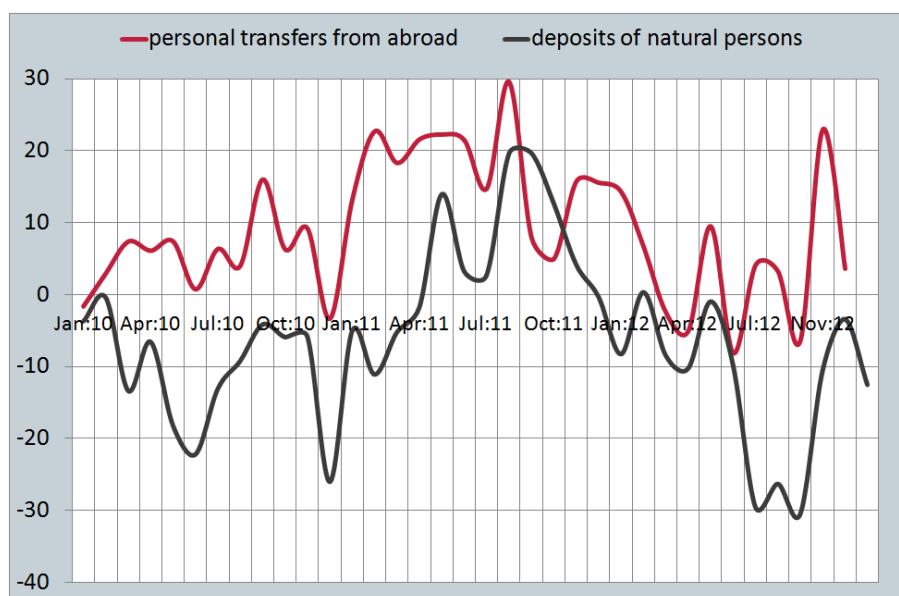
The 2012 evolutions in the Euro area will be long remembered in Moldova due to their impact on the national economy - weak and sensible, where the domestic demand is highly vulnerable to external factors. As already mentioned in the previous edition of MEGA no. 7, the peak of the negative external influence was achieved in the second quarter of 2012, when even households' consumption felt, which has the most significant impact on the GDP growth. In the Q3:12 the situation slightly changed, with households' consumption back on a positive path, but overall domestic demand still weak and negatively influenced already by internal factors.

Households' final consumption increased by 1% in Q3:11 and we estimate the rise in consumption for 2012 to be at the same 1% level. The severe drought of summer 2012 reduced the monetary incomes of the population, but also the in kind income; in fact, consumption of goods and services in kind, accounting for about 20% of the total households' consumption, registered the most significant decline. This has affected primarily the livelihoods of the rural inhabitants working on their own agricultural plots, which also represent the poorest groups of population. This is confirmed by the evolution of the population's disposable income. In Q3:12 the disposable income decreased in real terms by 2% y-o-y and the steepest decline was in incomes from individual agricultural activity - over 10%. Agricultural activity is an important source of income for rural population, especially in the harvest season. In Q3:12 it accounted for 16.4% of the total income, while in the same period of the previous year its share was as high as 18.1%. This has reduced the ratio of disposable income to the cost of living by 2.6 p.p. in rural areas, making the population more vulnerable and increasing the needs for social protection mechanisms that in short-term will be fully reflected in the budgetary expenditure.

Given the shrinking income of the population, the increase in final consumption is quite surprising. The loss in the income generated in the country was partly compensated by remittances that were on a positive trend since July 2012. The increase in transfers of natural persons from abroad through the banking system in 2012 - estimated to be around 3.2% - was mainly determined by higher transfers from CIS countries, where the economic situation was better than in EU, but also some specific works where Moldovan citizens are employed continued, unrelated to general economic developments (i.e. construction works and services related to the Sochi Olympics). While country-disaggregated data are not available for the transfers of natural persons from abroad, the currency structure suggests this fact, which is also confirmed by the balance of payments data on remittances. Thus, in Q3:11 the remittances from CIS countries rose by 15%, while those from other countries decreased. Russian Central Bank data show an increase in personal transfers from Russia to Moldova of about 35% in nine months of 2012.

A deeper analysis also indicates over a strong decrease in propensity to save of the population. In Q3:12 the deposits of natural persons in commercial banks decreased by 29% y-o-y. Usually, remittances were highly correlated with deposits (Chart 3). While the correlation is still valid, strong decrease in domestic income fuelled more remittances into consumption than into savings. In Q4:12 a slight stabilization was observed, with deposits still falling, but at a lower rate - 9%. However, the situation might change in several months if the remittances continue to grow. An interesting evolution in the last few months is the increase in long term deposits (over 1 year). This means that part of the money is saved for later consumption, thus lowering the capacity of the economy to grow.

Chart 3. Evolution of personal transfers from abroad and deposits of natural persons in commercial banks, y-o-y growth, %



Source: NBM and EXPERT-GRUP calculations;

While a slight increase in consumption was registered in the third quarter, the fluctuation of the incomes determined an equally volatile consumption. Both retail trade and services rendered to the population fluctuated in the second half of 2012. In November, the last month with available data, both indicators registered annual losses. Consequently, this had a negative impact on the wholesale trade and services rendered to enterprises for the whole period. Obviously, more frugal consumers make companies more conservative in investment and marketing decisions. Private investment in long-term tangible assets felt even more in the Q3:12. Although a slight increase in the investments in productive capacities was registered, it is still not enough to compensate for serious decline in the first half of the year.

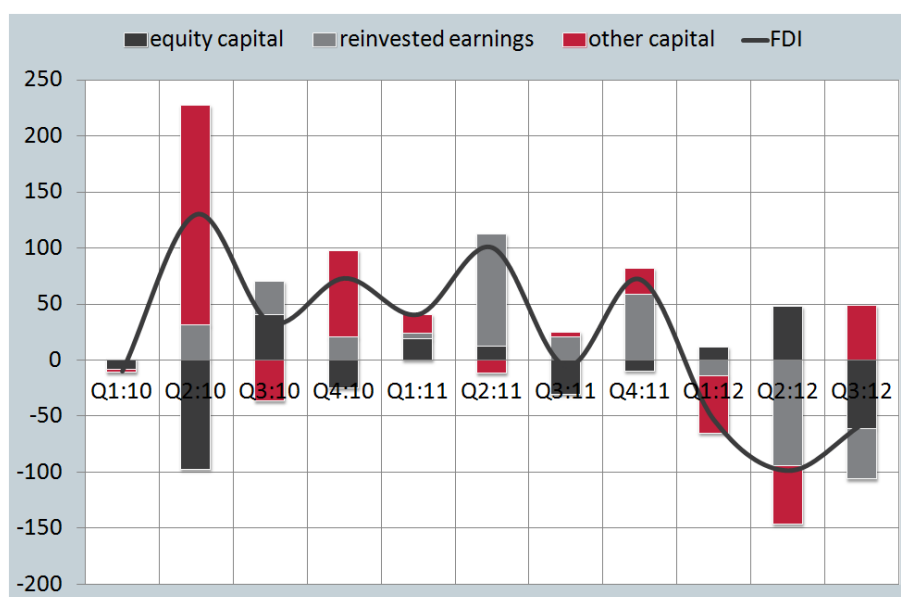
At the same time, by the end of the year the intensification of public investment was registered, that is quite common for Moldovan political process. In fact, public investment might be considered the savior of the Moldovan economy in 2012, with only public investment in long-term tangible assets growing this year. EXPERT-GRUP considers that increase in overall public capital investment and rise of investment in road infrastructure in particular are among the top five economic successes of 2012¹. These trends have determined a more sustainable structure of the state budget, compensated for the steep decline in private demand for construction works, which otherwise would have been fallen dramatically, and creates the necessary conditions for attracting investments in the regions. The budget for 2013 also intends to support public investment that is needed to trigger the economic growth. Thus, capital investment are planned to increase by 13% in nominal terms that would account for 22% of the total state budget expenditure. Most probably the importance of the public investment to trigger the economic growth will be high as the economy will still be in the recovery phase, with private investors less active.

But one of the major failures for 2012 may be considered the lack of foreign investment. FDI decreased significantly in the third quarter - 58% (Chart 4). For the first time in more than a decade, the decline in equity capital was registered, meaning that investors take away their capital. By now, this is the case only in the banking system that experienced an overall decrease of equity capital. However, recently several investors in industrial and service sectors made public their intentions to leave Moldova due to problems with the tax authorities. Thus, Moldova not only lost the international competition for FDI (FDI flows in Ukraine, Georgia, Bulgaria increased in the first half of 2012 despite the European crisis), but risks to lose the investors already settled in the country. Also, reinvested earnings are negative for the third quarter in row. This might be due to

¹ Real Economy no. 34, Expert-Grup, 2012;

the operating losses registered by the enterprises and therefore reported as a negative income payment and disinvestment in the enterprise.

Chart 4. Evolution of FDI (y-o-y growth, %) and the contribution of FDI' components to the overall growth (p.p.)



Source: NBM and EXPERT-GRUP calculations;

Short-term forecast and challenges

- We expect an increase in remittances up to 6% in 2013, due to growth in transfers both from EU and CIS countries. Nevertheless, we do not exclude a more pessimistic scenario, with remittances increasing only 3% if clouds are back on the European sky. Our prediction for 2014 is more optimistic given the expected recovery of European economy that might move remittances 10% up.
- We also do expect an increase in domestic revenues of the population in the second half of 2013 due to the recovery in the agricultural sector and related activities if the current year's weather conditions are favourable. The economic recovery will lead to a slight increase in employment and a more pronounced increase in salaries in the real sector of the economy in the second half of the year. Moreover, some increases in wages in public sector were already announced for January and June 2013.
- Consequently, these trends will have a significant impact on households' consumption that we expect to grow by 3% by the end of 2013. The prediction for 2014 is even more optimistic, with households' consumption expected to grow between 4 to 6% and, therefore, be back on its position of the main driver of the economy.

Policy recommendations

- Two key shortcomings that undermined Moldovan economy in 2012 were the incapability to attract new investors and the real risk to lose some of the existent ones. An important part of domestic demand is generated by foreign enterprises in Moldova. Most of the problems faced by the foreign enterprises are common for all other companies in Moldova, including SMEs that do not have voices powerful enough or do not have the opportunity to move abroad. Thus, a precondition for supporting domestic demand is to create a favourable business climate where enterprises will be active and consume, will open jobs and offer salaries.
- While public investment will be very important in the upcoming years, the Government should not enter the electoral campaign too early. Maximum transparency should be ensured in the public

investments-related procedures in order to use efficiently scarce resources and to win the trust of the taxpayers – a key precondition for sustainable financing of these investments.

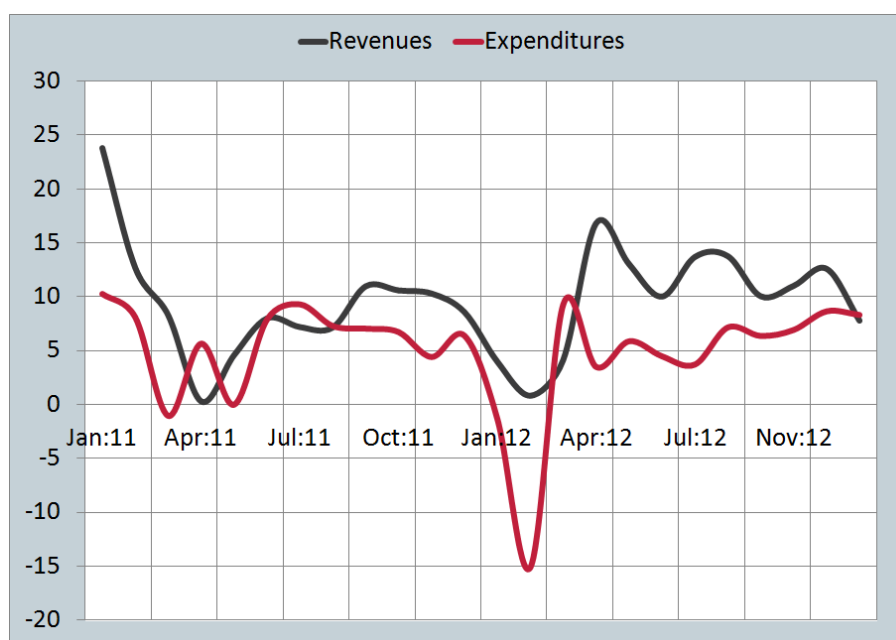
- The monetary policy of 2013 and 2014 should not limit the capacity of economy to grow. Although there are good reasons to expect a higher inflation in the following years and an increase in the policy interest rate might be needed, all changes in the monetary policy should take into account that the economy is recovering and both enterprises and population will need incentives to invest and consume. Therefore, the price of money should be reasonable, without burdening too much the economic agents.

■ Chapter 3. Public Finance

Walking a tightrope between fiscal sustainability and economic growth

At the beginning of 2012 the Government resorted to a series of measures aimed at ensuring a long-term sustainability of public finances by removing some legislative loopholes and replacing the foreign sources of financing the budgetary expenditures with the domestic ones. It reintroduced the corporate income tax (CIT) and raised the excises for a series of products. This gave a fillip to state budget revenues which rose during the first half of 2012 at a healthy rate, overcoming the growth of expenditures. However, the weakening of economic activity made the fiscal base to shrink with negative consequences for tax collections. Thus, during the second half of 2012 the discrepancy between the annual growth rate of revenues and expenditures started to decline, culminating at the end of the year when they almost equaled (Chart 5).

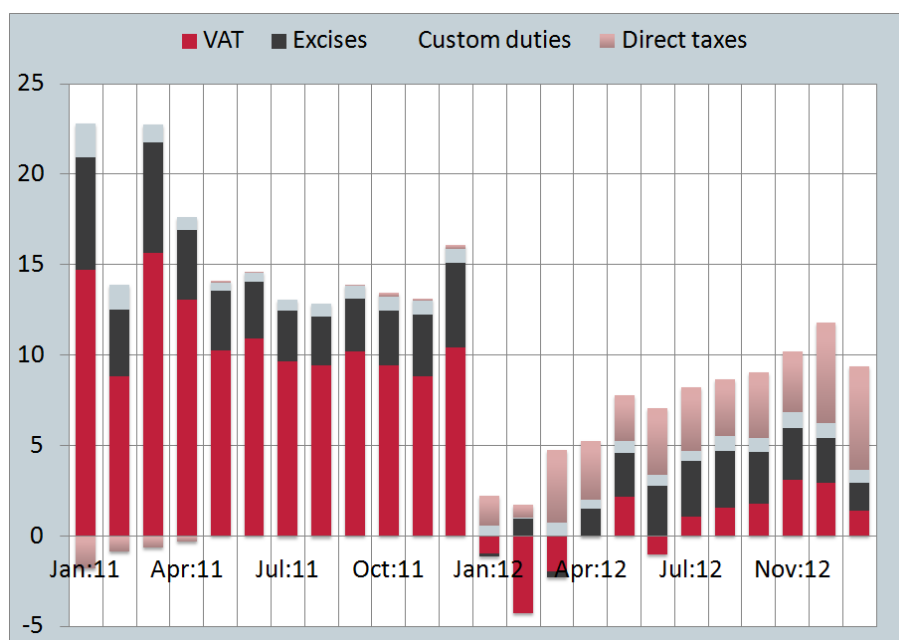
Chart 5. State budget revenues and expenditures, y-o-y growth, %



Source: Ministry of Finance and EXPERT-GRUP calculations;

During 2012 the state budget revenues rose by 7.8%, being mainly driven by accumulations from corporate income tax which grew 2.6 times. The reintroduction of the CIT had at least three important outcomes for the system of public finances. Firstly, it consolidated the direct taxation mechanism of revenue collection and significantly contributed to rebalancing of financing sources of the state budget. Hence, in 2012 the direct taxes replaced VAT as the main contributor to the y-o-y growth of fiscal revenues (Chart 6). As a result, during 2012, the share of direct taxes in total fiscal collections at the state budget increased 2.4 times (from 3.5% up to 8.4%). Secondly, as CIT forms about 30% of the fiscal collections at the local level, it strengthened to a certain extent the financial situation of the local governments. Thus, the share of own local tax revenues in total revenues of the national public budget increased from 8.6% to 11.1% during 2012. It reveals the consolidation of the local tax base and could positively contribute to improving the efficiency of the allocation of public money at the local level. Last, but not least, the reintroduction of CIT contributes to the long-term sustainability of public finances as it can compensate for the eventual decrease in foreign grants: at the end of 2012 the total CIT revenues exceeded the foreign grants for budgetary support by 24.3%.

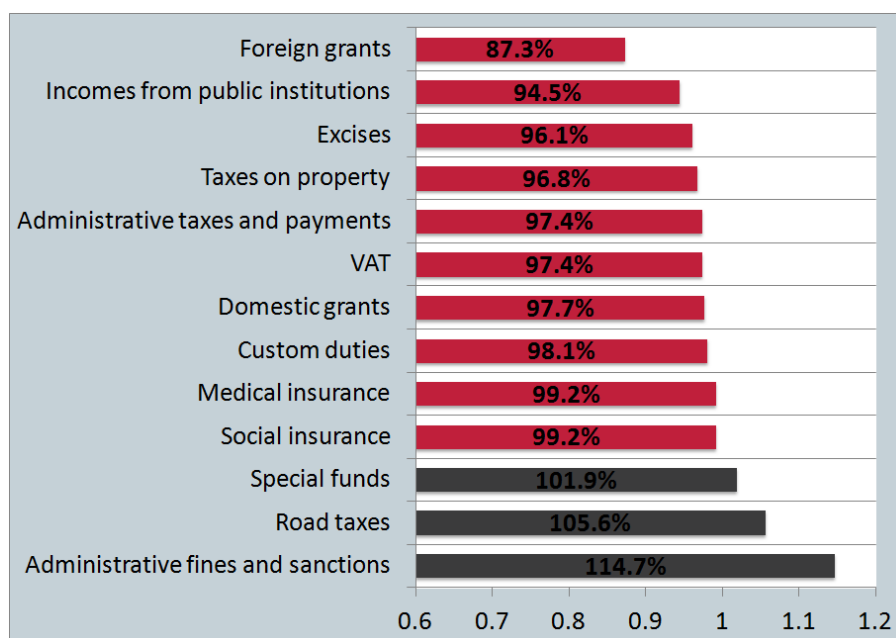
Chart 6. Breakdown of the main contributions to the y-o-y growth of fiscal revenues, (p.p.)



Source: Ministry of Finance and EXPERT-GRUP calculations;

The weakening economic activity during 2012 coupled with optimism bias in the state budget law for 2012 (see MEGA 7), made the total public revenues to underperform in comparison with the planned level (Chart 7). As a result, the public authorities collected MDL 676.5 million less than the original forecast, which put additional pressures on the expenditures side. This was not just the result of the economic recession, but also poor forecasting and planning within relevant public institutions. Additionally, the fact that in 2012 only 87.3% of the planned foreign grants were in fact received denotes two important issues: (i) poor absorption capacity of foreign grants, and (ii) financial difficulties faced by international donors which translates into less money channeled to local projects, as initially planned. Both problems undermine the stability of public finances in Moldova, given the strong reliance of Moldovan authorities on this source of funding public expenditures. Therefore, the consolidation of the local tax base and rationalization of budgetary expenditures will certainly be the main priorities of the fiscal policy in the next years.

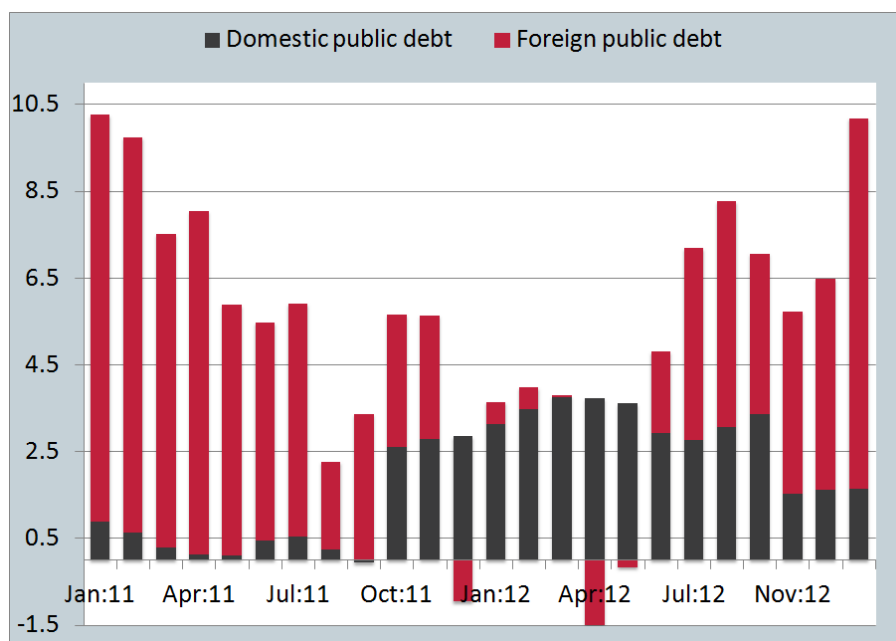
Chart 7. Collected revenues to the National Public Budget as a share of the planned levels, %



Source: Ministry of Finance and EXPERT-GRUP calculations;

The above mentioned issues caused the budgetary deficit to reach the estimated level of about 2% by the end of 2012, three thirds covered from foreign sources. As a result, in the second half of the year, the external public debt had the highest contribution to the overall debt expansion (Chart 8). Still, we may notice that the Government resorts to domestic debt more intensively as compared to the previous year. This is the result of weaker economic situation in 2012 which made commercial banks more reluctant to lend to businesses and households, leaving them with idle liquidities which were placed in low yield, but risk free T-bills.

Chart 8. The contribution of domestic and foreign public debt to the overall growth of public debt, (p.p.)

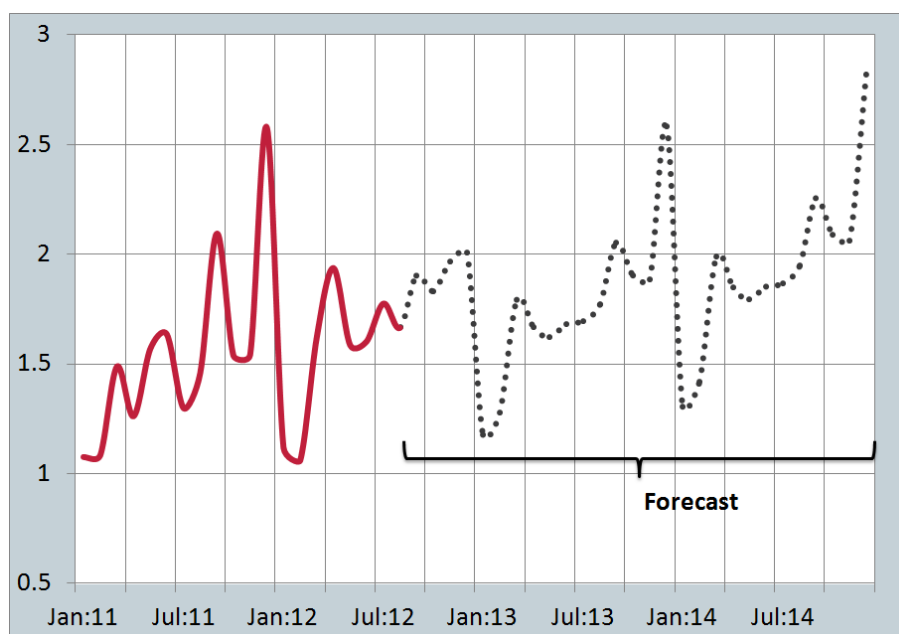


Source: Ministry of Finance and EXPERT-GRUP calculations;

Short-term challenges and forecasts

- The budgetary revenues in 2013 will be driven by 3 main forces: (i) the dissipation of drought effects during the second half of the year; (ii) a moderate economic recovery which will be accompanied by rising, though at a low rate, consumption, imports and production; and (iii) tax hikes, particularly in excises on tobacco, fuels and alcoholic beverages and in VAT for natural gas from 6% to 8%. A controlled depreciation of the national currency could also give a fillip to public revenues, after central bank's interventions on the domestic foreign exchange market and IMF statements about slight over-appreciation of the Moldovan leu. All in all, the state budget revenues are likely to increase in nominal terms by 8.5% in 2013, 3.5 p.p. of which being the result of the fiscal policy measures applied since the beginning of the year (Chart 9).

Chart 9. State budget revenues based on two different econometric approaches, bil. MDL



Note: The forecast based on a structural vector autoregressive model (SVAR) with 2 lags, based on monthly frequency, for the period 2005-2012, taking into account imports, exports, money in circulation, deterministic trends and seasonal dummies (other details are available upon request).

Source: Ministry of Finance and EXPERT-GRUP calculations;

- Despite the vulnerability of the Moldovan economy to foreign shocks, the key challenges affecting the sustainability of public finances are domestic ones. In 2013 these are directly related to two key issues. Firstly, there is a clear optimism bias in projecting the budgetary revenues for 2013, which can put additional pressures on spending commitments and create a higher-than-expected deficit. For example, the state budget law for 2013 is based on a projected economic growth of 5%, which is unlikely to be achieved given the persistence of weak economic conditions at the regional and domestic levels. According to the state budget law, the total revenues are planned to grow by 13.2% y-o-y, whereas our calculations reveal that it will hover at around 8.5%. It will create a gap of about MDL 940 millions which will have to be financed either by cutting some current expenditures or building up higher debt. The second domestic challenge threatening the stability of public finances is the slow pace of reforms in the social, education and health care spheres which are the most important consumers of public resources.
- Given the inappropriate macroeconomic fundamentals on which the state budget law for 2013 has been elaborated, the Government will have to amend it and adjust the revenues and expenditures to

the current economic circumstances. Particularly, the budget amendment will take into account a much slower economic growth (3.0%-3.5%) and lower-than-expected foreign grants.

Policy recommendations

- The Government walks a tightrope between two objectives which in long-term are complementary, but in short-term are in conflict one to another: (i) stabilization of public finances, and (ii) bolstering economic growth. Given the currently weak economy and high risk of fiscal evasion, the most optimal strategy would be to emphasize mostly on the optimization of some public expenditure and increase of the efficiency in tax collection. Hence, the source of fiscal sustainability lies in downsizing the state's role in the economy and enhancing the management of public money, which cannot be achieved without higher transparency and a broad reform in education, health and social spheres.
- There is a vicious circle between poor roads and low toll rates: the poor quality of roads makes people hesitant to pay taxes, which, in its turn, leads to insufficient resources for a proper maintenance of these roads. In order to break this circle, the Government should chose between borrowing from investors, by tapping resources on the domestic and international markets or borrowing from people by raising taxes and paying interest with better roads. The most advantageous option would be to turn to those who own more idle liquidities. As the current economic crisis made the disposable income of households to shrink, while investors and especially commercial banks became more risk averse, it would be more rational to turn to the latter ones. There are at least three reasons for that: (i) the current level of public indebtedness is relatively low which creates room for tapping more resources from domestic and especially foreign creditors; (ii) weak economic situation has always been a proper period for increasing public debt due to availability of idle resources held by banks and other investors; and (iii) as already mentioned, raising taxes when peoples' incomes are shrinking, uncertainty is huge and the roads are poor, does not seem to be a timely option..
- In order to reach the desired effects, the recent increases in excises and toll rates should correlate with a broad revision of the mechanisms of redistribution of public money for road reconstruction and maintenance. Particularly, the Government should increase the transparency of public tenders and ease the access of private companies to road maintenance and reconstruction projects. Additionally, it is necessary to reevaluate the current procedures of quality audit which proved to be inefficient given the poor quality of recently reconstructed roads. The failure to do so will result in profligate and non-transparent spending on road infrastructure and is likely to fuel corruption in this sphere which will further steer people's reluctance to pay taxes. During the last months of 2012 and the beginning of 2013 several important foreign companies announced their intention to leave Moldova due to the prosecutions from the fiscal authorities. No doubt, ensuring fiscal sustainability cannot be achieved without a higher fiscal discipline. However, it should be induced rather by using the "carrot" and, then the "stick" approach. During 2012, the administrative fines and sanctions were 14.8% above the planned level and 31.2% higher than 2011. Increasing the administrative pressures on taxpayers in times of crisis can depress further their entrepreneurial activity and even motivate them to leave the country. Hence, the "carrot" approach for strengthening the fiscal discipline should involve a higher quality of services performed by fiscal authorities and removing various loopholes in the fiscal legislation which induce uncertainty.

■ Chapter 4. Labor Market

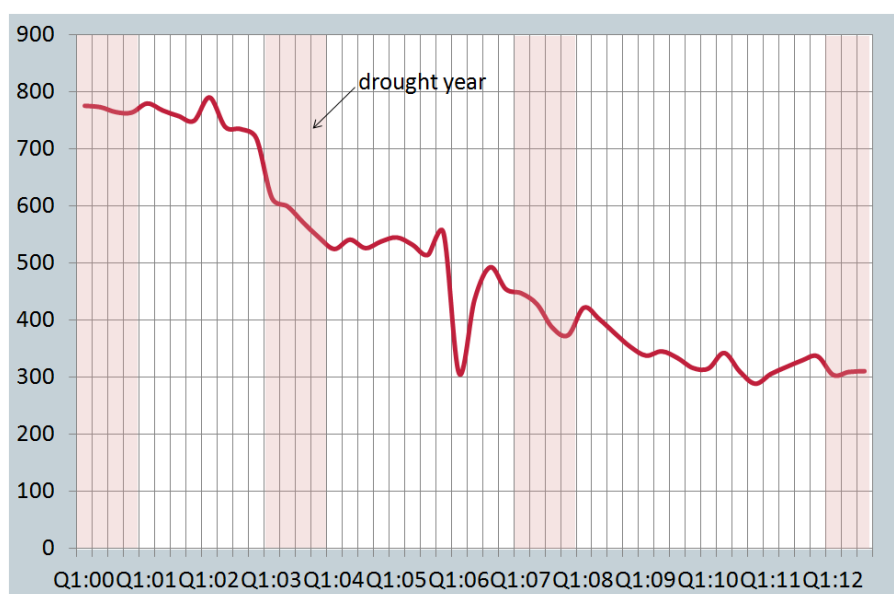
Worsening trends on the labor market: how much is due to the drought?

Labor market can be considered one of the weakest pillars of the Moldovan economy. Even during the years of strong economic recovery, labor market indicators followed mostly negative trends pointing out to the vulnerabilities of Moldovan economy, its inability to modernize and create jobs and failure of the educational system to adapt and respond to the changing needs of the real sector. With an employment rate under 40% during the last three years, Moldova is the worst performer in the region. At the same time, it seems that this low performance is already close to the minimum that can be attained in the current economic settings, where the migration opportunities have narrowed. Thus, while negative economic evolutions still affect the labor market, especially some qualitative aspects of it, the impact on the number of employed population is already weaker.

Thus, normally we would expect an intensification of jobs' loss in the third quarter due to the drought' impact on the agricultural sector employing a large share of labor force and its possible repercussions on other industrial and service branches. Indeed, the number of employed population fell by 4.5% in Q3:12 y-o-y compared to 2-3% in the first half of the year and we estimate the employment rate to set around 38.3% in 2012. However, this evolution is not very different from previous years with normal weather conditions. A sectoral analysis reveals even better the situation.

Employment in agricultural sector has decreased by 4.5% in Q3:12 y-o-y, but this is slower compared to other drought years, for instance to the year 2003 when the loss registered was up to 30% (Chart 10). However, further drought's repercussions on the labor market might be still visible 2-3 quarters from now as similar experiences show. For 2012 year we estimate the employment in agriculture to fall by 4%.

Chart 10. Quarterly seasonally adjusted employment in agricultural sector, thousand persons, 2000-2012

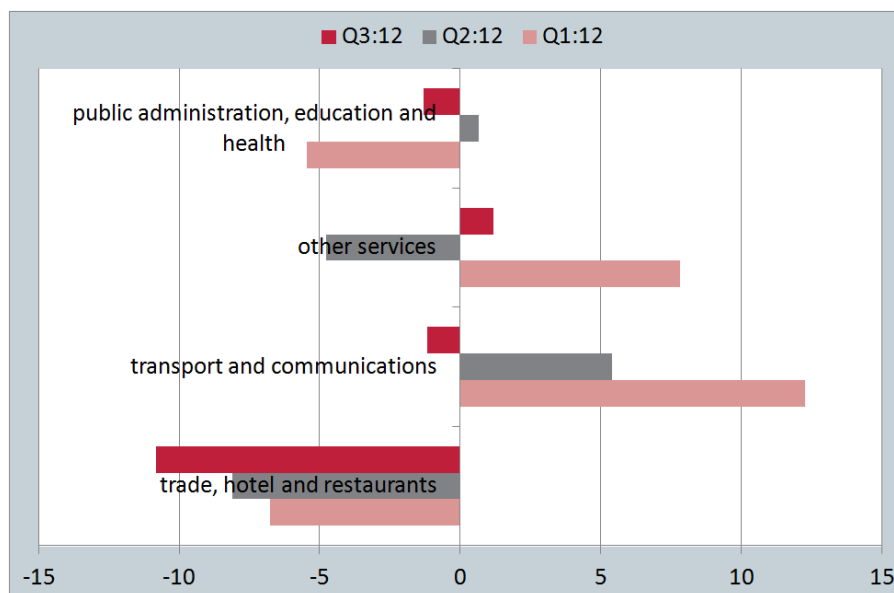


Source: EXPERT-GRUP calculations based on NBS data;

The main determinant of the overall employment decrease was the decline in employment in service sector, which accounted for over 50% of job losses in Q3:12, mostly taking place in market services branches. Employment in this sector reacts much faster to economic changes as it is directly linked to the consumption process. Opposite to this, in the case of agricultural sector, even though climacteric conditions influence the

employment in the sector, often the lack of other work opportunities and the possession of agricultural land keeps the population underemployed, but still in the sector. Moreover, high informality in service sector, especially in trade services, makes it simpler for the employers to fire the employees, whereas in other sectors, e.g. industrial, even in the case of decreasing demand, the dismissals may take longer when a work contract is binding. Thus, market services reacted quite strongly to unstable economic situation during the whole year, with the decline in employment in trade, hotels and restaurants of 12% y-o-y in Q3:12. Also, the situation in the transport and communication worsened after two quarters of growth, associated with the drought effects on agricultural production and general economic conditions (Chart 11). We estimate an overall decrease in employment in market services for 2012 about 5%.

Chart 11. Change in employment in service sector, y-o-y change, %, 2012



Source: EXPERT-GRUP calculations based on NBS data;

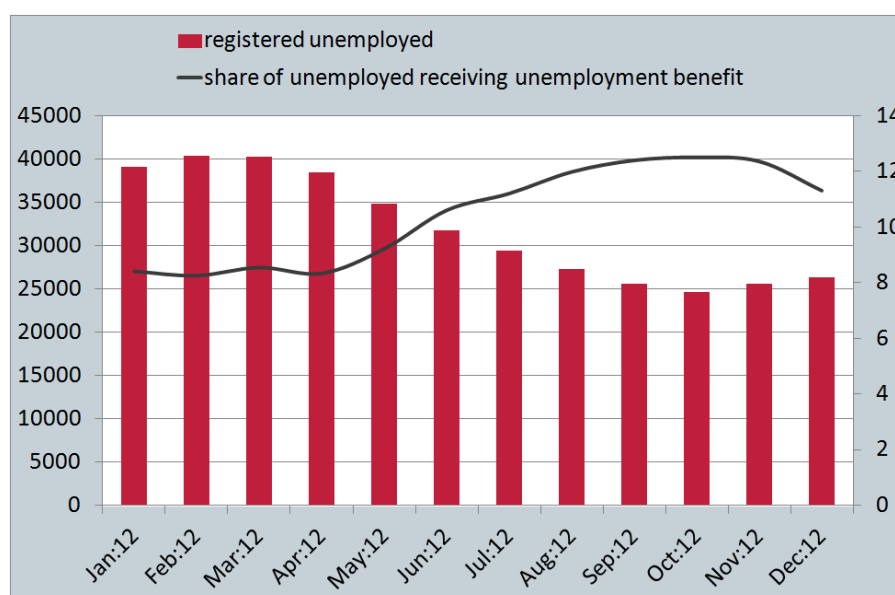
The decline in employment in industrial and construction sectors was less prominent and still generated by demand factors. We estimate a slight fall in employment in these two sectors of about 1% in 2012. However, the effects of the drought on the employment in several industrial branches are still awaited.

But the declining employment is not the only negative trend on the labor market pointing out to the reduction in workload. After five consecutive quarters of decline in under-employed population the share of under-employed rose in the third quarter of 2012, reaching 6.9%.

As usually, the youngest and the oldest population was the most affected by negative trends on the labor market. In fact, these groups include the individuals with less advanced educational backgrounds. In Q3:12 only the number of population employed with tertiary education increased by 6.5% y-o-y, while the number of employees with lower educational levels decreased. This is an important aspect to consider in educational and employment policies in Moldova. It is true that low demand will result in dismissal of the personnel directly involved in the production of goods / service delivery in the first place, while the administrative staff and the high qualified staff will be still in their position. However, only a comprehensive analysis may reveal all causes and it might be the case that sectors employing higher qualified staff are more immune to certain types of crises or, that Moldova actually experiences scarcity of tertiary graduates. On the other hand, it seems that there are several industries with chronic deficit of labor force with vocational education: textile and machinery industry that report monthly to the NEA a high number of vacancies that could not be filled in.

Despite the negative employment trends, the unemployment has diminished, but the irrelevance of this indicator was already exposed in MEGA no. 7. The number of registered unemployed dropped by 32% during 2012 (Chart 12).

Chart 12. Number of registered unemployed and share of unemployed receiving unemployment benefits, % (secondary axis)



Source: NEA and EXPERT-GRUP calculations;

This unfavourable situation on the labor market pushes further the population abroad. Due to a 4.7% increase in the number of persons working or looking for a job abroad in Q3:12 this figure reached a new maximum for this period. Most of the new migrants leave to the CIS countries, as suggested by the remittances statistics showing a rise in migrants' transfer only from this direction.

Despite these negative trends, the salaries were on a positive trend in the third quarter and the following months. The only sectors affected by declining wages are some industrial sectors where the external demand for goods has decreased strongly (metallurgical industry, manufacture of fabricated metal products, manufacture of office machinery and equipment, manufacture of communication equipment and consumer electronics) and some other sectors represented by few enterprises facing severe structural problems (manufacture of tobacco products).

Although agricultural and service sectors are highly concentrated in informal sector, the employment decreased more significantly in formal sector (by 5% y-o-y), while in informal sector and households employment was on a positive track. Nevertheless, the number of salaried workers dropped more in informal occupations, partly due to higher Governmental concern on undeclared work in 2012. In 2012 the Government started the implementation of the Action Plan for fighting undeclared employment and undeclared wages adopted in 2011. It amended the Contravention Code and Labor Code in order to define the undeclared work and the way it should be penalized. Also, the number of inspections has intensified and the number of cases of informal employment tracked down has increased, rising the companies' costs of undeclared work. Nevertheless, gaps in tracking down undeclared unemployment still persist: inspections on call are the main tools used today, with no real progress in implementing an information system where statistical data can reveal a possible existence of undeclared work, e.g. very low salaries, sudden changes in wages, long activity of the company despite continuous yearly losses.

At the same time, few incentives were created to declare the salaries. Moreover, starting with 2013, the payment compensation for temporary disability due to common illnesses or injuries unrelated to work (sick leave) will be paid from the employers' funds for the first five days and only starting with the sixth calendar day of temporary disability, the compensation will be paid from the state social insurance budget. This is a common practice in EU countries to impose a part of burden on the employer in different forms (as the number of days per each sick leave or a maximum amount of sick leave days per year) and in most of the countries the number of days exceeds the five days set in Moldova in 2013 (with higher number of days in

the most developed countries). In Ukraine and Romania - the two neighbours of Moldova - the number of days to be paid by the employer in the case of sick leave is set to five. Nevertheless, employers from all over the Europe are revolted by these measures and often opposition parties in developed countries have promised the reduction of the number of days paid by the employer. In case of Moldova, where the cost of doing business is already very high, this is an additional burden for the business activity and another incentive not to declare the salaries. Also, in setting such measures some important aspects of the quality of institutions should not be ignored: in the developed countries there is higher control and the patients cannot trick the doctors regarding the duration of illness or bribe them.

Short-term forecast and challenges

- As suggested by the recent data released, the recent drought will have a more moderate but longer effect on the labor market. Thus, we revised our forecast for agricultural employment, which is expected to decrease by 4% in 2013, but may rise by 2% in 2014 given the weather conditions are favourable. In the industrial sector we expect no major changes in 2013 and 2014 if the regional economic conditions are stable. In construction sector no change is expected in 2013, but with a rebound of up to 4% in 2014. The service sector, affected the most in 2012, will react more promptly to the economic stabilization with a possible 1-2% increase in employment if the economy is on positive track as predicted in Chapter 1.
- Given the above sector-level forecasts and the hypothesis that employment in public sector will remain stable, the employment rate is expected to stabilize around 38.5% level in 2013. The employment rate in 2014 may grow, but it this also depends on the general business environment policies, not only regional economic developments.

Policy recommendations

- Recent events threatened the images of some of the state institutions as several major foreign investors made public their intentions to leave Moldova due to some serious problems with the Fiscal Inspection. The Government has intervened and apparently the problems of these investors were solved. However, more than half of employment in Moldova is within the SME sector. It is fair to ask if the Government is also willing to solve the problems of each small company in trouble with the fiscal inspections that is not a rare situation. The rise in employment may be achieved only through right interventions in the business climate and by treating each company fair and equal.
- In 2012 Moldova advanced significantly in the relations with the EU. The experience of other countries that have already passed through similar process shows that trade has been the most important factor modeling labor markets of EU countries before their accession. In case of Moldova, the DCFTA with EU may increase the overall employment in Moldova as labor factor demand will grow in order to satisfy new internal and external demand for goods and services. But, all the benefits are expected to happen only under the assumption that Moldova can foster the necessary human capital². While, the negotiations of DCFTA are in the process, there is no intense activity of other ministries in this direction. The Ministry of Education and Ministry of Labor, Social Protection and Family should begin seriously rethinking the educational and employment policies to adapt to the new economic needs that might result from DCFTA with EU. The start should be a deep research and forecast of the labor market needs in long term (10 years) based on businesses' perceptions, replacement demand calculation, experience of other countries that already joined EU and European economic trends and should be followed by the necessary policy measures to meet these needs.

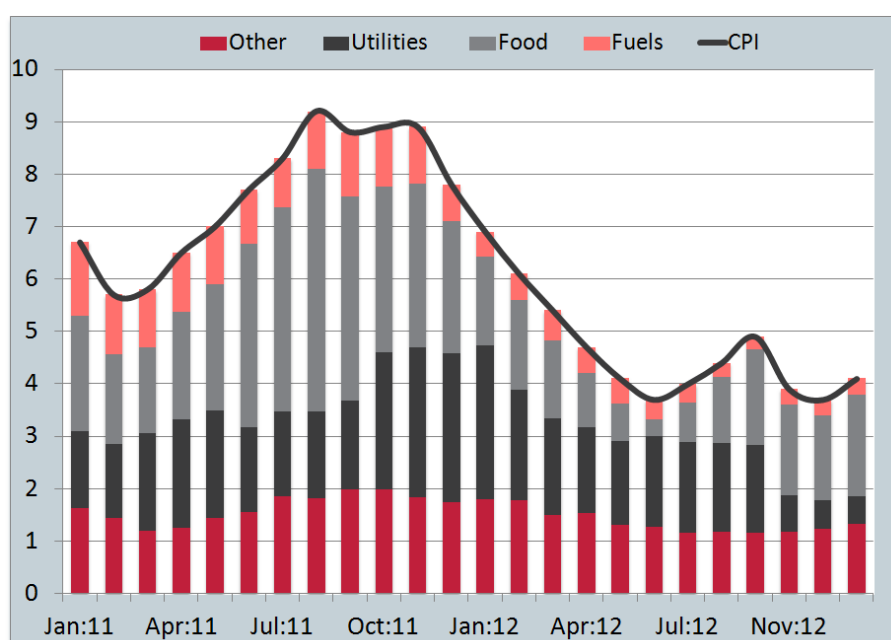
² Moldova National Human Development Report 2012. European Aspirations and Human Development of the Republic of Moldova, UNDP, 2012;

■ Chapter 5. Prices and Monetary Policy

Unconventional measures for taming inflation?

Over the last quarter of 2012, the dynamics of the annual headline inflation was influenced by a mix of inflationary and disinflationary pressures, owing primarily to supply-side factors. Thus, on the one hand, the regional drought repercussions continued to fuel the prices of foodstuffs, both local and imported. On the other hand, along with the dissipation of the effects of last winter's price hikes for gas and heating, the contribution of utilities' prices to headline inflation has slumped. As a result, at the end of December, about 47% of y-o-y CPI growth was determined by foodstuffs inflation – up from only 9% in June. At the same time, the contribution of utilities constantly decreased from 46% to 13% during the same period of time (Chart 13). The result of these counterbalancing effects was a 4.1% y-o-y headline inflation registered at the end of December, with the highest price jumps noticed for fresh vegetables (+22.7%), eggs (+19.5%) and fresh fruits (+11.4%).

Chart 13. Main components of CPI, y-o-y growth, %



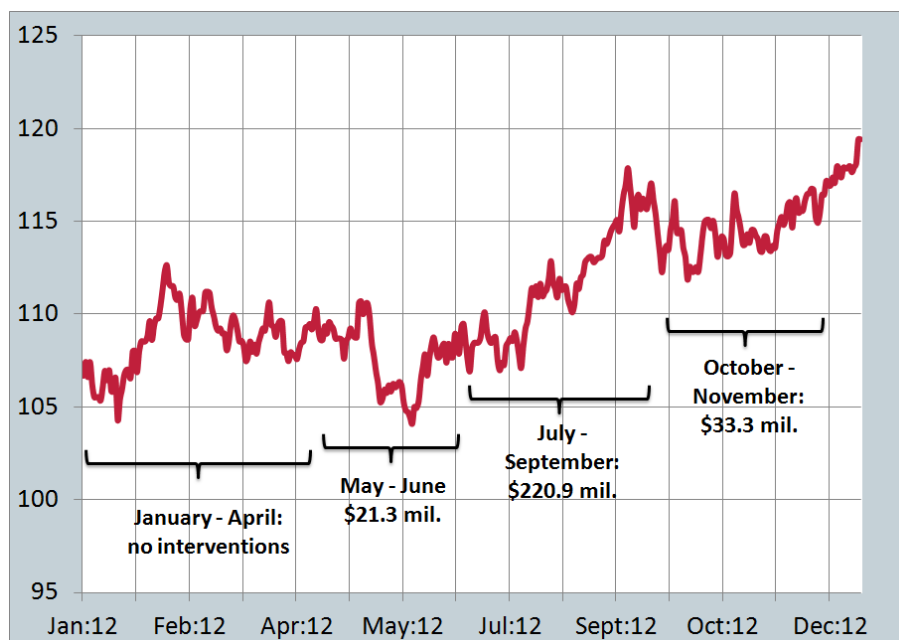
Source: NBS and EXPERT-GRUP calculations;

Hence, the foodstuffs replaced utilities as the main source of general price increase. In this way, the inflationary pressures changed in structure, but they did not change in nature. Thus, the CPI is still driven by cost-push factors while the domestic demand flounders. As a result, since September, the annual core inflation has hovered at around 3.6%-3.7%, whereas the contribution of CPI components, other than utilities, food and fuels, remained almost unchanged. Such settings have always been a major challenge for the monetary authority: it should keep one eye on maintaining price stability, which is its main policy objective, and the other eye on the necessity to nurture the economy back to a healthy growth. As the economic conditions weakened and the demand-side inflationary pressures remained low, the central bank kept the accommodative stance of its monetary policy. Thus, the policy rate remained at its historical low of 4.5%, which is almost equivalent with the NBM's mid-term inflation outlook.

Another important reason for keeping the policy rate intact is the fact that the effect of monetary easing from the beginning of 2012 haven't dissipated yet. Under such conditions, an additional policy rate cut could fuel additional inflationary pressures in the near future and could induce unnecessary policy volatility. Therefore, the central bank resorted to other tools in order to fine-tune the economy and prevent the disinflationary

pressures. Particularly, starting from May 2012 it has purchased important amounts of foreign currency on the domestic market, causing a controlled and moderate depreciation of the Moldovan leu (Chart 14). These actions appeared to be a compromise which satisfied both NBM's needs, through mitigating the disinflationary pressures and augmenting the foreign reserves' level, and Government's ones, through financing the fiscal gap and the current account deficit.

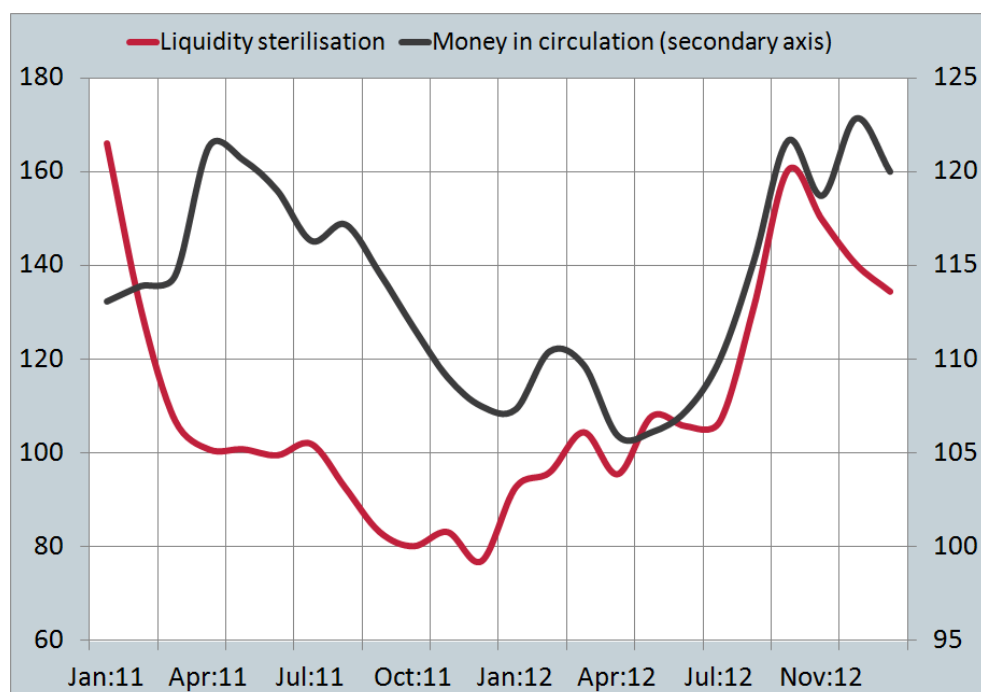
Chart 14. Average between daily official MDL/USD and MDL/EURO parities (y-o-y growth, %) and the amounts of foreign currency purchases operated by NBM on the domestic market



Source: NBM and EXPERT-GRUP calculations;

Also, NBM used intensively the liquidity sterilization open market operations during the second half of 2012. As the opportunity cost of holding money decreased due to the disinflationary process during 2012, while the monetary policy remains broadly accommodative, the growth rate of money in circulation has soared (Chart 15). If not adequately tackled, it could fuel the inflationary pressures in the near future: empirical estimates suggest that the fluctuations in money in circulation predict fluctuation in CPI by 1-2 quarters in advance. As a result, NBM increased its open market operations in order to sterilize the abundant liquidities from the economy and mitigate the long-term inflationary risks.

Chart 15. Liquidity sterilization operations and money in circulation, y-o-y growth, %

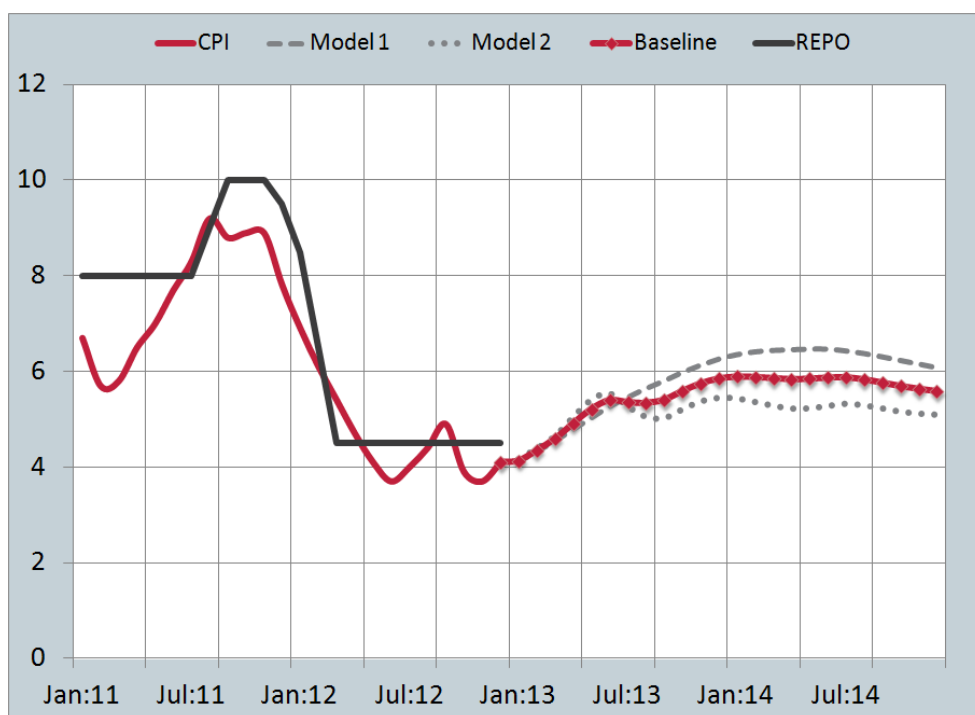


Source: NBM and EXPERT-GRUP calculations;

Forecast and challenges

- The 2013 year will be very different from the previous one in terms of inflationary pressures and trends. The dissipation of drought effects in the second half of the year will stabilize the foodstuff prices, but this inflationary factor will be replaced with the impact of tax hikes and especially in excises on imported gas and fuels. Additionally, the anticipated economic recovery for 2013 is likely to give a fillip to fledgling demand-side inflationary pressures, which, nevertheless, will remain quite low.
- Given the economic recovery anticipated in 2013 and the resurgence, though moderate, of demand-side inflationary pressures, the central bank might consider a gradual withdrawal of the accommodative stance of its monetary policy. It could imply a moderate hike in NBM's policy rate during 2013, aimed at further anchoring the long-term inflationary expectations. Still, the central bank will face two major challenges as an inflation targeting monetary authority: (i) the persistence of cost-push inflationary pressures, and (ii) high uncertainty related to local and regional macroeconomic prospects.
- Taking into account the macroeconomic outlook for the next two years, we expect that in 2013 the headline inflation will slightly increase owing to higher taxes and a recovery, though modest, in the domestic demand. Therefore, at the end of 2013, the y-o-y CPI is likely to reach the level of 5.0%, in the absence of other shocks (Chart 16). As the primary and secondary effects of tax raises will dissipate, the headline inflation will gradually subside to 4.5% until the end of 2014. All in all, the inflation outlook paints a favorable situation for the monetary authority which, apparently, managed to tame the inflationary expectations within the targeted interval of 5% (+1.5 p.p.).

Chart 16. REPO rate and y-o-y CPI forecast according to two different models and the baseline scenario



Note: Model 1 has been derived from a structural vector autoregressive model with two periods; Model 2 has been derived from a SARIMA (1[10],1,1)x(0,1,1) model. The baseline forecast was obtained as the average between model 1 and model 2. More details about the specification are available upon request.

Source: NBM and EXPERT-GRUP calculations;

Policy recommendations

- One of the most crucial aspects which should be kept in mind by BNM when taking monetary policy decisions is their relatively slow pass through the economy. Therefore, the central bank should be much more prompt and forward looking in comparison with other neighboring countries. It can't afford maintaining the accommodative stance of its monetary policy for a very long time as a delayed policy adjustment might easily make inflation spiral out of control. Therefore, the necessity to strengthen its forecasting abilities is crucial for a successful implementation of the inflation targeting strategy currently followed by NBM. It implies channeling much more financial and human resources into research activities and training focused on macroeconomic forecasting, which could diminish the policy uncertainty and allow for more decisions.
- Given the expected economic recovery and the inflation outlook for 2013 and 2014, the central bank should consider a gradual withdrawal of the accommodative stance of its monetary policy during the next two years. It implies keeping the policy rate at about 1-2 p.p. above the medium-term inflation forecast by the end of 2014. Hence, assuming that by this time the annual CPI is likely to stabilize at around 4.5% - 5.0%, the NBM's policy rate should be gradually adjusted up to the level of 6.0%-7.0% during 2013-2014. It is, also, urged by the strong growth in money in circulation, which accelerated after the recent monetary policy easing and which pose significant long-run inflationary pressures. Still, the largest part of this rebalancing should take place in 2014, when the economy will be back on a relatively healthy economic growth, while during 2013 the central bank could raise its policy rate only by a slight fraction. These monetary policy adjustments to new economic realities during the next two years should be correlated with an intensive communication with the public and stakeholders about the necessity and potential impact of these actions.

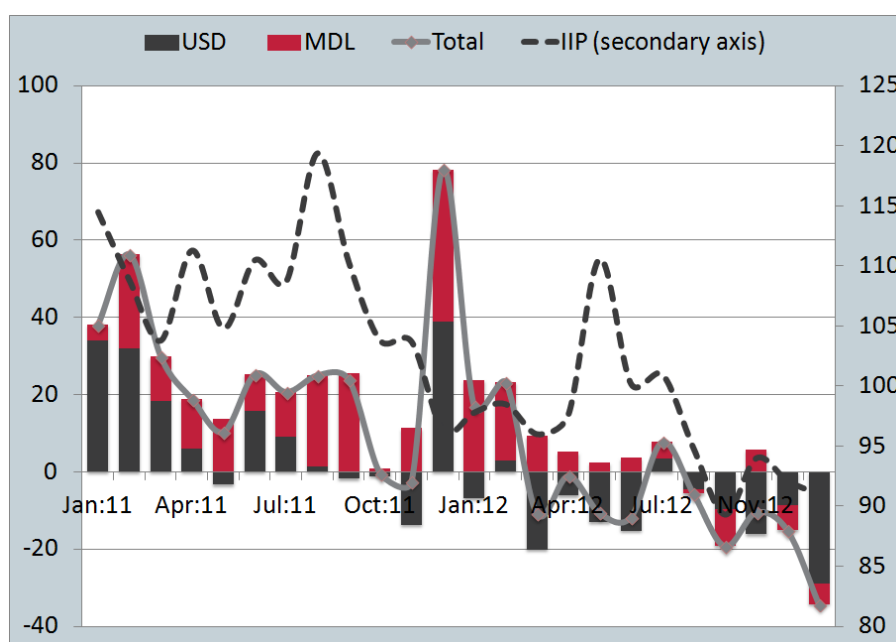
- Obviously, the recommendation above is conditional upon the expected economic recovery in 2013 and its further stabilization in 2014 – the baseline scenario. In case of a more pessimistic scenario, which might determine the domestic demand to remain anemic and the disinflationary pressures to persist, the central bank might further ease the monetary policy. It could imply a policy rate cut down to 4.0% during 2013. Nevertheless, the probability of this scenario is relatively low, as opposed to the baseline one.
- The draft amendments to the Law on NBM related to the internal management of central bank which will be examined by the Parliament during 2013 should not limit the independence of this institution. Therefore, the central bank should manage the pressures coming from some political actors aimed at restricting its operational independence by setting up closer control from the Government. According to the best practices, the decision making process in monetary institutions should be free of political bias and should be governed by apolitical experts. Moreover, the current legislative framework governing the NBM's activity should be further adjusted to the European norms of central bank independence. The current main legislative flaws are related to the provision which obliges the central bank to ask the Ministry of Justice for revision and expertise of its legal acts, the possibility of the Parliament to dismiss the members of the administration council of NBM with a simple majority (except for the Governor), as well as the lack of provision that gives the right to dismissed members to resort to courts. These issues should be addressed in the new amendments to the legislative framework governing the activity of the monetary institution in Moldova.

■ Chapter 6. Banking Sector

Banks shaping the economic cycle

Under the weight of economic recession a rational behavior of any bank is to increase its risk aversion and tighten the credit supply. It implies building higher capital buffers and channeling less money for financing consumption and investment that further cools down the economy. Thus, banks are not simply pro-cyclical, they rather shape the economic cycle. It is confirmed by the lending pattern of Moldovan banking system during 2012 and, especially, the second half of the year: in July-December total new credits declined y-o-y by 16.4%. Given the traditional liquidity constraints faced by most Moldovan firms, as well as poor availability of other financing sources, this negative trend has been mirrored in the dynamics of industrial production index (Chart 17).

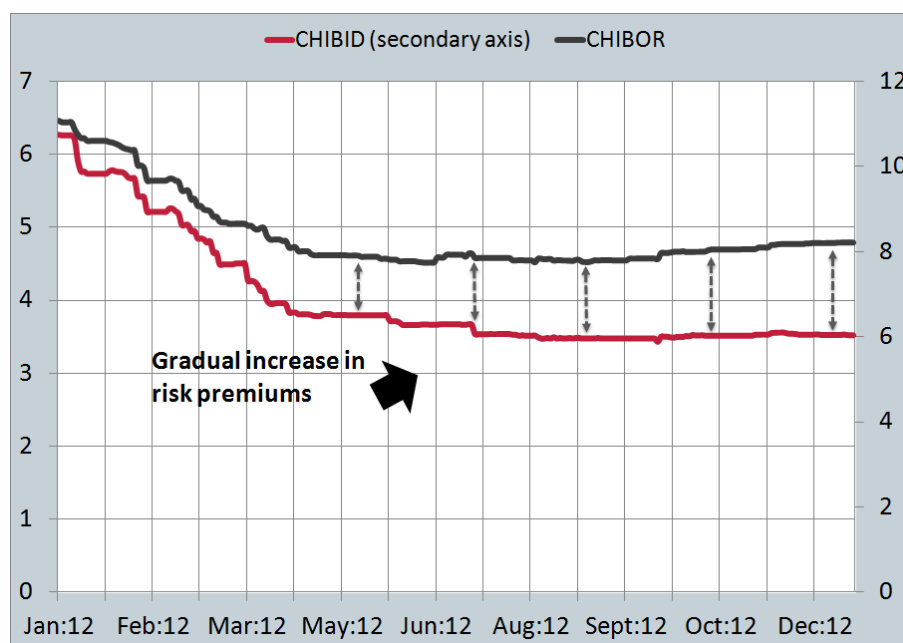
Chart 17. Annual growth of total loans, the contribution of loans in national and foreign currency to the total growth and index of industrial production, y-o-y growth, %



Source: NBM, NBS and EXPERT-GRUP calculations;

This credit crunch has been primarily driven by foreign currency lending, which slumped by 30.1% y-o-y during the second half of 2012, whereas the new credits in national currency declined at a much slower rate - 5.1% during the same period. In this way, the Moldovan banks continued to minimize their exposure to risks associated with the economic downturn in EU. As a result, the share of foreign currency lending in total new credits plummeted from 49.9% to 31.9% during 2012. Nevertheless, in the second half of 2012, the overall credit squeeze started to be fueled by lending national currency as well, whereas in the first half of the year it registered a positive y-o-y growth. It means that besides hedging against the EU crisis risks, the banks are immunizing their portfolios against the risks related to weakening domestic economy. It is confirmed by the gradual increase in the risk premiums on the inter-bank market during 2012 (Chart 18).

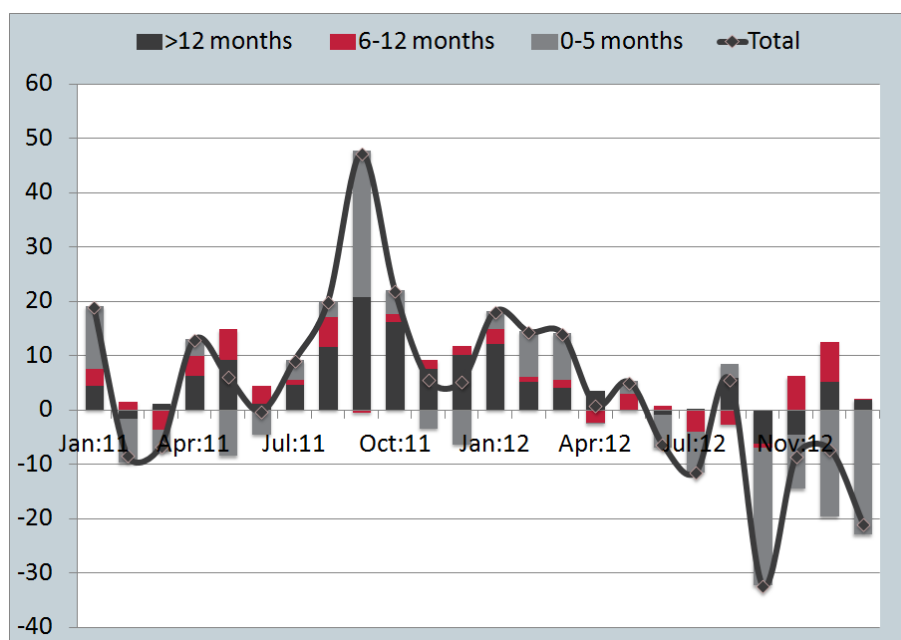
Chart 18. Difference between average CHIBOR and CHIBID interest rates for the entire spectrum of maturities, p.p.



Source: NBM and EXPERT-GRUP calculations;

The decreasing inflow of new deposits, which is the banks' primary source of capital, has been another culprit of the credit crunch from the second half of 2012. In this period, households and firms have lent to banks 13.7% less money as compared to the previous year. The harshest slump was registered for deposits of up to 5 months (-26.6%) which, with a share of about 40% in total deposits, had the biggest contribution to the overall decrease (Chart 19). This is the result of at least two factors: (i) households are smoothing consumption by compensating for the decrease in disposable income, while firms are using their short-term savings for purchases which could be advantageous during crises or to simply keep their businesses running; and (ii) some firms and households may convert their short-term deposits into medium or long-term ones as they postpone their investments or important purchases until the economic weather will brighten. This is confirmed by the fact that the amount of new deposits with maturities of over 12 months during the second half of 2012 almost did not change as compared to the previous year, whereas the deposits of 6-12 months even increased by 3.4% during the same period of time.

Chart 19. Annual growth of deposits and the contribution to the overall growth by maturity, %



Source: NBM and EXPERT-GRUP calculations;

As a consequence, the maturity structure of bank deposits visibly changed during 2012: the share of new deposits of 6-12 months and over 12 months in total new deposits increased from 18.2% and 27.2%, up to 25.3% and 34.0%, respectively. At the same time, the share of deposits with maturity of up to 6 months in total new deposits shrank from 54.6% to 40.0% during the same year. This shift denotes the fact that the economic situation worsening during 2012 did not hamper the public confidence in the banking system, while it still remains low as our previous studies suggest³.

Thus, the banking sector remained stable, highly liquid and well capitalized. As a result of the preventive measures applied by the banks, the share of non-performing loans in total loans decreased from 15.3% to 14.5% from July to December 2012, despite the economic downturn during this period. The biggest contribution to the current level of bad loans owes to the state-controlled bank “Banca de Economii” (BEM) where over half of total loans (55.3%) are non-performing. As a result, during 2012 BEM’s capital adequacy plummeted from 33.0% to 5.9%, well below the minimum acceptable threshold of 16%, while the tier 1 capital, at the end of the year, was only 64.8% of the required minimum. Despite its poor financial health, BEM remains liquid, with the short-term liquidity indicator of 49.7% (2.5 time above the minimum required level of 20%) and the long-term liquidity indicator of 0.45 (the maximum threshold is 1).

While the current situation at BEM is very acute and the policy options are limited, it came as no surprise for its management, owners and the regulator. EXPERT-GRUP stressed several times from the beginning of 2012 about the problems of bank’s capitalization and poor quality of its credit portfolio (see MEGA no. 6 and MEGA no. 7). Moreover, it is symptomatic that NBM has repeatedly warned the BEM’s Board of Directors about the strong risk exposure of the bank’s portfolio while the management and the Government did not undertake the necessary remedial measures to manage these problems. It points on a poor coordination and communication between the key institutions involved in this issue, as well as on potential frauds that should be closely investigated by the competent bodies.

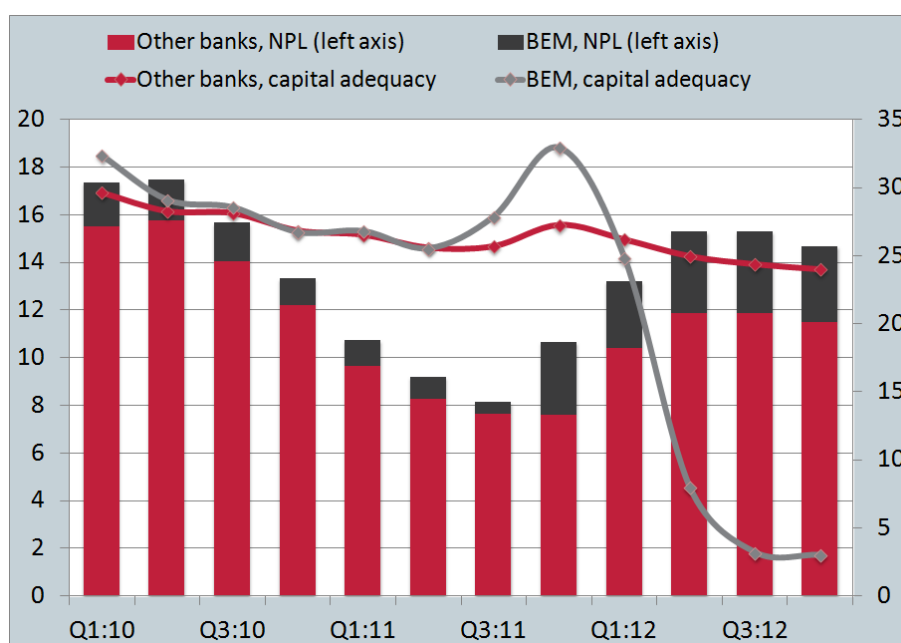
The BEM’s systemic importance does not stem simply from the fact that its assets account for about 12% and deposits for 13% of the entire banking system. Far more important is its social role: it has the highest

³ A. Lupusor (2011): “A Diagnostic Analysis of the Moldovan Banking System in the Context of Signing a Deep and Comprehensive Free Trade Agreement with EU”, Expert-Grup.

density of branches all over the country where people do not just take loans or open up deposits, but also receive different transfers from the state and abroad. Just like the public post, BEM is used by the central government as an indirect communication and money transfer tool for localities. Therefore, any troubles related to BEM and perceived by the public could easily steer panic in the society and undermine the confidence in the banking system as a whole. It emphasizes the crucial necessity to remediate as soon as possible the situation at this state-owned bank.

Nevertheless, except for this problematic bank, the overall situation in the sector remains comfortable, the capital buffers being sufficient to keep it stable and mitigate the current risks (Chart 20). As a confirmation, starting from March 2012, the Moldovan banks did not resort to the NBM's special credit line. On the contrary, the abundance of idle liquidities in the system made them to increase lending to the central bank: during the second half of 2012, the banks purchased by 35.9% more NBM certificates as compared to the same period of the previous year.

Chart 20. The share of non-performing loans in total credits and capital adequacy (min. 16%), breakdown for the bank “Banca de Economii” and all other banks, %



Note: The share of NPL in total loans and capital adequacy for November 2012 were estimated by EG.

Source: NBM and EXPERT-GRUP calculations

Short-term forecast and challenges

- During the next months the banks and public authorities will be facing a double challenge: (i) the endogenous one, which is related to the problematic situation of BEM and its risks posing for the entire banking system, and (ii) the exogenous challenges owing to the EU's economic crisis repercussions. Both could affect to a certain extend the public confidence, which has always been the main pillar of the banking system's stability. Therefore, the decision-makers will have to undertake more decisive actions aimed at fixing the balance sheet of BEM and avoiding any spillover effect to the system. At the same time, the commercial banks are likely to remain risk-averse, keeping the credit supply on the tight side, especially during the first half of 2013. In the second half of the year lending should rebound, though, on a moderate pace, with the economy entering the recovery phase of the economic cycle.
- Given the inflation outlook for 2013-2014, the average nominal lending rates will slightly increase to 12%-13% until the end of 2013, while during 2014 they could return to 10%-11%. The lowering of

credit interest rates in 2014 will be also triggered by diminishing risk premiums, which are likely to be kept high during 2013 due to high uncertainty and still weak economic conditions.

- Although during 2013-2014, the quality of banks' portfolios might improve on the grounds of economic recovery, the restructuring of bad loans accumulated during 2012 will remain very slow. The main reason lies in the legislative issues related to collateral execution and poor functioning of the judicial system. Therefore, the burden of non-performing loans will remain sizable, especially during 2013, being a major factor which will continue fueling the banks' risk aversion and straining the credit supply.

Policy recommendations

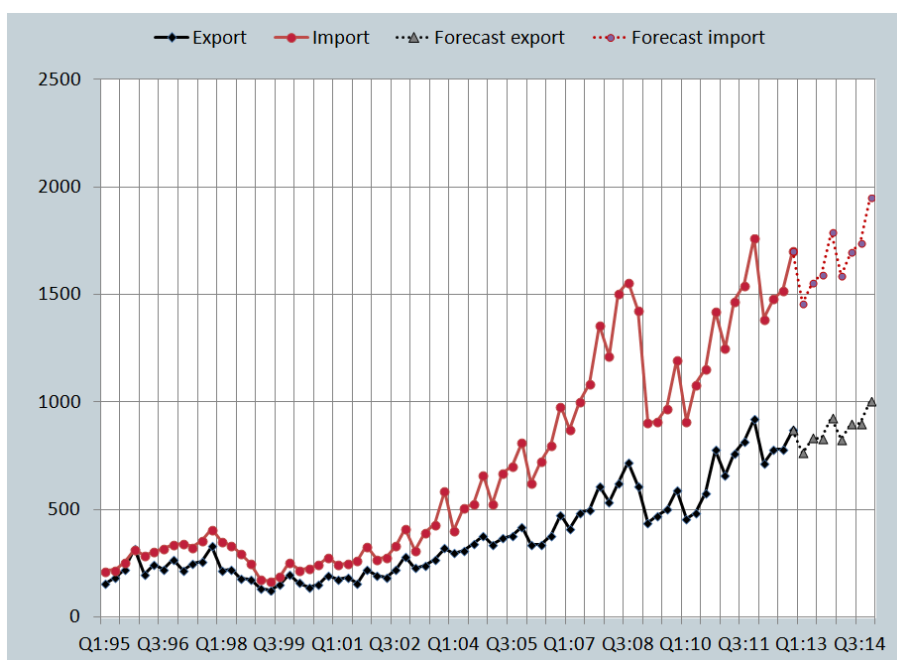
- While the economy has already entered into recession, it is timelier to discuss about post-crisis, rather than anti-crisis measures for improving the situation in the banking system. Given the fact that the most important challenge faced by the banks is worsening of their credit portfolios, the key priority on the decision-makers' agenda should be the adjustment of the institutional framework in order to make the commercial banks restructure easier and faster their bad loans. Particularly, it is necessary to allow the disputes between debtors and creditors to be settled out of courts and to facilitate the collateral execution in case of debtors' default. Strengthening the lenders' right will allow banks to spend less time recovering bad loans and devote more attention and their core activity - granting credits.
- Given the systemic importance of the state owned bank "Banca de Economii", it is necessary to undertake a comprehensive set of measures, which could be grouped in two sets. The first one will include immediate actions which should involve cleaning up the bank's balance sheet of bad loans and useless assets, executing the available collateral, settling all the delayed debts to other parties and bringing the bank's capital adequacy above the minimum required level. Additionally, it is necessary to apply and enforce all the necessary sanctions to those responsible for making the bank enter in many risky and doubtful lending practices. Obviously, these immediate measures will not solve the main issue which brought the bank to the current crisis: inefficient management and poor transparency. Hence, in order to prevent a similar situation in the future, the second set of measures should be oriented towards strengthening the management of this institution by specifying clear performance criteria, division of responsibilities among the decision makers within the bank and ensuring a full transparency about the bank's activity and shareholders' structure.

■ Chapter 7. Foreign sector

Moldova's trade reflecting global and regional economic woes

Statistical data for late 2012 show that the previous issue of MEGA rightly predicted that Moldova's trade with goods would continue to worsen by the end of the year 2012 (Chart 21). According to our estimates, last year Moldova's exports of goods posted a 1.0% annual decline. The handicap comes mainly on the account of the exports targeting EU markets (-6%), where demand receded significantly in 2012, with only some modest improvements appearing in Nov-Dec:12. Falling European demand has been the main culprit for Moldovan lower exports of clothes and shoes, which are among the most important items of Moldova's trade with Europe. At the same time, exports of machines and metals from Transnistrian region targeting EU markets also suffered. Exports to the CIS countries registered a 3% annual growth; however, by the end of the year the situation on the CIS markets deteriorated visibly. Exports to the third countries have also posted an unusually small growth of only 4%. The more depressing climate conditions have affected Moldova's exports of agricultural and food products to almost all destinations. For instance, in 2012 exports of cereals and products thereof, especially to the EU, halved compared to 2011. The dry summer also hit the exports of one of the most competitive Moldovan products on the EU market – oleaginous seeds and fruits.

Chart 21. Evolution and forecast of the quarterly trade flows of goods and services, million USD, Q1:95 – Q4:14



Source: NBM and NBS, forecast for 2013:Q1-2014:Q4 by EXPERT-GRUP;

Our predictions regarding the services exports for 2012 were less precise, with actual figures more rejoicing than we expected. We forecasted a further reduction of the volume of exported services, however balance of payments data for Q3:12 show a slight rebound against Q3:11 (+3%), mainly on the account of transport services (+2.7%, but declining), business travels (+17%) and informatics services (+17%). The foreign demand for Moldovan transport and business travels has good chances to grow in mid- to long-term, in result of Moldova's deeper economic integration with EU and introduction of the visa-free regime. As for the informatics services exports, their strong growth amid difficult economic times in the global economy testifies the high competitive potential Moldovan firms have. Opposite to trade with other services, the balance of trade with informatics services has been constantly positive since Q2:10. This potential, unfortunately, is not yet fully harnessed on the domestic markets.

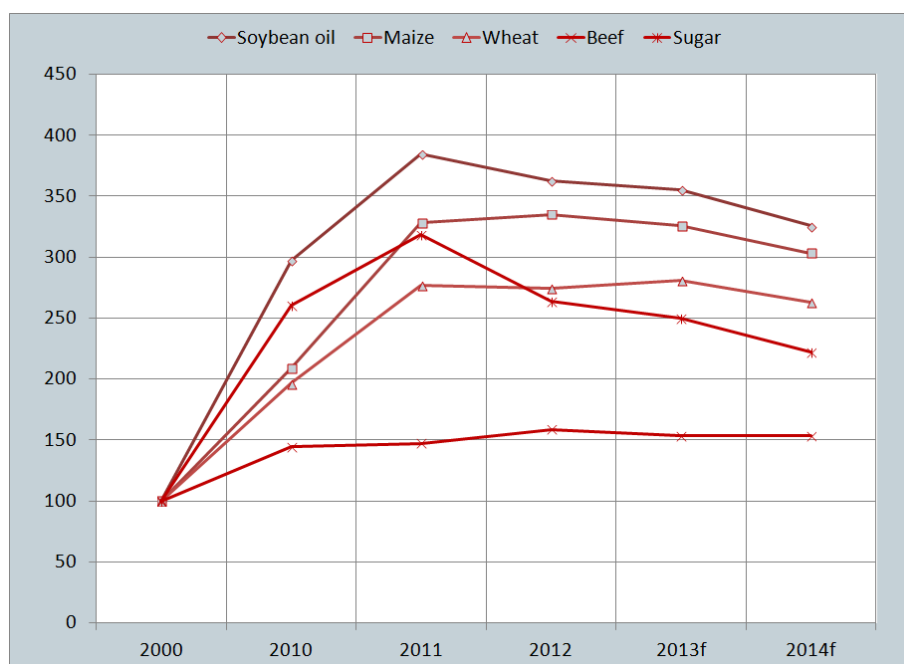
Imports of goods in 2012 did not look much more resilient than exports, with an estimated annual growth in 2012 of only 1.2%, mainly on the account of imports from the CIS countries (especially, from Ukraine, Russia and Belarus). Two defining features of the imports' dynamics in 2012 were falling domestic demand for investment goods and the substitution of the weaker domestic production of food and beverages with products supplied from abroad. While we see the latter as a trend likely to reverse in 2013, the former is a symptom of worsening economic confidence of Moldovan manufacturing and construction firms, which are cutting or postponing planned investments. The demand for imported investment goods is likely to remain timid over 2013, but with good chances to improve in 2014.

The economic year 2012 featured a timid post-crisis recovery in US, some European and developing countries; at the same time, most of the developed world entered deeper recessions. Across the European continent, the economic situations in various countries differ greatly, which reflected in Moldova's trade figures and patterns. One of the most worrying trends is the economic slowdown in **Germany**, with GDP growth rate going from 0.5% in Q1:12 to 0.3% in Q2:12 and only 0.2% in Q3:12. Investments in equipment and other productive facilities declined, reflecting worsening economic confidence towards this key European economy. This had palpable impact on Moldova's foreign trade, with exports falling by more than 35% y-o-y. If unabated, the falling trust in German economy may trigger confidence shocks across the entire European economy. The chances for a soon recovery in the EU are further undermined by the high unemployment rate, reaching a record 11.8% in the Euro-zone and 10.7% in the wider EU-27 area.

The weaker labor markets in the European Union already makes Moldovan migrants look for employment opportunities in CIS countries and other parts of the world (including Canada, US, Middle East). However, economic perspectives in the CIS region itself, including in **Russia**, are not that rosy. True, in 2012, the Russian Federation consolidated its position as the most important country-destination of Moldova's exports, with its share rising from 28.2% of total exports in 2011 to almost 30.9% in 2012. However, maintaining this figure in 2013 looks more problematic. Reflecting the economic troubles in the EU and the falling global prices for oil, the economic growth in Russia has slowed down significantly (from 4.9% in annual terms in Q1:12 to 1.9% in Q3:12), and immediate perspectives are equally dim. Moldova's immediate neighbors – **Romania** and **Ukraine** – are experiencing economic troubles that reflected into Moldova's trade figures: annual exports to Romania fell by more than 8% in 2012, while to Ukraine – by more than 20%. Curiously, exports to some more exotic – for Moldova – markets reported breathtaking growths, such as the case of New Zealand (6-fold growth of exports), Iraq (3.5-fold growth) and China (+90%). Some of these figures look more as outcomes of dubious one-off 'commercial transactions' rather than reflect genuine strategies of diversifying away from traditional export markets. In 2011, similar episodes happened, with 'exports' to Belize exceeding USD 20 million and to Panama – USD 6 million and vanishing next year.

Prices for global commodities in 2012 reflected the interplay of economic, technological and geopolitical factors, with some sizeable fluctuations in mid-2012, especially for food prices; however, by and large, the year ended where it began for most agricultural commodities (Chart 22). European debt crisis and slower growth prospects of China declined the prices for industrial commodities early in 2012, however by the end of the year the prices stabilized in result of easing financial tensions in Europe. In 2012, the new technologies applied so far only for gas exploitation (horizontal drilling and hydraulic fracturing) entered full swing in the oil industry, announcing significant global market changes in mid-term. Meanwhile, in 2012, the price of gas, expressed in energy-equivalent terms, reached historical lows compared to the oil. The hot and dry summer in key regions producing grains (maize in US, wheat in Eastern Europe and Central Asia) made the prices to grow sizably in the second part of the year, but the new prices heights do not look sustainable in short and mid-term.

Chart 22. Evolution and forecast of prices for key agricultural commodities, USD nominal price index 2000=100%



Source: World Bank, Development Prospects Group;

Short-term forecast and challenges

- The Euro area is expected to continue its economic woes in 2013, and to start recovery in 2014. The IMF expected GDP figure for 2013 is set at -0.2% (+1.0 in 2014)⁴, while other forecasting bodies expect a much worse outlook (such as -2.0% for 2013 and -1.0% for 2014, as forecasted by Capital Economics⁵). This will hamper Moldovan exports targeting two key countries in the area – Germany and Italy, which together account for about 13% of Moldova exports. Even more, this can undermine even more Moldova's prospects of attracting foreign direct investment from these technologically more advanced countries. For Russia, the IMF expects largely the same GDP growth figure for 2013 (3.7%) as its estimate for 2012 (3.8%); however, private forecasters adopt a more cautious stance, betting on a 2% growth in Russia's GDP for 2013. The latter is more in line with Russia's long-term economic slowdown as expected by senior Russian experts⁶. Romanian National Committee for Forecast expects the country's GDP to put a 2.0% growth in 2013, with some more upbeat outlook for 2014 (2.5%)⁷. In Ukraine, forecasts for 2013 are subject to high risks considering the complex domestic political environment and the vulnerability of the Ukrainian economy to multiple external risks. In late January 2013, the EBRD updated its regional forecast, lowering Ukrainian's figure for 2013 from 2.5% to 1.0%, which is the largest negative change in forecasts for the countries in the EBRD's panel.
- Global prices for key commodities of influence for Moldovan economy are not expected to register sharp changes in 2013-2014, but downside forces will likely prevail. The World Bank predicts that the crude oil will hover around 102 USD/barrel in the next two years. Subject to weather conditions, the barley and maize are expected to cheapen by 5% and 2.5% accordingly in 2013, and to lose

⁴ IMF, "Modest Growth Pickup in 2013, Projects IMF",

<http://www.imf.org/external/pubs/ft/survey/so/2013/NEW012313A.htm>;

⁵ Capital Economics, "Selected Macro-Economic Forecasts (as of 16th Jan. 2013)",

<http://www.capitaleconomics.com/key-forecasts/forecasts-macro-january-2013.pdf>;

⁶ "Эксперты РАН и ВШЭ поставили диагноз российской экономике, дав тревожный прогноз и совет"

http://newsru.com/finance/01nov2012/crisis_s_nami.html;

⁷ Comisia Națională de Prognoză „Proiecția principalilor indicatori macroeconomici pentru perioada 2012-2016”,

http://www.cnp.ro/user/repository/prognoza_2012-2016_varianta_de_toamna_2012.pdf;

other 6-7% both in 2014. The wheat will continue to gain modestly in price in 2013 (+2.2%), but will lose all the gains in 2014 (-6% to -7%). A worrying prediction for Moldovan producers of oil and oilseeds, in 2013 the soybean and palm oil prices (which can substitute the sunflower oil) are expected to average 3.6% and 2.1% lower prices than in 2012, and even lower in 2014, by 8.4% and 2.1% accordingly. The global prices for sugar are also set to decline in mid-term (Chart 22), which is of bad augur for Moldovan sugar companies.

- These regional and global perspectives will inevitably influence Moldovan trade. Considering, on the negative side, the rather grim economic outlook for EU, CIS and Moldova's immediate neighbours and, on the bright side, the expected recovery in agriculture, under the basic scenario we forecast a 6.5% growth in exports of goods and services in 2013 and a stronger 8.2% rebound in 2014 which is conditional on firmer economic growth in the EU. For 2013, the forecast is based on an expected 5.5% resumption of exports to the EU, and an 8.5% growth to the CIS⁸; the exports to third countries are expected to put a 7% growth y-o-y. Total volume of imports of goods and services will grow 5.0% y-o-y in 2013 and 9.0% in 2014. Combined with the expected modest growth in income and unilateral transfers from abroad, we expect slightly narrower current account deficits in 2013, which will widen again in 2014.

Policy recommendations

- Fostering Moldova's export potential as its key engine for sustainable economic growth remains our main general recommendation, which can be further detailed in already known policy and institutional interventions. Moldovan Government has to show more dedication in abolishment of all behind-the-border barriers to trade, as identified in the Ministry of Economy's study and related plan. Moldova needs a Customs Service pursuing a mission which would be more consonant to the facilitation of trade rather than to be a fiscal arm of the state. As shown in 2012, Moldova's exports potential can be easily undermined if foreign investors remain so uneasy about the Moldovan fiscal climate and how the state interacts with businesses in general.
- In short- to medium-term the economic situation in Europe will remain difficult, with its effects spilling over other parts of the world, including Russia. This sends clear messages for the Moldovan firms targeting these markets to adapt their production technologies and marketing strategies in order to manage the risks of the more sluggish demand by reducing production costs and adopting more aggressive marketing approaches. At the same time, firms have to start more actively searching for niches in the third-countries. The share of the third countries (others than EU, including countries that joined in 2000s, and CIS) in Moldovan foreign trade in goods increased from 6.2% in the year 2000 to 11.9% in 2010, but declined in 2011-2012. The third countries may represent particularly interesting outlets for Moldovan food and beverages.
- Moldovan exports of goods and services are predicted to recover a bit faster than domestic demand in 2013, which lowers the pressures on the current account. However, the downside risks to this forecast are high, and the Government should be firm on obtaining better terms of trade for the country. As energy and fuels are the key imports of Moldova, the Government has to put more efforts in negotiating fair prices for the energy imports. This is especially the case of imported natural gas, for which the price formula is coupled with the price for oil. While back in mid 2000s when the formula was agreed upon the natural gas traded just 7% below the oil in energy-equivalent terms, in 2011-2012 the gas averaged 82% of the oil in the same terms. In their negotiations with Gazprom over the price for imported gas, Moldovan negotiators should aim to 'decouple' the price for gas from the price for oil and not to aim for a long-period validity of the contract. With advancement of new exploitation technologies in US and elsewhere, the prices for conventional energy sources are set to gradually decline.

⁸ Adrian Lupusor, "Could the falling Moldova Exports to EU in 2012 Affect the Negotiations on the Deep and Comprehensive Free Trade Area?", http://expert-grup.org/en/biblioteca/item/download/926_9f326fa7f492a8165e31705f497f7d8d.

■ About EXPERT-GRUP

WHO WE ARE

EXPERT-GRUP is a Moldovan non-governmental and not-for-profit organization specialized in economic and policy research. EXPERT-GRUP does not represent any economic, corporate or political interests. As independent organization, EXPERT-GRUP reflects the ideals of the young Moldovan intellectuals who have created the institution with the purpose of contributing to Moldova's development. Among other types of organizations in the 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 supporting the development path of Moldova. Our key competence lies in the ability to provide professional, high-quality and objective research in such broad fields as:

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

PARTNERS AND DONORS

In the period 2006-2012 the EXPERT-GRUP has implemented more than 50 research and advocacy projects in different areas related to economic and policy research. More than 100 associated and non-associated experts from Moldova and other countries were involved in these projects. We have worked with such donors as Moldova Soros Foundation, Eastern European Foundation, Konrad Adenauer Stiftung, Balkan Trust for Democracy, Black Sea Trust, Friedrich Ebert Stiftung, UNDP Moldova, UNICEF, European Commission, Council of Europe, Open Society Foundation, Swiss Agency for International Cooperation, United Kingdom Department for International Development. In 2010 and 2012 the EXPERT-GRUP was elected member of the National Participatory Council of Moldova. Since 2008 the EXPERT-GRUP is member of the Policy Association for an Open Society – a network of policy centers uniting 56 think tanks from countries across Europe.