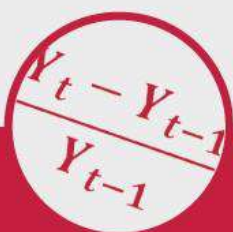


MEGA

1st Quarter, 2020, #21



**Economic growth and public finances
during an electoral period: conclusions
from 2019 and forecasts for 2020**

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Disclaimer

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About MEGA

MEGA is an English acronym standing for Moldova Economic Growth Analysis. MEGA is a biannual review published by EXPERT-GRUP since 2009 with the purpose of explaining the fundamentals of the recent economic trends in Moldova, analyzing economic policies and proposing solutions for the economic development strategies of the country.

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Contents

Contents	3
Key messages of the publication	5
Estimations and forecasts of the key macroeconomic indicators of the Republic of Moldova for 2019-2020	9
Real Sector	10
Main developments.....	10
Forecasts and risks.....	12
Households and Labour Force	14
Main developments.....	14
Forecasts and risks.....	17
Public Finances	19
Main developments.....	19
Can a high budget deficit stimulate significantly the economic performance in 2020?.....	22
Forecasts and risks.....	23
Financial Institutions.....	26
Main developments.....	26
Forecasts and risks.....	29
Prices and Monetary Policy	31
Main developments.....	31
Forecasts and risks.....	33
Foreign Sector	35
Main developments.....	35
Forecasts and risks.....	40

List of figures:

Figure 1. Output GAP, %	10
Figure 9. Evolution of investments in fixed assets, y-o-y growth, %	11
Figure 10. Weather conditions, deviations from the norm, and evolution of the agricultural sector, growth y-o-y, %	11
Figure 11. Industrial production dynamics in Jan-Nov:19, y-o-y growth, %	12
Figure 5. Development of personal income, real growth y-o-y, %	14
Figure 6. Dynamics of the employed population (thousand people)	15
Figure 7. Dynamics of the employment (left axis) and unemployment rates (right axis), seasonally adjusted, %	15
Figure 8. Dynamics of informally employed population (% of total employed population) with and without households	16
Figure 9. Dynamics of employment rate with and without households (%)	16
Figure 10. Evolution of the National Public Budget (planned and actual) deficit (% of GDP)	20
Figure 11. Comparative analysis of the NPB balance in May (% of total NPB revenues)	20
Figure 12. Dynamics of expenditures across the 'Economic services' (% y-o-y)	21
Figure 13. Dynamics of domestic borrowing from non/financial institutions (MDL million, cumulated since the beginning of the year)	21
Figure 14. Structure of assets and liabilities, %	27
Figure 15. Interest Rates Market, %	28
Figure 16. Dynamics of lending activity %, and intermediation throughout the financial system, MDL bln	29
Figure 17. Evolution of consumer price indices, y-o-y growth, %	31
Figure 18. NBM interventions on the foreign exchange market and net foreign currency purchases from individuals and legal entities, USD million	32
Figure 19. Monetary policy tools applied by the NBM	33
Figure 20 GDP growth in Russia and EU, % y-o-y	35
Figure 21. Evolution of prices for food and oil, % growth y-o-y	36
Figure 22. Foreign Trade of the Republic of Moldova, y-o-y change, %	37
Figure 23. Exports of the Republic of Moldova divided by groups of countries, USD million	38
Figure 24. The degree of influence of groups of commodities on the increase/decrease in exports, %	38
Figure 25. Imports of the Republic of Moldova divided by groups of countries, USD million	39
Figure 26. The degree of influence of groups of commodities on the increase/decrease in imports, %	39
Figure 27. Evolution of current account by components, net values, million USD	40

Key messages of the publication

After a relatively favorable economic year, 2020 brings more macroeconomic challenges, with major risks for the public finance system. Overall, the economic growth in 2020 will be tempered compared to the result recorded in 2019. Thus, after the economy grew by about 4.5-5% in 2019, in 2020 the GDP will advance by about 3.5-4%. Most economic sectors will show relatively slow growth rates in 2020. The most significant slowdown compared to 2019 will be registered in the construction sector. The sector that was the leader of growth in 2019, with an increase in value added close to 20%, in 2020 will advance by only 2%. On the other hand, domestic trade will remain on a positive track and will ensure the largest contribution to GDP growth in 2020. A first cause of this anticipated economic slowdown for 2020 is the complete dissipation of the effects of the fiscal reform implemented in the last quarter of 2018 (reduction of the social security contribution rate paid employers). Although the relaxation of the monetary policy and the increase of consumption will stimulate the dynamics of private investments, they will no longer benefit from the impulse generated by the mentioned tax reform. Also, the slowing of the economic advance in the EU (the main trading partner of the Republic of Moldova) will lead to the moderation of the rhythms of growth of Moldovan exports, with negative repercussions on economic growth. The expansionary budgetary policy will stimulate the expansion of domestic demand, by increasing public investments and budgetary wages, but this will be mainly covered by imports, further aggravating the current account deficit problem. At the same time, the mechanism of financing the budget deficit could have negative implications on the economic growth if the Government will actively resort to loans from banks, which will undermine the lending of the real sector (crowding out effect).

The year 2019 was a very complicated one for the national budget taking into account the multiple pressures that the public finance system had to face. First, the effects of fiscal reform, although positive in nature, have essentially undermined the balance of the state budget and the social insurance budget. Secondly, as a result of the reform of the pay system in the budget sector, the government had to face financial commitments that far exceeded the limits of fiscal prudence. Only the resumption of the external financial assistance in the fall of 2019, in parallel with the under-execution of the investment expenses, allowed the budget deficit to be framed within the budgetary-fiscal limits established by national legislation. At the same time, the Government has managed to attract only a small part of the grants for direct budget support and financing of capital investments planned for 2019. Thus, the financing of the deficit relied on internal sources, through issuing state securities and lending from commercial banks.

By 2020, public spending will grow faster than budget revenues in the context of a new election year. We forecast that in 2020 the total revenues of the national public budget will increase by about 1% f-a-p, while for the expenses we anticipate an increase of about 4% f-a-p. Although external financing has been resumed, it is partial (segmented) and slow, conditioned by a series of obligations that the Government has not at least formally assumed. In these circumstances, it will inevitably reduce the budgetary expenditures that depend directly on external sources of financing. Thus, the annual budget deficit for 2020 will fall within the range of 2.5 - 3.4% of GDP. At the same time, there are certain signals that the Government will implement a series of measures to mitigate the risks to public finances (eg: social and wage payments will be indexed to a minimum rate, the draft bill being already consulted in this regard with the government). Similarly, given the low rate of investment spending over the past 3 years, they will most likely be reviewed and implemented selectively, depending on their political impact. As a result, we estimate that budget expenditures will decrease by about 5.2% compared to the forecasted level. Overall, we advise the Government to diminish the budgetary deficit to about 1.5% of GDP by properly adjusting the planned budgetary expenditures. Our estimations show that this measure will not undermine the domestic demand and economic growth, but rather will consolidate the resilience and credibility of the fiscal and budgetary policies.

Taking into account the uncertainty regarding the financing of the budget deficit from external sources, the issuance of Eurobonds can serve both an opportunity for the development of the country and a major source of risk - it depends on the way the Government will implement this financing instrument. Eurobond issuance is a tool that could be used by the Government to finance certain infrastructure projects in the context of funding uncertainty from development partners. In this context, it is important for the Government to identify on the basis of a transparent and competitive process a well-established broker with an internationally recognized reputation that will deal with the placement of Eurobonds, following the model of recent emissions by Ukraine and Romania. A potential reliance on brokers with a dubious reputation that do not implement the highest standards in combating money laundering and that will not be able to ensure the creditors' integrity, could cause major image risks for the country and it could lure the country into risky credit schemes for the long-term development of the country. In this sense, it is very important to monitor these processes, and in the case of Eurobond issuance, it will be necessary an active mobilization of the civil society in monitoring of the use and management of these resources. Last, but not least, the issuance of Eurobonds, by no means, should be regarded as a replacement to the financial assistance available from the development partners of Moldova, but rather as a complementary tool to support the sustainable long-term development of the country.

In 2020, the need for a more active involvement of civil society in the formation and monitoring of budgetary processes, at central and local level, becomes even more stringent. Given the electoral context, high budget deficit planned for 2020, as well as the Government's temptation to resort to issuing Eurobonds as a financing mechanism for investment projects (and implicitly to cover part of the budget deficit), there are obvious risks regarding sliding the system of public finances into clientelistic arrangements, with negative implications on the efficiency of using public money. In this context, it is important to mobilize civil society and the general population in the formation and monitoring of budgetary processes, at central and local level. This should also become an essential priority of the donor community, in order to increase transparency and open the budgetary framework for citizens, starting with the transparency of budgetary spending at the institution level (including updating the BOOST database), and continuing with real and inclusive consultations on the fiscal and budgetary aspects. It is also important to continue strengthening the civil society capacities for active and constructive participation in the budgetary processes. Streamlining the governance of the public finance system is key to ensuring their efficiency, and the active participation of the population in the budgetary processes is fundamental in achieving this goal.

An important source of risks for economic growth in 2020 derives from the tempering of external economic growth.

The economy of the Republic of Moldova has already begun to temper as a result of declining external demand. Thus, total exports are stagnating, while exports to the EU have decreased in the context of an unfavorable situation in the given market, and those to the CIS have registered increases only due to drug re-exports. Exports to Turkey are also on the rise. In addition to these worrying developments, there are also a number of shortcomings related to the concentration of exports both in geographical profile and in terms of the structure of exported products. This is exacerbated by the fact that the majority of exported products have a rather low added value (either primary agricultural products or industrial products processed under the Lohn regime), revealing the low level of competitiveness of the domestic producers, which undermines the sustainability of exports. Worldwide uncertainties undermine investment prospects for the coming periods. Moreover, the anticipation of stagnation in food prices internationally, dictated by increased export availability, as well as the tempering of the EU automotive industry will amplify the negative effects on the growth of Moldovan exports to this direction. At the same time, the commercial conditions on the CIS market (in this case the Russian Federation) are still uncertain, and the prospects for their modification for the moment are anchored only in the pre-election promises. It will aggravate the problem of balance of payments, because the foreign investments and foreign assistance will no longer be able to balance the components of the current account deficit, which could put pressure on foreign currency and external debt.

Another source of challenges is related to maintaining the central bank's independence, taking into account the intensification of signals of interference attempts by some political and business interests in its monetary policy.

Although there are some inflationary risks, such as expansionary budgetary policy, the dynamics of international oil prices or adverse weather conditions, most likely the inflation dynamics in 2020 will be marked by a moderate disinflationary trend. Still, inflation will not fall below the lower limit of corridor targeted by the NBM (5%, +/- 1.5 pp). At the same time, the NBM has begun to gradually relax its monetary policy, an approach that will most likely continue throughout 2020. However, in the context of the abundance of liquidity in the banking system, its effects on real sector lending will be limited and delayed in time, while the main immediate beneficiary will be the Government due to the decline in the financing costs of the budgetary deficit. Thus, a relaxed monetary policy, amid an expansionary budgetary policy and a relatively stable economic growth (about 3.5%), denotes a potential source of macro-financial risks, as well as risks of political pressures on the NBM. The independence of the monetary authority was also tested in the context of initiatives regarding the reorientation of a part of the foreign exchange reserves for investment purposes. A possible realization of this intention will diminish the functional independence of the NBM and create enormous risks for the security of the national economy. In this respect, it is important to maintain the independence of the monetary authority which is the basis for ensuring macro-financial stability.

Climate shocks are becoming more frequent, which exposes the agricultural sector and the economy as a whole to major risks. Insufficient rainfall in parallel with the abnormally high temperatures this winter are fueling risks of mass freezing in 2020 and / or flooding and other climate anomalies. They risk jeopardizing agricultural production, which could translate into the recession of the agricultural sector, the reduction of employment in this sector, which is also the main employer in the Republic of Moldova, and undermine the production and exports of the agro-industrial sector due to the limited raw materials. As a result, in the event of the aforementioned risks, agriculture could grow much slower than the forecast level, which will also hit the economic growth of 2020. Overall, we point on the increased vulnerability of the agricultural sector and the national economy as a whole to climate change and shocks generated by this phenomenon, which tend to aggravate year-by-year. In this regard, it is necessary to increase the resilience of the agricultural sector to climate anomalies by stimulating investments in the infrastructure and equipment needed by farmers to protect against extreme temperatures or heavy rainfall, to stimulate the development of agricultural insurance, to popularize intensive farming practices and to increase farmers' access to water sources and intelligent irrigation systems.

The economic growth will be challenged by worsening of the demographic situation in parallel with the tightening labor market conditions. The labor market assessment denotes the perpetuation of the seemingly paradoxical situation of having at the same time low employment and low unemployment rates. This is explained by the increase in the share of inactive population, due to the migration (the main factor), population aging (the increasing share of people over 60 years in total population) and increased inactivity in some categories of the population (mainly women). At the same time, these trends have put increasing pressures on the labor market. Tightening labor market conditions is due to the continuous reduction in the supply of labor force, which cannot compensate the increased demand from firms. A relevant indicator highlighting the widening gaps between labor supply and demand is the number of job vacancies. During 2016 - 2019, their number practically doubled. The migration of the working age population causes the shortage of not only skilled labor force, but also the unqualified one, which poses constraints for the private sector. In this sense, it is necessary to streamline the systems of forecasting the needs for labor force from the companies and increase the flexibility of the educational system in order to make it better anchored into the firms' needs. In general, it is necessary to ensure a closer collaboration between the education system and employers, both at the level of schools / universities and companies, and at the level of public institutions (Ministry of Economy and Infrastructure and Ministry of Education, Culture and Research).

Last, but not least, an important source of risks also derives from the eventual hasty and non-transparent privatization of some important state assets expected for 2020. Already, there have been some signals about the

to privatize some important state-owned enterprises, which could serve as a source of financing the budgetary deficit in 2020. Although, in principle, we welcome the intentions of selling the state assets to private investors, we draw attention to the fact that any privatization must be operated in accordance with the highest standards of transparency, fair competition and good governance. These processes should not be carried out in a hurry, but in an open, consultative and well-calculated approach. Nor should they be viewed as a source of financing the budget deficit, but rather an opportunity to attract private investments, modernize the companies and increase the competitiveness of the national economy. In this regard, it is important the active participation of the civil society and the donor community in monitoring the privatization processes of the state's assets in order to ensure their credibility, as well as their efficiency.

Estimations and forecasts of the key macroeconomic indicators of the Republic of Moldova for 2019-2020

Percentage real growth y-o-y, unless indicated otherwise

Indicator	2019	2020
Wage	9,2	4,9
Household consumption	2,8	5,1
Investments in fixed assets, total	22	2
Public investments in fixed assets	23,1	3,3
Private investments in fixed assets	21,7	1,7
Gross fixed capital formation	13,2	-1,3
Export of goods and services	8,5	2,2
Import of goods and services	6,3	3,1
Gross Domestic Product	4,7	3,7
Net taxes on product	3,2	15,4
Gross value added, total	5,0	1,8
Gross value added, industrial sector	3,9	0,4
Gross value added, agricultural sector	1,4	3,8
Gross value added, transport services sector	3,7	1,1
Gross value added, trade sector	5,8	5,4
Gross value added, construction sector	18,0	1,9
New bank loans provided to companies in national currency	3,6	1,3
New bank loans provided to companies in national currency	-3,4	1,5
Consumer Price Index	4,8	4,7
Deficit (-) / surplus (+) National Public Budget, % of GDP	2,5	3,4
Deficit (-) / surplus (+) of the current account of Balance of Payments, % of GDP	11,0	10,9
The women employment rate, % of the female working age population	35,4	31,7
The men employment rate, % of the male working age population	43,4	40,1

Source: Expert-Grup estimates and forecasts

Real Sector

Amid expansionary budgetary-fiscal policy, the year 2019 showed a relatively good economic dynamics. The decrease in social contributions rate paid by firms allowed a considerable increase in private investments, while the growth in public investments boosted the construction sector and domestic trade. In 2019, we estimate that the Gross Value Added (GVA) grew by 5.1%, and the Gross Domestic Product (GDP) – by 4.7%. However, by the end of 2019, the stimulatory effect of the tax reform vanished, while the public investments slowed down. This resulted in tempering investment activity and economic dynamics. After growing at rates close to 20% in 2019, we forecast that private investments will actually stagnate in 2020, with a modest increase by about 2%. In addition, EU's economy slowdown will influence the economic development in 2020. In this context, we anticipate that in 2020, as compared with 2019, GVA growth rates will slow down to about 2%, and GDP will grow by 3.5-4.0%.

Main developments

In 2019, the aggregate demand had a stimulatory impact on the economic activity. The output gap¹ posted positive values during Q2-Q4:19 (Figure 1). Promotion of a stimulatory fiscal-budgetary policy fuelled the growth in demand. Thus, investments financed from public sources increased, the wages in the public sector were raised, and the tax cuts (decrease in Q4:18 of the employer's social contribution rate from 23 to 18%) boosted the private investments. The acceleration of the economic activity in Q1-Q3:19 was characterised by GVA growth by 5.4% y-o-y and GDP growth by 4.8% y-o-y.

Figure 1. Output GAP, %



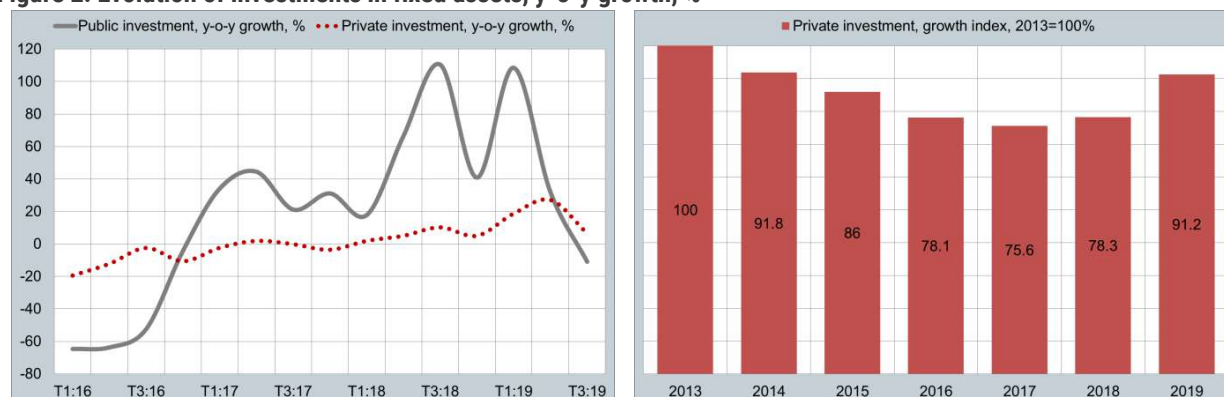
Source: NBS, Expert-Grup calculations

Despite the growth in private investments in 2018 and 2019, the 2013 level was not reached. In Q1-Q3:19, private investments increased by 16.1% y-o-y, after an increase by 5.9% in 2018. However, the growth pace in 2018 and 2019 did not compensate for the 2014-2017 investment regression. Thus, compared to 2013, investments amounted to 91.2% in 2019. Also, in the second half of 2019, the investment activity of the private sector visibly slowed down: after a growth of 18.7% y-o-y in Q1:19 and 27.1% in Q2:19, in Q3:19 it grew by 6.6% y-o-y. In addition, Q3:19 experienced the first decline in public investments by 10.9% y-o-y, after an accelerated growth during Q1-Q2:19 (Figure 2). This is related also to the high

The output gap¹ deviation is calculated as the difference between the actual GDP and potential GDP calculated on the basis of the Hodrick-Prescott filter.

basis of comparison: between 2015 and 2019, the highest growth of public investments was noticed in Q3:18 – by 108.1% y-o-y.

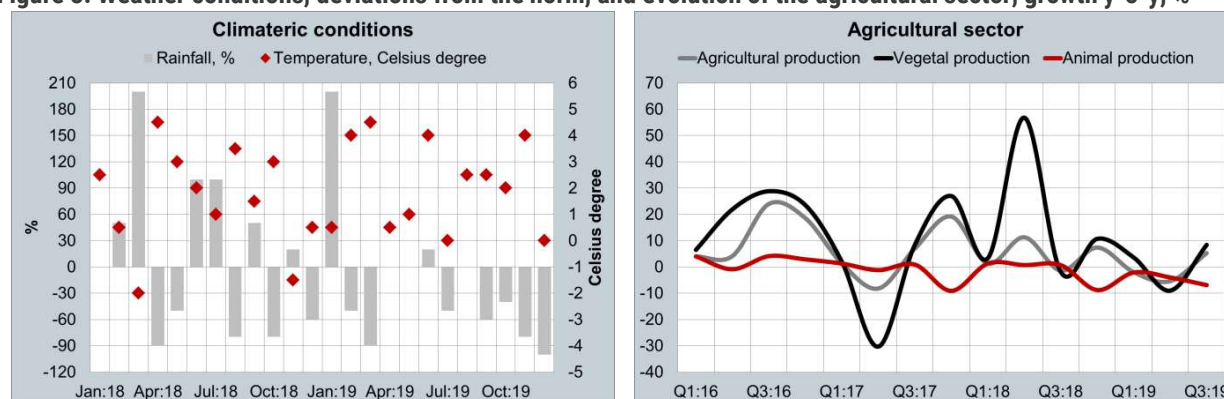
Figure 2. Evolution of investments in fixed assets, y-o-y growth, %



Source: NBS, Expert-Grup calculations

In 2019, the livestock sector shrank, but due to the advancement of the crops output agriculture experienced a slight increase. The vegetation period for the agricultural crops was characterised by relatively normal weather conditions. Most of the months in Q2-Q3:19 (except for July and September) experienced rainfall volumes that correspond to, or even exceed, the multi-annual norm. The temperature also did not vary a lot, the norm being exceeded by 0-4 degrees Celsius (Figure 3). As a result, crop production grew by 7.4% y-o-y in Q1:Q3:19, and the average harvest per hectare increased for most crops. In Jan-Sep:19, due to the decrease in the number of animals (cattle by 14.8% y-o-y, sheep and goats by 9.2% and pigs by 2%), the livestock sector shrank by 4.9% y-o-y. The shrinkage was characterised by a decrease in production of meat (-2.1%) and milk (-9.5), while egg production increased by 4.8%.

Figure 3. Weather conditions, deviations from the norm, and evolution of the agricultural sector, growth y-o-y, %



Source: NBS, Expert-Grup calculations

In 2019 the industry experienced a slight growth, which was driven by the increase in production in the processing industry. In Jan-Nov:19, the production volume grew by 2.5% y-o-y (Figure 4), while in Q1-Q3:19 the gross value added increased by 3.8% y-o-y. Due to the slowdown in the investment activity, in Jan-Nov:19 the mining industry shrank by 2% y-o-y. The volume of production in the processing industry grew by 3.4% y-o-y during the same period. The advancement of the agricultural sector stimulated the food processing industry (+5.6% y-o-y in Jan-Nov:19). Furthermore, the production volume of the sectors operating under the external processing agreements (lohn manufacturing) grew thanks to an increase in external orders: manufacture of motor vehicles, trailers and semi-trailers (+32% y-o-y), computers and electronic and optical products (+12.1% y-o-y), furniture (+12.1% y-o-y). Also, the energy sector shrank by 2.4% y-o-y. This dynamic was caused by

the decrease in the gross final consumption of electricity (-7.9% y-o-y in Jan-Nov:19) and natural

gas (-3.8% y-o-y). According to the National Agency for Energy Regulation (NAER) data, in Jan-Sep:19 the reduction of electricity supplies was caused by the decrease in the purchases by non-household consumers by 5.6% y-o-y, while households increased their electricity purchases by 3.1% y-o-y.

Figure 4. Industrial production dynamics in Jan-Nov:19, y-o-y growth, %



Source: NBS, Expert-Grup calculations

Expanding domestic demand favoured the increase in trade and construction. However, the economic dynamics slow- down or even decreased in certain sectors. Increase in household consumption and investment expenditures, both from public and private sector, boosted the domestic trade. In Q1-Q3:19, retail trade revenues increased by 16.1% y-o-y, and turnover for the market services provided to the population increased by 12.2%. Turnover in wholesale trade increased by 18.7% y-o-y, and amount of collected revenues, related to the market services provided to enterprises grew by 7.6%. The growth of the domestic trade sector is also reflected by the evolution of value added which increased by 5.8% y-o-y in Q1-Q3:19. Boosting of investment activity stimulated the construction sector. In Q1-Q3:19, the volume of contracted construction works increased by 17.4%, and value added increased by 19% y-o-y. However, due to the slowdown in investment activity in the second half of the year, the construction sector also experienced a slowdown in its growth rates. After growing in added value in construction sector by 15.7% y-o-y in Q1:19 and by 32% y-o-y in Q2:19, in Q3:19 the growth rate decline to 9.6% y-o-y growth. The economic slowdown in certain sectors led to a fall in the volume of goods transported in October and November, and as a result, during Jan-Nov:19 there was a decrease by 3% y-o-y.

Forecasts and risks

After a dynamic investment activity in 2019 in the private sector, the trend will slow down in 2020. Despite the slowdown in Q3-Q4:19, we forecast that in 2019 the total growth rate of private investments was about 20%. In 2020, the investments will be negatively influenced by the full dissipation of the effects related to reducing the rate of social contributions in the first quarter and by the increased budget deficit that will undermine the lending to the private sector. The relaxation of the monetary policy and the increase in households' consumption could have a positive influence on the investments' dynamics. All in all, the private investments in 2020 will grow by only 1.7% in real terms.

We estimate that in 2019 GVA grew by about 5%, and GDP – by 4.7%. We expect a slower dynamic in 2020: GVA will grow by about 2%, and GDP – by 3.7%. The slowdown of the economic dynamics will be caused by:

- ✓ Slowdown in investment activity. In 2020, thanks to the growth in public investments, the investments in fixed

assets will grow by only 2%, while the gross fixed capital formation will slightly decrease by about 1%;

- ✓ Slow growth in exports of goods and services. After a growth by about 8.5% in 2019, the export will grow by only 2.2% in 2020. The export slowdown will be caused by the deceleration in economic growth in EU – the main external market for the Moldovan products (about 2/3 of the export of goods);
- ✓ Imports will grow faster than exports. We anticipate that in 2020 the import of goods and services will increase by 3.1%, meaning a growth lower than in 2019 (+6.3%), but higher than export growth rate. The increase in the aggregate demand, thanks to an expansionary budgetary policy, will determine the imports to grow. Unfortunately, due to the low level of competitiveness of the Moldovan economy, domestic production capacities are limited, the demand being mainly covered by imports. The increasing gap between import and export will expand the base for collecting indirect taxes on products. As a result, we forecast for 2020 a decent growth on net taxes on products by 15%. In comparison, in 2019 we estimate that net taxes on products will grow by 3%.

The forecast is less certain in the case of agriculture. We estimate that in 2019 the value added in agriculture grew by 1.4%. In 2020, in case of relatively normal weather conditions, the sector will grow by 3.8% in 2020. However, Q1:20 is already characterised by weather conditions that may severely affect the harvest. The great danger for agriculture in Q1:20 is a possible heavy frost. In Dec:19 and Jan:20 there were no snowfalls that would provide a snow layer to protect the plants from a severe frost. In the event of very low temperatures in February and March, more crops will be affected. Another risk relates to little rainfall in Q1:20, which will reduce the amount of moisture in the soil. The agriculture forecast for 2020 relies on the fact that in the first quarter the amount of rainfall will be close to the average for the last 5 years. If in Q1:20 the amount of rainfall is less than the predicted value by 20%, then the agricultural sector will lose in advance up to 1.4 p.p. This decrease will determine the slowdown of export dynamics by 0.3 p.p. and of GDP by 0.1 p.p.

In 2020, due to the slowdown in export growth, the industrial sector will grow at a rate of below 1%. We estimate that in 2019 the value added in the industrial sector grew by 3.9%. The latter is expected to grow by only 0.3-0.4% in 2020.

In 2020, construction development will be marked by the reduction in investment activity. After an increase of 19% of the value added in construction in 2019, the sector will grow more slowly in 2020. We expect that value added in construction will increase by 1.9% in 2020.

The slowdown of the economic dynamics will cause a slow growth of the transport, but the trade will virtually be the engine of the economic growth. We believe that in 2019, GVA growth caused the expansion of the transport sector by 3.7%. But in 2020, due to the slower economic growth, the value added in transport will increase by a little over 1%. After an increase by 5.8% in 2019, the trade will grow by +5.4% in 2020, i.e. a rate closer to the result of the previous year. In 2020 the investment demand will slow down, but this dynamic will be offset by final consumption acceleration that will boost the trade.

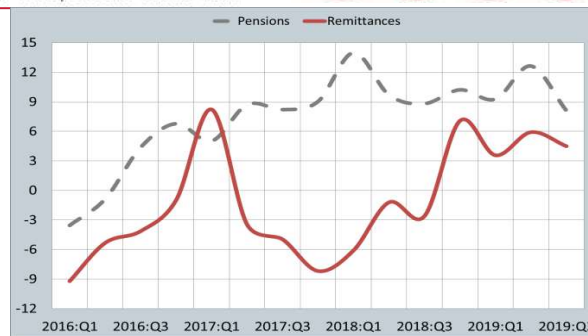
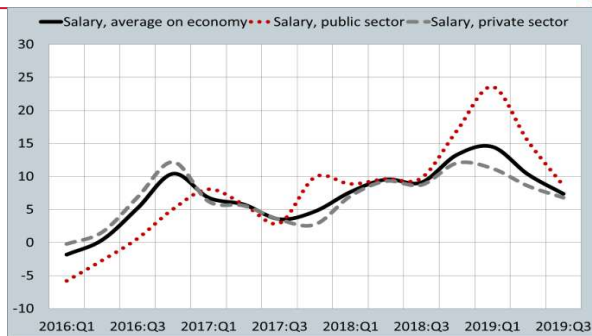
Households and Labour Force

The year 2019 was characterised by relatively rapid growth rate in households' income. Nevertheless, during the year, this dynamic was tempered. The stimulatory budgetary policy was the main driver of income growth. Thus, we estimate that wages in the budgetary sector increased in real terms by around 12%, and pensions – by more than 9%. The wages in the private sector also experienced a positive trend, while remuneration increased by 8.3% in real terms. In addition, a paradox happened in 2019: the rapid growth of the income was not followed by a similar growth in final consumption, which grew by only 3% y-o-y. In 2020, the income will continue to grow, at a slower rate. Though the Government will continue to promote an expansionary budgetary policy, we forecast that wages in the public sector and pensions will grow slower than 6%. We anticipate private sector wages to grow by 4.2% in real terms. The dynamics of remittances is uncertain and we assume that after a 3% growth in 2019, there will be a visible slowdown in 2020. On the other hand, in 2020 we anticipate an acceleration in consumption, with growth rates close to the dynamics of the income. At the same time, the labour market indicators will post worison dynamics: we estimate that the number of employees has increased by only 2.2% in 2019, while for 2020 a stagnation is forecasted. Moreover, while the employed population has declined in 2019 and will continue to shrink in 2020.

Main developments

In 2019, personal income grew, although its growth rates slowed down in the second part of the year. The Government played an important role in augmenting the personal income by increasing significantly the budgetary wages and pensions. The average gross wage increased in real terms by 10.6% y-o-y in Jan-Oct:19. Due to the salary reform in the public sector, the wage of public employees increased by 15.7% y-o-y. During the same period, the private sector wage grew in real terms by 8.8% y-o-y as a result of the higher GVA. At the same time, the wage growth rate slowed down during the year: from 11.2% y-o-y in Q1:19 to 6.8% y-o-y in Q3:19 in the private sector, and from 23.6% to 8.6% y-o-y in the public sector (Figure 5). As a result, the average wage growth also decelerated: from 14.5% in Q1:19 to 7.4% y-o-y in Q3:19. The pensions knew similar developments, their increase slowing down from 12.6% y-o-y in Q2:19 to 6.6% y-o-y in Q4:19. As a result, in 2019 the pensions grew by 9.1%. From Q4:14 to Q3:19, the remittances in real terms have been virtually in a continuous decline. This tendency reversed at the end of 2018, with the growth trend lasting for 4 consecutive quarters (Q4:18-Q3:19), while in Q1-Q3:19 the remittances grew by 4.7% y-o-y. The real growth of remittances was fueled by the nominal increase of this type of transfers by 3.2% y-o-y in Jan-Sep:19. At the same time, the nominal growth of remittances was determined by the increase in EU transfers by 16.7% y-o-y. Remittances from CIS decreased (-11.9% y-o-y in Jan:Sep:19), while transfers from other countries flat-lined.

Figure 5. Development of personal income, real growth y-o-y, %

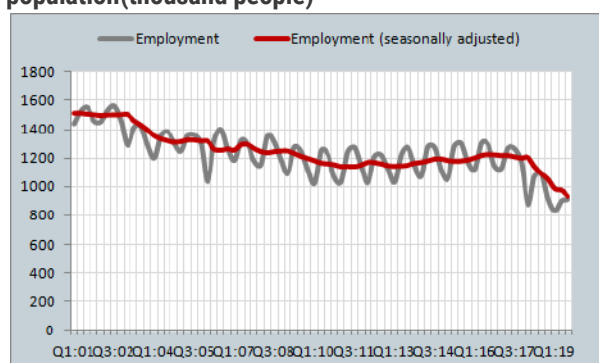


Source: NBS, Expert-Grup calculations

The cardinal adjustment of the methodology of Labor Force Survey (LFS) marked a defining moment in 2019 for the labor market indicators of the Republic of Moldova. The main changes made by the National Bureau of Statistics (NBS) to LFS related to the adjustment of population in accordance to the 2014 census and the exclusion from the employed population of the category of 'individuals employed in the auxiliary household (around the house) with the production of agricultural products for household's own consumption'.² These changes caused significant adjustments in a number of quantitative and qualitative indicators of the labor market, and their analysis highlights new trends and policy options.³

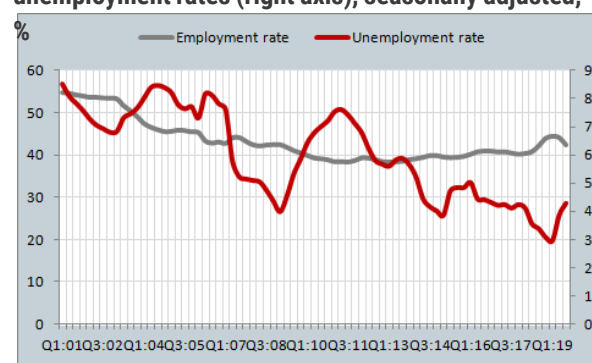
According to the statistics aligned with the 2014 census data, the labor force in the Republic of Moldova shrank significantly. The employed population decreased from about 1.2 million people in Q1:17 to 930 thousand people in Q3:19 (seasonally adjusted data), meaning that it shrank by 22.5% (Figure 6). The number of unemployed also decreased approximately in the same proportion by 23% during the same period. The analysis of the data already adjusted for 2018-2019 not only allows assessing the real size of the labour force, but also reveals new trends. The amended methodology did not result in sudden changes in the size of the labour force and its further stabilization, but also highlighted a new trend of its ongoing decrease during 2019. For instance, in Q3:19 the employed population shrank further by 15% y-o-y, which is already a new challenge for the national economy.

Figure 6. Dynamics of the employed population(thousand people)



Source: NBS, Expert-Grup calculations

Figure 7. Dynamics of the employment (left axis) and unemployment rates (right axis), seasonally adjusted,



Source: NBS, Expert-Grup calculations

The significant decline in the labour force according to the new methodology did not result in significant adjustments of the relative indicators. Thus, the employment and unemployment rates virtually did not post major developments during 2018-2019. The employment rates increased insignificantly during this period to 42-44% compared to 40-41% in 2017 (seasonally adjusted). Similarly, the unemployment rate has oscillated around 4% (seasonally adjusted) since 2016. The low employment and unemployment rates are due to a number of overlapping trends. The low unemployment rate was influenced by the economic growth and the increase in the labour force demand on behalf of business entities in the last years, a situation proved also by the doubling of the vacancies registered at the National Employment Agency during 2016-2019.⁴ The rise in the share of inactive population also explains the low employment and unemployment rates. The former is caused by external migration (main factor), by the aging of the population (a higher share of people aged over 60) and by increase of inactivity in some categories of population (mainly women). Thus, at first glance, the quantitative changes on the labour market did not modify significantly the intensity of labour use, since the mentioned trends have persisted

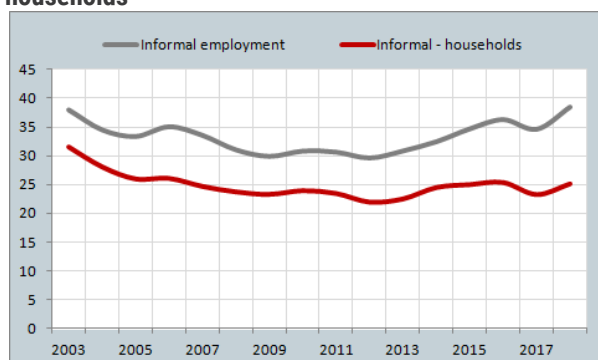
² <https://statistica.gov.md/newsview.php?l=ro&idc=168&id=6468>

³ Data adjusted to the new methodology are published for 2018 and 2019. NBS is to recalculate the data back to 2014.

⁴ <https://www.expert-grup.org/ro/biblioteca/item/1839-mega-edi%C8%9Bia-a-xx-a-%E2%80%99Eprovoc%C4%83ri-economice-dup%C4%83->

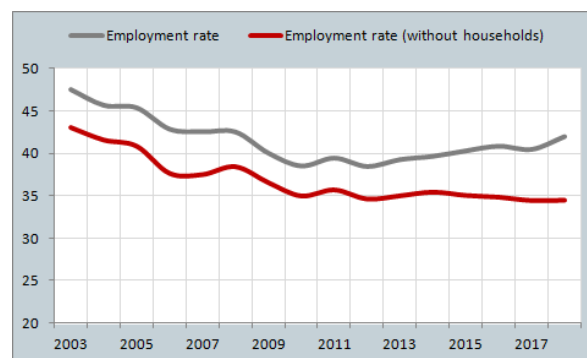
for a number of years. In addition, in order to confirm the accuracy of these trends, the remaining methodological changes at LFS, as a factor that can influence the category of the active population, need to be analysed more thoroughly.

Figure 8. Dynamics of informally employed population (% of total employed population) with and without households



Source: NBS, Expert-Grup calculations

Figure 9. Dynamics of employment rate with and without households (%)



Source: NBS, Expert-Grup calculations

The methodological adjustment of LFS had a pronounced impact on many qualitative indicators of the labour market.

Besides the alignment with the 2014 census results, the exclusion from employment of households that produce for their own consumption had a major impact on the indicators. Since household activity is considered an informal employment, its exclusion from the employment statistics led to the automatic decrease of the informal employment in the Republic of Moldova. Thus, the new statistics shows that the share of informal employment in total employed population in 2019 was only around 25%, being much lower than the 38% values recorded in 2018. Also, if we exclude retrospectively the households that produce for their own consumption from the statistics of informal employment we notice a different dynamic than the one observed according to the previous methodology. According to the recalculated data, the share of informal employment, though it remained at significant values of about 25% in the last years, did not show a downward dynamic (Figure 8). As mentioned in the previous MEGA edition, the household activity was the main driver of the growing dynamics of informal employment.⁵ In addition, the 'methodological' decrease of informal employment did not solve the issue of employment quality in the Republic of Moldova, but simply transferred a part of the population to the indicators on the intensity of labour force use (inactive population).

The methodological exclusion of households that produce for their own consumption from the labour force can lead to higher numbers of the inactive population. The number of inactive population needs to be increased on account of these households, which used to be assigned to the employed population, in order to keep the total number of the population over 15 years at the same level in the demographic data. However, such an adjustment leads in retrospect to a significant decrease in employment rates. Thus, the recalculated employment rates were only 35% in the last years, without any increase (Figure 9). In addition, this recalculation questions the employment rates already published officially on the basis of the new methodology of NEA, being of about 40% in 2019. Hence, there can be a sudden jump of the employment rate during 2017-2019, which is unlikely. These divergences can create hurdles for analysis of employment and activity indicators for two distinct periods – before and after of methodology revision. Without a recalculation of mentioned indicators it would be difficult to elaborate evidence-based policies, but to ensure such methodological compatibilities for two distinct periods it would be required an institutional support for NBS.

⁵<https://www.expert-grup.org/ro/biblioteca/item/1839-mega-edici%C8%9Bia-a-xx-a-%E2%80%9Eprovoac%C4%83ri-economice-dup%C4%83->

The review of NEA methodology also highlighted a higher gap between men and women on the labour market. According to the data from the previous methodology, the employment rates for men were slightly higher than for women. Thus, during 2016-2018, the employment rates for men (43-44%) exceeded on average by 3-5 p.p. those of women (38-39%). Once the methodology was revised, the discrepancy increased to 8 p.p. in 2019. The current situation may reveal a higher inequality between men and women as regards the participation on the labour market, or it may be a momentary increase caused by methodological changes. If this year the newly published data will show a persistence of the increased gap, this will be another sign that public policies need to be adjusted in order to stimulate women's employment on the labour market.

Forecasts and risks

After an accelerated growth in pensions and wages in 2019, the dynamics will slow down in 2020. The year 2019 was characterized by the promotion of budgetary policies to stimulate the income. Thus, according to the estimates, the real growth of pensions exceeded 9%, and the increase of budgetary wages reached 12% in 2019. In addition, the remuneration in the private sector also increased by about 8%. In 2020, though the Government will keep an expansionary budgetary policy, the income growth will be more modest. This can be explained by the high basis of comparison in 2019, when the income posted a relatively robust development. Thus, in 2020 the wages in the public sector will increase in real terms by 5.9%, and pensions – by 5.7%. In the private sector, due to the slower GVA growth, the wages will increase in real terms by 4.2%.

In 2019, according to the estimates, the final consumption grow relatively slowly, and we forecast a moderate increase in 2020. A paradoxical trend happened in 2019: though the personal income increased considerably, the consumption growth was relatively low, i.e. about 3%. For 2020 we forecast that the dynamic of the final consumption will approach that of the personal income. As a result, we foresee a 5.1% growth.

In 2020, the employed population will continue to follow a downward trend. It will shrink by about 9% y-o-y, while the number of employees will stagnate during 2020. The number of employed women will decrease faster (-11% y-o-y) than that of men (-9%). Thus, the decreasing trends of the population will slow down compared to 2018-2019, when the decrease was over 10% y-o-y; however, the trend remains a concern. The quality of this forecast and the definition of the gravity of the problem (by identifying additional factors to external migration) depend, however, on the completion of retrospective calculations by the NBS.

The methodological revision is one of the most important challenges related to the labour market forecasts. First, the current forecast is based only on data on the labour market adjusted only for the period 2018-2019, which increases the uncertainty. A possible recalculation by the NBS of the indicators, retroactively, until 2014 will provide the opportunity to improve the current forecast. Another source of uncertainty is the statistical treatment of households that produce for their own consumption. Namely, the real activity and employment rates, which may be lower than those currently published, depend on the estimation of this category of population by NBS. Release of population data for all categories of population by the NBS and its retrospective recalculation could help in solving the mentioned divergences.

A key risk for the functionality of the national economy is the tightening of labour market conditions. This tightening is due to the ongoing decrease in the supply of labour, which cannot compensate for the increase in the demand from firms. The number of vacancies is an eloquent indicator highlighting the widening gaps between labour supply and demand. Their number doubled during 2016-2019. External migration of the population leads to a shortage of both qualified and unqualified labour force, which is a constraint for expanding the businesses and attracting investments.

Public Finances

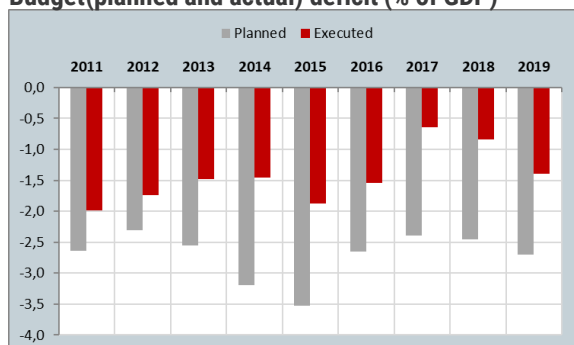
The year 2020 follows the traditions of an election year. It brings a number of challenges for country's public finances and probably the confirmation of some worrying scenarios, amidst the expansionary character of the investment programs and the increased budget deficit in election context, but also in the context of loosened monetary policy. Although the budget adopted for 2020 is mostly balanced, the review of the main macroeconomic indicators reveals a slight worsening of economic conditions in 2020. In addition, given the increase in salary, social and capital expenditures, the pressure on the budget deficit will increase, the latter being forecast at 3.3% of GDP for 2020. The constraint is even more acute given the uncertain financing of the deficit and in the absence of positive signs from the main external partners to this end. Thus, despite the current political discourse, in order to keep the budget deficit within reasonable limits, the Government could either identify alternative sources of financing by issuing Eurobonds, or rationalize the capital expenditures during the first half of 2020, and selectively resume certain projects with significant political capital during the second half of this year.

Main developments

Year 2019 ended up with a more balanced macro-fiscal framework than originally planned. One of the biggest challenges of the public finance system was to keep the budget deficit within the limits of the Budgetary-Fiscal Law, following the entry into force of the tax policy measures and of the Law on the Unified Salary System. By the end of the year 2019, the National Public Budget (NPB) deficit was estimated at about 1.4% of GDP, although a maximum of 2.74% was planned, which is within the limits set by the Law on Public Finance and Budgetary-Fiscal Accountability (Figure 10). The significant reduction in the budget deficit was mainly caused by the failure to implement the investment projects financed from external sources as a result of the adjustment made in August 2019 to the budget. The foreign loans to finance the budget deficit were 2 times lower than initially planned, thus being used the domestic loans. The resumption of external financing in Q3:2019 also resulted in a deficit estimated between 2.5% and 3.3% of GDP, forecasted for 2019.

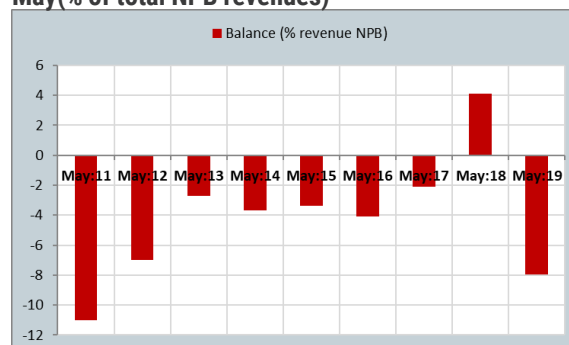
If during the first half of 2019 the public finances were under the pressure of certain initiatives adopted in 2018, with negative impact on the budgetary balance, then the second half of the year showed a balancing of the existing pressures, especially under the resumption of external financing. By the end of 2018 a number of initiatives were approved, which had (at least in the short run) a major negative impact on the 2019 public budget. On the one hand, a tax reform (decrease in the tax and social contribution rates) was implemented, which has tempered the growth rates in tax revenues: in May:19 these increased only by 7% y-o-y. On the other hand, a series of raises in salaries, social expenditures and capital investments were approved, including some that had an election overtone, which raised NPB expenditures by 21% y-o-y. The overlapping of these initiatives led to a swift growth of the budget deficit in the first five months of 2019, tempered by the end of the year. The deficit oscillated between 2.1% of the total revenue of NPB in May:19 to 2.9% in Jun:2019, reaching 1.4% of GDP at the end of the year (Figure 11). The budgetary deficit was stabilised including due to the launch of budgetary stabilisation mechanisms, while cutting on the capital investment projects, employment in the budgetary sector, etc. Besides, the resumption in external assistance in October and November 2019 was another important factor that contributed to the stabilization of public finances.

Figure 10. Evolution of the National Public Budget(planned and actual) deficit (% of GDP)



Source: Ministry of Finance, Expert-Grup calculations

Figure 11. Comparative analysis of the NPB balance in May(% of total NPB revenues)



Source: Ministry of Finance, Expert-Grup calculations

In the first 11 months of 2019, budget revenues grew slower than expenditures. Compared with the same period of 2018, the total revenues of the national public budget (NPB) amounted to MDL 56.6 billion, i.e. a nominal increase by 8.4% y-o-y, and the expenditures amounted to MDL 58 206.4 billion, i.e. by 12.7% y-o-y (MDL 6.6 billion). Thus, as regards 2019, it is estimated that revenues exceeded by 1.04% the level approved in initial the version of the budget. On the other hand, based on the experience of recent years, the expenditures were not executed fully in 2019, which resulted in a lower budget deficit than initially expected.

The tax reform in 2019 resulted in the decrease of the revenues from the collected individual income tax and contributions levied to the state social insurance budget, stimulating the taxation of population's consumption on the one hand and intensifying the collection of corporate taxes on the other. Compared to the first 11 months of 2018, the total nominal revenues of the state budget collected until Nov:2019 increased by 9.7% (MDL 3.2 billion), following the increase of general and collected revenues by 10.3% (MDL 3.4 billion). In addition, the revenues of the projects financed from external sources are lower by 34.6% (MDL 160.9 million). The revenues managed by the State Tax Service, compared to the same period of 2018, increased by 4.4% (MDL 644.1 million), i.e. MDL 15.32 billion. The revenues managed by the Customs Service amounted to MDL 20.6 billion, i.e. an increase by 6.4% (MDL 1.24 billion) compared to the same period of 2018. Out of the total amount of general and collected revenues (MDL 35.62 billion), the collected taxes and duties amounted to MDL 32.58 billion, i.e. by 6.4% (MDL 1.96 billion) more compared to the same period last year. The collected value added tax, considering reimbursements, amounted to MDL 18.26 billion (50.8% of total revenues), i.e. an increase by 7.9% (MDL 1.34 billion) compared to the same period of 2018. The excise duty revenues, considering reimbursements, amounted to MDL 5 billion, i.e. an increase by 9.2% (MDL 465.1 million) compared to the same period of the last year. The reimbursement of value added tax (VAT) and excise duties in 11 months of 2019 amounted to MDL 2.61 billion, i.e. with 3.3% (MDL 89.7 million) less compared to the similar period of 2018.

Stopping investment expenditures and imposing a moratorium on public sector employment led to the same scenario as in the previous years – the expenditures were executed slower in the first three quarters of the year, forming a budget surplus. By the end of November 2019, NPB expenditures were executed in proportion of 63% of the expenditures planned for the whole year. Thus, the budget surplus amounted to MDL 1.5 billion, much over the initially approved budget deficit. This trend was also noticed in 2018, when the budget had a surplus of MDL 1.5 billion after 9 months, but the year ended with a deficit of 1.4% of GDP. The recent trend shows that expenditures are executed in proportion of 95% of the expenditures planned in NPB. With this trend in mind, against the backdrop of growing revenues, the budget deficit in 2019 will not exceed 1.5% of GDP.

Foreign grants have been planned to be an important source of NPB revenues for 2019 but were not received until

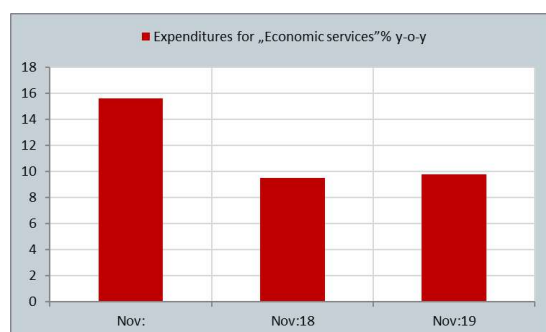
the end of the year. By November 2019, MDL 1.23 billion was received in foreign grants – a 37% y-o-y increase (most of the

receipts took place in October and November 2019). Despite this increase, the amount is significantly small if compared to what was planned for the current year. The 2019 draft NPB planned for almost MDL 1.96 billion in foreign grants, which accounts for 4.7% of the total planned revenues. The largest share of the grants – nearly MDL 1.23 billion – was planned for budget support, of which 590 million was the macro-financial support from the EU. Thus, the uncertainty about the resumption of foreign funding might affect a significant part of NPB revenues in 2020.

Another important factor that deepened the budget deficit was the significant increase in staff costs and social benefits. Compared to the previous period, the current expenditures for payroll and social benefits increased by about 27% y-o-y, representing over 50% of the total NPB expenditures at the end of the year. Although fixed asset expenditures rose by 14% y-o-y – including capital investments that rose by about 25% – this increase is explained by 1) selective re-launch of projects with foreign financing, and 2) low basis of comparison. While expenditures in the main component of the budget increased by 19% y-o-y, those for external-funding projects increased by as much as 25% y-o-y. Therefore the impressive increase in capital investment in 11 months of 2019 was caused namely by the expenditures of the projects with external financing. During this period the spending on capital investments under the projects with external financing (MDL 829.5 million) was much higher than for projects financed from the main component of the budget (MDL 563.2 million), so the main component is practically at the last year's level (Figure 12). Thus, the main reason why the budget deficit went upwards is the increase in current expenditures, the financing of which depends on the internal sources of revenues.

The budget deficit was mainly covered by internal sources. To cover the growing budget deficit, in 2019 the Government resorted, on the one hand, to the issuance of new t-bills, the volume of which grew by 339 million MDL y-o-y.⁶ On the other hand, the Government contracted direct loans from financial and non-financial institutions. In 2019, direct loans amounted to MDL 2.62 billion, with a due partial repayment of approximately MDL 2.14 billion. Despite the positive inflows from external sources, they are almost 2 times smaller if compared to the planned amounts, the net receipts of foreign loans planned for 2019 amounting to MDL 4.25 billion. About MDL 0.8 billion of this amount are IMF and EU loans for macro- financial support, and 1.3 billion MDL – the loan from the Romanian Government.

Figure 12. Dynamics of expenditures across the 'Economic services' (% y-o-y)



Source: Ministry of Finance, Expert-Grup calculations

Figure 13. Dynamics of domestic borrowing from non/financial institutions (MDL million, cumulated since the beginning of the year)



Source: Ministry of Finance, Expert-Grup calculations

Despite the significant increase in the deficit, the existing budgetary framework contains several mechanisms to mitigate the risks to public finance stability. Two compensatory revenue sources were provided for in the 2020 State Budget Law in order to finance the growing deficit.⁷ First, the Ministry of Finance contracted additional loans through t-bills over the

⁶ <http://mf.gov.md/sites/default/files/DSI%20la%20situatia%20din%2031-12-2019%20->

limits established by the state budget (MDL 1.6 billion).⁸ Second, a liquidity reserve was established through the issuance of t-bills in the amount of MDL 1.12 billion, that were not yet been used.⁹ Also, we anticipate a reduction in expenditures and budget deficit by suspending the projects funded from both internal and external sources. The suspension of certain investment projects is the traditional scenario, with their selective resumption depending on their election potential, in the last 2 quarters of 2020, there being the risk of inefficient use in the absence of their proper planning and execution. Under these circumstances, by the end of this year the budget deficit will most likely fall within the planned parameters.

Can a high budget deficit stimulate significantly the economic performance in 2020?

In order to understand the opportunity of raising the budgetary deficit to the level planned for 2020 (above 3% of GDP), we estimated the macroeconomic impact of this budgetary deficit (baseline scenario) in comparison with a twice lower deficit (alternative scenario). The national public budget for 2020 was adopted with a large deficit of MDL 7.4 billion, which exceeds 3% of the GDP. This decision provoked various public debates, taking into account its electoral flavor. In this context, to assess the impact of the high budget deficit on the economy, two different scenarios were used. In the baseline scenario (scenario 1), the deficit amounts to MDL 7.4 billion and represents the level set out in the 'State Budget Law for 2020', while in the alternative scenario (scenario 2) the difference between the expenditures and revenue will amount to MDL 3.7 billion (half of the deficit provided by baseline scenario).

A high deficit will determine the expansion of the public sector by increasing the budget expenditures, including the spending on investments and salaries. In the baseline scenario, the real expenditures will increase by about 3.8%, while the alternative scenario provides for a decrease by 1.3%. Also, according to the baseline scenario, the investments financed from budgetary sources and the wages in the public sector will grow, in real terms, by 3.3% and 5.9%, respectively. According to scenario 2, public investments will diminish by about 4.2% and the wages for public employees will increase by 4.1%. A higher budget deficit will require more financing and, as a result, the state debt servicing will increase. According to the baseline scenario the payments related to public debt will increase by about 14.7% and in case of a lower deficit, the debt servicing will diminish by 1.9% y-o-y. An increased level of public debt servicing requires a more active financing of the government by the banking sector, which limits the lending resources for the private sector and, as a result, the dynamics of bank loans is slowing down. Thus, a higher budget deficit will undermine the lending: the credit growth for firms, according to the baseline scenario, is estimated at about 1.4%, while according to the alternative scenario the increase will be about 3.8%. The slow increase in lending caused by the growth in budget deficit will determine a slower growth in private investments. According to the baseline scenario, private investments will increase by 1.7% and in case of a lower deficit the increase will constitute about 2.3%.

For aggregated economic indicators (final consumption, import of goods and services, GVA, GDP, share of current account in GDP) the difference between scenarios is minor and does not exceed the level of 0.2 p.p. The most eloquent example refers to the dynamics of the GDP. In the baseline scenario, the GDP grows by about 3.68%, while the alternative scenario provides for a growth of 3.65%. Thus, the difference between scenarios is insignificant – only 0.03 p.p.

⁸ <http://mf.gov.md/ro/datoria-sectorului-public/pia%C8%9Ba-primar%C4%83-a-vms/comunicate-privind-plasarea-vms>

⁹ <http://mf.gov.md/ro/trezorerie/rapoarte-privind-executarea-bugetului/rapoarte-lunare>

Table 1. Economic variables in 2020, baseline scenario vs alternative scenario

<i>Indicators</i>	<i>Baseline scenario</i>	<i>Alternative scenario</i>	<i>Difference, p. p.</i>
Budget expenditures, real growth, %	3.81	-1.27	5.08
Government debt servicing, real growth, %	14.70	-1.93	16.62
Budget revenues, real growth, %	1.02	0.75	0.27
New loans granted to legal entities, real growth, %	1.40	3.77	-2.37
Private investments, real growth, %	1.73	2.27	-0.54
Public investments, real growth, %	3.33	-4.15	7.48
Total investments, real growth, %	2	1.19	0.81
Average salary in the private sector, real growth, %	4.16	4.13	0.03
Average salary in the public sector, real growth, %	5.92	4.10	1.82
Average salary per economy, real growth, %	4.93	4.23	0.7
Final consumption, real growth, %	5.14	5.06	0.08
Import of goods and services, real growth, %	3.13	2.98	0.15
GVA, real growth, %	1.86	1.84	0.02
GDP, real growth, %	3.68	3.65	0.03
Current account/GDP, %	-10.87	-10.76	-0.11
Budget deficit/GDP, %	3.37	1.82	1.55

Source: Expert-Grup estimates

The main finding following the estimates is that the growth in the budget deficit up to a level that exceeds 3% of the GDP will not have a significant impact on the economic growth. Thus, the economic growth associated to a budget deficit under 2% of the GDP is virtually similar with the GDP growth related to a deficit that exceeds 3%. It means that the government can reach similar economic outcomes with a much lower budgetary deficit.

The main cause that determines a minor effect of the larger budget deficit refers to the inefficiency of public expenditures. This is an extremely serious problem for Moldova, as at regional level it ranks at the bottom in terms of efficiency of public expenditures among the states from Central and Eastern Europe and Caucasus¹⁰. To augment the influence of budget expenditures on the economic dynamics, it is necessary to start an authentic implementation of structural reforms: fight the corruption, optimize the public sector (approve performance-oriented budgets and put in place tools that would allow consulting the citizens on budget expenditures) and make the budget process transparent.

Forecasts and risks

The adoption of the 2020 State Budget generated lots of polemics and concerns, amidst the expansionary character of the investment programs and the increased budget deficit in election context, but also in the context of loosened monetary policy. However, a closer analysis of the 2020 State Budget Law reveals that only 10% of the fiscal space targets new policy measures, and 90% contributes to the implementation of policy measures undertaken in previous years. The main policy measures of the 2020 draft budget refer to the following: expand the local financial autonomy by increasing the breakdowns of the personal income tax and replenishing the Fund for the financial support of the local public authorities with 10% of the tax from the income gained from entrepreneurship; increase the wages by 6-10% for most budget employees; implement social assistance programs that provide higher social benefits to support individuals with low income. In addition, the macroeconomic parameters set out in the budget law are based on a slightly worsening forecast of the economic conditions in 2020. Compared to the forecasts approved in the 2020-2022 Medium-Term

¹⁰ <http://lapunct.md/2019/02/08/la-punct-de-ce-coruptia-scade-eficienta-cheltuielilor-publice/>



Budgetary Framework (MTBF), the key macroeconomic indicators were revised: the baseline scenario foresees the real growth of the Gross Domestic Product (GDP) from 4.0% to 3.6%, an inflation of 4.8% – a forecast quite close to the official figures, which foresee an economic growth from 3.6 to 4.0% and an inflation that may vary from 5.0% to 5.7%.

Budget expenditures will increase faster than the revenues until the end of this year, but the gap between their growth rates is expected to diminish. We forecast that in 2020 total NPB revenues will grow in nominal terms by 1.01% y-o-y, according to the baseline scenario, and by 0.7% y-o-y according to the alternative scenario, while expenditures – by about 3.81% y-o-y according to the baseline scenario and by -1.23 y-o-y according to the alternative scenario (reduced deficit). This dynamics will result in a budget deficit estimated at 3.37% of GDP in case of baseline scenario. In case of the scenario of reduced budgetary expenditures, the budget deficit will fall within the range of 2.5-2.7% of GDP.

According to the current forecast, we estimate that the deficit of the national public budget (NPB) will remain at the level of 3.37% of GDP, with concerns related to its electoral nature and repercussions on the stability of public finances and economic growth in the medium- and long-term. Still, the planned level of the deficit falls into the budgetary-fiscal rule provided by the Law on Public Finances (2.5% of GDP), calculated without grants. Out of this amount, the deficit related to investment projects financed from foreign loans will amount to MDL 4.8 billion, i.e. 65.3%. Hence, the budget deficit of the main component will amount to MDL 2.6 billion, i.e. 34.7% of the total deficit of the state budget, representing 1.1% of the GDP planned for 2020. If we remove the grant component from state budget revenues, the deficit will amount to MDL

3.5 billion, i.e. 1.6% of GDP. The key financing sources of the state budget deficit are external sources, net inflows from foreign loans for budget support (MDL 2.3 billion) and the implementation of projects financed from external sources (IMF, EU, WB, Romania) – around MDL 7.01 billion. The issuance of Government securities and the funds from privatization of public property (of which the net issuance of the Government securities on the primary market – MDL 2.0 billion, funds from the sales of equity stake – MDL 700.0 million, funds from the sales of assets of the banks in liquidation proceedings – MDL 200 million) are among the internal sources.

In 2020, the investment projects planned to be financed from external sources may be implemented to a low extent. For instance, in 2018, the fixed assets were executed to a proportion of 70% compared to the forecast level, while the financial resources targeting capital investments were executed to a proportion of only 50%, a trend that continued in 2019 (on 11 October 2019, 70% compared to the forecast level and only 40% of the financial resources targeting capital investments were executed). This is largely due to the poor planning of the projects (including capital investment projects), and as a result – low capacity to implement them. Under these circumstances, there is the risk of ineffective use and lock up of public resources that may lose their relevance and importance for the economic development and for a better standard of living of the citizens. At the same time, new projects that could lead to major changes cannot be launched as long as fiscal space is offered to existing capital investment projects.

One of the significant risks to the forecast is the uncertainty about the external financing. After one month since the beginning of the year, though the grant-side external assistance was partly resumed, there are real risks that Government's forecasts will not materialize. First, the IMF assistance program ends in March 2020, and the general practice of this institution is not to negotiate/approve agreements during election years, 2020 being an election year. Second, there is also the European Union's condition as regards the provision of financial assistance: implement anti-corruption measures, ensure the rule of law, continue structural reforms, especially justice reform – conditions also supported by the World Bank and other financial institutions targeted by the Government in order to lend funds, or the current Government has no clear commitments on any of these components. Another source of risk is the increasing number of loans taken by the Government from commercial banks by issuing Government securities, which could undermine private sector

lending (banks will prefer to channel their liquidities to virtually risk-free investments to the

detriment of the real sector, which could pose more risks given the economic slowdown in 2020). Under these circumstances, a large share of the planned budget expenditures under the projects with external financing will be suspended. Thus, there will be a replay of the scenario that we got used to during 2015-2018. The failure to receive external assistance to this end will not result in a pressure on the budget deficit, but rather in the immobilization of public resources and the reduction of the fiscal space to implement projects that are paramount for the national economy.

Other risks to public finances are related to the potential election nature of budget expenditure measures, which could undermine the efforts made to rationalise budget expenditures. Considering the presidential elections planned for autumn-winter 2020 and in the event of possible early parliamentary elections, the Government may be tempted not to revise, but to further amplify the social and investment capital commitments, like the previous governments did.

Taking into account the uncertainty regarding the financing of the budget deficit from external sources, the issuance of Eurobonds can serve both an opportunity for the development of the country and a major source of risk - it depends on the way the Government will implement this financing instrument. Eurobond issuance is a tool that could be used by the Government to finance certain infrastructure projects in the context of funding uncertainty from development partners. In this context, it is important for the Government to identify on the basis of a transparent and competitive process a well-established broker with an internationally recognized reputation that will deal with the placement of Eurobonds, following the model of recent emissions by Ukraine and Romania. A potential reliance on brokers with a dubious reputation that do not implement the highest standards in combating money laundering and that will not be able to ensure the creditors' integrity, could cause major image risks for the country and it could lure the country into risky credit schemes for the long-term development of the country. In this sense, it is very important to monitor these processes, and in the case of Eurobond issuance, it will be necessary an active mobilization of the civil society in monitoring of the use and management of these resources. Last, but not least, the issuance of Eurobonds, by no means, should be regarded as a replacement to the financial assistance available from the development partners of Moldova, but rather as a complementary tool to support the sustainable long-term development of the country.

Last, but not least, an important source of risks also derives from the eventual hasty and non-transparent privatization of some important state assets expected for 2020. Already, there have been some signals about the Government's interest to privatize some important state-owned enterprises, which could serve as a source of financing the budgetary deficit in 2020. Although, in principle, we welcome the intentions of selling the state assets to private investors, we draw attention to the fact that any privatization must be operated in accordance with the highest standards of transparency, fair competition and good governance. These processes should not be carried out in a hurry, but in an open, consultative and well-calculated approach. Nor should they be viewed as a source of financing the budget deficit, but rather an opportunity to attract private investments, modernize the companies and increase the competitiveness of the national economy. In this regard, it is important the active participation of the civil society and the donor community in monitoring the privatization processes of the state's assets in order to ensure their credibility, as well as their efficiency.

Financial Institutions

The evolution of the financial system in 2019 was determined by the reforms implemented in the previous years and by the general trends of the economic activity. The electoral period from the beginning of the year and the subsequent political events reduced the pace of reforms, particularly those that need the involvement of legislative authority. At the same time, stable macro-economic conditions, 'Prima Casa' Program and increase in household income revitalized to a certain extent the intermediation process, with significant results for households. This also determined a change in the business model for most financial market participants in terms of consumer and real estate loans. As a result, the profitability continues to grow in the banking, non-banking and insurance sectors. Even so, as a whole, the financial system had a low impact on economic growth, particularly in terms of ensuring the necessary financing for companies.

Main developments

The parliamentary elections at the beginning of the year marked the end of a full cycle in the country's economic, social and political development, including in terms of the activity of the financial system. The higher transparency of banks' shareholders, the improved financial situation of participants in the system and the enhanced capital intermediation infrastructure, set strong preconditions to shape some directions for the financial system modernization. In this regard, certain actions were included in the government's plans, but they have a sporadic, sometimes political nature, and do not fit in any global vision about the development of this area. Thus, stimulating the private pension system, creating a mechanism for accelerating investments (in the form of an investment bank or development fund) or facilitating the access of individuals to Government securities are some of the activities proposed for the¹¹ next years. Besides this, there are initiatives that are contrary to the recent reforms and to the international practices in this field that could disturb the current macroeconomic balance. We can mention the intention of certain political stakeholders to review the arrangements between the Government and the NBM by using a part of the foreign-exchange reserves for public¹² or even private purposes, or by reviewing the mechanism of reimbursement of emergency loans granted by the NBM during the banking crisis.

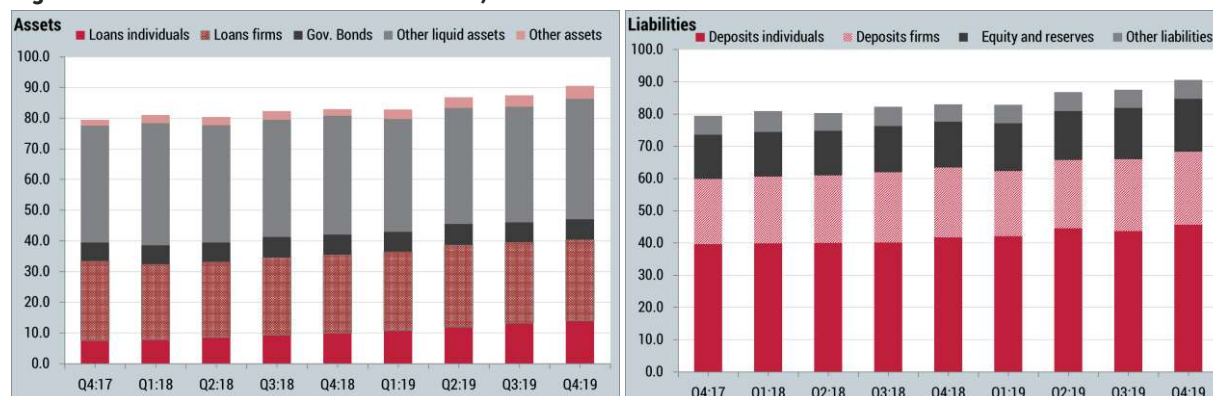
Similar to previous years, the individuals were the main drivers of liabilities and assets growth in the financial system. The growth of personal income along with the tax reform implemented at the end of 2018 increased the volume of available resources in the financial system. Thus, both the number of individual and corporate deposits and bank equity increased as a result of earning profit. On the assets side, the demand supported by consumer loans stimulated the intermediation activities both of banks and non-bank credit organizations. As a result, at the end of Q4:19 the assets of the national financial system amounted to about MDL 105 billion, having increased by about 10% compared to the previous year. At the same time, banks account for more than 86% of the total, while the rest of the financial institutions (non-bank credit organizations, insurance companies and savings and loan associations) account for slightly above 13%. At the same time, the level of asset concentration is still high in the banking sector, with those four systemically important banks accounting for 79% of total assets and 87% of total earned profit. Liquid assets continue to dominate the banks' balance sheets, less

¹¹ Activity Program of the Government led by Ion Chicu, <https://gov.md/ro/content/programul-de-activitate-al-guvernului-ion-chicu>;

¹² Statements of the President, Igor Dodon about the possibility to use a billion dollars from the state reserves for investments in economy, https://www.youtube.com/watch?v=zdKJ57CJ4qc&feature=emb_title

than half is represented by cash, Government securities (GS) or placements in monetary tools of the central bank (Figure 14). Although having increased, the stock of loans does not exceed 45% of the total bank assets, which reveals the persistence of structural gaps in the intermediation activities of the bank.

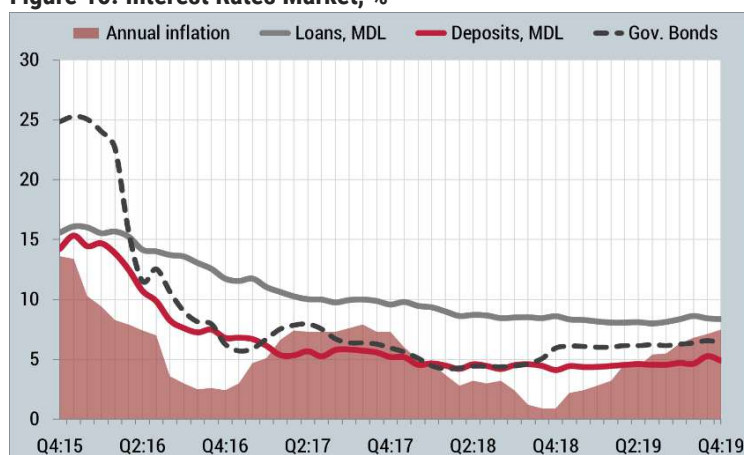
Figure 14. Structure of assets and liabilities, %



Source: NBM, Expert-Grup calculations

Commercial banks continue to be well-capitalized, with quite good quality assets and enough liquidities that can support the lending activity. Following the implementation of the macro-prudential policy and the introduction of certain additional capital requirements according to Basel III, banks own enough equity. At aggregate level, the rate of total own funds is around 25%, despite the limit set at 10%, plus capital buffers. Depending on the bank, this indicator ranges between 19% and 51%, with high values for small banks and low values for big ones. The short-term liquidity is still high, which confirms that there are still issues on the lending side. About 51% of the assets are liquid (GS, required reserves, NBM certificates) while the loans account only for 45%. On the other hand, the long-term liquidity tends to improve up to 0.72 out of 1, but continues to be low for various banks amid the expansion of the real estate credit portfolio with a long maturity. Therefore, despite the high level of liquidity, there is a problem concerning its quality and its capacity to support the lending activity. The banking sector has an excess of liquidity on very short term and cannot actively credit investment projects of companies – loans for at least 5 years. With no private pension schemes or investment funds in place, the few long-term liquidities that exist in the financial circuit are channeled in the ‘Prima Casa’ Program while the remaining financial resources can support only the current activity of companies, consumption credits and short-term GS. The quality of assets continues to improve thanks to the increase in the volume of new loans particularly to individuals who are responsible clients. The non-performing loan ratio diminished to 8.5%, by 4 p.p. y-o-y in Q4:19, with fluctuations between 4.6 and 18% depending on the bank. At the sector level, construction is still the most challenging area, while the portfolio of the service sector has improved significantly.

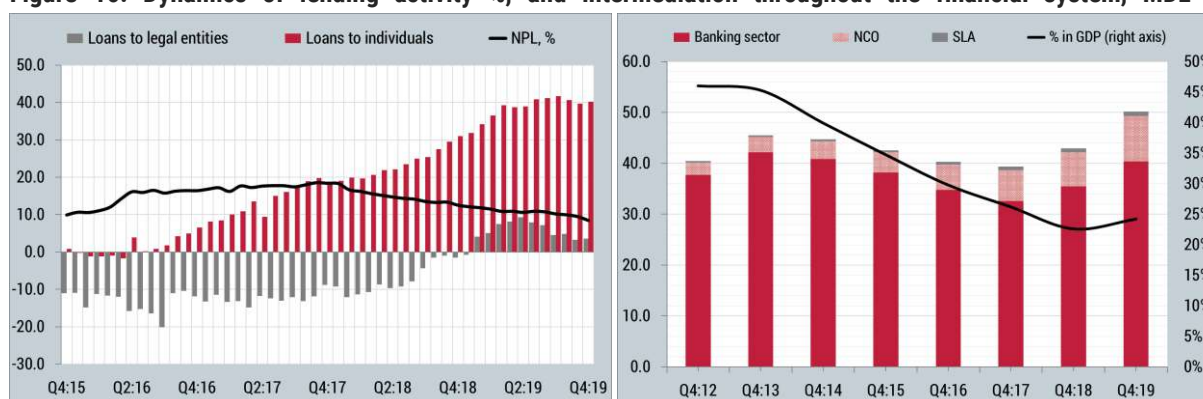
Interest rates in the financial market did not fluctuate significantly in 2019. The excess liquidity in the banking sector maintained the stability of the supply of lending resources, including their cost. At the same time, the loosening of the monetary policy by decreasing the base rate to the level of 5.5% could determine a slight decrease in interest rates in 2020. The interest rates of new loans in national currency continue to fluctuate at around 8%, thus ensuring a margin of about 3 p.p. compared to deposits (Figure 15). However, this concerns only the nominal interest rates, and after all the commissions are added they reach an effective level of about 10-12% for legal entities and minimum 14-16% for consumer loans. As regards to real estate loans accessed through ‘Prima Casa’ Program, effective interest rates register a slight increase. Thus, they can be set by the banks at a maximum margin of 8% beginning with Jan:20, which is the reference rate for the new deposits attracted in national currency, with the maturity from 6 to 12 months, (which is currently 5.8%) plus a maximum margin of 2%. Finally, the interest rates for GS tend to reduce due to a more relaxed monetary policy and due to the decreasing returns on monetary policy tools used to sterilize the excess liquidity.

Figure 15. Interest Rates Market, %

Source: NBM, Expert-Grup calculations

Based mainly on consumer loans, lending activity progressed significantly in 2019. The constraints related to lending to companies, the growth of the disposable income of households and the stability of interest rates allowed to extend the consumer loan portfolio by about 30% compared to the end of the last year, or two-folds compared to three years ago. Besides, the population continues to benefit from 'Prima Casa' Program implemented through commercial banks, which in 2019 registered over 2,700 new contracts. As a result, in 2019, the loans granted to individuals increased on average by about 40% y-o-y, reaching a share of 34% of the total on non-bank loans. Even if it is encouraging that the banking sector is becoming accessible for the population too, this trend shows that lending to legal entities and, implicitly, to real economy continues to be somehow blocked. The loans granted to legal entities slightly increased in 2019 (+3% y-o-y) with further modest growth prospects. Tax reform at the end of the last year did not yet fully awaken the appetite for investment. Moreover, issues remain both on the demand and supply side. Even if there is demand, it is not sound enough to access a bank loan due to the difficulty to submit some viable guarantees in order to ensure an enough stable return and the low interest to start some investment projects. The quality of supply is reduced by the high-risk premium taking into account the long periods of time to dispose of the collateral and cover the losses, as well as insufficient long-term liquidity to support investment projects.

Non-bank financing continued to increase rapidly and exceeded the performances registered by banks. Based on consumption micro-loans granted many times only on the basis of an identification document, this form of financing became quite known throughout the country, including in the communities with more difficult access to financing services. In 2019, an increase of about 30% y-o-y is characteristic both for non-bank lending companies represented by micro-finance and leasing companies and of about 5% y-o-y for savings and loan associations. Therefore, at the end of Q4:19, the non-bank lending stock amounted to about MDL 9.7 billion, which represents about 24% of the bank loan or almost 2 times more than four years ago. Even so, the degree of financial intermediation is still quite low as opposed to economic activity. Expressed as a percentage of GDP, it reached the level of about 24%, a slight increase compared to the end of 2018 (+ 3 p.p.), Figure 16.

Figure 16. Dynamics of lending activity %, and intermediation throughout the financial system, MDL bln

Source: NBM, NCFM, Expert-Grup calculations

The profitability of financial institutions remained high in 2019 too. Aggregated by sectors, in 2019 the financial institutions earned a profit of about MDL 3.3 billion, of which 70% were earned by banks. Besides the lending activity, banks earned consistent profit thanks to differences in the exchange rates and other related activities. Also, the monetary policy operations conducted by the NBM continue to be an important source of income for certain banks. Thus, the bank certificates used to absorb the excess liquidity, the required reserves of the overnight deposits generated revenue of at least MDL 1 billion. Under such conditions, the key profitability indicators of the sector – return on assets (ROA) and return on equity (ROE) remained at about the same level as in the previous year. At the end of Q4:19 these indicators reached the level of 2.5% and 14.6% respectively.

Forecasts and risks

Financial intermediation will advance in 2020, which will be supported, in particular, by individuals' demand for loans. The increase in personal income, accelerated implementation of 'Prima Casa' Program and the higher banks' focus on retail will further foster lending to individuals. As a result, the country's population is getting used to having a monthly payment to make – installment for a loan from a bank or a micro-financing company. Basically, one in three adults of working age has a bank or non-bank loan, which is at least twice higher compared to several years ago. Nonetheless, the level of financial education does not register the same trends. Even if financial concepts and products are somehow known, people understand them less. Most of the consumers heard about concepts like effective interest rate, inflation, risk, but few can give a correct answer when they are asked to explain them.

The increase in consumer loans and implicitly, in the aggregate demand, for now, does not generate the necessary investments that would boost lending to business entities. Basically, consumption grows on the basis of certain imported goods, while domestic companies have a rather reluctant attitude towards new investment projects. Moreover, the investments made in 2019 were the result of the tax reform and of using the companies' own and foreign funds, rather than domestic bank resources. In this context, the prospects of increasing lending to legal entities are still poor – only about 5% for 2020. In the intermediation process, there are challenges both with regard to the demand for and supply of funding to legal entities. Thus, the quality of demand is not good enough to meet the bank requirements, particularly with regards to the collateral or stable business profits. The quality of supply is reduced by the high-risk premium taking into account the long periods of time to dispose of the collateral and cover the losses, as well as insufficient long-term liquidity to support the investment loans. On top of all that, there are the political prospects for 2020, which will also be an electoral year.

The central bank forecasts a decrease in inflation in 2020, which will impact the interest rates, while certain risks will persist. After the peak level of 7.5% in Q4:19, the annual inflation will shrink continuously until the end of 2020, stabilizing around the inflation target of 5%. There is no objective reason for interest rates on loans to grow, with uncertainties stemming from current account deficit or unfavorable climate conditions, which would increase the food prices. Also, an increased Government demand for funding could orient the lending interest of banks towards Government securities. Moreover, the increased demand for consumer loans also reduces the interest of banks to finance the real economy. Thus, access to funding continues to be an issue for businesses.

The Agreement with IMF for supporting and monitoring the economic and financial reforms will end this year. On one hand, Presidential elections will be organized in 2020, and usually IMF does not conclude financing agreements during electoral periods. On the other hand, neither the recent political agreements seem to favor the negotiation of a new agreement as long as different visions as regards the economic policy are still promoted. Even if the Government acknowledges the importance to continue the dialogue with IMF and the access to international funding, sensitive topics like extending the budget deficit, interaction of domestic banks with money flows from the Transnistrian region or the banking fraud seem to be a barrier difficult to overcome.

In the context of new political arrangements, ensuring the independence of the central bank becomes a major challenge for 2020. On the one side, NBM should demonstrate its decision-making independence by separating the monetary policy from the Government's interests. On the other side, the Parliament should appoint apolitical persons in the NBM management, taking into account that the mandates of two deputy governors will end in the middle of the next year. Besides, maintaining the legal independence of the central bank is another test the Government should pass. Finding a solution with regards to the interests that the Ministry of Finance pays to the NBM for the guarantees previously granted by the Government to bankrupt banks, relaxing the monetary policy in the context of the budget deficit or even the intention to use a part of the foreign-exchange reserves for investment activities, such decisions should be strictly based on the international principles of central bank independence, namely: (i) sufficient capital to implement the monetary policy; (ii) legal protection of the members of management bodies; and (iii) ban of granting direct loans to the Government.

More than 5 years after the frauds in the banking sector, the investigations and recovery of assets are stagnating. Even if various investigations, recovery strategies or Parliamentary inquiry committees were initiated, the result is the same – more questions than answers. One thing is clear, both the frauds and the investigation process had and continue to have a strong political character and are a way-too-difficult test for the justice system. Therefore, the investigation concerning the 'stolen billion' continues to be a case of particular interest for the society and a major challenge for authorities, especially since the agreement with IMF, which kept the commitment alive, ends in March 2020. As time goes by, not only the chances to recover the money reduce, but the burden of the Ministry of Finance increases, which is forced to use also the taxpayers' money to reimburse the debt to the NBM.

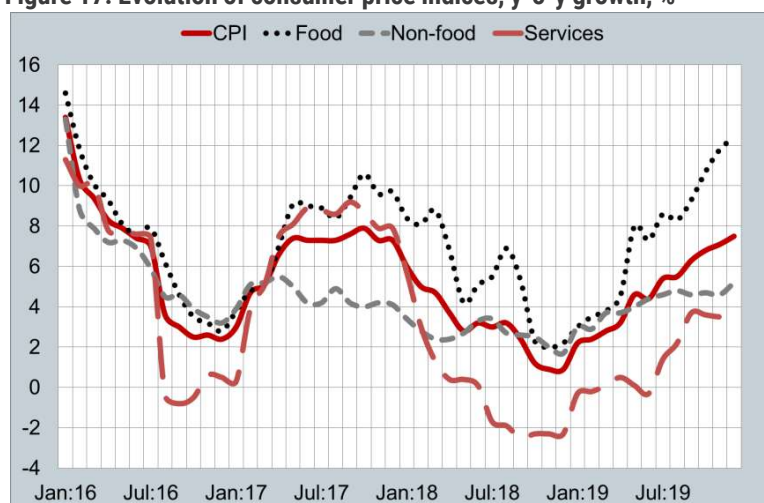
Prices and Monetary Policy

The 2019 year was characterized by a rising inflationary trend. The prices growth rate exceeded the level of 6.5% in Q4:19 and moved above the upper limit of the corridor set by NBM. This evolution was caused by the aggregate demand due to the stimulatory fiscal-budgetary policy and the explosive growth of some agri-food prices. The bland evolution of import prices will foster the disinflationary trends in 2020, and the average annual inflation will most likely be under 5%. At the same time, in Dec:19 on the background of some disinflationary expectations, NBM applied the monetary easing. Although there are some risks, we believe that in 2020 the trend of decelerating growth rate will be maintained, and the central bank will keep a relaxed monetary policy. At the same time, political declarations regarding the use of foreign-exchange reserves for investments are risky for the economic stability of the country.

Main developments

The year 2019 was marked by the acceleration of inflationary trends. The price growth rates increased from 2.2% y-o-y in Jan:19 to 7.5% y-o-y in Dec:19 (Figure 17). A factor contributing to the inflation rise is related to the increased aggregate demand determined by promotion of an expansionary fiscal-budgetary policy during 2018-2019. The average annual inflation rate was 4.8% in 2019, and the foodstuff prices grew the fastest. The rise of foodstuff prices was caused mainly by the increase in the price for potatoes (+43.2% y-o-y) and vegetables (+28.5% y-o-y). The Competition Council started an investigation in the context of significant rise of potatoes prices. Thus, it was concluded that the intensified phytosanitary control at the state border during April-May 2019 in selective way only for the imports from Belarus and applied in a discriminatory manner to certain firms led to significant reduction in the volume of imported potatoes. This resulted in shortages on the market¹³. Non-food goods became by 4.2% more expensive in 2019. The cigarettes showed the quickest rise in prices (+34.5%) among non-food products. This growth was determined by the increase of excise duties and the minimum trading price starting from 1 January 2019. The prices for services grew insignificantly, by 1.5%.

Figure 17. Evolution of consumer price indices, y-o-y growth, %



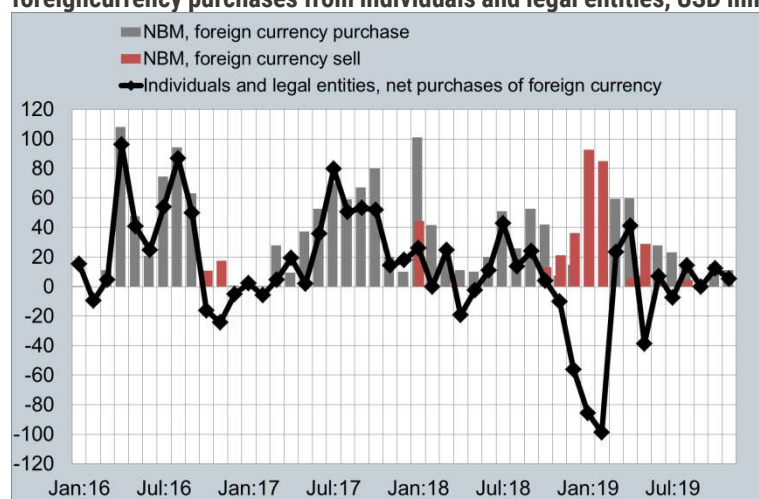
Source: NBS, Expert-Grup calculations

¹³<https://competition.md/libview.php?l=ro&idc=38&id=6717&t=/Presa/Noutati/Majorarea-pretului-la-cartofi-din-aprilie-mai-2019-consecinta-a-actiunilor-ANSA>



In 2019, the foreign exchange market had a different dynamic in Q1-Q2 than in Q3-Q4. This determined NBM to intervene by both buying and selling foreign currency. The amount of purchased foreign currency was almost equal to the sold one. An intensified depreciation of the official MDL/USD exchange rate was noticed in the first half of 2019: from 2.7% y-o-y in Jan:19 to 8.1% y-o-y in Jun:19. This can be explained by the higher demand for foreign currency on the domestic market in the first half of the year. The dynamic of foreign currency inflows did not decrease in Jan-Jun:19. The monthly difference between the import and export of goods in 2018 and 2019 ranged from 250 and 300 mln USD, and the remittances grew in Q1-Q3:19. In Jan-Jun:19, the negative values significantly exceeded the positive values of net foreign currency purchases from individuals and firms (Figure 18). This evolution can be associated with the increasing pessimistic expectations of the population in the context of a political instability. In the second half of the year, the internal market witnessed no pressures from demand side. Consequently, there was no shortage of foreign currency and the currency depreciation rate slowed down: from 6.5% y-o-y in Jul:19 to 1.1% y-o-y in Dec:19. Due to this dynamic, NBM intervened on the market as a seller of foreign currency in the first months of 2019, and later resorted mainly to buying foreign currency. Thus, in 2019 NBM purchased foreign currency worth USD 217.1 mln, and sold an equivalent of USD 222.2 mln. At the end of 2019, the official reserve assets amounted to about USD 3 bln. Foreign currency sales at the beginning of the year caused the decline in the value of the official reserve assets under USD 2.8 mln in Feb:19. This decline was recovered due to the foreign currency purchases and in Nov:19 the level of official reserve assets exceeded slightly USD 3 bln. Currently, Republic of Moldova has a relatively comfortable level of official reserve assets, which ensures a certain resilience to possible shocks. The official reserve assets covered 5.5 months of goods and service imports in Q3:19 (it is considered that a minimum level can ensure the import for 3 months). Also, the ratio between official reserve assets and the short-term foreign debt was 142.2%, well above 100% in Q3:19. This ratio is suggested by 'Guidotti-Greenspan rule', which recommends that reserves should fully cover the short-term foreign debt, as insurance if foreign funding stops¹⁴. Another sustainability indicator is the ratio between official reserve assets and the monetary aggregate M2. This indicator shall have at least 20%¹⁵ and it shows the resilience in situation when population would convert the national currency into foreign currency. In the Republic of Moldova, the indicator value is very high and was 86.9% in Nov:19

Figure 18. NBM interventions on the foreign exchange market and net foreign currency purchases from individuals and legal entities, USD million



Source: NBM, Expert-Grup calculations

¹⁴https://www.ecb.europa.eu/pub/economic-bulletin/articles/2019/html/ecb.ebart201907_01~c2ae75e217.en.html#toc2

¹⁵*Ibidem*

During 2019, NBM shifted from a tight to a relaxed monetary policy. The increasing inflationary risks determined NBM to raise the base rate in summer of 2019: in Jun:19 from 6.5% to 7%, and in Jul:19 from 7% to 7.5%. At the end of 2019, NBM predicted the fall of the inflation rate for 2020. The rate will stay within the corridor of $5\% \pm 1.5$ p.p.. In this context, in Dec:19 NBM decided to relax the monetary policy by decreasing immediately the base rate from 7.5% to 5.5% and reducing the reserve requirements rate for resources attracted in MDL from 42.5% to 41% in Q1:20. However, the monetary policy relaxing raises some concerns. The decision was made before becoming certain that the inflation trend will reverse downwards. At the same time, the monetary policy rate will decrease in the context of expansionary budgetary policy, setting thus preconditions for a cheaper funding of the budget deficit. Also, although liquidity surplus decreased in 2019, excess funds increased by the end of the year (Figure 19). If in Apr-Oct:19, daily balance of National Bank Certificates varied around MDL 5 bln, then in November and December it amounted to MDL 5.7 and 5.8 bln. In Jul:19, NBM decided to increase the reserve requirements rate for the resources kept in foreign currency from 14 to 17%, and in Dec:19 it was decided to rise it from 17% to 20% since Q1:20. Such a decision was made after the reserve requirements rate for resources attracted in foreign currency were constantly maintained at the level of 14% for 8 consecutive years (2011-2019). Through this approach, NBM will discourage the financial intermediation in foreign currency at some extent and will encourage the financial intermediation in national currency.

Figure 19. Monetary policy tools applied by the NBM



Source: NBM, Expert-Grup calculations

Forecasts and risks

The year 2020 will most likely be characterized by a disinflationary trend. The slowdown in global economic growth will decrease the dynamics of international prices, which will lead to a weak price evolution of goods imported in the Republic of Moldova. This will result in lower prices growth rates. Thus, during 2020, the inflation rates will decrease and in Q1:20, the price growth could reach the target level of 5%. In Q2-Q4:20 we forecast an inflation rate at the bottom of the corridor monitored by NBM, ranging between 4 and 5%. As result, the average annual inflation rate will be of 4.5-5% in 2020.

The 2020 inflationary background will favour a relaxing monetary policy. The factors which could affect the inflation in 2020 refer to: (1) pressures related to the increasing aggregate demand, caused by a stimulating budgetary policy, (2) a possible growth of international oil prices, caused by political instability in the Middle East and (3) potential adverse climatic conditions that will reduce the harvest and increase prices for agrifood products. However, these risks will most likely not change significantly the inflationary trend. In this context, NBM will maintain low monetary policy rates.

Political declarations regarding the intention to use foreign-exchange reserves for Government investments can be regarded as an 'attack' against the functional independence of the NBM. At the same time, a possible implementation of this intention poses a major risk for the national economy security. Official reserve assets are one of the most important resources used by the central bank to promote its policies. Withdrawing a significant part of foreign-exchange reserves and using it for different purposes than those of the monetary authorities will reduce significantly the NBM capacity to intervene. The diminishing of NBM resources implies, in fact, a reduction of its capacities and functional independency. Another aspect refers to the general purpose of the foreign-exchange reserves. In fact, these are the country's fund where financial resources are saved to be used only in case of serious issues caused by the sudden reduction of foreign currency inflow. Unfortunately, the Republic of Moldova is strongly exposed to such shocks. The financial and economic crises of 1998, 2009 and 2014/2015 resulted in a sudden reduction of the foreign currency inflow, and a severe external shock is a constant risk for the country. Third, the use of foreign-exchange reserves for Government investments will disrupt the economic dynamics. The risk is related to the mechanism by which the Government will be funded from foreign-exchange reserves and will convert them into MDL. This mechanism will initially lead to a sudden appreciation of MDL and will increase the money stock in circulation, which will rise the inflationary risks. The increasing investment demand will be covered mainly by imports, which will result in MDL depreciation and will further amplify the inflationary pressures. Thus, the currency market will see an increased volatility: the strong appreciation phase will be followed by a sudden depreciation, and the economic prospects will be eroded by a quick inflation growth, which will decrease people's standard of living.

Foreign Sector

The world economy shows clear signs of 'cooling' down and this phenomenon is accompanied by economic, and even geopolitical tensions between the biggest global players, which is risky for commercial performances and investment prospects of the Republic of Moldova. In fact, anticipating international stagnation in food prices, dictated by the increase in availabilities for export and the slowdown of EU automotive industry, will amplify the negative effects on the growth of Moldovan exports to this direction. While the trade conditions in the CIS (in particular - Russian Federation) stay uncertain, the prospects to change these conditions are fueled only by pre-election promises. All these aspects could aggravate the current account deficit of Moldovan balance of payments for the next period, while the stagnation of foreign investments and the slowdown of foreign assistance will not be able anymore to balance the components of the current account deficit, which could put pressure on the national currency and the external debt.

Main developments

The rhythm of global economy shrank to the lowest level registered since the global financial crisis from 2008¹⁶. Recent geopolitical tensions between major economies have increased uncertainty about the future of the global trading system and international cooperation, influencing business confidence and investment decisions, which has materialized through a cooling of the global economy as a whole. Moreover, the prospects for the growth of global economy for the near future are rather vague¹⁷, and according to the forecasts, a slight dynamisation will take place in 2020 due to anticipation of economic performances on a range of emergent markets. All these, given the existence of a range of threats that derive from the possibility that global tensions will reoccur, major economies will shrink significantly and financial markets will face major disruptions.

Figure 20 GDP growth in Russia and EU, % y-o-y



Source: IMF, Expert-Grup calculations

The economy of EU is affected by the internal and external circumstances and registers losses beyond expectations. The European economy faces a long-lasting decrease (Figure 20) in the context of a high domestic uncertainty, a less favourable external environment and several structural changes that affect essentially the industrial sector. The

¹⁶ According to the IMF forecasts, the global economy for 2019 will increase by about 3.0%, and according to the World Bank – by about 2.4%.

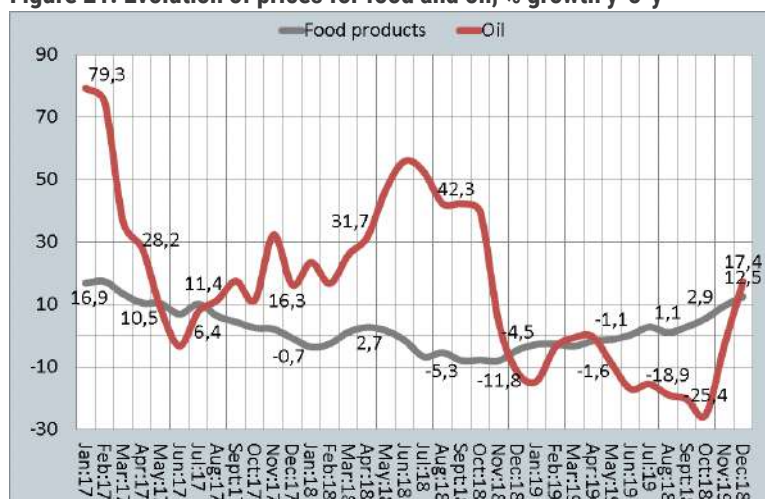
¹⁷ According to the IMF forecasts, the global economy for 2020 will increase by about 3.3%, and according to the World Bank – by about 2.5%.

international trade of goods stagnated and the previously identified risks related to trade tensions and geopolitical conflicts that occurred in 2019 as well as the high uncertainties related to trade policies and to Brexit did not reduce. However, these deficiencies are attenuated to some extent by growing employment and wages, decreasing inflation, more favourable financing conditions and tax support measures in some EU Member States, which increased domestic demand.

The economy of the Russian Federation contracted more than it was anticipated due to the developments on the market of energy resources. The decline in investments and trade, along with the ongoing international economic sanctions resulted into the slowdown in economic growth (Figure 20). Likewise, the industrial activity was affected by the reduction of the oil production agreed within OPEC, being accentuated by disturbances in the transit through pipelines to Europe. The volume of retail trade dropped substantially following the VAT growth while the consumers' trust remained low. In these circumstances, the central bank relaxed the monetary policy by reducing the base rate several times during 2019.

The positive economic prospects from some emerging markets resulted into the sudden increase of oil price. At the end of 2019, the oil price reached 63 USD/barrel, by USD 10 higher than in December 2018 (Figure 21). The sudden increase in price reflects the market expectations fueled by the signing of a trade agreement between the United States of America' and China. Also, the decision of OPEC to reduce even more the oil production puts pressure on prices. More recently, the events that took place in Iraq deepened the concerns about the potential disruptions in production and transportation of oil from the Middle East, and added volatility and additional risk premium to the global prices of oil on short term.

Figure 21. Evolution of prices for food and oil, % growth y-o-y



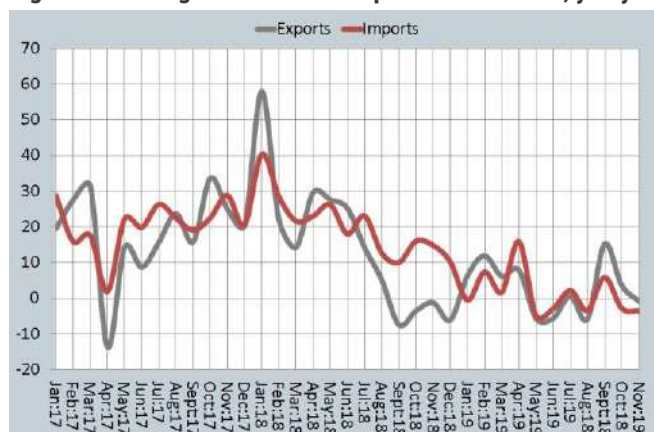
Source: FAO, Expert-Grup calculations

The international food prices reached the maximum level of the last 5 years. Thus, they were 12.5% higher than in Dec:19 y-o-y, registering the highest values since Dec:14 (Figure 21). The dynamics was mainly influenced by higher prices at international level for wheat, given the rising import demand of China and on the background of logistical issues that France faces following the protests. The vegetable oils price increased by 31% in Dec:19 y-o-y and reached the maximum level of the last two years. The most recent growth was determined by the increased prices of palm oil following the demand of the biodiesel sector. The sugar price increased by 6% in Dec:19 y-o-y, this dynamic being determined by the encouragement to produce ethanol in Brazil from cane sugar, which reduced the availability of sugar on the global market.

The export and import of Moldovan goods reached historic maximum in 2019, but the growth dynamics is slowing down. Thus, in Jan-Nov:19, the value of exports was by 3.0% higher than in the previous year and amounted to USD 2,561 million (Figure 22). At the same time, the value of imports in Jan-Nov:19 amounted to USD 5,302 million, i.e. only by 1.2% more y-o-y. Thus, the given developments resulted in the accumulation of a deficit of the trade balance in the

amount of USD 2,741 million, i.e. by 0.5% less y-o-y. On the other hand, the level of imports coverage with exports improved a little, amounting to 48.3% in Jan:Nov:19, compared to 47.5% y-o-y. At the same time, it can be observed the continuation of the downward dynamics of the growth rates of the foreign trade that started in 2018 and which shows that the deficiencies of the competitiveness of Moldovan economy got worse.

Figure 22. Foreign Trade of the Republic of Moldova, y-o-y change, %

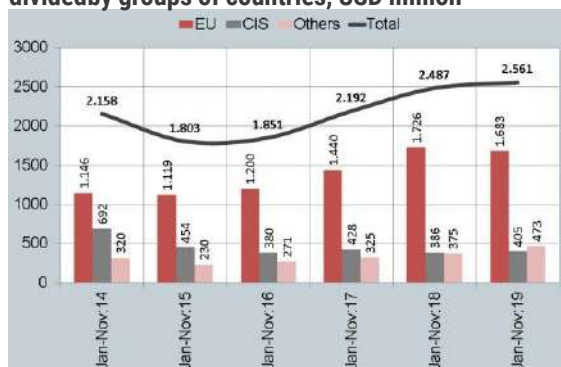


Source: NBS, Expert-Grup calculations

The export of Moldovan goods to European Union slightly decreased both in absolute and relative terms, with a total of USD 1,683 million in Jan-Nov:19 (Figure 23), down by 2.5% y-o-y and with a share of 65.7% in total exports (69.4% in 2018). The most significant increases in exports were registered to Germany (by 11.2% more y-o-y, as a result of an increase in export of cables), Czech Republic (by 48.0% more y-o-y, as a result of an increase in export of cables) and Poland (by 15.0% more y-o-y, due to increased exports of fruit juices and cables). At the same time, there were registered a decline in exports to Italy (by 15.8% less y-o-y, because of smaller exports in clothing, footwear and grains), to the United Kingdom (by 38.2% less y-o-y, because of smaller exports in clothing and sunflower seeds), but also to Romania (by 2.5% less y-o-y, because of smaller exports in sunflower seeds and sugar). The decline in exports to the EU market was mainly due to the less favorable economic situation on this market with lower prices for certain products (sunflower seeds and cereals) in the context of a larger external supply (such as from Ukraine), but also because of the increase of the domestic supply, which led to the reorientation of the given Moldovan exports to other markets.

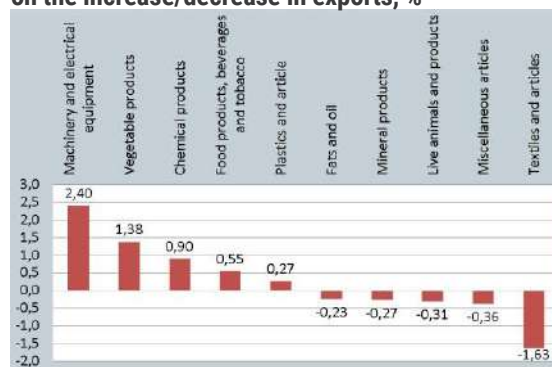
An excessive concentration of exports to the EU can be noted in geographical terms and in terms of diversity of the exported products. In spite of progressive integration of Moldovan exports into the European commercial system, we cannot ignore excessive concentration in geographic terms (over 76% of total EU exports are directed to only 4 member countries: Romania, Italy, Germany and Poland). The same applies in terms of diversity of exported products (over 70% of exports to EU are represented by only 7 categories of goods: electric circuits, textile items, oilseeds, parts of seats, grains, fruits and wine). At the same time, most of these exports were made under inward processing regime, which implies a rather small added value.

Figure 23. Exports of the Republic of Moldova divided by groups of countries, USD million



Source: NBS, Expert-Grup calculations

Figure 24. The degree of influence of groups of commodities on the increase/decrease in exports, %



Source: NBS, Expert-Grup calculations

Exports to CIS countries registered a positive evolution after partially resuming the reexports of medicines to the Russian Federation. In Jan-Nov:19, exports to the CIS countries remained unchanged in the total exports of the country, constituting 15.8% (in 2018 – 15.5%), which is equal to a value of USD 404 million, i.e. by 4.7% more y-o-y (Figure 23). This was mostly possible as a result of the increase in exports to the Russian Federation (+14.6% y-o-y following the growth of export of medicines, which are actually reexports) and to a smaller extent as a result of the increase in exports of fruits and fruit juices. At the same time, the exports to Belarus registered a 9.2% decrease y-o-y as a result of the decrease in export of textile items, while the exports to Kazakhstan diminished by 40.0% y-o-y as a result of the decrease in exports of diaries and wines.

The massive increase in exports to Turkey offset the decreases to other destinations. In Jan-Nov:19, exports to other countries of the world (beyond the EU and CIS), amounted to about USD 474 million (Figure 23) – an increase by 26.2% y-o-y, accounting for a share of 18.5% (in 2018 – 15.1%), exceeding the share of CIS countries in total exports. This spectacular development was possible thanks to a 89.3% increase y-o-y in exports to Turkey, as a result of the increase in exports of sunflower seeds and corn (products, for which preferential tariff quotas on export are provided under the new Free Trade Agreement with Turkey), but also to Switzerland with 46.7% y-o-y as a result of exports of grains. Last, but not least, we need to mention the massive increase in exports to Syria, by 3.3 times y-o-y as a result of the increase in exports of grains and sunflower oil.

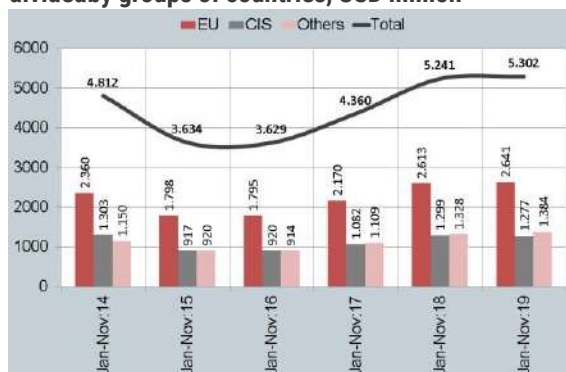
The export of electric machinery and equipment had the most significant influence on total exports growth (Figure 24). In Jan-Nov:19, the export of electric machinery and equipment increased by 11.5%, or by USD 60 million more y-o-y, as a result of the increase in exports of the automotive sector. The exports of vegetable products had also a positive impact on the dynamic of total exports due to massive exports of grains to Switzerland and of sunflower seeds to Turkey through a specialized company. Unfortunately, we cannot speak about an expansion of exports of fruits and nuts, both to CIS (with a very small increase only by 5.7% y-o-y), in spite of the fact that customs duties were not applied temporarily to imports to the Russian Federation, as well as to EU where there was registered a major decline in Jan-Nov:19 of 14.7% y-o-y for the export of fruits and nuts (the decrease refers mainly to the export of nuts, a part of which are actually reexports) as a result of the circumstances on the EU market.

Evolution of imports from the EU was determined by the modest growth of domestic consumption as well as by the needs of the national industry. The European Union is still the main source of imports, with a total value of USD 2,641 million in Jan-Nov:19 (Figure 25), up by 1.1% y-o-y and with the same share of 49.8% in total imports. The most significant increases were confirmed in Romania (by 32.0% more y-o-y, due to increase in imports of circuits and cables), Italy (by 4.6% more y-o-y due to increase in imports of mechanic machinery and equipment and medicines) and France (by 10.7% more y-o-y due to

increases in imports of mechanic machinery and equipment as well as cars). At the same time, decreases were

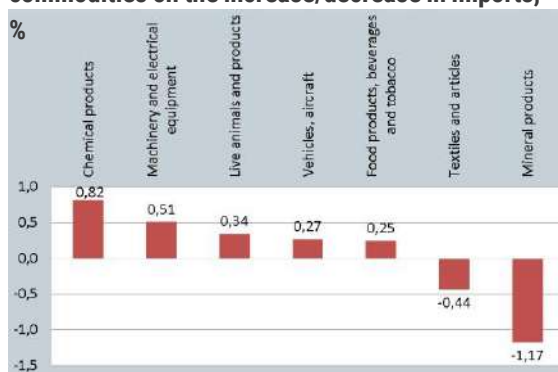
confirmed from Austria (by 12.7% less y-o-y, due to reduction in imports of copper wires) and Bulgaria (by 13.2% less y-o-y due to decrease in imports of petroleum oils).

Figure 25. Imports of the Republic of Moldova divided by groups of countries, USD million



Source: NBS, Expert-Grup calculations

Figure 26. The degree of influence of groups of commodities on the increase/decrease in imports,



Source: NBS, Expert-Grup calculations

Imports from the CIS diminished because of cheaper fuels. In Jan-Nov:19, 24.1% of the imports came from CIS countries (in 2018 – 24.8%), which is equal to a value of USD 1,277 million (about 28% of which are mineral products), having increased by 1.7% y-o-y (Figure 25). Decreases were confirmed from the Russian Federation (-3.0% y-o-y as a result of the decrease in the imports of clothing, petroleum oils and fertilizers), Turkmenistan (-80% y-o-y after the imports of petroleum oils dropped) and from Ukraine (-1.0% after the imports of electricity from this country reduced). At the same time, the most reliable increases were confirmed from Kazakhstan (+77.7% y-o-y as a result of resuming the imports of associated petroleum gas) and from Uzbekistan (almost twice y-o-y as a result of the increase in imports of textile items and vegetables).

Resumption of exports of pharmaceutical products to CIS countries impacted mostly the dynamics of imports of the Republic of Moldova (Figure 26). Thus, the positive evolution of imports of chemical products in Jan-Nov:19 occurred mostly due to the increase in imports of pharmaceutical products (+22% y-o-y), and their subsequent re-exports to CIS countries, these being rather logistical operations that involve virtually no added value to the country's economy.

Import of electric devices, as well as cables and circuits for the export-oriented industries grew significantly. Thus, during the reference period, the import of electric equipment grew by 2.9%, registering USD 954 million, which is USD 27 million more y-o-y. This dynamic is the result of resumed imports of telephone devices, as well as other house equipment, as a result of restoring the demand on the domestic market and the needs of the domestic industry specialised in assembling electrical circuits.

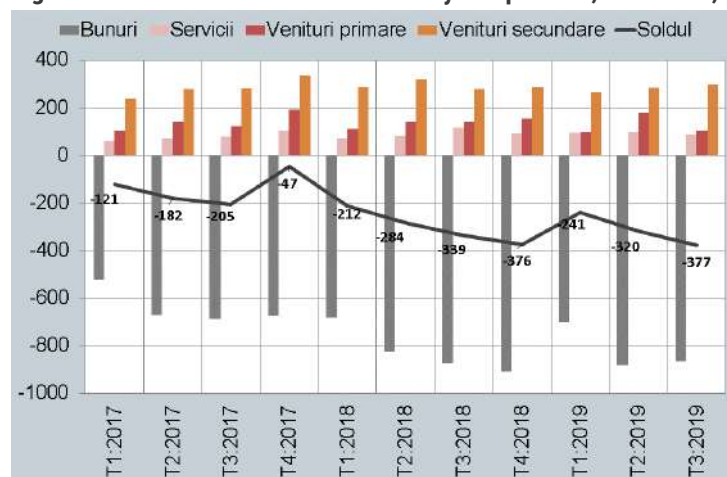
On the other hand, cheaper fuels and the change of electricity source negatively influenced the dynamics of imports. (Figure 26). In Jan-Nov:19, the negative influence on imports was caused by the mineral products, which decreased by about 6.8%, registering USD 845 million, which is by USD 61 million less y-o-y. This evolution was caused by lower prices for fuels by about 10% (although in quantitative terms the values remained almost the same) and due to the change of the electricity source according to a new supply contract, which provides for a higher share for the provider from the Transnistrian region compared to the share allocated for the supplier from Ukraine (as a result, the imports from the Transnistrian region are not reflected in the commercial statistics of the country).

The developments of foreign trade worsened the balance of the current account of the balance of payments. In Jan-Sep:19, the balance of payments of the Republic of Moldova registered a deficit of USD 938.3 million, which shrank by 12.3%

y-o-y. Reported to GDP, the deficit of the current account amounted to 10.6% (compared to 10.0% in 2018). This

development was determined by the negative balance of goods, while other components registered positive balances (Figure 27). Such a high level of the deficit of the balance of payments reveals once more the major deficiencies in the competitiveness of Moldovan economy and is one of the main risks to the macroeconomic stability of the country.

Figure 27. Evolution of current account by components, net values, million USD



Source: NBM and Expert-Grup calculations.

Forecasts and risks

Forecast for the foreign trade of the Republic of Moldova corroborates with growth trends of the global economy.

Thus, we estimate an annual increase in exports of goods and services by about 2.2% by the end of 2020, and an annual growth of imports by 3.1% in goods and services. These forecasts reflect the growth prospects of major trading partners of the Republic of Moldova in the light of new economic realities on a global and regional scale that show clear signs of 'cooling', which undermine even more the trade performances of the country.

Besides the worrying trade prospects, we found a number of deficiencies in terms of concentrating the exports both in geographic profile and depending on the structure of the exported goods. This is aggravated by the fact that these exports encompass a quite low value added (primary agricultural products, industrial products manufactured under inward processing arrangements), which emphasizes the low level of competitiveness of domestic producers and undermines the sustainability of exports as a whole. Under these conditions, the reassessment of the paradigm of increasing the exports is imminent, in particular, to increase the competitiveness and reach a higher value added.

According to the forecasts, by the end of 2020, the oil prices will slightly decrease. Although, according to forecasts, the oil prices will remain high in the first months of 2020 due to the events in the Middle East, these effects will diminish in the first half of 2020 and the fundamental components of the market will result into the decrease in oil prices in the second half of 2020 and in 2021. However, the quotations will remain volatile being consistent with the political and economic developments from the big producing countries and with OPEC cartel's intentions to limit the supply against the slowdown of the global economy.

According to the forecasts, in 2020, food prices will stagnate. This forecast is based on the large stocks accumulated from the major producers for product groups. Last but not least, the risk of new trade conflicts could decrease international trade and, implicitly, food prices. Nevertheless, evolution of the agri-food sector in the Republic of Moldova is still the great uncertainty for forecasts, taking into account its vulnerability to weather conditions.

Both external and internal economic objective factors mentioned above reveal a possible worsening of the current account deficit of Moldovan balance of payments for the next period. This prospect is determined by the decrease in the aggregated demand of the trade partners, which will have a negative impact on the dynamics of Moldovan exports, although the decrease in domestic consumption in parallel with decrease in imports could have a positive impact on the trade balance. However, the stagnation of foreign investments and the slowdown of foreign assistance will not be able anymore to balance the components of the current account deficit, which could put pressure on the currency and on the external debt. Last but not least, the anticipated decrease in the remittances of individuals, in the context of the global economy slowdown, will further exacerbate the problem of current account sustainability.