

MEGA

1st Quater, 2021, #22



The economy and public finances in 2021

Risks, forecasts and policy recommendations
for recovery

Authors:

Adrian Lupusor
Alexandru Fala
Dumitru Pintea
Stas Madan
Tatiana Savva
Vadim Gumene

Disclaimer

This document is published by the Independent Think-Tank Expert-Grup within the project “Inform, Empower, Act! Civil Society for good budgetary governance in Moldova” funded by the European Union and Konrad Adenauer Stiftung e.V. The contents of this document are the sole responsibility of „Expert-Grup” Independent Think-Tank and can under circumstances be regarded as reflecting the position of the donors.

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, analysing economic policies and proposing solutions for the economic development strategies of the country.

MEGA

Issue no. 22, February 2021

Authors (in alphabetical order):

Adrian Lupușor
Alexandru Fală
Dumitru Pinteă
Stas Madan
Tatiana Savva
Vadim Gumene

Contents

Abbreviations.....	5
Key messages of the publication	6
Executive summary	11
Estimates and forecasts of the key macroeconomic indicators for 2020-2021	13
Firms	14
Recent trends	14
Forecasts and challenges	17
Households and Labour Force	20
Recent trends	20
Forecasts and challenges	23
Public Finances	24
Recent trends	24
Forecasts and challenges	25
Special Edition: Does the 2021 budget respond to the needs of vulnerable people or not?	27
Conclusions	30
Financial Institutions	31
Recent trends	31
Forecasts and challenges	35
Prices and Monetary Policy	37
Recent trends	37
Forecasts and challenges	39
Foreign Sector.....	41
Recent trends	41
Forecasts and challenges	46

List of figures:

Figure 1. Share of companies that received/expect to receive national or local government support	15
Figure 2. Evolution of investments in immovable assets, growth y-o-y, %	16
Figure 3. Evolution of the agricultural sector, growth y-o-y, %	16
Figure 4. Industrial production in January-November 2020, growth y-o-y, %	17
Figure 5. Remittances, y-o-y increase, %	21
Figure 6. Employment indicators	22
Figure 7. The National Public Budget Deficit Developments, planned and achieved (% of GDP)	24
Figure 8. Comparative Analysis of the NPB Balance in May (% of the NPB overall revenues)	24
Figure 9. Banks' assets and liabilities, billion MDL	32
Figure 10. Interest rates in national financial market, %	33
Figure 11. Dynamics of lending activity %, and volume of funding of the overall financial system, billion MDL	34

Figure 12. Revenues and net profit obtained by commercial banks, billion MDL	34
Figure 13. Consumer price indices, y-o-y growth, %.....	37
Figure 14. NBM interventions on the foreign exchange market and foreign currency net purchases from individuals and legal entities, USD million, and exchange rate dynamics, y-o-y growth %.....	38
Figure 15. Monetary policy tools applied by the NBM.....	39
Figure 16. GDP growth in Russia and EU, % y-o-y	41
Figure 17. Food and oil price evolution, growth y-o-y, %	42
Figure 18. Foreign trade of the Republic of Moldova, change y-o-y, %	43
Figure 19. Exports of the Republic of Moldova by groups of countries*, USD million.....	44
Figure 20. Influence of categories of goods on growth/decline of exports, %	44
Figure 21. Imports to the Republic of Moldova by groups of countries*, million USD	45
Figure 22. Influence of categories of goods on growth/decline of imports, %.....	45
Figure 23. Evolution of current account by components, net values, million USD	46

Abbreviations

CIS	Community of Independent States
EU	European Union
EUR	Euro
GDP	Gross Domestic Product
GVA	Gross Value Added
MDL	Moldavian leu
NBM	National Bank of Moldova
NCFM	National Commission for Financial Markets
NPB	National Public Budget
SS	State Securities
y-o-y	Year on year

Key messages of the publication

The year 2020 was marked by the overlap of two major crises (the Covid-19 pandemic and the drought), causing the most severe recession in the last 20 years. Gross Domestic Product (GDP) estimated for 2020 shrunk by about 6.5%, because of the repercussions of the coronacrisis and drought that undermined the agricultural production. The restrictions imposed during the pandemic caused a sharp decline in sales, which determined companies to stop/postpone investments and cut on staff costs (reducing working hours and wages, technical unemployment and, to a lesser extent, personnel layoffs). This led to the contraction of consumption, which caused the boomerang effect on the private sector by lowering demand, and affected the national public budget through the under execution of revenues, especially from indirect taxes. Micro and small enterprises, in particular those that failed to diversify their markets and access foreign markets, were most affected. The most affected employees were those with low salaries, informally employed, mainly women, as well as the elderly and young people.

The recession has been aggravated by two key vulnerabilities of the country: low competitiveness of the private sector and lack of vision and capacity of politicians to intervene effectively to combat the economic and social effects of the crisis. Low competitiveness caused a low level of preparedness of the private sector to face the crisis, in terms of lack or insufficiency of spare financial resources and limited access to finance, poor diversification of markets and suppliers, low technology utilization and low productivity, and management not adapted to crisis. This is supplemented by the relatively low level of labour incomes and high level of informal economy and employment compared to the countries in the region, which exposed a large part of the population to poverty risks. The second vulnerability is related to the quality of the governance process, which is traditionally inefficient and unpredictable, as revealed in the context of the crisis by the amorphous, delayed and insufficient reaction of the government to support the population and businesses in the context of such a dramatic recession.

The support provided by the Government to counteract the economic implications of the epidemiological situation was the weakest in the region and, respectively, insufficient to cushion the effects of the crisis. Thus, the support package offered in 2020 was estimated at about 1% of GDP, which was the lowest in the region, where support amounted to about 5% of GDP on average. Such modest support was also due to the fact that the Government entered the crisis with a limited fiscal space, as the budget has been already approved with a deficit of over 3% of GDP, which was described in the previous edition of MEGA¹ as having an electoral connotation. Furthermore, the support was provided in a fragmented and poorly targeted manner. Thus, based on the data for 2020, out of the 320 million MDL planned for payments of wages or technical unemployment benefits, only 19% were capitalized and the average amount per application was only 59.2 thousand MDL. As for subsidies for interest on loans granted to companies for urgent needs, only 35.4% were assimilated in 2020 and the average amount per application was even lower, only 31.9 thousand MDL. Those amounts were not sufficient to offset or at least cushion the consequences of the crisis. Thus, their impact was insignificant. The way of handling the crisis from the perspective of the provided support should be analysed separately. In particular, it is a lesson learned for the future, suggesting that the Government should have had functional instruments for deal with future crises, and in the event of such shocks, the support should fast, well-targeted and should have acceptably offset losses, especially for the vulnerable groups.

We forecast a relatively high economic growth (+5.4%) for 2021, given a more favourable agricultural year, the revival of domestic consumption, and especially of the external consumption, as well as the low comparison basis. Obviously, the forecast also depends on the evolution of the pandemic, as it is based on the assumption of moderation of the crisis and gradual elimination of restrictions on travel and economic activity. Basically, the main growth factors in 2021 are agriculture, where gross value added is forecast to increase by 14.5%, which will boost final consumption (+8%), and the anticipated economic recovery in the region will also stimulate export growth by

¹ MEGA, 21st edition "Economy and Public Finances in the Election Period: Conclusions for 2019 and Forecasts for 2020": <https://www.expert-grup.org/ro/biblioteca/item/1903-mega-editia-xxi-economia-si-finantele-publice-in-perioada-electoral-concluziile-anului2019-si-prognoze-pentru-2020&category=178>

about 10% (higher than the growth rate of imports – with about 7%). However, that growth will take place against the background of declining investment activity, both in the private and public sectors. This denotes the low quality and sustainability of this economic growth forecast for 2021 and beyond. Therefore, if this uncertainty is maintained, also due to the political situation, we will see an increase in economic volatility for the coming years, which will also be quite slow, inertial, which does not involve generating decent jobs and enhancing the country's competitiveness. In this context, policies are needed to support the attraction of investments in technologisation of businesses and encourage businesses to make use of local raw materials for processing and export.

The adoption of the 2021 state budget gave rise to controversy and concerns against the background of non-transparent approval process, lack of consultations and approval of measures with electoral connotation. The Government submitted the draft Tax/Customs Policy and the 2021 draft State Budget Law to the Parliament on 1 December 2020. No genuine parliamentary debates were organized to this end, while the document openly promoted political clientelism. All these actions took place while lacking resources to cover the expenditures, and both the Law on Public Finances and Budgetary and Fiscal Responsibility and the Parliament Rules of Procedure were utterly violated. An example in the same vein is the distribution, through Annex 7 to the State Budget Law, of over 350 million MDL with a rather discriminatory and dangerous political discretion. Besides being a bad example of deliberate power abuse in the state, the Parliament itself gave an extremely threatening signal to the rule of law, where the abuse of the majority is legalized, having swept out all the endeavours of good governance and management of budget resources made since 2009. Even more severe is the fact that given the pandemic and the associated crisis, all amendments made by the Parliament do not respond to any of the current issues of the country, namely increased unemployment rate, issues faced by the health and education systems, and by the real sector.

Pandemic developments and political instability are the main economic risks in 2021. Growth could be well below the baseline forecast if another pandemic wave follows, possibly caused by the new strain of Sars-Cov-2 virus. In that case, we can expect a much slower growth (possibly 2-3%), against the background of continued decline in production, exports, investment and consumption. In addition, the current liquidity crisis faced by the real sector, caused by restrictions applied in the context of the pandemic situation, could turn into chain bankruptcies for employers and job losses for employees, causing the snowball effect on the economic crisis. The second risk derives from the unstable political situation, which can have two ramifications. In the event of early elections and the uncertain situation after the elections, for most of 2021, the Republic of Moldova will not be governed by a stable government with a full mandate. This will affect the Government's ability to respond to the crisis and, respectively, to support economic recovery, especially against the background of a relatively high budget deficit (estimated at over 5% of GDP). In the event of voting the Government proposed by President Sandu, the Republic of Moldova will have a Government without clear support from the parliamentary majority, which could lead to institutional sabotage by the Parliament by launching various populist initiatives, with major risks to the public finance system and macroeconomic situation (some similar actions have already taken place with the adoption of the laws that provided for the reduction of the retirement age and the repeal of the "one billion law" in December 2020). On the one hand, these risks fuel uncertainty, which will cause a reduction in private investment, and, on the other hand, they affect the Government's ability to implement the measures needed to support companies and the population, as well as to support economic recovery.

As a derivative of political risks, another major risk in 2021 is the financing of the budget deficit. We forecast that in 2021 the overall NPB revenues will rise by 4.1% y-o-y in nominal terms as per the main scenario and 3.7% y-o-y as per the alternative scenario. As for the expenditures, they should increase by approximately 11.3% y-o-y as per the main scenario and by -4.23 % y-o-y as per the alternative scenario (reduced deficit). According to the main scenario, such developments should result in an estimated budget deficit of 6.79% of GDP. In case of the scenario of lowering budget expenditures, which directly depend on foreign sources of funding, the budget deficit will not exceed 4.56% of GDP. The epidemiological situation determined also that the planned deficit level does not fit into the budget and fiscal rule stipulated by the Public Finance Law, i.e. 2.5% of GDP calculated without grants. Out of

this amount, the deficit relating to investment projects financed at the expense of external loans will make up 10.3 billion MDL. The State Budget deficit will be covered from foreign sources of funding, net receipts of external loans for budget support (1.4 billion MDL) and the implementation of projects financed from foreign sources (IMF, EU, WB, EBRD) – approximately 8.01 billion MDL. Among the domestic sources one can mention the issuance of state securities and the financial means derived from the privatization of public assets (of which the amount of 1.4 billion MDL comes from the net issuance of state securities on the primary market).

Given the unprecedented repercussions of the pandemic crisis and drought, the Government should urgently implement a comprehensive package of support measures for companies and the population, which would also support the economic recovery in 2021-2022. The package should be based on 3 key elements: (i) areas of support should be relevant, well targeted and create sufficient prerequisites for a quality economic recovery; (ii) measures should be anchored in a realistic resource framework; (iii) the implementation of the package of measures should be based on active and clear communication with its beneficiaries, as well as on efficient interaction with other relevant public institutions (e.g. National Bank of Moldova, State Tax Service, etc.).

1. *Areas of support.* In the immediate term, the measures should address the most pressing issue generated by the coronacrisis – liquidity shortage within companies. The aim of these measures should be to avoid the chain bankruptcies, as well as to maintain and even encourage entrepreneurship. To this effect, the following measures should be taken:
 - a. *Simplification of bureaucratic procedures* necessary to obtain support for companies and employees. Thus, in the immediate future there is a need to facilitate the disbursement of resources already allocated under the existing support instruments to companies and employees. This involves speeding up the examination of applications for support and relaxation of conditions to obtain that support. In order to avoid potential abuses or fraud by beneficiaries, that simplification should be followed, after a certain period of time, by state controls which would ensure the verification of the use of received resources.
 - b. *State guarantee* of loans taken out by companies to pay wages or other urgent payments to avoid bankruptcy. This could complement the existing instrument at the time of subsidizing interests on such loans, which is not yet actively used by companies. In order to avoid potential abuses or moral hazards, the share of loan guarantees, as well as that of subsidies for interest coverage could be 70-80%, with a certain own contribution by the economic agent.
 - c. *Subsidising the reduced working time.* The Government could provide subsidies that would compensate, at least partially, the lost income of employees whose working hours (and wages, respectively) were reduced. The share could be 70-80% to avoid fraud or moral hazard and to ensure that viable and potential jobs are preserved.
 - d. *Support measures should target the most vulnerable groups* – companies and employees who, according to surveys and data, proved to be the most affected by the crisis. In terms of companies, these should refer to micro and small enterprises, enterprises with limited or no access to foreign markets, and companies in the transport, hotels and catering and domestic trade sectors. In terms of employees, these should primarily refer to those with low incomes, informal employees, young people, elderly people and women.
 - e. *Grant and consultancy programme* for companies that process local raw materials, implement new technologies and focus on selling and exporting products with a higher level of processing. This measure is also needed during the period of economic recovery, in order to ensure conditions for a more sustainable and qualitative economic growth. For this support measures, the promotion of digitization of businesses should be regarded as a cross-cutting priority.
2. *Framework of resources.* To ensure the credibility and feasibility of that programme, it should be based on a clear resource framework. In this regard, around 1 billion EUR could be mobilized and allocated for measures mentioned above. These resources can be mobilized based on the following competitive advantages of the

Republic of Moldova: relatively well developed relations with the donor community, low indebtedness of the state budget and local budgets, low inflation rate and high level of liquidity and capitalization in the banking system. The main sources of funding can be:

- a. *Foreign assistance* (about 150-200 million EUR), mainly from EU, IMF and World Bank resources. At the moment, this is one of the areas with the greatest untapped potential by the Government of the Republic of Moldova. For example, in the midst of the 2020 crisis, when the budget deficit increased to 6% of GDP and the real sector faced an unprecedented liquidity crisis, the Government managed to attract 2.5 less non-reimbursable financing from donors compared to planned levels. In this regard, there is a need to set up a coordination unit for foreign assistance focussed on combating the effects of the pandemic, which would ensure a smooth communication between donors and the Government and, respectively, a faster disbursement of funds.
 - b. *State securities* (about 300 million EUR). The acceptable level of domestic government debt, in parallel with the abundance of liquidity in the banking system and a low level of inflation, low NBM policy rate and low interest rates, create all the necessary preconditions for increasing the Government's domestic loans. At the same time, actions are needed to expand the range of creditors/buyers of state securities (SS) on the primary market, in particular among companies and the population. This could simplify the procedures based on which anyone could purchase SS, which would allow the Government to take out domestic loans on more favourable terms.
 - c. *Municipal bonds* (about 50 million EUR). Following the model of the countries in the region, local public authorities could issue municipal bonds in order to identify resources needed to make capital investments. In the context of the coronacrisis and the budget constraints generated at central and local levels, this loan instrument can diversify the sources of financing of local public authorities and could even increase their financial autonomy. In order to develop this instrument, these bonds should be granted a preferential tax treatment, following the model of countries in the region, where income from investments in municipal bonds is not taxed (currently, the 12% taxation is a major barrier to the development of this instrument, especially since no issuance has been recorded so far).
 - d. *Issuance of Eurobonds* (about 500 million EUR). The current situation on foreign capital markets is favourable for the issuance of Eurobonds on favourable terms, thanks to the abundance of liquidity. The Republic of Moldova could mobilize a large part of resources needed for an active economic recovery programme by issuing Eurobonds at interest rates similar to those issued by Ukraine or Armenia (about 3-4% per year). In this regard, discussions with international rating agencies should be started as soon as possible in order to assess the macro-financial situation and update the country rating, which currently seems to be underestimated by one of these agencies.
 - e. *System of state guarantees and development of financial risk insurance, in parallel with stricter regulation of bank commissions in favour of consumers*. In the medium and long term, banks should be motivated to focus more on lending to the real sector, while other forms of income (e.g. commissions, currency speculations, etc.) should decrease as a share in the structure of banks' business models. In this regard, it is necessary to solve one of the classic failures of the free market, when the perception of the excessive risk in relation to certain categories of potential creditors leads to adverse selection by banks, which deprives those companies of access to finance and creates a vicious circle for them. Companies at high risk are micro and small businesses in the agricultural sector, without a credit history or even start-ups, which access new markets/niches. As a rule, such companies cannot offer any pledge or credible turnovers to obtain bank loans on favourable terms. In that case, the Government could establish a system of state guarantees to partially cover the risk perceived by banks. At the same time, financial risk insurance should be developed to enable banks to manage those risks more effectively. This would allow channelling the excess liquidities from the banking system into the real economy, while unlocking around 250-300 million EUR.
3. *Communication and coordination among institutions and with the target audience*. The programme of measures will not have the expected impact if it is not actively communicated to the target beneficiaries,

especially considering that, according to surveys, more than one third of companies are poorly informed or are not informed at all about the support measures implemented by the Government. In this regard, it is appropriate to place the relevant information on a website dedicated to support measures, for which companies can apply online. In addition, the package of measures involves interaction and coordination among various public institutions (e.g.: Ministry of Economy and Infrastructure, Ministry of Finance, National Bank of Moldova, State Tax Service, etc.). In this respect, it is necessary to set up an anticrisis cell, which should include high-ranking representatives (e.g. secretaries of state or ministers) from the institutions concerned, in order to ensure the necessary synergy. The respective unit should also actively communicate with the specialised unit on the coordination of foreign assistance during the pandemic, in order to ensure the synergy between the Government's actions and the support provided by development partners.

Executive summary

Firms. The Moldovan economy, which entered 2020 with a declining level of business confidence, had to absorb the shock of the crisis caused by both the pandemic and the severe drought. Restrictions imposed on multiple sectors, as well as on population mobility, declining demand in foreign markets, reduced disposable income and more prudent consumption with delayed purchases, pre-pandemic vulnerabilities in supply chains and the impact of the drought have caused, according to estimates, the largest economic decline in the last 20 years (-6.5%), the economy losing more than 10 percentage points compared to the pre-pandemic forecasts. The year 2021 will be marked by a continued decline in private investment, given the uncertainties related to the pandemic. The main challenge for companies is readjusting their business model to the new reality and ensuring a cash flow to maintain operational activity. On the other hand, a decline in public investment is also to be expected, determined by austere budgetary realities. In general, even if the economy grows in 2021, the parameters will remain below the level before the pandemic. In this context, we anticipate in 2021 an increase in GVA of about 5.6%, and an increase of GDP of 5.4%, taking into account a better year for agriculture and a low comparison base.

Households and Labour Force. The economic recession worsened the indicators reflecting the welfare of the population in 2020. We estimate that the final consumption expressed in real terms decreased by 7.7%, and the number of employed population decreased by 6.1%. Paradoxically, however, there was an increase in wages. Yet, this was a statistical result, reflecting both the reduction of the remuneration fund in real terms and the decrease in the number of employees. The remittances performed better than expected, with a minor decrease, of just over 2%, recorded in Jan-Sep:20. The contraction of economic activity hit hardest in people employed informally. For 2021, we forecast an income growth due to the economic recovery, by 1.7% for wages and by 3.3% for pensions. Final consumption will increase rapidly, by 8.3% - this growth will reflect the income growth on the one hand and the statistical effect of the low comparison base on the other hand. The labour market will experience a slight recovery, and the number of employed population will increase by 1%. The speed of economy recovery is the main uncertainty for 2021, which may affect the welfare of the population.

Public finances. Our country entered 2020 with an extremely limited fiscal space after several elections, and the pandemic situation affected the stability of public finances. Although the main budgetary parameters improved towards the end of the year, it does not represent the beginning of economic recovery, but rather the result of optimizing or under-executing several spending programs (eg under-execution of support programs for companies and the population in pandemic conditions). The main sources of covering the public budget deficit in 2020 was the issuance of state securities by increasing the debt ceiling on the domestic market from 2 to 6 billion MDL, but also the assimilation of external loans of about 9.7 billion MDL, although the estimated value at the beginning of September exceeded MDL 17 billion. The trend of consolidating public revenues continues in 2021, and the fiscal policy adopted for 2021 responds only in a limited measure to the main challenges of the year. At the same time, uncertainty about external financing remains a risk for 2021. Although external assistance on the part of grants and loans has been partially resumed, there are real risks that the Government's forecasts will not be fulfilled in part, because the IMF assistance program was not signed, due to the electoral nature of some budgetary measures, budgetary-fiscal policy measures that do not correspond to previously assumed international commitments.

Social inclusion of the state budget for 2021. The speed with which the draft laws on the budget were approved and adopted did not allow for an adequate level of transparency and reasoning, to reflect the needs of vulnerable groups in the budget, and to ensure, at the same time, the integration of the principle of gender equality. These issues are absolutely important, but unwisely overseen, especially in the context in which the pandemic has shown that in crisis situations, within the same vulnerable group, the likelihood of women being more affected is high in some dimensions (employment, access to services social and educational), and men are also affected differently, from the perspective of access to medical and social services, together affected by the financial pressure on the family, etc.

Financial institutions. In an unusual year dominated by the Covid-19 pandemic, policy interventions proved vital in keeping the stability and the confidence in the financial system. When the pandemic started, most financial institutions were well-capitalized, had sufficient liquidity reserves and strong shareholders to support them. Against this background, the measures implemented by the NBM and the NCFM allowed the banks and other credit institutions, in turn, to respond to the needs of the customers affected by the pandemic, either by postponing payments or by renegotiating the contractual clauses. In addition, the monetary policy interventions ensured the continuity of the lending activity, while banks provided the necessary financing both to the Government and to the private sector. However, despite their contribution to the crisis management, towards the end of 2020, the political actors threatened the stability of the financial system again. Several controversial laws voted by a group of MPs are likely to create risks to public finances and compromise many of the reforms implemented in the last years.

Prices and Monetary Policy. The year 2020 was characterized by a strong disinflationary trend. While in Jan:20 the annual inflation rate was 6.8%, by the end of the year the dynamics of the general price level practically stagnated, and the rate of CPI growth only reached 0.4% y-o-y in Dec:20. These developments were the result of the effects generated by the global recession, including the decline in domestic demand and the fall in international prices for goods. The foreign exchange market saw a relatively calm development, although at the onset of the crisis, in Mar-Apr:20, there was some increase in volatility. At the same time, despite the depreciation of the national currency against the Euro, both the official exchange rate against the USD and the nominal and real effective exchange rate of the Moldovan leu increased. For 2021, we anticipate a slow upward trend in prices, and the annual inflation rate will amount to 2.6%. Although there are some risks, the acceleration of the inflation trend is unlikely. In this context, in 2021 the NBM will have the same approach as in 2020 and will promote a relaxed monetary policy. The big risk comes from the political actors. Political statements and decisions may adversely affect the independence of the Central Bank and jeopardize the state's economic security.

External sector. The economic impact of the pandemic varied widely between countries, and the prospects for economic recovery are equally different. This is explained by the differences in the spread of the virus and severity of lockdown measures, the structural composition of the GDP and incentives adopted in response to the crisis. Although a recovery of several economies can be noted at the end of 2020, including the Republic of Moldova, the surge of infection rates has led to new lockdown regimes in many countries, which will affect the activity and economic confidence in the short term, with negative effects on consumption and investment. The contraction of Moldovan exports in conditions of crisis point to their vulnerability, which is determined by excessive concentration and dependence on demand in several markets (including the fragility of the current loan business model). Although the increase of international food prices in the context of logistical or administrative limitations offers some opportunities for Moldovan exports over the current year, the expected rise in oil prices could exert inflation pressures. Finally, we could anticipate a worsening of the current account deficit of the Moldovan balance of payments during the next period, and in such conditions stimulating investment and attracting foreign assistance will be vital from the perspective of balancing the components of the current account deficit, to avoid possible pressure on the currency and external debt.

Estimates and forecasts of the key macroeconomic indicators for 2020-2021

Percentage real growth compared to the previous year, unless specified otherwise

Indicator	2020	2021
Gross Domestic Product	-6.5	5.4
Wages	4.0	1.7
Final consumption	-7.7	8.3
Investments in fixed assets, total	-3.6	-10.4
Public investments in fixed assets	22.4	-18.4
Private investments in fixed assets	-9.9	-7.8
Gross Fixed Capital Formation	-0.3	-5.8
Export of goods and services	-17.8	9.6
Import of goods and services	-11.5	6.8
Net taxes on product	-12.0	3.4
Gross value added, total	-5.7	5.6
Gross value added, industrial sector	-6.7	1.3
Gross value added, agricultural sector	-24.4	14.5
Gross value added, transport services sector	-14.9	11.1
Gross value added, trade sector	-6.0	4.1
Gross value added, construction sector	3.9	-5.4
New loans provided to companies in national currency	10.9	13.6
New loans provided to companies in foreign currency	-12.4	17.1
Consumer Price Index	4.0	2.6
Deficit (-) / surplus (+) National Public Budget,% of GDP	8.3	6.8
Deficit (-) / surplus (+) of the current account of Balance of Payments, % of GDP	5	5.5
Women's employment rate, % of the female working age population	34.5	34.9
Men's employment rate, % of the male working age population	42.2	43.0

Source: Expert-Grup estimates and forecasts.

Firms

This chapter presents the extent of the impact on the Moldovan economy caused by two major determinants in 2020: the pandemic crisis and severe drought. To this end, the developments in the main sectors are presented, taking into account their level of resilience and the factors that affected them. In addition to the sector approach based on statistical data, the chapter also presents the latest data from business surveys which assessed the level of confidence, expectations and the perception of how the business was supported by the state during this period. Also, forecasts for 2021 are drawn and explained, along with the factors that will stimulate or inhibit economic growth, as well as main challenges that result primarily from the pandemic and political uncertainties and which are likely to undermine the country's competitiveness.

Recent trends

The pandemic further damaged the confidence of entrepreneurs in doing business in the Republic of Moldova. According to the NBS data on business demography², in the period 2017-2019 the business creation rate was significantly lower than the business liquidation rate, and this gap was only increasing. In 2019, the creation rate of 14.7% was 10.7 percentage points lower than the business liquidation rate, and we can assume that in 2020, a year of extreme survival for business, this trend has only amplified.

Lifting of the April-May lockdown and the relaxation of economic activities reduced the proportion of failed business sales, but depleted most of the survival reserves. According to two World Bank surveys conducted in 2020³, while in May 2020 companies estimated an average decrease in sales of 57.1% compared to May 2019, this indicator for November 2020 indicates a decrease of sales of 29.4% y-o-y. It should be noted that failed sales affected mainly small businesses. While the companies with more than 100 employees indicated in November 2020 a decrease in turnover of 14.2% y-o-y, those with a number of employees between 5 and 19 reported a decrease of 34.3% in the same period, which confirms a higher level of vulnerability of SMEs in the context of the pandemic. At the same time, the share of companies that declared that they had temporarily ceased their activity decreased from 12.8% in May 2020 to 5 percent in November 2020. Another reality of the pandemic is that companies have exhausted most of their survival reserves in 2020, given that 72% of the companies surveyed stated a decrease in liquidity/cash flow compared to the previous period (November compared to May).

The authorities' support for the business community is the lowest in the region, and in the case of micro and small enterprises with up to 19 employees the level of assimilated support is the lowest, even though they were most affected. The above-mentioned World Bank survey also measured the state's response to the pandemic for the private sector by the share of companies that have received/expect to receive national or local government assistance. The survey shows that only 5.9% of the surveyed companies received such support. This share is by far the lowest in the region, given that the responses of companies in Russia (26.5%), Estonia (42.8%), Romania (48.5%), Georgia (51.4%) or Poland (79.4%) show a much stronger state support in order to save businesses and jobs. Moreover, 22% of companies surveyed in Moldova said they did not qualify for government support, and 31% were unaware of any support opportunities⁴. Respectively, the number of companies that were not eligible for support exceeds almost 4 times the number of those that received or expect some assistance, and these figures confirm the earlier conclusions⁵ that the business support measures in the context of Covid-19 pandemic are weak,

² <https://statistica.gov.md/newsview.php?l=ro&idc=168&id=6853>

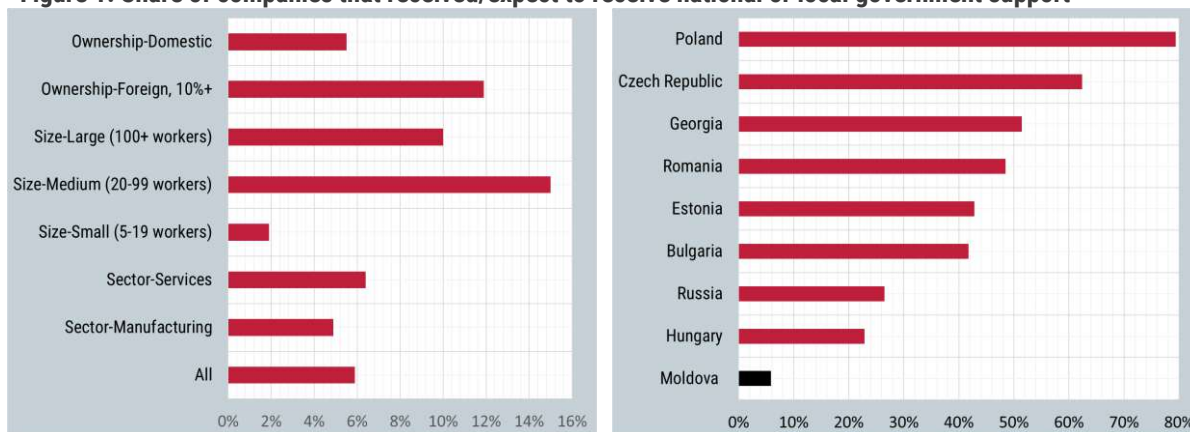
³ <https://www.enterprisesurveys.org/en/covid-19/chart>

⁴ https://www.worldbank.org/en/country/moldova/brief/moldova-economic-update?cid=ECA_FB_Moldova_EN_EXT

⁵ <https://www.expert-grup.org/ro/biblioteca/item/2052-raportul-de-stare-a-%C8%9B%C4%83rii-2020&category=182>

are largely conditional and therefore benefit a very limited number of companies. The figures on the types of companies that have received or will receive some form of government support are also relevant. Thus, such support is mainly aimed at medium and large enterprises and is almost completely missing in the case of micro and small businesses, and the figure of only 1.9% of companies with a workforce of 5-19 employees confirms this hypothesis.

Figure 1. Share of companies that received/expect to receive national or local government support

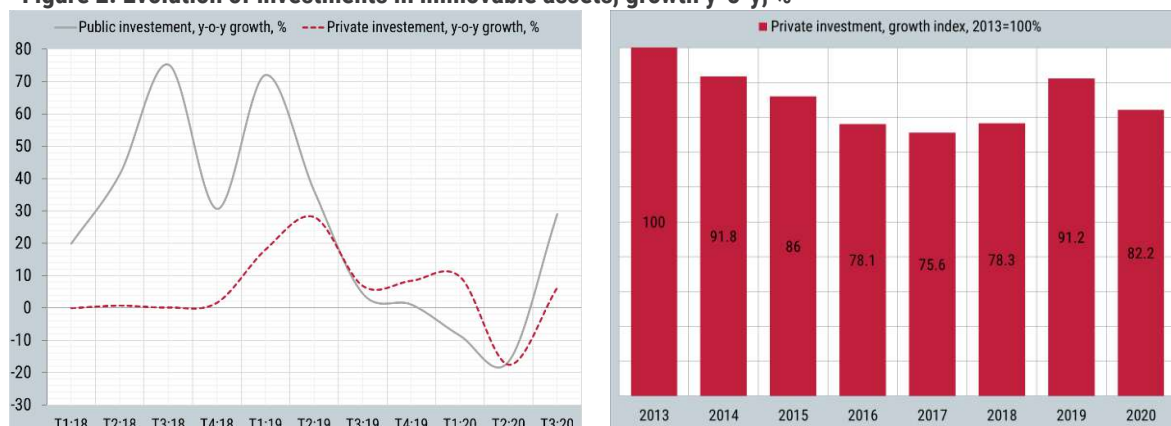


Source: NBS, COVID-19 companies survey, World Bank

The lockdown experience encouraged many companies to develop online sales, although this trend is not yet sustainable. The COVID-19 pandemic found domestic companies poorly prepared, as NBS data show that on average only every fourth company with ten or more employees has a website and according to NBM data there were only 412 e-commerce platforms⁶ in the first quarter of 2020, with no progress compared to the end of 2018. Faced with this, companies have made sustained efforts to be able to conduct online sales and the increase of the number of e-commerce platforms by 70 units in the second and third quarters of 2020 confirms this trend. At the same time, while in May 2020 the share of online sales of companies was on average 11.1%, in November 2020 this share dropped to 7.2%, but this evolution is explained by the increase in sales through traditional distribution channels once the post-lockdown conditions have relaxed rather than the decrease in absolute volumes of online sales.

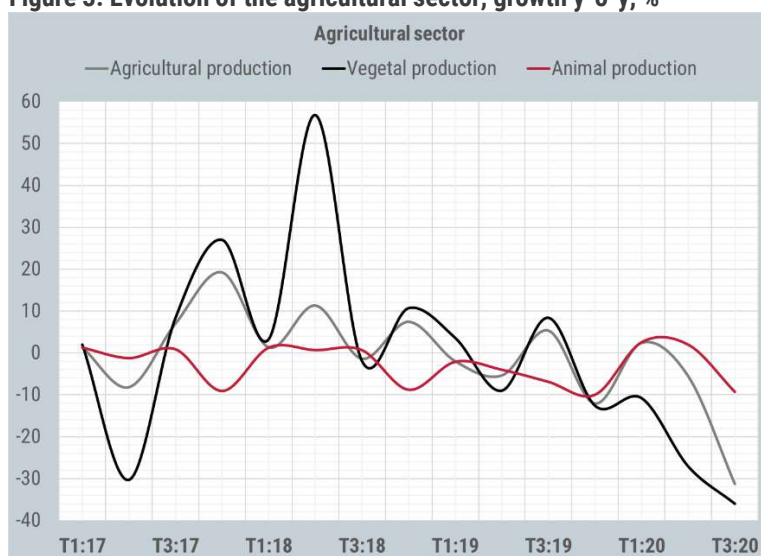
The pandemic situation and the reduction of companies' investments in order to survive move the value of private investments away from the maximum of the last 10 years, namely that reached in 2013. Even though 2 out of 3 MDL invested in the economy still come from private investments, in the first 9 months of 2020 their value decreased in real terms by 10.4% y-o-y. The steepest decline in private investment occurred in Q2 with the introduction of lockdown (-17.5% y-o-y), while in Q3 there was a slight increase of 6.3 % y-o-y. The decrease in private investment was due to the significant reduction in productive investment in machinery and equipment and was mitigated by the positive dynamics in the construction sector. At the same time, in Q1-Q3 of 2020 public investments recorded an increase of 27.8% y-o-y, which is due to the doubling of the Road Fund and the 60 percent increase in investment coming from external loans, which suggests that most public investment has been channelled into road infrastructure.

⁶ Software solution which allows to accept bank cards as online payment

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

Source: NBS, Expert-Grup estimates

The drought decreased the gross added value in agriculture by about a quarter. The results of 2020 show a decrease of agricultural output by 27.1% y-o-y (in comparable prices) caused by the decline of 35.9% in vegetal production and a reduction of 3.8% y-o-y in animal production. By far, annual crops (cereals and legumes, sunflower) remain the most affected with yield decreases per hectare of 40-50 per cent. Average reductions in productivity per hectare also occurred in the case of grapes (-28%), while in the case of fruits, nuts and berries (-22.8%) the decreases were slightly smaller. At the same time, last year's drought has further eroded the livestock sector, further accelerating the decline of livestock both in households and on farms, the number of cattle, sheep and goats and poultry being on 1 January 2021 lower by 15-20% on average.

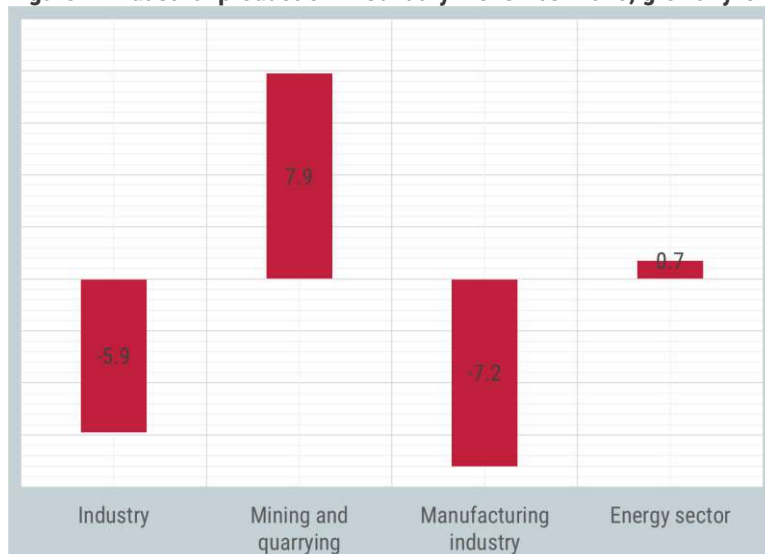
Figure 3. Evolution of the agricultural sector, growth y-o-y, %

Source: NBS data

The manufacturing industry is being dragged down by declining demand on foreign markets due to the pandemic, but also by the effects of drought on agriculture. The pandemic situation has directly influenced developments in industry, as most activities were halted as a measure to limit the spread of the virus, but especially as a result of decreased demand on foreign markets. The data for January-November 2020 shows a decline of 5.9% y-o-y, the most significant decreases being reported in the industries that are links of international value chains, with decreases of 35-40% in automotive sector and almost 10% in garment industry. The food and beverage industries, after positive developments in the first months of the year, recorded in January-November 2020 declines of 5.7% and 7.3% respectively, due to the drought that reduced the supply of raw materials and made them more expensive. The industry leaders of the year 2020 are the activities of manufacturing chemicals (+25.3%) due to the demand for disinfectants, the extractive industry and that of metal constructions: +7.9, respectively +3.9% associated with the

positive dynamics in construction, especially road infrastructure, but also the manufacture of furniture (+ 0.2%), which after massive decreases during the lockdown (-66.8% and -45.6% in April and May respectively), returned strongly in recent months, as longer stay at home made people invest in furniture.

Figure 4. Industrial production in January-November 2020, growth y-o-y, %



Source: NBS data

Domestic trade has been affected by declining disposable income, more prudent consumption and mobility restrictions, while the IT sector and construction have been on an upward trend. The results for the first 9 months of the year show an increase of turnover in the retail sector by 1.4% y-o-y and a decrease of 21.2% y-o-y in services rendered to the population. In the retail segment, the biggest winners were large chains, those selling mainly food, which were continuously active and assimilated part of the consumption usually made in the hospitality sector, and ICT products, where demand increased due to online education and teleworking, while small retailers, especially those in the markets, were significantly affected by both activity restrictions and disruptions in supply chains. The turnover of the hospitality industry decreased almost by half in the same period (-47.9% y-o-y), that of travel agencies and tour operators – down to 1/3 of the previous year, while that of recreational activities and leisure decreased by almost 40 per cent. The turnover in wholesale contracted in the first 9 months of the year by 8.2% y-o-y, services provided to companies decreased by 17.9%, including in transport and storage services by about 1/3. Construction industry showed a high level of resilience in the pandemic with an increase of 3.8% y-o-y (comparable prices) in the volume of works in January-September 2020, due to the continuation of residential projects and a high volume of public investment ("Good Roads" Program and road rehabilitation financed from external sources), but also the lack of restrictions during the lockdown, while the IT sector continued to expand in the new business environment, which manifested in an increase of 25 % of exports in IT services in the first 9 months of 2020.

Forecasts and challenges

The spread of pandemic, the measures taken to manage it and access to the vaccine, the structural features of the economy at the onset of the crisis, and the effectiveness, scope and time horizon of support measures taken by governments and central banks are the main factors that differentiate economic performance by the end of the year. The year 2021 will continue to be part of an exceptional situation where states will have to actively intervene to further support the population and companies, while making derogations from the budgetary and fiscal rules. Even the IMF, which always emphasizes caution, has repeatedly stated in its latest report on the outlook of the global economy that policy action should provide effective support until the ongoing recovery is firm, with a focus on promoting key imperatives to increase production potential, ensure a participatory growth that benefits everyone and accelerate the transition to lower carbon dependence.

Although an economic advance is anticipated for 2021, this will be due to the recovery of agriculture and a low base of comparison in 2020, but will be severely undermined by the pandemic and political uncertainties. Paradoxically, the Moldovan economy will grow despite a decline in both private and public investment. This growth is rather due to conjuncture factors and raises questions about its sustainability. As mentioned above, the role of state intervention through policies to support the economy, but also to properly manage the public health crisis will significantly influence the economic recovery of the country. In this respect, maintaining the induced political uncertainty and the lack of capacity of the political class to agree on issues of national interest, such as an economic recovery plan, bear the risk of generating a slow, inertial growth in the future, without creating new jobs and widening the competitiveness gap with the countries in the region. Therefore, the main challenge for 2021 is to revive the entrepreneurial spirit and boost private investment in conditions of uncertainty and liquidity shortages.

Most businesses expect a return to optimal sales in the second half of 2021. While in the business survey conducted in May 2020⁷ companies expected a return to a normal level of sales within 5.5 months (by November 2020), the extension of the pandemic state involving mobility limitations and activity restrictions greatly diminished their optimism. In November 2020 survey, companies indicated an average period of 7.2 months in which they expect a return to pre-pandemic sales, namely in the second half of 2021. In November 2020 just 22% of the companies surveyed indicated that they returned to a level of sales comparable to that achieved a year before.

We expect in 2021 a reconfiguration of several markets, by increasing the number of mergers and acquisitions. After the depletion of all survival resources in 2020 by most companies, the true proportions of Covid-19 pandemic impact on companies will be felt in 2021. In such a context, the gap between large and small companies will widen, as the strongest will maintain investments while others will reduce them, and the weakest will have no choice but to go bankrupt or be taken over by another entity, which is why we expect to see an increase in merger transactions. The corporate winners in this pandemic crisis will tend to be large companies that implement technological innovations, have sufficiently good levels of capitalization and governance models that allow them to adapt quickly to new realities.

The year 2021 will be characterized by a decreased appetite of companies for investment, but also by a reduction of public investments. Estimates for 2020 show a decrease of private investment of 9.9% y-o-y, and expectations for the current year show a further reduction of 7.8%, given that the main challenges for businesses in this year are easing the pressure on working capital and adapting business relations to the new reality. In the segment of residential construction, demand is expected to remain constant at a time when the pandemic has further revealed the importance of owning a home. Instead, after an estimated increase in public investment of 22.4% in 2020, for 2021 the forecast is a reduction of -18.4%, given that the demand from the state through public investment is likely to record a notable setback stemming from government instability and insecure sources of coverage of the public budget deficit, which could lead to a pronounced austerity in public finances, which in turn will affect public investment.

Estimates for 2020 show a reduction of GVA by 5.7% and of GDP by 6.5%. Projections for 2021 anticipate that the economy will not return to pre-pandemic levels but will achieve a 5.6% increase of GVA and a 5.4% increase of GDP. Such an evolution is conditioned by:

- ✓ **A low comparison base and the maintenance of high food prices is expected to generate a strong growth in agriculture.** Our estimates show that in 2020 the gross value added in agriculture contracted by 24.4%, while the forecast for 2021 is an increase of 14.5%, and agriculture will be one of the main factors to contribute towards the economic growth in 2021.

⁷ <https://www.enterprisesurveys.org/en/covid-19/chart>

- ✓ **In 2021, the industry will record a modest growth amid uncertainty and a slower recovery of export-oriented industrial sectors.** Our estimates show for 2020 a decrease of GVA in industry of 6.7%, and for 2021 an increase of value added of only 1.3% is anticipated.
- ✓ **In 2021 the construction sector will be affected by a decrease of investment activity.** While in 2020 the value added in constructions increased by 3.9%, the forecasts for 2021 indicate a decrease of GVA of 5.4%. An important indicator in this regard is the number of new building permits, which is decreasing. Thus, in 2020 the number of issued permits decreased by 1.9% y-o-y, including a decrease of 17.5% y-o-y in the number of permits issued for non-residential buildings and an increase of 8% in the number of permits for residential buildings. This situation suggests a reduction of activity in the productive sector of the economy.
- ✓ **Retail and transport activities will contribute to the economic advance in 2021, but their volumes will be below the level reached before the pandemic.** After the GVA in transport decreased by 14.9% in 2020, the anticipated increase for 2021 is 11.1%, while the retail, after having declined in 2020 by 6%, will increase by 4.1% in 2021.
- ✓ **Given the mobility restrictions in place, the year 2021 will be difficult for hospitality and tourism sectors,** with a level of activities still far below the figures before the pandemic.
- ✓ **Further application of the single tax in case of IT Park residents,** as well as the acceleration of digitization trends will keep the country's IT sector on an upward trend in 2021.

Households and Labour Force

This chapter analyses the developments in 2020, namely how the recession was transposed into the indicators that reflect the welfare of the population. Though the overall economy of households worsened, some less pessimistic developments can be noted. Thus, for instance, the remittances decreased quite slowly, contradicting the patterns of earlier economic crises in the Republic of Moldova. The chapter ends with forecasts that suggest an improvement on the households' economic condition in 2021.

Recent trends

In the context of the 2020 recession, the shrinking household final consumption had the greatest impact on the GDP decline. In Jan-Sep:20 the final consumption decreased by 8% y-o-y, causing the strongest negative impact on GDP (by -7.7 p.p.). The final household consumption shrank by 9% y-o-y and contributed to the GDP decline by 7.3 p.p. (Table 1). The shutdown measures taken in Q2:20 to contain the Covid-19 pandemic were one of the factors driving the reduction in the final consumption. It was in this quarter that the steepest fall in the final consumption in 2020 was recorded. The compression of final consumption by 15.7% y-o-y in Q2:20 was determined both by the shrinking income and by the measures limiting the socio-economic activity. These measures affected the normal way of life, as people limited the time spent in public areas, which also caused a decline in consumption. Similarly, in Jan-Sep:20 exports of goods and services decreased by 17.3% y-o-y and contributed to a compression of GDP by 5.4 p.p. Due to the increase in public investments, the gross fixed capital formation experienced a minor contraction, by 0.8% y-o-y and had a contribution close to 0 p.p. to GDP change. The decline of imports of goods and services by 12.6 y-o-y tempered the GDP decline by 6.6 p.p.

Table 1. Growth rate and contribution of use components to GDP formation

	Growth rate, %	Contribution, p. p.
Final consumption of domestic households	-9	-7.3
Final consumption of PA and NISH	-2.4	-0.4
Gross Fixed Capital Formation	-0.8	-0.2
Change in stocks	X	-1.7
Export of goods and services	-17.3	-5.4
Import of goods and services	-12.1	-6.6

Note: PA – public administration; NISH non-profit institutions serving households

Source: NBS.

The dynamics of wages in 2020 provide a truncated picture of the impact of the crisis on the welfare of the population. In Jan-Oct: 20, the average gross wage in the economy increased, in real terms, by 4.2% y-o-y. The growth was mainly determined by the increase of wage in the real sector by 5% y-o-y. In the budgetary sector, the real wage growth was much slower, of 1.8% y-o-y. However, this growth is quite misleading. Thus, the average wage is calculated as the ratio between the wage fund and the number of employees. If the decrease in the wage fund is less than the reduction of the number of workers, then statistically we have an increase in wage. This situation was characteristic for the year 2020. Although there are no final data on the remuneration fund and the number of employees, there are other variables that indicate a more unfavourable dynamics of the number of employees as compared to the changes in wages. In Jan-Sep:20, the wage fund related taxes decreased in real terms and increased in nominal terms. Compulsory state social insurance contributions increased, in current prices, by 1.9% y-o-y and decreased, in comparable prices, by 2.6%, while the compulsory health insurance premiums increased, in nominal expression, by 1.5% y-o-y and decreased, in real terms, by 3% y-o-y. In the same period, the number of officially employed persons shrank by 4% y-o-y. A similar development was recorded in 2009. The real wage increased then by 1.3%, as the 4% decrease in the number of employees was accompanied by a 1.5 % increase in the remuneration fund. After all, in the latest crises that the Republic of Moldova went through, the dynamics of the wages did not reflect the changes in the welfare of the population quite well. Therefore, in the times of economic decline, the decision-makers should use this indicator with care.

In 2020, remittances experienced a minor decline and this was a premiere that did not fit into the specific patterns of earlier crises. In Jan-Sep:20, remittances fell by 2.4% y-o-y, and their contribution to the decline of economy was low. This is different from the dynamics recorded in 2009 and in 2015, when remittances fell by 36.2 and 26.2%, respectively. Both in 2009 and in 2015 the decline in remittances was a key driving factor for the compression of economic activity. Moreover, the decrease in remittances in 2020 was caused by the developments in Q2:20, when a 15.3% y-o-y decline was recorded, while in Q1:20 and T3:20 the remittances increased by 7.2% and 1.9% y-o-y respectively (Figure 5). The Q2:20 decrease was determined by shutdown measures implemented internationally, including in many countries where Moldovan migrants work, to contain the Covid-19 pandemic. It is obvious that these measures affected the incomes of Moldovan migrants, which in turn affected the level of remittances. Yet, many Moldovans working abroad have stable activities in their countries of residence. In addition, some Moldovan emigrants benefited from fiscal-budgetary incentives in the states where they live. These factors positively influenced the level of remittances and offset the Q2:20 decline, which in turn resulted in a minor decrease in this type of transfers in Jan-Sep:20.

Figure 5. Remittances, y-o-y increase, %



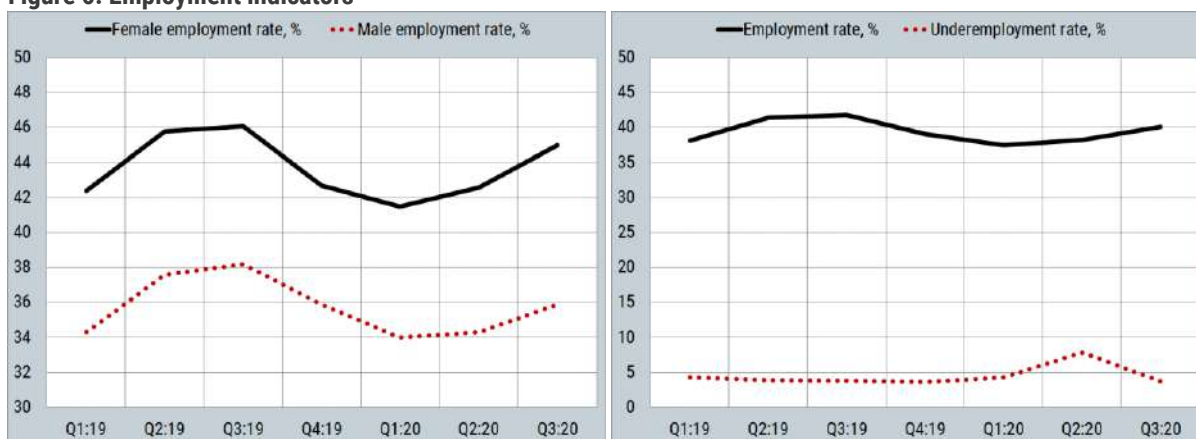
Source: NBS, Expert-Grup calculations.

In the Republic of Moldova, crises affect the welfare of the population by employment reduction. The 2009 and 2020 crises were characterized by an increase in the average wage and the decrease in the number of employed population. In 2009, the number of employed population shrank by 5.3%, while the average wage increased, in real terms, by 8.6%. In Jan-Sep:20 the number of employed population decreased by 5.6% y-o-y, while the average wage increased. This is explained by the low level of wages, which is characteristic for Moldova. In cases of compression of economic activity, in order to reduce their wage costs, employers have 2 possibilities: (1) keeping or reducing wages while reducing the number of employees or (2) reducing the wages, but keeping the employees. In this context, it should be noted that the decrease in the number of working hours could also be treated as a staff reduction. Since the wages are already low, an additional reduction can lead to a massive employee turnover. Under these conditions, the reduction of wage costs can be achieved by decreasing more slowly or even keeping the wages accompanied by a sharper staff reduction, by dismissing some of the employees or by reducing the working hours.

During the 2020 crisis, the level of employment decreased, while the underemployment rate increased. In Jan-Sep:20 the number of employed population decreased by 5.6% y-o-y, especially for women, who were much more affected than men. Thus, in Jan-Sep:20 the number of employed men decreased by 4.5% y-o-y (20.3 thousand people), and among women there was a decrease of 6.9% y-o-y (29.3 thousand people). The sharper decrease in women's employment compared to that for men was determined, among other factors, by the shutdown of educational institutions. One of the parents was practically forced to take time off or to work less in order to be

able to supervise the children left home, and for the most part, this task fell to the women. This can be explained by the following factors: (1) men's wages are higher than women's (in 2019 the average wage of men was 16.4% higher than that of women) and it is usually the household member with a lower wage who gives up work, and (2) in Moldovan families, women are those who traditionally take care of the children. Negative developments in the labour market were also reflected in the employment rates. In 2020 quarterly employment rates were lower than those recorded in 2019. However, the situation improved during the year, when the employment rate increased from 37.5% in Q1:20 to 40.1% in Q3:20. However, during the crisis the gap between employment rates of men and women increased (Figure 6). In Jan-Sep:20, the employment rate of men increased from 34 and 45%, while the employment rate of women increased from 34 and 35.9%. Consequently, in Jan-Sep:20 the gap between employment rates increased from 7.5 to 9.1 pp. The decrease in employment was accompanied by the increase in underemployment. The number of underemployed increased by 25% y-o-y in Jan-Sep:20, yet the increase in underemployment was concentrated in Q2:20 (Figure 6). The underemployment rate then reached 7.8% and doubled compared to Q2:19. It was during this period that the education facilities were closed and the parents had to reduce their working hours in order to take care of children. In Q1:20 and Q3:20, the underemployment rate was 4.3% and 3.7% respectively, which is close to the rates recorded in Q1:19 and Q3:20.

Figure 6. Employment indicators



Source: NBS, Expert-Grup calculations.

The informally employed population was the most affected by the recession. In Jan-Sep:20, the number of formally employed employees decreased by 3.7% y-o-y, while the number of informal employees decreased several times faster (-16.6% y-o-y). The number of people working informally and lacking the employee status decreased by 38.1% y-o-y. This can be explained by the fact that it has been much more difficult for companies in the informal sector to maintain their activity than for companies operating in the formal sector. Or, when facing the crisis, formal sector companies were able to take bank loans or even benefited from the support measures under the "Law no. 60 of 23-04-2020 on the measures to support entrepreneurial activity", such as subsidies for the payment of interest on loans accessed by entrepreneurs or the VAT reimbursement program, while informal companies did not have such opportunities.

The steepest decrease in the employed population was recorded in construction and industry. In Jan-Sep:20, the number of people employed in construction decreased by 7.3% y-o-y, and in the industry the decrease was 7.2% y-o-y. In the services sector, the decrease was slower and amounted to 5.8% y-o-y. Agriculture experienced the smallest decline in the employed population, with only 3.6% y-o-y. This development can be explained by the fact that the population employed in agriculture remained in the sector because employment in other sectors or emigration opportunities were limited during the crisis. At the same time, the impact of the drought is perceived as being temporary, and a recovery of farmers is anticipated for 2021-2022.

Forecasts and challenges

In 2021, the wages and pensions are expected to increase against the background of the economic recovery. We estimate that in 2020 the real wage increased by 4%, and for 2021 we anticipate an increase by only 1.7%. The increase in wages will be determined by the real increase of the remuneration fund by 2.3% - a development influenced, in its turn, by the economic recovery. According to estimations, in 2020 the average pension increased in real terms by 3.1%, and for 2021 we forecast a similar increase by 3.3%.

The decline in final consumption in 2020 will be fully offset by the rise anticipated for 2021. In 2020, final consumption fell by an estimated 7.7%, and for 2021 we forecast an increase by 8.3%. The increase in 2021 will be due to the income growth, but also to the statistical effect. In Q2:21 we anticipate a significant increase in consumption in annual terms. This will also be due to the very low comparison base, because in Q2:20 the steepest decrease in consumption for the entire 2020 was recorded as a result of shutdown measures.

After the decrease in 2020, employment indicators will slowly rise in 2021. The 2020 recession caused a decrease in the number of employed population by about 6.1% and the number of employees - 3.5%. In 2021, the situation in the labour market will improve to some extent due to the expected economic recovery. The projections point to marginal increases by 1.3% for the employed population and 1% for the number of employees. The labour demand will be tempered by increased productivity, and this will cause a slow growth of employment indicators.

The slow pace of economic recovery will be the main challenge for households in 2021. Although a rather positive context is expected, due to the growth of global economy by 5.5% and the⁸ EU economy by 4.1%⁹ and accelerated growth of agriculture in the country, there are many uncertainties that might hamper the recovery. The management of the Covid-19 pandemic is the biggest challenge in this regard. The emergence of a new strain of the virus, as well as delays in the delivery of vaccines to the EU brings a certain amount of pessimism and reduces the optimism regarding the rapid overcoming of the corona crisis. The domestic political instability and politicking decisions voted by the Parliament on 16.12.2020 (lowering the age of retirement and cancellation of payments to be made by the Government to the NBM based on the state bonds issued to the Central Bank in the context of providing emergency loans to insolvent banks: ~Banca de Economii", "Banca Socială" and "Eximbank") will affect the credibility of the Government of the Republic of Moldova, which will be translated into more difficult conditions for financing the budget deficit from external sources. In turn, this may jeopardize the economic growth prospects.

One of the challenges is that although there is an abundance of statistical information, public authorities lack a data system that could realistically reflect socio-economic dynamics during the crises. The statistical system of the Republic of Moldova is represented by several institutions that generate different data, including public data, which are provided with various periodicity. Despite this, the authorities do not have any system of indicators comprising the most relevant economic variables. The system of indicators can be used as an analysis tool and serve as a support for decision-making in crises. Broadly speaking, creating a data system involves sorting out irrelevant indicators. For example, in the case of crises, the analysis of the average wage in the economy in the Republic of Moldova could generate an erroneous picture. At the same time, the data on fuel procurement or on the import of final consumer goods would be much more informative indicators.

⁸ <https://www.imf.org/en/Publications/WEO/weo-database/2020/October>

⁹ https://ec.europa.eu/info/sites/info/files/economy-finance/ip136_en_2.pdf

Public Finances

The pandemic-induced exceptional situation extended to the public finances sector as well. The wide-scale spread of Covid-19 pandemic forced the world countries to opt for record public budget deficits while striving to adjust and curb the pandemic impacts on the economy. The Republic of Moldova was not an exception to this rule since it entered 2020 with an extremely limited fiscal space following several elections.

Recent trends

As the macroeconomic picture changed at a higher frequency path in 2020, such fact was mirrored in the National Public Budget (NPB) as well. The authorities made three budget corrigenda throughout the year. Even if a budget deficit of 8% of GDP was estimated under the last corrigendum of budget parameters in early September, the actual data show a significantly lower-than-expected deficit (5.5% of GDP for the state budget and 5.3% for the NPB), a fact caused by the annulment, optimization or underperformance of several spending programs (e.g. underperformance of support programs to companies and population under the pandemic conditions). The issuance of state securities served as one of the main sources to cover the budget deficit, thus, having increased the debt ceiling on the domestic market from MDL 2 billion to MDL 6 billion. Another source to this end was the assimilation of external loans worth circa MDL 9.7 billion, although their value estimated in early September exceeded MDL 17 billion.

In 2020 the budget revenues slightly dropped while the expenditures increased. Relative to 2019 data, the National Public Budget (NPB) overall revenues amounted to MDL 62.6 billion, showing a downward trend in nominal terms of -0.5% y-o-y, and the NPB expenditures reached MDL 73.3 billion or by 11.1% more y-o-y (MDL 7.3 billion). Hence, bearing on the NPB revenue estimates at the time of approving the 2020 Budget Law (MDL 69.2 billion), it can be ascertained that, due to pandemic, the public budget missed revenues worth circa MDL 8 billion in 2020. At the same time, the expenditures for 2020 were not carried out in full. If at the beginning of the year the planned public expenditures equaled to MDL 76.6 billion, the actual data show expenditure shrinking by MDL 3.3 billion and by MDL 4 billion as compared to September estimates. This should be perceived rather negatively under the conditions when, for instance, the support granted to the business community and population was extremely modest. At the same time, the expected risks described in the MEGA previous edition¹⁰ materialized for the public finances related to the potential election nature of budget expenditure measures in the context of 2020 Presidential Elections, when the governance augmented the social and capital investment commitments, just like the previous governments did. Hence, the significant drop in private investments has been compensated at the account of public investment increases in Q2 2020 and Q3 2020, by circa 23% y-o-y (at the expense of foreign-financed projects and of the road infrastructure works financed by the Road Fund).

Figure 7. The National Public Budget Deficit Developments, planned and achieved (% of GDP).



Source: The Author's own calculations based on the Ministry of Finance data.

Figure 8. Comparative Analysis of the NPB Balance in May (% of the NPB overall revenues).



Source: The Author's own calculations based on the Ministry of Finance data.

¹⁰ https://www.expert-grup.org/media/k2/attachments/MEGA_editia_XXI.pdf

Bearing on the 2020 macroeconomic picture, the institutions responsible for tax collection (the Customs Service and the State Tax Service) achieved an extremely good outcome, favored also by more evident decline in the informal sector activities (e.g. closure of markets, restrictions imposed on HoReCa), the consumption being more oriented toward formal commerce channels. Relative to 2019 data, the State Budget overall collected revenues in nominal terms are lower by -3.7% (MDL 1.46 billion) following the decline of general and collected revenues by -3.7% (MDL 1.46 billion). Concurrently, the revenues of foreign-financed projects are slightly higher by 1.3% y-o-y (MDL 4.5 million). Relative to 2019, the revenues administrated by the State Tax Service are lower by -1.1% (MDL -183.8 million), amounting to MDL 17.05 billion. The revenues administrated by the Customs Service constituted MDL 22.5 billion, shrinking by -1.6% y-o-y (MDL -369.8 million). Out of the collected revenues (MDL 38.15 billion), the receipts from taxes and fees equaled to MDL 35.77 billion, which is by -1.8% (MDL -640 million) less as compared to the same period of the past year. The receipts from VAT, taking into account the VAT refunds, constituted MDL 19.69 billion (51.6% of the overall revenues), being lower by -2.0% (MDL 405 million) relative to 2019. The revenues collected from excise taxes, taking into account the refunds, amounted to MDL 6.46 billion, which is by 3.9% (MDL 245.6 million) more relative to the past year. The VAT refunds totaled MDL 2.95 billion, by just 1.6% (MDL 47.6 million) more than in 2019, even if the authorities planned using this tool to support the business environment under the Covid-19 crisis conditions.

Although the foreign grants have been planned as an important source of revenues in 2020, the actual results show their modest assimilation. Even if the draft Budget Law planned the assimilated foreign grants to make up circa 4% of revenues (MDL 1.77 billion), the data on budget execution show an amount of attracted grants worth MDL 624.4 million only, which is 2.5 times less relative to the 2019 indicator. This outcome was affected also by the authorities' failure to deploy the third tranche of the EU macro-financial assistance worth EUR 40 million, of which half was provided as grants.

To help the partner countries tackle the pandemic short- and long-term effects, on 8 April, the European Commission pooled the EU budget resources with those of the EU Member States and of International Financial Institutions into a single package called the "Europe Team". The package included emergency support worth EUR 962 million to be provided to the Eastern Partnership countries.¹¹ Under this framework, Moldova received EUR 87 million as bilateral aid from the EU, mobilized through forwarding the already existing EU funds engaged in the Republic of Moldova. The funds shall be channeled to respond to immediate needs, such as supporting the health sector and the most vulnerable groups of the society, as well as the midterm objectives to curb the pandemic social and economic impacts. The EU is re-channeling and enhancing its budget support towards the Moldovan Government to help financing, for example, the procurement of medical materials and equipment or the social protection programs for the most vulnerable people. Likewise, the World Bank has launched Moldova Emergency COVID-19 Response Project (EUR 52.9 million). The Project seeks to take effective and timely action to respond to the COVID-19 pandemic by strengthening the country's healthcare system and mitigating social risks.¹² The main concern in this case is the efficient spending of these resources, especially when having evidence on inefficient or inappropriate spending, political clientelism, in particular, with respect to public procurement in the health sector.¹³

Forecasts and challenges

The adopted 2021 fiscal policy is slightly correlated with the main challenges of the year. Although the fiscal policy was subject to wide consultations in comparison with the previous years, its objectives are almost exclusively focused on strengthening public revenues. At the same time, it contains few components that could underpin the economic recovery desideratum in 2021. Moreover, the cancelling of personal exemption for the spouse under the false argument that such facility would stimulate employment is not so inspiring given the

¹¹ <https://covid19.who.int/region/euro/country/md>

¹² <https://www.worldbank.org/en/news/loans-credits/2020/04/24/moldova-emergency-covid-19-response-project>

¹³ <https://newsmaker.md/ro/ce-nu-e-in-regula-cu-licitatiile-si-achizitiile-publice-in-conditiile-starii-de-urgenta-din-moldova-analiza-nm/>

current crisis conditions and loss of income sources by many families. The capping the local fees and their regulation in the midterm (three years), with an annual increase as per the size of inflation was done while lacking consensus with the LPAs, being imposed by the central governance strong position without taking into consideration the wide range of implications of such measure. The adopted fiscal policy contains no measures aimed to stimulate investments in the private sector, which recovery is one of the main challenges of this year. Moreover, some of the existing measures that allowed for VAT exemption for investment activity¹⁴ have been cancelled. Likewise, the fiscal policy comprises no incentives and support measures such as granting the conditions for restructuring the budget obligations to sectors affected the most by the pandemic crisis, establishing a 2021 bonus system for the enterprises that settle the income tax in due time, establishing fiscal incentives, such as imposing a lower VAT on electronic payments through the Internet in order to sustain digitization, etc. The most important support measure in 2021 with fiscal implications is the use of a mechanism to subsidize those enterprises, which employ individuals with disabilities, young people, persons who lost their job either at home or abroad due to Covid-19 pandemic as MDL 200 million have been budgeted to this end. However, the enforcement manner of this measure is yet to be developed.

Adopting the 2021 State Budget gave rise to controversy and concerns against the background of non-transparent approval process, lacking consultations and approval of election-related measures. The Government submitted the draft fiscal/customs policy and the 2021 draft State Budget Law to Parliament on 1 December 2020. No reliable parliamentary discussions were organized to this end, while the document openly promoted political clientelism. All these actions took place while lacking resources to cover the expenditures, and both the Law on Public Finances and Budgetary and Fiscal Responsibility and the Parliament Rules of Procedure were utterly violated. An example in the same vein is the distribution, through Annex 7 to the State Budget Law, of over MDL 350 million with a rather discriminatory and dangerous political discretion. Besides being a bad example of deliberate power abuse in the state, the Parliament itself gave an extremely threatening signal to the rule of law, where the abuse of the majority is legalized, having swept out all the endeavors of good governance and management of budget resources made since 2009. Even more severe is the fact that given the pandemic and the associated crisis, all amendments made by the Parliament do not respond to any of the current issues of the country, namely increased unemployment rate, issues faced by the health and education systems, and by the real sector. The issue of capping the local fees is still a controversial topic when lacking genuine dialogue and a platform to consider the constraints such ceilings would impose on Mayoralties, as well as deep misunderstanding of what LPA autonomy should mean. The fact that Members of Parliament (MPs) ignore the LPA common interest makes us believe that the MPs have forgotten they must represent the interests of constituencies in Parliament since they were elected by them.

We forecast that in 2021 the NPB overall revenues would rise by 4.1% y-o-y in nominal terms pursuant to the Basic Scenario and by 3.7% y-o-y pursuant to the Alternative Scenario. As for the expenditures, they should increase by approximately 11.3% y-o-y as per the Basic Scenario and by -4.23% y-o-y as per the Alternative Scenario (mitigated deficit). According to the Basic Scenario, such developments should result in an estimated budget deficit of 6.79% of GDP. Should the scenario of lowering the budget expenditures be implemented, which directly depends on foreign sources of funding, the budget deficit would not exceed 4.56% of GDP. The epidemiological situation determined also that the planned deficit level does not fit into the budget and fiscal rule stipulated by the Public Finance Law, i.e. 2.5% of GDP calculated without grants. Out of this amount, the deficit afferent to investment projects financed at the expense of external loans would make up MDL 10.3 billion. The State Budget deficit will be covered from foreign sources, net entries of external loans for budget support (MDL 1.4 billion) and from the implementation of projects financed by foreign sources (IMF, EU, WB, EBRD) – approximately MDL 8.01 billion. Among the domestic sources one can mention the issuance of state securities and the financial

¹⁴ Cancelling VAT exemption with the right of deduction, excise tax, customs duty and customs clearance on imports and/or delivery of goods, services on the Moldovan territory, intended for investment assistance projects, financed at the expense of loans (Art.104 (c) (1), Art.124 (3) b) of the Tax Code, Art. 28 n) of Law No. 1380/1997).

means derived from the privatization of public assets (of which the amount of MDL 1.4 billion comes from the net issuance of state securities on the primary market).

Yet again, the 2021 investment projects planned to be financed from foreign sources would be implemented to a lower extent. For example, when talking about the performance level related to fixed assets in 2019, it reached 70% of the forecasted level and only 50% of the expected capital investments, the trend keeping its path in 2020 (on 11 October 2019, 70% as compared to the forecasted level and only 60% of the expected capital investments). Under such conditions there is a risk of inefficient use of public resources and their immobilization by projects that may lose their topicality and importance in terms of economic development and raising the standards of living of the country population. At the same time, as long as fiscal space is allocated to the existing capital investment projects no new projects would be launched to bring important changes.

Regarding the forecasts, one of the important risks stems from the uncertainty of external financing. In one month after the beginning of this year, although the external assistance in terms of grants and loans has been partially resumed, there are real risks that Government forecasts would not be attained. First of all, the IMF assistance program has not been signed yet due to the election nature of some budget measures and due to budgetary and fiscal policy measures, which do not match the undertaken international commitments.

Special Edition: Does the 2021 budget respond to the needs of vulnerable people or not?

In this section we analyze how equality principle has been mainstreamed in the budget process when dealing with each vulnerable group, as the gender equality is an important pillar in each group. This should be carried out while considering many categories of vulnerable groups, in light of the planned tools and mechanisms to fight inequalities, which emerged and took shape during the pandemic crisis (closure of schools and kindergartens, with no alternative, for children day-care, no state support to parents who were forced to quit their job in order to take care of their children, etc.).

Due to the negative impact of 2020 pandemic crisis, social vulnerabilities, which already were a major challenge for the Republic of Moldova, deepened because of restrictions imposed to halt/avoid the spread of the virus. Such fact particularly affected the vulnerable groups, mainly the women. Although these categories of population were already facing a long series of challenges, the pandemic crisis revealed the deficiencies and weaknesses of some state policy in terms of supporting the vulnerable groups, the latter being exposed to even greater challenges. Such fact was obviously reflected by the system inability to efficiently respond to crises when we talk about the social and economic protection system of vulnerable groups from our society.

The 2021 Law on State Budget and Fiscal and Budgetary Policy was passed on 16 December 2020. The Law was expected to comprise a number of mechanisms aimed to improve the precarious situation that many citizens from vulnerable groups were facing. In particular, it was expected to address the main issues related to access to education and social services for both women and men, comprise an assessment of support measures targeting the business environment and its revision to include other categories of beneficiaries, in particular young people, access to affordable medicines and food products in the context of unavoidable price raising following the adoption of amendments to the budgetary and fiscal policy, retaining and creating jobs, etc.¹⁵ Regretfully, the 2021 State Budget Law and the fiscal policy managed to address none of those issues, just slightly tackling them. Moreover, a series of measures have been introduced, which increased further the tax burden, especially for the young people, ignoring the issues the employed women are facing or not, and failed to safeguard additional support measures to older people and to people with disabilities.

¹⁵ <https://www.expert-grup.org/ro/biblioteca/raportul-de-stare-a-tarii>

Ensuring compliance with the gender equality principle in light of mirroring the needs of vulnerable groups in the 2021 budget is a task that neither has been carried out nor is visible in the current budgetary policy. Nowadays, one of the key challenges in the 2021 budget review is the availability of disaggregated data from the gender perspective. At the same time, the swift approval of the draft State Budget Law allowed for no transparency regarding the ways and rationale behind some budgetary decisions to show the needs of vulnerable groups in the state budget and to ensure concurrent mainstreaming of gender equality. Such matters are absolutely necessary components, especially in the context when the pandemic has demonstrated that in crisis situations, within the same vulnerable group, the probability that women are more affected on certain dimensions (keeping the job, access to social and education services) is high, while men, in their turn, are affected differently from the perspective of access to healthcare, social services, being affected together by the financial pressure on their family, etc.

The crisis impact has been felt unevenly by different groups of population. From the gender perspective, women from each vulnerable group have been particularly affected, as certain restrictions, regardless of their job place or economic activity they carried out, have had a major impact on their ability to keep that activity going. As a result, for example, 32% of women mentioned they were forced to work from home or stay at home from April through November 2020, while the country recorded average equaled to 26%. Overall, the crisis effects emphasized a greater level of vulnerability among certain groups of citizens, due to low income, specificity of economic sector their work for, and also their dependence on pre-school institutions and schools (people with young children).¹⁶

Elderly people

Taking into account the particular features of SARS-Cov-2 virus, the elderly people (either retired or not) are among the group with the highest risk of infection and mortality rate. As the elderly people have very low income (particularly the retired ones), the risk of augmenting the poverty rate among them increased dramatically. One of the causes is the need to reallocate the budget resources to support the public health system, and, in this way, the single payments to support the pensioners would be reduced or temporarily postponed. The indexation of pensions by 0.6% and 0.2% and postponing the indexation of social payments in 2021 do not address at least two important issues for this category of citizens: price increase for medicines and for basic food products. The increase in the price calculation base for medicines as of 31 December 2020 stemming from the written order amending the prices for medicines, issued by the Ministry of Health, Labor and Social Protection upon the request of the Medicines Agency, is reasoned as being a consequence of national currency depreciation relative to the main benchmarking currencies. Hence, the producer's prices, approved in MDL, will increase by minimum 5%, and the final price of medicines would increase even more. At the same time, taking into account the pandemic magnitude after the first half of the year, the elderly people have the tendency to take some precaution measures in case of getting infected, and buy in advance the medicines recommended for treatment, while such medicines are not included in the list of compensated medicines, thus, having a greater impact on their income. At the same time, in the context of a year when the agricultural sector also suffered from a severe draught, which may lead to price increase for some basic food products, the latter would have unfavorable effect on this vulnerable group, having exposed it to greater poverty. Against this background, having regard that women's life expectancy in the Republic of Moldova overrated men's life expectancy, the number of solitaire old women is higher than the number of men, while traditionally the pension of women is lower (as women are employed for shorter timeframes than men or are worse paid), one could expect the elderly women with small pensions to be particularly affected by the pandemic crisis.

Young people

Taking into account that the restrictions were imposed quite rapidly in spring 2020, while the authorities poorly disclosed the support measures for entrepreneurs and business environment under the pandemic crisis, the young people holding jobs subject to (temporary) liquidation lost their jobs (HoReCa, tourism, passengers

¹⁶ <https://statistica.gov.md/newsview.php?l=ro&idc=168&id=6840>

transport), with a pretty low probability to be reemployed, and job seekers found themselves in the situation when the probability to find a job was minor.¹⁷ In the context where the companies were forced to dismiss part of their employees, the former chose to retain the people with a certain level of work experience and with more advanced performance. In terms of gender issues, although this is not a stated fact, due to the circumstances in the education sector (partial closure of schools and kindergartens), women with young children were more susceptible to be fired than men. In some cases they volunteered to leave their job in order to take care of their children. The chances to resume the activity after partial removal of restrictions imposed on pre-school institutions and primary schools are limited, bearing in mind the restrictions imposed on economic activities as well. The Labor Force Survey (LFS) outcomes for Q3 2020 (the National Bureau of Statistics) show that the number of individuals affected by the pandemic crisis at their job place soared from quarter to quarter. Hence, the number of employed individuals who stated that COVID-19 affected their situation at the work place made up 21.5 thousand or 2.5% of the total employed population (relative to 33.2 thousand or 4.1% of the total employed population in Q1 2020 and 200.6 thousand or 24.4% in Q2 2020). According to the same data, COVID-19 affected the female population to a greater extent (3.4%) in comparison with the male population (1.6%).

The 2021 budgetary and fiscal policy ignores these issues; moreover, it comes up with a more unfair burden following the revision of personal exemptions by 5% – from MDL 24 000 to MDL 25 200 and, respectively, from MDL 18 000 to MDL 18 900, increasing the exemption for dependents by 50% – from MDL 3 000 to MDL 4 500 and cancelling the exemption for the spouse. The reasoning according to which this should be treated as an incentive for women to get formal employment during this period, disregarded the statistics presented by the LFS, and, once passed, would affect families with children, especially with young children. Another counterintuitive measure was standardizing the income tax rates, a measure valid as of 2021, also comes to increase the tax burden for the young people, especially in case when an individual leases something to another individual. Most beneficiaries of such services are the job seekers in Chisinau who cannot afford to buy a dwelling, the majority of whom are young people. The income of such people is heavily taxed at their work place, while the use of a 12% tax rate would heavily burden this category of citizens. A measure that equally affects the young entrepreneurs is the provision referring to the standardization of income tax rates when an individual leases something to a legal entity: services rendered by individuals are VAT non-deductible; thus, the lease services provided by individuals are placed at disadvantage in comparison with profile companies – payers of VAT.¹⁸ Levying a 12% tax rate on the whole amount received, without deducting the expenditures, is absolutely discriminatory towards the companies rendering such services. Moreover, the VAT paid by the company, which would benefit from the lease services provided by individuals, will apply also on 12% VAT, increasing exponentially the tax burden.

Social and economic status

The individuals employed by hotels and restaurants, markets, auxiliary services within education institutions, as well by a variety of professional services are mostly women. Namely these sectors suffered the most due to the imposed restrictions in the context of pandemic crisis, leading them from the status of individuals with low income to the status of individuals with no income at all (unemployed) or having shrunk significantly their income. To understand the severity of this situation, we shall mention that by the end of July 2020, the number of unemployed people registered with the National Employment Agency increased by 60.7%. Hence, such individuals found themselves in the situation when they cannot afford basic services and cover their basic needs. As there are no data available insofar to show any improvement in the pandemic crisis at least for Q1 2021, we shall consider how these needs are covered, and to what extent, by the 2021 budget. The most important 2021 support measure with fiscal implications is the use of a mechanism to subsidize those enterprises, which employ individuals with disabilities, young people, persons who lost their job either at home or abroad due to Covid-19 pandemic as MDL 200 million have been budgeted to this end. However, the enforcement manner of this measure is yet to be

¹⁷ <https://statistica.gov.md/newsview.php?l=ro&idc=168&id=6840>

¹⁸ <https://www.expert-grup.org/ro/biblioteca/item/2045-recomand%C4%83ri-privind-m%C4%83surile-de-politic%C4%83-fiscal%C4%83-%C8%99i-vamal%C4%83-pentru-anul-2021&category=180>

developed. According to the LFS outcomes, in comparison with Q3 2019, the number of people on unpaid leave increased five times, the number of people in technical unemployment increased four times, and these trends are primarily determined by the pandemic crises. As for the gender matters to this end, in the gender breakdown, men hold 35.6% of the total number of people who had a job but did not work due to pandemic, and women hold, respectively, 64.4% (*relative to 45.1% and, respectively, 54.9% in Q2 2020*).

Professional status

This group comprises the people whose employment excludes access to social protection tools, the people employed in the informal economy (and although statistical data on their share in the total number of employed people are available, no data showing the dynamics of people employed informally or who get paid “in envelopes” during the pandemic crisis have been published yet), the people employed by (micro and small) enterprises, which have neither capacities nor reserves to cover the wage costs during the period when the activity was halted, etc. In 2019, the share of self-employed people and of unpaid family workers reached 22%, the share of people employed informally made up 23%, and the share of people employed by micro enterprises reached 21% of the total number of employed people in 2018. Another vulnerable group in this context includes the people employed in the economic areas, which were completely halted in the first half of 2020 – accommodation and public catering services, road and air transport of passengers. There are jobs where physical presence at the work place is binding. When lacking financial compensations, this group is directly exposed to the negative impact of the crisis. Nowadays, there are no data available disaggregated by gender for the purpose of this group, but it is obvious that it is not a group strictly dominated by men or women, as they could be equally affected by the crisis. Taking into account the fact that the share of women in the “*Health and Social Assistance*” activity made up 81% of the total employed people in 2019, this group is, therefore, more exposed to the risk of being infected with COVID-19. The state support to this end was very limited. None of the 2021 budget documents addresses these issues.

Area of residence

Although the agglomeration and higher density of urban population make people from these areas more susceptible to infection, the agricultural crisis caused by the 2020 draught places the people from the rural area in the category of vulnerable groups, as they faced both crises simultaneously, especially when most people from the rural area work in the agricultural sector. In Q3 2020, the share of employed people from the rural area exceeded the share of employed people from the urban area (55.7% in the rural area and, respectively, 44.3% in the urban area), while 197.0 thousand persons or 22.8% of the total number of employed people worked in the agricultural sector.

Conclusions

Ensuring the needs of vulnerable groups in the 2021 budget is both an unfulfilled and invisible task in budgetary policies this year. The speed with which budget bills were approved and adopted did not allow for an adequate level of transparency regarding the needs of vulnerable groups in the state budget and to ensure, at the same time, the integration of the principle of gender equality. These issues are absolutely necessary, especially in the context in which the pandemic has shown that in crisis situations, within the same vulnerable group, the likelihood of women being more affected is high in some dimensions (employment, access to services social and educational), and men are also affected differently, from the perspective of access to medical and social services, and together affected by the financial pressure on the family, etc.

In view of the above, it is important that the state budget for 2021 at least partially reflects the realities of the pandemic crisis for next year. This involves including certain policy provisions and measures with budgetary coverage to support vulnerable groups, and those measures must contain the gender analysis element, and supporting those groups based on evidence from available data. It is also important to reflect, for 2021, some financial aid for vulnerable groups, in case new restrictions on economic activity will need to be applied in the event of a pandemic crisis. At this moment, although some measures have been adopted, they are fragmentary, not connected to the economic realities of the country, or worse, they do not have a mechanism of application.

Financial Institutions

This chapter outlines the status of financial institutions at the end of the unusual year dominated by the Covid-19 pandemic and their contribution to the recovery. It describes the trends in some relevant financial indicators characterizing the year 2020 and the factors that could underly the situation of financial institutions in the nearest future. It also analyzes some trends with macroeconomic impact, such as changes in the interest rates, the lending activity or the profitability of financial institutions, as well as some legislative measures that have the potential to radically affect the financial sector. The chapter also outlines some forecasts and challenges for the year 2021 to anticipate and eventually recommend the necessary policy interventions. Finally, the chapter addresses a special topic, the "municipal bonds" - a financial instrument unknown so far in the Republic of Moldova, but which can become a key element in the development of local communities.

Recent trends

Along with the previous years' reforms, the policy interventions implemented in 2020 have proven vital for keeping the stability and the confidence in the financial system in the context of an unusual year caused by the Covid-19 pandemic. The sound capitalization of the banks, the quality of the loan portfolio and the proper management of liquidity were the key elements that allowed continuing the lending activity even in times of maximum uncertainty. The stability of the banks allowed deferring the payments for some customers directly affected by the Covid-19 pandemic, while the gradual decrease in interest rates mitigated the effort of servicing these loans. At the same time, the intention to restructure the financial system supervisory mechanism was confirmed by Q3:20 by the initiation of the process of expanding the NBM's powers to supervise and regulate the non-bank credit market (non-bank credit organizations and savings and loan associations) and the insurance sector. Supported by the need for a new agreement with the IMF, but also by the risks identified in several areas, this concentration seems inevitable. However, the transition process must also take into account the interests of the consumers, namely the access to high quality, fast, fair financial services, at a reasonable cost.

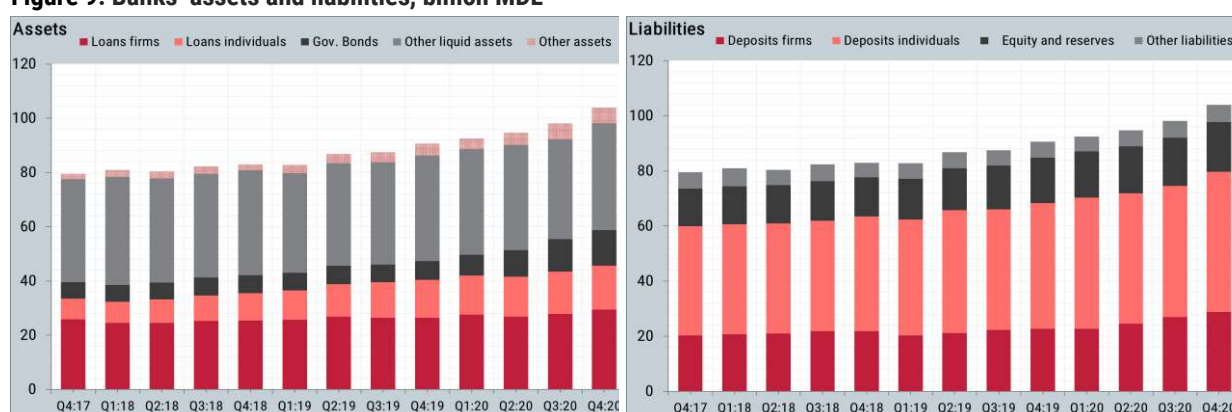
Despite the crisis management efforts, towards the end of 2020 the political actors threatened the stability of the financial system again. Pursuing narrow group interests, some groups in the Parliament voted for a controversial bill, thus repealing the law by which the mechanism for discharge of Government's obligations to the NBM resulting from the 2014-2015 bank fraud was implemented¹⁹. Besides the fact that the voting took place in violation of all requirements regarding the transparency and consultation of relevant institutions in the decision-making process, the repeal of the Law 235/2016 creates imminent risks both to public finances and to the macroeconomic balances existing in the national economy. It is also testing the already fragile trust of external partners and international financial institutions in the Republic of Moldova. Thus, if the debt of the Ministry of Finance to the NBM were cancelled, the latter would become under-capitalized, i.e. unable to fulfill its indisputable duties conferred by law, i.e. ensuring price stability and the confidence in the national currency. This could quickly exacerbate the financial position of businesses and individuals, as well as the stability of public finances, when the government will have to take on new debts in order to prevent a new crisis from escalating.

Even though this year brought many economic and political challenges, the financial system has remained stable and had a major contribution to the recovery of the situation. The banks are massively financing the budget

¹⁹ Law no. 235/2016 on the issuance of government bonds for the execution by the Ministry of Finance of the payment obligations derived from the state guarantees no. 807 of November 17, 2014 and no. 101 of April 1, 2015
https://www.legis.md/cautare/getResults?doc_id=124983&lang=ro#

deficit, with investments in government securities being the main generator of growth of banking assets; as for the liabilities, the savings of businesses and individuals in deposit accounts increased due to the slowdown in economic activity (figure 9). Having to cope with declining budget revenues and rising public spending, the Government has borrowed heavily from banks, the domestic debt balance increasing by about 6 billion MDL in Q4:20 compared to the beginning of the year, to around 14.6 billion MDL. At the same time, the stock of loans to the private sector increased by more than 5 billion lei due to the lower interest rates and easier loan requirements (this applies to loans granted in lei, while those in foreign currency expressed in lei remained at approximately the same level). As a result, the financial system assets reached over 118 billion MDL, the banks accounting for about 88% of the total amount, while the other financial institutions (non-bank credit organizations, insurance companies and savings and loan associations) account for just over 12%. The asset concentration remains high in the banking sector, with the four systemically important banks accounting for 78% of total assets and 90% of total accumulated profit.

Figure 9. Banks' assets and liabilities, billion MDL



Source: Author's calculations based on NBM data

The facilities provided by the NBM in amending some terms of the loan agreements allowed the banks to respond to the needs of customers affected by the Covid-19 crisis. The extension of maturity or deferral of payments for a certain period allowed keeping the quality of the loan portfolio and the banks' capacity to continue lending. During 2020, about 900 economic operators with loans of approximately 5 billion MDL (or 20% of the loan portfolio of the legal entities per sector) and about 20 thousand individuals with loans amounting to 2 billion MDL or (15% of the loan portfolio of individuals) benefitted from these measures.²⁰ As a result, the banks' loan portfolio has even improved, the non-performing loan ratio at the aggregate level decreasing by 1 p.p. compared to the one recorded at the beginning of the pandemic to only 7.4%. The banks followed the NBM recommendations and avoided transferring the profit to shareholders, which resulted in an increase in the volume of equity compared to total assets to just over 27% of total assets - a level considered high enough for crisis situations.

The interest rates continue to remain low following the des-inflationary trends of 2020. The decrease of the base rate to 2.65% in line with the inflation trends and the reduction of the level of required reserves by almost 10 p.p. up to 32% continues to provide the necessary liquidity for the banks, both to finance the budget deficit and to expand the lending activity. Therefore, even if the Government is forced to increase its internal debt in order to ensure the financing of budget spending, it does so at attractive interest rates of about 5% on Government securities with a 10-year maturity. At the same time, the rates on new loans in national currency fell below 8%, mainly due to the reduction in deposit rates below 4% (Figure 10). The decrease in interest rates on deposits at a faster pace than the rates on loans influenced the level of bank margin, which increased by about 1 p.p in Dec: 19 y-o-y, reaching 4.6 p.p. The risk premium calculated as the difference between the average rate on Government securities and the average rate on new loans increased by the same amount, reaching about 2.3 pp. As a result,

²⁰ INTERVIEW/ Governor of the National Bank of Moldova, Octavian Armaşu, answers the questions of Moldovan media representatives, <https://www.bnm.md/ru/node/61527>

actual interest rates on²¹ loans reached a level of about 10% for legal entities, and slightly higher, of 15-20%, for consumer loans. At the same time, given the low deposit interest rates, the maximum interest rate on real estate loans under the “Prima Casa” program was set at around 7% for the first half of 2021, which allowed maintaining interest for this type of loan and to a certain extent boosting the real estate and construction sectors, respectively.

Figure 10. Interest rates in national financial market, %



Source: Author's calculations based on NBM data

After an anemic first half year, the lending activity resumed its sustained pace despite the impediments caused by the Covid-19 pandemic. Several measures taken by regulators allowed the banks, but also the non-bank credit organizations, to maintain their lending capacity, especially under the conditions of maximum uncertainty in the spring of 2020. Thus, ensuring the necessary liquidity by adjusting the required reserves, relaxing the credit classification requirements, but also periodically informing the public about the measures taken helped avoid any kind of panic and perform financial operations that are normal in the economy. These elements complemented the already existing factors driving the increase in the lending level, such as declining interest rates and the capacity of banks, which became much stronger after the recent years' reforms.

Both individuals and companies continue to borrow from banks, especially as some customers need additional capital to cope with the effects of the pandemic or the drought. As a result, the total stock of bank loans increased by about 13% at the end of the year, strongly influenced by the loans provided to individuals, in particular the real estate loans. On the one hand, the pandemic has affected consumer preferences, which is seen in a slowdown in demand for consumer goods, holidays and other personal expenses. On the other hand, the focus on real estate loans remains strong, being dictated rather by the stringent needs for an own dwelling, especially as the low interest rates brought the monthly rates to values comparable to rents. Moreover, the “Prima Casă” program continues to be in the attention of the Government, which has been making constant allocations of about 50 million lei annually in recent years, including for 2021²². As for legal entities, they mainly finance their activity from sources other than the financial system. The growth rate of the stock of loans to businesses remains modest in most sectors, with the exception of trade and agriculture. Even so, as these sectors are among the most affected by the pandemic and the drought, the new loans are geared towards maintaining current activity rather than investing and expanding.

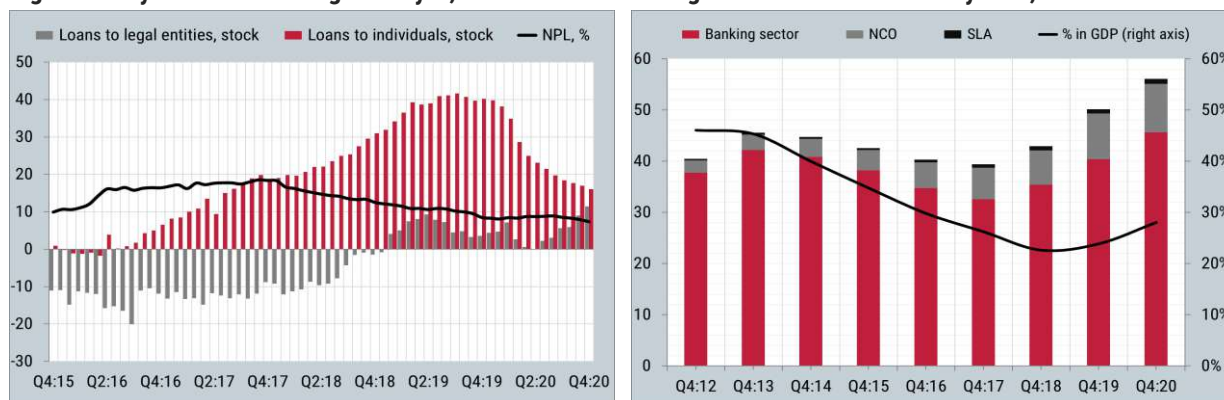
The growth rate of non-bank lending recorded a significant slowdown in 2020 due to a mix of factors including the pandemic and the legislative measures to limit indebtedness. With a lending model often based on consumer micro-loans granted based on the identity document only, the non-bank credit organizations increasingly feel the

²¹ Actual interest including additional fees charged (annual effective rate).

²² According to the Law on the state budget for 2021 for the implementation of the State Program “Prima Casa”, the amount of 70 million lei is allocated, including 50 million lei for the fulfillment of government bonds within the Program, https://www.legis.md/cautare/getResults?doc_id=124567&lang=ro

changing preferences of consumers in the context of the growing uncertainty about their future incomes. Moreover, the impossibility to organize events or the barriers in going on a holiday reduced the demand for loans for personal needs, the population taking a waiting position. At the same time, the limitation of the total costs that can be applied to loans of up to 50 thousand lei determined the non-bank credit organizations to be more prudent. Thus, at the end of Q3:20, the stock of non-bank financing amounts to about 10.4 billion MDL or an increase of only 6% compared to last year, recording the lowest rate in the past 6 years (figure 11).

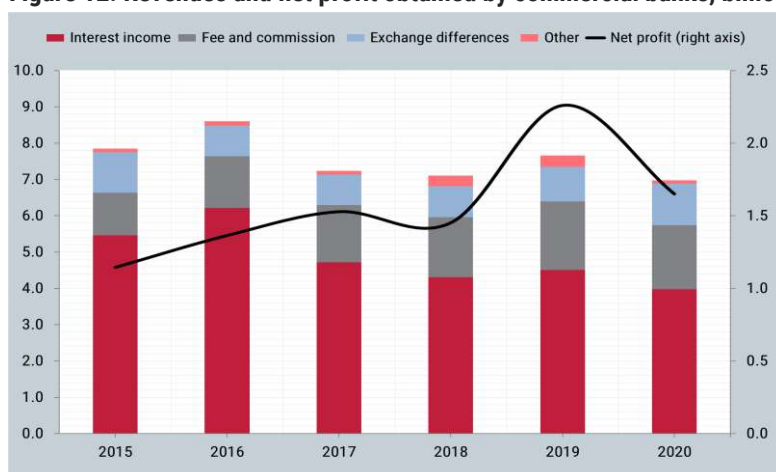
Figure 11. Dynamics of lending activity %, and volume of funding of the overall financial system, billion MDL



Source: Author's calculations based on NBM, NCFM data

Despite an extremely complicated year, the financial institutions continued to be profitable at a level comparable to previous years. Lending institutions have accumulated profit both from the core business - lending and from related foreign exchange and payment operations in the case of banks. The insurance sector also records profits even if certain types of insurance (e.g. Green Card vehicle insurance) were significantly affected by travel restrictions. Compulsory insurance, vehicle insurance in particular, maintained a high profitability, especially since there were fewer insured events during the quarantine period. Thus, the banking sector recorded the highest profit, of about 1.65 billion MDL (figure 12), followed by the non-bank credit organizations (300 mil. MDL) and the insurance companies with about 55 mil. MDL²³.

Figure 12. Revenues and net profit obtained by commercial banks, billion MDL



Source: Author's calculations based on NBM data

For the banks, the decrease in interest rates, in particular on monetary policy instruments, was offset by the growth in the loan stocks and exposures to the Government. Thus, additional revenues from Government securities have replaced the revenues from monetary policy instruments of the previous years. On the other hand,

²³ The profit recorded by non-bank credit organizations and insurance companies is reported at the end of Q3:20.

foreign exchange operations were more concentrated in banks mainly due to convenience - the transfers from abroad to individuals were made mainly through formal channels and the foreign exchange operations were made directly at the bank. Also, the dynamics of non-cash payments increased, both in number and value, in the context of the sanitary measures. E-commerce is becoming a habit, even more as the number of electronic platforms is constantly growing. As a result, revenue from exchange rate differences and from the commissions increased compared to previous years. Even so, the overall profit trends seem to be difficult to maintain in the coming year, in particular as the economic effects of the pandemic are not yet fully known, the vulnerabilities of the national economy are growing and the Government has no clear recovery program, being affected by both a political crisis and a crisis of idea, like it has always been in the recent years.

Forecasts and challenges

Financial intermediation will grow in 2021, as the companies need capital to improve their financial position affected by the crisis. Yet, we anticipate that the demand from individuals will continue to exceed the demand from companies as health restrictions are lifted. In addition, the real estate sector seems to not be affected by the crisis, since the demand for real estate loans has remained high even during the pandemic. In this context, the anticipated increase in lending to legal entities amounts to 10%, while for consumer loans or real estate loans it might exceed 15%. At the same time, these trends could be boosted by a much more sustained support from the state, if resources were identified for the implementation of support programs for companies and the population based on some credit guarantees much more consistent than the existing ones.

For 2021, the NBM forecasts a modest increase in inflation, which will ensure the stability of interest rates. After a decrease by 0.4% in Q4:20, annual inflation is expected to rise next year, but it will not exceed the 5% target. In this context, credit rates have no reason to increase significantly, with the uncertainty is coming rather from the public sector, which may use much more banking resources to finance the budget deficit if it fails to attract resources from foreign donors. Government demand usually directs the banks' investment interest to government securities to the detriment of loans, the former having zero risk and an attractive profitability. Even so, there are still sufficient financial resources in the banking system to support the economic recovery efforts of both the Government and the private sector. However, the banks should focus on the lending to real economy, by offering innovative and competitive products aimed at a faster relaunch of the economy.

In 2020, Moldova completed the negotiations on a new Agreement with the International Monetary Fund, but its approval was compromised by the legislative initiatives at the end of the year. The postponement of the "billion law" or the lowering of the retirement age are measures that compromise the structural reforms implemented in the context of the previous Agreement. If these laws remain in force, the Government can practically no longer guarantee the stability of public finances nor confirm its firm commitment to the already taken measures. The importance of a new Agreement with the IMF is critical in the context in which the country needs external financial support, especially as the economic and social challenges of the pandemic will remain acute in 2021. For the time being, the solution is expected to come from the Constitutional Court, where an appeal against these controversial laws was filed based on the key idea that the Parliament, or more precisely a group of temporary MPs, have no legal or moral right to threaten the stability of public finances, the well-being of the population and businesses, which have already been struck by the Covid-19 pandemic.

The approval of a new Agreement with the International Monetary Fund also depends on the fulfillment of some commitments related to the independence of the NBM or the "endless" investigations of the bank fraud. Although new people were proposed to fill all positions on the NBM Management Board, the Parliament's Legal Affairs Committee rejected two out of the 3 nominees. The reason for the rejection was that the nominees allegedly did not have the required banking experience, even if they had been working in the financial sector for many years. Under these circumstances, there are reasonable grounds to suspect some malicious interest groups and an attempt to delay the process of appointing deputy governors, or even an interest in controlling the central bank by appointing persons suitable for them. On the other hand, the change of the general prosecutor brought a new perspective on the investigation of bank frauds, by including other people who tried to divert the investigation tin

the list of those charged. Even so, the results are not yet visible, both as regards the proving of guilt and the recovery of the damage caused.

The year 2021 brings fiscal news, more specifically the taxation of revenues from financial instruments. Effective from January 1, 2021, the revenues from interests on the bank deposits held by the natural persons will be subject to 3% taxation and the revenues from investments in Government securities will no longer be exempted from taxes. While the taxation of bank interest is a widespread practice, especially in difficult economic times, the taxation of those who finance the budget deficit (interest on Government securities) seems at least strange and could affect the demand for Government securities, but also the cost of domestic state debt servicing. However, as the things around the domestic debt in our country are unusual in that the central bank has a large volume of securities issued by the Government, the purpose of this solution is most likely to tax the "investments" of the central bank - government bonds issued in the context of bank frauds and held by the NBM. Finally, the taxation also extends to other financial instruments that may arise at some point, such as corporate securities or those issued by local authorities (municipal bonds). This makes the emergence of such instruments even more unlikely, or municipal bonds could become an instrument to develop local communities as shown in Box 1.

Box 1. Special topic: Municipal bonds - an instrument to develop local communities

The vast majority of Local Public Authorities (LPAs) are not able to make the so much needed large-scale capital investments because of the scarce public funds. Even though there are some projects, the lack of financial resources delays the implementation and deprives the community of adequate services and better living standards. Under these conditions, the bank loans seem to be the only solution, but the low maturity compared to the payback period or the prudential rules in place can create serious problems of financial stability for LPAs and certain barriers for the banks.

In addition to the classic debt instruments such as bank loans, the state, companies and local authorities also have other lesser-known possibilities. These include the issuance of securities, specifically bonds, through which the capital needed to carry out investment projects can be attracted on often more favorable terms than bank loans. Even so, local authorities do not use this instrument for various legislative, investment or even financial infrastructure reasons. Moreover, interaction with the capital market requires special financial and economic forecasting skills that few entities can provide.

In order to promote this instrument, in the autumn of 2020 the study "Municipal bonds - an instrument to develop local communities" was launched, bringing more clarity around this instrument, namely:

1. *Presentation of the conditions under which municipal bonds may be issued, the purpose of issuing the approval of the Ministry of Finance, the stages of the issuance process as well as the repayment of loans taken as a result of the issuance of bonds;*
2. *The analysis of international practice, more specifically the development of the municipal bond market in 3 states in the region, whose experience is relevant for the Republic of Moldova, namely Romania, Bulgaria and Serbia;*
3. *The assessment of LPA revenues, whether they allow a true financial autonomy and how financially sustainable they are for the issuance of securities;*
4. *The opportunities provided by the issuance of municipal bonds. In addition to the advantages and opportunities presented by municipal bonds, the criteria to be met to ensure success in using this instrument are specified.*

Source: According to the study "Municipal bonds - an instrument to develop local communities", https://www.expert-grup.org/media/k2/attachments/Studiul_Obligatiunile_municipale_2020.pdf

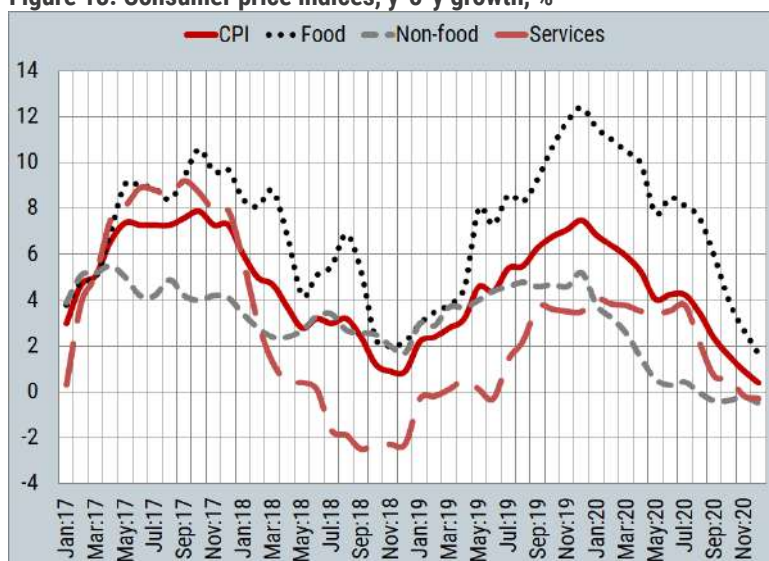
Prices and Monetary Policy

This chapter analyses the inflation trends, the national currency exchange rate, as well as the NBM's monetary policy interventions under the conditions of the 2020 recession. Against the background of the economic crisis, the inflation rate has decreased. In this context, the NBM relaxed the monetary policy. At the same time, for most of the year, the foreign exchange market experienced a stable development, despite some periods of increasing volatility. Forecasts and challenges are presented at the end of the chapter. Thus, for 2021 we anticipate a low inflation rate, which, despite some increase during the year, will remain below 3.5%, which is the lower threshold of the corridor targeted by the NBM. The attempts of politicians to reduce the independence are the main concern.

Recent trends

In 2020, against the background of the world economic crisis caused by the spread of Covid-19, the economy of the Republic of Moldova was marked by the slowdown of inflationary processes. In 2020, the price growth rates decreased from 6.8% y-o-y in Jan:20 to 0.4% y-o-y in Dec:20 (Figure 13). Consequently, the average annual inflation was 3.8% in 2020. The following price rises were recorded on major components: 7.4% for foodstuffs, 0.9% for non-food goods and 2.4% for services. There were also some decreases in prices during the year: in Aug-Dec:20 for non-food goods and in Nov-Dec:20 for services. The disinflation was caused by the compression of domestic demand and the cheapening of imported goods - factors associated with the global recession caused by the implementation of restrictions aimed at containing the Covid-19 pandemic. According to IMF, the international prices for goods declined by 11.7% y-o-y in Jan-Nov:20. As a result, the prices of goods imported into the Republic of Moldova also decreased: in Jan-Sep:20 the unit value indices of imported goods shrank by 6.8% y-o-y. Another factor determining the decrease in price growth rates was the NAER decision of 31 July 2020, approving the reduction of electricity tariffs. On the other hand, the decline in agricultural production, caused by a severe drought, was a pro-inflationary factor and caused a slower reduction in foodstuff prices.

Figure 13. Consumer price indices, y-o-y growth, %

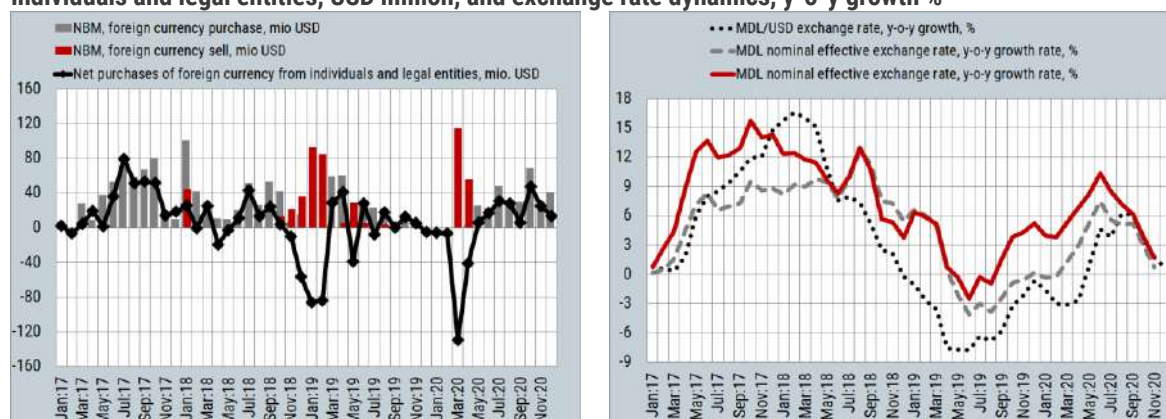


Source: NBS, Expert-Grup calculations.

The increase in volatility phase recorded at the beginning of the crisis in Mar-Apr:20 ended quickly, and the foreign exchange market underwent a relatively stable development in the rest of the year. The NBM intervened mainly as a buyer of foreign currency and only in Mar-Apr:20 it sold foreign currency in order to smooth the

dynamics of Moldovan leu. Overall, at the times of crises, Moldovans prefer keeping their savings in a foreign currency. The savings are mainly placed in demand deposits in foreign currency. Thus, in 2020 the balance of demand deposits in foreign currency increased at the fastest rate, with the average annual growth rate of 28.1%. An almost two times slower increase, by 15.6%, was recorded for demand deposits in lei. At the same time, long-term savings increased quite slowly: foreign currency deposits by 1.2% and lei deposits by 3.7%. It should be noted that the increase in foreign currency deposits with a maturity of more than one year was determined by the placements made by companies, which increased their long-term savings in foreign currency throughout the year. A similar development was recorded during the 2014-2015 crisis. Then the balance of foreign currency on demand deposits increased by 62.5%, the fastest growth compared to other types of deposits. At the onset of the crisis, in Mar-Apr:20, the preference for savings in a foreign currencies determined the decrease in currency supply from individuals. In order to balance the market, the NBM sold foreign currency in the amount of USD 114.6 million in Mar:20 and USD 55.9 million in Apr:20. After May:20 the NBM intervened only as a currency buyer. This behaviour was determined by the increase of the foreign exchange supply on the domestic market (Figure 14). The improvement of the current account position was one of the factors leading to the stabilization of the foreign exchange market. In Jan-Sep:20 the current account deficit decreased by USD 369.7 million y-o-y, due to the compression of imports of goods and services (-13.4% y-o-y in Jan-Sep:20), which prevailed over the effect associated with the shrinking of exports (-13.2% y-o-y in Jan-Sep:20). The remittances also experienced a slow decrease, of only 2.4% y-o-y in Jan-Sep:20. The exchange rate reflected the dynamics of economic conditions. Thus, in the first half of 2020, once a stabilization of the foreign exchange market was achieved, the leu saw an accelerated appreciation, while in the second half of the year the appreciation rate slowed down (Figure 14). Overall, in 2020 the Moldovan leu appreciated: the official MDL/USD exchange rate increased by 1.3%, the nominal effective rate increased by 3.2%, and the real effective rate by 5.9%. The increase in the nominal effective rate points to a depreciation of the currency of several trading partners of the Republic of Moldova against the leu. The increase in the real effective rate shows that, in addition to the strengthening of the leu, the inflation rate was lower in the main economic partners than in the Republic of Moldova. These developments have a negative effect on national competitiveness, as they contribute to the increase in the price of domestic products as compared to the price of goods originating in other countries. Due to foreign exchange purchases, the value of official reserve assets reached USD 3.8 billion at the end of 2020. Currently, the Republic of Moldova is in a comfortable position and has a high level of official reserve assets, providing a certain resilience to possible shocks. In Q3:19 the official reserve assets covered 7.4 months of imports of goods and services (the minimum level is considered coverage of imports for 3 months). Also, in Dec:20 the ratio between official assets and the monetary aggregate M2 was 85.8% (the value of this indicator must be at least 20%, showing the ability to cope with the massive conversion of the national currency into foreign currency).

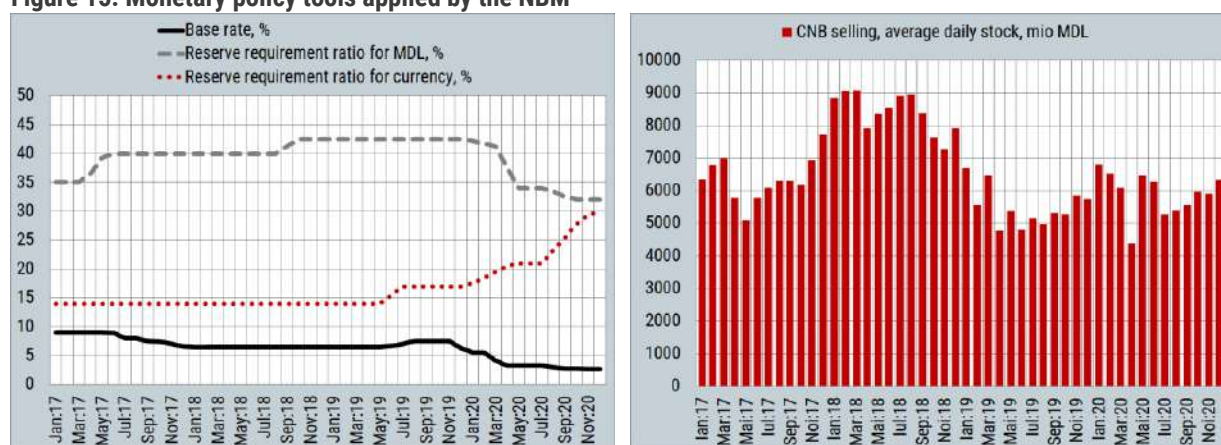
Figure 14. NBM interventions on the foreign exchange market and foreign currency net purchases from individuals and legal entities, USD million, and exchange rate dynamics, y-o-y growth %



Source: BNM, <https://www.bruegel.org/publications/datasets/real-effective-exchange-rates-for-178-countries-a-new-database/>, Expert-Grup calculations.

In 2020, under the conditions of the economic crisis, the NBM promoted a stimulatory monetary policy. As the disinflationary trend strengthened, the Central Bank decreased both the base rate from 5.5 to 2.65%, and the rate of required reserves for resources attracted in lei from 42.5 to 32%. The reduction of the required reserves rate for the resources held in MDL was accompanied by the increase of the required reserves rate for the resources held in foreign currency (Figure 15). In 2020, the required reserve ratio for resources held in foreign currency increased from 17 to 30%. This complex of measures had a positive effect on lending in lei, but discouraged the loans in a foreign currency. Thus, the new loans granted in lei recorded a marginal increase, only by 1.1%, while the new loans in foreign currency and those attached to the exchange rate decreased by 8.5%. In 2020, the liquidity surplus in the banking sector remained rather high, and the current liquidity indicator ranged between 49.3% (Aug:20) and 51.8% (Jul:20). During Jan-Jun:20 the average daily balance of National Bank Certificates (NBC) ranged between MDL 6.8 billion (Jan:20) and MDL 4.4 billion (Apr:20). In the second half of the year NBC purchases increased from MDL 5.3 billion (Jun:20) to MDL 6.3 billion (Jan:20). Consequently, in 2020 the average annual increase in the daily average balance of NBC was 7.6%. At the same time, the increasing state funding needs in the context of the shrinking budget revenues, as well as the lower base rate determined the increase of investments made by banks in state securities. Thus, in Jan-Sep:20 the number of traded state securities increased by 78.1% y-o-y.

Figure 15. Monetary policy tools applied by the NBM



Source: NBM, Expert-Grup calculations.

Forecasts and challenges

Most likely, the year 2021 will be characterized by a low inflation level, although there will be a slight acceleration of the price growth rate during the year. The expected global economy recovery will determine a certain increase in international prices. However, this development does not seem to determine a significant change in the price dynamics for products imported into the Republic of Moldova. We assume that, the overall import prices will have a not change too much in 2021, although for some categories of goods, such as oil products, some wider changes in import prices are possible. In this context, we anticipate that inflation will advance slowly and will begin to rise from a level of 2% in Q1:21 and by Q4:21 will exceed 3%. As a result of these developments, the average annual inflation rate will be 2.6%.

The inflationary trend in 2021 will be a prerequisite for further promoting a relaxed monetary policy. In 2021 the factors that could affect the dynamics of inflation refer to: (1) a possible more accelerated increase in international oil prices and (2) a faster depreciation of the national currency. However, most likely, these risks will not alter the inflationary trend significantly. In this context, the NBM could further reduce the required reserves.

The economic conditions of 2021 do not point to the need for aggressive NBM interventions on the foreign exchange market. Despite some episodic developments, the foreign currency market volatility in Mar-Apr:20 or the depreciation of leu against the Euro, there was an overall appreciation of the national currency in 2020. Moreover, the real effective rate of leu continued to appreciate on the long run, which negatively affects the competitiveness of domestic products. Some depreciation of the MDL would be beneficial for the competitiveness of products

made in the Republic of Moldova and could stimulate the economic recovery. In this context, the "pessimistic" outlook on inflation dynamics in 2021 is a favourable background for a certain controlled depreciation. Given the modest expected evolution of import prices, the negative impact of depreciation will be minimized (some of effects of the depreciation would be offset by sluggish dynamics of import prices). Against this background, the NBM could be a more modest seller of foreign currency in 2021 compared to 2020. Moreover, even the concept of inflation targeting implies that when there are no risks for achieving its main goal - maintaining the inflation rate and there are no prerequisites for accelerating the price growth rate, the central bank can target its policies to supporting the economic policy of the state.

The irresponsible actions of politicians are the main risk for the entire financial sector and, in general, for the economic security of the state. There has been an alarming trend in the recent years of attempts made by politicians to interfere in the work of the monetary authority. The 2019 political statements regarding the intention to use foreign exchange reserves for investment purposes by the Government can be mentioned in this context. However, the most serious consequences derive from the voting by the Parliament of the "Law no.230 repealing the Law no. 235/2016 on the issuance of government bonds for the execution by the Ministry of Finance of the payment obligations derived from the state guarantees no. 807 of November 17, 2014 and no. 101 of April 1, 2015". The Law no. 230 cancels the payments (principal and interest) deriving from the transformation into public debt of the guarantees offered by the Government to the National Bank, in the context of providing the emergency loans by the NBM to the three banks: „Banca de Economii”, „Banca Socială” and „Eximbank”. The law no. 230 was suspended by the Constitutional Court and does not produce legal effects until a ruling is issued by the court of first instance. However, it is not excluded that the law is reactivated after examination by the Constitutional Court. If the law re-enters into force, assets worth 12.6 billion MDL "will be deleted" from the NBM's balance sheet. As a consequence, the NBM will have to account for a loss of 12.6 billion lei, which would result in a negative statutory capital of 9.8 billion lei.²⁴ Likewise, the ratio between the statutory capital of the NBM and monetary bonds will become negative and will be -13.3%. In this situation, according to Article 9 of "Law no. 548 on the National Bank of Moldova", the Government, represented by the Ministry of Finance, will have to transfer to the National Bank a capital contribution in state securities at a market interest rate, in the volume required for increasing the statutory capital up to 4% of total monetary bonds. In other words, the impact on the national public budget, at best, will be zero, and the citizens will not feel any effect, while in the worst case, the costs of government loans may increase due to market conditions (in 2021, the rate on state securities will be higher than the 5% level set in the original law). Even if the Government does not have to make the payments deriving from the "Law on the issuance of bonds deriving from state guarantees", the amounts related to securities transferred to the NBM for increasing the statutory capital will have to be paid. On the other hand, the implementation of the Law no. 230 will severely affect the credibility of public authorities and, de facto, the credibility of the Republic of Moldova. By adopting this law, the state of the Republic of Moldova has shown that it cannot keep its word and does not honour its obligations. This will erode the trust in our country, and it will be very difficult for the Government to borrow from abroad, either from international financial organizations or from private investors abroad. In fact, the costs of external borrowing will increase, and this will ultimately be reflected in the welfare of citizens.

²⁴ https://www.ipn.md/ro/sabotajul-institutional-din-partea-psrm-grupul-pentru-moldova-si-7978_1078338.html

Foreign Sector

Following the devastating economic and social crisis caused by COVID-19, the global economy seems to be recovering from one of the deepest recessions. Beyond the currently uncertain prospects, it is clear that economies face a number of challenges that would ensure long-term sustainable growth and development, and the Republic of Moldova is not an exception. In fact, the current crisis revealed the existence of certain vulnerabilities of the country's economy, which require attention. On the other hand, its perpetuation also opened up a series of opportunities that need to be exploited in the next period.

Recent trends

Covid-19 pandemic caused the deepest global recession since World War II. Following a devastating economic and health crisis, the global economy appears to be emerging from one of the deepest recessions, with a slight recovery starting in the third quarter of 2020. Although the approval of vaccines and launch of extensive vaccination campaigns in several countries have fuelled hope for positive changes this year, new waves of infections, as well as new strains of the virus pose a threat. Amid exceptional uncertainty, the IMF forecasts a growth of the world economy of 5.5% in 2021 and 4.2% in 2022. The forecast for 2021 was revised in January (+0.3 pp) compared to the previous forecast²⁵, reflecting expectations of a resumption of economic activities (following vaccination), as well as the announcement of additional support measures in several large economies (USA, Japan).

Figure 16. GDP growth in Russia and EU, % y-o-y



Source: IMF estimates.

The economic consequences of the pandemic have varied between EU countries, and the prospects for economic recovery are equally different. This can be explained by differences in the spread of the virus, the severity of lockdown measures, the structural composition of economies, and the incentives adopted by countries in response to the crisis. EU economic activity suffered a severe shock in the first half of the year, but recovered strongly in the third quarter of 2020 with the phasing out of restrictions (figure 16). This recovery was supported by the resumption of trade and resurgence of consumer spending that fuelled domestic demand, while lifting of the blockages abroad boosted exports. However, a significant increase of budget deficits in European countries is

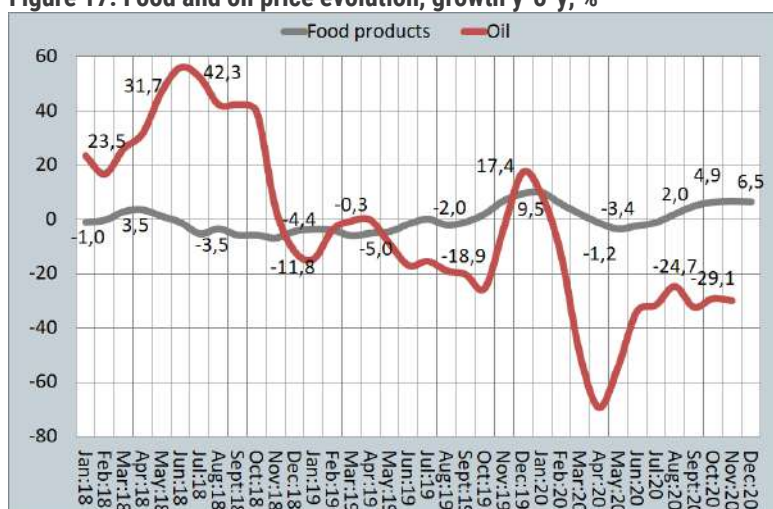
²⁵ IMF World Economic Outlook, January 2021.

anticipated as more resources are being spent on social security and economic support measures, while tax revenues are declining. Under these conditions, the European Commission forecasts a GDP growth of 4.1% for 2021, and a return to pre-crisis levels and a 3.0% growth by 2022. However, as a result of the recent epidemiological situation in several member states, growth projections are subject to an extremely high degree of uncertainty and risk.

In addition to the pandemic shock, the Russian economy has also experienced a sharp drop in demand for oil, leading to the deepest slowdown in 11 years. The economy declined sharply in the first two quarters (albeit with a slight recovery in the third quarter), amid the introduction of measures to limit the spread of the virus, less oil and gas production and lower prices for these commodities (figure 17). For 2021, the IMF forecasts a growth of 3%, and 3.9% for 2022 (against the previous forecasts of 2.8% and 2.3%, respectively), in the context of vaccinations initiated in several countries, including the Federation Russian. However, the main risks for the Russian economy come from the oil market, where uncertainty about the evolution of the pandemic could lead to more significant pressure on both demand and prices. In addition, the investment climate may worsen, amid rising taxes and limited support measures.

Positive economic outlook due to vaccination and a lower output have led to higher oil prices. After dramatic declines recorded at the pandemic onset, at the end of 2020 the oil reached a price of 49 USD/barrel (figure 17). The year-end price rise partly reflects market expectations of a better global economic situation in 2021 and the launch of mass vaccination campaigns in several countries. OPEC+ decisions to further decrease oil production also put pressure on prices. Saudi Arabia and Iraq have committed to voluntary production cuts to offset last year overproduction and the intentions of Russia and Kazakhstan to increase production, which hope to defend their market share from US.

Figure 17. Food and oil price evolution, growth y-o-y, %



Source: FAO estimates.

Food prices have reached their highest level in 6 years. They were 6.5% y-o-y higher in December 2020, reaching the highest values since December 2014 and marking the seventh consecutive month of growth (figure 17). Upward dynamics were recorded for cereals (+6.6% y-o-y), where higher wheat prices were caused by a cutback in supply from the largest producers (export restrictions and logistical bottlenecks in the context of the pandemic), the anticipation of worse harvests in the USA and Russian Federation, as well as the latest imposition of export taxes/quotas. At the same time, corn prices have risen, supported by the prospect of poor harvests in South America. Prices for vegetal oils have risen by 19% y-o-y in December 2020 reaching a 3-year high in response to a sharp rise in export taxes on palm oil in Indonesia (the largest producer of palm oil), but also to declining export availability in Argentina, where prolonged strikes have affected production and logistics. Prices for rapeseed and sunflower oil have benefited from the instable supply on the oil market, as there is a strong global demand for them. The price of sugar increased by only 1.1% y-o-y in December 2020, the latest trend being determined by a

substantial demand for sugar in China (the second largest importer of sugar). The positive production outlook in Brazil (the largest sugar producer), as well as the recent approval of export subsidies by India put negative pressure on world prices for this commodity.

The pandemic shock further affected the trade flows of the Republic of Moldova. The slowdown in economic activity has affected international trade, including that of the Republic of Moldova. While in 2019 the country exports reached an all-time high, in the first 11 months of 2020 they shrank by 11.5% y-o-y and totalled 2.3 billion USD, exports decreasing for all groups of countries (Figure 18). Similarly, imports had a descending evolution, reaching a value of 4.9 billion USD, which is 8.6% less than a year earlier. Therefore, these developments resulted in a trade deficit of 2.6 billion USD in the first 11 months of 2020, down by 5.8% y-o-y. On the other hand, the level of coverage of imports with exports decreased slightly, registering in the reference period 46.8%, compared to 48.3% in the same period of the previous year.

Figure 18. Foreign trade of the Republic of Moldova, change y-o-y, %



Source: Expert-Grup estimates based on NBS data

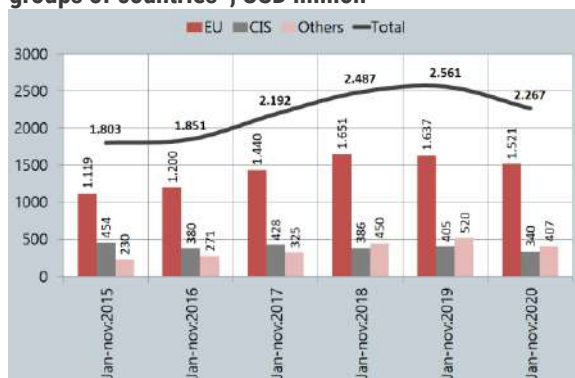
Following increases in previous years, exports to the EU are falling for the second year in a row. Thus, Moldovan exports to the European Union declined by about -7.1% y-o-y in the first 11 months of 2020, amounting to 1,521 million USD (Figure 19). At the same time, they kept their dominant position in total exports, holding a share of 67.1% (63.4% in 2019). However, one cannot ignore the excessive concentration in geographical terms, as over 75% of the exports to the EU are going to only four member states (Romania, Italy, Germany and Poland). Such a situation involves increased risks related to aggregate demand in these markets, as confirmed by the pandemic-induced crisis.

Thanks to low reference point of the previous year, exports of agricultural products to the EU even registered a slight increase. Although in the first 11 months of 2020 exports of some product categories decreased (determined either by the reduction of supply in light of bad harvests, such as the case of cereals, or by the oversaturation of certain markets and reorientation to other markets - fruits/nuts), overall exports of agricultural products to the EU registered a marginal growth of +1.1% y-o-y. The increase was largely possible thanks to the rather low reference point of the previous year (increases in exports of sunflower seeds, sunflower oil, ethanol and wines).

The decline of demand in the EU countries has mainly affected the exports of loan-based industries. The export of non-agricultural products diminished dramatically in the first 11 months of 2020, by about 10.9% y-o-y. In particular, in the context of the pandemic, the automotive industry registered a substantial cooling both in the EU and globally, which directly affected the assembly of automotive components (wiring, upholstery) in the Republic of Moldova. Similarly, the export of textile products was affected by the declined demand, reflecting a change in consumer behaviour.

Exports to the EU are characterized by an excessive concentration in terms of product diversity. Thus, over 70% of total exports to the EU market fall into only 7 categories of goods: electrical circuits, textiles, seat parts, oilseeds, oils, fruits and wine. At the same time, most of these exports were made under the *lohn* system (at the request of importers and using their raw materials), which implies a rather modest added value. All this points to the urgent need to diversify the portfolio of exported products, with an emphasis on those with a higher added value and the use of domestic raw materials. In fact, only half of the export potential to the EU under DCFTA is currently utilized by the Republic of Moldova²⁶.

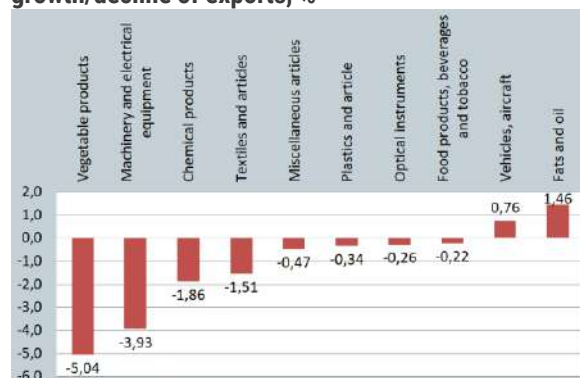
Figure 19. Exports of the Republic of Moldova by groups of countries*, USD million



Source: Expert-Grup estimates based on NBS data

*Starting with 2018, United Kingdom is included in Others

Figure 20. Influence of categories of goods on growth/decline of exports, %



Source: Expert-Grup estimates based on NBS data

Exports to the CIS countries fell as a result of declining re-exports of pharmaceuticals. In the first 11 months of 2020, the CIS share in the country's exports (15%) slightly declined compared to 2019 (15.8%), and totalled 340 million USD (-16% y-o-y) (Figure 19). The largest decreases (-15.5% y-o-y) were recorded in the Russian Federation, where re-export of pharmaceutical products dropped significantly, but fruit exports increased by 35%, as administrative barriers had been lifted. At the same time, exports to Ukraine declined by 19.8% y-o-y due to the decrease in export of sunflower seeds and cement (there is a trade dispute between the countries). Exports to Belarus also fell sharply by 18% y-o-y as a result of declining exports of wines, medicines (which are in fact re-exports), corn and fresh grapes. Although exports to Kazakhstan increased significantly (+38%), this trend was unfortunately largely due to re-exports of medicines.

The exports to other markets (other than the EU and CIS countries) registered the most dramatic decline. In the first 11 months of 2020, the exports to other countries (other than EU and CIS) amounted to 407 million USD, which is 21.8% less than a year before. The share of these declined to 17.9% of total exports (in 2019 - 20.3%), but still exceeding the share of exports to the CIS countries (Figure 19). This decrease was influenced by a 21.7% decline of exports to Switzerland (due to a significant drop in grain exports), by 14.5% to Turkey (due to a 50% fall in exports of sunflower seeds), but also declines of exports to more exotic destinations such as Syria, Malaysia and Indonesia, ranging between 7-11% (due to reduced grain exports).

The export of vegetal products had the most significant influence on the decrease in total exports (figure 20). Thus, in jan-nov:20 exports of vegetal products decreased by 19.7% y-o-y, or by 129 million USD, as a consequence of the decline of exports of cereals and oilseeds due to poor harvests in 2020 (-65% y-o-y). The downward trend was also determined by lower exports conducted under *lohn* system, such as machines and appliances (-17.4% y-o-y), and textiles (-12.8% y-o-y), which suffered because of the conditions in the EU market and a declining demand for these products. Re-export of pharmaceutical products to the Russian Federation also declined during the

²⁶ According to estimates, the current export potential to the EU is used at a rate of 41% in the case of agricultural products and 48% for non-agricultural products. Details: <https://www.expert-grup.org/ro/biblioteca/item/2101-opunitatile-zlsac-in-contextul-crizei-pandemice-cum-poate-zlsac-amortiza-socurile-si-consolida-rezilianta&category=182>.

reporting period. The only export products that had a significant positive impact are vegetal oils which recorded a significant increase of 40% y-o-y.

The evolution of imports from the EU was determined by a decrease of consumption and a lower demand by the local industry in the context of the pandemic. The main origin of imports remains the European Union with a total of 2,223 million USD in jan-nov:20 (figure 21), which is 14.1% less than the previous year, and holds a share of 45.8% of the total imports (48,8% in 2019). The most important decreases were recorded for imports from Romania (-26.2% y-o-y, due to lower import of petroleum oils, as international prices for this category of goods dropped), Italy (-16.5% y-o-y, due to lower imports of medicines for re-export) and Germany (-6.8% y-o-y, due to lower imports of copper wire and electrical circuits used by the automotive sector).

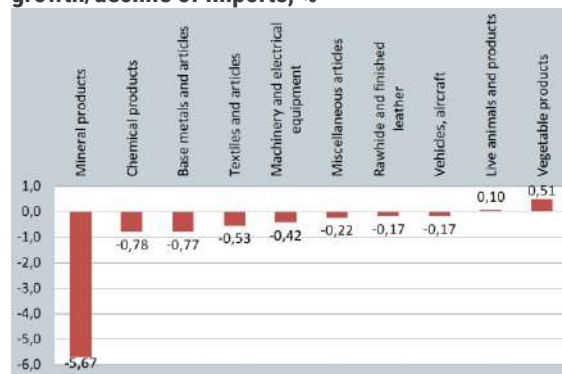
Figure 21. Imports to the Republic of Moldova by groups of countries*, million USD



Source: Expert-Grup estimates based on NBS data

*Starting with 2018, United Kingdom is included in Others.

Figure 22. Influence of categories of goods on growth/decline of imports, %



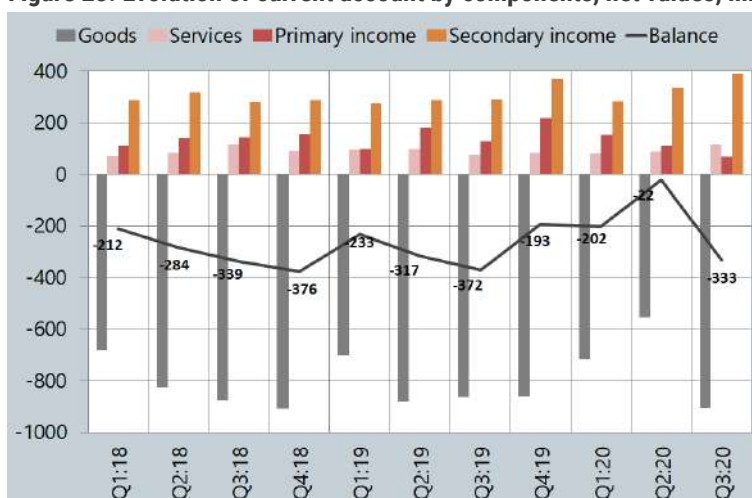
Source: Expert-Grup estimates based on NBS data

The decrease of imports from the CIS is explained by lower fuel prices. In the first 11 months of 2020, the CIS countries held a share of 24.4% in Moldova's imports. They totalled 1,183 million USD, which was lower by 7.4% y-o-y (figure 21) and about 21% of this total comprised mineral products, while in 2019 these constituted 28%. Imports from the Russian Federation were down by 13.7% y-o-y due to lower imports of natural gas and mineral fertilizers, from Ukraine – down by 8.6% after import of electricity from that country stopped, and from Belarus – down by 13.5% due to lower imports of petroleum oils. At the same time, imports from Kazakhstan increased 5-fold, following the delivery of 12 locomotives to the S.E. "Moldova Railway".

Cheaper fuels and replacement of electricity sources diminished the total value of imports (figure 22). In January-November 2020, Moldova imported mineral products in the amount of 544 million USD, which is 300 million USD (or about 35.6%) less than a year before. This is explained on the one hand by lower (30-40%) purchase prices for fuels (although the imported quantities remained virtually the same), but also by the change of the source of electricity. From 1 April 2020, 100% of electricity is bought from Transnistria, excluding Ukraine as a seller (deliveries from Transnistria are not reflected in the country's trade statistics).

The decrease of re-exports of pharmaceutical products to the CIS countries, combined with a decline of fertilizer imports have influenced the dynamics of imports of the Republic of Moldova. The import of pharmaceutical products, which were later re-exported to CIS countries, declined in jan-sep:20 by 11.7% y-o-y. At the same time, the imports of fertilizers (from Russia and Ukraine) decreased during the reference period by about 20.6% y-o-y.

Imports of raw materials for products manufactured under the Lohn system dropped significantly. During the reference period, the import of metals (mainly copper articles) decreased by 10.6% y-o-y, textiles by 7.6%, machinery and electrical appliances by 6.4%, various products (mainly toys) by 21% and raw/processed hides by 14%. This is explained by a lower demand on the final markets (almost exclusively EU) for the products manufactured under Lohn system in the Republic of Moldova.

Figure 23. Evolution of current account by components, net values, million USD

Source: NBM estimates.

Foreign trade developments led to an improved deficit of the current account of the balance of payments. In jan-sep:20, the current account of the balance of payments of the Republic of Moldova recorded a deficit of 556.6 million USD, decreasing by 39.9% y-o-y. Relative to GDP, the current account deficit was 6.4% (compared to 10.5% in 2019). This evolution was determined by a considerable decrease of the deficit of foreign trade in goods, a substantial increase of the surplus of secondary incomes and by a slight increase of the surplus of services (figure 23).

Forecasts and challenges

Forecast on the foreign trade of the Republic of Moldova is consistent with the prospects of a revived world economy. According to this scenario, the volume of global trade will increase by about 8% in 2021, and then slow down to a growth of 6% in 2022 (according to the IMF). Trade in services is expected to recover more slowly than trade in goods, which is in line with cross-border restrictions that will continue to affect tourism and business travel. In this context, we estimate an annual increase of exports of Moldovan goods and services of about 9.6% by the end of 2021, as well as an annual increase of 6.8% of imports of goods and services. These forecasts reflect the growth prospects of Moldova's main trading partners due to the new global and regional economic realities shaped by the Covid-19 pandemic (mass vaccination), although the latest developments in the epidemiological field (new wave of infections and emergence of new strains) could compromise the positive outlook even for the near future.

In addition to uncertain trade prospects, there are a number of shortcomings in the concentration of exports both geographically and in terms of their structure. This is exacerbated by the fact that the exports in question bear a relatively low added value - either primary agricultural products or industrial products processed in Lohn regime. This highlights the low level of competitiveness of domestic producers, which undermines the sustainability of exports as a whole, especially in times of crisis. In these conditions, a reassessment of the paradigm of export expansion is necessary, in particular as regards increased competitiveness and a higher added value.

The expected rise of international oil prices in 2021 could amplify the inflation pressure. In anticipation of global economic recovery, oil prices are expected to rise by over 20% in 2021 compared to 2020, but still stay well below the 2019 average. However, quotations will remain volatile, as a consequence of political and economic developments in major oil producing countries, as well as of OPEC intentions to cut supply and keep prices at an acceptable level, especially in light of last year price collapse.

Expected higher international food prices could boost exports. The pandemic crisis has exacerbated the already fragile trade conditions globally, caused by trade conflicts and weather shocks, by affecting production capacity and distorting logistics chains. This has led to a sharp rise in prices for virtually all food groups, and the outlook for

the current year does not yet suggest a decline. Under these conditions, exports of agricultural and food products could benefit from this opportunity, although domestic prices could also be affected. However, evolution of the agricultural sector in the Republic of Moldova remains the greatest uncertainty, taking into account its vulnerability to weather conditions.

Both external and internal economic factors mentioned above point to a possibly worse deficit of the current account of the Moldovan balance of payments in the next period. Even though there was an improvement in the current account deficit in 2021, maintaining such a level in the next period remains uncertain given the slow resumption of exports. However, low domestic consumption could positively affect the trade balance. In these circumstances, making full use of the opportunities under the preferential trade regimes (especially DCFTA) is crucial. This requires strengthening the efforts of both the producers, who should meet the access conditions, and the authorities, who should ensure the necessary regulatory framework. Last but not least, stimulating foreign investment and attracting foreign assistance become vital in order to balance the components of the current account deficit and avoid greater pressure on the currency and external debt, in particular if we take into account the expected lower remittances, which will further heighten the issue of the current account sustainability.