

MEGA: Moldova Economic Growth Analysis

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■ Key Policy Messages

- The current and the previous years proved once again the strong vulnerability of the Moldovan economy to climate and external shocks. The large openness of the economy coupled with poor competitiveness, explains a relatively high demand elasticity for the Moldovan products exported abroad. At the same time, poor capital and technological endowment, as well as insufficiency of storage capacities within the agricultural sector, makes the local farmers strongly dependent on climate factors. All these factors induce significant volatility in GDP and fuels a persistent macroeconomic uncertainty, which is an important culprit for low FDI performance in Moldova. Moreover, as argued in the previous issues of MEGA, these constraints are amplified by many structural deficiencies of the Moldovan economy, inefficient public sector, weak protection of property rights and slow systemic reforms.
- The Moldovan economy will post a fledgling recovery in 2013, being followed by a moderate stabilization in 2014. Hence, favorable climate conditions from the current year will trigger a 20% compensatory growth in agriculture, which will ensure about half of the 4.4% of the forecasted GDP growth for 2013. For the next year, the economy will be primarily driven by the services sector, which will contribute to about half of the forecasted 4.6% GDP growth in 2014. All in all, the Moldovan economy remains strongly dependent on the final consumption, which will continue to be the main driver of economic growth in short- and medium-term. Therefore, the previous risks and vulnerabilities associated with an economic growth model based on consumption and high trade deficit will persist, unless decisive actions for strengthening the country's competitiveness will be undertaken. For this to happen, it is necessary at least to increase the efficiency of the Customs' Service, modernize the road infrastructure, facilitate the technological transfer and set up a transparent, accountable and efficient judicial system.
- Despite positive growth expected for the near future, the Moldovan economy is forecasted to advance much slower compared to the previous years. The main reason lies in the wide spectrum of structural constraints hampering the long-term economic development. These primarily imply poor quality of human capital and population ageing, insufficiency of capital investments, slow technological absorption, extensive public sector and a wide network of state owned enterprises. Inefficient judicial system, weak property rights and high level of corruption add to this burden, which undermine the confidence of businesses and entire civil society in the state institutions and the macroeconomic outlook of the country. Hence, without fixing these fundamental development constraints, the public policies and the started reforms will not reach their desired outcomes.
- The Government's agenda for the early stage of its mandate is very ambitious consisting of jobs creation, fighting the corruption, and advancing the European integration. Obviously, the timeframe is fairly short to reach entirely or even partially the projected goals. However, to ensure a proper environment and resources for promoting the reforms, the political stability must be ensured and the external assistance shall be wisely and more intensively harnessed. However, the effective implementation of the Government's agenda will be hampered by the limited administrative capacities, high level of corruption within public institutions and the persistence of vested interests.
- Restoring the relations with IMF should be one of the key immediate priorities for the Moldovan Government. The new memorandum could be based on a stand-by facility, as it is not so important from financial reasons, but rather for enhancing the credibility of the international community and for speeding up the reforms. Also, it could help avoiding profligate spending in the upcoming pre-electoral year and could increase the accountability of the Government for its economic and fiscal policies. However, the negotiations are likely to be difficult, as the Moldovan authorities does not share the IMF's visions on a number of sensitive issues, such as the wages in the public sector or the fiscal regime for agricultural farmers.
- The benefits of favorable climate conditions this year will not be equally distributed throughout the entire agricultural sector. Thus, due to a strong increase in the supply of various agricultural products at the domestic and regional level, small farmers are likely face too low selling prices, which will undermine their profitability. At the same time, the most benefits will be ripped by a few number of intermediaries, which will take advantage of these circumstances, by purchasing at relatively low prices on the domestic market and exporting at profitable margins. This is a fundamental structural issue, which has to be properly addressed by policy makers. While the intermediaries have an important role in connecting small farmers to the foreign outlets, it is necessary to strengthen the bargaining power of small agricultural producers in relation to intermediaries. It could be achieved by diminishing the information asymmetry between both parties, through the implementation of electronic mechanisms for trading with agricultural products. Additionally, the market of intermediaries meets all characteristics of an oligopolistic competition, which allows a small number

of companies to operate at high margins, at the expense of the majority of agricultural producers. Hence, this should become a major object for investigation for the recently created Competition Council.

- The Government has to use the opportunity of low market prices for wheat in order to supplement the strategic reserve, which could be used in periods of deficits. However, purchasing the surplus of wheat on the market in order to adjust the price upwards, as suggested recently by some farmers, is not an efficient and sustainable policy tool for fixing the financial issues of the agricultural sector. The reason is that the storage capacities are not suitable for increasing the state stocks up to a level that would guarantee comfortable profitability levels. Moreover, the additional expenditures necessary for such market interventions were not projected in the state budget law, they incur strong opportunity costs and challenge the fiscal stability of the country. The most strategically correct policy solution would be to facilitate the access of farmers to foreign outlets, diminish the information asymmetry and increase the competition among intermediaries, as mentioned in the previous paragraph. Additionally, the farmers should improve their storage capacities in order to be able to keep larger stocks for a longer period of time and, in this way, to be able to send the surpluses of this year in the next year at a higher price.
- The managed currency depreciation during the summer period helped to increase the value of remittances expressed in Moldovan lei, which consequently fueled the consumption. It also served as an income source for the state budget through the channel of indirect taxes on imports and enhanced the price competitiveness of exporters. Additionally, the central bank consolidated its international reserves, by operating purchases of foreign currency on the domestic FOREX market. Although, this policy is in line with the objective of mitigation of deflationary pressures and boosting economic growth, its positive effects are likely to dissipate in the short-term and to be counterbalanced by much stronger long-term repercussions. Thus, the central bank should carefully consider the inflationary risks associated with such policy interventions. The main risks are stemming from the strong dependence of the Moldovan economy on imported consumer and industrial goods, as well as energy resources. As a result, any significant currency depreciation creates inflationary pressures by making the imported consumer goods immediately more expensive and, as a second round effect, by increasing the prices for domestically produced goods due to higher production costs.
- The easy monetary policy promoted by the central bank during the current year helped to set the stage for a revival in lending activity and economic growth. Nevertheless, the current stance seems to be too accommodative, taking into account the expected economic recovery and the inflationary pressures associated with the national currency depreciation and robust growth in money in circulation. In order to avoid excessive inflation volatility, the central bank should consider a gradual removal of the accommodative stance of the monetary policy by raising the base rate to 4.0%-4.5% until the end of 2013 and to 5%-6% until the end of 2014, unless additional inflationary shocks will occur.
- Moldova should advance on its European integration vector. Hence, it is important before the Vilnius Summit on Eastern Partnership in November 2013 to reach a common agreement on the content of the forthcoming Deep and Comprehensive Free Trade Area between our country and EU and finally sign it in 2014. Additionally, it is necessary to find out an optimal and feasible option for involving Transnistria into this process. The estimations suggest a net positive effect for Moldova as a result of signing this agreement, which is likely to spur exports from 10% to 15% and GDP by about 5%-6%. However, it implies short-term costs, as many weak enterprises, mostly from the agri-food sector, which are currently protected by custom tariffs, could not stand the competitiveness shock and finally could get bankrupt. In order to minimize these costs and maximize the benefits, it is crucial to tap for European funds available for implementing the DCFTA requirements and, at the same time, to strengthen the competitiveness of the Moldovan economy by improving the business climate and attracting more FDI.

■ Statistical indicators

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

	2009	2010	2011	2012	2013 estimate	2014 forecast
Population, million (excludes Transnistria), beginning of the year	3.568	3.564	3.560	3.559	3.559	3.559
GDP, billion MDL, current prices	60.430	71.885	82.349	87.847	98.997	110.830
GDP, billion USD, current prices	5.438	5.813	7.016	7.253	7.9836	9.0845
GDP per capita, USD at PPP	2830	3067	3347	3380	3687	4010
Real GDP, y-o-y % change	-6	7.1	6.8	-0.8	4.4	4.6
GDP deflator, y-o-y % change	2.2	11.1	7.2	7.6	7.9	7
Private consumption, y-o-y % change	-8.1	9.2	9.4	0.9	4.5	5
Gross fixed capital formation, y-o-y % change	-30.9	17.2	13	-0.8	8.0	13.0
Industrial production, y-o-y % change	-21.1	9.3	9.5	-3.1	6.0	5.0
Agricultural production, y-o-y % change	-9.6	7.9	5.0	-22.4	25.0	
Share of industry in GDP, %	13.3	13.3	13.6	13.9	14.1	14.3
Share of agriculture in GDP, %	8.5	11.9	9.2	11.2	13.0	12.8
Merchandise FOB exports, million USD	1283.0	1541.5	2216.8	2161.9	2409.2	2648.2
Merchandise CIF imports, million USD	3278.3	3855.3	5191.3	5212.9	5522.5	6088.5
Service exports, million USD	673.1	700.3	881.5	936.3	1025.2	1134.1
Service imports, million USD	712.9	763.8	88.1	957.4	1037.8	1133.3
Net foreign direct investment, million USD	138.6	193.9	260.4	139.4	160.0	200.0
Net work remittances, million USD	1106.8	1243.8	1511.5	1699.4	1850.0	2030.0
Current account/GDP, %	-8.6	-7.9	-11.5	7.6	-8.0	-7.8
Official reserve assets, end-year, million USD	1480.3	1717.7	1965.3	2515	n.a.	n.a.
Total external debt stock, million USD	4358.9	4786.3	5442.6	6135.4	6500	7200
External debt/GDP, %	80.2	82.3	77.6	84.6	81.4	79.3
Employment rate, % of population aged above 15	40.0	38.5	39.4	38.4	39.0	39.0
Unemployment rate, % of economically active population	6.4	7.4	6.7	5.6	5.4	5.2
Real wage growth rate, y-o-y % change	9.0	0.7	3.7	1.0	4.7	5
Consumer prices index, year end, y-o-y % change	0.4	8.1	7.8	5.2	4.5	4.5
General government balance, % of GDP	-6.4	-2.5	-2.4	-2.1	-1.0	-1.0
General government expenditure, % of GDP	45.3	40.8	39	40.3	41.3	42.0
Exchange rate, year average, MDL per USD	11.1	12.4	11.7	12.1	12.4	12.2
Broad money (M2), y-o-y % change	-3.8	18.3	14.4	20.0	17.0	20.0
Central bank refinancing rate, end-year, %	5.0	7.0	9.5	4.5	n.a	n.a
Total commercial bank loans, % of GDP	35.0	32.6	36	32	35	36.0
Bank deposit rate, %, average per year	14.7	7.6	7.54	7.6	7.5	7.5
Bank lending rate, %, average per year	20.3	16.3	14.4	13.3	13.0	12.5

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

■ Executive summary

Political Economy of Reforms

A new governing coalition with newly appointed Government has started a short-term mandate setting an ambitious agenda, which includes as top priorities jobs creation, fighting corruption and advancing reforms towards European integration. That includes serious improvements of the business environment, which constitutes both the objective and the tool to attract investments and foster the employment. At the same time, the Government aims at re-building the country's credibility that in the wake of the political turmoil has been seriously hampered. Actually, the success of reforms is conditional on the prolongation of the financial assistance by external donors. This support has been shrunk in the first half of 2013. Hence, the Government is pushed to ensure the international community that political commitments will be fulfilled and the political stability will be maintained. Another reason seems to stand behind the initiative to renew the dialogue with IMF. Amid pre-electoral year, the Government is likely to demand more flexibility from IMF, in order to avoid too painful reforms and incur excessive political costs. Although the negotiations on DCFTA were concluded, the Government has to mitigate and minimize the consequences stemming from non-participation of Transnistrian region in the harmonization of national regulatory system with EU's requirements. Finally, the Government should continue its work on existing European agenda, in parallel initiating the drafting of the post-Vilnius priorities.

Domestic Supply

After the 2012 decline, the economy witnessed a better evolution during the first half of 2013. In Q1:2013 the GDP grew by 3.5% y-o-y, with all sectors of the economy registering a positive dynamics. In spite of the risks associated with the economic uncertainty in EU and growth moderation in the CIS area, which are further worsened by the domestic vulnerabilities, we expect that the GDP will increase by about 4.4% in 2013. However, we do not exclude a more pessimistic scenario, according to which the economy could grow only by 3.5%. Agriculture will bring the largest contribution to the economic growth in 2013, which will expand by about 20%. Additionally, this increase will be supported by some progressed registered in other sectors. However, the excessive supply in the crops' sector, in particular in the wheat production, will keep the prices low, which could disfavor the agricultural producers. In the case of wheat, the average price is likely to stabilize at about 2 MDL/kg, while the eventual administrative efforts to make it higher in order to meet the producers' interests, will involve the withdrawal of an important quantity of cereals from the market. This policy option would not be compatible with the states storage and financial capacities. The Government should rather concentrate on facilitating the access of agricultural producers to foreign markets.

Domestic Demand

First signs of positive economic recovery registered in Q1:13 lack a sound foundation, as it is mainly driven by the households' consumption, which was mainly due to the growth of remittances and not on real economy. The rural population compared to urban one is dependent to a greater extent of transfers from abroad, which in Q1:13 constituted 21.0% in total revenues compared to 13.0% for the urban population. Remittances are not evenly distributed and are not sustainable in the long run. Considering the registered trends, the reforms for improving the domestic demand should focus on refining competition, enhancing conditions for investment and innovation in Moldova's domestic sector. We should consider taking further steps to boost domestic sources of growth. The started structural reforms should speed up in order to increase our growth potential and create desired decent jobs.

Public Finance

During the first semester of 2013, in spite of the swinging dynamics, the revenues of the national public budget grew at a higher rate than the expenses. Since the beginning of the year the tax collections grew continuously, except for May, and exceeded the planned level by 2.5%. Due to the influence of some sporadic factors, other non-fiscal components of the national public budget decreased or posted a modest development, leading to an underperformance by 3.5% as compared to the plan, for the first half of 2013. The possible political solutions related to the recapitalization of Banca de Economii and interventions on the cereals market will lay additional pressure on public finance. The public finances continue to be vulnerable to external economic shocks and are affected by the rigidity and low efficiency of the local budgetary system. The public finance reforms should aim at downsizing the public sector and enhancing its efficiency.

Labour Market

The labor market continues to be an important concern, as the key indicators registered in Q1:13 negative trends, such as high underemployment rate, low job opportunities especially in the rural areas, high level of informal employment, among others. These are some of the important factors, which foster citizens' emigration looking for a decent job abroad and trying to financially secure their families and children left behind. On a positive side, the recent opening of two important industrial parks should contribute to the creation of new job opportunities in the near future. Additionally, the prospective signing of the DCFTA and Association Agreement with EU, together with the visa liberalization regime could boost the trade, transportation and communications sectors. At the same time, the national educational system should become more flexible and better correlated with the economy's needs. The informal sector remains a significant concern. Although in short run, the informal economy seems to have a certain positive effect on the poverty reduction; the costs of it on the wellbeing and welfare of the entire country are much higher. In this respect, besides the already in place regulatory framework, a higher and stronger cooperation is needed among the labor, social security and tax inspectorates, as well as a higher information exchange and enforcement mechanisms for the existent regulatory framework.

Prices and Monetary Policy

Despite favorable climate conditions, the upward dynamics of the headline inflation over the last months has been mainly driven by foodstuffs' prices. At least two factors can explain this paradox: (i) the methodology change that occurred in May:13, and (ii) gradual depreciation of the national currency. Except for these factors, deflationary pressures persist, amid tepid economic activity, declining regional food prices and growing supply of agricultural products. Given the necessity to steer the inflation level closer to the proximity of the central bank's target, as well as to set the stage for a healthy economic recovery, the monetary policy remained broadly accommodative, with the base rate at its historical low. At the same time, NBM intervened on the domestic FOREX market and generated a managed depreciation of the national currency, as part of its ultra-easy monetary policy. Given the expected economic recovery and inflationary risks stemming from currency depreciation and monetary expansion, we urge the central bank to reevaluate its approach and gradually withdraw this accommodative stance of its monetary policy until 2014.

Banking Sector

In the first half of 2012 the banking sector indicators displayed contradictory developments. Thanks to the economic recovery, the lending activity has resumed. The decrease in the volume of newly attracted deposits occurred in parallel with a reorientation of funds from short term deposits to deposits with longer maturities. The unfavorable economic developments of 2012 and worsening of the situation at "Banca de Economii" failed to generate a significant progress in the sector. However, the problem of "Banca de Economii" poses a risk for the entire sector, and the capitalization of this institution is of crucial importance. In the short run, the shocks for the banking system could be triggered by the non-involvement and poor efficiency of line institutions and the justice system. The negligent attitude towards the security of investments in the financial sector can have an unrepairable long-lasting impact on the entire economy.

Foreign Sector

A modest recovery in Europe would do little to help the global economy, which is already burdened by slowing growth in Asia and many emerging markets and by only moderate U.S. expansion. Moreover, the estimated slowdown of the Russian economy will inevitably affect our domestic exports to this destination. The named factors have an important impact on our domestic economy, especially in terms of trade and foreign direct investments. The chronically negative trade balance and the continuously widening current account deficit hinders development, which means less expenditures and less production. The result is lower living standards and a less prosperous economy. On a positive side, the noticed signs of rebounding of Europe would benefit our exports to some of the EU countries and potentially influence the FDI.

■ Chapter 1. Political Economy of Reforms

Post-crisis reanimation

Since 2009, the political reality of Moldova became the hostage of the “balance of power” principle, which served to the creation of all pro-European governing coalitions. Thus, any attempt to review this principle has been producing disputes between the ruling parties. Thus, in early 2013, a new episode of political crisis was provoked by harsh disputes between the ruling parties on the dismissing of the general prosecutor, appointed by the Democratic Party. The accusation of covering up a crime addressed to the general prosecutor was heavy and it produced high public pressure. Amid this open conflict, the Liberal-democrat prime-minister was dismissed within the no-confidence voting on March 8. The arguments invoked against the Government were intertwined with corruption. The intervention of the Constitutional Court ended the political deadlock that was leading directly to early elections. By Court’s decision of April 23 the former prime-minister and leader of the Liberal-democrat Party, Vlad Filat, was declared as improper candidate to set up a new government. Therefore, by a presidential decree the deputy prime-minister, Iurie Leancă, was appointed as acting head of government. Subsequently, he created the new Government that was sworn in on 31 of May 2013, collecting the votes of 58 MPs, which formed the Pro-European Coalition.

The removing of the parties’ leaders from the front of the state institutions seems to bring benefits for the entire cooperation between state institutions, represented by different political forces. That can provide more stability and efficiency to the Government, which has a short mandate to achieve ambitious goals. In this respect, it placed the emphasis mainly on continuing the agenda set by the former Cabinet. Additionally, it attempts to maximize the possible outcomes before the end of its quick term.

Pro-European Coalition and Leancă’s government agreed on the program based on three pillars:

- **Jobs creation**, by speeding up the positive transformation of the business environment;
- **Fighting corruption**, by increasing the governance transparency and access to information, providing more incentives for electronic governance and making the activity of political parties more transparent;
- **European agenda**, which means the implementation of reforms within the process of political and economic integration with the EU.

More jobs via better business environment

To address the first task the Government foresees to move on the reforms aiming at stepping up the business environment, attracting more investments, promoting exports and liberalizing the domestic market of goods and services. The overall result is supposed to lead to boosting the jobs creation. In this regard, the Government has reiterated its readiness to implement further the goals of the National Development Strategy “Moldova 2020”. However, the financial constraints can slow down the ambitious tasks. Hence, an active work for collecting funds from external donors shall be undertaken by the Government.

In this sense, a call to support the implementation of the Strategy “Moldova 2020” was delivered to the European Bank for Reconstruction and Development (EBRD) by the Minister of Economy, Valeriu Lazăr, during the official meeting with EBRD’s regional director, Oliver Decamps, on July 23. Moreover, this proposal referred to the possibility of extending the EBRD’s financial portfolio related to Moldova over the exporting companies and SME, including the infrastructural and energetic projects. Overall, the partnership with EBRD is focused on three areas: (1) improving the business environment and corporative governance; (2) promoting of European standards and regional integration; (3) enhancing the commercial wealth and municipalities’ enterprises sustainability.

A promising measure in terms of reviving the business climate constitutes the set-up of the Economic Council, which gathers the stakeholders representing state institutions, business associations, investors, donors and civil society. The Council is drawn as a platform through which will be facilitated the interaction

between state and business actors. The financial viability of the institution is ensured by EBRD with 300,000 euro. Notwithstanding its declared inclusiveness and holistic approach, it is difficult to forecast its real added-value today as it was constituted on July 23. Actually, the Council should increase the capacity of the Government to deal with systemic shortcomings and in no case to spur the “top-down” interventionism. Otherwise, the Government will act as an “ambulance” solving particular cases faced daily by business actors because of the endemic corruption and heavy bureaucracy. Also, the Council should be established as a fully working body, where the discussed issues are taken into consideration in the decision making process. Hence, it should be excluded the attempt to miming the consultative process or to undermine its role by formalism.

Fighting Corruption – Mission Impossible?

The corruption produces the hugest losses to the country’s economy, damaging the business environment, hampering the justice and affecting directly the citizens’ welfare. Although all the governments after 2009 targeted this problem, the level of corruption is still high. According to the Corruption Perception Index for 2013, Moldova is placed on 94th rank, which is better than the rankings in previous years (2010 – 105th, 2011 – 112th). However, the situation on the ground seems to be worse, because the corruption turned out to be a general heavily endemic phenomenon that paralyzes the functionality of the state institutions. As an attempt to reduce the corruption, the prime-minister has disposed to speed up the integration of public services (provided by police, civil registry offices, fiscal office etc.) with government electronic payment service by August 25. The launch of the Government e-payment was declared as a priority in the beginning of the Government’s mandate. The new service of payment was designed by the Electronic Government Center of the State Chancellery, in common with Finance Ministry and National Bank of Moldova, aiming to diminish the bureaucracy and corruption. Consequently, the contacts with public servants will be minimized, while the queues for public services will be cut down. Even if the Government e-payment will be free of charge, it will take time and supplementary efforts to raise the awareness about its advantages.

The ensuring of governance transparency has been introduced in the Government’s program as part of anti-corruption agenda. In this respect, the transparency was reflected in developing e-Governance. It includes the spreading of electronic services in education, healthcare, social protection, agriculture, and other areas. Also, the Government’s program envisages the further implementation of existing laws on access to information, pursuing the goal to extend them over all public authorities. Notwithstanding the firm dedication for strengthening the open governance, there are deficiencies related to the opening of public data by the state institutions and public servants. The Report assessing the implementation of the Open Governance Action Plan of 2012-2013, issued by Association for Participatory Democracy (ADEPT) on July 2013, pointed out the inertia and reluctance within numerous state institutions. The difficulties in using the IT programs, the unreliability of data provided to the public or the using of old modalities to store the information are only few of the principal reasons depicted in the report. Hence, the Government through the Electronic Government Center should gear its actions towards improving the skills of human resources that work as public servants. Overall, the Government should take into consideration the impact of the human factor, which should be reduced and/or better educated, on the other hand, in order to fight corruption and provide transparency more efficiently.

European agenda – bridging with the EU

Both symbolically and politically, the most significant objective of the Government consists in bringing Moldova to an irreversible point in the process of European integration. To this end, it targets to initialize the Association Agreement (AA), Deep and Comprehensive Free Trade Agreement (DCFTA) and visa liberalization regime with the EU. The deadline for these goals is the Eastern Partnership Summit in Vilnius on November 2013, which will come after four years after the launch of the Eastern Partnership. While the AA and DCFTA are foreseen to be only initialed, the visa liberalization process is expected to be completed.

Hence, more palpable and realistic seems to be the concluding of the Visa Liberalization Action Plan (VLAP) implementation. Currently, the Moldovan part works on preparing the 5th assessment report, which is

expected to be released by September. At the same time, the European Commission plans to finalize drafting its 5th and final report in the run-up to the Vilnius summit. The Moldovan authorities have high expectations regarding the forthcoming evaluation.

In case of a positive outcome, the Commission will recommend to the Council of Ministers to assess the possibility to be lifted the visa regime for Moldovan nationals. As a result, the Government might strengthen its leverages to facilitate the circular migration, intensification of business relations between Moldovan companies and their EU partners, transfer of know-how and stronger demand for transport and travel services¹.

Traditionally, Moldovan society expresses skepticism on business environment. Nevertheless, Moldova has obtained a better average rank for business doing index in comparison with other countries from the region. In 2013, Moldova was ranked with 83th place out of 185 countries, which covers the regulations carried out from June 2011 to May 2012. According to the index, Moldova is behind such countries like Bulgaria (66th place) and Romania (72nd place). But it is placed in front of Croatia (84th rank) and Albania (85th rank), overstepping considerably Ukraine (137th rank). Actually, Moldova has occupied a better position by business doing index than Croatia, which became the 28th member of the EU on July (2013). Also, it has performed better than Ukraine with which the EU plans to sign DCFTA in November. Notwithstanding a good average for business doing index, Moldova is behind all above-mentioned countries by the criteria of “starting a business” (Moldova - 92th, Ukraine - 50th, Bulgaria - 57th, Albania - 62nd, Romania - 68th, Croatia - 80th). Another domain where Moldova has underperformed is “trading across border”, where Moldova got 142nd rank, which is worse than achieved other countries from the region, excluding Ukraine (145th).

Thus, the Doing Business report issued this year depicts that Moldova undertook actions in order to enhance the investment climate during 2011-2012. For instance, Moldova amended its law on joint stock companies, which allows the shareholders to petition the court for a rescission of transactions in case that implies damages for the company. Also, it has been reduced the withholding tax for dividends from 15% to 6%, and from 15% to 12% of the withholding tax for payments other than dividends. Moreover, it was approved a new tax regime for SME, which introduce a single tax of 3% for small companies' revenues obtained from operational activities. At the same time, Moldova authorities approved the increasing of the paying taxes' cost for companies by reintroducing the corporate income tax. However, these costs were offset by encouraging electronic operations related to tax payments. Even if the state seems to be creating more propitious regulatory environment for doing business, these efforts are undermined by the weak private property right protection and largely spread corruption in the various institutions of the state.

DCFTA – a “window-of-opportunity” to be open

On 12 June, the EU and Moldova concluded the negotiations on DCFTA, started on February 2012, which is part of the broader Association Agreement. DCFTA offers the access to a market of 500 billion costumers, promoting gradual integration of Moldova with the EU's internal market. This process is combined with reforms in a full range of regulatory areas, such as technical regulations, hygiene and phytosanitary standards (SPS), protection of intellectual property rights and competition rules. Due to these regulatory transformations Moldova's economy will become more competitive. The consumers will benefit from a market with higher standards in the field on food safety and industrial products. Moreover, the more transparent rules of competition can step up FDI and local investments.

During the negotiations on DCFTA, held on 15-16 May, Moldovan side asked for gradual liberalization, up to 10 years, for particular agricultural products (like fruits, vegetables, some items of conserves and juices, and milk products). Another proposal of Moldovan side regarding the introduction of quotas for specific European products (meat, products of meat, sugar, some milk products) was formulated in order to support additionally the local producers. On the other hand, the EU agreed on possibility to institute annual quantitative quotas for the export of 10 groups of Moldovan products (meat, sugar, cereals, milk, eggs etc.) to the European

¹ “National Human Development Report 2012: European Aspirations and Human Development of the Republic of Moldova”, UNDP Moldova, http://www.undp.org/content/dam/moldova/docs/Publications/UNDP_MD_NHDR_2012_English.pdf

market. These quotas will be established according to the requests coming from Moldovan producers. It is likely that the former will constitute a kind of compensatory measure in order to support the Moldovan exports, while Autonomous Trade Preferences will be annulled as a result of DCFTA's entering into force.

Another crucial issue related to DCFTA is the participation of Transnistrian region, which refused to take part actively in the negotiations and definitively refrained from implementing the necessary reforms. Hence, DCFTA and the annulment of the Autonomous Trade Preferences can have negative consequences for Transnistrian economy, which will hamper imminently the efforts of country's reintegration. However, namely the economic integration of Moldova with the EU constitutes a prerequisite that can foster the conflict resolution. In this respect, both Moldova and the European side should consider the creation of a system of incentives to engage the Transnistrian region companies to comply with EU requirements on production and quality standards. Consequently, it will stimulate the economic agents to lobby the political "establishment" of the region, in order to convince it about the necessity to harmonize region's regulatory rules with EU's norms. Also, practical actions that aim to check the rules of origin and the way are respected other regulatory requirements by the Transnistrian region producers can be achieved in cooperation with EUBAM.

Overall, the negotiation of DCFTA should not be treated as a final goal. The difficult part will constitute its implementation, which will require workable regulatory frameworks, functional institutions, applicable legislation and enforcement capacity of the government.

Dialogue with IMF

The political crisis rang the alarm among the external donors. Amid the political deadlock and the adopted legislation opposed to Moldova-IMF memorandum of cooperation, IMF decided to postpone temporarily its 3 years financial assistance. In fact, the program was closed being unfulfilled by the Moldovan side. As a result, Moldova did not receive the last tranche of loan worth 76 million of U.S. dollars, originally allocated to fill up BNM's reserves. In addition, Moldova's relation with IMF was damaged.

Since it was sworn, Leancă's Government undertook various actions to restore the trust of the external partners, particularly with IMF. Although it is clear that pre-electoral year is reducing the level of maneuver for the central authorities, the relation with IMF is significant for restoring the country's credibility. In this respect, on July 12, the prime-minister has approved the creation of the working group to draft a program of cooperation with IMF. Negotiations on new program of financing will start in autumn. The organization is interested to provide its assistance to maintain the macroeconomic stability and to support the reforms. In return, it suggested to the Government to review: (i) the last changes of the taxation in agriculture, which is also related to the single tax for agricultural producers; (ii) the re-opening of loopholes in the value-added tax regime; (iii) the increase in pensions and salary for dignitaries.

Moreover, IMF requested to be addressed the current challenges presented in banking sector. Hence, Moldovan authorities should ensure a comprehensive enforcement of the recently adopted shareholder transparency, including the suitability requirements. Additionally, by reforming the justice the protection of property rights in banking sector will be boosted. Particularly, the organization referred to the necessity to increase the capitalization of Banca de Economii, with further improvements of its management, and subsequent privatization. Overall, the general recommendations of IMF concern the maintaining of financial stability and carrying out structural reforms.

The fact that the Government has declared a major interest in restoring the dialogue with IMF as soon as possible bodes well for a fruitful collaboration with this institution. In fact, the presence of IMF can improve the image of the country in term of macroeconomic policy's feasibility and constitutes a weight proof in favor of country's credibility for external donors. At the same time, we should bear in mind that the political and electoral constraints are weakening the Government's level of maneuver. Consequently, the prim-minister highlighted that Moldova has achieved enough financial stability, and ultimately the country doesn't need the financial assistance from IMF. Nevertheless, the country needs a program with IMF to hold on its credibility.

In this sense, the Government seeks a very flexible dialogue with IMF, while the latter declared clearly that new reforms are necessary.

Short-term forecasts and challenges

- According to the Government's activity program, job creation is one of the main concerns on the policy agenda. In this sense, it has urged the reforms to be continued and the business environment to be advanced. But the heavy bureaucracy and standing corruption can undermine the efforts. Moreover, the Government encounters difficulties with finding funds to fulfill the reforms. The political turmoil in the beginning of the year determined a substantial loss of external financial assistance. That forced the Government to undertake actions to reassure the external partners about the political stabilization and European agenda of the country.
- It is unlikely that the Government has enough resources to improve radically and quickly the doing business conditions, in order to generate more employment. One of the factors that can bring the right incentive in this field is the implementation of new infrastructural projects and easing the entrepreneurial activity. That depends on the capacity of the Government to manage the existing financial resources and to attract new ones. As a demonstration in this sense can serve the construction of Ungheni-Iasi gas pipeline, which is supposed to start in the second half of 2013.
- The concluding of the DCFTA should be followed by activities for increasing the quality of Moldovan products, especially the agricultural ones. A special attention requires the efforts to extend the effects of DCFTA over Transnistrian region companies, which is actively boycotting the process of economic integration of Moldova with the EU.
- The relations between Moldova and IMF are likely to be restored due to political stabilization. But it is likely to oblige Moldovan authorities to readjust the legislation approved during the political crisis, which refers to taxes in agriculture, pensions etc. However, these are not the single issues to be negotiated with IMF. The next year legislative elections are likely to put additional pressure on Moldovan authorities in their dialogue with IMF.

Policy recommendations

- Although the Government concentrates its effort to fulfill the European agenda in pre-Vilnius summit interval, the new priorities for post-Vilnius term should be framed into an official document.
- While a propitious business environment takes time to be shaped, the Government should create conditions for infrastructural projects aiming to spur the employment. It means to generate employable human resources able to fill the potential jobs planned by the Government. In this sense, there is a necessity to set a permanent mechanism of vocational education dedicated for workers required by the construction companies. Such a call was launched recently by the current prime-minister. But it lacks a clear normative framework, the specific terms of implementation and the monitoring process, which should be defined in the upcoming time.
- Both Moldova and the EU need to convene timely on the measures and a timetable to facilitate applicability of DCFTA's provisions over Transnistrian region through engaging the companies. It is necessary to bear in mind the geopolitical prospects for the region amid the signing of DCFTA with Ukraine and the possible trade counter-actions from Russian side.
- A renewed program with IMF represents a way to restore the trust of external donors in country's economy. The policies in the field of agriculture, education, health, pensions etc. will be important issues in the negotiation with IMF; therefore the Government should work tightly with the Parliament to implement them. At the same time, the Government is pushing for much more flexibility in the context of pre-electoral year. But IMF can reject this approach, even if the new Government is guaranteeing a political stability. In this situation, the role of Moldovan side is to bring out a mutually acceptable proposal that will smooth the negotiations. Thus, the Government should build a comprehensive and predictable position, speaking with one voice together with other national stakeholders, and excluding any type of ambiguous political statements or actions.

■ Chapter 2. Domestic supply

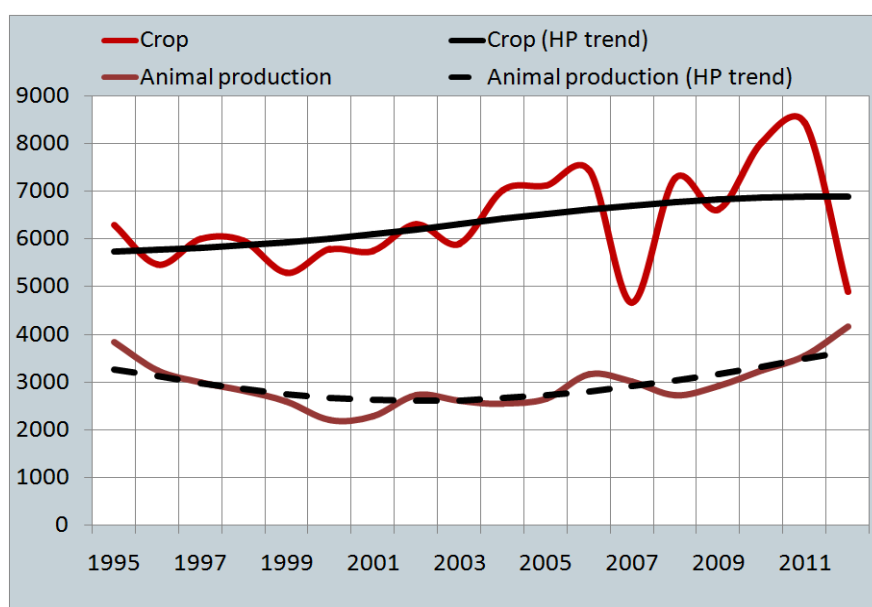
New growth, old model: how sustainable is economic recovery?

After the contraction during the last two quarters of 2012 (GDP dropped by 1.7% in Q3:2012 and by 2.5% in Q4:2012, y-o-y) in Q1:2013 the economy began to recover, posting a 3.5% y-o-y growth. It was driven by all GDP components, with an upward dynamics of gross value added by 2.9% y-o-y. The fastest growth has been registered by the services sector (+2.8% y-o-y), though it had an abnormal distribution: constructions skyrocketed by 10.5%, while the domestic trade grew by 3.5% y-o-y. Value added in agriculture and industry registered a more modest, but still promising dynamics: +2.3% and, respectively, +2.2%, y-o-y. Another important component of GDP, taxes on products, sloped by 5.5% y-o-y, owing to the depreciation of the national currency, better tax collection and higher taxes on some products.

Agriculture. During the first half of 2013 agricultural production has increased with 2.8% y-o-y. However this sector recorded a harsh decline during the last four quarters, reaching the lowest bound in Q3:2012 (-27.3% y-o-y). Crop production began to fall in Q1:2012 with the maximum decline being registered in Q4:2012 (-31.8% y-o-y). It has been caused by the dry weather of Q3:2011-Q1:2012 period and the hot summer of 2012. The most affected crops were maize, where the yield per hectare collapsed by 62.2% in 2012 y-o-y, followed by wheat, potatoes and sunflower, which lost 38.5%, 37.1% and, respectively, 35.9% of the harvest of the previous year. More resilient to unfavourable climacteric conditions was sugar beet with a decrease of yield by 19.3% in 2012.

The livestock output dropped by 1.9% y-o-y during the first half of 2013. Despite the decline during Q3:2012-Q2:2013, in long-run perspective the animal production records a positive evolution (Chart 1). Since 2002 livestock output trend keeps a positive track, growing annually by 3.4%, which is much lower than the evolution in crop production (+1.1%). This positive dynamics of the livestock output has been supported by the rather strong tariff protection enjoyed by this sector over the last years, but also due to a stronger profitability as compared to the crop production. Additionally, the share of shadow economy in livestock production is significantly lower than in crop production, which explains the „statistic” performance of this sector over the crop production. Importantly, there were important changes in the structure of livestock production, with an increasing share of pork and chicken meat, due to higher returns on investments and lower risks, as compared to beef or sheep meat production.

Chart 1. Evolution of agricultural sectors, mil. MDL (2000=100%)



Source: NBS, EXPERT-GRUP estimation;

Industry. After the 3.1% decline in industrial production during 2012, since Feb:13 it started to recover, posting a 5.9% y-o-y growth during the first five months of 2013. This fledgling revival has been driven by the sharp increase in Apr:13, when the industrial output registered a record growth since 2004 (+23.5%, y-o-y). The strongest rise (+20.9% y-o-y growth) has been recorded in mining and quarrying industry, mainly due to advancement in constructions sector. The manufacturing industry, also, had a promising evolution, posting a healthy 7.6% y-o-y growth.

Services. Unlike the industrial and agricultural production, the evolution of service sector was characterized by steady dynamics in 2012, which continued during Q1:13, registering a 2.8% y-o-y growth in value-added. Both segments of delivered services: supplied to population and to firms has increased by 7.1% and by 4.5%. At the same time, the domestic trade had more modest performances: wholesale trade rose by 5.8%, whereas the retail trade shrank by 2.2% y-o-y. Overall, the sector proved to be relatively stable and remained on a positive track even during the recession from the previous year. This is explained by the fact that the households' consumption, which strongly influences this sector, is traditionally smoother compared to exports or investments. Thus, despite the economic recession of 2012, remittances and real wages remained robust, which fuelled the domestic trade and services. The rigidity is mostly observed for wages in public institutions, which have an important share in total employment (21.5% in 2012).

The upward trend in foreign trade has triggered an increase in the volume of goods' transportation by 14.7% in first half of 2013, with a decelerating growth rate in Q2:2013 (+10.7%). This deceleration has been determined by the tempering of economic activity in Russia and still difficult and uncertain economic conditions in EU.

Constructions. In Q1:2013 construction showed a notable progress, with output increasing by 9.4% and value added - by 10.5%, y-o-y. The main reason is related to the revival in the investment activity: total investments posted a 4.5% y-o-y growth during the first quarter of 2013 year. Investments financed from public money registered the strongest growth (+97.2% y-o-y in Q1:2013), being followed by those financed from foreign sources (+45.7% in Q1:2013). The growth in investments financed from public money is explained by several important infrastructural projects, mostly in road rehabilitation. It also explains the rising share of engineering works (39.4% in 2012 compared to 31.5% in 2008), which bodes well for a healthy economic development in the long-run.

Short-term forecast and challenges

- The compensatory growth in agriculture, coupled with a fledgling growth in consumption will serve as the main driving forces of the economic growth for 2013-2014. Until the end of the current year, we expect the GDP to hover at around 4.0%-4.4%, which is in line with the estimates of public authorities and international community. Nevertheless, this growth will remain jobless and hardly enough for tapping the economy's potential. The weaknesses related to the GDP structure represent a major risk for the long-term growth, which is likely to remain low unless structural improvements will take place. The main challenges are related to the strong vulnerability to external shocks, as well as climate anomalies due to the poor technological absorption in agriculture.
- The recovery from agriculture expected for 2013 year will not solve the underlying problems of the sector: excessive land fragmentation, which undermines the economies of scale, poor technological endowment and, the resulting, sensitivity to climate conditions. Frequent and large oscillations in crop production challenges the long-term growth of this sector. A more dynamic evolution is registered by the animal production, which is determined by the growth of pork and poultry. However there are risks for livestock related to the volatility of crop production.
- The spectacular growth of wheat supply, both at the domestic and regional level, coupled with poor access to foreign outlets, could cause problems for local producers. We anticipate that, during this year, the average price for wheat will be approximately 2.0 MDL/kg. Grains selling on foreign markets will not provide large benefits, as in 2013 the world price of wheat will decline by approximately 9.1%. In these circumstances, it is possible that farmers will incur losses. Additionally, this market segment is constrained at least by two major factors. Firstly, the small number of companies that collect wheat for export which also have a strong bargaining power compared to small farmers, caused by their solitary activity, are signs of possible oligopoly situations on market.

Maintaining their profit margins while international prices are falling could cause collectors companies to purchase wheat from domestic producers at lower prices; secondly, the underdeveloped storage infrastructure is causing difficulties for storing wheat. Cereal producers perform spot transaction and could not benefit from future advantageous prices.

- Until the end of 2013, the industrial sector will record a 5%-6% y-o-y growth, which is likely to decelerate in 2014 to 4%-5%. The sector could benefit from the growth in services, especially in constructions. Meanwhile, EU economic instability and slowing growth in Russia could hamper exports, which would challenge the development prospects of the industrial sector.
- Moderate advance of service sector is expected in 2013, especially taking into account the positive evolution of constructions in Q1:2013 and the gradual increase in the share of engineering works. Still, the issues related to the quality of constructions works still persist, which undermine the positive spillovers of the large investments into the road infrastructure.

Policy recommendations

- The fact that the economic recovery for 2013-2014 will largely be fuelled by consumption, reveals the persistence of the same growth model led by remittances and consumption which is covered from imports. Thus, the domestic supply remains weak, being hampered by business climate constraints, strong non-tariff barriers, scarce investments, which boils down to the issue of competitiveness. Hence, it is necessary to improve the business environment through assumed and coordinated actions from line ministries and other public authorities. The main emphasis should be put on the facilitation of cross-border trade, improving the fiscal and customs' administration, elimination of bureaucratic barriers for obtaining various licenses, protection of property rights, ensuring a proper and efficient activity of main regulatory agencies and transparency of public institutions.
- The purpose of competitiveness enhancement is even more acute given the upcoming Deep and Comprehensive Free Trade Agreement with EU. Thus, in order to explore its advantages, Moldovan economy and its institutions should modernize and adjust to the EU and international standards. A special attention should be placed on developing the industrial sector, which could help the labour force to rapidly migrate from some agricultural sectors, which will prove uncompetitive once DCFTA will be implemented.
- Considering the fact that the in many cases the quality of construction works proved to be deficient and to undermine the positive spillover effects of these investments, it is necessary to ensure a more competitive tendering processes and enhance the quality audit of these works. It is also necessary to strengthen the transparency of tendering processes for such project, ensure a free and non-preferential treatment for each participant and establish a clear monitoring mechanism and accountability mechanism.
- The estimations show that in order to increase the price of wheat up to comfortable levels for farmers, the Government could be forced to withdrawn significant amounts of cereals from the market (Table 2). This policy option is hardly feasible, given the limited storage capacities and the fact that additional public money for this purpose were not planned in the state budget law. The Government should rather concentrate on facilitating the access of farmers to foreign outlets, increase the competition on the market of agricultural intermediaries and mitigate the information asymmetry between the agricultural producers and the market.

Table 2. Necessary amounts of grains to be withdrawn from the market in order to increase the price

Needed amount of grains to be withdrawn from the market in order to increase the price, thousand tons	Increase in wheat price, %
154.2	5
279.7	10
540.9	25

Source: EXPERT-GRUP estimations;

■ Chapter 3. Domestic Demand

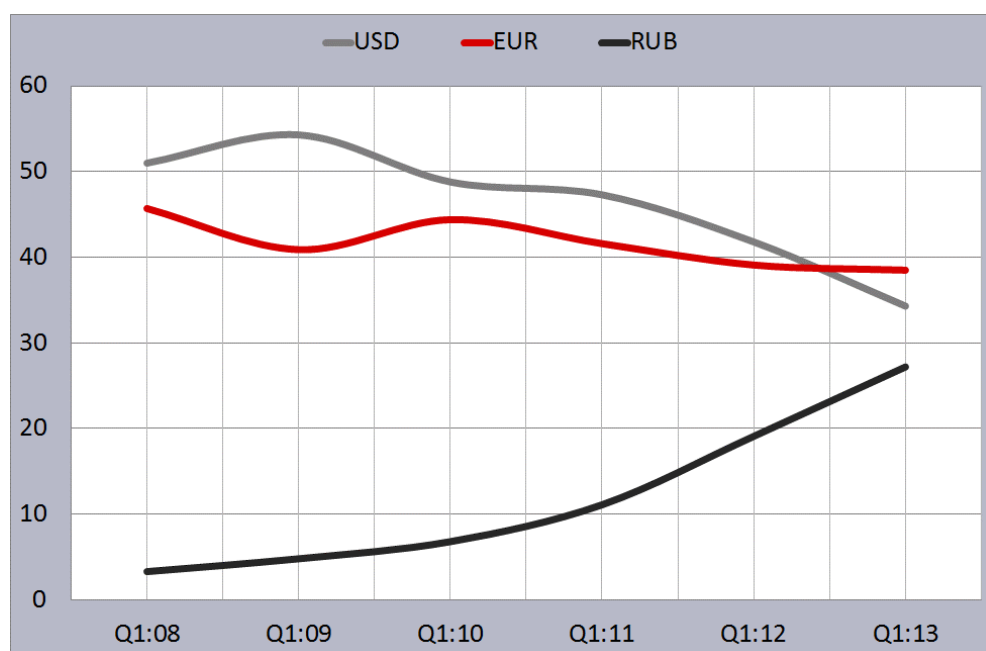
Consumption remains the main driver of the Moldovan economy

The economic recovery registered in Q1:13 was mainly driven by the households' consumption, which increased by 3.7%, y-o-y. While the average salary in May 2013 was 3758.5 lei, up 7.7% from May 2012, the total disposable household income in Q1:13 constituted only 1559.8 lei, in a small increase of 3.9% in real terms, y-o-y. Higher incomes led to the increase in the balance of retail deposits by 6.7% y-o-y, up to 27189.5 mil. lei during the first half of the current year. However, the current growth lacks a sound foundation and is cyclically observed during the previous years.

Salaries remained the main income source of the population, with a share of 42.5% in Q1:13, being by 1.4 p.p. lower compared to Q1:12. On the reverse, the share of social benefits for the population increased by 1 p.p. up to 19.4%, revealing the lagged social repercussion of the economic recession from the previous year. Remittances remained an important income source for the population, accounting on average 16.6% of the households' baskets. While comparing the disposable incomes in rural and urban areas, one could notice an important gap, both in terms of amount and structure. Urban households earn by 1.7 times more than rural families, mostly in salaries. Rural households heavily rely on incomes generated by individual agricultural activities (up to 19.3% of the overall disposable incomes) and on remittances (up to 21.0%). Both sources are challenging, as agricultural activities are very volatile and vulnerable to climate shocks, whereas remittances are not evenly distributed and are not sustainable in the long run.

Remittances play a crucial role in the development of the domestic economy. For January – May 2013, transfers from abroad in favor of natural persons represented 583.96 mil. USD, being on rise by 10.6% y-o-y, which fueled to a large extent the consumption. The rural population compared to urban is dependent to a greater extent on remittances, which constituted in Q1:13 about 21.0% of total revenues compared to 13.0% for the urban population. It is worth mentioning that the remittances from the Russian Federation continue to hold the leader share in total transfers from abroad, visibly increasing over the last years, on the grounds of worsening economic conditions in EU (Chart 2).

Chart 2. The share evolution of money transfers from abroad to natural persons via banking system, expressed in main USD, EUR and RUB, 2008 – 2013, %



Source: NBM;

Most of these remittances are consumed, while the propensity of population to save remained low, meaning that only a small portion of these inflows are directed into bank deposits. Moreover, the deficiencies marked in the banking sector in the recent past undermined further people's trust in banks.

Household's consumption patterns did not change in Q1:13, compared to previous periods. The average monthly consumption was 1656.1 lei per person, by 9.6% higher compared to same period of 2012. In real terms, households expenses rose by 5.0%, whereas the revenues – by only 3.9% y-o-y. It is explained by the traditional under-reporting of population's earnings, as well as by the difficult economic conditions, which made the household to consume more than they could afford, undermining the propensity to save.

The largest share of households' budget is allocated for foodstuffs, on average amounting to 43.4% in Q1:13 and only 6.7% is dedicated to health and 0.8% to education. On average, urban households expensed 1.4 times more than those in rural areas, pointing on the large gap in wellbeing between villages and cities. Household's maintenance costs were on rise during the last four years, in particular for urban households, partially reflecting the rising costs for heating and other commodities.

Short-term Forecasts and Challenges

- Consumption will remain the key driving force of the economic growth, at least in 2013 and 2014. Until the end of the current year, we expect total consumption expenditures to grow by 4.0%-4.5%, with the largest contribution from the private consumption of households (4.5% - 4.5%).
- In short-run, no structural changes should be expected in domestic demand, considering the fact that high poverty and instability makes the average Moldovans' to remain focused on fulfilling their primary needs (food and safety), standing as the first and second pillars of the Maslow Pyramid.
- Expenditures for household and maintenance seem to have reached a rather stable trend after two years of robust growth. This trend should continue in medium and long run, as we don't expect a substantial diversification of energy sources in the future.
- As economic conditions improve, although modestly, in the European Union, officially recorded remittances to Moldova are expected to keep up with the named growth. Despite the projected slowdown in Russia, still high oil price should continue to support Russian economy and implicitly the remittance outflows. Thus, the overall remittances are expected to grow during this year, as well as the next year, which will continue sustaining domestic consumption.

Policy Recommendations

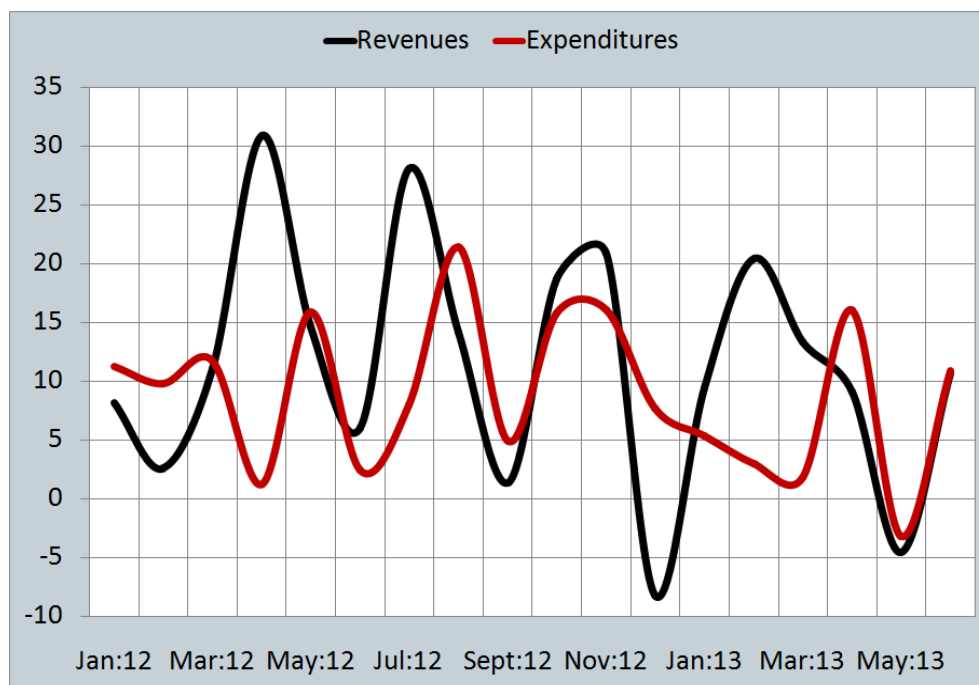
- Reforms to improving domestic demand should focus on refining competition enhancing framework conditions for investment and innovation in Moldova's domestic sector. This includes improving innovation support and promoting R&D.
- In our view, Moldovans are consuming much and producing little and inefficiently. This model is unsustainable without proper sources of value generation. Since material well being is largely based on remittances, the sustainability of the current growth model is questionable, as it doesn't solve social exclusion issue and don't create enough economic opportunities.
- We should consider taking further steps to boost domestic sources of growth. The started structural reforms should accelerate in order to increase our growth potential and create more decent jobs.

■ Chapter 4. Public Finances

Public finances mirroring the economic recovery

In the first half of 2013, the revenues of the national public budget were characterized by positive development, except for May, when they slightly decreased by 2.7% y-o-y. In Q1:2013 the revenues increased faster than the expenditures; in Q2:2013 the situation turned opposite and only in June the growth rates balanced (Chart 3). The revenues were "pulled down" under the impact of some temporary factors, but at the same time, the systemic risks continue to glide over the public finance.

Chart 3. Revenues and expenditures of the national public budget, y-o-y growth, %

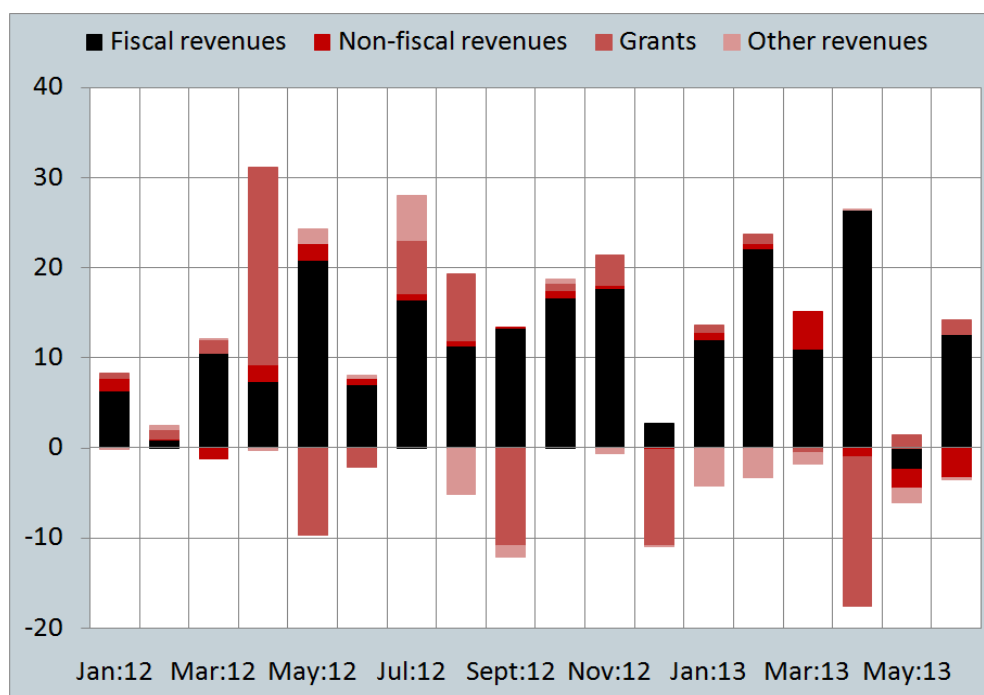


Source: Ministry of Finance and Expert-Grup calculations;

The tax collections, which account for about 90% of the public revenues, had the steadiest development in the first half of 2013 compared to other components of the public budget, having contributed the most to the increase. The following factors influenced the growth of tax revenues: economic development, increase of some taxes and depreciation of the national currency. During the same period of time, the paid services provided by public entities declined, which negatively influenced the budget outcomes. Lower revenues in Q2:2013 were mainly determined by the reduction of grants and non-tax revenues. The grant volumes shrank in March and April. These developments were caused by the political crisis in Chisinau. Foreign donors reduced the amount of funding because of the lack of clarity related to the future Government. In May, once the new Government was voted and premises for a stable operation of Government agencies were in place, the amount of grant funds increased suddenly and kept growing in June as well.

The non-fiscal revenues decreased because of two components: "Other revenues from entrepreneurship activity and property" and "Administrative charges and fees". Lower revenues from entrepreneurial activity and property could be explained by the quality issues related to the management of state-owned entities or companies where the Government has a participation. It worsens the financial results of these units and, in its turn, reduced the transfers of net profit and dividends related to the participation share. The decrease of administrative charges and fees is determined by the lower collections from some local taxes. This phenomenon points to deficiencies in fiscal management at the local level.

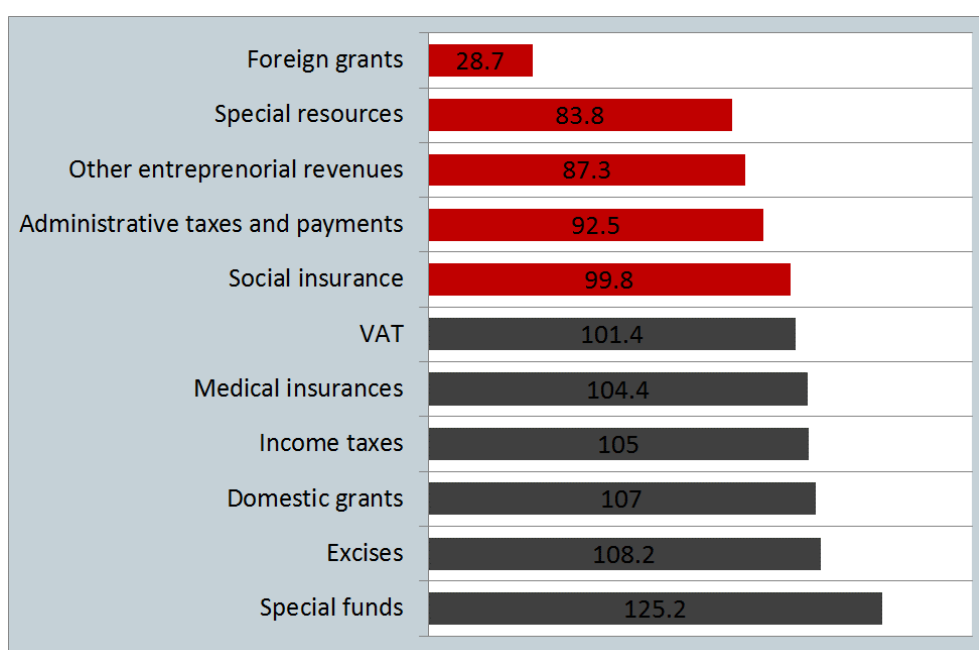
Chart 4. Contributions to the increase of national public budget revenues, %



Source: Ministry of Finance and Expert-Grup calculations;

The negative dynamics of several budget components induced the failure to fulfill the planned budget collection for the first semester of 2013. The revenues from public entities' special means, grants, other revenues from entrepreneurial activity and property, administrative charges and fees were all under the planned amounts, while most of tax revenues over-performed compared to the planned levels. At the same time, this result reveals inefficient planning and forecasting skills of the public sector institutions that are related to budget planning (Chart 5).

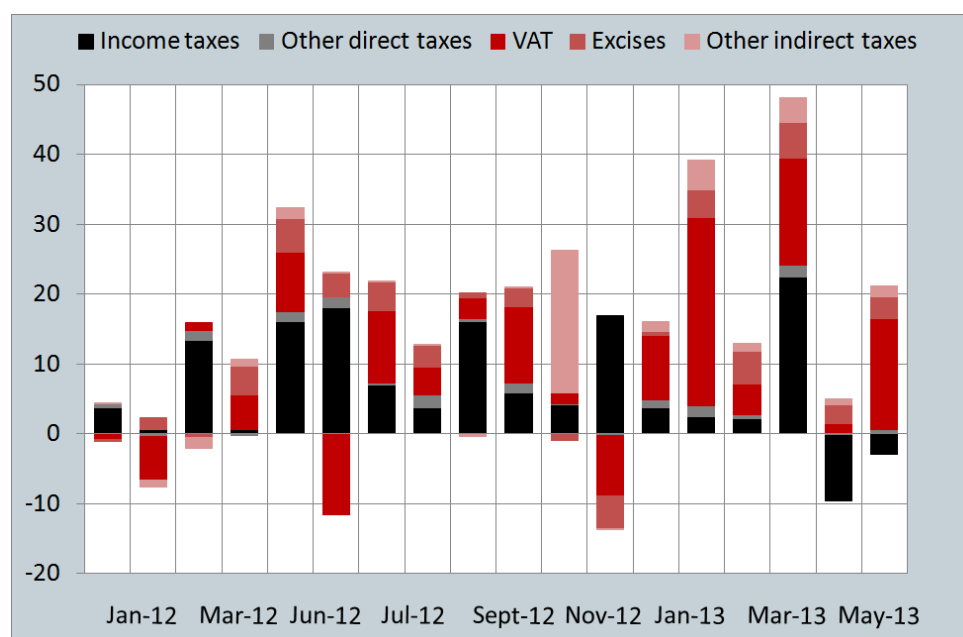
Chart 5. Fulfillment of the collection plan for budget revenues in semester I of 2013, %



Source: Ministry of Finance and Expert-Grup calculations;

The reintroduction of the corporate tax in 2012 strengthened the public finance. Thus, the income tax became one of the biggest components that contribute to the augmentation of fiscal revenues, competing with the VAT in this respect (Chart 6).

Chart 6. Contribution to the increase of fiscal revenues y-o-y, %



Source: Ministry of Finance and Expert-Grup calculations;

On the other hand, the strategy of financing the domestic public debt, which accounts for 30% of the overall public debt, only form short or medium term loans reveals that the Government has limited sources for current needs. This is also confirmed by the structural changes in the external public debt. Since 2012, the public authorities from the Republic of Moldova started to attract medium and short-term credits from abroad, reducing the share of long-term foreign loans. If, traditionally, about 70% of the public debt, consisted of long-term loans, currently their share shrank to 54.1%. Short-term credits were contracted from abroad in late 2012 in order to cover the budget deficit. The contraction of long-term loans in parallel with the moderate development of capital expenses can reduce the funding basis for some long-term investment projects. After the 2009 crisis the capital expenses had a positive dynamic, but they are still recovering. Even after a 3-year increase, the share of capital expenses in the GDP and their value in real terms is below the 2008 level.

Table 3. Evolution of capital expenditures

	2005	2006	2007	2008	2009	2010	2011	2012
Capital expenditures in current prices, MDL million	2334.6	3515.7	4055.6	4418.4	3051.8	3459.6	4321.5	5553.1
Capital expenditures in constant prices, MDL million (2000=100)	1042.9	1186.2	1209.8	1149.1	695.6	702.8	832.9	987.4
Capital expenditures - share in GDP, %	6.2	7.9	7.6	7	5.1	4.8	5.2	6.3

Source: Ministry of Finance and Expert-Grup calculations;

Short-term Challenges and Forecast

- Due to high economic risks encountered by EU and Russia, the revenues remitted to the Republic of Moldova could temperate, which in turn could reduce the imports and, thus, have a negative impact on collection from VAT, excises and custom duties.
- The political crisis from the beginning of this year undermined the foreign grants disbursements and most likely, the volume of this type of funding by the end of the year will not exceed the last year's level. A better fiscal management at the local level could enhance the execution of the plan related to the collection of administrative charges and fees.
- An underlying cause of the deficient public funds management is the poor quality forecasts, both on revenue and expenditure sides. However, the rigid payment procedure in the public sector is another factor that leads to the failure to implement the expenses plans. The low flexibility of expenses is caused by the fact that spending over MDL 50,000 from the local budgets shall be approved by a local council decision and this procedure can be quite lengthy; the inability to transfer the spending to another expenditure line if the money was planned for another category of expenses; the low autonomy of budget institutions in the use of public funds.
- A potential procurement of wheat from farmers based on forward contracts will need additional budget expenses of at least MDL 300 million (this amount could be much higher if it was necessary to buy more than 150 thousand tons of wheat). This possible Government intervention puts additional pressure on the budget, being necessary to identify additional funding sources.

Policy Recommendations

- Budget sustainability can be ensured by reforms that would downsize the public sector and enhance its efficiency. An important direction in the public sector reform consists in continuing the implementation of an efficiency-based employee remuneration system, which must be extended over all budgetary organizations. As well, a new regulation is needed to provide more flexibility to budgetary institutions in terms of managing their financial sources.
- In case of Moldova, there are limited possibilities to stimulate the growth by expanding public expenses and, on the contrary, the strong dependence of the economy on remittances makes budgetary stability extremely fragile. On the other hand, the low level of public debt ensures a certain room for maneuver, which would imply tapping for long-term loans. In this context, it would be appropriate to stop contracting foreign credits for purposes of funding the current needs. The foreign loans should be taken only for the long-term activities and should be used for investment projects. At the same time, it is necessary to establish a system to monitor the use of public funds in order to avoid unjustified expenditures.
- The preferential VAT regime for farmers (paying to the budget only 40% of the accrued VAT related to the delivery, the remaining 60% of the VAT remains with the business entity) creates good premises for fiscal evasion. There are cases when business entities enter into fictitious transactions in order to obtain benefits from this taxation regime. In this context, more consistent monitoring of business entities' transactions is needed, along with mechanisms for the prevention of such schemes.

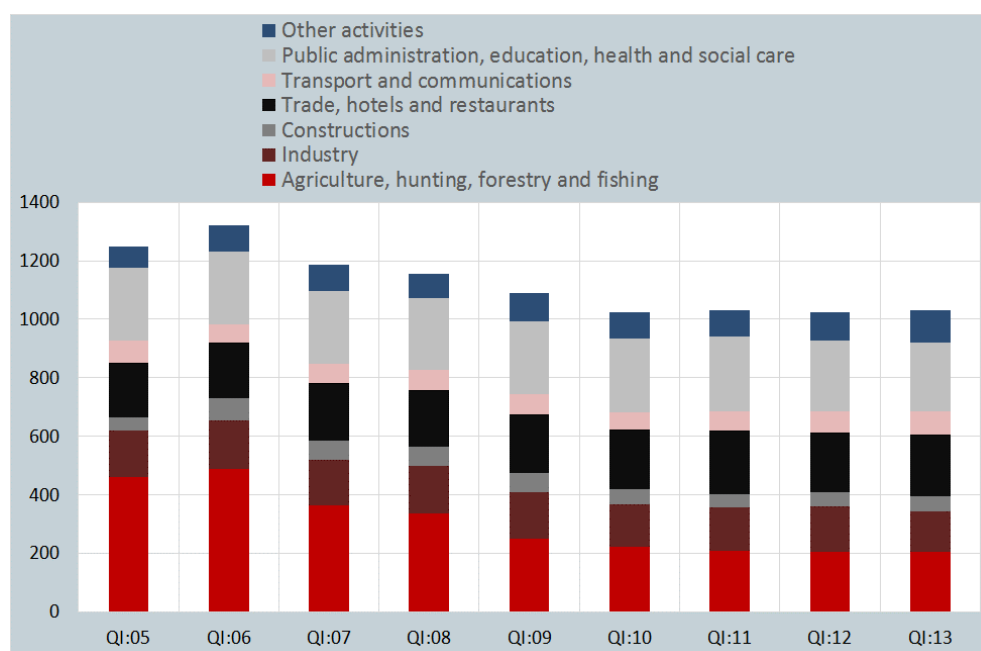
■ Chapter 5. Labour Market

The repercussions of a jobless recession

The labor market is on a spotlight these days, however the same struggling issues continue to persist: high underemployment rate, low job opportunities especially in the rural areas, high level of informal employment and increasing unemployment rate. The named factors foster citizens' emigration looking for a decent job abroad and trying to financially secure their families and children left behind. The labor market key indicators continue to register negative trends particularly the employment in the industrial sector which fell by 9.5% during the first quarter of 2013. On a positive side, the recent opening of two important industrial parks should contribute to the creation of new job opportunities. Additionally, the prospective signing of the DCFTA and Association Agreement with EU, together with the visa liberalization regime could boost the trade, transportation and communications sectors.

As a result of the lagged effect of the economic recession of 2012, the share of employment fell from 92.8% in Q1:12 to 91.9% in Q1:13, while the share of unemployed rose from 7.2% to 8.1%. These facts actually show a rather worrying situation, revealing a jobless recovery, taking place in 2013. The labour market indicators send mixed results, with a negative trend being attested in agricultural activities and a positive one – in non-agricultural activities. The employment in the agricultural sector continued to decline in Q1:13 and showed 19.9% of total employed, decreasing by 1.4 p.p. compared to Q1:12. The same decreasing trend was registered in the industrial sector: 13.5% of people were employed in industry (15.0% in 2012). On a positive side, the employment in the constructions' sector increased to 5.0% (4.7% in 2012), while the services sector has enabled 61.7% of total employment (60.1% in Q1:12). These disparities between the underperformance of the tradable sectors (agriculture and industry) on one side and positive performance of the non-tradable sectors (construction and services) reveals the specifics of the traditional consumption-led economic growth. At the same time, this poor performance of the tradable sectors undermines the export opportunities and complicates the switch to a new model of economic development: based on exports and investments.

Chart 7. Employed population by sectors of domestic economy, thousand persons



Source: EXPERT-GRUP calculations based on NBS data

The core determinant of the employment decline in agriculture seems to be the significant emigration of rural population, especially from the Southern region of the country. This phenomenon persisted over the last years, as the population density continued to shrink and the number of rayons with the smallest density of up to 74,9 people/km² increased from 7 in 2005 up to 9 in 2012.

The decreasing employment in industry was primarily driven by the food and beverages industry and more particularly by the manufacture of vegetable and animal oils, where the number of people employed declined by 90,2% and fats and mineral water and soft drinks (-11.1%). Other problematic sectors were the production of medical equipment, precision and optical instruments (-57.4%), production of radios, television and communication (-25.3%), production of leather, leather products and footwear (-17.4%) and wood and wood articles (-17.2%). These decreasing trends in employment create large opportunity costs for the economy, due to forgone public revenues from income and payroll taxes.

The goods sector's contribution to gross domestic product in Q1:13 was 19.2%, which is mainly due to the low productivity and the use of outdated technologies. Besides institutional issues, there persist certain negative factors affecting the industry itself. Among them might be mentioned:

- Worn out technological equipment (75-80%), which leads to lower quality;
- Intensive equipment that reduces competitiveness, generating excessive consumption of resources (energy, labor, raw material) which cannot enhance economic progress;
- Outdated technologies that do not face competition;
- Inadequate management in certain cases;
- Low investment in refurbishment and renovation;
- Low use of information technologies;

The informal sector experienced a significant growth and employed 12.0% (10,6% in Q1:12) of total employment in the economy, and 24.8% had an informal job. Informally employed workers constituted 25.4%, while 8.2% of all employees had an informal job. This is a worrying trend since it means lost tax revenues from businesses operating in the shadow market, funds that could be used for improving the public infrastructure. Additionally, the social security network loses funding, thereby hindering future economic growth prospects.

In Q1:13 the unemployment rate equaled 8.1%, being by 0.9 p.p. higher than in Q1:12, with the highest rate being registered for men (10.2%, compared to 6.0% for women). For the first five months of the current year, the total number of registered unemployed at the National Employment Agency was 22 107 people, out of which 43% were aged between 30 – 49 years.

Interestingly enough, the growth in unemployment rate was paralleled with an increase in vacancy rate. Thus, the number of new vacancies opened at the National Employment Agency in in June 2013 constituted 7 548 vacancies with 307 more than in the previous period. Out of them, about 71% represent vacancies for people with general secondary and vocational secondary education. Usually, employers struggle in finding the appropriate workers with such educational background, which points on the deficiencies of the Moldovan vocational education and training system and its poor correlation with economy's needs.

Short-term Forecasts and Challenges

- In the short- and medium-term, the employment in the agricultural sector is expected to follow a moderate decrease given the structural problems, as well as persistently unstable weather conditions. The employment in the industrial sector may experience a moderate positive trend considering the last developments in the industrial sector including the recent opening of two industrial parks. Employment in the constructions sector is projected to stabilize given the relatively stable demand for housing and renting spaces. Employment in service sector may follow a relatively stable positive trend with no major changes for both 2013 and 2014, however the prospective signing of the DCFTA and Association Agreement with EU, as well as the visa liberalization regime could boost the trade, transportation and communications sectors with spillovers for employment.

Policy Recommendations

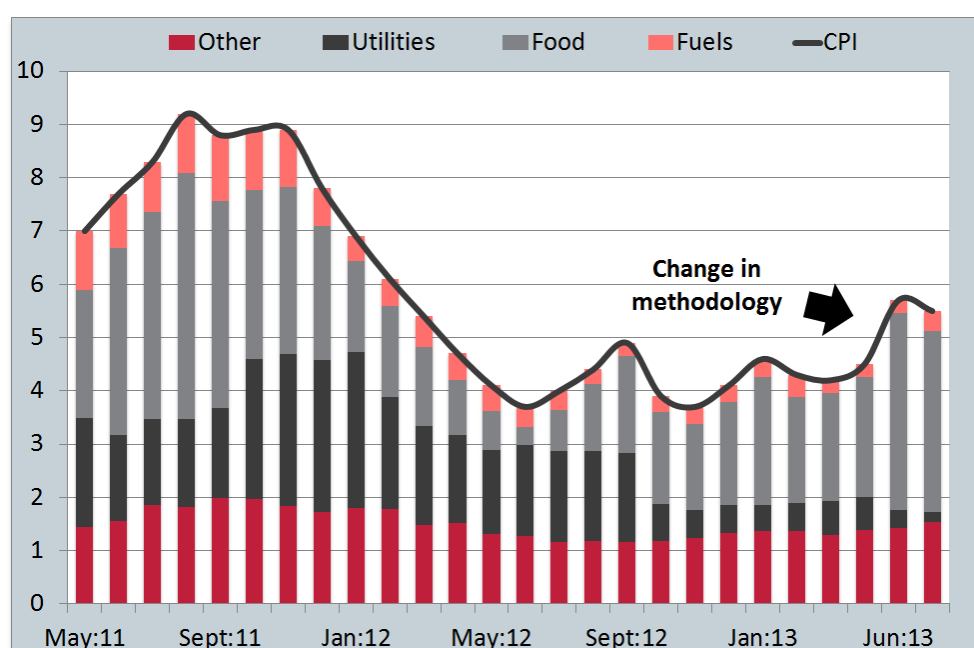
- The expansion of underemployment during the analyzed period denotes a series of deficiencies in employment and labor utilization in the economy, i.e. how well the labor force is being utilized in terms of skills, experience and availability to work. It means that there is a growth in the number of employees with overqualified background relative to their jobs and of those working part-time, but would prefer to work full-time. Consequently, it creates strong pull factors for migration of qualified workforce, fueling the brain drain phenomenon. This is particularly acute for the rural population where the unemployment is the highest. In this respect, although the Decent Work Country Program (DWCP) for 2012-2015 is in place, as well as 'Moldova 2020' and 'Rethink Moldova', together with other important documents, the expected outcomes of the named strategies are still under way and in short-term the changes are not yet observed. Thus, the creation and opening of new decent jobs especially in the rural area is of utmost importance in short term as well as in long term. At the same time, the national educational system should become more flexible and better correlated with the economy's needs.
- The informal sector remains a significant concern, leading to lost tax revenues from businesses operating in the shadow market. Especially considering that this lost tax revenue is extremely detrimental to communities, as lower funds are available for investments in infrastructure and this is particularly acute in the rural area. Additionally, the social security network loses funding, thereby hindering future economic growth prospects. Shadow market workers may even earn less than equivalent workers in the formal economy, considering the possibility of fines and the lack of employee benefits. Furthermore, the lack of contribution to the pensions fund in the end hinders not only the worker itself, but also other current beneficiaries of pensions.
- Although in short run, the informal economy seems to have a certain positive effect on the poverty reduction, its costs on the wellbeing and welfare of the entire country are much higher. The informal employment escapes taxation and regulation, which challenges the social protection system. It also undermines tax collection, implying high tax rates on those in formal employment or poor-quality government services. It also involves unfair competition and inefficient production methods, and facilitate illegal migration. In this respect, besides the already in place regulatory framework, a higher and stronger cooperation is needed among the labor, social security and tax inspectorates, as well as a higher information exchange (e.g., linking computer files) and enforcement mechanisms for the existent regulatory framework.

■ Chapter 6. Prices and Monetary policy

What happens when the central bank's objective (price stability) correlates with the Government's objective (economic growth)?

Over the first half of 2013, the annual headline inflation continued to follow a volatile pattern, with a slight upward dynamics. Hence, in Jun:13, the consumers' price index (CPI) posted a 5.5% y-o-y growth, up from only 4.1% registered at the beginning of the current year. Despite the favorable climate conditions, the rising inflation mostly owed to foodstuffs, which in Jun:13 explained about 2/3 of the variations in annual CPI (Chart 8). This is mostly explained by a methodological change occurred in May:13, when new agricultural products with higher prices and strong seasonal fluctuations were added to the CPI basket. As a result, the annual foodstuffs inflation skyrocketed to 9.2% in Jun:13, whereas the prices for non-foodstuffs and services grew by only 4.5% and, respectively, 2.0%, y-o-y.

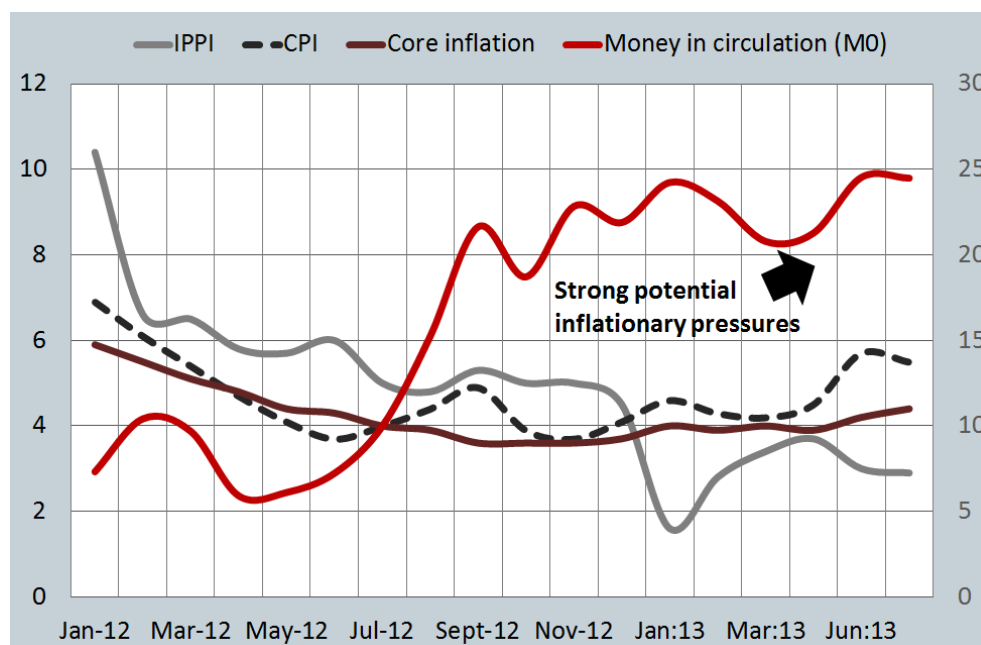
Chart 8. Main components of CPI, y-o-y growth, %



Source: NBS and Expert-Grup calculations;

Given the fact that this methodological change can be considered a one-off shock, its impact will fade away until the end of the current year. Therefore, it does not deserve the central bank's attention. At the same time, there are other worrisome tendencies, which require a proper monetary policy reaction. As the Chart 9 shows, the fledgling revival in CPI is paralleled with a robust growth in money in circulation, which in Jun:13 posted a 25% y-o-y growth. At the same time, the core inflation started to gradually recover, whereas the industrial producers' prices index showed a downfall over the last months. These trends suggest that the current inflationary pressures are explained to a certain extent by a modest growth in domestic demand, which was the main driver of the economic recovery in Q1:13. Part of this demand was fuelled by the currency depreciation during this year, which strengthened the purchasing power of households relying on remittances.

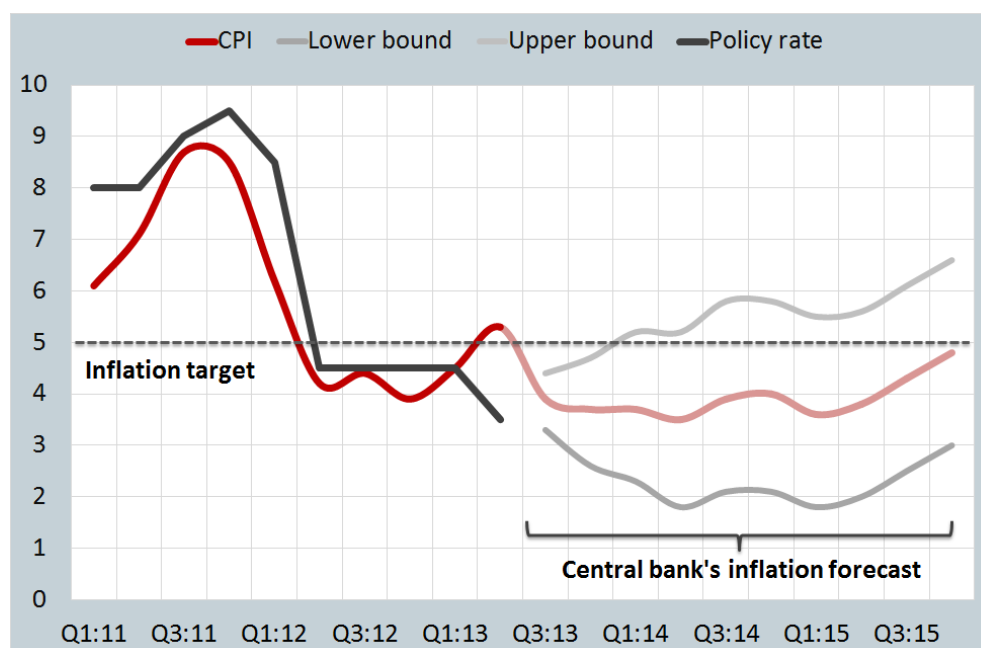
Chart 9. CPI, Industrial Producers Prices Index, core inflation and money in circulation, y-o-y growth, %



Source: NBS, NBM and Expert-Grup calculations;

Nevertheless, the healthy growth in money in circulation, paralleled with a gradual depreciation of the national currency, are not perceived by the central bank as major potential inflationary pressures. On the contrary, it maintains a very accommodative monetary policy stance by lowering the base policy rate to a new historical minimum of 3.5% in Apr:13 (Chart 10). In fact, given the officially expected headline inflation of 3.7% in 2013 and 4.0% in 2014, the NBM promotes a monetary policy of negative real rates. It is motivated by the necessity to bring the annual CPI up to the inflation target of 5% (± 1.5 p.p.) and, at the same time, fuel the economic growth by spurring lending.

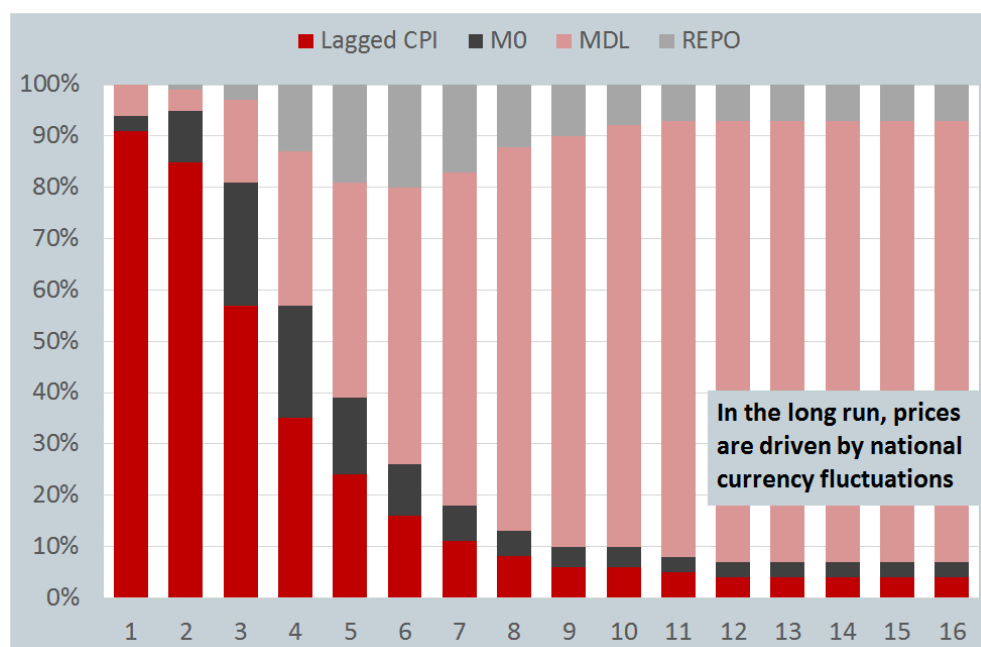
Chart 10. Central bank's main policy rate and official CPI forecast (y-o-y), %



Source: NBM;

This ultra-easy monetary policy was paralleled by a managed national currency depreciation, operated by the central bank through foreign currency purchases. As a result, in Jun:13 the Moldovan leu depreciated with respect to the US dollar by about 2.6% compared to Jan:13 and by 3.0% compared to the same period of the previous year. In fact, the central bank used these interventions on the domestic FOREX market as an alternative monetary policy tool for fighting deflationary pressures and taming the annual CPI in the proximity of the targeted interval. NBM resorted to such measures in the previous year as well, with the same purpose. The main motivation behind such unorthodox monetary policy instruments for an institution, which adopted inflation targeting, is the more efficient transmission mechanism, compared to the base rate manipulations. Our estimations denote that the national currency fluctuations have a much stronger and long lasting effect compared to REPO rate. The Chart 11 clearly shows that after the 4th quarter when the depreciation occurred, it becomes the most important inflationary factor, visibly outpacing the Repo rate, money in circulation and lagged CPI.

Chart 11. The estimated² importance of the main inflationary factors on the Consumer Price Index, % of variations explained (vertical axis), quarters (horizontal axis)



Source: Expert-Grup calculations;

Such an accommodative monetary policy stance, coupled with managed depreciation of the national currency, points, also, on the convergence between the central bank's objective of price stability with the government's objective of economic growth. Indeed, a policy of negative real rates supports lending, which in its turn, fuels investments and consumption, giving a fillip to the economic growth. Additionally, the depreciation of the national currency offers a certain price advantage for the Moldovan exporters, inflates the tax collections to the public purse from imported goods and fuels the current account deficit. However, how sustainable such a policy could be and what are its medium and long-term risks?

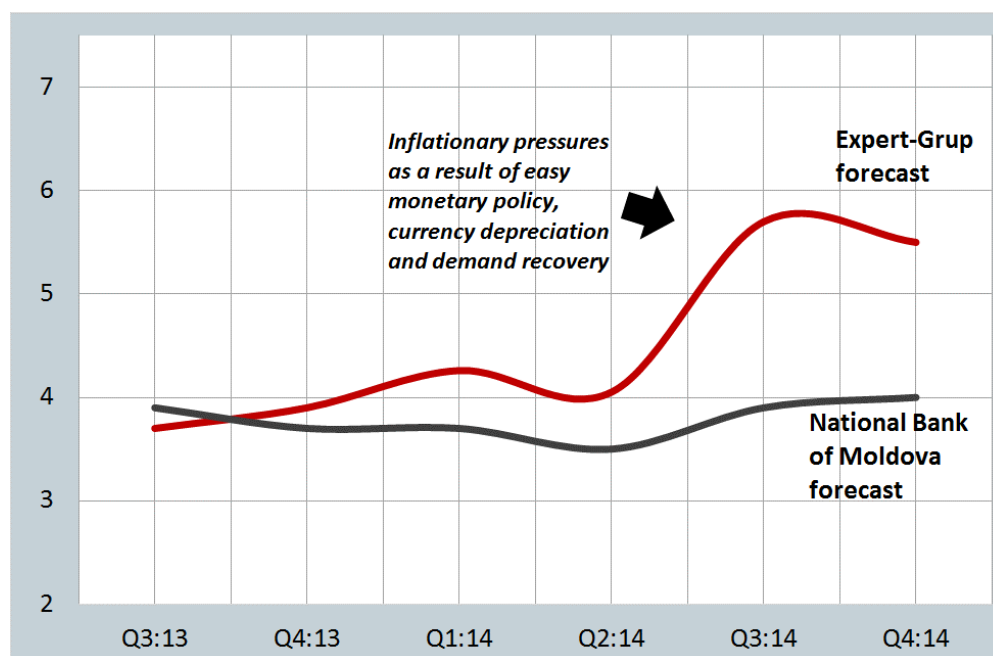
Short-term Forecasts and Challenges

- As a result of easy monetary policy, currency depreciation and economic recovery, the demand-side inflationary pressures will become much more visible in 2013-2014, compared to the previous year. We expect the annual CPI to stabilize at 3.8% at the end of 2013, before increasing to 5.5% at the

²The estimation is based on the Forecasted Error Variance Decomposition, derived from a structural vector autoregressive (SVAR) model, with 4 lags, built on a quarterly frequency. Please contact the authors for more methodological details.

end of 2014. Thus, our mid-term forecasted headline inflation hovers at the upper bound of the central bank's target, contrary to the official estimates, which argue that the annual CPI will remain close to the lower-bound of the target (Chart 12). In any case, the inflation level will hover within the targeted interval of 5% (± 1.5 p.p.), which can be considered an important achievement for the monetary authority and its inflation targeting strategy applied since 2010.

Chart 12. Compared forecasts of Consumer Price Index (y-o-y, %), Expert-Grup and the National Bank of Moldova



Source: NBM and Expert-Grup calculations;

- Favorable climate conditions of this year at the domestic and regional level, coupled with limited export opportunities for Moldovan agricultural workers, will pose deflationary pressures on foodstuffs. Particularly, it is related to fruits and vegetables and, especially, wheat. It could hamper the profitability of many small producers, as most of them do not have access to export infrastructure and are forced to sell at relatively low prices to a few number of intermediaries with stronger bargaining power. Hence, the foodstuffs inflation will stabilize until the end of this year.
- Therefore, a major challenge faced by the central bank will be to balance between the deflationary pressures on the foodstuffs market and inflationary pressures as a result of expected demand recovery, supported by lending, remittances and domestic incomes. Moreover, NBM exhausted its area of policy manoeuvres. Thus, the REPO rate is already below the expected inflation and the continuation of interventions on the domestic FOREX market could become dangerous once summer season ends, as the national currency could face depreciation pressures amid rising energy imports. Given these constraints, the central bank most likely could consider a gradual withdrawal of the accommodative stance of its monetary policy. It could imply raising the base policy rate at least to 4% during the next 2-3 quarters.

Policy recommendations

- The easy monetary policy may help the economy recover faster and manage the deflationary risks. However, it may cause even stronger damages in the long-run by letting the inflation spiral out of control, with harsh economic and social consequences. These risks should be carefully considered by the central bank, given the strong growth in money in circulation and the expected economic recovery for 2013-2014. Therefore, we suggest the policy rate to be gradually increased at least to

1.0-1.5 p.p. above the expected inflation, meaning that it should be raised at about 5.5%-6.0% until the end of 2014, unless negative economic shocks will occur.

- The deflationary pressures coming from foodstuffs should rather be the primary reason of concern for the Government and not the central bank. The reason is that these pressures will fade away already during the next year, as they are rather related to some structural issues faced by the Moldovan agriculture. Particularly, this situation is caused by limited export opportunities of small farmers, persistent oligopolies on the market of agricultural intermediaries, which can buy at low prices from farmers and sell abroad at high profit margins, lack of commodity trading instruments (e.g. forward contracts, swaps) and limited storing capacities of agricultural producers. Hence, the right policy actions should target these specific issues, whereas the monetary policy should be rather focused on anchoring the demand-side inflationary pressures.
- The managed floating currency regime followed by the central bank is generally appropriate for such a small economy as that of Moldova, where the transactions of a small number of economic agents could cause strong currency fluctuations. Nevertheless, the policy of managed depreciation of the national currency, used by NBM in 2012-2013 as an alternative monetary policy tool, cannot be a sustainable policy in the long-run and implies prominent long-term risks. Mainly, it is related to the heavy dependence of the Moldovan economy on imports, which become more expensive once the national currency depreciates and, hence, could hamper the inflation outlook.

■ Chapter 7. Banking Sector

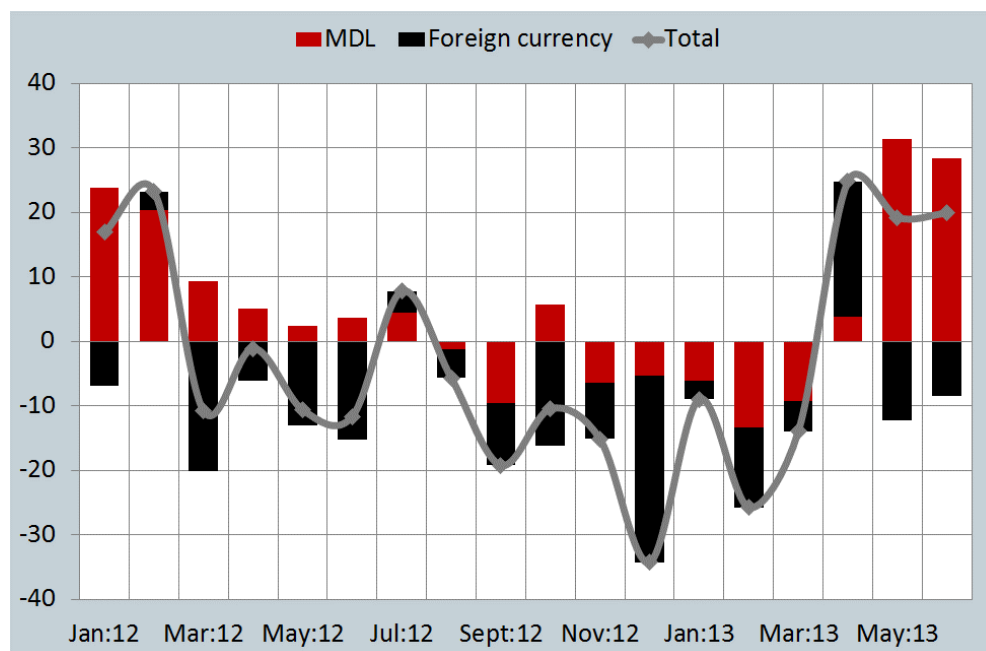
Is the banking sector a stability oasis of the national economy?

During the first half of 2012 the banking sector parameters displayed contradictory developments. After a period of shrinking crediting activity, which lasted for almost one year, between March 2012 and March 2013, in Q2:2013 the loan volume started to increase. However, this growth has been driven by lending in national currency, whereas the loans in foreign currency continued to subside. Two factors caused the loans in foreign currency to drop:

- during May-Jan:12, except for Jul:12, the imports grew at a negative rate, inducing a lower demand of business entities for foreign currency loans. Additionally, the lower volumes of foreign currency loans in May:13 and Jun:13 can be also explained by the decreasing imports (a 4.3% decrease in May:13);
- the economic uncertainty on foreign markets, coupled with a higher currency risk made banks more reluctant to issue foreign currency loans.

During Aug:12 – Mar:13, the loans in national currency also decreased. It has been caused by the recession in the second half of 2012 and the sporadic decreases of some sectors in Q1:13 (in Jan:13, the industry and transports witnessed negative growth rates, while in Mar:13 the retail trade underwent a similar pattern). Since Q2:13 the loan volumes have been increasing thanks to the higher volumes of loans in the local currency due to better economic conditions and outlook.

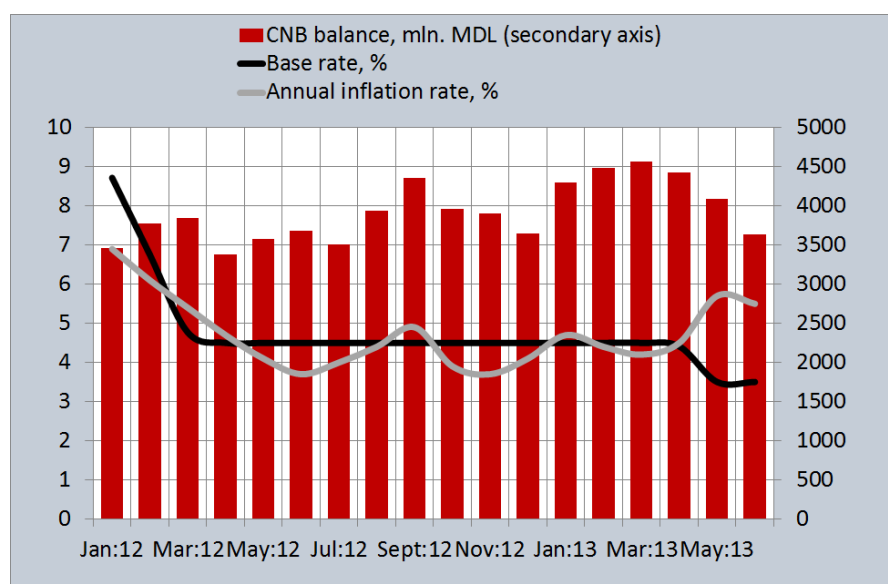
Chart 13. Annual loan growth rate, contribution of loans in the national currency and in foreign currency to the augmentation of the loan volume, %



Source: NBM and EXPERT-GRUP calculations;

Another driving factor for the increasing loan volumes in Q2:2013 was the accommodative stance of the monetary policy maintained by the central bank over the previous quarters. By reducing the base rate under the expected inflation level, the central bank diminished the attractiveness of National Bank Certificates and Treasury Bills and determined banks to direct more resources towards crediting the economy. The decrease of the base rate from 4.5% to 3.5% in Apr:13 led to a lower average daily balance of the central bank certificates in May:13 and Jun:13 (Chart 14).

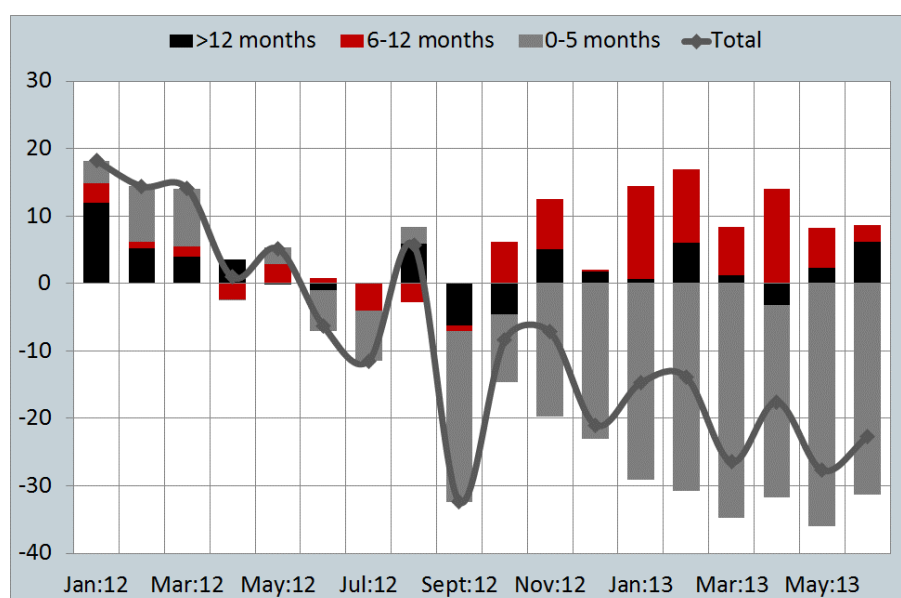
Chart 14. Development of the inflation rate, base rate and liquidity sterilization operations



Source: NBM and EXPERT-GRUP calculations;

The deposits followed a persistent downward trend since June 2012. The deposits dropped due to the decreasing deposits with a maturity of up to 6 months. At the same time, the volume of deposits with longer maturities – increased (Chart 15). It was mainly caused by shrinking households' incomes, as well as lower interest rates. The deposits maturing in up to six months have the lowest interest rates and the population either gives up on these placements or places the money on deposits with a maturity of over six months, which generate higher interest income. As a result, the growth in deposits maturing in over 6 months contributed during the first half of 2013 positively to the development of total deposits, though this dynamics hasn't compensated yet the decline in shorter-term deposits. This change in maturity structure of banks' deposits has also been determined by the business entities, which postponed their investment decisions. Finally, the issues at Banca de Economii also contributed to the decrease in total deposits. Nevertheless, so far it did not imply negative spillovers over the entire banking sector.

Chart 15. Growth contribution of various types of deposits, %

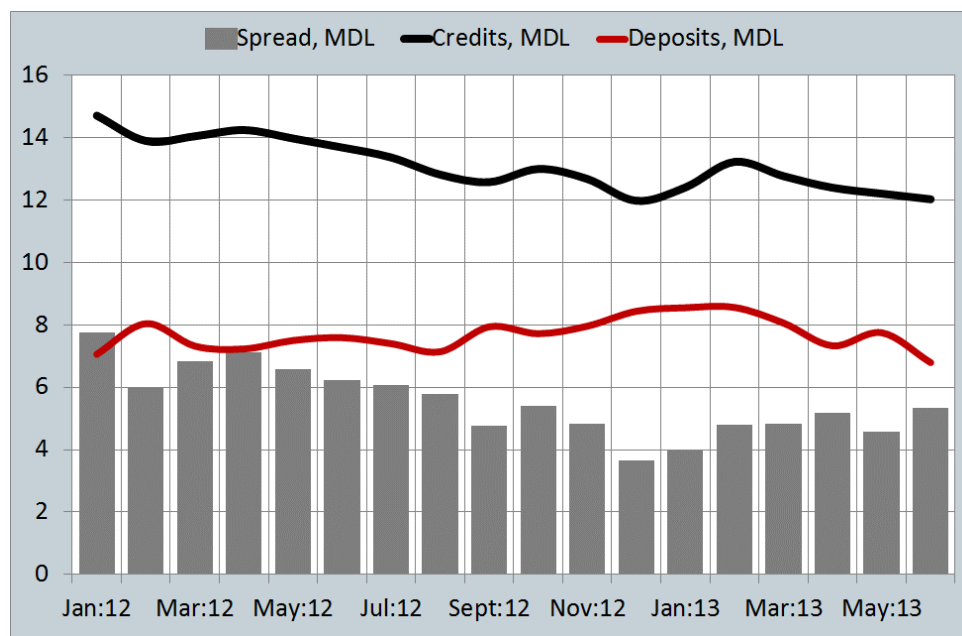


Source: NBM and EXPERT-GRUP calculations;

The bank margins for foreign currency operations underwent a lower variation compared to the margin on transactions in national currency. In the first semester of 2013, the margin related to the foreign currency operations evolved steadily in a corridor of 0.5 p.p. amplitude; in the same period of time, the margin on transactions in MDL increased by 1.4 p.p.. The augmentation of bank margin on MDL has several causes:

- shrinking volume of cheap resources (the deposits of up to six months) force the banks to delay the reduction of interest rates on loans in order to keep its profitability;
- the increasing demand for loans due to economic advance leads to a slower decrease of the interest rate on loans compared to the faster decline in the interest rate on deposits;
- keeping high margins points out to a low competition in the banking sector.

Chart 16. Bank margin on operations in MDL, %



Source: NBM and EXPERT-GRUP calculations;

Altogether, the banking sector continues to be stable, with sufficient liquidities and a good capitalization. The share of non-performing loans is decreasing in the total amount of loans; this indicator decreased from 14.5% in Dec:13 to 12.7% in Jun:13. The slight reduction of risk weighted capital adequacy ratio from 24.3% in Dec:12 to 23.3% in Jun:13 is most likely related to the increase in the amount of crediting, as loans have the highest risk weighting coefficient.

Banca de Economii is in a recovery phase: capital adequacy increased from 3.2% in Q3:12 to 10.2% in Q2:13 (the recommended level being 16%) and the share of unfavorable loans in total loans decreased slightly compared to Q4:12 - by 0.9 p.p. - accounting for about 54.5% in Q2:13. However, it is too early to state that the bank is truly making a comeback. Banca de Economii needs capitalization urgently - which is a mandatory, but not sufficient condition for the recovery of this financial institution.

Short-term Challenges and Forecast

- The economic downturn in 2012 and the unsolved issues at Banca de Economii affected the banking sector, but haven't caused its downturn. The traditional pragmatism and precaution of banks turned this sector in "an oasis of stability" in the uncertain economy of the Republic of Moldova. The high level of liquidity and good capitalization of the banks allows them withstand the unfortunate economic developments. The shocks that have been disturbing the banking sector of the Republic of Moldova for the last 3 years were determined by the inefficiency of the judiciary, poor lenders' rights, lack of cooperation and non-involvement of public institutions.

- Banca de Economii is under treatment and achieved certain progress. However, in order to ensure the bank's viability, it is necessary to increase the authorized capital.
- The change of Moldova Agroindbank (MAIB) owners remained a dark case for the public. The simultaneous procurement of MAIB share blocks by seven companies points to the likelihood of a hostile takeover. The empowered institutions must have checked whether those seven companies coordinated their actions or acted separately. The empowered institutions - General Prosecutor's Office and the National Commission of Financial Market had almost no involvement, while NBM had an expecting position and only performed a post-factum investigation, which was stopped by the decision of the law court. The downturn of BEM and obscure change of MAIB owners affected the sector's attractiveness for potential investors.

Policy Recommendations

- In the BEM case it is necessary to apply a 3-ingredient "treatment", comprised of (i) bank capitalization; (ii) strengthening the management's efficiency, and (iii) selling of the state's controlling stake to a private investor. This last measure could contribute to the enhancement of sector's investment attractiveness.
- In the short run, it is necessary to ensure the security of investments in the financial sector. In this respect, it is necessary to eliminate the vested interests and political influence on the activity of public entities and to enhance their collaboration. On the other hand, the justice reform is necessary and cannot be delayed anymore. The empowered institutions must be cautious and prevent "raider" transactions. Should a new hostile takeover occur, the attractiveness of the financial sector would be affected irrecoverably.

■ Chapter 8. Foreign Sector

Is the economic weather brightening in the region?

The global economy appears to be transitioning towards a period of more stable, but slower growth, which will have direct repercussions on the Moldovan economy. Global gross domestic product (GDP), which slowed in mid-2012 is recovering, and according to the latest World Bank forecast a modest acceleration is expected during 2013. Overall, growth in high-income countries is estimated to recover gradually, with GDP increasing by a modest 1.2% this year, but setting to 2.0 and 2.3 percent in 2014 and 2015, correspondingly³. As for the situation on the regional markets, many countries have still not recovered from the crisis. Unemployment and output gap remain high, as the banking-sector, households' consumption and fiscal restructuring have weighed down activity. Nonetheless, growth has strengthened in Lithuania, Turkey, and Ukraine. A positive development is that funding costs in core Euro Area countries have declined, and lending has started to rebound. Imports, exports, and industrial production have all returned to positive, though modest, growth.

Despite the early signs of recovery on the national level, advancement in Q2:13 indicates yet a fragile economy. Considerable gap in exports and imports led to the accumulation in Jan:13-May:13 of a trade deficit amounting to USD 1199.9 million, with 3.8 million (0.3%) more compared to the corresponding period of 2012. The European Union (EU-28) trade balance ended with a deficit of USD 507.8 million (in Jan:12-May:12 to USD 451.4 million), and the CIS countries – USD 294.8 million (in Jan:12-May:12 to USD 336.7 million). It means that Moldova consistently runs a current account deficit and is borrowing from abroad in order to finance current purchases of goods and services. This continual borrowing is not a viable long-term strategy and undermines future production. It undermines the aggregate income and respectively consumption, saving, investment, and tax revenue, which is rightfully considered to be "unfavorable" for the country. On a positive side though is the fact that in Q1:13 the coverage of imports by exports increased up to 46.9% which is the highest level recorded since 2006.

In Jan:13-May:13 exports totaled the highest value since 2005 and amounted to USD 939.2 million, in an increase by 8.9% y-o-y, owing to better economic conditions in the region. The goods exports (69.2% of total exports) registered an increase of 26.6% compared to Jan:12-May:12, whereas the re-exports of goods declined by 17.2% compared to the same period of the last year. Exports of goods to EU countries (EU-28) registered an increase of 1.2% compared to Jan:12-May:12, however their share in total exports decreased slightly and showed 45.5% (48.9% same period last year). Still the exports to the EU countries maintain their leading position compared to the exports to CIS, as the latter accounted for 40.4% (40.7% same period last year).

It is worth mentioning that, recently, Russia has simplified customs control procedure for agricultural production of Moldova, which should spur even more exports to the named destination (Russia is holding the leading position in domestic exports' destination). In this regard, at the Russian border were established five special points for the agricultural production from our country, the so-called 'green corridor'. Within these points goods will be subject to a simplified customs control and protection in order to minimize the time of making imports into the Russian Federation.

The ranking of exports did not incur changes during the analyzed period, thus: exports of manufactured items were still ranked first, accounting for 20.8% of total exports, however in a decrease by 11.8 p.p. y-o-y. In this section, same as last year significant shares held commodity exports of clothing and accessories (51.3% of total section and 10.7% of total exports) in a decrease by 10.8 p.p. y-o-y of total exports, furniture and parts thereof (21.2% of total section and 4.4% of total exports) in an increase by 2.3 p.p. y-o-y of total exports.

³ 'Global Economic Prospects', June 2013, World Bank

Exports of food and live animals were ranked second same as last year, representing 17.0% of the total value of exports, though in a decrease by 4.5 p.p. y-o-y. This section is represented mostly by the exports of fruits and vegetables (65.5% of total section and 11.1% of total exports which is lower by 4.3 p.p. y-o-y), cereals and cereal preparations (15.3% of total section and 2.6% of total exports in an increase by 0.6 p.p. y-o-y), sugar, preparations from sugar and honey (7.6% of total section and 1.3% of total exports, same as last year).

Exports of machinery and transport equipment were ranked third, holding a 16.4% share in total exports, in a decrease by 2.9 p.p. y-o-y. In this section had significant weights commodity exports of machinery and electrical equipment (63.0% of total section and 10.3% of total exports in an increase by 10.7 p.p. y-o-y), vehicles (15.0% of total section and 2.5% of total exports in an increase by 8.7 p.p. y-o-y), machinery general industrial applications (13.0% of total section and 2.1% of total exports in a decrease by 4.5 p.p. y-o-y).

In Jan:13-May:13 imports totaled the highest value since 2005 and amounted USD 2139.1 million, in an increase by 3.9% compared to the same period of 2012. Imports from EU countries (EU-28) still prevail those from CIS and continued to expand during the analyzed period and amounted to EUR 935.0 million (7.0% more than in Jan:12-May:12), with a share of 43.7% in total imports (42.4% in Jan:12-May:12). Imports of goods from CIS countries hold the second place registering a declining trend.

Looking at the ranking of imports by types of goods it may be concluded that it did not incur changes, thus on the first place were still imports of mineral fuels, lubricants and related materials which held 23.0% of total imports though in a decrease by 8 p.p. y-o-y (Chart). The attenuation of imports was mainly due to the reduction of purchases from the CIS countries by 6%. In this section, remain predominant gas and gas industrial products (48.3% of total section and 11.1% of total imports, in a decrease by 10.5 p.p. y-o-y), oil and oil products (42.8% of total section and 9.8% of total imports also in a decrease by 12.5 p.p. y-o-y), electricity (7.7% of total section and 1.8% of total imports in an increase by 80 p.p.).

On the second place are situated imports of machinery and transport equipment, which had a 20.2% share in total imports in a small decrease by 0.9 p.p. y-o-y. In this section an important share held electrical machinery (31.0% of total section and 6.3% of total imports in small increase by 1.6 p.p. y-o-y), road vehicles (23.5% of total section and 4.7% of total imports in a decrease by 9.6 p.p. y-o-y) industrial machines with general applications (14.2% of total section and 2.9% of total imports same as last year), machinery specialized for particular industries (13.0% of total section and 2.6% of total imports in a decrease by 7.1 p.p. y-o-y), telecommunications apparatus and equipment for recording and reproduction of sound and pictures (10.9% of total section and 2.2% of total imports in an increase by 22.2 p.p. y-o-y).

On the third place are found imports of manufactured goods classified mainly by material held a share of 17.0% in total imports in a decrease by 2.8 p.p. y-o-y. In this section mainly yarns, fabrics and textile articles held an important share (29.7% of total section and 5.1% of total imports in a decrease by 12 p.p. y-o-y), fabricated metal articles (13.8% of total section and 2.4% of total imports same as last year), iron and steel (13.8% of total section and 2.3% of total imports in a decrease by 4.2 p.p. y-o-y), non-metallic items (13.7% of the total section and 2.3% of total imports in an increase by 9.5 p.p. y-o-y).

FDI – the key for the modernization of the Moldovan economy

Investment contribution to GDP growth in Q1:13 was higher compared to the same period last year, in an increase by 1.0 percentage points compared to 2012, representing 2.9%, making it the most significant component share of total financial flows. It is worth mentioning though that this was due above all to a very low comparison base. This growth was supported mainly by investments from the state budget and the municipalities, but the contribution of private investors is decreasing. Direct investment flows in the analyzed period were mainly in the capital of companies accounted for 2.5 percent of GDP (0.7 p.p. above the previous year's value). Increased more than twice FDI accounted for 60.6 million USD, but this increase occurred after a fall of 50% in Q1:12 compared to the same period last year.

Open economies with skilled workforces and good growth prospects tend to attract larger amounts of foreign direct investment than closed, highly regulated economies. FDI can have a positive impact on the economy of any country which knows how and creates conditions for the investment to be channeled not only on areas of interest to investors, but especially in areas that would not exhaust internal resources but rather would strengthen and diversify. With a small open economy such as that of Moldova, any direct investment is more than beneficial. Recent studies in this area demonstrated significant positive effects of foreign companies coming in Moldova on the local process of creating jobs and increasing exports. However, despite the efforts made, Moldova continues to struggle in attracting FDI in the economy mainly due to a number of important factors, such as political instability, poor investment climate, high country risk, imperfect legislation, underdeveloped stock exchange market and poor infrastructure, and some more specific barriers such as high level of corruption at practically all levels, among others. Labour market shortages add to these constraints and are likely to continue hampering investment attractiveness in the long-term.

Moreover, internationally, Moldova is perceived as a country with a very high degree of risk, grade 5⁴, although compared to the previous period has made some improvements to the level of foreign investment protection. Compared to the EU, none of the countries has such a high degree of risk; Romania and Hungary were attributed 4th grade. Another indicator considered by foreign investors is that developed and evaluated annually by the World Bank, namely the 'Doing Business'. Of the 185 countries assessed, Moldova ranks 83⁵, a slight improvement compared to 2012 (No. 86) thanks to the improvement of the three indicators in particular, it was noted a significant increase in perceived level of investor protection, however, the remaining seven indicators showed a decline and the deepest fall was registered for the indicator of business starting attempts.

Short-term Forecasts and Challenges

- Recently, the International Monetary Fund lowered global growth forecast. Thus, it is estimated that worldwide this year will register a growth of 3.1% compared with 3.3% as previously expected. Moreover, a decline of growth is expected for the Russian Federation for this year, estimated at 2.3%. These factors should inevitably have an impact on international trade.
- Given better economic conditions in EU, higher supply of agricultural products and lower comparison base in 2013 as compared to the previous year, the total exports are expected to grow by 9%, with an acceleration to 10% in 2014. Total imports will grow by 8% until the end of the current year, and by 10% in 2014, due to the recovery in domestic demand.
- The FDI might register a slight increase more as a result of the registered relative political stability, the rather positive evaluation and developments in relation with the IMF, also the continued reforms acknowledged and positively regarded by the EU.

Policy Recommendations

- Reforms are needed on refining competition and enhancing the framework conditions for investment and innovation in Moldova's domestic economy. This includes improving innovation support, promoting R&D and investment in new technologies. Furthermore, this should diversify our exports and improve productivity. Important support for domestic producers and exporters, not only big ones, but also medium and small ones, is necessary in terms of assistance in attracting new technologies, access to cheap funds and easing the interaction with the government, especially in terms of inspections and supported costs, also interaction with customs authorities. The competitiveness remains limited by a business environment characterized by uncertainty and high transaction costs. Thus, improving the business environment, implementing the 2013-2020 Regulatory Reform Strategy, the Law "Guillotine 2+" and the new Inspections Law is an important task.

⁴ <http://www.euromoneycountryrisk.com/Home/Return/Contries/Moldova/Overview>

⁵ <http://www.doingbusiness.org/data/exploreeconomies/moldova>

■ About EXPERT-GRUP

WHO WE ARE

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

OUR ACTIVITIES

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

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

PARTNERS AND DONORS

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