

# MEGA

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## Economic perspectives in an electoral year

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### **About MEGA**

*MEGA is the English acronym for **Moldova Economic Growth Analysis**. MEGA is a biannual publication issued by EXPERT-GRUP since 2009 and has the main purposes of explaining the fundamentals of recent economic trends in Moldova, analyzing economic policies and coming up with strategic solutions for the economic development of the country.*



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## Abbreviations

|                 |                                                    |
|-----------------|----------------------------------------------------|
| AA              | Association Agreement                              |
| BATU            | Budgets of Administrative – Territorial Units      |
| CHIF            | Compulsory Health Insurance Funds                  |
| CEE EU          | Central and Eastern Europe Countries members of EU |
| CIS             | Community of Independent States                    |
| CPI             | Consumer Price Index                               |
| DCFTA           | Deep and Comprehensive Free Trade Agreement        |
| EUR             | Euro currency                                      |
| GVA             | Gross Value Added                                  |
| GS              | Government Securities                              |
| IMF             | International Monetary Fund                        |
| Jan:16 – Dec:16 | January, 2016 – December, 2016                     |
| LFPR            | Labour Force Participation Rate                    |
| LFS             | Labour Force Survey                                |
| NBC             | National Bank Certificates                         |
| NBS             | National Bureau of Statistics                      |
| NBM             | National Bank of Moldova                           |
| NCFM            | National Committee for Financial Stability         |
| NEA             | National Employment Agency                         |
| NPB             | National Public Budget                             |
| PEM             | PanEuroMed                                         |
| SB              | State Budget                                       |
| SSIB            | State Social Insurance Budget                      |
| Q1:16 – Q4:16   | Quarter 1, 2016 – Quarter 4, 2016                  |
| USD             | US dollar                                          |
| VAT             | Value Added Tax                                    |
| WTO             | World Trade Organization                           |
| y-o-y           | Year on year                                       |

## Key policy messages

**National economy is approaching an unfavorable equilibrium, marked by low growth rates.** In spite of favorable conditions (good agricultural year, re-launch of external assistance, increase in external demand and increase in remittances), the Gross Domestic Product grew by only 4.5% in 2017. This growth is not much higher than the 2016 evolution (+ 4.1%), when the situation was much more difficult, and is similar to the one projected for 2018-2019. These growth rates are below the potential levels and, given the current level of economic development, they are too low to ensure convergence in the western neighboring countries. Therefore, we find that economic growth stabilized around an unfavorable equilibrium, marked by low growth rates. These are due to two fundamental constraints: on the one hand, the population ageing trends diminish the population's propensity to consume, which affects the main engine of economic growth at present, and on the other hand, the shortage of private capital does not allow for the replacement of consumption with a more sustainable economic growth engine. As a result, the potential GDP over the last few years has seen a steady downward trend, which is expected to continue during the next years, further undermining the growth rates.

**Households' consumption, which has traditionally been the engine of economic growth, is slowing down, while no alternative sources of growth have been identified.** In 2017, the volume of retail trade and services rendered to the population declined, despite the rise in real salaries and remittances. This is explained by both temporary effects (e.g. appreciation of the national currency) and long-term factors related to the population ageing and the increase in the uncertainty level. These phenomena, which will have long-lasting effects, are obviously worrisome, as private investments continued to decline – a process that will most likely last for the next year as well. In order to exit from this equilibrium of low economic growth rates, it is necessary to stimulate private investment activity. Hence, the recent reforms aimed at enhancing the business climate should be complemented with active measures aimed at enhancing the confidence of the private sector in the country and its economic prospects: fostering the protection of investors' property rights and ensuring a fair market competition are vital conditions in this regard.

**The Republic of Moldova is entering a three-year 'electoral marathon', not being prepared from an economic and institutional point of view, which feeds a series of long-term economic risks.** Electoral periods are always marked by increased budget spending and uncertainty. In the case of the Republic of Moldova, the 2018 parliamentary elections, the 2019 local elections, and the 2020 presidential elections represent major constraints for the national economy, due to the current imbalances in public finances and modest investment activity. In particular, the propensity to engage in election-related public expenditures in the context of a budget deficit of 2.9% of the GDP planned for 2018 is likely to further exacerbate public finances that will fuel domestic Government debt and turn into budget austerity in the years after the elections. At the same time, the weak institutional framework, as well as the high level of politicization of public institutions, lead to increased uncertainty caused by the near elections, which undermines private investment activity: in 2017, despite economic growth, private investments declined, which will most likely remain stagnant in the coming years.

**Besides electoral factors, the public finances will be increasingly affected by the phenomenon of aging population.** This, on the one hand, puts pressure on public expenditures on insurance and social assistance and, on the other hand, deprives of important budgetary resources that could be geared towards accelerating the economic growth. Thus, over the past few years, productive expenditures (e.g. public investment in infrastructure, health and education), which lead to quantitative and qualitative increase in human and physical capital, grew more slowly than those for social protection. As a result, the country's public budget is becoming increasingly social, with no major impact on economic development. Thus, the current expenditure structure requires a fundamental rethink in order that the fiscal-budgetary policy be oriented towards stimulating sustainable economic growth.



**The high level of tax gap is another major constraint for economic growth that undermines the capacity of the state budget to contribute more actively to development.** The tax gap in the Republic of Moldova (the difference between the potential volume of tax revenue and the actual collected revenue) is quite high, being estimated at about 7% of the annual GDP. Although this share stabilized over the last years, the share of tax evasion that determines the tax gap increased substantially. This indicates some risks of increasing the propensity to tax evasion, which could become a major issue for the coming years. Therefore, in 2018 it is crucial to accelerate the efforts to fight tax evasion, without harming the business climate, with an emphasis on promotion of voluntary compliance (e.g. a more active communication with taxpayers and simplification of fiscal management and reporting).

**The slowdown in economic growth takes place in parallel with the slowdown in labor productivity and salaries.** Although, on the one hand, the growth rates of productivity and real salaries started to converge, on the other hand, they slowed down considerably. Taking into account that the level of labor productivity in the Republic of Moldova is among the lowest in CEE countries, this phenomenon could denote that indicators stabilized around a negative equilibrium manifested by the low impact of economic growth on population's wellbeing. This process was influenced by the worsening of the quality of employment and, in particular, by the increase in the informal employment and by the decrease in the share of jobs requiring medium and high skills.

**In order to stimulate the long term economic growth up to optimal levels (7-8%) it is instrumental to ensure the quality of structural and institutional reforms.** In 2018, virtually, all the ingredients of a qualitative economic growth will be available: tempered inflation, favorable agricultural year, external assistance that will lead to more public investments, increased liquidity in the banking system, more remittances, and a favorable external economic environment. These factors will ensure rapid economic growth only in the context of qualitative reforms that will improve the confidence of investors and public in the Government, and will therefore boost private investment activity. In this respect, the policy priorities for 2018 are as follows:

- **Public administration reform.** It must be carried out transparently, predictably and consistently with the Strategy approved in 2016. In order to achieve the expected effects, the reform must be based on functional and impact analyzes and not be limited to institution and staff optimization. The essence of the reform is to improve the quality of public services, and, to achieve this, internal processes at the level of the institutions needs to be improved, public service staff to be better motivated and dependence of public institutions on policy makers to be diminished.
- **Reform of the strategic planning system.** A key component of the public administration reform is to increase the effectiveness of the policy planning and budgetary programming system. In this respect, the development of a new National Development Strategy "Moldova 2030" was started, which is to draw the country's long-term development guidelines in line with the 2030 Agenda for Sustainable Development and the Association Agenda. Once the Strategy is approved, an ample process of optimizing sectoral strategies (e.g. reducing their number by about 10 times) and adjusting the remaining ones is to begin. In essence, there must be a long-term visionary document (NDS "Moldova 2030"), to anchor sectoral strategies which, in turn, to transform into budget programs. This triangle of strategic planning (NDS – sectoral strategies – budget programs) is crucial to ensure efficient management of the limited technical and financial resources available to the Government, ensuring predictability of public policies, and allowing to anchor resources into strategic objectives with sustainable effects, rather than to short-term (e.g. electoral) goals.
- **Building capacity and ensuring a real independence for integrity and anticorruption institutions.** Given that corruption is the main constraint on the business environment (according to the 2017/2018 Global Competitiveness Report) and the country's development, respectively, and the level of confidence of the population and economic agents in government is very low, increasing the effectiveness of the fight against corruption should be a key priority for 2018. In this respect, strengthening the technical capacities and ensuring



the full independence of integrity and anticorruption institutions, in particular of the National Integrity Authority and Anticorruption Prosecutor Office, is a must.

- **Banking sector reforms must be carried out in parallel with the progress of investigations into bank frauds and the recovery of stolen money.** Although we appreciate the efforts of the NBM to align the regulatory framework with international banking regulatory standards, their efficiency and credibility is affected by the lack of results in the investigation into bank fraud and recovery of laundered money (except for the income from the execution of assets of bankrupt banks). In this respect, the process and results of the investigations should be more transparent (without damaging the investigation process), coordination between the line institutions (General Prosecutor's Office, National Bank of Moldova, National Commission for Financial Market, Ministry of Finance, etc.) should be more efficient and without any political interference. Failure to ensure the transparency of this process will further affect its credibility, as well as the credibility of other reforms and will further undermine the confidence in the population in the government.
- **Increasing the level of transparency and governance in the financial and banking sector.** Despite some important progress made in this respect over the last period, a number of problems persist and more actions are to be fully implemented so that the progress achieved becomes irreversible. In particular, it is necessary to finalize the process of increasing the transparency of all commercial banks' shareholders and sell the shares put up for sale to persons complying with integrity and reputation standards.
- **Strengthening institutional capacity in the area of implementation and monitoring of the EU Association Agreement.** The public administration reform has further undermined the Government's capacities in this area. Given the strategic importance of this Agreement, improving the inter-institutional coordination on the implementation of the Agreement, strengthening the capacities to renegotiate the Agreement (e.g. negotiating the extension of tariff quotas, which in 2017 were exceeded) and implementing a transparent monitoring and assessment mechanism for implementation of the Agreement, take priority for 2018.

## Forecasts for 2018–2019

Tabel 1. Forecast of the key macroeconomic indicators

|                                  | 2018                        |                          | 2019                        |                          |
|----------------------------------|-----------------------------|--------------------------|-----------------------------|--------------------------|
|                                  | <i>Pessimistic forecast</i> | <i>Baseline scenario</i> | <i>Pessimistic forecast</i> | <i>Baseline scenario</i> |
| Gross Domestic Product, %        | 3,8                         | 5,6                      | 3,0                         | 4,0                      |
| Agriculture, GVA, %              | 4,0                         | 8,0                      | 4,0                         | 8,0                      |
| Industry, GVA, %                 | 4,1                         | 4,5                      | 0,6                         | 1,0                      |
| Constructions, GVA, %            | 5,4                         | 6,9                      | 5,4                         | 6,9                      |
| Domestic trade, GVA, %           | 7,3                         | 7,7                      | 4,9                         | 5,8                      |
| Transport, GVA, %                | 9,1                         | 9,6                      | 7,6                         | 8,0                      |
| Net taxes, %                     | 7,4                         | 8,2                      | 6,5                         | 6,9                      |
| Final consumption, %             | 3,7                         | 4,4                      | 1,8                         | 4,4                      |
| Gross fixed capital formation, % | 5,0                         | 8,7                      | 0,4                         | 2,5                      |
| Exports of goods and services, % | 15,0                        | 20,0                     | 9,0                         | 10,0                     |
| Imports of goods and services, % | 10,3                        | 13,6                     | 4,8                         | 6,0                      |
| Remittances, %                   | -5,0                        | -1                       | -5,0                        | -1                       |
| Bank loans in MDL, %             | 3,6                         | 5,3                      | 3,1                         | 4,5                      |
| Fiscal revenues, %               | 3,8                         | 5,6                      | 3,0                         | 4,0                      |
| Real wages, %                    | 5,0                         | 4,0                      | 5,6                         | 4,6                      |
| Inflation, %                     | 3,8                         | 5,6                      | 3,0                         | 4,0                      |

Source: EXPERT-GRUP estimates and forecast

## Executive summary

**Domestic Supply.** In 2017, GDP grew by 4.5%, being driven by the increase in external demand, public investments and household consumption. The sectors with accelerated growth of value added were: agriculture (+7.9%), trade (+6.6%), transport (+6.2%), constructions (+4.3%) and industry (+3%). In the light of increasing external demand and growth in public investments, we anticipate for 2018 a positive dynamics in all economic sectors, while the GDP could grow by 5.6%. At the same time, the political uncertainty will affect growth prospects in both 2018 and 2019.

**Domestic Demand.** In 2017, the economic dynamics intensified, and in the second half of the year, the GDP deviation showed positive values. Household consumption increased by 4.9%, which was driven by wage growth. Note that the wage growth in the public sector exceeded that of the private sector. At the same time, although the remittances went up, the appreciation of the Moldovan Leu had a negative impact on the purchasing power of remittances. Gross fixed capital formation increased by 5.3%. The increase was driven by the growth in public investment, which augmented by 30.2%. However, private investment continues to decrease for the fourth consecutive year, and in 2017 it decreased by 1.7%. The positive development of exports was not enough and, as a result, the net export (difference between exports and imports) had a negative influence on the GDP growth by (-2.7 p.p.). Positive developments are expected in 2018, and all GDP components will go up. However, the economic dynamics will be fostered by the public sector playing an active role, whereas the business environment confidence will remain low, and the private investment will register an insignificant trend. The political factor is likely to play a negative role again in 2018 and 2019, by due to high uncertainty for the private investment activity.

**Public Finance.** The year of 2017 ended with the improvement of the main macro-fiscal indicators, both due to the positive economic environment and the failure to implement the planned expenses. The National Public Budget expenses were executed in a proportion of only 95.6% compared to the revised amount in October 2017, which led to the reduction of budget deficit from the planned -2.8% of GDP to -0.8% of the GDP. The 2018 budget was drafted on the basis of fairly balanced macro-fiscal indicators, being closely consulted with the International Monetary Fund. At the same time, during the first months of 2018, in the State Budget adoption and execution phase, electoral initiatives with uncertain financial coverage appeared. Besides the electoral factor, which has a circumstantial character, the quality of public finances is influenced by a set of structural imbalances, capable to negatively influence the country's long-term economic performance. These imbalances are related to the faster growth of social spending than of the productive ones, oriented to infrastructure investment and human capital. Also, the fiscal space remains constrained by the persistence of non-observed economy, which leads to massive foregone revenues in the public budget. Finally, there are delays in reforming the current tax system, especially concerning the labour factor.

**Labour Market.** In 2017, the contradictory trends from previous years continued to persist on the labour market. On the one hand, the quantitative indicators of the labour market did not change significantly compared to the previous year. The employment rate accounts for 42.2% (-0.4 percentage points y-o-y) and the unemployment rate accounts for 4.1% (-0.1 percentage points y-o-y). On the other hand, the qualitative indicators revealed worsening or stagnation trends. The share of informal employment decreased down to 34.7% of the total employed population (-1.7 percentage point y-o-y), but remains relatively high. At the same time, the trends from previous years of cutting jobs that require high and medium skills have taken root. The share of these jobs decreased between 2012 and 2017 from 31% to 27% of the total number of employed population. The reduction in quality jobs had a negative impact on labour productivity, although it started to rise at rates similar to wages. Thus, the wage dynamics become more anchored and depends almost exclusively on labour productivity, the growth rates of which slowed down in the recent years. To stimulate the labour market performance, in 2017, the development of a more liberalized Labour Code started, the effects and degree of liberalization of which have not been yet fully studied.

**Prices and Monetary Policy.** In 2017, the inflationary dynamics increased and the price growth rates went up from 3% y-o-y in Jan:17 to 7.9% y-o-y in Oct:17. The year of 2018 began with a decreasing inflation trend: from 6% y-o-y in Jan:18 to 4.7% y-o-y in Mar:18. In 2017, the rise in the inflation rate was determined by domestic factors: higher prices for certain agricultural products caused by unfavorable weather conditions and higher tariffs for services. At the same time, the increasing currency inflows strengthened the national currency. The appreciation of the national currency had a disinflationary effect both in 2017 and in Q1:18. In order to diminish the negative effects associated with the fast appreciation of MDL, the central bank purchased currency in huge amounts, which lead to the additional issue of MDL and only increased the surplus of liquidity. In this context, in order to manage the excess of cash, the reserve requirements were lifted from 35% to 40% and the sterilization operations were intensified; in Mar:18 the average daily balance of National Bank Certificates (NBCs) reached about MDL 9 billion. However, in 2017, to stimulate lending, the base rate was cut from 9% to 7%, and to 6.5% in Q1:18. We expect the inflation rate to decrease and to reach the corridor of 3.5%-5% in 2018, and in 2019 the price growth could be around 5%. The major risks that could affect the inflation trend would, however, remain and the NBM will have to address at least three contradictory tasks: level out exchange rate fluctuations and manage liquidities.

**Banking sector.** More than 3 years after the banking frauds, the attention of external partners and lending financial institutions continues to be focused on the events from this sector. This is a signal that the integrity and resilience of the banking sector has not yet been fully ensured, as well as the fundamental importance of the reform commitments: reform actions were included in the list of conditionalities of the Memorandum of Understanding signed with the EU on macro-financial assistance to the Republic of Moldova. Also, in spite of the important progresses related to the stabilization of the banking sector, the most recent IMF assessment reveals that significant challenges remain and more actions have to be fully implemented in order for the achieved progress to become irreversible. The process of restructuring bank shareholders, started by the NBM three years ago, shows the first important results. Thus, out of the three banks subjected to special monitoring, BC Victoriabank is the first bank to attract a strategic investor with a good external reputation. However, overall, foreign investors seem rather reluctant to enter or even to continue to work in domestic banks. It is caused by the relatively small size of the national economy, low financial intermediation, and the echoes of the bank fraud.

**Foreign Trade.** In 2017, the foreign trade registered a positive evolution, although these performances are to be interpreted through the lens of the very low basis of comparison of 2016. Thus, the exports of goods in 2017 increased by 18.6% y-o-y. Geographically, the European Union is still the main destination of Moldovan exports with a share of 65.8% in the total exports and a 19.9% growth y-o-y (reaching a historic maximum in absolute terms). However, we notice an excessive concentration of destinations and types of exports to EU, most of these exports being made under inward processing regime, which implies a rather small added value. At the same time, the CIS countries, which account for 19.1% of all Moldovan exports, registered a 11.8% growth as a result of the partial resumption of exports of plant products to the Russian Federation, and due to the resumption of re-export transactions (mainly pharmaceutical products) to this destination. On the other hand, the import of goods in 2017 increased by 20.2%, mainly due to the new electricity supply contract concluded with Ukraine (previously, the Transnistrian supplies were not included in the trade statistics of the country), but also due to the needs of the national export-oriented industry. Despite the registered trade performance, there is a number of structural shortcomings reflected in the specialised international rankings (such as the Global Competitiveness Report 2017-2018 where the Republic of Moldova ranks 89 out of 137 states). Moreover, the main obstacles to business development in the Republic of Moldova, such as corruption, political and government instability, access to finance, inefficient state bureaucracy, inadequate infrastructure, etc. were highlighted. The total exports of goods and services are expected to grow in 2018 by about 10.8% and the imports are expected to grow by 10.3% thanks to the higher household consumption.

## Chapter 1. Domestic Supply

*In 2017, GDP increased by 4.5%, based on the increase in external demand, public investment and consumption. The sectors with accelerated growth of value added were: agriculture (+7.9%), domestic trade (+6.6%), transport (+6.2%), construction (+4.3%) and industry (+3%). In the light of deepening external trade relations and increasing public investments, we anticipate for 2018, a positive dynamics and the GDP could grow by 5.6%. Nevertheless, political uncertainty will limit growth prospects in the medium term.*

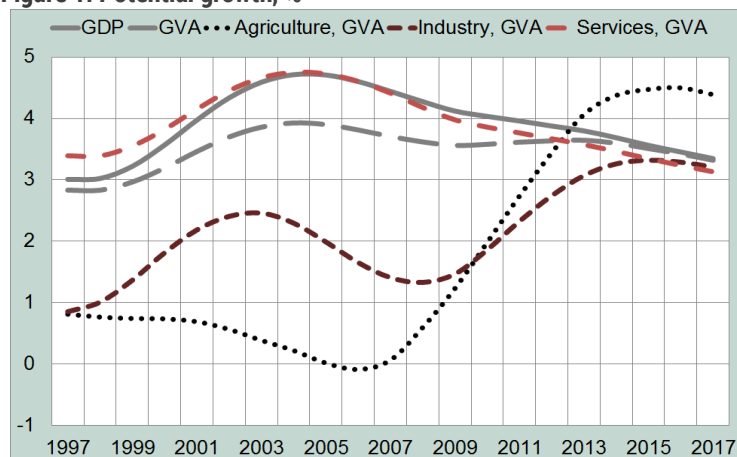
### Recent Trends

**In 2017, the GDP increased by 4.5%, and the most dynamic sectors were agriculture and trade.** In 2017, gross value added increased by 3.8%. Among the key economic sectors, the value added grew the most in agriculture (+7.9%) and in domestic trade (+6.6%). These two sectors contributed to the GDP growth by 1 and 1.3 p.p. A slower dynamics was registered in industry and utilities (increase in value added by 3% and contribution to GDP growth by 0.4 p.p.), information and communication (increase in value added by 3% and contribution by 0.2 p.p.) and construction (increase in value added by 4.3% and contribution by 0.1 p.p.). Other sectors experienced poor development, and their contribution to GDP growth was minor and constituted 0.2 p.p. The increase in taxes on products by 6.9% that influenced GDP growth by 1.1 p.p., also, played an important role. One of the factors that determined this evolution of product taxes was the rapid increase in the import of goods and services and in domestic trade.

**The tendency to slowdown in economic dynamics is observed in the long run. This trend is determined by the moderating growth in the service sector.** From 2010 until 2017, the growth rate of potential GDP<sup>1</sup> dropped from 4% to 3.3%. A similar dynamics is also seen in case of the growth in GVA's potential that decreased from 3.6% to 3.3% (Figure 1). Services influenced this evolution the most. In the long term, a continuous decline in the growth rates of value added in the services is noted. If in 2010 the advancement constituted 3.9%, then in 2017 the increase was 3.1%. After a phase of ascension, the increase in potential level of value added in agriculture has stabilized and was varying insignificantly in the range of 4.3-4.5% over the last 4 years. The situation in industry is similar: over the last years, potential growth constitutes 3.2-3.3%.

<sup>1</sup>The Hodrick-Prescott filter was used to calculate the growth rate of potential GVA in economic sectors.

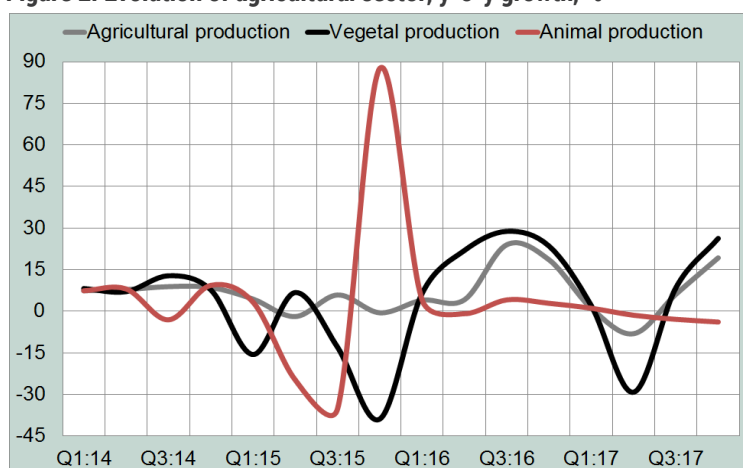
Figure 1. Potential growth, %



Source: NBS

Despite the unfavorable weather conditions in Q2:17, the agriculture advanced well in the second half of the year, and as a result, in 2017 the growth constituted 8.6%. The increase in the volume of agricultural products was determined by the growth of the plant-growing sector by 13.1%. After the decline in Q2:17, production growth has intensified in the following quarters and constituted 8.5% y-o-y in Q3:17 and 26.3% y-o-y in Q4:17 (Figure 2). Positive developments were registered for most agricultural crops, except for wheat and potatoes. Reduction of wheat harvest by 3% was determined by decrease in sown areas by 9.7%, although average harvest per hectare increased by 7%. Decrease in potato production by 8% was caused by the delays in harvesting because of unfavorable weather conditions in the spring of 2017. At the same time, the livestock sector decreased by 2.1%. During 2017, the decrease in animal production has slightly accentuated and went from -1.4% y-o-y in Q2:17 to -3.9% y-o-y in Q4:17. The decrease was determined by a 2.6% reduction of cattle and poultry farming, and a decrease in milk production by 3.8%. However, egg production registered positive dynamics, and the increase constituted 5.1%.

Figure 2. Evolution of agricultural sector, y-o-y growth, %

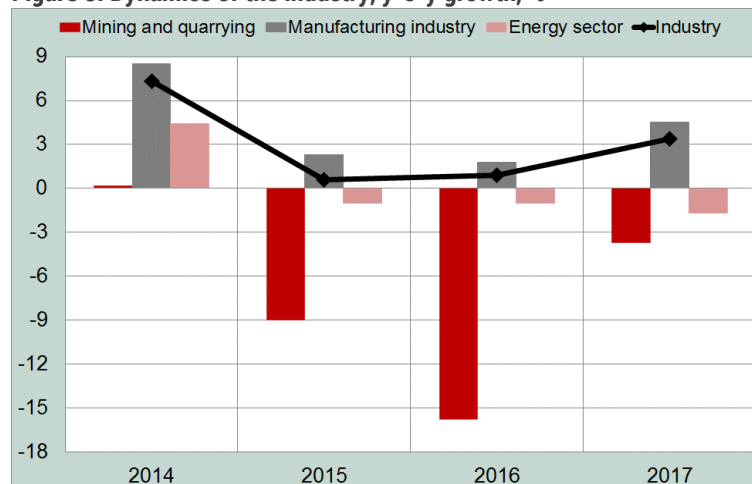


Source: calculations based on NBS data

In 2017, the industry experienced a modest growth, which was driven by advancement in the manufacturing industry. The sector experienced a period of constant growth during Apr-Nov:17, and as a result in 2017 the volume of industrial production increased by 3.4%. The manufacturing industry grew by 4.5% y-o-y and boosted the evolution of the whole industrial sector. In fact, the dynamics of the manufacturing industry is strongly correlated with the evolution of the entire sector (Figure 3). Advancement of processing industry was supported by the ascension of several important

subsectors: food industry (+6.4%), production of beverages (+7.8%), clothes production (+2.3%), production of electric equipment (+39.4%) and manufacture of motor vehicles (+12%). At the same time, the dynamics of mining industry and energy sector was dominated by phases of decline. As a result, mining industry shrank by 3.7% and energy sector – by 1.7%.

Figure 3. Dynamics of the industry, y-o-y growth, %



Source: calculations based on NBS data

In 2017, the growth in domestic trade was ensured by the increase in wholesale trade and services rendered to enterprises. At the same time, the retail trade and services provided to the population have been decreasing. In 2017, the turnover in wholesale trade increased by 19.9%, and the volume of collected revenues related to the services provided mainly to enterprises increased by 8.8%. Also, the turnover of the trade with vehicles and motorcycles grew by 12.9%. On the other hand, the turnover of the retail trade, expressed in comparable prices, diminished by 4.6%. The turnover for market services provided to the population, expressed in comparable prices, decreased by 0.4%.

In 2017, the transport has experienced explosive growth, while the construction sector has registered a modest advancement. In 2017, the volume of transported goods increased by 23.8%. The growth was determined by the growth of domestic trade and by the revitalization of foreign trade. The volume of contracted construction work increased by 2.3%. This evolution was based on the increase of public investments financed from budgetary sources.

## Challenges and Forecasts

- **In agriculture, the previous years' growth could continue in 2018. However, the dynamic of the sector remains strongly dependent on weather conditions.** In 2018, the growth of agricultural value added might constitute 8%. Although there can be an increase in agricultural production in 2019, the evolution of the sector will depend on weather conditions.
- **The industry will grow in 2018 as well. However, the growth will be caused rather by use of cheap labor force, than by re-engineering of the sector.** Since cost of labor force is lower than in other regional countries, the Republic of Moldova is attractive for international companies operating in the labour-intensive branches of industry. Over the last years, the advancement of the industry was caused, inter alia, by the expansion of certain sub-sectors, in which investors came 'looking for' cheap labor force, and the most eloquent example in this regard is the production of car cables. This trend will be maintained in 2018 as well. At the same time, several industry sub-sectors, such as: production of clothing, furniture manufacturing or cable production, operate on the basis of outward processing arrangements and depend on external controls. We anticipate an

increase in external demand for 2018, while the increase in industrial value added would vary between 4.1 and 4.5%. In 2019, the industry might grow by 0.6% according to the pessimistic scenario and 1% according to the optimistic one.

- **The trend registered in 2017 will be maintained in 2018, while the construction sector will be in ascending due to the larger public investments.** The value added in constructions could increase by 6.9% in 2018. However, the dynamics of private investments will be most likely anemic, and this factor will limit the growth of the sector. At the same time, the risks of low demand of individuals for real estate are getting stronger. Thus, the volume of investments made in the construction of residential buildings has been continuously decreasing since 2014, and the greatest decreases were registered in 2016 and 2017: -13.9% and -11.8%.
- **The higher public investments as well as the growth of consumption will boost domestic trade in 2018.** In 2018, the value added in trade will grow between 7.3 and 7.7%. We expect a 4.9% growth in 2019, and in an optimistic scenario the growth could reach 5.8%.
- **In 2018, the GDP could grow by at least 3.8%, and in a favourable situation the growth could reach 5.6%.** The governance structure and economic course followed after the 2018 parliamentary elections remains unclear, which fuels uncertainty.

## Chapter 2. Aggregate demand

*In 2017, the economic activity increased and the GDP deviation reached positive values. The leap of public investment by over 30% and the rise of the budgetary sector salary exceeding the rise of the wage in private sector fueled this economic growth. Despite the positive developments, worrisome trends are also noticed. Thus, although the increase of public investment boosted the overall investment activity, private investment is decreasing. In addition, although the consumption was sustained due to the rise in salaries, the purchasing power of remittances was negatively influenced by the MDL appreciation. For 2018, we anticipate that the Government will continue to play an active role in fueling economic growth, and GDP will grow with regard to all its expenditure components. At the same time, there is a risk that the level of business environment confidence will remain low and the private investment will stagnate. Because of the uncertainty surrounding the electoral period, this trend might continue in 2019 as well.*

### Recent Trends

While the aggregate demand had a restrictive impact on the economic activity in the first half of 2017, the situation changed in the second half of the year. GDP<sup>2</sup> deviation was negative in Jan-Jun:17, but in Jul-Dec:17 the indicator already showed positive values ( Figure 4). The increase in demand was driven by the more active involvement of the government sector. Thus, the investment financed from public sources increased and the salaries for the budgetary employees were raised. On the other side, the risks that might affect the dynamics of demand remain high. Thus, the business environment confidence continues to be low, and as a result, the stagnation in private investment is expected to continue. There are also challenges related to the appreciation of the national currency, which undermine the competitiveness of the economy abroad.

Figure 4. GDP deviation, %



Source: NBS, EG calculations

<sup>2</sup> The GDP deviation represents the difference between the actual GDP and potential GDP calculated on the basis of the Hodrick-Prescott filter.

**Exports of goods and household consumption had a major impact on the aggregate demand growth.** In 2017, the exports of goods and services increased and contributed to GDP growth by 5.5 p.p. However, the negative contribution associated with the increase in imports was higher than the positive effect related to the increase in exports. Household consumption increased by 4.9% and contributed to GDP growth by 4.2 p.p. (Table 2). Final consumption of the public administration and non-profit institutions serving households slightly increased by 0.2%, whereas the contribution to the GDP change was insignificant, reaching only 0.1 p.p. A positive development refers to the increase in the investment activity. Gross fixed capital formation increased by 5.3% and influenced GDP growth by 1.2 p.p. Along with exports and household consumption, variation of stocks is another component that had a significant influence on GDP growth and contributed to economic growth by 1.7 p.p. Growth in the agricultural sector is a key factor that led to changes in stocks in 2017.

**Table 2. Growth rate and contribution of GDP components to its formation**

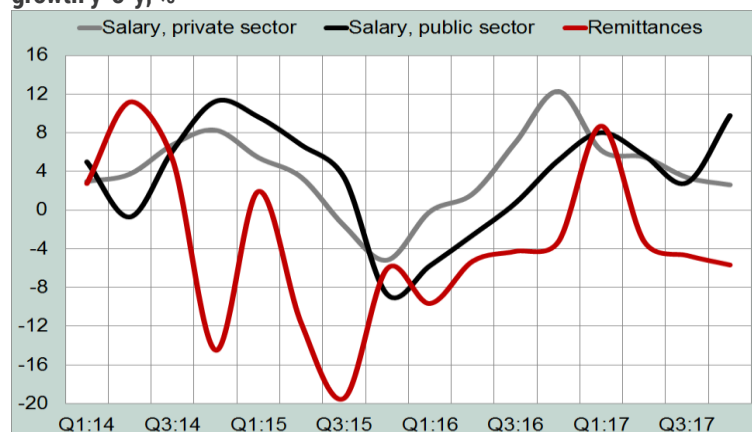
|                                 | Growth rate, % | Contribution, p.p. |
|---------------------------------|----------------|--------------------|
| Final consumption of households | 4.9            | 4.2                |
| Final consumption of PA and NPI | 0.2            | 0.1                |
| Gross fixed capital formation   | 5.3            | 1.2                |
| Variation of stocks             | X              | 1.7                |
| Exports of goods and services   | 12.7           | 5.5                |
| Imports of goods and services   | 11.4           | -8.2               |

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

*Source: NBS*

**The increase in disposable income boosted household consumption growth. Wage growth had the biggest impact on income growth, whereas the remittances dropped.** In 2017, people's disposable income increased by 2.2%, labor earnings increased by 4.8% and influenced the growth of disposable income by 2%, in real terms. The real average salary per economy increased by 5.1%, and the growth in the budgetary sector salaries exceeded the growth of the private sector wage. If in the first three quarters of 2017 the increase in the real salary in the public sector dropped from 8% y-o-y in Q1:17 to 2.8% y-o-y in Q3:17, then in Q4:17 the wage increased by 9.8% y-o-y (Figure 5). As a result, in 2017 the salaries in the budgetary sector increased by 6.5%, while in the private sector – by 4.4%. However, during 2017, the private sector salary growth rates steadily declined: from 6.2 y-o-y in Q1:17 to 2.6% y-o-y in Q4:17. The pensions income increased by 7.9% y-o-y and brought a 1.5% contribution to the growth in the disposable income. In 2017, the volume of remittances in USD increased by 9.7%, but because of MDL appreciation (in 2017 the MDL/USD and MDL/EUR rate declined by 7.2% and 5.6%, respectively) and price increase (in 2017 the inflation rate was 6.6%), the value of transfers converted into MDL and expressed in real terms decreased by 1.5%. As a consequence, in 2017 the remittance income decreased by 1.8% y-o-y and brought a -0.3% contribution to the disposable income dynamics. Also, despite a good agricultural year, the income from individual agricultural activity decreased by 15.2% and influenced the development of disposable income by -1%. This may point at the low productivity of households' agricultural activities, but it might also be a signal of certain anticompetitive arrangements among intermediaries imposing low purchase prices for small producers.

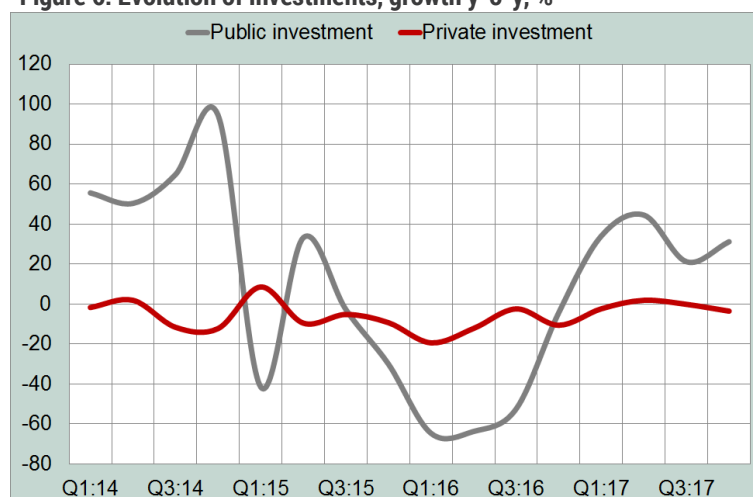
**Figure 5. Evolution of salaries and remittances expressed in MDL, real growth y-o-y, %**



Source: NBS, NBM, and EG calculations

The investment dynamics was supported by the growth of investment financed from budgetary sources, while private investment continued to decline. In 2017, investment in long-term tangible assets increased by 1.3%. Although in Q2:2017 the private investment increased by 1.9% y-o-y, throughout the rest of the year it decline (Figure 6). As a result, in 2017 private investment decreased by 1.7%, whereas the public investment grew by 30.2%.

**Figure 6. Evolution of investments, growth y-o-y, %**



Source: NBS, EG calculations

Although the export growth exceeded the import growth in 2017, net exports contributed to GDP growth in a negative way. In 2017, the exports of goods and services increased by 12.7%. The imports grew by 11.4%, which led to a negative contribution to the GDP evolution by 8.2%. Likewise, in the case of foreign trade in goods and services, the exports grew faster than the imports. The exports of goods increased by 13.4%, while the imports – by 12.8%. The exports of services increased by 11%, while the imports – by 4.9%. However, as the exports contribution was lower than that of imports, net exports had a negative effect and generated a 2.7% loss in the GDP growth.

## Challenges and Forecasts

- In 2018, the business environment confidence will remain low and this will reduce the private sector's investment appetite. The political factor will affect the behavior of the business environment, both in 2018 and in 2019. Private investment is following a downward trend since 2014. This is alarming and points at the

pessimism of business environment representatives. Unfortunately, political developments will only strengthen this feeling in the near future. In 2018, in the context of parliamentary elections, the companies will risk less and will be reluctant to initiate new projects. After the 2018 elections, the 'East-West' dilemma might move to a new stage. The possible growth of the share of Euro-sceptical forces in the parliament might discourage the business environment representatives even more. This observation is of particular importance given the higher tendency of anchoring of Moldovan companies to the EU market (in 2017 about 2/3 of the Moldovan exports of goods were oriented towards the EU).

- **The economic developments in 2018 will replicate the dynamics of 2017, and the public sector will play an active role in supporting economic dynamics. In the context of an election year, the Government will most likely use expansionary economic policy measures.** Thus, in 2018 public investment will continue to grow and capital formation will be boosted. **In 2018, the fixed capital formation might increase by 8.7%. Most likely, in 2019 the fixed capital formation will increase much less, by 0.4% according to the negative scenario and by 2.5% according to the positive scenario.** After the electoral period, in the medium term, the Government will weaken its 'expansionist' impetus and promote more prudent policies.
- **In 2018, the increase of disposable income will foster consumption.** It will be fueled by higher salaries in the public sector and private sector. The evolution of remittances might be affected by the appreciation of national currency. However, in the structure of disposable income the increase in the salary component will exceed the decrease in the purchasing power of the remittances. **As a result, the income growth will ensure a positive trend in household consumption, which in 2018 might increase by 4.8%. In 2019, the progress might reach 2.1% (negative scenario) or 2.9% (positive scenario).**

## Chapter 3. Public Finance

*The main macro-fiscal indicators improved considerably by the end of 2017, largely due to the favorable economic environment and non-execution of planned expenditures. In addition, the 2018 budget framework is based on fairly balanced macro-fiscal indicators, which were also coordinated with the International Monetary Fund. The budgetary risks related to the electoral factor, mentioned in the previous MEGA edition, materialized and were reflected in initiatives of increased expenditures, without proper financial coverage. In addition to the short-term electoral factors, public finances are facing a set of structural imbalances that can undermine sustainable economic growth. These imbalances are related to the fast increase in social spending, the persistence of foregone budget revenue due to non-observed economy and delays in carrying out certain tax reforms, especially of the labour factor.*

### Recent Trends

**The 2017 budget year ended with the improvement of the main macro-fiscal indicators, both due to the positive economic environment and the non-execution of the expenditure plans.** The balance of the National Public Budget (NPB) was the key indicator that registered a positive evolution. By the end of 2017, a NPB deficit of only 0.8% of GDP was recorded instead of the planned 2.8% of GDP in the budgetary amendment of October 2017. This discrepancy can be explained almost exclusively by the non-execution of planned expenditures and, to a lesser extent, by the increase in the budget revenue. Thus, NPB expenditures were executed only in proportion of 95.6% compared to the amount approved in the amended budget, although the final revenue of NPB exceeded the planned amount by 1%. As mentioned in the previous MEGA edition, a key factor contributing to the improvement of budget indicators and compensation for the loss of a part of the foreign assistance was the fast increase in tax revenue.<sup>3</sup> Tax receipts increased in nominal terms by about 18%, and in real terms by 9.6%. In fact, this impressive growth is almost exclusively explained by the return of tax collections to the long-term trend after the cyclical decline during 2014–2016 (Figure 7). The discrepancies between the planned and achieved budget indicators repeated in recent years and are caused by both macroeconomic volatility and low institutional forecasting capacities (even for the short-term).

**A budgetary framework with a maximum possible deficit according to the existing fiscal rules was approved for 2018, but the risks of increasing the electoral discretionary expenditures materialized.** The 2018 NPB was approved with a deficit of 2.9% of GDP, or 2.5% if grants are excluded, this being the maximum level allowed by the Law No 181/2014. This level of the budget deficit was caused both by the electoral factor and by the higher planned inflows of foreign assistance. The revenue and expenditure were planned initially to increase up to 8% y-o-y, but after lower than planned expenditure execution by the end of 2017, the expenditure growth rates in 2018 might reach as much as 13% y-o-y if they are fully implemented and in case there are no problems with external financing. At the same time, the main budgetary risks were initially related to the electoral factor, since the main budget indicators were coordinated with the International Monetary Fund. These risks materialized and resulted in higher discretionary spending initiatives of political nature and uncertain budget coverage. Already at the NPB discussion stage in Parliament, several Members of Parliament requested the Government to increase the transfers to certain Local Public Authorities, especially for the building and repair of social infrastructure. In total, additional funds in the amount of MDL 467.7 million were requested, but the Government approved additional allowances in the amount of MDL 101.3 million. Most of the endorsed requests for increased allowances were submitted almost exclusively by the Members of Parliament from

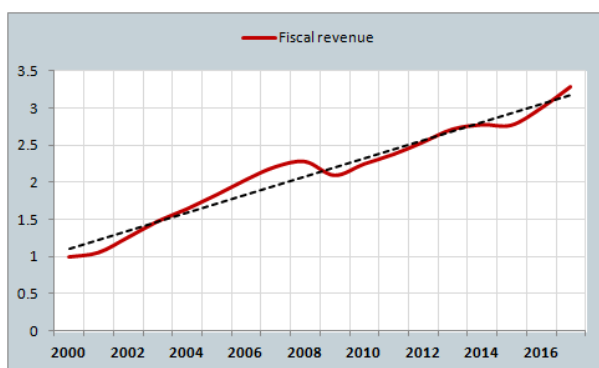
<sup>3</sup> [https://www.expert-grup.org/media/k2/attachments/MEGA\\_17\\_Romana.pdf](https://www.expert-grup.org/media/k2/attachments/MEGA_17_Romana.pdf)

the governing coalition.<sup>4</sup> Another electoral initiative, on the repair of local roads, belonged to the Democratic Party. It provided an estimated amount of MDL 1 601 million for that purpose. At least MDL 366.0 million of this amount are not covered from the State Budget.<sup>5</sup>

**The quality of public finances is affected not only by the factors with short-term impact such as the electoral ones, but also by the structural factors having an impact on sustainable economic growth.** In fact, the capacity of any economy to grow rapidly, to adjust to internal and external shocks, depends greatly on the sophistication and implementation of the fiscal-budgetary policy. The quality of this policy is influenced by such factors as the amount of public spending, the macro-fiscal balance (sustainability of the budget deficit), the structure and efficiency of public spending, the structure and efficiency of taxation and tax collection systems.<sup>6</sup> In many of these dimensions, public finances in the Republic of Moldova have been showing deficiencies and worrying trends in recent years.

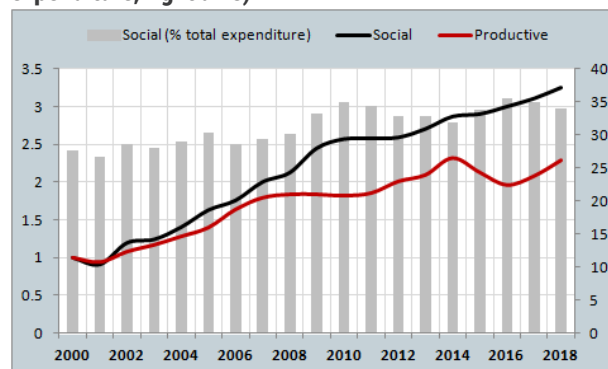
**The development of the public spending structure in the Republic of Moldova is not aimed at boosting long-term economic growth.** Some public spending, such as public investment in infrastructure, medicine and education usually boost the economic growth, as they lead to quantitative and qualitative increase in human and physical capital.<sup>7</sup> Other expenditures, which predominantly lead to higher consumption, such as the social ones, do not have a major impact on maintaining high rates of medium- and long-term economic growth. In the Republic of Moldova productive expenditures grew slower than those for social protection.<sup>8</sup> During 2000–2018 the social expenditures increased in real terms by 3.2 times while the productive expenditures only by 2.3 times (Figure 8). As a consequence, the share of social expenditures of NPB steadily increased from 27% to 34–35% within the reference period, augmenting during the years of economic crisis when productive expenditures are cut. The sharp increase of social allowances is caused by such factors as faster indexation of these expenditures compared to inflation, low progress in improving efficiency (when social allowances are received not only by the needy), but also the significant increase in the number of pensioners. Thus, the current expenditure structure requires a fundamental rethink to make the fiscal-budgetary policy oriented towards stimulating sustainable economic growth.

**Figure 7. The long-term index and trend of NPB tax revenue**



Source: Author's calculations based on Ministry of Finance data

**Figure 8. Productive and social expenditure indices (left axis) and share of social expenditure (% of total expenditure, right axis)**



Source: Author's calculations based on Ministry of Finance data

<sup>4</sup> [http://gov.md/sites/default/files/document/attachments/intr25\\_55.pdf](http://gov.md/sites/default/files/document/attachments/intr25_55.pdf)

<sup>5</sup> <https://www.expert-grup.org/ro/comentarii/item/1590-comentarii-la-initiativa-guvernului-privind-drumurile-locale&category=5>

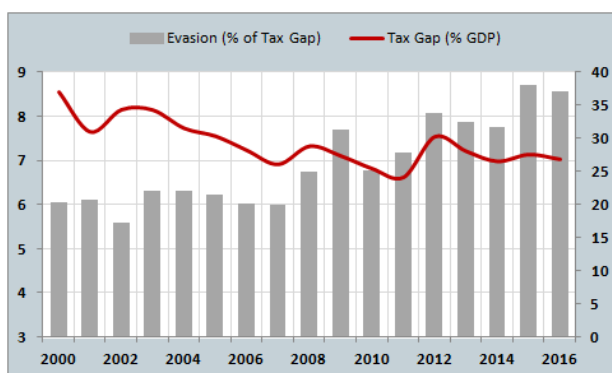
<sup>6</sup> S. Deroose, C. Kastrop, 'The Quality of Public Finances: Findings of the Economic Policy Committee – Working Group (2004 – 2007)', European Commission, 2008.

<sup>7</sup> J.M.Fournier, A. Johansson, 'The Effect of the Size and Mix of Public Spending on Growth and Inequality', Economics Department Working Papers, No. 1344, OECD, 2016.

<sup>8</sup> Productive expenditure was calculated as the difference between all budget expenditures and those for social protection, public order and defense.

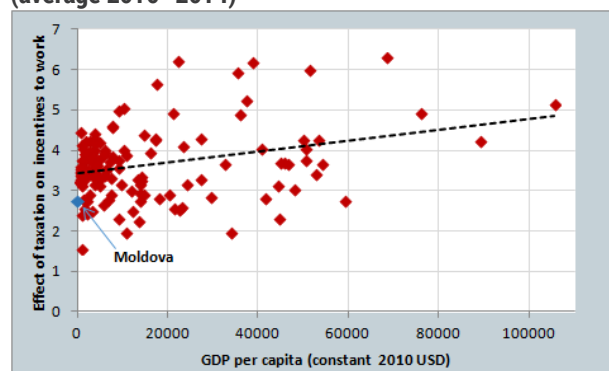
The volume of available budget resources is another key factor for boosting the economic growth, but the progress of maximizing tax revenues has been meager in recent years. Tax collections depend on the dynamics of the tax base, which is influenced by such factors as economic cycle and non-observed economy. However, during the last years, the non-observed economy in the Republic of Moldova, according to official figures, ranged from 22% to 24% of GDP, but without taking into account the contribution of illegal production and services (e.g. drugs, smuggling, etc.). Such level of non-observed economic activities leads to a tax gap (the difference between the potential volume of tax revenue and real collected revenue) of about 7% of GDP in the Republic of Moldova (Figure 9). The amount of foregone tax revenue is even higher due to illegal activities. Stabilization of the tax gap at 7% of GDP after 2010 can mislead about the real tax collection processes. This stagnation is rather due to structural changes in the non-observed economy, as the share of the gross added value of small non-observed enterprises and households decreased, though informal employment increased. However, the mentioned decline was offset by the increase in hidden production in the formal sector of the economy, that is in tax evasion. The share of tax evasion in the volume of foregone collections increased from 20% in 2009 to 37% in 2016. The increase in the level of corruption in the country during the reference period also played an important role in this involution.<sup>9</sup>

Figure 9. The evolution of the total tax gap (left axis) and the share of tax evasion (right axis)



Source: Author's calculations based on NBS data

Figure 10. The relation between the perception of labour factor taxation and the level of economic development (average 2010–2014)



Source: Author's calculations based on GCI and World Bank data

The sustainable economic growth also depends greatly on the taxation structure of the production factors, but the reforms in this area in the Republic of Moldova are to be analyzed more thoroughly. The direct taxes, especially of the labour factor, have a much broader and negative impact on the economic growth than the indirect taxes on consumption and property.<sup>10</sup> A simple analysis of the perception of labour factor taxation, calculated within the Global Competitiveness Index (GCI), and the level of economic development shows a negative relation between them (Figure 10). Thus, on average, a higher level of employee taxation leads to a more rigid labor market, higher informal employment and, as a consequence, to a lower level of economic development. The cost of payroll tax for enterprises in the Republic of Moldova is approximately equal to the average level recorded in the countries of Central and Eastern European member of the EU (CEE EU).<sup>11</sup> In 2015, the tax rate on the labour factor (% of the company revenue) was 30.8% in the Republic of Moldova, whereas the CEE EU average was 29.6%.<sup>12</sup> At the same time, many countries of the Commonwealth of Independent States took measures to significantly reduce the labour tax rates – Armenia and Georgia (0%), Kazakhstan (11.2%). Of course, a possible reform of the labour factor taxation method in the Republic of

<sup>9</sup> I. Morcotilo, 'Non-Observed Economy and Corruption: Links and Consequences', Expert-Grup, 2018.

<sup>10</sup> ECB Economic Bulletin, Issue 5/2017, 'The Composition of Public Finances in the Euro Area'.

<sup>11</sup> The following countries were included in the CEE EU group – Bulgaria, Czech Republic, Croatia, Estonia, Hungary, Letonia, Lithuania, Poland, Romania, Slovakia and Slovenia.

<sup>12</sup> Calculations based on World Bank data (Global Development Indicators).

Moldova should consider not only the options of compensating the lost revenue, but also the change of the current budgetary architecture, especially the role of the State Social Insurance Budget.

## Challenges and Forecasts

**Public finances in the Republic of Moldova show short-term stabilization tendencies. However, certain structural imbalances could affect long-term economic growth.** For the electoral year 2018, a fairly balanced budget, with regard to its key indicators, was developed and approved. At the same time, the risks mentioned in the previous MEGA edition regarding the occurrence of electoral expenses materialized. In addition to the cyclical electoral factor, there is a set of long-term challenges for public finance related to their structure and efficient use:

- **Faster growth of social expenditures as opposed to the productive ones.** The country's sustainable economic growth can be jeopardised if the current trends of faster growth of social expenditures compared to the productive ones continue. In fact, more money will be spent on consumption than in investment directed to human and physical capital. In case of failure to reform the current budgetary framework, there is a risk that the aforementioned trends would only increase due to the negative demographic trends. The decline of the population and the increase in the number of pensioners will only heighten the pressure on social expenditures.
- **Slow progress in capitalizing on the fiscal reserves of the non-observed economy.** Due to the major share of the non-observed economy in the Republic of Moldova, the public budget annually loses at least 7% of the GDP. However, a worrying trend is the increase in tax evasion over recent years, which offset the decrease of the production hidden by non-observed enterprises and households. The progress in this area depends both on strengthening the institutional capacities of the Tax Service and on other systemic factors for the national economy (e.g. fight against corruption). The existence of a major non-observed economy will still have a negative impact on tax revenue collection rates, which is expected to increase in 2018 by 5.3% in standard scenario, or by 3.6% in the pessimistic one.
- **Unused options for changing the structure of taxation.** A set of trends such as the demographic decline, high rates of informal employment, low competitiveness of local enterprises make it necessary to reform the current tax system, especially of the labour factor. The delay of reforms in this area risks to worsen those trends.

## Chapter 4. Labour Market

*In 2017, the contradictory trends of the past years continued on the labour market of the Republic of Moldova. On the one hand, employment and unemployment indicators did not undergo any radical changes, while labour productivity started to grow at the same pace as real wages. On the other hand, productivity growth rates are lower than in the previous decade, including due to further worsening of the employment quality. Quality is affected both by the major share of informal employment and by the reduction of high- and medium-skills over the recent years. The process of developing a more liberalized Labour Code started in 2017 to increase the efficiency of the labour market, but its effects are not clear yet.*

### Recent Trends

**In 2017, the labour market in the Republic of Moldova has made progress in terms of certain quantitative indicators.** The main indicators that characterize the labour market have slightly decreased, compared to the previous year. Thus, according to the official data, in 2017 the labour force participation rate was 42.2% (-0.4 percentage points y-o-y), the employment to population ratio was 40.5% (-0.3 percentage points y-o-y) and the unemployment rate accounted for 4.1% (-0.1 percentage points y-o-y). At the same time, the average salary per economy increased in real terms by 5.1% y-o-y, which is a rough equivalent to the increase in labour productivity (+5.2% y-o-y). Actually, the alignment of labour productivity and wages growth rates has started a few years ago, including due to the underestimation of productivity growth.

**The real rates of productivity growth are distorted, because the population decline registered in the 2014 Population Census was not included in the official statistics.** If we take into account the actual number of the employed population, adjusted in line with the declining population trends, then the annual growth rates of labour productivity would be higher by about one percentage point. This slight difference, at first glance, would lead to the amplification of the gap during the last decade. Thus, according to official data, labour productivity increased 2.7 times during the period of 2000–2017, but if we take into consideration the demographic trends, then the increase will be of 3.4 times (Figure 11).<sup>13</sup> At the same time, in both cases the productivity growth was lower than that of the real wage, which increased 3.7 times over the mentioned period. However, the trend towards convergence of real wage growth rates and productivity can be observed after 2009. Moreover, productivity growth rates, adjusted to the real number of the population, started to exceed or are similar to those of the real wage after 2009. However, a negative aspect is the significant decrease in average growth rates, both in terms of productivity and wages. Thus, when excluding major economic crisis of 2009 from the analysis, the average growth rates for both these indicators were of about 7-10% during 2000–2008, while in the period 2010–2017 they fell to 3-4%.

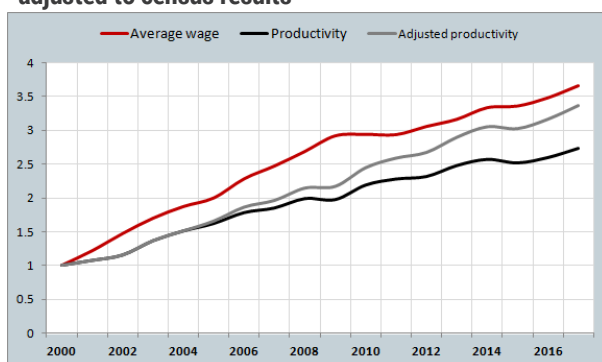
**The increase in the share of employee remuneration sources in Gross Value Added (GVA) was generated by the rapid growth of salaries, in real terms, over the past decade.** In fact, the share of employee remuneration in GVA reflects how much the labour factor benefits from economic growth.<sup>14</sup> The faster growth of salaries compared to labour

<sup>13</sup> Estimation based on the assumption that the employment rates, calculated on the basis of the Labour Force Survey, correspond to the long-term trends on the labour market (see MEGA No XVII of 2017). The employed population, adjusted to demographic trends, was calculated on the basis of application of employment rate to the estimated number of population after the 2014 census.

<sup>14</sup> The increase in remuneration share in GVA, mainly from very low values, does not indicate on the lack of competitiveness of the labour factor, but rather reveals the fair distribution of 'gains' of economic growth between labour and capital factors. If the share of remuneration is less than 50%, then the capital factor benefits more and vice-versa. Also, low or declining values of labour remuneration in the GVA indicate an increase in income inequality in the society since the number of capital holders is concentrated in the top 1–2% of the population (find recent global trends in International Monetary Fund 'World Economic Outlook: Gaining Momentum?' 2017).

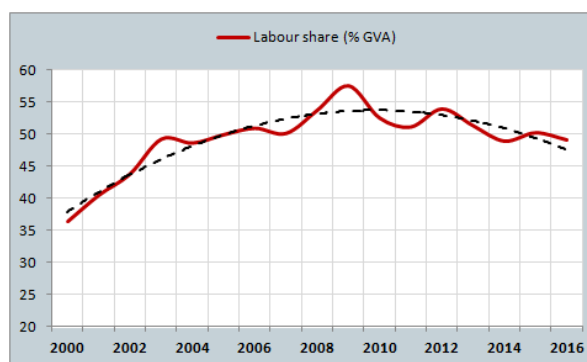
productivity during 2000–2008 led to an increase of the labour share in GVA from 36.4% to 53.7% during the mentioned period as well. After 2009, this share slightly decreased to 49% in 2016 with downward trend in the following years (Figure 12). The decreasing trend of the remuneration share in the GVA also points out that labour productivity has begun to grow faster than wages over the last years. In fact, the share of about 50% of remuneration in GDP is a long-term balance between production factors – labour and capital, specific to most countries. Thus, out of 40 countries for which data are available, 18 (or 45% of the total number of countries) have the share of remuneration in GVA in the range from 45% to 55%.<sup>15</sup> In the light of the balance between wages and productivity established over the past few years, recent developments show that wage dynamics is becoming more and more dependent and anchored by the progress of labour productivity in the Republic of Moldova, which however has a downward trend. Thus, significant increases in average wages in real terms will be difficult to achieve in the near future without any stimulation in labour productivity growth rates.

**Figure 11. Dynamics of average wage and labour productivity indices, according to the official and data adjusted to census results**



Source: Author's calculations based on NBS data

**Figure 12. Evolution of the labour share in the Republic of Moldova (% of GVA)**



Source: Author's calculations based on NBS data

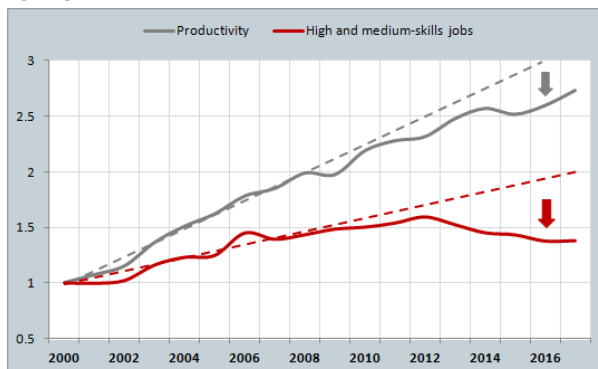
**Moderation in wage and productivity growth rates is influenced by the worsening quality of the employment.** As mentioned in previous editions of MEGA, informal employment has a negative impact on labour productivity. The informal employment amplified over the past years.<sup>16</sup> In 2017, the situation has slightly improved in this respect: the share of informally employed persons decreased by 1.7 percentage points y-o-y (from 36.4% in 2016 to 34.7% in 2017). Nevertheless, the share above 30% of informal employment remains extremely high. An additional factor that reflects the quality of employment and influences labour productivity is the evolution of jobs in their skills profile. If the share of jobs requiring advanced skills increases, labour productivity will be stimulated as well. This has been the case of the Republic of Moldova until recently. The share of high and medium skilled jobs increased very quickly during 2000–2012, when it grew from about 20% to 31% of the total employed population. After 2012, their share in the total population employed decreased down to 27% in 2017 (Figure 13).<sup>17</sup> The growth of informal employment and decrease in the share of high- and medium-skills jobs over the last years, coincide with the slowdown in labour productivity growth, which, however, also depends on other complementary factors (e.g. investments in fixed capital).

<sup>15</sup> Author's estimations based on International Monetary Fund data.

<sup>16</sup> [https://www.expert-grup.org/media/k2/attachments/MEGA\\_ediyia\\_XVI-a\\_Enigmele\\_creuterii\\_economice\\_dupl\\_furtunl.pdf](https://www.expert-grup.org/media/k2/attachments/MEGA_ediyia_XVI-a_Enigmele_creuterii_economice_dupl_furtunl.pdf)

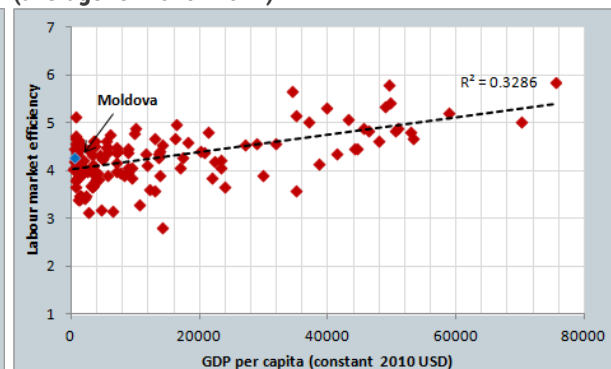
<sup>17</sup> The calculation of the number of jobs according to competencies was based on the statistics of major occupations in accordance with the Job Classification of the Republic of Moldova (CORM 006-14) and ISCO – 08.

**Figure 13. Indices of labour productivity and the share of occupations requiring high and medium level of skills**



Source: Author's calculations based on NBS data

**Figure 14. The relationship between the 'Labour market efficiency' indicator and countries' level of development (average for 2010–2014)**



Source: Author's calculations based on GCI and the World Bank data

The review of the legal and institutional framework that governs this market started in 2017 in order to improve the situation on the labour market. The main effort was directed towards the liberalization of labour legislation and the development of a new Labour Code.<sup>18</sup> The decision to develop a new Labour Code is based on the fact that the freedom of labour market in the Republic of Moldova ranks among last positions in the international rankings.<sup>19</sup> One of these rankings that is often quoted and used in local public policies is the Global Competitiveness Index (GCI), estimated by the International Economic Forum. In the latest 2017/2018 edition of GCI, Moldova ranks 94th out of 137 countries of the world in terms of labour market efficiency. Indeed, a simple analysis of the 'Labour Market Efficiency' indicator of GCI highlights that the level of economy's development depends on the efficiency of the labour market (Figure 14), which also corresponds with the theoretical principles of economic science. However, the 'Labour Market Efficiency' indicator is more complex and is made up of 10 components, which are calculated on the basis of questionnaires filled by business.<sup>20</sup> However, an analysis of correlation by each component apart and countries' level of development, as in the case of the 'Labour Market Efficiency' aggregate indicator, highlights the fact that for the good functioning of this market and for economic development, not only the level of legal liberalization is important, but also the other factors like taxation, companies' management culture, etc. For these reasons, it is imperative to take into account these particularities of the international rankings in the process of public policy development, including the change in the legislation.

A more reasonable indicator for comparing labour markets in different jurisdictions is the one compiled by the Organisation for Economic Co-operation and Development (OECD), which quantifies legal discrepancies.<sup>21</sup> This indicator quantifies the national labour legislation in terms of flexibility for the employers when hiring and firing employees. The final indicator consists of three sub-components calculated for (i) individual employment contracts, (ii) collective redundancy procedures, and (iii) fixed-term contracts. According to this indicator, in 2009 the Republic of Moldova had the highest level of strictness or the lowest level of flexibility of labour legislation both for the aggregate indicator and for most of its components if compared to all Central and Eastern European countries member of EU and the average for the Organisation for Economic Co-operation and Development (OECD).<sup>22</sup> The level of labour

<sup>18</sup> The Working Group on Development of the new Labour Code was established by Prime Minister's Order No 145-d, and started its activity at the end of 2016 (<http://consecn.gov.md/2017/10/05/libertatea-pietei-muncii-in-moldova-pe-ultimele-locuri-in-clasamente-internationale/>).

<sup>19</sup> <http://consecn.gov.md/2017/10/05/libertatea-pietei-muncii-in-moldova-pe-ultimele-locuri-in-clasamente-internationale/>

<sup>20</sup> These sub-components are (i) Cooperation in the relationship between employer and employee; (ii) Flexibility of wage-setting; (iii) Hiring and firing practices; (iv) The Impact of taxes on the motivation to work; (v) The link between remuneration and productivity; (vi) The role of professional management; (vii) Country capacity to retain talent (viii) Country talent retention capacity; (ix) Women's participation in the labour market; (x) The dismissal cost.

<sup>21</sup> <http://www.oecd.org/els/emp/oecdindicatorsofemploymentprotection.htm>

<sup>22</sup> 2009 was chosen for comparison because it is the most recent year when this indicator was calculated for the Republic of Moldova.

legislation strictness in the Republic of Moldova was also higher if compared both to the average for Commonwealth of Independent States (CIS) countries, and to the absolute majority of the countries of this group (Table 3).<sup>23</sup>

**Table 3. Indicators of labour legislation strictness in Central and Eastern European countries in 2009**

|                            | Individual employment contracts | Collective redundancies | Fixed-term contracts | Aggregate indicator |
|----------------------------|---------------------------------|-------------------------|----------------------|---------------------|
| Czech Republic             | 3.00                            | 2.13                    | 1.88                 | 2.39                |
| Estonia                    | 2.56                            | 1.75                    | 2.29                 | 2.31                |
| Poland                     | 1.82                            | 3.38                    | 1.92                 | 2.12                |
| Slovakia                   | 2.20                            | 2.88                    | 2.33                 | 2.37                |
| Slovenia                   | 2.19                            | 3.75                    | 2.17                 | 2.44                |
| Hungary                    | 2.43                            | 3.38                    | 2.50                 | 2.62                |
| OECD average               | 2.14                            | 2.89                    | 2.06                 | 2.23                |
| CIS Average                | 3.00                            | 1.57                    | 1.26                 | 2.04                |
| <b>Republic of Moldova</b> | <b>3.54</b>                     | <b>3.75</b>             | <b>1.88</b>          | <b>2.88</b>         |

Source: Author's calculations based on OECD and A. Muravyev (2010)

Note: Each indicator varies between 0 (most flexible) and 6 (most restrictive)

**The current level of labour legislation rigidity indicates on significant liberalization in this area.** Several factors should be taken into account during the labour legislation liberalization process, which is planned in Moldova by approving a new Labour Code. First, it is necessary to take into account that many empirical studies have not found a major negative impact of the strictness of labour legislation on the unemployment or employment levels, although there are also exceptions which indicate the equivocal nature of policy conclusions and recommendations.<sup>24</sup> Secondly, the efficiency of labour market liberalization reforms also depends on other reforms that boost economic activity, implemented in parallel (i.e. stimulating competition). It is therefore advisable to precede the development and adoption of the new Labour Code by an update of comparative data on labour legislation at international level, not only in terms of the OECD indicator, that has its shortcomings, but also by using other similar indicators. A complex analysis of the current situation in the Republic of Moldova in comparison with the countries in the region would allow to identify the vector of liberalization of the national legislation, and would facilitate the negotiation among the social partners, responsible for labour area.

## Challenges and Forecasts

**In 2017, the contradictory processes of the past years continued on the labour market in the Republic of Moldova.** Synchronization of wage growth rates and labour productivity is one of the positive trends, which however has been overshadowed by certain worsening of employment quality. The process of developing and adopting new Labour Code that liberalizes the relations between the employer and the employee was started in order to increase the efficiency of the labour market. However, the following trends and challenges in the medium run for the local labour market must be taken into account in the process of changing the legal and institutional framework of the labour market:

- **The uncertain impact of the labour legislation liberalization.** International practice shows, that the process of labour legislation liberalization has a measurable impact only if it is accompanied by other reforms, able to stimulate the performance of companies (i.e. competition). The complexity of the international indicators of comparisons between countries and their variety should be taken into consideration in the process of drafting the new Labour Code as well. Only such a complex comparative analysis would allow identifying the potential level of labour market liberalization in the Republic of Moldova.

<sup>23</sup> A. Muravyev, 'Evolution of Employment Protection Legislation in the USSR, CIS and Baltic States, 1985 - 2009', IZA no. 5365, 2010.

<sup>24</sup> OECD, 'OECD Employment Outlook 2013', 2013.



- **Continuing processes of employment quality worsening.** The declining trend of high- and medium-skills jobs has been entrenched and will likely continue its path in the following years. The negative effect of this trend is also amplified by the persistence of high rates of informal employment. Both factors mentioned above will inhibit the rapid growth in labour productivity, on which the salary increases are becoming more dependent as well.

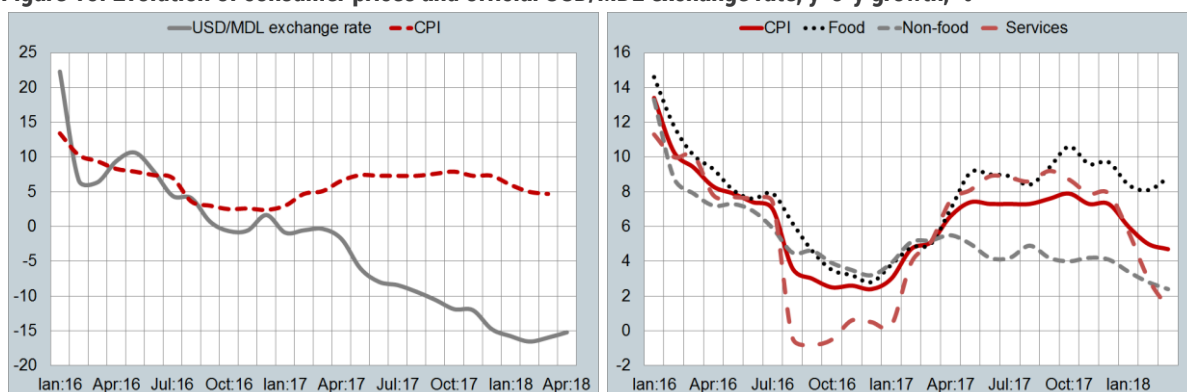
## Chapter 5. Prices and monetary policy

*If 2017 was marked by increasing inflationary risks, in early 2018 the trend reversed. The main factors that determined the inflationary dynamics in 2017 were higher prices for certain agricultural products and higher tariffs on public utility and health services. At the same time, on the background of larger currency inflows, the Moldovan Leu appreciation trend had a disinflationary effect in 2017 and in Q1:18. To avoid the excessive appreciation of the national currency, the NBM actively purchased from currency. However, the procurement of currency generated additional costs for the central bank in the context of managing the excess of liquidity in the banking sector. Thus, the NBM had to expand the sterilization operations on the monetary market and increase the reserve requirements up to 40%, reducing the base rate at the same time. We expect the inflation rate to stay within the corridor of 3.5-5% in 2018. The important risks, however, will remain and the NBM will have to continue managing prudently the excess liquidity in the banking sector, and to stabilize the exchange rate evolutions.*

### Recent Trends

**If 2017 was marked by more intense inflationary dynamics, in Q1:18 the price growth slowed down.** During 2017, the price growth rates raised from 3% y-o-y in Jan:17 to 7.9% y-o-y in Oct:17. However, the first signs of the trend change emerged in late 2017: in Nov:17 and Dec:17 prices grew by 7.3% y-o-y, while in Q1:18 the disinflationary trend strengthened: the inflation rate diminished from 6% y-o-y in Jan:18 to 4.7% y-o-y in Mar:18. In Q2-Q4:17, the inflationary dynamics was determined by internal factors: the evolution of food prices and tariffs for services (Figure 15). The rise in costs of food products was mainly caused by the increasing prices for certain categories of goods: meat, potatoes, vegetables and fruit. In 2017, the increase in the price of meat was caused by two factors: the price in meat increased on international market by 9%, and domestic sales of livestock and poultry dropped by 2.6%. The bad weather from Apr:17 delayed the potato harvesting in Q2:17, which led to higher prices for this product. The growth in prices for fruit and vegetables was caused by the pessimistic forecasts concerning the harvest in 2017, which in turn were based on the assumption that the unfavorable weather conditions from Apr:17 and the arid weather in Jul-Aug:17 will have a negative effect on the agricultural production. The increase in prices for services was determined by administrative decisions: in Q1:17 the Government ordered to increase the tariffs for medical services, and in Q2:17 ANRE approved to raise the tariffs for heating, water and sewerage services. At the same time, in 2017, the appreciation of the national currency had a disinflationary effect: MDL appreciated against USD by 7.8% y-o-y and against EUR by 5.6% y-o-y. The appreciation trend continued in Q1:2018 and the MDL appreciated against USD by 19.2% y-o-y, and against EUR – by 3.3% y-o-y. In fact, at the beginning of 2018, the strengthened MDL had an important role in reducing inflation.

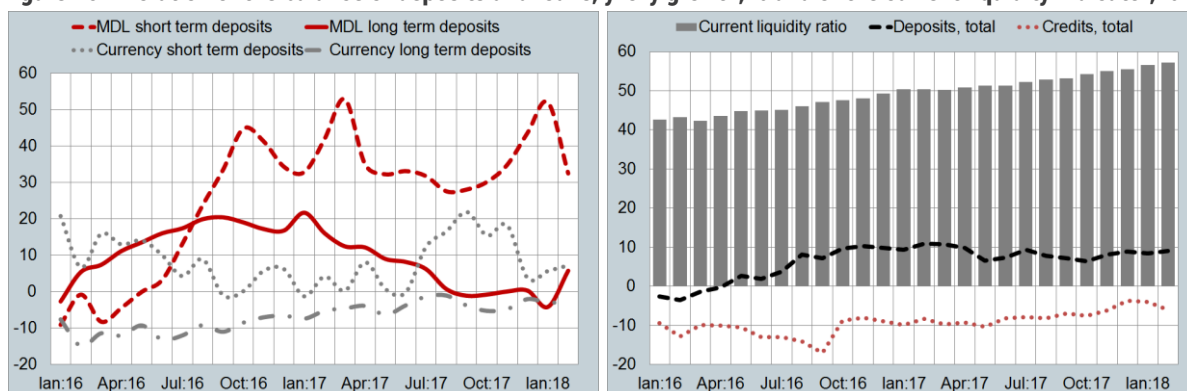
Figure 15. Evolution of consumer prices and official USD/MDL exchange rate, y-o-y growth, %



Source: NBS, IMF, NBM, EG calculations

**The growth of deposits maintains the excess liquidity in the banking sector.** During 2017 and Jan-Feb:18, the deposits grew constantly, with rates fluctuating between 6.4% y-o-y (Oct:17) and 11% (Feb:17). The deposits grew mainly due to the increase in demand deposits (Figure 16). Since Jan:17 an obvious decreasing trend was found in the growth rates of the term deposits balance in MDL<sup>25</sup>. The reluctance of the population to save money in the long run is driven by low confidence in the banking sector. Similarly, the appreciation of MDL demotivates the population and business entities to place their savings in foreign currency deposits. In this context, they prefer to place their money in MDL demand deposits. Currently, this option allows both to diminish the risks related to the depreciation of currencies against Moldovan Leu and to withdraw quickly the money in case of negative financial evolutions. At the same time, despite the increase of new loans offer (by 8.9% in 2017 and by 14.4% y-o-y in Jan-Feb:18), the balance of bank loans in MDL continues to fall (-6% y-o-y in Feb:18). In this context, because of the reduction in loan and the increase in deposits, the banks accumulate money, and as a result the upward trend in the current liquidity amplifies (in Feb:18 the current liquidity indicator reached 57.14%).

Figure 16. Evolution of the balance of deposits and loans, y-o-y growth, % and of the current liquidity indicator, %



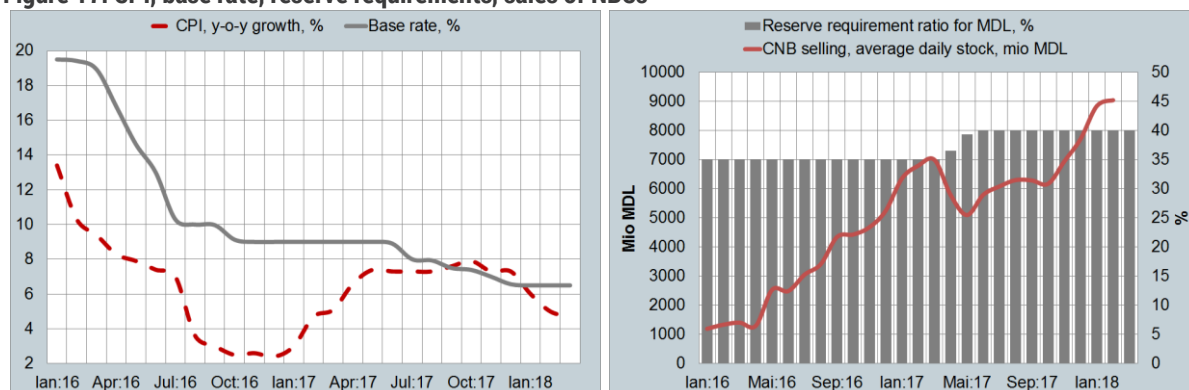
Source: NBM, EG calculations

**NBM strives to achieve two different objectives: maintain the inflation and stimulate the lending. This implies an additional effort by NBM.** In 2017, the NBM reduced the base rate from 9% to 7% in order to boost the lending activity. In Jan:18, the base rate reduced to 6.5%. Note that in the context of this easing, the base rate dropped below the level of inflation during Sep-Dec:17 (Figure 17). However, in Jan-Feb:18, the base rate exceeded again the growth

<sup>25</sup>The balance of term deposits in foreign currency has constantly decreased since Dec:15, although decreasing rates are constantly going down. Since Jul:16 the balance of the MDL demand deposits has grown at high rates, and since Sep:16 the increase has varied between 27.6% y-o-y (Aug:17) and 52.9% y-o-y (Mar:17). At the same time, the balance of foreign currency demand deposits is increasing, but since Sep:16 the ascension has slowed down.

rate of consumer prices due to the reduction of the inflationary dynamics. At the same time, in 2017, to mitigate monetary pressures on inflation, the NBM increased the reserve requirements from 35 to 40% (Figure 17). In Q1:18, the reserve requirements remained at the level of 40%. Also, to manage the excess of liquidity, the central bank has significantly expanded its sterilization operations on the monetary market. Moreover, in Feb:18, the daily average balance of NBC sold by NBM slightly exceeded 9 billion MDL, which represents the highest level in the history of this type of transaction (Figure 17).

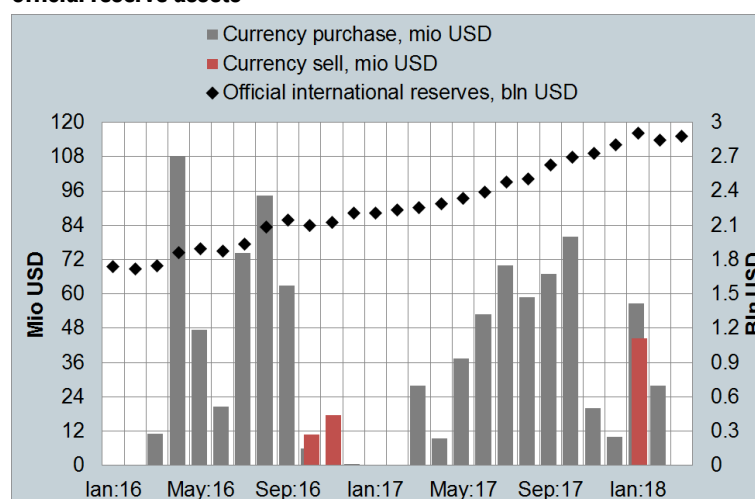
**Figure 17. CPI, base rate, reserve requirements, sales of NBCs**



Source: NBM, EG calculations

**NBM intervenes more actively in the foreign exchange market as a buyer because of MDL appreciation. The active purchase of foreign currency by NBM also involves massive interventions on the money market.** In 2017, the NBM was active on the foreign exchange market only as a buyer and purchased USD 433.7 million (Figure 18). In Jan-Feb:18, the central bank continued to intervene mainly as a buyer and purchased USD 84.5 million, but it also sold USD 44.4 million. The procurement of currency by the NBM brings more liquidities in MDL held by the banking sector, which requires an additional effort to manage the liquidities. Due to the NBM interventions in the foreign exchange market, the official reserve assets increased and in Mar:18 reached the level of USD 2.9 billion (Figure 18).

**Figure 18. NBM interventions on the foreign exchange market and official reserve assets**



Source: NBM, EG calculations

## Forecasts and Challenges

- **In 2018, the price growth will enter the bottom of the corridor targeted by the NBM and reach values of 3.5-5%. The level of uncertainty is higher for 2019, but the inflation rate will most likely remain close to the 5% level.** However, important risks that could affect the evolution of inflation will emerge.
- **Most likely, in 2018 the foreign exchange market will be marked by the increasing trend of currency inflow.** Increasing exports and maintaining external financial assistance will boost the inflow of currency. In this context, there will be pressures leading to MDL appreciation. Under these circumstances, the NBM will have to purchase foreign currency in order to diminish the negative impact on the trade balance.
- **In 2018, the symptoms of 'Dutch disease' may occur. Because of the appreciation of the national currency, the increase in prices for certain categories of non-tradable goods might grow in intensity.** The 'Dutch Disease' is driven by an increasing inflow of currency, which boosts the appreciation of the national currency and leads to higher prices for non-tradable products (goods that are not object of export-import transactions). Note that in 2007-2008 some signs of the 'Dutch disease' were noticed: the massive inflow of currency provoked the appreciation of MDL, which increased the prices for real estate. The evolutions registered in 2018 can be compared with those of 2007-2008, although there are several differences. Before the economic crisis of 2009, the increasing remittances and foreign investment fostered the demand for real estate. At present, the role of remittances and foreign direct investments diminished: if in 2008 the share of remittances in the GDP accounted for 31.2% and the share of FDI inflow was 11.7%, in 2017 the remittances accounted for 19.2%, and the foreign investment – 2.5%. At the same time, the share of foreign financial assistance offered to the Government increased. This encourages public investment. In this context, in 2018 it is likely that the prices for some services related to constructions will increase (such as design or inspection), and also that the prices for privately funded constructions will grow, as more workers could be involved in public projects.
- **Managing the excess liquidity in the banking sector and leveling out the national currency will continue to be the major challenges of the monetary policy.** By purchasing the currency, additional MDL will be issued, and the NBM will have to sterilize the additional money supply. It is possible that the sterilization operations will amplify in these conditions, while the reserve requirements are less likely to reduce significantly.

## Chapter 6. Banking Sector

*The financial and banking sector reform sped up at the end of 2017, with a range of laws and regulations being adopted to align with the latest and best international practices. The efforts to restructure bank shareholders also show the first really important results, BC Victoriabank being the first bank to attract a strategic investor with a good external reputation. However, the relatively small scale of the national economy, the low financial intermediation and the echoes left by the bank fraud, make it less attractive for large foreign banks. In addition, though more than three years passed since decapitalization of several banks, the investigation into persons involved and damage recovery go around in circles, which cause speculations and interpretations about the authorities' real intention to shed light on this issue, which is of particular interest for the society. At the same time, the banks' individual financial performances do not provide solid prospects either. The registered profit is rather a marginal effect of the monetary policy that may only be taken into account on a short run, than the result of the lending activity expansion.*

### Recent Trends

**The financial and banking sector reform agenda is being implemented at a sustained pace over the last period, but without any clear progress in terms of investigating the bank frauds and recovering of the stolen money.** Although in 2017 some actions were taken to improve the local banking sector and increase resilience to unexpected events, these are somehow shaded by the lack of results in the investigation of bank frauds. Also, despite the progress made in redressing the banking situation, some risks still remain, which are also explained by the continued application of an intensive monitoring regime at the largest banks. This is about finishing of increasing transparency of shareholders from all the commercial banks and insurance companies, about alienating shares put up for sale to high quality shareholders or about implementing a sound system of preventing and combating money laundering. From a legislative and regulatory point of view, the reform actions were intended to adopt acts transposing Basel III Agreement into the national legislation, respectively, a new framework law for the banking sector – Law on Banks' Activity<sup>26</sup>, and Regulation on Internal Governance and Risk Management in Banks<sup>27</sup>. The Law entered into force on 1 January 2018 and requires a comprehensive implementation process, as well as transition periods of up to three years, so that banks would have enough time to fully comply with the new rules.

**Reform actions were also meant to unblock the situation on alienating equity stakes at the largest sectoral banks and certain insurance companies.** Nonetheless, of all banks that face problems in ensuring transparency of shareholders, only BC Victoriabank managed to attract a strategic investor of high quality so far. It is Banca Transilvania Romanian bank which decided to purchase a 39.2% stake and, which, together with the European Bank for Reconstruction and Development, currently own 2/3 of BC Victoriabank. On the other side, after NBM blocked the rights of certain shareholders at the first two largest sectoral banks (BC Moldindconbank and BC Moldova-Agroindbank), the alienation process has stalled due to the lack of a detailed procedure for the cancellation, issuance and sale of shares held in transgression of the requirements for the quality of shareholding in banks' capital. To this end, in order to provide a legal framework which would expressly determine the stages for selling the newly issued shares, the criteria for setting

<sup>26</sup> Law No 220 of 06.10.2017 on Banks' Activity. It entered into force as of 1 January 2018

<sup>27</sup> Regulation on Bank's Activity Management Framework approved by the Decision of the Executive Board of NBM No 146 of 07 June 2017

the price, the terms of selling, as well as the means of compensating the former shareholders, the Law on Capital Market was amended and supplemented<sup>28</sup>. Moreover, to prevent any possible de-capitalization of banks<sup>29</sup>, the takeover of the shares by the State with subsequent sale to a potential investor was proposed as an interim measure. Thus, the Law on the Administration and Privatization of Public Property<sup>30</sup>, which allows the State, in the person of Public Property Agency, to get involved in the sale process, was supplemented as well. In addition, in March 2018, the meeting to establish the Single Central Securities Depository (CSD) was held. This should start its activity in April according to Law on CSD<sup>31</sup> and Regulation on CSD Supervision. This depository will be used to create an efficient pattern of keeping record of securities so as to confer safety and integrity to owners, to protect their rights and increase transparency of shareholders up until beneficial owners are exactly known.

**On the other side, after more than three years from the decapitalization of the banking sector, the defrauded assets are being recovered only through liquidation of the three banks.** This lack of results denotes serious concerns regarding the actual desire of the authorities to recover the money and punish the persons involved. Although the cross-institutional platform empowered to efficiently manage the investigation of banking frauds was created, so far, no public information exists on its meetings, decisions and results. The sole remarkable fact in recent months is the completion of the 'Kroll 2' report, which, according to its summary confirms that the Shor group was involved in the fraudulent process of granting credits, as well as the use of certain sophisticated money laundering mechanisms, or that actions were taken in a coherent chronological order to take full control over the three banks and steal as many funds as possible. The full report, including operative data on the tracing of defrauded funds, as well as the list of presumed beneficiaries, was submitted to Anti-Corruption Prosecutor's Office, the response of which is still awaited.

**The main financial and prudential indicators of individual and collective performances of commercial banks remain adequate, but also involve high opportunity costs.** Liquidity and solvency indicators remain above prudential requirements imposed by NBM, while capital reserves provide good absorption capacity for unexpected losses, as well as additional resources for crediting the economy. Risk weighted capital adequacy remains at over 30% across the banking sector, oscillating between 25% for large banks and over 50% for small banks. At the same time, at the aggregate level, the volume of liquid assets tends to reach 57% of the total assets, while at the individual level even more than 68% are recorded, which reveals that banks bear considerable opportunity costs in the absence of loan expansion. Aggregated bank assets reached the volume of MDL 81.9 billion at the end of Feb:18, which is some 10% more than in February 2017. The main contribution is still generated by deposits from individuals, which, however, on the asset side is not reflected in the 'loans granted' component, but in the cash accounts and other liquid assets. Following this progress, the share of granted loans amounts to only 39% of the total assets, by about 7 p.p. less y-o-y, i.e. by MDL 2 billion less. In spite of this, the banks continue to be profitable. High bank margins, credit fees, exchange rate fluctuations, or NBM remuneration to sterilize excess liquidity remain basic elements supporting the banks' final result.

**Lending activity became slightly more dynamic in terms of new loans, but still insufficient to improve the banks' financial intermediation function.** This trend is supported by the volume of newly granted loans, respectively, in 2017, new loans were granted in the amount of about MDL 24.5 billion, about 2 billion more y-o-y; this trend was confirmed in the first two months of 2018 as well. Nonetheless, loans granted before 2016 are reimbursed at a much faster pace, which implies a further decrease in the total balance of loans granted. As a result, the level of banking intermediation at the end of 2017 was only of 21.4% in relation to the GDP – the lowest level over the last 10-15 years. Thus, the

<sup>28</sup> Law No 171 of 11.07.2012 on Capital Market

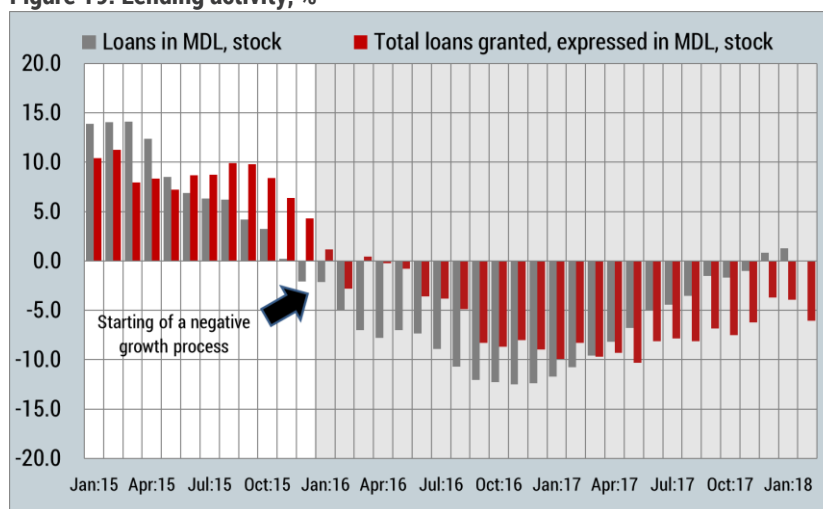
<sup>29</sup> The banks are obliged to redeem unsold shares in a relatively short term and simultaneously diminish the capital and compensate the eliminated shareholders.

<sup>30</sup> Law No 121 of 05.04.2007 on the Administration and Privatization of Public Property

<sup>31</sup> Law No 234 of 03.10.2016 on Single Central Securities Depository

balance of loans granted at the end of Feb:18 amounted to MDL 32.1 billion, falling by 6% y-o-y, or by MDL 2 billion less (Figure 19). The loans in foreign currency decreased the most, -13,6% y-o-y, especially those in USD, mainly granted to trade and industrial sector. This may also be a statistical effect, considering that the MDL/USD exchange rate decreased by about 20% during the reporting period, and foreign currency loans are finally provided in Moldovan lei. At the same time, the balance of loans decreased for legal entities only (-12% y-o-y), while the trend among the individuals is opposite (+20% y-o-y). The latter, however, is not enough, considering the 1/3 ratio in favor of legal entities for the entire portfolio. Nonetheless, this ratio may decrease, as the Government completed all technical procedures for the 'Prima Casa' State Program<sup>32</sup>, some banks already announcing the acceptance of applications as of 26 March this year.

**Figure 19. Lending activity, %**



Source: Author's calculations based on NBM data

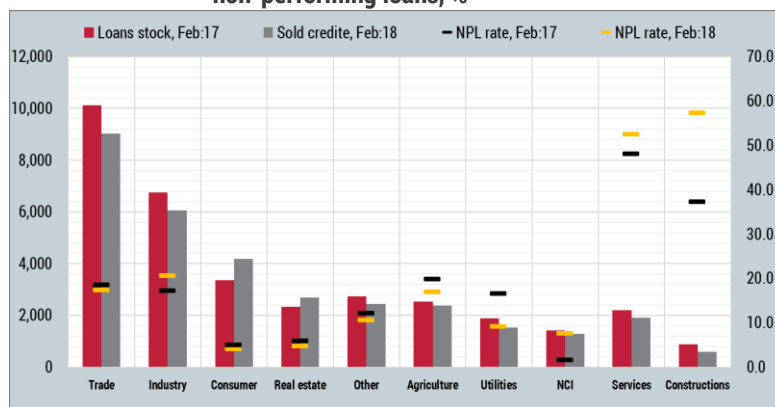
**Quality of bank assets tends to improve, pointing out measures adopted by the banks to reduce the stock of non-performing loans.** Separating good assets from bad assets and removing the latter from the balance sheet or implementing mediation techniques to resolve disputes with customers are among the new procedures applied by several local banks. Also, the trial and the collateral enforcement process is coming to an end for a large part of expired loans previously granted. For our country this process has been taking about 2 years, during which the bank is not able to proceed to the enforcement of the collateral and to the recovery of the damage. Against this background, as the non-performing loans ratio continued to grow throughout 2017, it tends to decline in the first months of 2018. Even if the calculation base is reduced (total balance of loans), the balance-sheet restructurings carried out by certain banks, the advancement of the recovery process or the actions supported by dialogue with the problematic customers contribute to the decrease of both non-performing loan stock and rate. As a result, the balance of debts for loans assessed as sub-standard, dubious and compromise decreased by about MDL 1 billion during Dec:17 – Feb:18, reaching MDL 5.3 billion or a share of 16.6% of the total loans granted at the end of Feb:18.

**In terms of economic sectors, the riskiest portfolios continue to be represented by exposures in construction and services, while agriculture and consumer loans show the opposite situation (Figure 20).** Besides, individuals continue to be the customers with the lowest non-performing loan rate of only 4%, which confirms the interest of banks in consumer loans or mortgages in the real estate sector. In addition, although the agricultural sector has an average share of non-performing loans, the banks remain reluctant to finance it. The extensive territorial location and high

<sup>32</sup> 'Prima Casa' ('First Home') Program aims to facilitate the access of individuals to the acquisition of housing by contracting loans partially guaranteed by the State, especially for young families. The program is national and has a social character, represented by state intervention in the credit guarantee process.

informal activity leave agriculture without access to bank loan, the demand being directed to less regulated sectors, such as microfinancing or leasing when it comes to agricultural machinery. At the same time, even with a large stock of non-performing loans, banks have enough capital to cover any possible losses. Amid a consistent revenue in 2017 and the maintenance of relatively austere dividend policies, the provisioning of non-performing loans improved, providing an additional guarantee for unexpected events. At the end of Feb:18, the accrued allowances for losses on assets and conditional commitments of the entire banking sector represented 115% of non-performing loans, while the allowances for impairment losses on assets and conditional commitments as per IFRS – about 71%.

**Figure 20. Total loans granted per sectors, MDL thousand vs non-performing loans, %**



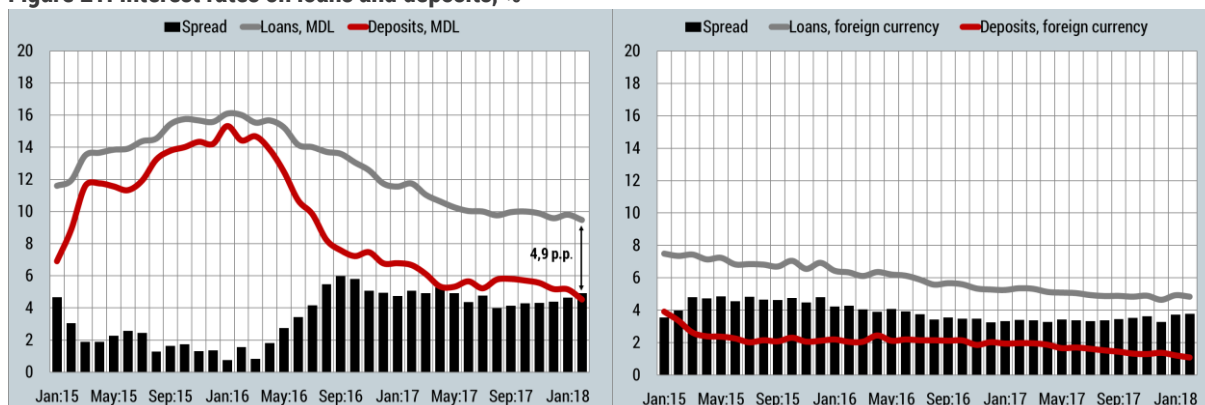
Source: Author's calculations based on NBM data

**For most banks, deposits attracted from the population and companies continue to be the main component of liabilities that finance lending.** At the end of Feb:18, the volume of deposits in commercial banks rose to MDL 61.8 billion, by about 8.4% more y-o-y. This growth was mainly generated by the increase of national currency deposits by almost MDL 5 billion, against the background of rather low interest rates for the deposits in EUR or USD. Following the 2014/2015 crisis, the deposits in MDL are becoming increasingly attractive, the current MDL/currency ratio being of 1.3 compared to only 0.7 three years ago or a share of 56.8%. Even so, a little more than half of the deposits attracted by banks are term deposits with interest, a sign that the confidence of the population and companies in the prospects of the national economy is not fully assured. Moreover, in the absence of other saving instruments, most of the population's financial assets are concentrated in commercial banks in the form of deposits, while access to Government or corporate securities is still limited.

**Although the cost of loans continues to decline, many of the resources attracted by banks do not find a counterpart in lending activity.** This confirms the companies' reluctance to invest and/or the wish to postpone investments until later, possibly, after the parliamentary election at the end of 2018. High bank margins remain one of the distinct features of the domestic banking sector, as a result of the increased materialization of risks, especially of the loan one, but also of a relatively high level of inefficiency. At the end of Feb:18, the bank margin registers an average of 4.9 percentage points for operations in MDL and of 3.8 percentage points for foreign currency ones – relatively constant levels in the last 2 years (Figure 21). The average interest rate on new deposits in MDL varies around 4.5%, which is below the annual inflation level of 5% registered at the end of 2017. At the same time, the average rate on new loans varies around 9.5%, by 1.5-2 p.p. less y-o-y. Consumer loans granted to the population continue to register on average a higher level of interest rates, both in MDL and in foreign currency, (about 14% and 7% respectively),

while companies can benefit from around 2 p.p. lower rates – and here we refer to the effective annual interest rate that includes all additional loan granting fees.

**Figure 21. Interest rates on loans and deposits, %**



Source: Author's calculations based on NBM data

**Excess liquidity in the banking sector remains a concern, both for the commercial banks and the NBM.** At the end of Feb:18, the aggregate short-term liquidity amounts to 57%, continuing to grow and rising by about 7 p.p. y-o-y. This phenomenon shows the lack of a sound demand for loan, but at the same time the reluctance or even the lack of banks' motivation to credit companies with a higher credit risk. As a result, the demand for financing these companies is supplied by other financial market compartments in the name of non-bank lending organizations, the excess of bank liquidity being further channeled to the facilities offered by the NBM through bank certificates (NBC) and 'overnight' deposits. These instruments currently account for about 18% of liquid assets, or 12% of total bank assets, which creates additional costs for the NBM in achieving monetary policy objectives. On the other side, both the long-term and maturity bands liquidity level remains around comfortable values, both from the perspective of banks' prudential requirements and their investment objectives.

## Challenges and Forecasts

- **Although the lending process seems to become more active, in 2017 the banking intermediation continued to decrease, the same situation being registered in the first months of this year.** In the context of an electoral year, investors' uncertainty increases and so does the reluctance to launch new business projects or to extend the existing ones. Inspired by consumers and real estate loans to individuals, we forecast for the year 2018 a real increase of about 15% in the new loans granted in an optimistic scenario or of 7% in a pessimistic scenario. At the same time, forecasts take into account the other components of the financial system that contribute directly to the financing of the economy, while an increased growth of assets of the microfinancing or leasing companies is observed in the recent times.
- **Bank exposures in the real estate sector will be fueled by the 'Prima Casa' Program launched by the Government and implemented by banks in partnership with the Organization for Small and Medium Enterprises Sector Development.** Officially launched on 26 March 2018, it already has several signed contracts and a relatively large number of applications under assessment. However, attention is drawn to the quite large group of people who may apply for loans under this program, namely persons under 45 years of age who have not owned or shared with the spouse any housing in the last 12 months, which means that for some this might not be the very first home. These circumstances make people wonder to what extent this program has a social character and who would be the main beneficiary. Real estate companies have already updated their offers and tend to establish partnerships with the banks in order to provide a large supply of

apartments. On the other side, the banks might neglect the standard real estate loans, paying more attention to and favoring applications secured by State guarantees.

- **Increasing the level of transparency and governance in the financial and banking sector continues to be the key aspect in the relationship with partners and foreign financial institutions.** Both the Agreement signed with IMF and the Memorandum of Understanding signed with the EU<sup>33</sup> emphasize an increased involvement of national authorities in assessing the quality of shareholders of banks and insurance companies, in determining final beneficial owners and in increasing governance standards. The most recent assessment on fulfillment of commitments taken by Moldovan authorities, carried out by IMF<sup>34</sup>, shows that important progress is being made in repairing the situation, including improving transparency in ownership and management, strengthening supervisory and regulatory frameworks, and carrying out bank level diagnostics. Nevertheless, significant challenges remain and more actions have to be fully implemented in order to keep up the progress. This is about finishing of increasing transparency of shareholders from all the commercial banks and about alienating shares put up for sale to persons complying with integrity and reputation standards.
- **Attracting high quality strategic investors remains one of the either financial and political objectives.** Moreover, to make the put up for sale shares of the largest banks more attractive, it was proposed to involve the State in their sale process. This fact implies increased attention in the event that the State purchases equity stakes given that the previous experience speaks of negligence and maladministration by those who represented the State's interests. In addition, the small scale of the national economy and the faulty intermediation process make the banking sector less attractive for large foreign banks. A good part of the revenue generated by banks does not derive from an organic growth of the lending activity but is rather the result of the NBM monetary policy, high level of the bank margin, and the revenue from non-lending activities.
- **The lack of results in terms of bank fraud and recovery of embezzled funds continue to affect both the overall picture of the financial sector and the confidence in investigation institutions.** Although many resounding files are in progress, the funds are recovered only through liquidation of the three banks and sale of their assets. NBM received the entire second investigation report of Kroll and Steptoe & Johnson companies in March, this year. The document comes with a number of additions to Kroll 1 Report and an analysis of exposures of defrauded banks during 2012-2014, the relation between 'Shor group' and shareholders of these banks, mechanisms of money laundering and the destination of fraudulent funds. At the same time, besides Ilan Shor, the published summary does not reveal any other names, while the detailed information, including in operative data on the tracing of defrauded funds, as well as the list of presumed beneficiaries being submitted to Anti-Corruption Prosecutor's Office.
- **According to Kroll investigation reports, both up to and during 2014-2015 banking crisis, the Republic of Moldova was targeted by mechanisms and groups specialized in bank fraud and money laundering.** Although a new law preventing and combating money laundering and terrorism financing has recently been adopted, the national financial system remains vulnerable from the point of view of transactions with suspicious funds or the impossibility of determining their final beneficiary. The temptation to use the national financial system as a platform for the legalization and transit of dubious funds is presented by the still large number of transactions that were assessed as suspicious (about 600 thousand annually). The delay in adopting the law prevented the development and adoption of secondary legislation, which was planned to be completed by the end of 2017, as our country undertook towards external partners. Therefore, the law contains general terms,

<sup>33</sup> Memorandum of Understanding Between the European Union and the Republic of Moldova on Macro-Financial Assistance

<sup>34</sup> The Second Review of the Republic of Moldova's Program, under the Extended Credit Facility and Extended Fund Facility, as well as consultations stipulated in the Article IV of the 2017 IMF Status. <https://imf.md/press/cr17398-MoldovaBundle.pdf>.



giving no details about the range of aspects related to the application of certain important provisions, such as identification and verification of a client and beneficial owner, definition of violations or procedure and means of application of fines.

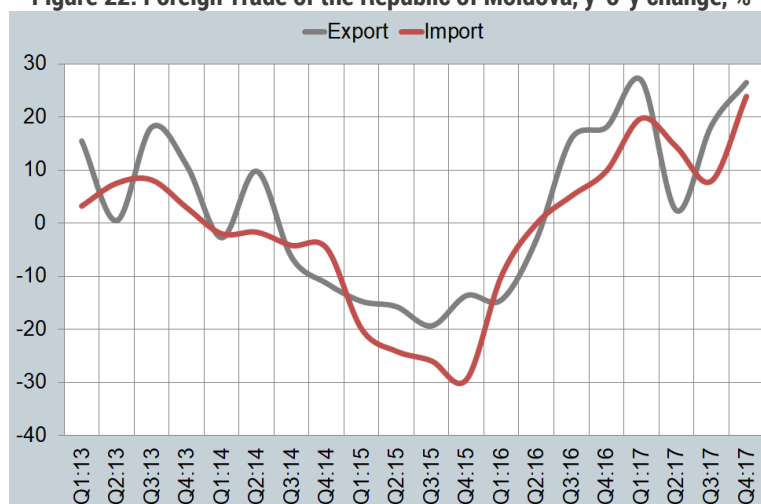
## Chapter 7. Foreign Trade

The foreign trade registered a positive evolution during 2017, but we have to take into account the quite low basis of comparison of 2016. This growth was possible due to the revitalization of the trade with EU, which reached the maximum, but also after the exports to the Russian Federation were partially resumed when the trade restrictions on imports were (partially) removed. As for the structural exports of the country – they show certain deficiencies regarding the competitiveness of the country as a whole and reveal a number of vulnerabilities that undermine the recorded performances. The public administration reform also impacted the institutional capacities of the entities responsible for implementing the DCFTA, which hindered the implementation of certain undertaken commitments. On the other side, in order to extend the commercial relations, the authorities have started negotiations with the People's Republic of China with a view to concluding a Free Trade Agreement with it.

### Recent Trends

The evolution of foreign trade in 2017 shows a revival after the dramatic drop registered during the past years. Thus, in 2017, the value of exports was by 18.6% higher than in the previous year and amounted to USD 2425 million (reaching practically the maximum value of USD 2428 million registered in 2014). At the same time, the value of imports in 2017 amounted to USD 4831 million, i.e. by 20.2% more y-o-y. Thus, the given developments resulted in the accumulation of deficit of the trade balance in the amount of USD 2406 million in 2017, i.e. by 21.8% more y-o-y. Respectively, there was an increase in the deficit both in relation to the EU countries, up to USD 792 million (from USD 642 million in 2016) and in relation to CIS countries – up to USD 743 million. (from USD 613 million in 2016). On the other hand, the level of coverage of imports by exports remained unchanged, amounting to 50.2% in 2017, compared to 50.9% in 2016. At the same time, the above-mentioned trends in relative terms should be interpreted through the lens of the very low basis of comparison of the past 2 years (Figure 22). Note that the same positive dynamics of foreign trade were also typical for the first two months of 2018, where exports increased by 38.0% and imports – by 33.8%.

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



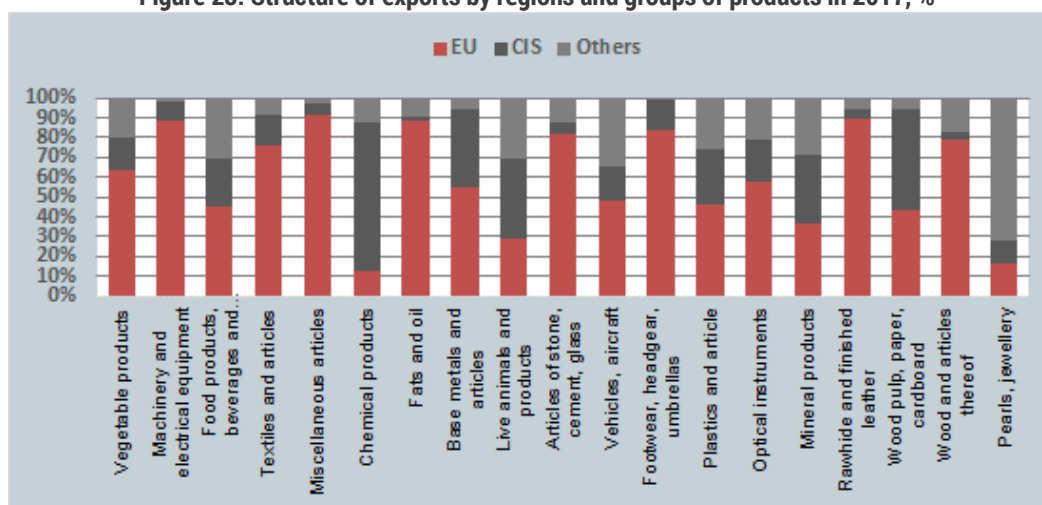
Source: Expert-Grup calculations based on NBS data

Geographically, the European Union is still the main destination of Moldovan exports, with a total value of USD 1597 million in 2017, reaching a historic maximum, up by 19.9% y-o-y and with a share of 65.8% in total exports (65.1% in 2016). In this region,

the most significant increases were confirmed to Romania (by 17.1% more y-o-y, as a result of an increase in cables, sunflower and rape seeds exports), Germany (by 31.2% more y-o-y, as a result of an increase in exports of chair parts, electric circuits, and nuts), but also in Italy (by 19.3% more y-o-y, due to increased exports of wheat, textile articles and electric circuits). At the same time, almost no decreases in individual exports towards any EU member state were registered, except for the insignificant reduction in absolute terms of exports to Finland (by USD 0.7 million less y-o-y, as a result of the decrease in the export of sunflower seeds). In spite of the aforementioned developments, which point to the progressive integration of Moldovan exports into the European commercial system, we cannot ignore excessive concentration both in geographic terms (over 70% of total EU exports are directed to only 4 member countries: Romania, Germany, Italy and the United Kingdom) and in terms of diversity of exported products (over 70% of total EU exports are only 7 categories of goods: electric circuits, textile articles, oilseeds, chair parts, fruits and wine). At the same time, note that most of these exports were made under inward processing regime (at the request of applicant and with the use of its raw materials), which implies a rather small added value.

**The use of export tariff quotas in the EU looks good.** Two categories of the products subject to annual exemption from customs duties were fully exported in 2017: the quotas on table grapes and plums were used to the extent of 100%. On the other hand, the quotas on apples, tomatoes and grape juice were used only in proportions of 5%, 4% and 1% respectively. At the same time, the products subject to an anti-circumvention mechanism<sup>35</sup>, eligible for exports (i.e. except for products of animal origin) saw impressive dynamics. Thus, in 2017, export quotas for wheat and processed cereals (to be more precise – for ethyl alcohol) were exceeded almost 7.6 times and 5.6 times respectively. While the quotas on other categories were used differently – from 52% and 93% for sweetcorn and processed sugar, up to 124% and 149% for maize and barley. Besides, these results reveal a higher potential of national producers, which needs to be considered when renegotiating the mentioned quotas, not to jeopardize potential exports in case of an increase in production capacity in the upcoming years.

Figure 23. Structure of exports by regions and groups of products in 2017, %



Source: Expert-Grup calculations based on NBS data

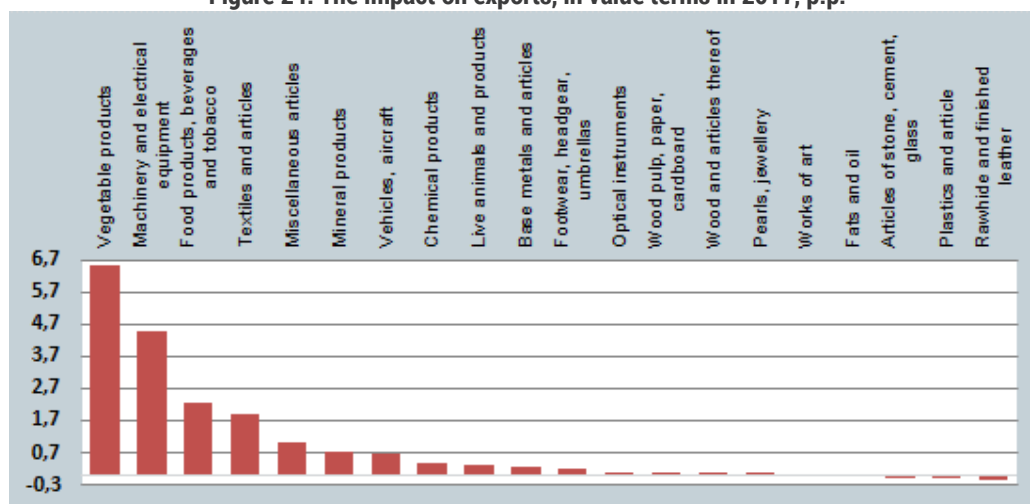
**Exports to CIS registered a positive evolution after partially resuming the exports to the Russian Federation.** In 2017, exports to the CIS countries continued to decline in relative terms, constituting 19.1% (in 2016 – 20.3%), which is equal to a value of USD 463 million, i.e. by 11.8% more y-o-y. The most important increases to this destination were registered by the Russian Federation (+9.2% y-o-y) as a result of the increase in fruit exports after the removal of the trade restrictions (grapes, apples, plums) and medicines (that are actually reexports). At the same time, since the armed conflict in Eastern Ukraine is settling down, Moldovan exports to this destination increased by about 31.8% y-o-y. The main products that registered increases are the limestone flux, the sunflower seeds and the mineral oils. At the same time, the exports to Belarus registered a 6.3% increase y-o-y as a result of the

<sup>35</sup> Mechanism establishing export quotas, but providing the possibility to exceed the maximum levels in the case of increased exports (such as better harvest or increase of the production potential of local businesses).

increase in export of corn and alcoholic beverages, while the exports to Kazakhstan increased by 29.3% y-o-y as a result of the increase in exports of milk and medicines.

**Exports to other countries of the world slightly diversified.** In 2017, exports to other countries of the world (beyond the EU and CIS), amounted to about USD 365 million – an increase by 22.4% y-o-y, accounting for a share of 15.1% (in 2016 – 14.6%). This spectacular development was possible thanks to a 69.3% increase y-o-y in exports to Turkey, as a result of the increase in exports of sunflower seeds and corn (products, for which preferential tariff quotas on export are provided under the new Free Trade Agreement with Turkey).

Figure 24. The impact on exports, in value terms in 2017, p.p.

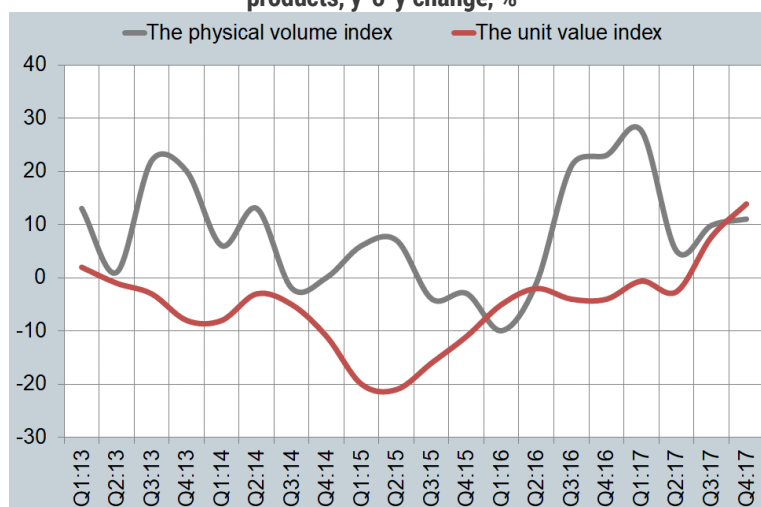


Source: Expert-Grup calculations based on NBS data

**Export of vegetable products had the most significant influence on total exports growth and increased due to deliveries of fruits, oilseeds and grains.** Thus, in 2017, the export of vegetable products increased by 25.1%, or by USD 133 million more y-o-y (a development owing exclusively to fruits, oilseeds and grains). On the other hand, the direct impact of the higher export of sunflower seeds was the decrease in the export of vegetable fats (namely, sunflower oil). The export of fruits had an equally positive evolution due to two reasons: 1) partial removal of trade restrictions by the Russian Federation; we should note here however the very low basis of comparison of 2016 (drastic reductions caused by the unfavorable weather conditions and by the trade restrictions in the Russian Federation), 2) exports reorientation to the EU market. Thus, even with the elimination of mentioned restrictions, the registered exports to the CIS countries of about USD 88 million are lower than the exports to the EU of about USD 119 million (for comparison, the historical maximum of exports to CIS countries was USD 112 million in 2011).

**The dynamics of exports expressed in quantities was much more impressive than that expressed in values.** In 2017, exports recorded a 'modest' overall result (+18.6% y-o-y), from the perspective of a quite low basis of comparison of 2016 (reaching practically the maximum value of USD 2428 million registered in 2014). However, in terms of quantity, foreign trade does not look the same as when illustrated according to values (especially in USD). Thus, there were quantitative increases in the main groups of exported products, despite the decrease in the unit value, especially in the first two quarters, as a result of the decrease in international prices for these products, with their further balancing in the last 2 quarters (Figure 25).

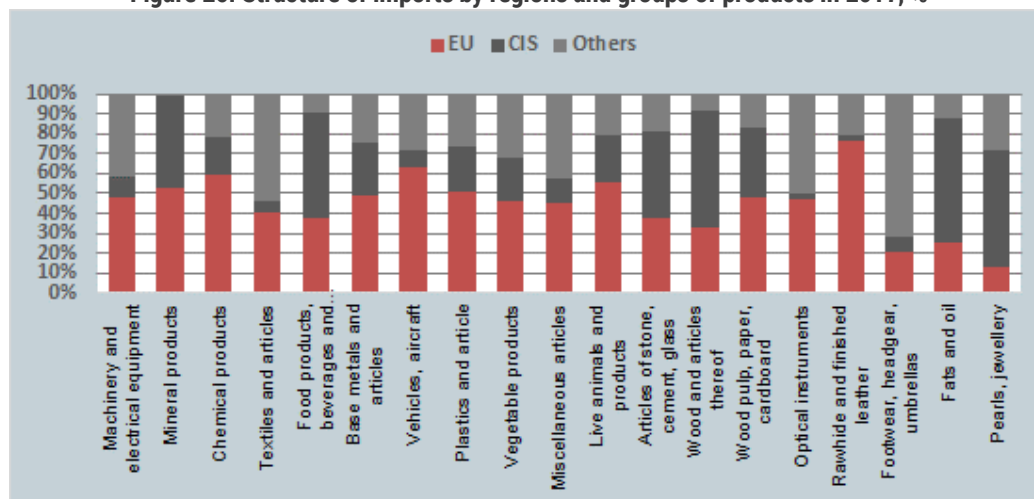
**Figure 25. Unit value index and physical volume index for the exported products, y-o-y change, %**



Source: Expert-Grup calculations based on NBS data

**Evolution of imports from the EU was determined by the revitalization of domestic consumption as well as by the needs of the national industry.** The European Union is still the main source of imports, with a total value of USD 2389 million in 2017, up by 21.1% y-o-y and with a share of 49.4% in total imports (49.1% in 2016). The most significant increases were confirmed from Romania (by 25.9% more y-o-y, due to increase in imports of petroleum oils), Germany (by 23.4% more y-o-y due to increase in imports of copper wire, fabrics and vehicles) and Italy (by 18.0% more y-o-y due to increases in imports of medicines and toys). At the same time, decreases were confirmed from the United Kingdom (by 7.9% less y-o-y, due to reduction in imports of mechanical appliances and fabrics) and Lithuania (by 13.0% less y-o-y due to decrease in imports of milk and petroleum oils).

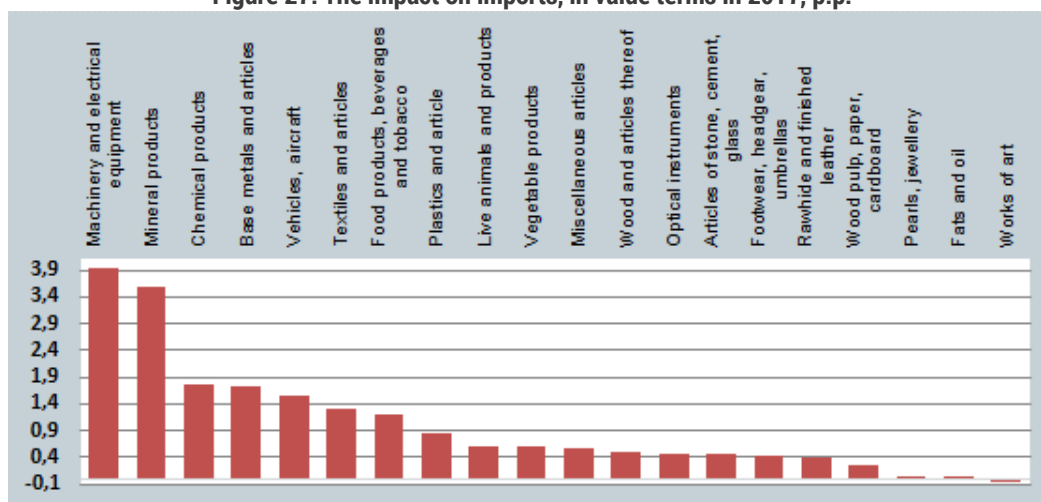
**Figure 26. Structure of imports by regions and groups of products in 2017, %**



Source: Expert-Grup calculations based on NBS data

**Increases in imports from the CIS was determined by the new electricity supply contract concluded with Ukraine.** In 2017, 25.0% of the imports came from CIS countries (in 2016 – 25.6%), which is equal to a value of USD 1206 million (about 30% of which are mineral products), having increased by 17.4% y-o-y. More was imported from Ukraine (by 33.1% more y-o-y, due to greater imports of electricity), from the Russian Federation (by 6.8% more y-o-y, due to greater imports of solid fuels, fertilizers and petroleum oils) and Belarus (by 13.1% more y-o-y due to the increase in imports of sugar and wood). At the same time, the imports from Kazakhstan dropped the most (-44.9% y-o-y), because of lower imports of petroleum gas.

Figure 27. The impact on imports, in value terms in 2017, p.p.



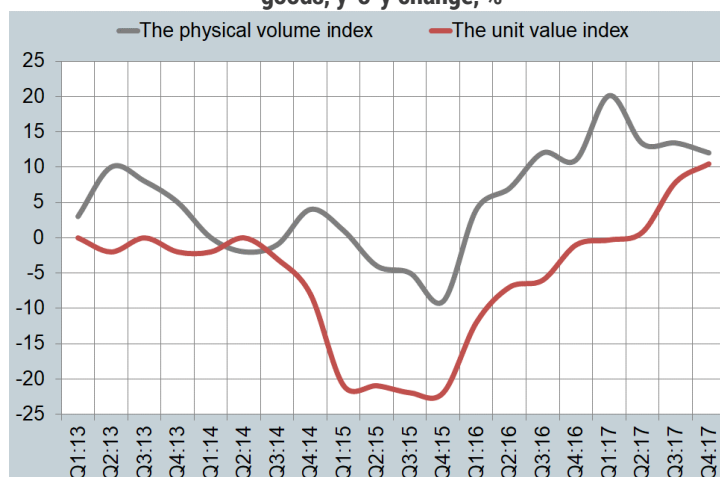
Source: Expert-Grup calculations based on NBS data

**Imports of electrical appliances, as well as cables and circuits for the export-oriented industries, had the most significant influence on the growth of total imports, and increased significantly.** Thus, during the reference period, the import of electric equipment grew by 24.6%, registering USD 801 million, which is USD 158 million more y-o-y. This dynamic is the result of increased imports of telephone devices, monitors, refrigerators, etc. as a result of restoring the demand on the domestic market and the needs of the domestic industry specialized in assembling electrical circuits. At the same time, the increase in imports of machinery used in agriculture should not be neglected as well.

**The rising fuel prices and the change of electricity source positively influence the dynamics of imports.** In 2017, the positive influence on imports was caused by the mineral products, which increased by about 22.9%, registering USD 774 million, which is by USD 144 million more y-o-y (Figure 27). This evolution was caused by the rising procurement prices for fuels by about 25% (although in quantitative terms the increases were much lower) and due to the change of the electricity source according to a new contract of electricity supply from Ukraine (previously, the electricity was supplied from the Transnistrian region and was not included in the trade statistics of the country).

**Resumption of re-exports of pharmaceutical products to CIS countries impacted the imports of the Republic of Moldova.** Thus, the positive evolution of imports of chemical products in 2017 occurred mostly due to the increase in imports of pharmaceutical products (+22% y-o-y), and their subsequent re-exports to CIS countries, a phenomenon which diminished in the past years.

Figure 28. Unit value index and physical volume index for the imported goods, y-o-y change, %



Source: Expert-Grup calculations based on NBS data



The increase in both the unit value index (mainly in Q3-Q4:17) and the physical volume index for the main groups of exported products, especially for mineral products, can be noticed in the reference period (Figure 28).

**Despite the registered commercial performances, we draw attention to the structural shortcomings reflected in the specialized international rankings, which indicates a low long-term sustainability of such a model of economic development.** Thus, according to the 2017-2018 Global Competitiveness Report, the Republic of Moldova ranks 89th out of 137 countries in the top of the global competitiveness. Despite the advancement by 11 positions as compared to the previous ranking, the Republic of Moldova is currently in the category of states the competitiveness of which is based on the intensive use of factors – it is characterized by inefficient industries, based on natural resources, climatic conditions and labor force. Moreover, the main obstacles to business development in the Republic of Moldova, such as corruption, political and government instability, access to finance, inefficient state bureaucracy, inadequate infrastructure, etc. were highlighted. All these elements greatly expose the national economy to exogenous factors such as economic crises or exchange rate fluctuation, that have immediate negative repercussions on the country's business environment.

## Challenges and Forecasts

- **The total exports of goods and services are expected to grow in 2018 by about 20%, expressed in MDL and in real terms. At the same time, imports are expected to grow by 13,6%.**
- The public administration reform hindered even more the implementation of DCFTA commitments, and the failure to strengthen the institutional capacity will maintain the risk of improper implementation of **the Association Agreement commitments**.<sup>36</sup>
- Given that the DCFTA is not completely harnessed (the results are still modest), the fact that the Republic of Moldova is not included in the group of third countries that have the right to export animal products to the EU market will fuel multiple **speculations on the economic opportunity of this agreement**.
- Taking into account the early exhaustion of EU export tariff quotas on certain products (plums, grapes, wheat, barley, corn, sugar, processed cereals), it is necessary to **renegotiate, as a matter of emergency, an increase in the allocated quantities** in the light of the new economic realities.
- Since the DCFTA preferential trade regime extended in the Transnistrian region too and there is no reliable mechanism to monitor the implementation of the agreement – **guaranteeing to European partners that the commitments under this agreement will be implemented correctly all across the country is uncertain**.
- In the context of the selective removal of the Russian Federation's trade restrictions on imports of Moldovan products, **excluding totally these restrictions and establishing trade relations on the basis of international rules** will remain a priority for the specialized authorities.
- **If the Russian Federation maintains the restrictions imposed on the imports of EU products** (especially for those directly competing with Moldovan products), the national producers will remain exposed to additional pressures on the EU markets that are over-saturated with similar products.
- Although the Republic of Moldova is part of the PEM Convention on Rules of Origin, it cannot benefit from the diagonal cumulation of origin due to the lack of full convergence of the respective Protocols under Free Trade Agreements that allow such cumulation, and the delay in this process **will not allow it to fully harness the opportunities provided by the DCFTA and by the Free Trade Agreement with Turkey**, in particular for the industries which practice such cumulation (such as the garment industry or industry of automotive components, etc.)

<sup>36</sup> According to the Report on carrying out of the 2017-2019 National Action Plan implementing the RM-EU Association Agreement during 2017, the Title V – 'Trade and Trade-Related Matters (DCFTA)' is about 65% implemented.



- Considering the initiation of trade negotiations on new free trade agreements (with countries like China and possibly Egypt, etc.), **the major challenge will consist in offering a sound economic justification and in objective quantification of the impact on the national economy, while ensuring transparency of the processes.**



## About EXPERT-GRUP

### WHO WE ARE

EXPERT-GRUP is a Moldovan non-governmental and not-for-profit organization that specializes in economic and policy research. EXPERT-GRUP does not represent any economic, corporate or political interests. As an 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 Moldovan civil society, EXPERT-GRUP positions itself as a politically and ideologically neutral think-tank.

### OUR ACTIVITIES

Our core activity is economic analysis, forecasting and policy research. In this area we offer a wide range of analytical products and services that help our beneficiaries to take decisions that support 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 forecasting;
- Political economy;
- Public finance;
- Human development and poverty reduction;
- Labor market and consumer behavior;
- Foreign trade;
- Financial markets;
- The economics of European integration;
- Sector-level economic analysis;
- Regional and local economic development; and
- Energy and environmental economics.

### PARTNERS AND DONORS

In the period 2006 –2017, the EXPERT-GRUP has implemented more than 100 research and advocacy projects in different areas related to economic and policy research. More than 130 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, FES, the UN Development Programme Moldova, the UN Children's Fund (UNICEF), the European Commission, the Council of Europe, the Open Society Foundation, the Swiss Agency for International Cooperation, and the United Kingdom Department for International Development. In 2010 and 2012 the EXPERT-GRUP was elected as a member of the National Participatory Council of Moldova. Since 2008 the EXPERT-GRUP has been a member of the Policy Association for an Open Society – a network of policy centres uniting 56 think tanks from countries across Europe.