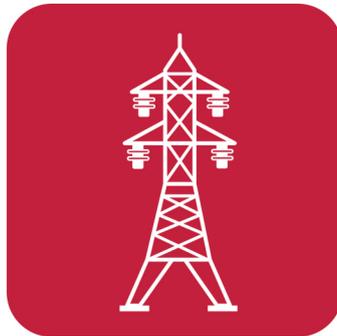




ECONOMIC REVIEW FOR 2014. CHALLENGES OF 2015



TOP 5

economic successes in 2014
economic failures in 2014
economic challenges for 2015

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■ Introduction

The year of 2014 was marked by prevailing interests of political economy over the economic policies in Moldova. As parliamentary elections approached, policymakers increasingly became more populist, often defying economic rationale. As a result, the pace of structural reforms has slowed, while many other necessary but unpopular reforms were suspended, and fiscal policy has become more generous.

In addition, several suspicious transactions and "corporate wars" involving banks and state institutions had threatened not only the stability of the banking sector, but also the security of the country as a whole. These internal vulnerabilities were exacerbated by a highly volatile economic, political and security environment in the region. In particular, the slow recovery of the EU economy and worsening economic situation in Ukraine and the Russian Federation have contributed to a slowing external demand for Moldovan exports.

Ukrainian security crisis has fuelled uncertainty among the local population and companies, which was already high due to the ongoing elections, thus negatively affecting consumption and investment activity.

Also, worsening economic and political relations with Russia have caused losses for Moldovan exporters oriented to this market; whilst depreciation of the Russian Rouble and the Ukrainian Hryvnia caused pressure on the national currency and triggered additional losses for exporters to these markets and families of migrants working in the Russia.

Amid these worrying trends, Moldovan economy seems to have managed to register a respectable 4.7% growth in the first three quarters over the previous year, this while Association Agreement with the EU has allowed an impressive growth of food exports to the EU market. Adoption of the new Education Code is expected to „refresh” the education system and support the efforts of the Ministry of Education to make the system more flexible, more transparent and better anchored to the needs of the country. Also, commissioning of the Iași-Ungheni pipeline is a small, but important step onto strengthening the country's energy security.

2015 is expected to be fairly difficult. While the challenge of forming a new government is a major one, it is surely not the only. First, it is important that the new government to assume the office on four years ahead while and having strong political support from Parliament. Second, the future government must have sufficient will and capacity to implement the commitments undertaken within the Association Agreement with the EU. Failure to meet these conditions might lead to a reduced external assistance, which would compromise the stability of public finances, would create additional pressure on the national currency and, most importantly, would compromise the structural reform agenda.

In addition, the local elections in 2015 will further complicate the future government's task to implement unpopular reforms. Another challenge of the next year is derived from a volatile external environment. This relates particularly to the risk of military escalation of the conflict in Ukraine, which could trigger a capital outflow from country, already observed in 2014. In addition, the anticipated economic recession in Russia and Ukraine that comes in hand with devaluation of their currencies, will undermine the incomes of exporters oriented to these markets and of our migrants from Russia, who are sending money back home. In addition, the slow recovery of the EU economies, coupled with internal export barriers and reduced competitiveness of Moldovan producers, will hinder the process of export reorientation to the EU market.

Here are the main policy priorities targeting fundamental development problems of the country, which could mitigate the challenges for 2015 and which must be included in the program of the future Government:

- Reviving the justice system reform;
- Increased transparency and a more effective regulation of political parties' financing;
- Continuing the education reform;
- Starting a reform of the public sector wage system;
- Starting a profound reform of the social security system;
- Increasing transparency and efficiency of the banking system regulation
- Fiscal consolidation (deficit reduction);
- Fundamental revision of the Labor Code (balancing the interests of employers and those of employees);
- Modernization of quality infrastructure;
- Increasing the budget transparency.

This is the seventh annual economic review of the Independent Think Tank Expert-Grup. The review was also performed for the years of 2008-2013, the purpose of which is to offer our audience an analytical

overview of major economic developments that defined the year and to help them better understand their implications.

The current issue include three rankings: (i) top 5 economic success in 2014; (ii) top 5 economic failures in 2014; and (iii) top 5 economic challenges for 2015.

Top 5 economic successes in 2014:

- Signing the Association Agreement between Moldova and the European Union
- Abolishing by the EU the visa regime for Moldovan citizens
- Economic growth amid difficult circumstances
- First steps towards energy security
- The adoption of a new Code of Education

Top 5 economic setbacks in 2014:

- Worsening relations with the Russia
- Suspicious transactions in the banking system
- Failing to implement the recommendations of the Financial Sector Assessment Program developed by the IMF
- Capital (FDI) outflow from the country
- Populist measures at the expense of structural reforms

Top 5 economic challenges for 2015:

- Failure to adopt an agenda for structural reforms
- Transnistria's "self-isolation"
- Continued destabilization in Ukraine
- Russia's economic recession
- fiscal imbalances at central and local level

Please note these rankings represent a consensus view of the Expert-Grup team over the economic developments, but not necessarily require a strict hierarchy according to their importance. While renouncing a strict hierarchy or quantification, Expert-Grup annual reviews try to identify events, statements and mega-trends that, in our view, defined 2014 and will mark the future economic evolution of the country.

■ Top 5 economic successes in 2014

Signing the Association Agreement between Moldova and the European Union

While we do understand that a genuine success will be reached only when the auspices of the agreement will be fully implemented, one cannot neglect the importance of signing, ratification and entering into force during 2014, which has elevated the bilateral relations with the EU - our most important economic and trading partner - to a whole new level. It is also important that this occurred despite a growing pressure from Russia and the crisis in Ukraine.

The document sets a renewed basis for bilateral relations, with mutual commitments, which provides technical and financial assistance from the EU (worth at least 500 million Euro over the next 3 years) in accordance with the performance of the Moldovan Government.

Although the purpose of the Agreement is not joining the EU, it confirms our commitment to the European identity and aspirations. Also, it includes concrete measures to advance bilateral relations through closer political association and deeper economic integration. In fact, the agreement proposes a profound reform agenda, which will bring our country closer to fulfilling the mandatory eligibility criteria to becoming EU member (political and economic criteria and effective implementation of EU legislation). Still, political instability, politicization of the institutions and failure of undertaking assumed reforms could seriously compromise the Association Agreement, reducing the fragile support of the population and affecting the country's European orientation.

Abolishing the EU visa regime for citizens of the Republic of Moldova

The EU's decision to abolish visas, which came into force on April 28, 2014, was due to the political commitment of Moldovan authorities, but also due to geopolitical pressures at regional level. The regime allows Moldovans holding biometric passports to travel freely (90 days within 6 months) in the EU and Schengen area (30 countries). According to official data, about 300 thousand Moldovan citizens visited European countries since abolishing the visa regime, and yet being recorded a small number of travel bans. It also had some first positive economic results. Thus, during the first three quarters of 2014, Moldovans have purchased from abroad goods and services worth over 3 billion MDL or by 7.2% more than last year (the third-quarter growth was 12.9% over the same period last year).

Among the positive effects of visa liberalization with the EU is the growing interest of Transnistrian population for Moldovan passports (at least 5,000 documents issued within January-April 2014). The irreversibility of visa-free regime still depends on the quality of migration management, but also on the efficient management of state borders. Therefore, it is important to continuously inform the population about the benefits of visa liberalization, which, among others, exclude facilitating employment opportunities with the labor market in the EU.

Economic growth amid turmoil

The Moldovan economy rose with a surprisingly sharp +4.7% rate in the first three quarters of this year over the same period last year. Moreover, the growth rate accelerated from 4.8% in the 1st quarter to 5.4% in the 2nd quarter and 5.7% in the 3rd quarter.

It is a respectable performance, considering its high base of comparison (in 2013, GDP rose with 9.4%), trade restrictions imposed by Russia, the security crisis in Ukraine and slow recovery of the EU economies.

Also, is it true that growth is not sustainable, but was rather fuelled by short-term effects. Therefore, a good weather boosted agricultural production amid trade restrictions from Russia, which contributed to an increase of domestic retail, wholesale and stocks' growth.

The infrastructure projects launched with the support of development partners contributed to the increase of gross fixed capital formation in construction, while the currency depreciation discouraged importers and marginally encouraged exporters.

However, the fundamental growth factors remained weak amid anticipated recession in Russia and Ukraine, and tighter fiscal policy in 2015, which are expected to undermine economic performance next year.

First steps towards energy security

The launch of Iași-Ungheni pipeline on August 27, 2014 created the essential prerequisites for diversification of energy sources in the medium and long run. In addition to reducing energy dependence on the sole gas supplier – Russia, the pipeline allows Moldova to connect to the European energy market. This is a major contribution to the national energy security, which takes place along with EU's efforts to unify their energy market and infrastructure integration, in order to establish an Energy Union.

The pipeline's delivery capacity can currently only cover 1/3 of our natural gas needs. However, this estimated volume can generate competition in the local gas market, creating economic opportunities and thus lowering prices for consumers.

In order to maximize the pipeline's potential, it is necessary to enhance the related infrastructure and its extension to Chisinau, while increasing efficiency of the company responsible for managing the pipeline in Moldova (Vestmoldtransgaz). Also, it is necessary to liberalize the local market for gas delivery and to make sure there is a solid contractual agreement with the Romanian gas provider.

Adoption of the new Code of Education

Adoption of the New Code of Education in July 2014 can be regarded as a crucial landmark in the modernization of education. The Code is focused on three main goals: improving the quality of education, ensuring access to education and improving the studies' relevance. Special emphasis is given to autonomy of universities, while empowering academic institutions by establishing collective management and administration bodies.

This reform aims to stimulate competition between higher education institutions, evaluate teacher performance and integrate the merit-based education principles, knowledge and performance. Innovations of the new Code include introduction of the lifelong learning concept, dual education principle, transparency in the schools' performance and popularizing international languages, in particular - English.

The Code aims to generate incentives for teachers' rejuvenation and reviving education in rural areas. Therefore, the envisaged reforms would allow a gradual adjustment of the education system to the needs of national economy. However, there is a risk of major resistance from the old system, but also constraints related to the human and financial resources.

■ Top 5 economic failures in 2014

Worsening relations with Russia

The accelerated dialogue with EU on the Association Agreement represented a final blow in the worsening relations with Russia. Although the Agreement focuses on actions to strengthen the rule of law, improving public administration or the modernization of the economy, the Russian authorities saw it from the beginning as an act against Russian national interests.

As a countermeasure, Russia applied embargo to various agro-food products, with additional restrictions on wines dating back in 2013. Moreover, Russia reintroduced tariffs on some 20 Moldovan product categories, thus violating provisions of the CIS Free Trade Agreement. Moldovan exports to Russian markets were hardly hit by the trade barriers, thus declining by 30%.

With a Russian Federation turned more geopolitically active in the region, determined to counter the expanding European influence, Moldovan diplomacy was rather passive than active. Rather, Moldovan authorities focused all efforts on the dialogue with EU, while minimizing contacts with Russia in order to avoid a frontal confrontation.

Suspicious transactions in the banking system

Although the whole banking system remains capitalized and has sufficient liquidity, 2014 saw some worrying trends involving several systemically important banks posing a threat to the national security. The main issues rose from ineffective governance of the concerned banks and ineffective risk management, which led to irresponsible or even fraudulent lending practices.

As a result, credit portfolio quality of the banks has worsened due to higher levels of toxic loans, decreased level of capitalization, while National Bank of Moldova (NBM) imposed an administration regime for two major banks with high mutual exposures (*Banca de Economii* and *Banca Socială*).

Failure to implement the recommendations of IMF's Financial Sector Assessment Program

Although the financial sector has recently become one of the main sources of state instability, authorities have not made enough effort to strengthen its resilience. The recent IMF report shows a minor progress in implementing the recommendations of recent Financial Sector Assessment Program.

According to the report, the main problems arise from banks' corporate governance, banking supervision, risk management, NBM independence, financial market infrastructure and inter-institutional coordination on settling these problems. Moreover, there has been constant political pressure on the central bank, which is against international practices in terms of banking regulation and monetary policy.

FDI outflow from the country

The high level of uncertainty associated with internal and external economic circumstances and the security crisis in Ukraine, led to a decrease of the Foreign Direct Investment (FDI) in Moldovan economy.

Therefore, from a stock of USD 3614.53 million at the end of 2013, the FDI has decreased to USD 3603.83 million at the end of the first half of 2014 (latest data available). If considering FDI inflows in the same period of about USD 74.47 Million, we can conclude that about USD 85 million of FDI have left the country in the first half of the year.

Populist measures at the expense of structural reforms

Elections negatively affected to structural reforms' agenda, so badly needed to boost the natural growth of Moldovan economy. Thus, most of the key reforms required for improving the investment environment have not delivered the expected results. A throughout analysis of the Roadmap for implementing Government's actions to remove key constraints from the business field in 2013-2014, will show that half of the actions have not been implemented or have been implemented formally, without any real impact on firms.

Pension system reform remains vague, while the justice reform disappointed both the society and development partners. At the same time, the Government has promoted a generous budget policy, increasing pensions, public sector wages and several infrastructure projects were started without the appropriate budget coverage.

■ Top 5 economic challenges for 2015

Failure to adopt structural reforms

The year of 2015 marks the beginning of a new electoral cycle, which at least theoretically represents a „window“ of about 1-2 years to promote a set of unpopular structural reforms which otherwise cannot be promoted in year with incoming elections.

In the case of Moldova, such reforms include the pension system, the public sector wages, labor regulation, optimizing the network of educational and hospital institutions, fiscal consolidation, full implementation of a fairly targeted social assistance system etc. However, these and other crucial reforms may be affected by the fragile pro-European majority in the Parliament, at least according to the difficult negotiations' process on forming a new Government and the upcoming local elections. Moreover, a weak Parliament coalition could also threaten the stability of the future government. These aspects will determine the quality and dynamics of reforms stipulated under the Association Agreement with EU.

Given the very limited budget resources, the authorities must show consistent performance and irreversibility in adopting the reforms, in order to further benefit from the full support of foreign development partners. Also, the reform agenda should be publicly promoted, especially in the verge of local elections scheduled for 2015, in order to strengthen and expand public support and improve public perception over the European integration.

Transnistrian 'auto-isolation'

2015 will be crucial for Transnistrian region's economy. At the end of 2015, the Autonomous Trade Preferences (PCA) that benefit local exporters to the EU market, which ensure 60% of the region's total exports (without deliveries to mainland Moldova, which cannot be considered as exports), will expire.

Hence, further defiance of the Association Agreement by Tiraspol could determine EU to apply customs duties on imports, thus risking the loss of its most important market and the definitive self-isolation. To avoid this scenario, in 2015, Moldovan authorities should identify effective ways of involving the decision makers in Transnistrian region in the implementation of Association Agreement with the EU.

For that to happen, the economic reasons shall prevail over political ones, aiming to stimulate economic convergence between the two sides. All parties must pursue an inclusive approach and a solution that would enhance the negotiation process and not the opposite. Among such solutions would include extending the PCA for Transnistrian companies registered in Chisinau. This feature would provide a necessary transitional period for identifying viable solutions, while being focused on closing gaps between the two sides.

The EU could impose conditions for Transnistrian authorities in order to maintain PCA, such as respecting the minimum conditions of the Association Agreement – standardization & quality infrastructure, rules of origin, customs cooperation, etc. Finally, efforts should be focused on a strong economic integration of the Transnistrian region into the Moldovan economy, discouraging its "self-isolation".

Continued destabilization of Ukraine

The wide range of problems faced by the neighboring country generate a series of challenges for Moldova in terms of economy, energy and national security. Thus, Ukraine is an important trading partner, supplier of electricity, the country through which Russian gas is delivered, but also a crucial actor in resolving the Transnistrian conflict. Ukraine's stability in 2015 depends on the irreversibility of the political transformations and the reforms started in various fields, but also its ability to control and prevent separatism nationwide.

It is also necessary to identify geopolitical formulas to co-exist with Russia, which strongly opposes Ukraine's Euro-integration projects. In this respect, EU and other international actors (US, G7, etc) shall provide consistent and complex support and interventions (political, diplomatic, financial and technical). Only under such conditions, stabilization of Ukraine can be guaranteed, with a positive impact on the entire region, including the Republic of Moldova.

Economic recession in Russia

Moldova's exposure to Russian economy has declined in recent years, but remained quite important, being mainly channeled through exports (5% of GDP) and remittances (13% of GDP). Other dependence variables (eg grants, loans, FDI) are insignificant.

Still, the energy dependence is overwhelming, Moldova is completely dependent on natural gas imports from Russia. However, this dependency is more influenced by political factors rather than economic ones. The expected economic slowdown in Russia for 2015, combined with the depreciation of the Ruble will affect the demand for Moldovan goods on its market, but also the income of Moldovan migrants in Russia. Overall, these effects could reduce Moldova's exports to Russia by 20% -30% and remittances inflows by 10% in 2015.

Cumulative adverse effect could be set around 2.0%-2.5% of GDP for 2015. Obviously, the effect is far from dramatic for Moldovan economy, given the shift of many producers towards the EU market. Therefore, EU's share in total Moldovan exports for the first 10 months of 2014 was 52.2%, up from 45.9% in the same period last year. Moreover, a full implementation of the EU Association Agreement will further facilitate this process.

Fiscal imbalances at central and local level

Election related budget expenditures in 2014, in particular increasing pensions, increased public sector wages and starting several infrastructure projects have negatively affected the fiscal position as they risk to undermine the stability of public finances including in 2015.

According to IMF estimates, the budget deficit, excluding grants, rose to 5.4% as of GDP in 2014 (from 3.8% as of GDP in 2013) and without adjustment measures, the deficit could rise to 7.1% as of GDP in 2015. In turn, it feeds the accumulation of Government debt, which amid limited access to foreign capital markets, generates major borrowing costs. Therefore, it is necessary to adopt fiscal adjustment measures, by optimizing non-priority budget expenditures, restraining from populist commitments with fiscal implications (excessive increases of salaries and pensions or grant ad hoc tax reliefs) while preventing and fighting more aggressively the tax evasion.

Moreover, a greater emphasis should be given to transparency and efficiency of local budget in the context of fully entering into force of the amendments to the Law on Local Public Finance, which enhances fiscal and budgetary autonomy of local public authorities. In this respect, it is crucially important to strengthen the legal and technical skills of the Court of Accounts in order them to execute performance audits of public spending at local level.

■ About Expert-Grup

WHO WE ARE

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

OUR ACTIVITIES

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

- Macroeconomic analyses and forecasts;
- Political economy;
- Public finance;
- Human development and poverty reduction;
- Labor market and consumers' behavior;
- Foreign trade;
- Financial markets;
- Economy of European integration;
- Economic analysis by sectors;
- Regional and local economic development;
- Energy and economy of environment.

PARTNERS AND DONORS

During 2006-2014 the Expert-Grup implemented over 70 research and advocacy projects in various areas related to economic researches and public policies. Over 100 experts, both affiliated and not affiliated to our institution, from Moldovan and abroad, were involved in these projects. We have worked with such donors as Soros Foundation Moldova, East Europe Foundation, Konrad Adenauer Foundation, Balkan Trust for Democracy, Black Sea Trust, Friedrich Ebert Foundation, UNDP Moldova, UNICEF, European Commission, Council of Europe, Open Society Foundation, Swiss Agency for Development and Cooperation, UK Department for International Development, World Bank, Organisation for Economic Co-operation and Development. In 2010 and 2012 Expert-Grup was selected as member of the National Participation Council. Since 2008, Expert-Grup has been member of the Policy Association for an Open Society - an international network consisting of 56 think-tanks from various European countries.

Disclaimer

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