Economic Recovery of 2016-2017 - Sustainable Path or Iceberg Effect?

Authors:
Adrian Lupușor
Alexandru Fală
Ana Popa
Dumitru Pîntea
Vadim Gumene
Valeriu Prohnîțchi
Disclaimer

This document is published by the Independent Think-Tank EXPERT-GRUP with the financial support of the Global Partnership for Social Accountability, World Bank. Opinions expressed in this document belong to the authors and are not necessarily the opinions of the Global Partnership for Social Accountability or the World Bank.

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.
Contents

List of figures .............................................................................................................................................. 4
Abbreviations ............................................................................................................................................... 5
Key policy messages .................................................................................................................................. 6
Forecasts for 2016–2017 ............................................................................................................................... 8
Executive summary ...................................................................................................................................... 9
Chapter 1. Domestic supply ....................................................................................................................... 10
  Recent trends ........................................................................................................................................... 11
  Challenges and forecasts ......................................................................................................................... 13
  Policy recommendations ......................................................................................................................... 13
Chapter 2. Domestic demand ..................................................................................................................... 15
  Recent trends ........................................................................................................................................... 15
  Challenges and forecasts ......................................................................................................................... 17
  Policy recommendations ......................................................................................................................... 17
Chapter 3. Public finance ............................................................................................................................ 18
  Recent trends ........................................................................................................................................... 19
  Challenges and forecasts ......................................................................................................................... 21
  Policy recommendations ......................................................................................................................... 22
Chapter 4. Labor market ............................................................................................................................ 22
  Recent trends ........................................................................................................................................... 23
  Challenges and forecasts ......................................................................................................................... 25
  Policy recommendations ......................................................................................................................... 25
Chapter 5. Prices and monetary policy .................................................................................................... 27
  Recent trends ........................................................................................................................................... 27
  Challenges and forecasts ......................................................................................................................... 29
  Policy recommendations ......................................................................................................................... 30
Chapter 6. The banking sector .................................................................................................................. 31
  Recent trends ........................................................................................................................................... 31
  Challenges and forecasts ......................................................................................................................... 35
  Policy recommendations ......................................................................................................................... 36
Chapter 7. Foreign trade .............................................................................................................................. 37
  Recent trends ........................................................................................................................................... 37
  Challenges and forecasts ......................................................................................................................... 40
  Policy recommendations ......................................................................................................................... 40
About EXPERT-GRUP .................................................................................................................................. 42
List of figures

Figure 1. Sectors contribution to GDP variation in Q1–Q2:15 and Q1–Q2:16, percentage points...........11
Figure 2. Contribution of industry branches (by main production) to the variance of total industrial
production in Q1–Q2:15 and Q1–Q2:16, percentage points.................................................12
Figure 3. Contribution of elements of use in GDP, percentage points........................................15
Figure 4. Monthly development of remittances and wages, (seasonally adjusted), Jan:07–Aug:16 ......16
Figure 5. Evolution of budget revenues and expenditures, y-o-y growth (%) ................................19
Figure 6. Evolution of GDP and tax revenue, y-o-y real growth (%) ..........................................20
Figure 7. Evolution of base rate, state securities interest rate and domestic state debt service........20
Figure 8. The evolution of unemployment and the employment rate (%) ....................................23
Figure 9. The structure of employed population by type of job and type of production unit (%) ......24
Figure 10. Official exchange rate USD/MDL and CPI, y-o-y growth (%)......................................27
Figure 11. Evolution of CPI, base rate and interest rate on the market........................................28
Figure 12. NBM transactions on the monetary market...............................................................28
Figure 13. NBM interventions on the foreign exchange market and official reserve assets (millions USD)
..........................................................29
Figure 14. Dynamics of bank assets, billion MDL ........................................................................32
Figure 15. Lending activity (%) ..................................................................................................32
Figure 16. Evolution of term deposits (%) ..................................................................................33
Figure 17. Interest rates on loans and deposits (%) .....................................................................34
Figure 18. Current liquidity ratio (%) and the liquidity supply and procurement between the NBM and
commercial banks, millions MDL ..........................................................................................34
Figure 19. Evolution of bank’s income and profitability (%).........................................................35
Figure 20. The Republic of Moldova’s foreign trade in 2013–2016, changes y-o-y (%) ..............37
Figure 21. The influence of exports in value terms in Q1–Q3:16, percentage points ...................38
Figure 22. The unit value index and the physical volume index of exported goods, changes y-o-y (%) .39
Figure 23. The influence of imports in value terms in Q1–Q3:16, percentage points ...................39
Figure 24. The unit value index and the physical volume index of imported goods, changes y-o-y (%) .40
Abbreviations

AA       Association Agreement
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
NBC      National Bank Certificates
NBS      National Bureau of Statistics
NBM      National Bank of Moldova
NPB      National Public Budget
PEM      PanEuroMed
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

- Although the 2016 economic year was more favorable than that of 2015, it confirmed that the Moldovan economy's main problem remains its poor competitiveness. After the recession of 2015 (-0.5%), the Gross Domestic Product (GDP) registered a marginal recovery in 2016 with a growth estimated at 3%. However, this improvement was dictated by two sectors where growth is likely to be unsustainable: Agriculture and Services. Agriculture registered a compensating increase after the 2015 drought; but the effect of a low comparison base will dissipate in 2017 and, on the background of low investments, the sector's growth cannot be sustained. The services sector recovered thanks to a modest increase in final consumption, which was in turn boosted by an increase in wages. This advance, however, happened against the backdrop of declining labor productivity and investments in fixed capital.

- These competitiveness issues were also revealed by the fact that, in 2016, final consumption made a comeback as a main driver of economic growth. This has led to an increase in imports, while exports in real terms have decreased. Thus, as we anticipated in the previous issue of MEGA, the main source that softened the economic shocks in 2015 (the net exports) dissipated in 2016. This had a major negative effect on the GDP due to an increasing discrepancy between exports and imports in 2016. An increased level of uncertainty regarding macroeconomic developments will remain in 2017, since the sources that propelled the economy in 2016 are not sustainable. Still, we can identify a limited revival of the industrial sector. This will lead to a marginal boost of exports and a modest growth of investment activity against the background of the effects of monetary policy relaxation, but also political stabilization (the post-electoral effect). We thus anticipate a GDP growth of 4–5%, providing there are no more meteorological, political, economic, or other types of shocks.

- Despite the economic recovery from 2016–2017, we emphasize the degradation of the quality of such growth. Besides the competitiveness and sustainability deficiencies mentioned above, the quality of economic growth is affected by at least three factors. First, work productivity keeps falling, which (in parallel with the increase in real wages) undermines the producers' capacity to compete in the domestic and external markets. Second, a significant part of consumption growth (the main economic growth driver) is happening because of consumption of in-nature goods and services. This was due to the agriculture revival and, accordingly, it happens mainly in low income rural households. Third, the fixed capital investments kept falling during 2016, and for 2017 we do not expect a substantial boost in investment activities. These factors reveal a lack of sustainability and inclusion of economic growth from 2016–2017. They will hold economic progress back over the coming years: for the following approximately five years we anticipate an economic growth of around 3–4% (+/-1 percentage points). Economic growth must be twice as rapid as this to ensure timely convergence with Central and Eastern European countries.

- The quality and sustainability problems of economic growth are also revealed by the labor market tendencies. The total employment rate increased on account of informal employment, while the formal employment rate has declined. At the same time, despite the shrinking employment rate in 2016, we observe negative tendencies in the structure of officially unemployed registered. The share of unemployed persons who had been fired from their previous job increased. This could be a proxy indicator for entrepreneurial activity, meaning the companies either scale down their economic activities or try to make their businesses more efficient.

- The main immediate challenge relates to the risk of misleading economic policy decision-makers about the economic tendencies, which look relatively good on surface but contain many subtleties. As we mentioned above, despite increased economic growth, consumption and employment, a more thorough analysis of statistical data reveals an increase in trade imbalances, the reduction of formal employment, decreasing work productivity, falling investments, and
increased consumption from informal sources. These all undermine the sustainability of economic growth. Consequently, the decision-makers should treat the key macroeconomic indicators with maximum caution. This is mainly related to the budgetary, fiscal and monetary policies, which should be stimulating rather than restrictive (in the spirit of promoting counter-cyclical policies). Thus, despite previous positive economic growth, raising the fiscal burden in 2017 should not be an option for fiscal policy. At the same time the National Bank of Moldova (NBM) should be bolder and more consistent about easing its monetary policy stance, as the demand-side inflationary pressures remain weak. The government should also be very cautious in promoting budgetary austerity: the lowered budget expenditures should not affect health and education, which not only have substantial shares in GDP but also influence the quality of human capital.

- **The main medium-term challenge relates to the low level of labor productivity.** The discrepancy between real wages and labor productivity, which has been observed over the past years, has lately become even more pronounced (even against the background of an emigrating working age population and the constant decline in employment rates). The competitiveness of the Moldovan economy is thus undermined by both the price and the quality of labor. This affects the country’s capacity to capitalize fully on the potential provided by the EU Deep and Comprehensive Free Trade Agreement (DCFTA): it fuels the balance of payment imbalances, puts constant pressure on the level of the NBM currency reserves (and therefore on the national currency), and generates macroeconomic volatility and exposure to external shocks. Even worse, it erodes the country's attractiveness for investments, which affects work productivity even more. Moldova was always caught up in this vicious circle, but it has become more and more dangerous in recent years against the background of several governance failures (political instability and banking fraud) that compromised the country’s attractiveness for investments. This will leave a mark on labor productivity and competitiveness over the next few years.

- **The main long-term challenge relates to the balance of payments deficit.** The discrepancy between financial flows leaving Moldova (e.g. imports) and those entering the country (e.g. exports, remittances) will increase over the next years, oscillating around 4–5% of the GDP. Although this level is comparable to other Community of Independent States (CIS) countries, the deficit is quite high in comparison with Central and Eastern European countries. Moreover, the issue of current account deficit is aggravated by the high level of external debt (which is practically equal to the GDP), as well as by the modest inflows of direct foreign investments (Moldova traditionally ranks lowest in Europe on Foreign Direct Investments per capita). The foundation for these imbalances is low competitiveness: the trade balance deficit is the main cause of the current account deficit, and the risks refer to macroeconomic stability (especially the national currency).

- **The medium- and long-term solutions are in the hands of the government.** To balance the current account deficit, exports need to be stimulated. To increase exports, competitiveness needs to be increased. To increase competitiveness, work productivity needs to be increased – an objective achievable only by boosting investment activity. According to the Global Competitiveness Report 2016–2017, the top three barriers for investors are corruption, policy instability and political instability. Unlike other barriers, which require resources and time to be fixed (e.g. access to financing, infrastructure, quality of labor), a firm and consolidated political will is necessary to remove the existing barriers. In this sense, the authorities should speed up (or unblock) justice reforms and implement an effective public administration reform (all solutions concerning these issues are included in the recently approved relevant strategies). Developing a public service that is transparent, professional and focused on the interests of the population and companies, supported by an incorruptible justice system, are the main factors that would boost investments in Moldova, and provide the work productivity, competitiveness and sustainability necessary for the economic growth model.
Forecasts for 2016–2017

Table 1. Forecast of the key macroeconomic indicators

<table>
<thead>
<tr>
<th></th>
<th>2016 Baseline forecast</th>
<th>2016 Pessimistic scenario</th>
<th>2017 Baseline forecast</th>
<th>2017 Pessimistic scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP, %</td>
<td>+3.4</td>
<td>+2.0</td>
<td>+5.5</td>
<td>+3.6</td>
</tr>
<tr>
<td>Agriculture, GVA, %</td>
<td>+19.4</td>
<td>+15.4</td>
<td>+5.0</td>
<td>+3.3</td>
</tr>
<tr>
<td>Industry, GVA, %</td>
<td>+1.6</td>
<td>+0.5</td>
<td>+6.1</td>
<td>+5.2</td>
</tr>
<tr>
<td>Constructions, GVA, %</td>
<td>-12.5</td>
<td>-13.4</td>
<td>+5.1</td>
<td>+4.0</td>
</tr>
<tr>
<td>Domestic trade, GVA, %</td>
<td>+4.9</td>
<td>+3.9</td>
<td>+6.8</td>
<td>+5.4</td>
</tr>
<tr>
<td>Transport, GVA, %</td>
<td>+1.8</td>
<td>+0.5</td>
<td>+6.5</td>
<td>+3.7</td>
</tr>
<tr>
<td>Net taxes, %</td>
<td>+0.8</td>
<td>+0.2</td>
<td>+3.9</td>
<td>+2.9</td>
</tr>
<tr>
<td>Final consumption, %</td>
<td>+2.1</td>
<td>+1.8</td>
<td>+5.1</td>
<td>+4.4</td>
</tr>
<tr>
<td>Gross fixed capital formation, %</td>
<td>-5.6</td>
<td>-6.5</td>
<td>+4.5</td>
<td>+4.0</td>
</tr>
<tr>
<td>Exports of goods and services, %</td>
<td>+3.9</td>
<td>+3.2</td>
<td>+7.3</td>
<td>+4.9</td>
</tr>
<tr>
<td>Imports of goods and services, %</td>
<td>+3.6</td>
<td>+3.3</td>
<td>+5.0</td>
<td>+4.6</td>
</tr>
<tr>
<td>Remittances, %</td>
<td>-5.6</td>
<td>-8.7</td>
<td>0.0</td>
<td>-5.0</td>
</tr>
<tr>
<td>Investments, %</td>
<td>-15.6</td>
<td>-16.2</td>
<td>+7.4</td>
<td>+5.8</td>
</tr>
<tr>
<td>Bank loans in MDL, %</td>
<td>-15.1</td>
<td>-17.6</td>
<td>+9.8</td>
<td>+7.4</td>
</tr>
<tr>
<td>Fiscal revenues, %</td>
<td>+3.7</td>
<td>+3.6</td>
<td>+6.3</td>
<td>+5.2</td>
</tr>
<tr>
<td>Real wages, %</td>
<td>+1.9</td>
<td>+1.7</td>
<td>+4.8</td>
<td>+4.0</td>
</tr>
<tr>
<td>Inflation, %</td>
<td>+6.5</td>
<td>+7.0</td>
<td>+4.5</td>
<td>+5.5</td>
</tr>
</tbody>
</table>

Source: EXPERT-GRUP estimates and forecast
Executive summary

**Domestic supply.** Compared to the previous year, the first half of the 2016 saw a more modest GDP growth of only 1.3%. The situation improved in the second half of the year, with the agricultural sector recovering what it had lost as a result of the drought in 2015. Based on the figures from the first three quarters, we expect that the agricultural output will have increased by 15–17% in 2016, whereas for 2017 we forecast a 5–6% growth in the volume of output. The industrial sector will continue stagnating until the end of this year, whereas for the year 2017 the scenarios cover a broad range of developments, from a light 0.5–1.0% recession up to a moderate 5.0–7.0% positive growth. A factor that can mitigate the recession might be Russia lifting its trade embargo, which would have positive implications for the beverages industry and fruits and vegetables processing industry. We expect the construction sector to remain on a negative path this year, with an expected reduction of 11–12% in the volume of construction works. The evolution of the forward-looking indicator – the number of issued construction permits – suggests a further reduction of about 5–7% in the volume of work in 2017. The level of economic activity in the market services sector denotes an annual growth of 3.0–3.2% in 2016. In a pessimistic scenario for the next year, we expect the services to grow 3.4–3.6%, whereas a positive scenario relies on a 4.4–4.8% growth. Both guarantee that the services sector will remain the key economic engine.

**Aggregate demand.** While in 2015 net exports served as the main component driving the GDP growth on expenditures, in 2016 the households’ final consumption recovered its leading position. At the same time, it is worth mentioning that around a quarter of the households’ final consumption growth is due to natural consumption, i.e. consumption financed by implicit income gain from subsistence agricultural activity. This finding raises questions regarding the quality and sustainability of consumption growth. It should also be noted that changes in stocks have played an unusually important role in the GDP growth in 2016. The positive variation in stocks is partly a result of the dissipation of the effects of the 2015 drought. Capital investments continued their decline in 2016, marking one of the longest episodes of investment decline since 2001. Considering spare capacities of the productive capital, we do not see an imperative need for investments growth to resume immediately. However, if capital investments continue their negative evolution in the medium term, imminent risks will emerge for the reproduction capacities of the productive capital.

**Labor market.** The improvement in the quantitative indicators of the labor market in 2016 is accompanied by the worsening quality of employment. The employment rate may be higher than 41% and unemployment may fall to approximately 4.5% by the end of 2016, but this growth in employment has only been ensured by a rise in informal employment in both the informal and household sectors. This implies low and uncertain incomes, or even subsistence incomes, and does not provide entitlement to social benefits. Moreover, it continues to diminish labor productivity, which will subsequently stop the growth of real wages, increase the desire to emigrate, and contribute further to the erosion of human capital. It is therefore necessary to identify and apply measures to reduce informal employment, some of them crucial in the short term. In the long term, it is important to adapt the educational policies to the needs of economy through effective forecasts and correlation of educational policies to other economic policies.

**Public finance.** At the beginning of 2016, the situation of public finance was complicated by political instability and economic uncertainties. Tax collections were decreasing, external financing was blocked, and the budgetary process was significantly behind schedule. Over the course of 2016, due to the economic recovery and monetary policy easing it was possible to diminish the pressure on the budget. However, despite a slight advancement in the GDP, the economic conditions have remained unfavorable, which has translated into reduced tax collections, and a significant part of external grants were not received. Under these circumstances the budget had to be adjusted, reducing it by MDL 2bn. In addition, the significant increase in public debt caused by converting the state guarantees related to emergency credits granted by the NBM will have a negative effect on public finances. Although the new
level of the state debt is not critical for the national economy, there will be additional pressure on the budget due to the increased costs of the public debt service. On the other hand, the signing of a new IMF Agreement will contribute to strengthening the national budget by unblocking external financing.

**Prices and monetary policy.** If the increasing inflation pressure determined a tightened monetary policy during 2015, then 2016 has been characterized by disinflation developments. "Calming down" the foreign exchange market, which has already determined a decrease of inflation, could help maintain the price increase in the proximity of the 5% level targeted by the NBM. At the same time, the tendency toward moderate inflation has allowed the central bank to achieve a gradual relaxation of the monetary policy by reducing the base rate. Still, the NBM has breathing room to continue its stimulating policy, especially by reducing the rate of mandatory reserves for resources attracted in MDL, which is currently set at 35%. At the same time, the excessive liquidity in the banking sector imposes a prudent decrease of the mandatory reserves to avoid creating monetary pressure on the inflation. The exchange rate stabilization has also allowed the monetary authority to change its behavior on the foreign exchange market. From a seller, the NBM has thus turned into a net currency buyer, and as a result the central bank has consolidated its currency reserve.

**Banking sector.** Once the effects of the recent crisis were stopped, a wide-ranging reform process was initiated, both at the central bank level and at the level of the commercial banks. During 2016, the NBM, with the support of the main development partners, has implemented a series of regulations and measures aimed at strengthening its independence and supervisory powers, while improving corporate governance and risk management in commercial banks. The financial situation of the banking sector is significantly determined by the general economic situation and the monetary policy implemented by the NBM. The main worrying trends are related to the lending activity, which continues to decline, as well as the quality of the loan portfolios, which continues to worsen. Thus, even if the high level of liquidity and capital allow banks to meet the requirements established by the NBM, some weaknesses persist, remediation of which is extremely important to ensure a healthy financial intermediation in the shortest time.

**Foreign trade.** During Q1–Q3:16, an attenuation of the persistent negative trends from the year 2015 could be seen, together with the setting up of a degree of political stability and the strengthening of the domestic economic conjuncture. However, these trends must be interpreted in the light of a very low comparison base of the year 2015. In Q1–Q3:16, therefore, exports of goods decreased by only 1% y-o-y, while in terms of geography, the main destination of Moldovan exports remains the European Union with a share of 64% of exports in total, followed by the CIS countries which accounted for a share of 21% of Moldovan exports. These negative export results, however, could be explained by the unfavorable climatic conditions for some products, and their delayed harvesting/realization, which are not yet reflected in the statistics. On the other hand, imports of goods in Q1–Q3:16 decreased by 2.2% y-o-y, mainly as a consequence of reducing the price for petroleum and gas, although in quantitative terms increases could be noticed for these categories. For 2016, the total exports of goods and services will have increased by about 3.9%, while imports are expected to increase by 3.6% due to the growing household consumption.
From an economic perspective, the first half of 2016 appeared more modest than the same period of the previous year, but the situation changed in the second half when agriculture recovered the level it had reached before the 2015 drought. The industrial stagnation and the recession in construction strictly limit economic growth in both 2016 and 2017. However, the commercial services, as the main drivers of the economy, will pull it forward during the current and the following year.

Recent trends

The GDP has accelerated in the second half of the year. In Q1–Q2:16, the GDP registered a 1.3% growth, less than in 2015, when the growth was of 3.6%. As Figure 1 shows, the main sources that limited the GDP growth were the construction and financial sectors, both shrinking by about 10%. The severe budgetary constraints in 2015 worsened in 2016, thus determining a negative contribution of public services to the GDP. The energy sector also had a negative impact. In Q3–Q4:16 there were positive developments. Agriculture reported a significant increase in production, but some positive influences came from the services sector as well.

Figure 1. Sectors contribution to GDP variation in Q1–Q2:15 and Q1–Q2:16, percentage points

Agriculture recovered the position it had lost because of the drought. From an agro-climatic perspective, the summer and fall of 2016 were slightly more favorable than 2015, but still much more arid than the historical norm of meteorological observations. The main impact of the drought fell on corn, sugarbeet and leguminous crops. Unusually arid weather hit the northern districts and threatened the sugarbeet crop, which is of major importance for that area. Nevertheless, thanks to a richer harvest of cereal crops (+30%), the crop farming sub-sector basically reached the 2014 level. The growth was significant for sunflower (+25%), fruits and vegetables (+20%), as well as grapes (+10%). The livestock sub-sector registered a less significant advancement (+3%), but the smaller growth rates of the livestock production are traditionally compensated by a more stable development in comparison with crops farming. The unusually strong growth of eggs production can also be noted (7%), mostly due to the increased livestock of laying hens. Milk production remained at 2015 levels, one of the causes being the fodder deficit in the households sector.

The industry shows a hesitant dynamic. In 2016 the Moldovan industry is going through a phase of stagnation, the amount of production delivered being 0.2% less than in Q1–Q3:15. Contrary to the opinion
dominating the media, the Russian embargo is neither the only, nor the main, cause of the current industrial production decrease. A combination of structural factors and circumstances are to blame for this. As Figure 2 shows, the decrease in domestic electricity production is the main cause of the industrial production decrease, but, in the context of institutional restructuring, sector assets consolidation and clean-up (following the establishment of the Termoelectrica in 2015), we believe that we are witnessing a temporary phenomenon. The same reasoning applies to the heating supply, which is another source negatively affecting industrial production in 2016. The shrinking by about 8% in the construction materials industry is also worth mentioning, and is determined by the unfavorable circumstances in the construction sector. The drop in the demand for raw materials from the construction materials industry translates, in turn, into a decrease in the activity of the mining and quarrying industry. We, however, believe that the decrease in the electric equipment, rubber and plastic goods, as well as in the canned vegetables production, should be made a priority, since these are industries that not so long ago were delivering production for exports at an increasing rate. The situation is especially concerning when it comes to the preserves industry: it is almost fully dependent on the Russian market and up until now, very little effort has been made toward diversification. It is worth remembering that over the past 10 years the beverages industry fell victim to repeated embargos from the Russian Federation, but producers learned their lesson and modernized production to allow them to enter other markets. It is yet uncertain whether the preserves industry will be capable of repeating the performance of the beverages industry.

At the opposite end of the scale, as in 2015, the cloths and apparel industry and the footwear industry are among the branches pulling the industry forward, with increases of 30% and 20% y-o-y respectively.

**Figure 2. Contribution of industry branches (by main production) to the variance of total industrial production in Q1–Q2:15 and Q1–Q2:16, percentage points**

**Construction.** 2015 was a very complicated year for the construction sector, which registered a 12.5% decrease in the volume of work performed. The difficulties continued in 2016: according to statistics, the work performed in Q1–Q2:16 was 13% below the 2015 level. Again, the sub-sector of residential constructions was the only one to pull up the main indicator, but this was mostly due to current repair and maintenance work. Whereas in previous years the projects financed from public sources partially compensated for the reluctance of private entrepreneurs, in 2016 the budgetary financing was cut. Amid the rising prices of construction and installation, and with the investors’ and banks’ wariness at their highest level, we can say that there is every possibility that the constructions sector will "freeze" totally, and that the urban landscape will collect even more abandoned unfinished constructions.

**Commercial services registered an approximately 3% growth in Q1–Q3:16.** However, the development of the wholesale trade reflects the less good mood of the commercial companies. In 2016 the dynamic was a rather sinuous one, but as a net effect we have about 4% drop in wholesales, which reveals a growing
pessimism among the traders. The services provided to businesses are at 2015 levels, which again shows the hesitant dispositions on the market.

Challenges and forecasts

- In 2016, the total agricultural production will grow by about 15–17%. For 2017, in the main scenario (the aridity indicator stays within normal historical limits), we anticipate a 5–6% growth;
- The industrial sector will close the current year with a growth close to zero. We see signs that the stagnation may go into a slight recession in 2017. An eventual lift of the Russian embargo will lead to a nil industrial growth in 2017;
- The construction sector will remain in the "red" till the end of the year, and we foresee an annual drop of about 11–13%. As the dynamics of the number of construction permits issued suggests (-10% in Q1–Q3:16 y-o-y), there is every possibility for the drop to continue in 2017, when we expect a 5–7% drop in the volume of work performed;
- The activity in the service sector will grow by 3.0–3.1% in 2016. In the main scenario, we anticipate the sector growth rate to slightly accelerate to 3.4–3.6% in 2017; and
- Corroborated by the hypothesis that net taxes on products and imports will remain stable, the anticipations above allow us to estimate that in 2016 we will have a GDP growth of 3.3–3.5%. In 2017, even though some sectors will continue reducing the production volume, they will also rationalize the intermediary consumption. The GDP growth will therefore be positive, between 3.4 and 3.5% in the pessimist scenario, or between 5.2 and 5.6% in the optimist scenario. We underline that the 2017 forecast counts on a "normal" year in terms of agro-climatic conditions.

Policy recommendations

- The main priority of the decision-makers should be to reduce agricultural vulnerability to drought. This implies a modification of the producer subsidies policy and subsidizing individual technologies more generously. However, it also involves adopting a state program to rehabilitate the central irrigation systems according to the model of the Transition to the High Value Agriculture project of the US-funded Compact Program. The financial resources required to cover the priority areas are high (about USD 250-300 million to cover 100 thousand hectares with irrigation systems), but the main problem that we see is the lack of government vision and initiative, not the lack of financial resources;
- The government ("the state") was not able to give any response to the disproportionate Russian reaction, which introduced trade barriers to a series of products from Moldova after the signing of the Association Agreement in 2014. To restore its image in the eyes of the producers, the government should grant them all necessary support in modernizing technological processes and transitioning to quality management systems that would allow them to access new markets. An improved model of the National Office of Vine and Wine could be replicated in the fruits and vegetables processing industry cluster;
- In the constructions sector a state policy on frozen residential constructions management should be defined. Better functioning of the institution of expropriating entrepreneurs who cheated individual investors should be ensured, together with the financial consolidation of those assets and transmission of given objects to good-faith entrepreneurs. At the same time, a serious investigation of price formation would show that there is huge potential to reduce the raw material prices by eliminating cartel agreements; and
- We maintain our already traditional recommendation of intensifying and implementing more credible efforts to simplify the regulatory framework in which the companies operate. The major priorities are normalizing the activity of state inspection bodies and ensuring equal conditions for competition on the market.
Chapter 2. Domestic demand

In 2016, the household final consumption came back as an essential element of the GDP by categories of use. However, a large part of the consumption growth was determined by the natural economy segment in the rural areas. The increase in the stocks, determined by the dissipation of the effects of the 2015 drought, was also an essential factor pulling up the economy. Investments continued to fall over the course of the entire year. While in 2015 the net exports were the only factor ensuring GSP growth, this year the situation changed dramatically, with imports growing in parallel with a real decrease in exports.

Recent trends

In 2016 there were important changes in the GDP structure by categories of expenditures. We remember that in 2015, the GDP by resources was "saved" only by the positive contribution of net exports (Figure 3). This development was not due to fundamental improvements, but rather to the sharp depreciation of the national currency, which in effect discouraged imports and provided a temporary support to exports. As we anticipated in the previous edition of MEGA, the positive effects of the depreciation on competitiveness have already dissipated. Indeed, in the first half of 2016, the net exports' contribution to GDP was strongly negative. The households' final consumption was the main component that pulled the GDP forward. Another essential element that positively contributed to the GDP variation in the first two quarters was the increase of stocks – a not quite positive sign, as we do not anticipate an essential growth of the market demand. This growth is rather the consequence of the industrial producers' inaccurate anticipations regarding the market demand development, and a growth in the agricultural production stocks as the agriculture recovered after the 2015 drought. It is true that the stocks growth could also suggest a much more painful hypothesis – Moldovan producers have already started to lose their market shares – but, for the time being, this cannot be validated due to the lack of annual statistics. The country's regression in the 2016 Global Competitiveness Rating is, however, a worrying development from this point of view.

Figure 3. Contribution of elements of use in GDP, percentage points

Note: HH—households. The market consumption of HH includes the consumption of non-profit institutions in the service of individual households.
In 2016, the households’ consumption was the main factor of the GDP growth. According to our estimations, the aggregate increased by 2% in Q1–Q2:16, generating two percentage points for GDP growth. However, we must note that almost a quarter of this consumption is accounted for by in-kind goods and services generated within the households. Thus, the improvement of the situation in agriculture ensured a higher effective or implicit income that fueled the household consumption, especially in the rural areas, in the first two quintiles. At the same time, it is evident that the importance of this in-kind consumption speaks loudly about a lower quality of economic growth. The problems of economic quality and sustainability are revealed by similar tendencies on the labor market, where the employment rate increased due to informal employment, while the official employment rate dropped (see the chapter entitled "Labor market"). Another essential factor supporting household consumption was an increase in real wages (+8.5% in Jan-Aug:16). Despite all economic vicissitudes, its constant growth persists for a long period (Figure 4). On the background of a labor productivity decrease (Chapter on "Labor market"), this tendency keeps eroding the economic competitiveness of the country. As for remittances, in the first half of the year they were below the 2015 level (already small in historical comparison), and a slight real increase took shape only in Jul-Aug:16. For the next 2–3 years, though, it is highly unlikely that remittances will come back to the ascending trajectory specific for the period of 2009–2013.

The public administration final consumption expenditures have had a moderately negative role on the evolution of the GDP by final uses. The public administration expenditures for final consumption decreased in Q1–Q2:16 by about 0.7% y-o-y, taking away 0.4 percentage points in the GDP growth in both quarters. This is a natural consequence of budgetary constraints getting more severe than in 2015, which limited the government and local administrations’ expenditures. The public administration expenditures for final consumption also decreased due to the uncertainties regarding the resumption of the external aid in 2016, as well as due to the government and parliament’s lack of discipline in observing the budgetary calendar.

The shrinking of investment activity had a significant negative contribution to the GDP in 2016. The decrease in capital investments persisted during six consecutive quarters, starting with Q2:15 until Q3:16. Only in Q2:16 did the shrinking of gross capital formation extract two percentage points of GDP growth. The main component in the gross fixed capital formation (construction) shrank by almost 20%
over the current year, and investments in equipment and machinery by about 30%. All investment financing sources were affected by the crisis, but the most affected were the investments financed from the national budget (a drop of almost 80%), while foreign investments shrank by about 40%.

**Net exports had a negative impact on the GDP.** In the first two quarters, net exports deprived the GDP growth of two percentage points. This is due to both the decrease in commodities real exports (-4%) and the accelerated increase in commodities imports (+3.5%). For services, the situation is symmetrical: exports have increased visibly (about 8%), while services imports, on the contrary, have shrunk by almost 4%. The decrease in external commodities demand is largely caused by the new problems in indirect access to the Russian market (before this, immediately after Russia introduced the embargo, exporters kept entering the Russian market through Belarus and Kazakhstan). At the same time, the smaller stocks of agricultural production caused by the severe drought in 2015 had a strong impact on export capacity.

**Challenges and forecasts**

- In 2016 we expect the final consumption to grow by 2.0–2.2%, almost exclusively due to household final consumption. The in-kind consumption component will play an essential role in this sense. In the second half of 2016 we see a slight increase of remittances. For 2017, we adopt a cautious forecast of final consumption growth by 4.2–4.6%, while under the more optimistic scenario the consumption will grow by around 5.0–5.4%. The increase in real wages will remain the main financing source of household consumption, while remittances will remain at the same level as in 2016;
- We anticipate a decrease in public administration consumption expenditure by 1.5% for the entirety of 2016. Following a more austere budgetary policy, the decrease of public consumption will continue in 2017, at a level of about 1.5–2.5%;
- Investments in gross fixed capital formation will continue their descending trend until the end of the year, and we estimate an annual decrease of about 6–7%. Considering the political, financial and budgetary risks, the perspectives for 2017 are very uncertain. In particular, the possibility that strong disagreements regarding the economic policy may arise between the currently elected president and the governments is not excluded, and it could have severe repercussions for the investment climate. A 4.0 to 4.5% growth is nonetheless feasible in both pessimistic and optimistic scenarios; and
- Considering Russia’s discouraging economic conditions, and also the related uncertainties for the European economy emanating from the migrant crisis, the new president of the USA and Brexit, the external demand will remain feeble.

**Policy recommendations**

- The stimulation of the final demand for market goods and services from households should take place on account of removing anti-competitive arrangements on the consumers’ markets. This especially concerns the markets for meat and fish products, medicine, construction materials, and goods for children. The nature of these arrangements has the direct effect of channeling super-profits toward obscure structures that control those markets;
- The decrease in public administration consumption expenditures is inevitable for the following several years. In this context, it is important to rationalize expenditures in such a manner as to have as high an economic efficiency as possible. It is important that the decreases do not touch the health and education sectors, which not only account for large shares of the GDP but are also responsible for the quality of human capital;
Returning private investments to an ascending trajectory is imperative, but not in the immediate term, since there are still unused production capacities. If the investments decrease continues throughout 2017, major risks for the capital reproduction capacity may, however, arise; and

Despite a major geographical diversification which, volens-nolens, has happened over the last few years, efforts are necessary to increase the presence of Moldovan exporters in third-world markets (non-EU and non-CIS) so that the general risks are minimized. At the same time, it is evident that efforts are necessary to fully capitalize on the advantages of the Association Agreement, including from the perspective of using the quantitative quotas granted by the EU.
Although the negative tendencies have been partially alleviated, the overall conditions of public finance remain difficult. Despite the slight GDP growth, the economic trends remain worrisome, which undermines the budget revenues. An important part of external grants was also not received. In this context, an adjustment was necessary in 2016, resulting in a 2.2 billion MDL budget decrease. At the same time, the pressures of an increased public debt caused by the conversion of state guarantees related to the emergency credits granted by NBM into public debt will be mitigated on the signing of a new IMF Agreement, which will open new external financing possibilities for the national budget.

Recent trends

This year was intense for the budgetary process organization. Over the course of a year, the overdue financial laws for 2016 were adopted, the fiscal and budgetary policy for 2017 was voted and the budget for 2017 was drafted. In early 2016, the budget and fiscal policy had not been voted because of political instability and the delay was considerable. Because of this, the adoption of regulatory documents became a formal task which should have been resolved as soon as possible,1 but these laws were only voted in Jun:16 and Jul:16. Toward the end of the year, the budgetary and fiscal policy for 2017 was voted and the draft law of the national budget for 2016 was published.

Budget revenues are growing in nominal terms and decreasing in real terms. In 2016, the development of budget collections and expenditures was volatile, and the cumulative growth was modest. Budget revenues registered fluctuations varying between a 7.9% decline (Mar:16) and a 10.3% y-o-y growth (Aug:16), and the modification of public expenditures oscillated between a 12.9% y-o-y decline (Jan:16) and a 15.6% y-o-y growth (Oct:16) y-o-y. Consequently, a slow progress was observed in Jan–Oct:16: budget revenues increased by 2.3% y-o-y, and expenditures by 3.9% y-o-y. At the same time, in real terms, the budgetary parameters decreased: during Jan–Oct:16, revenues decreased by 4.6% y-o-y, and expenditures decreased by 3.1% y-o-y.

Figure 5. Evolution of budget revenues and expenditures, y-o-y growth (%)

The economic revival, although marginal, reduces the pressure on public finance. However, under these circumstances, it was not possible to avoid the adjustment by which the budget revenues and

expenditures were diminished. The 0.8% y-o-y economic progress of Q1:16, and the 1.8% y-o-y economic progress of Q2:16, stimulated the growth of tax collections. Thus, tax revenues, expressed in real terms, increased by 3.6% y-o-y in Q2:16, and by 6.5% y-o-y in Q3:16, after a slight decrease by 0.7% y-o-y in Q1:16.

Figure 6. Evolution of GDP and tax revenue, y-o-y real growth (%)

Source: Authors’ calculations based on Ministry of Finance and NBS data

Another factor that took some pressure off the budget is related to monetary policy relaxation. The policy rate decrease determined shrinking interest rates for the domestic state debt service. Consequently, the growth rates of the domestic state tax debt have considerably decreased, and in Oct:16 a decrease by 4.5% y-o-y was registered.

Figure 7. Evolution of base rate, state securities interest rate and domestic state debt service

Source: Authors’ calculations based on Ministry of Finance data

The anemic dynamic of external trade (in Jan–Sep:16 the commodities exports decreased by 1% y-o-y, and imports diminished by 2.2% y-o-y) and the shrinking of certain industries led to lower budgetary revenues by 917.4 m MDL compared to the planned level. Because of difficulties related to international financing, the budget also did not receive over 1.5 billion MDL in foreign grants. Consequently, in Q3:16, the budget was adjusted. After the adjustment, the national budget revenue and expenditures were decreased by 2.2 billion MDL.

Converting the state guarantees in public debt will leave a mark on the national economy. The significant growth of state debt will generate substantial costs associated with the state debt
service and will constrain public finances. Nonetheless, the new level of public debt does not pose a critical risk for the national economy. On September 26, 2016, during the meeting of parliament, the government took responsibility for the draft law to convert the guarantees related to the emergency credits granted by NBM to Banca de Economii, Banca Sociala and Unibank in 2014 and 2015 into state debt. As a result of the bankruptcy of the three banks, the guarantee provided by the government was transformed into state debt. Besides the enforcement of legal provisions, the government resorted to this measure based on two other important considerations. The first was to avoid another blow to its image if it did not honor its payment obligations to NBM, which would compromise the ongoing negotiations with the IMF. The second was that if the government did not ensure this conversion, the NBM reserve fund would have turned into debt, which, according to the NBM Law, would have obliged the state to transfer the outstanding amount to the NBM. This conversion of state guarantees in turn increases the level of state debt. Thus, if in 2015 the share of public debt in the GDP was 35.3%, then in 2016 this indicator could reach 40.3–40.6% of the GDP, and in 2017 the debt level would be 41–41.7%. At the same time, the new value of the public debt will remain well under the critical level of 62% of GDP, and in the medium term, the insolvency risk for Moldova is moderate. Nonetheless, the public debt service for 2017 will require additional expenditure of over 600 m MDL.

The signing of the new IMF Agreement will mitigate the risk for public finance. Based on the agreement, Moldova will receive a new loan, and a part of the resources provided by the IMF could be used to cover the budget deficit. At the same time, the new IMF Agreement will unblock other external financing. The possibility of accessing these financial resources from other countries or organizations is directly correlated with the quality of the Moldovan relationship with the IMF. The development partners have waited for the discussions with the IMF, and the positive result of the most recent negotiations is a sign to resume external financing for Moldova. This agreement also establishes the framework for reforms the government must promote. After all, the IMF granted financial support on condition of the government's commitment to implement a series of reforms aiming at strengthening the financial system and public finance.

Challenges and forecasts

- The state's increased debt level could determine the government to finance itself from the domestic financial market more actively. This way, the competition for bank crediting resources between the state and the private sector will intensify, with negative repercussions on business environment financing. Diminished lending will affect the level of private investments, and economic growth could, ultimately, slow down;
- Unblocking the external sources following the signing of the IMF Agreement is important from the budget balancing perspective, as well as amplifying public investments in the national economy. As the 2015 experience showed, the budget can be balanced even without external sources, though public investments are diminished, since financing is directed toward current and social expenditures. Under these circumstances, the negative influence of an increased public debt on the economic growth can be compensated by the positive effects on investments, determined by resuming external financing; and
- For 2016, tax revenues in real terms will grow by 3.6–3.7%, and the budget expenditures could decrease by over 4%. In 2017, the positive effects related to economic growth, the eventual extension of the stimulating monetary policy, the signing of the new IMF Agreement and the unblocking of external financing will prevail over the unfavorable influences caused by the public

3 Ibid.
4 According to the Debt Sustainability Analysis produced by the World Bank and the IMF, the critical threshold of the public debt share in the GDP for states with similar economic development as Moldova is 62%.
debt increase. Because of this, tax revenue might increase in real terms by 5.2–6.3%, and budget expenditures may increase by 5.5–6.3%. In both 2016 and in 2017, the budget deficit will, most likely, have a share of GDP smaller than 3%.

Policy recommendations

- One of the stringent problems for public finance and the credibility of state institutions is recovering the financial means amounting to 12% of the 2015 GDP, which was stolen in the context of the banking sector fraud. Even a partial recovery of the stolen amount would diminish the pressures on the budget. Currently the "billion case" is reduced to two elements: measures directed at recovering the financial resources, and sanctioning the individuals who operated the fraudulent transactions (as well as the officials who did not interfere to block illicit operations). Regarding the measures taken to recover these financial means (at least two stages of the investigations were undertaken, in which jurisdictions where a part of the financial means were placed were identified), there has been no progress in the punishment of individuals (at least judging by the publicly available information). In this sense, the activity of the judicial institutions involved in investigating the banking sector looting needs to be intensified. At the same time, to prevent the passiveness of officials in counteracting illicit schemes in the future, the financial and criminal penalties for failure to consciously fulfill their duties should be increased;

- Budgetary sustainability can be ensured by reforms to shrink the public sector and increase its efficiency. In the medium term, regardless of the government's political allegiance, the implementation of a wide public administration reform in Moldova is inevitable. We must mention that this reform should not be reduced to optimizing public institutions or staff. It should focus on increasing its performance and service quality for the citizens, especially by increasing the attractiveness of the public services for talented specialists by promoting meritocracy, depoliticization, large-scale implementation of ICT solutions and by effectively embracing the "open governance" model; and

- One of the government's intentions is to increase the tax base, which is reflected in the IMF Agreement. The modification of taxation parameters, such as adjusting rates or exemptions, can bring some results, but the effect of these measures is short term, and after a certain period the situation returns to the original below optimal condition. A solution for increasing the tax base refers to the attempt to model fiscal morality (people’s intrinsic motivation to pay taxes). A first aspect is strengthening the confidence of the population in the budget and tax system. Ultimately, society does not perceive the connection between paying taxes and the benefits associated with budget expenditure. A specific example here refers to the pensions system. Reforming the system so that taxpayers can clearly see the connection between contributions paid currently and future incomes could determine an increase in compliance. In addition, the level of fiscal morality is determined by factors that represent fundamental aspects for the functioning of the state. The level of corruption, as well as the quality of governance, diminishes the inclination of Moldovans to pay taxes. The recipe for reducing tax non-compliance should include measures to implement fundamental reforms to ensure the good functioning of the state, such as combating corruption, and justice and public institutions reform.

Chapter 4. Labor market

---

7 Ibid., p. 7.
The quantitative indicators of the labor market registered an improvement during 2016. However, while the employment grows, its quality has declined, with an increase only in the number of informal jobs with low and uncertain incomes, or even of subsistence incomes, and no entitlement to social benefits. Meanwhile, the major labor market challenges remain low labor productivity, which reduces the quality of economic growth and will in the medium term stop the increase of real wages, and the continuous erosion of human capital and increasing inclination toward emigration.

Recent trends

Evolutions in the first half of 2016 year reflect an improvement in the statistical indicators of the labor market. The employment rate has registered a significant increase, reaching the level of 37.6% in Q1:16 and 43.8% in Q2:16. The evolution of unemployment seems to support this trend. The unemployment rate declined in the first semester, or has returned to its fair level after its rise from Q1:15. It registered 6.2% and 4% respectively in the first two quarters of the year (Figure 8). In this way, the activity rate reached a relatively high level, comparable to the pre-crisis levels in 2009.

Figure 8. The evolution of unemployment and the employment rate (%)

This apparently positive evolution of the main indicators of the labor market has been accompanied by worsening quality of employment. The employment growth during the last five quarters occurred only because of informal employment. In Q1:16 and Q2:16, the share of the employed population with informal jobs was 33% and 39% respectively, which is 5.6 percentage points and 1.6 percentage points higher compared to the corresponding period of the previous year. The number of persons engaged in the informal sector increased by 32% and 4.6% respectively in Q1:16 and Q2:16 y-o-y, and the numbers of those engaged in the household sector are even higher (35.9% and 15% respectively y-o-y). Despite the positive trend of global indicator of employment, therefore, people are involved in activities which offer low and unstable incomes, even subsistence incomes, and are not enrolled in social security schemes. At the same time, the number of persons employed in the formal sector continued its decline from 2014, with a reduction of 1.3% and 1.7% respectively in Q1–Q2:16 y-o-y (Figure 9).
The transition to informality in the labor market took place mainly on account of employment in the agricultural sector. In the first half of 2016 it increased by 14% y-o-y, and the share of employment in the agricultural sector reached a relatively high level (about 34%) in comparison with previous years. The agricultural sector thus rescues those who have no other economic opportunities. In the long term, however, the agricultural sector remains a problem from several points of view, including human capital. The economy of the Republic of Moldova will change, which will contribute to the restructuring of the agricultural sector: its modernization, wider use of agricultural technologies, and reduction in the number of workplaces. In this regard, the high number of people employed in the sector or who practice agricultural activities represents a real challenge. In 2015, out of 381.9 thousand persons employed in the agricultural sector (31.7% of the total employed population in the economy), 63% had not graduated from specialized education.

Despite the decrease of the unemployment rate in 2016, certain negative developments in the structure of officially registered unemployment were identified. The number of officially registered unemployed persons slightly decreased between January and September 2016, but the share of unemployed person fired from their previous workplace increased from 4.6% to 7% y-o-y. This tendency could be an indication that the activity of the business sector either shrinks economic activity or attempts to decrease the costs. The percentage of unemployed persons in employment declined by 6% in this the period. If previously we concluded that there was a fluidization of unemployment, the percentage of registered unemployed persons with unemployment duration up to 6 months decreased from 63.8% in Q1–Q3:15 to 57.4% to Q1–Q3:16. The number of unemployed persons returning from abroad due to the termination of an individual work contract also increased by 6.7%. Taking into account decreased work emigration during the same period, this evolution indicates increasing external pressures on the labor market.

Real wages have returned to a slight upward trend since June 2016. The increase occurred only in the real sector of the economy, while in the budgetary sector real wages continue to decline. Increases in real wages, though not significant, were recorded in most economic sectors except mining and quarrying, water supply and sewerage, public administration and education. However, the reduction in the number of employees by 2.7% in the first half of the year y-o-y has determined the decline of wage income in households’ income both as value and share by 0.5 percentage points in the first half of the year y-o-y (in Q2:16 the reduction was even higher, at 2.4 percentage points). Other income sources could not fully compensate for the loss in wage income, making the population sensitive to the current economic situation. The increase in wages coupled with the increase of informal employment will deepen the gap between real wages and labor productivity, and consequently will harm the competitiveness of the labor force of the Republic of Moldova.
Meanwhile, the discrepancy between the supply of the education system and the demand for a labor force remains significant, representing an additional barrier to economic development. In the ranking of the World Economic Forum of 2016, the Republic of Moldova scored only 3.09 out of 7 for the indicator "Ease of finding skilled employees."\(^8\) The share of overqualified employees decreased in 2015, whereas the share of underqualified employees has increased.

### Challenges and forecasts

- The trends of the current year could result in increasing the employment rate slightly over 41% and the reduction of unemployment rate to approximately 4.5% in 2016. Meanwhile, informal employment could reach almost 37% for 2016 (comparable to 2003–2004 levels), and this will have a major impact on the population's standard of living. The decreasing quality of employment, and migration to informal employment, involves uncertain and lower revenues and non-participation in social insurance schemes. This has immediate implications for population welfare, increasing the risk of poverty, but also for the social assistance and social insurance system;
- The reduction of growth rates of labor productivity and the rising discrepancy between productivity levels of agricultural and non-agricultural sectors represents a constant challenge for the economy. The increasing gap affects the quality of economic growth, which will be based on an extensive use of production factors; and
- The reduction of productivity will diminish the growth rate of real wages, which, together with economic and political failure, continues to support the desire to emigrate. In the most recent Public Opinion Barometer of October 2016, 53.5% of respondents indicated they would leave the country forever or for a time if they had the chance. This level was higher than that registered in April 2016, and was more likely to be indicated by young persons or those with higher education levels. This creates additional barriers for economic development.

### Policy recommendations

- Although informal employment is a short-term solution for a part of the population, in the medium term this has significant implications for wellbeing of the population, of the level of social protection, and of labor productivity. It is thus necessary to take urgent measures to tackle this phenomenon, including through:
  - Facilitation of the development of extension and of rural development services, to replace the subsistence agriculture with market-oriented agriculture and change the status of unpaid family workers on the labor market; and
  - Sustained efforts to formalize the emigration to new destinations, where professionals in construction are in high demand (i.e. Israel, Qatar, Kuwait), including the negotiation of favorable agreements of social and of labor rights protection. This may reduce the share of population not covered by social protection and, additionally, would allow remittances to remain a source of stabilization for Moldovan budgets for a time;
- In the medium and long term, it is important to conduct labor market forecasts based on technological trends in the region and correlate the supply of formal/informal education and life-long learning with demand. It is also necessary to correlate educational policies with other medium- to long-term economic policies. Anticipation and the economic priorities of other sectors should underpin the educational policies, which must be very flexible and capable of being modified quickly and efficiently; and

---

\(^8\) The Human Capital Report 2016, World Economic Forum. The "Ease of finding skilled employees" indicator has values from 1 to 7 (1 = very difficult, 7 = very easy).
• The growth of labor productivity must become a priority for the public authorities. This requires reforms in the education sector, increasing the ratio of fixed capital to employment, promoting direct investment, and encouraging research and development activities.
Chapter 5. Prices and monetary policy

Currency stabilization allowed for a gradual disinflation trend in 2016. Under these circumstances, NBM decreased its policy rate from 19.5% to 9% in the first nine months of 2016. However, there is still room to relax the monetary policy further by cutting the policy rate and, especially, by decreasing the rate of the mandatory reserves, which remained at the high level of 35%. At the same time, we call for a prudent monetary policy easing, given the persisting external and internal risks.

Recent trends

2016 was characterized by intensifying disinflation trends. The explosive price increase of 2015, when the consumer price index (CPI) jumped from 4.7% y-o-y in Jan:15 to 13.6% y-o-y Dec:15, was followed by a significant tempering of inflation in 2016. Thus, the CPI growth rates fell from 13.4% y-o-y in Jan:16 to 2.5% y-o-y in Oct:16. The inflation decline was mostly due to national currency stabilization (Figure 10), as the currency depreciation was the main inflationary factor in 2015. If during the previous year the official USD/MDL rate increased with a monthly rate over 30% y-o-y, then in 2016 the growth rates have dropped from 22.3% y-o-y in Jan:16 to 0.7% y-o-y in Sep:16, and in Oct:16 a decrease by about 0.1% y-o-y was noted. Other factors that determined a moderation of inflation in 2016 include developments in the international markets characterized by food products and oil becoming cheaper, although since Q3:16 these tendencies have been reversed. Global disinflation developments have been observed over the past couple of years due to these dynamics, with a corresponding impact on inflationary tendencies in Moldova. The unit value index of imported goods, which is a proxy indicator for import prices, decreased by 12% y-o-y in Q1:16 and by 7% y-o-y in Q2:16. The globally cheaper oil also caused a drop of fuel prices (except in Jan:16) and, indirectly, determined a decrease in prices for natural gas through distribution networks (the natural gas price growth rate dropped from 9.7% y-o-y in Jan:16 to 14.5% y-o-y in Oct:16).

Figure 10. Official exchange rate USD/MDL and CPI, y-o-y growth (%)

Source: Authors’ calculations based on NBS and NBM data

Decreasing the inflationary risks allowed the NBM to relax the monetary policy. The foreign exchange market stabilization and the reduction of inflationary pressures encouraged the monetary policy adjustment. Thus, in the first nine months of 2016, NBM consecutively reduced its policy rate from 19.5% to 9%. In parallel with moderating inflationary tendencies, this allowed a decrease in market
interest rates. Consequently, for the new deposits attracted in MDL, the interest rates dropped from 15.3% in Jan:16 to 7.2%, and for credits the decrease was from 16.1% to 13% (Figure 11). However, the level of mandatory reserves for resources attracted in MDL remained 35%, which was the level established in Oct:15. This blocks about one third of the resources held by banks in MDL.

Figure 11. Evolution of CPI, base rate and interest rate on the market

Source: Authors’ calculations based on NBS and NBM data

The increase in liquid assets held by the banking sector determined the NBM to change its behavior on the monetary market. If in 2015 the central bank mainly pumped money into the market, then in 2016 the monetary authority sterilized excess liquidity. The decrease in bank loans (in Oct:16 credits in MDL decreased by 12.3% y-o-y) accompanied by the growth of savings (in Oct:16 deposits in MDL increased by 27.8% y-o-y) determined an increase of available liquidity for financial institutions. Thus in Oct:16 compared to Oct:15 the current liquidity indicator increased from 41.7% to 47.6%. In this context, the banks have given up purchasing liquidity from the NBM (there have been no repurchase transactions as of Q3:16) and they started actively procuring National Bank Certificates (NBC: in Oct:16 the average daily balance of NBCs sold by NBM reached 4.43 billion MDL, a record level for transactions since Jan:2014). This happened even though the price of money dropped. Thus, while in 2015 the NBM provided money, in 2016 the central bank acquired the excess liquidity from commercial banks (Figure 12).

Figure 12. NBM transactions on the monetary market

Source: NBM

Exchange rate stabilization allowed the NBM to minimize its market interventions through currency sales. At the same time, the monetary authority resorted to currency purchases, which allowed
supplementing the official reserve assets. After the massive sales from early 2015 NBM reduced its currency providing interventions, and since Oct:15 NBM has operated on the market only to buy currency (except for Oct:16 when the monetary authority bought and sold currency at the same time). During the first 10 months of 2016, therefore, NBM bought currency amounting to 425.3 m USD, and the sales were 10.7 m USD. The currency purchases allowed the consolidation of the currency reserves, and in Oct:16 the official reserve assets amounted to over 2.1 bln USD. This level is nevertheless far below the 2.8 bln USD registered at the beginning of 2014.

Figure 13. NBM interventions on the foreign exchange market and official reserve assets (millions USD)

Challenges and forecasts

- We forecast that the annual average CPI will reach 6.5–7% in 2016 and 4.5–5.5% in 2017. The national currency exchange rate stabilization, and the more favorable agricultural year translating into an increased supply of agricultural products on the domestic market, are factors that will determine a decrease in inflationary pressures;
- However, there are certain inflationary risks. First, there is an excess liquidity in the banking sector, and the financial institutions will try to boost their crediting to decrease the costs associated with managing this. At the same time, an improvement, even the smallest one, in the economic situation (see Chapters 1 and 2) will motivate the companies to contract loans more actively. Under these circumstances, the inflation can be under pressure due to the aggregated demand. Second, there are risks related to increasing prices on the international commodities market, which could raise prices of imported goods. When it comes to fuels, however, a great risk for Moldova is not a price increase, but a price decrease on the global market. This is determined by the fact that a significant part of remittances come from the Russian Federation, which strongly relies on oil prices. A price decrease for oil negatively affects economic developments in Russia, and thus the remittances sent home by Moldovans working there. A decrease in transfers puts pressure on the exchange rate and, indirectly, stimulates the inflationary risks. In 2014–2015 Moldova was already affected by such a development, and considering the volatility characterizing the international oil market, it is not unlikely that this phenomenon may occur again; and
- In the context of the banking crisis, NBM’s image took a strong blow. Although in 2016 the administration was changed and its intervention capacity was strengthened, the credibility of the monetary authority remains low, which undermines the efficiency of monetary policies promoted by the NBM.
Policy recommendations

- The NBM should continue promoting a prudent monetary policy. Although the lack of inflationary pressure calls for monetary policy easing, the persistence of increased inflationary risks does not allow a rapid relaxation of the monetary policy;
- If no major inflationary risks materialize, the policy rate can be decreased by several percentage points during 2017. At the same time, the monetary policy should not follow regulatory and stability banking objectives, but should rather focus on the implementation of the inflation-targeting strategy. This means that the mandatory reserve rate should be decreased gradually over the following 2–3 years; and
- Immunizing the economy to currency shocks should be a concern for the NBM. Although the inflation-targeting regime implies little active NBM involvement on the foreign exchange market, in Moldova’s case (with a small, open economy) the national currency depreciation is one of the main inflationary factors. In this context, to be able to cope with potential currency shocks, NBM should rapidly bridge the gap in currency reserves that caused the need to pump in currency to alleviate the effects of the financial crisis from 2014–2015. Unlocking external financing for Moldova will help achieve this. In addition, to diminish the risks of speculative attacks on the currency market, the more active involvement of other institutions responsible for the economic security of the state (the Prosecutor’s Office, NAC) is also necessary.
Chapter 6. The banking sector

The results of the current banking crisis reveal the need to rethink the framework in which the national financial system conducts its activity. Once the effects of the crisis were stopped, a comprehensive reform process was initiated, both at the central bank level and at the level of the commercial banks. According to the proposed objectives, these reforms aim to ensure a healthy financial intermediation and to strengthen the resistance of financial institutions to numerous risks revealed during the crisis. In 2016, the NBM, with the support of the main development partners, consequently developed and implemented a series of regulations and measures aimed at fostering the independence and supervisory powers of the central bank, in parallel with the improvement of corporate governance and risk management in commercial banks.

Recent trends

_The assurance of an efficient reform of the financial/banking sector is crucial for the maintenance of trust and support of external partners._ In this respect, the banking sector was the main subject discussed by all foreign donors before resuming cooperation with the Moldovan authorities. The new IMF Agreement\(^9\) also seeks the rapid improvement of the governance and supervision of the financial/banking sector, while reaching the full transparency of the commercial banks’ shareholding structure until the middle of next year. At the same time, the acceleration of reform was determined by the strengthened functionality of the NBM, a process completed by filling all vacancies in both governing bodies (the Executive Committee and Supervisory Council). The new concept of financial stability is an essential step in the reform process, focusing on exempting the taxpayers to pay the "bill" for saving bankrupt banks. In this regard, the law on the recovery and resolution of banks\(^10\) assumes the orderly exit from the market of unviable institutions and provides the supervisory body with appropriate tools for rapid intervention in critical situations.

_Although a certain number of measures were taken to remedy the situation at the biggest three domestic banks, intensive supervision continues today._ This situation is explained by the fact that not all deficiencies related to transparency and the quality of the shareholders were solved, and there were still issues with the level of risky exposures or exposure to affiliated persons or groups. At the same time, because of the suspension of shareholder's rights for a group holding more than 50% in a bank, and to ensure a healthy and prudent leadership, the NBM introduced _the early intervention regime_ at one of the three banks under intensive supervision. This new tool presumes the replacement of management bodies to implement the arrangements set out in the recovery plan, an appropriate restructuring of debts, and changes in business strategy and the legal and operational structure, but not the _special administration or liquidation_ as supposed by the old framework for crisis settlement.

_Regarding the financial situation of the banking sector, it is significantly determined by the general economic conditions and monetary policy stance._ Even if the total assets of the sector registered a negligible increase, their structure recorded significant evolutions. In Sep:16, the total assets constituted 72.7 billion MDL, increasing by 5% f-a-p, or by 3.9 billion MDL from the beginning of the year. However, this increase is contrary to the trend of the basic component of assets, namely the gross loans. Their share was 50% in Sep:16, over 6 percentage points less f-a-p, or a decrease of over

---

\(^{9}\) The Economic Program with the Republic of Moldova was approved on November 7, 2016.

\(^{10}\) Law no. 232 of October 3, 2016 on the recovery and resolution of banks.
3 billion MDL. The reducing of the stock of loans is determined by the lack of a stable demand, in response to the relatively uncertain economic situation and to the average higher interest rates applied by banks. Affected by these trends, the commercial banks have placed their available funds in securities (NBC and state securities), which constituted about 14% of total assets in Sep:16, the rest being held in the form of cash (obligatory reserves), or other types of assets.

Figure 14. Dynamics of bank assets, billion MDL

Although the monetary policy tends to relax, the lending activity continues its downward trend. The total volume of new granted loans has significantly reduced during the first nine months of 2016, registering the value of 16.4 billion MDL in Sep:16, with 12.3% less than in the first nine months of 2015. The same situation is registered by the total stock of loans, which in Sep:16 registered the value of 36.3 billion MDL, decreasing by 8.3% f-a-p. Regarding the structure, the balance of loans in national currency has reached its lowest level in the last two years, constituting the value of 20.1 billion MDL at the end of Sep:16, with 12.1% less than f-a-p, or 55.4% from total loans.

Figure 15. Lending activity (%)

The negative trends in lending are complemented by the continued deterioration of their quality. The worsening financial conditions of borrowers (individuals and legal entities) has led to the increase of non-performing loans up to the level of 15.8% of total granted loans in Sept:16 (or a volume of 5.7 billion MDL), which is an increase of 6 percentage points compared to the same month last year. However, this is an aggregate indicator for the entire banking sector, and depending on the bank it varies around 3%–33%. At the same time, the most significant increases of non-performing loans were
registered by the banks placed under the monitoring of the NBM, one of the reasons being the reclassification of loans granted prior to special supervision. Not all non-performing loans are, however, automatically compromised, many of them being thus classified because of delays in repayment. The level of capital adequacy also till now allowed the banks to absorb the losses related to the deterioration of the loans portfolio, but further deterioration of assets could lead to the reduction of the level of capital under the rules approved by the NBM. In this respect, to mitigate these vulnerabilities, the NBM should continue reviewing the internal policies and strategies of commercial banks to clean the banks' balance sheets of non-performing loans and strengthen capital levels. The commercial banks must also work individually with each client to restructure or renegotiate the loans, as this solution could give better results than the pledge execution and application of the insolvency to the debtor.

**Along with the stabilization of the exchange rate, the public confidence in the national currency increased.** During 2016 the share of deposits in national currency significantly increased, stimulated by two factors: the reduction of foreign currency deposits and the growth of new deposits in MDL. Thus, in the Sep:16, the stock of total term deposits registered a slightly increase f-a-p, about 3%, or a volume of 34.7 billion MDL. At the same time, the stock of deposits in MDL increased by more than 20% f-a-p, while the stock of those in foreign currency decreased by about 11% f-a-p. This determined the change of deposits ratio in MDL versus foreign currency deposits, from 0.82 in Sep:15 to 1.1 in Sep:16.

**Figure 16. Evolution of term deposits (%)**

![Figure 16](image)

*Source: Author's calculations based on NBM data*

**With the easing of monetary policy, the banking margin in the national currency returned to the level recorded in 2014.** The difference between the average rate on loans and the average rate on deposits at the end of Sep:16 was 6 percentage points, increasing by 5 percentage points compared to the beginning of the year and by 3.5 percentage points y-o-y. At the same time, the margin for transactions in foreign currency maintained at a relatively stable level and constituted 3.7 percentage points, 1 percentage point less y-o-y. Thus, the easing of monetary policy for the moment mostly influences rates on deposits, while the cost of credit responds much more slowly.
Overall, the banking sector has sufficient liquidity to deal with potential shocks. The aggregated short-term liquidity indicator for the entire banking sector constituted 45.2% in Sep:16, increasing by 6.4 percentage points y-o-y. At the same time, some banks have a significant surplus of liquidity: the indicator Kp II even surpassed 60% (the minimum allowable level is 20%). To get a more relevant picture of the current liquidity of banks, the NBM has modified the calculation method of liquid assets, mainly the part related to interbank exposures. From now on, therefore, only interbank exposures placed at domestic and foreign banks with a sufficient rating and no interdictions will be taken into account.

11 The Regulations concerning the bank’s liquidation, modified through HCE of NBM no. 130 of December 10, 2015 (in force on June 30, 2016).
After structural developments in 2015, the results of the banking sector tend to stabilize. During Q1–Q3:16, the revenues of commercial banks derived from foreign exchange transactions decreased significantly, amounting only 1/4 compared to the same period in 2015, or 630 billion MDL at the end of Q3:16. Even so, at the aggregate level, the sector has registered a steady accumulation of profit, reaching approximately 1.37 billion MDL in Sept:16. The main profitability indicators of the banking sector in Sep:16, the Return on Assets and the Return on Equity, registered the values of 2.5% and 15% respectively, with a slight decrease compared to the beginning of the year. This was due to being affected by increased non-interest expenses which caused a reduction in the efficiency of banking activity.

Figure 19. Evolution of bank’s income and profitability (%)

Source: Author’s calculations based on NBM data

Challenges and forecasts

- In the first nine months of 2016, the NBM has gradually eased the monetary policy, but with no impact on the recovery of the lending process. This shows the slow transmission channel of monetary policy through the base rate and the timid growth process of the consumption, investment and economy. At the same time, not all monetary policy instruments are linked to the same extent. The NBM continues to use the high mandatory reserve rate to ensure the stability of the banking sector, which is not a sustainable practice and affects the efficiency of monetary policy. According to the estimations for Q4:16, the lending process will continue its negative growth, accounting for a volume by 15% lower y-o-y for the entirety of 2016. Moreover, taking into account the low comparison base, we anticipate an increase for 2017 in lending activity of up to 9.8% in an optimistic scenario, or 7.4% in a pessimistic scenario;

- The indicators related to the quality of banking assets continue to worsen. The number of loans classified as non-performing registered an upward trend in the first three quarters of 2016. This obliges the banks to formulate adequate provisions in relation to the risks assumed, which affects their capitalization. In the context of intensive surveillance of the largest banks in the sector, but also of the initiated reforms, the NBM seeks the revaluation of loans portfolios held by all commercial banks. Once evaluated, it becomes essential to initiate a restructuring process for the problematic cases and the stimulation of new and “healthy” loans. This is possible only in the case of the country’s economic recovery, while providing a financial intermediation process based on principles of transparency, fairness and equity;

- The confidence in the banking sector remains low. The NBM has blocked several rights of banking shareholders and withdrawn confirmation for several officials with key functions within a systemically important commercial bank, and this reveals serious problems of transparency and

---

12 The Decision of the Executive Committee of the NBM, March 2, 2016, concerning the blocking of the rights of a group of shareholders of BC “Moldova-Agroindbank”; The Decision of the Executive Committee of the NBM, October 20, 2016, concerning the blocking of the rights of a group of shareholders of BC “Moldinconbank”.

13 The Decision of the Executive Committee of the NBM, March 2, 2016, concerning the withdrawal of confirmation for two administrators of BC “Moldinconbank.”
corporate governance. Even if the efforts of the NBM in this regard are visible, some questions persist over risk and about some managers who allowed the engagement of banks in risky exposures and transactions. The need to restore trust and a positive image in the sector, but also the fulfilling of the commitments undertaken at the signing of the agreement with the FMI, will determine the NBM to review requirements toward the shareholders and persons holding key positions within banking institutions; and

- In the context of the banking crisis, there is a risk of its extrapolation in the non-banking financial sector. The gaps in supervision processes, the low transparency of effective owners of shares and faulty corporate governance demonstrate that non-banking financial institutions suffer from the same systemic problems as banking institutions. Thus, this sector is exposed to risks of fraud and similar crises to those that hit the banking sector.

Policy recommendations

- The Republic of Moldova needs to continue the reforms begun in the banking sector and boost those from the non-banking financial sector. Meeting all assumed commitments toward the main development partners is essential to respect the schedule and deadlines established in the new agreement with the FMI;
- At the same time, the NBM should take clear actions to strengthen the corporate governance if the banking sector and exclude persons whose activity has been associated with willful or intentional breach of laws, ethics, governance, or controls of any kind. To achieve this objective, it can approve alternative and complementary solutions to the existing framework, namely the transposition of fit and proper criteria that can meet the expectations in terms of competences and worthiness of the persons holding key positions;
- Lessons learned from the interaction of the local banking sector with the "offshore" jurisdictions need to be transposed into policy documents, which will ensure the elimination of all forms of exposure and interference between commercial banks and companies registered in these jurisdictions. In this regard, it is noted that "offshore" areas were an essential element that led to the concealment of funds diverted from liquidated commercial banks;
- To restore confidence in the banking sector and other state institutions, the investigation on embezzled funds from the three liquidated banks needs to be accelerated, given the modest results achieved so far (no funds have been recovered, except those resulting from the liquidation of banks). We also call for more transparency in relation to the criminal investigations related to the recent bank fraud, which could lead to higher public confidence about the correctness of the measures taken;
- The current deposit guarantee scheme cannot bear the economic costs arising from the bankruptcy of medium and large national banks (as demonstrated by the banking crisis, which resulted in the collapse of three banks). Under these circumstances, it is essential to reform the guarantee framework of bank deposits through the consolidation of the capacity of the Deposit Guarantee Fund, so that it can play a greater role in solving the crises involved in the liquidation of banks. It is necessary to increase the deposit guarantee threshold in the following years to be in line with current economic realities and to ensure adequate protection for depositors and banks in terms of strengthening confidence in the sector; and
- Finally, the institutions involved in harmonizing national legislation with the commitments undertaken by the signing of the Association Agreement with the European Union must strengthen their efforts to comply with the agreed terms. 2017 proved to be a complex year in this respect, with a volume of over 15 directives in the field of financial services which follow to be transposed (Annex XXXVIII(A) of the Agreement).
Chapter 7. Foreign trade

During Q1–Q3:16 there was an attenuation of the persistent negative trends from the year 2015, together with the setting up of a certain degree of political stability and the strengthening of the domestic economic conjuncture. During this period, the implementation of the assumed commitments within the DCFTA remained a priority for the authorities, although the arrears and delays were proper for this process. At the same time, the degree of implementation of the DCFTA in the Transnistrian region from January 1, 2016 is uncertain, in the absence of tools for monitoring and reporting the compliance of the region’s efforts. The free trade agreement between the Republic of Moldova and Turkey, which entered into force on November 1, 2016, should also not be neglected, as it could generate in perspective new commercial opportunities for our national economy.

Recent trends

After the dramatic decreases recorded during the previous year, in Q1–Q3:16 an attenuation of these negative trends was observed. Thus, in Q1–Q3:16, the value of exports was lower than in the previous year by 1.0% and totaled USD 1433 million. Meanwhile, the imports in Q1–Q3:16 amounted to USD 2896 million, which is by 2.2% less y-o-y. However, these trends must be interpreted in the light of a very low comparison base for the year 2015 (Figure 20).

Figure 20. The Republic of Moldova’s foreign trade in 2013–2016, changes y-o-y (%)

The exports to the EU continue to compensate for the decrease in exports on the CIS markets. In terms of geography, the main destination of Moldovan exports remains the European Union with a total of USD 915 million in Q1–Q3:16, increasing by 1.7% y-o-y and with a share of 63.8% in total exports (62.1% in 2015). The most significant increases were noticed in Bulgaria (2.2 times more y-o-y, as a result of increasing the exports of sugar and gas meters); Romania (6.8% more y-o-y, due to increasing the exports of sugar and wheat); and Germany (5.2% more y-o-y, after increasing the exports of chairs and chair parts). Meanwhile, the following decreases were noticed in the United Kingdom of Great Britain and Northern Ireland (17.9% less y-o-y, due to reducing the exports of soybeans and sunflower seeds); Italy (5.1% less y-o-y due to reducing the exports of sunflower oil); and Latvia (59.8% less y-o-y, due to reducing the exports of gas meters). It should be noted that for some products the dynamics were determined by a lower export potential (as in the case of sugar and soybeans), while for others, the dynamics were determined by the redistribution to other more attractive export destinations (in the case of gas meters, sunflower seeds and sunflower oil).
The usage of export tariff quotas to the EU presents a mixed picture. Only two categories of products subject to annual exemption from customs duties were exported in the first nine months of 2016: table grapes (5238 tons, in such a way the annual quota being used in proportion of 52.4%) and plums (5728 tons, which represents 57.3% of the allocated annual quota). The tariff quotas for apples, tomatoes, garlic and grape juice were completely unused. At the same time, the products subject to anti-circumvention mechanisms which were eligible to be exported (excluding products of animal origin) enjoyed impressive dynamics. During the first 10 months of the year, therefore, the export quotas for wheat and processed cereals (particularly ethyl alcohol) were exceeded by almost five times. For sugar, the quota was exceeded by a factor of 1.2. The usage for other products varied from 22.4% and 58.1% for processed sugar and sweetcorn to 77.7% and 88.6% for barley and corn, respectively.

The exports toward the CIS decreased due to a lower demand for Moldovan products on the Kazakhstan and Belarus markets. In Q1–Q3:16, the CIS countries were present in the country’s exports with a share of 21.0% (in 2015 it was 25.3%), which corresponds to a value of USD 301 million, 17.9% less y-o-y. The most important reductions were noticed in Kazakhstan (-81.4% y-o-y), as a result of reducing the exports of sugar, apples and wine, and Belarus (-22.7% y-o-y), due to reducing the exports of apricots, peaches and sugar. At the same time, considering that in the compared period (2015) the Russian Federation also applied tariff and non-tariff measures, the Moldovan exports to this destination decreased by only 3.5%, mostly due to the lower export of pharmaceuticals. However, against the backdrop of settling the armed conflict in eastern Ukraine, the exports toward this destination increased by 16.3% because of increased exports of wine and corn.

A slight diversification of exports toward other countries was noticed. In Q1–Q3:16, exports to the other countries of the world (other than the EU and CIS) stood at about USD 217 million, an increase of 19.4% y-o-y, with a share of 15.2% in total exports (in 2015 it was 12.6%). This spectacular growth was possible due to the increase of exports to Iraq, which totaled USD 24.7 million (2.6 times more y-o-y) as a result of increasing the exports of sunflower seed oil and to Malaysia (3.5 times more y-o-y) as a result of increasing the exports of wheat.

![Figure 21. The influence of exports in value terms in Q1–Q3:16, percentage points](Image)

Source: Expert-Grup calculations based on NBS data

The climactic conditions were reflected in the dynamics of exported vegetable products. In Q1–Q3:16, vegetables (mainly fruits and oilseeds) had the most negative influence on exports, which recorded a 7.3% decrease in Q1–Q3:16 (amounting USD 343 million, or USD 27 million less y-o-y). Vegetable fats and oils also decreased by 47.3%, totaling USD 26 million or USD 23 million less y-o-y (Figure 21). However, these negative results could be explained by the unfavorable climatic conditions for these products and their delayed harvesting/realization, which is not yet reflected in the statistics.

The re-exports of pharmaceutical products negatively influenced the dynamics of exports. In Q1–Q3:16, the export of chemical products had a major impact on reducing the exports overall. They registered a decrease of 25%, amounting to USD 64 million, which is USD 22 million less y-o-y (Figure 22). However, the negative
evolution of exports from this group of products was determined by the constant reduction of re-exports of pharmaceutical products to the CIS countries, mainly to the Russian Federation.

Figure 22. The unit value index and the physical volume index of exported goods, changes y-o-y (%)

![Graph showing unit value index and physical volume index changes](image)

Source: Expert-Grup calculations based on NBS data

**The imports from the EU diminished because of reducing the price of fuel and diminishing the imports of medical instruments and appliances.** The main source of imports remains the European Union with a total of USD 1435 million in Q1–Q3:16 (1.8% less y-o-y), holding a share of 49.6% of total imports (49.3% in 2015). The most significant decreases were noticed from Romania (9.6% less y-o-y, as the result of reducing the import of petroleum oils and plastic tubes and pipes); Austria (18.5% less y-o-y, as the result of reducing the import of cables and copper wires); and Germany (20.5% less y-o-y, due to reducing the import of medical instruments and appliances, cars and other vehicles).

Figure 23. The influence of imports in value terms in Q1–Q3:16, percentage points

![Graph showing influence of imports in value terms](image)

Source: Expert-Grup calculations based on NBS data

**The value of imports from CIS diminished as a result of reducing the price of oil gas.** In Q1–Q3:16, the CIS countries were present in Moldova's imports with a share of 25.2% (25.1% in 2015), which corresponds to a value of USD 729 million. This represented a decrease of 1.8% y-o-y (Figure 23). The most significant reductions from this market were noticed in the Russian Federation (-3.5% y-o-y, due to reducing the price of oil gas) and Uzbekistan (-79.0% y-o-y, due to changing the source of cheaper imports of mineral or chemical or nitrogenous fertilizers).

**The tariff measures applied to some imports from Ukraine did not reach their full scope.** Despite the Republic of Moldova's introduction of import duties for some sensitive products imported from Ukraine (such as dairy products, meat products and cement), the import dynamics indicate some equivocal effects. Thus, during the reference period, imports of dairy products increased by 10%, while imports of hydraulic cement reduced by
13% (but the tariff quota was exceeded by a factor of five). At the same time, the import of meat products remains insignificant, being similar to the period preceding the introduction of this measure.

Figure 24. The unit value index and the physical volume index of imported goods, changes y-o-y (%)

Although in value terms the imports registered a decrease of 2.2%, their quantitative evolution shows even a slight increase in Q2:16, their disaggregation indicating differences that are less obvious for most groups of goods y-o-y (Figure 24).

Challenges and forecasts

- In 2016, the total exports of goods and services will have risen by about 3.9% expressed in MDL and in real terms. At the same time, we expect imports to grow by 3.6% as a result of the increasing consumption.
- Also, starting with January 1, we can anticipate challenges and multiple speculations which will focus on the economic opportunity from extending the provisions of the DCFTA in the Transnistrian region, on behalf of the political players in the context of the so-called parliamentary elections in this region. At the same time, the authorities of the Republic of Moldova must strengthen their institutional efforts to guarantee a proper implementation of the undertaken commitments to their European partners, despite the risks arising from the lack of effective control over the given region.
- Since in 2017 the Moldovan authorities intend to extend unilaterally the customs duties for imports from Ukraine of some sensitive products for domestic producers (such as dairy products, meat etc.), there is the risk that this country may apply some similar measures (not necessarily on the same products), which will decrease the ability of Moldovan products to enter this market.

Policy recommendations

To diminish the influence of external economic risks, the trade policy of the Republic of Moldova should be directed to consider the following:

- Accelerating the reforms in the economic sector covered by the Association Agreement, with strict fulfillment of the commitments made under this agreement, while strengthening the institutional capacity of public authorities. It is also necessary to re-evaluate all guiding documents for the AA/DCFTA implementation in the format of a single tool, to exclude excessive pressure in the monitoring and reporting process during the AA/DCFTA implementation and realistically assess the target dates for implementation of activities with the aim of avoiding the "accumulation" of arrears;
- Ensuring strict implementation of commitments under the DCFTA in the context of extending preferential trade regime in the Transnistrian region, by strengthening the institutional efforts of both parties involved in the process. It is also necessary to identify a viable mechanism to monitor the implementation of the
DCFTA in the region, taking into account the responsibility of constitutional authorities to guarantee that commitments taken under the AA/DCFTA are implemented correctly over the entire territory of the country;

- Resuming discussions with the authorities of the Russian Federation to reassess the restrictive measures applied to goods of Moldovan origin, by presenting the arguments related to the alleged invasion of poor quality goods on the Russian Federation's market and by eliminating the subjective character in accepting the exports made only by certain Moldovan companies;

- If appropriate, initiating disputes within the WTO in response to the unjustified discriminatory measures applied by the Russian Federation to the Republic of Moldova;

- Not allowing the extension of unilateral tariff measures with respect to sensitive products (dairy products, meat, etc.) of Ukrainian origin to avoid establishing some similar measures for domestic products. Instead, it is considered appropriate to initiate an investigation regarding the opportunity of establishing some trade protection measures against the concerned goods, in accordance with the procedures prescribed in the bilateral free trade agreement between the Republic of Moldova and Ukraine, as well as in the WTO agreements;

- Although the Republic of Moldova is a member of the PEM Convention on the rules of origin, it cannot benefit from the diagonal cumulation of origin because the technical procedures were not completed for a proper implementation of the document. The responsible institutions must therefore focus their efforts on the full functionality of the new mechanism of cumulation of origin of goods, which could lead to a more dynamic commercial activity of the country;

- Since the WTO agreement on trade facilitation has entered into force, the authorities will make substantial efforts to comply fully with the multilateral commitments they have undertaken, and also to involve development partners in institutional strengthening, which will lead to streamlining the regional and international trade by reducing transaction costs, and optimizing the cross-border flow;

- Disseminating information to the business environment about the opportunities offered by the free trade agreement between the Republic of Moldova and Turkey, signed on September 14, 2014; and

- Considering the authorities' intentions to initiate trade negotiations on some new free trade agreements (with China, Egypt, etc.), evaluating the opportunity of these processes in the light of some purely economic reasons and only after performing comprehensive analysis (feasibility studies) based on empirical methods.
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 2006–2016 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.