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Economy as political hostage: election playground set-off!

Political campaign began long before the Central Election Commission announced its official start. Party leaders and public officials started the rush in fall 2008, making generous social and economic promises to the public. However, at the moment the battle is given for the hesitant voters which according to social polls account for 40% of the population able to vote. Obviously, the ruling party possesses sufficient communication, administrative and budgetary tools to gain most of these votes. For this purpose the ruling party is considering many tactics, including the economic manipulation of the electoral behavior.

For example, it is well known that in many rural communities in Moldova, the school teachers can influence significantly the election results because they are influential in the local public. Nevertheless, the majority of teachers lives under poverty line and are extremely sensitive to wage changes. The election strategy of the Communist Party pays additional attention to the tool of „salary motivation” for teachers. After several marginal increases of the wages in previous years, in January this year, the Government following a President’s initiative promised the teachers to double their average salary by the end of 2009. (In September 2008, the Government did not accept even a 35% salary raise as requested by the trade unions). The promises to double the salaries for the teachers who normally do not vote for the communist party are made to encourage them to change their mind by the elections day.

We are not against salary increase for teachers. Moreover, in 2008 we supported the teachers’ campaign for higher salaries (for example see, http://www.expert-grup.org/docs/re/re-5.pdf). However the global economic crisis and the underlying political message of this initiative, emphasize the risks behind doubling the salaries. The major risk is that in the second half of 2009, budgetary constraints could make it impossible to keep the election promises without affecting budgetary stability. Moreover, increasing two times the salary for teachers will make other public workers immediately claim the same changes to be made for their salaries.

Obviously, the consequences of this generous politics will have to be handled by the next government, regardless of its color or political affiliation. Taking into account that the elections day is closer while the future is long, the incumbent government is apparently ready to sacrifice some of its long term macroeconomic stability objectives.

Another election initiative of the communist party is the initiative to reduce by 20% prices for some types of bread from February 1st. In order to discuss this issue, the President summoned a meeting on food security. The pseudo-scientific argument for price reduction is that „small inflation allows decreasing the costs for basic food”. However, a reduced level of inflation does not mean smaller production costs. It is clear that smaller prices will be generated by „Franzeluta”, which will be subsidized from the
state budget, while private bakeries will incur losses (in other words, this initiative is anti-competitive as well). There are a small number of poor and vulnerable citizens, mainly speaking about urban pensioners, who indeed need cheaper prices for bread. The government should rather target the social needs of this group more efficiently, than adopting universal price reduction. Apparently the communist party does not take into account these “small details” and intends to gain at any price additional votes during elections.

Last months, there have been several interviews published with high state officials in newspapers favoring the ruling party. The subject of the interviews reveals the “significant progress accomplished during the last eight years of governance, better living conditions and achieving impressive economic results”. How can Moldovans be so short-sighted and not take into account the „improvements”, trying desperately to migrate abroad searching for a workplace?

Economic lessons from 2008 and challenges for 2009

A number of more or less recent economic events require additional analysis, even though they have already been reflected by media. Obviously, the energy crisis causing by disruption of Russian gas supply and transit through Ukraine to European consumers was the most important economic event since the beginning of this year. The gas crisis has to be examined in a broader perspective, allowing identifying in more details the economic challenges for the Moldovan government in 2009.

The „gas crisis” between Russia and Ukraine resulted in immediate economic damages to all consuming countries in Central and Eastern Europe. Some of these countries (Bulgaria, Slovakia) initiated already some legal actions against the Russian company „Gazprom” to cover the damages. Moldova did not initiate such actions, and apparently will not submit any claims, if judging by its attitude during the gas crisis between Russia and Ukraine and the mysterious way that Moldova found some quantities of gas to maintain minimal consumption. The “gas war” held Europe’s breath for 3 weeks, from January 1st when Russia reduced gas supply to Ukraine, until January 19th when gas supply resumed. We conducted a more detailed research of the crisis, which can be accessed at http://www.expert-grup.org/?p=210&lang=ro.

Another conclusion is that agreements between Russia and Ukraine should never be viewed as final and irreversible. As relations between Ukrainian president Victor Iuşcenko and country Prime Minister Iulia Timoşenko become more harsh with the presidential elections approaching, the gas supply agreements between „Gazprom” and „Naftogaz” can be sent to the court by the Ukrainian president in order to be cancelled as he already promised to do. Therefore, we can witness soon another episode of the „gas war” drama. Having in mind that the conflict can repeat this spring, it is suggested that Moldovan government and the companies operating power-generation plants make oil and coal deposits, while the companies operating power distribution networks – ensure that electric lines have enough capacities to transit double amount of energy.
Besides the immediate damages, European consumers had a hard lesson to learn from the „gas war”. Apparently this lesson was taken more seriously than in 2006. Particularly, EU announced quicker actions for launching the „Nabucco” project and interconnecting the national pipeline networks into a pan-European system, to provide a minimal energy security. It will take another couple of years to accomplish these projects, and there is no yet enough gas reserves from Central Asia to fill-up the “Nabucco” system. However, there is no doubt that the European governments are determined to follow this road. If Moldova manages to interconnect reversely with Romanian natural gas pipe system, it has the chances to benefit from both projects. This will require, however, other kind of relations with Romania than in the past three years.

Today, the government and private actors are more active in promoting ideas of developing alternative energy sources in Moldova. Ministry of Ecology and Natural Resources declares that it intends to contribute to attracting investments in facilities for substituting traditional fuels. Ministry of Economy and Commerce officials intend to take part in establishing an International Agency for Renewable Energy and there are meetings held at Government and with the President discussing the energy technological issues. However all these attempts do not answer the questions „where will investments come from?” According to some estimates, in 2008 the global foreign direct investments decreased by 20% and the forecasts for 2009 are even worse. It would be wrong to account for external assistance, including investments projects in infrastructure. The main bilateral donors of Moldova are not in the best economic shape. Moreover, taking into account that the price for traditional fuel decreased significantly (the price for 1 barrel of oil fluctuates around 40 USD), alternative energy resource investment projects become less attractive. Conclusion is obvious: investments have to be made while prices for oil were high.

According to all probabilities, in 2009 there will not be budget funds available for developing alternative energy projects. It is possible that these funds will not be available even in 2010, because according to economic analysis, global economy will start recovering only in 2010. Moldova cannot recover earlier from global economic crisis, even though in the short term our country had little to suffer compared to neighbor countries. In this context, there is an encouraging trend that the economic growth registered in 2008 was 7.2%. However a detailed analysis outlines several risks. Indeed, the key source of this growth was of „single use”. After drastic recession of the agricultural sector, -32% in the third quarter of 2007, the sector recovered with a +37% growth in the third quarter of 2008. The effect of this growth reflected in the annual GDP growth statistics. A similar performance is impossible in 2009. The industry is already in crisis and we are less optimistic concerning its recovery within the next 6-9 months. The service sector was less affected, but it can be hit by the crisis if remittances fall.

In the long run, Moldova can achieve energy security if it manages to interconnect reversely with Romanian natural gas pipe system.

The gas crisis has spurred in Moldova ideas for investments in renewable energy technology. However their economic efficiency is low when prices for conventional energy resources fall.

After dramatic recession in 2007 of agriculture and its recovery in 2008, we should not expect spectacular growth in 2009...
This is why the state budget for 2009 will have to be revised, if statistical data for the first months of the first quarter of the current year confirm the macroeconomic forecasts to be over optimistic. Particularly the government is aiming at 6% GDP growth, a 7.5% growth of the industrial output and 24% increase of imports. Taking into account the latest economic regional development trends (European Union economic slowdown, economic recession in Russia, political and economic uncertainties in Ukraine), we believe that these forecasts are excessively optimistic. Probably the only realistic indicator which can be achieved in 2009 is the inflation rate.

In the context of stagnating remittances, the main challenge for the government and National Bank will be to maintain under control the exchange rate of the national currency. In the Monetary Policy document for 2009, the National Bank reserved itself the right to “make currency interventions in order to diminish the excessive fluctuations of the official exchange rates and supplement the international currency reserves”. Taking into account that smaller currency transfers are expected from migrant workers, exporters, investors and international donors, we believe that the first objective (to diminish fluctuations) will dominate over the second objective (supplement international currency reserves). The protection shield of currency reserves at the National Bank from 2007-2008 is quite strong (the official currency reserves as of December 31, 2008 constituted 1,672 billion USD). However, taking into account the negative experience of the Russian central bank, the official reserves can easily disappear. Indeed, as of January 16, 2009, the National Bank currency reserves were 1.477 bn USD, which means 195 mln USD were spent in just two weeks. We do not exclude that the National Bank will be politically forced to protect the national currency, especially before the elections take place. Strong currency fluctuations have a psychological impact on the population which may affect its willingness to vote or the decision regarding the party to vote. After elections are over, the National Bank will have to decide either to pass the floor to a high inflation or currency devaluation. Taking into account the inflation targeting objective of the National Bank, it is likely that the institution will gradually let the national currency float freely in the second half of the current year. Otherwise, competitiveness of Moldovan exports will decrease due to national currencies depreciations in other countries of the region.

The Government will face another major challenge in 2009, as it will have to continue integrating economic agents from Transnistria into Moldovan legal framework. For now, the majority of regional economy agents are registered as Moldovan subjects. A large share of external trade of the region is made through the Moldovan customs system (over 80% of exports and less than 10% of imports). These are good conditions for settling the conflict, however time acts against Republic of Moldova. First of all, economic agents are divided between two political centers and this cannot last in time. The weak trust of the Transnistrian companies in the Moldovan government is proved
The major challenge is to maintain investment activity, which requires however reducing the business costs in Moldova.

Despite central banks in the region are generally increasing their interest rates, NBM decreased it and reduced the REPO rate to the level of 2006.

by two thirds of companies which are registered at the State Registration Chamber “temporarily”.

The key priority to ensure a stable economic development is to encourage investments. In order to prove that Moldova is a stable country and attract investments in 2009, it has to introduce radical institutional reforms with a clear development purpose and effect. These reforms should target corruption, reduce bureaucracy, decrease costs for administering business, diminish obstacles for international trade as well to encourage an efficient dialogue with international investors. These are main elements of the political mix which would allow Moldova overcome the global crisis without major losses and potentially even gain some advantages afterwards.

National Bank interest rate decrease: when will credits become cheaper?

Due to the tightening monetary policy previous year, the National Bank of Moldova was able to start the New Year with a cut in the basic interest rate for the main short term monetary operations. After its decrease in three turns in 2008, on January 15, the National Bank interest rate was established at 12.5% as in 2006. While neighboring countries have either increased or kept unchanged the interest rate at the first signs of the economic and financial crisis, Moldovan government had the possibility to reduce it from its highest level in the region.

Together with other instruments of monetary policy of the National Bank, interest rate reduction is targeted to make credits cheaper and as a consequence to increase investments. Nevertheless, evolutions in the second half of 2008 did not bring expected outcomes as commercial private banks increased their interest rates further (Graph 1). Since 2000, this is the first time when the interest rate for credits and deposits of the commercial banks was lagging to decreased after such a significant cut in the basic interest rate.

Today, despite a smaller basic interest rate, the real interest rate remains at its highest level since 2003 (Graph 2). There is a weak correlation between the National Bank interest rate and private banks interests. Recent evolutions had a minor influence on the cost of credit.
Foreign trade in a crisis environment

The impact of the global economic crisis becomes more apparent to the foreign trade of the Republic of Moldova. In October 2008 the decrease of exports and imports could be viewed as consequence of some incidental factors (explanation used by some officials – general decrease of fuel prices), however in November the situation became more evident: the crisis has touched upon Moldova.

According to official statistical data, both exports and imports registered a monthly decrease, down by 17.7% and 8.5% respectively. Additionally if imports increased in November 2008 compared to the same month in 2007, exports decreased compared to similar period by 16.8%. This generated a trade deficit of 3 billion USD, which is 46.2% more than previous year.

The decrease of exports can be explained first of all by flat economic growth and even technical recession in the partner countries. As a consequence demand for Moldovan exports shrunk. The economic sectors which depend on European industries are showing signs for slowdown. This is the case of textile enterprises, which mostly have tilling-based operations. Even though textile represent a significant share of foreign trade, their export starts decreasing in September 2009. Exports of metals will be heavily affected as well (majority of metal exports come from Transnistria and their statistics is not reflected in the National Bureau of Statistics concerning foreign trade) due to shrinking demand and fall of prices. More attention should be paid to exports of machinery, which increased significantly in the recent years. One of the main investors in this area in Moldova, the German company „Draexlmaier“ has temporarily stopped 5 of its plants in Romania, which may be interpreted as a sign of warning. On the other hand, compared to newly members of EU,
Republic of Moldova has lower labor cost advantage and could benefit from cost cutting which large European companies are conducting.

Traditional exports such as wine and food will be affected as well. Statistical data shows a decrease of monthly exports (especially in the wine sector). Exports to Kazakh market (where economic crisis started earlier) decreased significantly, and other markets could follow. Some Moldovan companies have already problems with delayed payments by the Ukrainian partners, while orders started to decrease dramatically.\(^1\)

Additionally the artificial resilience of the national currency may reduce the competitiveness of the Moldovan exports on the regional markets. Partner countries have already depreciated their currencies (the case of Ukraine), while Moldovan currency remains unchanged compared to other international currencies.

Concerning imports, the key factors are remittances from abroad and the need for equipment and raw materials for foreign and local companies from Moldova. There are signs that both factors are negatively affected by economic crisis.

As a result, there are uncertain evolutions for remittances: decrease of transfers from abroad 4 months in a row. This decrease is sufficiently important and cannot be explained just by reduction of cross rate between Euro and US dollar. The evolution trends for remittances and import level depend on each other (however consumption is less flexible and we can notice some lags in terms of imports and transfers). On Graph 3, it can be seen that import reduction was moderate compared to the currency transfer. This can be explained by the fact that holidays imply heavier consumption and respectively imports showed a moderate decrease. If this hypothesis validates, then in 2009, we can witness a stronger import decrease.

Meantime, the decrease of internal and external consumption will determine companies from Moldova to revise their investment plans and potentially suspend them temporarily (due to the sluggish industrial growth registered at the end of 2008). These kinds of decisions may contribute to reducing the imports of equipment to Moldova.

The fading foreign trade perspectives create a difficult situation for the government: both imports (due to budget incomes) and exports (due to work places and currency inflow) are equally important for economy. At the same time, Moldovan authorities have few mechanisms to handle the consequences of the global economic crisis, while limited resources do not allow introduction of additional funds to fuel internal consumption. The government however has important administrative instruments, which more

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often create additional obstacles for trade: these are administrative barriers, costly and complicated arbitrary procedures for export-import operations; complicated procedure for reimbursing VAT; corruption in customs; etc. Dealing with these problems in the sector may not be sufficient, but necessary for diminishing the crisis effects over the external trade of Moldova.

**Inflation mystery**

The grand surprise of 2008 is statistical data concerning inflation rate, which registered 7.3% in December 2008. As inflation fluctuated between 1.4-1.5% during the first 5 months of 2008, few people were expecting such a small annual figure for inflation rate. Despite the fact that such evolution can be defined as „mysterious”, its explanation can be found in the economic development of the recent period.

The first stage in the evolution of the inflation rate in 2008 was characterized by climbing inflation during the first 5 months of the year. In May, the annualized inflation rate was nearly 17%. The Republic of Moldova had to incur both external shocks, caused by rising prices for food and fuel on foreign markets and internal shocks generated by drought from 2007. The reasons for losing control over price dynamics were the following:

**Rising prices for food and agricultural products**, the reason why this period can also be called „agflation”. In January-May, the CPI for these products was nearly half as big as the average inflation level (25% and respectively 17% compared to May 2007)\(^2\). A similar price increase has not been registered since 1994, which speaks about the difficult situation of the food sector of those times. The global food crisis, characterized by shortage of supply against demand, resulted in price increase, so that inflation of prices for food was heavily determined by imports. The internal factor of inflation was the drought in 2007. Crop output fell by 23% compared to 2006. It has to be mentioned that food price increase started in summer 2007 and continued until summer 2008.

**Gradual price increase for fuel**, evolutions at the international stock exchanges and rising expectations for high inflation increased the pressures over the CPI in the first half of 2008. While quotations at stock exchanges were becoming higher with every next day, local prices for gas and diesel increased in the first half of the year by 10% and respectively 30%. As a consequence prices for passenger transportation followed the upward trend, which registered a 20.8% increase compared to December 2007.

**Rising Industrial Production Price Index** (IPPI), which reflects the rising costs and intermediary consumption in the economy, is another factor which contributed to overall price increase. IPPI

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\(^2\) National Bureau of Statistics
constitutes an important factor which determines the increase of the consumer prices, because it has a direct impact on the market price. IPPI has a hidden effect on the consumption prices, the outcomes of which are not immediately evident. The impact can be measured after 3-7 months, depending on the stocks. Therefore, the IPPI increase during 2007 (+28.4% at the end of 2007 compared to 2006) had a direct impact on the inflation rate in 2008.

The second stage in evolution of the inflation rate started in June 2008 and is characterized by falling inflation pressure consolidating control of the NBM and the Government over price changes. Moreover, prices decreased in December 2008, which is the first December deflation in the history of Republic of Moldova. Usually, in December prices have an upward trend. Their fall in the second half of 2008 is explained by the following:

 Favorable climate conditions from 2008 permitted to revive the agro food sector and increase the output starting with the second half of the year. As a result the gross value added in the sector grew by 25.2%, compared to the same period of the last year. This contributed to a reduction of prices for vegetables (-25.8%) and fruits (-9.9%) compared to 2007.

 Cheaper fuels, is a fact which defeated all previous forecasts. In the second half of 2008, prices for an oil barrel at international trade platforms started to decrease, which contributed to price reduction for fuels on the local market. In the second half of 2008, prices for gas fell by 40%, diesel – by 30%, which in the end reflected a down trend for the consumer and industrial price indexes.

 Monetary policy of the NBM was an essential factor for moderating inflation. Being worried about a significant inflation rise, National Bank undertook several measures in order to achieve its major objective – maintain price stability. There has been used a wide variety of policy instruments in order to reduce the monetary mass. In March-September there have been undertaken gradual increases of the interest rate from 16% to 18.5% and the mandatory level of reserves from 15% to 22%. As a consequence inflation pressure fell to a moderate level in the economy, which is reflected in the statistical data concerning monetary aggregate M0 (money in circulation). If in 2007 the amount of money in circulation increased by 41%, then in 2008 – it went up by 20%, which is a considerable slow down³.

 A stronger national currency was another reason for slower pace of price increases. Moldovan national currency “Leu”, grew in value by 8% compared to US dollar in 2008. These circumstances spurred import inflation, leaving importers gain additional funds. As a result, currency appreciation diminished considerably the inflation pressure in the economy.

³ National Bank of Moldova
Anti-inflation interventions of the Government were characterized by regulating prices for products which were important for final consumption. This is the case of sugar, when the government established ceiling prices. These interventions cooled down inflation which was mainly fueled by price increase for foods.

The impact of the global economic crisis on economic development of Moldova in 2009

Unfortunately, Moldova does not have sound solutions against global economic and financial crisis ...

... with direct state regulations

The current global economic crisis generated a range of exogenous causes which have an inevitable impact on the evolution of the Moldovan economy. Taking into account that the country is economically dependent on external markets the economic recession in EU and CIS (mainly Russia and Ukraine) will reduce foreign demand for the Moldovan exports, generate unemployment inside, as well as stronger migration policy control, which will affect Moldovan citizens working abroad and their remittances. In 2009 the crisis will have a more visible impact on the Moldovan economy.

The negative consequences of the world economic crisis will have undoubtedly and impact on the economic growth of the Republic of Moldova in 2009 and potentially in 2010. We anticipate that the crisis will have an impact on both components of the GDP: Gross Value Added and net taxes for product and import.

The gross added value in GDP depends directly on the volume of production and indirectly on intermediary consumption in the economy. As a result a potential reduction of the output in 2009 will have a negative impact on the economic growth. The first signs have already shown the evolution of the industrial output, which constituted a zero change in 2008. A more detailed analysis of the production value indicators shows the correlation between stagnation and export of respective products, which decreased due to shrinking demand for local products. In 2008, the export of main products has decreased: textiles (-8,8%), garments; fur processing (-14,9%), canned fruits and vegetables (-0,6%), bottled water and refreshing drinks (-16,6%), tobacco (-15,8%)4.

Additionally in 2009 services will show a negative development. The main sectors affected will be constructions and transport, which to the end of 2008 started to show first signs of recession: in January-September 2008 construction fell by 8,8% compared to same period of the previous year, while in January-November 2008 the volume of transported merchandise nearly stagnated compared to the same period in 2007, registering 0,1% decrease.

The fall of the gross value added will depend on intermediary consumption. It is necessary to emphasize that during the first three quarters of 2008, this value increased by 8,4% compared to the similar period of the previous year, which is a higher pace than production output and GDP dynamics. This was the reason for a reduced share of the gross value added in GDP, undermining the structure of the economic growth during this

4 National Bureau of Statistics
period. Higher intermediary consumption is influenced by increase of the industrial production price index (IPPI) on the local market. In 2008 the value of IPPI went up by 12.8%, which will have a negative impact on the growth of the gross value added. If this tendency remains unchanged in 2009, it will contribute to slower growth of the gross value added and reduced share of GDP.

Net taxes for products and imports are the second component of GDP which will be affected by the economic crisis. This indicator reflects the level of local demand and consumption of households which depends on disposable incomes of the population and incomes from remittances. This correlation can be emphasized by analyzing the evolution of transfers from abroad and final consumption in 2000 when first exponential increases of remittances were registered (over 10 times)\(^5\), retail trade (by 4.7 times)\(^6\), imports (4.8 times)\(^7\). As a result, the share of net taxes on products and imports in GDP increased from 12% in 2001 to 16% in 2008 (January-September).

Reduction of the share of gross value added against an increasing share of the net taxes for products and imports in GDP, undermines the quality of economic growth as well as increases the vulnerability of GDP growth as a consequence of reduced internal consumption generated by fewer remittances 2009. Due to economic difficulties incurred in EU, Russia and Ukraine, the financial situation of Moldovan migrant workers has aggravated (more details in „Major challenge in 2009: fewer remittances“ by EXPERT-GRUP, http://expert-grup.org/?p=211).

As the key factor which fuels internal demand is shrinking, mainly speaking about remittances from abroad, there is a certain risk of GDP stagnation at 2-3% growth level during 2009. The Ministry of Finance should revise its economic growth forecasts for the coming 2009-2011 years. Together with the Government it should undertake measure to achieve the objective during 2009-2011 to increase the share of the gross value added in GDP.

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\(^5\) From 152,94 mln. USD in 2000 to 1509,91 mln. USD in January-November 2008, Trade balance, NBM
\(^6\) From 6012,0 mln. lei in 2000 to 28220,1 mln. lei in 2007, National Bureau of Statistics
\(^7\) From 776,4 mln. USD in 2000 to 3689,5 mln. USD in 2007, National Bureau of Statistics